



Barriers to Reducing Needless Foreclosures

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Needless foreclosures are happening all around us.

Note that I am using a coldblooded business definition of "needless foreclosure," not a bleeding-heart one. Under my definition, if it costs the holder of the loan more to foreclose on a mortgage than to make it viable, it is a needless foreclosure. I am not counting the human toll exacted by foreclosures, which can be very high.

For example, it can cost the investor who held the mortgage about \$40,000 to foreclose on a home. It might have cost only \$25,000 to make the mortgage affordable to the borrower through a reduction in the interest rate. Modifying the loan contract in this way would have kept the person in his home and saved the investor money.

Mortgage contracts are modified, at some cost to the investor, to prevent the larger cost of a foreclosure. Loan modifications include adding the unpaid interest to the loan balance, called "interest capitalization," and calculating a new payment. To make the payment more affordable, the term may be lengthened or the interest rate reduced. In cases where the property is worth less than the loan balance, the balance may be reduced.

The problem is that there are major impediments to loan modifications, including:

Borrower denial. Developing a new loan contract that a distressed borrower can live with requires the full participation of the borrower. But many borrowers in trouble don't contact their servicers and may not respond when contacted.

Moral hazard. Investors are concerned that if modifications are offered too easily or too early, some borrowers will pretend to need one even though they really don't. This is a major reason investors restrict the discretion of servicers to modify contracts.

Restrictions on servicers. Third-party servicing in which the firm servicing the loan does not own it is more often the rule than the exception. In the case of loans that have been packaged and sold to investors, it is always the case.

Investors restrict the discretion of servicers to modify loan contracts because their interests are different. Investors want modification only if the alternative is a more costly liquidation or foreclosure. They want to avoid early modifications that would prove unnecessary, and they want to avoid encouraging borrowers to default who might not otherwise. Servicers, in contrast, want to protect their servicing fees, which they receive only from loans in good standing. Their general preference, therefore, is for early intervention.

A common contractual restriction on servicers is that modifications are permitted only for loans in default or for which default is imminent or reasonably foreseeable. Another is that any modification must be in the best interest of the investor. These create potential legal liability for the servicer. To be safe, some servicers limit modifications to loans already in default, which means 90 days delinquent or more.

Scarcity of staff. Most interactions between mortgage borrowers and servicers are handled by computers and relatively unskilled employees. Borrowers in serious trouble are referred to a smaller number of more skilled and specialized employees. With the onset of the mortgage crisis, servicers were caught short of this critical but costly resource. While they now claim to have expanded their staffs to handle the workflow, a financial disincentive to staff adequately remains.

Mortgage insurance. On mortgages carrying mortgage insurance that go to foreclosure, investors are protected up to the maximum coverage of the policy, which is usually enough to cover all or most of the loss. This discourages modifications. Why do a modification for \$15,000 if the \$40,000 cost to foreclose is going to be paid by the mortgage insurer? Even if the insurance coverage falls short of the foreclosure cost, the shortfall has to exceed the modification cost before modification becomes more attractive financially.

Second mortgages. Many of the borrowers in trouble have two mortgages with different lenders, which complicates matters. The servicer looking to modify the first mortgage must make sure that the borrower can afford both mortgages and that the second mortgage lender does not upset the apple cart by foreclosing. My mail from borrowers in trouble suggests that some servicers are prepared to work with second-mortgage lenders, and some are not.

Lack of public disclosure. Nothing in connection with modifications is publicly disclosed except what servicers wish to disclose, which invariably is whatever presents them in a favorable light. There is no way for the public to know who is doing a good job and who isn't.

Because of these impediments, modifications are making only a modest dent in the foreclosure problem. Other remedies will be discussed in a future article.