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`Buy and Bail' Homeowners Get Past Loan Restrictions

By Kathleen M. Howley - Aug 10, 2010

Harvey Collier, a mortgage broker in Fort Lauderdale, Florida, says he gets as many as 10 calls a month from people planning to default on their loans. The twist: They first want financing to buy another home.

Real estate professionals call it "buy and bail," acquiring a new house before the buyer's credit rating is ruined by walking away from the old one because it's "underwater," or worth less than the mortgage. It's an attempt to escape payments on a home whose value may never recover while securing a new property, often at a lower price with a more affordable loan.

The practice, which constitutes fraud if borrowers lie on loan applications, is continuing even after Fannie Mae and Freddie Mac, the biggest U.S. mortgage-finance companies, beefed up standards to prevent it, according to brokers such as Collier and Meg Burns, senior associate director for congressional affairs and communications at the Federal Housing Finance Agency. Whether driven by greed or desperation, the persistency of buy and bail underscores the lingering impact of the worst housing crash since the Great Depression.

"People were holding on, hoping the market would turn around," Collier, who won't work with applicants who intend to go into foreclosure, said in a telephone interview. "But now they're giving up because there's no light at the end of the tunnel in places like Florida."

The value of U.S. homes fell by a third from 2006 to 2009, as tracked by the S&P/Case-Shiller index. In some areas, the losses were bigger. Prices declined 56 percent in Las Vegas, 55 percent in Phoenix and 49 percent in Miami.

Such declines have left more than a fifth of single-family homeowners with mortgages underwater in the second quarter, according to a report yesterday by Zillow.com, a Seattle-based data company.

Rising Strategic Defaults

About 12 percent of residential-loan defaults in February were strategic, meaning homeowners decided not to make payments even though they could afford to, New York-based Morgan Stanley said in an April 29 report. The rate, which was about 4 percent in mid-2007, probably will increase even if home values start to recover, said Frank Pallotta, managing partner of Loan Value Group, a mortgage-consulting firm in Rumson, New Jersey.

"After home prices bottom, the borrower in a position of negative equity is able to quantify exactly how long it will take to recoup the loss, and may decide to walk away," Pallotta said.

Jumbo Loans

Most likely to walk away are borrowers with the best credit scores and so-called jumbo loans that exceed the caps set for mortgages bought by Fannie Mae and Freddie Mac, which range from $417,000 in most locations to $729,750 in high-cost areas, according to the Morgan Stanley report. People who choose to default typically have lost $100,000 or more in property value, said Brent White, a law professor at the University of Arizona in Tucson. No data exist on strategic defaults done in tandem with buy-and-bail purchases.

Buy and bail is most often pursued by people with big enough paychecks and low enough debt to qualify for two homes, according to Mark Goldman, a broker at Cobalt Financial Corp. in San Diego. That threshold is easier to meet since home prices retreated and mortgage rates fell to an all-time low, he said. The average U.S. rate for a 30-year fixed home loan dropped to 4.49 percent, the lowest in records dating to 1971, McLean, Virginia-based Freddie Mac said on Aug. 5.

Home Before Foreclosure

"Most people, if they have the means to do it, would like to make sure they have someplace to live before they let a house go into foreclosure," Goldman said. "They know they're going to kill their credit score, so they make sure to get a home they won't mind staying in."

Freddie Mac and larger rival Fannie Mae cracked down on buy and bail in 2008 by banning in most cases the use of rental income from an existing home to qualify for a new mortgage unless the first property has at least 30 percent equity.

"There were a number of policies put in place to squelch this type of activity, but people who are savvy can always find a way to circumvent policies," said Burns of the Federal Housing Finance Agency, which regulates Fannie Mae, Freddie Mac and the 12 federal home loan banks.

In addition to the rental restrictions, the mortgage giants now usually require reserves equal to six months of loan payments for both homes. The measures have been sufficient to block most applicants who attempt to buy and bail, said Pete Bakel, a spokesman for Washington-based Fannie Mae.

Still Going On

"We're always looking for ways to discourage the practice of buy and bail, but it still seems to be going on," said Brad German, a Freddie Mac spokesman. "It ultimately leads to higher costs for everyone as investors and others look for ways to price in the risk."

Buy and bail is fraud if applicants provide false information to obtain a loan, said Steve Beede, a real estate attorney at BPE Law Group Inc. in Fair Oaks, California. The Federal Bureau of Investigation is pursuing more than 3,000 mortgage-fraud cases, almost double the number from a year earlier, FBI Director Robert Mueller said in a June 17 statement.

"Buy and bail is not the most common mortgage-fraud scheme, but it's something we are aware of and investigate aggressively," said Stephen Kodak, an FBI spokesman, who declined to give specifics about cases. The bureau works with state police and local housing agencies to conduct investigations, he said.

Plans for Properties

Mortgage lenders often ask about plans for existing properties when vetting borrowers, said Beede, the attorney. Others don't seem to care, as long as there is enough income to pay both mortgages, he said. The new lender usually has no stake in the first loan, Beede said.

Clients of Ron Wilczek, a real estate broker in Tempe, Arizona, two months ago bought a house near Phoenix even though they couldn't sell their existing property because its value had sunk so far below its mortgage.

Now settled in their new residence, they may try to sell the first home for less than what they owe, said Wilczek, owner of Metro Phoenix Homes. If the lender won't agree to a short sale, they may just stop making payments, he said.

"You can make the argument that you must honor your commitments no matter what," Wilczek said. "On the other hand, you have people who are realizing that if they want any hope of a retirement or a better life for their families, they can't keep paying for something that will never, at least in their lifetimes, regain its value."

Ethics of Move

Even if owners have underwater loans, walking away is unethical, said Scott LeForce, president of Realty World Northern California Inc.

"A loss of value doesn't mean you have permission to run from your obligations," he said.

In about two-thirds of U.S. states, including Florida, lenders may pursue a borrower after foreclosure by seeking a deficiency judgment allowing a lien on new property for the amount still owed on a previous mortgage. In states such as California and Arizona, lenders may not have that option if the original home was a primary residence.

"Making it possible to pursue people who do this particular kind of default would go a long way to addressing the buy-and-bail problem," said Jay Brinkmann, chief economist for the Mortgage Bankers Association in Washington.

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