

Residential Mortgage Workouts Benefit Everyone

So Why Don't Lenders Get It?

COMMENTARY

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One reason why so many residential properties go to foreclosure sale is that some of the largest lenders don't seem to understand that modifying the terms of a residential mortgage can often be a win/win proposition.

With home prices down as much as 20 percent in some parts of the country, and foreclosure rates at their highest level in 30 years, taking a residential property to Sheriff's Sale usually results in a large loss for the foreclosing lender. The market is awash in available properties, and buyers are scarce.

Even in better times, a foreclosure sale is often a losing proposition for a number of reasons.

First of all, when a home goes to foreclosure sale, the only number that matters to prospective bidders is its value. Most foreclosure sale bidders are real estate professionals; they won't bid more than about 85 percent of a property's value, since they will incur costs to remove the occupants, spruce up the property and resell it.

Some lenders understand this fact and set their maximum foreclosure sale bids accordingly. An "upside down" lender will lose money if it is outbid, but it will avoid incurring additional expenses in a losing cause.

Unfortunately, many "upside down" lenders instruct their attorneys to bid the full amount of their debt at every foreclosure sale, which virtually guarantees that the lender will be the high bidder and will become the owner. The lender will then have to remove the occupants, and spruce up the property at its own expense to resell it, thus throwing good money after bad.

Then, as a final insult, the lender will likely receive only low-ball offers for the property; it seems that the presence of words like "bank," "mortgage company" or "savings and loan association" in the name of the seller causes all offers to be reduced by 10 percent or more. Given the number of foreclosed properties on hand, lenders are likely taking even larger losses on resales, simply to reduce their inventories.

Here is an illustration of how the arithmetic plays out: A hypothetical borrower owns a residence that is worth \$150,000. It is encumbered by a first mortgage with a balance of \$140,000. The most that a bidder is likely to offer at a fore-



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closure sale is \$127,500, or 85 percent of the property's value.

If the lender allows the property to be sold at this price, the lender will realize a principal loss of at least \$12,500, but if property taxes are delinquent, the lender could lose thousands more, because those taxes — and the costs of the foreclosure sale itself — are paid from the sale proceeds before any distribution to lienholders.

That would be bad enough, but then consider that the cost to evict, rehabilitate and resell usually runs between 10 and 15 percent of its value, or, in this example, another \$15,000 to \$22,500 in losses.

Finally, when the lender resells the property, it is unlikely to receive an offer higher than \$135,000, a 10 percent discount from its true value. When all is said and done, the lender has lost at least \$20,000.

For nearly 20 years, I have represented small- and medium-size lenders in all types of creditors' rights matters. I have never understood why lenders consistently overbid at their own foreclosure sales, except perhaps that it allows the foreclosure department to avoid taking the loss.

Never mind that the ultimate loss upon resale is often much greater than would otherwise have been the case; as long as it appears on someone else's budget, the foreclosure department is happy.

This, of course, makes absolutely no sense.

A true loan workout — and by this, I mean a structural change to the loan's terms, and not merely the tacking of delinquent install-

ments onto the end of the payment schedule — can allow the lender to avoid a loss and the borrower to avoid foreclosure sale. In some cases, a well-designed workout can even result in a modest profit for both parties down the road.

When a mortgage loan goes into foreclosure, the lender's focus must shift immediately from profit to loss mitigation. The assumptions upon which the loan was made must be discarded entirely, in favor of an analysis that focuses on current realities.

If a variable-rate loan has adjusted upwards to a point at which the borrower can no longer afford it, then — in order to avoid foreclosure — the rate must be reduced, and some delinquent interest may have to be forgiven to get the borrower back on track. The range of workable debt-to-income ratios is well-established, and no amount of cajoling by a collector can make an unaffordable loan affordable.

At this point, lenders often ask, "Why should I give a delinquent borrower a lower rate? Why should I forgive interest? I don't do that for my good customers."

The answer is part of the question: You give the delinquent borrower a lower interest rate specifically because they are delinquent; to avoid foreclosure and the likelihood of a significant loss of principal.

Thus, the workout officer's aphorism: "Worry about return of principal before you worry about return on principal."

Several factors should ease the lender along this path. For one, by the time a loan goes into foreclosure, it has almost certainly been placed on non-accrual status, meaning that the lender is no longer treating interest as income. This should make an interest rate reduction more palatable to the lender, because the lender's earnings have already been affected by the delinquency. For another, interest rates are near historic lows; the lost "opportunity cost" of carrying a delinquent loan is lower than it might otherwise be.

For a \$140,000 loan, an increase in the applicable interest rate from 5 percent to 8 percent — not uncommon in the marketplace —

increases the borrower's monthly payment (not including amounts that must be escrowed to pay taxes and insurance premiums) on a three-year-old, 30-year loan from \$751.55 to \$1,027.27.

For a borrower with a monthly take-home pay of \$2,100, this increases his or her debt-to-income ratio from about 36 percent (acceptable) to about 49 percent (dangerously high), even without considering escrows. Such an increase can spell the difference between affordability and foreclosure. If the loan's initial rate was set artificially low (a "teaser rate"), the shock of an interest-rate adjustment can be even worse.

If this loan falls six months delinquent, about \$5,500 of the \$6,200 past due will be interest. If the lender forgives that interest and lowers the rate back to 5 percent, the borrower should again be able to afford the payments. Five or six years down the road, the borrower will likely sell or refinance the property.

By then, property values will likely have recovered, and the lender will likely receive repayment of all of its principal, on top of the interest it has been collecting in the meantime. By any reasonable measure, this is a better result than a foreclosure sale could produce.

I sit once a month as a judge pro tem in Philadelphia's Mortgage Foreclosure Diversion Program. Though at the outset, some lenders seemed quite resistant to the notion that a workout could produce a better outcome than a foreclosure sale, as the program has gained momentum, many lenders have come to accept this notion, which is one reason why the program is successful.

Another reason why the program works is that it operates to triage delinquent loans, so that mitigation efforts can be concentrated on loans that are likely to be salvageable; to be sure, some mortgage loans are simply unaffordable to the borrower on any terms. These are often the product of inflated appraisals, falsified income statements or other potentially criminal conduct by borrowers, by others in the mortgage-origination food chain, or both. Obviously, such loans cannot be rehabilitated through the workout process, and foreclosure remains the only viable option.

Given the current economic climate, lenders should be more willing than ever to modify loan terms to avoid foreclosure sales. A properly structured workout agreement can save a borrower's house while helping the lender avoid a significant loss. •

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