MORTGAGE BANKERS ASSOCIATION

LENDERS' COST OF FORECLOSURE

POLICY PAPER

Congressional Education Series Briefing May 28, 2008

MORTGAGE BANKERS ASSOCIATION®
Investing in communities

Lenders' Cost of Foreclosure

Introduction

The recent increase in mortgage delinquencies and foreclosures has brought significant attention to the costs of foreclosure to homeowners, communities, and mortgage industry participants. Although the impact of foreclosure on homeowners and communities is apparent, some confusion still exists about the impact on industry participants, particularly lenders, servicers, and investors.

Foreclosure is a lengthy and extremely costly process and, generally, a losing financial proposition for lenders and investors. A recent Congressional Research Service paper, which analyzes current foreclosure issues, highlights how substantial and far-reaching these losses can be.[1] While losses can vary widely, several independent studies find them to be generally quite significant: over $50,000 per foreclosed home[2] or as much as 30 to 60 percent of the outstanding loan balance.[3]

This paper provides a summary of the impact to various mortgage industry participants, the foreclosure process, and the significant costs borne by participants.

The Industry Participants

When a ***lender*** holds a loan in portfolio, it retains the credit risk on the loan and typically takes a direct loss if the loan goes to foreclosure.

When a loan has been securitized, the ***investors*** in the mortgage securities hold the credit risk and take the loss if the loan goes to foreclosure sale. Mortgage securities generally are subdivided into groups known as tranches with distinct risk and return characteristics. As a result, losses usually are not borne evenly by all investors.

Foreclosure losses, however, do impact the overall transaction and the available proceeds. As costs are recovered, senior tranche holders are paid first, then the junior i.e., higher risk, higher yielding tranche holders suffer the initial revenue losses. Investors in the senior tranches, however, can also suffer financial losses when foreclosures and related costs exceed expectations.[4]

The ***servicer*** is contractually responsible for acting on behalf of the investor, for both portfolio-owned and securitized loans. As the agent, the servicer collects payments from the borrower and passes payments of principal and interest on to the investor and, in most instances, makes tax and insurance payments to the appropriate entities as well. Some portfolio lenders also service their own loans, in which case, the lender and the servicer are one in the same.

Throughout the foreclosure process, the servicer incurs direct costs as described below. Many, but not all, of the costs incurred by the servicer during the default, foreclosure and post-foreclosure period are reimbursed through mortgage insurance (if applicable) and upon final sale of the foreclosed property, known as real estate owned (REO).

The Process

Foreclosure is the process through which the lender or the servicer repossesses the underlying property when a borrower defaults[5] on his or her mortgage through non-payment. The foreclosure process technically is complete once a lender or servicer has acquired title to a property through a foreclosure auction or sale.

The term ***post-foreclosure,*** as used in this paper, describes the process of preparing and selling REO.

State law dictates the foreclosure process and timeline. As a result, foreclosure costs vary significantly from state to state. In certain states, foreclosure requires court action; this is known as judicial foreclosure. In judicial foreclosure states, foreclosure takes longer and, consequently, is more costly.

Even without a judicial foreclosure, the process is lengthy. The national average time between the first missed payment and the foreclosure sale is approximately one year.[6] After that, it may take additional time to gain possession of the property, clear title (if necessary), and prepare and sell the REO.

The Costs

Throughout the delinquency period, the foreclosure process, and the post-foreclosure process, lenders and/or servicers incur a variety of costs.

Delinquency Period Costs

Lenders and servicers begin incurring costs as soon as a borrower stops making timely mortgage payments. Many of these are time-dependent costs that continue to grow as long as the loan is delinquent, in foreclosure, or in the REO sales process. These costs include:

- ***Lost principal and interest payments.*** In the case of a loan held in a lender's portfolio, the lender incurs this loss directly. Where a loan has been securitized, the servicer incurs costs because transaction agreements usually require that they continue forwarding principal and interest payments to investors, using their own funds or borrowed funds, as long as the loan remains in the security.

- ***Tax and insurance payments.*** The lender or servicer is responsible for making these payments, if the terms of the loan call for these items to be escrowed, whether or not the borrower is making monthly mortgage payments. These obligations continue until the borrower resumes making payments or the property is sold.

- ***Maintaining the property.*** If the borrower is not properly maintaining the home, the lender or servicer is responsible for the ongoing costs of maintaining the property. This can include paying for lawn maintenance, securing the property, complying with safety codes, winterizing the property (where necessary), and homeowners association or condo fees, if relevant. These expenses continue until the property is sold.

- ***Lost servicing fee income.*** A servicer loses its servicing fee when a loan is delinquent as this fee comes out of the monthly payment received from the borrower.

- ***Costs of collection efforts/servicing.*** Servicing delinquent loans requires additional servicer resources, which can be up to three times the cost of servicing a current loan.[7]

Foreclosure and Post-Foreclosure Costs

Most of the listed pre-foreclosure costs are time-dependent costs that the lender and servicer continue to accrue throughout the foreclosure process. Additionally, there are several one-time transaction costs that occur once foreclosure has been initiated.

- ***Legal costs for handling the foreclosure.*** The lender or servicer incurs legal expenses in all jurisdictions. Legal expenses are higher in judicial foreclosure states. Additionally, a personal bankruptcy proceeding often accompanies foreclosure. This further pushes up the legal costs the lender or servicer who must also be represented in that proceeding.

- ***Administrative fees.*** Court fees, fees to publicize foreclosure notices, auctioneer fees, and title fees must all be paid. In some states, the local sheriff manages, conducts and holds the foreclosure sale or auction; sheriffs' fees also vary widely, but can be as much as four to five percent of the value of the property.

Once the lender has taken possession of and title to the property through a foreclosure auction or sale, it has to prepare and market the home for sale. These expenses can be significant, accounting for over 40 percent of foreclosure-related gross losses.[8] The main expenses during this phase of the process are:

- ***Costs of restoring the property to saleable condition.*** Often homes of borrowers in financial distress fall into disrepair, requiring significant repairs and capital improvements (including painting, plumbing repairs, replacing appliances and carpeting, and repairing water damage).

- ***Real estate commissions.*** Lenders typically use real estate agents to sell REO, which means commissions are paid upon sale.

Loss on REO Sale

The last step that creates a major expense for investors and servicers is the loss on the unpaid principal balance that occurs upon the sale of the REO. While exceptions occur, mostly in markets where home prices are increasing, investors and lenders do not typically profit from an REO sale. REO properties generally do not attract top dollar, and once sale proceeds are netted against the various costs incurred during the delinquency period and foreclosure process, the investor and lender usually end up with losses.[9] These losses make up approximately 20 percent of the total costs of foreclosure.[10] The current softness of the housing market could push this rate even higher.

The Role of Mortgage Insurance

Some loans carry mortgage insurance that can help servicers and lenders recover some of the costs of foreclosure. Low down payment loans sold to Freddie Mac or Fannie Mae require mortgage insurance. In the case of subprime and other loans sold into the private label market, mortgage insurance is less common as borrowers often used second liens as part of their down-payment.

Mortgage insurance can be in the form of FHA mortgage insurance, a Veterans Administration or other federal loan guaranty, or private mortgage insurance (PMI). Mortgage insurance claims are typically made once the lender or servicer has taken title to the property. Mortgage insurance can reimburse a servicer or lender for costs including unpaid interest payments, advances of taxes and interest, legal fees, and maintenance costs.

All mortgage insurance programs, however, have limits on reimbursements, whether based on the coverage level of insurance purchased (in the case of PMI) or on a percentage of reimbursable costs (in the case of FHA). Additionally, mortgage insurance does not reimburse for expenses such as capital improvements needed to bring a foreclosed property to salable condition, real estate agent commissions, tax and insurance payments made after the foreclosure sale and before the REO sale, and seller concessions that the lender or servicer may offer to effect an REO sale.

Conclusion

Foreclosure is a costly, complex, and time consuming process. For all the parties involved — the homeowner, the community, or the mortgage industry participants — foreclosures are a losing economic proposition. As this paper points out, foreclosure imposes significant costs on servicers, lenders, and investors. These costs not only impact their profitability, but also their ability to lend funds for new mortgages and continue to help finance homes for new borrowers.

When one looks at all the lender costs of foreclosure:

- The many transaction costs;
- The time-dependent costs that a lender or servicer incurs during the entire period from default to REO sale (which can exceed two years);
- The costs of selling the REO; and
- The fact, that once the REO is sold and any mortgage insurance claims paid, lenders and investors typically still are not made financially whole,

it is clear that lenders share the interest of homeowners and their communities to avoid foreclosure.

Endnotes

1 Darryl E. Getter, "Understanding Mortgage Foreclosure: Recent Events, the Process, and Costs," Congressional Research Service Report for Congress (November 5, 2007), pp. 9, 11 (http://assets.opencrs.com/rpts/RL34232_20071105.pdf).

2 Desiree Hatcher, "Foreclosure Alternatives: A Case for Preserving Homeownership," Profitwise News and Views (a publication of the Federal Reserve Bank of Chicago) (February 2006), p. 2 (citing a GMAC-RFC estimate) (http://www.chicagofed.org/community_development/files/02_2006_foreclosure_alt.pdf). See also Congressional Budget Office (CBO), "Policy Options for the Housing and Financial Markets," (April 2008), p. 17.

3 Karen M. Pence, "Foreclosing on Opportunity: State Laws and Mortgage Credit," Board of Governors of the Federal Reserve System (May 13, 2003), p. 1 (http://www.federalreserve.gov/Pubs/feds/2003/200316/200316pap.pdf).. See also CBO, p. 17; Community Affairs Department, Office of the Comptroller of the Currency (OCC), "Foreclosure Prevention: Improving Contact with Borrowers," Community Developments (June 2007), p. 3 (http://www.occ.treas.gov/cdd/Foreclosure_Prevention_Insights.pdf).

4 Getter, p. 12. Furthermore, even when the payment of principal is guaranteed, a foreclosure can mean the investor receives the full principal amount sooner than expected and thus suffers the loss of an expected cash flow stream that would include interest.

5 Industry practice generally defines default as being 90 days or more delinquent.

6 Amy Crews Cutts and William A. Merrill, "Interventions in Mortgage Default: Policies and Practices to Prevent Home Loss and Lower Costs," Freddie Mac Working Paper #08-01 (March 2008), p. 30 and Table 6 (http://www.freddiemac.com/news/pdf/interventions_in_mortgage_default.pdf).

7 OCC, p. 3.

8 Cutts and Merrill, p. 32.

9 CBO, p. 17; Getter, p. 9; Cutts and Merrill, p. 33.

10 Cutts and Merrill, p. 33.

MORTGAGE
BANKERS
ASSOCIATION®