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The Home Mortgage Foreclosure Crisis: Lessons Learned

by

Patricia A. McCoy⁺

From 2007 through 2011, the United States housing market suffered from a severe imbalance in supply and demand.¹ On the supply side, there were too many homes for sale and too many of those listings were foreclosed homes. In addition, there were several million homes awaiting sale in the foreclosure pipeline.² Many of these homes in the so-called “shadow housing inventory” eventually came on the market and pushed down house prices.

The demand for homes was also depressed. In the aftermath of the financial crisis, banks tightened their lending standards. Meanwhile, millions of households suffered a decline in creditworthiness, making it difficult or impossible for them to get loans.

Reducing the shadow housing inventory is one method to help correct the imbalance in housing supply. There are two ways to reduce that inventory. One is through foreclosure prevention, to keep homes with distressed loans from entering the shadow inventory to begin with. The other is to speed up sale of real estate owned (REO) on the back end.

In this chapter, I will focus on foreclosure prevention. Foreclosure prevention addresses the front end of the problem by keeping distressed borrowers in their homes. Where that is not possible, foreclosure prevention partly addresses the back end of the problem by seeking a “graceful exit” for the borrower while expediting sale of the home to a new owner.

We know that investors take heavy losses on foreclosures: on average, 50% or more.³ This suggests that a significant portion of distressed mortgages could be and should be resolved short of foreclosure. In theory, servicers and investors should be willing to do a loan workout whenever the net present value of loss mitigation exceeds the net present value of foreclosure. This “NPV” test defines the outer parameters of the loan workouts most servicers will perform.

⁺ Connecticut Mutual Professor of Law and Director of the Insurance Law Center at the University of Connecticut School of Law. My thanks to Eric Belsky, Chris Herbert, the Joint Center on Housing Studies at Harvard University, and the University of Connecticut School of Law for their generous support of this research. Thanks also to the anonymous reviewers who read this work.

¹ See, e.g., Goodman et al., “Modification Effectiveness,” 2.

² CoreLogic estimated this inventory at 2.3 million houses as of October 2012. CoreLogic, “CoreLogic® Reports Shadow Inventory Continues Decline in October 2012.”

³ Bernanke; Capozza and Thomson, 241-58; Cordell et al., “The Incentives of Mortgage Servicers,” 3, 11-12.

From society's viewpoint, foreclosure prevention should have two major objectives. The first is designing loss mitigation plans to minimize the chance of redefault. The second is to keep homes occupied whenever possible. Avoiding vacant homes is crucial to remedying the shadow inventory. Not only do these homes deteriorate in value, they attract crime and push down the value of neighboring homes.

Consequently, foreclosure prevention should strive for a solution that keeps the homeowner in the home. That means negotiating a loan modification whenever possible that satisfies the NPV test and is designed for success. But when that is not possible, the goal should be a short sale to a buyer who will keep the home occupied. Doing so will help reduce the negative externalities from abandoned homes.

Most first-time loan modifications are behind us now⁴ and we have substantial empirical evidence about what worked and what did not. In this chapter, I discuss the four main lessons from the last several years' experience with loss mitigation, including structural challenges to reaching the right level of loan modifications.

Loss Mitigation: Its Rationale And Techniques

The high loss severity for foreclosures creates space for loss mitigation strategies that resolve distressed mortgages at lower cost to both investors and borrowers. The most common test for making that determination is the net present value or NPV test. Under the NPV test, a loan modification or other workout technique is deemed cost-effective when the net present value of the workout exceeds that of going to foreclosure. Pooling and servicing agreements (PSAs) normally impose the NPV test on workouts of private-label loans and also require servicers to maximize recovery for the benefit of the investors in the trust as a whole. Servicers are supposed to implement this requirement by choosing the higher NPV, as between a loan workout and foreclosure. Federal loss mitigation programs impose their own NPV tests and many servicers also apply proprietary NPV tests to distressed loans held in portfolio.

NPV tests have their limitations. For one thing, NPV tests can be manipulated because PSAs give servicers of private-label loans wide discretion in how to calculate NPVs. Servicers can choose whatever values they want for variables such as the expected sales price from foreclosure, the discount rate applied to projected revenues from loan modification, and the chance of redefault. Investors have little ability to monitor or change the values that servicers use for these inputs.⁵ As a result, servicers can manipulate the NPV calculation for many distressed private-label loans to achieve the outcomes they want. The same problem affects

⁴ See, e.g., Moody's Investors Service, "US Private-Label RMBS and Servicer Quality," 4.

⁵ Cordell et al., "The Incentives of Mortgage Servicers," 18; Thompson, "Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior," 6-9, 18; Kiff and Klyuev, 8 n.10 (discussing market forces affecting choice of discount rates). For Fannie Mae and Freddie Mac loans and loans evaluated for Home Affordable Modification Program (HAMP) modifications, this discretion is more limited. The HAMP program, Fannie Mae and Freddie Mac require servicers to use standardized software to calculate NPV. Cordell et al., "The Incentives of Mortgage Servicers," 18; Credit Suisse.

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the NPV test for federal loan modifications and for loans held in portfolio, although to a lesser extent.⁶

In addition, it can be hard for distressed borrowers to meet the NPV test when their incomes have plummeted. During the financial crisis, the collapse in home values caused more than one-quarter of all borrowers to go underwater on their mortgages. Normally, negative equity is a necessary condition for default but not sufficient. Most underwater borrowers who default also suffer an income shock.⁷ If that income shock is too severe – as is often the case with unemployment -- the borrower may not qualify for a loan modification under the NPV test.

When loans go delinquent or are in danger of default, servicers have a variety of workout techniques at their disposal to resolve those loans short of foreclosure. (I use “loan workout” broadly in this paper to refer to the full spectrum of techniques to resolve distressed loans short of refinancing or foreclosure). This large menu of options gives servicers discretion about which technique to use.

Like refinancing, some workout techniques allow the homeowner to retain ownership of the home. Of those, some lower monthly payments, while others do not. *Capitalization* takes the borrower’s arrears and tacks them onto the principal, thereby increasing the monthly payments, either immediately or later on. When capitalization includes *forbearance*, the servicer temporarily lowers the borrower’s monthly payments but adds the forborne sums to the loan balance, meaning that the loan payments will eventually go even higher. When capitalization does not involve forbearance, the monthly payments immediately go up. One way or the other, capitalization alone does not involve modification of any loan terms.

Loan modifications, in contrast, alter the loan terms, either by extending the term of the loan, reducing the interest rate, lowering the principal, or some combination of the three. Many loan modifications have the effect of lowering monthly payments.

Capitalization and modifications share the ostensible objective of keeping homeowners in their homes. Other workout techniques result in liquidation and normally require homeowners to vacate their homes. In a *short sale*, for example, the servicer allows a borrower to sell the home for less than the outstanding loan balance and often forgives the remaining amount due. In a *deed-in-lieu-of-foreclosure*, the borrower deeds the house to the servicer and moves out, in exchange for full forgiveness of the debt. In some cases, however, the servicer may lease the home back to the borrower, relieving any need to vacate the home.

⁶ Special Inspector General for the Troubled Asset Relief Program.

⁷ See Foote et al., “A Proposal to Help Distressed Homeowners.” The exception is for deeply underwater homeowners, who may decide their home are worthless investments and walk away from their mortgages. *Ibid.*

The Federal Government's Evolving Approach To Loss Mitigation During The Crisis

In 2007 and 2008, the first two years of the financial crisis, private loss mitigation efforts by servicers were haphazard, with low success rates. In mid-2007, at the urging of the George W. Bush Administration, the mortgage industry launched the HOPE NOW Alliance to promote greater foreclosure prevention. The objective of HOPE NOW was to get distressed borrowers into loan counseling and to convince servicers to grant them proprietary loan modifications whenever possible.

HOPE NOW was strictly voluntary and did not offer financial incentives for loss mitigation. Similarly, HOPE NOW did not recommend a standardized template for loan modifications or a numerical target for lower loan payments. As a consequence, servicers varied widely in their approach to and handling of loan workout requests. According to HOPE NOW reports, between July 2007 and October 2012, the program completed over 15 million loan workouts. Only 32% of those workouts (4.81 million) were proprietary loan modifications, however. The remaining 68% (10.34 million) resulted in liquidation or deferred or rescheduled borrowers' payments temporarily without permanently lowering those payments. Furthermore, the proportion of proprietary loan modifications to other types of workouts fell in recent years, from about 50% in December 2008 to 31% in October 2012.⁸

HOPE NOW's initial performance was disappointing. During 2007 and 2008, only 8.5% of mortgages that were at least 60 days past due received loss mitigation of any kind (whether a loan modification, a short sale, or a deed-in-lieu-of-foreclosure).⁹ Furthermore, the majority of loan modifications in 2007 and 2008 actually *raised* borrowers' monthly payments instead of lowering them.¹⁰ For homeowners who were already struggling to meet their payments, these loan modifications were often destined for failure.

Sheila Bair, the Chairman of the Federal Deposit Insurance Corporation (FDIC), used the occasion of the failure of the mortgage lender IndyMac to spearhead a better approach to loan modifications. When IndyMac failed in 2008, the FDIC took over as IndyMac's conservator and assumed the servicing of more than 60,000 seriously delinquent mortgage loans.¹¹ The agency took that opportunity to implement a uniform template for loan modifications that was designed to handle the growing volume of distressed loans at IndyMac.

Under the program, known as "Mod in a Box," the FDIC evaluated IndyMac homeowners who were at least 60 days past due on their mortgages for loan modifications. The FDIC's goal was to lower monthly payments, not raise them, by reducing the borrower's front-end debt-to-income (DTI) ratio to 38%, subject to maximizing NPV. To get the DTI down to 38%, Mod in a Box instituted a standardized "waterfall" of workout techniques. The first

⁸ HOPE NOW, 4, 7.

⁹ Adelino, Gerardi, and Willen, 13-18 and table 5.

¹⁰ Adelino, Gerardi, and Willen, 11-12 and table 3.

¹¹ Brown.

step was to capitalize arrears. If more was needed to reduce the DTI ratio to 38%, then the FDIC lowered the interest rate. After that, the term could be extended, and if more was needed to hit the 38% target, the FDIC could grant the borrower principal forbearance.¹²

To induce servicers to cooperate, the FDIC paid them \$1,000 for every IndyMac loan they modified through Mod in a Box. By February 1, 2009, 9,901 or about 26% of IndyMac's seriously delinquent loans had been modified.¹³ Over time, the FDIC succeeded in lowering the redefault rates on later IndyMac loan modifications compared with those performed before April 2009.¹⁴

In late 2008, the new Federal Housing Finance Agency (FHFA) unveiled a parallel streamlined loan modification program for delinquent loans guaranteed by Fannie Mae and Freddie Mac.¹⁵ Previously, starting in the 1980s, the two government-sponsored entities (GSEs) had instituted their own proprietary loss mitigation programs for distressed mortgages.¹⁶ Neither program had used a standardized waterfall designed to lower mortgage payments.¹⁷

Both of these proprietary GSE programs reported disappointing results. In 2008, for instance, troubled GSE mortgages were less likely to be modified than loans held in portfolio or even private-label mortgages. That same year, workouts of GSE loans had smaller interest rate reductions on average than workouts of portfolio loans, which had smaller interest rate cuts in turn on average than private-label loan modifications.¹⁸ Lack of affordability was also a problem. In 2008, over half of GSE loan modifications increased monthly loan payments.¹⁹ Accordingly, it came as no surprise that the redefault rates for GSE loan modifications made in

¹² Brown.

¹³ Kiff and Klyuev, 16-18.

¹⁴ Brown, 5, 11.

¹⁵ Cordell et al., "Designing Loan Modifications to Address the Mortgage Crisis and the Making Home Affordable Program," 19; Federal Housing Finance Agency, "Foreclosure Prevention & Refinance Report: Third Quarter 2009," 18; Kiff and Klyuev, 16-18.

¹⁶ For descriptions of GSE and FHA loss mitigation programs and technologies before 2009, see Abt Associates; Crews Cutts and Green, "Innovative Servicing Technology," 5-7, 13-15; Crews Cutts and Merrill, "Interventions in Mortgage Default."

¹⁷ See Federal Housing Finance Agency, "Foreclosure Prevention Report: Second Quarter 2009," 8 (comparing the GSEs' prior proprietary loan modification programs with HAMP). For example, Crews Cutts and Green described GSE repayment plans at the time, which typically resulted in higher rather than lower monthly payments because the plans required people to resume their regular monthly payments plus pay off the arrears. See Crews Cutts and Green, "Innovative Servicing Technology," 6, 21.

¹⁸ See, e.g., Agarwal et al., "Market-Based Loss Mitigation Practices for Troubled Mortgages Following the Financial Crisis," 3, 16, 19. However, the GSEs were more likely on average to refinance troubled mortgages. *Ibid.*

¹⁹ See Federal Housing Finance Agency, "Report to Congress: 2010," 4.

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2008 and 2009 were substantially worse than in later years, after both GSEs overhauled their proprietary loan modification protocols to lower monthly payments.²⁰

Frustrated with these and other *ad hoc* approaches to foreclosure prevention that did not result in lower payments for distressed borrowers, the Obama Administration announced its own loss mitigation program, called “Making Home Affordable” (MHA), in February 2009. MHA was funded with \$36.9 billion in Troubled Asset Relief Program (TARP) funds. Mod in a Box and FHFA’s own streamlined program formed the model for the Obama Administration’s approach to loan modifications.

MHA’s main feature was a loan modification program called the Home Affordable Modification Program or HAMP. HAMP revamped the protocol for loan modifications in three important ways. First, HAMP sought to alter the NPV calculus and the compensation incentives of servicers by paying subsidies for modifications of owner-occupied loans that were NPV-positive. Second, HAMP instituted a standardized loan modification waterfall for participating servicers to make modifications more successful and to bring those modifications to scale. Finally, as part of that waterfall, HAMP required servicers to lower borrowers’ monthly payments to 31% of gross monthly income for 5 years, first by lowering interest rates as far down as 2%, then by extending the loan term to up to 40 years, and then, if necessary, by forbearing (or, at the servicer’s option, forgiving) part of the principal.

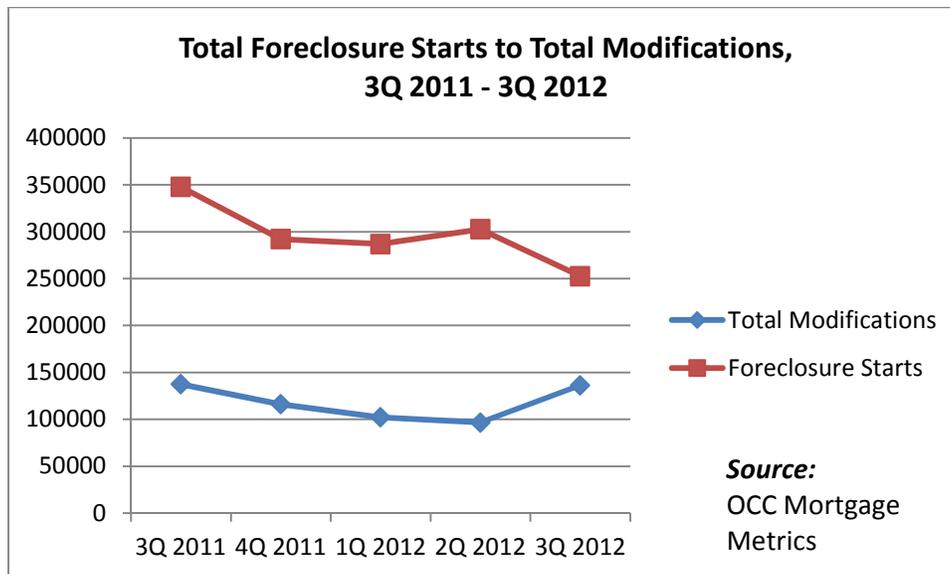
When HAMP was unveiled, the Administration predicted that it would assist 3 to 4 million homeowners restructure their mortgages by its original end date of December 31, 2012.²¹ HAMP fell short of that goal, completing only 1.136 million permanent loan modifications as of December 2012.²² Meanwhile, newly initiated foreclosures consistently outstripped permanent modifications (taking proprietary and HAMP modifications together) from third quarter 2011 through third quarter 2012, sometimes by as much as 2 to 1. The trend for earlier quarters was similar.²³

²⁰ Compare Federal Housing Finance Agency, “Report to Congress: 2010,” 4-8 with Federal Housing Finance Agency, “Foreclosure Prevention Report: Second Quarter 2009,” 12.

²¹ Department of the Treasury, “Homeowner Affordability and Stability Plan Executive Summary.” The Treasury Department later extended the HAMP program through December 31, 2013.

²² Making Home Affordable, “Program Performance Report Through December 2012,” 3.

²³ Office of the Comptroller of the Currency, “OCC Mortgage Metrics Report: Fourth Quarter 2011,” 22, 24; Office of the Comptroller of the Currency, “OCC Mortgage Metrics Report: Third Quarter 2012,” 5, 24.



Despite this track record, HAMP had certain successes. The program's emphasis on lower monthly payments and lower interest rates cut redefault rates substantially. Furthermore, HAMP improved over time in response to feedback. Some of the later changes to HAMP – especially the decision to triple the subsidies for principal reductions – further raised the success rate of HAMP modifications.

A Taxonomy Of Distressed Mortgages

In thinking about distressed mortgages and the best way to resolve them, it is worthwhile evaluating loans along three different dimensions. The first consists of the home's *occupancy prospects*. This dimension evaluates whether the house is occupied and, if so, whether there is a cost-effective loss mitigation technique that will keep the house occupied, either by the borrower or someone else. The second dimension is the ownership status of the loan, *i.e.*, whether the loan is held in portfolio or sold and, if so, to whom. The last dimension consists of the presence or absence of junior liens.

Occupancy Prospects

Let's turn first to occupancy prospects. This dimension can be broken down into three basic categories: currently occupied homes involving delinquent borrowers with sufficient cash flow to pass an NPV test; currently occupied homes that involve delinquent borrowers without sufficient cash flow; and vacant homes.

Most servicers, before they agree to modify a loan, will first determine whether a modification will increase the net present value of the loan relative to foreclosure. When an owner-occupant borrower has enough cash flow to make a loan modification NPV-positive,

normally a loan modification can be and should be designed to keep the homeowner in the home.²⁴

Owner-occupant borrowers who lack sufficient income to qualify for a traditional loan modification under an NPV test present a different and more complicated situation. There are various reasons why a borrower might experience such a large cash shortfall. Some borrowers suffer an income shock that is long-term or permanent in nature, such as shocks due to disability, retirement, a spouse's death, or divorce. Other borrowers lose their jobs, resulting in a steep income loss that may nevertheless be temporary in nature.²⁵ A third situation involves borrowers who could meet their loan payments when they lived in their homes, but had to move – often for new job postings – and could not sell their old homes for enough to pay off their mortgages due to negative equity. Some borrowers in this situation cannot afford dual housing payments and end up defaulting. In the most extreme version of this scenario, the borrowers are members of the U.S. armed forces who have received orders to move.

Finally, some distressed borrowers move out of their homes. Sometimes the departing borrowers rent their houses out; more often, their houses become vacant when they leave. Some vacant houses are awaiting foreclosure and will eventually go to sheriff's sale. Other vacant houses have gone through foreclosure and sale and are now sitting in inventory as bank real estate owned (REO). In the most difficult cases, sometimes referred to as "zombie loans," servicers refuse to even initiate foreclosure, sometimes because the owner of the loan does not want to assume title or the legal obligations that go with it, putting the house in legal limbo.²⁶ In other cases, second lienholders create hold-up problems that discourage the first lienholder from proceeding to foreclosure.²⁷ These situations are especially difficult to resolve because no one takes responsibility for the upkeep of the home.

Ownership Status Of The Loan

The ownership status of a distressed loan can also affect the servicer's flexibility to grant loss mitigation and what kind.²⁸ Distressed mortgages held in portfolio are the easiest to resolve short of foreclosure because the servicer has the full panoply of loss mitigation tools at its disposal.

The remaining mortgage loans are owned by investors. In the main, these investors are divided into two groups: investors in mortgage-backed securities issued by Ginnie Mae or the GSEs (Fannie Mae and Freddie Mac) and investors in private-label securities. Both the GSEs and

²⁴ Many of these same reasons apply to distressed loans to landlords owning residential rental properties that are currently occupied by tenants.

²⁵ At a minimum, usually such an income decline is 25% or more. See Foote et al., "A Proposal to Help Distressed Homeowners," 2 n.4.

²⁶ See, e.g., Government Accountability Office, "Vacant Properties."

²⁷ Agarwal et al., "Second Liens and the Holdup Problem in First Mortgage Renegotiation," 16-17, 19 (liquidation is less likely when a servicer of a securitized first-lien loan holds the second-lien loan in portfolio).

²⁸ See, e.g., Gelpern and Levitin.

private-label securitizations place limitations on the types of loss mitigation techniques that may be used. As of this writing, for example, the GSEs do not permit principal forgiveness in loan modifications.

Similarly, in private-label securitizations, the pooling and servicing agreement (PSA) for the loan pool usually places constraints on the servicer's ability to negotiate a workout. Nevertheless, the majority of PSAs permit some degree of loan modifications in the event of default, imminent default, or reasonably foreseeable default.²⁹

Most PSAs give servicers broad discretion to negotiate forbearance that temporarily extends delinquent payments but does not require a change of loan terms, so long as the servicer timely forwards the missed payments to investors.³⁰ While PSAs are usually stricter about permanent loan modifications, they vary widely from deal to deal.³¹ A small percentage of PSAs – roughly 10% -- prohibit any material loan modifications.³² The remaining PSAs do permit material loan modifications, but only when they are in the best interest of investors.³³ In such cases, the servicer's precise latitude to negotiate a loan modification will depend on the PSA. Many PSAs permit modification of all loans. Another group, consisting of about 35% of PSAs, limits modifications to 5% of the loan pool (measured by the loan amount or number of loans). PSAs may contain other restrictions on loan modifications. Examples include mandatory trial modification periods, use of specific resolution procedures, caps on interest rate reductions, restrictions on the types of eligible loans, and limits on the number of modifications in any one year.³⁴

For the 90% or so of private-label securitizations that allow loan modifications to some degree, it is not clear whether PSA limits on those modifications ever became binding. A Berkeley survey of PSAs concluded that "large-scale modification programs [could] be undertaken without violating the plain terms of PSAs in most cases."³⁵ Even for securitizations that prohibit loan modifications outright or cap them at 5%, some of those PSAs were amended to allow more modifications.³⁶ In addition, credit rating agencies no longer count modified loans that are current 12 months after modification against the 5% cap where one exists.³⁷

²⁹ Credit Suisse, 6; Hunt, 7. Among other things, this has the salutary benefit of allowing servicers to contact borrowers before any payments are missed to determine the borrower's ability to handle the new payments and, if not, to explore other options.

³⁰ Credit Suisse, 6; Hunt, 7.

³¹ See generally Eggert, 279-97.

³² Credit Suisse; Hunt, 6.

³³ Hunt, 7-9. In general, any change in the principal balance, the interest rate, or the final maturity will constitute a "material" modification. Hunt, 7.

³⁴ Credit Suisse, 67; Kiff and Klyuev, 11.

³⁵ Hunt, 10. See also Adelino, Gerardi and Willen, 13-18 and table 5; Thompson, "Foreclosing Modifications," 755.

³⁶ Most PSAs allow caps on loan modifications to be waived upon consent by a rating agency or a bond insurer; only a few require investor approval. Kiff and Klyuev, 11.

³⁷ Thompson, "Foreclosing Modifications," 755.

Thus, while servicers faced challenges in complying with multiple PSAs containing a hodgepodge of provisions, for the most part those agreements did not constrain their ability to modify distressed loans.

Lien Status

The lien status of a distressed mortgage can also affect the prospects for loss mitigation, because the presence of a junior lien can complicate a loan workout. About 25% of mortgages originated between 2004 and 2009 had one or more junior liens.³⁸ Junior liens were even more prevalent in borrowers with first mortgages held in private-label securitized trusts. By year-end 2009, over half of private-label mortgages had second liens, compared to 18% of GSE loans.³⁹

Borrowers with negative equity are also more likely to have junior liens. That comes as no surprise because junior liens boost combined loan-to-value ratios. As of second quarter 2012, 4.2 million underwater borrowers had second liens, with an average combined loan-to-value ratio of 128%.⁴⁰

It is also instructive to look at who owns junior liens. In the first quarter of 2011, only 2% of the outstanding \$929 billion in closed-end junior mortgages and home equity lines of credit (HELOCs) were held by securitized trusts; the vast majority of the rest were held by depository institutions and credit unions. Together that quarter, four of the nation's largest banks – Bank of America, Wells Fargo, JP Morgan Chase, and Citigroup – held 43% of all outstanding closed-end mortgages and HELOCs in portfolio.⁴¹

This imbalance between bank ownership of junior liens and investor ownership of private-label securitized first-lien loans creates principal-agent conflicts for banks that service private-label first liens and their own junior liens. From the viewpoint of investors, servicers should write down their seconds before modifying distressed private-label firsts. However, servicers may be reluctant to do so, because write-downs will reduce earnings, as well as bank capital.⁴² The capital implications alone are staggering, given that total outstanding second mortgages on banks' books equaled over half of all bank capital in 2011.⁴³

Evidence suggests that junior liens impede loan modifications. In general, it is difficult to study the effect of the presence of junior liens on a distressed homeowner's prospects for loan modification because most datasets do not allow researchers to identify which second liens are linked to particular first-lien loans. Two innovative studies overcame that hurdle,

³⁸ Been, Jackson, and Willis, "Sticky Seconds," 4.

³⁹ Goodman et al., "Second Liens: How Important?," 19-30; Prior, "Less than One-in-Five GSE Loans hold a Second Lien."

⁴⁰ CoreLogic, "CoreLogic® Reports Number of Residential Properties in Negative Equity Decreases Again in Second Quarter of 2012," 2.

⁴¹ Goodman et al., "The Case for Principal Reductions," 38-40; *see also* Been, Jackson, and Willis, "Sticky Seconds," 4; Goodman et al., "Second Liens: How Important?," 25-27.

⁴² *See, e.g.*, Agarwal et al., "Market-Based Loss Mitigation Practices," 16 (distressed second-lien piggyback loans are less likely to be modified than first-lien loans).

⁴³ Lee, Mayer, and Tracy.

however, and found that first-lien mortgages with junior liens were less likely to be modified than first-liens with none.⁴⁴ A third study⁴⁵ reported that junior liens were 11.3% less likely to be modified than first liens, which suggests that distressed borrowers who have those liens have greater difficulty in negotiating a comprehensive loan modification package.

There are several reasons why first-lien loan modifications are harder to negotiate when junior liens are present. For one thing, a surprising proportion of junior liens continue to perform after borrowers default on the firsts.⁴⁶ Other junior liens are both underwater and delinquent and thus often lack real worth apart from possible recourse or demanding a hold-up payment from the first lienholder in order to approve a workout.⁴⁷ Junior lienholders may perceive hold-up power in that regard because first lienholders usually require them to sign an agreement to continue to subordinate their claims before modifying a first mortgage.⁴⁸ Junior lienholders are often reluctant to agree or demand several thousand dollars in order to re-subordinate.⁴⁹ In other circumstances, the junior lienholder may not even be found because there is no central registry of junior liens.

Lessons Learned

Lesson One: Give Modifications With Lower Monthly Payments and Principal Reduction to Distressed Borrowers Who Have Sufficient Cash Flow

Where a distressed homeowner wants to stay in his or her home and has sufficient cash flow to make a loan modification NPV-positive, the outcome should be clear. Under these circumstances, there is no good reason for a servicer to deny a loan modification (unless a pooling and servicing agreement precludes one). That is because a loan modification will keep the house occupied and increase net recovery for both the homeowner and the owner of the loan.

⁴⁴ Agarwal et al., "Second Liens and the Holdup Problem in First Mortgage Renegotiation," 5, 18 (where a second lien creates the possibility for holdup, the first mortgage is less likely to be modified); Chan et al.

⁴⁵ Agarwal et al., "Market-Based Loss Mitigation Practices."

⁴⁶ See Goodman et al., "Second Liens: How Important?," 28; Jagtiani and Lang, 7; Lee, Mayer, and Tracy.

⁴⁷ See Cordell et al., "The Incentives of Mortgage Servicers," 27; see also Agarwal et al., "Second Liens and the Holdup Problem in First Mortgage Renegotiation," 2-3, 5 (where a second lien creates the possibility for holdup, the first mortgage is less likely to be modified).

⁴⁸ Randolph. First lienholders require these agreements even though the second lienholder would not gain priority over the first lienholder where the loan modification would not prejudice its rights. Loan modifications that drop the interest rate, extend the loan term, or reduce principal do not prejudice junior lienholders because they improve the lienholders' ability to collect on their loans. In contrast, refinancings, short sales, and deeds-in-lieu-of-foreclosure would require a resubordination agreement because they have a prejudicial effect on junior lienholder interests. *Ibid.*; Been, Jackson, and Willis, "Sticky Seconds," 6-8.

⁴⁹ Cordell et al., "The Incentives of Mortgage Servicers," 26-27.

The more compelling question is how to best structure loan modifications to minimize the chance of redefault. This is not a hypothetical concern. Consider the experience in 2008, when loans serviced by the largest banks and thrifts had a discouraging total 12-month 60+ day redefault rate of 58%. After that, servicers and policymakers learned a lot about how to cut the risk of redefault. Subsequently, with every passing year, the 12-month 60+ day redefault rate dropped steadily, down to 23% for modifications made in 2011. That was a 60% decline from 2008. Loan modification data for 2012 indicate that the redefault rate is generally holding steady or continuing to fall.⁵⁰

What led to that improvement? Overwhelming evidence shows that the right kind of loan modification significantly lowers redefault risk. The lesson is this: lower monthly payments reduce the risk of redefault and principal reduction lowers it even more.

Through 2008, the vast majority of loan workouts capitalized arrears without other measures designed to reduce payments.⁵¹ Perversely, this *increased* the borrowers' monthly mortgage payments. For borrowers with cash-flow problems – especially problems that were indefinite or permanent in nature – many of these workouts failed and later had to be redone.⁵²

⁵⁰ Office of the Comptroller of the Currency, "OCC Mortgage Metrics Report: Fourth Quarter 2011," 37-38; Office of the Comptroller of the Currency, "OCC Mortgage Metrics Report: Third Quarter 2012," 34-36.

⁵¹ In two path-breaking studies that brought this problem to light, law professor Alan White reported that over two-thirds of loan workouts studied increased both the borrowers' loan payments and principal by adding in overdue interest and fees without taking other steps to reduce monthly payments. The average principal increase was a whopping \$10,800. White, "Deleveraging the American Homeowner," 1114; White, "Rewriting Contracts, Wholesale," 509.

A study by the Boston Fed confirmed White's findings. By the end of 2008, plans increasing principal remained the most common type of workout by far. Such capitalization plans accounted for 61.5% of all loan workouts in fourth quarter 2008. Interest rate reductions came in second (26.7%) and principal reductions remained rare (1.4%). See Adelino, Gerardi, and Willen, 11-12 and table 3. According to the authors, as of 2009, Ocwen Loan Servicing, LLC and Litton Loan Servicing LP were the only servicers who granted principal reductions in nontrivial amounts. *Ibid.* at 12 n.17. See also Agarwal, Amromin, and Ben-David, "The Role of Securitization in Mortgage Renegotiation" (of pre-HAMP loans serviced by the 10 largest depository institution servicers from January 2008 through May 2009, only portfolio loans received principal deferrals, not private-label securitized loans. Only 3% of portfolio modifications had principal deferral and only 1% had principal write downs. Interest-rate reductions were deeper for private-label securitized loans than for bank-held loans and modifications of GSE and private-label securitized loans were more likely to capitalize interest arrears than modifications for bank-held loans); Collins and Reid, "Who Receives a Mortgage Modification?" (interest rate modifications lowered interest rates by 165 to 175 basis points); Goodman et al., "The Case for Principal Reductions," 34 (over 98% of all GSE and FHA loan modifications capitalized arrears); Mason, 32; Quercia and Ding, 171 (for Columbia Collateral File modified private-label loans in second quarter 2008, 8.4% received principal reductions, but only 3% received principal reductions of over 20%).

⁵² Goodman et al., "Mortgage Modification Activity—Recent Developments," 55; see also Agarwal et al., "Market-Based Loss Mitigation Practices for Troubled Mortgages Following the Financial Crisis," 20.

In contrast, there is abundant evidence that loan modifications that lower monthly payments, either through reduced interest, principal reductions or extensions of the maturity date, result in substantially lower redefault rates.⁵³ Workouts that cut interest rates perform better than workouts that only capitalize arrears. The bigger the interest rate cut, the lower the rate of redefault.⁵⁴ Cutting principal has the lowest redefault rate of all, probably because doing so lowers monthly payments while reducing the effect of negative equity as an independent driver of default.⁵⁵

In response to this experience, interest rate reductions and principal reductions and deferrals became more common in recent years. According to the OCC, the proportion of loan modifications reducing the interest rate grew markedly following the introduction of HAMP, hitting a high of 84% before falling to slightly lower levels in 2011 and 2012.⁵⁶ Over that same period, principal reductions and principal deferrals also grew quickly, albeit from very low levels. By third quarter 2012, 17.1% of loan modifications reduced principal and 19.1% deferred it.⁵⁷ That trend was especially pronounced in the private-label space, where principal reductions and principal deferrals made up 38.0% and 28.2% respectively or two-thirds of all private-label loan modifications in third quarter 2012.⁵⁸ In contrast that quarter, principal

⁵³ See Adelino, Gerardi, and Willen (lowering payments cuts redefault rates by 20%-40%); Agarwal, Amromin, and Ben-David, "The Role of Securitization in Mortgage Renegotiation," 5 (for every 10% drop in the monthly payment, the 60+ day delinquency rate dropped 4.3 percentage points (11% in relative terms), down from an average base rate of 49%); Agarwal et al., "Market-Based Loss Mitigation Practices for Troubled Mortgages Following the Financial Crisis," 22; Brown, 10 (IndyMac loan modifications); Goodman et al., "The Case for Principal Reductions," 29; Haughwout, Okah, and Tracy (for every 10% drop in the monthly payment, the 90+ day delinquency rate dropped 8% (4.5 basis points) from the average 12-month redefault rate of 56%); Making Home Affordable, "Program Performance Report Through March 2012," 7; Office of the Comptroller of the Currency, "OCC Mortgage Metrics Report: Fourth Quarter 2011," 41-43; Quercia and Ding, 171-194 (for Columbia Collateral File private-label securitized loans during the second quarter of 2008, lowering the monthly payment by 30% to 40% reduced the 30+ day delinquency rate by 18%); Voicu et al.

⁵⁴ Agarwal, Amromin, and Ben-David; Fuster and Willen; Goodman et al., "Modification Effectiveness," 5; Office of the Comptroller of the Currency, "OCC Mortgage Metrics Report: Second Quarter 2012," 43-44; Voicu et al.

⁵⁵ Bajari, Chu, and Park, 32-33; Das and Meadows; Goodman et al., "The Case for Principal Reductions," 29; Goodman, et al., "Mortgage Modification Activity—Recent Developments," 55; Goodman et al., "Modification Effectiveness," 4, 9; Haughwout, Okah, and Tracy; Moody's Investors Service, "Principal Reduction Helps to Reduce Re-default Rates in the Long Run," 5-6; Quercia and Ding, 171-94; Voicu et al. See also Board of Governors of the Federal Reserve, "The U.S. Housing Market," 4.

⁵⁶ Office of the Comptroller of the Currency, "OCC Mortgage Metrics Report: Fourth Quarter 2011," 26; Office of the Comptroller of the Currency, "OCC Mortgage Metrics Report: Third Quarter 2012," 25.

⁵⁷ Office of the Comptroller of the Currency, "OCC Mortgage Metrics Report: Third Quarter 2012," 25.

⁵⁸ Office of the Comptroller of the Currency, "OCC Mortgage Metrics Report: Third Quarter 2012," 28. That represented a significant increase from earlier years. Agarwal, Amromin and Ben-David reported that from January 2008 to May 2009, no private-label loan modifications in the OCC Mortgage Metrics dataset featured principal deferral or write-downs, while only 3% and 1% of portfolio loan

write-downs accounted for 37.8% of modifications to loans held in portfolio, while principal deferrals accounted for 8.4% (totaling 46.2%). Fannie Mae and Freddie Mac granted principal write-downs on no loans.⁵⁹

The growing trend toward principal relief was partly spurred by increased incentives under HAMP. In March 2010, the HAMP program started offering carrots to servicers to write down principal and extinguish junior liens.⁶⁰ Under that program, known as the Principal Reduction Alternative or PRA, for any underwater borrower owing more than 115% of the current value of his or her home (except for borrowers with GSE loans), HAMP servicers had to calculate the borrower's net present value using both the standard approach, plus an alternative approach that moved principal reduction down to a loan-to-value ratio of 115% to the top of the HAMP waterfall. If a principal write-down was needed to reduce the borrower's monthly payment to 31% of income, the servicer could – but was not obliged to -- reduce principal. To encourage principal write-downs, the federal government offered to pay 10 to 21 cents for each dollar of unpaid principal written down (depending on the loan-to-value ratio).⁶¹ In January 2012, the Administration tripled that subsidy to as much as 63 cents for every dollar written off.⁶² Gradually, the increased subsidy worked and this voluntary program took hold. For instance, in November 2012, 77% of all new trial modifications for non-GSE loans that were eligible for a principal reduction received one.⁶³

The \$25 billion state and federal mortgage servicing settlement in March 2012 boosted the incentives for principal write-downs even more. Under that settlement, the five largest servicers – Bank of America Corp., J.P. Morgan Chase & Co., Wells Fargo & Co., Citicorp, Inc., and Ally Financial, Inc. – agreed to at least \$10 billion in total in principal reductions to underwater borrowers who were past due or at risk of default.⁶⁴ In 2012, there was a big

modifications respectively did. Agarwal, Amromin, and Ben-David, "The Role of Securitization in Mortgage Renegotiation."

⁵⁹ Office of the Comptroller of the Currency, "OCC Mortgage Metrics Report: Third Quarter 2012," 28. Fannie and Freddie did grant principal deferrals in 31% and 44.5% of their loan modifications respectively in third quarter 2012. *Ibid.* Those borrowers will eventually have to repay the deferred principal, however.

⁶⁰ Department of the Treasury, "Making Home Affordable Program Enhancements."

⁶¹ If the servicer opted to reduce principal, it would initially treat the reduction as forbearance. To encourage borrowers to remain current on their new, lower loan payments, servicers would then forgive the forborne amount in three equal steps over three years, so long as the homeowner remained current on the payments. Department of the Treasury, "Making Home Affordable Program Enhancements."

⁶² Making Home Affordable, "Expanding our efforts to help more homeowners and strengthen hard-hit communities." The January 2012 directive also offered the first principal reduction incentives for GSE loans. As of this writing, the GSEs were still not availing themselves of those incentives.

⁶³ Making Home Affordable, "Program Performance Report Through November 2012," 4.

⁶⁴ Department of Justice. Eventually, the total principal write-downs under the agreement are expected to exceed \$10 billion because of the way those write-downs are credited toward the settlement. Principal forgiveness on first-lien mortgages that the servicers hold in portfolio earns \$1 of credit toward the settlement obligation for each \$1 written down at or below 175% LTV. In contrast, a

upswing in non-PRA principal reductions that did not qualify for a subsidy under HAMP. In all likelihood, that upswing was due to the settlement.⁶⁵ As of December 31, 2012, the five servicers reported granting \$6.04 billion in first-lien principal forgiveness and \$11.6 billion in second-lien modifications and extinguishments. Over 25,000 other borrowers were in active first-lien trial modifications which, if successful, could result in \$3.49 billion in additional write-downs.⁶⁶ This trend was poised to accelerate as the result of a later \$8.5 billion settlement between federal banking regulators and 10 large servicers in January 2013 for foreclosure abuses.⁶⁷ Under that settlement, the banks agreed to devote up to \$5.2 billion in loan modifications and forgiveness of deficiency judgments.

While the spurt in principal relief is notable – and may temporarily grow as the principal reduction provisions of the two federal settlements take effect – interest rate reductions still outstrip principal reductions by more than 2 to 1, despite their higher redefault rates. Fannie Mae and Freddie Mac continue to refuse to grant principal write-downs at all at the insistence of their conservator, the Federal Housing Finance Agency, which insists that principal forgiveness will increase the GSEs' accounting losses to the detriment of taxpayers.⁶⁸ Meanwhile, over 83% of all loan modifications made in the second quarter of 2012 -- and over 96% of those involving Fannie Mae, Freddie Mac and federally insured mortgages -- capitalized arrears.⁶⁹ Those capitalization plans undercut other loan modification terms such as rate reductions and term extensions by increasing the outstanding principal of the capitalized loans and thereby boosting the default risk of underwater borrowers.⁷⁰ As a result, we still have not achieved the optimal mix of loan modification techniques.

servicer only gets 45 cents of credit for every \$1 of a private-label securitized mortgage written down. Principal reductions made before March 1, 2013 receive an added 25% credit. *See, e.g.,* Consent Judgment, Exh. D-1, tbl. 1.

⁶⁵ Making Home Affordable, "Program Performance Report Through November 2012," 4.

⁶⁶ Office of Mortgage Settlement Oversight, "Ongoing Implementation," 3.

⁶⁷ Board of Governors of the Federal Reserve System and Office of the Comptroller of the Currency, "Independent Foreclosure Review to Provide \$3.3 Billion in Payments, \$5.2 Billion in Mortgage Assistance." The 10 servicers were Aurora, Bank of America, Citibank, JPMorgan Chase, MetLife Bank, PNC, Sovereign, SunTrust, U.S. Bank, and Wells Fargo.

⁶⁸ *See* Letter from DeMarco to Cummings; Office of the Comptroller of the Currency, "OCC Mortgage Metrics Report: Third Quarter 2012," 28. FHFA maintains that position even though it has conceded that when the higher HAMP subsidies were taken into account, principal reduction by the GSEs compared to principal forbearance would reduce taxpayer losses by \$1.7 billion." DeMarco Remarks before the Brookings Institution, 17-19. Fannie Mae and Freddie Mac's resistance to principal write-downs also explains the extremely low take-up rate on the principal reduction program paid for by the Hardest Hit Fund under the Troubled Asset Relief Program (TARP). *See* Government Accountability Office, "Troubled Asset Relief Program," 24-25 and figure 4; Office of the Special Inspector General for the Troubled Asset Relief Program.

⁶⁹ Office of the Comptroller of the Currency, "OCC Mortgage Metrics Report: Second Quarter 2012," 30.

⁷⁰ *See* Collins and Reid, "Who Receives a Mortgage Modification?"

What explains the continued resistance to principal reductions? While there are several reasons,⁷¹ typically servicers and FHFA cite moral hazard as the main concern. They argue that principal modifications will induce other borrowers who are able to pay their mortgages to strategically default (or threaten to default) in order to reduce their loan payments.⁷²

The severity of negative equity in this country following the financial crisis intensified this debate. As of June 30, 2012, 10.8 million borrowers (more than one out of every five homeowners) had underwater mortgages. Even that was an improvement over previous quarters.⁷³ The concern is that homeowners have growing incentives to walk away from their mortgages as their loans go more and more deeply underwater.

Moral hazard concerns are real.⁷⁴ Guiso, Sapienza & Zingales estimate, for instance, that 26% of mortgage defaults were strategic, based on surveys conducted in late 2008 and early 2009.⁷⁵ Still, it is important not to overstate the extent of moral hazard. The vast majority of underwater borrowers do not default. In second quarter 2012, for instance, almost 85% of underwater borrowers were current on their payments.⁷⁶ Furthermore, a large proportion of underwater borrowers who default do so due to cash flow difficulties, not strategic behavior.⁷⁷ Studies have concluded that underwater borrowers remain deeply averse to walking away from their mortgages until they reach high levels of negative equity, in part due to morality.⁷⁸

⁷¹ See, e.g., Letter from DeMarco to Cummings. For discussion of other explanations for this pattern, see McCoy, "Barriers to Home Mortgage Modifications During the Financial Crisis."

⁷² See, e.g., Ambrose and Capone, Jr., 105; Posner and Zingales, 577; Quercia and Ding, 171.

⁷³ See CoreLogic, "CoreLogic® Reports Number of Residential Properties in Negative Equity Decreases Again in Second Quarter of 2012." See also Board of Governors of the Federal Reserve, "The U.S. Housing Market," 4.

⁷⁴ Several studies have found evidence of strategic default by deeply underwater borrowers. See Bajari, Chu, and Park; Bhutta, Dokko, and Shan; Elul et al., 10-13; Goodman et al., "The Case for Principal Reductions," 29; Haughwout, Okah, and Tracy; Jagtiani and Lang, 7; Mayer et al.; but see Foote, Gerardi, and Willen, "Negative Equity and Foreclosure," 234 (finding little evidence of strategic default during the Massachusetts housing downturn in the early 1990s).

⁷⁵ Guiso, Sapienza, and Zingales, "Moral and Social Constraints to Strategic Default on Mortgages."

⁷⁶ CoreLogic, "CoreLogic® Reports Number of Residential Properties in Negative Equity Decreases Again in Second Quarter of 2012." See also Foote et al., "A Proposal to Help Distressed Homeowners," 2-3 and n.8 (over 90% of underwater Massachusetts homeowners over a three-year period during the housing bust of the early 1990s avoided foreclosure); Letter from DeMarco to Cummings (as of June 30, 2011, 74% of Fannie Mae and Freddie Mac borrowers with loan-to-value ratios above 115% were current on their loans).

⁷⁷ See, e.g., Bhutta, Dokko, and Shan; Foote, et al., "A Proposal to Help Distressed Homeowners," 1 n.1 ("[N]egative equity by itself does not necessarily result in default, unless the magnitude of negative equity is so large that the prospect of regaining positive equity is minimal. Defaults typically occur when negative equity is combined with a significant income disruption: the so-called 'double trigger' model of default").

⁷⁸ Bhutta, Dokko, and Shan; Guiso, Sapienza, and Zingales, "Moral and Social Constraints to Strategic Default on Mortgages"; Guiso, Sapienza, and Zingales, "The Determinants of Attitudes towards Strategic Default on Mortgages."

Underwater borrowers who default on their mortgages also suffer major damage to their credit records for several years at a minimum.⁷⁹

Moral hazard objections to principal reduction ignore the fact that all forms of loan modification trigger moral hazard to some degree.⁸⁰ If moral hazard was of overriding concern, one would expect servicers to resist interest rate reductions too. What is more, the strategic default objection does not take into account the benefits of a smaller shadow inventory to society or the fact that principal reductions, used wisely, *reduce* overall incentives toward strategic default by alleviating the negative equity that fuels that behavior.⁸¹

Further, there are techniques to discourage moral hazard when granting principal reductions.⁸² One way is to restrict principal reductions to financially struggling homeowners and deny them to homeowners who default for purely strategic reasons. For this reason, the HAMP program limits principal forgiveness and other types of HAMP modifications to borrowers who can show financial hardship. By requiring applicants to document financial hardship, HAMP allows servicers to distinguish borrowers with proven cash flow problems from those who are still able to pay their mortgages in full.⁸³ Another approach is to limit principal modifications to borrowers who became delinquent before the principal reduction program was announced.⁸⁴ Similarly, restricting principal reductions to borrowers with lower FICO scores and fully amortizing mortgages can constrain moral hazard because borrowers with

⁷⁹ See, e.g., Brevoort and Cooper, 2 (“the credit scores of mortgage borrowers entering foreclosure decline to subprime levels, regardless of their score level before their delinquency, and remain depressed for several years after foreclosure”).

⁸⁰ See, e.g., Goodman et al., “Modification Effectiveness,” 13.

⁸¹ See, e.g., Moody’s Investors Service, “Principal Reduction Helps to Reduce Re-default Rates in the Long Run,” 5-6 (“At any given level of payment reduction, a modification that achieves that reduction at least partly through principal forgiveness will have a lower propensity to default than one that does not,” especially “as the time horizon increases to 18 months”); Moody’s Investors Service, “Rising Home Prices Reduce Default Risk in Private-Label RMBS,” 6-8; Moody’s Investors Service, “The Impact of the Mortgage Settlement on RMBS Investors,” 5-6; Moody’s Investors Service, “US Private-Label RMBS and Servicer Quality,” 5 (predicting that “increases in principal reduction modifications . . . will improve collateral performance, because principal forgiveness will lower default probabilities . . .”)

⁸² See generally Goodman et al., “Modification Effectiveness,” 13-14; Goodman et al., “The Case for Principal Reductions,” 29.

⁸³ Making Home Affordable, “Handbook for Servicers of Non-GSE Mortgages,” 51. The mortgage servicing settlement is somewhat more ambiguous about a financial hardship test. While the settlement appears to limit principal write-downs to underwater owner-occupant borrowers “with economic hardship” who were at least 60 days delinquent as of January 31, 2012 (before the settlement was signed), it does not define “economic hardship.” Elsewhere in the settlement, the consent decree also seems to contemplate possible principal relief to current borrowers who are “at imminent risk of default due to [their] financial situation.” See, e.g., Consent Judgment, pp. D-2, I-1, I-7 through I-8. The settlement gives servicers broad discretion to define their own financial hardship test.

⁸⁴ The mortgage servicing settlement takes this approach. See, e.g., Consent Judgment, p. I-7.

higher FICO scores and less-than-fully amortizing mortgages are more apt to strategically default.⁸⁵

There are also ways to design principal reductions to discourage strategic default. For instance, the special servicer Ocwen uses several design features in the principal modifications it grants to underwater borrowers to reduce moral hazard. First, Ocwen writes down eligible loans to 95% of the current appraised value, in order to restore the borrower to positive equity. This draws on the insight that borrowers are unlikely to strategically default if their mortgages are “in the money.”⁸⁶ Second, to discourage redefault, Ocwen forgives one-third of the write-down each year for 3 years, so long as the borrower continues to perform. Finally, the borrower must agree to share 25% of any future home price appreciation with the investor, to limit any upside from strategic default.⁸⁷ Other times, servicers who write down principal may insist on a short sale that requires the borrower to move out instead of a partial charge off that keeps the borrower in the home. This too is intended to discourage strategic default.⁸⁸

Lesson Two: Don’t Put Off Granting Loan Modifications

Speed is of the essence when it comes to granting loan modifications to eligible borrowers. The evidence on point is clear. Distressed borrowers redefault at significantly lower rates when they receive loan modifications earlier in the delinquency process.⁸⁹ This effect is particularly pronounced for borrowers with lower FICO scores.⁹⁰

Disturbingly, recent trends have been going the wrong way. In the private-label market in 2008, only 5% of loan modifications were made after twelve months’ delinquency; in 2012, that number jumped to over 40%.⁹¹ What makes this even more surprising is that in July 2011, the HAMP program started making higher payments for modifications issued sooner rather

⁸⁵ Amromin et al.

⁸⁶ Cf. Moody’s Investors Service, “US Private-Label RMBS and Servicer Quality,” 1-2, 5 (“As the level of equity for the remaining non-delinquent borrowers improves with the tepid recovery in home prices, the number of strategic defaults will decrease . . .”). Even reducing negative equity to combined loan-to-value ratios of around 120% or less can sharply reduce incentives to engage in strategic default. See Bhutta, Dokko, and Shan; Guiso, Sapienza, and Zingales, “Moral and Social Constraints to Strategic Default on Mortgages”; Guiso, Sapienza, and Zingales, “The Determinants of Attitudes towards Strategic Default on Mortgages.” See also Agarwal et al., “Market-Based Loss Mitigation Practices for Troubled Mortgages Following the Financial Crisis,” 21-23 (defaults are caused by lack of affordability, as opposed to strategic behavior due to negative equity).

⁸⁷ Prior, “Ocwen unveils new principal reduction program”; see generally Goodman et al., “Modification Effectiveness,” 14. For similar equity sharing proposals, see Posner and Zingales, 577, and Das and Meadows.

⁸⁸ Thompson, “Foreclosing Modifications,” 755.

⁸⁹ Brown, 6; Goodman et al., “Modification Success—What Have We Learned?,” 57; Quercia and Ding, 171.

⁹⁰ Goodman et al., “Modification Effectiveness,” 5, 8.

⁹¹ Goodman et al., “Modification Effectiveness,” 5-6.

than later following default.⁹² Despite this subsidy, the proportion of private-label modifications made more than a year after default continued to rise.⁹³

Lesson Three: For Distressed Borrowers Who Lack The Cash Flow To Make A Loan Modification NPV-Positive, Find A Solution That Will Keep The Home Occupied

Some distressed homeowners do not have sufficient cash flow to satisfy the NPV test for a loan modification. Nor do they often qualify for a refinance.⁹⁴ These homeowners fall into a variety of groups, with different solutions. In some cases, it may be possible to keep people with inadequate cash flow in their homes. When that is not possible, top priority should be given to solutions that keep the home otherwise occupied.

Unemployed And Underemployed Borrowers

The single biggest group of distressed borrowers who may lack sufficient cash flow to meet the NPV test consists of people who are unemployed or underemployed. As of year-end 2012, 12.2 million individuals were unemployed in the United States⁹⁵ and up to two-thirds of them were homeowners.⁹⁶ In 2010, jobless and underemployed homeowners made up up to 23% of distressed borrowers.⁹⁷ Almost 68% of the people who applied to HAMP through November 2012 gave lost income from reduced pay or job termination as their reason for applying.⁹⁸

Many jobless homeowners do not qualify for a traditional HAMP loan modification because their drop in income is so severe that they would need a 50% payment reduction or

⁹² Making Home Affordable, "Making Home Affordable Program—Updates to Servicer Incentives." HAMP now pays servicers \$1600 for modifications completed within 120 days of delinquency, \$1200 for those completed within 121 days to 210 days of delinquency, and only \$400 for modifications completed more than 210 days following delinquency. Previously HAMP paid a flat \$1000 for all modifications completed, regardless of when they were done. *Ibid.*; Making Home Affordable, "Handbook for Servicers of Non-GSE Mortgages," 106.

⁹³ Goodman et al., "Modification Effectiveness," 5-6.

⁹⁴ The early refinance programs of the Bush and Obama Administrations did not have promising records. More recently, the GSEs and the FHA agree to refinance borrowers with Fannie, Freddie, and FHA loans into lower interest rate loans regardless whether they were underwater on their mortgages.

⁹⁵ Bureau of Labor Statistics, "The Employment Situation – December 2012."

⁹⁶ See Foote et al., "A Proposal to Help Distressed Homeowners," 10.

⁹⁷ As of 2009, for instance, economists Kyle F. Herkenhoff and Lee E. Ohanian estimated that unemployed borrowers held around 6% of mortgages, more than double the rate in 2005. Depending on the measure of the number of months they were past due, in 2009, 18% to 23% of delinquent homeowners were jobless and almost 16% of homeowners in foreclosure were unemployed. Herkenhoff and Ohanian, 2-3. See also National Association of Home Builders, "Mortgage Delinquencies."

⁹⁸ Making Home Affordable, "Program Performance Report Through November 2012," 6.

more in order to afford their mortgage. A loan modification that large will usually not pass the NPV test, eliminating any private incentive for servicers and investors to grant a workout.⁹⁹

Nevertheless, there are good public policy reasons for the government to intervene in conditions of mass unemployment. While the income disruption from joblessness is large, it also is temporary for most unemployed homeowners who plan to return to work. In December 2012, for example, it took 18 weeks on average – 3 ½ months – for the median jobless person to find new work.¹⁰⁰ Government relief makes sense under these circumstances by giving jobless borrowers breathing room to locate new work without losing their homes and the negative spillover effects that come with ouster.

When HAMP was first announced in early 2009, it did not contemplate special relief for unemployed borrowers. But by year-end 2009, the Obama Administration became concerned that HAMP was ignoring the millions of borrowers suffering catastrophic income drops due to job loss or reduced hours. By that point, the national unemployment rate was hovering around 9% and 25% of homes had underwater mortgages.¹⁰¹ Many underwater borrowers who lost their jobs were trapped because they could not make the payments and could not sell their homes for enough to pay off their mortgages. In response, by mid-2010, the Administration rolled out three programs to address the situation of these borrowers.

The Hardest Hit Fund. The Administration's first step, in February 2010, was to create the "Hardest Hit Fund" (HHF) to funnel money to unemployed homeowners in the worst-off states to help them pay their mortgages. The Hardest Hit Fund is financed through TARP and is meant to pay for "innovative measures" by state housing finance agencies (HFAs) to assist borrowers in states hit hardest by the financial crisis.¹⁰²

Originally, the Hardest Hit Fund was envisioned as a \$1.5 billion program making grants to the 5 states with home price declines of 20% or more. Eventually, after 4 rounds of funding, HHF expanded into a \$7.6 billion TARP program extending assistance to 18 states and the District of Columbia.¹⁰³ The Department of the Treasury approved plans by different states to

⁹⁹ See Foote et al., "A Proposal to Help Distressed Homeowners," 3-4.

¹⁰⁰ Bureau of Labor Statistics, "The Employment Situation – December 2012." The average spell of joblessness was longer, however, clocking in at 38.1 weeks (slightly over 7 months) as of December 2012. *Ibid.*

¹⁰¹ Office of the Special Inspector General for the Troubled Asset Relief Program, "Factors Affecting Implementation of the Hardest Hit Fund Program," Summary at 1.

¹⁰² Office of the Special Inspector General for the Troubled Asset Relief Program, "Factors Affecting Implementation of the Hardest Hit Fund Program," Summary at 1. Formally, funding for the Hardest Hit Program was authorized in the Emergency Economic Stability Act of 2008 (EESA).

¹⁰³ Department of the Treasury, "Hardest Hit Fund"; Department of the Treasury, "Obama Administration Announces Additional Support for Targeted Foreclosure-Prevention Programs to Help Homeowners Struggling with Unemployment"; Office of the Special Inspector General for the Troubled Asset Relief Program, "Factors Affecting Implementation of the Hardest Hit Fund Program," Summary at 1.

use Hardest Hit funds to address a variety of local housing challenges, including jobless and underemployed borrowers, underwater borrowers, and second liens.¹⁰⁴ While state HFAs can use their Hardest Hit funds for any or all of these reasons with Treasury's approval, all of them targeted unemployed homeowners.¹⁰⁵ This is reflected in the demographic makeup of the borrowers who received assistance through HHF. As of September 30, 2012, 92% of the borrowers assisted by HHF gave unemployment or underemployment as their reason for applying. About half had underwater mortgages and about 64% were delinquent on their mortgages when they applied for help.¹⁰⁶

The Hardest Hit Fund got off to a disappointingly slow start. Collectively, the 19 HFAs estimated that HHF would assist up to 486,000 borrowers by the program's end in 2017. But 2½ years after it started, the Hardest Hit Fund had only helped 77,164 borrowers and had only spent \$742 million – less than one-tenth of its TARP allotment – as of September 30, 2012. \$199 million or about 27% of that money went to administrative costs.¹⁰⁷

According to the Government Accountability Office (GAO) and the Special Inspector General for TARP (SIGTARP), there were several reasons for the slow rollout. For one thing, the Treasury Department “rushed out the program without appropriate collaboration of key stakeholders.”¹⁰⁸ For another, administration of the program was entrusted to state HFAs, which often lacked experience in running programs of this type.¹⁰⁹ On top of that, large national mortgage servicers refused to participate in the program for 9 months, until Fannie Mae and Freddie Mac issued guidance for HHF servicing in October 2010.¹¹⁰

The first round of funds, approved on June 23, 2010, went to 5 states where the average home price fell by more than 20% from its high: Arizona, California, Florida, Michigan, and Nevada. The second-round money went to the top 5 states with the highest proportion of residents living in counties where the unemployment rate topped 12% in 2009. Those states were North Carolina, Ohio, Oregon, Rhode Island, and South Carolina. Round three awarded HHF funds to states whose unemployment rates had exceeded the national average in the past 12 months. Those states included all of the previous 10 states, plus Alabama, Georgia, Illinois, Indiana, Kentucky, Mississippi, New Jersey, Tennessee and the District of Columbia. The fourth round awarded additional funds to all of the previous participants for approved programs. See Congressional Oversight Panel, 39-40.

¹⁰⁴ Office of the Special Inspector General for the Troubled Asset Relief Program, “Factors Affecting Implementation of the Hardest Hit Fund Program,” Summary at 1; White House.

¹⁰⁵ See Congressional Oversight Panel, 40; Government Accountability Office, “Troubled Asset Relief Program,” 24.

¹⁰⁶ Department of the Treasury, “Q3 2012 Consolidated Performance Report.”

¹⁰⁷ Department of the Treasury, “Q3 2012 Consolidated Performance Report”; Office of the Special Inspector General for the Troubled Asset Relief Program, “Factors Affecting Implementation of the Hardest Hit Fund Program,” Summary at 1-2.

¹⁰⁸ Office of the Special Inspector General for the Troubled Asset Relief Program, “Factors Affecting Implementation of the Hardest Hit Fund Program,” Summary at 2-3.

¹⁰⁹ See Government Accountability Office, “Troubled Asset Relief Program,” 27-28.

¹¹⁰ See Government Accountability Office, “Troubled Asset Relief Program,” 28; Office of the Special Inspector General for the Troubled Asset Relief Program, “Factors Affecting Implementation of the Hardest Hit Fund Program,” Summary at 2-3.

Based on this lackluster performance, SIGTARP warned: “If Treasury cannot achieve the desired level of homeowners assisted . . . , Treasury should put the funds to better use toward [other] programs that are reaching homeowners.”¹¹¹ SIGTARP and GAO were also concerned about the Hardest Hit Fund’s lack of transparency.¹¹² Treasury delayed reporting aggregate results for HHF until mid-2012. Even today, those results do not appear in Treasury’s monthly HAMP report or the Administration’s housing scorecard. Instead, they are buried on the Treasury Department’s website.¹¹³ There are still no publicly available data on the success rate of HHF borrowers, three years into the program.

Despite these obstacles, HHF’s payment assistance provisions for unemployed and underemployed borrowers proved substantially easier to implement than its provisions for principal forgiveness, reducing second liens, or transition aid. As of first quarter 2012, less than 5% of HHF funds for borrowers had been spent on the latter three activities, while 96% were spent on assisting jobless borrowers make mortgage payments or pay off past due amounts.¹¹⁴ According to GAO, it was easier for HFAs to top off loan payments or pay off arrearages because those two types of relief required minimal servicer involvement. In contrast, principal reduction, second-lien relief, and transition assistance required active decision making involvement by servicers. That, plus the GSEs’ refusal to adopt the principal reduction program, impeded the success of those aspects of the Hardest Hit Fund.¹¹⁵

The HAMP Unemployment Program. One of the Hardest Hit Fund’s biggest drawbacks was in limiting relief to homeowners in the targeted states. By mid-2010, federal data suggested that income loss had become the most common reason for mortgage defaults.¹¹⁶ The high correlation between job loss and default drove home the importance of addressing the plight of unemployed homeowners nationwide, not just in the worst-off states.

Consequently, in March 2010, the federal government broadened HAMP to help out-of-work homeowners, regardless of their state. Under what came to be known as the “Unemployment Program” or “UP,” the government encouraged servicers to cut the mortgage payments of unemployed borrowers who were eligible for HAMP to 31% of gross income or forbear payments altogether for 3 to 6 months (later expanded to 12 months or more) while

¹¹¹ Office of the Special Inspector General for the Troubled Asset Relief Program, “Factors Affecting Implementation of the Hardest Hit Fund Program,” Summary at 3.

¹¹² See Government Accountability Office, “Troubled Asset Relief Program,” Highlights and 22, 35, 37; Office of the Special Inspector General for the Troubled Asset Relief Program, “Factors Affecting Implementation of the Hardest Hit Fund Program,” Summary at 2-3; see also Congressional Oversight Panel, 107.

¹¹³ See Department of the Treasury, “Q3 2012 Consolidated Performance Report.” The Treasury Department’s monthly TARP reports to Congress contain only a cursory update on the Hardest Hit Fund program.

¹¹⁴ See Government Accountability Office, “Troubled Asset Relief Program,” 24-25 and figure 4.

¹¹⁵ See Government Accountability Office, “Troubled Asset Relief Program,” 25.

¹¹⁶ See, e.g., Foote et al., “Reducing Foreclosures.”

the homeowners looked for work.¹¹⁷ If a borrower assisted through UP later regained employment, he or she had to be considered for a traditional HAMP modification. Any payments forborne under the UP plan would be capitalized if the borrower qualified for a HAMP modification. Otherwise, if the UP forbearance period ended and the borrower did not qualify for traditional HAMP relief, he or she would be considered for a short sale or a deed-in-lieu-of-foreclosure under the Home Affordable Foreclosure Alternatives program.¹¹⁸

For a variety of reasons, the Unemployment Program barely got off the ground. Two-and-a-half years following its inception, as of October 31, 2012, only 29,050 UP forbearance plans had been started.¹¹⁹ In all likelihood, this disappointing take-up rate is partly due to the fact that the government gave servicers no added financial incentives for participating in UP.¹²⁰ Furthermore, Fannie Mae and Freddie Mac refused to participate in the program, probably because servicers were encouraged (but not required) to grant principal modifications under the UP program.¹²¹

The Emergency Homeowners Loan Program. Whatever its merits, one reason the UP program fell short was that it did not provide servicers with financial incentives for assisting unemployed borrowers. Consequently, in the Dodd-Frank Wall Street Reform and Consumer Protection Act in July 2010, Congress authorized the Department of Housing and Urban Development (HUD) to create a third program – the Emergency Homeowners Loan Program or EHLP – providing \$1 billion in aid to unemployed homeowners in the remaining 32 states and Puerto Rico that did not receive Hardest Hit funds.¹²² That aid consisted of zero-interest, non-recourse, subordinate loans for up to \$50,000 to help unemployed or underemployed borrowers stay current on their mortgage payments for up to 24 months.¹²³ No payments were due during the five-year term of the loan so long as the recipient used the home as his or her principal residence and remained current on the first mortgage. With each passing year of satisfactory performance,

¹¹⁷ To qualify, the loan in question had to be for the borrower's owner-occupied principal residence, have a mortgage balance of less than \$729,750, and be originated before 2009. In addition, the borrower had to prove financial hardship and receipt of unemployment benefits. After six months, if the borrower found work with lower pay or did not find work at all, he or she would respectively be considered for a permanent HAMP modification or a short sale combined with relocation assistance. Department of the Treasury, "Making Home Affordable Program Enhancements to Offer More Help for Homeowners."

¹¹⁸ Office of the Special Inspector General for the Troubled Asset Relief Program, "Quarterly Report to Congress," 77-78.

¹¹⁹ Making Home Affordable, "Program Performance Report Through November 2012," 4. Of those forbearance plans, 25,045 required a reduced mortgage payment and 4,005 required no payment at all. *Ibid.*

¹²⁰ Making Home Affordable, "Home Affordable Unemployment Program: An Overview for Servicers of Non-GSE Loans" ("there are no incentives associated with UP for the servicer at this time").

¹²¹ See Department of the Treasury, "Making Home Affordable Program Enhancements to Offer More Help for Homeowners."

¹²² Dodd-Frank Wall Street Reform and Consumer Protection Act § 1496.

¹²³ Department of the Treasury, "Obama Administration Announces Additional Support for Targeted Foreclosure-Prevention Programs to Help Homeowners Struggling with Unemployment."

20% of the balance would be retired and the EHLN note would be extinguished after 5 successful years.¹²⁴ On the other hand, if the homeowner did not meet the repayment obligations, the loan would be paid out of any home equity that remained after the other loans were retired, without recourse against the borrower.¹²⁵

To qualify for EHLN assistance, borrowers had to meet a complicated set of strict criteria, including receipt of a notice of intention to foreclose and loss of at least 15% of gross income due to unemployment, underemployment, or a medical emergency. In addition, applicants needed to show that they had a reasonable likelihood of being able to resume repayment on their first mortgage loans within two years.¹²⁶

Congress imposed a tight application deadline of September 30, 2011, on all EHLN loans.¹²⁷ Unfortunately, HUD did not start taking applications until June 20, 2011, 11 months after Dodd-Frank's passage.¹²⁸ HUD allowed 5 states to disburse their EHLN funds directly; NeighborWorks America distributed the funds in Puerto Rico and the other 27 states.¹²⁹ In the end, less than 12,000 of the approximately 100,000 people who applied for EHLN loans qualified for them and HUD left nearly half the funds unspent.¹³⁰ That was less than half of the 30,000 families HUD originally projected the program would assist.¹³¹ Further, of the money that was disbursed, almost half went to borrowers in three states: Connecticut, Maryland, and Pennsylvania.¹³² All three of those states directly disbursed EHLN funds.

The Department's Inspector General blamed EHLN's disappointing performance on HUD's "delays in establishing EHLN." According to the IG, those delays were due to "the uniqueness of the program, outsourced application intake and evaluation, lack of a permanent management structure, and the aggressive timeframe for obligating the funds."¹³³

¹²⁴ Department of Housing and Urban Development, "Emergency Homeowner Loan Program – Summary."

¹²⁵ Department of Housing and Urban Development, "Emergency Homeowner Loan Program – Summary."

¹²⁶ Department of Housing and Urban Development, "Emergency Homeowner Loan Program – Summary."

¹²⁷ Dodd-Frank Wall Street Reform and Consumer Protection Act § 1496.

¹²⁸ Department of Housing and Urban Development, Office of Inspector General, "Audit Report No. 2012-FO-0003," at 69.

¹²⁹ Connecticut, Delaware, Idaho, Maryland, and Pennsylvania were the states that served as direct providers. Government Accountability Office, "Foreclosure Mitigation," 30-31.

¹³⁰ See Buckley; Avila; Dennis; Department of Housing and Urban Development, Office of Inspector General, "Audit Report No. 2012-FO-0003," at 69-70; Government Accountability Office, "Foreclosure Mitigation," 30-31; Schmit; author's calculations from USASpending.gov.

¹³¹ See Dennis.

¹³² Schmit.

¹³³ Department of Housing and Urban Development, Office of Inspector General, Audit Report No. 2012-FO-0003, at 69.

When the history of the federal government's recent loss mitigation programs for unemployed borrowers is considered to date, it is apparent that the three programs fell short of their goals. Through the third quarter of 2012, those programs only helped a total of 117,235 unemployed or underemployed borrowers. This number pales compared to the estimated 902,000 to 1.297 million delinquent borrowers who were unemployed as of September 2012.¹³⁴ Furthermore, billions of dollars in federal aid to unemployed borrowers remain unspent.

There are several reasons for this poor performance. First, the federal approach to unemployed homeowners was piecemeal in multiple respects. The only ongoing program with funding – the Hardest Hit Fund – applied to less than 40% of the states. EHLF covered the entire country and was funded, but only was a one-time band-aid with a tight statutory deadline. The program expired before more than a few thousand households could be helped. Even then, most of those EHLF recipients were concentrated in three states. Meanwhile, HAMP's Unemployment Program is still in operation (and applies to every state), but servicers have largely ignored it, probably because it does not pay servicer or borrower subsidies.

Lack of GSE cooperation further hindered the take-up rate of two of the programs. Fannie Mae and Freddie Mac were slow to issue guidance for the payment assistance provisions of the Hardest Hit Fund and refused to participate in its principal reduction provisions at all. Similarly, the GSEs boycotted HAMP's Unemployment Program, probably because servicers are encouraged (but not required) to consider principal forgiveness.

Little is known about the performance of these programs. The Hardest Hit Fund makes its aggregate statistics difficult for the public to locate and does not publicly report the success rate of its borrowers. The EHLF program has not issued statistical reports at all (leaving it to HUD's Inspector General and GAO to ferret out basic data on that program). HAMP's Unemployment Program does report the number of borrowers assisted in the Treasury Department's monthly HAMP report, but the success rate of those borrowers is unknown.

Without results as to borrower performance, it is difficult to draw firm conclusions about features of these programs that are likely to have greater success. But some tentative conclusions can be drawn. First, the Hardest Hit Fund's program to pay mortgage arrears and upcoming mortgage payments for borrowers who have suffered job loss or reductions in pay for up to 24 months has had the biggest take-up rate of any of the Administration's three foreclosure prevention programs for unemployed borrowers. In all likelihood, direct payments experienced success because they did not require servicers or investors to write down the interest rate or principal.¹³⁵

¹³⁴ According to LPS, as of September 30, 2012, approximately 5.64 million borrowers were delinquent on their mortgages or in foreclosure. LPS, 18. Extrapolating from Herkenhoff and Ohanian, 2-3, this estimate assumes that somewhere from 16% to 23% of those borrowers were unemployed.

¹³⁵ See Foote et al., "A Proposal to Help Distressed Homeowners."

Second, and related to the first point, foreclosure prevention efforts for unemployed borrowers are likely to fail if servicer participation is voluntary and unfunded. HAMP UP offers no financial incentives to servicers to forbear on mortgage payments and that is likely one reason why that program has had so little success. In contrast, HHF directly subsidizes mortgage payments for unemployed borrowers, which helps explain why it has had almost three times the take-up rate of HAMP UP in a smaller number of states.

Third, the federal government should have provided targeted relief to jobless borrowers on a nationwide basis from the outset. Instead, the government delayed providing nationwide assistance and, when it did provide that assistance, it did so on a short-fuse deadline (the EHLP program) or without funding and on terms that the GSEs opposed (HAMP UP).

Fourth, any program of broad geographic scope for individual relief to borrowers will necessarily have delays in implementing that program on the ground. Dividing that relief among three different programs run by two different federal departments using different local delivery mechanisms compounded those implementation delays and spawned borrower confusion and resistance by servicers.

Fifth, the one-shot fix in EHLP was a serious mistake, particularly with that program's unrealistic application deadline. Unemployment is an ongoing problem and consequently relief needs to be ongoing too.

Finally, the problems in rolling out the Hardest Hit Fund and HAMP UP point out the need for cooperation and closer involvement by the Federal Housing Finance Agency, Fannie Mae and Freddie Mac. The GSEs dragged their feet in issuing servicing guidelines for the Hardest Hit Fund, which seriously delayed its implementation. Meanwhile, the GSEs' opposition to voluntary principal reduction features helped neuter HAMP UP and limit the success of the Hardest Hit Fund program.

Rate Resets And Option ARM Recasts

Performing borrowers facing unaffordable rate resets on adjustable-rate mortgages (ARMs) formed another group who could have stayed in their homes with the right type of loan modification. When the foreclosure crisis unfolded in 2007 and early 2008, policymakers' main concern was about the payment shock from pending rate resets on hybrid ARMs, interest-only ARMs and option ARMs.¹³⁶ The Bush Administration's first response was an FHA refinance

¹³⁶ For a description of the payment shock problem, see McCoy, "Rethinking Disclosure in a World of Risk-Based Pricing," 123. A related problem involved recasts on Option ARMs, which had a negative amortization feature that allowed borrowers to defer principal and even part of their principal payments during the initial period of their loans. Under the terms of those loans, eventually the loan "recast" and the borrowers had to start amortizing the skipped principal and interest, which had been added to the principal. Together, a rate reset combined with a recast could significantly boost the monthly payments on an Option ARM loan. See *ibid.*

program called FHA Secure, which the Administration rolled out in August 2007. Under that program, borrowers facing unmanageable increases in their mortgage payments due to upcoming rate resets on their adjustable-rate loans received the chance to refinance into FHA-insured fixed-rate loans. Most servicers refused to participate in the program, however, because they would have to take a write-down of up to 10% on the borrower's existing mortgage in order for the debtor to qualify for an FHA Secure loan. At the end of the day, the program only assisted 4,200 total borrowers and the federal government wound it down in late 2008.¹³⁷

In late 2007, policymakers and industry also began considering tackling the rate reset problem through loan modifications. In December 2007, the American Securitization Forum unveiled a plan for voluntarily freezing interest rates on securitized subprime adjustable-rate mortgages.¹³⁸ Meanwhile, FDIC Chairman Sheila Bair started giving speeches arguing that adjustable rate mortgages should be frozen at their initial rates to avoid defaults from sudden payment shock. She urged servicers to adopt her plan, saying that if the industry did not adopt voluntary modification programs, Congress would "do it for them."¹³⁹

After LIBOR and other ARM indices plunged in the fall of 2008,¹⁴⁰ concerns over payment shock eased and attention turned to other causes of mounting delinquencies. As the crisis unfolded, early payment defaults shot up, indicating that large numbers of homeowners could not afford their monthly mortgage payments even at the initial interest rates. Some early payment defaults were attributable to reckless underwriting or fraud, particularly in cases of low- or no-documentation (the so-called "liars'") loans. In the meantime, rising unemployment emerged as the new, main driver of mortgage delinquencies. Between May 2007 and October 2009, unemployment soared from 4.4% to 10%.¹⁴¹ Others who kept their jobs experienced cuts in hours or in pay.

While concerns over rate resets and Option ARM recasts abated over time, a not insignificant fraction of mortgage delinquencies were associated with these features, particularly during the early phase of the crisis. One group of researchers placed an upper bound on delinquencies from rate resets at around 12%.¹⁴²

Although this group of borrowers was smaller than those hit by unemployment and reductions in pay, loan modifications offering payment reductions could have helped borrowers facing prohibitively expensive rate resets to stay in their homes. That is particularly true for

¹³⁷ Cordell et al., "Designing Loan Modifications to Address the Mortgage Crisis and the Making Home Affordable Program"; Corkery, C1.

¹³⁸ See American Securitization Forum.

¹³⁹ Terris.

¹⁴⁰ See, e.g., LIBOR.

¹⁴¹ See Bureau of Labor Statistics, "Labor Force Statistics from the Current Population Survey."

¹⁴² See Foote, Gerardi, and Willen, "Why Did So Many People Make So Many Ex Post Bad Decisions?," 5-7. This estimate is not far from the 10.9% of borrowers in active permanent HAMP modifications who reported an "excessive obligation" as their primary hardship reason. Making Home Affordable, "Program Performance Report Through November 2012," 6.

borrowers in unaffordable ARMs who were able to make their mortgage payments before their rates reset.

People With Dual Housing Payments

Job relocation is another reason why some underwater homeowners ran out of money to pay their mortgages. One group of researchers recently estimated a nationwide baseline two-year mobility rate of 10% to 11% from 1985 through 2009. Relatively few of those individuals had negative equity during that period, even though home prices had started to fall in 2007.¹⁴³ However, home prices continued to decline after 2009 and did not stabilize until 2012. In the process, a growing number of homeowners became underwater on their mortgages, including some who needed or wished to relocate.

Civilian Homeowners. Some underwater borrowers who had been current on their mortgages had to move away for new job assignments, but could not sell their homes for enough to retire their mortgages. Their challenge was to juggle their old mortgage payments plus their new rent or mortgage in the new location. Some of these homeowners made enough to manage both payments, while others made do by renting out the old home or negotiating lower payments on their mortgages.¹⁴⁴ Other homeowners who relocated fell behind on their old mortgages.

For homeowners who cannot generate enough cash to manage dual housing payments, a short sale would often be beneficial. Before 2011, servicers were highly resistant to short sales, even when those sales were NPV-positive, for the same reason they were resistant to other types of principal reduction. Thus, the eight largest servicers reported that only 6.2% of their borrowers who were applied for but were rejected for HAMP trial modifications were in the process of short sales or deed-in-lieu-of-foreclosure transactions as of July 2010.¹⁴⁵

This resistance to short sales ebbed over time, partly due to increased federal subsidies. The Obama Administration started down this path in March 2009, when the Treasury Department announced it was offering financial incentives to servicers for alternatives to foreclosure. These incentives included payments to servicers for approving short sales and payments to investors to extinguish second liens that could impede those sales.¹⁴⁶

After those measures failed to gain traction, the Treasury Department revamped the program, renaming it the “Home Affordable Foreclosure Alternatives” program (HAFA) in March 2010. HAFA increased incentive payments to servicers to approve short sales from \$1000 to \$1500, on the condition that they excuse any deficiency and not require a financial contribution or promissory note from the borrower. To also encourage short sales, the government increased subsidies to junior lien holders to 6% of the outstanding loan balance, up

¹⁴³ See Ferreira, Gyourko, and Tracy, 9-10, 16, tables 1, 3.

¹⁴⁴ Generally, however, civilians who relocate will not be eligible for HAMP modifications on the mortgages on their old homes because they no longer are owner-occupants.

¹⁴⁵ Department of the Treasury, “Making Home Affordable Program: Servicer Performance Report Through August 2010.”

¹⁴⁶ Department of the Treasury, “Making Home Affordable Updated Detailed Program Description.”

to \$6,000, to induce them to release their liens. The government also doubled its relocation payments to borrowers who completed short sales or deed-in-lieu transactions, up to \$3000.¹⁴⁷

In 2010, Fannie Mae and Freddie Mac allowed short sales, but only under relatively stingy circumstances. In April 2012, under pressure from the Administration, the Federal Housing Finance Agency liberalized the GSEs' short sale guidelines to increase the number of short sales for distressed GSE loans. Those measures included a 60-day deadline for responding to short sale offers and enhancements addressing borrower eligibility, documentation, appraisals, antifraud safeguards, payments to junior lienholders, and mortgage insurance.¹⁴⁸ A few months later, in a highly significant move, FHFA announced that Fannie Mae and Freddie Mac would henceforth allow underwater homeowners to complete short sales even if they were current on their mortgages so long as they had an eligible hardship. The GSEs defined "eligible hardship" to include job relocation, the death of a borrower or co-borrowers, divorce or disability. In addition, the GSEs agreed to waive deficiencies from short sales under certain circumstances and started offering second lienholders up to \$6,000 to agree to a short sale.¹⁴⁹

The March 2012 state-federal mortgage servicing settlement added to the impetus toward short sales. Under that settlement, the nation's five largest mortgage servicers agreed to grant at least \$10 billion in principal reductions, partly in the form of short sales.¹⁵⁰ In addition to procedural protections meant to spur short sales, the agreement gave the five servicers different amounts of credit, depending on lien status, for short sales that forgave the deficiency balances of the borrowers.¹⁵¹

These developments contributed to a surge in short sales by the fall of 2012. HAFA completed a total of 78,260 short sales by September 30, 2012.¹⁵² Meanwhile, Office of

¹⁴⁷ Department of the Treasury, "Making Home Affordable Program Enhancements to Offer More Help for Homeowners." *See also* Making Home Affordable, "Home Affordable Foreclosure Alternatives (HAFA)"; Making Home Affordable, "Home Affordable Foreclosure Alternatives Program: Overview."

¹⁴⁸ Federal Housing Finance Agency, "Fannie Mae and Freddie Mac to Streamline Short Sales to Help Borrowers and Communities."

¹⁴⁹ Federal Housing Finance Agency, "FHFA Announces New Standard Short Sale Guidelines for Fannie Mae and Freddie Mac."

¹⁵⁰ Department of Justice; *see, e.g.*, Consent Judgment.

¹⁵¹ Servicers, for example, received \$1 in credit toward the settlement for every dollar in payments to unrelated second lienholders to release their second liens in connection with a short sale. For loans held in portfolio, servicers received 45 cents for every dollar written down on a first-lien loan and anywhere between 90 cents and 10 cents for every dollar written down on a second-lien loan (depending on whether the second lien was current) in completed short sale transactions. Meanwhile, servicers received 20 cents in credit for every dollar written down for releases by investors on first-lien loans they owned as part of a short sale. In all cases except possibly the release of an investor second lien, the servicer or investor also had to forgive the deficiency. *See, e.g.*, Consent Judgment, Exh. D-1, tbl. 1.

¹⁵² Making Home Affordable, "Program Performance Report Through October 2012," 4. The following month, that total rose to 83,741 short sales over the life of the HAFA program. Making Home Affordable, "Program Performance Report Through November 2012," 4.

Mortgage Settlement Oversight reported that 113,534 short sales and deeds-in-lieu-of-foreclosure had been granted under the mortgage servicing settlement for the six-month period ending September 30, 2012, totaling about \$13.13 billion in total relief or an average of \$115,672 per borrower. No other category of consumer relief under the settlement agreement that period was remotely as large.¹⁵³

The growth in short sales was also apparent from data for third quarter 2012 overall. RealtyTrac reported that short sales outside of foreclosure accounted for 22% or slightly over 220,000 of all residential sales during third quarter 2012, up from 17% during third quarter 2011.¹⁵⁴ The GSEs took credit for 33,972 of those third quarter short sales, up from 8,054 short sales by the GSEs in first quarter 2009.¹⁵⁵ Meanwhile, in the so-called “fiscal cliff” legislation in early January 2013, Congress laid the groundwork for a continuation of this trend by extending the Mortgage Forgiveness Debt Relief Act, excusing homeowners doing short sales from federal income tax on any deficiency balances forgiven through December 31, 2013.¹⁵⁶

This new, greater ease in arranging short sales is not a panacea. Short sales present major coordination problems. For one thing, they depend on borrowers taking the initiative to list the short sale. But too many distressed homeowners facing eviction become discouraged and abandon the property. Short sales also depend on servicers and investors being willing to give approval (which the subsidies have had partial success in addressing). Even when approval is forthcoming, it may take too long, causing the sale to fall through.

Nevertheless, barriers to short sales are falling at the margin, which should encourage more underwater borrowers to attempt them. This will benefit both civilians relocating elsewhere and members of the armed services who were ordered to transfer.

Military Homeowners With PCS Orders. An especially compelling case of the relocation issue involves members of the armed forces who receive “Permanent Change of Station” or “PCS” orders. These orders are commands to move to a new military installation for reassignment, often under short deadlines. Servicemembers who received PCS orders but were underwater on their mortgages faced often difficult options. Generally, they did not earn sufficient salary to make double housing payments on their new homes and their old. While they had a right to be evaluated for foreclosure prevention under the Servicemembers Civil Relief Act (SCRA),¹⁵⁷ servicers did not always cooperate with that request. Some servicers pressured servicemembers to waive their statutory rights; others stalled processing requests for relief. In the worst cases, servicers illegally foreclosed on soldiers’ homes or told servicemembers that they must be delinquent before they could qualify for assistance. Such a delinquency, however,

¹⁵³ Office of Mortgage Settlement Oversight, “Continued Progress: A Report from the Monitor of the National Mortgage Settlement,” 3.

¹⁵⁴ RealtyTrac; computations by author. According to RealtyTrac, the average short sale price in third quarter 2012 was \$82,312 lower than the combined outstanding loans on the properties being sold.

¹⁵⁵ Federal Housing Finance Agency, “Foreclosure Prevention Report Third Quarter 2012,” 32.

¹⁵⁶ The American Taxpayer Relief Act of 2012 § 204(a).

¹⁵⁷ 50 U.S. Code App. §§ 501-597b.

would likely jeopardize the servicemember's security clearance and, with it, his or her job.¹⁵⁸ This sequence of events was not only of grave concern to the individuals involved, but also had broader implications for military readiness and national security.

Even if the SCRA were consistently observed, the Act would not fully alleviate this situation. The SCRA only applies to mortgage loans to servicemembers that were originated before the homeowner's military service began.¹⁵⁹ And even when the SCRA applies, if the servicer is seeking foreclosure, the homeowner has already gone delinquent in all likelihood and put his or her security clearance and job at risk.

In response, federal officials announced several new initiatives to improve the loss mitigation options for military homeowners facing PCS orders. In the March 2012 state-federal mortgage servicing settlement, for instance, the five large servicers that were party to that agreement agreed to measures to protect SCRA rights, including mandatory look-backs and compensation where they had improperly denied benefits under the Act. As part of the settlement, the servicers agreed to provide short-sale opportunities and to waive deficiencies for underwater military homeowners in PCS order cases.¹⁶⁰

Three months later, the Federal Housing Finance Agency announced that under new agency guidelines, Fannie Mae and Freddie Mac would approve short sales by military homeowners who received PCS orders without first requiring those borrowers to go delinquent. In addition, FHFA confirmed that servicemembers with Fannie or Freddie loans would not be required to contribute financially to obtain approval for a short sale. Nor would they be liable for any deficiency.¹⁶¹

In some cases, servicemembers with PCS orders planned to return to their homes and wished to renegotiate their mortgages. To assist those borrowers, the HAMP program modified

¹⁵⁸ See, e.g., Henriques, "A Reservist in a New War, Against Foreclosure"; Henriques, "Mortgage Companies Settle Suits on Military Foreclosures"; Petraeus.

¹⁵⁹ 50 U.S. Code App. § 533(a). In those instances, if the servicemember defaults on the mortgage during the period of military service or within 90 days thereafter, no foreclosure, sale or seizure of the property is valid unless there is a court order or the servicemember waived his or her rights under the Act. 50 U.S. Code App. § 533(c); see also 50 U.S. Code App. § 517. In any court proceeding, the court may grant a stay and *must* grant a stay "for a period of time as justice and equity require" where the servicemember files an application showing that his or her ability to comply with the obligation is materially affected by military service. The court can also "adjust the obligation to preserve the interests of all parties." 50 U.S. Code App. § 533(b).

¹⁶⁰ See, e.g., Consent Judgment, A-32 through A-35, E-5, Exhs. H through H-2. Importantly, the five servicers agreed not to require a servicemember to be delinquent to qualify for a short sale, loan modification, or other loss mitigation relief if the servicemember was suffering financial hardship and was otherwise eligible for such loss mitigation. *Ibid.* at A-34.

¹⁶¹ Federal Housing Finance Agency, "FHFA Announces Short Sale Assistance for Military Homeowners with Fannie Mae or Freddie Mac Loans." Previously, in 2011, the two GSEs had published guidance confirming that PCS orders constituted a hardship for purposes of forbearance and loan modifications. *Ibid.*

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its guidelines effective June 1, 2012 to allow certain military homeowners with PCS orders to qualify for traditional HAMP loan modifications.¹⁶²

Taken together, these provisions represent a sea change in the treatment of distressed military homeowners with PCS orders. The short sale provisions, however, do not cover all mortgages. Furthermore, in order for those provisions to be successful, servicers have to observe them. Mindful of that challenge, in June 2012, federal banking regulators issued an interagency guidance advising compliance. The guidance was relatively weak, however, and simply flagged concerns about certain servicer practices regarding military homeowners with PCS orders without requiring those practices to be reformed.¹⁶³

Other Cash-Strapped Delinquent Homeowners

The last group of cash-strapped, distressed homeowners consists of those whose incomes have become permanently or indefinitely impaired. If they cannot meet the NPV test for a loan modification and cannot refinance their mortgages, it will be difficult for them to stay in their homes.

In some circumstances, it may be possible for an investor to take a deed-in-lieu-of-foreclosure and rent back the home to the borrower at a market rate. This is easier said than done, however. First, the homeowner must be able to afford the rental price. In many areas, however, increasing demand since 2008 for rental housing caused rental prices to rise. Second, whoever assumes the deed must be willing to own and maintain the property and to act as a landlord. Servicers and private-label investors are unlikely to volunteer for this role. As a result, transfer/leaseback programs have not come to scale and an organized response will be needed if that option is to become viable.

Barring a rental solution, other distressed borrowers who have suffered such large shocks to income that they do not qualify for a loan modification will probably have to move out. If matters come to that, the priority should be on helping the affected borrower transition to more affordable lodgings while finding a new owner to occupy the home. If the mortgage is underwater, this will usually require a short sale combined with relocation assistance for the borrower.

In March 2009, the Administration announced subsidies to encourage these types of alternatives to foreclosure. In addition to subsidies for short sales and releases of second liens that could impede those sales, the Treasury Department offered borrowers \$1500 to cover their expenses of relocation.¹⁶⁴ A year later, in its new HAFA program, Treasury announced that

¹⁶² Under the revised guidelines, servicemembers who had to move due to PCS orders, but who planned to return to their houses and did not buy a house somewhere else, could now qualify as “owner-occupants,” qualifying them for HAMP loan modifications. Petraeus.

¹⁶³ Board of Governors of the Federal Reserve System et al., “Interagency Guidance on Mortgage Servicing Practices.”

¹⁶⁴ Department of the Treasury, “Making Home Affordable Updated Detailed Program Description.”

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it was doubling relocation assistance and boosting payments to servicers and second lienholders to agree to short sales.¹⁶⁵

To date, despite the rise in short sales, HAFA's progress has been discouraging. As of November 2012, only 85,881 HAFA plans had been completed, with 83,741 involving a short sale.¹⁶⁶ That number paled compared to the approximately 3 million foreclosures that were completed between April 2009 and November 2012.¹⁶⁷

Final Lesson: Current Subsidies Are Not Enough To Overcome The Existing Barriers To Cost-Effective Loss Mitigation

So far, this analysis has proceeded on the assumption that investors will approve loan modifications and short sales that have a higher net recovery than going to foreclosure. The reality has been otherwise. Most observers agree that there have been too few cost-effective loan modifications and short sales. And even if loss mitigation were granted whenever it was NPV-positive, the NPV test would still not take into account society's interest in preventing abandoned homes and the negative spillover effects that result from them.

The slow pace of workouts is the result of incentive structures that cause servicers to prefer foreclosure to NPV-positive loan modifications or short sales in too many cases.¹⁶⁸ The leading source of those incentives is today's system of servicer compensation.¹⁶⁹ Loss mitigation is costly to staff and servicers receive too little for that labor-intensive task under today's flat-fee compensation system. In addition, servicers are positively rewarded for rejecting NPV-positive loss mitigation solutions because their only real assurance of collecting advances and penalties such as late fees, default management fees, and the like is by going to foreclosure.¹⁷⁰ The same incentives encouraged the nation's largest servicers to cut costs through robo-signing and other abuses of the foreclosure process, which eventually resulted in enforcement decrees and the multi-billion-dollar mortgage servicing settlement.

The Obama Administration tackled the issue of servicer compensation with subsidies that were meant to reverse the incentives created by the current system of servicer

¹⁶⁵ Department of the Treasury, "Making Home Affordable Program Enhancements to Offer More Help for Homeowners."

¹⁶⁶ Making Home Affordable, "Program Performance Report Through November 2012," 2.

¹⁶⁷ Department of Housing and Urban Development and Department of the Treasury, "The Obama Administration's Efforts To Stabilize The Housing Market and Help American Homeowners," 3.

¹⁶⁸ See McCoy, "Barriers to Home Mortgage Modifications During the Financial Crisis."

¹⁶⁹ For a full analysis of that compensation system and the incentives it creates, see McCoy, "Barriers to Home Mortgage Modifications During the Financial Crisis," 16-20.

¹⁷⁰ McCoy, "Barriers to Home Mortgage Modifications During the Financial Crisis," 17-18, 20; McBride; Thompson, "Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior," 17. Servicers have additional incentives to artificially generate late fees by not posting on-time payments promptly or postponing collection until late fees can be assessed. Thompson, above, at 17.

compensation. The subsidy experience had mixed effectiveness. HAMP's biggest success was in reversing the trend from loan modifications that *increased* monthly payments – with high redefault rates – to loan modifications that *lowered* monthly payments, often substantially. The federal government accomplished this objective in two ways: first, by paying servicers to cut loan payments and interest rates and second, by publicizing the effect of those lower payments in reducing redefault rates. This aspect of HAMP was so successful that proprietary loan modification programs migrated toward the HAMP approach over time as the redefault rates of HAMP modifications steadily dropped.

One can see a similar though less pronounced effect in HAMP's principal reduction program. HAMP never made principal reductions a mandatory part of the HAMP waterfall for participating servicers. Instead, HAMP expressly encouraged servicers to consider principal forgiveness and then paid them for granting it. Principal reduction modifications became much more common after the Administration tripled its payments for those features and after the superior performance of principal write-down modifications became known. Similarly, short sales – which also involve principal write-downs – surged after the HAMP program upped its subsidies for those workouts.

There are three takeaways from the principal write-down experience. The first involves transparency. From 2008 onwards, a growing body of publicly available studies by securities analysts and university and government researchers found that principal write-downs had better redefault rates than interest rate reductions or capitalization of arrears.¹⁷¹ In all likelihood, this evidence of the salutary effect of principal write-downs on the success rate of modifications encouraged servicers and investors to approve more of them (in the HAMP and proprietary spheres alike). Second, tripling the HAMP subsidies noticeably boosted the number of principal forgiveness workouts. Finally, despite that surge, interest rate reductions still outpaced principal reductions as of late 2012, even though principal reductions do better in lowering redefault rates. And the heightened subsidies did nothing to bring Fannie Mae, Freddie Mac or FHFA on board with the principal reduction strategy. As this suggests, federal subsidies for voluntary principal write-downs – at least at the subsidies' current level – go only so far in overcoming resistance to modifications using principal forgiveness.

Other aspects of HAMP demonstrate the limited power of subsidies. This can be seen in the disappointingly low number of total loss mitigation plans approved, the high number of loan modifications that still capitalize arrears, and the failure to process workout requests more quickly over time on average.

The Administration's foreclosure prevention programs for jobless and underemployed homeowners epitomize these problems. One conclusion from that experience is that subsidies worked better than none. The program with the best take-up rate– the Hardest Hit Fund – eclipsed servicer resistance to some extent by directly subsidizing loan payments for unemployed borrowers. In contrast, the HAMP Unemployment Program provided no subsidies whatsoever, which doomed that program from the start.

¹⁷¹ See note 55 above.

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Even with subsidies, however, the Hardest Hit Fund to date has only made a dent in the problem of unemployed borrowers. Despite HHF's generous funding, the take-up rate has been too low. So while HHF subsidies made some difference at their current level, they were not enough to tackle the unemployment problem wholesale.

Finally, the checkered experience with the foreclosure prevention programs for the unemployed underscores the need for transparency. These three programs have been the least transparent of all of the Administration's loss mitigation initiatives. Given their limited success, one must ask whether easy-to-find online monthly reports about total take-up rates and results would have spurred those programs to improve. If the federal government is going to spend billions of dollars on foreclosure prevention, then it has a responsibility to the public to release data on the outcomes of all of those programs voluntarily, regardless of their funding source.

Going Forward

In retrospect, the foreclosure prevention experience of the past six years was a mixed success. The number of loan modifications and other workouts was lower than expected. Meanwhile, too many unnecessary foreclosures occurred, inflicting needless, widespread losses not only on homeowners and investors, but also on surrounding communities in the form of depressed housing values, shrinking tax bases, crime and neighborhood decay.

At the same time, loss mitigation initiatives in recent years provide a rich lode of data and experiences that can inform policymaking. These initiatives offer two sets of overarching insights. One set concerns the question of what workout techniques work better than others. The other set addresses the question of how to overcome the barriers to adoption of the most effective workout techniques.

Best Practices In Workouts

With respect to the first set of insights – i.e., the most effective workout methods -- it is important to keep the objectives of foreclosure prevention in mind. From the viewpoint of investors, loss mitigation should be granted where it will increase net recovery relative to foreclosure. Subject to that condition, from the viewpoint of society, loss mitigation should strive to keep the affected home occupied in order to avoid the fallout that comes from a vacant home. Preferably this should be accomplished by keeping the homeowner in the home or, where that is not possible, through a short sale to a new homeowner. Finally, design matters: loan workouts should be designed to minimize the risk of redefault.

To achieve those objectives, HAMP and, before that, Mod in a Box, drove home the importance of using a standardized loss mitigation template. The emergence of these templates had several salutary effects. They helped focus workout evaluations on home retention at the individual borrower level. As a result, loan modifications rose noticeably after HAMP was implemented. In addition, the templates helped servicers process high volumes of distressed mortgages more efficiently. The templates also improved redefault rates substantially by requiring the use of algorithms that were designed to produce lower monthly payments.

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The emphasis on lower monthly payments turned out to be crucial to success. Furthermore, the way in which monthly payments were lowered also had an effect on redefault rates. In particular, dollar for dollar, reducing principal is a more powerful way of avoiding redefault than lowering interest rates, at least for deeply underwater borrowers.

The recent history of loss mitigation also demonstrates the importance of early intervention. Redefault rates improved noticeably on average for loan modifications granted in the first few months of delinquency.

Finally, the disorganized and disappointing approach to the plight of unemployed homeowners makes clear that more could have and should have been done. From the outset, the government should have offered that foreclosure prevention to jobless homeowners on an ongoing basis without artificial deadlines and regardless of their state of residence. Moreover, policymakers needed to recognize that loan modifications for the unemployed will often fail the NPV test because their income loss is so severe. For this reason, direct assistance with mortgage payments until the homeowners find new jobs will be more effective than expecting servicers to undertake the likely futile exercise of evaluating those individuals for loan modifications under the NPV test.

Reducing Barriers To Optimal Loss Mitigation

During the financial crisis and its aftermath, policymakers struggled to improve the disappointing take-up rate on foreclosure prevention. The George W. Bush Administration used a voluntary approach to loss mitigation, which did not work. Things improved once the Obama Administration adopted the HAMP waterfall template and handed out subsidies for HAMP participation. Still, loss mitigation rates were below what the Administration originally had projected. This suggests that going forward, subsidies alone will not be enough to produce the right level of loss mitigation. Instead, the lessons from the foreclosure crisis will need to explicitly be made part of the servicing industry's institutional design.

The first task will be to reform servicing guidelines to institutionalize the parts of HAMP that worked, especially the standardized waterfall, the emphasis on early intervention,¹⁷² and the attention to lower monthly payments, including through principal reduction. Right now, the federal government has a historic window in which to accomplish that task. That window has opened because the nation's system of housing finance is currently in flux. One thing certain: that system will change. The eventual reform of the housing finance system will give the government a rare opportunity to standardize loss mitigation protocols for future generations. It is imperative, moreover, that the government take action, because the spillover

¹⁷² The Consumer Financial Protection Bureau has taken major strides toward this objective by requiring servicers to notify delinquent borrowers in writing of their loss mitigation options within 15 days of the borrower's second missed payment. Consumer Financial Protection Bureau, "Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act."

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effects of the foreclosure crisis were too costly¹⁷³ to relegate foreclosure prevention to private contracting alone.

In standardizing loss mitigation protocols, one task will be to amend federal servicing guidelines. Today, virtually all home mortgages are federally guaranteed or insured, either by the GSEs, FHA, the VA, or the Rural Housing Service. Because these instrumentalities are all within the Executive Branch's control, the Administration should take measures to incorporate HAMP's features into the servicing guidelines for all four programs going forward.

In addition, the Administration needs to find a way to make FHFA and the GSEs to include principal reduction in their loss mitigation arsenal. Some of the strongest resistance to key provisions of HAMP came from FHFA, Fannie Mae and Freddie Mac. The GSEs and FHFA refused to participate in principal reductions and undermined HAMP's Unemployment Program because HAMP UP merely required GSE servicers to consider principal forgiveness. Convincing FHFA and the GSEs to drop their resistance and come on board will be essential to any meaningful plan to boost the number of cost-effective loan modifications.

Another task will be to revamp private-label pooling and servicing agreements for future securitizations. In 2007 and 2008, the private-label mortgage-backed securities market collapsed and that market remains moribund today. Investors are not likely to return to the private-label market without major reforms, including enhanced disclosures, more robust data, improved due diligence, stronger representations and warranties, credible credit ratings, stronger structures, and revamped PSA provisions. The need to change PSAs provides a ripe opportunity to institutionalize the HAMP protocols in the private-label market of the future.

Strong consideration should also be given to requiring servicers to adopt HAMP protocols for loans held in portfolio, given the heavy negative externalities from needless foreclosures. If federal banking regulators had insisted early on on deeper write-downs to distressed mortgage loans – especially distressed junior liens – that would have removed a powerful obstacle to loan modification relief. Requiring banks to mark down their distressed loans more promptly would increase their incentives to engage in the right level of loss mitigation.

While reforming servicing guidelines is necessary, it is not enough. The experience of the past few years made clear that the current servicing system presents other institutional barriers to the right level of loss mitigation. Chief among those barriers is our broken system of servicer compensation. Today, servicers are overpaid for servicing current loans and underpaid for processing delinquent loans.

Servicer compensation reform is not an immediate fix because the current compensation arrangements apply to the delinquent loans now in the pipeline. However, revamping servicer compensation to properly pay servicers for processing and approving NPV-

¹⁷³ The Government Accountability Office recently estimated, for instance, that cumulative output losses from the recent financial crisis could exceed \$13 trillion. See Government Accountability Office, "Financial Regulatory Reform," 17, 23-24.

positive loan modifications would help avoid servicing breakdowns in the future. In particular, servicing compensation needs to be re-designed to reduce the amount paid for performing loans and to properly reward servicers for processing loss mitigation for distressed loans.

Of course, one cannot discuss servicer compensation without discussing subsidies. The whole point of HAMP subsidies was to reverse the incentives toward excessive foreclosures that the current system of servicer compensation creates. While those subsidies had some success, that success was only partial. In light of this experience, some argue that HAMP subsidies should have been higher. But if servicer compensation is meaningfully reformed and servicing guidelines are appropriately amended, possibly future subsidies could actually be reduced. The Consumer Financial Protection Bureau's new ability-to-repay and qualified mortgage rule¹⁷⁴ will also likely help by limiting the number of poorly underwritten mortgages requiring loss mitigation to begin with.

Finally, there is serious reason to be concerned about the wide variation in servicers' propensity to grant workouts.¹⁷⁵ Relatively little is known about the reasons for this disparity and more research is needed into the possible causes, whether they stem from differences in business models, investor types, or other factors.

In the meantime, the Consumer Financial Protection Bureau has come out with new rules that will help hold servicers to the same high standard. Under those rules, servicers *must* evaluate borrowers who timely apply for all loss mitigation options permitted by the investor for which the borrower may be eligible. Similarly, servicers may not initiate foreclosure if a timely application is pending for a loan modification or other alternative to foreclosure.¹⁷⁶ Importantly, the Bureau can examine mortgage servicers for compliance with these rules and initiate enforcement in the event of violations.

Differences in servicers' batting averages also underscore the importance of transparency in holding servicers accountable. The HAMP program publishes loss mitigation statistics for the largest individual servicers every month. In addition, HAMP audits servicers for compliance with its protocols and has called out servicers by name in public for subpar

¹⁷⁴ Consumer Financial Protection Bureau, "Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act."

¹⁷⁵ See, e.g., Agarwal, Amromin and Ben-David, "The Role of Securitization in Mortgage Renegotiation"; Been et al., "Determinants of the Incidence of Loan Modifications"; Collins and Herbert, "Loan Modifications as a Response to the Foreclosure Crisis"; Goodman et al., "Mortgage Modification Activity—Recent Developments," 55. See *generally* Making Home Affordable, "Program Performance Report Through December 2012," for statistics on the modification activities of individual large servicers.

¹⁷⁶ Consumer Financial Protection Bureau, "Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act."

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performance. These “naming-and-shaming” tactics have pressured servicers to clean up compliance.¹⁷⁷

Transparency also has another valuable effect in disseminating knowledge and best practices. After the recent spate of studies on the effect of different workout techniques on redefault rates, servicers increasingly gravitated toward techniques that were more successful. This suggests that the studies may have served an educational role in bringing about that change. If the future mortgage default database mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act contains robust data fields on loss mitigation methods, that database could help government and independent researchers alike to extend that research in the future.

The federal government should also work with the servicing industry to make sure that servicers take advantage of the best technologies available. It is unimaginable, for instance, why servicers still expect borrowers to fax in their loan modification requests and supporting documentation when secure digital transmission would avoid lost paperwork and be centrally accessible for all of a servicer’s employees to read. Eliminating outdated technologies such as fax submissions should substantially reduce some of the most maddening and protracted breakdowns in the loss mitigation process.

In conclusion, this country’s recent experience with foreclosure prevention has yielded a number of concrete lessons. While those lessons are clear and progress has been made, successfully implementing those lessons in the current servicing environment is not an easy matter. It is crucial not to let the memory of loss mitigation’s challenges fade as the inventory of distressed mortgages declines. Instead, regulators, the servicing and securitization industries, and the public at large should make good use of the coming years to adopt the structural changes that are needed to improve loss mitigation once and for good.

¹⁷⁷ Eventually, the state-federal mortgage servicing settlement and the later federal settlement of the robo-signing enforcement actions addressed some of the same problems. However, those settlements were limited to the largest servicers.

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