Center for American Progress

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Sustainable Mortgage Modifications

Setting Clear Benchmarks to Measure Progress and Identifying Possible Next Steps to Contain the Foreclosure Crisis

Andrew Jakabovics March 2009

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Introduction

What a difference seven weeks makes. The Obama administration's quick move to implement a broad-reaching government program to combat home mortgage foreclosures for creditworthy at-risk borrowers in order to protect communities from further decay stands in sharp contrast to the ineffective approach taken by the Bush administration for close to two years as our economy sank into recession.

Moving beyond the Bush era's industry-led approach to loan modifications known as the Hope Now Alliance, which resulted in few substantive or sustainable modifications, the Obama administration's Making Home Affordable program sets out clear guidelines and calculations for participating mortgage service companies to modify mortgages in order help worthy homeowners stay in their homes.[1] The plan is based on the simple truth that foreclosures are costly for nearly all involved: homeowners, mortgage lenders and investors, and communities across the country.[2]

The beauty of the program is that it requires mortgage service companies to do what is in the best interest of their customers—lenders and investors—by requiring them to offer modifications in a consistent manner on all loans for which they are responsible when modification maximizes the net present value of a mortgage compared to foreclosure. The program, in short, aligns the interests of borrowers, lenders and investors when foreclosure is clearly not preferable to loan modifications for any of them, and helps stabilize housing prices in communities nationwide.

Success, however, is not guaranteed, which is why the Obama administration and Congress must put in place appropriate tools to measure progress towards those goals. Both the Bush administration's weak efforts and the more serious but as yet unsuccessful attempt initiated by Congress under the Hope for Homeowners program—enacted in July 2008 but with little to boast about to date—serve as reminders that it is not entirely predictable how such a large and diverse market involving many different financial institutions and millions of borrowers in a variety of circumstances will respond to a program encouraging modifications.

The Making Home Affordable program is thoughtfully designed and has every prospect of succeeding, but constant evaluation should be built into the program from the beginning so that if it isn't working—or even if some aspects are and some are not—then we will know these things quickly and can take corrective action. As the program gets underway, now is the critical time to establish clear reporting requirements and benchmarks for mortgage service companies to meet.

Moreover, if regular, ongoing evaluations of participating mortgage servicers indicate they are failing to meet expectations for the number of modifications made on non-Fannie Mae or non-Freddie Mac mortgages under program guidelines, then the government should consider taking additional action to modify loans. These next steps are not without controversy, but as we will argue in this presentation, they deserve serious consideration if the benchmarks for individual servicers or the program as a whole are not met.

The program is predicted to provide 3 million to 4 million homeowners with mortgage modifications over the next two years.[3] Working off the low end of that range, it seems reasonable to set a performance benchmark for the program based on that anticipated level of modification activity of 750,000 modifications within six months. Or calculated another way, mortgage servicers should be expected to modify 25 percent of their troubled portfolios in the same time frame. Because we do not have the luxury of waiting before evaluating the new program's success or failure—absent a concerted effort to modify loans, an estimated 9 million families will lose their homes over the next four years[4]—the Obama administration needs to measure itself against basic metrics for success both for individual mortgage servicers and the program as a whole.

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The metrics detailed in this paper should be established within the next three months, in keeping with the Obama administration's commitment to efficient and effective use of taxpayer resources. Congress should take additional actions now, well in advance of the six-month evaluation date, to provide the administration with the authority necessary to implement the suggested next steps should it become clear that the mortgage-modification benchmarks are not being met, either by the program as a whole or by servicers individually. We will also argue these points in the pages that follow.

Establish clear mortgage modification standards to demonstrate commitment and certainty

During the Bush years, the mortgage servicing industry was largely left alone, with no government role in trying to establish clear industry-wide mortgage procedures for making sustainable modifications. Instead, loose private-sector guidelines issued in June 2008 prioritized repayment plans over modifications. These repayment plans often tacked on past due amounts—including late fees—to already unaffordable monthly payments. The Obama administration's plan, in contrast, explicitly requires servicers to adjust monthly payments down to 31 percent of income and waive unpaid late fees in order to be eligible for incentive payments and subsidized interest rate buy-downs.

The lack of a true industry standard for modifications under the Bush administration allowed servicers to favor repayment plans over sustainable mortgage modifications as an interim alternative to foreclosure. The reason: following the standard waterfall approach led in most cases to repayment plans that maximized short-term returns in the form of a few additional months' payments while delaying losses ultimately realized in foreclosure. Unfortunately, many of these repayment plans have led to redefaults by borrowers as servicers tack on additional fees and charges which end up burdening the homeowner with higher—not lower—monthly payments.[5]

Crucially, the Obama administration's program creates a clear industry standard for mortgage modifications which, in addition to helping keep borrowers in their homes, helps servicers fulfill their legal obligations to maximize value for their customers, the home mortgage lenders and investors.[6] Further, the servicing industry can safely make more modifications knowing they are protecting the long-term value of individual mortgages and the overall value of the mortgage-backed securities in which they were often bundled.

The speed at which the program was rolled out—only two weeks elapsed between the initial announcement on February 18 and the release of detailed program rules on March 4—demonstrates the Obama administration's commitment to acting quickly to prevent further foreclosures and house price deterioration. By comparison, eight months elapsed last year between then-Treasury Secretary Henry Paulson's oversight at the creation of the Hope Now Alliance and the issuance of the aforementioned guidelines.

The Obama administration must continue to move swiftly due to the cumulative impact of the Bush administration's inaction on the housing crisis in 2007 and 2008. We cannot afford to waste another year hoping that mortgage servicers will get their acts together and make sustainable modifications.[7] If they are failing to make modifications, we need to know quickly and respond accordingly.

How the Home Affordable Modification Program works

The Making Home Affordable program boasts a program within it called the Home Affordable Modification Program. HAMP combines expanded refinancing opportunities for borrowers with loans bought by now government-controlled mortgage finance companies Fannie Mae and Freddie Mac with sustainable modification components for other at-risk homeowners. HAMP recognizes the critical role that all mortgage servicers play in the entire mortgage process. Specifically, it lays out clear guidelines for how servicers are to handle modifications, and offers servicers incentives not only for making modifications but also for prospectively reaching out to at-risk borrowers in advance of default.

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The full program also looks to Congress to implement changes to the bankruptcy code that would allow bankruptcy judges to treat home mortgages on an equal basis as second homes, yachts, and cars, giving judges the power to split individual mortgage indebtedness into secured and unsecured components in cases where the loan balance exceeds the value of the property. The bankruptcy changes as well as mandatory program participation for future recipients of Troubled Asset Relief Program funds—the $700 billion financial services rescue package enacted by Congress last fall—are widely viewed as useful sticks to get servicers to expand their modification activities. Additionally, the bankruptcy bill now before Congress includes a so called "safe harbor" provision for servicers who make modifications in accordance with HAMP guidelines, protecting the servicers from lawsuits by investors when modifying loans.

Participating servicers will evaluate each loan in their portfolios with the aim of reducing borrowers' monthly obligations to no more than 31 percent of their income. The net present value of the modification will be compared to the net present value of proceeding to foreclosure, taking into account the carrying costs of the property until sale and likely further depreciation of the soon-to-be vacant house. Where modifications provide a higher net present value, HAMP guidelines stipulate they be offered to homeowners. Under these conditions, servicers' legal obligations to their clients would also seem to require modification.

This 31 percent debt-to-income ratio is established under HAMP as the industry standard for sustainable modifications. Changes to loans that fail to meet this standard are ineligible for government-funded incentive payments or subsidies. This reasonable monthly payment ratio will help reduce the likelihood that the modifications will end in another default.

To modify mortgages under the HAMP rules, servicers will proceed according to a standardized process. First, they will verify income and the current monthly payments, inclusive of principal and interest on the first lien on the property, property taxes, insurance, and homeowners' association or condominium fees where applicable. Then, servicers will reduce the interest rate on the mortgage in increments of one-eighth of a percent, down to a minimum of 2 percent, to try to reach the 31 percent debt-to-income ratio.

If the two-percent threshold is reached before achieving the 31 percent debt-to-income ratio, then the servicer is to extend the repayment period up to 40 years. Extending the time allocated for paying back the loan significantly reduces the amount of principal paid each month, lowering the total monthly payment. If the combined interest rate reduction and increased loan length are insufficient, the servicer is directed to "forebear" principal, which means to treat some of the principal separately, charging no interest on that amount and not demanding repayment on it until sale, refinancing, or full payoff of the interest bearing amount. Servicers also have the option to forgive principal outright to achieve the 31 percent debt-to-income target, either alone or in conjunction with the aforementioned steps.

Servicers will be paid $1,000 by the government for each loan they modify with additional $1,000 payments annually for up to three years so long as the modified loan remains current. This is additional incentive for servicers to modify mortgages in accordance with the program.

In addition, servicers will be paid $500—with an additional $1,500 passed to lenders and investors in these mortgages for modifying mortgages of at-risk borrowers before they go into default for the first time. All of these steps are designed so that HAMP results in modifications that can be sustained for at least five years. What's more, HAMP limits interest rate increases at the end of the five-year modification term to no more than 1 percent annually up to the original interest rate or the prevailing rate reported by Freddie Mac at the time of modification, whichever is less.

Home Affordable Modification Program expectations

Now that the Obama administration has set out clear guidelines for all participants in the Home Affordable Modification Program, we anticipate that servicers will soon be ramping up their efforts to sustainably modify existing mortgages at risk of delinquency or already in default. Indeed, Citigroup Inc., JPMorgan Chase & Co., Bank of America and Wells Fargo & Co., which collectively service two-thirds of all mortgages, have indicated they are likely to participate.[8] Optimally, we would like to see all servicers, regardless of size, participate in the program. Bank of America has already announced a partial foreclosure moratorium until they get their end of HAMP up and running, and we strongly encourage all other servicers to follow suit.[9]

Still, we need clear measurements of success and failure, and should the volume of modifications fall short of clearly defined expectations then it will be high time for more aggressive actions to be taken. HAMP has a number of important provisions, including:

- Modification based on sustainable monthly payments.
- Eligibility for households at risk of default but still current on their loans.
- Basing the decision to modify relative to the residual value of the property in foreclosure.
- Requiring servicers who choose to participate in HAMP to apply the modification guidelines to their entire portfolio, with the exception of loans in pools whose servicing contracts expressly prohibit modifications.

In addition to the expected participation by large servicers, all future recipients of TARP funds will need to participate, which should also increase the program's take-up rate. Nevertheless, participation is only part of the equation. It is critical that the administration put forth a clear set of performance metrics to identify best practices and those who aren't up to that standard. Moreover, even if the data show servicers are legitimately making a good faith effort to modify loans yet these modifications in the aggregate remain few relative to the scale of the foreclosure problem or are subject to high rates of redefault, then it may be necessary to revise program rules or move towards more aggressive policies.

Setting clear program benchmarks

There is no single performance metric that unequivocally would determine an individual servicer's success or failure, and by extension, that of the program as a whole. That's why we suggest a range of measurements that might be appropriate, including comparing a servicer's modification and redefault rates to those of Fannie Mae and Freddie Mac. In short, we need both absolute and relative measures of modifications.

By way of comparison, we need a far greater level of transparency than is currently provided by the Hope Now Alliance, which reports only modification activities extrapolated to the industry level—even though its members service nearly 72 percent of outstanding mortgages. Under the Obama's administration's new set of programs, the government should collect and publish monthly performance reports by each servicer.

There may be legitimate reasons servicers can't achieve the same rates of modifications as for loans guaranteed by Fannie Mae and Freddie Mac, but an initial test should be to make that comparison. The burden of proof should fall to the servicers to provide compelling evidence—based on their specific portfolios—of why they fell short of this baseline.

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Counts of modifications and percentages of serviced loans constitute simple baseline metrics to compare across servicers, but deeper analytics we would like to see reported would include comparisons within serviced portfolios of loans owed by borrowers with high total levels of indebtedness—taking into account second mortgages, credit card debt, school loans, and the like—compared to those whose total indebtedness is lower. Those borrowers with high levels of indebtedness are more likely to redefault, so their modifications should be closely monitored to alert us of a possible need for program adjustments.

We would also like to see the mortgage services companies break out their modification activity by individual mortgage holder to see if mortgages that were securitized are modified at the same rates as those retained by the original lenders. Servicers' fiduciary obligations require them to maximize value for investors in mortgage-backed securities, but it is hard to know without full disclosure which loans are governed by which servicing contracts and which contracts limit to one degree or another the type or volume of modifications that can be made. Loans that were never sold and remain on banks' balance sheets are theoretically easier to modify since a simple statement of corporate policy and directive to the servicing arm to make modifications should suffice.

Tracking loan performance over time, broken out by these categories, will also help identify problem servicers as well as program deficiencies. Determining the redefault rate for groups of loans and individual servicers is a crucial metric for analyzing the costs and benefits of the program from a taxpayer's perspective. To that end, establishing a consistent standard for redefaults, such as 60-plus days delinquent within six months of modification, will be important.

Creating additional tools and mandatory mechanisms to increase mortgage modifications

This reporting and evaluation process outlined above may uncover significant barriers to modifications that are difficult to remedy within the existing context. One serious potential barrier may be servicer capacity, and if that proves to be the case, then the logical next step is to take mortgages out of their hands. The capacity of mortgage servicers to modify mortgages has been a problem since the foreclosure crisis first dawned over a year ago. Even with incentive payments to servicers, they may not have the necessary manpower and remain unwilling to invest in technology to handle the volume of calls we expect them to achieve.

Case in point: Bank of America recently announced it was shifting employees to their servicing department to handle the additional volume of calls they had been getting, but it was not clear from the reports whether these employees will have the necessary authority to approve modifications.[10]

If within a reasonable period of time—say three months or certainly no more than six months—it becomes clear that individual servicers are failing to meet the reasonable levels of modification activity expected of them, then the time will have come to move from carrots to sticks. Similarly, if the HAMP effort as a whole does not meet the level of modification activity set out from the beginning, then more aggressive modification policies should be implemented across the board. These next steps are not without controversy, but they are specifically intended to increase the number of modifications.

These action-forcing mechanisms potentially include:

- Principal reduction.
- The exercise of the government's right of eminent domain on mortgage-backed securities.
- Changes to rules that govern so-called Real Estate Mortgage Investment Conduits in which individual mortgages have been bundled up, sliced into pieces, and sold to investors.
- Expanded bankruptcy provisions to help at-risk homeowners.

All of these mechanisms are complex, requiring the detailed examination we offer below.

Principal reductions

If we find that over time a significant number of modifications end in redefaults, then principal reductions might be better as a first step in the modification process rather than the last. New research from the University of North Carolina[11] shows that principal reduction is ultimately more effective over the long term in preventing redefaults than interest-rate reductions alone, particularly for borrowers who are "underwater," owing more on their home than the home is worth. Borrowers who have some equity in their homes are more likely to keep trying to stay in them, but the same will not be true for borrowers who have no equity in their homes and thus don't see the small amount of principal being paid down each month ever getting them out of a deep hole.

The HAMP effort relies heavily on interest rate reductions to quickly create sustainable mortgages. More aggressive action to offer relief to borrowers whose loans are held by servicers with poor redefault track records should include principal write-downs to the current value of the property in conjunction with adjusting mortgage payments to the 31-percent debt-to-income ratio. Similarly, if HAMP as a whole results in high rates of redefaults, then principal write-downs to the current value of the property should become the new modification standard.

Principal write-downs and interest-rate reductions offer identical net present valuations over the full life of the loan. Likewise, net present values from either type of modification are the same when the property is sold for less than the amount owed after the principal balance write-down. The only time returns to lenders and investors in these modified mortgages would vary is if the property is sold for more than the balance on the written-down mortgage. And in that case, lenders and investors would lose more in the case of principal reductions than if they had just reduced interest rates. There are potentially tax implications on both sides that would differ based on the type of modification used.

The propensity for borrowers to walk away from severely underwater loans, however, improves the net present value calculation for principal balance write-downs compared to interest-rate adjustments for the same monthly payment. The reason: Calculating in the cost of foreclosure means it is probably better for lenders or investors holding these mortgages to go for principal reduction as a way to lessen redefault risk.

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The possibility of a potential windfall for borrowers receiving a principal balance write-down on their mortgages presents a real question about the public perception of fairness in the modification process. Responsible borrowers who continue to make payments based on the original value of their homes may feel the system is biased in favor of people who are perceived to have overreached. So-called "windfall recapture" provisions could mitigate some of this problem. They would ensure homeowners who eventually profit from the sale of their houses share those profits with their lenders and investors. But 100 percent recapture, which would effectively leave borrowers with little hope of ever building up equity, would likely do little to reduce the risk of redefault and could have the effect of stripping away the principal repaid by borrowers over time. The upshot: A balance needs to be struck.

Another potentially controversial aspect of principal balance write-downs is that they require an immediate loss in valuation based on current market price because any subsequent price appreciation would flow to the homeowner rather than the lender or investor. Interest-rate reductions, on the other hand, allow lenders and investors to retain upside potential but do little to minimize default risk in severely underwater mortgages. In practice, however, there is no expectation of rising housing values over the next several years, so the issue is likely moot.

Applying eminent domain

If mortgage servicers are simply too slow to offer modifications, then the government can break the logjam by acquiring entire pools or individual whole loans contained in such pools via eminent domain, which allows the government to acquire private property for a larger public purpose. While eminent domain is most often used to purchase real estate outright, the power has also been extended to taking other forms of interest in real estate such as leases. Given that mortgages (and by extension, pools of mortgages) are also considered to be interests in real estate, the use of eminent domain should apply to them as well.

The issue then becomes one of statutory authority to act. Professor Howell Jackson, dean of Harvard Law School, recognizes "there is a general federal statute that authorizes federal officers to use the power of eminent domain when they have been given statutory authority to purchase real estate."[12] The secretary of the Treasury was granted the explicit authority to purchase mortgages under the Emergency Economic Stabilization Act of 2008.[13] Based on this, Jackson notes that the use of eminent domain for the acquisition of mortgages and mortgage pools appears to be permissible, but argues that congressional action explicitly granting this authority would remove all uncertainty.

Under eminent domain, property holders are entitled to receive just compensation for their losses and have the right to sue the government if they believe the payment they received was less than fair market value of the property. In this context, existing investors would get paid out based on a fair market value of any individual mortgage or of the pool as a whole. After acquisition, the Treasury Department as sole owner of the mortgage or the pool would then be able to unilaterally modify loans by whatever means they choose, including writing down principal to the current value of the property. Subsequent Treasury-funded acquisitions of mortgages and mortgage-backed securities under eminent domain could be funded by resecuritizing modified mortgages through the Government National Mortgage Association, or Ginnie Mae, offering buyers of the new securities an explicit guarantee just like traditional Federal Housing Administration mortgages.

Using REMIC rules for a public purpose

There are at least three ways in which the regulations that govern Real Estate Mortgage Investment Conduits, or REMICs—which are tax-advantaged trusts that issue bonds backed by mortgages that have been pooled and sold into the trusts—could be modified to increase modifications. The simplest change would be to modify the REMIC rules that govern the treatment of the trusts holding securitized mortgages such that trusts with contracts that limit modifications would no longer be eligible for tax-advantaged REMIC status. Investors and trustees would probably restructure their contracts with servicers to eliminate restrictions on modifications to maintain REMIC status, and consequently, we should expect modification rates to rise accordingly.

Taking the idea of rescinding REMIC status for trusts whose contracts with servicers limit modifications one step further, REMIC status could also be revoked for mortgage pools that exceed a certain default or foreclosure rate. Just as above, where the threat of lost status will trigger modifications, this more aggressive regulatory change will provide strong impetus to minimize redefaults as well.

A variation on this concept would be to implement regulatory changes to make REMICs behave more similarly to pools of credit card loans and other asset-backed securities, which include an early amortization trigger that forces the issuer of the asset-backed securities to repurchase the pool. In the case of REMICs, however, instead of passing the mortgage pool back to the issuer, the pool could be passed to Fannie Mae or Freddie Mac for modification. Investor payouts in those instances would be based on calculations of pool value as under the eminent domain scenario, with investors retaining the right to litigate perceived damages.

Expanded bankruptcy provisions

If mortgage servicers' efforts to modify loans prove to be weak, with a demonstrated lack of good faith efforts being made, then expanded access to relief in bankruptcy court for homeowners should be considered. Congress is currently considering legislation that would allow some borrowers to have their loans written down to the current value of the property by a bankruptcy judge, but not all at-risk borrowers would automatically qualify. Recognizing that foreclosures impose significant costs on neighbors and communities, Congress could seek to allow consistent access to relief for all at-risk borrowers.

Moreover, Congress could consider eliminating the five-year clawback provision that would allow note holders to recapture up to 90 percent of profits generated on sale created by a judge's write-down of principal balance. This clawback provision is part of the legislation that recently passed the House of Representatives. Eliminating this provision would strengthen borrowers' hands and potentially move more servicers to participate in the program. The bankruptcy bill currently before Congress could be amended to sunset the clawback provision six months after enactment if modifications fail to meet the program's benchmarks.

Conclusion

In keeping with the Obama administration's belief in transparency and accountability, reporting requirements and benchmarks in its Home Affordable Mortgage Program should be established in short order. Should either mortgage servicers individually or the HAMP program as a whole fail to meet the suggested levels of modifications—750,000 modifications in the aggregate or 25 percent of individual servicers' mortgages within six months—then the need for additional tools and mandatory mechanisms will be clear. Now is the time to put those additional measures in place so that they can be rapidly implemented should the need arise.

Endnotes

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Andrew Jakabovics is the Associate Director for Housing and Economics. He works on housing, household debt, and higher education, as well as other issues related to sustaining and growing the middle class. Jakabovics has appeared on television and radio and in print, most recently for his research on the effects of the current mortgage crisis and potential policy solutions. Prior to joining American Progress, Jakabovics served as the research chief of staff for the MIT Center for Real Estate's Housing Affordability Initiative. In 2004, he founded a grassroots organization, Kiruv for Kerry, which conducted outreach to the Orthodox Jewish community, drafted position papers, and connected policy issues with Jewish principles. He has also lectured on the relationship of Jewish law to the modern, democratic state. Andrew holds a B.A. in Urban Studies from Columbia University and an M.C.P. from the Massachusetts Institute of Technology, where he is currently pursuing his doctorate.

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