LIFELINE LETTERS

REAL ESTATE MARKET INSIGHTS FROM LIFELINE – ISSUE 1, 2010

Between Loan Modification and Foreclosure
A US Treasury Program Encourages Short Sales and Deeds-in-Lieu

Summary

The US Treasury recently provided details of a program first announced in May 2009, the Home Affordable Foreclosure Alternatives Program, HAFA, which recognizes that many homeowners will not qualify for a loan modification. For them, it may be sound public policy to encourage practical alternatives to foreclosure.

For those who don't qualify for loan modification through HAMP (Home Affordable Modification Program) or a servicer's own modification program, or borrowers who decline a modification, the HAFA program makes alternatives like a short sale or deed-in-lieu of foreclosure (DIL) more attractive. The program has strict qualification and reporting guidelines. It provides financial incentives to mortgage servicers, homeowners, lien holders and mortgage investors.

The program is effective April 5, 2010 but financial institutions can choose to implement it sooner. Participation is voluntary but strongly encouraged.

Discussion and Definitions

Short sales and deed-in-lieu's are complex transactions involving coordination and cooperation among a number of parties including, but not limited to, servicers, appraisers, borrowers (sellers), buyers, real estate brokers and agents, title agencies, and often mortgage insurance companies and subordinate and other lien holders as well as mortgage investors acting indirectly through the servicers. Some definitions are necessary for clarity.

In a short sale, the servicer of the mortgage allows the borrower to sell the mortgaged property with the understanding that the net proceeds from the sale may be less than the total amount due on the mortgage. The short sale must be an arm's length transaction with the net sale proceeds (after deductions for reasonable and customary selling costs) being applied to a discounted ("short") mortgage payoff acceptable to the servicer. The servicer accepts the short payoff in full satisfaction of the total amount due on the first mortgage, and may or may not waive rights to come after the borrower in the future for any deficiency in that payoff.

In a deed-in-lieu of foreclosure (DIL), the borrower voluntarily transfers ownership of the mortgaged property to the servicer of the mortgage in full satisfaction of the total amount due on the first mortgage. The servicer's willingness to approve and accept a DIL is contingent upon the borrower's ability to provide marketable title, free and clear of mortgages, liens and other encumbrances. Generally, servicers require the borrower to make a good faith effort to sell the property through a short sale before agreeing to accept the DIL. However, under circumstances acceptable to the investor in a mortgage-backed security containing the mortgage or mortgage holder, the servicer may accept a DIL without the borrower first attempting to sell the property.

Contrary to popular belief, a foreclosure is neither a market clearing mechanism nor the market's "invisible hand" at work. A foreclosure is, in fact, evidence of market failure as a transaction is forced in a situation of extreme information asymmetry, where the non-bank buyer assumes the worst and likely bids accordingly and perverse incentives exist for the departing homeowner to destroy value. A foreclosure auction sale where all market participants know that the sale is taking place under duress and where the buyer lacks reliable information on the condition of the home is a home price determined under conditions of a broken market.

We are firmly of the view that every negative equity distressed transaction where the first-best option of loan modification is rejected, should be a short sale.

A foreclosure leads to further distressed home inventory hitting the market, value destruction simply from the foreclosure process and lower market prices that reflect the destroyed value of the asset. Alternatives to foreclosure seek to preserve that value.

The HAFA program complements HAMP by providing viable alternatives for borrowers who are either HAMP-ineligible or they are HAMP-eligible and decline a loan modification. Of course, loan modification which preserves a homeowner's ownership status remains the preferred but not always attainable outcome.

Specifics of the HAFA Program

The HAFA program simplifies and streamlines the pre-foreclosure use of short sales and DIL options by incorporating a number of attractive features which include financial incentives to borrowers, servicers and investors, and a streamlined application process.

Incentive payments for a completed short sale or DIL are generous. Mortgage servicers can receive $1000 for the extra effort they put in to avoid foreclosure. Homeowners receive $1500 when they agree to a short sale or DIL and when they obtain a waiver from any further claims. Mortgage investors may receive up to $1000 of the short sale proceeds to help them accept short sales as a preferred outcome to a foreclosure. Last, up to $3000 of proceeds may be paid to subordinate lien holders as a nuisance avoidance payment to get them to give up their right to enforce a foreclosure.

This last payment is exceedingly important as a subordinate lien holder has the ability to hold up a pre-foreclosure solution and whose seemingly irrational behavior keys off that fact. Knowing that they can put on hold a sensible pre-foreclosure solution, subordinate lien holders may demand more than the zero payment they would likely receive in a foreclosure. Paying them a fee in recognition of that power is pragmatic and clever.

The HAFA program requires that borrowers be fully released from future liability for the debt via a deficiency waiver by the servicer and any mortgage insurer involved. With either the HAFA short sale or DIL, the servicer may not require a cash contribution or promissory note from the selling borrower. The sale must represent an arm's length transaction.

There is a timeline specified to keep the sale from stalling. Once a servicer determines that a homeowner does not qualify for a loan modification, the servicer has a 30 day window in which a borrower must be considered for the HAFA program. Once an offer is received for a short sale, mortgage servicers have 10 days to approve or reject the proposed sale.

To discourage flipping of distressed real estate, the purchaser may not sell the property within 90 calendar days of closing. Every potential eligible borrower must be considered for HAFA before a loan is referred to foreclosure or a pending foreclosure related sale goes through.

What does this mean?

A program that encourages pre-foreclosure distress resolution for a financially strapped homeowner is a positive for society, the financial system and the country's aggregate consumer wealth. The streamlining of processes makes short sales and DILs administratively less "cottage industry" and more "industrial scale", as scalability would be required to solve such a large problem. Last, the actual payments make the financial reward of a pre-foreclosure resolution more attractive.

The cash payment to the subordinate lien holder removes much of an impediment to the completion of a short sale or a DIL, and is a clever recognition of their right to enforce a foreclosure solution.

To banks and mortgage servicers, HAFA makes short sales and DILs pre-foreclosure somewhat easier to approve and financially more attractive. They receive a small amount of money which compensates them for taking on the extra administrative burden of a short sale; and the more streamlined that process can become, the more of that one-time success based payment they will get to keep. However, the bank or servicer still has to figure out what a property is worth in a short sale situation and still has to approve them serially. No bulk approval mechanism is contemplated in the HAFA program.

To distressed homeowners who do not enter a loan modification, alternatives other than foreclosure become more financially attractive and administratively easier as well. Despite this program, they will likely still have to vacate the home, which means the social and family impact of a change of residence remains as a very real and potentially traumatic cost. Such a cost cannot be directly modeled but is intuitively quite high. As the credit impact of a short sale or DIL is somewhat less than a foreclosure, the homeowner's credit is less impaired.

To buyers like Lifeline the HAFA program is a welcome gift. Lifeline is in a unique position in that it offers a "bulk" potential short sale model with formulaic, objective and bank-accepted pricing for a short sale. But the financial incentives provided by HAFA enables buyers like Lifeline to manage the various incentive payments that they may have to make in a manner more favorable to the buyer.

To summarize, the HAFA program is welcome relief especially when it is combined with a program like Lifeline to keep families in their homes, as former homeowners now renters, and possible future homeowners again, sharing the positive social, family and financial impacts of avoiding foreclosure in a financially equitable proposal for all parties.