Foreclosure Alternatives: A Case for Preserving Homeownership

By Desiree Hatcher

Residential foreclosures have become a growing concern in the lending industry. GMAC-RFC (Residential Funding Corporation), America's largest private issuer of mortgage-backed securities and a leading warehouse lender, estimates that it loses over $50,000 per foreclosed home. According to the U.S. Census Bureau's statistical abstracts, the number of nonfarm mortgage loans in foreclosure at year-end 2003 (the latest year for which information is available) was over 500,000. This translates into $25 billion in foreclosure cost for lenders.

Of course, lenders are just one stakeholder in the foreclosure process. What are the total costs associated with foreclosing on a home? Who is responsible for paying these costs? Are there alternatives to the foreclosure process? And if so, what are the advantages of using those alternatives?

The Cost of Foreclosure – Who Pays?

The impacts of mortgage foreclosures are widespread and costly not only for homeowners, but for lenders, servicers, insurers, cities, and neighborhoods. What follows is a description of the cost to each of these stakeholders.

Homeowners: Some of foreclosure's effects on homeowners are readily apparent, while others are just as severe but less well known:

- Loss of a stable, secure place to live.
- Loss of equity in the property.
- A damaged credit rating. Poor credit resulting from foreclosure often becomes a barrier to obtaining rental housing or purchasing another home.
- Potentially higher costs to replace lost housing.
- Possible tax consequences. For tax purposes, foreclosure is treated like a sale; any principal balance and accrued interest forgiven are treated as income for the former owner. The amount of gain or loss is determined just as if the property had been sold for cash equal to the face amount of the debt.

Private and public lenders: A public lender is any entity that uses government funding (public funds) to make loans. This includes cities such as Minneapolis and St. Paul, that have mortgage lending departments, or any nonprofit organization that uses government funding to make mortgage loans. For public lenders, major foreclosure losses are absorbed by loan servicers and mortgage insurers.

Insurance protects most private lenders from major foreclosure losses but does not cover certain types of expenses — for example, those related to holding and maintaining the property. A private lender is any entity not using government funding to make loans, including banks, credit unions, and thrifts. Greater losses are faced by private lenders that originate mortgage loans under their own affordable homeownership programs. These loans, which do not meet conventional underwriting criteria, are held in lenders' portfolios. For the lender, foreclosure means absorbing the full loss for outstanding principal, accrued interest, legal fees, costs of holding and maintaining the property, and real estate broker fees, less any amount recovered through the sale of the property.

Loan servicers: For loan servicers, the income stream from servicing fees stops when borrowers halt payments.

Mortgage insurers: The cost of foreclosure for mortgage insurers is the amounts paid for claims as either insurers in government mortgage programs (FHA, VA) or insurers of conventional mortgage loans. The amount of loss equals the outstanding principal and all the expenses incurred, less the proceeds from the sale of the house.

Cities: Cities do not incur large direct losses from foreclosures, but they do suffer significant — and costly — consequences. Foreclosed properties often deteriorate and lose value, eventually requiring restoration or demolition. If a house is beyond repair, the city absorbs the cost of demolishing it. If the house is vacant, the city also loses tax revenue. Additional costs include administrative expenses involved in rehabbing or demolition, health and building department expenses for property checks, health and safety violations, and condemnation.

Neighborhoods: Boarded-up houses and empty lots affect property values and marketability throughout a neighborhood. Houses in the vicinity of a boarded-up house can decrease in value. Even beyond the immediate area, foreclosed properties affect the "comparables" used in appraisals. Boarded-up properties also increase the likelihood of vandalism and other criminal activity.

Alternatives to Foreclosure

There are workout options available to lenders to help borrowers keep their home. However, some lenders do not inform borrowers that alternatives are available, in part because not all lenders are fully aware of alternatives to foreclosure. What follows is an overview of foreclosure alternatives. It should be noted that these options work best when the loan is only one or two payments behind. Borrowers delinquent beyond two payments severely limit their options.

For Temporary Setbacks

Reinstatement: Accepting the total amount of back interest and principal owed by a specific date. This option is often combined with forbearance.

Forbearance: Reducing or suspending payments for a short period, after which another option is agreed upon to bring the loan current. A forbearance option is often combined with a reinstatement, when it is known that the borrower will have enough money to bring the account current at a specific time in the future. The money might come from a bonus, investment, insurance settlement, or a tax refund.

Repayment Plan: With a repayment plan, the bank agrees to add, for example, half the amount of the first missed payment onto each of the next subsequent two payments. These plans provide some relief for borrowers with short-term financial problems, such as expensive car repairs that make it too difficult to pay the mortgage in a given month.

For Long-term or Permanent Set Backs

Mortgage Modification: If the borrower can make the payments on the loan, but does not have enough money to bring the account current or cannot afford the total amount of the current payment, a change to one or more of the original loan terms may make the payments more affordable. The loan terms could be changed in one or more of the following ways:

- Adding the missed payments to the outstanding loan balance;
- Changing the interest rate, including making an adjustable rate into a fixed rate;
- Extending the repayment term.

Short Refinance: Forgive some of the debt and refinance the rest into a new loan, usually resulting in lower financial loss to lender than foreclosing.

Claim Advance: If the mortgage is insured, the borrower may qualify for an interest-free loan from the insurer to bring the account current. Full repayment of this loan may be delayed for several years.

For Older Homeowners

Reverse Mortgage: Reverse mortgages allow older homeowners (with little or no outstanding mortgage debt) to convert the equity in their homes to cash while retaining ownership. With a regular mortgage, the borrower makes monthly payments to the lender. But with a reverse mortgage, the borrower receives money from the lender and generally does not have to repay it for as long as they live in the home. In return, the lender holds some — or all — of the home's equity. For more information on reverse mortgages, go to www.ftc.gov.

If Keeping the Home is Not an Option

Sale: If the borrower can no longer afford to repay the mortgage, the lender agrees to give the borrower (or their agent) a specific amount of time to find a purchaser and pay off the total amount owed.

Pre-foreclosure Sale or Short Payoff: If a property's net sales proceeds do not cover the loan in full, the lender may accept less than the full amount owed. Though the lender takes a loss on the sale, the additional cost of foreclosing on the property is avoided.

Assumption: Allow a qualified buyer to assume the mortgage, even if the original loan documents state that it is non-assumable.

Deed-in-lieu: Agree to allow the borrower to voluntarily surrender the property and forgive the debt. This option may not be available if other liens such as judgments of other creditors, second mortgages, and IRS or state tax liens exist.

Note: both a short sale and a deed-in-lieu damage the borrower's credit rating less than a foreclosure as they reflect efforts by the borrower to come to terms with the lender. But the short sale is less damaging than a deed-in-lieu, because it indicates recognition by the lender that the event was caused by factors outside of the borrower's control.

Is Foreclosure Prevention Effective?

A national study released July 2004 by Freddie Mac Deputy Chief Economist Amy Crews Cutts and George Washington University Professor Richard Green found that home retention workouts, such as repayment plans and loan modifications, are very effective at keeping borrowers in their homes. The study found that repayment plans lower the probability of home loss by 80 percent among all borrowers and by 68 percent among low- to moderate-income borrowers. Repayment plans appear to work well, regardless of the income level of the homeowner. For more detailed information, this study can be found at www.freddiemac.com/corporate/reports.

Is Foreclosure Prevention Cost Effective?

Do mortgage foreclosure prevention programs save public and private dollars? In 1995, the Family Housing Fund undertook an evaluation of the cost-effectiveness of the Mortgage Foreclosure Prevention Program (MFPP). MFPP was established in Minneapolis and St. Paul in 1991 to provide counseling and, in some cases, financial assistance to help low- and moderate-income homeowners avert foreclosure. Supported by a combination of private and public funding, the program is administered by the Family Housing Fund, and the results compiled in a database maintained by the Amherst H. Wilder Foundation's Research Center.

The study focused on data from two participating Twin Cities agencies: the Northside Residents Redevelopment Council (NRRC) and the St. Paul Housing Information Office (HIO). The study covered the period between July 1991 and March 1995. During this time, over 800 homeowners in the Twin Cities received foreclosure prevention counseling and/or emergency assistance. Total expenditures for the program were $1.6 million.

The average cost of foreclosure prevention in this study was $3,300 ($1.6 million divided by 487 homeowners who had their mortgage reinstated). The cost of foreclosure, on the other hand, was many times higher. The exact amount varies with factors such as interest rates and their effects on refinancing, the strength or weakness of the local real estate market, the type of mortgage insurance (FHA, VA, or private), and whether the property is sold quickly or abandoned, boarded, or demolished. In this study, costs were estimated for two typical scenarios:

- In Scenario 1, a house with an FHA mortgage goes into foreclosure, becomes vacant and boarded up, and is eventually acquired by the city, which rehabilitates it and sells it.
- In Scenario 2, a house financed with a privately insured, conventional mortgage goes into foreclosure, is put on the market, and is sold, recouping some expenses.

The tables below compare the costs of mortgage foreclosure prevention versus the costs of foreclosure to stakeholders under the two scenarios.

Scenario 1		
	Foreclosure Prevention Cost	Foreclosure Cost
Homeowner		$7,200
Lender		$1,500
Servicer		$1,100
FHA-HUD		$26,500
City		$27,000
Neighbors		$10,000
Counseling, Financial Assistance	$3,300	
Average Cost per Household	$3,300	$73,300

Note: Losses listed in Scenario 1 for lenders, servicers, FHA-HUD, and the city represent dollar losses directly related to the foreclosed property, unrecovered rehab subsidies, and lost tax revenues. They do not include administrative cost, such as staffing of servicers' collection departments, public health inspections and condemnation process, the cost of police calls, or city staff time spent coordinating rehabilitation work.

Scenario 2		
	Foreclosure Prevention Cost	Foreclosure Cost
Homeowner		$7,200
Lender		$2,300
Servicer		$1,100
Private Mortgage Insurer		$16,000
Counseling, Financial Assistance	$3,300	
Average Cost per Household	$3,300	$26,600

Note: Losses listed in Scenario 2 for lenders, servicers, and private mortgage insurers represent dollar losses directly related to the foreclosed property. They do not include administrative costs, such as paying for collections or foreclosure staff.

In Scenario 1, the combined losses for all parties were about $73,300 — over 22 times the average cost of prevention. In Scenario 2, the combined losses were about $26,600 — eight times the cost of prevention. These figures were based on average losses experienced by typical homeowners served by the foreclosure prevention program and by lenders, servicers, mortgage insurers, and neighborhoods. The losses calculated for the city were at the lower end of the typical range. Losses to lenders were lower in Scenario 1 than in Scenario 2 because FHA mortgage insurance provides more comprehensive coverage than private mortgage insurance.

In addition, the study yielded the following results regarding the effectiveness of the foreclosure prevention program:

- Of the 800 homeowners serviced during the review period, the two agencies helped 487 (60 percent) homeowners to reinstate their mortgages.
- Of the 487 mortgages reinstated, 432 (89 percent) were FHA, VA, or privately insured. Averted losses to the insurers totaled an estimated $9.6 million.
- After two years, 244 (50 percent) of the homeowners were still current on their mortgages, dropping the averted losses to an estimated $5.4 million. Still, the savings are more than triple the program's cost.

Foreclosure prevention is both impactful and cost effective. The collected losses to the many parties affected by foreclosure are many times the cost of working with the homeowners to prevent foreclosure before it occurs. Furthermore, the benefits of foreclosure prevention increase for lending institutions, mortgage insurers and investors, government at all levels, and homeowners with each home saved.

As indicated previously, workout options work best early in delinquency. However, many people avoid calling their lenders when they have money troubles. Most are embarrassed to discuss money problems with others or believe that if lenders know they are in trouble, they will rush to collection or foreclosure. It is to the lender's advantage to contact the borrower as soon as delinquency begins. Borrowers who don't feel comfortable talking with their lender should immediately contact a HUD-approved housing counseling agency. A counselor will help assess the borrower's financial situation and determine what options are available. A counselor will be familiar with the various workout arrangements and will know what course of action makes the most sense for the borrower, based on their circumstances. In addition, the counselor can call the lender with the borrower or on the borrower's behalf to discuss a workout plan. Also, a counselor will have information on local services, resources, and programs that may provide the borrower with additional financial, legal, medical, or other assistance.

To find out more about HUD-approved housing counseling agencies and their services, call (800) 569-4287 or go to www.hud.gov to look at the list of HUD-approved agencies by state.

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