

# short·sales *redefined:* *a new look to real estate*



## The Truth Behind The Short Sale Market

By: Michael Cuevas, Illinois Licensed Realtor

Five years ago, most individuals were not familiar with the term “short sale”. Now in 2010 and 2011, short sales are becoming more and more common and the housing market has continued to suffer and remain distressed. The amount of foreclosures, short sales, and overall large housing inventory has hurt everyone’s business. Furthermore, the overall depreciation and deterioration of the housing market can be contributed to lender and GSE (Government Sponsored Enterprises) short sale policies. Short sales have been the leading loss mitigation method, but are the policies created by many of the *GSE*’s and lenders the cause of the large influx of foreclosures and short sales? One notable negative outcome of these policies is the current inventory in the marketplace and the surplus of short sales and foreclosures, which can be extremely detrimental to the economy as a whole. In March 2011, Core Logic states that roughly 24% of homeowners are underwater or owe more on their property than what their home is actually worth. This is a staggering statistic considering that in the third quarter of 2010, the percentage of U.S. homeowners underwater was at 19%. What is even more daunting is that this number increased by 5% in only six months! Many experts have been predicting for the last two years that by 2012 this number will reach 50%. While we still have some time before the year 2012, one thing for certain is there is still a very large housing crisis on our hands. Can you imagine if these numbers increased any further? How much of the American wealth would disappear? What can we do right now to further mitigate the overall loss in the housing market? The market, as a whole, increasingly deteriorates *GSE*’s, banks/lenders, and the American citizens reap the negative effects.

Furthermore, if short sales are a way to mitigate the lenders or *GSE*’s loss, why are there so many policies that make the short sale process so difficult? Many would think short sales should be encouraged and supported by the government, yet the policies in place regarding short sales end up costing taxpayers billions of dollars and larger losses to both *GSE*’s and lenders. Lets first look at the Nationwide Foreclosure and Short Sale Summary to see what the figures show.

## **Part 1: 2010 Nationwide and State Foreclosure Summary**

State	2010 Total Foreclosure (FC) Sales						Avg. REO Discount%	Avg.Pre-FC Discount%
	# of FC Sales	% Chg from 2009	%Chg from 2008	Pct. of All Sales	Avg. FC Sales Price	Avg. FC Discount%		
U.S. Total	831,574	-31.14	-13.76	25.96	\$172,030	28.13	36.30	15.06

The chart above is from Realty Trac and displays the national percentage discount of REO's and Short Sales from the national average sale price of non-foreclosure homes. The chart above shows that the National Average Sales Price of all foreclosure properties (pre-foreclosure or short sale and actual foreclosures), was discounted an average of 28% from the average sales price of Non-Foreclosure properties. The figures above suggest we should be doing everything possible to avoid properties ever reaching pre or post foreclosure, however, when taking into consideration other factors and economic indicators, it is impossible to think that properties are not headed towards foreclosure one way or the other. If you examine the statistics further, you will be able to see a huge difference in loss between pre-foreclosures and actual foreclosures. Pre-foreclosures are what we will refer to as short sales and actual foreclosures we will refer to as REO's. When properties are foreclosed (REO) on or get sold at an auction, they sell for 36% less than the fair market value vs. 15% of the fair market value if they were sold via a short sale. That is a whopping 21% differential in market value prices! It is the foreclosed homes or REO's, which are closing out at rock bottom prices that are doing more damage to the marketplace than the short sales. In addition, there are many more foreclosures or REO's in the marketplace. It would be ignorant to believe that we could avoid properties to reach foreclosure, but when you take into consideration the figures above, don't you believe it would make more sense to get these properties sold via a short sale rather than go through foreclosure?

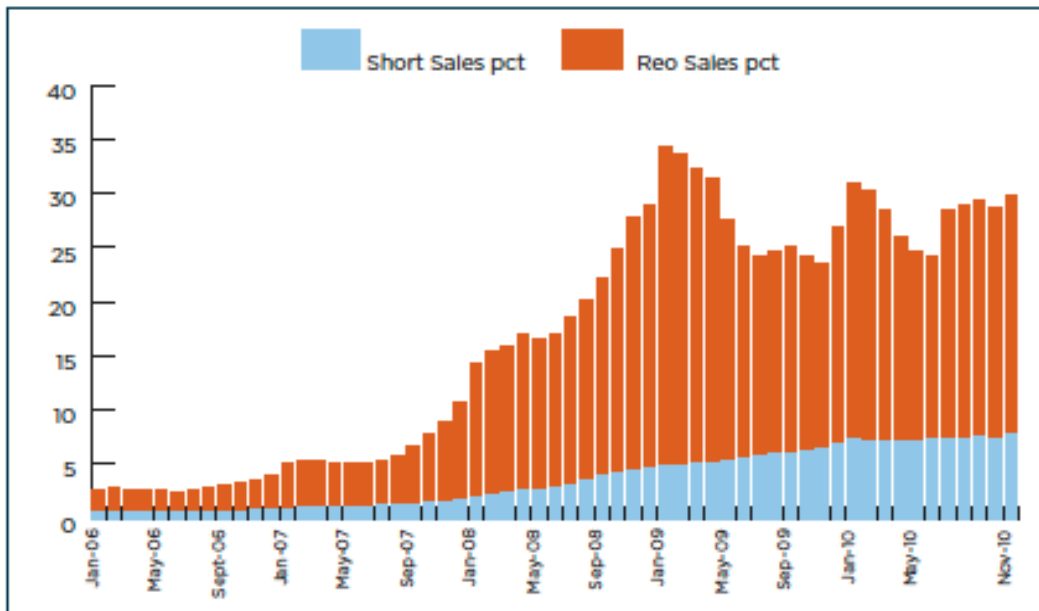
- **Average REO Discounted Price = 36%**
- **Average Pre-FC=(short sale) Discounted Price = 15%**

The figures above are astounding so why would major GSE's and lenders be making it so difficult to complete short sales? Nationally speaking there is an additional 21% discount in sales price on average from when a property reaches short sale vs. letting it go to auction or become an REO. It is this staggering statistic that has left many baffled, confused, and angry as why there are such tight restrictions and increasing regulations on the short sale process and guidelines in which lenders and GSE's implement. Are they shooting themselves in the foot and only setting themselves for a greater loss? They are doing this not only on their books, but also on the American taxpayer by placing horrible guidelines and processes for short sales. One thing has proven to be true based on all foreclosure avoidance options: in order for the market to recover we first must get rid of the bad debt. Ineffective short sale policies and guidelines are only creating a much larger problem vs. helping sustain the problem that we already have. For example, HAFA and HAMP programs have shown to be problematic and non-effective so it's time for the problem to fix itself through private market solutions. Please refer to my additional report specifically on HAMP and HAFA and the true figures behind those programs.

## **2010 STATS & INFO**

***2010: 2,871,891 U.S. properties in 2010 received a foreclosure filing (Default Notice, Auction Notice, and/or Bank Repossession). This number could have surpassed 3 million if foreclosure activity had not dropped in the 4<sup>th</sup> quarter due to the foreclosure documentation controversies in late 2010.***

## DISTRESSED SALES AS PERCENTAGE OF TOTAL SALES



As the number of short sales and REO's continue to rise it is becoming evident that short sales are beginning to play more a role in the recovery as indicated from the chart above.

### **Total Foreclosed homes = REO, Pre-FC, and/or Auction.**

- Total Foreclosure homes accounted for 26% of all U.S. residential sales in 2010.
- Total Foreclosure homes accounted for 29% of all U.S. residential sales in 2009.
- 831,574 = Total Sales Volume of U.S. Residential Properties which were in Foreclosure (REO, Pre-FC, Auction).
- Sales Volume for Non-Foreclosure properties in 2010 decreased 18% from 2009.

According to the statistics above, the amount of foreclosures and short sales within the marketplace have only led to a much larger depreciation of market values throughout the United States. Traditional sales are down 18% from 2009. The typical buyer's mindset and mentality is now opposite of what it was in the 2004-2007 "boom" days. Buyers are more concerned with the value of the property rather than falling in love with a property, and rightfully so. The question many Realtors have trouble answering is "how does one explain the market value?" It is my opinion

that the market value is 5-10% below what the most recent comparables sold at. Think about it from a logical point of view and as a buyer yourself. Would you pay the market value in this current real estate climate? The answer is most likely “no” and that is why this is a problem and my motivation for compiling this report and placing it into the right hands immediately. The main point that I want to get across is that the longer we have to face this foreclosure epidemic, the longer we are going to endure overall damage and depreciation of our marketplace in general. I am aware that there are many other aspects leading to the soft real estate market such as, unemployment, properties that are underwater, and many others, but what we can do is at least mitigate the damage as much as possible. Real estate ownership is a privilege and should be a way to build wealth, but in this market and in the foreseeable future it is proving to be the exact opposite. Unfortunately, both potential and current property owners are losing confidence and that can be a very dangerous thing. Something must be done to restore and stabilize the market so this does not occur. Let’s look specifically at REO’s or Bank Repossessed Properties.

## **REO STATS**

- 512,886 REO/Bank-Owned Properties Sold in 2010.
- 36% = Average \$ Discount for REO/Bank-Owned Properties in 2010.
- 33% = Average \$ Discount for REO/Bank-Owned Properties in 2009.
- REO sales accounted for 16% of all U.S. residential sales in 2010.
- REO sales accounted for 18% of all U.S. residential sales in 2009.
- REO sales accounted for 13% of all U.S. residential sales in 2008.

As you can see above, there is a continuous trend we are observing here and even though REO/bank owned sales are down 2% from the previous year, the overall discount from a traditional sale is what is discouraging. This percentage has increased by 3% within the last year! This is indirectly affecting the overall marketplace in a very negative way and no one sees this coming. While it is too early to tell what 2011 will bring us, all economic indicators suggest that the trends will only get worse in the months to follow. This will also lead to an increased amount of foreclosures and a larger amount of homeowners will be in default.

Let's now look at some basic figures regarding pre-foreclosures or short sales.

### **PRE-FORECLOSURE (Pre-FC, aka short sales)**

- 318,688 Pre-Foreclosure Properties Sold in 2010.
- 15% = Average \$ Discount for Pre-Foreclosure Properties in 2010.
- 17% = Average \$ Discount for Pre-Foreclosure Properties in 2009.
- Pre-Foreclosure sales accounted for nearly 10% of all sales in 2010.
- Pre-Foreclosure sales accounted for nearly 11% of all sales in 2009.
- Pre-Foreclosure sales accounted for nearly 11% of all sales in 2008.

There are not as many short sales as there are REO's, which probably amounts to about 40% less. The REO's also sell for an average of 15% less than a traditional sale in 2010 vs. 36% less as an REO, but yet there are not nearly as many short sales taking place. In 2010 there were 512,886 REO's sold compared to 318,688 short sales. Short sales confirm an estimated savings of roughly an additional 21% of the sale price as well. The solution to this problem is not rocket science. To lessen the blow we should be encouraging more short sales as the primary way to mitigate loss. The foreclosures are unavoidable at this point! Many people wonder why there are not more short sales that close successfully. It is very obvious that short sales are the way to go. According to statistics, only 24% of short sales actually close. This implies that 76% of attempted short sales fail! If 100% of short sales close with short sales being 11% of the closed transactions in 2010, would that mean that 44% of short sales would be the marketplace in 2010? The main source of short sale failure is simply due to short sale lender and servicer policies, incompetent real estate professionals, and an overall lack of education on the topic. Many Realtors tend to shy away from short sales naturally and so many homeowners are STILL ILL ADVISED on the benefits short sales have for both the homeowner and the banks. You would think logically, one would believe that instead of letting a property go all the way to foreclosure, lenders and servicers would attempt to do a short sale. The truth is policies regarding short sales make them unattractive and a huge headache for most people to take on. Why do the GSE's not have this data? How do the GSE's not have this data? Why are short sale policies not being reformed? Who is advising the GSE's? If it is the

banks, don't you think there is an adversarial relationship when servicing rights pay more money to foreclose than they do to short sale? What's really going on here?

## **U.S. STATE OVERALL FORECLOSURE DATA**

Five states accounted for 51% of the nation's total foreclosure activity in 2010: *California, Florida, Arizona, Illinois, and Michigan*. Together these five states documented nearly 1.5 million properties receiving a foreclosure filing during the year.

**The following list breaks down the top 10 foreclosure states and the percentage of foreclosure sales within these states.**

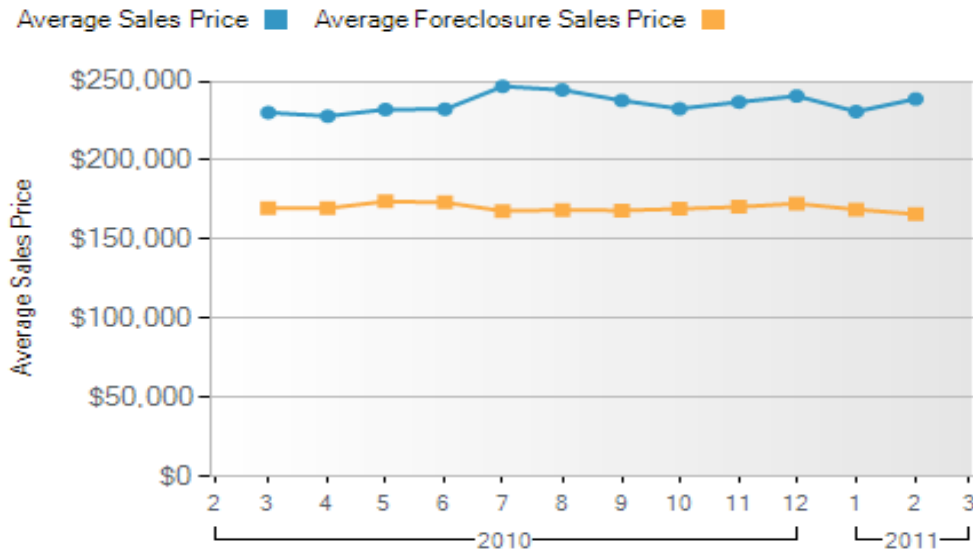
- **Nevada:** Foreclosure Sales in Nevada accounted for 57% of all residential sales in 2010.
- **Arizona:** Foreclosure Sales in Arizona accounted for 49% of all residential sales in 2010.
- **California:** Foreclosure Sales in California accounted for 44% of all residential sales in 2010.
- **Florida:** Foreclosure Sales in Florida accounted for 36% of all residential sales in 2010.
- **Michigan:** Foreclosure Sales in Michigan accounted for 33% of all residential sales in 2010.
- **Georgia:** Foreclosure Sales in Georgia accounted for 29% of all residential sales in 2010.
- **Idaho:** Foreclosure Sales in Idaho accounted for 28% of all residential sales in 2010.
- **Oregon:** Foreclosure Sales in Oregon accounted for 28% of all residential sales in 2010.
- **Illinois:** Foreclosure Sales in Illinois accounted for 26% of all residential sales in 2010.
- **Virginia:** Foreclosure sales in Virginia accounted for 25% of all residential sales in 2010.
- **Colorado:** Foreclosure sales in Colorado accounted for 25% of all residential sales in 2010.

## **2010 Foreclosure Comment:**

Foreclosures will continue to represent a substantial percentage of all U.S. residential sales and continue to sell at an average sales price that is significantly below the average sales price of properties not in foreclosure.

The increased supply of foreclosures and weak demand from homebuyers will both continue to weigh down the prices of properties in 2011. The housing market will not fully recover until the oversupply of foreclosures on the market winds down and the economy improves for more buyers to enter the housing market. It will also not recover until all of the negative debt is resolved as well as the insane amount of inventory is absorbed. The one fact that is evident throughout all of the statistics is that our government and our society should be doing everything possible for all properties to not be foreclosed on. Specifically, I mean short sales should be encouraged and foreclosure should be avoided. At this stage in the game I think it is safe to assume that short sales are the leading loss mitigation option within the marketplace right now. With a 21% savings, lenders and GSE's fail to recognize that an REO property actually causes the overall depreciation, which negatively affects all property owners throughout the country. Current short sale policies are gradually evaporating the wealth of this country and damaging the next generation of Americans.

**Why Do REO's and Short Sales sell for so much less than short sales?**



There are many factors that contribute to this, but an REO property is more than likely more distressed than a short sale. For example, REO's are not going to be staged or freshly painted in most cases so the direct vacancy of the property will naturally yield less money. Ask any Realtor or watch any HGTV show and you will see. Also, homeowners become spiteful and are more likely to

leave a property in the worst condition once they know the bank is going to take it back from them. We all know this is not morally correct, but this is the reality of the situation. When a property sits vacant, the wear and tear accumulates quickly. For example, in a colder climate, which is usually four months out of the year, a property sits vacant and it risks the chances of freezing or pipes bursting. This causes much more damage to the property, therefore, decreasing the value of the property. Additionally, vacant properties have a much higher chance of being vandalized or broken into. What incentive does a homeowner have to keep the property in great condition? REO's, when reverted back to a lender, will always sell for less because they must liquidate it immediately to get it off the lender's books. Prices tend to be lower when REO's enter the marketplace from the beginning of the listing history as well. It's just the way it is and will not change anytime soon. The more important figure being left out here is the prices reflected are only including sales prices and not the total loss suffered by the lender or GSE at foreclosure or short sale. Especially in a foreclosure, those costs rarely get reported and can be quite expensive i.e., court costs, maintenance costs, unpaid property taxes, HOA liens. These costs all contribute to the total amount lost during the foreclosure process. The costs for these items in a short sale are in majority of cases settled, which is not the case when a property is foreclosed on. Short sales, on the other hand, have the opposite effect.

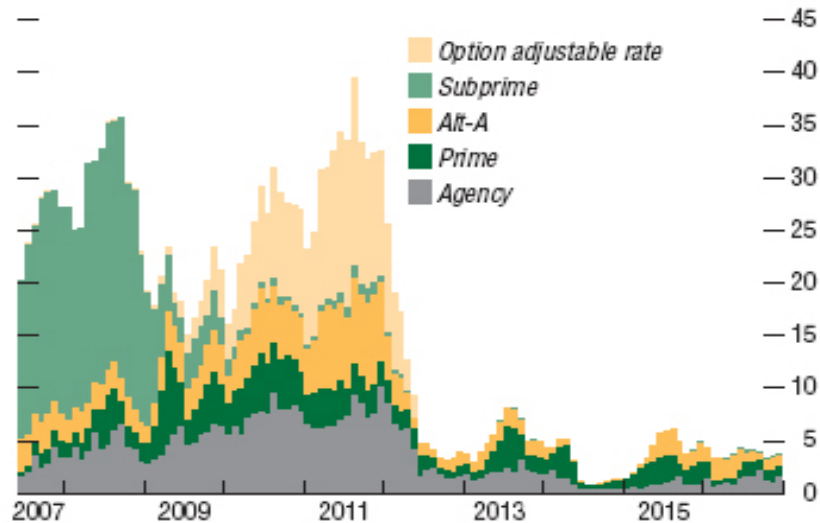
Before we get into the specific issues we face with short sales we should first address the current state of the market and where we are now headed. In addition to the research already mentioned, Core Logic found the following statistics in an in depth study of 250,000 short sale transactions.

The following statistics are key findings from the study:

- ▶ The number of short sales has more than tripled since 2008. Multiple variables indicate short sales will continue to be a significant factor for the industry.
- ▶ approximately 4% of short sales have a subsequent resale within 18 months.
- ▶ Investor-driven short sales are not inherently bad, since investors provide the industry with necessary liquidity

## The Current Market and Foreclosure Potential

**Figure 1.7. Monthly Mortgage Rate Resets**  
(First reset in billions of U.S. dollars)



Source: Credit Suisse.

The previous chart shows the amount of mortgage resets that are coming in 2011 along with 2012. You can see that the amount surpasses that of what we once knew and thought of as the “foreclosure boom” of our lifetimes from 2007-2010. This chart suggests that we are in the middle of another foreclosure tsunami. With the economy not fully recovering and many other factors, another large wave of foreclosures is here and a double dip is realistic if not already present in the housing market.

### NEGATIVE EQUITY STATISTIC:

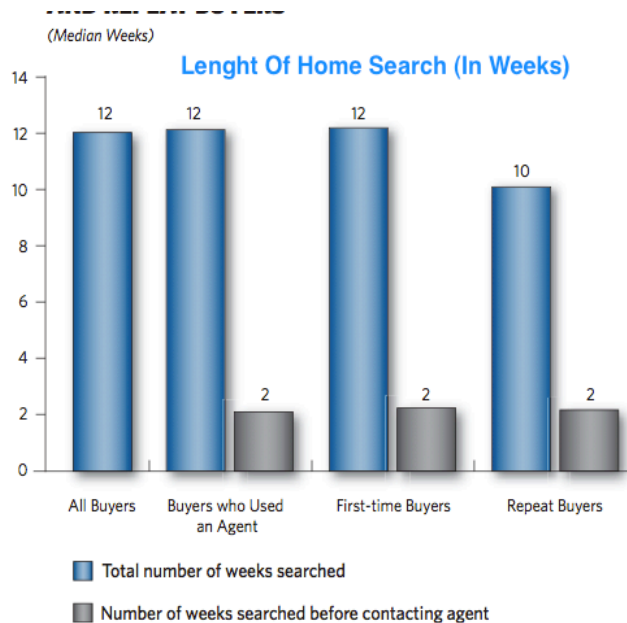
- 4<sup>th</sup> QTR 2010: 23.1%, or 11.1 million of all residential properties with a mortgage were in negative equity at the end of the fourth quarter of 2010.
- 4<sup>th</sup> QTR 2010: U.S. had \$751 billion in Negative Equity
- 4<sup>th</sup> QTR 2009: U.S. had \$800 billion in Negative Equity
- 4<sup>th</sup> QTR 2010: 2.4 million borrowers had less than 5% equity, referred to as “near-negative equity”.
- Negative equity, means borrowers owe more on their mortgages than their homes are worth.

**(Bar Chart) Equity Earned In Recently Sold Home In 2010**

**All Sellers**

TENURE IN HOME	Dollar value	Percent
1 year or less	\$37,626	17%
2 to 3 years	\$0	0%
4 to 5 years	\$6,000	3%
6 to 7 years	\$17,000	11%

This is a chart taken directly from National Association of Realtors. Borrowers who purchased two to five years ago all show negative equity in their residences. Borrowers who have purchased in the last year show a substantial amount of equity, which can be attributed to them by buying some type of foreclosure property for a discount. Equity sales or “foreclosure” sales are what are currently driving the real estate market. They are currently the majority of real estate sales. If the market were to depreciate another 4-6% in the next year or two, that would put all homeowners who purchased a property in the last 2-7 years underwater. This is a very scary thought.



This is the amount of time potential purchasers are spending on making a decision when searching for a property. Realtors would interpret this graph as an obvious factor related to the recent depreciation and price drops. This also suggests a very long market time for properties listed as well as a very cautious buying community. Longer search times only suggest that there is a large amount of inventory within the marketplace. This suggests that there is a high level of inventory within the marketplace and a sense of uncertainty within the overall market. Both are very negative for the real estate marketplace.

### **Short Sale Policies: Are they really helping us or hurting us?**

Most people would look at this information and understand that it is obvious that short sales are the best way to mitigate losses for properties inevitably headed towards foreclosure. They will also agree that we are headed towards another foreclosure wave or a double dip in the housing market. However, at the same time only 24% of short sales attempted ever succeed. With short sales as one of the last mitigation options left, why are they so difficult to process? The overall view regarding short sales is poorly looked upon and even frowned upon amongst many Realtors and other professionals simply due to the process itself. It is the GSE and short sale lender policies that attribute a majority of the failure and negative stereotypes short sales receive. While we cannot speak of each individual private investor and their specific guidelines, we can speak for the GSE guidelines regarding short sales specifically for HUD/FHA, Freddie Mac, and Fannie Mae. The first area of discussion is the negative view these GSE's have towards the real estate investor community.

## **RELEVANT INVESTOR DATA & INFO:**

Real estate investors have received much criticism and the topic of many slanderous topics in the last few years regarding short sales, however they are a major component to the overall economic recovery. As a matter of fact they represent a very important percentage of the buying population and are the key to market stabilization. According to the National Association of Realtors cash buyers made up 35% of the buying population surpassing of first time buyers. While we cannot obtain direct statistics for this it is safe to assume that many cash buyers are also investors. This does not take into account the percentage of investors who are buying properties, which are financed! The lack of buyers in the marketplace is leading to the depreciating values and the overall insane amount of inventory. For GSE'S to criticize the type of buyer who purchases a property on a short sale is ludicrous. However, they do it on a daily basis and GSE's may not approve short sales in which an LLC, investor, or other entity is the purchaser. If it were not for the investor community, the real estate market would be in worse financial situation than where it is right now. From the statistics alone, there is a 21% decrease in the sales price and an undetermined additional amount in holding costs that accumulate on a foreclosure. Thus, the GSE's have been held up on the fact that an investor may resell the property for a profit. I can understand their position because they are trying to get the most out of the short sale process, but it's the overall picture that is contradictory. Investors are discriminated upon because they are investors and they will make a profit. Although, that is the point and the reason capitalism has succeeded in the greatest country in the world! Let's say an investor did resell the property for a profit and made a gross margin of 15% on the transaction, that would still be a 6% higher net than the GSE would get than if the property went to foreclosure less the additional holding and foreclosure costs that would accumulate. If you interview short sale investors and rehabbers across the country they are not going to gross more than 20% of a gross profit in 99% of their transactions. Once a property becomes an REO what do you think happens to it? An investor can purchase it and the property is wholesaled or rented out for cash flow. When a property goes all the way to REO that becomes the new comparable in the neighborhood at a sales price that is 21% less, thus hurting the neighboring properties and lowering values or what the market is willing to pay. This only shifts more people

into a negative equity position and increases the chances of another property entering into foreclosure. This same frustrating pattern has been repeated time and time again. Remember the figure that was cited on the first two pages of this report, that in just six months the overall percentage of homeowners who are in a negative equity position rose by a whopping 5%. That number will rise in the next 12 months, which is inevitable. This leads to an overall depreciation, which increases more short sales and foreclosures.

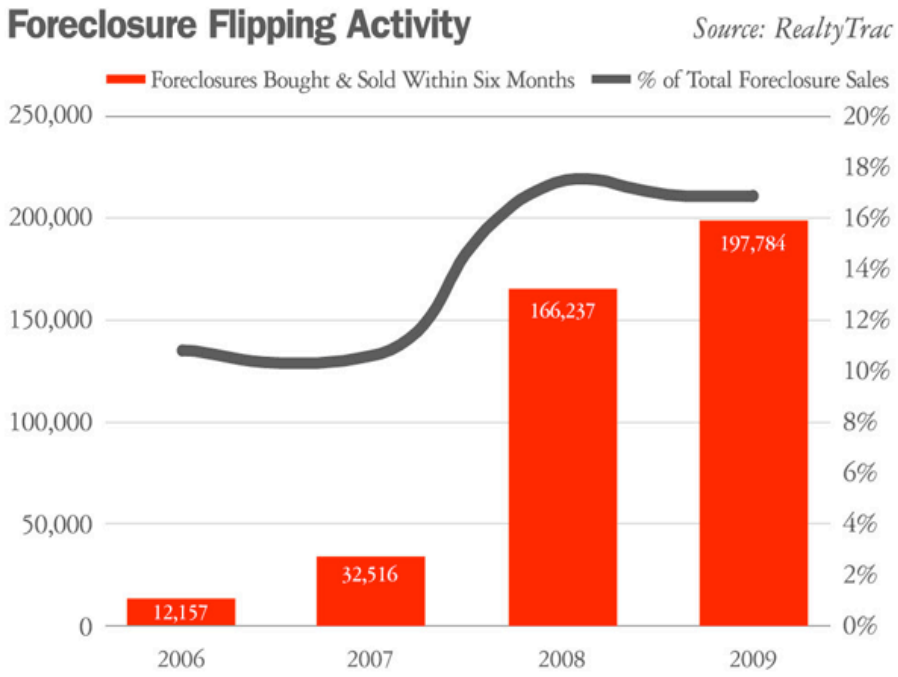
Investors and foreclosures are the heart of the current real estate market. The recent changes with the 90-Day Seasoning Rule on FHA backed loans, provides evidence that HUD and the FHA have recognized this fact. However, GSE policies regarding short sales contradict this position. As a matter of fact, legal opinions from the GSE legal counsel have directly contradicted the short sale policies in place. Freddie Mac's *Attachment A*, which was released last year and was a legal opinion, states the following: "Property flips are not inherently illegal and not all transactions involving a rapid purchase and resale are improper. Legitimate property flips are acceptable transactions in connection with loans purchased by Freddie Mac. Some indications of property flips that may be legitimate include:

Sales of properties in which the property seller acquired at below market value after purchasing as a result of a distress sale (i.e. REO sale, short sale, tax lien sale, bankruptcy trustee's sale, etc.), where any increase in the sales price over property seller's acquisition cost can be clearly shown to be the result of the difference, if any, in the market's reaction to distress sales and typical arms-length market".

Freddie Mac's short sale policy regarding any sort of short sale investor completely contradicts this statement. They will simply not work with investors or at least do not like to and think it's a better idea to take the chances and foreclose on a property to lose an additional 21% vs. letting a private market solution to their problem gross 10%.

Furthermore, when properties are foreclosed on they are also most likely sold to investors who will wholesale the properties or rehab them for a profit. This is a very healthy thing for the

overall housing market and is a revenue booster to the government, not a detriment. The Government thrives on taxes, which is a result of success of the private sector. Resale of properties generates millions of dollars in transfer stamps to local and state governments yet they are being discouraged by short sale policy guidelines which GSE's hold. This is also discouraging for groups like the National Association of Realtors who endorse the resale of properties. When a property is resold to an investor via short sale it must be done in full compliance with the proper disclosures. GSE lenders and some servicers have put a 30-90 day restriction on the resale or properties, which are purchased through means of short sales. Many people argue that this is unconstitutional and contradicts what local governments encourage. Let's take a look at the investor community specifically in depth on investors who rehab or quickly wholesale a property overall. The following graph will illustrate what is taking place in the real estate market amongst the investor community currently:



Investors are a major driving force in the liquidation of the housing recovery. Of course investors will make money, but that's the point in a capitalistic society. When they make money it gets transcended through the community, which is a good thing. If you go online right now and Google short sale investing you will find a tremendous amount of negative opinions, most of which

are not true. Real estate investing has and always will be legal and to put a negative connotation on it is of disrespect to the Constitution. I will not argue that there are some bad apples out there as there are in any business and government, however, the overall concept for investors is a necessary component of the housing recovery process. This is especially true considering that our unemployment rate remains somewhat stagnant at around 10%. There are simply not enough buyers out there to purchase these properties that will live and enjoy the properties as a personal residence. It just cannot happen metaphysically. Let's take a look at FHA specifically and their recent move to wipe seasoning requirements on buyer financing. Their recent policy suggests that there is a demand for properties, which were newly acquired through short sale or REO and being resold.

### **The FHA and the 90-Day Rule**

Due to the recent amount of properties being resold to qualified buyers and being purchased and resold within a 90-day period, FHA took the lead and changed their guidelines to offer financing to FHA qualified borrowers who purchased a property from an investor who “wholesaled” or “flipped” it to them.

**2010:** The FHA insured more than 21,000 mortgages for properties that were resold within 90 days.

**2003:** HUD moved to change the FHA guidelines to limit ILLEGAL flipping of properties. The new guidelines created the 90-day rule, which states that FHA will not insure any loan for any property that has been sold within the past 90 days. Currently, HUD has temporarily waived the anti-flipping rule with a waiver and is continued through December 31, 2011.

**Point well taken but it is important to consider the distinction between what is legal and illegal flipping.**

**LEGAL “FLIPPING”:** The quick purchase and sale of property. This is a common, lawful practice, which is now encouraged by the FHA.

**ILLEGAL “FLIPPING”:** A perverse process involving a real estate broker, appraiser, lender, and settlement provider. In illegal flipping it is common to see fraudulent appraisals to support a falsified higher value, or fraudulent loan applications and phony settlements. A property can be sold at an inflated price to an unqualified borrower. The unqualified borrower now owns an overpriced property with large monthly mortgage payments. The results are extremely negative for the new homeowner, the lender, and the immediate real estate market that the property was located in. People may also view flipping as when a third party uses only one set of funds to close two transactions which is frowned upon.

**Quotation from FHA Commissioner, David H. Stevens:**

*“Because of past restrictions FHA borrowers have often been shut out from buying affordable properties. This action enables our borrowers, especially first-time buyers, to take advantage of this opportunity and buy a home that has recently been rehabilitated. It will also help to move more foreclosed properties off the market and reduce the number of vacant homes in neighborhoods throughout this country”.*

**Quotation from HUD:**

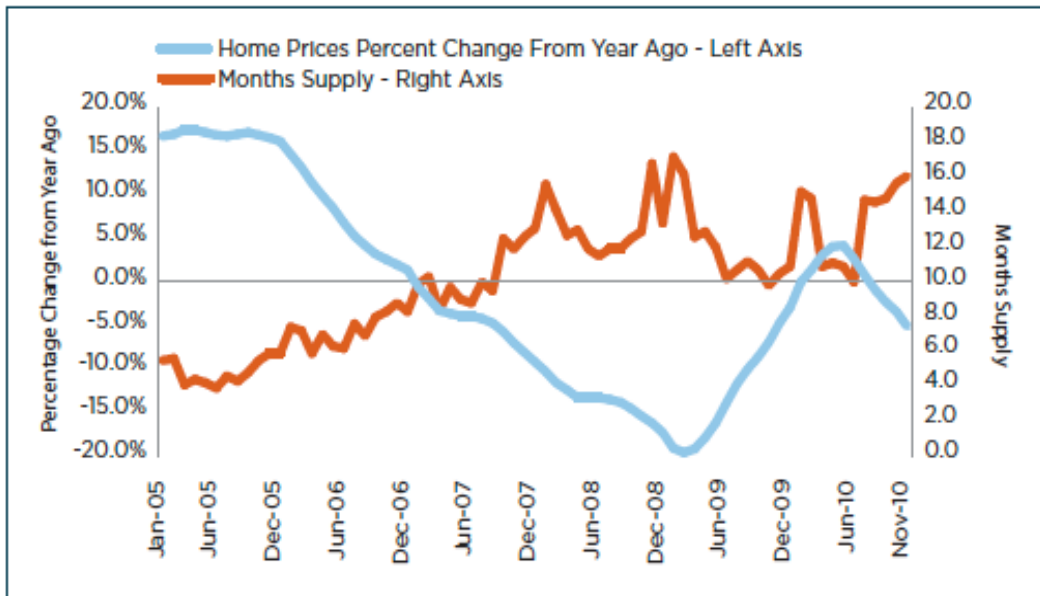
*“While the waiver is available for the purpose of stimulating rehabilitation of foreclosed and abandoned homes, the waiver is applicable to all single family properties being resold within the 90-day period after prior acquisition, and was not limited to foreclosed properties”.*

I find it interesting that FHA would state this and Freddie Mac would release a legal opinion about how property flips are not illegal, but contradict any statements with short sale policies. In addition, Freddie Mac has no seasoning requirements on the loans in which they purchase yet their short sale policies are conflicting and say otherwise.

## **Freddie Mac, Fannie Mae, & FHA Short Sale Approval Policies**

Fannie Mae and Freddie Mac hold roughly half of the mortgages throughout the United States. We can see that most lenders tend to follow their guidelines especially in short sale policies. It appears as if whatever Freddie and Fannie does, the rest seem to follow, but I'd like to really expose some of the very bad policies that are in place regarding short sale approval guidelines and how they affect all Americans. This is a very important to take into account because their policies do have a direct effect on our market. Please refer to the graph below, which demonstrates the decline in home prices with an increase in home supply. If the short sale policies are more rigid and strict, the longer it takes to liquidate underwater properties, the uglier this situation can get.

**FIGURE 4A: MONTHS SUPPLY REMAINS VERY HIGH**



## **Short Sale Approval Guidelines**

The majority of short sales are being serviced through various servicing companies throughout the United States and the actual servicing company is rarely the actual owner of the note that is being sold via a short sale. Regardless of who services the actual note, those servicers are only delegated to approve short sales based on the Freddie, Fannie, and FHA short sale approval guidelines.

## **Freddie Mac**

To get a short sale approved through Freddie Mac the purchase price must net 88% of the amount of the appraisal or Broker Price Opinion. This is also known as a BPO. When a short sale package is sent into the bank or servicer they are going to determine the eventual sales price of that property based on the current market value, not what is owed. The servicing company will commission an independent third party to the property to determine this value. According to Freddie Mac guidelines, in order to approve a short sale, Freddie will only approve 88% NET of what the appraisal amount is. So let's put this in context. If a BPO comes in at \$100,000, Freddie Mac will need to NET roughly \$88,000. Furthermore, the broker's commission, which is usually at 6%, additional closing costs, which is usually an additional 3-6% depending on the file, must also be considered as well. Therefore, Freddie must receive, in most cases, an offer close to 100% of the BPO amount! Now I want you to go back to the statistics we mentioned earlier. If an REO will net the bank on average of 36% less than fair market value at foreclosure then why would these guidelines remain the same? Guidelines need to stay current with the marketplace and this is a major reason why Freddie Mac short sales are headed towards foreclosure for an additional 21% less in the gross sales price. Please also keep in mind that the additional costs to foreclose are not calculated with this simple logic. This is insane, but it is the current policy. You can now see one of the main reasons why so many short sales get denied and head to foreclosure because it is nearly impossible for the following: 1.) Get fair market value for a distressed sale and 2.) The minimum net requirements are out of touch with the reality of the marketplace. Under this basic equation and using the example above, if Freddie Mac were to receive an offer of \$97,000-\$100,000 on a property they valued at \$100,000 it would get approved. Anything less than an offer of \$95,000 would get denied and the property would head towards foreclosure. When all is said and done, the

property would sell at 36% of the current market value price. According to the statistics, the property would sell an REO at roughly \$64,000 and net less the closing and holding costs that have accrued! Does this make sense? More importantly, guess who foots the bill at the end of the day, the American Taxpayers!

## **Fannie Mae**

Fannie Mae has a similar equation but is a little more lenient and easier to work with. Their required net from BPO amount is roughly 82%. In the same example above we could probably get a \$89,000-\$91,000 deal approved but if that was not the case, the property would head to foreclosure and receive an offer as an REO at roughly \$64,000! This is extremely frightening, but welcome to the world of GSE short sale policies. How no one has figured this out yet still makes me sick to my stomach.

Let's take a look at both Freddie and Fannie reported losses in the last two years.

### **According to Freddie Mac's 4<sup>th</sup> Quarter & Full-Year 2010 Financial Results Report:**

“REO operations expense for the full-year 2010 was \$673 million, primarily driven by maintenance expenses, property write-downs and net disposition losses, partially offset by recoveries.”

“The company expects its REO inventory to continue to grow in 2011. However, the pace of its REO acquisitions could slow due to further delays in the foreclosure process, including delays related to concerns about deficiencies in foreclosure documentation practices”

## **Freddie Mac Numbers & Helpful Info**

- Freddie Mac full-year 2010 net loss was \$14.0 billion.
- Freddie Mac full-year 2009 net loss was \$21.6 billion.
- REO Operations Expense for 2010 was \$673 million.

- REO Operations Expense for 2009 was \$287 million.
- Freddie Mac Financed 1.8 million single-family homes in 2010
- According to President's Obama's 2012 budget Freddie Mac & Fannie Mae combined will cost taxpayers \$73 billion through 2021.
- Foreclosing on a Freddie Mac mortgage takes an average of 15 months to complete, according to the Hollis McLoughlin, Senior Vice President, External Relations at Freddie Mac.

### **Fannie Mae Numbers & Info**

- Largest single issuer of mortgage-related securities in the secondary market in 2010, estimated at 44% of single-family mortgage-related securities.
- Fannie Mae financed approximately 2,712,000 single-family convention loans in 2010.
- Fannie Mae Total Net Loss in 2010: \$14 billion.
- Fannie Mae Total Net Loss in 2009: \$72 billion.
- From the Fannie Mae 4<sup>th</sup> Quarter & Full-Year 2010 Report;
 

“Given the large current and anticipated supply of single-family homes in the market, it will take years before Fannie Mae’s inventory of real estate owned (REO) properties approaches pre-2008 levels.”
- Fannie Mae completed 75,391 Pre-foreclosure Sales (short sales) & Deeds-In-Lieu of Foreclosure completed in 2010.
- Fannie Mae completed 39,617 Pre-foreclosure Sales (short sales) & Deeds-In-Lieu of Foreclosure completed in 2009.
- Fannie Mae acquired 262,078 Single-family REO properties in 2010.
- Fannie Mae acquired 145,617 Single-family REO properties in 2009.
- Total Carrying Value of Fannie Mae’s Single-family REO inventory at December 31<sup>st</sup> 2010 was 162,489 valued at \$15.0 billion.
- Total Carrying Value of Fannie Mae’s Single-family REO inventory at December 31<sup>st</sup>, 2009 was 85,155 valued at \$8.5 billion.

## **FHA Short Sale Guidelines**

FHA short sales are starting to become more prevalent. One of the major reasons is because FHA typically only requires 3% down. Therefore, most of the borrowers in FHA programs are under water from the day they purchased the property if they considered the costs to sell. FHA is a combination of Fannie and Freddie policy guidelines. They require that they must net 88% of the net amount, but will adjust that number by 2% every 30 days the property is listed. They will approve a short sale and then offer an approval to participate with a net dollar amount, which must be received. Every 30 days they will take 2% less until an 82% net is received and then it is capped out. Again the net figures do not make sense when you compare them to the grand scheme of things. You can definitely expect more FHA short sales to come about in the next couple of years.

One policy that is very bad within the FHA program is when there is a second lien or HELOC involved. FHA policy states if there is a second lien on title they will not entertain the short sale unless the second lien is approved. What has happened is thousands of borrowers who need to do a short sale have since taken out a Home Equity Line of Credit on the property. The values have plummeted and there is no longer any equity left in the property which leads to a short sale. The HELOC cannot release their lien without being offered something. Nothing can be offered to the HELOC since the file cannot proceed to the next stage and the lien cannot be released without being offered something first. FHA states they will not proceed with the short sale process until the lien is released. This is very backwards because it requires the first lien to offer something to the second lien before the second lien can make a decision. This is the policy that is affecting short sales in our nation right now! Again, this is another reason why I am putting the facts in front of you so you can help take action and help stabilize the housing market.

## **Solution**

A simple solution to this problem, where more short sales get approved and to limit GSE's loss is to have them reform their short sale approval net guidelines. A net of 75% or less of the BPO would be a good start which can get adjusted as the market adjusts. It should be more, but this would be a good start and doable. This would increase the number of short sales completed, which would lead to overall less depreciation and less REO's. This would also lead an easier transaction to close, for the market to correct itself, and a higher net to the GSE's and lenders. More short sales would close and less homes would foreclose, both which would be very healthy to an already ailing marketplace. The less amount of REO's that hit the market, the better for the market overall. If REO's are selling for 36% under market value short sale net guidelines need to be reformed from what they currently are.

## **Facilitation and Third Party Fees**

One of the largest reasons many short sales fail is the lack of competence the Realtors or other professionals have when facilitating the transactions. There is not a whole lot of research available that educates Realtors about loss mitigation or short sale negotiation. The negotiators on behalf of the servicers for the most part are going to more than likely have the upper hand with anyone they deal with in terms of experience. All GSE's have negative stereotypes with any types of third party fees that come into play. There is a huge demand for this type of work for the any homeowner or Realtor in order to speed up the transaction. However, both GSE's state they will not pay third party fees, therefore, the lack of cooperation with small companies popping up that offer this service makes a free market solution to this problem near impossible to occur. Facilitating a short sale transaction takes additional training and those out there who are working in this field become easily deterred due to current GSE policy. A standard fee would be around 3% of the sales price for

this service. However, these fees are frowned upon and considered “evil” in the eyes of many of the GSE’s and lenders. Is it worth it to pay a third party fee of 3% to an entity who can facilitate a short sale much quicker than any servicer or risk taking an additional 36% loss at foreclosure because of their policies? The fees need to not be scrutinized and allow a private market solution to assist in the housing recovery but once again this is blocked. Instead money is contributed to HUD counseling services and other non-profit agencies, which only prolong the inevitable form occurring. This would encourage a private market solution to this problem and speed up housing recovery. Third party fees should be encouraged as long as they are properly disclosed and everything is above board. Perhaps a licensing requirement should be implemented.

A logical and fairly simple solution to this is to regulate and encourage this new industry within the marketplace. Homeowners and Realtors need this service badly and this is one of the main reasons why we are enduring the current financial crisis. Third party fees should be paid and encouraged for this service, as it is an additional way to mitigate the GSE’s loss. This can create jobs and help the private market assist with the problem. Again, we now know the American taxpayer foots this bill at the end of the day. GSE’s need to be focused on the net number received and the short sale is a business decision nothing else. They should be working off of a net figure necessary when all costs are taken into consideration.

## **Second liens and HELOCS**

Many people tend to forget whom the true owner of record of a property is when it is in foreclosure. Realtors are the biggest culprit of this, but let me explain the difference very clearly. When a homeowner is in foreclosure they are the owner of record all the way up to the point the foreclosure takes place. It is then the bank will regain ownership and possession of property to liquidate because that’s essentially what the foreclosure process is. The relationship that a homeowner and a lender have at that point is completely adversarial. They have an opposite economic interest. The bank owns the note on the property and the homeowner owns the property itself. However, GSE’s will only allow a certain percentage, generally 6% or \$3,000 to any

subordinate lien position. In the 2011 market, many of the properties have a home equity line of credit, or HELOC, attached to their property. The nature of this loan is what is very important. At the foreclosure sale the lien on title will get wiped off for a HELOC but the rights to collect on that debt will not cease to exist. It is like having a credit card. A lender who holds this note does not have to enter a deficiency judgment to pursue collection, the collection process can begin immediately. However lenders will either take this debt to their recovery department or they will sell it to a third party or debt collection agency where the homeowner will be sought for collection. Currently, and this will differ amongst borrowers and banks who hold these liens, the going rate to purchase collection rights on this debt is roughly \$0.08 cents on the dollar or even less. Current policies suggest that a homeowner cannot contribute nor can their purchaser contribute a dollar amount to settle this debt on behalf of a homeowner. What this does is not give any incentive for the homeowner to go through with a short sale unless all debt is settled. This results in driving more homeowners towards Bankruptcy as an option vs. a short sale since there is no incentive for them to do a short sale. Additionally, when the property goes to foreclosure we know it will sell for 36% less than fair market value so don't you think we should be coming up with ideas on how to encourage more homeowners to do short sales vs. not? What do you think a homeowner really wants? They want to put this behind them, get rid of their debt, and avoid having to file a Bankruptcy at all costs. Current GSE policy towards homeowners in this position does the exact opposite. They will not allow any money towards any lien in the second position, which only drives the property towards foreclosure. This in turn affects the taxpayers and the overall housing market. This includes HOA liens, 2<sup>nd</sup> liens, and additional judgments that may appear on title.

There is a simple fix; do not limit any liens in second position to any dollar amount and leave it negotiable. A GSE should not be in control of this, but keep it negotiable and on the table. GSE's do not need to throw money at people to do short sales; they need to help them get out of all debt. This would be a huge savings to the programs that are currently in tact. GSE's need to be looking at the bottom line not worried about what other liens are receiving. If they want to limit the dollar amount to any secondary lien holder, fine, but the homeowner or owner of record should have the right to counter a buyer any way they like. Purchasers of these properties can be countered to

contribute towards other the lien, which is a true win-win situation for all parties involved. GSE's avoid foreclosure and so do the borrowers, therefore everyone wins. Current GSE policy will not allow any party to contribute additional money towards anyone else other than to a GSE. If done so it must be disclosed but in today's market they are really cracking down on this, leaving borrowers to consider bankruptcy as better alternative. This policy needs to be modified so that people can get out of their debt and the housing market will not suffer as bad in return. This will also allow for more closings of short sales in the long run.

### **PMI Companies**

PMI companies are also another reason why short sales fail. PMI companies must also approve the short sale and gain approval since they are insuring some of the loss. Many times the length of time for PMI response or approval takes so long that the buyer of the property becomes impatient and walks away from the deal. In many cases the PMI companies can take an additional 30 days to approve the short sale in addition to the 2-4 months that the potential purchaser has already waited causing them to walk away. Many times the PMI company is capped or maxed out on what they will insure on the loss. When this happens they do not care if the property goes to foreclosure or short sale because their loss is identical. They will often request that the borrower execute a promissory note or offer cash contribution at closing. This almost always kills the deal! A simple solution to this can be that PMI companies must approve all short sales and give a response within 48 hours of deal submission. The borrower should also be able to contact the PMI company directly vs. working through the servicer companies bogged down process, which just creates additional unnecessary delays.

## **Conclusion**

With the uncertainty of the GSE future one thing remains evident which is within the short sale marketplace there needs to be some reform in regards to the current policies and guidelines that are in place. It has been proven that investors bring a much needed liquidation aspect to the recovery of the housing market. It has also shown that the GSE short sale policies are not in touch with the reality and even contradict themselves. While the demand for short sales are increasing it is certain that REO's will decrease as lenders, GSE's, Realtors, and the general public become more informed with the truth. The numbers don't lie and are factual. I hope that you can pick this report up and read the truth about the housing market. Spread the truth and in the end the housing market, our economy, and our nation will prevail.