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POLICYUPDATE

Lenders Remain Slow to Modify Problem Loans

BY DAVID VAN DEN BERG

Foreclosure notices have been filed on about 6 million American homes since January 2007, according to RealtyTrac. To try to reduce foreclosures, the federal government has implemented multiple programs. They include bringing borrowers and mortgage servicers together, reducing monthly payments and interest rates, extending loan terms, and delaying or reducing principal. President Obama announced in February the most recent government action, a mortgage loan modification and refinancing program called "Making Home Affordable."

Making Home Affordable gives mortgage servicers an upfront payment of $1,000 for each successful modification after completion of a trial period and "pay for success" fees of up to $1,000 per year for up to five years if the borrower remains current. Homeowners may also earn up to $1,000 a year for five years for principal reduction if they stay current and pay on time. Refinancing would also be available, but borrowers may face higher payments when switching from adjustable to fixed-rate mortgages.

For the modification program, borrowers must have a monthly payment greater than 31 percent of their monthly income. For the refinancing program, the mortgages must be guaranteed by Fannie Mae or Freddie Mac and the borrower cannot owe more than 125 percent of the home's current value on their first mortgage.

To date, the U.S. Department of the Treasury has signed contracts with more than 45 servicers to participate in Making Home Affordable. Between loans covered by those servicers and loans owned or guaranteed by Fannie Mae and Freddie Mac, about 85 percent of loans in the country are covered by the program. But since the policy took effect, only 12 percent of eligible borrowers have modified their loans.

A Boston Fed paper finds that fewer than 8 percent of seriously delinquent borrowers have had their mortgages modified since 2007. For a lender, the decision to modify a loan is a gamble for two reasons. First, about 30 percent of delinquent loans will "self-cure" — meaning the borrower will eventually be able to make the existing payments — without modifications. Second, a significant number of borrowers whose loans are modified will default again. "Finding profitable modifications is not nearly as easy as it looks," says Paul Willen, a Boston Fed economist and a co-author of the paper.

Also, the choice between foreclosure and modification isn't the only one lenders and borrowers face. "Short sales," in which the lender agrees to take a loss on the property, and deeds in lieu of foreclosure, where the borrower hands over the deed of the property to the lender, are alternatives. In these cases, lenders often agree not to seek deficiency judgments against borrowers. In states where lenders have more options for collecting money owed by borrowers, economists Andra Ghent and Marianna Kudlyak find in research published by the Richmond Fed that these options are usually exercised more frequently and the probability of default through foreclosure is also lower.

Still, in some cases, foreclosure may be rational for borrowers, lenders, or both. A borrower with sufficiently negative equity, for instance, might be better off to walk away from the home.

Foreclosed properties can become run-down and have a negative effect on neighborhoods in which the property is located. The negative externalities that result from these foreclosures — including the decline in value of surrounding houses in the same neighborhoods — might be big enough to warrant government intervention, says Chris Foote, an economist at the Boston Fed. The trouble comes in designing a program to mitigate these potential problems without causing other problems, such as encouraging people who don't need modifications to apply for them.

Pinpointing the reason borrowers fall behind on mortgage payments would help in designing better programs aimed at avoiding foreclosure. Economists disagree about the causes of America's increase in foreclosures. Foote and co-authors suggest in a separate Boston Fed paper that the crisis stems from household income drops and an unprecedented fall in house prices. What's really needed is significant but temporary assistance rather than the moderate and permanent assistance offered by loan modification. "The right policy would be to extend unemployment insurance benefits or make direct transfers," Foote says.

Atif Mian, an economist at the University of Chicago, acknowledges that job losses and other negative income shocks are important factors in rising foreclosure levels. But those aren't the biggest reason for the large number of foreclosures. Indeed, default levels started rising before unemployment did. "The problem really started with an overleveraged household," he says. Therefore, the only solution for helping borrowers in trouble now is to reduce the principal on their mortgages, Mian says. That's a painful process that involves changing contracts.

To proponents of loan modification programs, renegotiation of mortgages is "a type of public policy holy grail," write Willen and co-authors. That's because modification policies help borrowers and lenders at little or no cost to the government. While the effectiveness of current programs is still to be determined, policymakers would do well to monitor them and the changes in borrower and lender behavior. **RF**