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## REWRITING CONTRACTS, WHOLESALÉ: DATA ON VOLUNTARY MORTGAGE MODIFICATIONS FROM 2007 AND 2008 REMITTANCE REPORTS

Alan M. White

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# REWRITING CONTRACTS, WHOLESALE: DATA ON VOLUNTARY MORTGAGE MODIFICATIONS FROM 2007 AND 2008 REMITTANCE REPORTS

*Alan M. White\**

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## INTRODUCTION

The 2007-08 credit crisis in the United States, precipitated by defaults on subprime mortgages, resulted from a classic debt bubble, featuring massive borrowing on the basis of rapidly inflating asset values, in this case residential real estate.<sup>1</sup> Debt crises can be resolved quickly or slowly. Crisis resolution invariably requires that the underlying asset values return to normal levels and that debt which will never be paid off by borrowers be written

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\* Assistant Professor, Valparaiso University School of Law. My thanks to Kevin Byers for his invaluable assistance in identifying and locating the remittance report data, and to Patricia McCoy for her reliably thoughtful comments.

1. See Gary B. Gorton, *The Panic of 2007* (Yale Int'l Ctr. for Fin., Working Paper No. 08-24, 2008), available at <http://ssrn.com/abstract=1255362>.

off, with or without massive transfers of the underlying assets.<sup>2</sup> The revaluation of assets and write-down of debt can be accomplished in several ways, including government bailouts, currency inflation (which shifts losses from borrowers to lenders), legislation, asset seizures by lenders and subsequent resales, or by the slow workings of the market.<sup>3</sup> The losses can be borne by lenders, borrowers, taxpayers, or some combination of these.<sup>4</sup> To take an example from the Great Depression, U.S. debts were written down by 50% or more in 1935 through the legislative expedient of voiding gold clauses in contracts.<sup>5</sup> Taxpayers absorbed the losses from the savings and loan crisis of the 1980s.<sup>6</sup> Japan's "lost decade" in the 1990s offers an example of the slow and agonizing approach to resolving a debt crisis. The central bank and government were unwilling to require banks to write down their assets and instead allowed overvalued debts to remain on the books in the vain hope that they could eventually be repaid, causing a huge drag on the national economy for more than a decade.<sup>7</sup>

Home mortgage debt in the United States mushroomed from about \$4 trillion in 1998 to \$10 trillion in 2007.<sup>8</sup> During the same decade, the median income remained virtually unchanged in constant dollars,<sup>9</sup> and the number of homeowners rose at a relatively modest pace.<sup>10</sup> Inevitably, homeownership has become progressively less affordable, and the ability of Americans to service their growing mortgage debt has reached a break-

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2. Anna Gelpern, *Financial Crisis Containment*, 41 CONN. L. REV. (forthcoming 2009).

3. *Id.*

4. *Id.*

5. Randall Kroszner, *Is it Better to Forgive than to Receive? An Empirical Analysis of the Impact of Debt Repudiation* (Nov. 2003) (unpublished manuscript), available at [http://www.law.northwestern.edu/colloquium/law\\_economics/Kroszner.pdf](http://www.law.northwestern.edu/colloquium/law_economics/Kroszner.pdf).

6. Timothy Curry & Lynne Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, 13 FDIC BANKING REV. 26 (2000), available at [http://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2\\_2.pdf](http://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf).

7. See Tim Callen & Jonathan D. Ostry, *Overview*, in JAPAN'S LOST DECADE: POLICIES FOR ECONOMIC REVIVAL 1, 5 (Tim Callen & Jonathan D. Ostry eds., 2003).

8. BD. OF GOVERNORS OF THE FED. RESERVE SYS., FEDERAL RESERVE STATISTICAL RELEASE: FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: FLOWS AND OUTSTANDINGS FIRST QUARTER 2008, at 8 (2008).

9. The median income for 1998 was \$48,034 and for 2006 was \$48,201 in constant 2006 dollars. CARMEN DENAVAS-WALT ET AL., U.S. CENSUS BUREAU, INCOME, POVERTY, AND HEALTH INSURANCE COVERAGE IN THE UNITED STATES: 2006, at 29 tbl.A-1 (2007), available at <http://www.census.gov/prod/2007pubs/p60-233.pdf>.

10. Alan M. White, *The Case for Banning Subprime Mortgages*, 77 U. CIN. L. REV. (forthcoming 2009).

ing point.<sup>11</sup> The rapid growth of subprime mortgage lending was an important contributor to the mortgage debt bubble.

In the case of the August 2007 collapse in the subprime mortgage market, U.S. policy-makers have recognized the need for some sort of intervention to readjust home values and mortgage debt, but have to date been unwilling to use the tools of taxpayer-funded bailouts or legislated debt reduction. Instead, the Treasury Department encouraged voluntary efforts by mortgage servicers, on behalf of the investors holding the inflated debt, to renegotiate the terms of residential mortgages.<sup>12</sup> Lenders and mortgage servicers, faced with rapidly escalating foreclosure rates, plunging home prices, and mounting losses, were exhorted to renegotiate mortgage terms with borrowers in order to stave off even more widespread defaults and foreclosures.

A year into the crisis, it is possible to begin evaluating the success or failure of these voluntary efforts to resolve the debt overhang by renegotiating contracts one at a time, albeit on an unprecedented scale. Data on voluntary mortgage modifications are available from a number of sources, including the HOPE NOW ad hoc coalition of mortgage servicers and counselors, the Mortgage Bankers Association, and the working group of state banking and consumer credit regulators working on the foreclosure crisis.<sup>13</sup> These data provide some evidence as to the effectiveness of the voluntary restructuring approach, which aims to avoid any taxpayer contribution and to allocate losses between borrowers and lenders on a negotiated, and hopefully optimal basis.<sup>14</sup> On the other hand, the various available reports do not specify what kind of modifications are implemented, and the degree, if any, to which mortgage debt is being reduced to a more sustainable level.

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11. See Christopher L. Foote et al., *Subprime Facts: What (We Think) We Know about the Subprime Crisis and What We Don't 3-4* (Fed. Reserve Bank of Boston, Public Policy Discussion Paper No. 08-2, 2008), available at <http://www.bos.frb.org/economic/ppdp/2008/ppdp0802.pdf> (discussing background of subprime crisis and the importance of the rise and fall in home prices).

12. See *infra* note 32 and accompanying text.

13. See JAY BRINKMAN, MORTGAGE BANKERS ASS'N, AN EXAMINATION OF MORTGAGE FORECLOSURES, MODIFICATIONS, REPAYMENT PLANS, AND OTHER LOSS MITIGATION ACTIVITIES IN THE THIRD QUARTER OF 2007 (2008); STATE FORECLOSURE PREVENTION WORKING GROUP, ANALYSIS OF SUBPRIME MORTGAGE SERVICING PERFORMANCE: DATA REPORT NO. 2 (2008), available at <http://www.banking.state.ny.us/pr080422.pdf>; HOPE NOW Industry Data, [http://www.hopenow.com/industry\\_data.html](http://www.hopenow.com/industry_data.html).

14. Alice Rivlin, Senior Fellow, Metro. Policy Program, Remarks at the State Summit on Foreclosure and Housing Solutions: State and Federal Policy in the Foreclosure Crises (May 28, 2008), available at [http://www.brookings.edu/speeches/2008/0528\\_foreclosure\\_rivlin.aspx](http://www.brookings.edu/speeches/2008/0528_foreclosure_rivlin.aspx).

To supplement the national reports on mortgage modifications, this paper analyzes data derived from monthly remittance reports by mortgage servicers to their investors, which provide rich detail on individual mortgage foreclosures and modifications. The selected sample consisted of monthly reports from July 2007 through June 2008 for twenty-six different subprime loan pools, and included data on 4,344 loan modifications. The data include the loan balance, monthly payment and interest rate, before and after modification. This Article will begin by reviewing some history of the voluntary plan to resolve the subprime mortgage crisis and the previous reports on voluntary loan modifications. It will then present the new data from remittance reports, and in particular on two key outcomes of loan modifications: whether total mortgage debt is being reduced, and whether monthly payments for individual homeowners are reduced.

### I. LOSS MITIGATION AND LOAN MODIFICATIONS: THE VOLUNTARY APPROACH

While bankruptcy regimes can be a useful means to realign debts and asset values, the U.S. Bankruptcy Code specifically forbids bankruptcy judges from modifying most residential mortgages by reducing the debt to the market value of the property.<sup>15</sup> Efforts in Congress to amend the Bankruptcy Code and permit judges to impose debt restructuring through principal reduction have thus far met stiff resistance from the banking industry, and consequentially have been stymied.<sup>16</sup> Without a bankruptcy regime (or something comparable) as a coercive tool, homeowners have little choice but to attempt to negotiate concessions, such as interest rate reductions or payment deferrals, individually with their servicers.

A significant portion of the \$10.5 trillion in mortgage debt owed by Americans by 2008<sup>17</sup> consisted of subprime mortgages, and this trend continues to grow.<sup>18</sup> By the end of 2007 mortgage debt exceeded total aggregate home equity (in other words, Americans had borrowed more than half

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15. 11 U.S.C. § 1322(b)(2) (2006); *Nobelman v. Am. Sav. Bank*, 508 U.S. 324, 324 (1993); Adam J. Levitin & Joshua Goodman, *The Effect of Bankruptcy Strip-Down on Mortgage Markets* (Georgetown Law and Econ., Research Paper No. 1087816, 2008), available at <http://ssrn.com/abstract=1087816>.

16. Kevin Drawbaugh, *Senate Kills Bankruptcy Revamp In Housing Bill*, REUTERS, Apr. 3, 2008, <http://www.reuters.com/article/telecomm/idUSN0319323820080403>; Tim Taylor, *Durbin Bankruptcy Amendment Fails*, ROLL CALL, Apr. 3, 2008, <http://www.rollcall.com/news/breakingnews/22815-1.html?CMP=OTC-RSS>.

17. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 8, at 8.

18. About 5.5 million out of 45 million, or 12% of all mortgages outstanding at the end of March 2008 were subprime. MORTGAGE BANKERS ASS'N, NATIONAL DELINQUENCY SURVEY Q1-2008 (2008).

the value of all homes in the country) for the first time.<sup>19</sup> Although home prices began declining in 2007, and dropped by 20% or more in some areas, housing affordability had not improved much by the middle of 2008 because home prices were still out of the reach of many Americans.<sup>20</sup>

The subprime credit crisis reached the breaking point in August 2007 after several investment funds relying heavily on subprime mortgage derivatives collapsed, securities affected by subprime defaults were discovered in bank portfolios around the world, interbank lending suddenly froze, and the Federal Reserve and European Central Bank had to inject billions of dollars and euros into the international financial system.<sup>21</sup> As the subprime crisis unfolded, home values that had risen to unsustainable levels began to decline.<sup>22</sup> At the same time, increasing numbers of homeowners defaulted on their mortgages and faced foreclosure.<sup>23</sup> Investors had assumed that in the event of defaults, securities backed by U.S. home mortgages would be safe, because the homes securing the mortgages could be foreclosed and sold to recover any unpaid loans. In practice, however, subprime mortgage servicers rarely recover 100% of the debt in a foreclosure.<sup>24</sup> After the 2007 crisis, the combined effect of high foreclosure rates and plummeting home values meant that foreclosure recovery rates (usually measured as loss severities<sup>25</sup>) progressively worsened. Bond rating agencies have predicted loss severities on subprime foreclosures as high as 50%.<sup>26</sup>

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19. See JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *THE STATE OF THE NATION'S HOUSING 2008*, at 7 (2008), available at <http://www.jchs.harvard.edu/publications/markets/son2008/son2008.pdf>.

20. *Id.* at 21.

21. See Larry Elliott, *Credit Crisis-How it All Began*, *GUARDIAN*, Aug. 5, 2008, at 22, available at <http://www.guardian.co.uk/business/2008/aug/05/northernrock.banking>.

22. Home prices in the United States more than doubled between 1997 and 2006, before falling more than 15% from 2007 to 2008. See *CSI: Credit Crunch*, *ECONOMIST*, Oct. 20, 2007, at 4, available at [http://www.economist.com/specialreports/display\\_story.cfm?story\\_id=9972489](http://www.economist.com/specialreports/display_story.cfm?story_id=9972489); Peter Hong, *Home Prices Drop by Record 15.8% in May*, *L.A. TIMES*, July 29, 2008, at C3, available at <http://articles.latimes.com/2008/jul/29/business/fi-homes30>.

23. See White, *supra* note 10; Vikas Bajaj, *Housing Lenders Fear Bigger Wave of Loan Defaults*, *N.Y. TIMES*, Aug. 4, 2008, at A1.

24. See Glen Schultz et al., *Modeling Nonprime Mortgage Prepayment, Delinquency and Default*, in *THE HANDBOOK OF MORTGAGE-BACKED SECURITIES* 752-53 (Frank J. Fabozzi ed., 6th ed. 2006) (reporting that historical subprime losses consistently exceeded 30%).

25. Loss severity is the ratio of the loss on a loan to the unpaid balance due. See Thomas Zimmerman & Laurent Gauthier, *Mortgage Credit Quantified*, in *THE HANDBOOK OF MORTGAGE-BACKED SECURITIES*, *supra* note 24, at 951, 970-72.

26. See FRANCIS PARISI & THOMAS G. GILLIS, *STANDARD & POOR'S REVISES U.S. SUBPRIME, PRIME, AND ALTERNATIVE-A RMBS LOSS ASSUMPTIONS* (2008), [http://www2.standardandpoors.com/spf/pdf/media/subprime\\_prime\\_alt-a\\_072908.pdf](http://www2.standardandpoors.com/spf/pdf/media/subprime_prime_alt-a_072908.pdf); see also FITCH RATINGS, *ESCALATING COSTS IMPACTING RMBS LOSSES* (2008),

In this environment, it makes economic sense for mortgage servicers, on behalf of lenders and investors, to seek alternatives to foreclosure by restructuring mortgage loans with borrowers, where the borrower can be expected to repay even 80% or 90% of the original debt.<sup>27</sup> Wooden insistence on adherence to the original contract terms may result in the servicer recovering far less than if the contract is modified. Borrowers who are unable to pay subprime mortgages on their original terms may be able to make reduced monthly payments. Payments may be reduced by dropping the interest rate or the loan balance, or both. Borrowers whose mortgage debt exceeds their home value may have an incentive to default, but that incentive can be reduced if the servicer agrees to write down the loan balance to the property value.<sup>28</sup> Resolution of the mortgage debt crisis without truly massive foreclosures thus depends on loan modifications that accomplish two things: reducing principal debt and reducing monthly payments. Based on these arguments, Bush Administration officials and bank regulators called on mortgage servicers to negotiate interest rate and principal reductions by modifying mortgage contracts, as an alternative to foreclosure, in appropriate cases.<sup>29</sup>

Securitization of mortgages has added layers of difficulty to the task of loss mitigation for subprime mortgages.<sup>30</sup> Servicers face constraints on

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[http://www.fitchratings.com/corporate/reports/report\\_frame.cfm?rpt\\_id=391428&sector\\_flag=20&marketsector=1&detail=3](http://www.fitchratings.com/corporate/reports/report_frame.cfm?rpt_id=391428&sector_flag=20&marketsector=1&detail=3).

27. PATRICIA MCCOY & ELIZABETH RENUART, JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., THE LEGAL INFRASTRUCTURE OF SUBPRIME AND NONTRADITIONAL HOME MORTGAGES 34 (2008), available at [http://www.jchs.harvard.edu/publications/finance/understanding\\_consumer\\_credit/papers/ucc08-5\\_mccoy\\_renuart.pdf](http://www.jchs.harvard.edu/publications/finance/understanding_consumer_credit/papers/ucc08-5_mccoy_renuart.pdf); Sheila C. Bair, Foreword, *The Case for Loan Modification*, FDIC Q. Third Quarter 2007, at 22, available at [http://www.fdic.gov/bank/analytical/quarterly/2007\\_vol1\\_3/FeatureArticle\\_1\\_V1N3\\_Full.pdf](http://www.fdic.gov/bank/analytical/quarterly/2007_vol1_3/FeatureArticle_1_V1N3_Full.pdf).

28. Benjamin Bernanke, Chairman, Fed. Reserve, Remarks at the Independent Community Bankers of America Annual Convention: Reducing Preventable Mortgage Foreclosures (March 4, 2008), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20080304a.htm>.

29. *Id.*; see also Blair, *supra* note 27. The F.H.A. mortgage insurance program operated by the U.S. Department of Housing and Urban Development has a long-standing formal program to mitigate foreclosure losses by, among other things, permitting modifications to existing mortgage contracts for homeowners in payment distress. See Letter from John C. Weicher, Assistant Sec'y for Hous. & Fed. Hous. Comm'r, U.S. Dep't of Hous. and Urban Dev., to All Approved Mortgagees (Apr. 26, 2005), <http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/05-18ml.doc>.

30. Securitization is the process of pooling mortgages or other financial assets and selling the rights to various portions of the resulting cash flow to investors in complex bond structures. The trustee for the investors retains a servicer to collect mortgage payments and distribute them to the investors. See Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039 (2007).

their ability to renegotiate mortgages, and have little economic incentive to incur the additional cost of loan modifications.<sup>31</sup>

On October 10, 2007 Treasury Secretary Henry M. Paulson, Jr. announced the formation of a coalition of mortgage servicers and housing counseling agencies, called HOPE NOW, to stimulate a voluntary effort to restructure mortgages, and ostensibly to respond to the subprime foreclosure crisis without mandatory debt restructuring measures or a taxpayer-financed bailout.<sup>32</sup> In December 2007, the HOPE NOW coalition announced an initiative to encourage mortgage servicers to “freeze” interest rates on certain adjustable-rate mortgage (“ARM”) loans to prevent foreclosures resulting from sudden payment increases.<sup>33</sup> Apart from the rate freeze plan, HOPE NOW functioned primarily to exhort various industry participants to increase efforts to prevent foreclosures, and to collect and report data on the success of those exhortations.<sup>34</sup>

The payment increases targeted by the rate freeze plan were the result of hybrid ARM structures where the initial interest rate was lower than the rate in effect for most of the loan life, the latter being calculated by adding an index rate to the stipulated margin.<sup>35</sup> Although the initial interest rates on subprime ARMs were not particularly low, the loans were designed so that a payment increase due to the rate reset was inevitable after two to three years.<sup>36</sup> While much attention was focused on the payment reset issue, it has become apparent that the subprime foreclosure crisis was not a result of payment resets, but instead reflected the fact that many subprime mortgage payments were unaffordable from the date of origination.<sup>37</sup>

The HOPE NOW servicer coalition reports, issued beginning in February 2008, noted the significant increase in voluntary loan modification

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31. See Kurt Eggert, *Comment on Michael A. Stegman et al.'s "Preventive Servicing Is Good for Business and Affordable Homeownership Policy": What Prevents Loan Modifications?*, 18 HOUSING POL'Y DEBATE 279 (2007).

32. See Press Release, HOPE NOW, HOPE NOW Alliance Created to Help Distressed Homeowners (Oct. 10, 2007), available at [http://www.fsround.org/hope\\_now/pdfs/AllianceRelease.pdf](http://www.fsround.org/hope_now/pdfs/AllianceRelease.pdf).

33. Edmund L. Andrews, *In Mortgage Plan, Lenders Set Terms*, N.Y. TIMES, Dec. 7, 2007, at A1.

34. *Id.*

35. See Beverlea Gardner & Dennis C. Ankenbrand, Fed. Deposit Ins. Corp., *Hybrid ARMs: Addressing the Risk, Managing the Fallout*, SUPERVISORY INSIGHTS, Summer 2008, at 14, 16, available at <http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum08/sisum08.pdf>.

36. *Predatory Lending and Home Foreclosures: Hearing Before the S. Banking, Housing and Urban Affairs Comm.*, 110th Cong. (2007) (statement of Martin Eakes, Chief Operating Officer, Self-Help Credit Union and the Center for Responsible Lending).

37. See Foote et al., *supra* note 11.



agreements, as well as repayment plans, beginning in the last quarter of 2007.<sup>38</sup> HOPE NOW estimated that 140,000 mortgages were modified in the fourth quarter of 2007, 170,000 in the first quarter of 2008, and 220,000 in the second quarter of 2008.<sup>39</sup> The HOPE NOW surveys did not include information on the type of modifications being offered by its members.

A working group of state consumer protection and bank supervisor agencies issued a report in April 2008 that there were 24,000 loan modifications closed and 139,000 “in process” in the four-month period from October 2007 through January 2008.<sup>40</sup> The state regulators also noted that many payment plans and proposed modifications were started but not completed.<sup>41</sup> Although it does not provide numbers, the report comments that freezing the interest rate on variable-rate mortgages was the most common modification.<sup>42</sup> The HOPE NOW and state regulator reports chose to emphasize different aspects of the same data. HOPE NOW pointed to the large increase in raw numbers of payment plans and modifications, while also acknowledging the even larger increase in foreclosure starts and sales.<sup>43</sup> The state regulators highlighted the gap between total delinquencies and modifications, and the gap between workout efforts initiated and completed agreements, suggesting that many homeowners were seeking help but getting “lost in the shuffle.”<sup>44</sup> Although the state regulators recognized the importance of determining what kind of modifications are implemented, they have not provided statistical information on that question to date.

The Mortgage Bankers Association (“MBA”) responded to industry critics with its own survey of mortgage foreclosures, payment plans, and modification agreements in January 2008.<sup>45</sup> The MBA reported that servicers encountered significant difficulty contacting borrowers in foreclosure, 23% of whom made no response to servicers’ attempts to contact them.<sup>46</sup> The MBA survey also found that 29% of borrowers in foreclosure had already

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38. See HOPE NOW industry data, *supra* note 13.

39. *Id.* The 220,000 modifications in the 2nd quarter of 2008 can be compared with 246,000 completed foreclosure sales and 573,000 foreclosure starts in the same quarter.

40. STATE FORECLOSURE PREVENTION WORKING GROUP, *supra* note 13, app. a.

41. *Id.* at 7-8.

42. *Id.* at 9.

43. See HOPE NOW industry data, *supra* note 13.

44. See CAL. REINVESTMENT COAL., THE GROWING CHASM BETWEEN WORDS AND DEEDS: LENDERS STILL FAILING TO LIVE UP TO THEIR PUBLIC COMMITMENTS TO MODIFY HOME LOANS AND HELP BORROWERS AVOID FORECLOSURE 4 (2007) (reporting results from survey of housing counselors and finding dissatisfaction with the responsiveness of mortgage servicers and their willingness to modify mortgages to prevent foreclosures).

45. See BRINKMAN, *supra* note 13.

46. *Id.* at 10.

defaulted on prior repayment plans.<sup>47</sup> The thrust of the MBA report was that the disproportion between loan modifications and the total number of mortgage foreclosures could be explained in part by these two factors.<sup>48</sup>

While investors and rating agencies are understandably skeptical about servicers and borrowers who repeatedly enter into unrealistic payment or modification plans that are unlikely to succeed,<sup>49</sup> consumer advocates point out that many servicers have offered cookie-cutter repayment plans that require increased monthly payments; this at a time when homeowners cannot afford their current payments. If servicers would cut interest rates, principal balances, and monthly payments, more loan modifications would succeed and result in on-time repayment. Consumer advocates have also criticized mortgage servicers for devoting inadequate personnel and resources to the modification effort and for showing a lack of sensitivity to the plight of homeowners.<sup>50</sup>

Loss mitigation can take many forms.<sup>51</sup> First, to deal with payment arrears, a servicer can add the unpaid interest for the months in arrears to the total loan balance and then calculate a new (necessarily higher) monthly payment that will amortize the increased balance over the remaining months of the mortgage life.<sup>52</sup> Without a modification of the principal or interest rate, reamortizing plans neither reduce mortgage debt nor diminish the payment stress faced by the borrower.<sup>53</sup>

Second, the rate freeze modifications also do not diminish mortgage debt or payment stress, except insofar as they prevent payments from increasing due to future rate adjustments. While a rate freeze may help prevent some loans from going into default, it will not help a borrower who had difficulty meeting the initial loan payment. There is considerable evidence that rate resets on hybrid ARMs have not been the primary cause of the foreclosure crisis of 2007-2008.<sup>54</sup>

A third type of loan modification addresses payment stress by reducing the interest rate in order to reduce the monthly payment. An interest-only

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47. *Id.*

48. *Id.* at 3.

49. The bond rating agency Moody's reported in July 2008 that nearly half of the mortgages modified in the first half of 2007 were in serious default by March 2008, and only about one-third were still current or paid in full. AASHISH MARFATIA, MOODY'S SUBPRIME ARM LOAN MODIFICATION UPDATE (2008); see CAL. REINVESTMENT COAL. *supra* note 44.

50. See Gretchen Morgenson, *Silence of the Lenders: Is Anyone Listening?*, N.Y. TIMES, July 13, 2008, at BU1.

51. See MCCOY & RENUART, *supra* note 27, at 32.

52. CREDIT SUISSE, SUBPRIME LOAN MODIFICATIONS UPDATE 3 (2008).

53. *Id.*

54. See Foote et al., *supra* note 11.

reduction deals with payment stress as a cause of default and foreclosure, but does not reduce the homeowner's overall mortgage debt, or deal with the negative equity problem that results when home values decline below the amount owed.

A fourth type of loan modification would reduce principal debt and the interest rate to deal with both payment stress and negative equity issues. This fourth category of modifications is still largely theoretical, and has not been used to any significant degree.

The previous reports on the number of modifications do not answer important questions about the effectiveness of the voluntary mortgage resolution plan. They do not reveal whether overall mortgage debt is being reduced, nor whether monthly payment burdens are being eased. The data reported in this Article can begin to answer these questions.

## II. STUDY METHOD

Loan-level data on individual mortgage modifications and individual foreclosures are available for one segment of the market: subprime mortgages that were pooled and securitized. Trustees and their servicing companies report monthly to investors on the performance of the mortgage loans.<sup>55</sup> These monthly performance reports, known as remittance reports, provide loan-by-loan details on defaults, foreclosures, losses on foreclosed homes, and negotiated loan modifications.<sup>56</sup>

Mortgage servicers prepare monthly remittance reports for the investors who hold a stake in securitized mortgage loan pools. These monthly reports allow investors to see how the underlying mortgages are performing, with detailed data about prepayments, defaults, foreclosures, losses and loan modifications. The remittance reports are not filed with any public agency such as the Securities and Exchange Commission, and their availability varies by servicer and trustee. In addition, different securitization trustees and servicers provide different data elements and detail in their monthly reports. For this study, I used the reports made available by CTS Link, the Wells Fargo trust service web site.<sup>57</sup> These cover mortgage pools for which Wells Fargo serves as trustee; the pools are serviced by many of the leading mortgage servicing companies.

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55. See, e.g., Deutsche Bank Investor Reporting, <https://tss.sfs.db.com/investpublic/> (last visited Feb. 24, 2009); Global Corporate Trust Reporting, <https://gctinvestorreporting.bnymellon.com/Home.jsp#> (last visited Feb. 24, 2009); Wells Fargo Corporate Trust Services, [www.ctslink.com](http://www.ctslink.com) (last visited Feb. 24, 2009).

56. See *supra* note 55.

57. See Wells Fargo Corporate Trust Services, *supra* note 55.

In order to accumulate a reasonable data set of mortgages facing foreclosure that are a likely candidate for modification, I selected twenty-six pools of subprime loans originated in 2005 and 2006, containing approximately 106,000 mortgage loans. Preference was given to the largest available single pools. These pools were most likely to consist of subprime, primarily adjustable mortgages, with significant numbers of mortgages remaining during the 2007–2008 reporting period, and with many potential candidates for mortgage modifications. Monthly reports were collected for a twelve-month period, from July 2007 through June 2008. The HOPE NOW initiative was announced in the early part of this period, and national reports indicate a rapid growth in the number of mortgage modifications during this time frame.<sup>58</sup>

Remittance reports were downloaded and entered into a database from the following twenty-six loan pools:

Table 1: Mortgage pools in Study Sample

Pool name	Originator	Servicer
ABFC 2005-OPT1	Option One	Option One
ABFC 2006-OPT1	Option One	Option One
ABFC 2006-OPT2	Option One	Option One
ABFC 2006-OPT3	Option One	Option One
Aames MIT 2005-4	Aames Mortgage	Aames Funding
Aames MIT 2006-1	Aames Mortgage	Aames Funding
ACE Securities 2006-CW1	Countrywide	Countrywide
ACE Securities 2006FM-1	Fremont	Fremont
First Franklin LT 2005-FF6	First Franklin	First Franklin
FFLT 2006-FF1	First Franklin	First Franklin
FFLT 2006-FF11	First Franklin	First Franklin
Fremont HLTrust 2005A	Fremont	Fremont
Fremont HLTrust 2006A	Fremont	Fremont
HSIASC WMC2006-1	WMC	Wells Fargo
JPMAC2006-CW2	Countrywide	Countrywide
Merrill Lynch MIT 2006-1	WMC	Wells Fargo
Park Place 2005WHQ1	Argent/Ameriquest	HomEq
Park Place 2005 WHQ4	Argent	HomEq
Renaissance HELT2006-1	Delta	Ocwen
Renaissance HELT2005-1	Delta	Ocwen
SASCO 2006BC6	Various	Aurora

58. HOPE NOW industry data, *supra* note 13.

WFHET 2005-1	Wells Fargo	Wells Fargo
WFHET 2005-2	Wells Fargo	Wells Fargo
WFHET 2005-4	Wells Fargo	Wells Fargo
WFHET 2006-2	Wells Fargo	Wells Fargo
WFHET2006-3	Wells Fargo	Wells Fargo

Descriptive statistics were calculated using Excel 2008 for Macintosh v. 12.0 and SPSS 16.0 for Macintosh.

Countrywide and Wells Fargo were the number one and two originators, respectively, of mortgages in all categories in 2006.<sup>59</sup> The sample includes seven of the top ten subprime originators in 2006<sup>60</sup> and six of the top fifteen subprime servicers in 2007.<sup>61</sup>

This sample obviously has its limitations. Servicers of securitized loans may have different incentives than lenders who retain ownership of mortgage loans on their own balance sheets (so-called portfolio lenders). The number and extent of voluntary loan modifications in the sample may not be representative of loan modifications by lenders who hold subprime mortgages in their own portfolios. Nevertheless, given that subprime mortgages account for more than half of all foreclosures,<sup>62</sup> and that the vast majority of subprime loans that led to the crisis were securitized, this sample provides important insights as to what the voluntary debt resolution plan has yielded to date in the subprime market.

For each loan pool, the prospectus prepared for investors was downloaded and retained. The prospectuses and supplements provide detailed descriptions of the pools of mortgage loans.<sup>63</sup> Most of the mortgage pools in the sample were dominated by hybrid adjustable-rate subprime mortgages, although the Renaissance pools originated by Delta Funding Corporation were mostly fixed-rate loans. Many of the pools included significant percentages of “no-doc” loans, in other words, mortgages approved without verification or documentation of the borrower’s income. For example 52% of the loans in the HSIASC 2006-WMC1 pool were stated in-

59. See INSIDE MORTGAGE FIN., THE 2008 MORTGAGE MARKET STATISTICAL ANNUAL 43 (2008).

60. *Id.* at 217.

61. *Id.* at 241.

62. According to the National Delinquency Survey for the first quarter of 2008, 10.74% of 5,542,054, (595,000) subprime mortgages, were in foreclosure, compared with 2.47% (1,117,000) of all mortgages (45,224,567). MORTGAGE BANKERS ASS’N, *supra* note 18.

63. See, e.g., SEC Info, HSI Asset Securitization Corp., Prospectus Supplement (Form 424b5), at A1-A23, S28-29 (July 6, 2006), <http://www.secinfo.com/dr66r.v1Qq.htm>.

come (no income verification) loans.<sup>64</sup> Loans tended to be geographically concentrated in California and a few other high-growth states. In other respects, the mortgages in the study sample were typical of subprime mortgages originated in 2005 and 2006.

### III. LOAN-LEVEL DATA ON MORTGAGE REFINANCINGS, DEFAULTS AND LOSSES DURING THE 2007-08 CRISIS

#### A. Growing Defaults, Foreclosures and REO

In July 2007 the average delinquency rate in the pools was 19%, and 1.4% of all loans entered foreclosure that month (an already disturbing 16.8% annual rate of foreclosure starts). By June 2008, the average delinquency rate had nearly doubled to 34%, and foreclosure starts were at 2.3% per month, or 27% annually. In all pools, the number of loans entering the foreclosure and real-estate-owned (“REO”) categories far outpaced the number of prepayments, so that the foreclosure and REO inventory steadily increased in every month. While some increase over time in defaults and foreclosures in a static mortgage pool is to be expected, the magnitude of the increase in the study period is extraordinary, and is one indication that the voluntary resolution plan is falling short.

#### B. Losses on Foreclosed Properties: Loss Severities Worsen

Mortgage servicers and investors measure the losses on individual mortgage loans by comparing the dollar loss incurred to the total outstanding mortgage debt. This ratio is known as “loss severity.”<sup>65</sup> Loss severities increased steadily in most pools from July 2007 to June 2008 (see Figure 1). By June 2008 loss severities in individual pools ranged from 17% to 71%, with the average loss severity running at 38%.

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64. *Id.* at A20.

65. Zimmerman & Gauthier, *supra* note 25, at 951, 970-72.

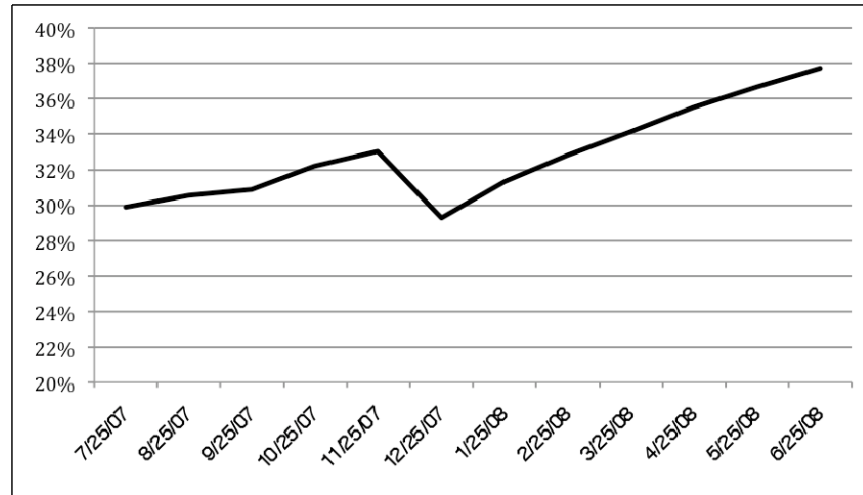


Figure 1: Increasing Loss Severities

To take one example from the study data, an Illinois property in the First Franklin 2006-F11 pool was originated in late 2006 with a \$630,000 original balance and a 100% loan-to-value (“LTV”) ratio, and an interest rate of 10.125%. The home was foreclosed and sold with a total loss realized in June 2008 of \$332,000. A California property in the same month in the same pool with an original mortgage balance of \$272,000, thought to represent an 80% LTV ratio, with 7.375% interest, was sold at a loss of \$185,000. In either case, had there been a viable homeowner with any reasonable income, it is hard to imagine that a modification reducing principal and interest to an affordable level could not have produced a smaller ultimate loss for investors than wiping out all interest and 52% to 68% of principal. Loss severities are a critical motivating factor for investors and servicers in deciding whether and how to renegotiate mortgage loan contracts. The data on loss severities in the study pools certainly point to strong economic incentives for servicers to mitigate losses through loan modifications.

### C. Refinancing Option Fades Away

To understand servicer behavior in negotiating loan modifications it is also important to understand the servicers’ and borrowers’ other options. In the first half of the study period, many homeowners were able to refinance their mortgages, even if they were in default, thus perhaps reducing the need for modifications.

While it is clear that total residential mortgage debt in the United States reached a point that was not sustainable by the middle of 2007, that debt total did not shrink much as the crisis began to unfold. From June 30, 2007 to March 31, 2008, total residential mortgage debt actually continued to increase, from \$10.24 trillion to \$10.61 trillion.<sup>66</sup> The total mortgage debt in the sample loan pools shrank steadily during the study period, partly from refinancing and sales (payment in full) and partly from foreclosure liquidations. This shrinkage in outstanding balances in static mortgage pools does not, however, equate to an overall reduction in mortgage debt. This is because until the middle of 2008 many mortgages were prepaid by refinancing with a new mortgage, typically at a higher balance to pay the refinancing costs.<sup>67</sup>

Refinancing, while it solved the borrower's and servicer's immediate problem, did nothing to resolve the debt overhang, because the new mortgage will invariably bear a larger principal, especially when the borrower pays a prepayment penalty when refinancing within the first two or three years.<sup>68</sup> Borrowers who refinanced were simply "kicking the can down the road,"<sup>69</sup> increasing, not decreasing debt. The study sample shows that the refinancing outcome was still fairly common in the last six months of 2007, but gradually disappeared during the first half of 2008. In July 2007 there were 314 loans liquidated (foreclosed properties sold) compared with 2654 loans paid in full via refinancing or sale. By June 2008, however, the totals were nearly equal: 948 liquidations and 1036 loans paid in full. The trend was generally consistent throughout the study period (see Figure 2).

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66. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 8, at 8.

67. See CTR. FOR RESPONSIBLE LENDING, RISKING HOMES TO PAY OFF CREDIT CARDS I (2005), available at [http://www.responsiblelending.org/pdfs/ip012-Risking\\_Homes\\_Credit\\_Cards-1105.pdf](http://www.responsiblelending.org/pdfs/ip012-Risking_Homes_Credit_Cards-1105.pdf).

68. Truth in Lending Act Regulation Z, 73 Fed. Reg. 44522 (July 30, 2008) (55% of subprime borrowers in 2/28 ARM loans with prepayment penalties ended up paying the penalty).

69. SHEILA C. BAIR, FED. DEPOSIT INS. CORP., STATEMENT ON THE STATE OF THE BANKING INDUSTRY (2008) (referring to short-term repayment plans by mortgage servicers as "kicking the can down the road").



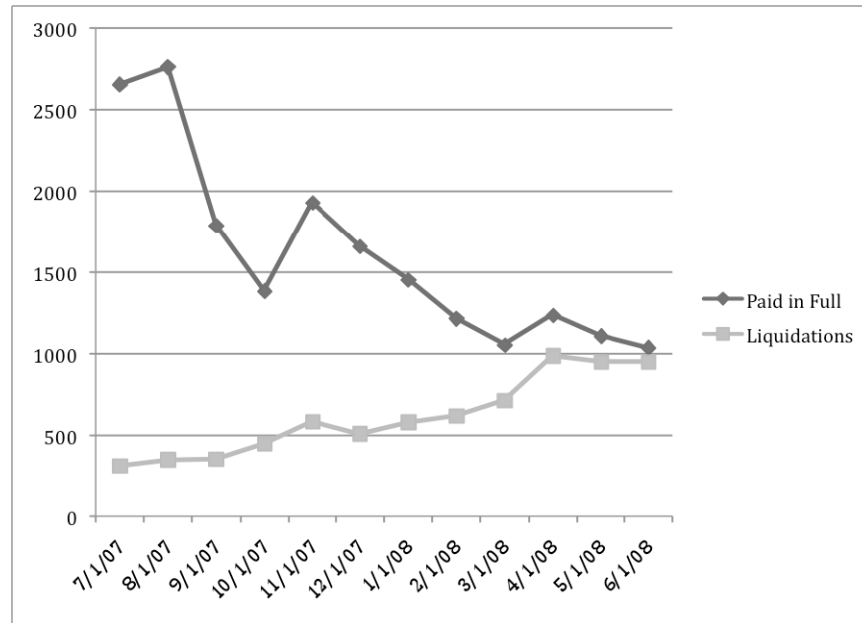


Figure 2: Prepayments vs. Foreclosure Liquidations

Surprisingly, refinancing continued long after the August 2007 freeze-up of the credit markets, and even into early 2008. Nevertheless, by the final month of the study, June 2008, the refinancing (or voluntary sale) option was rapidly declining. The option of refinancing obviously is more attractive for the servicer, because its investor receives payment in full, and the costs of negotiating a mortgage modification are avoided, along with the legal uncertainties. The apparent reluctance to engage in large-scale modifications may in part be explained by the continued viability of the refinancing option, which shifted the debt problem from one economic actor to another, rather than tackling it head-on.

Prepayment speeds slowed dramatically as the refinance market dried up and that option disappeared. Prepayments include both foreclosure sales and payment in full resulting either from home sales or refinancing. Prior to the August 2007 crisis subprime prepayments typically ran at an annual rate of 35% or more, so that a pool of mortgages would virtually all be repaid over five or six years.<sup>70</sup> By June 2008 prepayment speeds in the loan

70. Prepayment speeds are calculated as conditional prepayment rates, which are a fraction of the remaining loans outstanding, not a fraction of the original total. Thus, if the prepayment speed remains at 35%, in the second year 35% of the remaining 65% of loans will

pools studied were running as low as 12%,<sup>71</sup> and nearly half of all prepayments were foreclosure liquidations. These prepayment speeds would mean that it would take ten to fifteen years for the mortgages to be paid off (or foreclosed), suggesting a very drawn-out resolution process for the sub-prime mortgage crisis.

The declining number of monthly refinancing has serious implications. If the trend as of June 2008, of equal numbers of foreclosure liquidations and loans paid in full, continues, the final outcome for half of the remaining loans in the pools will be a foreclosure sale. It also means that the REO inventory will continue to accumulate and put downward pressure on home values.

#### IV. THE LOAN MODIFICATIONS—THE NATURE AND SCALE OF THE EFFORT

##### A. Virtually No Principal Reductions, Some Payment Reductions

In the study sample of twenty-six loan pools over twelve months, there were a total of 4342 loan modifications reported. The number of modifications increased from twenty-nine in July 2007 to a high of 880 in April, declining somewhat to 582 in June, 2008, the final month covered (see Figure 3).<sup>72</sup> During the same twelve months, there were 19,911 foreclosures started and 8327 properties foreclosed and taken into REO.

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prepay, and so forth. As the loan pool declines, so does the absolute number of prepayments, at a constant prepayment speed.

71. This is the twelve-month average conditional prepayment rate as of June 25, 2008 for the ABFC 2006-OPT3 (Option One) pool.

72. See HOPE NOW industry data, *supra* note 13. The HOPE NOW report for June 2008 also showed a decline in mortgage modifications from April to May, but showed an increase from May to June of 2008.

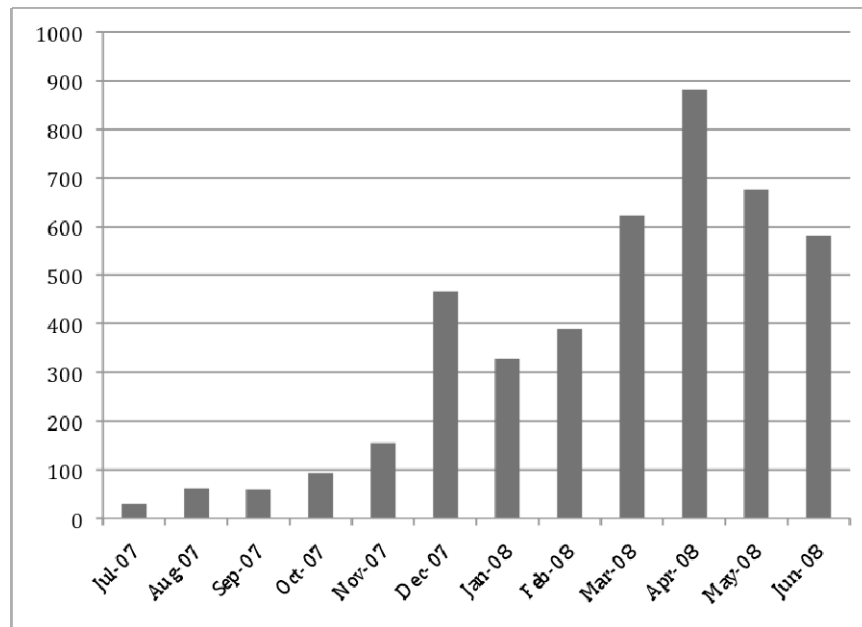


Figure 3: Total Monthly Modifications.

In the aggregate, the loan modifications failed to reduce the outstanding mortgage debt. The amount owed on the modified loans went from \$912 million before modification to \$933 million after modification. A few loans did have their principal balance reduced, but only sixty-two (1.4%) of the 4342 modifications reduced the principal balance by more than 1%, and only forty (0.92%) reduced principal by more than 10%. Some of these large principal reductions may have resulted from litigation.

The most common forms of modifications involved either no change in interest, with a modest increase in principal (recasting arrears) or a reduction in the interest rate and payment with principal remaining the same or increasing slightly, in other words, interest-only reductions. The increases in principal balances were likely due to capitalization of unpaid interest or other charges. There were also significant numbers of rate freeze modifications, where the balance, rate, and payment remained essentially the same after modification.

Thus, one of the two most important goals of the voluntary mortgage restructuring plan is not being achieved. Without principal reductions, overall mortgage debt is not reduced, and homeowners continue to face the problem of negative equity, potentially for many years to come. Without principal reductions, the only way debt will realign with property values is

through eventual foreclosures or short sales, or through the slow process of amortization of thirty-year loans.

The news is slightly better regarding reduction in payment stress. Monthly mortgage payments were reduced in 54% of the modifications. On the other hand, 23% of reported modifications resulted in payment *increases*, likely a product of recasting arrears. The remaining 23% of modifications did not change the monthly payment.<sup>73</sup> The share of modifications with payment reductions increased somewhat over time (see Figure 4).

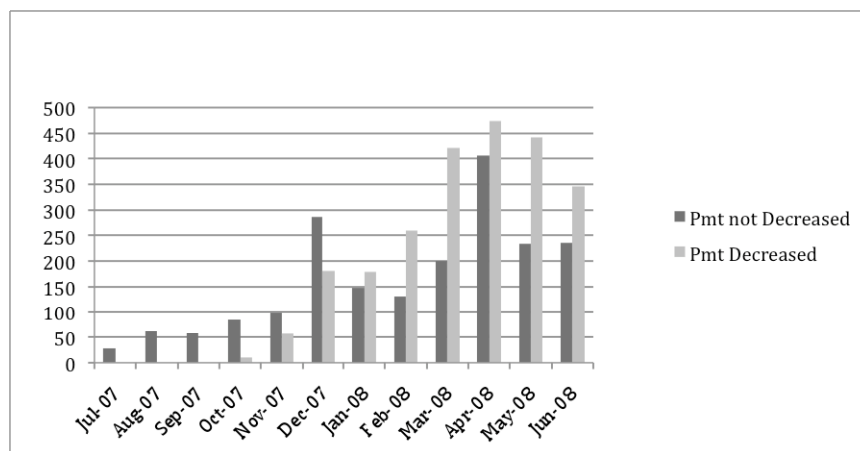


Figure 4: Modification Effect on Monthly Payment

The largest payment reduction involved a \$730,000 mortgage in the Fremont HLT 2005A pool. Without reducing the principal, and by reducing the interest rate from 12.1% to 4%, Fremont dropped the payment from \$7,614 to \$3,717 per month, which surely shows the power of interest rate modifications. The average payment reduction for modifications with a payment reduction was \$360.14 (\$258 median reduction), and the average percentage reduction was 21%. The reports do not disclose whether the payment changes are permanent or temporary.

73. There seemed to be some inconsistency in reporting, with a number of modifications reported as reducing interest rates significantly without changing either the principal or monthly payment, a highly unlikely outcome unless the term of the mortgage was significantly altered. The anomalous cases were not sufficiently numerous to affect the analysis.

Table 2: Effect of Modifications on Monthly Payment

	Payment Change	Percent	Cumulative Percent
-1000 and up	135	3.1	3.1
-900 to -1000	39	0.9	4
-800 to -900	56	1.3	5.3
-700 to -800	73	1.7	7
-600 to -700	93	2.1	9.1
-500 to -600	161	3.7	12.8
-400 to -500	206	4.7	17.6
-300 to -400	270	6.2	23.8
-200 to -300	392	9	32.8
-100 to -200	488	11.2	44.1
0 to -100	1428	32.9	76.9
0 to +100	632	14.6	91.5
+>100	369	8.5	100
Total	4342	100	

On the other hand, the average interest rate AFTER modification on all modified loans was 7.54% (7.4% median). Given the near-complete absence of principal reductions and the still above-market interest rates being paid,<sup>74</sup> the mortgage modifications of 2007–2008 should not be regarded as bailouts for the affected homeowners by any means.

The modifications that did not change either the interest rate or the payment amounts are likely to have occurred when an adjustable interest rate was due to increase. Servicers may have agreed to forego a scheduled rate and payment increase, either for a limited time or for the remainder of the mortgage term. The HOPE NOW initiative in a December 2007 announcement encouraged these “rate freeze” modifications.<sup>75</sup> Unfortunately the remittance reports do not include loan-level information regarding adjustable rate terms, before or after modification, but provide only the principal, interest, and payment amount before and after modification.

74. The conventional mortgage rate for the week of August 11, 2008 was 6.52%, and was as low as 5.7% earlier in 2008. Bd. of Governors of the Fed. Reserve Sys., Statistical Release, H.15 Selected Interest Rates (Aug. 11, 2008), available at <http://www.federalreserve.gov/Releases/H15/20080811/h15.pdf>.

75. See *supra* note 33 and accompanying text.

Thus rate freezes and recasting of arrears (which increase payments and balances) accounted for about half the mortgage modifications in the 2007 to 2008 period. While slightly more than half of loan modifications involved an interest rate reduction and resulting payment reduction, fewer than 1% reduced the actual mortgage balance. Payment stress was thus reduced somewhat, and debt overhang not at all.

### B. Modifications Compared to Foreclosures

To evaluate the overall scale of the voluntary modification effort, it is useful to compare the number of modifications of all kinds with the total number of delinquent loans, the number of new foreclosures started, and with the number lost to foreclosure.

Table 3: Modifications vs. Foreclosure Starts and Sales

	Modifications	Delinquent Loans	Foreclosures Started	Liquidated Loans
Monthly average per pool	14	951	64	24
Total all pools July 2007	27	19,375	1,412	314
Total Dec. 2007	467	25,170	1,783	511
Total March 2008	621	27,098	1,530	712
Total June 2008	582	27,470	1,868	948

The number of modifications is significant, but still exceeded largely by the number of new foreclosures started each month, and the number of loans liquidated after disposition of a foreclosed property (see Table 2).

### C. Variability Among Servicers

Mortgage servicers were far from consistent in their approach to loan modifications. The number of modifications varied considerably among the different loan pools. The two Park Place 2005 WHQ1 and WHQ 2 pools (Argent originator, HomEq servicer) had none and one, respectively, while the Ace Securities 2006-FM1 pool (Fremont) had 701 modifications over twelve months. Even comparing modifications to the number of liquidated foreclosure properties, or the number of delinquent loans, the level of modification activity varied tremendously. Each loan pool, of course,

varies in size, and is composed of loans with different characteristics, and the servicers may face different constraints on their ability to modify loans. Nevertheless, the variation remains striking. To take one example, Option One modified 2% of its delinquent loans in one pool, 11% in an older pool, and 7.5% in a more recent pool. Fremont modified 38%, 41.5%, and 56% of its delinquent loans over the course of the twelve months, compared with 0% to 10% in a number of pools.

Table 4: 12 month totals, Modifications vs. Delinquent Loans and Liquidated Foreclosures by Pool

	Liquidated	Modified	Delinq. (Max)	Mods/Liq.	Mods/ Delinq.
Aames MIT 2005-4	459	476	1140	103.70%	41.75%
Aames MIT 2006-1	281	157	673	55.87%	23.33%
ABFC 2005-OPT1	99	42	381	42.42%	11.02%
ABFC 2006-OPT1	349	26	1196	7.45%	2.17%
ABFC 2006-OPT2	212	43	1140	20.28%	3.77%
ABFC2006-OPT3	132	65	867	49.24%	7.50%
ACE 2006-CW1	182	81	1159	44.51%	6.99%
ACE 2006-FM1	560	701	1689	125.18%	41.50%
FF MLT 2005-FF6	223	113	641	50.67%	17.63%
FF MLT 2006-FF1	538	294	2316	54.65%	12.69%
FF MLT 2006-FF11	381	129	2316	33.86%	5.57%
Fremont HLT 2005A	187	276	490	147.59%	56.33%
Fremont HLT 2006A	303	408	1084	134.65%	37.64%
HISASC 2006- WMC1	554	142	1171	25.63%	12.13%
JPMorganMAT 2006-CW2	213	67	1264	31.46%	5.30%
Merrill Lynch MIT 2006-WMC1	742	352	1374	47.44%	25.62%
Park Place 2005 WHQ1	621	1	1395	0.16%	0.07%
Park Place 2005 WHQ4	585	0	1783	0.00%	0.00%
Renaissance HELT 2005-1	68	155	537	227.94%	28.86%

	Liquidated	Modified	Delinq. (Max)	Mods/Liq.	Mods/ Delinq.
Renaissance HELT 2006-1	124	70	893	56.45%	7.84%
SASCO 2006-BC6	230	47	1183	20.43%	3.97%
Wells Fargo HET 2005-1	183	116	785	63.39%	14.78%
Wells Fargo HET 2005-2	122	100	735	81.97%	13.61%
Wells Fargo HET 2005-4	132	134	813	101.52%	16.48%
Wells Fargo HET 2006-2	167	299	1226	179.04%	24.39%
Wells Fargo HET 2006-3	180	177	1621	98.33%	10.92%

The type of modifications also varied considerably among pools and servicers. Some servicers were much more likely to reduce monthly payments, while others limited their modifications to recasting or rate freezes that did not reduce monthly payments.



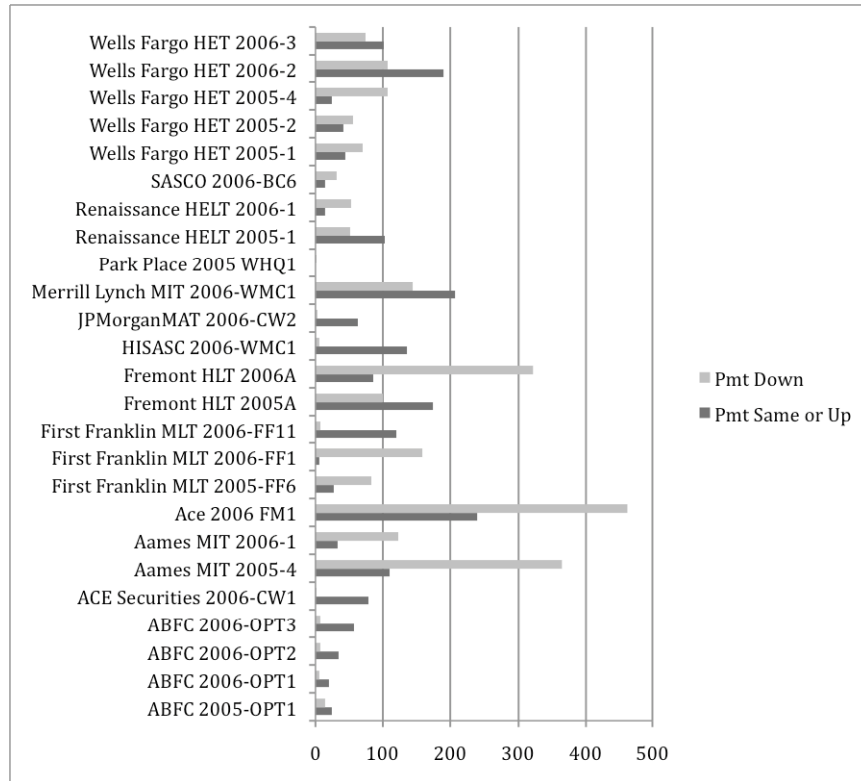


Figure 5: Variability Among Servicers, Modification Quantity and Type

#### D. Adjustable Rate Loans and the Payment Shock Issue

Loan modification activity did not seem to relate to the timing of payment adjustments for adjustable-rate mortgages. Although most of the pools studied included significant numbers of hybrid ARMs with high reset rates, there was no obvious correlation between peak loan modification activity and the date on which most of the payments on the ARMs were due to adjust up (see Table 4). Nor did there appear to be more modification activity in loan pools that had not reached their reset date than in pools that had passed their reset dates. This evidence is consistent with the view that the payment adjustment issue is somewhat of a red herring, and that defaults, foreclosures, and workouts are driven by other factors, such as payments that were unaffordable at inception.<sup>76</sup>

76. See generally Foote et al., *supra* note 11.

Table 4: Rate Resets and Month of Maximum Modification Activity

Pool	Peak Mods	Peak Month	Reset Peak	2/28s	3/27s	Notes
ACE Securities 2006-CW1	17	5/25/08	4/15/08	52.00%		
Aames MIT 2005-4	121	3/25/08	7/1/07	85.60%		
Aames MIT 2006-1	33	2/25/08	12/1/07	63.50%		
Ace Securities 2006-FM1	220	12/25/07	4/23/08	63.00%		
First Franklin MLT 2005-FF6	33	3/25/08	4/25/07	64.37%	16.82%	63% are I/O
First Franklin MLT 2006-FF11	38	3/25/08	9/1/08	63.00%	19%	
Fremont HLT 2005A	35	8/25/07	12/1/06	81.00%		
Fremont HLT 2006A	76	5/25/08	3/1/08	90.00%		
HISASC 2006- WMC1	60	6/25/08	11/1/08	64.00%	11%	
Merrill Lynch MIT 2006- WMC1	227	4/25/08	12/1/07	74.50%	4%	
Renaissance HELT 2005-1	41	5/25/08	Fixed rate pool			
Renaissance HELT 2006-1	33	5/25/08	Fixed rate pool			
SASCO 2006- BC6	19	4/25/08	10/1/08	60%	13%	
Wells Fargo HET 2005-1	22	6/25/08	4/1/07	83.50%		
Wells Fargo HET 2005-2	22	6/25/08	7/1/07	85.85%		
Wells Fargo HET 2005-4	32	4/25/08	10/1/07	85.16%		
Wells Fargo HET 2006-2	76	4/25/08	4/1/08	89.07%		
Wells Fargo HET 2006-3	38	6/25/08	10/1/08	74.46%		

### E. Discussion

The mortgage debt overhang continues to grow, and as of June 2008, defaults, foreclosures, and REO (foreclosed homes owned by mortgage servicers) continue to mount, adding to the glut of unsold homes and the drag on the economy. The voluntary mortgage modification effort is providing

some relief for many homeowners, but is not, broadly speaking, having an impact on the debt crisis.

The following salient points emerge from the data. First, the number of defaults, foreclosures, and REO properties increased steadily throughout the 2007-2008 period studied, and are all at extraordinarily high levels.

Second, loss severities are increasing rapidly, meaning that as the crisis unfolds, foreclosure sales will continue to glut the market with unsold properties and depress home values, while yielding progressively lower returns for mortgage investors.

Third, there are no signs in the study data of the crisis bottoming out or reaching a turning point, through June 2008. Instead, the disappearance of refinancing and the acceleration of foreclosures means that the number of homes in foreclosure and REO will continue to grow, and at present rates will not be liquidated for several more years. All things being equal, the 2005 and 2006 loan pools in this study could take as many as ten years to process the delinquent loans into foreclosures, the foreclosures into REO, and to sell the REO, at present rates.

Fourth, the effort to increase loan modifications has had some success, although the number of loans modified is still outstripped by loans being foreclosed, even at very high loss levels.

Fifth, the modification effort is not solving the fundamental debt overhang problem, because principal balances are not being reduced. The subprime crisis is unique in the sense that banks and investors have already written off hundreds of billions of dollars of securities backed by subprime mortgages, but only a small fraction of those losses actually correspond to completed loan liquidations. More importantly, homeowners have not been relieved of the devalued debt, either through completed foreclosure sales or loan concessions. Many are still stuck in a “sweat box” struggling to pay above-market interest rates on above-market mortgage loans.<sup>77</sup>

Sixth, only a bare majority of modifications involve any payment relief for borrowers, while many modifications are simply arrears capitalization arrangements that put borrowers in greater payment difficulty.

Seventh, there is no consistency among servicers regarding their approach to mortgage modifications. The HOPE NOW effort has not produced any uniformity in the approach to voluntary mortgage workouts. Instead, there is huge variation among servicers in the quantity and quality of loan modifications. Some had already begun modifications at the begin-

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77. See Ronald Mann, *Bankruptcy Reform and the Sweat Box of Credit Card Debt*, 2007 U. ILL. L. REV. 375, 384-92 (2007) (discussing how credit card banks profit from allowing delinquent borrowers to struggle in a “sweat box” of making partial payments and incurring late fees and penalties but not being cut off completely).

ning of the study period, some began in December or January after the public announcements by Treasury and HOPE NOW, and some seemed reluctant to engage in loan modifications until late in the study period, with a few modifications appearing first in March or April 2008, months after the crisis began and the exhortations to renegotiate had been made. In some pools, 80% of modifications reduced the borrower's monthly payment, while in others, 95% or more of modifications increased payments or left them unchanged.

### CONCLUSION

The need for mortgage restructuring was clearly growing during the 2007-2008 period, as delinquencies and losses progressively worsened. Given the choice between permanently writing down principal debt and interest rates, or simply rescheduling unpaid payments, it is understandable that mortgage servicers would avoid the former option and favor the latter. Thorny questions of servicer authority are avoided, borrowers and their advocates are placated, and some foreclosures are avoided. On the other hand, if the twin objectives are to reduce the unsustainable levels of subprime mortgage debt, and to reduce the payment burden on mortgage borrowers in or near default, the voluntary plan is not working. Borrowers who remain indebted for amounts exceeding property values will retain the incentive to give up their valiant struggles to repay their subprime loans, and foreclosures will be delayed rather than prevented.

The voluntary mortgage renegotiation plan, while it may be significantly reducing hardship for individual homeowners temporarily by curbing or delaying foreclosure sales, is doing little if anything to get at the underlying problem of debt overhang. If things continue as they are, the losses, which have largely been recognized by the ultimate holders of the investments, will continue to be parsed out between mortgage servicers and homeowners for many years to come, and to be magnified by the senseless process of foreclosure and sale at losses of 50% or more in a distressed real estate market. Without bankruptcy reform, legislated debt reduction, or a similar solution, the subprime crisis will drag on for years.<sup>78</sup>

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78. See David Herszenhorn, *Bush Signs Sweeping Housing Bill*, N.Y. TIMES, July 31, 2008. As of this writing, legislation had just passed into law that would provide FHA-insured refinance mortgages to homeowners with pre-2008 mortgages in payment distress who are able to persuade their servicer to accept payment of less than the full debt owed (90% of the value of the home, waiving all prepayment penalties and other fees). American Housing Rescue and Foreclosure Prevention Act of 2008, Pub. L. No. 110-289, § 1402, 122 Stat. 2654, 2800. Although the legislation may stimulate servicers to reconsider their approach to defaulted mortgages, it still depends entirely on the willingness of the mortgage industry to write down principal voluntarily, a willingness that has not been evident to date.