

**Questions to Dr. Roberto Quercia, Professor and Director, Center for
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Re a hearing of

The Subcommittee on Housing and Community Opportunity

“Examining the Making Home Affordable Program”

On March 19, 2009

1. Your testimony notes that the lack of guidelines and standards for principal reduction may limit or discourage the use of this successful tool to keep people in their homes. What would you suggest in terms of guidelines and standards in this regard? What would your ideal principal reduction framework look like?

The President's plan mentions the use of principal reduction as a last resort. It is our understanding that under the President's plan, principal reduction should be considered if other means of making a mortgage payment affordable do not bring payments down to a reasonable level. The plan is very explicit on how to use rate reductions and term extensions, but provides little clarity on the principal reduction approach.

When borrowers have some equity in their homes, rate-reduction or term-extension can lower the mortgage payment enough to keep them in their homes.

However, the current crisis is characterized by the pervasiveness of so called homeowners “underwater.” Our research and the literature have demonstrated default rates are extremely sensitive to whether borrowers have real equity in their homes. At a minimum, we believe that principal reduction should be encouraged along with other forms of loan modifications. Use of principal reduction could be based on net present value (NPV) calculations. When deciding among types of modifications, short term affordability should be considered along with reducing long term re-default risks.

Thus, the key question is whether the expected future losses are lower when relying on principal reduction than those resulting from other types of loan modifications. If the answer is lower with principal reduction, then principal reduction should be implemented.

In our research, we found that, compared to rate reductions, a loan modification with principal forgiveness has a lower re-default rate and in many cases it increases the net present value for investors.

Ideally, for those with little or negative equity in their properties, some combination of rate reduction and principal reduction or forbearance will be the most effective tool to keep people in their homes. In order to increase borrowers’

willingness to repay the modified loan and allow them to refinance/move if possible, principal forgiveness should be significant enough to help borrowers have some equity in their properties.

Under the President's plan, the payment reduction subsidy is based on affordability considerations, even in the event of principal forgiveness. However, compared to a rate-reduction modification, principal reduction involves an actual write-down of the value of the mortgage on the banks' books. This is one important reason why many banks are reluctant to do principal reduction loan modifications. We strongly encourage the government to develop a detailed guideline for principal reduction and provide some additional subsidy for loan modifications with a significant principal reduction.

More broadly, even for loans modified by ways other than principal reduction, principal reduction should be a consideration after a period of time, say five years, when borrowers want/need to refinance, or earlier if/when they need/want to move. If at that time, borrowers are still underwater, the principal should be reduced to the market value of the property. In particular, this should be the case for many borrowers with subprime loans.

Finally, bankruptcy reform that gives judges power to restructure mortgages and reduce mortgage payments should provide significant incentive to servicers to seriously consider principal reduction as an effective means of loan modification. Bankruptcy reform should be a key priority as most borrowers facing hardship with their mortgage payments are also facing hardship paying other expenses as well, for example credit card, car loan, medical, student loan, and utilities bills,

2. Can you expand upon what you noted about tailoring modifications to individual borrowers and unique housing markets? What kinds of situations are you thinking of? Many analysts have noted that the standardized modification process in the President's plan is a good thing – how would you build off of that to better fit individual circumstances?

The government's plan aims to standardize the modification process, allowing borrowers to get fair access to timely and consistent loan modifications. Our study findings confirm that one key component to making modified loans more sustainable is that the mortgage payments are reduced enough to be truly affordable to the borrowers. The current plan which focuses on rate reduction and payment relief should address the problem for many troubled borrowers.

However, we also found that the type of loan modification has substantial impact on the performance of modified loans and that modifications should be better tailored to specific borrowers in specific markets. For instance, government, servicers, and investors should develop clear guidelines for different types of borrowers, taking into consideration borrower FICO scores, debt-to-income ratios (DTI), and loan-to-value ratios (LTV), payment affordability, and the local market conditions.

Since our earlier study, we have done additional work in this area. We identified three types of housing markets in the country. We estimated the re-default risks associated with different types of loan modifications in each of these markets. Not surprisingly, we found that the re-default risks associated with specific types of modifications differ by market. For example, even the same type of modification, say rate reduction, exhibits a higher re-default risk in some markets, like California, Nevada, Florida and Arizona, than in others.

In addition, we were able to compare the impacts of increasing mortgage payment affordability using different types of modification. Thus, for example, for a typical borrower with negative equity and a debt to income ratio of about 50 percent prior to modification, a combination of rate reduction and principal reduction that brings payment to 31 percent minimizes losses over time. In contrast, for a similar borrower who has a debt to income ratio of just 40 percent prior to a modification, lowering their payment through principal reduction exclusively minimizes losses the most. We also found that relative effectiveness of principal reduction and rate reduction may vary across different markets and a modification with principal reduction is generally preferred in markets with more subprime mortgages and greater house price decline.

Overall, the additional research confirms that tailoring loan modifications to the specific characteristics of the market and the borrower has the highest likelihood of succeeding in the long run. Our simplified analysis suggests that it is possible to develop a set of criteria to guide loan modifications that make an active use of all options, including principal reduction.

3. Your research noted that the timing of the loan modification matters – early intervention can decrease the risk of re-default. Does your research include households that were targeted for modifications before they were delinquent? Are you referring to 30 days delinquent versus 90 days delinquent?

Yes, we include households that were targeted for modifications before they were delinquent, as well as those in different delinquency statuses (30, 60 and 90 days).

4. Do you believe the President's plan targets homeowners early enough? As you know, homeowners must show that they are either delinquent or face imminent hardship. Would you change anything with regard to this aspect of the plan?

We think the President's plan targets homeowners early enough so the key is the servicers' implementation of this guideline. This is because the program is driven by the servicer's actions and not the borrower's. The servicers need to approach the troubled borrowers proactively, especially those who are facing an imminent risk of default. Bankruptcy reform along the lines described above would provide a strong encouragement to servicers to consider all modification options proactively.

5. What kind of research and data do you and others need, going forward, to keep analyzing what works and what doesn't work in terms of loan modifications. What types of research questions do you suggest government agencies undertake?

The OCC, OTS, Treasury and GSEs have been collecting very detailed information on loan modifications. We encourage these agencies to make the data publicly available to researchers. Such data can certainly be made available without compromising privacy of borrowers or financial institutions. Allowing more researchers access to such data would advance the understanding of issues and solutions, in a very cost-effective manner.

Access to some large datasets such as Loan Performance and Lender Processing Services (LPS, formerly McDash) data can also be used to help benchmark the performance of modified loans to the industry overall. These are proprietary and expensive datasets to access. Why does the government have to pay for such data? Why is the information not in the public domain?

6. In your opinion, what are the obstacles to implementing more effective types of loan modifications, similar to the ones addressed in your testimony?

There are several obstacles to implementing more effective loan modifications.

First, there has been a lot of uncertainty about the market and about likely government action. When this occurs, market players tend to wait for clarity before acting. Players may have waited to see the depth of the crisis before considering whether loan modifications are more desirable than the foreclosure path. They may also wait to see if additional or alternative government policy may be more beneficial to them than the current policy. Until players get a better sense of emerging market trends and the permanency of government policy, they may not adopt loan modifications aggressively.

A second obstacle is the banks' reluctance to write down principal. They have concerns that if house prices were to fall further they need to write down again but if house prices rise subsequently, they could not share the gain. Of course, a rate reduction modification is also susceptible to additional pressure to write-down again when house prices continue to fall. Adoption of a NPV calculation of likely long term losses under all different modification options may help address this reluctance. As our research suggests, a reduction in principal can reduce the risk of foreclosure and may increase the expected payoff in many cases. Principal reduction should be considered along with other forms of loan modifications.

A third obstacle is the issue of securitization and PSAs. Mortgage servicers may be reluctant to modify loans because of fears of being held responsible for their action by bond holders. The servicers are afraid that bond holders may sue them if the contracts have restrictions on the kinds and numbers of loan modifications they can make. Most mortgage back investment instruments (MBS, CDOs, SIVs)

have credit enhancement that are supposed to make the investor whole in the case of a foreclosure. In these cases, the bond holder would have to agree to take less through a loan modification than the credit enhancement is expected to pay. For securitized loans in bond without credit enhancement modification could be more likely. Although there have been some clarification and liability protection regarding the issue of servicer liability in recent legislation, market participants may be waiting for a legal test of these new protections before embracing modifications full scale. Any additional clarity that can be provided will be helpful.

Fourth, the issue of securitization becomes even more complex when second liens are in place. There is nothing in the President's plan or elsewhere that provides incentives to second lien holders to agree to a modification. A few months ago, it was estimated that 8.9 million borrowers with both first and second mortgages were underwater or almost underwater. This presents a difficult problem to solve, especially with credit enhancements in place, unless second lien holders are strongly encouraged or forced to modify loans.

A solution to the problem of securitization and second liens is bankruptcy reform. Allowing judicial modification of first and second mortgage loans would allow judges to deal with the legal quagmire faced by servicers in many instances where there is a securitized first lien and/or a second line.

Five, related to the points above, there are lack of guidelines about important aspects of loan modifications. For instance, there is a lack of guidelines to deal with second liens and the provision of appropriate incentives for more effective loan modification alternatives, such as principal reduction. Servicers are paid the same regardless of what modification they implement.

Last, but certainly not least, even in the absence of the above obstacles, we believe that there is a lack of capacity in the servicing industry to undertake the large number of loan modifications required. With limited available resources, and some perceptions about investor resistance, servicers are likely to prioritize the loans they service for their own portfolio over loans with mortgage insurance, those securitized with the GSE's or in private MBS, and those serviced for others.

7. Is more data and research necessary to better understand the magnitude of the foreclosure crisis and the impact of different types of loan modifications?

Definitely. Things have been changing rapidly. Since 2008, servicers have started to implement large scale modification programs. The crisis has impacted the housing markets in different ways. The policy environment is changing rapidly. All these factors make the collection of data and more research needed to understand what type of specific loan modification are most effective where.

8. What kind of oversight and evaluation metrics should be used to assess the success of the program?

We did not examine these issues in our research. However, we concur strongly with Andrew Jacobovic's testimony at the same hearing calling for development of early indicators or benchmarks. It is not necessary to wait a year to find out if the program has helped anyone. One suggestion for developing and tracking such benchmarks is to build off servicer performance monitoring systems such as S&P's SEAM system. A handful of straightforward metrics could be used to measure implementation and also to benchmark servicers to identify best and worst practices.

9. What measures do you recommend to prevent for-profit mortgage servicers from defrauding borrowers?

We did not examine these issues in our research.