Voluntary Loan Modifications Fall Far Short:

Foreclosure Crisis Will Continue Unabated Without Court-Supervised Modifications

CRL Issue Brief | January 30, 2008

PAULSON PLAN REACHES ONLY 3% OF AT-RISK HOMES

Wall Street analysts estimate that by the end of next year 2.0 million families will receive a foreclosure notice leading to the loss of their home.[1] Merrill Lynch estimates that direct investor losses from mortgage defaults will total $400 billion.[2] An estimated 3.5 million families are trapped in "exploding" adjustable-rate mortgages (ARMs) that are due to increase to unaffordable interest rates in the next two years. On many of these loans, the debt owed is more than the value of the house.[3]

Lenders who marketed exploding ARMs assured borrowers they would be able to refinance before the interest rate on the loans jumped to a higher level. But today, refinancing or selling is not possible for too many families. Homeowners with distressed loans have two options: Either obtain a voluntary modification from their loan servicer[4] or lose their house to foreclosure.

The Mortgage Bankers Association claims that servicers are voluntarily modifying loans in sufficient scale to address the current foreclosure crisis. Further, in December, the Treasury Department announced an initiative to encourage lenders to streamline loan modifications for a subset of distressed subprime mortgages ("Paulson plan"). However, recent industry data, coupled with an updated analysis of who will qualify for the Paulson Plan, clearly shows that voluntary initiatives are and will fall far short of the effort needed.

Existing modification efforts are insufficient. MBA data show that foreclosures are outstripping modifications 7 to 1. For the subprime ARMs that are at the root of the current crisis, foreclosures outnumber modifications 13 to 1.

Future modifications unlikely to be sufficient. While the Paulson plan is welcome, only 3% of subprime ARM borrowers are likely to receive streamlined modification under its terms.

Court-supervised modifications of distressed mortgages are necessary to significantly reduce foreclosures and prevent further economic damage. HR 3609, "The Home Ownership and Mortgage Equity Protection Act," could prevent 600,000 homes from being lost to foreclosure—and in so doing also would prevent $72.5 billion of wealth from being lost by families who are faithfully paying their mortgages, but whose property values would decline because they happen to live near foreclosed homes.[5]

I. Existing modification efforts are insufficient.

<u>Moody's finds just 3.5% of resetting loans modified</u>. Examining mortgages during the first eight months of 2007, Moody's Investors Service found that lenders only modified 3.5% of subprime

loans resetting to higher levels. This compares with industry estimates that up to half of these borrowers will lose their homes to foreclosure after the reset.[6]

MBA numbers demonstrate that foreclosures dwarf modifications. On January 17, the MBA released statistics on the number of modifications its members accomplished in the third quarter of 2007.[7] However, as the Washington Post concluded in the headline to its coverage: "Foreclosures, Lenders' Preferred Fix."[8] The numbers reported belie the MBA's claim that the pace of voluntary modifications is sufficient:

- The MBA reported that foreclosures initiated outstripped loan modifications by a 7 to 1 margin (384,388 to 53,573).
- Astoundingly, for the subprime ARMs that are the root of the current foreclosure crisis, servicers modified just over 12,000 loans nationwide, initiating foreclosures 13 times more often (166,415 to 12,741).
- A day after the MBA's numbers came out, HOPE NOW[9] reported based on a separate set of numbers. It claimed that there were 120,000 loan modifications in the second half of 2007.[10] Still, this pace is well behind foreclosure starts: those in the third quarter alone, as reported by MBA, outnumbered modifications for the third and fourth quarters combined, as reported by HOPE NOW, by three to one.

Repayment plans don't help homeowners with exploding ARMs. When homeowners fall behind on their mortgage payments, lenders often offer a repayment plan that requires the family to pay a portion of the delinquent amount in addition to their regular monthly payment until they catch up. However, as the MBA recognizes, repayment plans are for borrowers "who have a short-term setback, such as being between jobs or dealing with a temporary disability."[11] The MBA is counting repayment plans as a solution to an unaffordable subprime ARM on par with a sustainable loan modification, and suggests that nothing should be done to stop foreclosures for families who can't make the payments on a repayment plan.

For homeowners with exploding ARMs, repayment plans set them up to fail. When a family has a subprime ARM with an interest rate that jumps from 8% to 12% after the second year, the problem is that they cannot afford the 12% interest rate. (And, again, when these families received the loan, they were routinely told by professionals not to worry about the increase because they would be able to refinance before the reset occurred.) Requiring homeowners with an exploding ARM to pay a portion of previous missed payments in addition to the 12% due is no solution at all. And to suggest that a family who cannot keep up the repayment plan in this situation should not be counted as one needing a loan modification is to add insult to injury.

The absence of detailed reporting leads to questions about whether the few modifications implemented are sustainable. Even where loan modifications are done, they are often not sufficient to address the problem of unaffordable interest rates and prevent foreclosure. The Paulson plan recommends freezing the teaser rate for five years, while Sen. Dodd's Homeowner Preservation Summit of lenders and servicers recommended making the initial rate permanent and/or reducing principal balance of the loan.[12] However, the largest lender in the country, Countrywide, previously acknowledged during an investor call that most of its modifications actually "involved deferring overdue interest or adding the past due amount to a loan," not reducing interest rates or principal balances.[13] Modifications of this type are no more than formalized repayment plans**,** still requiring borrowers to pay unaffordable interest rates plus an additional amount to cover, over time, the amount that is delinquent. In the absence of any requirement that the terms of the modifications be made public, one cannot be certain that voluntary modifications fully address the problems of unaffordable subprime ARMs. Loan servicers need to report not just the number of modifications, but also their terms.

MBA's grudging support for modifications is unwarranted. The MBA claims that borrowers voluntarily chose exploding ARMs whose payment rise by 30% to 50% after the second year, and questions whether they deserve modifications. According to the MBA, "Even in the current environment, loan modification of ARMs in the form of freezing interest rates can be seen as rewarding borrowers who decided to take a risk and take out loans with lower initial payments than what they would have been required to make with fixed rate, fully amortizing loans**."**[14] In fact, it was much more likely a mortgage broker or lender who suggested and placed a borrower in an exploding ARM, not the borrower who requested such a mortgage.

A recent study for the *Wall Street Journal* found that 61% of subprime loans originated in 2006 that were packaged into securities and sold to investors "went to people with credit scores high enough to often qualify for conventional [i.e., prime] loans with far better terms."[15] And for even the 39% who didn't qualify for conventional loans, industry has stated that borrowers placed in subprime hybrid ARMs could have received sustainable, amortizing thirty-year fixed-rate loans, for at most a half to 8/10 of a percentage point greater interest rate above the teaser rate on the unsustainable exploding ARM loan they were given.[16] Borrowers likely paid more than they needed to because their broker was paid what is called a "yield-spread premium," or kickback, for steering them to a more expensive mortgage. Roughly half the time, brokers would also place them in a "no doc" loan, which carried even more unnecessary interest costs. This means that homeowners who were sold a "no doc," exploding ARM loan could have qualified and received a 30-year fixed rate loan for less than the teaser rate of the ARM.

II. Future modifications unlikely to be sufficient: only 3% of subprime ARMs are eligible for the Paulson plan.

The slow pace of loan-by-loan modifications by servicers points out the need for streamlined modifications in bulk. The Paulson plan provides the outline of just such a streamlined plan, and for this reason is very welcome. However, a new analysis by CRL concludes that not enough homeowners meet the strict terms of the plan to fundamentally change the current situation.

- CRL concludes that just 3% of homeowners with subprime ARMs are likely to receive a streamlined modification under the terms of the plan. Appendix A describes the methodology of this analysis.
- In fact, the plan is likely to help fewer subprime ARM borrowers than servicers initiated foreclosure actions on in the third quarter of last year alone – 118,200 helped to 166,415 foreclosed.

There are two reasons that the Paulson plan will not help more people.

1. Eligibility is narrow.

- No reset loans. Although the plan purports to cover loans originated in 2005, it excludes any homeowner whose mortgage interest rate already reset before January 2008, so the hundreds of thousands of homeowners who received "exploding" 2/28 adjustable-rate mortgages in 2005 cannot get relief.
- No delinquency. The plan also excludes families more than 30 days behind in their payments. Ironically, many families were previously told by their lenders that they could not get a loan modification until they were delinquent.
- Improved credit scores. To qualify, a homeowner needs to have had good payment history on the loan, but the plan then excludes those whose credit scores have in the meantime improved by 10%. These criteria are mutually exclusive. It is difficult to understand why borrowers who start with a low credit score and increase that score by 10%, and yet are still below the cutoff for conventional refinances, would not be eligible.
- Cannot refinance. Even if the borrower's loan balance exceeds the value of the borrower's house because of property depreciation, or their credit score started low but improved by 10%, they would not be eligible for streamlined modification, even though they cannot refinance.
- Non-traditional loans. The plan does not cover payment-option ARMs or interest-only loans, which are not typically considered subprime but also face significant payment increases in 2008 and beyond.

2. A voluntary plan doesn't surmount current obstacles.

The plan relies on voluntary decisions by individual mortgage servicers and investors. No one is required to follow it. The plan therefore does not remove the strong financial and legal incentives servicers have to foreclose on loans rather than to modify them:

- It is not in the financial interests of servicers to modify. As reported in *Inside B&C Lending*, "Servicers are generally dis-incented to do loan modifications because they don't get paid for them but they do get paid for foreclosures." In fact, "it costs servicers between $750 and $1,000 to complete a loan modification."[17] Since servicers decide whether to modify, the fact that a modification rather than foreclosure would be in the interests of investors as a whole is irrelevant.
- Servicers fear lawsuits from classes of investors harmed by the specific modification selected challenging the terms of any such modification to which the servicer might agree.[18] This is true even if the modification is in the interests of investors as a whole. In contrast, foreclosure is, from the industry's point of view, a practice that provides a shield from lawsuits.
- Piggyback seconds – Many mortgaged properties have both a primary and a junior lien holder, who has directly conflicting financial interests that often precludes their ability to agree on a modification that would keep the borrower in the home.
- Over a third of pooling and servicing agreements between the servicer and investors prevent modification of more than 5% of the loans,[19] a threshold that will often be met.

Recent experience shows that the likelihood of widespread modifications is small under the voluntary approach; as recently noted in *Inside B&C Lending*, "Some servicers are not doing any loan mods at all."[20] These obstacles suggest that many of the loans even eligible for the Paulson plan will not actually be modified. But even using a generous estimate that 75 percent of them will be, as CRL has in its newest analysis, the number of families helped would still be a small fraction of what's needed.

The Paulson plan is admirable in its goal of providing streamlined modifications, and well constructed for those homeowners who qualify for such a result. However, those who do not qualify, who are otherwise eligible for individualized modifications, will face the same problems hampering such modifications today. Given the magnitude of today's economic woes, the plan won't help nearly enough borrowers to avoid further widespread economic damage from foreclosures. The Paulson plan is certainly part of the solution of avoiding mass foreclosures, but it can't be the only one.

III. Court-supervised modifications are necessary to significantly reduce foreclosures.

<u>600,000 foreclosures prevented</u>. CRL estimates that court-supervised modifications allowed by HR 3609, "The Home Ownership and Mortgage Equity Protection Act," could prevent 600,000 homes from being lost to foreclosure, and prevent $72.5 billion of wealth from being lost by families who are faithfully paying their mortgages but who have the misfortune of living within a block of these foreclosures.

Similarly, according to Mark Zandi, Chief Economist and Co-Founder of Moody's Economy.com, allowing homeowners access to court-supervised modifications would prevent about one-quarter of foreclosures likely to occur between now and the end of next year—or about 570,000 homes saved.[21]

<u>Current law excludes homeowners from protection but includes yacht owners</u>. Today homeowners are denied equal access to bankruptcy protections. Court-supervised modification of loans under a chapter 13 payment plan is available for owners of commercial real estate and yachts, but is denied to families whose most important asset is the home they live in. In fact, current law makes a mortgage on a primary residence the only debt that bankruptcy courts are <u>not</u> permitted to modify.

<u>The bipartisan, compromise House bill narrowly targets loans that would face foreclosure</u>:

- <u>Relief available only when foreclosure is imminent but a family could afford to pay a mortgage readjusted to a fair-market value.</u> A strict "means test" would limit relief to those homeowners with income sufficient to cover a mortgage modified to a fair market value, and such a modification would be limited to borrowers who have received notice from their servicer that foreclosure is imminent.
- <u>Judicial discretion limited; favorable loan terms for lender guaranteed</u>. The interest rate will be market rate plus a risk premium, the loan term stays the same, and the principal balance cannot go below the value of the home. In foreclosure, the lender cannot recover any more than the market value of the home, and typically recovers far less after a one- to two-year process. Families who could not afford a market rate loan cannot qualify.
- <u>Relief available for existing loans only</u>. This limitation removes any concerns that could reasonably be raised about the bill's impact on the cost or availability of credit for future loans.

- Bill applies only to loan products federal regulators deem potentially dangerous: subprime and "non-traditional" loans (that is, interest-only loans and payment option ARMs). Conventional fixed-rate or adjustable-rate loans are not eligible.

Advantages of court-supervised modification:

- No cost to the US Treasury. Provides a fair way for approximately 600,000 families to keep their homes while avoiding further damage to the economy as a whole– far more than any other solution proposed or implemented.
- Would mitigate a projected $350 billion in losses to financial institutions and a projected $72.5 billion in losses to homeowners living near foreclosures.
- Targets only truly distressed loans, and excludes homeowners with enough income to keep their original mortgage.
- Removes the threat of investor lawsuits—a major obstacle to voluntary loan modifications by lenders. As a result, the likely outcome is that most modifications would occur outside of bankruptcy.

In Summary: We Need to Maximize Sustainable Loan Modifications.

The subprime problem has become everyone's problem. Foreclosures are not only harming the families who lose homes, they also spread negative effects through entire communities and the wider economy. In a recent analysis, CRL found:[22]

- 40.6 million neighboring homes will experience devaluation because of subprime foreclosures that take place nearby.
- The total decline in house values and tax base from nearby foreclosures will be $202 billion.

To the extent that foreclosures can be prevented and help provided to struggling homeowners to allow them to continue paying, the entire economy will be better off.

---

[1] Mark Zandi, *Written Testimony of Mark Zandi, Chief Economist and Co-Founder, Moody's Economy.com Before the House Subcommittee on Commercial and Administrative Law Hearing on "The Growing Mortgage Foreclosure Crisis: Identifying Solutions and Dispelling Myths"*, (January 29, 2008) (available at http://www.responsiblelending.org/pdfs/paulson-brief-final.pdf).

[2] Merrill Lynch, *The Market Economist: Weekly guidebook for the global investor* (December 14, 2007).

[3] Three out of eight subprime ARMs originated in 2006 had an initial loan to value ratio of 95% or greater. Christopher Cagan, "Mortgage Payment Reset: The Issue and the Impact" (First American Core Logic, March 19, 2007). As of December, 2007, the Case-Shiller House Price Index, which measures sales prices in the 20 largest metropolitan areas, is down 4.9 percent since 2006. Standard & Poor's, "The S&P/Case-Shiller U.S. National Home Price Index Posts a Record Annual Decline in the 3rd Quarter of 2007." November 27, 2007, available at: (http://www2.standardandpoors.com/spf/pdf/index/CSHomePrice_Release_112766.pdf).

[4] A loan modification is a change in the terms of the loan, such as freezing the teaser rate of an ARM for a period of time or the life of the loan, reducing the interest rate or principal balance, extending the term of the loan, or increasing the principal balance by the amount the borrower is delinquent.

[5] 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.

[6] Christopher Cagan, cited in Ivry, Bob, "Subprime Borrowers to Lose Homes at Record Pace as Rates Rise" (Sept. 19, 2007), Bloomberg, available at: http://www.bloomberg.com/apps/news?pid=email_en&refer=finance&sid=akOEPec30TR4.

[7] http://www.mortgagebankers.org/NewsandMedia/PressCenter/59454.htm
[8] Renae Merle, *Washington Post*, D1 (January 18, 2007).
[9] HOPE NOW is a cooperative effort among counselors, servicers and lenders to provide outreach to borrowers; www.hopenow.com.
[10] http://www.fsround.org/hope_now/pdfs/5-18JanuaryRelease.pdf.
[11] http://www.mortgagebankers.org/NewsandMedia/PressCenter/59454.htm, page 7.
[12] http://dodd.senate.gov/index.php?q=node/3863/print.
[13] Gretchen Morgenson, “Can These Mortgages be Saved?” *New York Times* (September 30, 2007).
[14] http://www.mortgagebankers.org/NewsandMedia/PressCenter/59454.htm, page 5.
[15] Rick Brooks and Ruth Simon, “Subprime Debacle Traps Even Very Credit-Worthy As Housing Boomed, Industry Pushed Loans To a Broader Market,” *The Wall Street Journal* at A1 (Dec. 3, 2007).
[16] January 25, 2007 letter from Coalition for Fair and Affordable Lending, a subprime lending trade group, to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner, at 3.
[17] Inside Mortgage Finance Reprints, “Subprime Debt Outstanding Falls, Servicers Pushed on Loan Mods” (Nov. 16, 2007) (quoting Karen Weaver, a managing director and global head of securitization research at Deutsche Bank Securities).
[18] Sam Garcia, “Group Warns on Large Scale Modifications: Consumer Mortgage Coalition Sends Letter to FDIC,” MortgageDaily.com (October 9, 2007) (servicer doing widespread modifications “faces potential legal action from the securitization trustee and even from the securities holders themselves”).
[19] “Loan Modifications in U.S. RMBS: Frequently Asked Questions,” Moody’s (June 6, 2007).
[20] Inside Mortgage Finance Reprints, “Subprime Debt Outstanding Falls,” see note 16.
[21] Testimony of Mark Zandi, chief economist and co-founder of Moody’s Economy.com, before the U.S. Senate Committee on the Judiciary, “The Looming Foreclosures Crisis: How to Help Families Save Their Homes,” (December 5, 2007).
[22] http://www.responsiblelending.org/issues/mortgage/research/subprime-spillover.html.

CENTER FOR RESPONSIBLE LENDING

Number and Proportion of Homeowners with Subprime Adjustable Rate Mortgages Estimated to Receive Interest Rate Freeze Under Treasury Department Plan (January 28, 2008)

Eligibility Criteria	Proportion Excluded	Proportion Included	Homeowners Qualifying	Source
Outstanding Subprime ARMs	-	-	3,699,084	MBA National Delinquency Survey 3Q07 (MBA); assume MBA coverage of 80%
Proportion securitized	10%	90%	3,329,175	MBA; Bank of America Securities (BoA)
Made in 1/05-7/07 & adjust in 1/08-7/10 & fixed rate period <=36 months	49%	51%	1,697,879	BoA
Owner-occupied	7%	93%	1,579,028	BoA
Less than 30 days delinquent (OTS method)	26%	74%	1,168,481	McDash Analytics
Borrower not eligible for FHA refinance	42%	58%	678,887	McDash Analytics
Borrower credit score < 660	36%	64%	434,488	McDash Analytics
Borrower credit score has not improved 10%	36%	64%	278,072	McDash Analytics
Loan does not terminate prior to reset	22%	78%	216,896	BoA
Subordinate lien holder consents or no junior lien	15%	85%	184,362	UBS shows 30% junior lien; assume 50% approve
Securitization documents do not constrain modification	10%	90%	165,926	Bear Stearns; Moody's
Borrower makes two on-time payments following modification notice	5%	95%	157,629	Assumption
Servicer and investors concur and execute plan	25%	75%	118,222	Assumption
Total	**97%**	**3%**	**118,222**	

References:

Mortgage Bankers Association, *National Delinquency Survey Q307*
Bank of America Securities, *MBS/ABS Trading Analytics* (11/26/07)
McDash Analytics, *Core Database* (12/2007)
Dale Westoff, Senior Managing Director, Bear Stearns & Co, Inc., *Subprime Spillover* (3/9/07)
David Lu, Director, U.S. Securitized Products Strategy Group, UBS, *How Bad is 2006 Subprime Collateral?* (11/21/06)
Moody's, *Loan Modifications in U.S. RMBS: Frequently Asked Questions* (6/6/2007)