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Home Foreclosures: Will Voluntary Mortgage Modification Help Families Save Their Homes?

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Chairman Cohen, Ranking Member Franks and members of the Committee, thank you for this opportunity to testify concerning the vital questions of how we are responding and should respond to the foreclosure crisis. I have studied the subprime mortgage industry for the past ten years, and I am conducting ongoing research on mortgage defaults, foreclosures, workouts and modification agreements. I testified in September of last year before the House Financial Services Committee about the inadequacy of voluntary action by mortgage servicers, and unfortunately the foreclosure crisis has grown dramatically worse since then. Month after month up to and including June 2009 foreclosures continue to increase, and voluntary modifications have failed to keep pace with foreclosures, much less to turn the tide.

The Administration's Home Affordable program, offering incentives to mortgage servicers to increase voluntary modifications, has not been in effect long enough to evaluate. It is clear, however, that this new voluntary, incentives-based program will not and cannot achieve the necessary degree of foreclosure prevention and mortgage debt reduction that are the essential prerequisites to an economic recovery.

Today I will summarize my findings on foreclosures and mortgage modifications during the last twenty-four months. I want to emphasize two key points. First, foreclosures and the economic waste associated with them continue to increase month after month. Second, voluntary mortgage modifications are increasing, not decreasing, total mortgage debt, in a manner that will only prolong the crisis.

Month after month we have seen an increase in new foreclosure filings, from about 125,000 in July 2007 to a high of 290,000 in March 2009. There was a temporary slowdown in the fourth quarter of 2008, as Fannie Mae and several major banks, as well as a number of states, instituted temporary foreclosure freezes, but the steady rise in foreclosures has now resumed, so that we are not even at the peak of the crisis yet.

The losses on foreclosures also continue to rise. Mortgage investors lost an appalling 56% of the total mortgage debt on foreclosures in November 2008, and an even more appalling 65% in June 2009. In the pool of subprime and alt-A mortgages that I follow, there was about 100 times as much money lost on foreclosure sales in June as there was in writing off interest and principal for modified mortgages. There were about ten times as many liquidated foreclosures as there were modifications with debt reduction, and the foreclosure losses on each mortgage were about ten times the amounts of the write-offs on modifications.

While mortgage servicers steadily increased loan modification numbers from July 2007 through February 2009, modifications have tapered off and declined since then. One possible explanation is that the Administration's Home Affordable program requires that homeowners enter a 3-month temporary trial payment period before their loans are permanently modified, and the Home Affordable contracts were not completed until April, so perhaps we will see increased modification activity in August and September. On the other hand, the Treasury Department has set very modest goals for the program, announcing that they expect 50,000 modifications to be completed in the initial phase. Given that HOPE NOW reported about 125,000 voluntary modifications each month through March, 2009, and that there are close to 2 million homes in foreclosure now, the Administration's numbers are not nearly ambitious enough.

Voluntary mortgage modifications continue to increase overall mortgage debt, not reduce it. There are still fewer than 10% of modifications that involve any forgiveness of interest or principal (in June 2009), and fewer than 2% of modifications actually reduce the principal loan balance. Meanwhile, the most common voluntary modification involves *adding* unpaid interest and fees to the balance, so that the homeowner owes more, not less, than before the modification. As a result, more and more Americans owe more than their home is worth. In the long run, these homeowners will have no incentive to continue struggling to make payments, and they will face a crushing debt burden for years to come.

Mortgage modifications in 2007 and early 2008 frequently did not even reduce monthly payment burdens. Things have improved somewhat on this front, and now about 60% of modifications do result, at least temporarily, in reduced monthly payments. This is usually achieved by temporary reductions in interest rates, or by extending 30-year mortgages to 40 years, or both.

Many voluntary mortgage modifications reduce interest and payments only for a three- to five-year period, and are thus kicking the can down the road. Homeowners with modified loans thus will face interest rate and payment increases in 2012, 2013 or 2014, similar to the payment shocks that resulted from subprime adjustable-rate mortgages in the first place. Moreover, many modifications result in large balloon payments that come due when the mortgage matures.

The Boston Federal Reserve Bank recently released a discussion paper whose central argument is that mortgage servicers have rational economic reasons for not modifying mortgages.[1] In particular, they argue that because modified loans redefault at a high rate, and unmodified loans in default are sometimes cured and paid in full, voluntary modifications could result in overall losses, so mortgage servicers are acting rationally by foreclosing, not modifying.

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[1] Manuel Adelino, Kristopher Gerardi & Paul Willen, Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization (Boston Federal Reserve Bank Public Policy Discussion Paper 09-4, July 6, 2009).

There are two problems with this argument. First, the authors use a theoretical model to compare foreclosures with modifications, and the outcome of the model depends entirely on the assumptions made about redefault, cure and loss severity rates. If losses on foreclosures are high, mortgages in default have a low probability of getting caught up or paid in full, and modifications can result in on-time payment in a majority of cases, then modifications will indeed save servicers and investors money. The second problem is that the need to prevent foreclosures and reduce mortgage debt goes beyond the need of the mortgage company to maximize return on a particular loan. Every additional foreclosure sale reduces the value of surrounding properties and also reduces the value of mortgages held by other investors and financial institutions. The cost of losing a home for the family affected is incalculable, and is also not borne by the mortgage holder.

These externalities fully justify intervention to reduce foreclosures and encourage modifications, and more specifically to reduce existing mortgage balances to bring them into line with home values, while allowing families to remain in their homes and preventing the emptying and devastation of neighborhoods. The simplest way to achieve the deleveraging of American homeowners is to allow bankruptcy judges to reduce mortgages to the value of the property for those homeowners who choose to go through the rigors of Chapter 13, including devoting all their available income to debt repayment. Mortgage reduction in bankruptcy is an essential complement to the voluntary mortgage modification programs that so far have not gotten to the heart of the problem.

Detailed summaries of the mortgage foreclosure and modification data I am following are available on my web page at:

http://www.valpo.edu/law/faculty/awhite/data/index.php

In addition I have written two papers summarizing the limitations of voluntary mortgage modifications in 2007 and 2008, which are available at:

http://ssrn.com/abstract=1325534 and http://ssrn.com/abstract=1259538.

I would be happy to answer any questions, and to respond to any specific queries from you or your staff regarding the available foreclosure and modification data.

1. Comparison of Foreclosure Losses and Modification Write-Downs:

May 26, 2009 Columbia Collateral file (subprime and alt-A)					
	Number	**Avg Loss**	**Avg Original Balance**	**Loss severity**	**Total Losses**
Liquidated Foreclosures	32,267	$141,953	$219,677	64.62%	$4,580,416,861
Loan Modifications with write-offs	2,343	$13,077	$221,199	5.91%	$30,638,804
Ratio of Foreclosure losses to Modifications write-downs:					149.50

June 25, 2009 Columbia Collateral file (subprime and alt-A)					
	Number	**Avg Loss**	**Avg Original Balance**	**Loss severity**	**Total Losses**
Liquidated Foreclosures	31,856	$143,987	$222,714	64.65%	$4,586,843,026
Loan Modifications with write-offs	3,135	$14,353	$223,162	6.43%	$44,996,967
Ratio of Foreclosure losses to Modifications write-downs:					101.94