by Paul Willen, Federal Reserve Bank of Boston

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WHY Few Lenders Are Modifiying Loans

Many commentators have attributed the severity of the foreclosure crisis in the United States in 2007 to 2009 to the unwillingness of lenders to renegotiate mortgages. As a consequence, they have placed renegotiation at the heart of the policy debate.[1] Every major policy action to date has involved encouraging lenders to renegotiate loan terms in order to reduce borrower debt loads.

According to the Treasury-sponsored HopeNow initiative, in December 2007 lenders were expected to prevent adjustable-rate mortgages from increasing to higher rates at the first reset of the mortgage. Then Hope for Homeowners, enacted by Congress in July 2008, expected lenders to write off a substantial portion of the principal balance of mortgages for financially distressed households. Finally, the Obama administration's Making Home Affordable Plan, announced in February 2009, expected that the plan's financial incentives to servicers would get loans renegotiated with a reduced interest rate for a significant period.

The Appeal of Renegotiation

The appeal of renegotiation to policymakers is simple. If a lender makes a concession to a borrower by, for example, reducing the principal balance on the loan, that can prevent a foreclosure. This is clearly a good outcome for the borrower, and possibly good for society as well. But equally important to policymakers is the belief that it can also benefit the lender. The lender loses money only if the reduction in the value of the loan exceeds the loss the lender would sustain in a foreclosure. In short, according to proponents, renegotiation of home mortgages is a type of public policy Holy Grail, in that it helps both borrowers and lenders at little or no cost to the government.

One message is quite clear: lenders rarely modify loans.

To evaluate this argument, Federal Reserve economists analyzed data from 2005 to first-quarter 2009, considered borrowers over the year subsequent to their first serious delinquency (defined as two or more missed mortgage payments), and counted the frequency of modifications. The results are instructive.

One definition of renegotiation that was explored is *concessionary modification*, which reduces a borrower's monthly payment. Concessionary modifications may entail reductions in the principal balance or interest rate, extensions of the repayment period, or a combination. This definition of renegotiation was a key focus of the analysis because of the consensus among many market observers that concessionary modifications are the most, or possibly the only, effective way of preventing foreclosures.

Next the definition of renegotiation was broadened to include any modification, regardless of whether it lowers the borrower's payment. The common wisdom is that modifications always involve concessions to the borrower, but many—and in some subsets, most—modifications involve the capitalization of arrears into the balance of the loan, and thus lead to increased payments.

No matter which definition of renegotiation is used, one message is quite clear: lenders rarely modify loans. Fewer than 3 percent of the seriously delinquent borrowers in the sample received a concessionary modification in the year following the first serious delinquency. More borrowers received modifications under the broader definition, but the total still accounted for fewer than 8 percent of the seriously delinquent borrowers. The numbers are small both in absolute terms and relative to the problems these borrowers face. Lenders initiated foreclosure proceedings on more than half these loans and completed them on almost one-third.

Why Is Renegotiation Rare?

So why is renegotiation so rare? If the logic for Making Home Affordable is correct, lenders should find renegotiation attractive, even in the absence of government prodding. Yet the data show very little renegotiation.

The leading explanation holds that lenders are reluctant to renegotiate because the process of securitization, in which loans are bundled and sold off, muddies the waters. Loan pooling and servicing agreements sometimes place limits on the number of modifications a servicer can perform for a particular pool of mortgages. In addition, some have argued that the rules by which servicers are reimbursed for foreclosure expenses may provide a perverse incentive to foreclose rather than modify. Another issue is the possibility that those investors whose claims are adversely affected by modification will take legal action. Finally, the Securities and Exchange Commission (SEC) has historically held that contacting a borrower who is fewer than 60 days delinquent constitutes an ongoing relationship with the borrower and may change the status of the loan.

Some market observers express doubts about the renegotiation-limiting role of securitization, including J.P. Hunt, who conducted an exhaustive review of pooling and servicing agreements.[2] Although servicers have expressed concern about lawsuits, of the more than 800 lawsuits filed by investors in subprime mortgages through the end of 2008, not one questioned the right of a servicer to modify a loan. Even the Congressional Oversight Panel, which generally has viewed securitization as a problem, conceded in 2009 that the "specific dynamics of servicer incentives are not well understood." Finally, the SEC ruled in 2008 that if a default was "reasonably foreseeable," then contact with a borrower prior to 60-day delinquency would not affect the accounting status of the loan.

The empirical analysis provides strong evidence against the role of securitization in preventing renegotiation. Consider renegotiation rates for private-label (nonagency) securitized loans and for loans that are not securitized but held on the loan originator's balance sheet. For the narrowest definition of renegotiation (payment-reducing modification), the difference in the likelihood of renegotiation—in the 12 months after the first 60-day delinquency—between securitized and unsecuritized loans is statistically insignificant. For the broader definition, which includes any modification, the data even more strongly reject the role of securitization in preventing renegotiation.

What about subprime loans? Although they comprise only 7 percent of all mortgages, they account for more than 40 percent of serious delinquencies and almost 50 percent of the modifications. Strikingly, the results obtained for the subprime sample are consistent with the results for the full sample.

Risks to Lenders

The policy debate has focused exclusively on the ways securitization impedes renegotiation. It implicitly assumes that lenders who do not securitize, but rather hold the loans in their portfolios, face no institutional impediments. Portfolio lenders complain about having to identify modifications as "troubled debt restructurings" on their books, which leads to reduction of capital under accounting rules and increased scrutiny from investors. Also, the shortage of qualified staff, an oft-heard complaint from borrowers seeking renegotiation, affects servicers of portfolio loans and private-label loans equally.

Renegotiation exposes lenders to two types of risks that can dramatically increase costs.

So if securitization contract frictions are not a significant problem, then what is the explanation for lenders failing to renegotiate with delinquent borrowers more often? The proposed explanation is quite mundane: in the period studied, lenders expected to recover more from foreclosure than from a modified loan. That may seem surprising, given the large losses lenders typically incur in foreclosure, which include both the difference between the value of the loan and the collateral, and the substantial legal expenses.

But renegotiation exposes lenders to two types of risks that can dramatically increase costs. The first is a "self-cure" risk. Between 2005 and the first quarter of 2009, more than 30 percent of seriously delinquent borrowers cured their problem without receiving a modification within the first 12 months of becoming delinquent. Lenders might be assuming, therefore, that 30 percent of the money spent on a modification is wasted. The second risk comes from redefault. The data show that a large fraction of borrowers who receive modifications end up back in serious delinquency within six months. In that case, the lender has simply postponed foreclosure. In a world with rapidly falling house prices, the lender will now recover even less in foreclosure.

Proponents of mass modifications focus on the costs of foreclosure and the benefits of renegotiation and, in that context, the unwillingness of lenders to modify loans appears irrational. But redefault and self-cure risks make the problem far more complex. Measuring self-cure and redefault risks is also extremely difficult since one needs to assess counterfactual scenarios. To measure self-cure risk, for example, one has to assess what would have happened to borrowers who did receive a modification if they hadn't received it.

The implications for policy are threefold. First, "safe harbor" provisions, which shelter servicers from investor lawsuits, are unlikely to affect the number of modifications and should be little help. Second, and more broadly, the number of foreclosures that can be stopped without generating increased losses to investors may be smaller than many have argued. And third, to prevent foreclosures, policymakers need to provide financial assistance directly to borrowers so they can make their payments, or directly to investors to overcome the risks and make modification profitable. Making policy based on the assumption that everyone benefits from renegotiation will not work.

Paul Willen *is a senior research economist and policy adviser at the Federal Reserve Bank of Boston.*

Endnotes

1 This article is based on Paul Willen, Manuel Adelino, and Kristopher S. Gerardi, "Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization" (paper no. 09-4, Federal Reserve Bank of Boston Public Policy Discussion Paper Series, 2009).

2 J.P. Hunt, "What do subprime securitization contracts actually say about loan modification?" (working paper, Berkeley Center for Law, Business and the Economy, 2009).