"Running the Numbers" in Mortgage Foreclosure

a flexible and efficient approach to achieve lender profits & homeownership stability

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Note: This article was authored in January and February of 2009, with later supplementation. Financial concepts are sound and accurate; legal conclusions may be outdated, as the law in this area is evolving rapidly.

More consumers are losing their homes than ever before, and they are losing faith in the American mortgage lending system. More lenders are foreclosing their mortgages than ever before, and they are losing faith in the American mortgage lending system. The real estate construction industry withers, and banks are hesitant. Jobs are lost, consumer spending shrinks, and recession becomes a concern. In the international investment market, the clamor for American mortgage securities falls silent; the world has lost faith in the American mortgage lending system. What is to be done?

It is a fair statement that trust creates trust, and mistrust creates mistrust. No doubt, contracts broken create dashed expectations. Unfortunately, every one feels cheated right now, both borrowers and lenders. What is to be done?

Are the greedy lenders to blame? Are the greedy builders to blame? The greedy consumers, the greedy realtors? It doesn't matter; the fixing of blame is far from a cure.

It is the primary focus of this article to encourage realism, and avoid the fixing of blame. The two parties left in the deal, after all the profits have been made, are the lender and the consumer. One wants payments; the other is willing to pay. One wants the house; the other doesn't want the house. Is there a way for everybody to get what they want? Will their original expectations be satisfied? There is good news and bad news. First the good news: everyone can get what they want.

The bad news: they cannot get everything they wanted or expected in the past. Regardless of legal rights and notions of what is "honest", "fair", or "enforceable" the refinance may not be available, the home too often cannot be sold for the loan amount, and the payment has increased for interest and taxes. Indeed, times have changed.

Market conditions have changed dramatically. The contract assumptions as to what is a "reasonable performance" must change with those market conditions, or everybody loses. The goal is not to ask lenders to become astute social scientists, but to help them make money. The goal is not to ask consumers to become savvy financiers, but to help them keep their homes. From of old the question has been "If I pay, can I keep the home?" Now the question comes into sharper focus: "How much, when?"

Fortunately, the mathematics of real estate finance are flexible, even when the parties are unwilling to compromise. We can get to where we want to go by understanding where we are now. The compromising realist keeps his performing loan or his home; the stubborn idealist loses up to 40% of his investment value or 100% of his home. Clearly, there are rational choices to be made, and disasters to be avoided.

In modern residential real estate finance, there are five variables with which we can tinker: term, interest rate, payment, starting balance, and ending balance. The important issue to most consumers is that "the payment is too high". For that reason, extending the loan term, or lowering the interest rate, or adjusting the loan balance become powerful tools in a loan workout.

Lenders should be encouraged by government mandate to use these tools: term, rate,and balance. Even a partial or temporary adjustment is often enough to attract the homeowner's commitment to regular mortgage payments. But we must be careful to encourage and nuture his hope: any loss less than 40% of the principal is a victory, when compared to foreclosure. So the issue becomes generating options and dialogue, not a "take it or leave it" deal left on voicemail.

The problem is not the math, it is the lack of trust. If we can restore that trust in mathematic fundamentals, we can clean up the mess. We can then recreate a trustworthy system where such *renegotiations are not necessary; "back to the future" of reasonable downpayments, fixed interest rates, loans based on actual income and sound appraisals, and full disclosure to consumers. But first we must clean up the mess. A simple example done on an ordinary handheld calculator shows our current crisis is "just math".*

Suppose Cary Consumer takes out a home loan from Larry Lender. In this simple example Larry holds the loan, without servicers, originators, warehouse lines, wholesalers, securitization, syndication, or mortgage pools. Larry simply makes a loan and holds the paper, expecting payment. In a more complex loan structure, we would expect Larry to communicate effectively with the same pragmatic realism that is here described; a small loss is better than a large loss.

In our example, Cary has just bought a home for 5% down, and has a mortgage loan of $200,000. His loan of $200,000 is at 7%, which requires a payment without taxes or insurance of $1,330.60 per month. After 24 months of making his payments faithfully, Cary loses his job as a mortgage broker. Contemplating his job search, Cary realizes that he has paid only $4,210.11 of principal in $31,934.52 paid to the lender over 2 years, and he still owes $195,789.89 of the original balance.

Because jobs offered to him pay much less than he is accustomed to making, Cary continues to search for two years, and no mortgage payments are made. With 7% interest, Cary's loan balance is now $225,120.40. He is clearly "upside down" on his home but wishes to keep it. There are workout options, as many as colors in the rainbow.

Adjust Term & Rate: *Now Larry comes from a long line of Lenders, all sharp Hoosier financiers. He offers Cary a deal: the loan balance will be considered (after two years of nonpayment) to have grown at only 5% interest per year, with a current balance due of $216,336.35. Larry is willing to accept this sum over 40 years at the original 7% interest. Even though sixteen thousand dollars more is owed than the original balance, Cary thinks this is fair: he has lived in the home rent free for two years, after paying for the first two years. In addition, Cary's payment will be only $1,344.38, just $14 more than he was paying originally.*

Larry is also happy with the deal: a sacrifice of 4% interest over two years has avoided a loss in foreclosure that Larry estimates would be 10 times that amount. Cary's gratitude makes him more than ever determined to make timely mortgage payments. Larry can't believe his lucky break, that he coaxed the homeowner to stay, simply by being flexible.

Keep Original Terms or Short Sale*: In another example, what if both homeowner and lender were hoodwinked by market forces? For the sake of this example, the builder sold the home for $210,000 with $10,000 down. All payments have been made by Cary, but now the home is worth only $160,000, with a loan balance of $196,000. Clearly the homeowner is "upside down", but he continues to make his mortgage payments on time and plans to stay in the home for the next 10 years while his kids are still in elementary and high school. Is there any need to call the loan due, because of the negative equity? Absolutely not. As long as the homeowner can make the payments, he should be encouraged to do so.*

If he cannot make the payments and must sell the home to downsize to a smaller payment, adjustment of the loan balance to be paid off as part of the sale may be productive. With continuous possession transferred from seller Cary to his buyer, and keys handed over at the closing table, even the short payoff will involve less loss for the lender than foreclosure. As long as the loss is not at the level of the 40% benchmark, previously cited as a typical loss to lenders in a foreclosure blighted neighborhood, the lender can do better in a "short sale" than he could do in foreclosure.

"Back End" Payment Shortfalls: *In another example, Larry might have given Cary an adjustable rate mortgage on a home with lots of equity. If the mortgage rate has gone up, and Cary cannot make the higher payments, perhaps some part of interest can go unpaid, added to the "back end" of the loan. This is the theory of the FHA "reverse mortgages" given to those over 65: they actually pay no payments at all!*

Work Out Deed in Lieu & Leaseback: *What about when the lender bends over backwards with flexible terms, and still the consumer cannot pay? Let's consider a case where the interest is reduced to the lowest possible interest rate, say, 2%. If as a further break, Larry Lender is willing to knock off 15% of the loan balance of $200,000, and that balance is reamortized to 40 years, this will give a low payment: $514.80. Bear in mind, the original payment was $1330.60, $816 per month more! Most of us would be delighted to get a 2% home loan amortized over 40 years, with or without principal reduction.*

If Cary still can't make the monthly mortgage payment with a loan balance of $170,000, which is 3.4 times his annual salary of $50,000 per year, what can be done? Frankly, he should examine his budget: realizing that his mortgage payment is less than 25% of his net take home pay, he should be able to do it. But Cary thinks this is just too much house to support on his salary. Should Cary surrender the home immediately, or is there still some deal which can be struck for mutual advantage?

The answer is found in looking at lender loss statistics: in this neighborhood, what % of value will be recouped when the home is resold after foreclosure? Can Larry Lender do better than $120,000 (net sales price after all expenses) by keeping Cary in the home? Clearly, the home is worth more occupied by its original owner, not left vacant for two years. Even leasing to Cary for a number of years at $550/mo. (plus taxes and insurance) is better than having the house vacant with no cash flow. Of course, some payment terms must be required from all occupants whether they are staying long or short term, buying with a mortgage or land contract, occupying with a deed or lease.

What if Loss on Transaction is Too Great? *If indeed the federal government intends to be a "backstop against losses" for lenders who hold "toxic assets" among $4.5 trillion of mortgages, are we not wise to make those assets less toxic? It would seem that any deal to keep homeowners paying and living in the home is good for us as taxpayers. Make the homeowner pay to stay, on whatever level is possible. Be flexible with that homeowner and the eviction process. Every penny of rent/mortgage payment tendered goes straight to the bottom line and paying expenses. How to calculate payment terms: What can the homeowner afford, either as a lease payment or as a mortgage payment? How to determine if the homeowner retains the deed: Is the monetary commitment which he is willing to make sufficient to amortize debt, or is he merely paying to occupy the property over the short term?*

What does it take to make this happen? A rational, aggressive commitment to one's own self interest is required, as is solid math. Those of us who understand the math need to sharpen the pencil and create a win-win transaction. Those of us who don't understand the math need to trust 1) that the math works, and 2)that the rational self interest of the parties can work for the good of us all.

What is the Federal Government going to do? *Two approaches are proposed as of March, 2009. Neither is yet widely understood or used. These changes are similar to those proposed herein, but they affect different classes of people in better or worse situations, in bankruptcy court or not.*

Currently, changes are being considered for use in the bankruptcy courts, to create changes in interest rate, principal balance, and payment for the consumer. But as of this writing, those changes have only been considered and approved by the U S House of Representatives, but not by the U S Senate. In late April 2009 or early May, these changes will likely be subject to a full Senate vote. Of course, until that vote and reconciliation with the House bill, loans of those in bankruptcy will not be affected at all.

The other approach which most directly gives rights to consumers to affect loan terms is the "Making Home Affordable" initiative, with program guidelines announced March 4, 2009. Since this program is fairly new, not all issues have yet been clarified.

Painting with a broad brush, the Obama administration has created a refinance program, and a loan modification program. These programs are expected, per the news release, to become "standard industry practice in pursuing affordable and sustainable mortgage modifications".

Obviously, the government is expecting the mortgage industry to heed the "summary of guidelines" recently published.

The refinance program is designed to help with refinancing loans which are "under water" due to falling home values. This program is perfect for the homeowner who now owes more than the home is worth. He can refinance a first mortgage which is as much as 105% of the current value of his home. But this program only applies if the homeowner is not late on mortgage payments. As it is the purpose of this article to examine default and foreclosure solutions, this refinance program will not be considered further.

The loan modification program will be available for 5 years of payment relief, and uses a matrix for the adjusting of mortgage payments, a sample of which is shown below. You will note it first adjusts rate as far down as 2% if necessary, for five years; then adjusting the amortization term of the loan, up to 40 years amortization if necessary. If more adjustment is necessary, lenders may adjust principal which accrues interest, reserving some portion of principal as an "interest free" loan payable at the end of term as a balloon payment. The federal government is willing to compensate loan servicers who will adjust the homeowner's loan payment down to 38% of the homeowner's take home pay. In order to reduce the homeowner's payment even further, the government will share the loss, dollar for dollar, to adjust the loan payment down to 31% of the homeowner's take home pay. Thus, many homeowners who have high mortgage payments should be able to have those loans modified, under the Obama plan. But let's look at a simple matrix below, such as the Obama plan envisions. Note that after rate, the term and balance can be adjusted:

years	rate	balance	payment	pymt %
30	7%	$200,000.00	($1,330.60)	100%
30	6%	$200,000.00	($1,199.10)	90.12%
30	5%	$200,000.00	($1,073.64)	80.69%
30	4%	$200,000.00	($954.83)	71.76%
30	3%	$200,000.00	($843.21)	63.37%
30	2%	$200,000.00	($739.24)	55.56%
35	2%	$200,000.00	($662.53)	49.79%
40	2%	$200,000.00	($605.65)	45.52%
40	2%	$190,000.00	($575.37)	43.24%
40	2%	$180,000.00	($545.09)	40.97%
40	2%	$170,000.00	($514.80)	38.69%
40	2%	$160,000.00	($484.52)	36.41%

As the chart shows there is some payment, right down to 36.41%, which can be calculated in giving the homeowner options. With the alarming losses in foreclosure proceedings, clearly foreclosure is not the best option for any one.

But the really good news is twofold: 1) the government will pay lenders to modify loans, even sharing losses if necessary, and 2) the government requires the lender to modify loans, and suspends foreclosure action, while borrowers are considered for loan modifications, deeds in lieu of foreclosure, and short sales. Once the lender starts working with the Obama program, they must modify all loans which qualify under this program.

The process should be fairly simple for industry veterans: 1) qualify what the borrower can afford, based on traditional guidelines of 31% to 38% of net income used for housing, and no more than 55% of net income used for total debt payments; 2) adjust the mortgage payment to the affordable range, by lowering the rate, increasing the term, or carving out interest free balloon payments, in that order. Modified payments will be kept in place for 5 years, and the rate thereafter will be fixed, not floating with the market. Note that there are no more "adjustable rate mortgages", popularly referred to as "ARMs". They have gone the way of the dinosaur.

Loan servicing agents who work with the "Making Home Affordable" program are required to seek lender approval for loan modifications, and must modify absent fraud, in most cases where any affordability test can be satisfied. In a simplistic analysis, the loan modification, or deed in lieu of foreclosure, or short sale must be done unless the loss in foreclosure would be less. This is like a breath of fresh air: it looks like the financially strapped homeowner is finally being given some options.

What should we do from here? *With the new federal mortgage guidelines, we will find a major shift in marketplace thinking, away from foreclosure and towards keeping homes occupied by paying homeowners. But it may take lenders a few years to implement new ways recommended by the Obama administration.*

Meanwhile, tens of thousands of Hoosiers are losing their homes, as bewildered lenders erroneously foreclose, refusing to accept payments in a "all or nothing" strategy. Quite simply, there is a volume of bad loans which must be modified, keeping lenders solvent and families housed in a dwelling of their choice. This win-win transaction is clearly the best option, and lenders who are slow to learn how to lessen the economic harm of foreclosure need to be reminded that Indiana favors any workout less costly than foreclosure, whether it be loan modification, short sale, or deed in lieu of foreclosure. Practical Hoosiers want more advantages for both lender and borrower alike.

Indiana as a state can easily agree with the federal plan, and require a predictable mediation result in a foreclosure case: a modification that complies with federal guidelines for mortgage payments, using a matrix (as shown above) for adjustment of mortgage payments for at least 5 years. Of course, this payment must be based on realistic debt to income ratios. If "the numbers just don't add up", then other options short of foreclosure should be considered first. But all of us need to "do the math", and ask: "With what option do we lose the least?"

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