

Deleveraging American Homeowners:
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American homeowners are carrying 10.5 trillion dollars in mortgage debt, a number that has risen by 250% in the past decade. While banks have written down more than half a trillion in mortgages and mortgage-related securities, homeowners have gotten little or no relief. A broad range of economists from Nouriel Roubini to Ben Bernanke to Martin Feldstein have recognized the need to deleverage the American homeowner. The excess mortgage debt is depressing home prices and consumer spending, and acting as a drag on the broader economy. Empirical evidence from mortgage servicer reports to investors show that for the most part, the necessary deleveraging of homeowners is not happening.

In a paper published on-line in August, I compiled mortgage foreclosure and modification data from a sample of securitized subprime mortgage pools. I have since expanded my study to look at data on more than 3.5 million subprime and alt-A mortgages (all securitized.) About 300,000 of those mortgages were in foreclosure as of November 25, 2008, which is about one-sixth of all foreclosures pending. The 21,000 mortgage modifications in the November data represent about 20% of the monthly total modifications reported by HOPE NOW for October 2008.

My findings from both the smaller sample and the larger sample are consistent, and are as follows:

1. Modifications are not reducing principal debt, and are actually increasing total mortgage debt. This is because almost no modifications include significant cancellation of either past due interest or principal, and because many modifications involve capitalizing unpaid interest and fees into a larger debt and reamortizing the loan. These are accounted for as negative prepayments, which occurred in 68% of loan modifications. The average capitalized amount added to loans was \$10,800, on average mortgage debt of about \$210,000.

In my earlier study covering July 2007 to June 2008, fewer than 2% of modifications reduced the principal loan balance. In the broader sample and for the month of November 2008 only, some principal was canceled, and reported as a partial loss, for about 10% of modifications. However, two servicers (out of 43), Litton Loan Servicing and Ocwen Loan Servicing, accounted for nearly all of these modifications. Similarly, about 8% of loans reflected some write-off of unpaid interest, almost all loans serviced by Litton and Ocwen. Ocwen has recently reported that its aggressive modifications are resulting in significantly lower rates of redefaulting than industry averages.

2. Meanwhile, servicers are incurring huge losses for investors by foreclosing. The average foreclosure loss on a first mortgage in November 2008 was \$145,000 or about 55% of the average amount due. Loss severities increased steadily throughout

2007 and 2008 and are expected to worsen in 2009. In these circumstances, rational investors should accept mortgage principal reductions corresponding to home value declines of 20% or so, were it not for the various obstacles to servicers' restructuring of mortgage loans.

3. Although there has been more emphasis on reducing payment burdens recently, voluntary mortgage modifications are not consistently reducing monthly payment burdens. Only 35% of modifications in the November 2008 report reduced monthly payments below the initial payment, while 20% left the payment the same and 45% increased the monthly payment.

4. The variations among servicers in the number and quality of modifications are enormous. The chance of homeowners receiving a beneficial modification varies widely depending on which servicer happens to administer their mortgage. This variation suggests that not every servicer is doing the maximum possible to reach and work out terms with every defaulted borrower.

5. Fewer than 50% of modifications made in January 2008 were current in payments on November 25, 2008. There were not enough modifications with payment or principal reductions in the January data to evaluate whether more aggressive modifications performed better.

6. Many modifications are temporary. The FDIC template for Indymac modifications encourages this approach, by adjusting interest rate and amortization term, only for five years, with rate and payment increases after five years. Servicers also use balloon payments and other forms of deferrals in order to reduce payments without reducing total debt. Thus, the totals reported by the industry include many loans that are being modified to include deferred payment shocks, negative amortization or other non-amortizing features of the sort that caused the foreclosure crisis.

7 Moral hazard and informal forbearance: significant numbers of mortgage loans are seriously delinquent, but not in a modification program or in foreclosure. In the November 2008 data file there were more than 120,000 loans more than 120 days past due but not in foreclosure, compared with about 21,000 modifications and 300,000 in foreclosure (or bankruptcy). The fact is that the foreclosure crisis is overwhelming the ability of servicers to either restructure or foreclose on all the delinquent loans.

For full text of August report go to <http://ssrn.com/abstract=1259538>.