

UNDERSTANDING FORECLOSURE

Background

When a consumer takes out a mortgage, they are entering into a contract to make payments under specific terms. If a borrower fails to make a payment, the contract is violated. The servicer of the loan fails to receive a payment and accordingly does not receive a payment for managing the loan. The financial institution holding that loan fails to receive payments of interest and principle. In many cases, the stream of principle and interest payments are packaged into bonds or mortgage-backed securities with other loans and sold to investors seeking particular types of financial instruments. After several missed payments, the servicer and lender involved in the mortgage will begin aggressive actions to recoup past-due payments and lay the groundwork to foreclose on the home. Depending on the state and the borrower's circumstances, borrowers may then have their home sold at a foreclosure auction in order to pay off the collateral underlying the mortgage.

The foreclosure process varies by state, but generally borrowers have at least 60 days from their first missed payment to take action to avoid foreclosure (in some states, borrowers may have a year or more to attempt to reinstate their loan). While most consumers are unaware of this fact, there are many options available to assist a homeowner prior to foreclosure. These options include the following:

- **Forbearance**—suspending or reducing payments for a period of time;
- **Repayment plan**—adding past-due amounts to the future monthly payments;
- **Loan modification**—adding the past-due amounts to the principal balance, extending the term of the loan, or reducing the interest rate;
- **Deed-in-lieu of foreclosure**—returning the property to the investor so the borrower walks away without a foreclosure on their credit; and
- **Pre-foreclosure sale (short sale)**—selling the property for less than is owed on the mortgage.

However, in too many cases, borrowers fail to make contact with their lender when they miss their first payments. Research suggests borrowers feel (overly) confident they can correct their financial situation, or are too physically and emotionally taxed to respond to calls and letters from their servicer. Given that the majority of defaults are related to a job loss or illness in the family, borrowers have other serious issues to manage outside of their mortgage payments. Even when borrowers do work with their lender, they may feel distrustful or angry, or they may be generally be uncooperative. The legal process related to mortgages and mortgage foreclosure is intimidating for any consumer, let alone a consumer in financial distress. Nonprofit counseling has provided a valuable tool to help borrowers take control of their situation, work cooperatively with their lender and develop strategies to address the delinquency and get them back on track.

In the last decade, the financial industry has made tremendous strides in developing alternatives to foreclosure, such as targeted outreach programs and efforts to partner with third-party organizations to make sure borrowers in default are involved in some

positive steps toward recovering their financial situation. The rapid rise of foreclosures since 2002, beginning with declining manufacturing areas in the Midwest and spreading to other communities by 2006, has encouraged further advances in the field, although clearly more can be done.

Overview of Foreclosure Process

Figure 1 below illustrates the timeline involved in the foreclosure process. The first stage includes borrowers who have not yet missed a payment, but are at risk of missing a payment. Borrowers may know the next payment will be difficult to make, or they may receive information about a job loss or other crisis that impacts their ability to pay their mortgage.

Traditionally, lender and nonprofit programs have not focused as much on this group, although strategies such as homebuyer education courses, borrower workshops and community outreach programs may help alert borrowers in this category that action is needed. The better this segment can be addressed, the fewer borrowers will require more intensive services later in the timeline.

Figure 1

Early Stage	Prefiling Stage	Foreclosure Stage	Predelinquency
1 to 60 days	61 to 120 days	121 or more days	

The early stage, from within days of missing a payment, is an area of increasing innovation. Lenders and servicers recognize that reaching borrowers in this phase is critical because the borrower has not accumulated such a large outstanding balance and there are more options available. However, not all lenders and servicers can offer most of the alternatives to foreclosure described above, in part because of agreements with investors in mortgage pools and industry guidelines. Moreover, some servicing operations assign borrowers in this stage to “collections” agents. Although the capacity of collections departments is changing rapidly because many servicers have not had to manage large numbers of defaults in the past, in some institutions collections agents may not be aware of all of the options available to borrowers, or they may not be willing to take the time to explore a borrower’s situation and needs. This situation is changing, but borrowers still complain of mistreatment in this phase.

In the next phase the borrower is far enough behind that a single catch-up payment is unlikely and further options are required. The lender will begin the process of assessing the condition of the home and laying the legal groundwork for filing for foreclosure. The costs of legal filings and other activities can be expensive, often eroding any chance the lender can actually cover the value of the loan if the home does end up being sold at an auction. This stage has experienced some of the most significant changes in recent years, and most borrowers, if they make contact and have the ability to cooperate, can enter into one of the alternatives to foreclosure described above.

At the foreclosure stage, the borrower is in imminent danger of losing their home. Foreclosure sales will be scheduled and the borrower, if not in contact, will be served with multiple legal actions. However, even at this stage, especially in states with borrower-friendly foreclosure laws, a loan in default can be redeemed.