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Article

Deleveraging the American Homeowner: The Failure of 2008 Voluntary Mortgage Contract Modifications

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The subprime foreclosure crisis has resulted in residential mortgage debt burdens far beyond what borrowers can repay. Many economists have recognized the need to deleverage the American homeowner. Empirical evidence from mortgage servicer reports to investors show that for the most part, the necessary deleveraging of homeowners is not happening. This Article reports on a study of data from more than 3.5 million subprime and alt-A mortgages, including about one-sixth of all foreclosures pending, and about 20% of the monthly total modifications in November 2008. The key findings are the following: (1) modifications are not reducing principal debt, they are increasing it. Almost no modifications include significant cancellation of either past due interest or principal, and many modifications involve capitalizing unpaid interest and fees and reamortizing the loan, which occurred in 68% of loan modifications. Some principal was canceled, and reported as a partial loss, for about 10% of modifications; (2) servicers are incurring huge losses for investors by foreclosing. The average foreclosure loss on a first mortgage in November 2008 was $145,000 or about 55% of the average amount due. Loss severities increased steadily throughout 2007 and 2008 and are expected to worsen in 2009. In these circumstances, rational investors should accept mortgage principal reductions corresponding to home value declines of 20% or so, were it not for the various obstacles to servicers' restructuring of mortgage loans; (3) fewer than half of voluntary mortgage modifications reduced monthly payment burdens; (4) the variations among servicers in the number and quality of modifications are enormous. This variation suggests that not every servicer is doing the maximum possible to reach and work out terms with every defaulted borrower; (5) many modifications are temporary. For example, some adjusted interest rate and amortization terms were only for five years, with rate and payment increases after five years. Servicers also use balloon payments and other forms of deferrals in order to reduce payments without reducing total debt. Thus, the totals reported by the industry include many loans that are being modified to include deferred payment shocks, negative amortization or other non-amortizing features of the sort that caused the foreclosure crisis; and (6) significant numbers of mortgage loans are seriously delinquent, but not in a modification program or in foreclosure. The foreclosure crisis is overwhelming the ability of servicers to either restructure or foreclose on all the delinquent loans.

The Article discusses the many reasons why necessary mortgage restructuring is not happening and proposes several policy responses.

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ALAN M. WHITE*

I. INTRODUCTION: DELEVERAGING MORTGAGE BORROWERS AS A COLLECTIVE ACTION PROBLEM

The subprime foreclosure crisis of 2007 was precipitated by the rapid increase in defaults and foreclosures on subprime mortgage loans to homeowners in the United States.[1] The actual and anticipated losses from these mortgage loans caused dramatic declines in the value of mortgage-backed securities that were issued to fund subprime and alt-A mortgages, as well as direct losses to banks that held mortgage loans directly. As of October 2008, the International Monetary Fund estimates that financial institutions will write down $85 billion of subprime and alt-A mortgages on their own books, while the various holders of mortgage-backed securities and derivative securities will write down $500 billion as a result of losses.[2] Adding corporate debt, prime and commercial mortgage losses and all other categories, world-wide financial losses are estimated at $1.4 trillion.[3] While there were obviously weaknesses in these other debt markets, the subprime mortgage losses hit first and triggered the broader credit crisis.

Although financial institutions and other investors have recognized mortgage-related losses and embarked on an unprecedented deleveraging process,[4] most of the underlying mortgages remained on the shoulders of American homeowners by the end of 2008. Aggregate U.S. home mortgage debt had not declined a year and a half into the crisis, despite having reached clearly unsustainable levels. The process of foreclosing defaulted mortgages and reselling homes at lower prices (thus substituting

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[1] For an excellent timeline of the crisis of 2007–2009 with links to stories on each key event, see Posting of Edward Harrison to Credit Writedowns, http://www.creditwritedowns.com/credit-crisis-timeline#Timeline (Nov. 20, 2008).

[2] Int'l Monetary Fund, *Global Financial Stability Report: Financial Stress and Deleveraging: Macrofinancial Implications and Policy* 15, tbl.1.1 (Oct. 2008), *available at* http://www.imf.org/external/pubs/ft/gfsr/2008/02/index.htm.

[3] *Id*.

[4] *See id*. at 18–25 (noting that the deleveraging of banks involves recognizing losses, writing down loans and securities on bank balance sheets, reducing exposure to additional risk and injecting new capital).

smaller mortgages for larger ones) was the only deleveraging that occurred. Foreclosure liquidations increased monthly and reached about one hundred thousand per month at the end of 2008,[5] resulting in a total of nearly one million foreclosures during that year.[6] While the average loss per property in November was roughly $124,000,[7] much of that was from unpaid interest. The deleveraging of homeowners would be represented only by the difference in mortgage debt between the failed mortgage and the new purchaser's mortgage amount. While it is difficult to estimate the net mortgage debt reduction resulting from this process, it was clearly less than $100 billion.

The difference between the annual foreclosure-induced debt reduction for homeowners of less than $100 billion and the $500 billion in expected financial losses from mortgages was the unresolved excess leverage of the American homeowner at the end of 2008. This missing write-down represents mortgages that were still outstanding but not expected to be paid. Home mortgage debt grew faster than the ability of homeowners to service it throughout the decade preceding the crisis, and especially from 2004 to 2007. By the end of the third quarter of 2008, there were nearly six million mortgages delinquent or in foreclosure,[8] and fourteen million homeowners are projected to have mortgage debt exceeding the value of their property.[9]

Given that overleveraging was caused in part by loan structures that deferred principal and even interest, further deferrals seem unlikely to solve the problem. Fundamentally, the principal amount of mortgage debt in the United States must be reduced in order to bring down delinquency and foreclosure levels and stop the erosion in home prices. This in turn is essential for the broader economy both because of the significant role that home prices and new home construction play and because of the drag on consumer spending imposed by the debt service homeowners cannot maintain.[10] While there is no consensus on the optimal level of consumer or mortgage debt, there is broad agreement that home prices and mortgage debt must both be reduced from their 2007 peaks at the height of the

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[5] HOPE NOW Loss Mitigation National Data July 2007 to November 2008, http://www.hopenow.com/upload/data/files/HOPE%20NOW%20Loss%20Mitigation%20National%20Data%20July%2007%20to%20November%2008.pdf.

[6] Les Christie, *Banks Working to Prevent Foreclosures*, CNNMONEY.COM, Jan. 29, 2009, http://money.cnn.com/2009/01/29/real_estate/Hope_Now_foreclosures_easing/index.htm?postversion=2009012912.

[7] *See infra* Part III.E (noting that the average loss in November for mortage loans was $124,000).

[8] *See* MORTGAGE BANKERS ASSOCIATION OF AMERICA, NATIONAL DELINQUENCY SURVEY Q308 (2008) (reporting about two percent of mortgages in foreclosure and four percent delinquent, in a survey of forty-five million mortgages representing eighty percent of all mortgages).

[9] Douglas W. Elmendorf, Senior Fellow, Brookings Institution, Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Apr. 10, 2008), *available at* http://banking."senate.gov/public/_files/ElmendorfSenateBankingTestimonyApril112008.pdf.

[10] *Id*.

bubble in order to achieve sustainable economic growth.[11] Deleveraging homeowners is necessary not only for the economy as a whole, but in particular to limit losses on existing mortgage debt. As of this writing, eighteen months into the crisis, mortgage industry efforts to restructure loans have failed to achieve the necessary deleveraging.

Mortgage servicers face a classic collective action problem.[12] Each individual servicer in the face of declining home values wants to foreclose on defaulted mortgages as quickly as possible in order to avoid deepening losses. On the other hand, mortgage servicers and investors as a whole would maximize returns on defaulted mortgages by halting or slowing the addition of unsold homes to the inventory, allowing demand to reach equilibrium with supply so that homes could be sold at optimal prices. Moreover, the home price decline contributes to unemployment which produces more mortgage defaults.

No single servicer or group of servicers, however, has any economic incentive to organize a pause in foreclosures or to organize a deleveraging program to benefit the group.[13] If a single servicer attempts to compromise mortgage debts in order to achieve a better return from a foreclosure sale, other servicers who continue foreclosing will benefit as free riders incrementally from the servicer's forbearance or workout because they will sell in a market with incrementally fewer foreclosed properties. Moreover, the servicer engaged in more aggressive modifications will face short-run resistance from investors.[14] Reinforcing the collective action problem are various contractual and legal barriers to renegotiation of mortgage debt.[15] The empirical evidence presented below confirms that a year and a half into the subprime crisis the mortgage industry has been unable to achieve

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[11] DEAN BAKER, THE KEY TO STABILIZING HOUSE PRICES: BRING THEM DOWN (2008), *available at* http://www.cepr.net/index.php/publications/reports/the-key-to-stabilizing-house-prices:-bring-them-down; Martin Feldstein, *How To Help People Whose Home Values Are Underwater,* WALL ST. J., Nov. 18, 2008, at A21, *available at* LEXIS, News Library, WSJNL File.

[12] *See generally* MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 5–8 (1971) ("One purpose that is . . . characteristic of most organzations, and surely of practically all organizations with an important economic aspect, is the furtherance of the interests of their members."); TODD SANDLER, COLLECTIVE ACTION: THEORY AND APPLICATIONS (1992) ("Collective action arises when the efforts of two or more individuals are needed to accomplish an outcome. Activities that involve the furtherance of the interests or well-being of a group are often examples of collective action.").

[13] Sebastian Mallaby, *Paulson Behind the Curve*, WASH. POST, Dec. 10, 2007, at A19, *available at* LEXIS, News Library, WPOST File.

[14] *See* Gretchen Morgenson, *Assurances on Buyback May Cost a Lender*, N.Y. TIMES, Aug. 23 2007, at C1, *available at* LEXIS, News Library, NYT File ("[S]ervic[ers] . . . may have less incentive to help troubled borrowers who are interested in working out their loans . . . because doing so could put the parent company on the hook to buy back a loan.").

[15] Kurt Eggert, *Comment on Michael A. Stegman et al.'s "Preventive Servicing Is Good for Business and Affordable Homeownership Policy": What Prevents Loan Modifications?*, 18 HOUSING POL'Y DEB. 279, 288–90, 292 (2007); *see also* Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 HOUSING POL'Y DEB. 753, 760–61, 774–75 (2004) (discussing the behavior of servicers toward borrowers and the laws regulating such action).

efficient and equitable deleveraging of American homeowners.

II. STUDY METHOD AND STATUS OF MORTGAGES

This Article extends my prior study of voluntary modifications in subprime loan pools[16] by looking at a much larger database of 3.5 million subprime and alt-A loans known as the Columbia Collateral File.[17] This larger database permits more reliable analysis of mortgage modification and foreclosure behavior by a broad range of servicers. In addition, beginning with the November 25, 2008 report, the Columbia Collateral File added fourteen additional variables describing modification agreements according to their type. These new reports allow investors to learn, for example, whether mortgage modifications are temporary or permanent, whether and to what extent interest is being forgiven or postponed, and whether adjustable rate or interest-only loans are being converted to fixed rate or amortizing loans. These data confirm that voluntary modifications are generally increasing rather than reducing mortgage debt and are not consistently reducing payment burdens, and that foreclosures are resulting in extremely high loss severities. The new data also offer additional important insights into the actions of servicers in response to massive loan defaults, discussed below.[18]

The Columbia Collateral File is released monthly. For this Article I looked at the files for January, October, November, and December of 2008.[19] The 3.5 million mortgages in the November database are all

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[16] Alan M. White, *Rewriting Contracts Wholesale: Evidence from Mortgage Remittance Reports*, 36 FORDHAM URB. L.J. (forthcoming 2009).

[17] The Columbia Collateral File contains current month performance data for alt-A and subprime mortgage pools that have been securitized, and for which Wells Fargo Corporate Trust Services serves as trustee. Wells Fargo Corporate Trust Services, http://www.ctslink.com (containing links to investor report files) (last visited Feb. 10, 2009). For purposes of this study, subprime is defined as loans that do not conform to Fannie Mae or Freddie Mac underwriting standards and are priced above the higher-cost loan threshold for reporting under the Home Mortgage Disclosure Act. *See* 12 C.F.R. § 203.4(a)(12) (2009) (describing reporting standards under the Home Mortgage Disclosure Act). Alt-A refers to loans that are below the subprime price levels and are securitized privately, i.e., not by the government-sponsored entities (GSEs). Alt-A loans typically are loans made to borrowers with higher credit scores but with less income documentation than required by GSEs or with negative amortization or other product features not offered by GSEs. Many of the subprime loans in the database were made to borrowers with "prime" credit scores: for first lien adjustable-rate mortgages, 24% of subprime loans reflected FICO scores above 650. *See* Wells Fargo Corporate Trust Services, *supra* (containing links to the Columbia Collateral File database).

[18] Wells Fargo Corporate Trust Services, *supra* note 17. The data reported in this Article can be downloaded from Wells Fargo Corporate Trust Services, *supra* note 17 (after registering with the web site) as fixed-field text files. The data dictionary can be downloaded from the site as well. The resulting data may be analyzed using a statistical software package such as SPSS (which I used), SAS or STATA.

[19] For convenience I excluded the relatively small number of mortgages securitized before 2000. The Columbia Collateral Files for loan deals securitized in 2000 through 2007 were combined and analyzed using SPSS for Mac and Excel. All statistics reported in this Article are based on the author's calculations.

privately securitized and represent one-third to one-half of subprime and alt-A mortgages, about 7% of all U.S. mortgages. Included are 233,000 mortgages in foreclosure and 69,000 in bankruptcy, a total of about 300,000. This compares with about 1.8 million foreclosures as of September 30, 2008,[20] so the database includes about one-sixth of all mortgages in foreclosure.

About 29% of the mortgages in the file were delinquent on November 25, 2008 (36% for adjustable rate mortgages). This is higher than the national rate for all mortgages and reflects the subprime and alt-A composition of the database. Most of the mortgages modified (93%) were first lien mortgages. Modifications were concentrated in the subprime (as opposed to alt-A) portion of the mortgages: 88% of modified loans were subprime, compared with 43% of unmodified loans.[21] To look at it another way, 1.4% of all subprime loans were modified in a single month, compared with 0.1% of alt-A loans. This can be explained in part because only 44% of the adjustable rate subprime loans are still current, compared with 80.3% of the adjustable alt-A loans, while 28.5% of subprime ARM loans are more than 180 days past due, compared with 9% of alt-A ARMs.

III. VOLUNTARY MORTGAGE MODIFICATIONS ARE NOT REDUCING, BUT ARE IN FACT INCREASING, MORTGAGE DEBT

The new data confirm and update my prior findings.[22] Most voluntary modifications result in increasing debt, by capitalizing unpaid interest, and little interest or principal is being forgiven. More than half of modification agreements still increase monthly payments rather than reduce them. The variation in intensity and aggressiveness of modifications among servicers continues, while loss severities on completed foreclosures continue to mount.

For the November 2008 monthly reporting period, there were 21,219 mortgage modifications reported. The HOPE NOW coalition estimated there were 103,000 modifications industry-wide in the month of October,[23] so the Columbia Collateral File sample represents about one fifth of all modifications.[24] Most loans that were modified had been delinquent in the

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[20] Mortgage Bankers Ass'n, *Nat'l Delinquency Survey* Q3 (2008).

[21] These figures are based on the adjustable-rate mortgages with data on the margin for calculating the adjustable interest rate (1.9 million of the 3.6 million), and defining subprime as margins exceeding 4% over the index, a somewhat less-inclusive definition than the Home Mortgage Disclosure Act high-cost loan definition. *See supra* text accompanying note 17 (describing the more-inclusive definition of subprime).

[22] White, *supra* note 16 (reporting on mortgage modifications in the period July 2007 through June 2008).

[23] *See* HOPE NOW Industy Data, http://www.hopenow.com/industry_data.html (last visited Feb. 13, 2009) (reporting mortgage loss mitigation statistics).

[24] The 100,000 monthly modifications can be compared with the nearly 200,000 monthly foreclosure filings, 1.8 million mortgages in foreclosure and 3 million seriously delinquent mortgages

prior month's report: about 21% were current prior to modification, 68% were delinquent by more than 60 days and 50% were more than 120 days delinquent. On the other hand, only 23% of the modified loans had been in foreclosure, bankruptcy or REO (real estate owned, i.e. properties already foreclosed but not yet sold) prior to modification, so the typical modified loan was seriously delinquent, but had not yet been referred for foreclosure action, a growing category whose implications I will revisit in a later section.

A. *Most Modifications Increase Debt*

More than two-thirds (68%) of modifications reported in November 2008 capitalized unpaid interest and/or fees by adding them to the outstanding balance. These loan increases are accounted as negative prepayments, i.e. they have the opposite effect as an unscheduled principal payment by the borrower. In 44% of modifications, the amount capitalized was more than $5,000. The average capitalized amount was $10,800 per mortgage out of an average balance of $225,000. A total of $165,000,000 was added to the total balance due on 21,219 modified loans. Extrapolating these numbers to the entire mortgage market, we can estimate that a bit less than $1 billion was added to outstanding principal mortgage debt in a single month by voluntary modifications.

In addition, a considerable number of modifications involved deferral of unpaid interest and/or principal and conversion of that amount into a balloon payment. One way servicers reduce monthly payments while not writing off unpaid interest and advances for legal fees is to reamortize the current principal while converting unpaid interest and advances to a balloon payment due at the end of the term. This is another device that focuses on the immediate monthly payment cash flow problem, while leaving homeowners with negative equity. The FDIC's standard loan modification approach relies on balloon payments, characterized as deferred principal, in order to achieve payment reductions without actually writing down principal mortgage debt.[25] One thousand five hundred of the 21,200 modifications reported in November featured a balloon payment. Nearly all of the balloon payments (90%) had due dates more than twenty years in the future, so, by and large, the balloon feature was used as a way to defer unpaid amounts to the end of the loan term.

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at the end of the third quarter of 2008. HOPE NOW Industry Data, *supra* note 23 (supplying data regarding monthly foreclosure filings); Mortgage Bankers Ass'n, *supra* note 20 (reporting mortgages in foreclosure and delinquent mortgage statistics).

[25] *See* FED. DEPOSIT INS. CO., FDIC LOAN MODIFICATION PROGRAM 8–9 (2008), *available at* http://www.fdic.gov/consumers/loans/loanmod/FDICLoanMod.pdf (describing the FDIC's loan modification methodology).

B. *Debt Writedowns Occur in a Very Small Portion of Modifications, and Are Done by Only a Few Servicers*

Mortgage modifications are widely viewed as partial debt cancellation, and therefore as likely to create moral hazard issues.[26] The fear is that borrowers not in default will stop making payments to benefit from what are perceived to be generous restructuring terms. In fact, more than nine out of ten voluntary mortgage modifications in 2008 involved no cancellation of principal, past-due interest or even late fees or expenses. The typical modification requires the homeowner to capitalize unpaid amounts or to convert them to a balloon payment. If the modifications being offered were better understood, it is unlikely that they would create much of a moral hazard effect among other mortgage borrowers.

A very small percentage of November 2008 modifications involved reported forgiveness of interest, and only seven of the forty-three servicers reporting modifications reported significant interest forgiveness (see Table 1). This may in part be due to spotty reporting, but it is not surprising to see that the two servicers most engaged in reducing principal, Litton and Ocwen, are also reporting significant numbers of loans with past-due interest forgiven. In all, about 8% of modified loans had reported interest write-offs greater than one monthly payment. In the remainder of modifications where homeowners owed unpaid interest, the interest was apparently deferred or capitalized.

Table 1

Interest written off > Current P&I Servicer	Frequency	Percent	Cumulative Percent
EMC MORTGAGE CORPORATION	1	0.1	0.1
GMAC MORTGAGE, LLC	10	0.6	0.7
LITTON LOAN SERVICING	675	42.0	42.7
OCWEN LOAN SERVICING, LLC	890	55.4	98.1
RESIDENTIAL CREDIT SOLUTIONS, INC	5	0.3	98.4
SAXON MORTGAGE SERVICES, INC.	24	1.5	99.9
SPECIALIZED LOAN SERVICING LLC	1	0.1	100.0
Total (out of 21,184 November 08 mods)	1606	100.0	

[26] *E.g.*, David Reilly, *New Bailout Again Raises Moral Hazard*, WALL ST. J., Nov. 12, 2008, at C18, *available at* LEXIS, News Library, WSJNL File ("The danger is that loan holders who otherwise could meet their payments would decide to fall behind to get their cut of the bailout.").

Modifications with a write-down of principal or interest can also be identified based on the servicer reporting a recognized loss. About 10% (2,147) of the modifications reported in November were associated with a recognized loss of $1,000 or more (see Table 2).

Table 2

Modifications with loss > $1,000 Servicer	Frequency	Percent
AURORA LOAN SERVICES LLC	49	2.3
BAYVIEW LOAN SERVICING, LLC	88	4.1
CARRINGTON MORTGAGE SERVICES, LLC	1	0.0
EMC MORTGAGE CORPORATION	1	0.0
GMAC MORTGAGE, LLC	9	0.4
HOME LOAN SERVICES, INC.	9	0.4
LITTON LOAN SERVICING	1,011	47.1
OCWEN LOAN SERVICING, LLC	942	43.9
OPTION ONE	4	.2
PAUL FINANCIAL, LLC	1	.0
RESIDENTIAL CREDIT SOLUTIONS, INC	1	.0
SAXON MORTGAGE SERVICES, INC.	23	1.1
SELECT PORTFOLIO SERVICING,INC	1	.0
SPECIALIZED LOAN SERVICING LLC	1	.0
WILSHIRE CREDIT CORP	4	.2
Total (out of 21,184 November 08 mods)	2,145	100.0

In the November Columbia Collateral file about 1,100 modified loans were reported with principal forgiveness amounts, about 1,900 had interest forgiveness amounts reported, and about 900 had expenses forgiven and reported. The total of 2,145 (roughly 10% of modifications) with reported losses represent some combination of write-offs in those three categories. Thus, in 90% or more of the modifications, there is no forgiveness of past-due interest, expenses, or principal reported.

C. *Most Voluntary Mortgage Modifications Did Not Reduce Monthly Payment Burdens*

Payment stress is relieved in only about half of all modifications. Comparing the initial monthly payment and current monthly payment for

all mortgages reported modified in November, 47% showed a reduced monthly payment, 18% showed an unchanged payment, and 35% showed an increased payment. This is consistent with the results of my smaller survey for the prior twelve-month period.[27] Despite the increasing attention to reducing payment burdens,[28] many servicers remained unwilling, at the end of 2008, to make sufficient reductions in interest rates to offset the capitalization of arrears. Indeed, only 53% of November modifications reduced the interest rate by more than 1%, nearly one in three modified loans still bore interest at a rate above 8%, and the mean rate after modification was 6.9%, all of this in a market where the conventional mortgage rate was below 6%.[29]

D. *The Extent and Types of Voluntary Mortgage Modifications Vary Widely among Different Mortgage Servicing Companies*

Servicers vary widely in their voluntary modification activity. The same variations observed in a small sample of nine servicers and 100,000 mortgages were found among modifications in a pool of 3.5 million mortgages managed by eighty different servicers (see Table 3). Modifications for the month ranged from a negligible fraction of none for forty-seven servicers to 35% of all mortgages in foreclosure for one servicer. Payment reductions ranged from 9% to 89% of modifications. Interest or principal write-offs were found in 42% of one servicer's modifications (Litton), but were non-existent for most servicers.

Table 3: November 2008 Modifications by Servicers

	Total Mods	**&of Mods w/ Pmt Reduced %**	**% with >$1000 writeoff**	**Mods/ FC**
Accredited Home Lenders, Inc.	18	61.1%	0.0%	3.24%
American Home Mortgage Servicing, Inc.	96	7.3%	0.0%	1.47%
Aurora Loan Services LLC	1729	44.1%	2.7%	7.13%
Bank of America, N.A.	11	18.2%	0.0%	0.48%
Bayview Loan Servicing, LLC	294	23.8%	27.7%	7.71%
Carrington Mortgage Services, LLC	1332	76.6%	0.1%	35.13%

[27] *See* White, *supra* note 16 (describing relevant changes in mortgage payments during a twelve-month period from July 2007 to June 2008).

[28] *See* FED. DEPOSIT INS. CO., *supra* note 25, at 5–6 (explaining the philosophical focus of loan modification as a means to relieve payment pressures among mortgage borrowers).

[29] *E.g.*, FED. RESERVE BOARD, STAT. RELEASE H.15 (Dec. 1, 2008), *available at* http://www.federalreserve.gov/releases/h15/20081201/ (listing the conventional mortgage rate for Nov. 28, 2008 as 5.97%).

	Total Mods	**&of Mods w/ Pmt Reduced %**	**% with >$1000 writeoff**	**Mods/ FC**
Central Mortgage	209	57.9%	0.0%	16.10%
Chase Home Finance, LLC	437	44.6%	0.0%	7.45%
Citi Residential Lending, Inc.	36	30.6%	0.0%	3.47%
CitiMortgage, Inc.	12	16.7%	0.0%	3.25%
Countrywide Home Loans Servicing LP	579	17.5%	0.0%	3.20%
EMC Mortgage Corp.	1168	48.9%	0.1%	9.47%
Everhome Mortgage Co.	20	25.0%	0.0%	3.01%
GMAC Mortgage, LLC	71	67.6%	11.3%	1.52%
Home Loan Services, Inc.	179	11.7%	4.8%	7.25%
HomeQ Servicing Corp.	117	71.8%	0.0%	1.54%
IINDYMAC Bank, F.S.B.	9	88.9%	0.0%	0.31%
JPMorgan Chase Bank, N.A.	76	42.1%	0.0%	28.00%
Litton Loan Servicing	2318	44.7%	41.8%	10.03%
M&T Mortgage Corp.	10	10.0%	0.0%	9.61%
Nationstar Mortgage LLC	114	85.1%	0.0%	0.28%
Ocwen Loan Servicing LLC	2942	53.4%	27.0%	13.29%
Option One	5005	46.8%	0.1%	19.11%
Popular Mortgage Servicing Inc.	141	0.7%	0.0%	0.99%
Regions Mortgage Inc.	16	68.8%	0.0%	4.88%
Residential Credit Solutions, Inc.	18	50.0%	5.6%	7.08%
Saxon Mortgage Services Inc.	347	46.7%	6.1%	5.30%
Select Portfolio Servicing Inc.	92	12.0%	1.1%	3.07%
Specialized Loan Servicing LLC	11	54.5%	9.1%	3.05%
Suntrust Mortgage, Inc.	36	33.3%	0.0%	12.20%
Wells Fargo Bank, N.A.	1159	12.9%	0.0%	0.41%
Wilshire Credit Corp.	460	35.9%	0.8%	3.12%
Total (excluding mods with missing data or by servicers with fewer than 8 mods)	19112	45.3%	10.1%	18.83%

While there were some relevant differences among servicers, none could explain the wide variation in modification activity. Some servicers were predominantly managing subprime pools, while others mostly handled alt-A pools, with lower levels of defaults and accordingly of modifications as well. On the other hand, comparing modifications to foreclosures is a rough control for that difference, and the variations

remain striking. The variation among servicers is an important finding in itself, in that it reveals the ad hoc and uncoordinated nature of the entire 2007–2008 mortgage restructuring process. It also strongly suggests that not every servicer is modifying mortgages in the most effective way nor restructuring every salvageable mortgage loan. Indeed, the variation suggests the opposite: many preventable foreclosures were not prevented.

E. *Severe Foreclosure Loss Rates Continue Increasing*

Losses on foreclosures continue to be large, exceeding 50%. The average loss in November for all mortgage loans with losses was $124,000, on an average loan size of $212,000—a 57% loss. About one-tenth of 1% of the mortgages in the pool (30,816) had losses in November (excluding the small portion of modified loans that had write-downs treated as losses). However, about 6,800 of the unmodified mortgages with losses were second lien mortgages. The average loss for the 21,000 first mortgages liquidated in November was $145,000, representing an average loss of 55% of the amount due. Losses on second lien mortgages were close to 100%.

In comparison, for the modified loans with some amount of principal or interest written off, the average loss recognized was $23,610. The average loss across all modifications was of course much lower, given how few modifications involved *any* write-offs.[30] This seven-to-one difference between foreclosure losses and modification write-offs is striking, and lies at the heart of the failure of the voluntary mortgage modification program. Particularly for foreclosed loans with losses above the 57% average, some of which approach 100%, the decisions of servicers to foreclose is mystifying. Certainly, some properties are not occupied, are owned by investors unwilling to pay any mortgage debt, or otherwise must be foreclosed. There is probably no good empirical test to determine exactly how many of these wasteful foreclosure sales could have been avoided, but the inference is strong that servicers are not fully mitigating losses. At a minimum, there is room for servicers to be more generous in writing down debt for the loans they are modifying, while still recovering far more than from foreclosures in the depressed real estate market of late 2008. I will consider some of the reasons for this apparently irrational behavior in a later section.

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[30] *See supra* Part III.B ("In all, about 8% of modified loans had reported interest write-offs greater than one monthly payment.").

IV. ADDITIONAL FINDINGS

A. *Not Modified, but Not Foreclosed: Informal Forbearance*

The reluctance to modify mortgages is explained in part by concerns about the importance of contractual obligations, and in part by the need to prevent homeowners from believing that they can default on loan obligations without consequences. It is perhaps surprising then to see that servicers are allowing about one in seven extremely delinquent borrowers to remain in default without being foreclosed.

While there were 15,500 loans modified in October 2008 in the database, and 21,100 in November, there were 420,000 mortgages that were more than 180 days past due in the November file. And while about one-third of those were REO and about half are in foreclosure or bankruptcy, a remarkable 64,900 mortgages are in serious default, but the servicer is not taking legal action to enforce them. If we expand the seriously delinquent category to include 120-day delinquencies, a point at which servicers normally would have started foreclosure, there are nearly 127,000 defaulted mortgage contracts not being enforced, about eight times as many as are being modified each month. In fact, in the 120- to 180-day delinquent category, the odds are less than 50/50 that a foreclosure has been started. Who are these lucky deadbeats?

A closer examination of the defaulters with no foreclosure reveals some of the factors at play. About 30% of the defaulted loans not in foreclosure were second lien mortgages, compared with 8% of all loans. Junior lien mortgages are unlikely to have much, if any, foreclosure value in the current declining home value environment, so it is not surprising that servicers would refrain from foreclosing them. About 12% of mortgages in default but not in foreclosure had initial loan-to-value ratios above 95%, compared with 5.6% for all loans. About 70% of non-enforced defaults are subprime, compared with about 43% of all loans in the database. However, while some non-enforcement may be rational given these factors, a considerable amount of the non-enforcement on defaulted mortgage contracts is due to servicers being overwhelmed and simply unable to handle the volume.[31]

Moreover, even the 200,000 or so foreclosures in the Columbia Collateral file are not all cases where the servicer is actively seeking to recover the property. According to HOPE NOW data, the number of new foreclosure filings is outpacing the number of monthly foreclosure sales by about two to one,[32] meaning that servicers are not selling about half the

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[31] Bob Ivry, *Lenders Swamped by Foreclosures Let Homeowners Stay*, BLOOMBERG NEWS, Apr. 4, 2008, http://www.bloomberg.com/apps/news?pid=20601109&sid=aOluOO8Vy0gc&refer=home.

[32] HOPE NOW Indsutry Data, *supra* note 23.

homes that have been referred for foreclosure proceedings. In other words, in many cases foreclosures are being started but not pursued to sale. Combining the defaulted loans not in foreclosure with the foreclosures not being brought to sale, one could reasonably extrapolate that more than a million mortgages are in formal or informal forbearance of some kind.

B. *Modification Agreements: Temporary vs. Permanent*

Fourteen percent of November modifications reported a change in the next payment adjustment date. Of those, 9% had modified rate adjustment dates in twelve months or less, 17% in twelve to twenty-four months, 43% in twenty-four to thirty-six months, 19% from thirty-six to sixty months, and the remaining 12% from five to ten years. Thus, the majority of postponements for payment resets were for three years or less. Because of the very limited reporting on this aspect, it is difficult to know how many other modifications were temporary or permanent. The November collateral file also contained a field to flag temporary modifications, but it was blank for more than 75% of cases.[33] For those reporting, there were about four times as many permanent modifications as temporary modifications. State regulators report that about three times as many modifications were permanent as temporary, but data were missing on 40% of modifications.[34] It is difficult to reach any conclusions about either the relative share of temporary versus permanent mortgage rewrites, or about any trend. The December 2008 FDIC modification program, which if anything is more aggressive than the practices of most servicers, calls for interest rate concessions below current market levels to expire in five years at most, although it does encourage permanent conversion of adjustable rates to fixed.[35]

C. *Adjustable-Rate to Fixed-Rate*

Most modified mortgages (71%) were adjustable-rate before being modified.[36] Many of the modified ARMs were rapidly approaching their first adjustment date: fifty-seven percent of modified ARMs had their first interest adjustment date falling between October 2008 and June 2009, i.e. in the nine-month period beginning just before the reporting period. Clearly, looming rate resets were a significant factor in determining which

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[33] The December 2008 file "Temporary Modification" field was blank for 81% of cases.

[34] STATE FORECLOSURE PREVENTION WORKING GROUP, ANALYSIS OF SUBPRIME MORTGAGE SERVICING PERFORMANCE: DATA REPORT NO. 3 SEPTEMBER 2008, at 9 (2008), *available at* http://www.csbs.org/Content/NavigationMenu/Home/SFPWGReport3.pdf.

[35] FDIC LOAN MODIFICATION PROGRAM, *supra* note 25, at 3, 5, 9.

[36] Data on ARM-to-fixed conversion are more robust in the December 2008 collateral file, from which these summary statistics were calculated. There were still missing data for 45% of the ARMs in the ARM-to-Fixed (Y/N) field.

mortgages were modified. On the other hand, most modified mortgages were delinquent before modification, so the looming reset was not the sole cause of default. Two explanations are possible. It may be that servicers chose to focus their efforts both on loans with imminent reset dates and loans that are in default as a matter of setting priorities when faced with an unmanageable volume of modification requests. Or it may be that borrowers with upcoming reset dates are perceived as more worthy of aid despite their having already defaulted.

Only about one-third of the ARMs were converted to fixed rate mortgages, while 14% had reported adjustment rates postponed from one to five years. It is possible that missing data account for some additional ARM modifications, but nevertheless, the data indicates that many adjustable-rate mortgages, perhaps as many as half, retain their adjustable rate nature, with a risk of future payment increases.

D. *Nontraditional Mortgages: Interest-Only and Negative Amortization*

Fourteen percent of modified loans had been interest-only initially. Of the modified interest-only mortgages, about one-third were reported as having been converted to amortizing loans. Loans with negative amortization, the so-called option-ARMs, predicted to comprise a significant number of foreclosures in the 2009 to 2011 period, are not being modified in any significant numbers, yet. Negatively amortizing mortgages comprised 9% of all mortgages, 10% of delinquent loans and foreclosures, but only 3.6% of modifications in the November Columbia file. Two servicers, Central Mortgage and EMC, accounted for three-fourths of all the modified negative amortization loans. These nontraditional loans were the subject of particular regulatory concern[37] and were understood to carry a greater risk of default and foreclosure.[38] About one-quarter of the modified option-ARMs had rate adjustment dates postponed, while the rest retained their original rate adjustment dates. One-third were coded as having been converted from amortizing to interest-only in the modification data, an odd designation, but perhaps meaning that those negative amortizing loans were converted to interest-only. That would represent a rather incremental reduction in the future payment shock, which will still occur at the end of the interest-only period. Despite the knowledge that these particularly dangerous mortgages

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[37] U.S. GOV'T ACCOUNTABILITY OFFICE, ALTERNATIVE MORTGAGE PRODUCTS: IMPACT ON DEFAULTS REMAINS UNCLEAR, BUT DISCLOSURE OF RISKS TO BORROWERS COULD BE IMPROVED, (Sept. 20, 2006); Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609 (Oct. 4, 2006).

[38] *See* Michael Moss & Geraldine Fabrikant, *Once Trusted Mortgage Pioneers, Now Pariahs*, N.Y. TIMES, Dec. 25, 2008, at A1, *available at* LEXIS, News Library, NYT File (referring to option ARM loans as the "Typhoid Mary" of the mortgage industry).

threatened to prolong the foreclosure crisis, little was done in 2008 to restructure them on a sounder basis.

E. *Other Modification Agreement Terms*

I obtained a small sample of 2008 mortgage modification documents from consumer attorneys and housing counselors.[39] Their provisions were consistent with the empirical evidence; they illustrated the capitalizing of unpaid amounts, sometimes reducing interest rates to as low as 3%, but often leaving them at 6% to 7%. Only one, a Litton modification, cancelled any debt (interest and expenses, not principal). The remainder all involved capitalization of arrears and a resulting increase in total debt. When payment reductions were achieved, it was with a combination of term extensions (some to 40 years), rate reductions and balloon payments.

The modification form agreements vary from servicer to servicer; no industry standard form has emerged. One form included an atypical reverter clause, providing that if the borrower fails to make payments under the modified term for 90 days, the modified terms are canceled and the mortgage reverts to its original terms. While there have been reports of servicers using modification agreements as a means to obtain releases of potential consumer claims, only one of the 2008 forms I reviewed included broad releases, in the form of an agreement by the borrower that there are no defenses, counterclaims or rights of set-off to the note. Another modification from May 2008 did include a provision that the borrower would agree to cooperate in signing replacement loan documents including lost notes. This clause presumably deals with the common problem with securitized mortgages, leading some courts to refuse to allow foreclosure based on lack of standing or failure to state a claim.[40]

Another modification provided for the borrower to pay modification fees of $500, which was added to the borrower's balance. Several modifications included the addition of attorney fees and costs rolled into the balance. This is troubling in light of Professor Kathleen Porter's study.[41] In a survey of mortgage servicer claims filed in bankruptcy, Porter found that more than 20% of the arrears amounts were servicer, attorney fees and foreclosure costs, and that the median amount claimed was

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[39] The modifications referred to in the following section are on file with the author.

[40] *E.g.*, *In re* Foreclosure Cases, 521 F. Supp. 2d 650, 654 (S.D. Ohio 2007) (noting that a plaintiff's failure to prove that he or she had standing when the foreclosure complaint was filed will result in a dismissal without prejudice until plaintiff is able to establish standing requirements at a future date).

[41] Katherine Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 TEX. L. REV. 121 (2008).

$1857.[42] Her research also found that servicers did not adequately itemize these amounts or provide supporting documentation, leading to the inference that some of these amounts may be excessive or unearned.[43]

In short, the typical voluntary modifications of 2008 were not unlike the subprime loan originations they were meant to resolve: borrowers were kept in debt exceeding home values and exceeding their ability to amortize, with deferrals of interest, balloon payments, and temporary low interest rates. Nontraditional mortgages were not consistently converted to safer, fixed-rate amortizing loans. Meanwhile, many mortgages that were not restructured languish in limbo, neither modified nor foreclosed.

V. REPERFORMANCE AND REDEFAULT

Another aspect of the failure of the voluntary mortgage modification process has been the high level of "redefaults" on modified mortgages, i.e. modifications that are followed by further payment delinquencies.[44] The redefault problem has resulted in criticism of the very idea of modifying mortgage loans.[45] On the other hand, there is considerable evidence that more aggressive modifications, especially those that reduce the principal debt, are much less subject to high rates of redefault.[46]

I separately examined 3,517 mortgages modified in the January 2008 Columbia Collateral file that still appeared in the November 2008 file.[47] Overall, 53% were current or due for the current month's payment, and 19% were more than 180 days delinquent. On the other hand, only 17% were in bankruptcy or foreclosure, and 3% were in REO, so most modified mortgages remained active accounts ten months after modification.

Redefaults were worse than the national average in California, Florida, Arizona and Nevada, where property values have declined significantly. Redefaults were lower than the national average for the hard-hit industrial

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[42] Katherine Porter, Presentation at the University of Iowa Subprime Housing Crisis Symposium: Falling Further: Default Costs in Home Foreclosures, at slide 6 (Oct. 11, 2008), *available at* http://ppc.uiowa.edu/SubprimePresentations/KatherinePorter.pdf.

[43] Porter, *supra* note 41, at 152–61.

[44] *See* Charles Duhigg, *Fighting Foreclosures, F.D.I.C. Chief Draws Fire*, N.Y. TIMES, Dec. 11, 2008, at A1, *available at* LEXIS, News Library, NYT File (noting statement by Comptroller of the Currency that more than half of mortgages modified by national banks were delinquent again after six months).

[45] *See* Sheila Bair, *Sheila Bair's Mortgage Miracle*, WALL ST. J, Dec. 3, 2008, at A16, *available at* LEXIS, News Library, WSJNL File ("Infuriated at the difficulty of modifying mortgages, the Beltway crowd doesn't understand that such contracts weren't designed to let people live in houses they can't afford.").

[46] MERRILL LYNCH, LOAN MODIFICATIONS: WHAT INVESTORS NEED TO KNOW, (Nov. 21, 2008); CREDIT SUISSE, SUBPRIME LOAN MODIFICATIONS UPDATE 6 (Oct. 1, 2008); LEHMAN BROTHERS, THE LOAN MODIFICATION STORY SO FAR (Sep. 11, 2008).

[47] *See supra* note 17 and accompanying text (describing the Columbia Collateral file). There were originally 3,639, with the difference representing prepayments and liquidated foreclosures.

states like Ohio and Michigan.[48] This suggests that the extent of negative home equity may play a greater role than unemployment and economic distress.

Redefaults also varied somewhat among different servicers. Countrywide's modified loans performed worse than the average, with 52% more than sixty days past due, while Litton had 45% of modified loans more than sixty days past due. This is consistent with the hypothesis that more aggressive modifications are more likely to be successful, although these differences are not dramatic.

Different types of modifications are expected to have different redefault rates. This did not appear to be the case with the January 2008 modifications, although data limitations may explain the results. Only five of the 3,634 January modifications involved any substantial write-off of principal or interest, so there was no useful data on the performance of modifications with principal write-downs. Comparing modifications that reduced payments with those that increased payments, there were surprisingly minimal differences in the delinquency status of modified loans. About 48% of modified loans were sixty days or more past due, whether the modified payment had been lower, higher, or the same as before the modification. Those modifications that capitalized more than $10,000 in past-due interest and fees had a sixty-day default rate of about 50%, and 17% foreclosures, compared with 47% sixty-day defaults and 14% foreclosures for modifications with minimal or no capitalization (negative prepayment less than $1,000).

Loans originated in 2004 and 2005 had better reperformance rates (58% current or thirty-days past due) than loans originated in 2006 (45%) and 2007 (only 40% current or thirty-days past due). Not surprisingly, FICO scores at origination were correlated with reperformance: 48% of borrowers with scores below 550 were delinquent versus 37% of borrowers with FICO scores above 700.

Another factor that has been identified as predictive of redefault rates for modified loans is whether the loan was delinquent or current before being modified. Most of the mortgages modified in November had been delinquent in October before being modified (see Table 4).

Table 4 October Status of Mortgages Modified in November 2008

	Days Past Due	***Percent***
Current	4,368	20.6
30 days	2,492	11.8
60 days	1,884	8.9

[48] Sixty-day or more delinquent modified loans were 47% of all modified loans, compared with 52% for Arizona, 57% in California, 54% in Florida and 57% in Nevada.

90 days	1,895	8.9
120 days	4,118	19.4
>180 days	6,427	30.3
Total	21,184	100

On the other hand, only one in five modified loans had been in foreclosure prior to modification (see Table 5).

Table 5 October file status of November file mods

	Frequency	***Valid Percent***
No action	15,904	75.1
Bankruptcy	191	0.9
Loss Mitigation	570	2.7
Foreclosure	4,123	19.5
REO	396	1.9
Total	21,184	100

Modified mortgages that were current (or not seriously delinquent) when modified were must less likely to default again than modified mortgages that were in serious default before being modified.[49] Loans modified before default were more likely to involve conversion of an adjustable-rate mortgage to a fixed rate to prevent a sharp payment increase.[50] These rate reset modifications represent the single category in which servicers engaged in preventive loan restructuring, largely as a result of the December 2007 HOPE NOW rate freeze initiative.[51]

It is now apparent that mortgage modifications will succeed in achieving sustainable repayment and in reducing the aggregate debt overhang, but only if they include reductions of principal to align debt with property values, are permanent and fully amortizing, and are negotiated as early as possible in the delinquency, or even before a delinquency occurs. On the other hand, continuation of the existing model will simply defer additional accumulated mortgage debt into 2009 and beyond, further prolonging the foreclosure crisis.

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[49] CREDIT SUISSE, *supra* note 46, at 6; LEHMAN BROTHERS, *supra* note 46, at 2, 4.

[50] CREDIT SUISSE, *supra* note 46, at 6; LEHMAN BROTHERS, *supra* note 46, at 2, 4.

[51] *See* Edmund L. Andrews, *Mortgage Aid, Within Limits*, N.Y. TIMES, Dec. 7, 2007, at A1, *available at* LEXIS, News Library, NYT File (noting that the Greenlining Institute estimated that only 12% of subprime borrowers would benefit from the rate freeze).

VI. WHY ARE VOLUNTARY MORTGAGE MODIFICATIONS FAILING AND WHAT CAN BE DONE?

Mortgage servicing agents have thus far failed to modify mortgages in ways that would clearly reduce investor losses for their principals. The reasons for this failure are multiple and complex. They include contractual limitations, economic incentives, reliance on outdated cash flow models, and industry culture. Servicers face a variety of incentives and obstacles in their efforts to maximize return for investors and keep their costs down. Some have argued that servicers profit when more borrowers default and go into foreclosure.[52] The reality is somewhat more complex than that.

Mortgage servicer compensation (for securitized mortgages) is governed by pooling and servicing agreements (PSAs). Servicers receive income from a fixed portion of monthly interest payments actually received, from late fees and other default charges, and from the interest on funds held for investors or escrow.[53] On the other hand, servicers typically must advance interest to investors when the borrower does not make a payment.[54] They also advance funds to third parties, like lawyers, during the foreclosure process. The servicer recovers its advances only when the borrower eventually brings payments current or when a foreclosure sale is completed. In either case the servicer is entitled to recover its advances before turning over the balance to investors. Thus, if a foreclosure sale yields only 25% of the total amount due then the servicer still recovers 100% of interest advances and other advances from the sale proceeds,

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[52] Posting of Katie Porter to Credit Slips, http://www.creditslips.org/creditslips/2008/05/piling-on-fees.html (May 16, 2008, 5:56 EST).

[53] *See, e.g.*, Pooling and Servicing Agreement, Series 2005-W5, among Argent Securities, Depositor, Ameriquest Mortgage Company, Master Servicer, and Deutsche Bank National Trust Company, Trustee, § 3.18, Dec. 1, 2005, *available at* http://www.sec.gov/Archives/edgar/data/1346253/000088237706000099/d406287_ex4-1.htm (describing a typical pooling and servicing agreement for a subprime mortgage pool).

The compensation provision is as follows:

As compensation for the activities of the Master Servicer hereunder, the Master Servicer shall be entitled to the Servicing Fee with respect to each Mortgage Loan payable solely from payments of interest in respect of such Mortgage Loan, subject to Section 4.03(e). In addition, the Master Servicer shall be entitled to recover unpaid Servicing Fees out of Insurance Proceeds, Subsequent Recoveries or Liquidation Proceeds to the extent permitted by Section 3.05(a) (ii), out of general funds in the Collection Account to the extent permitted by Section 3.05(a) and out of amounts derived from the operation and sale of an REO Property to the extent permitted by Section 3.13. The right to receive the Servicing Fee may not be transferred in whole or in part except in connection with the transfer of all of the Master Servicer's responsibilities and obligations under this Agreement.

Additional servicing compensation in the form of assumption fees, late payment charges, insufficient funds fees, reconveyance fees and other similar fees and charges (other than Prepayment Charges) shall be retained by the Master Servicer only to the extent such amounts, fees or charges are received by the Master Servicer. The Master Servicer shall also be entitled pursuant to Section 3.05(a)(vi) to withdraw from the Collection Account, pursuant to Section 3.04(h) to withdraw from any Escrow Account and pursuant to Section 3.13(b) to withdraw from any REO Account, as additional servicing compensation, interest or other income earned on deposits therein, subject to Section 3.06.

Id. at § 3.05.

[54] *See id.* at § 4.03 (describing advances).

assuming they are sufficient to cover the advances. On the other hand, if a delinquent mortgage is modified, then the servicer will not recover the advances made to investors on that account until the borrower repays the servicer. This is particularly problematic for the servicer when the advances are deferred in a balloon payment due in thirty years.

A servicer faced with a delinquent mortgage thus is faced with an immediate and ongoing cash outflow of interest each month. If the servicer forecloses, it will advance more money for legal fees but hope to recover its advances in the three to twelve months that it will take to foreclose and sell the property. In that event, it will also recover some additional revenue from late fees once the sale is completed. If the servicer modifies the mortgage, it will no longer be required to make new advances (if the borrower resumes and continues payments), but will have to wait a long time to recover prior advances, unless the homeowner makes a cash payment at the time of the modification. This is why many servicers insist on at least recovering attorney fees advanced before modifying a mortgage. In an environment where financial institutions that service mortgages are concerned about cash flow, it is apparent why they might prefer to foreclose: to recover past advances rather than gamble on modifications. To put it another way, the investor losses may be very large, but the servicer will almost always benefit by completing a foreclosure sale.

Some PSAs delegate broad discretion to servicers to modify mortgage terms, including reductions of interest rate or principal debt,[55] while others provide no such discretion or authority at all.[56] In the latter case, the rigidity of the servicer-investor contract prevents any flexibility in modifying the mortgage loan contract. The PSA itself can usually be modified, but only with the consent of a supermajority of investors, a necessarily cumbersome process. The widely publicized suit by investors against mortgage servicer Countrywide was based on a PSA that did not permit modifications, unless the servicer repurchased the mortgage loans before modifying them.[57]

Even if a servicer is not restricted by the PSA and is willing to defer recovery of prior advances, it will not modify a mortgage unless it believes that the modification will produce a greater present value (or smaller loss), given the risks, than immediate foreclosure. Servicers model the costs and benefits of modifications by comparing the net present value of projected

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[55] *Id.* at § 302.

[56] *See, e.g.*, Sale and Servicing Agreement, Saxon Asset Securities Trust 2006-1, Saxon Asset Securities Trust 2006-1, Issuer, Saxon Asset Securities Company, Depositor, Saxon Funding Management, Inc., Master Servicer, Saxon Mortgage Services, Inc., Servicer, and Deutsche Bank Trust Company Americas, Indenture Trustee, Apr. 1, 2006, *available at* http://idea.sec.gov/Archives/edgar/data/1361039/000116231806000629/exhibit991.htm.

[57] Vikas Bajaj, *Fund Investors Sue Countrywide Over Loan Modifications*, N.Y. TIMES, Dec. 2, 2008, at B8, *available at* LEXIS, News Library, NYT File.

cash flow from a modified mortgage with the projected present value of a foreclosure sale recovery.[58] These present value models rely on a large number of assumptions, often based on history of past performance. One factor, for example, is the projected redefault rate. If a servicer has a history of 50% or more redefaults, its present value model will predict lower cash flow from modified mortgages than if a lower redefault rate is assumed. Likewise, servicers have to estimate loss severities on future foreclosures.[59] If they use historical data, servicers are likely to underestimate loss severities and thus tip the scales in favor of foreclosure and against modification.

Finally, some very practical realities are preventing both the number and depth of mortgage modifications needed. Servicers are overwhelmed[60] and faced with a rapidly changing political and legal environment. Past habits and groupthink probably play some role in the reluctance to engage in modifications differently than in the past. New initiatives are announced by federal agencies monthly, and servicers understandably do not want to start writing down loans after a taxpayer-funded bailout program.[61] These are just some of the factors that have led to the present impasse.

To get out of the impasse, the mortgage industry needs a coordinated set of policies that will discourage wasteful foreclosures while offering clear guidance on how and when to make aggressive and permanent adjustments to failing mortgage loan contracts. The lessons of 2007 and 2008 can be put to good use if the empirical evidence is used to build better models of the costs and benefits of modifications and foreclosures. The federal government, as de facto owner of various failed or failing financial institutions and manager of the Fannie Mae/Freddie Mac portfolio of mortgages, is in the best position to establish clear objectives for the restructuring of America's mortgage debt. Successful restructuring would include the reduction of debt to levels that correspond to stable home values and to the ability of homeowners to repay.

A successful comprehensive set of policies should include the following. First, the program must include some form of foreclosure moratorium or selective postponement for the maximum number of

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[58] AMERICAN SECURITIZATION FORUM, STATEMENT OF PRINCIPLES, RECOMMENDATIONS AND GUIDELINES FOR THE MODIFICATION OF SECURITIZED SUBPRIME RESIDENTIAL MORTGAGE LOANS 3–4 (2007), *available at* http://www.americansecuritization.com/uploadedFiles/ASF%20Subprime %20 Loan%20Modification%20Principles_060107.pdf.

[59] *See* FED. DEPOSIT INS. CORP., WORKOUT PROGRAM GUIDELINES NET PRESENT VALUE WORKSHEET (2008), *available at* http://www.fdic.gov/consumers/loans/loanmod/NPV.xls; MOODY'S INVESTOR SERVICES, THE IMPACT OF THE FDIC'S AND FHA'S MORTGAGE LOAN RESCUE PROGRAM ON U.S. RMBS LOSS EXPECTATIONS (2008) (giving examples of present value assumptions for comparing loan modifications and foreclosure losses).

[60] *See supra* note 32 (discussing the high volume of foreclosures and servicer response).

[61] *See* Charles Duhigg, *Fighting Foreclosures, F.D.I.C. Chief Draws Fire,* N.Y. TIMES, Dec. 10, 2008, at A1, *available at* LEXIS, News Library, NYT File (discussing proposal to provide government insurance for modified mortgages).

salvageable mortgages. While Fannie Mae and Freddie Mac announced a six-week holiday moratorium on November 20, 2008,[62] a freeze on foreclosures needs to last long enough to allow the existing inventory of foreclosed homes to be sold in an orderly fashion without continually swelling the inventory. A freeze also needs to allow a genuine and comprehensive mortgage restructuring to be implemented nationwide, a process that could certainly take twelve months or more. A moratorium or delay would obviously need to exclude vacant properties and loans to borrowers whose income is clearly inadequate to repay any conceivable modified mortgage.

In conjunction with the postponement of avoidable foreclosures, the federal banking agencies, including the FDIC and Treasury, must continually reevaluate and improve the FDIC's current standardized approach to mortgage modifications, and deal with the principal debt reduction issue. The standardized approach to modifying loans should be applied across the board to all federally-owned mortgages and be mandated for financial institutions receiving any of the various forms of federal aid.[63] Allowing bankruptcy courts to impose mortgage modifications, including principal reductions to align debt with home values, would be a useful step.[64] On the other hand, the cost of bankruptcy, including legal fees, is high for debtors,[65] and bankruptcy modifications should not be viewed as a substitute for systematic mortgage restructuring outside of bankruptcy.

The FDIC and other federal agencies should also lead the way by offering any homeowner with negative equity a principal reduction to be replaced by a balloon payment that automatically declines by 20% per year and is reduced to zero after five years. The existing program, consisting of offering principal deferrals only when needed to reduce payment burdens without any hope of permanent debt cancellation, fails to offer homeowners necessary incentives to continue repaying their debt.

Less attractive solutions would include purchases by the Treasury Department of delinquent mortgages at par or some negotiated discount, followed by a restructuring and principal reduction similar to what was done by the Homeowners Loan Corporation in the 1930s. This would shift the losses investors would otherwise bear to the taxpayer. The government did not insure mortgage-backed securities, and investors' risks were

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[62] Zachary A. Goldfarb, *Fannie, Freddie Halt Foreclosures for Holidays*, WASH. POST, Nov. 21, 2008, at D1, *available at* LEXIS, News Library, WPOST File.

[63] Ralph Vartabedian, *Federal Bank Bailout Isn't Trickling Down, Panel Told*, L.A. TIMES, Dec. 17, 2008, at A13, *available at* LEXIS, News Library, LAT File.

[64] Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy,* 2009 WIS. L. REV. (forthcoming 2009), *available at* http://ssrn.com/abstract=1071931.

[65] Michelle J. White & Ning Zhu, *Saving Your Home in Chapter 13 Bankruptcy* 5, 24–25 (Nat'l Bureau of Econ. Research, Working Paper No. 14179, 2008), *available at* http://www.econ.ucsd.edu/~miwhite/white-zhu-nber14179.pdf.

described in detail in the securitization documents. There is no reason that investors should not accept the smaller losses of systemic restructuring, given that they otherwise face the larger (uninsured) losses of massive foreclosures.

FDIC Chair Sheila Bair's proposal to insure modified loans against further default under certain circumstances might offer servicers an incentive to modify mortgages more aggressively.[66] On the other hand, this proposal amounts to a contingent taxpayer bailout and suffers from the drawback that servicers are likely to adversely select the riskiest modifications to include in the insurance program.

A genuine solution to the foreclosure crisis must involve a range of initiatives, all aimed at bringing existing mortgage debt down to sustainable levels. The only other option is to continue relying on voluntary industry efforts while waiting for a housing market recovery, essentially the Federal government's response through the end of 2008. Although banks have written down billions in assets and restored some capital, borrowers are still crushed by the burden of mortgage debt. Their continuing struggle is measured in the ever-growing inventory of homes acquired by mortgage servicers at foreclosure sales that remain unsold, the pending foreclosures that are not going to sale, and in the hundreds of thousands of families who are stumbling along in informal forbearance or in modification agreements that defer and increase their debt.

[66] *See* Bair, *supra* note 45 (discussing modification of more than two million loans).