WHY ARE MODIFICATIONS SO HARD?

Andreas Lehnert
Board of Governors of the Federal Reserve System

Disclaimer

These comments represent my own opinions are not necessarily those of the Board of Governors of the Federal Reserve or its staff

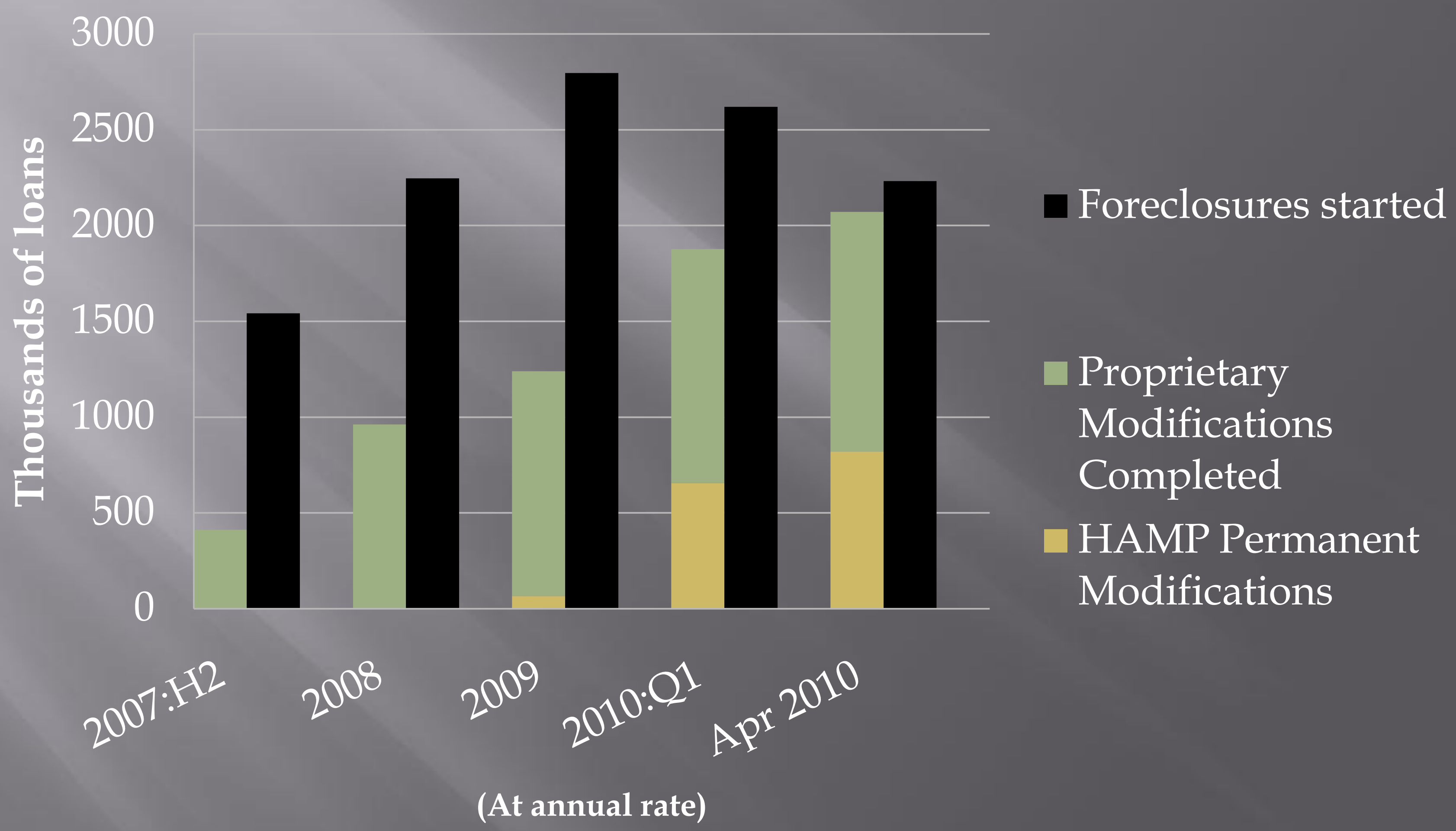
Outline

- Modifications not as common as we'd expect
- Modifications should be good for everyone
- Focus on
  - Junior liens
  - Negative equity

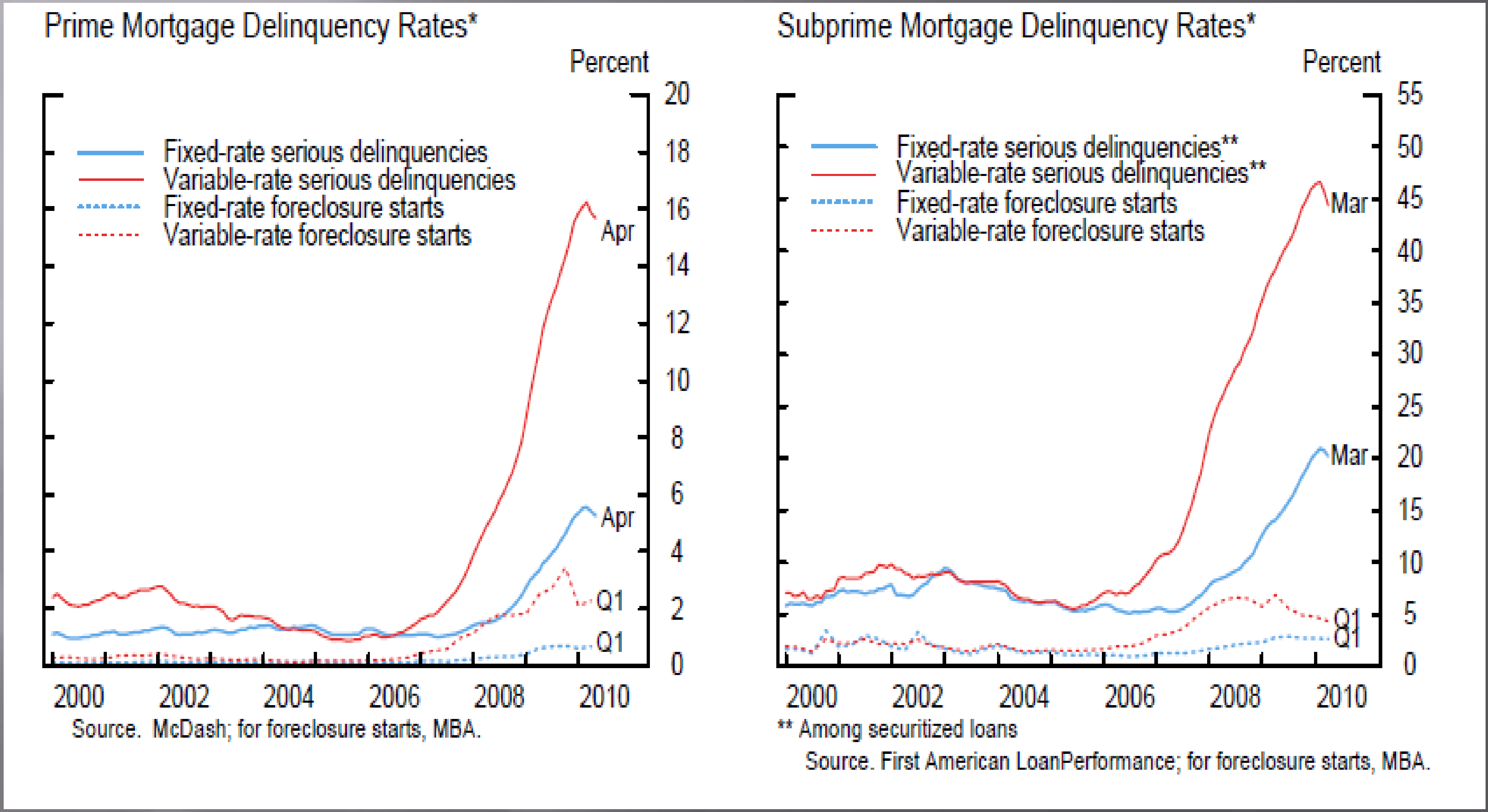
What the data show

- Modifications got off to a slow start in 2007
- Administration's standard modification protocol—HAMP—didn't get going until mid-2009
- Modifications are starting to catch up with new foreclosures
  - But big backlog of loans *in* foreclosure
  - Pace of foreclosures is artificially low right now

Modifications vs Foreclosures

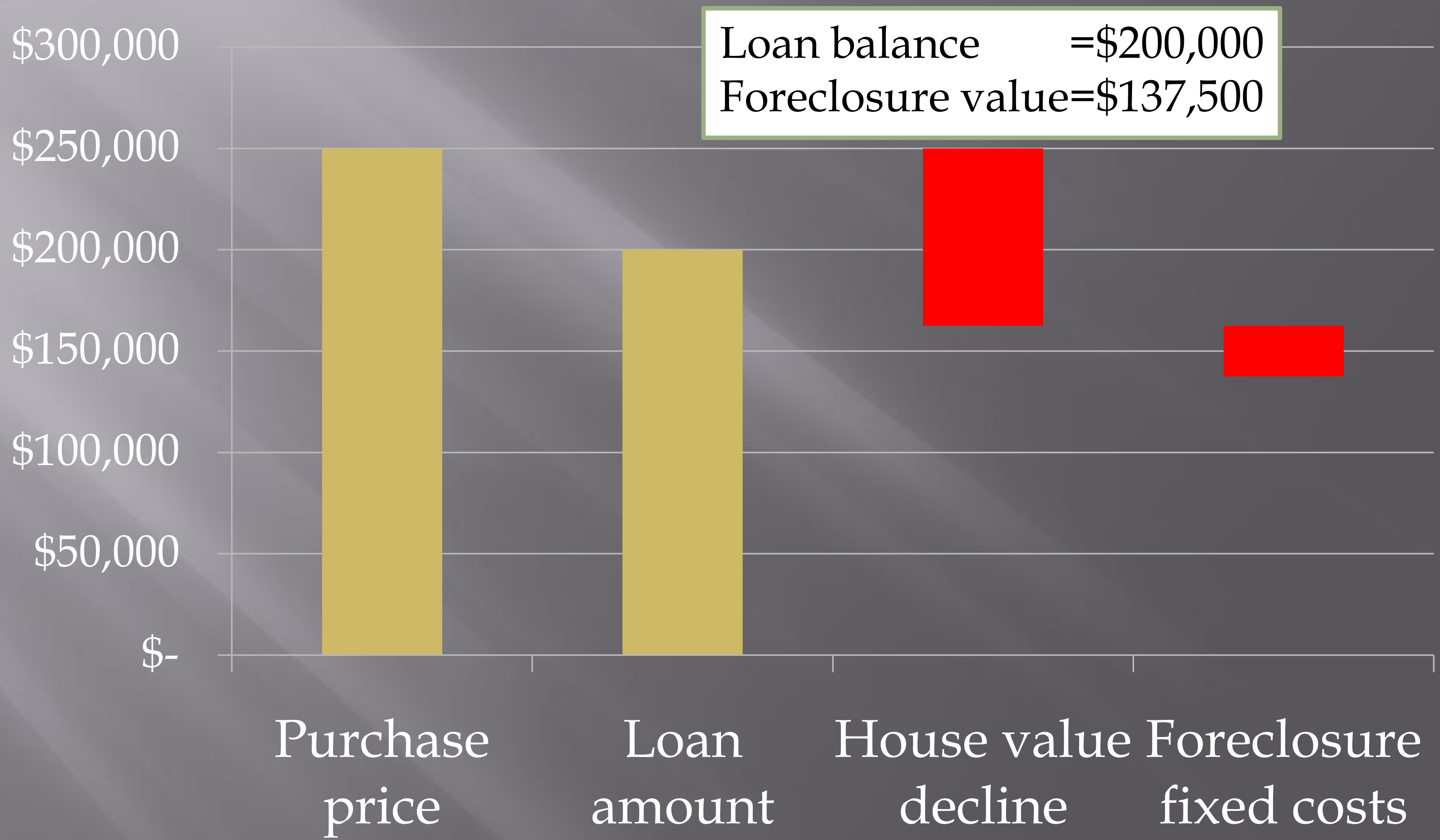


Foreclosures Lag Delinquencies



The economics (and sociology) of mortgage modifications

Economics of Modification



Do lenders actually think like this?

- Several specialty shops cut these deals
  - Buy whole mortgage loan below par
  - Strike great deals with underlying borrower
- Requires a bank to sell loans below par
- Actual scale ≈ tens of billions (estimate)
- Required scale ≈ 100 x more

What's going on?

- **There is no such thing as a "lender"**
- Loan mods handled by ***servicers***
  - Large scale back-office operations
  - 20 years of economies of scale
  - (But no scale economies for modifications)
- So let's talk to some servicers…

What mortgage servicers say
(From papers by CDLLM)

(1) No clear instructions

(2) No investor ever complained about <u>too many</u> foreclosures

(3) Capacity constraints ("expensive")

(4) Junior liens are a problem

Problems of affordable-payment plans

(5) Unsuitable for temporarily unemployed

(6) Can't address negative equity

HAMP Addresses Common Problems

	Obstacle to Successful Modification	HAMP Feature to Address
1	Lack of guidance	Explicit waterfall, NPV test, instructions
2	Fear of investors	Establishes new “standard industry practice”
3	Capacity constraints	Payments to servicers
4	Junior liens	2MP program makes payments
5	Unemployment	New temporary forbearance protocol
6	Negative equity	“Short refi” protocol

Junior liens

Junior Liens

- Piggybacks (closed-end seconds) taken out at origination, e.g. 80/20 “borrow the downpayment”
- Home equity lines of credit taken out after origination; can be extremely large
- Lots of them, but not sure how many
  - 1 out of 2 borrowers (Amherst)
  - 1 out of 4 borrowers (Other estimates)
  - Presence of piggyback → 2x default risk (GLSW) so highly common among *delinquent* loans

Why do Junior Liens Matter?

- Senior lienholder insists that junior resubordinate in modification
- Maintain payment priority and have junior feels more pain than senior
- Junior has to agree to short sales

The trouble with junior liens

- Opaque
  - Hard to know if borrower has a junior
  - Even if the same bank holds both!
  - Phone borrower to find out about them

The trouble with junior liens

- Operational
  - One more party who can lose/delay paperwork

The trouble with junior liens

- Discourage borrowers
  - One more creditor to placate
  - Borrower is referee between two opposed parties

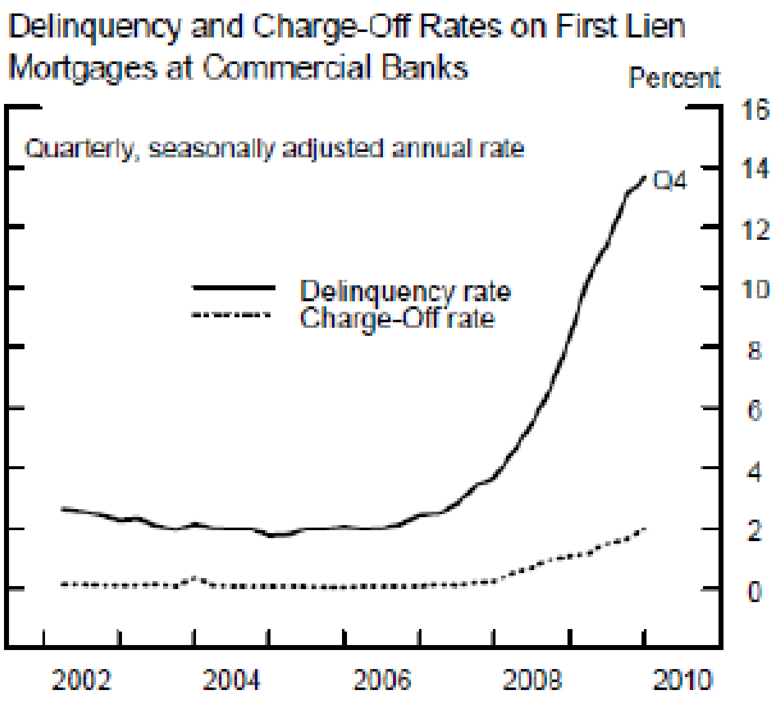
The trouble with junior liens

- Hold up motive
  - Junior lien holder demands payment to go away
  - Either to resubordinate or to extinguish

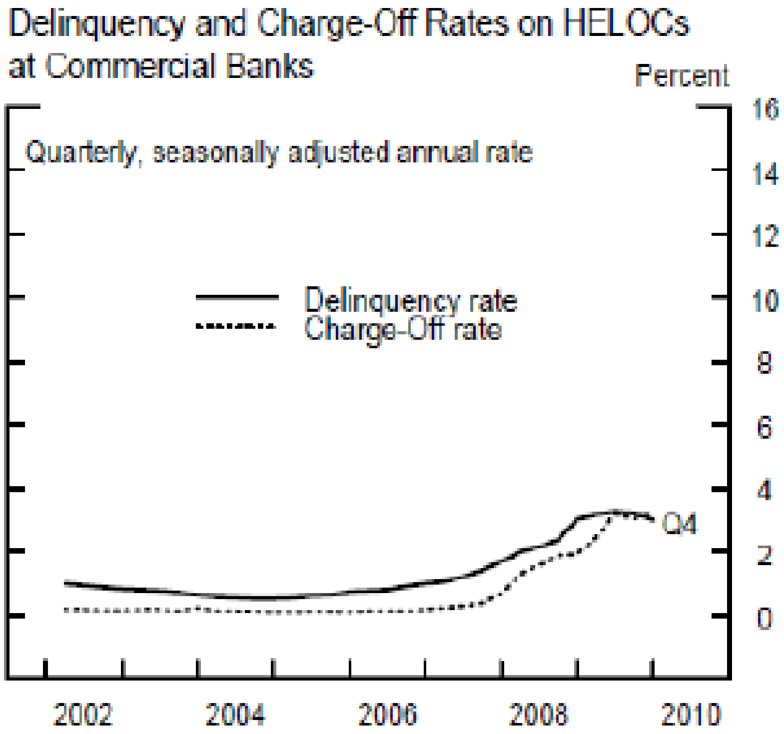
The trouble with junior liens

- Strategic/accounting motive:
  - Junior may be current even though senior is delinquent
  - Lienholder has no incentive to take accounting loss

First liens are likelier to go delinquent than junior liens



Source. Federal Reserve.



Source. Federal Reserve.

Puzzle: Why pay your second but not your first?

- More aggressive collection by junior lender?
- Preserve access to HELOC (in borrower's mind)
- Borrower makes the smaller payment

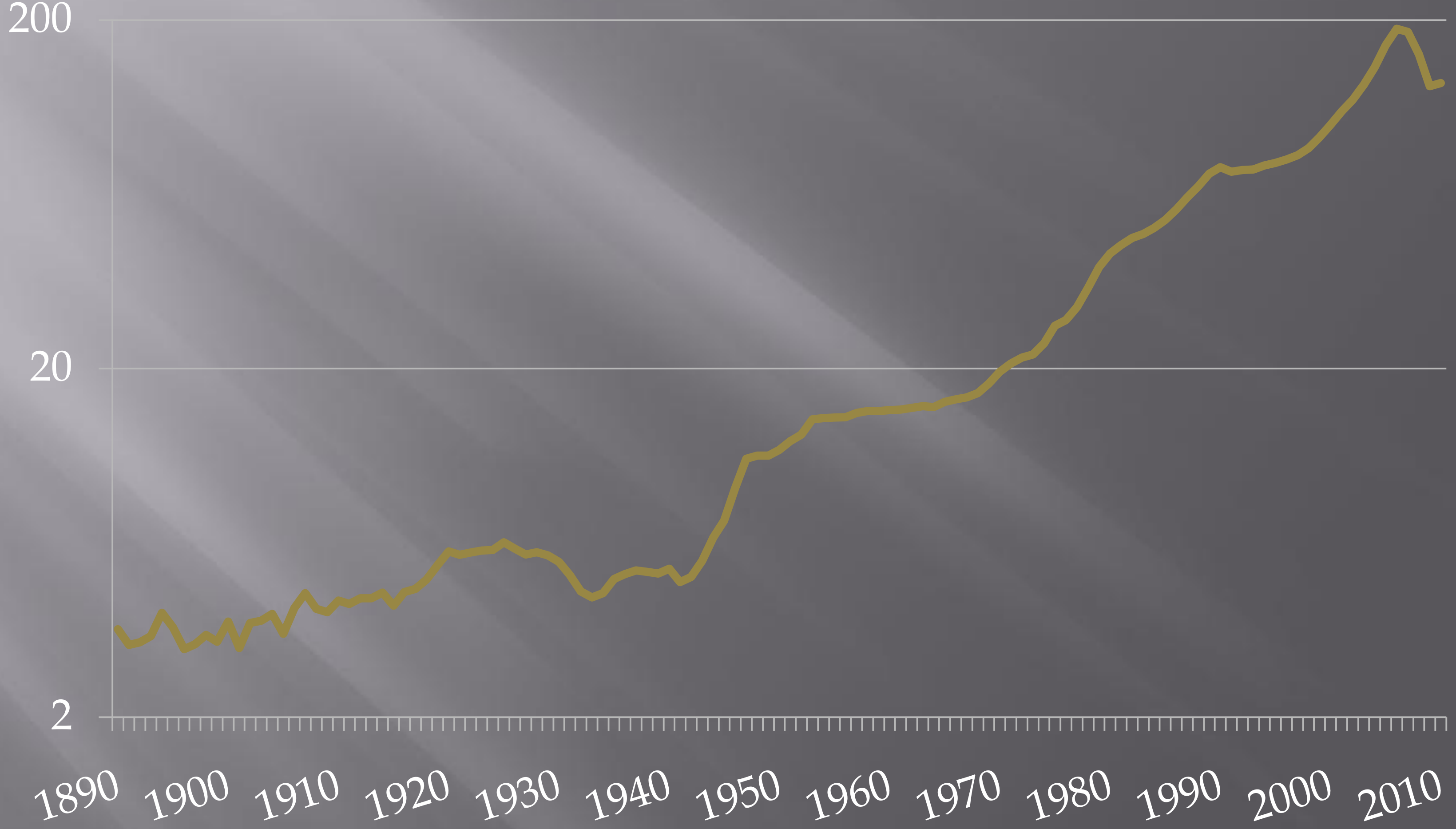
Puzzling behavior is one PSA away from disappearing

But junior liens as a whole better underwritten, overall lower delinquency not a puzzle

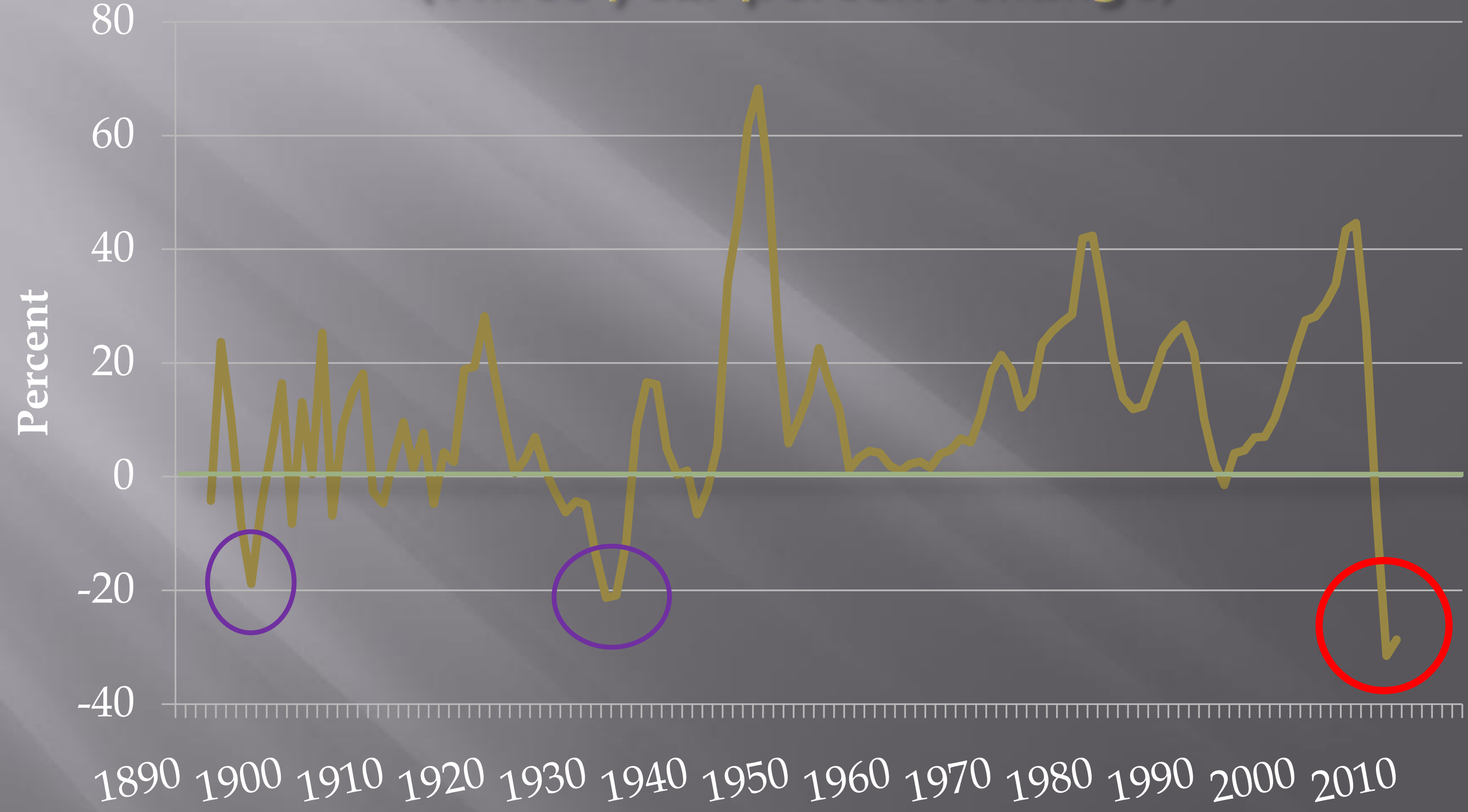
Negative equity

Nominal House Price Index: 1890—2010

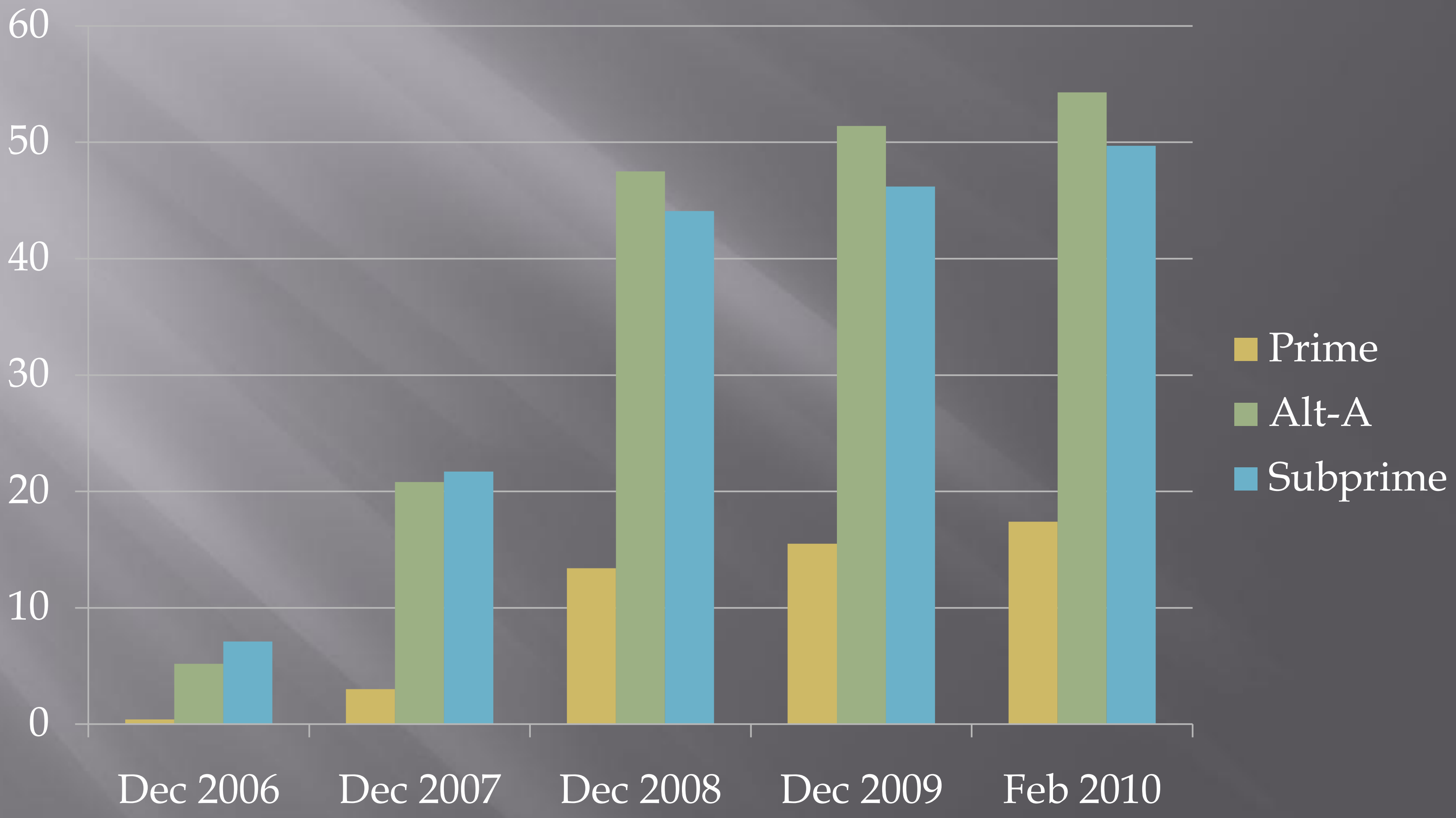
(Log scale)



Nominal House Price Index: 1890—2010
(Three year percent change)



Percent of borrowers underwater



Policy Response to Negative Equity

- To keep borrowers in homes, likely to need some hope of getting positive equity
  - Don’t need to write principal down to <100
  - Could use shared appreciation mortgages

Policy Response to Negative Equity

- Servicers reluctant to implement principal writedowns
  - Some PSAs prohibit
  - “The first loss is the best loss”

Policy Response to Negative Equity

- Incentive and equity problems
  - Paradox that severe *ex post* punishments leads to better *ex ante* outcomes
  - Hard to reward speculation
  - Balance against real deadweight costs posed by foreclosures

Conclusion

- Unprecedented lending boom followed by all-time record nominal price drop
- As many as 1 borrower in 4 now underwater
- Negative equity will be a feature for years to come