How The $25 Billion Foreclosure Settlement Will Really Affect The Housing Market

Well, struggling homeowners, that long-anticipated mortgage relief plan President Obama has been alluding to has finally been reached. Today the Department of Justice announced that its 16 month-long investigation into bank-related foreclosure abuses, following the robo-signing debacle of fall 2010, has culminated in a $25 billion mortgage relief plan aimed at helping homeowners.

The largest joint federal-state settlement ever, the deal was struck between the Department of Justice (DOJ), the Department of Housing and Urban Development (HUD), 49 state attorneys general, and the country's five largest mortgage loan servicers: Bank of America Corp., Citigroup Inc., JP Morgan Chase & Co., Wells Fargo & Company and Ally Financial Inc.

U.S. Attorney General Eric Holder said in a statement released by the DOJ today:

"It holds mortgage servicers accountable for abusive practices and requires them to commit more than $20 billion towards financial relief for consumers. As a result, struggling homeowners throughout the country will benefit from reduced principals and refinancing of their loans. The agreement also requires substantial changes in how servicers do business, which will help to ensure the abuses of the past are not repeated."

It sounds very exciting. And indeed, as my colleague Deborah Jacobs outlines in her article, "What The Mortgage Relief Plan Would Do For Homeowners," the settlement promises to aid underwater homeowners who are behind on payments in getting their principal balances negotiated down; to enable homeowners who are not behind to get refinanced on their mortgages; and to award former homeowners who were improperly foreclosed upon between 2008 and 2011 one-time restitution payments of about $1,500 to $2,000. (More on this here: "Why Homeowners Can't Bank On The Mortgage Relief Plan.")

About 1.8 million homeowners are reportedly expected to benefit from this settlement, most notably in foreclosure-riddled states like California and Florida. California, one of the last states to sign onto the settlement, will reap a huge chunk of the settlement money: up to $18 billion. As my colleague Steve Schaefer reports, the banks must offer at least $12 billion in principal reductions or short sale offers just to California homeowners that are either behind on their underwater mortgages or, as the State of California Department of Justice notes, "almost behind in their payments."

Foreclosure has become a common term in the past several years as millions of American homeowners have faced the process since the housing bubble burst. More than three million homes have been fully foreclosed upon since 2007. In 2011 alone, nearly 1.9 million homes had one or more foreclosure filings attached to them, according to RealtyTrac. CoreLogic estimates that nearly 11 million homeowners are "underwater" on their mortgages, or paying off loans that are worth more than the value of their homes.

Looking at these numbers, a $25 billion settlement that reaches only two million homeowners, despite the fact that this deal is the largest of its kind ever, seems likely to fall short of reaching all of the homeowners in need. So how will the foreclosure settlement actually affect the housing market as a whole?

How This Will Affect The Foreclosure Process

For starters, explains Sam Khater, a senior economist for CoreLogic, it will likely decrease the time it takes for a defaulted bank note to go through the process of foreclosure. CoreLogic, a Santa Ana, Calif.-based firm that compiles real estate data, reports that 830,000 homes were foreclosed upon in 2011, a 24% decrease from the year before. Th decrease wasn't due to a lessening number of homeowners defaulting; it was due to the fact that mortgage lenders have been much more cautious and much slower in processing default notices. It's a trend that took root following the robo-signing scandal in late 2010. In states where foreclosures must undergo a judicial process like New York and New Jersey, the process for each home to go through foreclosure has been taking as long as three years. Now that could change.

"This settlement will remove some of the uncertainty around those foreclosures and it will allow the flow of foreclosures to get moving again," Khater predicts.

If the foreclosure process ramps up that will mean two things: that distressed inventory could potentially get cleared out faster, and that home prices will fall further in the short term in response to that fact. “If the flow of foreclosures pick up they will roll over into REO (bank-owned) properties that generally sell at a 30% discount as compared to non-distressed home sales, which will put some downward pressure on prices, which will be good in the long-run but cause a little more pain for homeowners in the meantime” notes Khater.

Daren Blomquist, a vice president at RealtyTrac, an Irvine, Calif.-based foreclosure listing site, also believes the foreclosure numbers will rise, as more delayed foreclosures now get processed.” All of this will result in more foreclosure pain in the short term as some of the foreclosures that should have happened last year instead will happen this year, ” he says. RealtyTrac estimates that there will be one million completed foreclosures, or REOs, in 2012 — a 25% increase from 2011. In other words, a return to the pace seen before the robo-signing scandals.

Of course, as foreclosure numbers increase, there is the hope that the situations where loan modifications and short sales can be arranged will be, ultimately contributing to a decrease in the number of future foreclosures.

Both Blomquist and Khater believe that shadow inventory, or the homes that have yet to enter the foreclosure market either as distressed properties or as REO properties listed for sale,will begin clearing out as well. CoreLogic reports that roughly 1.6 million homes fall under this category. Many real estate experts believe that once shadow inventory clears out, a true housing market bottom can be reached and a recovery can fully take place.

All of this sounds hopeful– for the longer term, at least. But remember that this settlement will only reach a fraction of the homeowners who arguably should have access to this type of aid — and only those homeowners who have mortgages privately held by these five banks. “It appears that the principal writedowns will go to only a fraction of the 12.5 million borrowers nationwide whom we estimate our seriously underwater, meaning they owe at least 25% more on their mortgage than their property is worth,” notes Blomquist.

A cause for more questions and concern, the banks will have up to three years to dole out their relief packages to homeowners who are eligible under the settlement. And what framework will qualify a homeowner as “eligible” has yet to be specified. (We do know that homeowners in Oklahoma, the sole state that opted out of the settlement, are not be eligible.)

Fannie, Freddie and the Government’s Housing ‘Bailouts’

Realtors in New York state, which like California was one of the last states to sign onto the settlement, remain skeptical. “Certainly any action that will help bring confidence back to troubled New York homeowners and the housing market as a whole is welcome,” says Duncan R. MacKenzie, chief executive of the New York State Association of Realtors, in a statement. ”However, there are more fundamental [housing] issues that need to be addressed in Washington [D.C.] if New York State and the nation are to return to normalcy.”

Which raises the question of Fannie Mae and Freddie Mac. While private lender-serviced foreclosures may push through the pipeline faster now, it’s crucial to note that we are still talking about a relatively minute number of distressed loans, out of a relatively small percentage of mortgages in general.

What’s missing from this plan is the Government Sponsored Entities better known as Fannie Mae and Freddie Mac. While the top five banks engaged in this settlement may seem like financial giants, in terms of mortgages, the GSEs trump them. An estimated 82% of all mortgage bonds are held by Fannie Mae, Freddie Mac and the Federal Housing Administration (FHA). And as much as 96% of all mortgages that have been written since the downturn are backed by these government-affiliated entities. These GSEs are not involved in this particular settlement and these mortgage relief opportunities do not necessarily apply to the homeowners who have loans through them. In fact, a principal balance reduction program instated by these mortgage giants would cost as much as $100 billion, according to a Federal Housing Finance Agency analysis released last month.

Additionally, homeowners with mortgages held by private sector banks other than the five involved in this settlement will not have access to this “relief plan.” (My colleague Dan Fisher notes that as many as nine more banks may still join this settlement, here.)

Also important to note is the fact that other housing incentives where government has been involved have fallen far short of expectations. For example, the Home Affordable Refinance Program (HARP) aided less than a fifth of the estimated five million struggling homeowners it was expected to help. Its lackluster success has even led to the recent launch of a revised version known as HARP 2.

“I think you are going to find that the average American homeowner that’s on the verge of losing their home will think this new settlement is a golden parachute for them to stay in it,” comments one skeptical Realtor who handles distressed sales in the New York Tristate Area. “And ultimately, after much energy, they will find that this is one more housing-related disappointment.”