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How Banks Are Worsening the Foreclosure Crisis

How the banking industry is undermining efforts to keep people in their houses

By Brian Grow, Keith Epstein and Robert Berner

The bad mortgages that got the current financial crisis started have produced a terrifying wave of home foreclosures. Unless the foreclosure surge eases, even the most extravagant federal stimulus spending won't spur an economic recovery.

The Obama Administration is expected within the next few weeks to announce an initiative of $50 billion or more to help strapped homeowners. But with 1 million residences having fallen into foreclosure since 2006, and an additional 5.9 million expected over the next four years, the Obama plan—whatever its details—can't possibly do the job by itself. Lenders and investors will have to acknowledge huge losses and figure out how to keep recession-wracked borrowers making at least some monthly payments.

So far the industry hasn't shown that kind of foresight. One reason foreclosures are so rampant is that banks and their advocates in Washington have delayed, diluted, and obstructed attempts to address the problem. Industry lobbyists are still at it today, working overtime to whittle down legislation backed by President Obama that would give bankruptcy courts the authority to shrink mortgage debt. Lobbyists say they will fight to restrict the types of loans the bankruptcy proposal covers and new powers granted to judges.

The industry strategy all along has been to buy time and thwart regulation, financial-services lobbyists tell *BusinessWeek* . "We were like the Dutch boy with his finger in the dike," says one business advocate who, like several colleagues, insists on anonymity, fearing career damage. Some admit that, in retrospect, their clients, which include Bank of America (BAC), Citigroup (C), and JPMorgan Chase (JPM), would have been better off had they agreed two years ago to address foreclosures systematically rather than pin their hopes on an unlikely housing rebound.

In public, financial institutions insist they've done their best to prevent foreclosures. Most argue that giving bankruptcy courts increased clout, known as cramdown authority, would reward irresponsible borrowers and result in higher borrowing costs. "What we're trying to do now is target the bill to make it as narrow as possible," says Scott Talbott, a lobbyist for the Financial Services Roundtable. On the defensive, the industry nevertheless benefits from one strain of popular opinion that home buyers who took on risky mortgages—even if the industry pushed those loans—don't deserve to be rescued.

AN INDUSTRY IN DENIAL

However the skirmish ends, the industry's contention that it has done as much as possible to limit foreclosures seems hollow. Some statistics it cites appear to be exaggerated. Even pro-industry figures such as Steven C. Preston, a Republican businessman who headed the Housing & Urban Development Dept. late in the Bush Administration, concede that many lenders have dragged their heels. "The industry still has not stepped up to the volume of the problem," Preston says. One program, Hope for Homeowners—which Bush officials and banks promised last fall would shield 400,000 families from foreclosure—has so far produced only 25 refinanced loans.

Meanwhile, an already glutted market sinks beneath the weight of more foreclosed homes. Borrowers whose equity has evaporated have nothing to tap into if the recession costs them their jobs. Some lawmakers and regulators are calling for a foreclosure moratorium. "People are falling through the cracks," Preston says. "That's bad for communities, bad for the individuals losing their homes, and bad for investors."

In early 2007, as overextended borrowers began to default on too-good-to-be-true subprime mortgages, housing experts sounded an alarm heard throughout Washington. Christopher Dodd (D-Conn.), chairman of the Senate Banking Committee, wanted to push a bill requiring banks to modify loans whose enticingly low "teaser" interest rates soon give way to tougher terms. But he knew that with Republicans strongly opposed, he lacked the muscle, according to Senate aides. So Dodd did what politicians often do. He convened a talkfest: the Homeownership Preservation Summit.

A who's who of banking executives gathered on Apr. 18, 2007, behind closed doors in an ornate hearing room in the marble-faced Dirksen Senate Office Building. Dodd told them they needed to get out in front of the foreclosure fiasco by adjusting loan terms so borrowers would continue to make some payments, rather than stopping altogether. Foreclosure proceedings typically cost banks about 50% of a property's value. That's assuming the home can be resold—not a certainty when empty houses multiply in a neighborhood. "What are you doing?" Dodd asked the executives. "What do you need me to do to help you modify loans?"

Some from the industry denied a foreclosure problem existed, including Sandor E. Samuels, at the time chief legal officer of subprime giant Countrywide Financial. They vowed to continue selling loans with enticing introductory rates as well as those requiring minimal evidence of borrowers' income. "We are going to keep making these loans until the last second they are legal," Samuels later told a fellow participant.

On May 2, 2007, Dodd's office issued a "Statement of Principles" stemming from the summit. It outlined seven vaguely worded industry aspirations, such as making "early contact" with strapped borrowers and offering modifications that could include lowering loan balances. The principles had no effect, some summit participants now concede.

Much of Dodd's attention shifted to his campaign for the Democratic Presidential nomination. Senate Banking Committee spokeswoman Kate Szostak says Dodd aggressively pursued the foreclosure issue, but "both the industry and the Bush Administration refused to heed his warnings." The lawmaker accepted $5.9 million in contributions from the financial-services industry in 2007 and 2008.

Asked about his role at the summit, Samuels confirmed in an e-mail that he "did speak—formally and informally—about the performance" of subprime loans. But he declined to elaborate. He now works as a top in-house lawyer for Bank of America, which acquired Countrywide in July 2008.

A major reason financial institutions and investors are so determined to avoid modifying loan terms more aggressively has to do with accounting nuances, say industry lobbyists. If, for example, a bank lowered the balance of a certain mortgage, there would be a strong argument that it would have to reduce the value on its balance sheet of all similar mortgages in the same geographic area to reflect the danger that the region had hit an economic slump. Under this stringent approach, financial industry mortgage-related losses could far surpass even the grim $1.1 trillion estimated by Goldman Sachs (GS) in January. A desire to postpone this devastating situation helps explain lenders' intransigence, says Rick Sharga, vice-president of marketing at RealtyTrac, an Irvine (Calif.) firm that analyzes foreclosure patterns.

By mid-2007, Bush Administration officials were deeply worried about the financial industry's unwillingness to confront the growing catastrophe. Even banking lobbyists say they realized that their clients had lapsed into denial. The K Street representatives agreed that Treasury Secretary Henry Paulson needed to step in, says Erick R. Gustafson, then the chief lobbyist for the Mortgage Bankers Assn. "It was like an intervention," he says. "We had to get Treasury involved to get the banks to give us information."

That summer, Paulson, a former CEO of Goldman Sachs, summoned industry executives to the Cash Room, one of Treasury's most elegant venues. There, beneath replica gaslight chandeliers, Neel T. Kashkari, a junior Goldman banker whom Paulson had brought to Treasury, urged industry leaders to move swiftly to keep more consumers from losing their homes. Bankers know how to adjust interest rates, extend loan durations, and, if necessary, lower principal, said Kashkari, who has temporarily remained in his post. A couple of months later, Paulson summoned the executives again, this time to his conference room. "We told them we need to get over the goal line," recalls a former top Treasury official. "Cajoling is a euphemism for what we did. We pounded them."

One product of the Treasury conclaves was the Hope Now Alliance, a government-endorsed private sector organization announced by Paulson on Oct. 10, 2007. Lenders promised to cooperate with nonprofit credit counselors who would help borrowers prevent defaults. Faith Schwartz, a former subprime mortgage executive, was put in charge.

WINDOW DRESSING?

The alliance got off to a shaky start. An early press release contended that there had been more foreclosures nationally than the Mortgage Bankers Assn. was conceding at the time. "We looked like the Keystone Kops," says an industry lobbyist. Soon it became apparent that the program was primarily a public-relations effort, the lobbyist says. "Hope Now is really just a vehicle for collecting and marketing information to the Treasury, people on the Hill, and the news media."

In a press release last Dec. 22, Hope Now said it had prevented 2.2 million foreclosures in 2008 by arranging for borrowers to catch up on delinquent payments and, in some cases, easing terms. But the data don't reveal how many borrowers are falling back into default because many modifications don't, in fact, reduce monthly payments. The alliance doesn't receive this information from banks, says Schwartz.

There's reason for skepticism. Federal banking regulators reported in December 2008 that fully 53% of consumers receiving loan modifications were again delinquent on their mortgages after six months. Alan M. White, a law professor at Valparaiso University, says the redefault rates are high because modifications often lead to higher rather than lower payments. An analysis White did of a sample of 21,219 largely subprime mortgages modified in November 2008 found that only 35% of the cases resulted in lower payments. In 18%, payments stayed the same; in the remaining 47%, they rose. The reason for this strange result: Lenders and loan servicers are tacking on missed payments, taxes, and big fees to borrowers' monthly bills.

Consider the case of Ocbaselassie Kelete, a 41-year-old immigrant from Eritrea who called Hope Now last fall. Kelete, a naturalized U.S. citizen, bought a $540,000 townhouse in Hayward, Calif., in November 2006 with no down payment and 100% financing from First Franklin Financial, a subprime unit of Merrill Lynch. At the time, he and his wife earned $108,000 a year from his two jobs, with a pharmacy and an office-cleaning service, and hers as a janitor. Kelete says First Franklin and his realtor convinced him that he could afford a pair of mortgages, one with a 7.5% initial rate that would rise after three years, and a second with a fixed 12% rate. His monthly payment would total $3,600.

"WORK WITH ME"

"The realtor said, 'Just make sacrifices for two years. Home prices will go up, and you can refinance at a lower rate,' " Kelete recalls. He regrets signing a mortgage he couldn't afford—a mistake many people made during the subprime craze. Home prices didn't go up. He lost his office-cleaning job. First Franklin modified his loans, but added on property taxes it had failed to collect earlier. Kelete's monthly bill rose to $3,900. In October 2008, he called Hope Now. A counselor set up a conference call with First Franklin. The lender's representative said Kelete should get another job or give up the house, the borrower says. Kelete responded that he'd already lost his second job cleaning offices and couldn't find another in a faltering California economy. "Why don't you work with me?" he asked First Franklin. The lender declined. The Hope Now counselor said there was nothing more to do. "Foreclosure is the only future I see," Kelete says. A spokesman for BofA, which acquired Merrill in December, declined to comment, citing the borrower's privacy. After *BusinessWeek*'s inquiries, however, First Franklin contacted Kelete about lowering his monthly payments.

Hope Now's Schwartz acknowledges she is fighting an uphill battle. By her calculation, 45% of the borrowers her organization advises still end up in foreclosure. "If I seem frustrated," she says, "it's because we are dealing with nothing but an exploding problem." She has a full-time staff of four in Washington; 500 counselors participate in the industry-funded hotline. "You shouldn't take it lightly, what we have achieved," Schwartz says. She bristles at suggestions that the statistics she disseminates are misleading. "I print what I know," she says, noting that some of her bank members aren't forthcoming about loan modifications. "It's like herding and juggling cats."

By early 2008 it was obvious that Hope Now wasn't halting a significant percentage of foreclosures. Democrats in Congress began gathering ideas for a government-sponsored remedy. Many of those ideas came from the industry. Lobbyists and congressional aides referred to one concept as "the Credit Suisse plan." Another, "the Bank of America plan," would allow borrowers to refinance mortgages with loans guaranteed by the Federal Housing Administration. Representative Barney Frank (D-Mass.), the chairman of the House Financial Services Committee, had solicited BofA's advice via an old Boston acquaintance, Anne Finucane, the bank's chief marketing executive and a politically active Democrat. He assigned several aides, including Michael M. Paese and Rick Delfin, to work out the details.

Francis Creighton, a Democratic former staff member on the Financial Services panel who had gone to work as a lobbyist for the Mortgage Bankers Assn., negotiated with Paese and Delfin. Creighton's Republican colleague Gustafson huddled with aides to such GOP lawmakers as Representative Spencer Bachus and Senator Richard Shelby, both of Alabama.

Before long, the anti-foreclosure provisions were being altered in ways the industry favored. Shelby, the ranking Republican on the Senate Banking Committee, along with other Republicans insisted on the pro-industry language in exchange for their support, aides say.

In the end, the program included stiff up-front and annual fees and a requirement that homeowners pay the government 50% of any future appreciation in the property's value—all of which made it much less attractive to borrowers. Moreover, the banks' participation was made entirely voluntary; there was no way to pressure them to cooperate.

Congress approved Hope for Homeowners on July 26, 2008, as part of a larger measure imposing restrictions on the mortgage finance firms Fannie Mae (FNM) and Freddie Mac (FRE). At the Mortgage Bankers Assn., lobbyists gathered in Gustafson's corner office to lift plastic cups of wine in celebration.

Those familiar with Hope for Homeowners anticipated that its fine print would discourage all but a few borrowers. "We knew it was likely to have limited appeal," says Preston, the former secretary of HUD, which oversees the FHA. George Miller, executive director of the American Securitization Forum, a Wall Street trade group, calls the program and its 25 refinanced loans "useless" because of the onerous details.

BROKEN BILL

Shelby, for his part, never expected Hope for Homeowners to accomplish much, according to Republican Senate aides. He agreed to it to gain Dodd's support for greater regulation of Fannie and Freddie—and only when assured the program wouldn't drain tax dollars. "My consistent aim throughout this crisis has been to protect the American taxpayer," Shelby told *BusinessWeek* in a statement. He accepted $565,000 in contributions from the financial-services industry in 2007-2008.

Frank, whose industry contributions totaled $948,000 over the same period, says he became skeptical Hope for Homeowners could achieve its initial goal of helping 1 million people. But he expected much more progress than the mere 25 refinancings that have occurred so far, according to HUD. He blames Republicans and the industry for undercutting his legislation. "I didn't have the votes to do more," he says.

The Massachusetts liberal hasn't given up hope of repairing Hope for Homeowners. He is working on changes that would cut borrowers' up-front fees and provide bonus money for mortgage servicers that agree to participate in the voluntary program. Frank aides Paese and Delfin aren't assisting with the fixes: They have left their congressional staff positions for lobbying jobs with the Securities Industry & Financial Markets Assn. in Washington. They say they are observing the one-year federal ban on speaking with their former boss about business they did on the Hill.

In the first days of 2009 it appeared that progress might be possible on a different front. A slumping Citigroup came back to the Treasury Dept. for a second round of bailout money. Bowing to pressure from regulators, Citi broke ranks with its rivals and dropped its opposition to bankruptcy cramdown.

Senator Dick Durbin (D-Ill.), who since 2007 had led unsuccessful efforts in Congress to give bankruptcy judges authority to modify home loans, dispatched his senior economic policy adviser, Brad J. McConnell, to talk with lobbyists for JPMorgan Chase and Bank of America. "Each agreed to take [the idea] back to their folks to see what they could do," says a person familiar with the talks. Citi's concession, the imminent Obama inauguration, and intensifying public hostility toward big banks contributed to an atmosphere Democrats assumed would be conducive to compromise.

TALKING POINTS

By the time McConnell talked to the JPMorgan and BofA representatives the next day, however, "they had gone on full defense mode and started to complain about how lousy a deal Citi had struck," says the person familiar with the exchanges. Bank opposition, Durbin says, "was very shortsighted in light of the mess they have created in our economy."

In the following weeks, banking lobbyists launched a renewed attack on the cramdown legislation, enlisting as an ally Republican Representative Lamar Smith of Texas, among others. Apart from Citi, "the industry remains united in that bankruptcy cramdown would destabilize the market" by creating widespread uncertainty about the value of numerous troubled mortgages, says Steve O'Connor, senior vice-president for government relations at the Mortgage Bankers Assn. His group is distributing talking points to key congressional aides laying out reasons why "Congress should defeat bankruptcy reform legislation." These include the argument that if lenders can't be confident that loan terms will survive, they will raise rates and reject riskier borrowers. Industry lobbyists are organizing home state bankers to pressure moderate Democrats they hope will be receptive to limiting the kinds of loans eligible for cramdown. One target: Senator Evan Bayh of Indiana.

Stefanie and James Smith of Santa Clarita, Calif., fear they may need the help of a bankruptcy court if they are to keep the subdivision home they bought for $579,000 in November 2005. Stefanie, 37, a university human resources coordinator, and James, 40, a federal law enforcement agent, borrowed the entire amount in two subprime loans that required a total monthly payment of $3,000. A representative of their lender, Countrywide, told them not to worry, says Stefanie: They would be able to refinance in a year.

By mid-2007 they were running late on payments, and refinancing options had dried up. With their monthly bill scheduled to jump to more than $4,000 this January due to a rising mortgage rate, Stefanie contacted Countrywide last summer. She asked for a loan modification so they could avoid default. In December the lender said it would be willing to increase their payment by $600. That was better than the scheduled rise of $1,100, so the Smiths agreed.

But now they are struggling to pay the higher amount. Countrywide's parent, BofA, declined to comment, citing the Smiths' privacy. After *BusinessWeek*'s questions, though, Countrywide called them to discuss cutting their payments.

"We knew when we bought that the payments would be a stretch," says Stefanie. She regrets assuming they would be able to refinance at a lower rate. "We are not deadbeats," she adds. "All we want is a mortgage we can afford."