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What Loss Mitigation Taught Us About Housing Finance Reform

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by Patricia McCoy
Guest Blogger

From time to time, Housing Perspectives features posts by guest bloggers. Today's post was written by Patricia McCoy, Liberty Mutual Insurance Professor, Boston College Law School, and former Assistant Director for Mortgage Markets, Consumer Financial Protection Bureau.

Since 2007, the federal government and servicers have groped toward striking the right balance between cost-effective loss mitigation and unavoidable foreclosures for homeowners with delinquent home mortgages. Among other things, this painful experience resulted in a cornucopia of data about the right way and wrong way to do loss mitigation. Nevertheless, none of the leading housing finance reform proposals has incorporated these lessons. Take, for example, the Johnson-Crapo bill, which was the leading reform contender and made it to the Senate floor. That bill would vaguely require servicers to establish “loss mitigation options that seek to enhance value” but says nothing about the best way to do so. That oversight is unfortunate because it sets us up to repeat the mistakes of the past.

First, some history. Eight years ago, the federal government became focused on foreclosure prevention as mortgage delinquency rates began to spike. The George W. Bush Administration sought to achieve that goal through moral suasion and voluntary compliance by servicers under the aegis of HOPE NOW. Later, the Obama Administration turned up the heat by offering a carrot and a stick: a carrot consisting of the HAMP Program, which paid servicers to grant loan modifications when doing so would increase recovery, and a stick through rulemakings and enforcement. One of the results was a rich trove of data on what makes loss mitigation work and why.

So what did we learn? I address this question in some detail in a chapter in the Joint Center’s latest book, *Homeownership Built to Last*, but here are a few quick takeaways:

1. Standardized decision tree, or “waterfall,” such as that employed by HAMP to lower monthly payments, is key to minimizing default rates (by cutting the interest rate or, if necessary, reducing principal).

2. Foreclosure prevention is more successful the sooner it is granted after a homeowner’s first delinquency – ideally within two to three months.

3. The federal government should offer meaningful relief to people who are temporarily unemployed and need help making their mortgage payments until they get back on their feet.

These three techniques are a win-win for distressed homeowners and for investors by avoiding needless foreclosures while maximizing investor recovery.

But there’s one final lesson that is directly relevant to housing finance reform. We can’t implement lessons one through three unless we remove servicer barriers to effective foreclosure prevention. In 2007 and 2008, the private-label mortgage-backed securities market collapsed and that market remains moribund today. In the aftermath, servicers rushed to foreclosure in too many cases, saying that pooling and servicing agreements with investors (PSAs) tied their hands. Investors disputed those claims, complaining that the PSAs did not in fact bind servicers’ hands and that foreclosure prevention would have enhanced recovery in many of those cases.

After that sour experience, investors will not be eager to rush back to the private-label market unless loss mitigation rules give them stronger protections. It is important, going forward, that

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PSAs in future deals give servicers no excuse to deny loan modifications that will increase investor recovery vis-à-vis foreclosure. Since PSAs are privately negotiated, the only real way to assure that is to prescribe standard loss mitigation protocols and require PSAs to follow those protocols in any housing finance reform law that Congress enacts. The protocols should require servicers to evaluate loan modification requests by distressed borrowers using a standardized waterfall that is designed to reduce monthly payments to an affordable target level. Under that waterfall, servicers should attempt to attain the target payment level first through interest rate reductions and then, if need be, through principal reductions. The statutory protocols should also set time limits for loan modification decisions to help encourage early intervention. With these protocols in place, we can help avoid the experience in recent years where useless foreclosures pushed down home prices and delayed the economic recovery.

Posted by Harvard Joint Center for Housing Studies at 9:28 AM

Labels: foreclosure, GSEs, HAMP, homeownership, mortgage finance, policy

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