Session IV:
Remedies

Reflections on Remedies

Kathleen Engel, *Associate Dean, Suffolk University Law School*

Research Needed

Throughout the country, cities, states, and the federal government are implementing programs designed to stimulate the housing market, convert distressed properties to productive use, and help borrowers who are in default or on the verge of defaulting on their home mortgage loans. How well these programs work is, at best, difficult to measure, which renders informed policy making a challenge. Specific issues:

- For several years, loan cramdowns have been on the table. Those in favor contend that they will make loans more affordable and stabilize the market. Opponents argue that people will default to be able to take advantage of opportunities for cramdowns. How do we know the extent to which moral hazard is a real, and not just a theoretical, problem? This is a tough nut to crack using actual data, but we may get closer to understanding the extent of moral hazard through experiments where people are given different scenarios and advised of the consequences of cramdowns, e.g., possible damage to their credit scores and increased tax liability based on debt forgiveness, and see what choices they make.

- Controlled, field experiments are difficult for several reasons. The first is that people who run programs designed to help homeowners may be unwilling to have a control group. Second, differences in people's financial situations would make it almost impossible to determine which factors best predict whether a particular individual would succeed under a particular program. With that said, it is possible to use treatment and control groups to determine whether, on average, a program is beneficial.

- Given that many programs are regional or statewide, it might be possible to compare states with similar demographics where only one has the program that is being studied. An alternative would be to look at border counties of abutting states where the economic conditions would likely be similar to see what effect a program might have.

- Given the complexity of housing markets and the many actors involved in housing finance, loan modifications, and REO, it behooves researchers to avoid simplifying their analyses in ways that could lead to mistakes in their conclusions about causal relationships. Although model building and empirical studies can help uncover phenomena, the complexity of housing markets demands qualitative study as well. For example, there could be empirical evidence that mediation programs are correlated with delays in foreclosures and corresponding declines in property values. From this evidence, one could conclude that mediation programs are the culprit when the real culprit could be servicers who delay mediation because they don't have the resources, are opposed to modifications because they make more money with foreclosures, or have conflicts of interest because affiliated entities own second mortgages that could be wiped out in a modification. Only through observation of the actual transactions coupled with empirical analysis can we fully understand what is taking place in programs.

- There is anecdotal evidence that some borrowers are suffering from "modification fatigue" because they have been stymied by lost documents, phone loops at call centers, and the like. It would be valable to study what the experiences of borrowers have been. This might be possible by examining loan files to calculate the nature and frequency of borrowers' communications with lenders and servicers.

Policy

- In thinking about distressed properties and borrowers in default, what is the potential role of the Community Reinvestment Act (CRA)? One problem with CRA is that it is most valuable to depository institutions at the peak of the business cycle when there are a lot of mergers and acquisitions and when banks want to expand their services. At the bottom of the cycle, the converse is true. As a result, the CRA is least valuable when it is most needed to infuse creative financing to ameliorate the problems of distressed properties, neighborhood decline, and underwater borrowers. One option would be to give greater weight to banks' CRA-eligible activities in bad times and allow them to bank their credits for the future. Of course, for banks that are suffering themselves, no amount of CRA credit will be an incentive to invest in communities.

- Ideally, at mediation borrowers and servicers/lenders bring all the information needed to determine borrowers' eligibility for a loan modification. That doesn't always happen and the mediation either fails or is delayed. For borrowers, they may not fully understand what they are supposed to bring or how to obtain the required documentation, especially if they are not represented by counsel. Services and lender do know exactly what to bring, yet there is evidence that they do not always have accurate figures and, at times, lack the authority to renegotiate a loan. Given the differences in sophistication, one policy question is whether unprepared and unrepresented borrowers should be treated with greater leniency than lenders or servicers who are ill-prepared.

Lingering Questions

- **To the extent that we are confident that some programs are successful, are the programs scalable?**

- **Given that almost everyone agrees that delays in foreclosure are bad for neighborhoods, is it possible to preserve homeownership through modifications and protect communities at the same time?**

- **How can we gather information on effective programs to help aGs decide how to deploy their funds from the robo-signing settlement?**

- **Has it been a mistake to predicate eligibility for a modification on default? Would a better policy be to allow modifications if borrowers are underwater to avoid the problem of moral hazard?**

- **Historically, one of Fannies and Freddie's missions has been affordable housing. Are the current policies of the FHFA consistent with these goals?**

Does Foreclosure Counseling Help Troubled Homeowners? Summary of Key Findings from the Evaluation of the National Foreclosure Mitigation Counseling Program

Peter A. Tatian, *Neil S. Mayer, Kenneth Temkin, and Charles Calhoun*

Housing counseling is making a difference in helping many homeowners avoid foreclosure and stay in their homes. A large share of this counseling is being funded through the National Foreclosure Mitigation Counseling (NFMC) program, which is a special federal appropriation, administered by NeighborWorks® America (NeighborWorks), designed to support a rapid expansion of foreclosure intervention counseling in response to the nationwide foreclosure crisis. NeighborWorks distributes funds to competitively selected organizations across the country, which in turn provide much needed foreclosure prevention and loss mitigation counseling services at no cost to homeowners. Over 1.35 million struggling homeowners have received counseling through the NFMC program.

As this is a federal appropriation, NeighborWorks must inform Congress and other entities of the NFMC program's progress. The Urban Institute was selected by NeighborWorks to undertake an evaluation of the first two rounds of the NFMC program, which included persons counseled in 2008 and 2009. Our research answered the following questions.

- Did the NFMC program help homeowners stop an existing foreclosure?
- Did the NFMC program help homeowners receive loan modifications that resulted in lower monthly payments than they would have otherwise received without counseling?
- For homeowners who cured a serious delinquency or foreclosure through a loan modification or some other means, did NFMC counseling help them to remain current on their loans longer and more frequently than they would have without counseling?
- For borrowers with seriously troubled loans, did NFMC counseling increase their chances of first obtaining a cure and then sustaining that cure and avoiding redefault?
- Did the NFMC program help reduce the number of overall foreclosure completions?

The final results of this evaluation were released in December 2011. The research demonstrated that the NFMC program was having its intended effect of helping homeowners by improving the quality of mortgage modifications, increasing the frequency and sustainability of cures of delinquencies and foreclosures, and reducing the number of foreclosure completions. In addition, the program helped build the nation's foreclosure counseling capacity. As detailed in a final report and research brief, the evaluation documented the positive impacts of the program, which are summarized below.[i]

Improving outcomes for troubled homeowners. Counseling provided through the NFMC program yielded measurable and substantial improvements in client outcomes. One of the most commonly sought solutions for a homeowner who cannot afford his or her monthly mortgage payments is a loan modification, which involves changing the terms of the current mortgage, such as by lowering the interest rate. Ideally, these changes would reduce the monthly payment to make the loan affordable to the homeowner. Obtaining a modification typically involves frequent interaction and negotiation with the mortgage servicer and counselors can provide a crucial level of support to clients during this process. The evaluation found that NFMC clients who had their loans modified paid $176 a month less, on average, than homeowners who received loan modifications without the benefit of counseling assistance.

[i] The summary research brief and final report are available on the Urban Institute website at http://www.urban.org/publications/412492.html.

Counseling also increased the frequency and sustainability of cures of delinquencies and foreclosures. The data showed that homeowners in serious delinquency (three or more months of missed payments) or foreclosure had 89 to 97 percent higher relative odds of bringing their loans current through a modification if they got counseling help, as compared to troubled borrowers who did not use counseling. Furthermore, NFMC clients who got a delinquency-curing loan modification were 67 to 70 percent less likely to redefault on their mortgage payments nine months later. When these results are synthesized, they demonstrate that NFMC counseling nearly doubled the rate of curing and sustaining troubled loans.

One of the most significant impacts of the NFMC program on the national foreclosure crisis was in increasing the number of foreclosures ultimately avoided. Between January 2008 and December 2010, the program reduced the number of foreclosure completions for counseled homeowners by 13,000. Put another way, the NFMC program prevented nearly one in seven foreclosure sales that would have been completed without counseling.

Since foreclosure sales create social costs, avoiding foreclosures generates savings. Each foreclosure sale prevented by the NFMC program was estimated to have saved an average of $70,600 in avoided costs. These savings included $10,000 in moving costs, legal fees, and administrative charges for homeowners; $40,500 in deadweight lender losses; $6,500 in local government administrative and legal costs; and $13,900 in reduced neighboring property values. Assuming the 13,000 loans that avoided foreclosure because of counseling do not complete foreclosure at some point in the future, the NFMC program has helped save local governments, lenders, and homeowners $920 million, which is about $1,200 per client served by the program.

When the full costs of providing counseling services to these clients is accounted for, the savings represented a total counseling benefit-to-cost ratio of 2.4 to 1.

Building national capacity for foreclosure mitigation counseling. The NFMC program increased the funding available to counseling organizations, allowing them to hire more counselors and serve more clients. Before the national housing crisis, foreclosure counseling was a small share of the services provided by housing counseling organizations. The rapid rise in mortgage delinquencies meant that counseling organizations had to shift priorities and rapidly ramp up their capacity to provide foreclosure counseling. With NFMC funding, organizations increased the number of foreclosure clients served and expanded their service areas to respond to the increasing demand for help.

To be effective, counseling organizations also had to improve their responsiveness to the challenges faced by their clients. The NFMC program evaluation gathered extensive information from counseling agencies on specific challenges, as well as on the strategies and best practices used to address them. Counseling organizations identified lack of servicer responsiveness and client financial difficulties (such as loss of income) as their two biggest challenges. Effective counseling organizations have developed several best practices to address these and other obstacles, including building contacts and relationships with servicers, assessing a client's situation in terms of proposals that a servicer will be willing to consider, working through a "crisis budget" with the client to prioritize expenses, and empowering clients to be informed advocates on their own behalf.

The evaluation of the NFMC program has shown that counseling has been an important and successful tool in addressing the record number of troubled homeowners who have faced, and continue to face, loss of their homes because of foreclosure. While counseling cannot solve the foreclosure crisis by itself, it nonetheless has helped homeowners achieve better outcomes, which in turn has benefited the country by reducing the numbers of non-performing and failed mortgages, avoiding social costs associated with foreclosures, and allowing more people to retain their homes.

Remedies: The Effectiveness of Settlement Conferences as a Means to Prevent Properties from Ending Up in REO Inventory

Kirsten Keefe, *Senior Staff Attorney, Empire Justice Center*

The failure of national mortgage servicers and federal regulators to adequately address the foreclosure crisis has prompted a number of states to pass consumer protections in an attempt to salvage the crisis within their borders. The most popular has been the advent of mediation programs, intended to bring the servicer and borrower together through a formal process to see if a loan modification or other work-out can be achieved.

New York State, a judicial foreclosure state, was the first, in February 2010, to institute mandatory settlement conferences in every mortgage foreclosure of a primary residence.[i] The statute requires a conference to be scheduled within 60 days of the filing of the affidavit of service and Request for Judicial Intervention (RJI), a document that triggers the case to be assigned to a judge.[ii] Plaintiffs are required by law to appear in person or by phone, and by a representative who is fully authorized to settle the case. There is a duty to negotiate in good faith and parties are prohibited from imposing fees on the other for participation in the settlement conference process.[iii]

The most resounding success of New York's settlement conferences has been bringing homeowners to the defense table. According to the 2011 Report of the Chief Administrator of the Courts for NYS, "only 10 percent of homeowner-defendants did not appear for any of their scheduled conferences, down from an estimated 90 percent prior to the legislation."[iv] This is simply incredible, and extremely meaningful when one thinks about a legal action to repossess a home as being one of the most serious and detrimental lawsuits that an average citizen could be party to.

New York's Foreclosure Process and Shadow Docket: Delays Caused by Mortgage Servicers

In NY, a foreclosure is initiated with the filing of a summons and complaint with the court which is then served on the homeowner. The plaintiff next is to file a Request for Judicial Intervention (RJI), triggering assignment of the case to a judge, along with the filing of the affidavit of service. Defendants have 20 or 30 days to file an answer, depending on how they were served. Under court rule, simultaneously with the RJI, plaintiff's attorney must file an Affirmation confirming they have communicated with the servicer and attesting to the veracity of the complaint. Within 60 days of the filing of the RJI, the court must schedule a mandatory settlement conference—theoretically extending the foreclosure timeline by only 30 or 40 days.

But servicers are failing to file RJI's in thousands of cases across the state, causing these cases to sit in limbo in what has become known as a "shadow docket." Why plaintiffs are choosing not to prosecute these cases is unknown though it may have to do with the inability of the servicers to provide adequate documentation to their lawyers to enable them to file the Affirmation.

Delays are further caused by servicers through the settlement conference process, failing to send a representative with authority to settle, or the usual dilatory tactics invoked by services in the loss mitigation process.

Courts are also reporting a significant docket of cases which have moved out of the settlement conference process unresolved, but yet plaintiffs are not prosecuting to judgment and sale. Homeowners are also having their cases dismissed by the plaintiff, only to have it re-filed at a later date.

[i] N.Y. C.P.L.R. 3408 (McKinney 2009). See also Uniform Civil Rules of the Supreme and County Courts Sec. 202.12-a (effective Feb. 13, 2010), available at http://www.courts.state.ny.us/courts/2jd/kings/civil/202.12-a_rev_Residential-Mortgage-Foreclosure-Action-Settlement-Conference.pdf.

[ii] C.P.L.R. 3408(a); Sec. 202.12-a(b). At the time of filing the RJI, plaintiff's attorney also must file an Affirmation pursuant to Administrative Order No.548-10, modified March 2011 Admin Order No. 431-11, available at http://www.nycourts.gov/attorneys/pdfs/AdminOrder_2010_10_20.pdf.

[iii] Id. at 3408(c), (f), (h); See also Sec. 202-12-a(c)(4).

[iv] New York State Unified Court System, 2011 Report of the Chief Administrator of the Courts Pursuant to Chapter 507 of the Laws of 2009, at 4, available at http://www.courts.state.ny.us/publications/pdfs/ForeclosuresReportNov2011.pdf.

In the very least, the settlement conferences have increased participation of homeowners in their own defenses and have made the court process friendlier and more accessible.

The report further notes that the settlement rate in foreclosure cases increased 29 percent over the 11-month period studied (November 2010 through September 2011).[v] This is evidence that servicers are capable of working with homeowners and resolving foreclosures when compelled to do so. The advantages of mediation programs are many. In addition to bringing the parties together, these programs can oversee the exchange of documents, impose deadlines, and enforce timelines so typically violated by the large servicers under the Home Affordable Modification Program (HAMP). In many ways, the settlement conferences in NY have become a means to babysit the HAMP process and ensure servicers are properly reviewing applications and not improperly denying relief to homeowners.

There has been misplaced blame recently on state consumer protections for elongating the foreclosure process. In fact, it is not these laws that create the long timelines adding costs to the process, but rather the failure of the servicers to comply with these programs, as well as with HAMP directives, that is causing the great delays in states. A report issued by the National Consumer Law Center (NCLC) in February 2012, found that "Foreclosure conference and mediation programs had little, if anything, to do with these delays."[vi] Citing a study conducted by The Reinvestment Fund of the Philadelphia foreclosure diversion program, the mediation process took on average 53 days, a process that could easily be held within the typical 10-month time period it takes for a default foreclosure to be completed.[vii]

In NY, the state attributed with having the longest foreclosure timeline, the settlement conference process is in fact being invoked to compel servicers to move foreclosure cases forward. (See insert for an explanation of NY's foreclosure process.) Delays are the fault of plaintiffs and their mortgage servicers and can be lumped into four categories: (1) lenders are not filing required paperwork to trigger settlement conference scheduling, creating a "shadow docket" of cases filed with no action; (2) servicers are engaging in dilatory practices causing conferences to be adjourned multiple times; (3) once removed from the settlement conference part, lenders are not moving cases to judgment and sale; and (4) lenders are voluntarily seeking dismissal of actions, only to re-file at a later date.[viii] In June 2012, New York's Office of Court Administration (OCA) amended its settlement conference rules to prompt courts to schedule status conferences to address the shadow docket and force servicers to prosecute foreclosure cases.[ix]

Delays disadvantage homeowners. Interest and fees continue to accrue in these cases that will eventually be capitalized onto the principal balance through a loss mitigation evaluation, rendering an eventual loan modification for the homeowner less probable. Ultimately, delays will mean fewer homeowners remaining in their homes and more properties ending up in REO inventory. The delays also cause harm to communities, and hamper national prospects to emerge from the foreclosure crisis. No doubt, some proportion of the cases sitting in limbo with no prosecution in New York's courts, involve properties that are abandoned, or which the homeowner can no longer afford. These properties are not being moved through the court system and returned to the market for sale or other disposition—they are just sitting in limbo and especially if abandoned, deteriorating in their condition and value.

[v] Id. at 6.

[vi] Geoff Walsh, Rebuilding America: How States Can Save Millions of Homes Through Foreclosure Mediation, National Consumer Law Center, 38, (Feb. 2012), available at http://www.nclc.org/foreclosures-and-mortgages/rebuilding-america.html.

[vii] Id.

[viii] See MFY Legal Services, Inc., Justice Unsettled: How the Foreclosure Shadow Docket & Discontinuances Prevent New Yorkers from Saving Their Homes, (May 2012), (finding in Brooklyn and Queens courts, as of April 2012 almost 75 percent of foreclosures filed in October 2011 sat in the shadow docket, and as of March 2012, 43 percent of November 2010 and March 2011 filings remained in the shadow docket), available at http://www.mfy.org/wp-content/uploads/Justice-Unsettled-plus-APP.pdf. A review of cases filed November 2011 through May 2012 in the Capital Region of NY showed that as of August 2011, 67 percent of cases in Albany and Rensselaer counties, and 59 percent in Schenectady county had not had RJI's filed and sat in the shadow docket.

[ix] Amending Uniform Civil Rules of the Supreme and County Courts adding section 202.12(a)(b)(3) (June 18, 2012), available at http://www.nylj.com/nylawyer/adgifs/decisions/070212order.pdf.

The settlement conferences also play a vital role in linking distressed homeowners with reputable direct assistance provided by non-profit housing counseling and legal services programs. In a survey of New York's 62 county courts, conducted by Empire Justice Center in the summer of 2012, nearly 90 percent of clerks who responded from areas where these services are available reported that they regularly refer homeowners to local non-profits. Some courts have directly involved advocates, having them assist in an initial informational conference for homeowners. Other courts provide space in the courthouse for advocates to meet with homeowners who appear at the conferences without counsel. Involving advocate representatives for homeowners makes the process more efficient for the court, and it is well recognized that homeowners are more likely to get an affordable loan modification with the assistance of a counselor.

A number of states, and some counties, have instituted mediation programs including: Connecticut, Delaware, District of Columbia, Hawaii, Illinois (Cook Co.), Indiana, Maine, Maryland, Nevada, New York, Ohio (Cayuga Co.), Pennsylvania (Philadelphia Co.), Rhode Island, Vermont, and Washington.[x] Mediation programs have been developed in states with both judicial and non-judicial foreclosure processes. The programs have a unifying goal—to bring the parties together in a supervised forum to ensure that options for a loan modification or other workout have been explored and exhausted before a home is lost to foreclosure.[xi] States and localities recognize that it is far preferable to keep homeowners in their homes if they can afford them.

NY's Settlement Conferences

From November 2010 to September 2011:
- 4,253 initial settlements were scheduled
- Homeowners appeared in 90 percent of cases
- 80,450 conferences were held, including 55,043 adjournments
- It took four to eight appearances to settle
- Settlement rate rose 29 percent from previous year

Source: NYS Unified Court System, 2011 Report of the Chief Administrator of the Courts Pursuant to Chapter 507 of the Laws of 2009.

[x] See Walsh supra (identifying mediation programs across the country).

[xi] See e.g., C.P.L.R. 3408(a) stating settlement conference shall be held "for the purpose of holding settlement discussions pertaining to the relative rights and obligations of the parties under the mortgage loan documents, including, but not limited to determining whether the parties can reach a mutually agreeable resolution to help the defendant avoid losing his or her home, and evaluating the potential for a resolution in which payment schedules or amounts may be modified or other workout options may be agreed to, and for whatever other purposes the court deems appropriate."

The structure of mediation programs differs and states have been learning from one another to enhance effectiveness and efficiency within their processes. Some are overseen by judges while others involve independent mediators. Requirements also vary in terms of whether the conferences are mandatory, or an opt-in, requiring the defendant homeowner to schedule the conference. Rules vary as well regarding the production of documentation by the parties (including proof of ownership by the foreclosing party), requirements to negotiate in good faith and payment for the conferences. The ability of the party overseeing the negotiations to sanction a non-complying servicer seems to be a key element to the success of mediation programs.[xii]

An important aspect that has not been factored by those criticizing state programs for holding up the foreclosure crisis is the increased number of homeowners in states with mediation who will remain in their homes with once-again performing loans, preventing more properties from being dumped into REO inventory or otherwise glutting housing markets. The current reality of New York's shadow docket, coupled with the fact that once a case reaches the settlement conference process it takes on average four to eight distinct appearances before the court for a resolution to be reached with the servicer,[xiii] means that it is probably still too soon to fully calculate the long-term benefits settlement conferences will have for the state and its communities. We are able to predict, however, based on the increased rate of homeowners getting modifications as a result of the conferences that they are definitely working to prevent more homes from ending up in REO. And prevention is always the best remedy.

[xii] See Walsh supra (providing an in-depth study of mediation programs and their differences).
[xiii] New York State Unified Court System, supra at 2.

Earned Principal Reduction[i]

Adam Ashcraft and Joseph Tracy, *Federal Reserve Bank of New York*

The significant decline in house prices and increase in unemployment rates across many local housing markets as a result of the financial crisis and Great Recession created considerable stress for homeowners with mortgages. Many of these homeowners found themselves in situations where the current value of the house was less than the outstanding balance on their mortgage(s)—what we will call being underwater or in negative equity. In addition, many homeowners faced significant cutbacks in their income due to unemployment or underemployment. This situation makes it difficult for the household to continue to make their monthly mortgage payment(s) in a timely manner. The combination of these two situations often leads to a default and eventual foreclosure.

As foreclosure rates increased over time and across local housing markets, efforts were undertaken to try to minimize the risk that borrowers would default on their mortgages. A common strategy for dealing with borrower stress was to lower the monthly mortgage payments. This was done either through a modification of the existing mortgage to reset the interest rate lower and to extend the term of the mortgage or through special refinance programs. Two notable examples are the Home Affordable Modification Program (HAMP) and the Home Affordable Refinance Program (HARP).

For underwater borrowers, a key aspect of these programs is that they do not attempt to deal directly with the fact that the borrower has no equity in the house. An important question is whether negative equity is an important risk factor for future defaults even if the borrower can currently afford to make the required monthly payment. Economists are known to disagree with each other and this question is no exception. However, empirical studies of mortgage default consistently find that borrowers in negative equity are more likely to default holding constant a wide range of other risk factors.

Over time the practice of treating negative equity through principal reduction—that is, writing down the balance of the mortgage to the borrower—has become more prevalent. For example, the 2012 Q1 OCC Mortgage Metrics Report indicates that 10.2 percent of all modifications over the period covered by the report involved a principal write-down. Looking across categories of mortgages the frequency of this intervention varied widely: 28.9 percent for mortgages in bank portfolios; 18.9 percent for mortgages, in private securities; and 0 percent for agency mortgages guaranteed by the GSEs (Freddie Mac and Fannie Mae). This indicates that the GSEs are clear outliers with regard to using principal write-down as a tool for mitigating default risk.

The purpose of this note is to summarize our analysis of the economic case for a principal reduction program for agency mortgages. Since the GSEs are in conservatorship, the economic case should be based on the mandate to the Federal Housing Finance Authority (FHFA) as the regulator of the GSEs to minimize the risk to taxpayers. That is, could a principal reduction program reduce the expected losses to the GSEs? If so, what would be the structure of the program that creates the best return for taxpayers?

[i] The views expressed in this article are those of the author and do not necessarily reflect the views of the Federal Reserve Bank of New York or the Federal Reserve System.

We evaluated a program that we call “earned principal reduction.” This program is designed to dovetail with the existing HARP. That is, the first step for an underwater borrower with an agency mortgage is to refinance using HARP in order to reduce the required monthly payment. The next step would be to enroll in the earned principal reduction program. The basic idea of the program is that the borrower earns over time the right to pay off the mortgage at a discount. The borrower earns this discount by staying current on the monthly payments. The earned discount grows over the first three years of the program. The discount is designed to allow the borrower after three years to be able to sell the house and pay off the mortgage even if house prices do not increase. In return, the borrower agrees to give up a pre-specified percentage of any house price appreciation that may occur until the house is sold. As such, our earned principal reduction program has the feature of a streamlined short-sale agreement where the borrower earns the right to do a short-sale by making three years of timely payments. Importantly, the earned discount does not change the monthly payment amount. This is why it is useful for the borrower to lower the monthly payment by first refinancing under HARP.

An important point to note is that the balance of the mortgage is not written down at the time that the borrower enrolls in the program. Rather, any loss that may be incurred by the GSEs from the discounted payoff option is realized only when the house is sold. This acts to spread out the realization of the losses into the future. However, from the borrower’s viewpoint the option to pay off the mortgage at a discount in three years should reduce the default risk from the outset since the borrower now has a clear path to be able to sell the house.

A key concern of any mortgage intervention program is moral hazard. That is, does the program create incentives for borrowers to engage in undesired behavior in order to qualify for or benefit more from the program? Opponents to principal write-down programs argue that these programs create incentives for borrowers who would otherwise keep paying their mortgage to go delinquent in order to qualify for the write-down. This assumes, however, that delinquency is a requirement to qualify. To avoid moral hazard, we must design the program so that eligibility and treatment depends on the borrower’s degree of negative equity and not on the borrower’s payment history. Furthermore, as described above, once enrolled in the program the borrower must remain current in order to earn the discounted payoff. Insulating the program from moral hazard concerns turns out to be an important constraint on the program design.

To evaluate the economics of an earned principal reduction program, we need to project cash flows for different types of situations regarding the borrower and the mortgage assuming first that the program is not available and then assuming that they participate in the program. These projected cash flows capture both payments by the borrower, any earned discounted payoffs that are exercised at a sale of the house, and any costs incurred if the borrower defaults and the mortgage goes into foreclosure. These cash flows are weighted by their associated estimated probabilities given a specified forecast scenario and then discounted back to current dollars. The end result is what is called the net present value (NPV) for the mortgage.

To implement this analysis we use a large sample of agency mortgages from the LPS Applied Analytics database. We use this data to estimate payment transition matrices for different situations facing the borrower and the mortgage. These transition matrices indicate for each possible current payment situation for a borrower (for example, current, 30-days delinquent, 60-days delinquent, etc.) the probability associated with the borrower moving to each payment situation in the following month. Different transition matrices are estimated for borrowers with different ranges of negative equity.

The first question to address is why should we consider any intervention for a borrower who has not missed a payment to date simply because the borrower has negative equity? We can use our cash flow analysis to evaluate the impact of borrower equity on the likely losses on a mortgage conditional on the borrower having made all payments in a timely manner up to the present. Start with a borrower who has positive equity in the house. Our estimated NPV for this borrower is 99.1 percent of the full value of the mortgage. In contrast, if we assume that the borrower is underwater by 25 percent or more, then the estimated NPV falls to 82.3 percent. This drop in the economic value of the mortgage reflects both that this borrower is more likely to default in the future and conditional on a default the expected losses are higher. The key point is that the fact that a borrower has made all payments to date does not guarantee that they will make all future payments.

For a given degree of negative equity, the estimated NPV on a mortgage decline sharply as we move from a borrower who is current to one who is already delinquent. If moral hazard were not a concern, then we would want to design mortgage interventions to be more aggressive for delinquent borrowers. However, this is where the moral hazard constraint becomes binding. If we designed the earned principal reduction program to be more aggressive in its treatment as borrowers exhibit more stress as reflected in their payment status, then we risk borrowers intentionally going delinquent in order to qualify for this more aggressive treatment. This limits us to varying the treatment intensity to the borrower's degree of negative equity which is not subject to moral hazard.

Can our earned principal reduction program increase the expected NPVs on underwater agency mortgages? Our initial analysis indicates that with even modest upside sharing of any house price appreciation, small reductions in the borrower's negative equity raise the expected NPV. However, to justify a discounted payoff option that allows the borrower to be able to sell the house after three years without putting up any additional funds of their own requires that the borrower with significant negative equity be willing to give up more than half of any upside in house prices. Less upside house price sharing would be required in this case for borrowers who are already delinquent, but as discussed earlier, we must set the same program parameters for delinquent borrowers as for current borrowers.

The analysis indicates that a broad-based earned principal reduction program can be justified for all negative equity borrowers with agency mortgages. The program would save taxpayers money relative to not offering the program. In addition, since mortgage servicers are not involved, the program does not require any subsidies to induce servicers to participate. The ultimate degree to which the program reduces the losses to the GSEs depends on the borrower take-up rate. An important issue is the degree to which underwater borrowers are willing to give up potential house price appreciation in return for a definite path to being able to sell their house. The take-up rate will also depend on how effectively the GSEs market the program and its benefits. The simplicity of the program should make it easy for borrowers to evaluate and there is no complicated process involved in signing up. The benefits to the program, however, will also depend on how quickly the program is implemented.

Homeowners' Emergency Mortgage Assistance Program – Discussion Notes[i]

James Orr, *Assistant Vice President, Federal Reserve Bank of New York*

Program Objectives

The Homeowners' Emergency Mortgage Assistance Program (HEMAP) is a Pennsylvania initiative that provides temporary financial assistance to borrowers who become delinquent on their mortgages because of unemployment or other financial hardship beyond their control. The program was established in 1983 with the goal of helping homeowners stay in their homes and thus preventing distressed home sales, which were believed to be very damaging to many communities in the state. The assistance is in the form of a loan to homeowners to make their mortgage current and then to help them continue to make their regular mortgage payments until their income is restored. Underlying the program was the idea that a temporary loss of income—rather than the terms of the mortgage—had caused the mortgage delinquency. The program is thus a potential alternative to a loan modification, such as might occur for delinquent borrowers under the Home Affordable Modification Program (HAMP).[ii]

Key Program Features

The administration of HEMAP has several key features. One is that borrowers must be suffering financial hardship owing to circumstances beyond their control. This financial hardship is not limited to unemployment but extends to other situations such as illness or divorce. A second is that borrowers become eligible only after their mortgage is 60 days delinquent. At that time, the lender/servicer is required to notify borrowers of their eligibility to apply for a HEMAP loan. After receiving notification, a borrower has about one month to meet with a credit counseling agency, and the agency then has a month to forward an application to the Pennsylvania Housing Finance Agency (PHFA). The PHFA then makes a determination of the borrower's eligibility based largely on job history, mortgage payment history, and a judgment about the borrower's prospects for re-employment in the area. It is expected that a successful applicant has a reasonable prospect of resuming full mortgage payments within 24 months, or 36 months in periods of high unemployment. If approved, the loan proceeds go directly to the lender/servicer.

The screening process is challenging, particularly the task of determining the re-employment prospects of laid-off workers. But the program statistics indicate that the experience with HEMAP has been very positive. Since the program began operation, roughly 75 percent of applicants were determined to be ineligible; however, of the eligible applicants, about 80 percent have paid off their loans in full and remained in their homes. These loan repayments, in turn, have been an important source of the program's continued funding.

[i] The views expressed in this article are those of the author and do not necessarily reflect the views of the Federal Reserve Bank of New York or the Federal Reserve System.

[ii] For a fuller description of the HEMAP program and a comparison of the costs of HEMAP and a HAMP modification for a hypothetical unemployed borrower, see the article "Help for Unemployed Borrowers: Lessons from the Pennsylvania Homeowners' Emergency Mortgage Assistance Program," by James Orr, John Sporn, Joseph Tracy, and Junfeng Huang, in the Federal Reserve Bank of New York's Current Issues in Economics and Finance, available at http://www.newyorkfed.org/research/current_issues/ci17-2.html.

Lessons for Future Mortgage Assistance Programs

The HEMAP offers several lessons for policy makers considering similar efforts to provide loans to borrowers suffering temporary financial hardship. With regard to the target population, loan programs might be more efficient if focused strictly on unemployed borrowers. Program data show that more than half of the loan recipients who failed to repay their loans cited factors other than unemployment as the reason for their financial hardship. Different types of assistance may be warranted for borrowers whose loss of income was not due to unemployment. With regard to the timing of the assistance, the unemployment insurance application could simultaneously trigger an application for mortgage assistance. The information on an applicant's residence and earnings and employment history would be readily available, thus streamlining the screening process. If the application for mortgage assistance was processed quickly, the lender/servicer might not need to be involved at all and might well see fewer borrowers becoming delinquent. Without arrears to consider, loan amounts would likely be lower.

One factor that was not present to any great extent in Pennsylvania since HEMAP began was negative equity. Loans in these cases are riskier because they are effectively unsecured. "Underwater" borrowers who experience a loss of income have a higher likelihood of defaulting. In these circumstances, there may have to be a write-down of the principal. The lenders/servicers would appear to have an incentive to do so as the HEMAP loan would help to ensure that the borrower would continue to make mortgage payments for up to two years. Some form of shared appreciation might give an added incentive to the lender/servicer to write down the principal in the presence of a HEMAP loan.

Pennsylvania's experience with HEMAP led the New York City Bar Association to propose that New York State adopt a similar program that would provide bridge loans to homeowners experiencing temporary financial hardship to help them meet their mortgage payments.[iii] That proposal initially limits the target population to workers who are experiencing a loss of income due to unemployment. Using unemployment insurance figures for New York State for 2009, we estimate that roughly 5,000 homeowners would have qualified for a HEMAP-like bridge loan. While this number represents a small fraction of the roughly 1.5 million applications for unemployment insurance in the state that year, the loan program is not being proposed as a comprehensive solution to the problem of mortgage delinquency and foreclosure. Rather, the loan program should be considered as a potential alternative to a loan modification, and one that is tailored to homeowners who are suffering a temporary loss of income.

[iii] The proposal is available at http://www2.nycbar.org/pdf/report/uploads/9_20072233-BridgeLoanAssistanceProgram.pdf.