MORTGAGE INDUSTRY MAKING FEW LOAN MODIFICATIONS TO HELP KEEP BORROWERS IN THEIR HOMES

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On August 31, President Bush announced a White House initiative to help homeowners facing foreclosure. In his press conference, the President said, "I strongly urge lenders to work with homeowners to adjust their mortgages. I believe lenders have a responsibility to help these good people to renegotiate so they can stay in their home." Regulators have urged the same actions for banks they regulate.[1]

Four months earlier, in May, lending industry leaders committed to helping borrowers to avoid foreclosure, by modifying loan terms to "ensure that the loan is sustainable for the life of the loan, rather than, for example, deferring the reset period."[2] These lenders agreed that such modifications should include, as appropriate, one or more of:

- "Switching from an adjustable to a fixed rate loan at an affordable rate"
- "Reducing the interest rate"
- "Reducing the principal in order to ensure affordability"
- "Reamortizing the loan."[3]

Unfortunately, despite the extensive public discussion, lenders are not modifying loans in any significant numbers.[4] Just recently, Moody's surveyed the modification practices of subprime servicers constituting 80% of the total market. Moody's concluded that subprime losses will continue to increase, and it will have to continue to downgrade subprime securities, because "most servicers had only modified approximately 1% of their serviced loans that experienced a reset in the months of January, April and July 2007."[5]

Moreover, many of those few modifications that are being made do not comply with the objective of long-term sustainability. Indeed, most of Countrywide's foreclosure prevention activities consist of simply capitalizing arrearages, or taking the borrower's home before the foreclosure proceedings are completed.[6]

Even those servicers and lenders who genuinely wish to help homeowners in distress, or who recognize that investors as a whole would fare better under a modification than through foreclosure, face significant obstacles to modifying loans. The following are four main reasons for failing to modify:

- Fear of Investor Lawsuits. The servicer has obligations to investors who have purchased mortgage-backed securities through pooling and servicing contracts. Modifying a loan typically impacts various tranches of a security differently, which raises the specter of investor lawsuits when one or more tranches lose income. For example, a modification that defers loss will favor the residual holder if the excess yield account is released, but will hurt senior bondholders. In this situation, the least risky course for the servicer is to pursue foreclosure – even though this may be the least economically beneficial for investors as a whole.

- Dilemma of Piggyback Seconds. 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.[7] When there is a second mortgage, the holder of the first mortgage has no incentive to provide modifications that would free up borrower resources to make payments on the second mortgage. At the same time, the holder of the second mortgage has no incentive to support an effective modification, which would likely cause it to face a 100% loss; rather, the holder of the second is better off waiting to see if a borrower can make a few payments before foreclosure. Beyond the inherent economic conflict, dealing with two servicers is a negotiating challenge that most borrowers cannot surmount.

- Servicers Overwhelmed by Demand. The magnitude of the crisis has simply been too much for many servicing operations to effectively respond. Hundreds of thousands of borrowers are asking for relief from organizations that have traditionally had a collections mentality, have been increasingly automated, and whose workers are simply not equipped to handle case-by-case negotiations. Many of these servicers are affiliated with lenders who are going bankrupt or facing severe financial stress, and therefore they are cutting back on staff just as the demands are increasing significantly. In addition, housing counselors and attorneys have observed that even when top management expresses a desire to make voluntary modifications, the word does not filter to the front-line staff.

- Mismatched Incentives between Servicer and Investor. Foreclosures are costly – often costing 40% or more of the outstanding loan balance – but these costs are borne by investors, not servicers. In fact, servicers often charge fees by affiliates for appraisals and other foreclosure-related services, and so can be economically incentivized to proceed to foreclosure, even where a loan modification would be better for investors.[8]

Since, for the various reasons listed above, servicers have not modified loans that are proceeding directly to foreclosure in significant numbers, Congressional action is needed to enable bankruptcy courts to order loan modifications. This will remove the threat of investor lawsuit and therefore lead to voluntary modifications on a much larger scale than has occurred to date. This legislation would be in the interest of borrowers and investors alike.

1 White House press release, August 31, 2007. See also the Interagency Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages, http://www.federalreserve.gov/newsevents/press/bcreg/20070904a.htm (Encouraging lenders to address subprime hybrid ARM resets by pursuing "appropriate loss mitigation strategies designed to preserve homeownership. . . . Appropriate loss mitigation strategies may include, for example, loan modifications, deferral of payments, or a reduction of principal.")

2 Homeownership Preservation Summit Statement of Principles (May 2, 2007), http://dodd.senate.gov/index.php?q=node/3870/print (The Principles were announced by Senator Dodd, and endorsed by the Mortgage Bankers Association, CitiGroup, Chase, Litton, HSBC, Countrywide, Wells, AFSA, Option One, Freddie Mac, and Fannie Mae).

3 Id.

4 See generally "Modified Mortgages: Lenders Talking, Then Balking," San Francisco Chronicle, 9/13/07 ("Lenders are uniformly unwilling to make loan modifications for homeowners whose interest rates are resetting higher, said Rick Harper, director of housing at Consumer Credit Counseling Services of San Francisco, which talks to about 1,000 delinquent borrowers a month."); Jim Wasserman, "Foreclosures stack up: Frustrated borrowers who lenders to try to work things out say it's a fruitless ordeal," Sacramento Bee, 9/2/07; "Tangle of Loans Feeds Foreclosure Crisis," The Boston Globe, 7/3107 http://www.boston.com/business/personalfinance/articles/2007/07/31/tangle_of_loans_feeds_foreclosure_crisis/.

5 Michael P. Drucker and William Fricke , Moody's Investors Service, Moody's Subprime Mortgage Servicer Survey on Loan Modifications, September 21, 2007 ("Based on the survey results, Moody's is concerned that the number of modifications that will be performed in the future by subprime servicers on loans facing reset may be lower than what will be needed to significantly mitigate losses in subprime pools backing rated securitizations.").

6 Gretchen Morgenson, Can These Mortgages Be Saved?, The New York Times (Sept. 30, 2007).

7 Credit Suisse, Mortgage Liquidity du Jour: Underestimated No More, March 12, 2007, p. 5.

8 Gretchen Morgenson, Can These Mortgages Be Saved?, The New York Times (Sept. 30, 2007).