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FHA Assets Sales Study - Final Report

Executive Summary

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Executive Summary

Introduction

- During the 1980s, defaults on Federal Housing Administration (FHA) mortgages increased due to weak real estate markets and other factors so that by the early 1990s FHA had accumulated a sizable inventory of non-performing loans -- approximately 2,400 multifamily and 110,000 single-family mortgages.
- The large inventory of mostly troubled loans consumed a disproportionate amount of FHA staff time, detracting from the agency's ability to manage its insured portfolio. To remedy the situation, in March 1994 Congress and the Administration initiated an aggressive program to sell FHA's stock of non-performing loans.
- From 1994 to 1997 over 1,200 multifamily loans and nearly 100,000 single family loans were removed from HUD's inventory by the loan sales. Largely as a result of these sales, by early 1998 the inventory of loans was reduced to about 1,100 multifamily and 14,000 single family loans.

Study Focus and Methodology

- The primary purpose of this study was to gather information on what has happened to the loans after sale by HUD. Until now, little has been known about what has happened to the properties after sale and what the effect of these sales has been on the occupants and the properties.
- This study is best characterized as exploratory in nature. The study's findings are based on qualitative assessments of outcomes gained through interviews with a small sample of loan buyers as well as a few broad quantitative measures of current property rents and expenditures for a subsample of properties.
- The quantitative measures gathered from loan buyers are compared to data available from HUD's data bases for the loans prior to sale for a before-and-after comparison of the properties' rent levels and expenses.
- A total of eleven loan buyers were surveyed, including eight purchasers of multifamily loans and three purchasers of single family loans. The buyers contacted were active in all seven multifamily loan sales and in three of six single family sales.

- Of the eight multifamily buyers, interviews were conducted with seven, data on the current status of loans was obtained from six, and detailed data on a small sample of loans was obtained from four. In the end, the current status of 530 loans was obtained, or about half of all loans sold, and recent financial statements were obtained on 85 loans.
- Of the three single family loan buyers participating in the study, one buyer provided quantitative data on the current status of loans purchased, while the other two buyers only agreed to be interviewed but did not provide any data on loans purchased.
- Because of limited cooperation from single family loan buyers, the study's intended scope regarding these loans was more limited than planned.
- The study also intended to evaluate the impact of the loan sales on HUD staffing levels and asset management capabilities. However, given the substantial and simultaneous reorganization of HUD's operations as part of the HUD 2020 Management Reform Plan, it proved to be virtually impossible to isolate changes in HUD staffing levels and operations associated with the loan sales program.

Findings Regarding Multifamily Loan Sales

Asset Management Techniques of Loan Buyers

- Most of the surveyed loan buyers of non-performing loans indicated that their goal in purchasing these loans was to seek resolution of the loan over a relatively short period of time (two to three years) either by negotiating with the property owner to obtain a payoff (of either the full, or in many cases, discounted debt), selling the loan, or foreclosing and ultimately selling the property.
- Relatively few instances were found where loan buyers had agreed to loan modifications, reflecting the strategy of most buyers to liquidate these assets rather than to hold a portfolio of loans.
- The approach to managing the non-performing loans was fairly similar across the buyers interviewed. The threat of foreclosure provided critical leverage for loan buyers to convince borrowers to make required payments or to negotiate with the buyers to reach a mutually agreeable payoff amount. If borrowers were not current in their payments, virtually all of the buyers indicated they would immediately begin foreclosure.

- As would be expected, the ability of loan buyers to influence property management was completely dependent on whether the loans were performing or not. Buyers reported having little leverage over property owners as long as owners were current in their payments.
- With respect to foreclosed properties, virtually all of the buyers described a strategy for managing these assets entailing first remedying any deferred maintenance, then increasing occupancy, and finally raising rents to the market level.
- Several buyers indicated that foreclosure was a more likely outcome compared to loans bought from the RTC because a higher price was paid for HUD loans. Having paid a higher price for the loans, the loan buyers had less room to offer property owners a discounted payoff and still realize a sufficient return on their investment. This observation highlights the tradeoff for the government between receiving a higher return on loan sales and the likelihood of foreclosure of these loans.
- In contrast, the goal of the loan buyer in the Performing loan sale was to securitize and sell the loan portfolio. Most of the loans purchased by this buyer were, in fact, pooled, securitized and sold fairly quickly, with the buyer's servicer partner retaining the servicing rights.

Current Loan Disposition

- In total, the current status of 530 multifamily loans was obtained from buyers, representing about half of the multifamily loans sold, including 389 non-performing loans and 141 loans from the Performing sale.
- Buyers of loans from non-performing loan sales were found to have been successful in achieving their goal of fairly quickly liquidating these assets. Only a third of the loans are still owned and serviced by the original buyers, including 20 percent that are classified as performing and 13 percent that are classified as non-performing.
- Slightly less than another third of the loans have been foreclosed on, with the large majority of these still owned by the buyers.
- Loans sold in the Partially Assisted sale were somewhat more likely to have been foreclosed on than loans from other non-performing sales -- 37 percent compared to 27 percent. However, there is no significant difference between the characteristics of foreclosed loans from this sale compared to foreclosed loans from other sales.

- The remaining loans, representing slightly more than a third of the loans sampled, are no longer owned by the buyers, including 23 percent that have been prepaid and 13 percent that have been sold.
- In sharp contrast to the outcomes for non-performing loans, all of the loans from the Performing loan sale are currently either performing, have prepaid or have been sold.

Factors Associated with Loan Disposition

- No statistically significant differences were found in loan characteristics by disposition (i.e., performing, non-performing, paid off, or foreclosed). The characteristics examined include variables related to the degree of financial distress (measured by the level of delinquencies), vacancy rates, the level of expenses relative to industry standards, and tenant characteristics (measured by the average rent level, and the income level and racial profile of the census tract where the property is located).
- This finding is consistent with the loan buyers' assessment that there were no distinguishing characteristics of loans that prepaid compared to those that were foreclosed on.
- Buyers noted that there were factors other than current financial condition that played a role in determining a loan's outcome. Such issues as environmental liabilities, very high neighborhood crime rates, or excessive deferred maintenance might make the loan buyer less likely to pursue foreclosure and become the owner of the property, all else equal.
- Based on interviews with loans buyers and detailed financial data for a subsample of loans from the Partially Assisted and Performing loan sales, it seems that properties with poor physical conditions were more likely to end in foreclosure. But since the due diligence data did not include any measures of property conditions, the validity of this contention could not be evaluated statistically for all loans for which disposition data was obtained.

Likely Disposition of Loans If HUD Had Retained Ownership

- The largest difference between actual outcomes and those projected under HUD-ownership is with regard to the share of loans still in the loan portfolio. Under HUD ownership, 76 percent of the loans would still be in its portfolio. In comparison, only 38 percent of non-performing loans sold are still in the buyer's portfolio.
- The much quicker resolution of loans is in part due to a rate of foreclosure that has been twice the rate that would have been expected under continued HUD ownership

(36 percent compared to 19 percent) and a payoff rate that is five times the HUD projected rate (26 percent compared to 5 percent).

- While the current rate of foreclosure is higher than would have been expected under HUD-ownership, it is not clear whether the ultimate foreclosure rate will be higher than the projected HUD foreclosure rate of 56 percent. Only if more than half of the remaining loans in the portfolio (most of which are currently performing) end in foreclosure will the overall foreclosure rate exceed the projected HUD rate.

Evaluation of Tenant Displacement

- The general reaction of buyers suggested that their experience with removing problem tenants from these properties was not out of the ordinary compared to their experience with other multifamily properties.
- A few buyers did share isolated instances where entire properties were vacated because of extremely poor physical conditions. However, such extreme cases of tenant displacement seem to have been limited to a few isolated cases.
- An analysis of data on rent levels before and after the loan sale for 85 sampled loans found that the majority did not exhibit rent increases beyond the increases experienced in the market as a whole. In fact, a slight majority of loans have experienced rent increases that are less than the rate of increase in the FMR.
- Only 10 percent of sampled loans experienced annual rent increases that were between 1 and 2 percent above the market rate, and only another 10 percent had increases that were 2 percent above the market rate.
- The most significant finding regarding tenant displacement concerns the renewal of project-based assistance contracts for loans in the Partially Assisted sale. The servicer of these loans reported that their general intention was to not seek renewal of these contracts, noting that they had not yet had a case where they had sought renewal of these contracts.
- The servicer noted that affected tenants did, in fact, obtain vouchers from the local housing authority in compensation, but that these tenants were generally not likely to stay in their old apartments as rents would rise “significantly” above their previous levels. Thus, subsidized tenants may be likely to experience very high levels of displacement, at least those living in properties whose loans have been foreclosed on.

Changes in Property Conditions

- Virtually all of the buyers indicated that, based on inspections conducted as part of their due diligence process, properties whose loans were paid off or were performing tended to be in good physical condition. In contrast, properties that were foreclosed on almost always required some level of investment to rectify deferred maintenance.
- In most cases, the level of investment required was not substantial, perhaps requiring a roof to be replaced or investments of several hundred dollars a unit to replace carpets or appliances. But virtually all of the buyers reported isolated cases where substantial investments of several thousand dollars per unit were needed, totaling from \$500,000 to \$3 million.

Changes in Property Management

- An examination of financial data from 85 sampled loans corroborates loan buyers' assertions that expenses are generally higher on these properties than for the industry as a whole. Among the sampled loans, total expenses were found to be 37 percent above the industry median. Only 17 percent of properties had expenses below the median, while 26 percent had expense levels that were 50 percent or greater above this benchmark.
- Since the time of HUD ownership, the average annual percent change in total expenditures has been 0.6 percent annually. In comparison, the industry median expenditures grew at a 2.5 percent annual rate for the comparable period (generally covering three to four years). The result has been that the distribution of property expense levels has become closer to the industry standard, although they are still generally higher.
- The findings also substantiate loan buyer claims that among foreclosed properties expenses were likely to have been inflated, as they were particularly high compared to industry norms. Since the time of HUD ownership, expenses on these foreclosed properties have declined sharply. The expense category exhibiting the sharpest retreat among these loans has been management fees, which have declined at a 5.8 percent annual rate over the several year period covered by the collected data.

Findings Regarding Single Family Loan Sales

Asset Management Techniques of Loan Buyers

- The goal of loan buyers generally appears to have been to create a portfolio of performing loans, often with the intention of securitizing these loans. To accomplish this goal, loan buyers generally tailored an approach to each homeowner's circumstances that would establish an affordable level of payments while preserving as much of the existing debt as possible.
- In most cases borrowers are offered forbearance agreements, but in some cases new loan agreements were established which may include extensions of the loan term, changes in the interest rate, or even reductions in the total level of indebtedness.
- One apparently common approach among loan buyers to quickly establish a record as a performing loan, was to place all past-due payments and other charges into a separate non-interest bearing account. Through this arrangement, the loans were immediately brought current, while the loan buyer still maintained the total level of indebtedness.
- Through these methods loan buyers appear to have been fairly successful in quickly establishing a portfolio of performing loans and securitizing these pools.
- The loan buyers interviewed for this study indicated that foreclosure was the least preferred option given the time and expense of this process. However, some level of foreclosures were reported to be inevitable as some owners were found to be not interested in retaining ownership of the homes.

Current Loan Disposition

- Based on data provided by one loan buyer, less than two years after purchase 82 percent of the portfolio was still owned, including 62 percent characterized as performing and 20 percent characterized as non-performing.
- The 18 percent of loans that were no longer owned consist of 11 percent that had been foreclosed on and 7 percent that had been paid off.

Likely Disposition If HUD Had Retained Loans

- Based on the historical performance of HUD-owned loans, it is estimated that 51 percent of the loans would be non-performing and 37 percent would be performing under HUD ownership. In contrast, the sampled loan buyer reported that only 20

percent of purchased loans were non-performing and 62 percent were performing. In sum, loan buyers have been fairly successful in developing a portfolio of performing loans and achieving a faster disposition of other loans.

- The share of loans that are no longer owned by the loan buyer is somewhat higher than would have been expected under HUD ownership. Under HUD, only 12 percent of loans would have been resolved, whereas under the loan buyer 18 percent are no longer owned.
- This higher resolution rate is due to both a higher foreclosure rate (11 percent versus 6 percent expected under HUD) and a higher payoff rate (7 percent compared to 6 percent under HUD).
- While the foreclosure rate is currently higher than projected under HUD ownership, it seems quite likely that the ultimate foreclosure rate will be much lower. HUD's foreclosure rate would be expected to rise rapidly in the next few years, reaching nearly a third of the portfolio in another three years and half of the portfolio by the end of five years. With much lower share of loans currently non-performing than under HUD, future foreclosure rates may be much lower than HUD has experienced.

Chapter 1 - Introduction

1.1 Background

Since 1934, the Federal Housing Administration (FHA) of the Department of Housing and Urban Development (HUD) has insured single and multifamily mortgages that might not otherwise have qualified for conventional financing. During the 1980s, defaults on FHA mortgages (particularly multifamily mortgages) increased due to weak real estate markets. By the early 1990s, FHA had accumulated a sizable inventory of non-performing loans. Prior to beginning the loan sales program, the agency owned almost 2,400 defaulted multifamily and 110,000 single-family mortgages.

The large inventory of troubled loans consumed a disproportionate amount of FHA staff time, detracting from the agency's ability to manage the insured portfolio and prevent further defaults. To remedy the situation, in March 1994 Congress and the Administration initiated an aggressive program to sell FHA's portfolio of loans.¹ Specifically, the broad goals of these sales were to:

- Reduce the inventory of held notes to free up staff to focus on managing the insured portfolio;
- Improve asset management to increase recoveries on defaulted assets; and
- Enhance resident services and the quality of the community by returning properties to private hands, creating the potential for reinvestment in the properties and consequent improved housing quality.

As summarized in Exhibit 1-1, between 1994 and 1997 a total of seven auctions of multifamily loans and six auctions of single family loans were held. In addition, there were also sales of Title X land loans, Title I manufactured housing loans, and health care mortgages, as well as transfers of multifamily mortgages to Fannie Mae and the Missouri Housing Development Commission (these latter sales and transfers are not part of the scope of the present study).

With regard to the first two objectives, the assets sales program seems to have been quite successful. As shown in Exhibit 1-1, over 1,200 multifamily loans and nearly 100,000 single family loans were removed from HUD's inventory by the loan sales. As a result, by early

¹ While most of FHA's portfolio of loans consisted of non-performing loans, some of the HUD-held loans sold were performing. Aside from 221 (g) (4) loans that were assigned to HUD as performing loans in their 20th year, the other performing loans were non-performing at the time they were put to HUD by lenders, but subsequently cured their defaults and became performing loans.

Exhibit 1-1**Summary of FHA Loan Sales**

Sale	Date of Sale	Number of Loans	Unpaid Balance (\$ Millions)	Sales Proceeds (\$ Millions)	Estimated Savings to HUD (\$ Millions)
Multifamily Loan Sales					
HUD-Held G4 Loans	Oct 94	206	152	110	4
Southeast	Mar 95	177	907	724	438
National Performing	Sep 95	142	282	250	-26
West of the Mississippi	Sep 95	152	622	385	108
Partially Assisted	Jun 96	158	884	646	213
North and Central	Aug 96	151	847	622	235
Midwest	Dec96	107	873	763	360
Multifamily Totals		1,093	4,567	3,499	1,332
Single Family Loan Sales					
HUD-Held G4 Loans	Jun 94	15,212	98	84	2
Sale #1	Oct 95	13,009	523	393	8
Sale #2	Mar 96	16,539	758	634	144
Sale #3	Sep 96	16,996	805	730	164
Sale #4	Jan 97	18,894	1,121	1,039	247
Sale #5	Sep 97	17,990	1,140	1,030	265
Single Family Totals		98,640	4,445	3,910	830
Other Sales					
Title X Land Loans	Jun 94	0	99	17	9
Title 1 Manuf. Hsg. Loan	Sep 95	2,702	26	0	0
Title X Land Loans	May 96	1	11	2	3
Title 1 Manuf. Hsg. Loans	May 96	13,112	162	2	1
Health Care Mortgage Notes	Jul 97	34	Not Avail.	Not Avail.	Not Avail.
Multifamily Mortgage Transfers					
Fannie Mae	Aug 94	85	89	89	Not App.
Missouri Housing Dev. Comm.	Sep 96	26	30	Not App.	Not App.

Notes: "Expected Savings to HUD" is HUD's estimate of the difference between the sale proceeds and the expected present value of cash flows that HUD would have received from sold loans if retained. "HUD-Held G4 Loans" are performing loans assigned to HUD in their 20th year by lenders as was previously allowed under the terms of FHA mortgage insurance.

Sources: "FHA Mortgage Loan Sales Summary of Results," Hamilton Securities Advisory Services, Inc., August 1997; Loan sales web site (<http://www.fhplace.com>); and "Single Family Mortgage Sale #5, Post-Auction Review," Ernst & Young LLP.

1998 the inventory of loans was reduced to about 1,100 multifamily and 14,000 single family loans.² In addition, as also shown in Exhibit 1-1, the proceeds realized by HUD from these sales were estimated to have exceeded the expected cash flow if HUD had retained these loans by \$2.2 billion.

However, with regard to the last objective, little has been known about what has happened to the properties after sale to evaluate what the effect of these sales has been on the occupants and the properties. The primary purpose of this study was to gather information on what has happened to the loans after sale by HUD to assess the extent to which this goal has been achieved. While HUD believes that returning properties to private hands creates the potential for reinvestment in the properties and consequent improved housing quality, critics have argued that the greater freedom that private investors have in managing these loans may lead to the displacement of low-income renters. This study provides a first assessment of the outcomes associated with the loan sales program.

1.2 Focus of the Study

This study addresses issues related to the effect on properties and their occupants of the sale of multifamily and single family loans. The specific questions to be addressed in each of these areas are outlined below. While there is considerable overlap in the issues related to multifamily and single family loans, there are enough differences to warrant a separate discussion of each.

In addition to the issues related to the current status of the properties and occupants affected by the loan sales program, the study also intended to evaluate the impact of the loan sales on HUD staffing levels and asset management capabilities. However, as discussed in detail in Appendix B to this report, this aspect of the study was greatly curtailed for two reasons. First, after interviewing HUD headquarters staff it became clear that given the substantial reorganization of HUD's operations as part of the HUD 2020 Management Reform Plan (including the consolidation of the 81 single family field offices into four homeownership centers) along with the general downsizing of the Department, it would be virtually impossible to isolate changes in HUD staffing levels and operations associated with the loan sales program from the other enormous changes that the Department is experiencing. Second, data on trends in staffing over time for asset management functions were not readily available. Because of these impediments, it was not possible to draw any conclusions regarding the effect of the loan sales program on HUD staffing for asset management or other functions. Appendix B describes the information

² Of course, in addition to the loan sales effort, changes in the loan inventory during this period are the result of new loans entering HUD's portfolio and loans leaving the portfolio due to foreclosure or prepayment. HUD staff reported that with regard to multifamily loans there has been some increase in the rate of loan payoffs and foreclosure by HUD in recent years, but by and large the very significant reduction in the loan inventory is due to the loan sales program. With regard to single family loans, an equally important development in the reduction of the loan portfolio has been the elimination of the assignment program. See Appendix B for a discussion of this issue.

obtained from HUD on staffing levels and relevant organizational changes since the loan sales program began.

Multifamily Loans

1. What specific asset management techniques were employed by the purchasers?

The series of actions taken after purchase of the loans is profiled, including efforts such as those to improve property management and financial performance, restructure debt, or initiate foreclosure. The study also explores what were the decisive factors in deciding whether to pursue workouts, offer discounted payoffs, sell, or foreclose the loans. This information provides insights into the motivations of loan buyers and possible causes for the outcomes realized.

2. What is the current status of the loans?

A basic question answered by the study is whether the purchasers of the loans still own the notes or whether the loans were paid off, sold or foreclosed on. More specifically, the possible outcomes include retention of the loan by the buyer (either with or without a restructuring of loan terms), a payoff of the total or discounted outstanding debt, sale of the loan to either other investors or the borrowers as whole loans or securitized as part of a pool, or foreclosure and sale of the property.

3. What property or occupant characteristics seem related to the disposition of the properties?

The study evaluates how property characteristics are related to the outcomes found, both to better evaluate the consequence of asset sales for particular properties and possibly to enhance HUD's own management practices. The data collected are analyzed to reveal any associations between the outcomes and such factors as property type, location, neighborhood characteristics, or previous financial performance. The relevant outcomes include not only the disposition of the property as described above (most notably foreclosure), but also whether there have been increases in rent levels, improvements in physical conditions, or changes in management practices.

4. What would have been the outcome if HUD had retained the loans?

In order to evaluate whether the loan sales program changed the outcome (i.e., still owned, paid off, or foreclosed) that would have been expected if HUD had retained the loan, a projected distribution of outcomes is estimated based on HUD's historical experience with these loans. The principal issues for this analysis are whether the loan sales program changed the likely outcomes and/or the speed at which resolution was achieved.

5. To what extent have the low- and moderate-income occupants of the properties been displaced?

One of HUD's principal concerns is whether low- and moderate-income occupants of the properties affected by the assets sales program have been displaced as a result of either rent increases following the loan sale or other efforts by new property management to remove tenants. To explore this issue, the study examines the extent of rent increases following sale as well as other efforts by property management to remove undesirable tenants.

6. To what extent has the physical condition of the properties improved?

Some of the properties in HUD's loan inventory had been poorly maintained as a result of the properties' troubled financial circumstances or simply because of poor or corrupt management. One of the desired outcomes of the assets sales program evaluated is whether physical deficiencies in properties have been remedied as a result of the loan sales.

7. To what extent has management of the properties improved?

For a large share of HUD-owned loans, poor property management is believed to be a significant cause of the property's financial distress. One of the potential benefits of the asset sales program is to make use of private investors' greater expertise and greater leverage to improve management practices. This study explores the extent to which there have been improvements in property management following the assets sales.

Single Family Loans

1. What specific asset management techniques were employed by the purchasers?

As with multifamily loans, the series of actions taken after purchase of the loans is profiled, including routine servicing as well as efforts to offer forbearance, restructure debt, or initiate foreclosure. The study also explores what were the decisive factors in deciding which course of action to pursue with a homeowner. This information provides insights into the motivations of loan buyers and possible causes for the outcomes realized.

2. What is the current status of the loans?

As with the multifamily loans, a basic question addressed is whether the purchasers of the loans still own the notes or whether the loans were sold or foreclosed. More specifically, with single family loans the possible outcomes include retention of the loan by the buyer (either with or without a restructuring of loan terms), the sale of the loan to other investors (as whole loans or as a securitized pool), prepayment of the loan by the owner, or foreclosure and sale of the

property. For single family properties, foreclosure is a direct measure of the extent to which households were displaced as a result of the sale.³

3. *What would have been the outcome if HUD had retained the loans?*

As with multifamily loans, in order to evaluate whether the loan sales program changed the outcome (i.e., still owned, paid off, or foreclosed) that would have been expected if HUD had retained the loan, a projected distribution of outcomes is estimated based on HUD's historical experience with these loans. The principal issues for this analysis are whether the loan sales program changed the likely outcomes and/or the speed at which resolution was achieved.

1.3 Methodology

This study is best characterized as exploratory in nature. In order to evaluate what has happened to properties whose loans were sold by HUD, we have had to rely on the voluntary cooperation of loan buyers to provide information about their business practices and about the outcomes realized with regard to specific assets. Given the likely hesitancy of these private sector entities to share such confidential information or to devote a great deal of time to aiding the research effort, the study was designed to rely on qualitative assessments of outcomes gained through interviews with loan buyers and to gather a few broad quantitative measures of property rents and expenditures following sale. The quantitative measures gathered from loan buyers are compared to data available from HUD's data bases for the loans prior to sale for a before and after comparison of the properties' rent levels and expenses. These measures allow a somewhat crude examination of how property conditions have changed since sale to address the study's research questions. For example, the potential for displacement of low and moderate income tenants is evaluated by considering the extent to which rent increases have exceeded market-wide increases, while changes in property management will be evaluated by examining the extent to which property expenses have changed relative to industry standards. While this type of analysis certainly cannot definitively answer the questions of interest, it nonetheless provides a first assessment of what has become of these loans since sale by HUD.

Specifically, a small sample of buyers, consisting mostly of those who have purchased a large number of loans, were selected as candidates for participation in the study. (See Appendix A for a thorough summary of the results of efforts to obtain borrower participation in the study.) A total of ten loan buyers were to be surveyed, including eight purchasers of multifamily loans and

3 As with multifamily loans, the study intended to evaluate the factors associated with the different outcomes realized. Unfortunately, buyers of single family loans proved unwilling to share loan-level data that would have permitted this analysis. A complete summary of the approach used to gather data from loan buyers and the study team's success in obtaining cooperation from loan buyers is presented in Appendix A.

two purchasers of single family loans.⁴ The multifamily buyers were asked to provide three types of information. First, buyers were interviewed about the general asset management strategies employed and their assessments of the relevant outcomes. Second, buyers were asked to provide information on the current status of each loan purchased. Finally, buyers were asked to provide the most recent financial operating information on a sample of about 20 loans to support the detailed quantitative analysis of how property conditions have changed since sale. It was anticipated that not all buyers would be willing to provide the requested information. In the end, eight multifamily buyers participated to some degree. Of the eight, interviews were conducted with seven, data on the current status of loans was obtained from six (although only five provided data on a loan-by-loan level), and detailed data on a small sample of loans was obtained from four. In the end, the current status of 530 loans was obtained, or about half of all loans sold, and recent financial statements were obtained on 85 loans.

It is important to note that while the information obtained relates to a fairly large share of the loans sold, the sample is not necessarily representative of all loans sold for several reasons. First, the sample consists entirely of data from buyers of a large number of loans, and so is not necessarily representative of what happened to loans obtained by small-volume purchasers (who purchased about a tenth of the loans sold). Second, even among large buyers there may well be a selection bias in terms of which firms were willing to participate in the study. While there was a great deal of similarity in the actions taken and outcomes realized by the buyers interviewed, it is not known whether buyers who chose not to participate or were not contacted differed in any material way from the participants.

With regard to single family loan sales, buyers were asked to provide two types of information. First, buyers were interviewed about the general asset management strategies employed and their assessment of the relevant outcomes. Second, buyers were asked to provide information on the current status of each loan purchased in a chosen sale.⁵ In the end, information was obtained from three single family loan buyers. Unfortunately, only one buyer would provide quantitative data on the current status of loans purchased, and then only on an aggregate basis and not loan-by-loan. The other buyers only agreed to participate in interviews and in one case would not even provide an estimate of the distribution of outcomes realized. To supplement the information obtained from buyers, HUD headquarters and field office staff involved in ongoing monitoring of loan servicing following the loan sales were also interviewed. Given the limited data obtained, it is obviously not known how representative the findings regarding outcomes for single family loan sales are of these sales generally.

4 The sample sizes were a function of the resources available, the nature of the research questions, and the number of overall loan buyers in these two groups. In the seven multifamily loan sales there were a total of nearly 60 buyers, while in the single family sales there were only eight.

5 Most single family loan buyers bought thousands of loans and were active in more than one sale. In order to minimize the level of effort required of buyers, the request for data was limited to purchases in a single sale.

1.4 Outline of the Study

Chapter 2 presents the study’s findings with respect to multifamily loans, while Chapter 3 presents the results for single family loans. The subsections of these chapters correspond to the research questions outlined in Section 1.2 above. Appendix A discusses the sampling approach used to select loan buyers as well as individual loans for study. Appendix B discusses issues related to evaluating the impact of the loan sales program on HUD staffing for asset management and other functions.

Chapter 2 - Multifamily Loan Sales

2.0 Introduction

This chapter presents the study's findings with respect to the asset management strategies used and the outcomes realized by buyers of multifamily loans. As described more fully in Appendix A, the information was obtained from a total of eight loan buyers, representing small and large volume purchasers and virtually all of the seven multifamily loan sales. The degree of cooperation varied among these eight buyers, however, so that some portions of the study's findings are based on information from a subset of these eight buyers. In particular, information on current loan disposition was obtained from five buyers and detailed financial data on specific loans was obtained from four buyers (although the majority of these loans are from two buyers representing the Performing⁶ loan sale and the Partially Assisted sale). Throughout this chapter the outcomes associated with loans from the Performing sale will be discussed separately from the outcomes associated with other sales, all of which consisted of non-performing loans. In addition, special attention will also be given to outcomes associated with the Partially Assisted loan sale given that this is the only sale of properties with project-based housing subsidies. The sections of this chapter correspond to the research questions outlined in the introduction for multifamily loans. The final section presents a summary of findings regarding each of these questions.

2.1 Asset Management Techniques of Loan Buyers

This section describes the asset management strategies and techniques employed by the buyers of HUD loans. The approach used to manage these assets is quite clearly a function of the buyers' general goals in buying the loans and the particular resolution they had anticipated for each asset at the time they bid in the auction.

Most of the surveyed loan buyers of non-performing loans indicated that their goal in purchasing these loans was to seek resolution of the loan over a relatively short period of time (two to three years) either by negotiating with the property owner to obtain a payoff of either the full or (in many cases) discounted debt, selling the loan, or foreclosing and ultimately selling the property. Only one buyer of non-performing loans indicated that their goal was to purchase a portfolio of loans that they would continue to service. But this buyer admitted that they also purchased loans that were likely to end in foreclosure. In fact, the foreclosure rate for this buyer was as high or higher than for other buyers, so that despite the stated difference in its goal, the disposition of this buyer's portfolio was essentially no different from that of other buyers.

6 The National Performing loan sale will be referred to as the "Performing loan sale" for the sake of simplicity since it is the only sale of performing loans.

The goal of the loan buyer in the Performing loan sale, in contrast, was to securitize and sell the loan portfolio. Most of the loans purchased by this buyer were, in fact, pooled, securitized and sold fairly quickly, with the buyer's servicer partner retaining the servicing rights. A few loans that were not suitable for the pool were retained, but ultimately these loans were also pooled and sold. The servicer of these loans indicated that they had very little leverage over the property owners as apparently the lender's rights to be able to physically inspect the property and obtain financial information were terminated when the mortgage insurance was canceled upon sale by HUD. Some borrowers voluntarily allowed the lender to annually conduct inspections and obtain financial information, while others refused. In general, this lack of control over borrowers has not been a problem as none of the loans have experienced any financial delinquencies.

The approach to managing the non-performing loans was fairly similar across the buyers interviewed. In general, an initial meeting would be held with the property owner shortly after sale. This meeting was intended to communicate the message that owners were expected to make required payments and that if these payments were not made the mortgagee would exercise their option to pursue foreclosure. Buyers also reported scheduling site visits to the property to inspect the physical condition of the property and the management practices used. However, property owners were not always cooperative in allowing these inspections. The loan buyers commented that they expected it might take some time for property owners to adjust to the more aggressive management of the loans than owners had experienced under HUD, but buyers were surprised at how long it took for owners to understand that failure to make required payments would result in the initiation of foreclosure proceedings.

The threat of foreclosure provided critical leverage for loan buyers to convince borrowers to make required payments or to negotiate with the buyers to reach a mutually agreeable payoff amount. If loans were not current in their payments, buyers would immediately begin foreclosure. If property owners were motivated to seek a non-foreclosure resolution, the loan buyer would enter into agreement to allow for negotiations while not limiting their ability to move forward with foreclosure proceedings. In these circumstances, loan buyers would sometimes provide forbearance agreements in cases where property owners were making good faith efforts to resolve their financial difficulties. However, these agreements were generally for a limited period of time (a year or less) and would often require the owners to come up with a payoff amount at the end of the agreement or forfeit the property.

Of course, in some cases it was clear from the outset that foreclosure was likely or inevitable. As part of the process of determining which loans and how much to bid, buyers had analyzed the properties' financial performance to determine the value of the underlying asset. Given this estimated value and the amount of outstanding debt, the buyers had determined the most likely outcome for each loan. For buyers interested in minimizing the amount of time they owned these assets, the principal choice was between a payoff of the outstanding debt or foreclosure on the property. While most buyers indicated that a payoff of the loan was the preferred option because of the ease and speed of resolution, it was clear that in certain cases foreclosure was inevitable

given the level of indebtedness.⁷ Of note, several buyers indicated that foreclosure was a more likely outcome with loans bought from HUD compared to loans bought from the RTC because a higher price was paid for HUD loans. Having paid a higher price for the loans, the loan buyers had less room to offer property owners a discounted payoff and still realize a sufficient return on their investment. One representative of a property owner interviewed indicated that in certain cases loan buyers were single-minded in their pursuit of foreclosure, while the same buyer might offer a discounted payoff on another property which had a similar level of indebtedness. The owner's interpretation was that the buyer had simply paid less for the latter asset making a payoff feasible.

In general, according to buyers, loans that paid off were those that were not saddled with an excessive amount of debt relative to the value of the property. In those cases, the owner had a strong incentive to find a solution to their financial problems to protect their equity in the property. But buyers noted that there were factors other than current financial condition that played a role in determining a loan's outcome. For example, loan buyers would also assess the liabilities associated with a property to determine the attractiveness of foreclosing and becoming the property owner. Such issues as environmental liabilities, excessive deferred maintenance, or very high neighborhood crime rates might make the loan buyer less likely to pursue foreclosure, all else equal. That properties in areas with high crime rates might have lower foreclosure rates seems counter to the expectation that these properties might experience greater distress and so be more likely to end in foreclosure. Buyers' comments suggest that, at least in some cases, the potential difficulties of managing properties in high crime areas made them willing to accept a lower return from a discounted payoff rather than pursuing a potentially higher return by means of foreclosure.

Most buyers also indicated that the foreclosure rates they experienced were higher than they had anticipated. In some cases, a loan buyer's anticipated disposition strategy for a loan would be to reach an agreement with the owner on a discounted payoff value, but they discovered that property owners were not interested in pursuing a payoff. Rather, in these cases owners had been pursuing a strategy of draining cash from the property at the expense of property maintenance and so were not interested in retaining the property given the high level of deferred maintenance. These owners would generally fight the foreclosure process only up until the point a receiver was put in place and they could no longer control the cash flow.

Relatively few instances were found where loan buyers had agreed to loan modifications, although all of the buyers indicated that this was one of the options they pursued with owners. The exception to this finding was one buyer who was interviewed but did not provide data on the

7 An important distinction for loan buyers was whether property owners used litigation to fight foreclosure proceedings or not, as a contested foreclosure would lengthen the time and increase the cost needed to obtain the property. However, loan buyers indicated that the likelihood of litigation did not deter them from pursuing foreclosure. In some cases, litigation was inevitable. For example, given the negative tax consequences of foreclosure, general partners of limited partnerships often have a fiduciary obligation to limited partners to take all steps possible to avoid or delay the negative financial impacts of foreclosure.

disposition of purchased loans. This buyer reported that it renegotiated terms on about a quarter of its loans which were characterized as having only marginal financial difficulties. Otherwise, the relative lack of loan modifications in part seems to reflect the strategy of most buyers to liquidate these assets rather than to hold a portfolio of loans. To the extent that a loan modification was feasible, an agreement would be reached regarding the payoff amount and property owners would find another source of financing for this amount. Interestingly, even the buyer that professed to be motivated to purchase loans to create a portfolio of performing loans reported a very small number of loan modifications. This buyer noted that the current very competitive market for multifamily financing was marked by underwriting standards that were too permissive for his firm to compete with. A number of loans owned by this firm were reaching agreements on payoff amounts and then refinancing with other sources.

Buyers reported having little leverage over property owners to improve property management as long as owners were current in their payments, either under the original note terms or a provisional workout agreement (PWA), which were forbearance agreements commonly negotiated between HUD and property owners to establish a feasible payment plan given the property's financial condition.⁸ In fact, buyers reported that with the regulatory release associated with the sale of these notes by HUD, the only requirement of property owners of performing notes was to provide annual financial information. Lenders were not even entitled to inspect the properties. The ability of loan buyers to influence property management was thus completely dependent on whether the loans were performing or not.

As discussed above, if loans were delinquent in their payments, all of the buyers reported that they would immediately pursue foreclosure. If owners appeared to be managing the properties well and the level of indebtedness was low enough that a payoff or restructuring option might be feasible, temporary agreements might be reached to provide owners time to find a solution to their financial problems. If owners did not appear to be managing the property well or were generally not cooperative, the buyers would pursue foreclosure and seek to have a receiver put in place to manage the property. If temporary agreements were reached with owners to avoid foreclosure, during this period owners might seek to reduce expenses, increase rents or raise additional capital to meet their debt obligations.⁹ Loan buyers generally did not report making requirements regarding the efforts that should be used to increase income or reduce expenses -- it was simply up to the owner to determine how best to solve its problems. The principal exception to this lack of requirements was with regard to maintenance and repair. As part of

8 Along these lines, buyers expressed a number of complaints regarding the PWAs entered into by HUD with property owners. One complaint was that the agreements were for too long a period. As long as owners were performing under the terms of the PWA, buyers had little leverage over the owners. Coupled with the concern about the length of the agreement was the often generous terms, giving owners little incentive to entertain payoff offers. Buyers also noted that the language in these contracts was so vague that they felt that unless owners were in gross non-compliance it would be difficult to prevail in any court actions challenging these agreements. However, one buyer noted that if they determined the owner was financially able to pay more than called for by the PWA they felt they were within their rights to cancel the agreement and seek higher payments.

9 In some cases temporary agreements were reached simply to delay foreclosure to minimize the tax consequences on property owners. For example, by waiting until the next fiscal year to foreclose so that any adverse tax implications would be delayed for a year.

these temporary agreements buyers would generally require owners to undertake necessary repairs and to adequately maintain the property. If by the end of the temporary agreement owners had not found a solution to their financial difficulties, foreclosure would be pursued (often without litigation from the owners).

While most buyers indicated that the preferred outcome was to avoid foreclosure, they were all quick to note that they were by no means averse to taking possession of properties. In fact, buyers anticipated taking possession of some properties in preparing their bids. All of the buyers described a similar strategy for managing loans that became REO to maximize the value of these properties prior to sale. The first step is to undertake any deferred maintenance, repairs or capital improvements that would enhance the property's value. Buyers reported that loans that ended up being foreclosed generally required some degree of investment to improve conditions. During this period vacancies would be expected to rise both as a means of facilitating the upgrading of units upon turnover and because of efforts to remove tenants who either failed to pay rent, were destructive of property, or were otherwise disruptive of the community. Upon completion of property improvements the next step would be to increase occupancy. Once target occupancy rates were achieved, owners would begin increasing rents to market levels for the property type and location. At that point, the value of the property would be maximized and sale sought.

While this general strategy was common to all buyers, there was some variation in the degree to which they would seek to maximize property value before selling. Some owners began seeking suitable buyers even as properties were proceeding through foreclosure. Others did not appear to be actively seeking buyers until after the value maximizing process was well underway. Relatively quick sales of foreclosed properties were mainly reported in cases where the property was located in a crime ridden area or substantial rehabilitation or reconstruction was required. Reflecting the general practice of seeking to enhance property value before sale, a large share of the foreclosed properties were still owned by buyers at the time they were contacted for this study.

2.2 Current Loan Disposition

One of the basic questions to be addressed by this study is what became of the loans following their sale by HUD? The anticipated outcomes included buyers holding the loans either under the original or renegotiated terms, selling loans to borrowers (which loan buyers refer to as a payoff or discounted payoff if less than the total debt is accepted), selling loans to other investors (either as whole loans or as a securitized loan pool), or foreclosure.

In total, the current disposition of 530 multifamily loans was obtained from buyers, representing about half of the multifamily loans sold, including 389 non-performing loans and 141 loans from the Performing sale. Sampled loans are from five of the seven auctions. However, the two loan buyers who were interviewed but did not provide loan disposition information were involved in

the two auctions for which no data was obtained. In general their description of loan outcomes was similar to that reported by other buyers.

Exhibit 2-1 summarizes this information. As shown, buyers of loans from non-performing loan sales have been successful in achieving their goal of fairly quickly liquidating these assets. While the loan sales occurred fairly recently (between one and a half and three years ago) only a third of the loans are still owned and serviced by the original buyers, including 20 percent that are classified as performing and 13 percent that are classified as non-performing. The non-performing loans are generally in the middle of a foreclosure or bankruptcy process. As a result, many of these properties will ultimately become REO. The performing loans may be current under either the original loan terms or a PWA. In cases where the loan is performing under a PWA, the loan may become non-performing upon expiration of this agreement. However, buyers reported that it was not uncommon for loans to pay all arrearage and become performing under the original terms upon expiration of the PWA. Aside from the one buyer who expressed an interest in owning a performing loan portfolio, many of the buyers expressed the goal of selling or negotiating a payoff of the performing loans. However, one buyer noted that the low interest rates and long maturities made these assets of less interest to investors.

Slightly less than another third of the loans have been foreclosed on, with the large majority of these still owned by the buyers. The low sales rate of REO property appears to be a function of both the relatively short amount of time that has passed since taking ownership of the properties (less than a year in many cases) as well as the buyers' strategy of upgrading the properties before sale. With many of the non-performing notes in a foreclosure process, the overall foreclosure rate may be expected to reach in excess of 40 percent.

Finally, slightly more than a third of the loans are no longer owned by the buyers, including 23 percent that have been prepaid and 13 percent that have been sold. Loan buyers' methods for characterizing loan payoffs did not always allow for distinctions between payoffs of the full loan amount versus discounted payoffs. But based on interviews with the buyers, in most cases, payoffs appear to have been at some discount of the total indebtedness. Almost all of the loans reported as sold in Exhibit 2-1 represent loans that were purchased almost immediately after the initial sale by another unsuccessful bidder. In interviews with buyers they noted that in some cases individual loans had been sold to third parties, but these sales appear to have been included in the paid off category. However, buyers' comments suggest that such sales accounted for a small share of payoffs.

Exhibit 2-1

Current Status of Sampled Multifamily Loans

	Non-Performing Sales	
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Exhibit 2-1**Current Status of Sampled Multifamily Loans**

	Total Sample	Partially Assisted	Other Non-Performing	
Owned	33%	31%	35%	72%
Performing	20%	18%	22%	72%
Non-Performing	13%	13%	13%	0%
Foreclosed	31%	37%	27%	0%
REO	27%	32%	24%	0%
Property Sold	4%	5%	3%	0%
No Longer Owned	36%	32%	38%	28%
Paid Off	23%	21%	24%	18%
Loan Sold	13%	11%	14%	9%

Source: Proprietary data from loan buyers.

The outcome of loans sold in the Partially Assisted sale is of particular interest because of concern for the impact of the sale on subsidized tenants. The principal difference in outcome for these loans compared to other non-performing loans is that the partially assisted loans were somewhat more likely to have been foreclosed on than loans from other non-performing sales -- 37 percent compared to 27 percent.¹⁰ This higher foreclosure rate is about equally offset by lower rates of both loans still owned as well as those that have been sold or prepaid.

Finally, in sharp contrast to loans from non-performing sales, all of the loans from the Performing loan sale are currently either performing, have prepaid or were sold. However, as noted previously, virtually all of the loans from the performing sale have been securitized. But because information was available on the current disposition of securitized loans still serviced by the original servicer, this information has been used to characterize the current disposition of these loans.

¹⁰ However, as discussed in Section 2.3, there is no significant difference in the characteristics of loans foreclosed in the Partially Assisted sale from those foreclosed in other non-performing loan sales.

2.3 Factors Associated with Loan Disposition

This section examines the question of whether there is any relationship between loan disposition and property, tenant, or location characteristics. This analysis focuses on the outcomes for loans sold in the non-performing loan sales as there has been little variation of interest in the outcomes of loans sold in the performing loan sale.¹¹ The issues which this analysis was meant to address include whether any particular conditions were associated with foreclosure compared to a payoff settlement being reached and whether the degree of financial or management deficiencies was highly indicative of the likelihood of foreclosure.¹² Another issue of concern to HUD was whether foreclosure was more likely for properties in higher income areas where gentrification of the property may have been a profitable option.

Loan-level data on the current disposition of 339 loans was used for this analysis.¹³ It is important to note that while these loans represent a fairly large share of the non-performing loans sold, the results are not necessarily indicative of the outcomes of all sold loans as only three loan buyers provided loan-level data for non-performing loan sales. Exhibit 2-2 provides a comparison of selected mean characteristics of the loans sampled compared to all other loans sold in non-performing loan sales. The sampled loans have a somewhat lower average rent (\$499) compared to other non-performing loans (\$565), which may reflect differences in tenant profile or geographic location. The degree of financial distress is quite similar, however, with little differences evident in the delinquencies per unit, the debt service coverage ratio or the vacancy rate. The interest rate is slightly higher among the sampled loans, which might have been part of the appeal of these loans for loan buyers. Finally, the average project size of sampled loans is also somewhat smaller than for other loans (175 units compared to 203) and the number of years in the HUD inventory is somewhat less (6.0 years compared to 7.6).

But while this comparison indicates that there are some differences between the sampled loans and other non-performing loans, as will be discussed below, there is no statistically significant relationship between these loan characteristics and the outcomes found. Thus, it does not seem likely that these differences in characteristics would be associated with different outcomes. A more important factor would be the strategies and asset management practices employed by other buyers, about which nothing is known.

11 Virtually all of these loans continued to be performing loans following sale, although a few technical defaults have occurred (e.g., additional debt was obtained without prior approval of the lender).

12 In planning the study it was anticipated that an important outcome category would be loans which were offered workouts or loan modifications. However, these outcomes were not found to represent a common approach used by loan buyers. Instead, for most buyers, a discounted payoff was the principal alternative to foreclosure.

13 Disposition information on a total of 530 loans was obtained. However, this total includes data on loans from the Performing loan sale and data from one buyer which provided only a summary of loan disposition and not loan-level disposition information. These latter categories of loans are excluded from this analysis.

Exhibit 2-2

Comparison of Selected Mean Characteristics of Sampled Non-Performing Loans with Other Non-Performing Loans Sold

Variable	Sampled Loans	Other Loans
Average Rent per Unit (\$)	499	565
Delinquencies as Percent of GPR	111%	104%
Delinquencies per Unit (\$)	6,565	6,585
Debt Service Coverage Ratio	0.76	0.75
Vacancy Rate	10.8%	11.1%
Interest Rate	8.35%	7.79%
Number of Units	175	203
Years HUD-Held	6.0	7.6
No. of Loans	339	480

Notes: "Average Rent Per Unit" is average gross potential rent per unit.

Sources: HUD's Due Diligence data bases (D3) for loan sales.

Two additional sources of data have been used for this analysis. The first source is the due diligence data bases assembled by HUD and its contractors as part of the sale process. These data bases contain basic descriptive information on the properties (including location and structure type), summary data from the most recent available annual financial statement submitted to HUD, and loan terms and performance. These data sets provide some variables which can be used as proxies for the degree of financial and managerial distress of the properties at the time of their sale by HUD. The degree of financial distress was proxied by two measures of the degree of delinquencies¹⁴ (total delinquencies divided by the number of units and delinquencies as a percent of gross potential rent) and the debt service coverage ratio. The degree of managerial distress was proxied by the vacancy rate.

Another factor examined is the ratio of total property expenses to the appropriate IREM¹⁵ benchmark. High levels of expenditures may reflect fraudulently inflated expenditure levels or very high levels of maintenance and services. On the other hand, low expenditure levels may indicate extremely efficient management or poor maintenance and services. Despite the difficulty

14 "Delinquencies" include delinquent interest and principal payments.

15 IREM data refers to data from the "Income/Expense Analysis: Conventional Apartments" publication series of the Institute of Real Estate Management (IREM). Data on total expenses per net square foot by region and building type were used as benchmarks to compare to expenses reported to HUD as part of the annual financial statement. The financial information available in the HUD data base was from various years from 1992 to 1996. IREM data from the corresponding year was used.

of interpreting this measure it has been included because of HUD's interest in the degree to which property expense levels deviate from industry norms.

The number of years the loan had been held by HUD was also examined as loans held longer by HUD tend to be somewhat more likely to survive as performing loans.¹⁶ Other variables from the HUD due diligence data base that were examined include the average gross potential rent per unit (as a proxy for the income level of tenants), the interest rate, and the number of units in the property.

The second source of data used was tract level data from the 1990 Census of Population and Housing. The income level and racial composition of the census tracts where the properties were located were used as proxies for the race and income of the tenants, as no tenant characteristics are available from HUD data sources for unassisted properties.

The results of this analysis indicate that there are no statistically significant¹⁷ differences between any of the loan disposition categories in any of the mean characteristics considered (see Exhibit 2-3 for means and standard deviations of characteristics by loan disposition). There were also no significant differences in the characteristics of loans falling into different disposition categories between the Partially Assisted sale and other non-performing loan sales. This finding is consistent with the loan buyers' assessment that a diverse set of factors were associated with loan outcomes so that loans could not easily be categorized by their disposition. Buyers noted that there were cases in which they had anticipated reaching a settlement with property owners for payoffs, only to discover that the owner was not motivated to retain ownership. Thus, foreclosed properties included both those that were severely distressed as well as others exhibiting less distress. Alternatively, buyers also indicated that in some cases they did not foreclose on severely distressed properties because of financial and legal liabilities that might be associated with these properties. Thus, paid off loans also include properties exhibiting both low and high levels of distress. Finally, it seems clear that the outcome was also a function of the price paid by buyers for individual assets, which may not have been related to the degree of financial or managerial distress of the property.

While no statistically significant differences in the characteristics of loans by outcome were found, there were some slight differences in the central tendencies by category. Generally, there was a slight tendency for loans in poorer areas with higher concentrations of minorities to end in foreclosure. Foreclosed loans also generally have higher levels of financial and managerial distress as indicated by the level of delinquencies and the vacancy rate. This association of higher foreclosure among properties in lower income areas and with higher degrees of distress would be expected. However, the weakness of the association found is consistent with loan

16 This issue is discussed in more detail in Section 2.4 below.

17 Unless otherwise noted, all significance tests were evaluated at a 95 percent confidence level.

Exhibit 2-3

Mean and Standard Deviation of Property Characteristics By Loan Disposition for Non-Performing Loans (Standard Deviations in Parenthesis)

Variable	All	Owned		Paid Off	REO		Loan Sold
		Per-forming	Non-Perf		Owned	Sold	
Tract Characteristics							
Income as % of Area Median	92.6% (0.327)	99.2% (0.305)	89.3% (0.268)	100.8% (0.309)	92.1% (0.361)	79.2% (0.247)	76.2% (0.317)
Poverty Rate	15.2% (0.116)	14.2% (0.101)	13.3% (0.109)	11.5% (0.082)	18.2% (0.135)	19.7% (0.114)	17.3% (0.126)
Percent Minority	32.6% (0.268)	28.3% (0.245)	33.0% (0.296)	27.6% (0.212)	35.6% (0.278)	36.4% (0.289)	39.6% (0.314)
Property Characteristics							
Average Rent Level	\$499 (209)	\$455 (134)	\$555 (325)	\$515 (150)	\$456 (121)	\$477 (154)	\$586 (342)
Delinquencies Per Unit	\$6565 (6815)	\$2822 (3259)	\$7107 (7589)	\$5116 (4603)	\$7331 (4669)	\$13593 (10004)	\$10423 (11268)
Delinquencies as % of GPR	110.6% (0.911)	51.9% (0.578)	106.6% (0.707)	86.7% (0.753)	136.2% (0.760)	221.9% (1.163)	154.3% (1.273)
Debt Service Coverage Ratio	82.7% (0.746)	95.4% (0.358)	87.1% (0.490)	104.9% (1.389)	65.4% (0.322)	42.0% (0.265)	70.1% (0.348)
Years HUD Held	6.0 (4.03)	7.8 (5.59)	5.9 (5.69)	5.7 (3.61)	5.5 (2.28)	5.5 (2.54)	5.5 (2.59)
Total Expenses as % of IREM	142.7% (0.862)	126.2% (0.608)	152.0% (0.880)	144.8% (0.561)	152.6% (1.259)	133.4% (0.426)	135.1% (0.475)
Vacancy Rate	10.8% (0.092)	7.4% (0.073)	9.6% (0.054)	10.1% (0.071)	12.8% (0.113)	18.4% (0.113)	11.6% (0.097)
Interest Rate	8.4% (1.2)	7.8% (1.3)	8.4% (1.3)	8.5% (1.1)	8.7% (1.3)	8.7% (1.2)	8.3% (1.0)
Number of Units	175 (111.5)	148 (84.4)	187 (79.1)	196 (106.1)	168 (120.1)	190 (224.0)	181 (111.3)
No. Observations	339	66	43	74	100	13	13

Notes: "Income as Percent of Tract Median" based on Median Household income for tract and MSA. "Percent Minority" is percent of Population that is not White, Non-Hispanic. "Average Rent Level" is average gross potential rent per unit. "Debt Service Coverage Ratio" is the ratio of total annual net revenue to the annual debt service payments.

Sources: Tract Characteristics from U.S. Bureau of the Census, 1990 Census of Population and Housing, STC 3-C. Property Characteristics from due diligence data base (D3 Data) compiled by HUD from various administrative data bases and records as part of loan sales process. Loan status from proprietary data from loan buyers.

buyer comments that other factors, such as aversion of environmental liabilities or high crime areas (which generally have lower income levels and higher minority shares), sometimes lead to a decision to pursue discounted payoffs on loans that might otherwise have been foreclosed on.

Rent levels were also somewhat lower in foreclosed properties, perhaps reflecting the lower income levels of the neighborhoods where these properties were located as well as poor maintenance by owners. The tendencies for foreclosed properties to be in poorer areas with lower rent levels suggests that loan buyers were not systematically foreclosing on properties with greater potential for gentrification.

In contrast, paid off loans generally exhibited less financial distress and were found in somewhat higher income areas, while performing loans exhibited the lowest levels of financial distress. Non-performing loans generally exhibited higher levels of financial and managerial distress and were located in poorer areas than either paid off or performing loans, although they were not as troubled as foreclosed properties. As a result, it might be expected that some share of the non-performing loans may be able to avoid foreclosure.

While there are no measures of property conditions in the due diligence data, loan buyers generally commented that property conditions were somewhat worse for those properties whose loans were ultimately foreclosed. In part, the poorer condition of foreclosed loans was reported to reflect owners neglect of the properties during the time that it took to proceed with foreclosure. But in other cases, the poor conditions were reported to reflect the strategy of some owners to neglect maintenance in order to drain more cash from the properties. Thus, based on these comments, it seems that poor physical condition of properties may have been associated with loan disposition. But absent measures of property conditions for all loans for which data on disposition was obtained, the validity of this contention cannot be evaluated statistically. However, as will be discussed more in Section 2.6, data on expenditures for maintenance and repair and capital improvements for foreclosed properties in the Partially Assisted sale suggest that foreclosed properties did, in fact, have a greater degree of deferred maintenance than properties whose loans were sold in the Performing sale.

2.4 Likely Disposition of Loans if HUD Had Retained Ownership

To evaluate how the sale of loans affected ultimate loan disposition, the information on current loan disposition was compared to the disposition that would have been expected if HUD had continued to own these loans. Until recently, little systematic information was available on the historical performance of HUD-held multifamily loans. Recently, in an effort to improve the methodology used by HUD to perform the credit subsidy analysis associated with the loan sales program, Booz-Allen & Hamilton, Inc. (Booz-Allen) analyzed the historical performance of some

700 loans in HUD's portfolio.¹⁸ The 700 notes correspond to the types of notes sold in the loan sales program, including unsubsidized properties and those with Section 8 rental assistance on 50 percent or less of its units. The loan performance incorporated in this credit subsidy model provides the basis for predicting the outcome if HUD had retained ownership of these notes.

The three potential outcomes identified by Booz-Allen are paid-in-full, foreclosure, and third party sale. Third party sales refer to the purchase of the property by a party other than HUD at a foreclosure sale. For purposes of comparison with the outcomes identified by loan buyers, the third party sales rate are included as part of an overall foreclosure rate. Of the 700 notes studied, Booz-Allen found that 35 percent would ultimately be paid-in-full, with the remaining 65 percent foreclosed (including 37 percent that ended in a third party sale).¹⁹

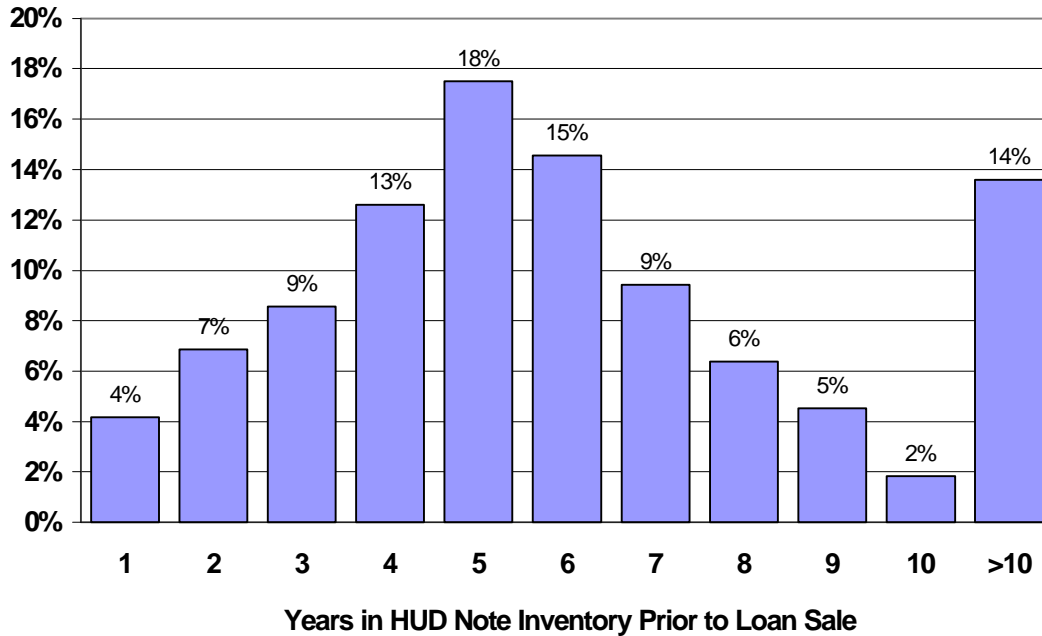
These rates of loan termination for HUD-held loans provide the basis for comparison with the outcomes observed for sold loans. However, in order to provide a relevant comparison, two factors must be considered. The first factor is the length of time HUD had held the notes before the loan sales. As illustrated in Exhibit 2-4, there was fairly wide variation among loans sold in the time they had been owned by HUD. The median loan had been held five years, but 11 percent had been held two years or less and 14 percent had been held for more than ten years. Over time, as the most troubled loans are foreclosed on, the remaining loans represent a group of more financially secure properties. As a result, loans that have been in HUD's portfolio for a long time are less likely to be foreclosed on than newer loans. For this reason, in projecting the outcome if HUD had retained the loan portfolio it is important to take the age distribution into account.

Given the age distribution shown in Exhibit 2-4, it would be expected that 56 percent of the sold loans would ultimately have been foreclosed on if retained by HUD, with the remaining 44 percent loan ultimately paying-in-full. However, this is the long-run outcome, and only three years (at most) have passed since these loans were sold. The second factor to consider in establishing a benchmark for the rate at which loans would either be foreclosed or become paid in full is the number of years that have passed since the loans were sold by HUD (again, taking into account the length of time since the loans were assigned to HUD).

18 Booz-Allen & Hamilton, Inc., *Model Documentation & User's Guide for the "Value-to-HUD" Model for Multifamily Notes* (McLean, VA: Booz-Allen & Hamilton, Inc., February 17, 1998).

19 In the model developed by Booz-Allen, loans are first probabilistically assigned to each of the three outcome categories based on their payment history during the first three years owned by HUD. Then, for each of these outcomes, a separate spreadsheet model specifies the rate at which loans will be terminated over time. The annual termination rates are based on the historical performance of HUD-held loans from the time that the loans were acquired by HUD.

Exhibit 2-4
DISTRIBUTION OF NON-PERFORMING LOANS SOLD
BY NUMBER OF YEARS IN HUD’S INVENTORY

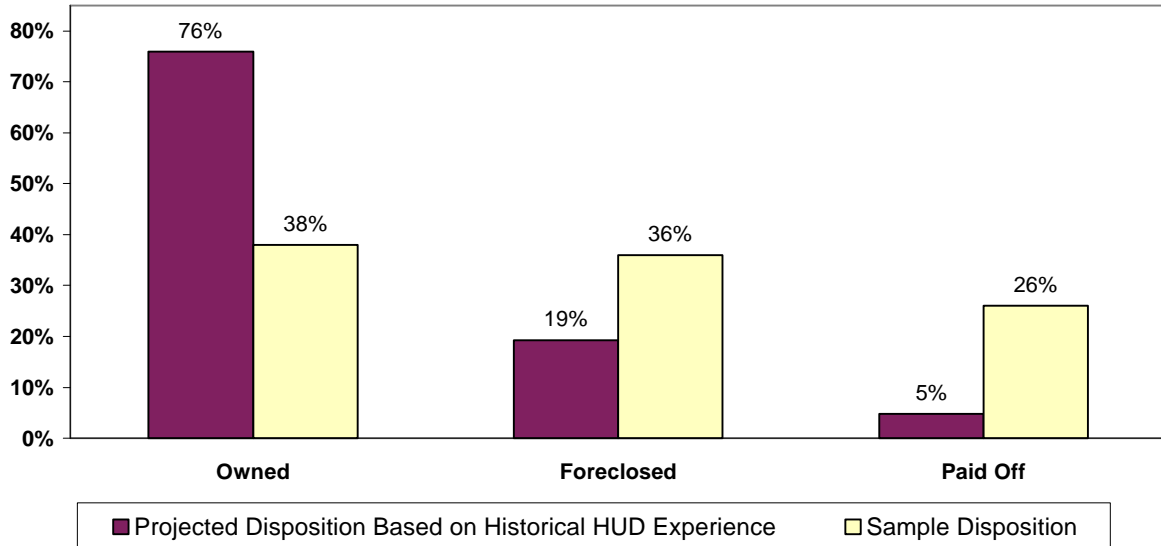


Source: Tabulations using data from HUD's Due Diligence (D3) and F47 data bases.

Exhibit 2-5 compares the current disposition of sampled loans with the projected outcome at the same point in time if HUD had retained ownership. The largest difference in outcomes is with regard to the share of loans still in the loan portfolio. Only 38 percent of the non-performing loans sold are still in the buyer's portfolio of loans.²⁰ In comparison, if HUD had retained these loans, 76 percent would still be in its loan portfolio. Quite clearly, buyers have been quite successful in achieving a fairly quick resolution of these loans. The quicker resolution of loans is in part due to a rate of foreclosure that has been twice the rate that would have been expected under continued HUD ownership (36 percent compared to 19 percent). However, there have been even larger increases in the payoff rate, which is five times the rate that would have been expected under HUD ownership (26 percent compared to 5 percent). It is important to note that the current market for multifamily financing is quite competitive, which may well have contributed to the loan buyers ability to achieve a quicker resolution of these loans than was evident in HUD's experience over the last ten years.

²⁰ Loans sold by the buyers immediately after sale for which the current disposition is unknown are not included in this analysis, as their disposition following sale by HUD is unknown.

Exhibit 2-5
COMPARISON OF SAMPLED LOAN DISPOSITION
WITH PROJECTED DISPOSITION UNDER HUD OWNERSHIP



Sources: Proprietary loan buyer data and estimates based on analysis of historical HUD loan performance in "Model Documentation and User Guide for the Value-to-HUD Model for Multifamily Notes," Booz-Allen & Hamilton, Inc., February 1998.

While the current rate of foreclosure is higher than would have been expected under HUD-ownership, it is not clear whether the ultimate foreclosure rate will be higher than the projected rate of 56 percent under HUD ownership. Only if more than half of the remaining loans in the portfolio end in foreclosure will the overall foreclosure rate exceed the HUD rate. It does not seem likely that there will be such a high foreclosure rate on the remaining portfolio as a majority of these loans are currently performing (although some are performing according to the terms of a PWA and not the original note terms). Assuming that all currently non-performing loans end in foreclosure, the ultimate foreclosure rate would be 44 percent, substantially below the predicted rate of 56 percent.

Thus, at this point, it appears that there have been two principal results of the loan sales program on loan outcomes. First, loan buyers are pushing loans to a much faster resolution of the project's financial difficulties than would have been expected under HUD, with half the number of loans still in portfolio at this point in time compared to the projected HUD experience. Second, the ultimate foreclosure rate may be somewhat lower than the 56% rate projected under HUD-ownership.

2.5 Evaluation of Tenant Displacement

One of the principal concerns of this study was to determine what impact, if any, the sale of loans by HUD have had on tenants of the affected properties. The principal impact of concern to HUD is whether the loan sales were associated with sharp increases in rents which might displace low and moderate income tenants. Rather than attempt to measure the extent to which individual tenants were displaced (and evaluate whether rent increases were the proximate cause of the move), the methodology used in this study was to compare rents before and after the loan sale to evaluate the extent to which rents have increased. These increases were then compared to overall market rent trends to determine whether these increases have been above market trends. Such a finding would indicate a situation where some low and moderate income tenants may have been displaced.

To undertake this analysis, detailed financial information was collected on a sample of loans from the participating buyers. Not all buyers were willing to provide this information, so not all buyers represented in the data on loan disposition are represented in the analysis of changes in the properties' financial circumstances. In addition, even for buyers who did provide this information, data were generally not available for loans that had been paid off. As a result, the collected data mainly represent two classes of loans - those that are performing and those that have been foreclosed on. Four buyers provided detailed loan data, but the sampled loans disproportionately come from two sources: foreclosed loans in the Partially Assisted sale (for which HUD receives monthly reports as an equity investor in this loan pool) and loans from the Performing loan sale.²¹

Although the loan sample is not representative of all loans sold, the sample does provide information on rent changes for loans at what may be regarded as two extremes. At one extreme, sampled properties from the performing loan sale are those which were not in any financial distress and have continued to be owned and managed by the same entities as when the loans were owned by HUD. At the other extreme, the sampled loans from the Partially Assisted sale are solely foreclosed loans, which include some of the more financially distressed properties and which, based on the interview with the loan servicer, have been subjected to fairly aggressive efforts to increase rents. The loans sampled from other non-performing loan sales are mostly performing loans, although a few are foreclosed properties, and so fall somewhere between these two extremes.

A critical limiting factor in undertaking this analysis is that due diligence data available from HUD do not indicate the income profile of tenants, rent by unit type, or even the distribution of unit sizes.²² As a result, it is not possible to directly identify the extent to which a particular property

21 See Appendix A for a more detailed discussion of loan sampling methodology and results.

22 Information on the loans sold comes from due diligence data bases created by HUD as part of the sales process. A standard set of information was available for all sales which included basic descriptive information on the properties (number of units, stories, and buildings), summary information from the most recent annual financial statement, and loan terms for the original note and any

was home to low and moderate income tenants (except for the Partially Assisted notes for which the number of subsidized units is known). In order to determine the relative affordability of a property, the average rent per unit was calculated and compared to the 2-bedroom FMR for the relevant area. An important concern with this approach is that no adjustment can be made for differences in unit sizes. As a result, projects with a large share of larger units will be mistakenly identified as less affordable, while those with a large share of studio or one bedroom apartments will be identified as more affordable. This circumstance should be kept in mind in reviewing the findings presented below regarding rent levels. There is not the same concern regarding analyzing changes in overall rent levels, as the distribution of unit sizes is not a factor in this analysis.

Of course, any increases in rents must be considered in the context of improvements in property conditions. To the extent that properties had become run-down, increases in rents may have been needed to pay off needed repairs. In these cases, concerns for tenant displacement may be offset somewhat by the improvements in living conditions realized. To the extent possible, changes in maintenance and repair expenditures were considered in evaluating the reasonableness of rent increases observed.

In addition to an analysis of data on rent levels, the issue of tenant displacement was also addressed in interviews with buyers. The interviews were also used to probe the extent to which there were efforts to remove undesirable tenants who either failed to pay rent, damaged the property, or otherwise were disruptive of the community. In order to provide a context for considering the findings of the data analysis, the findings from buyer interviews are summarized first.

Loans sold in the Partially Assisted sale are the only loans which include properties housing subsidized low-income tenants. As a result, this group of loans merits special attention. A unique concern with regard to the Partially Assisted sale is whether contracts with HUD providing the project-based Section 8 assistance were not renewed. As a result, the issues and findings related to the renewal of Section 8 contracts is also discussed separately.

Findings from Buyer Interviews

Loan buyers' understanding of tenant impacts was largely confined to properties that had been foreclosed on or were well into the foreclosure process. As discussed above, buyers had relatively little involvement in the management of performing loans. With respect to properties that had been foreclosed on, virtually all of the owners noted that their goals for these properties included first remedying any deferred maintenance, then increasing occupancy, and finally raising rents to the appropriate market level. Buyers noted that properties that became REO were generally poorly maintained and, as a result, rents had often declined below relevant market

modifications made. For a few sales, more detailed information was available on recent payment histories of the notes, and for the Partially Assisted sale detailed information was available on the number of units by size and presence of subsidy.

levels.²³ However, buyers noted that efforts to increase market rents were generally not intended to change the tenant profile of the properties, but simply to solidify the financial soundness of the properties.

Specifically with regard to the issue of tenant displacement, buyers did acknowledge that there were circumstances under which problematic tenants were removed from properties - generally for non-payment of rent, but also in some cases because of disruptive or criminal behavior. The general reaction of buyers suggested that their experience with removing problem tenants from these properties was not out of the ordinary compared to their experience with other multifamily properties.

A few buyers did share isolated instances where entire properties were vacated because of extremely poor physical conditions. In one case, a property was found to have literally hundreds of code violations. Because of the legal liabilities posed by this situation, the property was emptied of tenants. The city government reportedly wanted to tear down the property, but the buyer managed to find a developer to purchase the property to undertake a substantial rehabilitation. In another example, a buyer reported a property that was also rife with physical defects, including holes in the floors and ceilings. The buyer was concerned about liability on this property and so removed all of the tenants. Once empty, they marketed it to developers for rehabilitation. While indicating that the poor condition of the building was the critical factor in the decision to pursue this strategy, the buyer did concede that the surrounding neighborhood was of higher quality than this property so that the rehabilitated property will serve a higher income population. However, such extreme cases of tenant displacement seem to have been limited to a few isolated cases.

Partially Assisted Properties

The buyer which reported the most aggressive efforts to increase rents in foreclosed properties was involved in the Partially Assisted sale.²⁴ Given the particular concerns related to the project-based subsidies for these properties, the outcomes for these properties are being considered separately. The properties sold in this sale almost entirely had market rate mortgages, but all had some Section 8 project-based assistance, either as part of the Section 8 new construction program or as part of a Loan Management Set Aside (LMSA) apparently awarded as a way to stabilize income when the properties became financially troubled.

23 Buyers attributed this lack of maintenance in part to the PWAs that many non-performing loans were subject to which (at least in some cases) provided little incentives for owners to keep rents up because they did not allow them to retain a share of any increases in net cash flow.

24 The Partially Assisted sale was structured differently than the other loan sales. In this sale, the loans were sold as a single portfolio of loans, with separate auctions of debt and equity with single entities winning these two auctions (the sale structure was modeled after the so-called "N-Deals" developed by the RTC). HUD also retained a share of the equity in this pool and so continues to be a minority owner. The winning equity bidder chose the loan servicer. As a result of this structure, a single firm services all of these loans and provides monthly reports to HUD as an equity owner.

An issue of particular concern with these properties is whether the contracts providing the project-based subsidies will be renewed upon expiration. Data from HUD's due diligence data base indicates that almost all of the LMSA contracts were to expire between 1996 and 1999, while the new construction contracts were mostly going to expire between 2001 and 2005. At present, the Federal Government is routinely renewing these contracts for one-year terms. However, while the government will generally renew these contracts, for a variety of reasons owners may decide not to pursue renewal of the project-based subsidies. Current law requires owners to give HUD and tenants six months notice of their intention to not renew these contracts. If such notice is not given, tenants must be allowed to stay in the properties while paying only the tenants' portion of the rent due (that is, 30 percent of their monthly income). In the event that owners do not renew the project-based assistance, under present policy HUD converts the project-based assistance into tenant-based vouchers for income-eligible tenants.

It is important to note that HUD's sale of loans for these partially assisted properties did not change either the incentives or the ability of property owners to choose to not renew the project based assistance. To provide some protection for tenants, HUD did include in the loan sales agreements requirements that owners agree to not discriminate against voucher or certificate holders seeking to reside in these properties. Of course, this requirement does not protect tenants from rent increases which they cannot afford. Thus, to the extent that owners choose to not renew project-based subsidy contracts in order to increase rents, subsidized tenants may be displaced from their current residences. On the other hand, tenants may well welcome the greater mobility afforded by the vouchers to choose a more convenient or desirable residential location.

HUD's prior experience with expiring project-based subsidies generally suggests that few property owners have been opting out of contracts. But most of this experience is for fully-subsidized properties with below market interest rate loans. Since opting out of the project-based assistance is also associated with the loss of these below market interest rate loans it is not surprising that few owners choose to opt out. But since loans sold in the Partially Assisted sale did not have subsidized mortgages, there was a much smaller disincentive for opting out of project-based subsidies. HUD staff were unaware of any evaluation of the rate at which properties without subsidized mortgages were opting out of these contracts.

In response to the question of whether and under what circumstances project-based assistance contracts on foreclosed properties were not being renewed, the firm responsible for managing these properties from the Partially Assisted sale indicated that as a general rule they will not seek renewal of these contracts. The particular reasons for this decision vary by property, but the following four general factors were cited:

- Rents allowed by the subsidy contract may be below the appropriate market rate for the property;

- Turnover costs on subsidy units are much higher than for unsubsidized units, with the servicer indicating that expected turnover costs were five times as high as for unsubsidized units (\$2,000 compared to \$400);
- The presence of subsidized units in the project lowers the appeal of the property to both potential renters and investors; and
- Administrative requirements of these contracts raise management costs.

While the management firm did not provide information on which properties have already had contracts for project-based subsidies discontinued, a review of administrative records obtained from HUD indicates that 11 properties from this sale have converted from project-based assistance to vouchers. Of these, six properties have been foreclosed on and five were from other categories, including performing loans, non-performing loans, and paid-off loans. Since foreclosed loans make up about a third of the loans sold, this number suggests that contracts are not being renewed on foreclosed properties at about twice the rate of the remaining loans. Of the 50 loans foreclosed on at the time of this analysis, 24 had contracts expiring before the end of 1998. Given the stated intention of not renewing contracts, it might have been expected that more properties would have appeared as having not renewed contracts. But since many foreclosures have only been completed in the past year, and owners must give 6 months notice prior to the renewal date of the contract, it is, in fact, not surprising that only six have been canceled at this point.

The management firm was also questioned about whether tenants have received vouchers to compensate them for the lost project-based assistance and whether they have remained as residents of the properties using these vouchers. The firm responded that as far as they knew tenants did, in fact, receive vouchers, but that in general tenants did not remain because units were rehabilitated and rents increased “substantially” making the apartment less affordable for the tenant.²⁵ Based on these comments it appears likely that subsidized tenants will ultimately be displaced from many, if not all, of the foreclosed properties in the Partially Assisted sale. While it is not known why contracts were not renewed for other properties that were not foreclosed, it might be assumed that these owners were pursuing similar strategies as well with similar consequences for subsidized tenants.

While the provision of vouchers protects these tenants from having to pay more for rent, it is not known how the relocation of these households otherwise may affect their welfare. In general, the

²⁵ However, it should be noted that the most recently available average rent among foreclosed properties from the Partially Assisted sale is \$477 per month, which is a fairly affordable rent level. For example, assuming that a ratio of rent to income of 30% is affordable, this average rent would be affordable for households with income of at least \$19,080 per year. This income level is 42% of the national median family income for fiscal year 1998 as defined for the Section 8 program, which would qualify the household as being very low income (having income below 50% of the median). In order for the Partially Assisted properties to become unaffordable for low and very low income households, the increases in average rents on these properties would have to be substantial.

broader choices provided by vouchers would be expected to result in improvements in household welfare. However, in these specific circumstances tenants will incur moving costs that might otherwise have been avoided. In addition, having lived for some time in their present location, tenants may prefer to stay in the same area to be near employment and friends and to avoid having their children change school districts, but may not be able to find another affordable apartment in the same area. However, an evaluation of these issues is beyond the scope of the present study.

Analysis of Changes in Rent Levels

Before turning to a discussion of the changes in rent levels found, a few issues related to the nature of the data should be noted. First, the time periods for which data were collected varies by loan. Data available from HUD for the properties prior to the loan sale ranged from the immediately preceding calendar year to several years prior to sale. The data collected from the buyers was generally from either 1997 or 1998. In order to make rent changes comparable for all loans, an annualized percent change was calculated. But as a result, in some cases the rent changes include several years of experience while still HUD-owned, while in others the rent changes are purely for the period since sale. Another factor to note is that in some cases the data available for the sampled properties were only for a few months (or even a single month) from 1998. In these cases annual levels were estimated from this partial year data. If the monthly or quarterly data were not representative of the cash flows for the entire year, the resulting annual estimate may be fairly inaccurate.

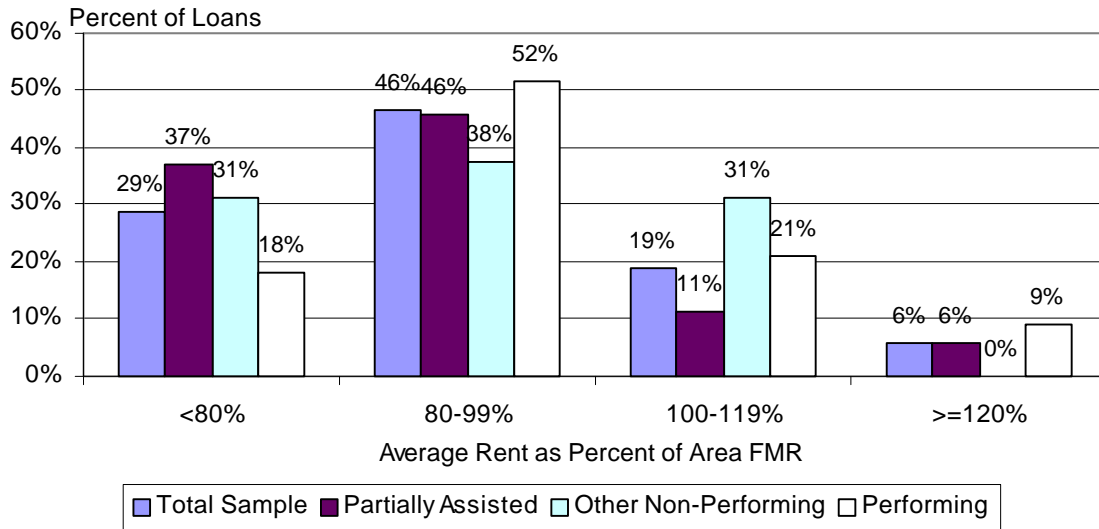
In order to provide a sense of how affordable these properties were for low and moderate income tenants prior to the loan sale, the ratio of average gross potential rent²⁶ per unit prior to sale by HUD to the appropriate area 2-bedroom FMR was estimated, with the area FMR representing a moderate-priced apartment.²⁷ Prior to sale by HUD, the average monthly rent on these properties was 89 percent of the area FMR. As shown in Exhibit 2-6, for nearly 30 percent of properties average rents were below 80 percent of the FMR, and for nearly half of the properties rents were between 80 and 100 percent of the FMR level. Only 25 percent of the properties had average rents in excess of the area FMR, and in most of these cases rents were less than 120 percent of the FMR. Thus, in general, the properties provided fairly affordable apartments.

A comparison of rent levels for loans sampled from different sales reveals no significant difference between these groups. The average rents ranged from a low of 86 percent of the area FMR for loans from the Partially Assisted sale to a high of 91 percent for performing loans. As shown in Exhibit 2-6, the distribution of rent levels was also fairly similar across these loan categories, with the majority of loans in each sale type having average rents below the area FMR.

26 "Gross Potential Rent" is the total rent that would be collected under complete occupancy. The average gross potential rent per unit is an estimate of per unit rent.

27 Up until 1994 the Fair Market Rent was set at the 45th percentile rent, and beginning in 1995 was reduced to the 40th percentile. Since the rent information from HUD's data base covers a time span from 1992 to 1995, the FMR series was adjusted to an estimate of the 40th percentile for 1995 through 1998. Thus, the FMR series used for comparison corresponds to the 40th percentile rent.

Exhibit 2-6
DISTRIBUTION OF SAMPLED LOAN RENT LEVELS PRIOR TO SALE



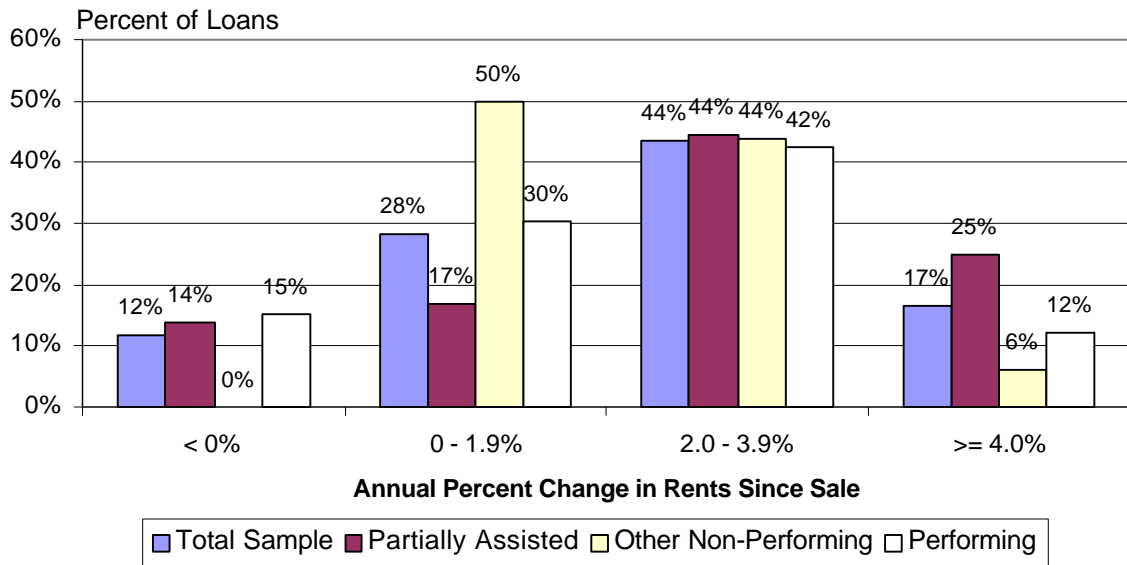
Source: Estimates made based on HUD Due Diligence data base (D3) and FMR data.

Since sale by HUD, rents have increased on average by 2.4 percent annually among the sampled loans. As shown in Exhibit 2-7, the most common increases were between 2 and 3.9 percent annually, with over 40 percent of all properties experiencing increases of this magnitude. Another 40 percent of properties had annual rent increases of less than 2 percent, including over 10 percent where rents were actually found to decline. Of significance, with regard to potential tenant displacement, 16 percent of properties experienced rent increases of more than 4 percent annually, with about a third of these cases having increases of more than 6 percent annually and a fifth of these having increases of more than 7 percent annually. Thus, while there were some instances of fairly sizable annual changes in rent levels, these cases represented a fairly small share of the loans sampled.

Again, there was no statistically significant difference across sales in the level of rent increases. The highest average increases were for properties from the Partially Assisted sale, where rent increases averaged 2.8 percent annually. In comparison, the lowest level of rent increases was among loans from the Performing loan sale where average increases were 2.0 percent annually. But as shown in Exhibit 2-7, the distribution of rent changes by sale were fairly similar. The principal difference is that among loans from the Partially Assisted sale, in excess of 20 percent had rent increases above 4 percent annually, while for other sales about 10 percent of loans or less

experienced rent increases of this magnitude. It is also worth noting, however, that all of the sampled Partially Assisted loans were foreclosed and virtually all buyers reported that foreclosed properties tended to have somewhat depressed rents due to poor management and maintenance. As was presented in Section 2.3, foreclosed properties did have somewhat lower rent levels on average than other loans. Thus, it might be expected that the Partially Assisted loans would experience somewhat greater rent increases than Performing loans.

Exhibit 2-7
DISTRIBUTION OF ANNUAL PERCENT CHANGE IN RENTS
SINCE SALE BY HUD



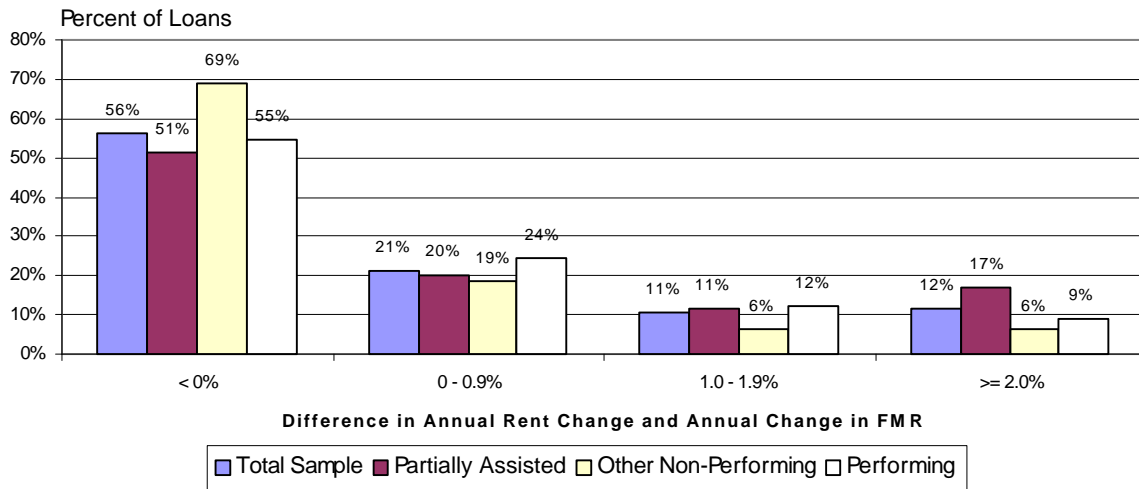
Source: Estimates based on HUD Due Diligence data base (D3) and proprietary loan buyer data.

Of course, these estimated rent increases need to be compared to a market benchmark in order to evaluate whether the increases have exceeded trends in the local market and thus might be associated with displacement of low and moderate income tenants above and beyond that produced by normal market processes. Trends over time in the area FMR were used to provide this comparison. Specifically, the annual percent change in the FMR over the same period for which rent data have been collected is subtracted from the estimated annual percent change in rent. Positive differences indicate rent changes that have exceeded market rates, while negative differences indicate rent changes that are smaller than for the market overall.

Overall, the rent changes observed in the sampled loans have been less than the increases in the area FMRs. The annual average rent increase of 2.4 percent is 0.6 percentage points lower than the average annual change in the FMR. Exhibit 2-8 shows the distribution of the differences in rent changes from the FMR rate. For more than half of the loans, the annual increase in rents has lagged the change in the FMR level. About 20 percent had annual increases that were between 0 and 0.9 percent greater than the FMR change, 10 percent had increases between 1 and 2 percent above the market rate, and another 10 percent had increases greater than 2 percent above the FMR rate (with a maximum of 4.6 percent above). Thus, while there were some instances of rent increases that exceeded the market increases, cases where these increases were as large as 1 percent above the market rate were a fairly small share of the total sample. Since more properties experienced declines in rents compared to market levels than experienced increases, the share of properties with average rents below the FMR actually increased from 75 percent to 78 percent. So overall, rents in these properties have become somewhat more affordable since their sale by HUD.

Once again there was no significant difference in outcome across the different loan sales. The largest difference between estimated rent increases and the market rate was for loans from the Performing sale and loans from non-performing sales other than the Partially Assisted sale where the difference averaged -0.7 percent. The smallest difference was for loans from the Partially Assisted sale where the difference was -0.4 percent. As shown by Exhibit 2-8, the distribution of these differences across the loan sales was also very similar, with few, if any, differences of note.

Exhibit 2-8
DISTRIBUTION OF DIFFERENCE IN ANNUAL PERCENT CHANGE IN RENTS
FROM THE ANNUAL PERCENT CHANGE IN THE AREA FMR



Source: Estimates based on HUD Due Diligence data bases (D3), FMR data, and proprietary loan

Given the stated goal of loan buyers, and in particular the servicer of Partially Assisted loans, to take steps to increase rents to market levels on foreclosed properties, it might have been expected that rent increases would have been higher for partially assisted and other non-performing loans (although only about a third of the loans sampled from other non-performing loan sales were foreclosed properties). Yet, rent increases were found to be no higher on average than for loans from the Performing loan sale. One explanation is that loan buyers have not yet had time to execute their strategy for increasing rents. The Partially Assisted servicer noted that the process of turning properties around could take as long as three years. During the first period, deferred maintenance is cured. During the second period occupancy is increased. Finally, after the property has been physically upgraded and full occupancy reached, rents will be increased to the market level. Given that many of these properties have been owned by the servicer for a year or less, it is perhaps not surprising that rents have not yet increased.

In fact, the finding that rents have tended to decline could be consistent with buyers being in the early stages of turning properties around where rents might decline while necessary repairs are undertaken and management attempts to reach full occupancy. However, the fact that Performing loans, where such work is not needed, have experienced very similar patterns of rent declines suggests that efforts to turn properties around are not likely to be the main reason for declining rents relative to market levels.

To understand better the potential determinants of the observed rent changes, the correlation of rent changes (relative to market changes) with several other variables was estimated.²⁸ As shown in Exhibit 2-9, there is a significant negative correlation between the ratio of rent level to FMR prior to sale and rent changes after sale for the partially assisted (-0.43) and other non-performing loans (-0.54), but not for performing loans (0.07). Thus, lower rent levels relative to market levels were associated with greater rent increases following sale. This finding is consistent with an interpretation that non-performing loans, particularly those that were foreclosed on, had depressed rent levels due to poor management. These properties have experienced greater than average rent increases as they return to more appropriate rent levels.

There was also found to be a significant negative correlation (-0.38) between vacancy rates prior to sale and changes in rents for loans in the Partially Assisted sale, while there is a smaller and non-significant correlation for performing loans (-0.16). Thus, for properties with lower vacancies prior to sale, rent increases since sale have been larger. This finding is consistent with the view that the buyer in the Partially Assisted sale will attempt to push rents up aggressively once occupancy has been increased. For properties where occupancy was already high, these increases have already become evident.

To evaluate whether rent increases have resulted from improvements in property conditions, the correlation between rent changes relative to market changes and the percent change in total operating expenses as a percent of the median IREM expenses for similar properties was estimated. For performing loans, a significant positive correlation (0.37) was found, while a smaller, non-significant correlation was evident for loans from the Partially Assisted sale (0.17). This finding suggests that increases in property maintenance and services may be associated with the observed rent increases.

For properties from the Partially Assisted sale, information was also available on the capital expenditures made since foreclosure to improve these properties. An examination of these data also reveals a similarly small correlation (0.11) between the level of expenditures per unit and the change in rent levels. Again, this lack of association may simply indicate that more time is needed to allow the property owner to realize intended rent increases.

Finally, to evaluate whether changes in rents were associated with particular locations, the correlations between rent changes relative to market changes and the income and racial composition of census tracts where the properties are located were estimated. Virtually no correlation was found between either income level (as measured by both tract income as a share of the area median and the tract poverty rate) or racial composition.

28 The simple correlations presented do not control for the interrelationship of property characteristics. A multivariate regression analysis, which would control for these interdependencies, was beyond the scope of this study.

Exhibit 2-9**Pearson Correlation of Difference in Annual Percent Change in Rent from Annual Percent Change in Area FMR with Selected Property Characteristics Prior to Sale (Significance Level in Parenthesis)**

Variable	All Sampled Loans	Partially Assisted Loans	Performing Loans	Other Non-Perf Loans
Property Characteristics				
Rent as Percent of FMR	-0.26 (0.02)	-0.43 (0.01)	0.07 (0.70)	-0.54 (0.03)
Vacancy Rate	-0.18 (0.09)	-0.38 (0.02)	-0.16 (0.37)	0.10 (0.72)
Change in IREM Expense Ratio	0.21 (0.06)	0.24 (0.17)	0.37 (0.04)	0.09 (0.74)
Tract Characteristics				
Income as % of Area Median	-0.04 (0.71)	-0.08 (0.64)	0.03 (0.87)	-0.11 (0.69)
Poverty Rate	-0.02 (0.815)	0.03 (0.88)	-0.11 (0.55)	0.05 (0.85)
Percent Minority	0.07 (0.56)	-0.02 (0.92)	0.00 (1.00)	0.30 (0.26)
No. Observations	85	36	33	16

Notes: "Income as Percent of Tract Median" based on Median Household income for tract and MSA. "Percent Minority" is percent of Population that is not White, Non-Hispanic. "Average Rent Level" is average gross potential rent per unit.

Sources: Tract Characteristics from U.S. Bureau of the Census, 1990 Census of Population and Housing, STC 3-C.
Property Characteristics from due diligence data base (D3 Data) compiled by HUD from various administrative data bases and records as part of loan sales process.
Loan status from proprietary data from loan buyers.

In sum, most sampled loans did not exhibit rent increases beyond the increases experienced in the market as a whole. In fact, a slight majority of loans have experienced rent increases that are less than the rate of increase in the FMR. Only 20 percent of sampled loans experienced annual rent increases that were more than 1 percent above the market rate, and only 10 percent had increases that were 2 percent above the market rate. While it was anticipated that loans in the Partially Assisted sale might have experienced sharper rent increases given the loan servicer's stated goal of aggressively pursuing a strategy of upgrading properties, there was no statistically significant difference in rent increase among loans from this sale compared to performing loans. Of course, it is possible that sharper rent increases may still occur in the future as the loan servicer continues to execute its strategy of upgrading these properties.

2.6 Changes in Property Conditions

Some of the properties in HUD's loan inventory may have been poorly maintained as a result of the properties' troubled financial circumstances or simply because of poor or corrupt management. One of the desired outcomes of the loan sales program was that as a result of more aggressive loan servicing or foreclosure, these physical deficiencies would be rectified. Two methods were used to evaluate the extent to which property conditions improved following the sale of loans by HUD. The first method was to explore in interviews with buyers the issue of property conditions upon acquisition of the loans and the steps taken to improve property conditions as needed. The second method was to gather data on property expenditures for maintenance and repair from loan buyers to see how the level of expenditures had changed from the period when the loan was owned by HUD. The findings from these two sources of information will be discussed in turn below.

Findings from Buyer Interviews

As has been described previously, buyers had much more knowledge of property conditions for those loans that were foreclosed on while they had less involvement with the operations of performing loans. Virtually all of the buyers indicated that based on inspections conducted as part of their due diligence process, properties whose loans were paid off or were performing tended to be in good condition. In fact, buyers indicated that in some cases the level of maintenance was actually excessive on these properties. For example, buyers reported that for loans that were operating under PWAs, which limited the financial return owners could achieve, it was not uncommon for owners to undertake unnecessary or overly costly maintenance and repair using firms that were also owned by the property owner.

In contrast, properties that were foreclosed on almost always required some level of investment to rectify deferred maintenance. In part, the need for improvements stemmed from owners cutting costs during the foreclosure process. But in many cases loan buyers reported that disinvestment in the properties had been occurring over the course of a number of years. As described above, buyers indicated that a number of property owners had been pursuing a strategy of draining cash from properties rather than maintaining the value of the property. Evidence of disinvestment in properties was mentioned as a factor in deciding whether to pursue foreclosure, as loan buyers would seek to protect the collateral underlying the loan.

In most cases, the level of investment required was not substantial, perhaps requiring a roof to be replaced or investments of several hundred dollars a unit to replace carpets or appliances. But virtually all of the buyers reported isolated cases where substantial investments of several thousand dollars per unit were needed, totaling from \$500,000 to \$3 million. Buyers indicated that the poor condition of the properties would have depressed rent levels and that a goal of making these investments was to improve the rents that could be charged. It was the buyers'

strong sense that the tenants of these properties were made better off by these investments as the quality of the development was improved while the general tenant profile did not change.

Analysis of Expenditures for Maintenance and Repairs

For the sampled properties, annual expenditures on maintenance and repair were collected to compare to the levels experienced while the loans were HUD-held.²⁹ However, it often proved difficult to obtain information that was comparable with the data submitted to HUD. The principal problem encountered was that in many cases payroll data was reported as a separate, aggregate category, while in HUD's reporting payroll associated with maintenance and repair are reported as part of this field. As a result of this and other problems, only 51 of the sampled loans provided data that was comparable to data available from HUD.

The data collected indicates that there was great variation in the degree of change in expenditures for maintenance and repair. Overall, the average annual increase was 2.4 percent. However, the range was from a low of -16.2 percent to a high of 23.7 percent, with a quarter of the loans experiencing declines of 3.7 percent annually or more and another quarter experiencing increases of 8.9 percent annually or more. Such large annual fluctuations in expenditure levels are to be expected as a result of such factors as non-recurring expenditures and fluctuations in weather related costs. When asked about the large variations observed, loan buyers suggested that such substantial changes were also consistent with the fact that in some cases expenditures had been heavily inflated, while in others a lack of maintenance was being rectified. Of course, in part this very broad range may also reflect errors in the data reported, either in the HUD data base or in that collected from loan buyers.

Interestingly, the average change in maintenance and repair expenditures for loans in the Partially Assisted sale was 7.0 percent, while for loans from the Performing sale the annual change averaged -1.0 percent (this difference is not statistically significant). As might be expected, the foreclosed loans tend to have much large increases in maintenance and repair expenditures than performing loans. But even for the performing loans, a broad range of changes was found, from a low of -15.1 percent annually to a high of 15.8 percent annually. Such a broad range among properties which did not experience any changes in ownership or management suggest that the fluctuations observed may largely be a function of normal yearly fluctuations in expenditures.

One other source of information on investment in property improvements comes from the Partially Assisted loans. The monthly reports submitted to HUD include all capital improvement expenditures made on foreclosed properties. This information indicates that the average property had nearly \$700 per unit invested in capital improvements since being acquired in foreclosure.

²⁹ It should be noted that the time period over which changes in expenditures are calculated varies by loan. Data available from HUD for the properties prior to the loan sale ranged from the immediately preceding calendar year to several years prior to sale. The data collected from buyers was from either 1997 or 1998. On average, the change in expenditures covered a period of three and a half years. In order to make changes in expenditures comparable for all loans, an annualized percent change was calculated.

The range of expenditures was from less than \$100 per unit for about a fifth of the properties, to in excess of \$1,000 per unit on a third of the properties. To date, the highest level of expenditures was nearly \$4,000 per unit, although the loan servicer reported plans for even greater investment in another property during the coming year.

While this servicer reported being very aggressive in pursuing property improvements as a means of maximizing property values, the range of expenditures was not dissimilar from the characterizations given by other buyers in their interviews. In sum, it seems safe to conclude that among foreclosed properties, a small share required minimal investments, many required moderate levels of investments, and relatively few required substantial amounts.

2.7 Changes in Property Management

It is believed that a large percentage of the loans that end up in HUD's inventory are there because of poor management. This poor management may be evident in a variety of ways, including poor property conditions, depressed rent and occupancy levels, and elevated expense levels. This section analyzes changes that have occurred in property expense levels since sale as an indication of the extent to which property management has been improved.

Findings from Buyer Interviews

Loan buyers indicated that in determining an appropriate value for the properties while preparing their bids, they undertook a financial analysis of the property, using as a starting point the information available in HUD's due diligence data base. Buyers generally commented that expenses were expected to be somewhat higher than average on HUD-insured properties (perhaps about 10 percent according to one source), reflecting in part the age and type of properties as well as the tenant profile. However, based on the loan buyers' often extensive experience in managing multifamily properties, it was sometimes evident from their analysis that property expenses were in excess of what would be expected even for these types of properties. To the extent that loans were performing or were able to meet an agreed upon payoff value, loan buyers did not attempt to rectify these inflated expenses themselves. Of course, in determining an acceptable payoff value for the loan, buyers would rely on their own estimate of reasonable property expenses.

In the case of foreclosed properties, all loan buyers reported bringing in new property management as soon as possible. Buyers generally had established relations with large property management firms around the country to provide these services. It was rare for loan buyers to retain the same property management even if the firm was not related to the previous owner. One buyer related that there was only a single instance where prior management was not changed, and in this case the manager was ultimately replaced when improvements in property operating conditions were not as significant as hoped.

Buyers universally indicated that for foreclosed properties it was not uncommon for previous management to have been corrupt, incompetent or both, so that property expenses were well above appropriate levels. In part, the inflation of expenses was related to paying above market prices to family members or family-owned businesses for property management services. In general, getting property expenses down was one of main goals of new property management. In terms of how expenses were inflated, the most often cited categories were maintenance and repair and management fees. As discussed in the previous section, changes in maintenance and repair expenditures showed a great deal of fluctuation following sale, with steep increases as common as steep declines. Changes in management fees will be discussed below.

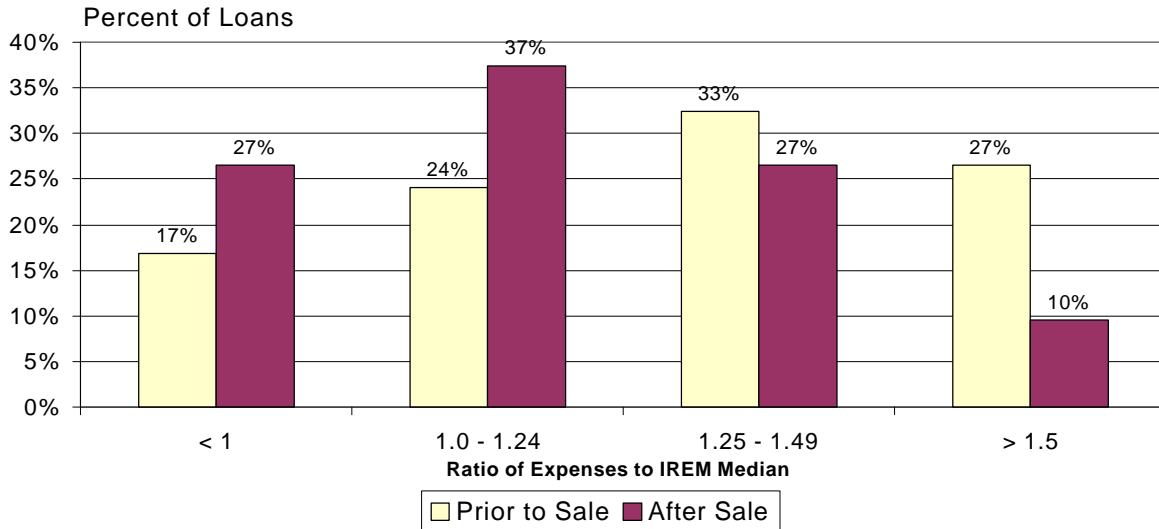
Analysis of Property Expenses

Exhibit 2-10 presents the distribution of total property expenses relative to industry medians both before and after sale for the 85 sampled properties. As shown, expenditures on these properties are generally high relative to the median expenditure reported to IREM. Prior to sale, the average property had expenses that were 37 percent above the IREM median. Only 17 percent of properties had expenses below the IREM median, while 26 percent had expense levels that were 50 percent or greater above this benchmark. This finding is in keeping with buyer contentions that expense levels exceeded industry standards, and in some cases the differences were substantial.

Following the loan sale, the average annual percent change in total expenditures was 0.6 percent annually.³⁰ In comparison, the IREM benchmarks grew at a 2.5 percent annual rate for the comparable period. Thus, expenditures declined in real terms following sale by nearly 2 percentage points a year. As can be seen in Exhibit 2-10, the result has been that the distribution of property expense levels has become closer to the industry standard, although they are still generally higher. The share of properties with expenses less than the IREM median has increased to 25 percent of properties, and nearly two-thirds of the properties having expenses less than 125 percent of this benchmark.

30 It should be noted that the time period over which changes in expenditures are calculated varies by loan. Data available from HUD for the properties prior to the loan sale ranged from the immediately preceding calendar year to several years prior to sale. The data collected from buyers was from either 1997 or 1998. On average, the change in expenditures covered a period of three and a half years. In order to make changes in expenditures comparable for all loans, an annualized percent change was calculated.

Exhibit 2-10
DISTRIBUTION OF PROPERTY EXPENSE LEVELS BEFORE AND AFTER LOAN SALE



Note: Property Expenses are total operating expenses per net square foot.

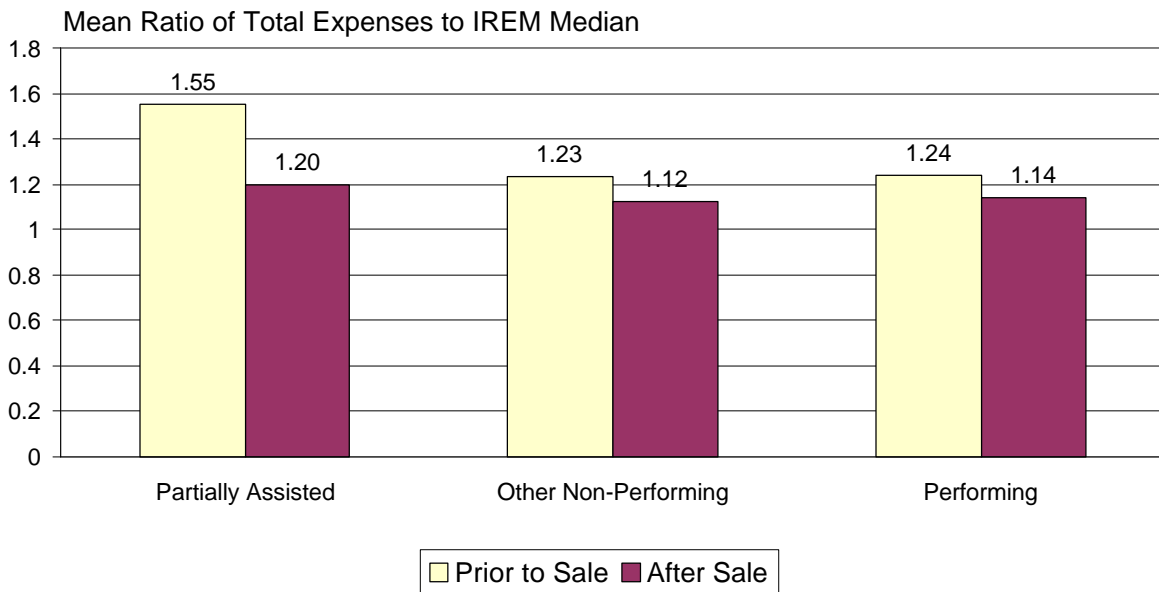
Sources: HUD Due Diligence data bases (D3), proprietary buyer data, and "Income/Expense Analysis: Conventional Apartments," IREM, various years .

There were some cases where expenditures increased over this period relative to the IREM benchmark. In 18 percent of the sampled loans the ratio of expenses to the IREM median rose. In 10 percent of cases, the increase was fairly substantial (10 percent of more). In part, these increases could represent cases where properties had not been well maintained and a higher level of expenditures was needed. But some of the instances of rising expenditures were among loans from the Performing loan sale. So these increases may well reflect normal year-to-year fluctuations in expenditures. Given the small share of loans experiencing increases in expenditures, it seems fair to conclude that in most cases expenses may have been unnecessarily high.

Exhibit 2-11 compares the average expense ratio before and after sale for the three loan sales categories in the sample studied. As shown, the highest level of expenditures prior to sale was among loans in the Partially Assisted sale. On average these loans had expenses that were more than 50 percent above the IREM median. In contrast, for other non-performing and the Performing loan sales, on average expenses were only about 20 percent above the IREM measure. (It is important to note that most of the loans sampled from other non-performing loan sales were performing loans, while all of the loans sampled from the Partially Assisted sale were foreclosed loans.) Following the loan sale all three categories of loans showed declines on average. But the declines among the Partially Assisted loans was much larger, dropping by 35 percentage points relative to the IREM standard, while for the other sales the decline was about 10 percentage points on average. Interestingly, following this decline the expense levels for the

Partially Assisted loans was generally in keeping with loans from the other sales. This finding corroborates the loan buyers' opinions that expenses on the HUD properties were generally inflated above market standards, with foreclosed properties often having greatly inflated expenses. It is somewhat puzzling why declines in expenses would be found among the performing loans as these properties had not experienced any change in management or ownership. Again, this change may reflect either normal yearly fluctuations or inaccuracies in the data.

Exhibit 2-11
CHANGE IN TOTAL EXPENSES BY LOAN SALE



Note: Property Expenses are total operating expenses per net square foot.

Sources: HUD Due Diligence data bases (D3), proprietary buyer data, and "Income/Expense Analysis: Conventional Apartments," IREM, various years .

One area of expenses where declines were most pronounced for the Partially Assisted loans was in management fees. Among these properties, the median change in management fees was a decline of 5.8 percent annually (while, in comparison, the median change in total expenditures was an increase of 2.5 percent annually). In comparison, among loans from the Performing loan sale, the median management fee increased by 2.3 percent annually, a rate that is in keeping with the change in rent levels for these properties.

In sum, an examination of financial data from sampled loans corroborates loan buyers' assertions that expenses are generally higher on these properties than for the industry as a whole. The findings also substantiate the buyers claims that among foreclosed properties expenses were particularly high. Since sale, expenses on foreclosed properties have declined sharply, so that at present expenses are not much different than found for loans from the Performing loan sale that

were sampled. Clearly, for foreclosed loans from the Partially Assisted sale the institution of new management has led to sharp reductions in expenses.

2.8 Summary of Findings

Asset Management Techniques of Loan Buyers

- Most of the surveyed loan buyers of non-performing loans indicated that their goal in purchasing these loans was to seek resolution of the loan over a relatively short period of time (two to three years) either by negotiating with the property owner to obtain a payoff of either the full or (in many cases) discounted debt, selling the loan, or foreclosing and ultimately selling the property.
- Relatively few instances were found where loan buyers had agreed to loan modifications, reflecting the strategy of most buyers to liquidate these assets rather than to hold a portfolio of loans.
- In contrast, the goal of the loan buyer in the Performing loan sale was to securitize and sell the loan portfolio. Most of the loans purchased by this buyer were, in fact, pooled, securitized and sold fairly quickly, with the buyer's servicer partner retaining the servicing rights.
- The approach to managing the non-performing loans was fairly similar across the buyers interviewed. The threat of foreclosure provided critical leverage for loan buyers to convince borrowers to make required payments or to negotiate with the buyers to reach a mutually agreeable payoff amount. If loans were not current in their payments, virtually all of the buyers indicated they would immediately begin foreclosure.
- Buyers reported having little leverage over property owners as long as owners were current in their payments. The ability of loan buyers to influence property management was thus completely dependent on whether the loans were performing or not.
- With respect to foreclosed properties, virtually all of the buyers described a strategy for managing these assets entailing first remedying any deferred maintenance, then increasing occupancy, and finally raising rents to the market level.
- Several buyers indicated that foreclosure was a more likely outcome compared to loans bought from the RTC because a higher price was paid for HUD loans. Having paid a higher price for the loans, the loan buyers had less room to offer property owners a discounted payoff and still realize a sufficient return on their investment. This observation

highlights the tradeoff for the government between receiving a higher return on loan sales and the likelihood of foreclosure of these loans.

Current Loan Disposition

- In total, the current disposition of 530 multifamily loans was obtained from buyers, representing about half of the multifamily loans sold, including 389 non-performing loans and 141 loans from the Performing sale.
- Buyers of loans from non-performing loan sales were found to have been successful in achieving their goal of fairly quickly liquidating these assets. Only a third of the loans are still owned and serviced by the original buyers, including 20 percent that are classified as performing and 13 percent that are classified as non-performing.
- Slightly less than another third of the loans have been foreclosed on, with the large majority of these still owned by the buyers.
- Loans sold in the Partially Assisted sale were somewhat more likely to have been foreclosed on than loans from other non-performing sales -- 37 percent compared to 27 percent. However, there is no significant difference between the characteristics of foreclosed loans from this sale compared to foreclosed loans from other sales.
- The remaining loans, representing slightly more than a third of the loans sampled, are no longer owned by the buyers, including 23 percent that have been prepaid and 13 percent that have been sold.
- In sharp contrast to the outcomes for non-performing loans, all of the loans from the Performing loan sale are currently either performing, have prepaid or were sold.

Factors Associated with Loan Disposition

- No statistically significant differences were found in loan characteristics by disposition (i.e., performing, non-performing, paid off, or foreclosed). The characteristics examined include variables related to the degree of financial distress (measured by the level of delinquencies), vacancy rates, the level of expenses relative to industry standards, and tenant characteristics (measured by the average rent level, and the income level and racial profile of the census tract where the property is located).
- This finding is consistent with the loan buyers' assessment that a diverse set of factors were associated with loan outcomes so that loans could not easily be categorized by their disposition.

- Buyers noted that there were factors other than current financial condition that played a role in determining a loan's outcome. Such issues as environmental liabilities, very high neighborhood crime rates, or excessive deferred maintenance might make the loan buyer less likely to pursue foreclosure and become the owner of the property, all else equal.
- Based on interviews with loans buyers and detailed financial data for a subsample of loans from the Partially Assisted and Performing loan sales, it seems that properties with poor physical conditions were more likely to end in foreclosure. But since the due diligence data did not include any measures of property conditions, the validity of this contention could not be evaluated statistically for all loans for which disposition data was obtained.

Likely Disposition of Loans if HUD Had Retained Ownership

- The largest difference between actual outcomes and those projected under HUD-ownership is with regard to the share of loans still in the loan portfolio. Under HUD ownership, 76 percent of the loans would still be in its portfolio. In comparison, only 38 percent of non-performing loans sold are still in the buyer's portfolio.
- The much quicker resolution of loans is in part due to a rate of foreclosure that has been twice the rate that would have been expected under continued HUD ownership (36 percent compared to 19 percent) and a payoff rate that is five times the HUD projected rate (26 percent compared to 5 percent).
- While the current rate of foreclosure is higher than would have been expected under HUD-ownership, it is not clear whether the ultimate foreclosure rate will be higher than the projected HUD foreclosure rate of 56 percent. Only if more than half of the remaining loans in the portfolio (most of which are currently performing) end in foreclosure will the overall foreclosure rate exceed the projected HUD rate.

Evaluation of Tenant Displacement

- The general reaction of buyers suggested that their experience with removing problem tenants from these properties was not out of the ordinary compared to their experience with other multifamily properties.
- A few buyers did share isolated instances where entire properties were vacated because of extremely poor physical conditions. However, such extreme cases of tenant displacement seem to have been limited to a few isolated cases.
- An analysis of data on rent levels before and after the loan sale for 85 sampled loans found that the majority did not exhibit rent increases beyond the increases experienced in

the market as a whole. In fact, a slight majority of loans have experienced rent increases that are less than the rate of increase in the FMR.

- Only 20 percent of sampled loans experienced annual rent increases that were more than 1 percent above the market rate, and only 10 percent had increases that were 2 percent above the market rate.
- The most significant finding regarding tenant displacement concerns the renewal of project-based assistance contracts for loans in the Partially Assisted sale. The servicer of these loans reported that their general intention was to not seek renewal of these contracts, noting that they had not yet had a case where they had sought renewal of these contracts.
- The servicer noted that affected tenants did, in fact, obtain vouchers from the local housing authority in compensation, but that these tenants were generally not likely to stay in their old apartments as rents would rise “significantly” above their previous levels. Thus, subsidized tenants may be likely to experience very high levels of displacement, at least those living in properties whose loans have been foreclosed on.

Changes in Property Conditions

- Virtually all of the buyers indicated that based on inspections conducted as part of their due diligence process, properties whose loans were paid off or were performing tended to be in good physical condition. In contrast, properties that were foreclosed on almost always required some level of investment to rectify deferred maintenance.
- In most cases, the level of investment required was not substantial, perhaps requiring a roof to be replaced or investments of several hundred dollars a unit to replace carpets or appliances. But virtually all of the buyers reported isolated cases where substantial investments of several thousand dollars per unit were needed, totaling from \$500,000 to \$3 million .

Changes in Property Management

- An examination of financial data from 85 sampled loans corroborates loan buyers’ assertions that expenses are generally higher on these properties than for the industry as a whole. Among the sampled loans, total expenses were found to be 37 percent above the industry median. Only 17 percent of properties had expenses below the median, while 26 percent had expense levels that were 50 percent or greater above this benchmark.
- Since the time of HUD ownership, the average annual percent change in total expenditures was 0.6 percent annually. In comparison, the industry median expenditures grew at a 2.5 percent annual rate for the comparable period (generally covering three to

four years). The result has been that the distribution of property expense levels has become closer to the industry standard, although they are still generally higher.

- The findings also substantiate loan buyer claims that among foreclosed properties expenses were particularly high compared to industry norms. Since the time of HUD ownership, expenses on these foreclosed properties have declined sharply. The expense category exhibiting the sharpest retreat among these loans has been management fees, which have declined at a 5.8 percent annual rate over the several year period covered by the collected data.

Chapter 3 - Single Family Loan Sales

3.0 Introduction

This chapter presents the study's findings with respect to the asset management strategies used and the outcomes realized by buyers of single family loans. As described more fully in Appendix A, the information was obtained from three loan buyers, representing small and large volume purchasers and three of the six sales. In addition to purchasers, HUD staff involved in monitoring post-sales loan servicing were also interviewed to profile the asset management techniques used by buyers. The sections of this chapter correspond to the research questions outlined in the introduction for single family loans. The final section presents a summary of findings regarding each of these questions.

3.1 Asset Management Techniques of Loan Buyers ³¹

This section describes the asset management strategies and techniques employed by the buyers of HUD loans. Of the three single family loan buyers that ultimately participated in the study, only two shared information on their approach to managing these loans. To supplement the information obtained from loan buyers, interviews with HUD staff involved in the monitoring of post-sale loan servicing were also conducted to obtain a profile of the servicing practices employed by loan buyers.³²

One firm that shared information on its approach to servicing the purchased loans bought a relatively small volume of loans. This purchaser indicated that their goal was to create a portfolio of performing loans that they would then continue to service. Upon purchase, they began negotiations with homeowners to modify the loan terms to enable the owner to meet their debt obligations. The servicer would request income information from the borrower to determine the borrower's ability to pay and to then determine how to modify the mortgage to set a realistic payment schedule. The preferred modification was to extend the term of the loan to make

31 It should be noted that loan buyers and loan servicers were not necessarily the same entity. In the single family sales, many buyers had their loans serviced by other firms. In order to protect the confidentiality of the loan buyers participating in this study, when referring to the firms contacted for this study the terms "buyer" and "servicer" will be used interchangeably.

32 The loan sale agreements required that purchasers of single family loans use a HUD-approved servicer and that the loans be serviced in accordance with HUD servicing requirements for loans in the assignment program. As part of the sale agreement, HUD also retained the right to review and audit the servicing of loans to ensure that the servicing requirements were being met (this right was implicit in the agreements for the first three sales, and made explicit in the agreements for the last two sales). Through these audits, HUD staff have obtained information about the practices employed by loan servicers. In addition, as part of the sale agreement, borrowers retained the right to free counseling and at the time of the second sale HUD established a 1-800 phone number for borrowers to call for information and assistance. Through this process, HUD staff have handled a large number of inquiries from homeowners and have served as a mediator between loan servicers and borrowers. From these contacts, HUD staff have learned a great deal about the servicing practices of loan buyers.

monthly payments affordable for the homeowner. However, to the extent that extending the loan term was not sufficient to create an affordable payment, they would also write off a portion of the outstanding debt or reduce the interest rate. The renegotiation of terms was completed with approximately 60 percent of the borrowers within three months, and with almost all of the remaining homeowners within six months. The portfolio manager estimated that 85 percent of the loans either became performing loans or prepaid, with the remaining 15 percent of loans either being foreclosed on or simply written off. Loans would be written off if it was financially not feasible to pursue foreclosure or loan modification given the level of debt, the value of the property and the income level of the homeowner.

The other buyer interviewed indicated that their goal in purchasing these loans was to create a portfolio of performing loans that could then be securitized. Upon purchase, the firm would contact borrowers to inquire about their interest in maintaining ownership of their homes (in some cases they were not). In cases where owners were motivated to stay in the home, the firm would gather financial information on the household to determine the appropriate course to pursue with them. Depending upon the specific circumstances, a variety of actions might be taken, including offering temporary forbearance, modifying loan terms (including write downs of the amount owed), or approving a short sale (where less than the total amount of indebtedness is accepted from proceeds from the sale of the home). The firm's goal was to obtain as high a return as possible given the household's resources. However, foreclosure was reported to be the least desirable option for the loan buyer given the time and expense entailed and given its goal of creating a pool of performing loans. Loan modifications, including reductions in the amount owed, would generally be offered in cases where homeowners were otherwise not motivated to retain ownership because the level of debt greatly exceeded the value of the home. More commonly, forbearance agreements would be offered to maintain the level of indebtedness while setting affordable payment levels given the household's current financial situation.

After a workable payment was established, if owners made several consecutive payments the loan buyer would then offer to put all past delinquencies into a non-interest bearing account. To the extent that the required monthly payment exceeded the amount required under the original loan terms, the payment in excess of the original loan's monthly payment was used to pay off these delinquencies. This approach greatly reduces the time needed to establish a payment history as a performing loan as delinquencies do not have to be paid down first. The loan buyer can thus move to securitize these loans much more quickly than if they had to wait for the borrower to pay off past delinquencies which may represent many months or years of missed payments. The loan buyer also noted that this approach greatly simplifies the servicing by not having to keep track of a potentially long series of missed payments. The benefit for the homeowner is that their loan is no longer recorded as being delinquent.

This firm created a special servicing group for the HUD loans, including a delinquency team and a forbearance renewal team. The delinquency team closely tracks the payment performance of the loans and follows up on any late payments. The buyer noted that because of the troubled

payment history of these loans, follow-up begins even before the industry-standard 15-day grace period has expired. An automated system is employed to aid the delinquency team in personally contacting the household by phone to inquire about any late payments.³³ The purpose of the forbearance renewal team is to renegotiate the forbearance agreements each year. Their goal is to increase payments as much as possible given the households' financial circumstances. Both the delinquency and forbearance teams are given financial incentives to achieve their goals of lowering delinquencies and increasing payments.

Discussions with HUD staff suggest that many of the buyers pursued similar strategies to those described by these two buyers. Forbearance agreements and loan modifications were commonly used so that homeowners could afford to make regular payments. The loan modifications reportedly included changes in the remaining term of the loan and reductions in the interest rate if the rate was above the current market rate. HUD staff also corroborated that there were instances where if the loan buyer determined that a homeowner could not afford to pay off the total accumulated indebtedness, they would write off a portion of the outstanding debt. The strategy of putting all delinquencies into a non-interest bearing note to accelerate the time needed to establish a record as a performing loan was also commonly used by loan buyers.

HUD staff noted some concern with the servicing approaches used. One concern was that not all loan modifications were favorable for homeowners. There were some instances in which borrowers were offered new loans at interest rates above their current rate. While a higher interest rate might be warranted given the historically poor performance of these loans, borrowers and their advocates were concerned that these higher rates would make it even less likely that they would be able to meet their payment obligations. Another concern regarding modification or refinancing of loans is that any rights the borrower might have to continued forbearance are terminated upon modification or refinance of the loan (excluding simply extending the loan term). As a result, beginning with the fourth sale, the loan sale agreements required servicers to notify mortgagors of this condition, specifically noting that the borrower will be forfeiting the right to reduced or suspended payments even if changes in the households' financial circumstances would have provided for such remedies under HUD's servicing requirements. In addition, servicers were required to obtain written acknowledgments from mortgagors that they had received the disclosures. Servicers were also required to provide mortgagors with a toll free number to obtain a list of HUD-approved housing counseling agencies that could assist them in considering proposed modifications. While HUD staff expressed concern about whether borrowers sufficiently understood the ramifications of loan modifications or refinancing, the HUD staff contacted were unaware of any borrower complaints concerning a loss of rights to forbearance that resulted from a loan modification or refinance.

33 The system used generates five phone calls simultaneously, with the computer delivering the first live answer to the customer service representative. If no answer is received or an answering machine responds, the number is logged to be followed at a later time. This process greatly increases the number of completed phone calls that can be made in a day. The buyer noted that this system was being used for all of their loan servicing, not just the loans purchased from HUD. While such aggressive servicing may enhance loan performance, in some cases borrowers have complained that servicers' actions have constituted harassment.

An obvious concern with the approach of increasing monthly payments to pay down past delinquencies is whether the increase in monthly payments are affordable for the borrower. Of course, in order to pay down accumulated delinquencies, an increase in payments will be required at some point. In general, complaints about increases in the required monthly payments were among the most common borrower inquiries received by HUD.³⁴

Under the terms of HUD's servicing requirements, loans in the first 36 months following assignment to HUD are eligible for reduced or suspended payments if the borrower is financially unable to pay the required monthly payment. Specifically, during this first 36 month period, servicers cannot set a mortgage payment that would cause total housing expenditures (including hazard insurance, utilities, property taxes and routine maintenance) to exceed 35 percent of net effective income.³⁵ If warranted, all mortgage payments may be suspended during this period. However, servicers may require a new forbearance agreement with higher payments if the borrowers' financial condition improves or is found to not have been accurately represented at the time the original forbearance agreement was established. During the post 36- month period, borrowers must pay at least the monthly payment called for under the original loan terms, but may be required to pay more if they are financially able to do so. In this period, required payments can exceed 35 percent of net effective income, but must be "affordable." In determining whether a payment level is affordable the servicer is to consider whether the household's net effective income is sufficient to meet the payment and any "essential" expenses related to the borrowers health, employment or transportation needs. In addition to the ability to increase monthly payments, during the post 36-month period, servicers also have the right to demand lump sum payments of arrearage to the extent that borrowers have the financial ability to make such a payment.

Within these guidelines, loan servicers have a certain amount of discretion to determine the level of payments that are "affordable" for the borrower. Based on interviews with HUD staff, loan buyers appear to have been fairly aggressive in pursuing increases in payments from borrowers. Some servicers were known for increasing payments sharply or pursuing payment of all arrearage as loans entered the 37th month of assignment and the forbearance period ended. Borrowers have reported to HUD situations where their payments have been increased by factors of 3 or more or where letters have been received demanding payment of all arrearage, totaling many thousands of dollars. In addition to demanding higher payments, buyers have described intensive servicing systems which place phone calls to borrowers to inquire about late payments even before the 15-day grace period has ended. In short, based both on the description of servicing practices described by buyers and complaints received by HUD, it seems clear that these firms

34 From December 1996 through July 1998 HUD logged nearly 4,000 inquiries from borrowers affected by the loan sales program. A review of HUD logs of borrower inquiries from this period suggests that about a third of borrower inquiries could be classified as complaints regarding the payments being required by the loan servicers, while approximately two-fifths of the calls could be classified as requests for information about the loan's disposition or the borrowers rights, with most of the remaining calls relating to discrepancies between the borrower and the servicer regarding the amount owed or the receipt of payments.

35 "Net effective income" is gross income less federal, state and local income, social security and other payroll taxes.

were much more aggressive than HUD in pursuing both regular and increased payments from borrowers which came as something of a shock to some borrowers.³⁶

It is important to note that HUD did take steps to ensure that servicers complied with the requirement that loans were serviced following the same guidelines as those used by HUD. For example, in following up on specific complaints from homeowners, HUD staff would contact servicers to determine whether the increase in payments being required was consistent with HUD servicing guidelines. To some extent the issues reflected situations where servicers were simply not following HUD's servicing requirements. But often the root of the controversy would lie in differences of opinion about what constituted expenses necessary for the household's health, employment or transportation. To the extent that there was a fairly consistent pattern of a servicer applying servicing guidelines in a way that did not appear to be consistent with HUD's requirements, HUD would use its right to conduct an audit of the servicer and to meet with senior representatives of the loan servicing firm to correct the firm's servicing practices. HUD staff report that servicers were generally responsive to these audits, with fewer complaints logged following these reviews.

3.2 Current Disposition of Loans

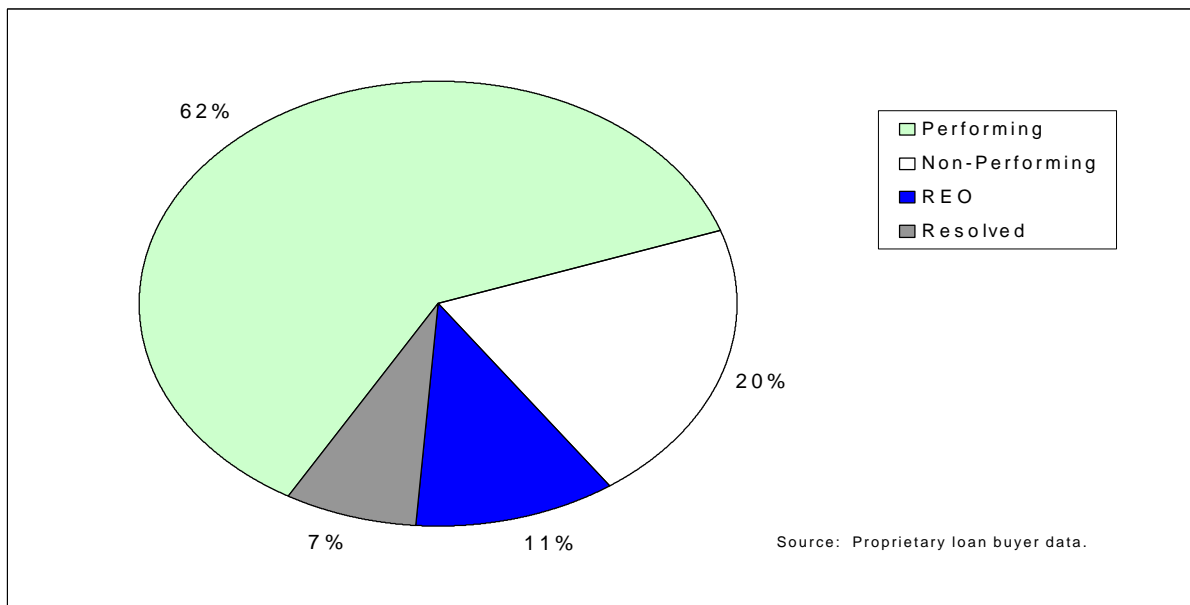
One of the basic questions to be addressed by this study is what became of the loans following their sale by HUD? The anticipated outcomes included buyers holding the loans either under the original or renegotiated terms, securitizing and selling loans to other investors (either as whole loans or as a securitized loan pool), or foreclosure. Information on loan disposition was obtained from two firms: one relatively large volume purchaser and one relatively small volume purchaser. The large volume purchaser provided detailed information on the current disposition of the portfolio it purchased in one auction. The small volume purchaser was cooperative, but because the loan portfolio had been sold more than a year ago, no detailed data was available on these loans. Thus, the information on the loans purchased by the small volume firm is based on the recollections of the portfolio manager regarding their experience with these loans. The third buyer interviewed for this study would not provide any information on the distribution of outcomes, although some indications of loan performance were provided. While the information collected (particularly from the large volume purchaser) provides the only quantifiable data

36 In one case, a servicer's treatment of borrowers has led to the institution of a class action lawsuit for allegedly violations of both the agreement with HUD regarding borrowers forbearance rights and the Fair Debt Collection Practices Act. (A discussion of the court order certifying the class is in *Housing and Development Reporter*, June 29, 1998, page 124-125.) The action which appears to have triggered the class action was the sending of foreclosure notices to 2,000 borrowers, apparently without regard to whether the borrowers were operating under an existing forbearance agreement or had an expired forbearance agreement but were current in their payments, requiring an automatic renewal of the forbearance agreement. It is not clear to what extent the practices of this servicer were more aggressive or egregious than other firms, or whether the affected homeowners were simply more enterprising in seeking legal protection. Interestingly, by no means did HUD receive a large volume of complaints about this servicer. In fact, HUD staff responding to consumer inquiries were generally unaware of the lawsuit.

available on the disposition of loans following their sale by FHA, it is important to note that it is not known how representative these findings are for other loan buyers or other auctions.

The disposition of loans purchased by the large volume firm is presented in Exhibit 3-1. A large majority of loans (81.9 percent) were still active, with most of these loans categorized as performing (61.5 percent).³⁷ Of the remaining loans, 10.9 percent had been foreclosed on, with most of these properties still in the possession of the firm (8.1 percent). Finally, 7.2 percent of the initial portfolio was categorized as “resolved” loans, indicating that the loan had been paid off.

Exhibit 3-1
SINGLE FAMILY LOAN DISPOSITION



As discussed above, the small volume purchaser indicated that their goal in purchasing these assets was to create a portfolio of performing loans by renegotiating loan terms to make the payments affordable for the homeowner. The portfolio manager estimated that this process resulted in 85 percent of the loans either becoming performing loans or being prepaid, with the remaining 15 percent of loans foreclosed on or written off. Their subsequent experience with the remaining loan portfolio was quite good, with very few defaults over the more than two years that they owned this portfolio. At that time the firm had restructured its business and was no longer

³⁷ Performing loans include those that are performing according to the terms of a forbearance agreement or bankruptcy ruling as well as current loans. No data was provided on the number of loans performing following modification of the loan’s terms. Non-performing loans include delinquent loans for which payment disputes are pending as well as those for which foreclosure is in progress but not complete.

seeking to obtain and service residential loans. When an offer was received to sell the portfolio, the firm securitized the pool and sold it.

While it is not clear how reliable the estimates of loan performance are for the small volume purchaser given that they are based on the portfolio manager's generalized recollection, it is interesting that the foreclosure rate is comparable to that reported by the large buyer. The primary difference between the two experiences is that the small buyer reported very few defaults, while the large buyer reported that 20 percent of its portfolio was non-performing. The other buyer interviewed (who did not provide data on loan disposition) indicated that it was not uncommon for loans to be several months in arrears. The much better performance of the small volume buyer's loans may reflect the fact that this buyer had greater flexibility to renegotiate loan terms as a result of having paid much less for the loans it purchased. However, it should be noted that even a 20% non-performing rate is substantial improvement over HUD's experience, as will be discussed in the next section.

In addition to the issue of whether loans are currently performing, another question of interest is whether the loans have been pooled and securitized. The small buyer reported that it did, in fact, securitize and sell its portfolio. The third buyer contacted noted that its goal was to securitize the loans, and they noted that they had been fairly successful in achieving this goal. HUD staff report that securitization appears to have been a common goal of other loan buyers as well. This strategy is evident in the actions taken by buyers to modify loan terms and restructure delinquencies in order to establish a performing payment history as quickly as possible. Once such a payment history has been established, the loans would be suitable for pooling and sale. HUD staff obtained indirect evidence that other buyers were also successful in implementing this strategy. While attempting to identify the current servicer of individual loans, HUD would sometimes learn that the loan had been transferred to another servicer as part of a sale of a loan pool.

3.3 Likely Disposition of Loans if HUD had Retained Ownership

To evaluate how the sale of loans affected ultimate loan disposition, the information on current loan disposition will be compared to the disposition that would have been expected if HUD had continued to own these loans. Historically, the portfolio of loans that have been assigned to HUD have not performed well. An analysis of the performance of loans in the assignment program over the period from 1984 to 1993 indicated that nearly 40% of these loans were ultimately foreclosed.³⁸ In addition, further analysis by HUD suggests that the changing nature of the

38 Robert F. Cotterman, *Examination of FHA's Single Family Assignment Program: Data Base Development and Statistical Analysis* (Santa Monica, CA: Unicon Research Corporation, May 31, 1996).

portfolio of assigned loans since 1990 would lead to foreclosure rates of 50 percent or higher.³⁹ In fact, the specific loan performance estimates developed by HUD for estimating the credit subsidy associated with the loan sales calls for an ultimate foreclosure rate of 64 percent for these loans.⁴⁰

In order to evaluate how the loans for which information on current disposition was obtained from the large volume loan purchaser would have performed if they had been retained by HUD, we have made use of HUD's estimates of loan performance underlying the projections of what the value to HUD would have been of retaining these loans. These estimates of loan performance are based on a combination of a long-run analysis of loan cohorts beginning in 1984, as well as more recent cross-sectional analysis of portfolio performance from the early to mid-1990s. The model used by HUD to project loan performance uses annual rates of default, foreclosure and prepayment for loans by the number of years that have passed since the loans entered HUD's assignment program (in addition to information about payment and recovery rates as well). Using the average number of months that the sampled loans had been in the assignment program at the time of sale and the amount of time that had passed since the sale at the time that the loan disposition was reported, these annual rates can be used to project what share of the sold portfolio would be performing, non-performing, foreclosed properties, or paid off.⁴¹

Exhibit 3-2 compares the actual performance of the sampled loans to the projected share of loans that would be in each category if HUD had retained these loans. The largest difference in experience is with regard to the share of loans that are performing. Based on HUD's experience, slightly more than half of the loans would not be performing. In contrast, only 20 percent of the sampled loans were not performing.

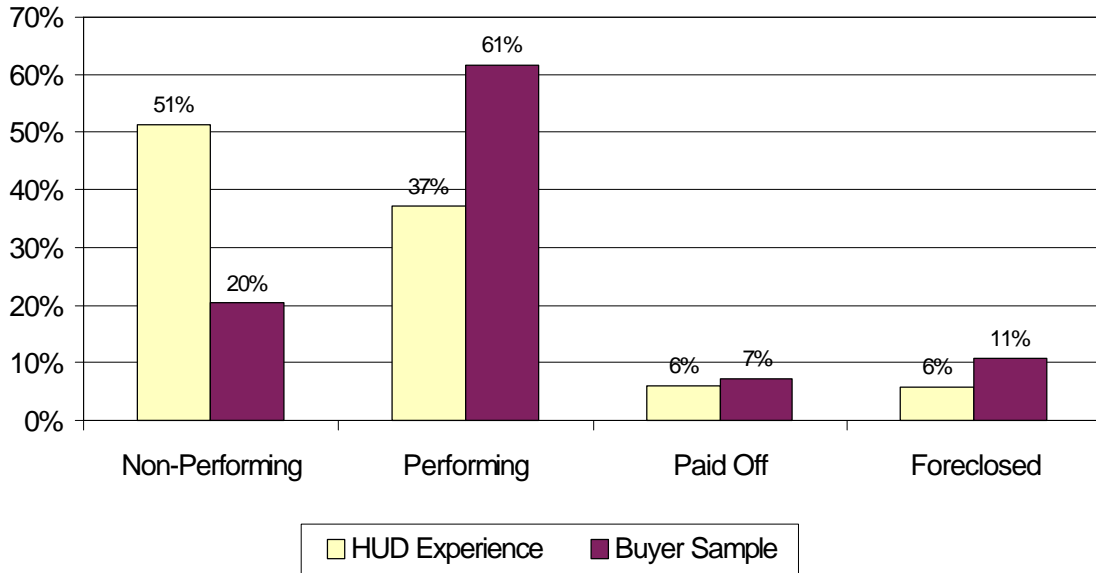
A large share of the decline in non-performing loans is accounted for by a much higher share of performing loans. In HUD's experience, 37 percent of the sold loans would be characterized as performing at this point in time. But among the sampled loans the performing rate was nearly 25 percentage points higher. In part, this difference may reflect the approaches used by servicers to speed up the rate at which the loan become performing, such as by creating another note with past arrearage or by modifying or refinancing the note to quickly cure the default. Still, once these changes are made borrowers must meet the new payments to remain current. This comparison suggests that loan servicers have been quite successful at creating a portfolio of performing loans.

39 Charles A. Capone, Jr., *Single Family Mortgage Assignment: Historical Experience and Future Directions for Borrower Relief Efforts* (Washington, DC: U.S. Department of Housing and Urban Development, Office of Policy Development and Research, September 1995).

40 Charles A. Capone, Jr., *Credit Scoring Parameter Development* (Washington, DC: U.S. Department of Housing and Urban Development, Office of Policy Development and Research, February, 1996).

41 Ideally we would like to have information on the distribution of loans sold by the number of years they had been in HUD's portfolio as this would allow for a more precise projection of future loan performance given the different paths followed over time by different age cohorts. Absent such data we have had to make use of the overall portfolio average.

Exhibit 3-2
COMPARISON OF SAMPLED LOAN DISPOSITION
WITH PROJECTED DISPOSITION UNDER HUD OWNERSHIP



Sources: Proprietary loan buyer data and estimates based on analysis of historical HUD loan performance in "Credit Scoring Parameter Development," Charles A. Capone, Jr., HUD, February 1996.

The remaining decline in the rate of non-performing loans is accounted for by higher rates of foreclosure and, to a lesser extent, payoff. The sampled foreclosure rate of 11% is nearly twice as high as the rate that would have been expected based on HUD's experience. However, it should be noted that HUD's foreclosure rate would be expected to rise rapidly in the next few years, reaching nearly a third of the portfolio in another three years and half of the portfolio by the end of five years. As future foreclosures are a function of current non-performing loans, the much higher share of performing loans among the sampled portfolio may bode well for future foreclosure rates that are lower than HUD has experienced. In part, the higher current rate of foreclosure may be interpreted as servicers achieving a quicker resolution of loans that ultimately would have ended in foreclosure if owned by HUD.

3.4 Summary of Findings

Asset Management Techniques of Loan Buyers

- The goal of loan buyers generally appears to have been to create a portfolio of performing loans, often with the intention of securitizing these loans. To accomplish this goal, loan buyers generally tailored an approach to each homeowner's circumstances that would establish an affordable level of payments while preserving as much of the existing debt as possible.
- In most cases borrowers are offered forbearance agreements, but in some cases new loan agreements were established which may include extensions of the loan term, changes in the interest rate, or even reductions in the total level of indebtedness.
- One apparently common approach among loan buyers to quickly establish a record as a performing loan, was to place all past-due payments and other charges into a separate non-interest bearing account. Through this arrangement, the loans were immediately brought current, while the loan buyer still maintained the total level of indebtedness.
- Through these methods loan buyers appear to have been fairly successful in quickly establishing a portfolio of performing loans and securitizing these pools.
- The loan buyers interviewed for this study indicated that foreclosure was the least preferred option given the time and expense of this process. However, some level of foreclosures were reported to be inevitable as owners were found to be not interested in retaining ownership of the homes.

Current Loan Disposition

- Based on data provided by one loan buyer, less than two years after purchase 82 percent of the portfolio was still owned, including 62 percent characterized as performing and 20 percent characterized as non-performing.
- The 18 percent of loans that were no longer owned consist of 11 percent that had been foreclosed on and 7 percent that had been paid off.

Likely Disposition if HUD Had Retained Loans

- Based on the historical performance of HUD-owned loans, it is estimated that 51 percent of the loans would be non-performing and 37 percent would be performing under HUD ownership. In contrast, the sampled loan buyer reported that only 20 percent of purchased loans were non-performing and 62 percent were performing. In sum, loan

buyers have been fairly successful in developing a portfolio of performing loans and achieving a faster disposition of other loans.

- The share of loans that are no longer owned by the loan buyer is somewhat higher than would have been expected under HUD ownership. Under HUD, only 12 percent of loans would have been resolved, whereas under the loan buyer 18 percent are no longer owned.
- This higher resolution rate is due to both a higher foreclosure rate (11 percent versus 6 percent expected under HUD) and a higher payoff rate (7 percent compared to 6 percent under HUD).
- While the foreclosure rate is currently higher than projected under HUD ownership, it seems quite likely that the ultimate foreclosure rate will be much lower. HUD's foreclosure rate would be expected to rise rapidly in the next few years, reaching nearly a third of the portfolio in another three years and half of the portfolio by the end of five years. With much lower share of loans currently non-performing than under HUD, future foreclosure rates may be much lower than HUD has experienced.

Appendix A

Sampling Approach and Results

Appendix A - Sampling Approach and Results

This appendix will describe the sampling approach used to select buyers for inclusion in the study and then to sample loans for the collection of detailed data from these buyers.

A.1 Sampling of Multifamily Loan Buyers

Among the seven multifamily loan sales there were approximately 55 loan buyers, of which 10 purchased 10 or more loans.¹ Of the remaining 45 loan buyers, 32 purchased a single loan. The initial sampling plan called for obtaining information from 6 large volume purchasers of multifamily loans and 2 purchasers of a small volume of loans (defined as fewer than 10 loans). All 6 of the large volume purchasers contacted agreed to participate, although to varying degrees. Four buyers cooperated fully, agreeing to be interviewed, providing loan-by-loan status information, and providing detailed financial information on a sample of loans. One buyer agreed only to provide aggregate data on purchased loans and would not agree to be interviewed. The last large volume purchaser agreed to be interviewed, but declined to provide any data on the status of loans purchased or financial data for a sample of purchased loans. Several of the large volume buyers required confidentiality agreements that limit the ways in which the information and data can be reported and prohibits providing access to this information by any other entity (including HUD).

Of the 2 small volume purchasers selected for participation, one bought a single loan and another bought five loans. Most of the small volume purchasers bought only a single loan and were reported to largely represent property owners who purchased their own loan. The purchaser of a single loan contacted was found, in fact, to be the owner of the property affected. After purchasing the loan, the property was reportedly sold. Aside from a brief interview the owner refused to provide any additional information. The other small volume purchaser refused to participate in the study at all and would not answer any questions regarding their experience. In declining to participate, this firm noted that the information was confidential, that they saw no possible benefit to themselves from participating, and that they did not wish to divert their staff effort to participate in this study. It was decided to substitute another large volume purchaser for this buyer to obtain information on a larger volume of loans. The substitute buyer was reluctant to participate in the study, but ultimately did provide an interview by telephone although they would not provide any detailed data on the loans purchased.

¹ The number of loan buyers is approximate because in some cases special partnerships or corporations were established to purchase the loans on behalf of a parent organization. As a result, it is not always possible to identify the firm purchasing the loans.

A.2 Sampling of Multifamily Loans for Collection of Detailed Data

With regard to the sampling of loans for collection of detailed financial data, the intention was to identify the status of loans purchased and to then to draw a random sample of up to twenty loans in proportion to the prevalence of the outcomes found. The loans potentially chosen for sampling included only those loans for which data was available from HUD for the period prior to sale. A maximum sample size of twenty was chosen in order to limit the amount of time and effort required of buyers. One impediment to implementing this approach was the availability of information for different outcomes. In particular, there was generally no information on loans that were paid off as these loans were not owned long enough by the buyers to have obtained recent financial information. Thus, sampled loans generally were either those that were still owned by the firm or were foreclosed on.

Of the four buyers that provided detailed data, one provided data on twenty loans. However, of these, only 14 included data that was either recent enough or complete enough to provide a basis for comparison with conditions prior to sale. Another buyer provided data on eleven loans (reflecting the number of loans managed out of the headquarters office), but of these only two had data that was either recent enough or complete enough to provide a basis for comparison with conditions prior to sale. In order to compensate for the small number of loans obtained from these buyers, a much larger sample of loans was obtained from two other buyers than was anticipated. One buyer generously allowed access to all loans for which recent financial data was available. The other buyer was involved in the Partially Assisted loan sale, in which HUD retained an ownership interest in the loans. This sale was also structured differently than the other sales, with the entire pool of loans sold rather than selling individual loans. As a result, detailed financial information was available through HUD for all loans that had been foreclosed on. All of these loans were included in the analysis. In all, detailed data was collected on 85 loans, largely representing performing loans from the Performing loan sale, and foreclosed loans from the Partially Assisted sale.

A.3 Single Family Loan Buyers

Among the 6 single family loan sales, there were approximately 9 loan buyers, including 4 who purchased 10,000 loans or more. In many, but not all cases, a firm other than the buyer serviced the loans. The research design called for selecting two single family loan buyers to participate in the study. The initial candidates were selected to provide information on a large volume of loans from two different sales that had taken place more than a year ago to allow for sufficient time to have passed since sale to have achieved some resolution. Of these two buyers, one refused to participate at all, while the other buyer agreed only to provide aggregate data on the current status of loans sold (refusing to be interviewed or to provide loan-by-loan status information). To replace the buyer that refused to participate, another buyer was chosen to

provide information on loans purchased from the same sale. This buyer agreed to participate, but as all the loans had been sold the buyer could not provide any data on the outcomes realized. A third buyer was then contacted to supplement the information obtained from the first two buyers. This buyer agreed to be interviewed regarding asset management techniques but would not provide any data on loan status or even provide an estimate of the share of loans falling into different outcome categories.

Appendix B

Impact of the Loan Sales Program on HUD Staffing

Appendix B - Impact of the Loan Sales Program on HUD Staffing

B.1 Overview

An important goal of the loan sales program was to reduce staff resources devoted to managing HUD-owned loans, freeing staff to focus more attention on managing the insured portfolio. As presented in the introduction to this report, the loan sales program has been associated with a significant reduction in the number of loans held by HUD. Since 1994, when the loan sales program began, the multifamily portfolio has been cut by more than half and the single family portfolio has been cut to a tenth of its peak level.

Initially, this study intended to examine the impact of the loan sales program on HUD staffing for both asset management and any other aspects of FHA's operations affected by the loan sales program. Ideally, the first step in this analysis would have been to determine the extent to which the loan sales program reduced the number of staff needed for loan management. Then, to the extent that there were reductions in the staff devoted to these functions, we would identify how these staff were redeployed. Interviews with HUD field staff were to have been conducted to evaluate how the reduction in the loan portfolio and any resulting staff reassignments changed the staff's capacity to handle their asset management responsibilities. Similarly, any aspects of FHA's operations which received additional staff was to have been investigated to evaluate any changes in the staff's capacity to meet its responsibilities. Finally, to the extent possible, the financial value to HUD from any reduction in staffing needed for asset management was to have been estimated.

However, after interviewing HUD headquarters staff it became clear that given the substantial and simultaneous reorganization of HUD's operations and the significant staff reductions associated with HUD's 2020 Management Reform, it would be virtually impossible to isolate changes in HUD staffing levels and operations associated with the loan sales program from the other enormous changes that the Department has undertaken. These changes were perhaps most significant on the single family side where the elimination of the assignment of non-performing loans to HUD was another significant policy change that affected the size of HUD's loan portfolio.

Among the significant operational changes at HUD is a substantial reorganization of field office operations. On the single family side, field operations are being consolidated from 81 separate Field Offices to 4 Homeownership Centers. On the multifamily side, Field Offices are being reorganized into 18 Program Hubs and 33 Program Centers, with new national Assessment and Enforcement Centers being created to centralize certain aspects of the asset management functions. The restructuring of the field office operations was already well underway in many

cases as our study began. As a result, the investigation of how the reduction of HUD's loan portfolio affected field office operations was essentially moot.

Of course, while it may not be possible to isolate the effect of the loan sales program on staffing levels or operations, it might still be possible to evaluate how the staffing for asset management has changed over time as a result of all of the changes at HUD. On the single family side, such an analysis is essentially not needed since HUD's loan portfolio has been so drastically reduced that most of the HUD staff positions devoted to these functions have been eliminated. For multifamily operations the most important measure for this analysis would be the ratio of assets managed to staff. Unfortunately, data on asset management staff levels over time were unavailable to conduct such an analysis.

This Appendix will summarize the information gathered on the organizational changes that HUD has implemented over the last few years which impede an analysis of the impact of the loan sales program on HUD staffing. The first section identifies the individuals interviewed in HUD headquarters to understand changes in FHA's operations and staffing over the period since the loans sales program began. The next two sections then briefly discuss the most significant changes in HUD's single family and multifamily operations respectively. The final section presents available data on trends in HUD's Office of Housing staff levels over time.

B.2 HUD Headquarter Staff Interviewed

With regard to the evaluation of how HUD staffing has been affected by the asset sales program, we conducted interviews with HUD headquarters staff in the Office of Housing to learn about the changes in operations that have taken place since the loan sales effort began. Exhibit B-1 lists the individuals (and their departments) with whom interviews were conducted. The original research design indicated that HUD field office staff might also be interviewed to evaluate the impact of the program on field office operations. However, interviews with headquarters staff revealed that the extensive reorganization of field office operations that has occurred over the last few years (and is continuing to occur) rendered such an analysis infeasible. As a result, field office staff were generally not interviewed (with the exception of staff involved in post-sales homeowner complaints related to the single family loan sales).

Exhibit B-1
HUD HEADQUARTERS STAFF INTERVIEWED

Office	Name
Office of Housing - Federal Housing Administration	
Assistant Secretary for Housing-FHA Commissioner	
Office of the Housing-FHA Comptroller	Kathryn M. Rock Gerald H. Salzman James Beale
Office of Accounting and Analysis	Russell Greata
Office of Housing Budget	Linda S. White
Office of Financial Services	
Single Family Post Insurance Division	James Curry Jackie Dinker
Multifamily Financial Operations Division	Samuel N. Conner Paul McDowell
Deputy Assistant Secretary for Multifamily Housing Programs	
Office of Portfolio Management	Frank Malone
Program Support Division	Marc Harris Ivery Himes Susan Sacco
Deputy Assistant Secretary of Single Family Housing	
Office of Insured Single Family Housing	Kathleen Malone
Servicing Division	Joseph McCloskey Charlene Weaver
Office of General Counsel	
Office of Insured Housing	
Multifamily Mortgage Division	Millicent Potts Greg Bolton Anthony Ruvolo
Single Family Mortgage Division	Mary Roma Jeff Swartzbaugh

B.3 Single Family Operational and Organizational Changes

Elimination of the Assignment Program

In addition to the loan sales program, another significant policy change which served to reduce the portfolio of single family loans held by HUD was the elimination of the assignment program. Up until early 1996, before a servicer of an FHA-insured single family loan could initiate foreclosure, a borrower was given the opportunity to petition HUD to take assignment of the loan and provide forbearance to the borrower. If accepted for assignment, HUD would pay the lender a full insurance claim and take possession of the loan. Among other factors, loans for

which assignment was requested were evaluated to determine whether the borrower was likely to successfully reinstate in the next three years.

During the first half of the 1990s the number of loans accepted for assignment rose from about 10,000 loans or less per year to more than 15,000 loans per year.¹ With the elimination of the assignment program in April 1996 the flow of new loans into HUD's portfolio slowed to a trickle (borrowers that had applied for assignment prior to the elimination of the program could continue to be assigned to HUD so the flow of new loans did not end abruptly with the end of the program). If the assignment program had not been eliminated and the flow of loans to HUD had remained the same, perhaps upwards of an additional 30,000 loans would be in HUD's portfolio at present. Thus, declines in staffing needed to manage the single family loan portfolio are due both to the loan sales program and the elimination of the assignment program.

Of course, another important implication of the elimination of the assignment program is that the number of properties from defaulted loans that HUD now receives has increased substantially. So while staff needed for loan management has declined, the need for staff to manage property disposition has increased. However, HUD hopes to privatize the property disposition function in the near future largely to eliminate the need for HUD staff for this purpose.

Changes in Insurance Operations

The stated goal of the loan sales program was to allow HUD to shift staff resources from managing HUD-held loans to managing the insured portfolio. Thus, an evaluation of whether the loan sales program achieved this goal would require an evaluation of the extent to which staff were freed up to handle insurance endorsement, processing and claims. However, in recent years FHA has greatly modified its loan processing operations which has lowered the level of FHA staff needed to handle these functions. Most notably, FHA has introduced "FHA Connection," an Internet-based system which provides lenders with direct access to HUD's processing systems and data bases to handle insurance endorsement and loan queries which previously had been done by HUD's field office staff. In essence, the introduction of this system is part of a process of changing the nature of FHA's operations from a retail to a wholesale approach. Interviews with Office of Housing staff overseeing field office operations noted that these changes in the single family insurance operations of FHA are being counted on to enable HUD to reduce staff devoted to insurance endorsement related tasks from about 2,300 at their peak to less than 800.

Field Office Organization

1 Charles A. Capone, Jr., *Providing Alternatives to Foreclosure: A Report to Congress* (Washington, DC: U.S. Department of Housing and Urban Development, Office of Policy Development and Research, March 1996).

As mentioned above, the single family field operations are in the process of being reorganized from 81 separate Field Offices to 4 Homeownership Centers.² This consolidation is modeled in part after Fannie Mae’s field office organization, which manages its national operations out of four regional offices.³ Previously, each of the 81 Field Offices included staff to handle the three main divisions of FHA’s operations: insurance endorsement, asset (loan) management, and property disposition. Under the new arrangement, each of the 4 Homeownership Centers will be devoted to marketing and outreach, insurance processing and underwriting, quality assurance, and property disposition. Because of the great reduction in the loan inventory and the goal of ultimately eliminating this aspect of HUD’s operations, only the Denver center will be responsible for loan servicing and loss mitigation out of a satellite Oklahoma City office.

B.4 Multifamily Operational and Organizational Changes

Changes in Insurance Operations

HUD has undertaken a variety of changes in its operations with the goal of reducing the cost and processing time (and hence staff time) needed for handling insurance applications. A fast-track process has been implemented which allows field offices to tailor application processing to local needs (including waiving certain requirements) and requires lenders to order and pay for appraisals and inspections. A GAO study noted that anecdotal responses from HUD field office staff found some substantial reductions in staff time needed for loan processing as a result of these changes.³

Field Office Reorganization

While significant, the reorganization of multifamily field office operations, has been somewhat less dramatic than for single family operations. Previously there were 53 field offices which included staff for each of the three main FHA functions (loan processing, servicing, and property disposition). The new organization of 18 Hubs and 33 Program Centers does not eliminate any field offices. Rather it mainly consolidates the management of field office operations.

However, there are several aspects of field office operations that will be centralized. First, information collected by the Hubs and Program Centers on the financial and physical condition of insured properties will be sent to a single Assessment Center for evaluation. The Assessment Center will establish a consistent methodology for assessing this information to determine if problems in property management are evident which warrant further investigation or action by HUD. To the extent that the Assessment Center determines that property owners are failing to

2 These Homeownership Centers are located in Denver, Philadelphia, Atlanta and San Antonio.

3 *HUD Management: Information on HUD’s 2020 Management Reform Plan*, (Washington, DC: U.S. General Accounting Office (GAO/RCED-98-86), March 1998.

maintain their properties or are engaged in financial improprieties, the case will be referred to the new Enforcement Center. The Enforcement Center will work with the Department of Justice and other law enforcement agencies to take action against these owners. In addition to these two Centers, the property disposition responsibilities are also to be consolidated in two offices serving two halves of the country. In sum, while the number of field offices with multifamily operations will not change, many of the functions previously handled in individual field offices will be centralized in the Assessment and Enforcement Centers and the two property disposition centers.

B.5 Trends in Office of Housing Staff Levels

Ideally, we would have liked to obtain information on the Office of Housing⁴ staff levels for loan management functions at the field office level, particularly for multifamily housing. This data could then have been compared to changes in the number of loans managed by each field office (which was obtained from the Office of Multifamily Housing) to estimate changes in the ratio of loans managed to staff. Staff from the Office of Housing's Office of Budget and Field Resources provided assistance in gathering data on HUD staff levels over time. In order to obtain the requested information we were told that it would be necessary to review budget reports for each field office to extract information on field office staffing levels. An additional complication in obtaining this information is that field offices are not identically organized. In particular, in some cases loan servicing and property disposition are reported as a single staff total. Thus, for some field offices it would be necessary to develop a methodology for disaggregating these staff levels into a separate loan management staff estimate. The Office of Housing staff responding to our request for staffing data did not have staff available for compiling this information. As a result, we were only able to obtain some total measures of staff levels over time for the Office of Housing.

Information on staff levels associated with loan management were not available, although data on "Asset Management," including both loan management and property disposition, was provided. For single family operations, a concern with this aggregation is that with the termination of the assignment program, property disposition activities will be increasing. Thus, including property disposition may mask any declines in loan management staff. Another significant failing of this information is that it is not available for field offices in either 1996 or 1997. Since a large majority of the asset management staff is in field offices, this lack of data makes it essentially impossible to evaluate how the overall levels of staffing for asset management have changed over time.

There are two indications, however, of what the magnitude of the declines in asset management staff may have been. First, the overall decline in field office staff over this period, and second,

4 While the loan sales program relates to FHA operations, budgetary information is apparently generally only available for the Office of Housing, which encompasses FHA and project-based assistance functions.

the decline in asset management staff in headquarters. Information from 1994 indicates that about two-thirds of both single family and multifamily field office staff were involved in asset management, so the overall trend in field office staffing may be indicative of the magnitude of change in asset management staffing. Changes in headquarter staff devoted specifically to asset management provide another indication of changes in asset management staffing. But since the headquarter's staff represents a small share of total asset management employment and changes in HUD's management structure generally may result in divergent trends between headquarters and the field staffing levels, it is not clear how accurate an estimate this measure provides. Absent other data, however, this information will be discussed.

Exhibit B-2 summarizes the relevant information obtained. Between 1994 and 1997 the Office of Housing staff declined by a total of 19%, reflecting the significant downsizing of HUD's staff. In comparison, single family field office staff experienced somewhat greater declines over this period (-21%), while multifamily field office staff declined much less (-8%). The relatively greater declines in single family staff is in keeping given the relatively more significant changes in its operations generally and much greater decline in the loan portfolio, in particular.

With regard to asset management, headquarters staff devoted to single family asset management declined by 27% between 1994 and 1997, a somewhat greater decline than overall single family operations. This large decline in asset management might be expected given the sharp reduction in the size of the HUD-held loan portfolio. For example, in interviews with Office of Housing staff in the Single Family Post-Insurance division, it was noted that the Notes Branch of this division, which employed about 100 staff at its peak, was eliminated following Single Family Loan Sale #5. Of course, as mentioned, these declines in loan management would then be offset by greater number of staff needed for property disposition.

For multifamily housing, the declines in headquarters staff devoted to asset management was 15% between 1994 and 1997, compared to a 16% decline for all multifamily staff. The relatively small difference in declines for asset management staff from the total multifamily staff is consistent with the fact that the multifamily portfolio, while reduced by about half, remains fairly large. In addition, the magnitude of field office changes has been smaller. As a result, there may have been much less reduction in the scope of responsibilities for asset management at the headquarters level. In keeping with comments made by HUD staff interviewed, for multifamily operations, the most significant impact of the loan sales program was most likely a reduction in the ratio of loans to staff to a more manageable level rather than a reduction in the level of staff needed.

Exhibit B-2
TRENDS IN OFFICE OF HOUSING STAFF LEVELS: 1994-97
(STAFF LEVELS IN FTES)

	1994	1997	Percent Change
Office of Housing	6,001.0	4,831.3	-19%
Headquarters	957.0	822.2	-14%
Single Family	449.0	356.3	-21%
Asset Management	292.0	212.3	-27%
Multifamily	249.0	208.4	-16%
Asset Management	173.0	146.6	-15%
Field Offices	5,044.0	4,009.1	-21%
Single Family	2,469.5	1,941.7	-21%
Asset Management	1,545.1	NA	NA
Multifamily	2,076.2	1,907.0	-8%
Asset Management	1,385.2	NA	NA

Notes: Asset Management includes loan management and property disposition.
Headquarters and Field Office totals include an "Other" category
for functions that are not solely related to single or multifamily operations.

Source: HUD, Office of Housing, Office of Budget and Field Resources.