Solution to Housing Crisis Requires Adjusting Loans to Fair Market Value through Court-Supervised Modifications

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The U.S. faces a deepening foreclosure crisis driven by the rise in "under water" mortgages. For years, subprime lenders engaged in a reckless lending spree, marketing the most risky types of loans to the most vulnerable families, even many who could have qualified for affordable and sustainable loans. The results have driven our country to the brink of recession. Consider the current situation:

- Home prices have fallen by 5% to 10% nationwide, and market experts predict that prices will decline by an additional 20%.[1]
- 30% of families now holding recent subprime mortgages are upside down: they owe more on their mortgage than their home is worth.[2] Foreclosures will increase because families cannot sell the home, refinance the mortgage, or get a home equity loan.[3]
- Holding an upside down mortgage now exceeds "exploding" interest rates[4] as the major factor driving families into foreclosure.[5]
- Foreclosures reached an all-time high in the fourth quarter of 2007, and they are projected to get even worse.[6] Fitch has concluded that 43% of recent subprime loans made will be lost to foreclosure.[7]
- At least two million American families are expected to lose their homes to foreclosures initiated over the next two years, and 40 million of their neighbors will see their property values decline as a result.[8]

For homeowners who are upside down in their mortgage, simply adjusting the interest rates frequently isn't enough. People with "negative equity" are not able to sell or refinance, even if they need to relocate for a new job or use equity to help pay hospital bills or other essential expenses. In many cases, foreclosure becomes inevitable when it could have been prevented.

Regulators and economists increasingly recognize that loan balances must be reduced to avoid unnecessary foreclosures that will further damage the economy.

Federal Reserve Chairman Ben Bernanke: "When the mortgage is 'underwater,' a reduction in [loan] principal may increase the expected payoff by reducing the risk of default and foreclosure." "Preventable foreclosures" could be reduced, he said, by enabling loan servicers to "accept a principal writedown by an amount at least sufficient to allow the borrower to refinance into a new loan from another source." This would "remove the downside risk to investors of additional writedowns or a re-default."[9] Seventy-one percent of the economists responding to a New York Times survey agreed with Chairman Bernanke on this point.[10]

FDIC Chairman Sheila Bair: Lenders "should be more aggressive about writing down principal."

Treasury Secretary Henry Paulson: "There will be instances where lenders are going to clearly see that the best solution for them which is less costly than a foreclosure is going to be a writedown of principal on a mortgage."[11]

Voluntary write-downs fall far short of results needed to restore market confidence.
Unfortunately, voluntary efforts by lenders, servicers and investors are not sufficient to address the massive number of foreclosures. Looking at the first eight months of 2007, Moody's Investors Service found that lenders modified only 3.5% of subprime loans that reset to higher interest rates.[12] According to a recent report by the State Foreclosure Prevention Working Group, a collection of state Attorneys General and Bank Commissioners, only 24% of seriously delinquent borrowers were working with professionals in any type of loss mitigation activity that could lead to preventing a foreclosure.[13]

Efforts of the Hope Now Alliance also fall short. As recently acknowledged by the vice chair of Washington Mutual, a senior policy adviser for the Financial Services Roundtable who helps run the program, many of the homeowners who have sought Hope Now assistance "will not receive long-term relief and could ultimately face higher total costs."[14] Moreover, "[o]nly a very small group of borrowers could get their mortgage principal reduced outright."[15] Chairman Bernanke noted that loan modifications involving "reductions of principal balance have been quite rare."[16]

Why aren't more mortgages modified?
The fact that most loans are "securitized" – i.e., packaged as investments – has resulted in conflicting financial interests among the different players involved:

- Loan servicers frequently fear that modifications will trigger lawsuits by particular tranches, or classes, of investors;[17]
- Loan servicers often have stronger financial incentives to foreclose than to work with the loan. (Servicers are reimbursed for foreclosing, but must generally cover the cost of loan modification, on average $750-1,000 per loan, out of their own pockets.);[18]
- The common presence of "piggy back second mortgages" often makes it impossible for servicers to modify either mortgage because the second mortgage holder has no incentive to cooperate.[19]

Court-supervised modifications would make large-scale foreclosure prevention possible.
Increasing loan modifications would be the most effective way to curb the foreclosure epidemic and reduce economic damage. Given the obstacles to voluntary modifications, the only way to achieve meaningful loan modifications on a larger scale is to permit courts to restructure mortgages on family's homes under chapter 13 of the bankruptcy code. Once this process is in place, it is likely that most loan modifications will occur voluntarily outside of court.[20]

Bills in the House (as reflected in the Chairman Conyers/Rep. Chabot compromise (HR 3609)) and Senate (Sen. Durbin's bill, included as Title IV of the Foreclosure Prevention Act (S.2636)) would provide judges the authority to modify harmful mortgages marketed by subprime lenders in recent years, in order to provide families with one last chance to save their homes before foreclosure. **They would help some 600,000 families stuck in bad loans to keep their homes**.

What these bills do:
- For existing loans only, permits bankruptcy courts to reduce the secured mortgage amount to the fair market value of the property;

- Applies to homeowners who have (1) received a subprime or non-traditional loan; (2) who meet an IRS means test demonstrating they do not have the financial ability to make their house payments; and (3) who otherwise would lose their house to foreclosure.
- Senate bill allows the lender/investor to recapture any price appreciation if the home is sold before the plan is completed.[21]

The means test for homeowners ensures that only qualified families receive loan modifications. The American Securitization Forum, representing the interests of bond investors, has said that mortgage servicers "should have a clear basis for concluding" that borrowers are unable to make their payments before reducing loan principal.[22] This is precisely what the Durbin bill's means test accomplishes. Only homeowners who will qualify for strip-down (indeed, the only homeowners who will qualify for any relief at all) are those who do not have sufficient monthly income (after deductions for limited living expenses set by IRS guidelines) to cover their mortgage payments, and for whom foreclosure is imminent.

The bills ensure fairness to lenders, investors and servicers: They guarantee the recovery of at least the amount that could be recovered through a foreclosure sale, while avoiding the substantial costs of foreclosure. Recent estimates based on subprime mortgage foreclosures from the fourth quarter of 2007 indicate that mortgage-holders lose more than 50% of the loan value when they have to foreclose.[23]

Lenders can choose other alternatives. While the bills permit eligible homeowners to obtain court-supervised modifications, they also give lenders the option to avoid it. The recent ASF fast-track modification process enables lenders to modify loans in borrowers' favor without borrower consent. When servicers exercise this option, the homeowner would be able to pay the mortgage, would therefore fail the IRS "means test," and would thus be ineligible for court-supervised modification.

Other Benefits:

- No cost to the U.S. Treasury.
- Narrowly targets families who would otherwise lose their homes, and excludes families who do not need assistance.
- Helps maintain property values for families who live near homes at risk of foreclosure. Saves American families not facing foreclosure $72.5 billion in wealth by avoiding 600,000 foreclosures by their neighbors.[24]

About the Center for Responsible Lending

The Center for Responsible Lending (CRL) is a national nonprofit, nonpartisan research and policy organization dedicated to protecting home ownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, one of the nation's largest community development financial institutions.

For additional information, please visit our website at **www.responsiblelending.org**.
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1 Lawrence Summers, Prevent US foreclosures, Financial Times (Feb. 24, 2008) (supporting idea of court-supervised modifications under chapter 13 of the bankruptcy code).

2 Edmund Andrews, Relief for Homeowners is Given to a Relative Few, New York Times (March 4, 2008) (loans originated in 2005 and 2006).

3 Kristopher Gerardi, Adam Hale Shapiro & Paul S. Willen, Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures, Federal Reserve Bank of Boston Working Papers, No 07-15 (Dec. 3, 2007) at 3-4 (this otherwise good article misses the fact that certain loans themselves can create the cash flow shortfall that cause underwater loans to fail, when they are structured with initial low payments that are scheduled to rise, such as subprime 2/28 hybrid ARMs, and that certain loan terms have been statistically demonstrated to increase foreclosures, such as prepayment penalties).

4 Recent interest rate cuts will alleviate the problem somewhat for some homeowners, but will not be as significant for borrowers trapped in subprime 2/28 and 3/27 loans as might be expected. This is because the loans were structured so as to guarantee rate increases without regard to whether rates in the economy rise or fall, and to limit the impact of interest rate cuts. As Chairman Bernanke noted, "In 2008, about 1-1/2 million loans, representing more than 40 percent of the outstanding stock of subprime ARMs, are scheduled to reset. We estimate that the interest rate on a typical subprime ARM scheduled to reset in the current quarter will increase from just above 8 percent to about 9-1/4 percent, raising the monthly payment by more than 10 percent, to $1,500 on average. Declines in short-term interest rates and initiatives involving rate freezes will reduce the impact somewhat, but interest rate resets will nevertheless impose stress on many households." Statement of Federal Reserve Chairman Ben Bernanke on March 4, 2008, reprinted by Bloomberg.com and available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=apeU.0IaETdM ("**Bernanke statement**").

5 According to Mark Zandi, chief economist at Moody's Economy.com, in an email dated March 19, 2007, as a very rough measure short of performing additional analysis, it is reasonable to assume that 20% of house losses would be prevented by interest rate reductions and 80% by stripdown of mortgages, and the ratios may shift more in the latter direction as prices continue to fall. See also Bernanke statement ("The recent surge in delinquencies in subprime ARMs is closely linked to the fact that many of these borrowers have little or no equity in their homes.") As interest rates certainly rise in the future, foreclosures due to payment shock will rise with them. The increase in prime delinquencies is further evidence of the effect of lower property values: the MBA reports that prime adjustable-rate loans past due almost doubled from 2006 to 2007, from 4.3% to 8.1%, even as short-term rates have fallen. Vikas Bajaj, Foreclosures Jump to Record High, and Focus Turns to Relief Efforts, New York Times C1 (March 7, 2008).

6 Renae Merle, Home Foreclosures Hit Record High, Washington Post, March 6, 2008.

7 Fitch Ratings estimates total losses of 25.8% of original balance in Q4 2006 loans placed in MBS they rated, and that loss severity will be at 60%, which means that 43% of the loans are projected to be lost to foreclosure (25.8/60); lack of home price appreciation said to increase defaults. Glenn Costello, Update on U.S. RMBS: Performance, Expectations, Criteria, Fitch Ratings, p. 17-18 (not dated, distributed week of February 25, 2008). According to Michael Bykhovsky, president of Applied Analytics, an estimated 40% of outstanding subprime mortgage loans could go into default over the next three years; the dire outlook due to declining home values (press briefing at the Mortgage Bankers Association's National Mortgage Servicing Conference, February 27, 2008).

8 Moody's Economy.com, http://judiciary.house.gov/media/pdfs/Zandi080129.pdf; Center for Responsible Lending, Suprime Spillover, http://www.responsiblelending.org/issues/mortgage/research/subprime-spillover.html

9 Bernanke statement; see also, Edmund L. Andrews, Fed Chief Urges Breaks for Some Home Borrowers, The New York Times (Mar. 4, 2008); John Brinsley, Bernanke Call for Mortgage Forgiveness Puts Pressure on Paulson, Bloomberg.com (Mar. 5, 2008).

10 Phil Izzo, Housing Market Has Further to Fall, The Wall Street Journal (Mar. 13, 2008) ("Last week, Federal Reserve Chairman Ben Bernanke suggested that lenders could aid struggling homeowners by reducing their principal — the sum of money they borrowed — to lessen the likelihood of foreclosure. Some 71% of respondents [ie, economists surveyed by the NYT] agreed with the suggestion.")

11 John Brinsley, Bernanke Call for Mortgage Forgiveness Puts Pressure on Paulson, Bloomberg.com (Mar. 5, 2008).

12 Aashish Marfatia, US Subprime Market Update November 2007, Moodys' Investors Service (Dec. 17, 2007) at 2.

13 Analysis of Subprime Servicing Performance, Data Report No. 1, February 2008.

14 David Cho and Renae Merle, Merits of New Mortgage Aid Are Debate – Critics Say Treasury Plan Won't Bring Long-Term Relief, The Washington Post (Mar. 4, 2008) (citing remarks of Bill Longbrake, senior policy adviser for the Financial Services Roundtable and vice chair of Washington Mutual).

15 Id.

16 Bernanke statement.

17 Harris Terry, ARM Workout Calls Trigger Fierce Debate, American Banker (Oct. 9, 2007) ("Servicers are 'scared to death' of being challenged by investors for making too many modifications, [Citigroup Managing Director Tim] Bolger said. 'Talking about getting modification rates up, they're probably going to err on the conservative [side] if they think any investor is going to come after them.'").

18 Inside Mortgage Finance Reprints, Subprime Debt Outstanding Falls, Servicers Pushed on Loan Mods (Nov. 16, 2007); Bernanke statement ("[S]ervicers may not pursue workout options that are in the collective interests of investors and borrowers. … [T]he barriers to, and disincentives for, workouts by servicers remain serious problems"). Gretchen Morgenson and Jonathan D. Glater, "Foreclosure Machine Thrives on Woes," The New York Times (Mar. 30, 2008) ("Nobody wins when a home enters foreclosure … That's the conventional wisdom, anyway. The reality is very different. Behind the scenes in these dramas, a small army of law firms and default servicing companies, who represent mortgage lenders, have been raking in mounting profits.)

19 William Launder, Second Liens Proving Hurdle on More Refis, American Banker (Mar. 6, 2008) ("In better times, getting approval for subordination was considered a formality that at worst might set the borrower back a few hundred dollars in fees. But in today's tanking housing market, lenders are finding that a second mortgage is virtually unsecured, and they are doing what they can to protect their interests — even if that means making it harder for the borrower to get out of an onerous first mortgage."); Kenneth R. Harney, Actions Don't Match Words of Help, The Washington Post (Mar. 1, 2008) ("Bottom line: If you've got a second mortgage and need to refinance, there could be a big pothole in the road. The second-mortgage holder might stand in the way."); William Launder, Servicers Have Full Plate In Dealing with Seconds, American Banker (Feb. 20, 2008); Somewhere between one-third to one-half of 2006 subprime borrowers took out "piggyback second" mortgages on their home at the same time as they took out their first mortgage. See Credit Suisse, Mortgage Liquidity du Jour: Underestimated No More, March 12, 2007, p. 5.

20 According to Richard Levin, Vice Chair of the National Bankruptcy Conference, Chapter 12, in which loans on family farms, including secured by a principal residence, can be modified, has actually led to a decrease in its use because as lenders and borrowers have come to understand how the law operates, they are increasingly able to reach agreements on their own, without intervention from the courts. http://judiciary.house.gov/media/pdfs/Levin071030.pdf (page 4-5).

21 See CRL summaries: http://www.responsiblelending.org/pdfs/hr-3609-support-brief.pdf; http://www.responsiblelending.org/pdfs/senate-bankruptcy-support-brief-feb27.pdf.

22 John Brinsley, Bernanke Call for Mortgage Forgiveness Puts Pressure on Paulson, Bloomberg.com (Mar. 5, 2008) (citing statement of the American Securitization Forum).

23 See Fitch, p. 18.

24 Families lose 1.14% of their own house's value for every foreclosure that occurs on their block. Woodstock Institute, "There Goes the Neighborhood: The Effect of Single-Family Mortgage Foreclosures on Property Values," June 2005, http://www.woodstockinst.org/content/view/104/47/. Median house value of $212,000 * 1.14% * 50 houses/block = $121,000 cost/foreclosure * 600,000 avoided = $72.5 billion saved.
http://www.realtor.org/Research.nsf/files/MSAPRICESF.pdf/$FILE/MSAPRICESF.pdf