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Factors underlying short sales

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ABSTRACT

The short sale process has emerged as the most common alternative to the traditional foreclosure process in the recent mortgage crisis. This paper examines the factors that affect the liquidation outcome between these two ways of disposing the housing asset. We find that better quality borrowers such as those with higher credit scores and with full documentation status are more likely to prefer and obtain approval of short sales, involvement of mortgage insurance firms and second lien holders reduces short sales, and that state foreclosure laws such as longer foreclosure delay and the statutory right of redemption reduce short sales. The results have implications for ostensibly borrower-friendly measures promoted by governmental entities.

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1. Introduction

A short sale is an alternative to foreclosure for financially distressed borrowers. In fact, short sales have increased dramatically in recent years, and even outnumbered bank-owned REO sales in a number of states.[2]

In a short sale, the borrower sells the property in the market for less than the outstanding loan balance, and conveys the proceeds to the lender. There are a number of programs with different rules set by the FHA, the GSEs, Home Affordable Foreclosure Alternatives (HAFA), and individual financial institutions. In some programs (such as HAFA) or by negotiation, the borrower may be able to completely settle their debt (no deficiency).

From a borrower's perspective, a short sale (relative to the traditional foreclosure process) can be attractive because it may (1) avoid a deficiency; (2) have less impact on the credit score; (3) enable quicker access to mortgage financing for a future purchase;[3] and (4) result in some

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[2] According to RealtyTrac, in the first quarter of 2012, short sales outnumbered REO sales in twelve states that included Utah, California, Arizona, Florida, Indiana, Colorado, and New York. RealtyTrac shows a national average of a 33% year-to-year increase of pre-foreclosure sales, which are typically short sales, in January 2012 (Blomquist, 2012).

[3] For example, after a short sale, the borrower may qualify to buy another home with a Fannie-Mae backed mortgage within two years. While after foreclosure, the borrower may be eligible to buy another home in five to seven years.

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immediate pecuniary benefits such as relocation assistance (HAFA). From a lender's perspective, a short sale can be attractive because it may result in a lower loss and realize the proceeds quicker than a traditional foreclosure. For the housing market, short sales will not depress the market price as badly as foreclosures. Indeed, Clauretie and Daneshvary (2011) showed theoretically that a short sale has a lower price discount than a traditional foreclosure, and Daneshvary and Clauretie (2012) showed empirically that short sales produce no spillover effects, which is different from REO sales.

Despite Clauretie and Daneshvary (2011) and Daneshvary and Clauretie (2012), there is a dearth of research on short sales. In fact, to our knowledge, we have not found any other empirical papers devoted to short sales.[4] The purpose of this paper is to examine short sales and uncover which factors affect the liquidation outcome between a short sale and a foreclosure. As a brief summary, we find that carrying private mortgage insurance and second lien reduce short sales, better borrowers lead to more short sales over foreclosures, but that states with long foreclosure times and those with statutory redemption rights have relatively fewer short sales, as those borrower friendly legal features raise the relative benefits of following the traditional foreclosure processes.

From a policy perspective, some government entities have intervened into the mortgage market by adopting more borrower friendly rules and practices, many of which extend the foreclosure period. These interventions may unintentionally decrease a borrower's propensity to seek a short sale and thus raise the proportion of traditional foreclosures. Such traditional foreclosures are associated with problems such as deferred maintenance and higher losses to the lender relative to the quicker short sales.

In addition, recent governmental interventions have had the effect of raising credit standards for new loans. To the degree that this leads to higher quality borrowers, this may increase the proportion of short sales relative to traditional foreclosures. Thus, short sales may play a more prominent role in the future.

This paper is organized as follows: in Section 2, we discuss factors that might affect the choice of short sale, in Section 3 we describe our data and estimation model, and present the empirical results in Section 4. We summarize the key findings in Section 5.

2. Factors underlying short sales

Typically, for a short sale, the borrower lists the property on the market as a short sale (often after consultation with the lender – the cooperative short sale approach). Subsequent to obtaining an offer, the borrower submits a short sale application with the offer letter to the lender for approval.[5] In the process, both the borrower and the lender play a role.

In this section, we discuss potential factors that could change the short sale versus foreclosure liquidation outcome. These factors include relevant state foreclosure laws, borrower characteristics, involvement of other financial institutions such as private mortgage insurance firms as well as second lien holders, and macro market conditions. Taken together these variables could affect the borrower's propensity to pursue the short sale, the chance of receiving an offer for the short sale property on the market, and the financial institutions' desire to approve the short sale.

From the state law perspective, we are interested in the three aspects of foreclosure laws: minimum state foreclosure time, statutory right of redemption, and recourse.[6]

States specify the minimum time required for completing certain foreclosure steps, such as how long the advertisement of the foreclosure auction should be published. During the foreclosure process and before the foreclosure sale, the borrower can stay in the property without making payments. In some states with the statutory right of redemption, borrowers are allowed to occupy the property until the end of the redemption time period. Longer delay provides more "free rent" for the borrower.[7] From a borrower's perspective, delay is expected to increase the relative benefit from foreclosure, and thus decrease the borrower's propensity to seek a short sale.

A statutory right of redemption gives the borrower the right to redeem the foreclosed property during the redemption time period after the conclusion of the foreclosure sale.[8] The redemption price typically is the purchase price at the foreclosure auction plus interest and certain fees.[9] The original intention of the statutory right of redemption was to allow the borrower extra time to work out financing and retain the house as well as to ensure a fair foreclosure auction sale price (Baker et al., 2008; Hart, 1964). With this option, the borrower may choose to redeem the house if the house price increases after the auction sale, if the redemption price is significantly lower than the fair market value, or whenever the borrower obtains a positive utility by paying off the purchaser and retaining the property.[10] All else equal, the redemption right increases the expected utility from the foreclosure process, and thus tends to decrease the borrower propensity to pursue a short sale.

[4] Ghent and Kudlyak (2011) investigate the impact of recourse on different types of defaults, where short sales are included in the category of lender-friendly defaults.

[5] Recently, some financial institutions such as Bank of America have launched cooperative short sale programs where the terms (such as the list price, commission and deficiency, etc.) of the potential short sale are negotiated before marketing the house. Subsequent to receiving an offer, the cooperative approach reduces the lender delay in acceptance or rejection of the short sale application.

[6] Throughout the paper, the right of redemption refers to the statutory right of redemption, not the equity right of redemption.

[7] Ambrose et al. (1997) show theoretically that longer delay increases the borrower default propensity. Zhu and Pace (forthcoming) find empirical support for the theoretical "free rent" theory on default behavior.

[8] Varying from state to state, certain other parties, such as the junior lien holder, may also have the statutory right of redemption as well.

[9] In some states, such as in Alabama, the borrower needs to pay back the full outstanding loan amount to regain ownership of the foreclosed property.

[10] Empirically, Bauer (1985) document that over 10% of foreclosed properties are statutorily redeemed in Iowa.

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