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# CRS Report for Congress

## Understanding Mortgage Foreclosure: Recent Events, the Process, and Costs

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# Understanding Mortgage Foreclosure: Recent Events, the Process, and Costs


## Summary

As evidenced by the numerous bills introduced in the 110th Congress during the first session, there is much concern over recent developments in the housing and mortgage markets. Bills such as H.R. 3019, the Expand and Preserve Home Ownership Through Counseling Act (Representative Judy Biggert), and H.R. 3666, the Foreclosure Prevention and Home Ownership Protection Act (Representative Betty Sutton et al.), include sections that speak specifically about foreclosures. These bills would authorize studies on current defaults and foreclosures, as well as possible causes. In addition, H.R. 5818, the Neighborhood Stabilization Act of 2008 (Representative Maxine Waters), has been introduced to establish a loan and grant program, administered by the Department of Housing and Urban Development, to help states purchase and rehabilitate foreclosed homes to stabilize as many properties as possible. This report provides a general analysis and overview of current foreclosure issues addressed in the bills cited above.

It begins with a description of the behavior of aggregate foreclosure rates. The behaviors of foreclosure rates are placed in the context of activity in the housing and mortgage market to illustrate any relationships. The foreclosure process is then explained, first from the point of view of a traditional financial lending institution, and then from the viewpoint of securitization when loans are sold in secondary markets. Finally, this report collects information from other studies to obtain an estimate of the average foreclosure costs. A brief discussion of the effect uniform foreclosure legislation may have on costs follows.

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## Introduction

The recent rise in mortgage foreclosure rates may warrant a more detailed understanding of the foreclosure process, which is the focus of this report. A brief summary of foreclosure activity and concurrent activity in the housing market begins the discussion. Next, a description of the foreclosure process is presented, first under a traditional banking context, followed by a summary of how the process works when mortgage loans are securitized. The last sections focus on lender foreclosure costs. Estimates of foreclosures costs are presented followed by a discussion of whether a national foreclosure law could help reduce those costs.

## The Recent Foreclosure Experience

The Mortgage Bankers Association (MBA) reports on the percentage of delinquencies and foreclosures in its National Delinquency Survey (NDS) every quarter. The sample consists of more than 41 million loans serviced by mortgage companies, commercial banks, thrifts, credit unions, and other servicing institutions.[1] The data on foreclosure rates used in **Figure 1** and **Figure 2** come from the NDS. The figures include data on foreclosure rates for prime loans, Federal Housing Administration (FHA) insured loans, subprime loans, and a composite rate for all foreclosed loans. The foreclosure rate for each loan category is computed as the total number of foreclosures at the end of the quarter divided by the total number of loans in that particular category. The loan categories are defined as follows:

- Prime loans are typically made to creditworthy borrowers who meet the standards set by the government sponsored enterprises (GSEs) known as Fannie Mae or Freddie Mac.[2]

- Alternative or "Alt-A" loans typically meet the GSE credit score requirements; however, they do not meet the standard requirements for documentation, property type, debt (or qualifying) ratios, or loan-to-value (LTV) ratios. FHA targets Alt-A borrowers, although they do insure loans for borrowers with lower credit scores. Although the

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[1] For more information about the Mortgage Bankers Association and the National Delinquency Survey, please go to [http://www.mbaa.org].

[2] For background and other information about GSEs, see CRS Report RS21724, *GSE Regulatory Reform: Frequently Asked Questions*, by N. Eric Weiss.

agency allows more flexibility with respect to debt and LTV ratios than prime lenders, FHA borrowers typically must comply with standard documentation requirements.

- Subprime loans are made primarily to borrowers with impaired or limited credit. Subprime loans do not have to meet the GSE credit score requirements, and other standard underwriting requirements may also be waived, including standard documentation requirements.[3]

**Figure 1** indicates that subprime foreclosure rates have always been greater than prime and FHA foreclosure rates. When housing prices were rising and interest rates were falling between 2002 and 2005, the overall foreclosure rate for all loan categories was steady along with prime loans. Subprime foreclosure rates declined markedly between 2002 and 2005.[4] Foreclosures began to rise, however, in early 2006, and have continued rising through the fourth quarter of 2007. The average foreclosure rate for all subprime loans during this period was 5.20%, while the average foreclosure rate for all FHA loans was 2.22%. The foreclosure rate for all prime loans averaged 0.96%. Given a low prime foreclosure rate relative to the other loan type categories and the fact that prime loans make up a larger share of the mortgage market, the overall foreclosure rate for all loans in the survey averaged 1.33%. The maximum foreclosure rate over the entire period for all loans in the survey was 2.04%, which occurred during the fourth quarter of 2008. The rise in the overall foreclosure rate since 2006, therefore, reflects the large increase in subprime foreclosure rates.

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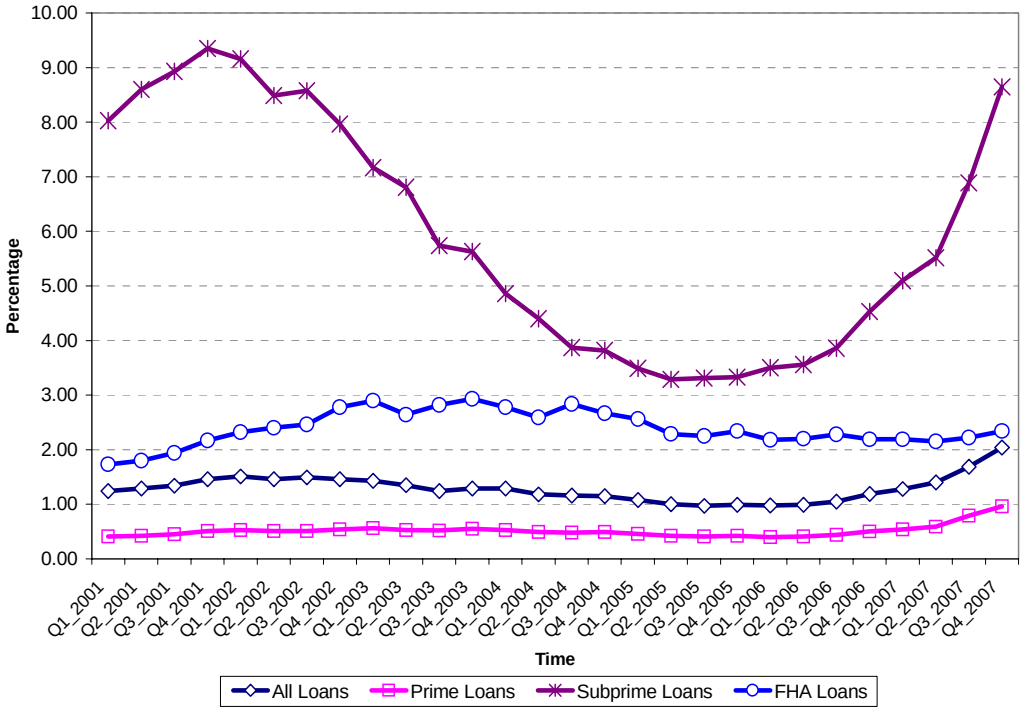
[3] See CRS Report RL33930, *Subprime Mortgages: Primer on Current Lending and Foreclosure Issues*, by Edward Vincent Murphy.

[4] FHA foreclosures saw an increase arguably because some of its more creditworthy borrower were refinancing out of FHA. These borrowers were either obtaining prime loans and no longer pay FHA mortgage insurance premiums or they wanted to obtain cash-out refinances that exceed the FHA loan limits, since house prices were rapidly appreciating. Hence, the rise in the FHA foreclosure rate might reflect a decrease in the denominator of total mortgage loans, rather than an increase in the numerator of total foreclosures.

**Figure 1. Percentage of Foreclosures by Aggregate Category**

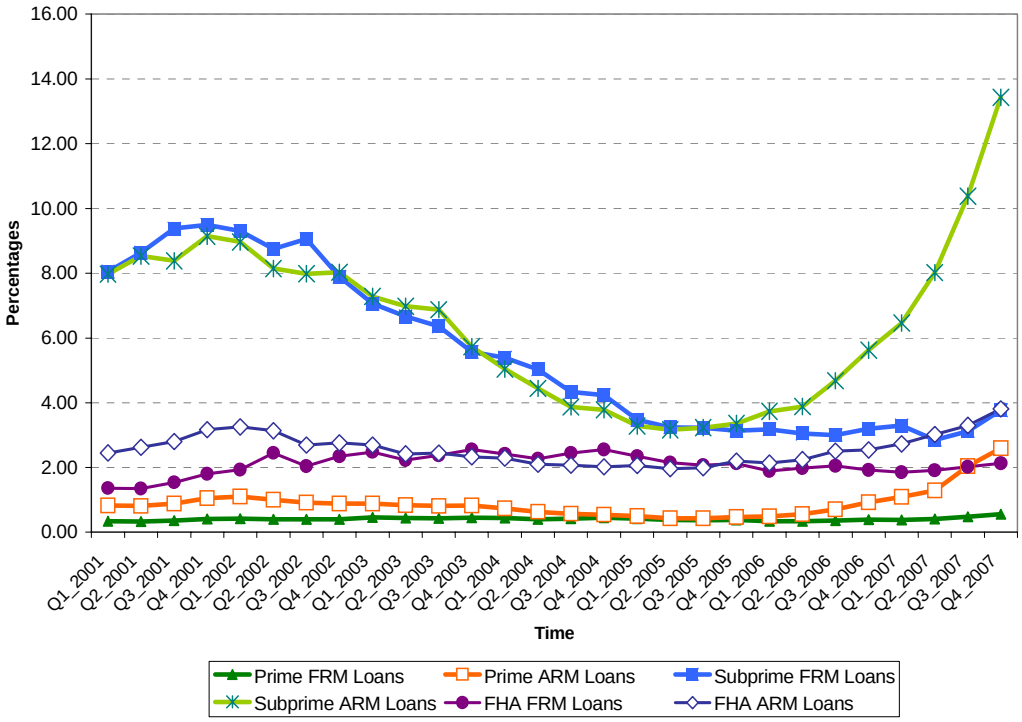



**Source:** Mortgage Bankers Association.

In **Figure 2**, the composite categories have been further separated into fixed rate mortgage (FRM) foreclosures and adjustable rate mortgage (ARM) foreclosures. From 2006 to the fourth quarter of 2007, the subprime foreclosure rates are again the highest, followed by FHA, and then prime loans. The foreclosure rates averaged 3.18% for subprime FRM loans, 7.03% for subprime ARM loans, 1.97% for FHA FRM loans, 2.79% for FHA ARM loans, 0.41% for prime FRM loans, and 1.21% for prime ARM loans. The NDS does not report composite foreclosure rates for all FRM loans or all ARM loans. Based upon the information provided here, however, the overall FRM and ARM composite foreclosure rates are likely to be much lower than the equivalent rates computed for the subprime and FHA categories. Furthermore, the composite series of FRM loan foreclosure rates is likely to be lower than composite series of foreclosure rates for ARM loans.[5] The descriptive data in **Figure 2** indicate that many of the foreclosures were associated with ARM loans, in particular, the subprime ARM loans.

[5] See CRS Report RL33775, *Alternative Mortgages: Causes and Policy Implications of Troubled Mortgage Resets in the Subprime and Alt-A Markets*, by Edward Vincent Murphy.

**Figure 2. Percentage of Foreclosures FRM versus ARM**




**Source:** Mortgage Bankers Association

If lenders effectively take into account information about creditworthiness (such as credit history, income, and wealth) when borrowers apply for loans, then foreclosures should reflect unpredictable changes in economic or personal circumstances that neither the borrower nor the lender can anticipate. Examples of unanticipated changes in personal circumstances include divorce, sudden changes in health, and job loss. Given no abnormal rise in national divorce rates or debilitating medical injuries, those reasons cannot fully explain the recent rise in foreclosures. Foreclosures could potentially be attributed to local unemployment conditions. For example, foreclosures in Ohio rose when its unemployment rate rose to approximately one percentage point higher than the annual U.S. national unemployment rate (5.5% compared with 4.6% in 2006). Rising job losses, however, still can not entirely account for aggregate developments. Florida, for instance, had unemployment rates at or below the U.S. national average during 2006, yet the state still experienced a marked rise in foreclosures. Hence, unanticipated changes in personal circumstances do not sufficiently explain the recent rise in foreclosures.

The slowdown in the rate of house price appreciation and sales activity are examples of unanticipated changes in economic circumstances that can potentially translate into a rise in foreclosures. According to the U.S. Census Bureau, new home prices between June 2006 and June 2007 fell by 4.11%, and new home sales were down by 22.18%. According to the National Association of Realtors, median existing home prices over the same period fell by 0.04%, and existing home sales

declined by 11.25%.[6] Falling house prices and the more rapid decline in home sales activity occurred simultaneously with the rise in foreclosure rates. Borrowers with financial or cash flow problems are likely to find it difficult to avoid foreclosure when they cannot quickly sell their homes for prices that would cover most or all of their mortgage obligations. Refinancing or selling a home prior to an interest rate adjustment on an ARM loan, which may result in a substantial increase in the monthly payment, may not be feasible options in the current market. Houses may not appraise for amounts necessary to eliminate mortgage insurance premiums, which may have provided some reduction in the monthly payments for distressed borrowers. Given that more homes sit on the market for several months at a time, sellers are unable to raise listing prices to cover the outstanding mortgage, any owed property taxes, and any additional home equity loan expenses. The incentive for borrowers to default also increases when house values fall below the outstanding balance owed. Hence, a rise in foreclosures would not be considered unusual given the recent decline in housing market activity. Housing market activity and foreclosure rates are cyclical in nature, and typically move in opposite directions.

In addition to unanticipated housing market changes, the mortgage market also experienced structural changes, most notably, the expansion of the subprime market. Prior to this expansion, people with impaired credit were unable to obtain home equity or cash-out refinance loans from prime market lenders. Furthermore, when home prices began to exceed the maximum FHA loan limits in various regions, credit impaired borrowers looked for alternatives to FHA. Hence, the growth in subprime lending over the late 1990s and early to mid 2000s became the vehicle used to gain access to mortgage credit by people evaluated as having lesser credit quality. In fact, subprime loans are estimated to have accounted for 20% of all mortgage originations by 2005.[7] Given that the recent housing market slowdown is the first to include this structural change, it has become more apparent that subprime borrowers may be more susceptible to changing housing market conditions than prime borrowers, and perhaps those who satisfy current FHA requirements for mortgage insurance. Consequently, the perception of what should be considered a 'normal' rise in foreclosures rates during a housing market slowdown may arguably need to be revised upwards.

## The General Foreclosure Process

Foreclosure is usually governed by state law, and the process varies widely by state. The description of the foreclosure process provided in this report, therefore, will be presented in very general terms. The process will be first explained assuming a traditional lending framework, followed by a brief explanation of how the process works when the mortgage has been securitized.

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[6] The January 2006 to June 2007 time frame would have been chosen to coincide with the period the foreclosures began to rise as reported by the NDS. Some of the housing price and sales data, however, are not seasonally adjusted, making it necessary to use the June 2006 to June 2007 period for computing annual rates.

[7] See Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, "Higher-Priced Home Lending and the 2005 HMDA Data," *Federal Reserve Bulletin* (September 2008), p. A125.

## A Traditional Lending Framework

Foreclosure can begin after a borrower defaults on the mortgage loan.[8] Default is generally defined as being 90 days delinquent, although some lenders may use other definitions. Once in default, the lender must decide whether a loss mitigation or workout option would suffice, or whether to proceed with foreclosure, the process of recovering losses by repossessing and selling the property. A large incentive to resolve a default with an alternative loss mitigation option arguably exists because, as this report will show, foreclosure and subsequent disposition of the property can be a lengthy and costly process for the lender.[9] Homeowners with substantial equity in their home arguably have a greater incentive to cooperate with the lender and renegotiate an arrangement to avoid foreclosure. Foreclosures are, however, more likely to occur when homeowners have little (10% or less) equity in their homes. Moreover, if the value of a house falls below the value of the mortgage, or if very little or no downpayment was used to purchase the home, the borrower may have a financial incentive to walk away and not take the necessary steps to avoid foreclosure.[10]

The foreclosure processes can take anywhere from several months to almost two years depending upon the state. The lender must prove the borrower is in default, and follow various legal procedures prior to the authorization of a foreclosure auction to ensure a valid transfer of title. In *judicial foreclosure* states, a foreclosure petition must be heard and ruled upon by a judge who examines all of the evidence in the case. In the *power-of-sale* states, the lender holds a deed of trust with a clause that allows foreclosure without court action. Hence, it takes longer to complete foreclosure, and the associated costs are greater in judicial foreclosure states than in power-of-sale states, since more legal work is involved.

After proper notification requirements have been satisfied, the foreclosure auction begins. States typically require that the property owner be given some advance notice about when the foreclosure auction will take place. In addition, a legal advertisement must appear in local news media announcing the time and place of the auction, a legal description of the property, and the sale terms and conditions. At the auction, the auctioneer may begin with the reading of the legal advertisement

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[8] For a primer on delinquency, default, foreclosure, and loan workouts, see Charles A. Capone, "Research Into Mortgage Default and Affordable Housing: A Primer," prepared for the Local Initiatives Support Corporation for Home Ownership Summit 2001, November 8, 2001, available at [http://www.lisc.org/files/906_file_asset_upload_file755_793.pdf].

[9] Loss mitigation or 'workouts' refer to a menu of possible options to avoid foreclosure. Lenders may choose from various options, which may include rescheduling payments and/or restructuring the loan, to help distressed borrowers become current and continue to stay current in the payments. If borrower circumstances would not allow for the loans to re-perform, agreement to a pre-foreclosure sell or deed-in-lieu of foreclosure may also be considered a form of loss mitigation.

[10] Although a borrower with little home equity may not suffer a major financial loss after foreclosure, the ability to obtain any subsequent loans may be severely affected for several years.

and then set the minimum bid. The highest bidder at the conclusion of the bidding period assumes title and responsibility for the property.

Although the lender may prefer not to participate in the auction, which could result in assuming title to the property and additional carrying costs, there are legal and financial incentives for lenders to place a bid. First, the sale price of the foreclosed property should be at least 70% of the fair market value to prevent the former homeowner from successfully having the foreclosure overturned. If the property sold for an extremely low price, the difference between the current mortgage and the sale price, the remaining unpaid balance, is higher. Consequently, if the original mortgage was recourse debt, the former homeowner would be liable for a larger amount of debt. If the mortgage was nonrecourse debt, the unpaid mortgage debt is cancelled, and the borrower has received what is considered taxable income. The more debt discharged, the higher the tax liability.[11] The lending institution, therefore, could be accused of neglecting its fiduciary responsibility to the former homeowner to minimize the ensuing liability, especially if these liabilities were to result in insolvency. Under these circumstances, a lawsuit filed by the former homeowner against the lender could result in reversal of the foreclosure and perhaps an additional financial award for damages. Hence, the courts adopted a precedent after the *Durrett vs. Washington National Insurance Company* ruling in which a "reasonable" sale price on foreclosed property is approximately 70% of fair market value.[12] Lenders, therefore, may have to bid on the property to prevent the former homeowner from successfully having the foreclosure overturned.

Second, the lending institution has a financial incentive to minimize its losses. The lender may deem other bids to be too low and believe the property may fetch a higher market price depending upon current conditions. Of course, when house prices are rising, the lender may be able to recoup more losses than when they are declining, which means housing market conditions can be important. Because of these legal and financial incentives, the lender typically submits the highest bid at the foreclosure auction and winds up with the property title.

The foreclosure process does not necessarily end after title of the property is transferred. In nine states, the *statutory right of redemption* exists, which allows the borrower a period of time ranging from several months to a year to repurchase the property after the foreclosure auction. Regardless of whether the winning bid comes from the lender or some other auction participant, the foreclosure sale is not final in

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[11] The state where the mortgage is originated determines whether the mortgage is recourse or nonrecourse debt. For a discussion on recourse and nonrecourse debt as well as the tax liability issues associated with debt forgivness, see CRS Report RL34212, *Analysis of the Proposed Tax Exclusion for Canceled Mortgage Debt Income,* by Pamela J. Jackson and Erika Lunder.

[12] *Durrett v. Washington National Insurance Co.*, 621 F. 2d 201 (5th Cir. 1980). See Charles A. Capone, *Providing Alternatives to Mortgage Foreclosure: A Report to Congress,* Department of Housing and Urban Development, Washington, DC, 1996 at [http://www.huduser.org/Publications/pdf/alt.pdf] and Scott B. Ehrlich, "Avoidance of Foreclosure Sales as Fraudulent Conveyances: Accommodating Sate and Federal Objectives," *Virginia Law Review*, vol. 71, no. 6 (September 1985), pp. 933-980.

these states until the borrower has received a specified period of time to regain possession of the property. The homeowner regains possession by repaying the amount of the total indebtedness, which is determined by applicable state laws. Hence, the length of time from the initiation to completion of foreclosure process depends on whether the foreclosure must go to court and whether the right of redemption exists.

After incurring costs to foreclose, the lender incurs costs to sell the property purchased at auction. Given that the property is likely to be sold "AS IS" at auction, a foreclosed property may need rehabilitation before it can be used as a primary residence, an investment, or for resale. A foreclosed property acquired by a lender is accounted for as *real estate owned* (REO), which is the inventory of foreclosed houses lenders carry until resold. As with any seller, the lender may need to repair any deferred maintenance or outright damage in preparation to put the property on the market. Lenders still require the services of realty brokers, who are paid commissions, to sell REO properties. Meanwhile, the lender still incurs costs such as foregone interest, property taxes, and any other delinquent liabilities assumed from the previous borrower. Consequently, even if the property were sold at market value, the lender has incurred losses. The distinction of being a REO property, however, may have the effect of reducing the list price below current market value. Furthermore, the lender may pay some or all of closing costs to entice new buyers, just as any seller might do in any ordinary real estate transaction. Once title has been transferred to a new owner, the tabulation of the lender's total foreclosure costs, from borrower default to final property disposition, may begin.

The discussion so far has focused upon a single lender foreclosing on a single mortgage. If the borrower used two loans to acquire the property, however, then two lenders would be affected. Suppose a borrower who has been foreclosed upon obtained a primary loan for 80% of the total loan amount and a 'piggy-back' or secondary loan for the remaining 20%. The proceeds of the REO sale generally go to pay off the primary lender first, who generally has priority, and the lender of the secondary loan gets whatever is left over. Given that foreclosure costs can be substantial, the second lender faces a greater possibility of not recouping anything on the unpaid secondary loan balance.

As stated earlier, lenders may initially want to try a loss mitigation solution with defaulted borrowers. Although a workout may result in a reduction of some of the expected revenues from the original mortgage agreement, the revenue loss may still be considered a far less costly alternative to foreclosure.[13] Of course, if a loan falls into default again after a loss mitigation option has previously been applied, the additional foregone interest expenses are also added to the overall foreclosure costs. Hence, loss mitigation may be a less costly alternative to foreclosure only if it is successful at 'reperforming' the mortgage loan, but substantially increases

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[13] The Federal Housing Administration (FHA) insures lenders against borrower default, and FHA, as opposed to the lender, initiates and disposes of foreclosed properties. Lenders that have FHA-insured mortgage loans in default, however, are required to show documentation that some form of loss mitigation was offered to borrowers. FHA will not incur the costs of foreclosure without first determining whether a loss mitigation option can be applied.

foreclosure costs if unsuccessful. For this reason, lenders may have mixed opinions and adopt different policies regarding the frequency of loss mitigation usage based upon their individual experiences.

Finally, it is important to note that foreclosures are rarely profitable for honest lenders. Fraudulent sellers profit by successfully selling overvalued properties. Damaged properties can be sold at inflated prices using fraudulent appraisals or making shoddy repairs that pass inspections. Should home buyers realize they may be victims of fraud and perhaps have loans higher than the actual property values, they may simply choose to walk away and allow the property to be foreclosed upon. The lender, who is likely to be saddled with an over-valued property that must be repaired and resold, may also be considered a victim of fraud under these circumstances.

## A Structured Financing Framework

The term "lender" has previously been used under the more traditional context in which a bank that originates a mortgage holds it in portfolio. In modern financial markets, however, originators do not necessarily keep loans in their portfolios. Loans originated in the primary market, where the home purchaser and the loan originator conduct business, are often sold in the secondary market, where the loan originator and an investor conduct business. The process of structured financing in the mortgage market will be briefly explained in four steps.

First, a home buyer goes to an originator, which can be a financial institution or mortgage broker, who then approves and makes a mortgage loan. Second, the originator may then choose to sell the loan to a securitizer. A securitizer can be a government sponsored enterprise, such as Fannie Mae or Freddie Mac, or a private securitization trust.

Third, the securitizer has the responsibility of transforming the individual mortgages into asset- or mortgage-backed securities. These securities can be subdivided into various *tranches*, or groups of securities with specific risk and return characteristics. For example, suppose the securitizer decides to create a senior-junior tranching structure. The senior tranche may be designated as the one that gets paid out to its set of investors first, but the yield may be lower than the junior tranche, which is designated to be paid out last. When the securitizer decides to sell the tranches in the secondary market, the senior tranche will appeal to investors that prefer lower risk investments, and the junior tranche will appeal to investors that prefer to take higher risks for the possibility of earning a higher yield. The senior-junior tranching structure is only one of the numerous disbursement structures securitizers can use to entice investors. This particular tranching structure, however, is used throughout this report for the sake of illustration.

In the last step, the securitizer sells the tranches to investors, who become the ultimate "lenders." The investors are typically hedge funds, pension funds, or other financial institutions. (If the securitizer decides not to sell the securities to third party investors and hold them in its own portfolio, then the securitizer becomes the investor.) Investors generally have funds to invest and need securities with very specific risk or return characteristics. Financial institutions, in particular, hold assets

and liabilities with revenue and payment streams that are often not synchronized, and asset-backed securities can be used to better match cash inflows and outflows. Hence, when securitizers can effectively identify and create securities that satisfy various investor needs in the secondary market, they can appeal to more investors and attract more credit, which can be used for the funding of loan originations in the primary market.

The key difference between the foreclosure process under a traditional banking versus a structured financing framework has to do with the amount of flexibility the mortgage holder has to make important financial decisions when default occurs. The degree of flexibility depends on whether the mortgage holder is the actual owner or an agent acting contractually on behalf of a set of owners. Suppose the securitizer either acts as or appoints a *servicer,* who collects mortgage payments from borrowers and disburse them to the tranches. The securitizer or investor is likely to establish rules that the servicer is contractually obligated to follow, since the servicer is an agent acting on behalf of the investor or securitizer. When default occurs, the rules have provisions that state: (1) whether or not the servicer can offer a loss mitigation solution, and if so, what types and limitations; (2) when the servicer can initiate foreclosure; (3) if the servicer may act as an agent at the foreclosure auction; and (4) any bidding rules the servicer must follow. For example, if a servicer has permission to initiate foreclosure, the rules are likely to state how much can be bid (e.g. up to a certain percentage or the full amount of a borrower's unpaid balance) at a foreclosure auction. Given that the costs associated with foreclosure will be borne by the ultimate investors, the rules are designed to minimize those expenses.[14]

Any foreclosure costs generated from defaulted mortgages in a pool of mortgage-backed securities must be subtracted from the proceeds paid to the securitization trust. Suppose the securitizer is currently using the senior-junior tranching structure described above. If the senior tranche gets paid first, then the junior tranche will initially suffer the revenue loss.[15] The investors in the senior tranche would be adversely affected should the number of foreclosures exceed expectations, and associated costs exceed the stream of revenues that would have been paid out to the junior tranche. Of course, fewer foreclosures can possibly translate into the junior tranche holders being rewarded with higher yield than senior holders, since they are compensated for assuming more default risk.[16]

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[14] See CRS Report RS22741, *Is Securitization an Obstacle to Subprime Borrower Workouts?*, by Edward Vincent Murphy.

[15] In some cases, securitizers may decide to keep a tranche in its portfolio, and the retained tranche would be referred to as *excess spread*. If a junior tranche were retained and became the excess spread, this tranche would consist of the cash flow remaining after the principle and yield to senior tranche holders, any loan servicing fees, and any losses associated with default and foreclosure costs were paid. The securitizer earns whatever cash remains, which provides a strong financial incentive to effectively minimize default and foreclosure costs. If the junior tranche is sold rather than retained in portfolio, the investors' payout would be the same, but the tranche would not be referred to as excess spread.

[16] The liquidity crisis of August 2007 was triggered by senior tranche holders reassessing the riskiness of their exposure to financial problems exceeding expectations. See CRS

(continued...)

## Estimates of Foreclosure Costs

The legal fees, foregone interest, property taxes, repayment of delinquent obligations by the former homeowners, and selling expenses make foreclosures extremely costly to lenders.[17] Obtaining an estimate of foreclosure costs that can be attributed solely to the lender is difficult without proprietary data that is closely held by lenders and financial institutions. Many studies may provide a dollar value associated with foreclosure costs, but it is difficult to know how cost estimates were obtained without access to the proprietary data used in the studies.[18] A study cited in a Freddie Mac Working Paper estimated the total costs of foreclosure for a sample of loans was approximately $58,759 per loan.[19] Those costs include the interest lost during the delinquency period, foreclosure costs, and disposition of the property — costs that the lender would be likely to incur. The working paper does not state explicitly if these costs were paid by the lender, nor whether the $58,759 was an average or median amount per foreclosure, but it did say the foreclosure process took an average of 18 months to resolve. Hence, this reported dollar amount may be fairly representative of the actual costs incurred only by a single lender, presumably in 2002.[20]

Foreclosure costs are far-reaching. In addition to losing their homes, borrowers are likely to find it extremely difficult to obtain credit at low rates in the future, if they can even get loans. Lenders suffer the losses associated with acquiring the property from the borrower, settling outstanding claims, repairing any damages, and selling the property. Local governments may face the problem associated with vacant units in neighborhoods and loss of tax revenues. Foreclosure may reduce the value

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[16] (...continued)
Report RL34182, *Financial Crisis? The Liquidity Crunch of August 2007*, by Darryl E. Getter, Mark Jickling, Marc Labonte, and Edward Vincent Murphy.

[17] This section of the report returns to the generic use of the term 'lender', although the discussion is applicable to investors, who have servicers acting on their behalf.

[18] See Desiree Hatcher, *Foreclosure Alternatives: A Case for Preserving Homeownership*, Profitwise News and Views, published by the Federal Reserve Bank of Chicago (February 2006). The article mentions that GMAC-RFC (Residential Funding Corporation) reported losing $50,000 per foreclosed home.

[19] See Amy Crews Cutts and Richard K. Green, *Innovative Servicing Technology: Smart Enough to Keep People in Their Houses?*, Freddie Mac Working Paper #04-03 (July 2004). The authors cite Craig Focardi, *Servicing Default Management: An Overview of the Process and Underlying Technology*, TowerGroup Research Note, No. 033-13C (November 15, 2002). The $58,759 cited in the Freddie Mac report comes from Focardi's study.

[20] It is not clear whether the final sales price was subtracted from the gross costs in order to obtain the net cost of foreclosures to lenders. If this figure is net costs, then estimated foreclosure costs reflect current market conditions at the time the estimates were computed. Foreclosure costs are likely to be higher during 2006 and 2007 when housing market activity has slowed. Lenders would be unable to turn over foreclosed properties as quickly and market prices have declined in many areas over this period.

of neighboring homes. As a result, foreclosure is something that parties directly and indirectly involved with the property would want to avoid.[21]

## Could National Foreclosure Laws Reduce Costs?

For concerned or responsible parties considering a nationalized foreclosure process, an important question would be, would a more uniform process reduce costs? The answer depends upon whether the balance of rights in such a law favors the lender or the borrower. It may be argued that inconsistent and lengthy foreclosure periods create uncertainty, which drive up costs, and may possibly drive up lending costs for non-defaulting borrowers. Lenders may decide to charge higher rates and require higher downpayments, which could result in a reduction of the supply of credit, to defer anticipated losses.[22] Hence, reducing the time it takes for foreclosure shifts the balance of rights more toward the lender, which could reduce lender costs and perhaps costs to borrowers that do not have repayment problems.

On the other hand, a federal foreclosure law structured to favor borrowers would increase the time available for borrowers to avoid losing their homes. For example, a federal law could extend the statutory right of redemption to all states. If, however, federal laws did favor borrowers, it might be more difficult for borrowers to overturn foreclosures once they became final, since it would become increasingly difficult to argue that ample time was not provided to reach a resolution.

Finally, even if a federal foreclosure law were structured to represent a compromise, the impact on costs would be ambiguous. A process designed to take longer than a few months, but completed in less than two years, may result in costs increasing for lenders in states where the process moves rather quickly and declining for lenders in states where the process moves slowly. The net effect on a national cost estimate, therefore, is indeterminate. Under a federal foreclosure law, however, it may become easier to obtain a much more reliable national estimate of the actual foreclosure costs, since lenders would follow similar foreclosure procedures nationwide.

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[21] The Joint Economic Committee estimates that foreclosures on average may cost as much as $80,000. This estimate includes costs to homeowners, loan servicers, lenders, neighbors, and local governments. See U.S. Congress, Senate Joint Economic Committee, *Sheltering Neighborhoods from the Subprime Foreclosure Storm*, Special Report by the Joint Economic Committee, 110th Cong., 1st sess. (Washington: GPO 2007) at [http://jec.senate.gov/Documents/Reports/subprime11apr2007revised.pdf].

[22] See Karen M. Pence, "Foreclosing on Opportunity: State Laws and Mortgage Credit," *Review of Economics and Statistics*, vol. 88, no. 1 (2006), pp.177-182. This study finds average loan sizes smaller in states with more protections for borrowers, which could translate into higher costs on all borrowers in those states.