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Fair Game

Why Treasury Needs a Plan B for Mortgages

By GRETCHEN MORGENSON

AFTER months of playing pretend, the Treasury Department conceded last week that the Home Affordable Modification Program, its plan to aid troubled homeowners by changing the terms of their mortgages, was a dud. The 10-month-old program is going nowhere, the Treasury said, because big institutions charged with implementing it are dragging their feet.

“The banks are not doing a good enough job,” said Michael S. Barr, assistant Treasury secretary for financial institutions, in an article published last Sunday in The New York Times.

After the government spent hundreds of billions of dollars bailing out banks, the Obama administration rolled out the $75 billion loan modification plan to show its support for beleaguered homeowners. But if the proof of the pudding is in the eating, homeowners are going hungry.

A stalled loan modification plan might not be worrisome if the foreclosure crisis were abating. Yet at the end of September, a record 14.4 percent of borrowers were either in foreclosure or delinquent on their mortgages, the Mortgage Bankers Association reported.

It’s time for the government to acknowledge the flaws in its program and create one that might actually succeed. Only then will the supply of homes for sale, and the pressure on prices associated with that overhang, be reduced.

The Treasury program has decided to tackle the delinquent mortgage problem by reducing the interest rate on eligible borrowers’ loans to a level that makes monthly payments affordable. But how it calculates affordability is one of the program’s major flaws — at least that’s the view of Laurie Goodman, senior managing director at Amherst Securities Group and head of mortgage strategy at the firm.

Her research shows, for instance, that 70 percent of modifications involving only interest rate cuts, rather than reductions in the principal borrowers owe, have failed after 12 months. The Treasury program is likely to have similar outcomes.

According to government investigators, the average monthly mortgage payment for a borrower under early plan modifications fell by 34 percent. Assessing for possible success under these terms, Ms. Goodman analyzed past redefault rates on modifications that cut payments by 34 percent. She found that 65 percent of borrowers fell back into delinquency.

The terms of loan modifications also make them especially failure-prone because the government calculates "affordability" (how much mortgage debt a borrower can actually manage) in a highly unusual way — raising serious questions for the housing market over all and for the program's effectiveness for borrowers.

Moreover, investors in first liens, like pension funds and mutual funds, also get beaten up in this process.

For example, in devising what it considers an affordable mortgage payment, the program doesn't account for all of a borrower's debts — the first mortgage, second lien, credit card debt and automobile payments. Instead, it calculates affordability using only the borrower's first mortgage payment, insurance and property taxes.

As a result, what may look like an affordable mortgage payment under the Treasury plan quickly becomes onerous when other debt is added. While the government may ignore a borrower's second lien and revolving credit obligations, you can be sure the creditors that extended those loans will not. Redefaults seem a likely result.

Another flaw in the program, Ms. Goodman said, is its failure to consider how much equity, or negative equity for that matter, the borrower has on a property. She said that while many analysts contend that unemployment is the major predictor of mortgage defaults, her research shows that negative equity, when a borrower owes more on the home than it is worth, is actually the driving force.

Ms. Goodman recently compared the experiences of prime mortgage borrowers living in areas with an 8 percent unemployment rate. Those with at least 20 percent equity in their properties were falling two payments behind for the first time at a rate of only 0.22 percent a month. But the same 60-day delinquency rate for those who owed at least 120 percent of the value of their homes was 1.46 percent a month.

“We have kicked the problem down the road through modifications that don’t work,” Ms. Goodman said in an interview last week. “You have to address the second liens and ultimately have some type of principal write-down program so borrowers can re-equify.”

Unfortunately, there is a $442 billion reason that wiping out second liens is not high on the government’s agenda: that is the amount of second mortgages and home equity lines of credit on the balance sheets of Bank of America, Wells Fargo, JPMorgan Chase and Citigroup.

These banks — the very same companies the Treasury is urging to modify loans that they service — have zero interest in writing down second liens they hold because it would mean further damage to their balance sheets.

Say a troubled borrower has a first mortgage owned by a pension fund in a securitization trust and a second lien held by the bank that services the loans. The servicer is happy to modify the first mortgage under the Treasury program because the pension fund holding that loan takes the biggest hit while the second lien is untouched. This hurts the investor who holds the first mortgage and the borrower, who must pay off the second lien, which typically has a significantly higher interest rate.

The result? Yet another conflict of interest enriching financial companies while impoverishing investors and consumers.

AN interesting data point: when banks do own all the mortgages on a property they seem to see the merit in principal reduction modifications. Studying second-quarter government data, the most recent available, Ms. Goodman found that when banks owned the loans, 30.5 percent of modifications reduced principal balances.

When they service someone else’s loan or hold a second lien on the property, they rarely allow principal reductions.

Of course, cries of moral hazard will erupt if borrowers get large cuts in their principal balances. Rightly so. Why should those who took on too much debt to buy too much house get rescued when those who were prudent go unrewarded?

But doing nothing also has hazards, the most obvious being continuing foreclosures, which nobody wants, and further declines in real estate prices that will hurt homeowners as well as investors.