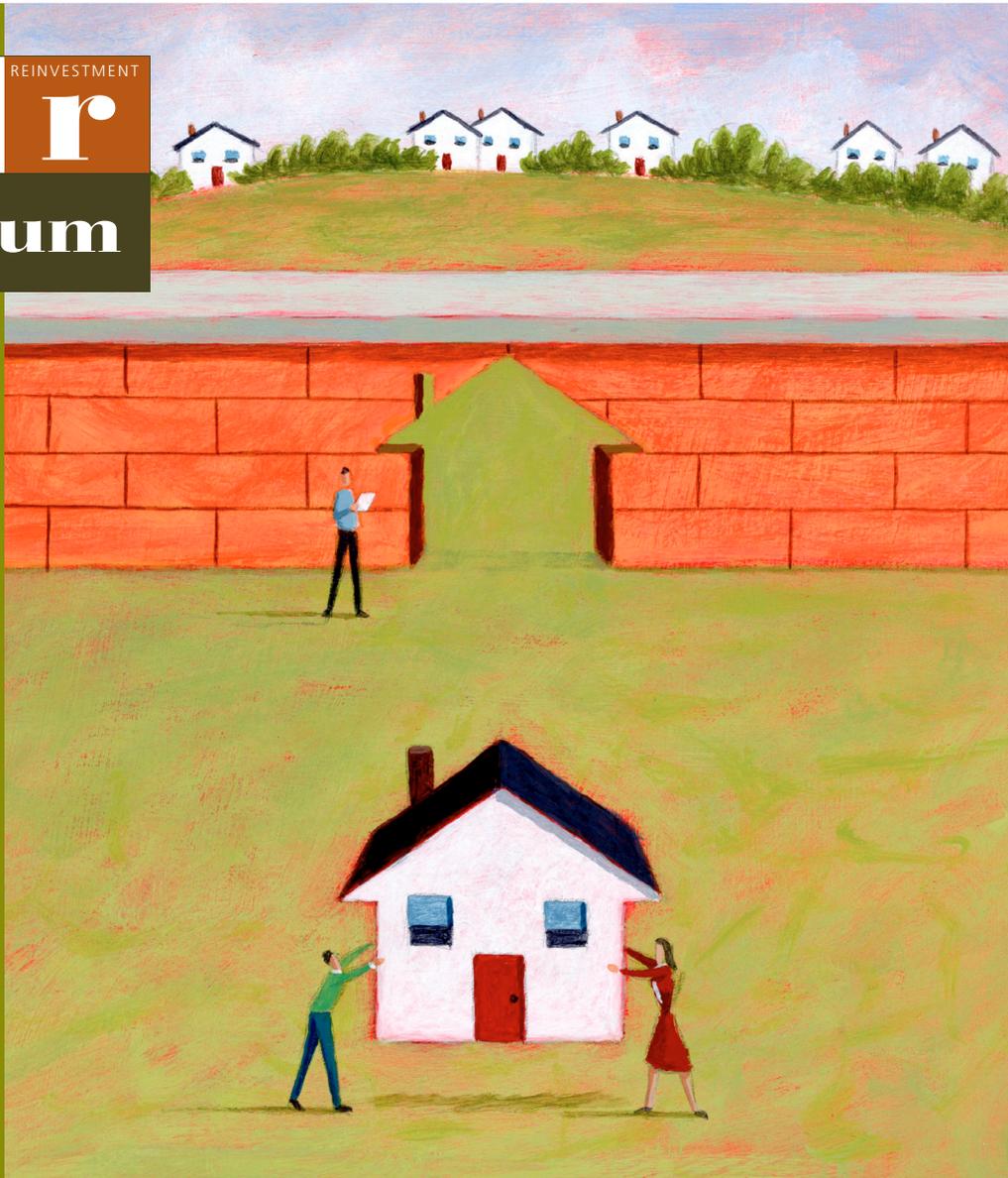


CONTAINING A FIRESTORM: ADAPTIVE POLICIES NEEDED TO ADDRESS CHANGING FORECLOSURE LANDSCAPE



CR FORUM

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Like a wildfire leaving devastation in its path, the foreclosure crisis continues to wreak havoc on many families and communities throughout the Fourth District, especially in the largest urban areas. Fueling this raging fire is the complex and rapidly shifting nature of the crisis. Only a year ago the primary reason for foreclosures centered on subprime mortgages. Today, the primary driver is unemployment, further widening the consumption arc of this blaze. At-risk mortgage loans are forcing many borrowers into foreclosure, resulting in equity loss, credit damage, and possibly homelessness, along with other devastating effects on communities, including a glut of vacant and blighted properties.

The problem of troubled loans is not diminishing. Nationally, the delinquency rate for mortgage loans in the third quarter of 2009 rose slightly to almost 10 percent, up from 8.9 percent in the second quarter. Of the four states comprising the Fourth Federal Reserve District—Ohio, Kentucky, Pennsylvania, and West Virginia—all are also reporting slightly climbing delinquency rates (*see figure 1*).

A crucial response to high rates of delinquent loans has been to promote loan modifications. Modified loans provide homeowners an opportunity to secure more sustainable mortgage payments through modifying original loan terms. In 2009, the Obama Administration launched the Making Home Affordable Program, aimed at helping distressed borrowers and servicers reach successful loan modifications.

Despite these efforts, many at-risk homeowners struggle to reach sustainable loan modifications and save their homes. In fact, research reveals that nationally only about 3 percent of delinquent borrowers have been successful in securing concessionary loan modifications.¹ Preliminary research findings for loan modifications completed here in Ohio reveal similar results. (*See sidebar “Behind the numbers,”* pg.4)

To better understand the players and decisions involved in the loan modification process, the Federal Reserve Bank of Cleveland conducted a series of focus groups over the past several months with borrowers, representatives from servicers and lenders, and housing counselors to learn

about the challenges to attaining long-term loan workout solutions between borrowers and servicers. What we’ve heard and learned from the data confirms what is being reported in the national press.

In this publication, we

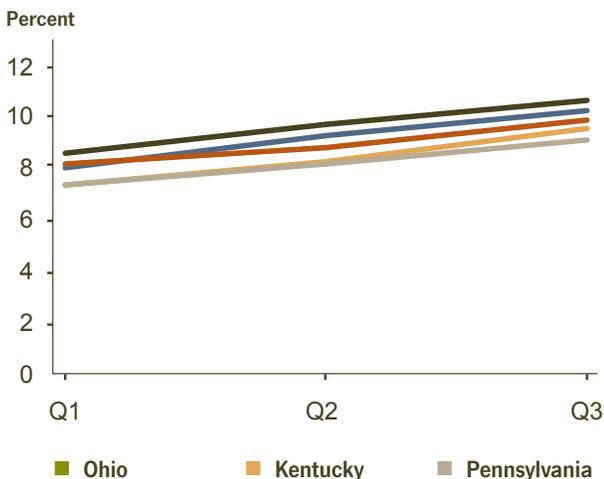
- highlight our key findings from the focus groups and other outreach,
- examine some national, state, and local efforts to connect borrowers and servicers, and
- zero in on the issue of income interruption due to job loss or other factors to explore policy considerations from a Fourth District perspective.

KEY FINDINGS

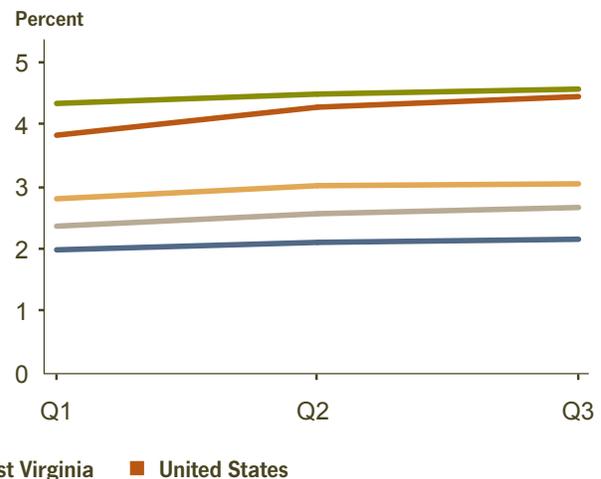
Borrowers are overwhelmed and confused

Borrowers face a dizzying array of pressures in overcoming their troubled loan situations. Already anxious about the possibility of losing their homes, borrowers are confronted with multiple servicer contacts; they might receive calls from servicers’ collections, loss mitigation, and home preservation departments. The result is mounting confusion and stress. If a loan is sold, homeowners are often forced to renegotiate from the beginning with a new servicer. Foreclosure rescue scams are an additional stress to borrowers. Noted one Cleveland-area housing counselor, “I’d say every client sees probably one or two pieces a day [of marketing] that could be loss mitigation from lenders, could be ‘We buy houses,’ could be ‘We buy ugly houses.’”

Figure 1. Delinquency Rates, 2009



Foreclosure Rates, 2009



Source: Mortgage Bankers Association

Unemployment is now the primary driver of new foreclosures

In contrast to the early days of the crisis, when subprime loans were implicated as the primary driver of most delinquencies, the most common factor today in mortgage delinquencies is unemployment. Under-employment is also a factor. According to Neighborworks America, as of late 2009 about 65 percent of borrowers nationally cite unemployment as the primary reason for their delinquency.² In Cincinnati, one housing counselor estimated that some 60 percent of clients seeking foreclosure prevention counseling are unemployed, a significant increase from earlier in 2009. This shift widens the scope of the foreclosure crisis, creating a much more difficult challenge in modifying troubled loans and keeping families in their homes. “I tried to get a modification,” one worried borrower noted. “They told me, ‘We can’t help you. You don’t have a job.’” Jobless borrowers with no other income sources are left with very few options.

Servicer inefficiencies are undermining the loan modification process

Communication disconnects and servicing industry fragmentation are hampering efforts for borrowers, counselors, and servicers to reach successful loan modifications. Borrowers acknowledged that servicers made numerous attempts to contact them. However, after establishing contact with their servicers, borrowers often experienced difficulties in working with their servicer/lender. Several reported having to resubmit lost paperwork and struggling to reach appropriate servicer contacts. This often led to high levels of frustration and feelings of helplessness. “You never get the same person, even if you call back and ask for that person. They’ll tell you, ‘Well, hey, you [are] talking to me now,’” stated one discouraged homeowner.

Another homeowner stated that while she and a housing counselor were working with the loss mitigation department of her servicer, she simultaneously received threatening calls from the servicer’s collections department. “When I talked to the mortgage company, they still were threatening me,” she shared. “They’re still calling, threatening me, and saying, ‘We’re going to foreclosure.’”

Servicers and housing counselors alike admit to lacking capacity to handle the overwhelming number of delinquent loans. Contributing factors include high counselor turnover rates, time-intensive hiring and training processes, shifting

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policies and procedures, and budgetary constraints. One reason servicers cite as an impediment to reaching scale with loan modifications is that every borrower has a different path to delinquency involving varied loan products, and each loan product has its own history of being bought and sold by investors. “Lenders are having difficulty approving modifications and workouts in a timely way. It takes on average 60–90 days to obtain some resolution. Not all representatives appear to be properly trained in offering options, and many times the client and counselors must talk to several departments before reaching the right person,” shared one frustrated counselor.

Borrower re-defaults are adding to difficulties

High rates of re-defaults continue to compromise efforts to keep borrowers in their homes. In the first quarter of 2009, nearly 43 percent of borrowers who had originally been 60 days or more delinquent re-defaulted on their loan modifications after six months.³ Some borrowers are re-defaulting because of income loss. Ohio’s double-digit unemployment is affecting borrowers’ ability to sustain even modified loans. Some borrowers may be re-defaulting because their loan modifications were less than optimal. Servicers, for example, may not be factoring in that a borrower’s circumstances may change in the current economy when offering a borrower a loan workout option. Often, a distressed borrower will accept whatever loan modification the servicer offers, unaware that they might have qualified for a modification with more favorable terms. Meanwhile, servicers and lenders maintain that some borrowers are not making the lifestyle changes necessary to support successful, sustained loan modifications.

Behind the numbers: A preliminary look at loan modifications in Ohio

The anecdotal evidence in this report points to numerous challenges that face homeowners hoping for a loan modification to avoid foreclosure. What happens once a loan is modified? To learn more about loans that make it past the hurdles and end up being modified, the Cleveland Fed's Community Development research team began looking at data on loan modifications taking place within Fourth District states. In this preliminary analysis, we focus specifically on Ohio, hard hit by both the subprime crisis and deteriorating economic conditions. (Our full analysis will also include Pennsylvania and Michigan.) Here, we seek to address the following questions: How many loans are delinquent in Ohio and, of those, how many are being modified? By what means? Are these modified loans remaining current six months later? And, perhaps most important from a policy standpoint, which types of loan modifications seem less likely to re-default?

To perform this analysis, we looked at Lender Processing Services (LPS) data on loans originated from 2005 through 2007 in Ohio. Our first step was to identify loans that became delinquent—which we define as loans that are 60 or more days delinquent or in the process of foreclosure. While the LPS data set contains specifics on the delinquency status of loans, it does not include information on loan modifications. However, using an algorithm developed by colleagues at the Boston and Atlanta Federal Reserve Banks, we were able to identify loans that appear to be modified.¹

What we're finding

In a nutshell, lots of delinquencies and not many modifications. Since the first quarter of 2007, Ohio's delinquency rate has been steadily rising (see chart 1). The delinquency rate is calculated as the percent

of delinquent loans out of all active loans. As shown, the percent of delinquent loans increased from about 5 percent in the first quarter of 2007 to nearly 15 percent by the third quarter of 2009.

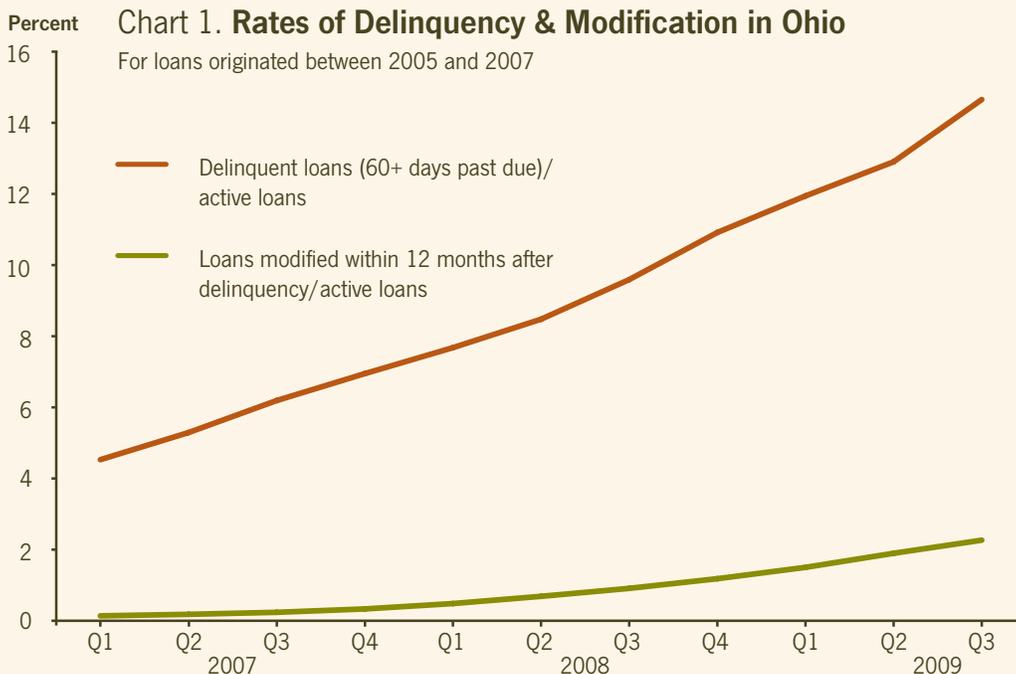
We then identified the number of loans modified within 12 months of the loan becoming delinquent for the first time. The modification rate is calculated as the percent of loans ever modified within 12 months of delinquency out of all active loans. As illustrated in chart 1, we see that the percentage of modifications, although very low, is increasing slightly over time, from less than 1 percent throughout 2007 to more than 2 percent by the third quarter of 2009.²

A loan can be modified by way of one or more of the following alterations to its original terms:

- Fixed-interest-rate reduction
- Adjustable-interest-rate reduction
- Principal decrease
- Term change
- Principal increase

The first four are all concessionary, meaning that the servicer absorbs some level of loss with the modification.

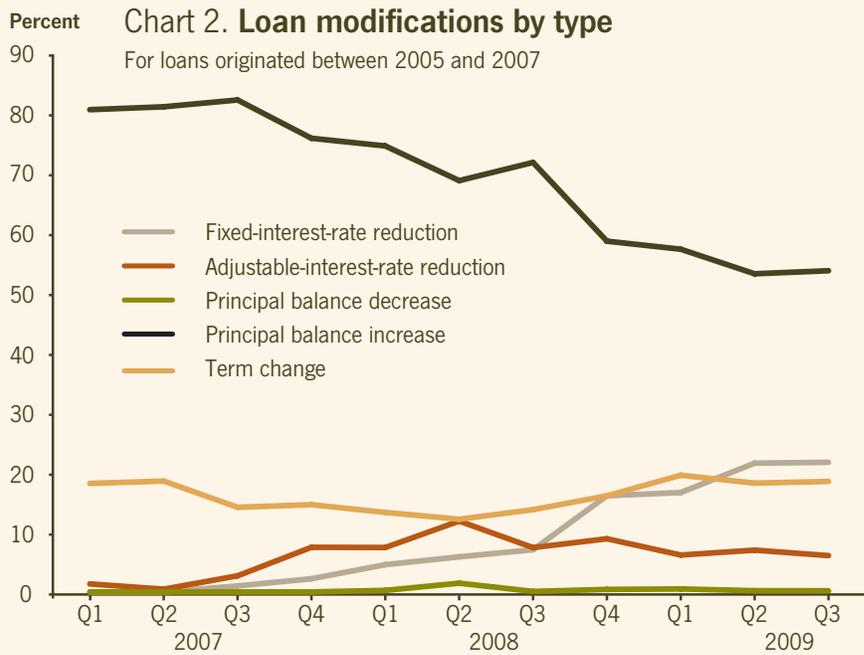
Of the loans being modified within 12 months after delinquency, a principal balance increase is the most common modification type in Ohio. However, as illustrated in chart 2, principal balance increases comprise a smaller percentage of the modifications over time, decreasing from 81 percent in the first quarter of 2007 to about 54 percent in the third quarter of 2009. With respect to concessionary modifications, term changes were most common through the first



1 Adelino, Manuel, Kristopher Gerardi, and Paul S. Willen. "Why Don't Lenders Renegotiate More Home Mortgages? Redefault, Self-Cures, and Securitization." Working Paper 2009-17. Federal Reserve Bank of Atlanta, August 2009.

2 Even when extending the time period for delinquent loans to be modified past the 12-month mark, the modification rate reaches only 3 percent by the third quarter of 2009.

Note: The percentage of loans modified is an estimate based on the algorithm used in this analysis.
Source: Federal Reserve Bank of Cleveland analysis of Lender Processing Services (LPS) data.



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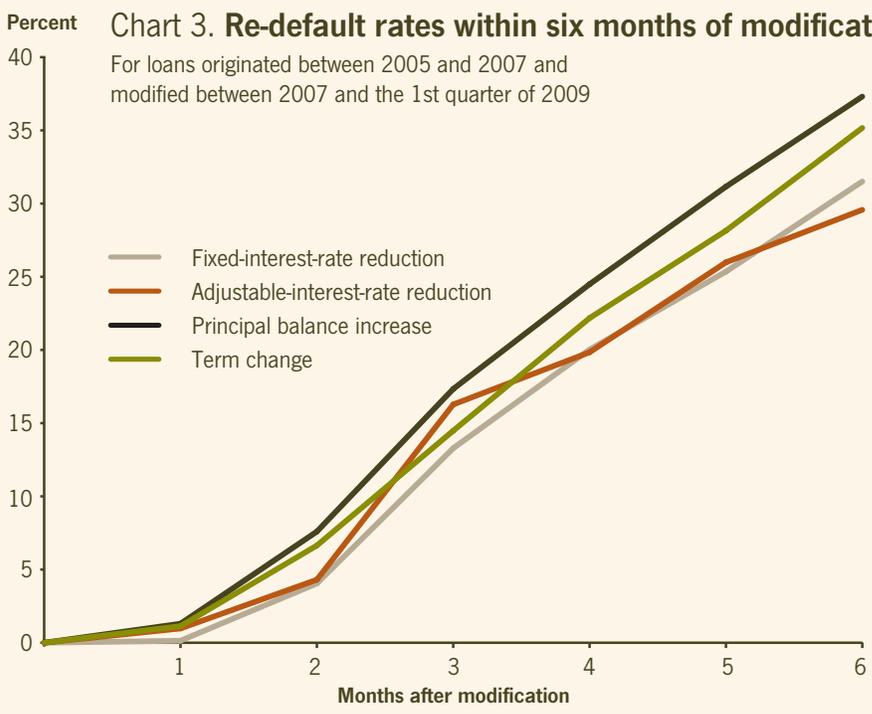
quarter of 2009. Fixed-interest-rate reductions have increased steadily over time. The percent of modifications that resulted in a principal balance decrease was negligible in nearly every quarter examined.

Finally, we looked at the performance of loans by modification type in 2007, 2008, and the first quarter of 2009. Specifically, we look at how many loans re-defaulted within six months of the modification. We define a re-default as a loan that, following one of the alterations listed on page 4, becomes 60+ days past due within six months of the modification.

Consistent with reports on national figures, re-default rates in Ohio are relatively high across four of the modification types. (The number

of modifications resulting from a principal balance decrease is too small to report.) As shown in chart 3, six months after receiving a loan modification, nearly a third of homeowners have re-defaulted on their loans. While our analysis thus far does not shed light on why these re-default rates are so high, economic conditions and continued falling housing prices certainly play a part.

We will explore the policy implications of these findings in our complete report on this research, which will be completed in the first quarter of 2010. For additional research from the Cleveland Fed's Community Development group, go to www.clevelandfed.org/communitydevelopment.



Note: The percentage of loans modified is an estimate based on the algorithm used in this analysis.
Source: Federal Reserve Bank of Cleveland analysis of Lender Processing Services (LPS) data.

CONNECTION EFFORTS

Over the past couple of years, several initiatives have been employed to help distressed borrowers work with their servicers to reach sustainable loan modifications or other workout solutions. Some of these efforts are showing promising results, while others are falling short of expectations.

Borrower outreach events

In 2007, the federal government introduced HOPE NOW, a voluntary servicer industry plan to modify troubled mortgages. These large-scale outreach events held throughout the country, including many here in the Fourth District, provide distressed homeowners the opportunity to meet face-to-face with their servicer/lender. HOPE NOW reports that nationally nearly 3 million loan workouts were completed from July 2007 through November 2008. However, a Congressional Oversight Panel report released in March 2009 reveals that “a majority of these ‘workouts’ were repayment agreements that increased homeowners’ monthly payment.”⁴

Recent workout figures through the third quarter of 2009 released by HOPE NOW present slightly better results. During this period, loan modifications represented about 51 percent of all reported loan workouts, up from the 42 percent in 2008. Despite these improvements, some continue to question the success of this voluntary industry plan.⁵

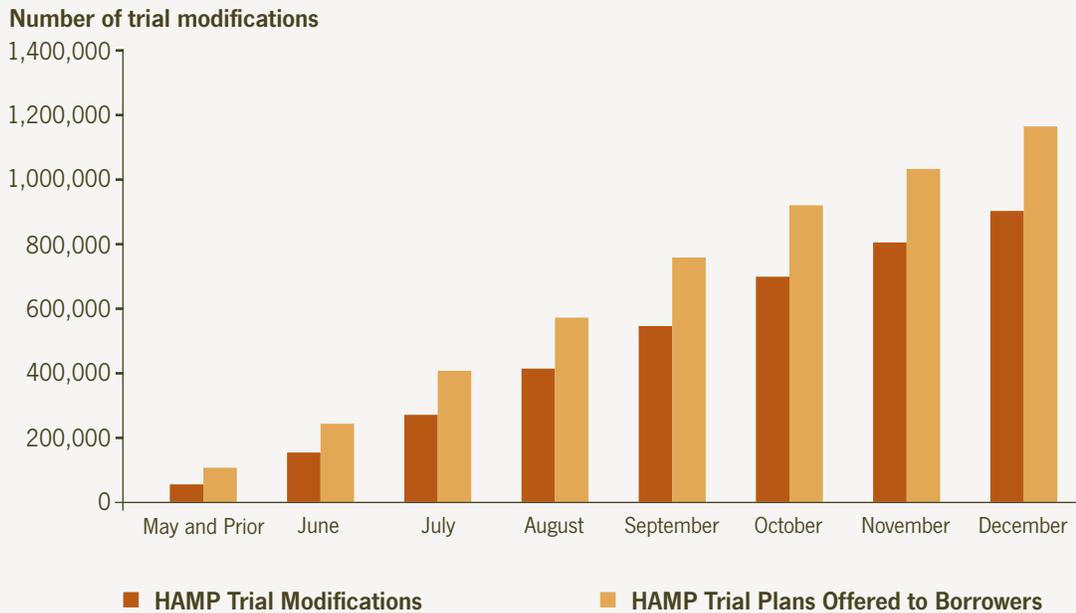
Making Home Affordable Program

In March 2009 the Obama Administration launched a plan to stabilize housing markets and help 3–4 million Americans reduce their monthly mortgage payments to affordable levels over the next three years. The plan, called Making Home Affordable, consists of two primary features—the Home Affordable Modification Program (HAMP) and the Home Affordable Refinance Program (HARP). Under the HAMP, eligible delinquent borrowers or those at risk of imminent default have an opportunity to secure loan modifications, reducing payments to no more than 31 percent of their gross income. Servicers are encouraged by incentives to modify these troubled mortgage loans. Another aspect of the plan available through HARP provides borrowers who are ‘upside down’ on their loans an opportunity to refinance.

Treasury reports that increasing numbers of trial modifications have been extended and accepted (*see figure 2*), and nearly 4 million borrowers have refinanced their troubled loans through the HARP. According to Treasury, the Making Home Affordable Program is on target to meet its established goals. One significant drawback to the Obama Administration’s Making Home Affordable plan, however, is that it provides limited assistance for borrowers experiencing income disruptions.



Figure 2. 2009 HAMP Trial Modifications (cumulative, by month)



Making Home Affordable: Analysis of Current Data on Program Results

In January 2010 the U.S. Treasury released its monthly Servicer Performance Report for the Making Home Affordable Program (HAMP). The report details the number of HAMP loan modifications offered and accepted by borrowers through December 2009, at both aggregate and servicer-specific levels. Nationally, 1,164,507 trial modifications have been extended to homeowners, representing an 11 percent increase from November. The actual number of trial modifications started, which includes all loans in which at least one new payment has been made, is 902,620. Trial modifications are up 19 percent from November. Permanent modifications completed by year-end 2009 total 66,465, representing an increase of 52 percent from November. Overall, 25 percent of the estimated 3.3 million borrowers 60-plus days delinquent are currently in a trial modification. The modification performance of participating servicers varies significantly.

Source: FinancialStability.gov

Also, because of the heavy emphasis on reaching loan modifications through the Making Home Affordable Program, some other, perhaps more advantageous, workout options for borrowers are being overlooked. Area housing counselors are concerned that some options available prior to the Making Home Affordable Program are no longer being considered by some servicers and lenders. To ensure that servicers and lenders continue to explore all possible loan workout options available for borrowers beyond Making Home Affordable, an added incentive might be considered. One way to offer this incentive would be for the U.S. Department of Treasury to agree to include all sustainable workouts in a servicer's monthly progress report. Presently, this report captures only loan modifications completed through the Making Home Affordable Program.

PROMISING APPROACHES TO CONNECT BORROWERS WITH THEIR SERVICERS

In light of current initiative shortcomings, other approaches to connect borrowers with their servicers are being launched. While many of these programs are just getting off the ground, it appears that they can play a vital role in connecting borrowers with servicers and an opportunity to negotiate a successful loan workout solution.

Foreclosure prevention phone-a-thon

A new outreach approach recently introduced by the U.S. Department of Treasury improves on previous efforts. In October 2009, Treasury partnered with HUD and

the Homeownership Center of Greater Cincinnati to conduct a three-day foreclosure prevention phone-a-thon. With this effort, callers will benefit from working with a certified housing counselor in developing an action plan, a budget, and financial analysis, followed by a face-to-face appointment with the caller's servicer/lender. The plan aims to produce sustainable workout solutions and reduce the time it normally takes servicers to process and reach workout solutions from 180 days or longer to 30 days. According to the Homeownership Center of Greater Cincinnati, the phone-a-thon generated 4,434 calls resulting in 435 homeowners meeting with their servicers. These meetings led to more than 120 instances of homeowners avoiding foreclosure. Based on the initial success of the program, Treasury is now considering this effort as a potential national model in reaching timely workout solutions.



Court-mediated programs

Court-mediated foreclosure programs are rapidly emerging throughout the country as another option to tackle the persistent foreclosure crisis. These programs vary by jurisdiction, but generally a representative of the borrower's servicer/lender who is authorized to negotiate settlements is required to meet with an eligible borrower and a court-appointed mediator to work toward a successful workout solution. Not all court-mediated negotiations, however, result in resolution.

In 2007 the Ohio Supreme Court developed a program mediation model, clearing the way for Ohio counties to develop foreclosure prevention programs. Today, all of Ohio's counties offer some level of court foreclosure mediation. Cuyahoga County's program, launched in June 2008, requires homeowners to meet a minimum threshold of having monthly expenses equal to or less than monthly income, or otherwise be willing to consent to the foreclosure or provide a deed in lieu of foreclosure. According to the Cuyahoga County Common Pleas Court, nearly

20 percent of homeowners apply, most of whom (roughly 87 percent) are accepted into the program. Of those participating, more than half avoid foreclosure through mediated settlements. The average time it takes to reach a successful loan workout solution is 120 days.

POLICY OPTIONS TO AID BORROWERS WITH DISRUPTED INCOME

Policymakers looking to stem the mortgage foreclosure crisis and help re-stabilize neighborhoods are assessing several legislative proposals. Many of these proposed policies play out quite differently when examined from a regional perspective. National policymakers are exploring several ideas that would allow eligible borrowers facing unexpected income loss or disruptions an opportunity to stabilize their financial situations while trying to avert foreclosure.

One existing program is the Pennsylvania Homeowner's Emergency Mortgage Assistance Program (HEMAP). Launched in 1983, HEMAP was Pennsylvania's response to homeowners struggling to stay in their homes in the wake of the state's steel industry nosedive and thousands of jobs lost. Through HEMAP, Pennsylvania homeowners can secure two types of loan assistance, one designed to bring delinquent loans current and another targeting those homeowners requiring ongoing assistance in making their mortgage payments. According to Brian Hudson Sr., executive director and CEO, Pennsylvania Housing Finance Agency, the state's HEMAP has been very successful, saving 42,700 families from foreclosure by providing more than \$442 million in loans to at-risk homeowners since 1983.

To date, the state has appropriated \$225.5 million to capitalize the HEMAP program to assist struggling homeowners. Of that amount, more than \$246 million—in repayments including interest and principal from some 20,000 loans—has been repaid. These repayments are used to replenish program funding to assist additional homeowners struggling to keep their homes.

A hardship relief program like Pennsylvania's could offer much-needed assistance to many distressed borrowers throughout the Fourth District. In fact, at a national level a government payment-sharing plan has been proposed by the Federal Reserve Bank of Boston; this proposal offers similar relief to distressed homeowners across the country.⁶



Under this plan, homeowners suffering from significant income disruptions that have mortgage balances exceeding the values of their homes would be eligible for government-sponsored mortgage payment assistance. Borrowers confronting this scenario are unlikely to be able to refinance or sell their homes or find assistance with existing foreclosure prevention programs.

The Boston Fed plan recommends extending financial assistance through both grants and loans. Grant assistance would be available for those borrowers significantly affected by income loss due to unemployment and with little to no other financial resources. Borrowers facing decreased household income resulting from job loss or reduced work hours would be required to repay government-issued payment assistance with interest. Rates for these loans would be set above prime to discourage abuse. In either case, payment assistance would expire once a homeowner regains financial stability or after two years, whatever comes first.

CONCLUSIONS

Clearly, policymakers must consider the multiple challenges facing homeowners, servicers, and civic leaders in different kinds of communities when crafting a comprehensive policy approach to overcome the foreclosure crisis and stabilize neighborhoods. What works in one area may not work in another. The circumstances driving this crisis are shifting faster than programs can be designed and implemented. Further compounding the situation is that the Fourth District

consists of many weak-market communities, which are more vulnerable to delayed economic turnarounds given current high unemployment and foreclosure rates. A report by the Brookings Institution showing second quarter of 2009 economic performance of the nation's 100 largest metropolitan areas includes six Fourth District regions—Akron, Dayton, Cincinnati, Cleveland, Toledo, and Youngstown—among the nation's weakest markets (characterized by high population loss, declining property values, slow to no job growth, and struggling economic environments). A weak regional economy exacerbates the pressure on homeowners already at risk of foreclosure.

Servicer inefficiencies continue to frustrate homeowners looking to prevent foreclosure. Bolstering current efforts that connect borrowers with lenders and servicers and expedite sustainable loan modification outcomes is a critical first step. New promising efforts highlighted in this report may provide some relief; however, servicers also must take a more active role in overcoming these challenges.

In addition, the lack of assistance to unemployed homeowners through Making Home Affordable and other foreclosure prevention programs highlights a huge gap in helping borrowers with income disruptions. The increase in mortgage delinquencies from unemployment underscores the need to include a national HEMAP-like relief program as part of a comprehensive policy solution. A flexible, more accommodating policy approach to helping distressed homeowners can act as a firewall to prevent further spread of and damage from this pernicious crisis.

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Endnotes

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