Good Deeds Punished:

State-Run Mortgage Lender Forecloses on Californians Current on Their Loans

A report prepared for the California Senate Rules Committee

October 24, 2011

Prepared by John Hill

California Senate Office of Oversight and Outcomes

John Adkisson
John Hill
Dorothy Korber
Nancy Vogel

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Executive Summary

Despite the housing slump, the California Housing Finance Agency is taking an unusually strict line with borrowers who are trying to avoid severe losses by renting out their residences, in some cases foreclosing even though the borrowers are willing and able to continue paying. The practice not only puts borrowers in a bind – it costs the agency money.

Battered by the real estate downturn, the California Housing Finance Agency, known as the state's affordable housing bank, recently shifted its focus from making low-interest home loans to reducing foreclosures in the overall market.

"Preventing foreclosures will not only benefit the families directly impacted, it will help stabilize neighborhoods, communities and the entire California economy," according to the state agency's latest annual report.

Yet CalHFA is forcing some of its own borrowers into foreclosure - even though they stay current on their mortgage payments. The agency is trapping others in homes that they have outgrown.

These borrowers want to rent out their CalHFA-financed homes because of a change in life circumstances, such as getting married or having children. In a normal real estate market, they would have sold their houses or condos and paid off their mortgages. Selling now means severe losses. Instead, they hope to lease out their residences until the housing market begins to recover.

But unlike state housing finance agencies in most other states, CalHFA is hewing to a strict policy of allowing rentals only if the borrower is facing an unforeseen economic hardship such as the loss of a job.

It has foreclosed on at least 21 borrowers who were violating its requirement that a borrower occupy the home for the life of the mortgage. That number may just be the start. Another 49 borrowers who rented out their residences are delinquent, likely headed for foreclosure. Still more, 186, are renting out their CalHFA-financed homes without permission. CalHFA is telling these borrowers they must return to their homes, pay off their loans in full, seek a waiver or face foreclosure.

Much of this activity has occurred within the past year. So far in 2011, the agency has sent out 218 “acceleration” letters, notifying borrowers that they are in technical default and must take action or face foreclosure.

As the housing crisis continues, these numbers will keep growing.

The agency says it doesn’t know how many borrowers were denied permission to rent and as a result remained in homes they no longer consider suitable or moved back in to avoid foreclosure.

Nor does it seem to have a firm grasp on the size of the problem. Between May and October 2011, the agency provided the Senate Office of Oversight and Outcomes three widely varying sets of statistics of borrowers who were denied permission to rent or renting without its approval.

The state of affairs at CalHFA should not be confused with the larger foreclosure crisis among private lenders, in terms of the number of people affected or the causes. But the relatively small number of borrowers squeezed by CalHFA’s policy find themselves in a unusual situation not seen in the private sector: They are willing and able to live up to their commitments, only to be told that their mortgage payments will no longer be accepted.

Among those who have run afoul of CalHFA’s policy is Marcia Wold. The Mountain View school teacher bought a condo in Sunnyvale with a CalHFA loan. She loved living in a quiet place with a pool a few steps from her door, so happy to have her own washer and dryer that she actually looked forward to doing laundry. But after marrying a man with a young son from a previous marriage, she concluded they could not live in her 724-square-feet place. She moved into the house that her husband co-owns with his parents.

Even after she rented out her condo, she was losing $1,000 each month. Still, she was determined to meet her obligation to keep paying her note until she could sell or refinance. Somehow, CalHFA found out she was renting and foreclosed.

Wold cried the weekend before the foreclosure sale.

“They took away a part of me, because I worked so hard for it,” she said. “This represented that I had made it. And they took that away from me.”

CalHFA also denied Wold’s request to forego reporting the technical default to credit reporting agencies. Her credit rating has dropped from a stellar 802 to 679, complicating the couple’s hopes to refinance the Los Gatos house where they now live.

Other borrowers told our office that they are remaining in or returning to properties they have outgrown to avoid foreclosure.

"I think it's a horrible program," Dan, an active duty member of the Navy, said in an interview. Dan is headed for foreclosure because he rented out his 820-square-foot condo at a loss after getting married and having a child. "It's almost like predatory lending. You expect something like that from Countrywide, but not from (an entity) with the name California in the title."

Not only does the policy disrupt the lives of the borrowers – it costs CalHFA money. Each foreclosure, on average, translates into $38,000 in uninsured losses for the agency. Now that two CalHFA insurance funds have been wiped out by foreclosures, each new default costs more than $50,000 in uninsured losses.

CalHFA officials say they must adhere to the policy because of an opinion from the bond counsel for many of its issuances. The bond counsel interpreted a section of the Internal Revenue Code as prohibiting renting. It advised CalHFA that federal law requires a borrower whose loans come from tax-exempt bonds to remain in the residence for the life of the mortgage.

Most other states surveyed by our office, facing the same wave of rental requests from distressed homeowners, interpret the IRS code differently. They say that it's enough for borrowers to live in the property for a reasonable time. Only two states – Nevada and Georgia – maintain policies of foreclosing on borrowers who rent but are current on their payments. A Georgia official said his agency has not had to resort to that type of foreclosure for several years.

The IRS limits the number of loans that don't comply with the owner-occupancy requirement to 5 percent. CalHFA officials believe that exceeding the cap could threaten the tax-exempt status of the bonds that have traditionally funded their single-family loan program.

Yet, even if the agency granted a waiver to every property now being leased without permission, the total would add up to only 1.68 percent of its loans – well below the IRS limit.

Officials for other state housing agencies say that another reason they don't foreclose is to avoid financial losses. They also point out that foreclosing on borrowers who are in a bind because of the upside down market runs counter to their mission.

"We're not going to be foreclosing on homes if they're making their mortgage payments in this market," said Lisa DeBrock, homeownership program manager for the Washington state Housing Finance Commission.

Minnesota is one of the states that take a more forgiving approach. Years ago, the state decided not to foreclose on borrowers who moved out and rented because of a change in life circumstances.

As a Minnesota Housing official told our office, "Life happens down the road."

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Marcia Wold worked three jobs so she could afford to rent an apartment in Silicon Valley. She ended up with one that was smaller than the Mountain View high school classroom where she taught math. Even that was a stretch. At the end of each month, when she ran out of cash, she racked up more credit card debt to pay for food and gas.

After years of financial struggle, she still harbored hopes of owning her own place. So when she heard about a California program that would allow her to buy with no money down, she didn't hesitate. In 2005 she became the owner of a Sunnyvale condo.

Six years later, the bank foreclosed. Like so many others in the housing bust, Wold found it impossible to hold on.

The difference: Wold never missed a mortgage payment.

Wold and others like her are losing their properties, trapped in difficult living situations or selling at a loss as a result of a decision by the California Housing Finance Agency to deny many borrowers permission to rent out their former homes. Wold moved out of her CalHFA-financed condo because she married a man with a child from a previous marriage and concluded the three could not live in her 724-square-foot condo. Renting the condo made sense since she could not sell without taking a huge financial hit.

A total of 235 CalHFA borrowers are currently renting out their properties without permission from the agency. CalHFA has foreclosed on 21 of these loans. The agency cannot say how many, like Wold, would have continued paying off their loans.

Another 49 loans are delinquent, putting them at high risk for foreclosure. A much larger number – 186 – are in limbo, renting without permission but current on their payments. These borrowers are receiving an ultimatum from CalHFA: move back in, pay the loan in full, apply for a rental waiver or face foreclosure. Since the beginning of 2011, 218 borrowers have been sent "acceleration letters" informing them that they owe the unpaid balance of their mortgages unless they take corrective action.

An unknown number have been denied rental waivers and either decided to sell, stay in the property or move back in to avoid foreclosure. Many of these borrowers have outgrown their CalHFA-financed residences but, prohibited from leasing the property, live in cramped quarters. As the housing crunch continues, more will run afoul of CalHFA's policy.

Marcia Wold in front of the Sunnyvale condo she lost to foreclosure.

These numbers pale in comparison to the tally of homeowners with mortgages from private lenders who have gone through foreclosure in a larger crisis that has nothing to do with CalHFA or its policies. But the CalHFA borrowers face a highly unusual situation not seen among private lenders – they want to keep paying but have been told they can't.

Most other states contacted by the oversight office are taking a more lenient approach. Although each state policy is unique, all but two of the states contacted by the oversight office said they are not foreclosing on borrowers for violating the owner-occupancy requirement, as long as they are current on their payments. Only Nevada and Georgia have policies similar to California's. Georgia's agency said it had not foreclosed on a borrower who rented for several years.

California borrowers who go through foreclosures take a hit to their credit rating, with implications for getting a job or renting an apartment. CalHFA insists on informing credit reporting agencies of these borrowers' technical defaults even though they continue making payments until the end. In addition, the borrowers lose out on the possibility of regaining equity in the property when the housing market bounces back.

But the ill effects are not limited to borrowers. CalHFA loses money on each foreclosure – an average of $37,839 of uninsured losses per foreclosed property. As a result of foreclosures among all its borrowers, not just those who rented, CalHFA has burned through its mortgage insurance fund and a special gap insurance fund, as well as some of the reserves it had accumulated in its bond indenture. That's driven up uninsured losses to $56,000 per foreclosure in the most recent quarter.

Foreclosures, in general, are well known to cause undesirable ripple effects. They drive down property values of nearby homes. The Center for Responsible Lending estimated in 2009 that price declines on homes within an eighth of a mile of a foreclosed property averaged $7,200. The decreased value of the foreclosed property and nearby houses translates into reduced property taxes for schools and other public services.

CalHFA foreclosures can also lead to evictions of tenants who were living in the borrower's property.

CalHFA itself has emphasized the importance of preventing foreclosures. With its single-family home loan business drastically reduced, CalHFA has focused on using federal funds to minimize foreclosures in the overall housing market.

"Preventing foreclosures will not only benefit the families directly impacted, it will help stabilize neighborhoods, communities and the entire California economy," Peter Carey, acting board chairman, and L. Steven Spears, then-executive director, wrote in an introductory message to the agency's most recent annual report.

Borrowers Rent to Avoid Losses

Many of the CalHFA borrowers moved because of an unforeseen change in life circumstances. They got married, had children, or needed to move in with elderly parents to take care of them. In normal times, they would simply have sold their CalHFA-financed homes. But in the upside down housing market, they can't sell without absorbing substantial losses. They can't refinance because the amount they owe is greater than the depressed value of the property. Even though they are willing and able to continue paying off their loans, they are given an ultimatum by CalHFA: move back in, pay back the loan in full, refinance or face foreclosure.

After getting married in 2010, Wold moved into a Los Gatos house that her husband, Ken, owns jointly with his parents. She left the condo vacant for several months before she found renters. Even then, after paying a commission to a property management company and homeowner association dues, she was losing $1,000 a month.

Somehow, CalHFA's mortgage servicer found out she was renting. And on Valentine's Day 2011, the condo was auctioned off in a foreclosure sale.

The weekend before, "I would be sitting on the couch – Ken would look at me and I'd be crying," Wold recalls. "They took away a part of me because I worked so hard for it. This represented that I had made it. And they took that away from me."

Other borrowers, intent on avoiding foreclosure, find themselves trapped in places that are too small.

A San Diego law enforcement officer told the oversight office that he's outgrown the 500-square-foot apartment conversion he bought with a CalHFA loan in 2005. He was engaged to be married at the time, and now lives in the one-bedroom, one-bath place with his wife and 16-month-old child.

"It puts a strain to the whole family situation, especially with the little one running around," he said.

He's now preparing to ask CalHFA for a rental waiver, but the research he's done on the policy leaves him little hope.

"The stipulation that you've got to live there the life of the loan is not realistic," he said.

CalHFA says that it is bound by federal laws and regulations. CalHFA mortgages are underwritten by tax-exempt bonds. In return for the tax exemption, state housing finance agencies must adhere to restrictions on how the money is used. Years ago, before the housing market collapsed, one of the agency's bond counsels concluded that the Internal Revenue Code, with some narrowly defined exceptions, requires borrowers to live in homes financed by bond proceeds for the duration of their mortgages. If CalHFA allowed too many borrowers to rent, the bond counsel advised, the agency might jeopardize the tax exempt status of its bonds.

"All of what we're doing here is to make sure we can honor our obligations to bondholders," Bruce Gilbertson, the agency's director of financing, said in an interview with the oversight office.

But housing finance officials elsewhere have reached a different conclusion. Officials in other states, chosen for our survey because of their size or high rates of underwater mortgages, said that, like their counterparts in California, they're dealing with a wave of borrowers who rented out their properties. But most said they interpreted the Internal Revenue Code to

CalHFA Gambled in Hot Housing Market, Now Pays the Price

Despite its status as a government entity, the California Housing Finance Agency fell prey to many of the ills that afflicted private lenders during the collapse of the housing market. This was at least partially the result of CalHFA's decision to keep up with the private market by offering unconventional loans and loosening underwriting standards. The agency's losses from foreclosures have wiped out its mortgage insurance fund and drained its reserves.

CalHFA was established in 1975 to offer low-interest mortgages to first-time homebuyers and to promote the development of affordable rental housing. The agency generates money for mortgages by issuing tax-exempt private activity bonds. A network of lenders approved by the agency makes loans to homebuyers. CalHFA then purchases the mortgages. The agency repays the bonds with the proceeds from individual mortgages. It is self-supporting and does not tap into the general revenues of the state. The agency has 23,100 loans in its single-family housing portfolio.

A February 2011 report by California State Auditor Elaine Howle describes how the agency, on the advice of Wall Street bankers, tried to stay relevant in the go-go housing market, only to be caught in the same collapse that hit the private home-loan industry.

According to the audit, the agency sought over nine years to pump up its loan volume. Agency officials used volume as a key measure of performance. According to some former officers, it accepted higher and higher risks to meet those goals.

The agency got encouragement from Wall Street investment banks that later were caught up themselves in the housing meltdown, the audit states, including Bear Stearns, which collapsed in 2008, and Goldman Sachs.

"In 2005 and 2006," the audit states, "to compete with alternative mortgage products being offered by the lending industry, CalHFA introduced two new primary mortgage payments with no down payment required." One was a 35-year loan, with the borrower required to pay only interest for the first five years. The second was a 40-year mortgage. Because the monthly payments for these loans were lower, borrowers could qualify more easily.

Around the same time, CalHFA weakened some of its underwriting standards, according to the audit. It increased the allowable debt-to-income ratio from 36 percent to 45 percent and, in some cases, 55 percent. It also stopped requiring down payments.

When the housing market and the larger economy tanked, these alternative loans were the most likely to turn sour. Conventional 30-year loans had a 90-day delinquency rate of 14.2 percent between 2005 and 2010, the audit found. Thirty-five year loans, by contrast, went delinquent at more than twice the rate – 29.3 percent. The rate for 40-year loans was also significantly higher at 21.2 percent. Overall, since 2007, almost 3,000 loans have ended up in foreclosure. The new loans and the general deterioration of the economy led to a dramatic increase in 90-day delinquency rates in the mortgages not insured by the federal government, the audit found – from 1 percent in 2005 to 10 percent in 2010.

These unconventional loans made up a significant share of CalHFA's lending in the mid-2000s. When they went bad, the agency's mechanisms for covering losses were stressed.

Its mortgage insurance fund, made up of insurance premiums paid by borrowers, was wiped out. A gap reserve was set up by the agency when it reduced the amount of insurance homeowners were required to carry, with the understanding that CalHFA would make up the difference. That reserve also ran dry. When these two insurance sources and the sale of the foreclosed property are taken into account, CalHFA has covered about 87 percent of its losses from foreclosure. The remaining 13 percent - $112 million – has come out of the bond indentures' reserves.

The audit concludes that it is unlikely that CalHFA will become insolvent. But CalHFA's bond issuances and insurance fund have been downgraded by credit rating agencies. The agency is still making loans, but at a greatly reduced volume. The agency has shifted its focus to administering a federal program to help distressed homeowners – not just those with CalHFA loans - to avoid foreclosure. It has also done some loan modifications for its own borrowers. The agency completed 244 loan modifications in the fiscal year that ended in June 2010, according to its annual report.

require that the borrower intended in good faith to move into the property rather than setting out to be a landlord. They don't believe, in the current market, that the IRS would crack down on states that allow distressed homeowners who lived in the property for a reasonable time to lease.

Minnesota is one of the states that take a more forgiving approach than California's. It decided years ago not to foreclose on borrowers who moved out because of a change in life circumstances, as long as they stayed current on their loans.

"Life happens down the road," said Barb Spiess, a staff member at Minnesota Housing.

A Wave of Requests Led to CalHFA Policy in August 2010

Before the housing market collapsed, CalHFA prohibited leasing of homes by borrowers "with very limited exceptions," according to a staff memo on August 8, 2010. The agency reasoned that the program was not meant to set up borrowers as landlords.

With the recession, CalHFA started getting many more requests to allow rentals. Staff granted more exceptions than it had in the past, when borrowers did not face devastating losses from selling homes that were worth much less than they had paid.

But the agency found itself in a bind, according to the memo. It had based its original policy not to grant most rental requests on advice from its bond counsel at the time, Orrick, Herrington & Sutcliffe. Orrick opined that one section of the Internal Revenue Code prohibited commercial uses of properties funded by tax-exempt bonds, a definition that included rentals.

In 2005, CalHFA hired another firm, Hawkins, Delafield & Wood, to handle its new single-family issuances. Hawkins disagreed with Orrick on the question of rentals. It advised the agency that the Internal Revenue Code section required only that the borrower intended to live in the house, not stay there for the life of the mortgage.

Faced with conflicting opinions, CalHFA staff attempted to come up with a policy that would reconcile them and that both bond counsels could endorse. The policy went into effect in August 2010. It prohibited rentals unless the borrower could document one of the following involuntary financial hardships:

- Reduction in income because of reduced hours, pay cuts, or a new job.
- An involuntary increase in living expenses or medical costs.
- An involuntary job transfer, including a military posting, with a possible return in one year.
- Being forced to look for a job outside the area with the possibility of return, or selling or refinancing the home, within a year.

Several months after this policy was approved, the agency added another economic hardship exemption. Starting in 2005, CalHFA, in an attempt to keep up with the private mortgage market, started offering unconventional mortgages, such as a 35-year-loan with the first five years interest-only. These borrowers faced increased mortgage payments after the first five years. CalHFA amended its policy to include those increased payments as an "involuntary" economic hardship qualifying the borrower for an exemption to the no-rental policy.

Even borrowers who met the criteria were allowed to rent out their homes for only a year, with the possibility after that of extensions. The policy also stipulated that under no circumstances could rental exceptions exceed 5 percent of total single-family loans, the cap cited in the Internal Revenue Code. If the number approached 5 percent, all requests would be denied.

"It is driven by our desire to stay within what our bond counsel says is safe harbor, to stay under 5 percent," Charles McManus, the agency's director of mortgage insurance, said in an interview with the oversight office. "We use hardship guidelines as our monitor for what's approved and what's not approved. We try to be very consistent."

As of mid-September 2011, about 1.68 percent of residences paid for by CalHFA loans were occupied by renters. This number included 147 properties that received rental waivers from CalHFA and another 235 that were being leased without permission. That means that even if the agency granted waivers to every borrower whose property was being rented, the total would be 1.68 percent - well below the 5 percent cap. If CalHFA takes action against all of those who are renting without permission – forcing them to sell, move back in or face foreclosure – the total percentage of renters would be only 0.6 percent.

But the agency has chosen to take a conservative approach.

In part, that's because other borrowers may be renting without CalHFA's knowledge, said Di Richardson, CalHFA's director of legislation. "There could be another two percent we don't know about," she said – pushing the agency closer to the 5 percent limit.

If the agency hit the limit, she said, it would not be able to grant any more waivers, regardless of each borrowers' circumstances.

"We wouldn't be able to accommodate those that did have a hardship," she said.

Internal Revenue Code Focuses on Borrower's Intention to Move In

Internal Revenue Code Section 143 requires that 95 percent of borrowers occupy the homes that were financed by tax-exempt bonds. But the language focuses on borrowers' intentions when they take out the house loan rather than subsequent actions years later. Experts in the field rely on that language for their interpretation that borrowers who rent because of a hardship or change in circumstances are not in violation of the code.

Section 143 requires those who issue tax-exempt mortgage bonds, such as CalHFA, to make a good faith attempt to assure that borrowers intend to occupy properties as their primary residences. Ninety-five percent of the bond proceeds must go to residences that met the requirement of owner occupancy *at the time the mortgages were executed*. Residences intended to be used as investment properties or vacation homes do not qualify for mortgages funded by the tax-exempt bonds. Any deviations from these rules must be corrected within a "reasonable time" after being discovered, according to the federal law.

U.S. Department of Treasury regulations further specify that to meet the requirement of "good faith," bond issuers or their loan servicers must spell out the owner occupancy requirements in mortgage documents. Bond issuers such as CalHFA must also establish "reasonable procedures," such as investigations, to assure compliance with the owner-occupancy and other requirements.

The regulations themselves describe what this looks like in practice. Say that a bank acting as loan servicer for a state housing finance agency gets signed affidavits from borrowers that they intend to move into the property within 60 days and to maintain it as their primary residence.

The state, according to Treasury regulations, has met the test of a good faith effort. If this occurs in 95 percent of cases, the state is in compliance with Internal Revenue requirements.

But what if a borrower moves out and leases the property? Borrowers transferred by their employers to another part of the country or forced by market conditions to rent out their former homes would not be considered out of compliance, according to *ABCs of Housing Bonds* by Joseph P. Rogers, Jr. and Howard Zucker, recognized as a leading publication in the field. (The two authors are bond counsels for Hawkins, Delafield, the law firm hired by CalHFA in 2005 to handle its single-family issuances.)

"Since the test is whether the residence can reasonably be expected to become the principal residence of the mortgagor, a loan should not be treated as an unqualified loan where unforeseen circumstances force a mortgagor to lease the residence," the authors wrote.

Treasury regulations specify that such borrowers, if they are gone for more than a year, cannot claim the deduction for mortgage interest. But even then, Treasury is authorized to allow the deduction if "the failure to meet the residence requirement resulted from circumstances beyond the mortgagor's control."

Sujyot Patel, a partner in the law firm Peck, Shaffer & Williams in Cincinnati, told the oversight office that he advises clients that they must develop consistent procedures to show that the homeowner intended to move into the property and did live there for a period of time. Peck, Shaffer is the bond counsel for Georgia, Louisiana and Ohio and underwriter's counsel in Kentucky.

"We say home ownership has to be there," Patel said. "If the person moves out after three months, then the housing agency didn't do a good enough job of screening."

But the firm's advice also takes into account the reality of current times, Patel said – a "perfect storm" in the housing market that can leave borrowers facing severe losses if they are forced to sell. As long as the housing agency has done its due diligence when the loan was made, Patel said, it has the flexibility to look at rental requests case-by-case, taking into account whether the mortgage is underwater. Such waivers can be reviewed for possible renewal every year, he said.

Patel's firm advises clients that there has to be real economic hardship for a homeowner to qualify for a rental waiver. An example would be a borrower who no longer could afford the mortgage payments but was unable to sell without taking a huge loss.

The firm has not formulated an opinion about borrowers who moved out because they got married or had children or experienced another change in life circumstance. But as long as an agency has a clear policy and applies in consistently, Patel said, there is little chance of the Internal Revenue Service investigating and almost no chance that it would strip a bond issuance of its tax-exempt status.

"I just can't see that the service would ever declare these bonds taxable," he said.

L. Steven Spears, CalHFA's chief deputy director, finds little comfort in such assurances: If the IRS does not intend to enforce the rule in the depressed housing market, why hasn't it issued a clarification?

"That would be really, really helpful," Spears said.

The oversight office contacted the Internal Revenue Service seeking such a clarification. Through a spokeswoman, the IRS's Compliance and Program Management section responded that "a residence must be one that can be reasonably expected to become the principal residence of the mortgagor within a reasonable time after the financing is provided." Among the factors that go into this assessment is "the good faith of the mortgagor." A residence may not be used as "an investment property." Bond issuers such as CalHFA are given the latitude to resolve violations as long as they made a good faith effort to comply with the law, have a 95 percent compliance rate overall, and correct violations within a "reasonable time." The IRS declined to make anyone available for an interview.

Most States in Our Survey Take a More Lenient Approach Than California Does

The oversight office surveyed 20 states covering more than two-thirds of the U.S. population, including large states and those with a high rate of underwater mortgages, to find out how they were handling borrowers who leased out their properties.

Several said that the problem has become acute since the housing bubble burst.

"We're seeing so much more of that now, it's unfortunate," said Sandy Gaver, single family program manager of the Florida Housing Finance Corporation.

Each state housing finance agency has its own way of dealing with the dilemma. But only two of the states we contacted have policies similar to California's. They, too, foreclose on borrowers who are current on

How Other States Deal with Renting

STATE	HOUSING FINANCE AGENCY POLICY ON BORROWERS WHO WANT TO RENT	ACCEPTABLE REASONS
Arizona	reviews case by case, still formulating policy	n/a
Florida	allows if mortgage is underwater	mortgage is underwater
Oregon	no policy - hasn't seen the problem	n/a
Washington	does not foreclose on current loans because of renting	any
New York	allows if mortgage is underwater	include job transfers or increase in family size
New Jersey	allows if borrower cannot pay back outstanding loan	include outgrowing house, needed to care for parent or moved for job
Nevada	does not allow except for military tours of duty; borrowers must sell, move back in or face foreclosure	military deployment
Michigan	allows as long as mortgage insurer approves	include death in family, decrease in income, change in marital status
Texas	allows, but borrower must not claim mortgage interest deduction	any, as long as borrower doesn't claim mortgage interest deduction
Maryland	has not seen the problem much; any cases would be referred to housing agency committee	n/a
Massachusetts	allows if loan underwater, borrower is not making a profit on renting and can show hardship	include increase in family size, medical problems, relocation for job, loss of income
Virginia	allows	any
Colorado	allows	any, as long as borrower intended to occupy and not renting would pose a hardship for the family
Utah	has had a moratorium on foreclosures for two years	any
Ohio	allows	any
Illinois	still working out a policy	n/a
Georgia	does not allow except for military deployment	military deployment
Minnesota	allows	any
Idaho	allows if borrower intends eventually to move back in; even if not, allows borrower to rent out while arranging a sale	any

payments but have violated their mortgage agreements by renting out their properties. A Georgia official said his agency has not foreclosed on anyone in those circumstances for a few years. A Nevada official could not say how many foreclosures have occurred because owners rented.

Most of the other states we contacted follow much more forgiving policies. Florida, which like California has been hit hard by the housing downturn, allows renting on a case-by-case basis if an appraisal shows that the mortgage is underwater. Washington does not foreclose on any borrowers who rent. New York allows renting if the mortgage is underwater regardless of the reason the borrower is moving out. It could be something as simple as the homeowners having a child.

New Jersey has a similar policy. The borrower must document a loan-to-value ratio of 95 to 97 percent. Even though the house in this case is worth slightly more than the outstanding mortgage - and so is not technically "underwater" - state officials took into account closing costs that borrowers would incur if they were forced to sell. As long as the loan meets this test, New Jersey allows renting for any change in circumstances – the borrower may have outgrown the house, moved to care for a sick parent, or been transferred by an employer.

Michigan allows renting if the mortgage insurer approves. Massachusetts allows it if the mortgage is underwater and the borrower can show hardship such as growth in family size, medical issues, job relocation or loss of income. The borrower is not permitted to make money on the rental.

Virginia has been permitting rentals for two decades after a federal court ruled that it could not foreclose on a soldier who was transferred and leased his property. The court ruled that once the borrower complied with the terms and conditions of his loan, what he did afterwards could not be grounds for foreclosure, said Michele Watson, director of homeownership programs at the Virginia Housing Development Authority.

"The minute we had our hand slapped, we changed our policy," Watson said.

Utah has had a moratorium on foreclosures for two years. Ohio sends borrowers a letter pointing out that the state has a legal right to foreclose, but allows renting if the borrower can produce real estate listings showing that the mortgage is underwater, a lease agreement and renter's insurance. Minnesota stopped foreclosing 17 years ago on those who violated the owner-occupancy requirement. The housing finance agency had been calling second mortgages due in these cases, but recently decided to discontinue that policy as well.

Other States Take Different View of Internal Revenue Code

Several of the states contacted by the oversight office said they interpreted the Internal Revenue Code to mean that a borrower must make the property his or her primary residence within a reasonable amount of time, not that the borrower must stay there for the life of the mortgage. Colorado is one of the states that take that view. It now has 908 properties on rental waivers, which adds up to 5 percent of its portfolio. Officials admit that many more homes may be rented without the agency's knowledge. Yet the IRS is not challenging the tax-exempt status of the agency's bonds.

Other state housing agencies say one reason they don't foreclose is that it would cost them money.

In Washington, for instance, the Housing Finance Commission would lose the money owed on second mortgages each time it foreclosed, said Lisa DeBrock, homeownership program manager.

"Financially, it's not a good decision," she said. "We're out thousands of dollars."

DeBrock was one of several state housing officials who emphasized another point: Their operations are meant to promote homeownership. Foreclosing on borrowers who are in a bind because of the upside-down market runs counter to their mission.

"We're not going to be foreclosing on homes if they're making their mortgage payments in this market," DeBrock said.

In New Jersey, "if they're paying, we pretty much think we have a good customer," said Jerome Keelen, director of single family programs at the state Housing and Mortgage Financing Agency. The agency tells borrowers who are renting that it wants them to sell or refinance as soon as possible. It reviews the rental waivers periodically. But as long as the borrowers would face a financial hit by selling, Keelen said, "We'll give it for as long as the hardship truly exists."

Florida's agency takes a similar view.

"We don't want to create a hardship," Gaver said. "It's not our mission. It's definitely not what we're here for…We don't like to see foreclosures at all."

The Ohio Housing Finance Agency believes that it will remain within the IRS guidelines as long as it keeps track of the 200 to 300 borrowers who have received rental waivers.

"It's hard for me to swallow, to say that I'm going to foreclose on them because they're not living in the property, especially if they're current" on their loan payments, said Tom Walker, homeowner operations manager. Told of California's policy, Walker responded, "That's pretty harsh."

Two States Have Policies Like California's

Nevada is one of the two states we found whose policy resembles California's. It may be no coincidence. The Nevada Housing Division formulated its policy several years ago on the advice of bond counsel Orrick, Herrington & Sutcliffe – the same law firm that served as the California agency's counsel when it came up with its first policy on rentals.

"We don't have any choice, in our opinion," said Lon DeWeese, chief financial officer of the Nevada Housing Division.

Nevada does an annual survey of borrowers to determine if any have moved out. If they have, the borrowers must either move back in, put the house up for sale or default. The housing division recognizes that many borrowers are dealing with a difficult market – Nevada has consistently ranked as the state with the highest percentage of underwater mortgages. But negative equity is no more a hardship for borrowers than making money on a property during a housing market surge should be considered an unwarranted windfall, DeWeese said.

DeWeese said he could not estimate the number of foreclosures that have resulted from technical default because of renting. Nevada's housing finance agency pulled out of the whole mortgage business in 2006 and has been focusing just on down payment assistance.

Georgia is the other state with a strict no-rental policy.

"We may let them do it for a short period of time, but not very long," said Phil Cottone, director of homeownership at Georgia Housing & Finance Authority.

But Cottone could not recall a recent case of the authority foreclosing on a borrower because of a violation of the rental policy. It's happened a couple of times in "years past," he said. More common is a homeowner who moves out under financial duress and stops making payments, which leads to foreclosure.

"It hasn't been that big an issue for us," Cottone said.

CalHFA's Policy Puts Borrowers in a Fix

Marcia Wold has always adored Tigger. The bouncy tiger from the Winnie-the-Pooh books adorns her cell phone cover. Her personalized license plate announces her devotion to him to the world. It makes sense – Tigger is a good totem of Wold's sunny outlook.


Marcia Wold takes a break from grading math homework to chat with her mother-in-law, Nancy Wold.

Twelve years ago, she decided to live in California while visiting from Illinois for a teacher's conference. The drive from the San Francisco airport to the city was enough to win her over – a few weeks later, she moved.

She worked three jobs: one teaching math, one teaching a night class for GED students, and the last as a nanny. After school, she would pick up her clients' kids and drop them off in Milpitas, and then head straight to the night school class.

After buying her condo through CalHFA in March 2005, she was so delighted to finally have her own washer and dryer that she actually looked forward to doing laundry. She completely remodeled the place, starting with the bathroom, which for some reason had carpet on the floor. She put in a new refrigerator, a stove, a garbage disposal and countertops.

Wold loved living in an oasis sheltered from highway noise. To burn off stress, she swam laps in the pool a few yards from her door, and walked in the shade of massive redwoods in the development's park. She saw the humble condo as a symbol of how she had managed to find a toehold in one of the priciest communities in the nation. When she inherited $10,000 from her grandmother, she used it to pay down her mortgage. In retrospect, she wishes she had gone on a cruise.

After she met Ken on Match.com and the couple married, they thought for a long time about trying to live in the 784-square-foot condo. Ultimately, they decided it would be too hard on Kelley, Ken's 5-year-old son from a previous marriage. And so they moved into the house in a canyon outside Los Gatos that Ken owned with his parents.

All was well until Wold received a letter from CalHFA in April 2010, telling her that she had to move back into her house or pay off her loan in full.

"I honestly thought it was a joke," Wold recalled. Her second thought was that it was a minor misunderstanding that would easily be cleared up with a phone call. Indeed, the CalHFA representative she talked to told her that there were many borrowers like her who got married or had a change in life circumstance, and advised her to apply for a one-year waiver of the owner occupancy clause.

"She said in her experience, it would be no problem," Wold said.

Several months later, in July, CalHFA returned one of her mortgage payments. Wold called CalHFA again. The same representative said CalHFA was getting a lot more requests than usual. She suggested that Wold send the mortgage payment back to CalHFA and it would be taken care of.

In October, Wold got a letter that her request for a rental waiver had been denied. Unless she paid off the loan or moved back in, CalHFA would pursue foreclosure.

Wold owed about $35,000 more than the condo's estimated value. Selling would mean a huge financial hit, and moving back in was not an option. And so she prepared for the inevitable.

She asked a CalHFA official if she would refrain from reporting the foreclosure to the credit-reporting agencies. The official said no. Knowing that her credit score would plummet, Wold bought a car a month before the foreclosure sale. Sure enough, her credit score has dropped from 802 to 679. With Ken's parents planning to move to a retirement community, Ken and Marcia had hoped to refinance the mortgage under their names. But with the sagging credit score, Marcia realizes that she will have to pay a higher rate or rely on Ken's parents to help refinance.

Wold wasn't the only one to suffer financial consequences. She bought the condo for $335,000 and still owed $320,000. CalHFA sold the condo in June for $235,000. If the agency had allowed Wold to rent out the condo until the market turned around and she was able to sell it, it might have recovered the entire amount it was owed, as well as avoiding the costs of selling the property.

CalHFA's losses from foreclosures of all kinds have stressed the agency's books during the housing crisis. As of the end of August 2011, the agency had foreclosed on 2,972 properties. It has been able to recover about 87 percent of outstanding loans and expenses. But in doing so, it exhausted its mortgage insurance fund, which consisted of premiums paid by borrowers. It also burned through a gap insurance fund that it had set up. The remaining 13 percent - $112.5 million – has been covered by reserves accumulated by the bond indentures.

Agency Has a Hard Time Producing Numbers Documenting Size of Problem

The agency itself seems to be having a hard time quantifying the number of borrowers affected by its policy. The oversight office in May asked CalHFA for the number of borrowers who had been denied permission to rent. Over the course of the next five months, the agency gave our office three different sets of widely varying statistics. The agency attributed the discrepancies to the development of a new system for tracking renter-occupied properties prompted by our office's inquiries. Officials said that, before the housing downturn, there was never a need for such a system.

"We believe we are near completion with this system, and the numbers provided…are mostly accurate," the agency said in a written response to our questions.

But the system focuses on the number of CalHFA residences that are occupied by renters. It does not track the number of rental requests that have been denied.

CalHFA would not give our office names or any other information about borrowers who lost their properties as the result of technical default for violating the no-rental policy. The agency argued that, as confidential consumer information, the information is exempt from public disclosure. We were only able to find others like Wold by searching on-line forums for people facing foreclosure.

Many of the stories sounded similar. The borrowers said they had been unaware of the owner-occupancy provision or thought nothing of it, assuming that in a normal housing market they would simply be able to sell the CalHFA property if they wanted to move elsewhere. As their families grew or they went through other changes, they moved and rented out the property, often at a considerable loss. Even so, they were willing to keep paying off their mortgages until the market turned around and they could sell or refinance. Then they got the ultimatum from CalHFA: move back in, pay off the loan or face foreclosure. With rental agreements in place, some were unable to move back in. Selling would mean wiping out their 401(k)s or other savings. And so they let the properties go.

"I can assure you that many people affected by this policy were unaware of this restriction when they signed their mortgage paperwork," Dan, an active duty member of the Navy, wrote in an email to our office. "The wording is quite hard to understand, especially for the new homeowner who many of these loans were targeting."

He said that his mortgage broker explained that the clause just meant that he couldn't use the property as a place of business.

"Looking back, I was incredibly naïve and – for lack of a better word – stupid," Dan wrote. "However, I do believe that CalHFA, my agent and my broker were disingenuous and contributed to an enormously serious problem so many Californians and Americans now face."

Dan bought an 820-square-foot San Diego condo in 2007 using a CalHFA loan. He got married the following year. The couple had a child in 2010. When Dan spoke to the oversight office, he and his wife were expecting a second one. About a year ago, pressed for space, they bought a house a few miles away and rented out the condo. They were losing $800 every month. When Dan contacted the loan servicer to ask about refinancing, he disclosed that he was no longer living in the condo. CalHFA initiated the foreclosure process, which takes about three months.

"I think it's a horrible program…," Dan said in an ensuing interview with our office. "It's almost like predatory lending. You expect something like that from Countrywide, but not (from an entity) with the name California in the title." Countrywide Financial, bought by Bank of America in 2008, was the target of lawsuits by state attorneys general alleging deceptive and predatory lending practices.

Andrea and Joshua Bernard received what Andrea described as a "shocking" letter from CalHFA in late September 2011. The couple moved to the Inland Empire from Portland, Oregon, after a café they had been operating went belly up and Joshua got an attractive job offer in California. They lived at first in a travel trailer. But when they found out they were expecting a second child, they started looking for a more suitable place. In 2007, they found an 880-square-foot house in San Jacinto near the end of a cul de sac with a view of a nearby ridge for $245,000, and arranged a loan through CalHFA.

Andrea recalls that the loan servicer, Countrywide, told the couple that their contract required them to live in the house for at least three years. An escrow officer later confirmed the three-year figure.

Andrea started a photo business, and in 2010, the couple had a third child. They looked into adding to their house, but realized the monthly payments would grow beyond what they could afford. Assuming they had met the three-year residency requirement, they rented out the house – at a loss of $840 a month – and bought a bigger, cheaper one that would accommodate the children and Andrea's growing business.

The CalHFA-financed house was now worth about $70,000 - $175,000 less than they had paid. The Bernards knew other people who were simply walking away from their underwater homes.

"We just absolutely did not feel like that was the right thing to do," Andrea said. "We wanted to continue to meet that obligation – not wanted to, but needed to."

After getting the default letter from CalHFA, the Bernards contacted the loan servicer, Bank of America. Andrea said the bank could tell her little about CalHFA's requirements, but said that if she contacted CalHFA directly, the agency would send her back to Bank of America. The Bernards have a 35-year mortgage, and were required to pay interest only in the first five years. Their monthly payment is scheduled to increase in 2012. Andrea said that the workers she talked to at Bank of America did not inform her that under CalHFA's policy, increased payments in the sixth year of a 35-year loan could be grounds for a rental waiver. She only learned about the exemption when told by our office.

The Bernards plan to ask for an exemption, but fear that a one-year extension wouldn't resolve their problem, since the mortgage would still be deeply underwater and the house still too small for their family and Andrea's business.

"I definitely feel like we're being punished for trying to do the right thing," Andrea said. "I don't know what the ethical thing to do is right now. We have been forced into a situation that was in part our fault, but not through any purposeful effort to be deceitful or fraudulent. I don't think foreclosure would be a correct or just punishment."

"They're Just Hurting Themselves," One Borrower Says

Stephen and Britt Reiman have been trying to no avail to honor their commitment to CalHFA. Stephen bought a Palmdale house in 2007, before the couple met. They found each other on eHarmony – it turned out that they were both engineers at different locations of the same company. After Britt moved from Arizona to California, the two decided to buy a bigger house so they could start a family, and rented out the CalHFA property. Stephen didn't remember reading the no-rental clause. When CalHFA pointed it out to him, he figured he must have assumed that, if it came to it, he could just sell the house.

Stephen's mortgage was five years of interest only, so he has no equity in the house. After those first five years, the monthly payments are due to increase from $2,500 to $3,000. The tenants are paying only $1,450 a month, less than half the mortgage.

The original purpose of the owner-occupancy clause was to make sure that borrowers didn't buy property to make money. The Reimans, like other borrowers in the same fix, are clearly not doing that.

"We were making up the difference out of our own pockets to honor the loan," Britt Reiman said in an interview with the oversight office. "We were trying to make it work."

The Reimans' request for a rental waiver was denied, and in June, they were told to move back in, refinance or sell the house.

"We can't move back in because we have the renters there," Britt Reiman said.

Now they're resigned to foreclosure and the hit to Stephen Reiman's credit. They hope that Britt's credit score will be spared in case they need to borrow for anything. They have a hard time understanding why CalHFA would be willing to lose money on their loan when they wanted to keep current until they could sell and repay the mortgage in full.

"They're just hurting themselves," Britt Reiman said.

Other borrowers, intent on avoiding foreclosure, find themselves trapped in residences that are too small.

A borrower in Southern California told the oversight office he bought his two-bedroom condominium shortly before he got married. His wife had a previous child, and now they've had two more. They decided to move into her father's spacious house after he passed out on the driveway, spent a couple of months in intensive care, and returned home needing help. The borrower rented out his CalHFA property to his aunt. He told CalHFA that he had moved out, and received a letter this summer demanding full payment of the outstanding balance or proof that he had moved back in. He said that despite the condo's limitations, he plans to return with his family of five to the condo.

One borrower described her situation in an on-line forum. She and her husband were also refused a rental waiver by CalHFA. They live in a 640-square-foot condo in San Diego.

"Even though I wasn't supposed to be able to have children, we are blessed with a rambunctious 2-year-old and, unfortunately, downstairs neighbors who demand complete silence or they are up banging on our door," she wrote. "I haven't slept well in months because they won't let the baby cry at night, so he has to sleep with us."

Senate Office of Oversight and Outcomes

1020 N Street, Suite 560

Sacramento, CA 95814

Telephone: (916) 651-1518

Facsimile: (916) 324-5927

http://www.sen.ca.gov/oversight

Special Counsel John Adkisson • john.adkisson@sen.ca.gov

Office Manager Cathy Cruz • cathy.cruz@sen.ca.gov

Principal Consultant John Hill • john.hill@sen.ca.gov

Principal Consultant Dorothy Korber• dorothy.korber@sen.ca.gov

Principal Consultant Nancy Vogel • nancy.vogel@sen.ca.gov

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