Federal Ownership of Troubled Securities Alone Will Not Stop Foreclosures that Drag Down the Economy

Allowing the Federal government to purchase illiquid mortgage-backed securities (MBS) has been presented as a comprehensive solution to the economic crisis, but it has a serious flaw. This plan will NOT increase loan modifications that prevent foreclosures. Large-scale loan modifications—adjusting the terms of a loan to make it affordable—is the only way to prevent massive foreclosures still ahead.

Under the bailout proposal, the government would simply become one of the investors that forecloses on homes. Mortgages are divided into groups owned by hundreds of thousands of interests. The government will buy a <u>portion</u> of those interests, not individual loans. **The same factors that have frustrated private attempts to modify loans will remain in place.**

<u>Existing Legal Contracts Constrain Modifications:</u> Under the U.S. Constitution, the government cannot unilaterally modify existing contracts and legal agreements that dictate the treatment of loans that have been securitized.

- Agreements often explicitly limit the number of loans that may be modified to 5% of the loan pool;
- Other investors may sue to prevent modification of the loans; and
- Too often modifications made under these agreements are those least likely to lead to a sustainable mortgage.

<u>Junior lien holders will refuse to stay in back of the line.</u> Many mortgages in recent years were structured with two loans: the main mortgage, and a second (or "junior") lien loan. Second liens are the last to receive any value from a foreclosure. However, if the bigger first-lien loan is modified, the second lien leaps ahead to claim first payback from foreclosure. Because this greatly disadvantages the first loan, first loan holders often cannot modify the loan unless the junior lien-holder agrees to stay in the back of the line (called subordinating their interests). However, many junior lien-holders are blocking modifications by refusing to cooperate.

<u>Loan servicers will continue to be overwhelmed.</u> Loan servicers will not change, and they will continue to be overwhelmed by requests for loan modifications and assistance. These servicers are under-resourced and have net incentives that tend to steer them away from making modifications.

<u>Homeowners still have no escape routes to avoid foreclosure.</u> With home prices in virtual free fall, refinance options eliminated for many, and higher adjustable-rate mortgage payments still ahead, home losses will continue to rise, which in turn will continue to exert downward pressure on home prices.

<u>Only solutions that prevent foreclosures can address the root causes of our present crisis.</u> This crisis began with reckless subprime loans, and any effective solution must address the foreclosures caused by these loans, which are driving millions of homeowners into foreclosure, distressing families, neighborhoods and the overall financial system.

Any solution that fails to increase loan modifications in ways that accept some pain now to prevent larger pains later will ultimately fail.