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Home Sales Held Hostage by Junior Lien Holders: Mortgages

By Prashant Gopal and John Gittelsohn - Jul 23, 2012

Tom Axon's mortgage-collection firm gets about 25 calls a day from delinquent homeowners' brokers seeking approval to sell their houses for a loss and avoid foreclosure. We'll help, his staff tells them, as long as we get paid enough.

Axon, working with co-investors, buys distressed U.S. home- equity loans and other junior real estate liens, often for pennies on the dollar. Investors like Axon have to be dealt with whenever a home is sold in a short sale, a transaction in which the lenders agree to accept less than what's owed on the property.

"The short-sale brokers know us -- they know we're not cupcakes," Axon, 60, chairman of Jersey City, New Jersey-based mortgage-servicer Franklin Credit Management Corp., said in an interview. "At the end of the day, my friend, you signed a contract. You owe money and we're willing to reach an accommodation that is commensurate with your ability to pay."

Tough bargaining by second-lien holders is delaying deals and killing some short sales, even as banks embrace the practice to avoid costly foreclosures and help clear the market of homes that are worth less than the loans on them, said Vicki Been, a New York University law professor who has studied mortgages.

"It's an opportunity for the second-lien holder to charge a price for their cooperation, because it's needed for a short sale," Been, a director at NYU's Furman Center for Real Estate & Urban Policy, said in a telephone interview. "If they're too greedy, it may squelch the whole deal."

Second Mortgages

Roadblocks involving second liens are standing in the way of more short sales, which reached the highest number in three years in the first quarter -- 133,192 total transactions -- said Daren Blomquist, vice president at RealtyTrac Inc., a real estate information service in Irvine, California.

While about 39 percent of homes that have entered the foreclosure process have more than one lien, just 4.2 percent of short sales -- 5,658 transactions -- completed in the first quarter were on homes with second mortgages, according to an analysis RealtyTrac performed for Bloomberg.

The average time to sell a property with multiple liens was 448 days, up 27 percent from a year earlier, the company said. It took 352 days to sell homes with a single mortgage, a 6 percent increase from the first quarter of 2011.

"It appears that short sales with multiple liens aren't happening as frequently and are taking longer to complete," Blomquist said in a telephone interview. Short sales that fail tend to end up as foreclosures instead, he said.

'Biggest Hurdle'

In June, short sales of homes with multiple loans were completed an average of 19.75 months after the borrower's last payment, according to an analysis by J.P. Morgan Securities, a unit of JPMorgan Chase & Co. (JPM) That's about two months, or 12 percent, longer than short sales of homes with single mortgages.

Second-lien holders are protecting their interests, "which, unfortunately, don't dovetail with everybody else's interest," said Mark Zandi, chief economist at Moody's Analytics Inc. in West Chester, Pennsylvania.

"Subordinate liens have become the biggest hurdle to resolving the foreclosure crisis more quickly," he said.

Homes with second mortgages were twice as likely to be underwater, according to a July 12 report by real estate information provider CoreLogic Inc. (CLGX) That makes them candidates for short sales, even if they don't have delinquent loans, because their mortgage debt is greater than their resale value. The average negative equity for homes with second liens was $82,000, compared with $47,000 for single-mortgage homes, Santa Ana, California-based CoreLogic said.

'Hostage Situations'

"It's very much like hostage situations," Sam Khater, CoreLogic's senior economist, said of second-lien holders. "It's like an all-or-nothing situation in terms of payoff, and they're very unwilling to bargain."

Banks, facing an onslaught of pending foreclosures, are turning to short sales because their losses are about 15 percent lower than on repossessions, which can take years to complete while taxes along with legal, maintenance and other costs accumulate, according to Moody's Investors Service in New York.

Holders of first mortgages are pre-approving short sales, streamlining the closing process, forgoing their right to pursue unpaid debt and giving some borrowers cash incentives of as much as $35,000 for relocation expenses.

U.S. government programs have prodded banks to speed up short sales because they're less damaging to credit scores and property values than repossessions are. The Home Affordable Foreclosure Alternatives program, known as HAFA, pays servicers as much as $2,200 and homeowners as much as $3,000 for completing short sales. The program was changed in March to increase payments for second-lien holders who agree to release borrower liability, lifting the maximum settlement to $8,500 from $6,000.

60 Days

For loans guaranteed by Fannie Mae (FNMA) and Freddie Mac (FMCC), the government-run mortgage companies, servicers now must communicate final decisions on approvals within 60 days of a buyer's short-sale request. Fannie Mae tries to put a limit on negotiations by capping the amount junior-mortgage owners can receive at $6,000 or 6 percent of the unpaid balance, whichever is less. The company's guidelines don't allow any party to the transaction, including the buyer, seller or real estate agent, to kick additional money to the junior-lien holder.

"We want to help more borrowers avoid foreclosure through alternatives such as short sales, and we hope that second-lien holders will do their part," Andrew Wilson, a spokesman for Washington-based Fannie Mae, said in an e-mail.

The right to collect on unpaid junior liens varies with state laws and type of loan. In 39 states, including Florida and New York, lenders may seek deficiency judgments, giving them recourse to pursue borrowers for unpaid mortgage balances.

Deficiency Judgements

So-called piggyback loans, which were used to help cash- strapped buyers make down payments in the middle of the last decade, are often exempt from deficiency judgments because the money was used to purchase a home. Borrowers don't have the same protections with home equity lines of credit if the money wasn't used to purchase or improve a house.

It took more than eight months of negotiations and offers from three buyers to close a $1.5 million short sale on a Fountain Hills, Arizona, house in which PNC Financial Services Group Inc. (PNC) handled both the first and second liens totaling $2.9 million, said Janice DeLong, a Realtor with ROI Properties Inc. in Phoenix.

The sale stalled for the last time in June when PNC's negotiator for the $2 million first lien objected after initially agreeing to a final settlement, known as a HUD-1, under which the second-lien holder would get $275,000 of $900,000 in debt, DeLong said.

'They Reneged'

"They issued an approval letter, and then they reneged," DeLong said in a telephone interview.

The deal closed only after DeLong's client agreed to reduce the initial second-lien payment to $88,000 while surrendering to PNC's demand not to waive its right to try to collect the junior loan's balance, she said.

"PNC pursues deficiency judgments unless otherwise negotiated in the short-sale agreement," Fred Solomon, a spokesman for the Pittsburgh-based lender, said in an e-mail.

While PNC doesn't comment on specific loans, it's common for first and second liens serviced by the same bank to be controlled by different investors who have different negotiating positions, said Solomon, whose bank had $28.4 billion in second liens as of June 30.

"You may find cases in which a bank is servicing a first mortgage loan on behalf of an investor, and the same bank holds a second lien on the mortgaged property," he said in the e- mail. "The mortgage-servicing team of the bank operates at the direction of the investor, according to rules established by the investor, in negotiating with another part of the bank."

Largest Banks

The four largest U.S. banks -- Bank of America Corp., Wells Fargo & Co. (WFC), JPMorgan and Citigroup Inc. (C) -- held 48 percent of the $849.5 billion in second liens as of March 31, according to the newsletter Inside Mortgage Finance. Home equity lines of credit accounted for $590 billion, or 69 percent of the value of second liens, as of that date, according to Amherst Securities Group LP.

Risks associated with home-equity loans "may escalate" as borrowers face rising obligations to pay down principal on lines of credit, according to a July 5 report by the Office of the Comptroller of the Currency. Borrowers, who were allowed to make nominal or interest-only payments on the credit lines for as long as 10 years, will be obligated to pay down $15 billion in principal in 2013, $29 billion in 2014 and $53 billion in 2015, according to the report.

Loan Writedowns

Banks were ordered, in a January directive by regulators including the Comptroller of the Currency and the Federal Deposit Insurance Corp., to accelerate their writing down of second-lien values to reflect rising payment obligations and falling home value. The four largest banks reported $2.43 billion in writedowns on their second liens in the quarter ended June 30, down 13 percent from the previous three months.

Some of the mortgages are being sold to buyers such as Axon, whose company services about 40,000 loans, most of which are owned by joint ventures that he has an interest in.

The handful of companies that dominate the secondary market for nonperforming second liens are trying to persuade large banks to sell their portfolios of subordinate debt, said Lou DiPalma, managing partner at Garnet Capital Advisors LLC, a loan-sale consulting firm based in Harrison, New York.

Collecting on delinquent subordinate debt is expensive and complicated, especially when the borrower no longer lives in the house. Servicers for such loans make 80 percent of their money from 20 percent of loans, DiPalma said.

Valuable Liens

Nonperforming junior liens sell for between a quarter of a penny and 60 cents per one dollar of the outstanding balance, he said. The most valuable junior liens are delinquent loans on properties where the owner is not underwater, he said. Loans that are the cheapest and hardest to collect on involve foreclosed properties where the homeowner has already been evicted.

“In this business, it’s possible that you can not only lose the purchase price, but because it costs you money to service the loan, you can even lose more than what you paid,” DiPalma said.

Franklin Credit Holding Corp. (FCMCQ), which owes secured lenders $820.6 million after the housing crash reduced the value of its mostly subordinated loans, filed for bankruptcy in June. Its reorganization plan, approved by lenders, would let it transfer to shareholders its 80 percent stake in Franklin Credit Management, a non-bankrupt mortgage-servicing subsidiary, according to a regulatory filing.

Younger Borrowers

While Axon of Franklin Credit Management declined to say how much his company collects on average, he said it’s higher than the industry standard of 6 percent of the unpaid balance. Sometimes he wins agreements with borrowers to repay debt over many years. His company focuses collection efforts on younger, more-educated borrowers, and doesn’t pursue debts held by the elderly, disabled people or members of the military, he said.

USAA, a San Antonio, Texas-based lender that specializes in providing insurance and credit to U.S. troops and veterans, pursues debts even when borrowers are forced to sell for a loss because of a military transfer order.

Lower Delinquencies

"USAA is able to maintain an extremely high repayment rate of deficiency balances after short sales due to the thorough manner in which we evaluate a member's complete financial condition and ability to repay," Dave Pacholczyk, a USAA spokesman with Fleishman-Hillard Inc., said in an e-mailed response to questions. "This approach means that those who are able to do so may be asked to contribute a higher amount at closing and will be asked to pay the remaining balance where the law permits."

USAA had 220,000 second liens with a balance of $9.4 billion as of the end of May, and only 1.6 percent of the portfolio was delinquent or uncollectable, Pacholczyk said. That compares with an average delinquency rate of 5 percent for home equity lines of credit and 12 percent for piggyback mortgages throughout the industry, according to Been of NYU.

Tshai Wright's bank agreed in December to give up a third of what she owed so she could sell her Miramar, Florida, home. She qualified for a $3,000 relocation payment through the federal HAFA program as well. That's around the time she heard from Franklin Credit Management, which is trying to collect on her piggyback loan.

Lender Power

Franklin wouldn't settle for anything less than half of the about $69,000 she owed, and wouldn't participate in the HAFA program. After months of negotiations and three extensions from Wells Fargo, her primary lender, it turned down the short sale. Now she is considering Franklin's offer to modify her payments.

"It's crazy," said Wright, a 35-year-old paralegal who is going through a divorce, causing a decline in her household income. "They're a junior-lien holder, and there's too much power they have."

Franklin Chief Financial Officer Paul Colasono said his company was willing to settle for "substantially less than she owed," or to reduce Wright's mortgage payments to a level she could afford.

The key to success is knowing something about the borrower, according to Axon. Franklin's Face to Face Home Solutions division dispatches retired police officers and firefighters to speak with delinquent borrowers and write reports that describe the condition of their properties and their attitudes about paying. A BMW parked in the driveway may be a clue to a homeowner's finances, Axon said.

The company also compiles a profile of the borrower using public databases, credit scores, original loan applications and, sometimes, Facebook and Twitter pages, and ranks borrowers based on their ability to pay, Axon said.

"We are making our decisions based on characteristics of the borrower," he said. Homeowners are "the ones being stubborn. They're the ones who got their money and bought their boat, and now they want their boat for free. The fact is we're willing to discount the obligation, get this behind them, and have them fulfill their obligations. If everybody gave everybody what they got for free, we wouldn't have a banking system."

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