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The latest on servicing and modifications

By Michael Konczal

Kevin Drum wants to know what the latest empirical work tells us about the servicer industry. Let's do this: Hot off the presses (October 2010), here's Sumit Agarwal, Gene Amromin, Itzhak Ben-David, Souphala Chomsisengphet and Douglas Evanoff on "Market-Based Loss Mitigation Practices for Troubled Mortgages Following the Financial Crisis." The abstract, my bold:

> Using a unique dataset that precisely identifies loss mitigation actions, we study these methods -- liquidation, repayment plans, loan modification, and refinancing -- and analyze their effectiveness. We show that the majority of delinquent mortgages do not enter any loss mitigation program or become a part of foreclosure proceedings within six months of becoming distressed. We also find that it takes longer to complete foreclosures over time, potentially due to congestion. We further document large heterogeneity in practices across servicers, which is not accounted for by differences in borrower population. **Consistent with the idea that securitization induces agency conflicts, we confirm that the likelihood of modification of securitized loans is up to 70% lower relative to portfolio loans. Finally, we find evidence that affordability (as opposed to strategic default due to negative equity) is the prime reason for redefault following modifications.**

To continue:

> We find that within six months after becoming seriously delinquent, about 31% of the troubled loans that enter our sample in 2008 are in liquidation (either voluntary or through foreclosure), 2.4% enter a repayment plan, 2.2% get refinanced, and 10.4% are modified. The rest (about 54%) have no recorded action. The staggering amount of delinquent loans that see no action from lenders/investors is consistent both with the idea of an industry overwhelmed by the wave of problem mortgages and with the difficulty in overcoming the severe asymmetries of information that inhibit active loss mitigation.

So both: They appear to be ineffectual in general but also doing a better job for themselves than for the mortgages they service. Bad information and conflicts of interest.

Speaking of conflicts: "In terms of magnitudes of the estimated coefficients, second lien loans are the least likely to be modified, controlling for all other loan characteristics. This is hardly surprising, as

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junior liens likely suffer most severe losses in modifications." The difference in the modification rate when a second lien is involved is on the order of 11-13%, significantly higher. Second liens are largely held by the four largest banks, who also do a disproportionate amount of the servicing (for a longer story about the conflict in junior and second liens have with first mortgages, valuation and the way servicing is carried out, see here for starters).

In case you are interested, here are the rates of re-default by modification type:

Panel G: Rates of Redefault within 6 Months, by Modification Type

Modification type	Quarter 2008Q1	2008Q2	2008Q3	2008Q4
Interest Rate Frozen	8.1%	24.5%	31.8%	31.2%
Interest Rate Reduction	24.9%	62.7%	54.0%	53.2%
Term Extended	6.2%	11.2%	23.4%	19.8%
Principal Deferred	0.3%	1.4%	6.5%	2.1%
Principal Writedown	0.0%	0.1%	1.3%	0.7%
Capitalization	15.1%	32.9%	46.5%	46.9%
Combination	30.1%	63.1%	65.8%	59.7%

Notice how low it is for those with principal write-downs.

Paul Willen of the Federal Reserve Bank of Boston points out that when we look at this we should focus more on the fact that there are so few modifications being carried out, so the conflict of interests -- that mortgages that are owned by the servicers get favorable treatment relative to other investors -- aren't huge in the aggregate. That's true, and points to both answers being correct. So a lot depends on your framing. While at the margins there is clear evidence that servicers are creating modifications for mortgages in their own portfolios but not those that they service for others, there aren't that many modifications going on in general.

Which goes to a broken system. As Georgetown University law professor Adam Levitin notes,

> Mortgage servicing is a failed business model. Their solution? Attempt to automate default management by shuffling all defaulted loans off to foreclosure and to use robosigning and other corner cutting techniques to lower costs while charging junk fees on defaulted loans to increase income.
>
> The critical thing to realize about servicers is that they are not subject to any oversight. Investors lack the information to evaluate servicer decisions, while securitization trustees are paid far too little to want to stick out their necks and supervise servicers (with whom they often have cozy business relationships). A securitization trustee is not a general purpose fiduciary; it is a corporate trustee with very narrow duties defined by contract, and entitled to rely on information supplied by the servicer. So we've got a case of feral financial institutions, a sort of servicers run wild, with both homeowners and MBS investors bearing the costs of unnecessary foreclosures, all because servicers misjudged the housing market and didn't charge enough to cover the costs of properly performing their contractual duties.

Mike Konczal is a fellow at the Roosevelt Institute. He blogs about finance, economics and other topics at Rortybomb and New Deal 2.0, and you can follow him on Twitter.

By Michael Konczal | November 9, 2010; 1:24 PM ET

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As I stated in a previous post the problem is easy to boil down into a couple of statements (at least for underwater borrowers):

1. For most borrowers facing foreclosure that are underwater the only thing that is going to ultimately stop the foreclosure is principal reduction, all other solutions simply allow the homeowners to stay in their house a little longer while the servicers make big fees.

2. Banks are never going to reduce principal balances, not because they don't think it might make sense on an individual basis, but because setting the precedent will induce alot of borrowers who otherwise would still make their payments to demand principal reductions as well and render the banks insolvent.

I don't see an easy way out of this short of the coercing the banks into insolvency and taking them over. The only other solution that seems more palatable right now is for Fannie and Freddie to provide cost free refinancing (regardless of how underwater you are) without paperwork or appraisal of all existing loans at a 4% 30 year fixed (with no principal reduction). This would obviously require another big bailout package but at least we could separate the people who could potentially make their payments with good loan terms from those who are going to likely foreclose under any circumstance.

Posted by: ArizonaGlen | November 9, 2010 2:03 PM | Report abuse

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Posted by: ArizonaGlen | November 9, 2010 2:04 PM | Report abuse

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Ezra:

JP Morgan has already estimated the total cost to the industry as a whole from the foreclosure problem. Low end 60 billion, high end 110 billion. There will most likely be a tobacco litigation type settlement signed off on by all parties, time frame one year minimum two years outside.

But who is this Jamie Dimon fellow anyway. It's not like he has ever taught in a university, written a blog, or won a Nobel Prize!

Let's get to the heart of the matter. What does Krugman have to say about this?

Posted by: 54465446 | November 9, 2010 2:59 PM | Report abuse

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So this is completely misguided. If you read the paper, you will discover that the 70% figure applies to the GSEs (Fannie Mae and Freddie Mac). The GSEs, for all intents and purposes, own exclusive rights to the mortgages that they securitize because they own the credit risk of these mortgages, which means that when a loan becomes delinquent, they have FULL DISCRETION over what happens to it. In other words they can tell the servicers that they hire to modify every single delinquent loan if they think it is profitable or in their best interest! This is actually evidence AGAINST the idea that frictions in the securitization process inhibit

"efficient" loan modifications. If the GSEs have full discretion and modify significantly fewer loans than private institutions that securitize mortgages and portfolio lenders, then that should tell us that the problem isn't with the private securitizion market!

The relevant difference, which is between privately securitized mortgages and portfolio mortgages, is about 30% (not 70%). This is still statistically significant but of a much lower magnitude than the number you are quoting...

Posted by: nardos | November 9, 2010 5:01 PM | Report abuse

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