Loan modifications and foreclosure prevention

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FDIC/FRS Mortgage Symposium
October 25, 2010

I am speaking today as a researcher and a concerned citizen and not as a representative of the FRB Boston or the Federal Reserve System.

A medical analogy

- **Disease:** Serious delinquency.
  - Left untreated usually leads to foreclosure.
  - Bad for borrower, lender and society
- **Medicine:** Renegotiation
  - Cheap compared to foreclosure
  - Effective
- Question: If there's a cheap and effective medicine, why do we still see so many people succumbing to the disease?

Medicine is rarely used

- But it is rarely used.
- Adelino, Gerardi and Willen (2009) found that after a borrower first went 60DQ,
  - Only about a 9% chance of getting a modification in the next six months.
- Agarwal et al. (2010) find largely the same thing.
- Is this because modification is a narrow definition of renegotiation?
  - No.
  - Agarwal et al. (2010) show what everyone already knew – repayment plans don't work.
  - For all practical purposes: modification = renegotiation.

Why is the medicine so rarely used?

- Two theories emerged to explain why:

1. **Institutional Problems**

- 50% recovery rates in foreclosure was *prima facie* evidence that modification was more profitable than foreclosure for investors.
- People attributed the small number of mods to
  - Securitization
  - Irrationality of servicers
  - "Groupthink"
- Policy prescriptions:
  - Safe harbor
  - Incentive payments to servicers

2. Informational Problems

"The key task for the lender is to identify borrowers with negative equity who are truly at risk of foreclosure. If the lender provides loss mitigation to a borrower who is not at risk, then it incurs the cost of this action, but obtains no benefit from it, since the borrower would have made the promised payments anyway. The better job a lender can do to accurately identify at-risk borrowers, the more assistance it can profitably offer to individual at-risk borrowers, and the more foreclosures it can avert."

–Foote, Gerardi and Willen (*JUE*, 2008)

- Identification problem is extremely hard.
- Modification was often less profitable for investors than foreclosure, despite the high cost of foreclosure.
- Policy Implications
  - To prevent foreclosures, you need to make the investors suffer
  - Or taxpayers
- As far as public policy, went, the institutional story won out.

Understanding the information problem

- Suppose we have two borrowers: Ed and Eric
- Ed and Eric both need payment reduction
- Both WILL DEFAULT without assistance
  - Eric needs a 10% reduction.
  - Ed needs a 50% reduction
  - Foreclosure costs 60%.
- **Problem: I can't tell Ed and Eric apart.**

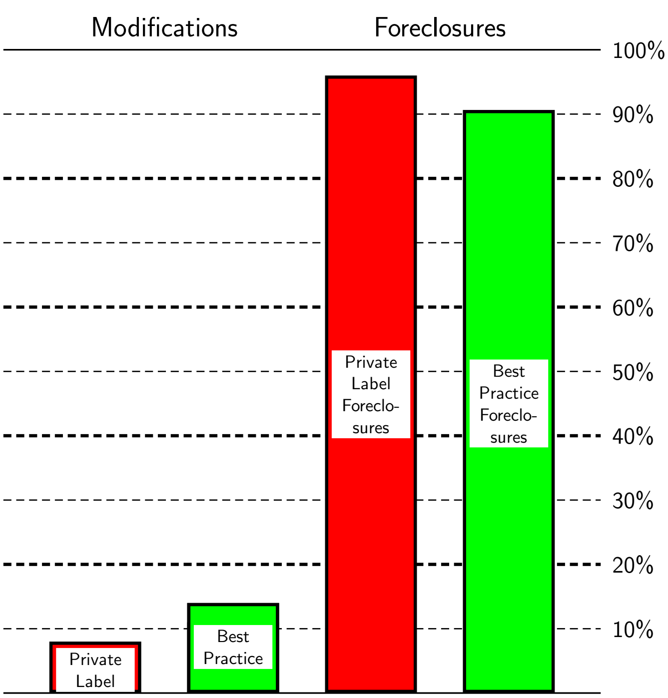
Policy	Loss on Eric	Loss on Ed	Mean Loss	# of Foreclosures
Do Nothing	60%	60%	60%	2
Cut 10%	10%	60%	35%	1
Cut 50%	50%	50%	50%	0

- Both borrowers will default if you do nothing – no strategic default.
- Yet it is *still* profitable to foreclose.

Information v. Institutions: The Verdict

- If institutional factors are important, we should see more modifications where the contract frictions are weaker:
  - Portfolio loans
  - GSE loans
  - In the "old days"
- Adelino, Gerardi and Willen, 2009 (2006-Sept 2008, not including TARP and conservatorship, 2009):
  - Show that portfolio lenders modify 1% more 60DQ loans.
- Agarwal et al., 2010 (2008-May 2009, including TARP and conservatorship)
  - Show that the GSEs (not subject to PSAs, etc.) modify 3% *fewer* 60DQ loans.
  - Show that portfolio lenders modify 3% more 60DQ loans
- Ghent (2010) and Rose (2010) show that even during the depression, when loans were held by banks, few mods.

Why don't lenders renegotiate more home mortgages?



- The difference between an imaginary best practice and private label.
- 13% v. 8% modification rate
- 33% redefault v. 50%.
- 91% versus 96% foreclosure rate.
- That's an upper bound on the "institutional problem."
- Best of all possible worlds: future foreclosures fall from 5 million to 4.75 million.

Bottom Line

- There are no free lunches in foreclosure prevention.
  - We cannot prevent millions of foreclosures by changing the incentives of intermediaries.
  - Or come up with some previously unimagined "shared appreciation" scheme that makes everyone better off
- That's been the roadmap for three years of failed policy (HopeNow, H4H, HAMP).
- Lenders foreclose on borrowers because it is in their financial interest to do so.
  - Modification is expensive and often ineffective medicine.
- To prevent foreclosure, we must either:
  - Pay lenders or the borrowers a lot of money.
  - Or force lenders to modify loans.
- Which of those we do is a political not economic question.

The slide you've all been waiting for...

- The end.