A F F O R D A B L E H O U S I N G

ISSUES

SHIMBERG CENTER FOR AFFORDABLE HOUSING

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Foreclosure Prevention

The rise in mortgage foreclosures, and especially the dramatic rise in subprime mortgage foreclosures, has the potential to undermine the significant homeownership gains made by lower-income and minority consumers during the 1990s. Aside from the devastating impact of foreclosures on borrowers and communities, their increase also costs all participants in the mortgage industry. To address the problems caused by a rising foreclosure rate, banks and others have developed programs to reduce the number of foreclosures. Many of these programs were developed as partnerships between banks acting as loan servicers and nonprofit organizations that provide financial counseling to homeowners.

The June 2007 Community Developments Insights produced by the Community Affairs Department of the Controller of the Currency is dedicated to the subject of preventing mortgage foreclosure. Selected portions of that report have been reproduced here. The full report can be found on the Internet at http://www.occ.gov/cdd/resource.htm.

What Is Foreclosure Prevention?

Over the past two decades, technological innovations in credit scoring, processing, and underwriting of mortgage loans helped fuel the growth of the prime and subprime mortgage markets. Additionally, the growth of the secondary mortgage market, the increased appetite of investors for mortgage backed securities (MBS), and the more recent period of low interest rates, all came together to create a housing boom that increased the nation's homeownership rate from 65 percent in 1995 to 69 percent in 2006.

However, as lenders tried to keep pace with the demand for MBSs, some originators, primarily in the subprime mortgage market, began to combine the underwriting of borrowers with weaker credit scores with other higher risk elements, such as higher loan-to-value ratios or incomplete income documentation. The unintended consequence of the mortgage industry's ongoing effort to extend homeownership opportunities to less creditworthy consumers has been an increase in foreclosure rates.

Why Is Foreclosure Prevention of Interest to Banks?

Banks recognize that keeping homeowners in their homes is often the best way to mitigate credit losses, preserve customer relationships, maintain stable neighborhoods, and minimize the detrimental effects vacant properties can have on crime and property values. Banks that originate and service mortgage loans are aware that prudent attempts to workout loans of homeowners who have defaulted on their contractual obligations are often in the best interests of both the lender and the borrower. When borrowers default on their home loans, some specific and measurable reasons exist for why banks should be interested in preventing foreclosure. These reasons include:

Reputation Risk - Banks face negative publicity over rising foreclosure rates in general and over individual cases when the bank may have made the loan or is currently servicing the loan. In addition, when a significant number of loans in an investment pool go into default, the secondary market can develop concerns about all loans originated by that institution. These defaults can negatively affect the institution's ability to sell new loans on the secondary market. In addition, investors rely on the Nationally Recognized Statistical Rating Organizations (NRSROs) to gauge the effectiveness of a servicing operation and the quality of loans. A large number of foreclosures can affect negatively a bank's servicing rating assigned by a rating agency.

Costs to Bank-Owned Portfolio - For loans that are held in a bank's portfolio, direct losses can result from foreclosures. These losses are affected by the property's condition, local market conditions, fees, and advances related to the length of time it took to foreclose on the property. General estimates of the losses to lenders on a foreclosure range from 20 to 60 cents on the dollar.

Costs of Servicing - Most mortgage loans are sold to secondary market investors, shifting much of the risk of foreclosure to the servicers and investors and costing banks that service loans. As a delinquency progresses, servicers often make advances for taxes, insurance, property preservation, inspections, and legal costs. Servicers must also make advances on principal and interest to investors, regardless of whether the servicer has received a payment from the borrower. Many, but not all, of these advances are reimbursed once the property is liquidated, but the servicer still faces the cost of funds for advancing fees, expenses, and debt service payments. In addition, servicing a foreclosure requires the servicer to use additional staff resources. One bank reported that servicing a loan in foreclosure is at least three times as costly as servicing a current loan.

Major Investors Paying Incentives for Workouts - The income from these workout incentive payments can be substantial and offset some of the costs associated with servicing operations. The availability of such incentives is determined by the performance of an investor's loans and the relationships among the various parties involved (servicer, investor, etc.).

Property Values - Vacant and abandoned properties are vulnerable to vandalism, deterioration, and criminal activities. A large number of foreclosures can increase the supply of homes on the market, negatively affect neighborhood values, and drive down sale prices.

Community Reinvestment Act (CRA) Credit - Two primary activities are useful in preventing foreclosures and each may receive positive CRA consideration. First, banks can provide financial counseling to low- or moderate-income homeowners, either directly or through a nonprofit agency, to help keep them in their homes. Second, banks may provide refinancing of higher variable rate mortgages into lower fixed-rate mortgages for low- or moderate-income borrowers. Examiners will consider such a program as responsive in helping to meet the credit needs of its community.

How Does Foreclosure Prevention Work?

Effective foreclosure prevention relies on increasing the amount of contact between servicers and delinquent borrowers. According to the Communtiy Development Insights report, all of the banks interviewed for the report described increasing the contact rate between servicers and delinquent borrowers as the key to success of their foreclosure prevention initiatives. However, mortgage servicers have found that traditional collection methods are no longer producing satisfactory results. The old method was to flood borrowers with letters and telephone calls. Although servicers still use the letter and the telephone as the main means of contacting borrowers, the callers convey a number of positive messages early in the call. Many servicers use software that can propose a workout solution with a payment schedule based on such factors as the borrower's income and other expenses. The software also incorporates any investors' requirements into the servicing agreement. These software packages also script the call for the servicing staff.

Default Intermediation

There are three main models for reaching borrowers who are late on payments:

Direct servicer contact - Banks are trying a number of direct contact strategies to improve their contact rate such as using non-standard call times, using customer friendly approaches, attempting to contact by going door-to-door. Some banks are using scoring models to help them determine which late paying borrowers are priority contacts. These models provide a score that identifies the risk of a borrower going further into delinquency. The models incorporate borrower-specific factors, such as payment patterns and credit scores, combined with economic data, such as local unemployment rate and trends in real estate values. The main purposes of these scoring models are: (1) to streamline collection calls by risk-ranking delinquent accounts to identify loans most likely to benefit from early intervention to avoid foreclosure and (2) to identify loans most likely to create a loss without an intervention.

Direct contact by counseling agencies - In addition to the servicers' requirements to notify eligible borrowers of the availability of homeownership counseling by the servicer or a HUD-approved nonprofit counseling agency, many servicers have begun to partner with these counseling agencies. Some servicers have realized that counseling agencies are more trusted by borrowers and that borrowers may be more likely to respond to a call or letter from a counseling agency. These servicers have found that by partnering with a counseling agency, their contact rates with delinquent borrowers have increased. These partnerships capitalize on the desire of both banks and counseling agencies to have borrowers stay in their homes if they can afford their mortgage payments.

National toll-free number for borrowers to call - Several reputable national nonprofit organizations have partnered with mortgage servicers to provide no-cost telephone counseling to delinquent borrowers. NeighborWorks America has partnered with the Homeownership Preservation Foundation to establish a 24-hours-a-day, seven-days-a-week, toll-free hotline for homeowners to discuss their delinquency problems with a housing counselor. Calls flow into a national call center staffed by English- and Spanish-speaking counselors. Callers are prioritized immediately. Depending on the nature of the problem, counseling can be provided as part of the initial call or through a series of follow-up calls or in-person visits to a local housing counseling service to which the borrower is referred. If a workout can be arranged with the lender, counselors can also provide budgeting assistance and other financial education to help ensure that these borrowers can meet the terms of their workout agreements. In about 25 percent of the counseling sessions, the homeowner is recommended for loan workout, and the counselor helps the homeowner work with the servicer on a loan modification.

Direct Contact by Counseling Agencies

Some servicers have contracted with nonprofit housing counseling agencies to make an initial contact with borrowers who are late on payments. Under this scenario, a servicer provides a pre-selected counseling agency with a list of borrowers to contact. The counselor is trained to make a friendly call to the borrower, emphasizing his or her ability to work with the borrower and help the borrower work out a solution with the lender. The borrower has the option of sharing financial information with the counselor.

This strategy begins with a letter from the counseling agency to the borrower, providing a toll free number and a Web site. The letter states that if the counseling agency does not hear from the borrower, the agency will contact the borrower by telephone. When contact is made, the counselor can collect documentation and information needed to evaluate loss mitigation options, with permission from the borrower. If no feasible plan can be developed, the counselor helps develop a detailed plan for selling the property. Overall, some servicers have concluded that the fees paid to counseling agencies are considerably lower in comparison with the costs of foreclosure.

National Toll-Free Number for Borrowers

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Options for Borrowers and Servicers - Once the servicer has made contact with the delinquent borrower, either directly or through a counseling agency, there are a variety of options to be discussed. These options are divided into two major groups: retention workout options and non-retention options. Retention workout options allow a borrower to retain possession of the home. Alternatively, non-retention options result in the borrower relinquishing the home, but avoiding the expense and stigma of foreclosure process.

Retention Workout Options - Retention options allow a borrower to retain possession of the home. There are several workout options that loan servicers, borrowers, and nonprofits can utilize in their best efforts to keep the borrower in the home. The earlier these conversations occur, the greater is the likelihood of a successful outcome.

Early Contact Discussion of Alternatives - For loans with upward adjusting payments (such as hybrid ARMs and payment-option ARMs), some servicers have begun contacting borrowers prior to the scheduled payment increase to advise them of the new payment amount. If the borrower cannot afford the new payment and is reasonably likely to default, the servicer may be able to modify the loan to create longer-term affordability. In some cases, servicers acting on behalf of lenders are offering to refinance ARMs into lower-cost, fixed-rate loans.

Repayment Plan -The servicer increases the regular monthly payment until the delinquency is repaid. Typically, the payment period extends over a two- to six-month period.

Loan Modification - A loan is modified in a written agreement between a borrower and servicer that permanently changes one or more of its original terms. The loan modification may include an interest rate concession, reducing the principal balance outstanding, extending the term of the loan, establishing escrows for taxes and insurance, or adding the delinquent interest amount to the unpaid principal balance.

Forebearance - Forebearance is an agreement to allow a reduced or suspended payment for a specific period of time, usually not to exceed three months. The borrower still owes the unpaid amount, which may be worked out later with a loan modification.

Non-retention Options - There are some situations in which the borrower will be unable to retain the home, and foreclosure is inevitable. In these cases, quick action is needed to reduce the financial hardship on the borrower and to limit any losses to the lender. All parties involved must look seriously at the borrower's financial profile and be willing to admit when leaving the home is the best alternative.

Sale of the House - Borrowers are encouraged to sell their house and pay off the mortgage in full. Servicers can assist in the marketing and sale of the home.

Short Sale - A servicer agrees on behalf of an investor to accept the proceeds of a pre-foreclosure sale in satisfaction of the loan, even though the proceeds may be less than the amount owed on the mortgage.

Deed in Lieu of Foreclosure - A workout in which a borrower voluntarily conveys clear property title to the servicer in exchange for a discharge of the debt. This option is generally used when the home has been listed for sale for a period of time with no activity.

Developing Options - Some banks that hold mortgage loans in their portfolios have determined that offering fixed-rate loans to refinance a higher rate ARM may save some borrowers from foreclosure. Recent announcements from the government-sponsored enterprises (GSEs), specifically Fannie Mae and Freddie Mac, have indicated a willingness to purchase some of these refinanced loans once program guidelines have been established. This is a significant option for loan servicers to monitor in the near future. Separately, at least two states are considering a bond sale to establish a pool of funds to refinance higher rate and ARM loans in danger of foreclosure into new fixed-rate loans. Certain states also have rescue funds that will refinance loans from areas hit by job losses from industrial dislocations. Loan servicers should be aware of options available in various states.

What Are the Key Risks and Regulatory Considerations Presented by Alternatives to Foreclosure?

Banks must consider a number of risks and regulatory issues as part of their foreclosure prevention programs. Most often mentioned issues relate to privacy and the need to obtain third-party authorizations from borrowers. These third-party authorizations would permit the servicer to engage a local nonprofit counseling agency to reach out directly to delinquent borrowers, as the borrowers are more likely to open mail and answer telephone calls from a nonprofit counseling agency. The suggestion has been made that a disclosure explicitly authorizing the servicer to provide information on a borrower to a nonprofit counseling agency if the borrower is in danger of default should be made part of standard mortgage closing documentation. Foreclosure procedures vary by state. Some states mandate judicial foreclosures, which are processed through the courts, and others allow non-judicial foreclosures, which are processed without court intervention. Judicial foreclosures take much longer to process, allowing more time for the development of a workout plan, yet providing an incentive for borrowers to remain in their homes without making payments for a significant period of time.

Declining housing prices in some areas create additional risks to lenders, servicers, and investors. Declining values present a scenario in which the servicer has little or no built-in equity margin to serve as a cushion while negotiating a workout with a delinquent borrower. Also, the borrower has no real incentive to agree to the workout plan if the property is worth less now than when it was originally purchased. There also are safety and soundness issues that banks also address as part of offering foreclosure prevention programs.

The National Foundation for Credit Counseling has a network of local affiliated credit counseling agencies that are available to partner with loan servicers. Other community-based organizations are involved in these initiatives and are listed on HUD's Website (http://www.hud.gov/offices/hsg/sfh/hcc/hcs.crm)

Government Involvement

The detrimental effects of numerous foreclosures in any residential neighborhood are well documented. As a result, some local governments have combined forces with nonprofits and loan servicers to develop outreach programs to delinquent borrowers. For example, Chicago's Homeownership Preservation Initiative (HOPI) links delinquent borrowers with nonprofit credit counseling agencies through a 3-1-1 non-emergency hotline.

Government Sponsored Enterprises (GSEs) - The major secondary market investors, who are the largest purchasers of mortgages in the United States, recognize the benefits of foreclosure prevention programs and are directing their delegated servicers to incorporate them into their operations.

Federal Housing Administration (FHA) - The Federal Housing Administration, a major insurer of mortgages made to subprime borrowers, requires that all delinquent borrowers of FHA-insured loans be referred to nonprofit credit counseling agencies.

Conclusion

Banks recognize that keeping homeowners in their homes is the best way to mitigate credit losses, preserve customer relationships, and maintain stable neighborhoods. Unfortunately, not all borrowers can avoid the loss of their property. In many instances, however, foreclosure prevention works best when borrowers and loan servicers communicate to determine their options and the best course of action.

For a variety of reasons, borrowers often avoid having this communication with their loan servicers. Because the number of delinquent mortgages is rising, loan servicers are looking at new techniques to improve their contacts with delinquent borrowers to enhance the chances for homeowners to remain in their homes and to reduce losses. Best practices include: training servicing personnel in customer friendly outreach and on how nonprofit counseling agencies can assist them in this activity; providing servicer training for counseling agencies on acceptable options and outcomes related to delinquent borrowers; and, paying incentives to staff members based on the number of successful workouts they complete.

Resource Guide

OCC Community Developments Newsletter on Foreclosure Prevention

http://www.occ.gov/cdd/spring06b/cd/index.html

Interagency Statement on Working With Mortgage Borrowers

http://www.occ.gov/ftp/bulletin/2007-14.html

NeighborWorks America Center for Foreclosure Solutions

http://www.nw.org/network/neighborworksProgs/foreclosuresolutions/default.asp

HUD Certified Counseling Agencies

http://www.hud.gov/offices/hsg/sfh/hcc/hcs.cfm

Homeownership Preservation Foundation

http://www.hpfonline.org

Service Members Civil Relief Act

http://www.occ.treas.gov/Consumer/servicemember.htm

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