Another Tool in the Toolkit: Short Sales to Existing Homeowners

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Overview

Edward DeMarco, acting director of the Federal Housing Finance Agency (FHFA), is drawing fire from congressional Democrats for preventing Fannie Mae and Freddie Mac from writing down the principal on home mortgages held by underwater borrowers. With U.S. taxpayers already on the hook for nearly $200 billion in losses incurred by Fannie and Freddie since September 2008, DeMarco understandably doesn't want to make a bad situation worse.

The lawmakers, however, have a point. The housing slump may be the most significant brake on America's economic recovery. That's why it's worth experimenting with creative ways to help delinquent underwater homeowners dig out from under a mountain of "negative equity."

Private sector experiences suggest that a carefully conceived principal reduction program could achieve significant savings for U.S. taxpayers by reducing losses at Fannie Mae and Freddie Mac. Such a program could be enacted responsibly and fairly without fueling moral hazard—the risk that borrowers who otherwise would make their mortgage payments go delinquent in an effort to get their principal balances reduced.

In effect, Fannie and Freddie can offer "short sales" back to the existing homeowners in return for a share of their home equity. Unlike foreclosure and traditional short sales, which are to third parties and usually at a discount to true market value, this approach would help support home prices, lower future default risk, and save taxpayers billions of dollars.

I propose that FHFA direct Fannie Mae and/or Freddie Mac to conduct a pilot program to test the technique's viability and that Congress ask the Congressional Budget Office (CBO) to independently assess the potential savings for U.S. taxpayers should such a program be implemented on a full-scale basis.

The Principal Matter

Foreclosures are very expensive for lenders. In addition to the large costs of carrying, maintaining, and oftentimes improving homes they have foreclosed upon, disposing of the properties in foreclosure sales typically nets less than their fair market value. Similarly, short sales to third parties also usually suffer “distressed sale” discounts to the homes' fair values. According to the latest LPS Home Price Index data, in today’s depressed real estate markets, foreclosed homes sell at an average discount of 29 percent and short sales at an average discount of 23 percent.[1] And, of course, having on ongoing supply of such properties for sale adds pressure on home prices.

To avoid foreclosures, and thereby minimize their losses, many banks have already reduced principal balances on mortgage loans that they own. They have done this in two ways: by reducing the balances of outstanding mortgages through loan modifications, and by agreeing to short sales of homes which result in the borrowers' loan obligations going away. In a short sale transaction, the bank lets the borrower sell her home for less than the mortgage loan balance without requiring her to repay the difference. This is a principal writedown for the borrower—it is equal to the amount by which the mortgage loan balance exceeded the sale price of the home in the short sale transaction.

Fannie Mae and Freddie Mac already provide underwater borrowers with relief on mortgage principal by allowing short sales of homes. In fact, both of the government-sponsored enterprises (GSEs) recently announced plans to streamline their short sales processes in order to stimulate the use of the technique. If they and FHFA are comfortable with granting principal reduction through short sales, then they must believe that doing so minimizes losses.

So the debate should not be about whether principal reduction per se can help minimize losses. It does. Rather, we should determine whether there is a better way to implement principal writedowns in order to reduce losses further for the GSEs without also creating meaningful additional moral hazard. Doing short sales of their homes to delinquent underwater homeowners, with them sacrificing some home equity as a cost, has the potential to save the GSEs (and, consequently, U.S. taxpayers) billions of dollars without stimulating moral hazard.

A Better Short Sale: Test Program

A major impediment to the housing market's recovery is "negative equity"— owing more for a house than it is worth. The number of underwater homeowners is substantial and has continued to grow. Most estimate that at least one-fifth of mortgage borrowers now have negative equity. The GSEs’ own books of business bear this out. As of March 31, 2012, almost 19 percent of Fannie Mae’s $2.8 trillion[2] of unpaid principal balances in its residential mortgage loan book had negative equity, while 20 percent of Freddie Mac’s $1.7 trillion book was underwater.[3] Many of these loans will become delinquent in the future, adding to the GSEs’ losses, because underwater homeowners are much more likely to default on their mortgages than those with positive equity.

If this were a business situation, a lender typically would try to restructure a company's debt rather than have it struggle unsustainably in a negative equity position. By restoring the company to economic health, the lender minimizes its loss. In corporate debt restructurings, lenders frequently reduce debt principal in exchange for getting equity in a company. The government should have Fannie Mae and/or Freddie Mac implement a pilot program to do the same with delinquent underwater residential mortgage borrowers.

Specifically, for targeted delinquent underwater borrowers in the pilot program, the GSEs should offer:

- to reduce mortgage principal balances such that positive homeowner's equity is reestablished (e.g., a mark-to-market loan-to-value of 90%), and

- to reset their mortgage interest rates to a current market level.

In exchange, the GSEs would receive a percentage of these borrowers' homeowner's equity in the form of "equity share certificates." To assure that occupying homeowners have incentives to make mortgage payments, to maintain and improve their homes, and to attract others to their neighborhoods, lenders should receive equity shares of less than 50 percent -- probably between 30 and 40 percent.

The equity share certificates would be separate from the restructured mortgage loans, allowing them to remain outstanding if the mortgage is refinanced but to become payable when the house is sold. Thus, there will be time for the GSEs to earn some home price appreciation and for the certificates to be valued independently, which would promote their potential for attracting private capital back into the housing finance system.

The pilot program will test if the GSEs have substantially lower losses versus selling these homes on a distressed basis to third parties via foreclosure or short sales. Because the existing homeowners have a vested, long-term interest in their homes and communities, they are likely to “pay” closer to the fair values of their homes when agreeing to the levels of their loans' lowered principal balances. The GSEs also will have the "upside" provided by the equity share certificates. Moreover, pressure on home prices is reduced by keeping these homes off the market as distressed properties, thereby benefitting the broader community and improving the GSEs' ongoing mortgage risk profiles.

Reducing Moral Hazard

DeMarco and others are concerned that granting principal writedowns on residential mortgage loans will increase moral hazard unacceptably by encouraging borrowers who otherwise would remain current on their loan payments to default. This risk already exists in an environment in which the GSEs seek to promote short sales. Indeed, with short sales to third parties, borrowers get a full principal writedown without suffering any associated economic cost. In a short sale to the existing homeowner, however, moral hazard should be much lower because of the material cost to the borrower from giving up a meaningful share of home equity in exchange for getting the benefit of reduced principal. Additional protections against promoting undue incremental moral hazard can be built in through a variety of program design features—e.g., limiting eligibility to loans on owner-occupied principal residences, imposing timing constraints for eligible delinquent loans, granting principal reduction over time with ongoing borrower performance on their modified loans, creating uncertainty by limiting availability via targeting borrowers selectively, and other constraints.

Independent Assessment

The potential savings for taxpayers from doing short sales to existing homeowners as proposed above, versus the current alternatives of foreclosure and short sales to third parties, should be analyzed by the Congressional Budget Office. The CBO has the models needed to do the analysis and could get the data required to assess the potential savings from a formal program. Specifically, the CBO could run underwater mortgage loans—both performing loans and those currently delinquent—through its probability of default and loss-given-default models assuming status quo loss mitigation and loan liquidation techniques. By doing so, it will get an estimate of aggregate losses from underwater loans that are currently delinquent as well as for those that are expected to become delinquent in the future. The CBO then could rerun the analysis assuming instead that short sales to existing homeowners are implemented in the manner described above. It then would have an estimate of total expected losses from underwater mortgages when using the proposed technique as a tool to resolve delinquencies. The difference between the two aggregate loss estimates will identify if there are potential savings from having a formal program of short sales to existing homeowners.

I believe that tens of billions of dollars could be saved for taxpayers. But, rather than simply assert this, the CBO should establish once and for all what the potential savings are from implementing such a program. The pilot program we advocate then would demonstrate if the technique, in fact, will work in reality with delinquent borrowers.

Conclusion

Principal writedowns for delinquent underwater mortgage borrowers already are granted through the GSEs' short sale programs. Rather than foreclose on these borrowers or have them sell their homes to third parties at distressed prices, the

GSEs could save substantial sums by doing short sales to current homeowners at fair market values. In exchange for having their mortgage principal balances reduced by this transaction, the borrowers would grant the GSEs a percentage of their home equity. Relative to foreclosure and short sales to third parties, the GSEs will minimize their losses by negotiating higher home prices with existing homeowners and through retaining upside potential provided by the equity share certificates. Moreover, the equity sharing component and other program design features will assure that moral hazard risk is minimized.

The CBO should assess such a program and estimate the potential savings from using the technique in place of status quo loss mitigation and loan liquidation techniques. A pilot program should be launched by the GSEs to test if delinquent underwater borrowers agree to the transaction on an effective basis and perform successfully on their restructured mortgages in practice.

Endnotes

[1] "Short Sale and Foreclosure Discounts Converge", Real Estate Economy Watch, May 11, 2012, http://www.realestateeconomywatch.com/2012/05/short-sale-and-foreclosure-discounts-converge/.

[2] "Fannie Mae 2012 First-Quarter Credit Supplement", p.6, Fannie Mae, May 9, 2012, http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2012/q12012_credit_summary.pdf.

[3] "First Quarter 2012 Financial Results Supplement", p. 24, Freddie Mac, May 3, 2012, http://www.freddiemac.com/investors/er/pdf/supplement_1q12.pdf.

About the Author

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