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**Barriers to Federal Home Mortgage Modification Efforts
During the Financial Crisis**

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Introduction

Since mid-2007, the federal government has devoted enormous sums of money and effort to foreclosure prevention. Washington's approach to rising foreclosures has evolved over time. In the first iteration, the government confined its efforts to coordinating loss mitigation by private industry. In the second iteration, starting with President Obama, the government supplemented that approach with subsidies for loan modifications. To a lesser degree, the Obama Administration has also attempted to increase the costs to servicers of rushing to foreclosure.

So far, the results have been mixed. Under the George W. Bush Administration, two successive programs to refinance distressed borrowers into FHA loans turned out to be a failure. Last December, the Obama Administration's ambitious program to increase loan modifications stumbled when the government revealed that most temporary modifications failed to graduate to permanent modifications. While the graduation rate has since improved, the level of permanent modifications remains well below what policymakers had hoped for.

To bring permanent modifications to scale, more will be needed. The lack of permanent modifications may partly be due to insufficient subsidies to servicers for underwriting permanent modifications. More importantly, the resistance to permanent modifications may also be the product of accounting rules that require immediate write-downs for reductions in interest rates or principal that are permanent in nature, rather than temporary.

If the latter is the case, then stronger medicine will be needed. Short of overhauling the accounting rules – which raises larger complications of its own – the government's options are limited. Either it will have to further subsidize losses arising from write-downs, compel write-downs by law, or encourage voluntary write-downs through stronger means, including the threat of bankruptcy cram-downs or slower access to foreclosure court.

Rationales for Foreclosure Mitigation

During the financial crisis, policymakers advanced two main justifications for foreclosure prevention. The first consisted of the economic self-interest of investors, while the second involved minimizing the harmful spillover effects to society from foreclosures.

Interestingly, redressing wrongs to injured borrowers was not a central rationale for loss mitigation. From an operational perspective, resolving wrongs to select borrowers would likely mire the loss mitigation process in protracted delays. Public backlash by some against borrowers

who defaulted on their loans probably also played a role. Finally, as Federal Reserve Chairman Ben Bernanke repeatedly stressed, foreclosures injure neighborhoods and communities, regardless of who is to blame.¹

Potential Benefits to Investors and Other Holders

In numerous instances, holders of distressed home mortgages could reduce their losses by agreeing to workouts instead of going to foreclosure. This dynamic is especially compelling for non-conforming mortgages, i.e., loans not guaranteed by Fannie Mae, Freddie Mac, or the federal government. Jumbo mortgages and most subprime mortgages are non-conforming loans. Most of these were securitized in the private-label residential mortgage-backed securities (RMBS) market.

The loss severity rates from subprime residential foreclosures average around 50%.² This high loss severity results largely from the high deadweight costs surrounding foreclosure. The biggest deadweight costs are missed mortgage payments during the period leading up to foreclosure.³ In addition, the lender or trust incurs assorted transaction costs during the process of foreclosure, including realtor commissions, legal fees, utilities, taxes, insurance, and maintenance. These costs can consume 10% to 15% of the loan balance. Finally, foreclosed homes sell at a 5% to 15% discount compared to normal homes, due to the fire sale nature of foreclosure and the poor condition of many foreclosed homes.⁴ These high loss severities create room in many instances for investors and banks to cut their losses by agreeing to workouts of troubled loans.

Avoiding Harmful Spillover Effects

Avoiding harmful spillover effects to society from foreclosures was the other major impetus for loss mitigation programs. This objective gained added urgency as falling housing prices dragged down the larger economy.

¹ Kiff and Klyuev (2009), at 14.

² Cordell et al. (2008), at 12-13. See also Bernanke (2008), at 3.

³ Generally, servicers are contractually obliged to advance principal and interest to the trust pending foreclosure. Once a foreclosure proceeds to sale, however, servicers can recoup those advances from the sale proceeds. Cordell et al. (2008), at 11.

⁴ Bernanke (2008), at 3; Cordell et al. (2008), at 11-13.

Starting in 2007, the national decline in home prices created a negative feedback effect that triggered and then prolonged the ensuing recession.⁵ As home prices dropped, more and more homeowners fell into negative equity when the balances on their mortgages came to exceed the value of their homes. Previously, during the housing boom, many of these households had taken out subprime or exotic adjustable-rate mortgages (ARMs)⁶ with payments that ultimately became unmanageable. Once their home equity evaporated, these “underwater” borrowers found that they could not refinance or sell their homes for enough to retire their loans. The result was a sharp spike in residential mortgage delinquencies and foreclosures.

Mounting foreclosures further depressed housing prices. On the demand side, foreclosures fueled tighter credit as banks raised their underwriting standards to prevent more delinquencies. Losses from foreclosures also eroded banks’ capital, constraining their capacity to lend. The resulting dearth of credit dampened the number of buyers looking for homes.

Foreclosures also had supply side effects. As foreclosure sales flooded the market, foreclosed homes sold at steep discounts, further pushing down home prices. Foreclosed properties depress the values of nearby homes by anywhere from 1% to 9%.⁷ That, in turn, reduces the property tax revenues on those neighboring homes. Vacant foreclosed homes also breed squatters, vandalism, and crime, sending neighborhoods into a tailspin and requiring higher municipal outlays for police and social services.⁸

Eventually, the downward spiral in property values pulled down the larger economy. As households became unable to tap their home equity to spend, purchases declined. Consumption fell and employers laid off workers (Figure 1), causing household incomes to contract. Shrinking paychecks forced more and more households to default on their mortgages. (Figure 2). By the end of 2009, serious delinquencies had hit an all-time high. In December 2009, 7.01% of all prime mortgages were 90 days delinquent or more, compared to 3.74% in December 2008. Over that same period, the percentage of subprime mortgages that were 90 days delinquent or more soared from 23.11% to 30.56%.⁹ Meanwhile, foreclosure inventories rose to record highs

⁵ Kiff and Klyuev (2009), at 4-5.

⁶ Most notably hybrid 2/28 or 3/27 ARMs, interest-only ARMs, and option payment ARMs.

⁷ Kiff and Klyuev (2009), at 5.

⁸ Bernanke (2008), at 3; Kiff and Klyuev (2009), at 13.

⁹ Mortgage Bankers of America (2010).

(Figure 3), further dampening home prices. Standard & Poor's projects possibly higher mortgage liquidation rates in the future.¹⁰

In September 2008, as losses soared on mortgages and mortgage-related securities, the financial system came to the brink of collapse. Foreclosure prevention seeks to break this disastrous negative feedback loop by keeping borrowers in their homes and current on their loans.

Federal Foreclosure Prevention Policies

The federal government has three basic models for foreclosure prevention at its disposal. First, it can convene market actors to coordinate and facilitate foreclosure prevention by private industry. Second, the government can offer subsidies to induce foreclosure prevention. Finally, the government can take actions to increase the costs to market participants of pursuing unnecessary foreclosures.

During the current economic crisis, the federal government mainly pursued the first and second models. The third model had sparing use. At any given point during the crisis, the model that was chosen depended on the objective being pursued – refinancing or loan modification – and the Administration that was in power.

Refinance Programs for Delinquent Borrowers

During the summer of 2007, the private-label market for RMBS crashed, setting the stage for a tsunami of foreclosures. Once the private-label market vanished, many financially stressed borrowers were no longer able to refinance unaffordable loans. The paucity of refinance options was especially severe for borrowers who were delinquent or had underwater loans (meaning loans in excess of the value of their homes). With no way to escape impending rate resets on their ARMs and other onerous loan terms, millions of households were soon in default.

That summer, the federal government sought to stave off the wave of foreclosures by refinancing some delinquent borrowers into FHA-insured loans. The first major refinance program was FHA Secure, which the George W. Bush Administration launched in August 2007. Under FHA Secure, borrowers who faced high payment shock from imminent rate resets on their adjustable-rate loans were given the opportunity to refinance into FHA-insured fixed-rate loans. Participation by servicers was voluntary. Servicers shunned the program, however, because it

¹⁰ Standard & Poor's (2010).

required them to take a write-down of 3% or 10%, depending on the borrowers' circumstances, for the borrower to qualify for an FHA Secure loan. Eventually, after only about 4,100 borrowers qualified for the loans, the federal government brought the program to a halt at the end of 2008.¹¹

In October 2008, the Bush Administration rolled out another refinance program, called Home for Homeowners or H4H. H4H was designed to refinance delinquent borrowers with underwater loans into FHA-insured mortgages. Again, under H4H, servicers had to first write down the principal, this time to no more than 96.5% (or sometimes 90%) of appraised value. In addition, servicers had to pay a 3% upfront FHA insurance premium and waive prepayment penalties and late fees. Borrowers had to share any future property appreciation at resale with the government. Like FHA Secure, these terms were no more attractive to servicers than going to foreclosure. The program was an abysmal failure: by May 2009, only one borrower had been refinanced into an H4H loan.¹²

These refinance programs were the main instance in which the Bush Administration offered subsidies to promote foreclosure prevention. Nevertheless, both programs had a dismal rate of success because they depended on cooperation by servicers on unattractive terms. In designing both programs, the government tried to navigate competing goals without success. Thus, the government imposed the write-down requirements to avoid rewarding lenders for making inflated amounts of loans. But with participation voluntary, servicers were unwilling to take large, certain write-downs instead of taking their chances on foreclosure. Furthermore, in H4H, the government made servicers, not borrowers, pay the FHA insurance premium on the assumption (usually correct) that distressed borrowers lacked that kind of cash. This hefty premium, along with the mandatory waiver of prepayment penalties and late fees, were an added reason why H4H refinancings did not appeal to servicers.

Loan Workouts

Federal programs to encourage loan workouts were the other major approach to foreclosure mitigation during the crisis. Under the George W. Bush Administration, the federal government mostly relied on the first model – coordinating private industry efforts -- to prod

¹¹ Corkery (2008).

¹² Kiff and Klyuev (2009), at 21-22; Merle (2009).

servicers to modify distressed loans, to little avail. In contrast, the Obama Administration adopted the second model, offering subsidies to servicers to modify distressed loans.¹³

During the early stages of the crisis, in 2007 and the first part of 2008, public policy was mostly concerned with impending rate resets on ARMs. As the crisis progressed, however, the spike in early payment defaults made clear that increasing numbers of homeowners could not afford their monthly mortgage payments even at the initial interest rates. Some of these loans were infected with fraud or sloppily underwritten from the start, especially reduced documentation loans. The widening recession also took its toll. Between May 2007 and November 2009, unemployment soared from 4.4% to 10%.¹⁴ Others who remained employed suffered lower wages due to reduced hours or pay cuts. By 2009, lost income outstripped other reasons for seeking loan workouts, such as rate resets or illness.¹⁵ As this evidence amassed, it became increasingly clear that lower monthly payments were essential to successful loan workouts.¹⁶

When loans become delinquent or 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 other than foreclosure). Some workout techniques lower monthly payments, while others do not. *Capitalization* takes the borrower’s arrears and tacks them onto the principal, thereby increasing the monthly payments.¹⁷ Capitalization 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 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 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.

¹³ Both Administrations also sought to expand refinancing opportunities through Fannie Mae, Freddie Mac, and the Federal Housing Administration. This paper does not address those refinancing programs; instead, its focus is on loan modification programs.

¹⁴ Bureau of Labor Statistics.

¹⁵ The Treasury Department reported that in 2009, lost income was the single biggest reasons why borrowers sought loan workouts under the Obama Administration’s Making Home Affordable program. Roughly half of all borrowers who received permanent loan modifications under that program did so due to loss of income.

¹⁶ See, e.g., Adelino et al. (2009), at 3; Congressional Oversight Panel (2009).

¹⁷ Some capitalization plans reduce monthly payments for a few months in hopes that the borrowers will get back on their feet. Because the forborne revenues are added to the loan balance, eventually the monthly payments rise above the originally scheduled amounts.

The Bush Administration rolled out an initial federal loan modification program in mid-2007. With the change in Administrations, the federal government altered its approach to loan modifications and that approach continues to evolve today.

Bush Administration

HOPE NOW

The HOPE NOW Alliance, a private, voluntary program operated by the mortgage industry, formed the heart of the Bush Administration's foreclosure prevention efforts. The industry launched the Alliance in mid-2007 at the urging of the U.S. Departments of the Treasury and Housing and Urban Development. HOPE NOW's purpose was to coordinate servicers, loan counselors, and the securitization industry to identify distressed borrowers early on, get them into mortgage counseling, and persuade servicers to modify their loans. Its original members included Fannie Mae and Freddie Mac, credit counselors, eleven servicers servicing about 60% of subprime loans, and other mortgage market participants. By officially touting the program, the Bush Administration made HOPE NOW the focus of its repeated calls for servicers to modify more loans.¹⁸

HOPE NOW was strictly voluntary in nature: nothing required servicers to participate in the program or modify loans that met its guidelines. Between July 2007 and December 2008, the program reported completing 3.1 million loan workouts. 63% of those workouts (3.183 million), however, simply deferred or rescheduled borrowers' payments temporarily without permanently lowering those payments. For many borrowers, these workouts were unlikely to succeed. Another 37% of the workout plans (1.175 million) were loan modifications that lowered the interest rate, reduced the principal, or extended the maturity date of the loan.¹⁹

Subsequently, the proportion of HOPE NOW workouts consisting of loan modifications declined sharply. In December 2008, roughly half of all of HOPE NOW's workouts consisted of loan modifications. By November 2009, that percentage fell to 30%.²⁰ Meanwhile, the success rate of HOPE NOW workouts is unknown, because the program does not provide that type of data.

¹⁸ Paulson (2007a); Paulson (2007b).

¹⁹ Hope Now (2008), at 7.

²⁰ Hope Now (2009).

Streamlined Loan Modification Programs by the FDIC and the GSEs

In 2007 and 2008, Sheila Bair, Chairman of the Federal Deposit Insurance Corporation, took a different tack, calling for a systematic, streamlined approach to loan modifications that was better designed to handle the growing volume of distressed loans. The agency took the opportunity to put such a plan into effect after it inherited the servicing of over 38,000 seriously delinquent loans as conservator of the failed mortgage lender IndyMac in 2008. Unlike HOPE NOW, the FDIC was able to mandate participation in its program using its power as conservator.

Under the FDIC's "Mod in a Box" program, all borrowers who were 60 days delinquent or more on owner-occupied loans but not in bankruptcy were considered for loan modifications. The program's objective was to maximize net present value relative to foreclosure while reducing the borrower's front-end debt-to-income (DTI) ratio to 38%. The program sought to achieve this through a sequence of workout steps. First the program capitalized arrears. Then, the program sought to get the DTI ratio below 38% by first reducing the interest rate. If that was not enough, the term was extended, and if more was needed to hit the target, the principal could be reduced. The servicer received \$1000 for each modified loan. Between August 20, 2008 and February 1, 2009, 9,901 or about 26% of IndyMac's seriously delinquent loans were modified.²¹

In the latter part of 2008, the new Federal Housing Finance Agency introduced a similar streamlined loan modification program with slightly different triggers and targets for delinquent conforming loans guaranteed by the two government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac.²² Both streamlined loan programs had their limitations. The FDIC's program suffered from narrow coverage. The GSEs' program applied to more loans, but did not cover the private-label securitization market, which contained the bulk of subprime loans. Commentators queried why the programs were limited to serious delinquencies and did not take negative equity into account. They also asked whether the DTI targets were realistic or took sufficient account of the borrowers' other debts.²³ Despite these issues, the two streamlined programs would later form the template for the Obama Administration's loan modification initiatives.

Obama Administration

²¹ Kiff and Klyuev (2009), at 16-18.

²² Kiff and Klyuev (2009), at 16-18; Federal Housing Finance Agency (2010); Government Accountability Office (2010), at 18.

²³ See, e.g., Congressional Oversight Panel (2009); Kiff and Klyuev (2009), at 19. The FDIC later lowered its DTI ceiling to 31%. Government Accountability Office (2010), at 18.

Bankruptcy Cram-down Legislation

By the time the Obama Administration took office in January 2009, foreclosures were poised to surge while permanent loan modifications were sorely lagging. As one of its first actions, the new Administration sought legislation to increase the bargaining power of homeowners facing foreclosure. At the urging of the new Administration, in March 2009, the House of Representatives voted to allow federal bankruptcy judges to reduce the outstanding principal on first-lien, owner-occupied mortgages of bankrupt debtors. The banking industry lobbied heavily against a bankruptcy cram-down, however, and the Senate defeated the bill.²⁴ The failed bankruptcy cram-down campaign was the one major instance to date where the federal government sought to increase the cost to servicers of threatening foreclosure.

HAMP

Had the bankruptcy legislation passed, it would have given distressed homeowners a stick to prod servicers to make loan modifications to avoid a possible cram-down in bankruptcy court. With the legislation's defeat, the Obama Administration turned to subsidies to achieve its goals. Its major innovation was to revamp federal loan modification policies in two respects: to streamline loan modification protocols and to pay servicers to modify more loans.

The result was the "Making Home Affordable" program, which the Treasury Department unveiled in February 2009. The program's central plank was the Home Affordable Modification Program or HAMP. HAMP sought to alter the financial incentives of servicers by paying them to modify loans where the net present value of a loan modification would exceed that of going to foreclosure.

Initially, HAMP offered servicers \$1000 to modify a first mortgage that was at least 60 days delinquent and \$500 to modify a home loan at imminent risk of default. In addition, the program rewarded servicers with an added \$1000 per year for the first three years following a modification if the borrower did not redefault. The federal government financed the subsidies with \$36.9 billion in Troubled Asset Relief Program (TARP) funds.²⁵

HAMP built on the basic streamlined design of the FDIC's "Mod in a Box" program, albeit with more generous parameters. To qualify for HAMP, borrowers had to be owner-

²⁴ Bernard (2009).

²⁵ Government Accountability Office (2010), at 6. There were special incentives for modifying loans of borrowers who were current on their loans but at imminent risk of default. For these modifications, mortgage holders received \$1500 and servicers, \$500. Department of the Treasury (2009a); Department of the Treasury (2009b).

occupants and have a housing debt-to-income ratio of over 31%. They also had to be in default (defined as 60 days late or more on their loans) or at risk of imminent default.²⁶ At the outset, HAMP sought to lower borrowers' monthly payments to 31% of gross monthly income by three means: first by reducing interest rates, then by extending the loan term to up to forty years, and then, if necessary, by forbearing part of the principal. Any forbore principal would be due at the end of the loan term, but no interest would be charged on that amount.²⁷ Significantly, HAMP did not require servicers to permanently reduce principal in order to hit the 31% target. Nor did HAMP take high total debt-to-income ratios into account.²⁸

HAMP broke the loan modification process into two parts. Initially, qualifying borrowers received a trial modification. If they stayed current on their trial modifications for three months – and submitted full documentation of qualifying incomes and financial hardship – then they would receive permanent loan modifications.²⁹

Participation in HAMP was widespread. All servicers who serviced loans guaranteed by Fannie Mae or Freddie Mac were automatically eligible to participate in HAMP. A handful of servicers who received more than one bailout under the Troubled Asset Relief Program (TARP) had to participate in the program.³⁰ Later, as part of the Helping Families Save their Homes Act in May 2009, Congress extended HAMP to FHA loans.³¹ As of January 2010, 113 servicers, covering 89% of eligible mortgages, had signed on to HAMP.³²

Other Foreclosure Prevention Programs

Many borrowers were not suited for loan modifications under HAMP because they could not manage to make even the reduced monthly payments at the target 31% DTI ratio. For borrowers in that situation who were otherwise eligible for HAMP, Making Home Affordable proposed offering financial incentives to servicers to accept short sales and deeds in lieu of foreclosure rather than going to foreclosure. The program was not slated to take effect, however,

²⁶ The Government Accountability Office found that servicers have widely varying definitions of the term "risk of imminent default." As a result, a borrower may qualify for HAMP with one servicer, but not another. Government Accountability Office (2010), at 13-14; see also Office of the Special Inspector General for the Troubled Asset Relief Program (2010), at 26.

²⁷ Andrews (2009); Department of the Treasury (2009a); Department of the Treasury (2009b).

²⁸ Fitch Ratings (2009), at 7.

²⁹ Andrews (2009); Department of the Treasury (2009a); Department of the Treasury (2009b).

³⁰ Andrews (2009); Department of the Treasury (2009a); Department of the Treasury (2009b).

³¹ Department of Housing and Urban Development (2009).

³² Office of the Special Inspector General for the Troubled Asset Relief Program (2010), at 10.

until April 10, 2010.³³ Meanwhile, some individual financial institutions offered their own private loan modification programs.³⁴

The Pace of Foreclosure Mitigation to Date

Through 2008, the pace of loan workouts and modifications remained slow. With the introduction of HAMP, however, the aggregate numbers began to improve. We can see this in data showing that foreclosure starts flattened out during the first three quarters of 2009, even though serious delinquencies and loans in foreclosure continued to surge. (Figures 3 and 4). Still, as of this writing in spring 2010, temporary loan modifications account for most workouts under HAMP. The pace of conversions to permanent modifications has markedly improved in recent months but still has far to go.

2007-2008

During 2007 and 2008, when HOPE NOW was the main modification program, only a paltry percentage of mortgages at least 60 days past due received a workout of any kind. A Federal Reserve Bank of Boston study of those loans reported that only 3% experienced an interest rate reduction, a principal reduction, and/or an extension of the loan term in the first 12 months following the first serious delinquency. Only 8.5% received any kind of workout at all (including a principal increase, a short sale, or a deed-in-lieu of foreclosure).³⁵

These are aggregate numbers, however, and over the course of that two-year time span, the success rate improved. Servicers of non-conforming home mortgages agreed to more loan workouts with each successive quarter in 2007 and 2008. In fourth quarter 2008, there were 7 to 8 times more loan workouts than in first quarter 2007.³⁶ Over the period 2007-2008, the mix of workout techniques also changed. Workouts that reduced monthly payments became more prevalent and workouts that increased monthly payments declined.³⁷

These numbers masked the fact that the bulk of loan modifications in 2007 and 2008 actually *increased* borrowers' monthly payments instead of reducing them. In two path-breaking studies that brought this problem to light, law professor Alan White reported that over two-thirds

³³ HAMP Update (2009); Department of the Treasury (2009a); Department of the Treasury (2009b).

³⁴ Government Accountability Office (2010), at 18.

³⁵ Adelino et al. (2009), at 13-18 & tbl. 5.

³⁶ Adelino et al. (2009), at 11-12 & tbl. 3.

³⁷ Fitch Ratings (2009b), at 10.

of loan workouts studied increased the borrowers' principal by adding in overdue interest and fees. The average principal increase was a whopping \$10,800.³⁸

The Boston Fed study 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%).³⁹ (Figure 5).

The implications of these findings were profound. The wide prevalence of capitalization plans at year-end 2008 indicated that servicers were kicking the proverbial can down the road by temporarily delaying foreclosures, not preventing them. Increasing monthly payments for cash-strapped borrowers usually was a recipe for failure, in view of the long average stint of unemployment during this recession, coupled with negative equity. More would be needed to induce servicers to lower monthly payments.

2009 and HAMP

HAMP sought to alter servicers' fee calculus by handing them cash for making loan modifications. While this intention was worthy, HAMP's progress remains modest. HAMP had some success in discouraging capitalizations and encouraging interest rate reductions. HAMP had great success in boosting the number of trial loan modifications. The number of HAMP borrowers who moved into permanent modifications, however, has been disappointingly low, although the numbers have started to improve.

By 2009, for approved workouts, interest rate reductions surpassed capitalizations that increased principal. By the third quarter of 2009, for example, fully 81.1% of workouts by national banks and thrifts involved reducing interest rates. Principal reductions increased slightly, while term extensions held steady.⁴⁰ Fitch Ratings found similar trends for private-label securitized mortgages.⁴¹ Thus, HAMP may have spurred the trend toward more loan modifications with lower payments.

HAMP also produced large numbers of trial loan modifications. From HAMP's inception through year-end 2009, over 1.1 million borrowers were offered trial loan

³⁸ White (2009a), at 1114; White (2009b).

³⁹ Adelino et al. (2009), at 11-12 & tbl. 3. According to the authors, Ocwen Loan Servicing, LLC and Litton Loan Servicing LP were the only servicers who granted principal reductions in nontrivial amounts. *Id.* at 12 n.17. See also Mason (2009), at 32.

⁴⁰ Adelino et al. (2009), at 11-12 & tbl. 3; OCC and OTS (2009), at 23, 28.

⁴¹ Fitch Ratings (2009b), at 10.

modifications. But of the 900,000-some borrowers who accepted trial modifications, only 66,465 – less than 8% -- graduated into permanent modifications. Servicer performance was all over the lot: CitiMortgage had modified 47% of its eligible seriously delinquent loans as of December 31, 2009, while Wachovia had only modified 3%.⁴² The low rate of permanent modifications made Fitch Ratings conclude: “[T]he conversion from trial mod under HAMP to actual finalized modification status has been disappointing.”⁴³

Reportedly, several issues stymied permanent modifications. Some borrowers failed to complete their paperwork; other times, servicers lost their files. Other borrowers who did complete their paperwork were ineligible for HAMP based on their verified income. The government also paid servicers to do trial modifications, leading some to ask whether servicers had adequate financial incentives to carry through with permanent modification plans. Some accused servicers of deliberately approving trial modifications, collecting incentive payments, and proceeding to foreclosure to maximize their fees.⁴⁴

In November 2009, the Obama Administration turned up the heat, pressing servicers to grant more permanent modifications. In an effort to raise the costs of not making permanent modifications, the Treasury Department even threatened to shame servicers who dragged their feet and subject them to fines and other sanctions. In addition, the government announced it would withhold incentive payments until modifications became permanent. The following month, the number of permanent loan modifications more than doubled.⁴⁵ In January 2010, the government streamlined borrowers’ documentation requirements to make it easier to convert temporary modifications to permanent ones.⁴⁶

These measures, taken together, helped increase the permanent modification rate in just a few months. From HAMP’s inception through February 2010, 170,207 (15.5%) of all trial modifications resulted in permanent modifications. Another 91,843 permanent modifications

⁴² Department of the Treasury (2010d), at 3-5. See also OCC and OTS (2009), at 43-44 (among servicers that were national banks or thrifts, only 4.1% of seriously delinquent borrowers and borrowers in foreclosure received new loan modifications).

⁴³ Fitch Ratings (2009), at 2.

⁴⁴ Federal Housing Finance Agency (2010), at 13-14; Goodman (2009).

⁴⁵ Department of the Treasury (2010d), at 3; Goodman (2009). At the end of December 2009, servicers had approved another 46,056 permanent loan modifications and were awaiting acceptance by borrowers. For borrowers who received and accepted permanent loan modifications under HAMP, the median monthly payment dropped by over \$500. Their median housing debt-to-income ratio dropped from 45% to 31% and their total debt-to-income ratio dropped from 72.2% to 55.1%. Department of the Treasury (2010d), at 3-4.

⁴⁶ Department of the Treasury (2010a).

were approved and awaiting acceptance in February 2010. Assuming all of those pending modifications were accepted by the borrowers, that would raise the graduation rate to 24%.⁴⁷

Still, the federal government remained dissatisfied. In March 2010, it took even more aggressive steps to boost permanent loan modifications. One provision was designed to give breathing room to out-of-work borrowers. For the first time under HAMP, unemployed borrowers who qualified for HAMP could have their mortgage payments cut to 31% of gross income for three to six months while they looked for work.⁴⁸

In a sister provision, the Administration offered first-time carrots to servicers to approve principal write-downs and extinguish junior liens.⁴⁹ Going forward, for any underwater borrower owing more than 115% of the current value of his or her home, HAMP servicers had to calculate the borrower's net present value using both the standard approach, plus an alternative approach containing incentives for writing down principal. 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 induce 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).⁵⁰

Another part of the March 2010 announcement was designed to assist relocation for delinquent borrowers who failed to qualify for loan modifications. To encourage more short sales, the government hiked subsidies to junior lien holders to release their liens to 6% of the outstanding loan balance. In addition, incentive payments to servicers to perform more short sales rose from \$1000 to \$1500. The government also planned to double relocation payments to borrowers who successfully completed short sales or deed-in-lieu transactions, up to \$3000.⁵¹

Finally, the March 2010 initiative rolled out more measures to lower administrative barriers to HAMP modifications. The Treasury Department prohibited servicers participating in HAMP from pursuing foreclosure during loan modification negotiations and trial modification periods. Servicers also had to start considering borrowers in bankruptcy for HAMP relief upon request.

⁴⁷ Department of the Treasury (2010c).

⁴⁸ 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 have a monthly mortgage payment exceeding 31% of his or her income. 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 (2010e).

⁴⁹ Department of the Treasury (2010e).

⁵⁰ 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 forbore amount in three equal steps over three years, so long as the homeowner remained current on the payments. Department of the Treasury (2010e).

⁵¹ Department of the Treasury (2010e).

HAMP was extended to homeowners with FHA loans. No foreclosure sale could go forward without written certification that the borrower was ineligible for HAMP. Finally, the government raised the incentive payments to servicers for making permanent loan modifications.⁵²

Possible Obstacles to Optimal Levels of Loan Modifications

Although HAMP increased loan modifications with lower payments, the level of permanent loan modifications remains lower than hoped for. Meanwhile, principal reductions, while growing, remain rare. This section asks, what are possible frictions that might impede principal write-downs and permanent loan modifications?

Servicer Compensation

One of the underlying assumptions behind HAMP was that compensation structures make servicers resistant to loan modifications. When servicers reject modifications that would improve the net present value of loans relative to foreclosure, this presents a classic agency problem vis-à-vis the investors who own those loans. HAMP aims to correct this incentive structure and the resulting agency problem by subsidizing servicers to approve more loan modifications.

HAMP's diagnosis is at least partially correct, even if its solution falls short. In private-label RMBS, servicers have four main sources of revenue: fixed servicing fees, float, default fees, and income from residual interests in the loan pool. This compensation structure has many moving parts and creates incentives pointing in different directions. In the main, however, this structure tilts servicers of private-label RMBS away from principal and interest reductions toward foreclosures and capitalization of arrears.

Fixed Servicing Fees

The single biggest component of servicer compensation is the fixed monthly servicing fee. This fee is computed as a percentage of the outstanding principal balance of the loan pool. Typically, annual fees are 25 basis points (bps) for prime fixed-rate loans, 37.5 bps for prime ARMs, and 50 bps or more for subprime loans. The servicer takes this fee off the top of borrowers' monthly payments before remitting principal and income to the trustee to pass on to investors.⁵³

⁵² Department of the Treasury (2010e).

⁵³ Cordell et al. (2008), at 15.

This fixed-fee structure can cut in favor either of a loan workout or foreclosure. A workout that keeps a loan on the books allows the servicer to continue to collect the servicing fee on the loan. At the same time, the fixed-fee structure favors workouts that raise monthly payments over modifications that lower them. Capitalizing arrears and default fees are more attractive because they pump up the unpaid balance of the loan pool and thus the servicing fee. Principal write-downs are less attractive because they lower the unpaid balance of the loan pool.⁵⁴

In other respects, the fixed-fee structure militates in favor of foreclosure. In private-label securitizations, investors do not pay servicers additional fees for completed loan workouts. Instead, servicers must pay the high cost of overhead and labor for loss mitigation out of their fixed monthly servicing fees. The higher those costs, the more reluctant a servicer will be to pursue loss mitigation in lieu of foreclosure.⁵⁵

HAMP seeks to alter this compensation structure by paying servicers for each completed loan modification. Similarly, Fannie Mae and Freddie Mac pay servicers bonuses for executing workouts. But the GSEs pay significantly more for short sales than for loan modifications, which skews incentives away from modifications for conforming loans.⁵⁶

Bottom-line, the fixed-fee structure can promote workouts, but only those of a certain kind. This structure makes servicers averse to principal write-downs. Conversely, it causes servicers to favor capitalizations, while making them indifferent to interest rate reductions.

Float

Servicers also collect “float,” consisting of the interest earned on mortgage payments that are held in escrow. Servicers collect this interest between the date when borrowers send in their payments at the beginning of the month and the 25th of the month, when the payments are usually passed through to investors.⁵⁷ Float has little effect on incentives to do loan modifications.

Default Fees

Servicers charge borrowers default fees, such as late fees and default management fees, for late loan payments. Under pooling and servicing agreements (PSAs) for securitized trusts,

⁵⁴ Thompson (2009), at vi, 19-20.

⁵⁵ Cordell et al. (2008), at 23.

⁵⁶ Cordell et al. (2008), at 17, 20-22.

⁵⁷ Tanta (2007).

servicers get to keep all or part of these default fees and can collect them out of the proceeds from foreclosure.

The ability to assess default fees creates incentives toward foreclosure and capitalizing arrears. Default fees are highly lucrative and servicers want to collect them as soon as possible. In a loan workout, the way to do that is to condition an agreement on immediate upfront payment or to capitalize arrears, either of which will increase the borrower's payments. But if the default fees continue to mount, at some point a workout will become impractical. At that point, servicers will generally initiate foreclosure to collect the default fees.⁵⁸

Income from Residual Interests

Some servicers of private-label RMBS own the residual tranche of the loan pool, also known as the "B piece." Usually, the B piece only pays excess interest. In other words, the B tranche only pays out if the interest payments by the borrowers exceed the monthly interest payments due to the senior tranche holders. As the junior tranche, the B piece holds the first-loss position, meaning that it is the first to absorb losses from a delinquent loan.

Servicers who hold the B piece may favor loan workouts over foreclosure to avoid losses to the residual tranche. At the same time, they are likely to resist interest rate reductions that would eat into their excess interest payments.⁵⁹

To summarize, servicers' compensation structure is consistent with patterns seen in HAMP. Most aspects of servicer compensation make servicers favor foreclosure over loss mitigation. To the extent that servicers do loan modifications, the fixed monthly servicing fee helps explain why servicers prefer interest rate reductions over principal reductions. Furthermore, servicers who own the B piece may resist interest rate reductions as well.

The Cost Structure Of Servicers

The cost structure of servicers also helps explain the low levels of permanent loan modifications seen to date. Under the standard PSA, servicers do not get added compensation for the higher costs associated with loss mitigation. This makes foreclosure relatively more

⁵⁸ Tanta (2007); Thompson (2009), at 17. This component of compensation is also subject to abuse. Disreputable servicers have incentives to manufacture late fees by not posting on-time payments until after the due date or delaying initiating collection until late fees can be assessed. Servicers may also seize the opportunity to assess junk fees at exorbitant rates for out-of-pocket expenses that are non-existent or trivial in amount. Thompson (2009), at 17.

⁵⁹ Thompson (2009), at 3-4, 7-8, 20.

attractive. Similarly, servicers' contractual obligation to advance interest and sometimes principal payments on delinquent loans tilts them toward foreclosure.

Expenses Associated With Loss Mitigation

From a servicer's perspective, loss mitigation is expensive when compared to foreclosure. Workouts require personal dealings with individual borrowers, each of whom is in a unique situation. Similarly, servicers who pursue loss mitigation still incur many of the costs associated with foreclosure because they typically pursue foreclosure simultaneously while loss mitigation is underway. This two-track process is encouraged by the credit rating agencies, which condition servicers' ratings on not delaying foreclosure on distressed loans.⁶⁰ The March 2010 revisions to HAMP grappled with this issue by prohibiting foreclosure proceedings against HAMP-eligible borrowers during loan modification negotiations.

The monthly servicing fee structure fails to reward servicers for the higher costs associated with loss mitigation. That is because the servicing fee remains fixed even if overhead and labor costs go up. Further, under PSAs, servicers cannot recoup overhead or labor costs at payoff or foreclosure.⁶¹ For this reason, servicers have little incentive to incur added overhead or labor costs with no prospect of added compensation. Since overhead and labor are usually substantially higher for workouts than for foreclosures, this tilts servicers in favor of foreclosure. Servicers who are under financial stress – as many are these days -- will invest even less in a fully staffed loss mitigation operation in order to cut costs.

The practical effect is a noticeable underinvestment in loss mitigation activities. Most servicers lacked the staff or expertise to handle the flood of loan workout requests during the financial crisis. Borrowers and housing counselors reported persistent difficulties in getting servicers to answer phone calls and stories about servicers who lost documents submitted by borrowers abound.⁶² Too few servicers automated their systems to streamline loan modifications.⁶³ In sum, the fixed-fee structure of servicers, combined with the high cost of loss mitigation, resulted in a business model that was not prepared to accommodate an unprecedented level of delinquent loans and workout requests.

⁶⁰ Cordell et al. (2008), at 15; Thompson (2009), at 15.

⁶¹ At payoff or foreclosure, a servicer can recover all principal and interest payments advanced and out-of-pocket costs such as legal fees, title searches, and appraisals, that are associated with foreclosure or loan workouts. In contrast, PSAs do not pay servicers for overhead and labor, except out of the fixed monthly servicing fee. Kiff and Klyuev (2009), at 11.

⁶² Cordell et al. (2008), at 9.

⁶³ Cordell et al. (2008), at 23.

HAMP tackles this problem by paying servicers bonuses for loan modifications that are approved. This likely explains the seemingly impressive shift in HAMP away from capitalizing arrears toward interest rate reductions. The question is whether this shift is as significant as it seems, in view of the fact that most modifications where it appeared were temporary, not permanent, in nature.

Until recently, HAMP's main effect was to subsidize temporary loan modifications without much permanent relief. In part, this may have been due to unrealistic loan documentation requirements, which have now been changed. More likely, servicers found temporary modifications cheaper to process because HAMP did not require them to re-underwrite the file until the permanent modification stage. Accounting considerations likely also played a role, as I later discuss. Recent changes to HAMP by the Treasury Department have started resulting in more permanent loan modifications, but more needs to be done.

The Cost of Advancing Payments

The cost of advancing delinquent payments and financing those advances is another major factor in servicers' cost calculus. Under the typical private-label PSA, servicers must advance interest payments (and sometimes principal) for delinquent loans to investors for the time period specified in the PSA. Some PSAs require advances until a loan becomes 90 days delinquent; others require advances until the home is liquidated after foreclosure. In addition to making advances, servicers must pay property taxes and insurance on all delinquent loans until the loans are paid off or the properties are sold.

The advance payment requirement often inclines servicers toward foreclosure. That is because servicers can recoup all advance payments from the sale proceeds of foreclosure, which encourages them to make haste. While servicers can also recover their advances in loan modifications, unlike foreclosure, the speed of recovery in loan modifications is uncertain and often slow. To the extent that servicers agree to loan modifications, they are likely to condition those modifications on quick repayment of all advances.⁶⁴ That may boost the borrower's monthly payments, at least temporarily.

The advance payment requirement entails another major cost consideration. Servicers must finance the advances that they pay and this debt service can be substantial. Moreover,

⁶⁴ Tanta (2007); Thompson (2009), at 23-26.

unlike advances themselves, servicers cannot recover the cost of financing those advances from the proceeds of foreclosure. Consequently, servicers have an interest in terminating advance payments as quickly as possible. In states where the foreclosure process is fast (generally non-judicial foreclosure states), this will cut in favor of foreclosure. In states where foreclosure proceedings are slow (judicial foreclosure states), servicers are more likely to pursue quick workouts to restore the loan to current status and stop making advances. Unless those workouts reduce the interest rate or principal, however, they are not likely to succeed over the long haul.⁶⁵

Accounting Treatment

The choice of workout techniques also has consequences for the accounting treatment of loans and the need to take write-downs. Current accounting rules make servicers resistant to principal and interest reductions. These rules also make servicers more amenable to temporary modifications than permanent ones.

FAS 15 is the central consideration in this regard. Under that provision, permanent modifications of principal or interest require immediate write-downs. To the extent the servicer owns the residual tranche, it will likely absorb all or part of that loss. In contrast, temporary modifications do not trigger the need for write-downs. Thus, FAS 15 encourages temporary loan modifications over permanent ones and short-term payment plans with dubious success rates over modifications that permanently reduce principal or interest.⁶⁶

FAS 15 is another likely reason why temporary modifications have risen sharply under HAMP while permanent modifications have lagged. That is because permanent modifications condition the acceptance of HAMP payments on a stiff added cost, in the form of write-downs.

⁶⁵ Thompson (2009), at 26. Piskorski et al. (2009) found that servicers of delinquent securitized loans proceeded to foreclosure more often in states with fast foreclosure tracks than in states with slow foreclosure procedures, relative to servicers of delinquent loans held in portfolio. *Id.* at 16-17.

⁶⁶ Thompson (2009), at 12-14, 22. A short-term payment plan suspends terms or full monthly payment requirements for a brief period to allow the borrower to make up missed payments. After the period expires, the payment schedule reverts to the original terms of the mortgage.

In addition, permanent concessions to allay a borrower's financial difficulties must be treated as troubled debt restructurings under FAS 15 in order to preserve the bankruptcy-remote status of a securitized trust. Among other things, troubled debt restructurings require establishing loan loss reserves under FAS 114.

In 2007, the Securities and Exchange Commission laid to rest another question surrounding the accounting treatment of modified loans. Under FAS 140, a securitized pool limited to assets that are "passive in nature" receives two benefits. The loan pool is protected from claims by creditor against the underwriter or sponsor of the loan pool. In addition, the transferor of the assets does not need to hold capital against those loans. Previously, there had been concern that modifying loans before they became delinquent would disqualify a loan pool from favorable treatment under FAS 140. In a letter dated July 24, 2007, however, then Securities and Exchange Commission Chairman Christopher Cox wrote Congressman Barney Frank, the Chairman of the House Banking Committee, assuring him that modifications before delinquency would comply with FAS 140 so long as default was "reasonably foreseeable." *Rappeport* (2007).

Servicers that are subject to minimum capital requirements can be expected to shun those write-downs vigorously in order to preserve capital.

Junior Mortgages

Another major sticking point may consist of the presence of junior mortgages. Modifications of first-lien loans become significantly harder to negotiate when there are junior liens on the home. Under existing legal rules, if a first mortgage undergoes significant modification, it risks losing its senior status and turning the junior lien holder into the senior lien holder.⁶⁷ For this reason, first lien holders generally require junior lien holders to sign an agreement to continue to subordinate their claims before agreeing to modify a first mortgage. Often this is impossible because the junior lien holders cannot be found. Even when they can be located, junior lien holders are often reluctant to agree or demand several thousand dollars in payments in order to re-subordinate their claims.⁶⁸

This hurdle is a high one. The Treasury Department has estimated that up to half of all distressed mortgages are backed by junior liens.⁶⁹ About one-third of subprime 2/28 hybrid ARMs originated in 2005 and 2006 were accompanied by piggyback junior mortgages. Other subprime loans are encumbered with junior home equity lines of credit.⁷⁰

Currently, HAMP offers a second lien modification program, but servicers do not have to participate in it and uptake has been extremely slow to date. As of March 2010, only three servicers had signed agreements to participate in the second lien program.⁷¹ The March 2010 revisions to HAMP seek to encourage higher participation by increasing the subsidies to release junior liens. Whether those subsidies – pegged at 6 cents on the dollar – will be enough remains to be seen.

Contractual Limitations in PSAs for Private-Label Securitizations

In addition to possible hurdles posed by revenue, cost, accounting, and lien status considerations, there has been much discussion of the role that PSAs may play in limiting

⁶⁷ Randolph (2010). A first lienholder may forfeit senior status for increasing the interest rate but not for decreasing it. Increasing the principal balance will also often lead to forfeiture. Extending or shortening the payment schedule will usually not jeopardize senior status. *Id.*

⁶⁸ Cordell et al. (2008), at 26-27.

⁶⁹ Office of the Special Inspector General for the Troubled Asset Relief Program (2010), at 16.

⁷⁰ Cordell et al. (2008), at 25.

⁷¹ Office of the Special Inspector General for the Troubled Asset Relief Program (2010), at 16.

servicers' discretion to modify loans. When a non-conforming loan is securitized, the servicer's ability to negotiate a workout is subject to the constraints in the PSA for the loan pool. The majority of PSAs permit material loan modifications to some degree in the event of default, imminent default, or reasonably foreseeable default.⁷²

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.⁷³ This language may be another reason why temporary loan modifications have predominated HAMP's outcomes to date.

While PSAs are usually stricter about permanent loan modifications, they vary widely from deal to deal.⁷⁴ A small percentage of PSAs – roughly 10% -- prohibit any material loan modifications.⁷⁵ The remaining PSAs do permit material loan modifications, but only when they are in the best interest of investors.⁷⁶ 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 often contain one or more 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.⁷⁷

For the 90% or so of private-label securitizations that allow loan modifications to some degree, it is unclear whether limits on those modifications have become binding. The Boston Fed study expressed doubts on this score after finding minor differences at most in the rates of loan modifications for non-conforming loans held by securitized trusts versus those held in portfolio.⁷⁸ Similarly, a Berkeley survey of PSAs concluded that "large-scale modification programs may be undertaken without violating the plain terms of PSAs in most cases."⁷⁹ Even for securitizations that prohibit loan modifications outright or cap them at 5%, some of those

⁷²Credit Suisse (2007), at 6; Hunt (2009), at 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.

⁷³Credit Suisse (2007), at 6; Hunt (2009), at 7.

⁷⁴ See generally Eggert (2007).

⁷⁵ Credit Suisse (2007); Hunt (2009), at 6.

⁷⁶ Hunt (2009), at 7-9. In general, any change in the principal balance, the interest rate, or the final maturity will constitute a "material" modification. Hunt (2009), at 7.

⁷⁷ Credit Suisse (2007), at 6-7, 20; Kiff and Klyuev (2009), at 11.

⁷⁸ Adelino et al. (2009), at 13-18 & tbl. 5. See also Thompson (2009), at 6.

⁷⁹ Hunt (2009), at 10.

PSAs have been amended to allow more modifications.⁸⁰ In addition, credit rating agencies no longer count modified loans that are current 12 months after modification against the 5% cap where one exists.⁸¹ Taken together, these findings raise questions whether the limitations in PSAs explain the low level of permanent loan modifications, at least for the 90% of securitized trusts that allow modifications.

Calculating Net Present Value

Before a servicer may modify a loan held by a private-label securitized trust, it must first determine that modification will maximize the net present value of the loan, relative to foreclosure. PSAs normally require servicers to maximize the recovery for the benefit of the investors in the trust as a whole. Servicers implement this requirement by choosing the higher net present value (NPV), as between a loan workout and a foreclosure.

Although the NPV requirement sounds formulaic, PSAs give servicers of private-label RMBS a high degree of latitude in how to calculate net present value. This discretion allows the servicer to pick the likely sales price from a foreclosure, the discount rate to apply to the reduced revenue stream from a loan modification, and the likelihood that the borrower will redefault. Investors rarely monitor these choices or question them.⁸² As a result, for many distressed loans, servicers can produce a NPV calculation to support either a loan modification or foreclosure.

There are three key factors in servicers' NPV determinations. First, servicers are concerned about the risk that a modified loan may quickly redefault. Second, some distressed loans self-cure. Finally, servicers worry about moral hazard, i.e., the concern that loan modifications will encourage other borrowers who are current to default on their loans as well.

Redefault Rates

The likelihood that a borrower will redefault on a loan following a workout will directly affect the net present value calculus. As redefault becomes more likely, servicers will prefer to initiate foreclosure immediately instead of delaying the inevitable. This has the enticing effect as well of accelerating the servicer's final payout. Housing price movements will also affect the

⁸⁰ 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 (2009), at 11.

⁸¹ Thompson (2009), at 6-7.

⁸² Cordell et al. (2008), at 18; Thompson (2009), at 6-9. See also Kiff and Klyuev (2009), at 8 n.10 (discussing market forces affecting choice of discount rates). For GSE loan pools, this discretion is more limited. Fannie Mae and Freddie Mac require servicers to use standardized software to calculate NPV. Cordell et al. (2008), at 18; Credit Suisse (2007), at 6-7, 20.

attractiveness of immediately going to foreclosure. In the recent climate of falling home prices, any delay in an inevitable foreclosure would depress the ultimate sales price at the sheriff's sale. All of these dynamics discourage loan workouts.⁸³

Concerns about redefault are not hypothetical. Studies consistently show that redefault rates for many recent loan workouts have been relatively high. The Boston Fed reported, for example, that the redefault rate⁸⁴ for loan workouts of all stripes was 40% to 50% during the first 6 months following workout.⁸⁵ Similarly, OCC and OTS reported that 42.7% of loans modified in the first 3 months of 2009 were at least 60 days delinquent 6 months later.⁸⁶

That said, the right workout technique can substantially lower the risk of redefault. As discussed, many loan workouts during the crisis involved capitalizing arrears, which had the effect of increasing borrowers' monthly mortgage payments. For borrowers with cash-flow problems – especially problems that were indefinite or permanent in nature – such workouts were doomed to failure.

In contrast, evidence consistently shows that loan modifications that lower monthly payments, either by reducing interest, reducing principal, or extending the maturity date, have substantially lower redefault rates. The Boston Fed reported that redefault rates for those types of modifications dropped to 20% to 40%.⁸⁷ The OCC and OTS reported similarly improved rates for modifications that decreased payments in 2008-2009; in contrast, the 6-month redefault rate for workouts increasing payments over that period was 53.6%. The agencies further found that the bigger the decrease in payments, the lower the redefault rate.⁸⁸ Researchers at the University of North Carolina found that lowering monthly payments reduced the likelihood of redefault by 10% to 18%, compared to workouts that raised them. Principal write-downs had the lowest default rate of all, probably because they lowered monthly payments while reducing or eliminating negative equity.⁸⁹

⁸³ Adelino et al. (2009), at 21.

⁸⁴ Defined as loans that were 60 days delinquent, 90 days delinquent, in foreclosure, or in real estate owned within 6 months after modification.

⁸⁵ Adelino et al. (2009), at 19 & tbl. 8. See also Cordell et al. (2008), at 23.

⁸⁶ OCC and OTS (2009), at 30. See also Fitch Ratings (2009b), at 9-10.

⁸⁷ Adelino et al. (2009), at 19 & tbl. 8; Quercia and Ding (2009), at 175-177, 184-190. See also Mason (2009), at 35 (interest rate modifications lower 9-month redefault rates more than 10% compared to capitalizing arrears or principal modifications).

⁸⁸ OCC and OTS (2009), at 36-37. See also Fitch Ratings (2009b), at 10-12.

⁸⁹ Quercia and Ding (2009), at 188-190.

Cure Rates

The cure rate also affects the net present value calculation. This is the rate at which seriously delinquent borrowers resume payments on their own. Cure rates can retard loan workouts by giving servicers hope that borrowers will repay with no further intervention, either by making up their arrears or paying off their loans in full. In many instances of cure, the servicer's recovery is higher than it would be from lowering the monthly payment by modifying the loan.

Up through 2006, the cure rates on distressed mortgages were substantial. From 2000 through 2006, prime loans had an average cure rate of 45%; for subprime loans, the average cure rate was 19.4%. During the financial crisis, however, cure rates took a nosedive. By 2009, cure rates had plummeted to 6.6% for prime loans and 5.3% for subprime loans.⁹⁰ The tight market for refinance loans and the rising tide of underwater mortgages helped explain this decline. The sharp fall in cure rates may be another reason why servicers have been more amenable to modifications and other types of workouts, at least of the temporary type.

Moral Hazard and Strategic Default

Finally, servicers, lenders, and investors have understandable fears that loan modifications will induce other borrowers who have the wherewithal to pay their mortgages to strategically default (or threaten to default) to negotiate lower loan payments. Strategic defaults have become a special concern now that so many borrowers have underwater mortgages.

Fears of strategic default make servicers especially reluctant to reduce principal. To the extent servicers write down principal, they often 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 punitive effect is designed to discourage strategic defaults.⁹¹

Tranche Warfare

In the debate about the low incidence of permanent modifications, commentators have also pointed to the role of potential fear of litigation from modifying loans. This colloquy stems from the fact that a servicer's decision to choose loan modification over foreclosure affects different tranches differently. Modifications that return loans to performing status benefit the junior tranche

⁹⁰ Fitch Ratings (2009a).

⁹¹ Thompson (2009), at 9.

by helping it avoid sustaining losses from foreclosure. At the same time, modifications that cut the monthly payments hurt the senior tranches by reducing their revenue stream. Instead, senior tranche holders may prefer foreclosure because the junior tranche will absorb the loss first while the senior tranche holders will often receive their principal back in full.⁹²

These dynamics have fueled speculation that servicers avoid loan modifications to limit the risk of “tranche warfare,” i.e., lawsuits against them by tranche holders.⁹³ There is scant evidence that tranche warfare is a real impediment to loan modifications. No investors have sued servicers to date for agreeing to loan modifications. In part that is because a sufficient number of investors must consent before suit can be filed.⁹⁴ Meanwhile, servicers report that investors rarely question workouts, examine NPV calculations, or even threaten to bring a lawsuit.⁹⁵

In 2008 and 2009, Congress alleviated any concern that tranche warfare might affect servicers’ psychology by enacting a safe harbor for servicers from investor suits for modifications that comport with standard industry practice or government modification programs.⁹⁶ These statutory provisions did not raise the level of loan modifications in any obvious way, however, suggesting that tranche warfare is not the reason for low levels of loan modifications.

Tax Considerations

To the extent that tax considerations might have played a role in loan modification determinations in the past, those considerations have been allayed. Virtually all securitized trusts are structured as pass-through entities under the Real Estate Mortgage Investment Conduit or REMIC provisions of the Internal Revenue Code to avoid double federal income tax liability. At one time, it was thought that the REMIC tax rules penalized loan modifications.⁹⁷ This concern arose from the fact that REMICs must be limited to static loan pools to keep their tax-favored status. It was feared that loan modifications would destroy the static nature of the loan pool. On

⁹² Kiff and Klyuev (2009), at 11-12.

⁹³ Eggert (2007).

⁹⁴ Thompson (2008), at 8.

The PSAs for certain Countrywide securitizations contained a unique clause allowing Countrywide to modify up to 5% of the loan pool in dollar terms only if Countrywide bought back the modified loans from the loan pool. Hunt (2009), at 9-10. In *Greenwich Financial Services Distressed Mortgage Fund 3, L.L.C. v. Countrywide Financial Corporation*, No. 650474/2008 (N.Y. Sup. Ct., N.Y. Ct., filed 2008), an investor in a securitized Countrywide trust sued Countrywide to force it to buy back any loans that it modified under a settlement agreement with state attorneys general. Despite surface appearances, the *Greenwich* suit is not an actual case of tranche warfare because Greenwich concurred that Countrywide had the latitude to modify the loans. Instead, Greenwich simply demanded that Countrywide buy back the loans it modified pursuant to its agreement. Thompson (2009), at 42 n.48.

⁹⁵ Cordell et al. (2008), at 23.

⁹⁶ HOPE for Homeowners Act of 2008, Pub. L. No. 110-289, div. A, tit. IV, § 1403 (July 30, 2008); Pub. L. No. 111-22, div. A, tit. II, § 201(b) (May 20, 2009) (codified at 15 U.S.C. § 1639a).

⁹⁷ See, e.g., Thompson (2009), at 9-10. See generally Barr and Feldman (2008).

May 16, 2008, however, the Internal Revenue Service laid this concern to rest by ruling that loan modifications for owner-occupied homes will not endanger REMIC status so long as the loan is in default or the servicer reasonably believes there is a significant risk of default. In addition, any modification must follow a standard protocol.⁹⁸ Due to this IRS ruling, tax considerations no longer pose a significant obstacle to modifications of distressed home loans.

Lessons Learned

At this point, federal foreclosure prevention programs of one sort or another have been underway for nearly three years. In this section, I discuss the lessons to be learned.

The Importance Of Aggressive Early Intervention

During the crisis, the federal government's foreclosure prevention efforts got off to a painfully slow start. Only later did those efforts become more aggressive, particularly under the Obama Administration.

The federal government's early lukewarm response was a serious mistake. Aggressive loss mitigation from the outset of the crisis might have slowed the spread of the nation's housing woes, which instead triggered the deepest recession since the Great Depression. By stopping unnecessary foreclosures early on, home values would have stabilized more quickly, helping to halt the negative feedback loop and the widespread loss of jobs. In addition, large-scale loss mitigation would have been easier before so many people became unemployed.

Programs to Refinance Distressed Loans Failed

Despite a substantial investment of time and money, both federal programs to help delinquent borrowers refinance into FHA loans were an abysmal failure. There were two main reasons why both of them foundered. First, servicers' participation in the programs was voluntary in nature. Second, and related to the first, the federal government insisted that participating servicers and investors take sizeable principal write-downs as the condition of making FHA refinance loans.

The government had ample justification for not paying more to pay off loans than the underlying collateral was worth. Doing so would have saddled the government with unwanted

⁹⁸ Internal Revenue Service (2008). See also Internal Revenue Service (2007).

losses while rewarding lenders and investors for making loans in inflated amounts. Nonetheless, servicers and investors proved adamantly opposed to taking the required write-downs.

Given the mortgage industry's implacable resistance to reducing principal, any government attempt to revive a refinancing program will have to grapple with hard choices.⁹⁹ For a voluntary program to work, the government would probably have to reduce any principal write-down to a trivial level or eliminate it outright. Alternatively, the government could compel servicers to sell loans to the government at a mandatory haircut and then refinance some or all of those loans into new FHA loans. That type of compulsion seems highly unlikely in the current political climate.

Loan Modification Programs Show More Promise, But Face Significant Hurdles

The Right Model for Loan Modifications

From 2007 to the present, the government's approach to loan modification programs evolved. Initially, the government limited its involvement to coordinating and facilitating loss mitigation efforts by private industry. After that effort failed to gain traction, the Obama Administration augmented that approach with subsidies designed to change servicer incentives. To a lesser extent, the Administration pursued isolated strategies to increase servicers' cost of automatic foreclosure.

Model 1: Government Coordination And Facilitation

Ultimately, the HOPE NOW model, in which the government limited its intervention to moral suasion and coordination of private industry, failed to produce sustainable loan modifications in any significant amount. Coordination alone was not enough to alter the incentives faced by servicers. Nor was it enough to streamline workouts to handle such large volumes of distressed loans. Although HOPE NOW marginally increased workouts, most of those workouts had a high risk of redefault because they increased mortgage payments for borrowers who could not even manage their existing monthly payments.

Nevertheless, the tremendous coordination efforts undertaken by HOPE NOW had a positive effect on the borrower end, by improving the response rates of distressed borrowers. Servicers for private-label securitized mortgages have long complained that reaching distressed

⁹⁹ In March 2010, for example, the Obama Administration announced a new set of liberalized FHA refinance rules for borrowers with underwater loans. Department of the Treasury (2010b).

borrowers can be difficult or impossible. Although its magnitude is unclear, the problem is very real. Some borrowers understandably hide their heads in the sand in the hopes of delaying foreclosure. Others have given up or don't trust their servicers.¹⁰⁰

Outreach activities by HOPE NOW and other groups including NeighborWorks America helped tackle this problem by putting homeowners in touch with housing counselors. Still, more could be done in this regard. Servicers for private-label RMBS usually do not hire "door knocker" firms, probably due to doubts that investors would reimburse them for the fees incurred.¹⁰¹ In contrast, Fannie Mae and Freddie Mac have begun hiring these services, which drive to delinquent borrowers' homes and knock on the door. Door knockers have had substantially more success in reaching borrowers to broach loan workouts, with rates as high as 90%.

Coordination could also help alleviate the frictions posed by junior mortgages. Many first-lien servicers cannot even locate the holders or servicers of junior-lien loans in order to discuss subordination. A centralized government registry of servicers for first- and junior-lien mortgages could help solve this coordination problem.¹⁰²

Model 2: Federal Subsidies to Servicers

HAMP tackled the fundamental task of altering servicers' revenue and cost calculus through a carrot in the form of cash subsidies. It succeeded in making capitalizations less common and interest rate reductions more common. This is a worthy accomplishment, given how important lower monthly payments are to reduced redefault rates.

However, HAMP boosted interest rate reductions at the expense of capitalizations mostly in the context of temporary loan modifications. The larger goal – more permanent loan modifications with lower monthly payments – has remained frustratingly elusive, although the recent numbers have encouragingly improved.

The government has tinkered with various solutions to this problem, including streamlined borrower documentation, on-site visits to servicers, threats of sanctions, and public shaming.¹⁰³ These efforts contributed to the rising level of permanent loan modifications.

¹⁰⁰ See Mullainathan, Schoar and Tania (2010).

¹⁰¹ Cordell et al. (2008), at 10.

¹⁰² Kiff and Klyuev (2009), at 27.

¹⁰³ For instance, the latest HAMP report lists the rate of active loan modifications by name for 22 individual servicers. Department of the Treasury (2010c). Meanwhile, with respect to compliance oversight and sanctions, the Treasury Department did not plan to roll out remedies or penalties for servicers who violated HAMP guidelines until April 2010. Government Accountability Office (2010), at 11.

Nevertheless, the key question remains: is the current level of federal subsidies enough to overturn the strong disincentives that servicers face to making sustainable loan modifications on a permanent basis? And if not, what will it take?

Bringing permanent modifications to scale faces a difficult set of challenges. First, economic trends may cause servicers to become even more skittish about the cost-effectiveness of large-scale loan modifications. If serious delinquencies continue to rise, so may redefault rates. Similarly, if home values fall in individual localities or unemployment rises, that will tilt the NPV calculus further toward immediate foreclosure. While HAMP cannot tackle all of these problems, it might be able to improve redefault rates if – and that’s a big if – it can convince servicers to make permanent loan modifications that lower monthly payments.¹⁰⁴

The best way to lower redefault rates is to reduce principal for borrowers with underwater mortgages. Research shows that negative equity combined with unaffordable payments is a leading driver of defaults, particularly once negative equity hits 20%.¹⁰⁵ If underwater borrowers can regain some equity, they will have more incentive to stay current on their loans. But as we have seen, servicers fight principal reductions tooth-and-nail because these reductions cut into their monthly servicing fees. They further resist principal haircuts because accounting rules saddle them or their trusts with immediate losses for permanent loan modifications via mandatory write-downs, which can then eat into their capital.

From the larger standpoint of the economy and society, it would be better for financial institutions and trusts to move forward by recognizing these losses now. But so long as regulators give servicers, banks, and trusts discretion to avoid immediate recognition of losses, most will avoid taking unnecessary write-downs at all cost. In fact, one reason why the March 2010 revisions to HAMP made principal write-downs optional, not mandatory, may have been to avoid any appearance that the capital of the nation’s frail banking system was being further eroded.

¹⁰⁴ The government also needs to consider taking borrowers’ total debt into account – including credit card, car payments, and other non-real estate debt – and not just mortgage debt when computing the 31% DTI ceiling. Currently, HAMP ignores non-mortgage debt when lowering mortgage payments below 31% of gross income. In this sense HAMP operates with blinders, meaning that heavily indebted borrowers may have difficulty even meeting HAMP-modified payments. This throws the sustainability of many permanent modifications into question, in turn, since over half of all permanent modifications under HAMP involve borrowers with total DTIs of over 50%. Government Accountability Office (2010), at 15-16; Office of the Special Inspector General for the Troubled Asset Relief Program (2010), at 15-16.

To date, the Treasury Department has instead approached the problem by requiring servicers to tell borrowers with a total DTI of over 55% to get HUD-approved housing counseling. However, the government does not track the number of borrowers who actually obtain that counseling because it considers it overly burdensome. Nor does the government measure the efficacy of counseling in reducing redefaults. Government Accountability Office (2010), at 16, 20.

¹⁰⁵ Bernanke (2008), at 4.

Addressing this problem will require strong medicine. One way would be a fundamental overhaul of the accounting rules or a decision by federal regulators to require financial institutions to take those write-downs. Tweaking HAMP's requirements will not achieve either step, however.

Alternatively, HAMP could subsidize principal write-downs to vitiate their effect on servicing fees and on capital.¹⁰⁶ The March 2010 revisions to HAMP started down this road.¹⁰⁷ But because principal haircuts remain at servicers' discretion under those revisions, it is necessary to ask whether the March 2010 subsidies are large enough to induce those write-downs. The subsidies may need to be larger – substantially larger – to achieve that goal. Alternatively, the government could offer to subsidize the cost to servicers and investors of any subsequent redefault. Finally, it is time to consider introducing the threat of a mandatory haircut to principal if servicers do not agree to voluntary haircuts themselves.

Model 3: Increasing the Cost of Rushing to Foreclosure

The current amount of subsidies may not be sufficient to yield permanent loan modifications in optimal amounts. For that reason, the government should consider steps to increase the cost to servicers from needless foreclosures.

The first is more data and transparency. One of the untold stories of foreclosure prevention efforts so far has been the remarkable effect of exposés and shaming. Alan White threw the government's rosy statistics on loan workouts by national banks, thrift institutions, and HOPE NOW into doubt by publishing proof that the majority of those workouts increased borrowers' monthly payments rather than lowering them. His seminal research and the press coverage that it sparked led to renewed public pressure for more sustainable modifications. More recently, government data about the scarcity of permanent loan modifications under HAMP focused attention on ways to increase permanent modifications. Public outrage over TARP put pressure on major banks to step up loan modifications as well.

¹⁰⁶ Kiff and Klyuev (2009), at 23, for instance, propose having the government pay half of any principal write-down.

¹⁰⁷ In a similar vein, there is a question whether HAMP's subsidies are big enough to compensate servicers for the re-underwriting they must do to process permanent modifications. Until recently, borrowers could qualify for HAMP trial modifications without submitting paperwork, which eased the underwriting burden of servicers at the trial modification stage. At the permanent modification stage, however, servicers had to gather documentation from borrowers, verify their eligibility for HAMP, and underwrite their ability to handle a permanent modification. This latter task cost considerably more, raising questions whether HAMP subsidies are sufficient to cover the expense.

In January 2010, to facilitate conversions to permanent modifications, the Treasury Department started requiring servicers to verify borrowers' eligibility for HAMP before starting trial modifications effective April 15, 2010. Government Accountability Office (2010), at 6-7, 11-12; Office of the Special Inspector General for the Troubled Asset Relief Program (2010), at 13. Because this did not alter the financial incentives faced by servicers, the result will probably be to reduce the number of new trial modifications.

None of this would have happened without publicly available data on outcomes and reporting. Data reporting needs to be standardized and expanded to include all key fields bearing on sustainable outcomes. The Government Accountability Office has reported in that regard that the Treasury Department still does not systematically track critical metrics, such as servicer compliance, denials of trial modifications, or the default rate on trial and permanent loan modifications. Nor has the government established benchmarks for performance.¹⁰⁸

Second, the federal government should make foreclosure contingent on good faith loan modification attempts. The March 2010 changes to HAMP tackle this objective in two ways: by forbidding foreclosures from going forward while HAMP negotiations are pending and by requiring servicers to certify that borrowers are not eligible for HAMP as a prerequisite for foreclosure.¹⁰⁹ An even stronger measure would be for Congress to enact legislation requiring servicers to go to court-supervised mediation and bargain in good faith before they can proceed to foreclosure.¹¹⁰ Both Philadelphia and the State of Connecticut, for example, mandate court-supervised mediation before a servicer can foreclose on a loan.¹¹¹

Finally, it is time to enact federal bankruptcy cram-down legislation for owner-occupied homes. Such legislation would insure equal treatment for all secured loans.¹¹² More importantly, it would alter servicers' cost calculus by forcing them to factor in the risk that a bankruptcy judge would write down the value of the home.¹¹³ The prospect of a cram-down would help counteract the resistance to principal haircuts in a way that nothing else has to date. Such legislation would be less heavy-handed, moreover, than federal legislation forcing servicers to write down loans.¹¹⁴ The fact that servicers lobbied so hard – and so successfully – against such a provision in early 2009 is a strong indication that cram-down authority could significantly change the terms of loss mitigation discussions.¹¹⁵

¹⁰⁸ Government Accountability Office (2010), at 8-11.

¹⁰⁹ In a similar vein, Fannie and Freddie instruct mortgage servicers who handle their loans to refrain from foreclosing on homes until the borrowers had been considered "sufficiently" for a loan modification, repayment plan, or forbearance plan. Federal Housing Finance Agency (2010), at 6. FHA also mandates loss mitigation for the loans that it insures and courts have made this a precondition of going to foreclosure in many states. Thompson (2009), at 27.

¹¹⁰ Geanakoplos and Koniak (2009) would go further and appoint federal trustees to decide which troubled mortgages should be modified, left alone, or be put in foreclosure.

¹¹¹ Goodman (2009).

¹¹² Levitin (2009), at 571.

¹¹³ Kiff and Klyuev (2009), at 26.

¹¹⁴ Zingales (2008) would allow underwater borrowers to write down their principal balances by the same percentage home values dropped in their zip code, starting from the time they financed their homes.

¹¹⁵ Fears that cram-down authority would dampen future credit appear overstated. To the contrary, the evidence on point suggests that allowing bankruptcy judges to write down principal on a debtor's principal residence will have little future adverse impact on the supply of mortgage credit. Levitin (2009), at 576, 578, 586-599.

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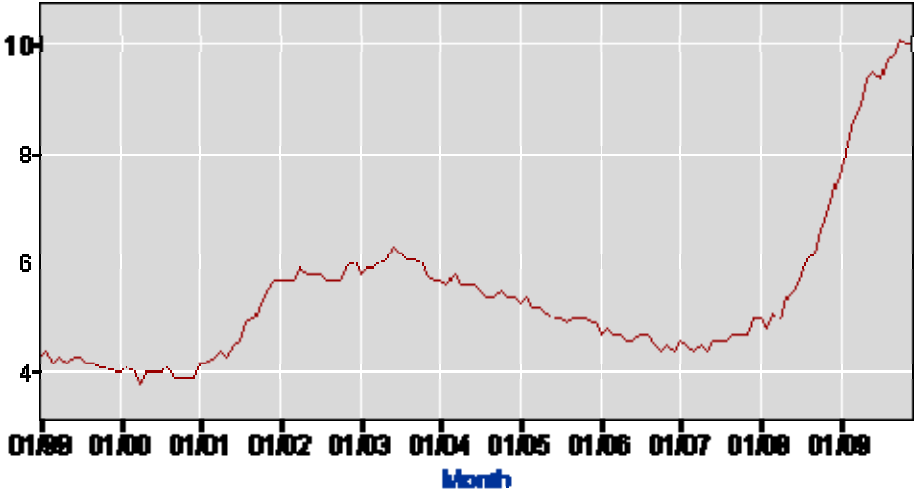
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Figure 1. U.S. Unemployment Rate, 1999-2009



Source: U.S. Bureau of Labor Statistics.

Figure 2. Total Percentage of Mortgages Delinquent (Excluding Foreclosures) by Product Type

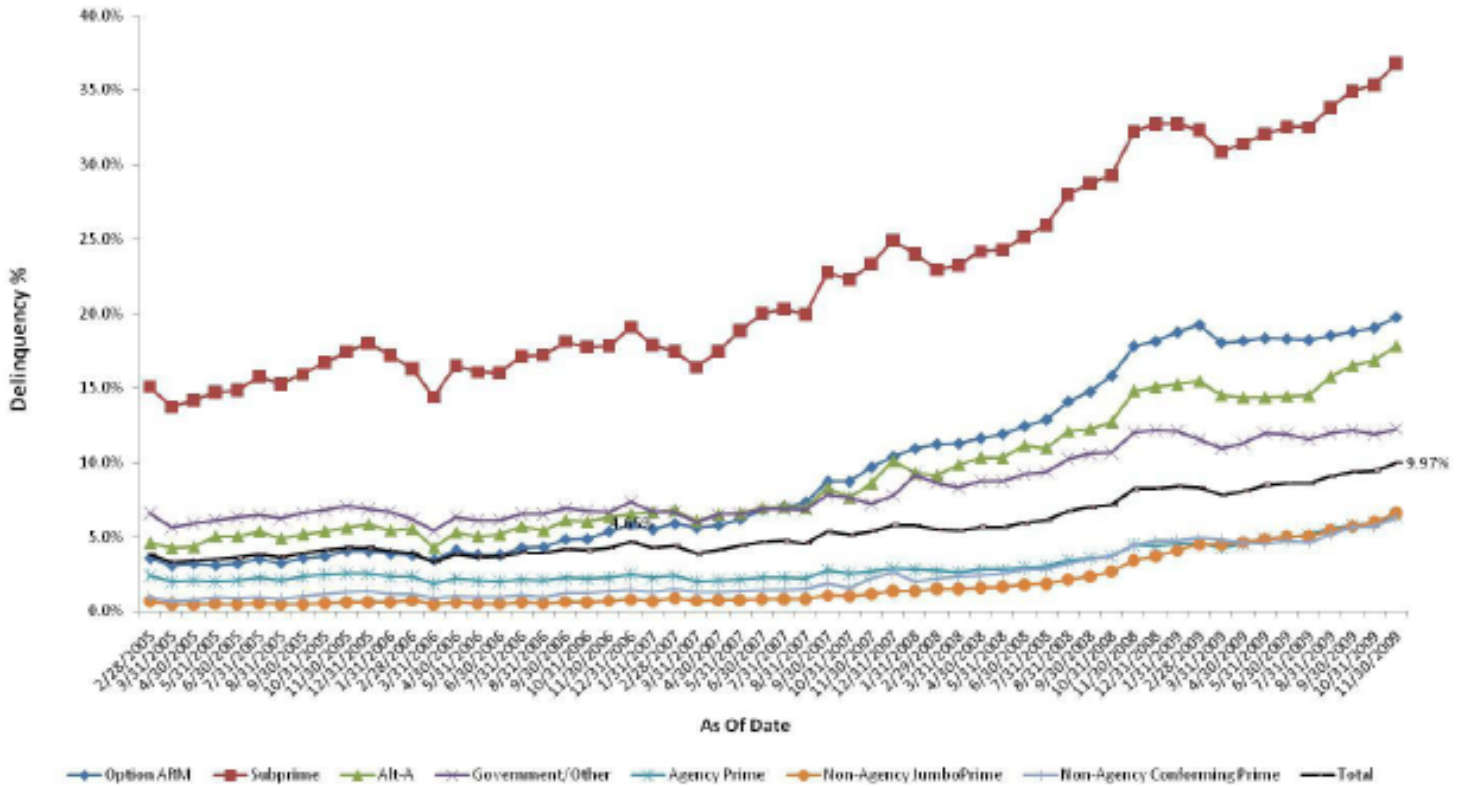
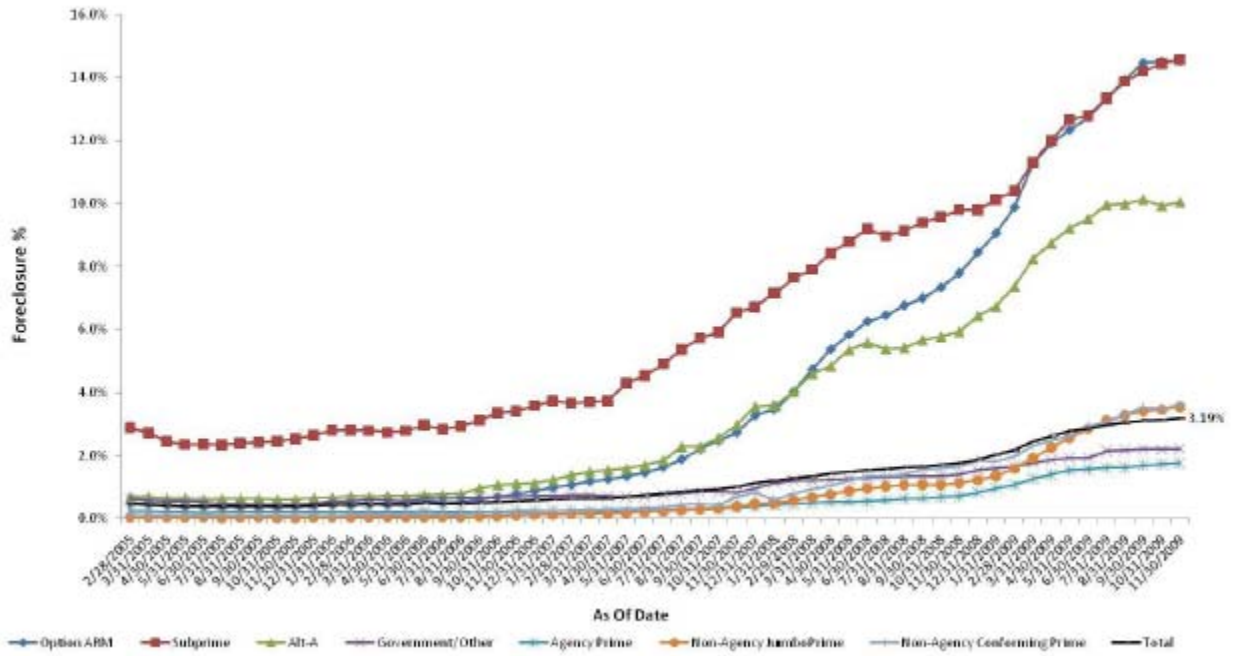


Figure 3. Total Percentage in Foreclosure by Product Type



Source: Information provided by LPS Applied Analytics

Figure 4. Foreclosure Starts versus Serious Deterioration



Source: Information provided by LPS Applied Analytics

Figure 5. Number and Distribution of Workouts in Non-Conforming Home Loans

	# Loans Modified	Interest Rate Reductions	Principal Reductions	Principal Increases	Term Extensions
1Q 2007	10,940	5.3%	6.2%	76.4%	12.2%
4Q 2008	74,800	26.7%	1.4%	61.5%	10.5%

Source: Adelino et al. (2009), tbl. 3.