

BARRIERS TO FORECLOSURE PREVENTION DURING THE FINANCIAL CRISIS

Patricia A. McCoy^{*}

The number of modifications to distressed residential loans following the 2008 financial crisis has been disappointingly low compared to the number of foreclosures. This raises concerns about the presence of artificial barriers to loan modifications in situations where foreclosure should be avoidable. There are three pressing reasons to care about what the real barriers to foreclosure prevention are. First, foreclosures that could have been avoided inflict enormous, needless losses on borrowers, investors, and society at large. Second, overcoming artificial barriers to foreclosure prevention will result in loan modifications with higher rates of success. Finally, knowing what to fix is necessary to identify the right policy solution.

Numerous theories have been advanced for the relatively low level of modifications, including: restrictions on loan modifications in private-label servicing agreements, threats of lawsuits by private-label investors, servicer compensation arrangements, the high cost of loss mitigation, accounting rules, junior liens, and tax considerations. This Article concludes that servicer compensation coupled with the costly nature of loan workouts, accounting standards, and junior liens form the biggest impediments to an efficient level of loan modifications. These factors also tilt the mix of loan modifications toward types of modifications with higher redefault rates. Other explanations, such as servicing agreement restrictions, tax consequences, and the threat of lawsuits, are either not at play or are of second order importance.

^{*} Connecticut Mutual Professor of Law and Director of the Insurance Law Center at the University of Connecticut School of Law. The Author was the Assistant Director for Mortgage Markets at the Consumer Financial Protection Bureau in 2011, where she oversaw the Bureau's mortgage policy initiatives. The Author thanks the Pew Charitable Trusts and the Joint Center on Housing Studies at Harvard University for their generous support and for hosting her presentations of earlier versions of this work at symposia.

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INTRODUCTION

Since housing prices fell nationwide in 2007, triggering the financial crisis, the U.S. housing market has struggled to dispose of the huge ensuing inventory of foreclosed homes. In January 2013, 1.47 million homes were listed for sale.¹ Another 2.3 million homes that were not yet on the market—the so-called “shadow inventory”—were in foreclosure, held as real estate owned or encumbered by seriously delinquent loans. Discouragingly, the size of the shadow inventory has not changed significantly since January 2009.²

Reducing the shadow inventory is key to stabilizing home prices. One way to trim it is to accelerate the sale of foreclosed homes, thereby increasing the outflow on the back-end. Another way is to prevent homes from entering the shadow inventory to begin with, through loss mitigation methods designed to keep struggling borrowers in their homes. Not all distressed borrowers can avoid losing their homes, but in appropriate cases—where modifications can increase investors’ return compared to foreclosure and the borrowers can afford the new payments—loan modifications can be a winning proposition for all.

This Article analyzes the progress of foreclosure prevention over the past six years, with a focus on loan modifications. Since mid-2007, the federal government has devoted enormous effort and sums of money to foreclosure prevention. Washington’s approach to rising foreclosures evolved over time. In the first iteration, the government confined its efforts to convening private actors and encouraging them to coordinate their loss mitigation efforts. In the second iteration, starting with President Obama, the government augmented that approach with subsidies for loan modifications. To a lesser degree, the Obama administration also attempted to increase the cost of rushing to foreclosure to servicers.

The results have been mixed. Under the George W. Bush administration, two successive programs to refinance distressed loans into Federal Housing Administration (“FHA”) loans proved to be a failure. In December 2009, the Obama administration’s ambitious program to increase loan modifications stumbled when the government revealed that most temporary modifications failed to graduate into permanent modifications. While the graduation rate has since improved, the level of permanent modifications remains well below what policymakers had aimed for. This raises concerns about the existence of artificial barriers to loan modifications in situations where foreclosure should and could be avoided.

1. Calculations made by author based on national housing data reported in February 2013. See Lexie Puckett, *Spring Home Buying Season Off to Early Start*, REALTOR.COM (Mar. 14, 2013), <http://www.realtor.com/blogs/2013/03/14/spring-home-buying-season-starts-early/>.

2. Press Release, CoreLogic, CoreLogic Reports Shadow Inventory Down 28 Percent From 2010 Peak, 1–2 fig.1 (Mar. 26, 2013), available at <http://www.corelogic.com/downloadable-docs/shadow-inventory-report-q4-2012.pdf>.

There are numerous theories as to what those barriers are. Some fault restrictions on loan modifications in private-label servicing agreements, while others point to threats of lawsuits by private-label investors. Servicer compensation arrangements, the high cost of loss mitigation, accounting rules, junior liens, and tax considerations have also been singled out for blame. This Article evaluates those theories and determines that servicer compensation together with the high cost of loan workouts, accounting standards, and junior liens are the biggest impediments to efficient levels of loan modifications. These factors also tilt the types of loan modifications that are made toward modifications with higher redefault rates. Other explanations, such as servicing agreement restrictions, tax consequences, and the threat of lawsuits, either are not at play or are of second-order importance.

There are three pressing reasons to care about what the real barriers to foreclosure prevention are. First, foreclosures that could have been avoided inflict enormous, needless losses on borrowers, investors, and society at large. Second, overcoming artificial barriers to foreclosure prevention will result in loan modifications with higher rates of success. Finally, knowing what to fix is necessary to identify the right policy solution.

Three basic reforms are needed to relieve the impediments to foreclosure prevention. The first involves our broken system of mortgage servicing. That system is the product of skewed compensation incentives, and reforming servicer compensation needs to take top priority in policies to strengthen foreclosure prevention. In the future, servicers need to be paid less for servicing performing loans and more for doing loss mitigation whenever efficient.

The second reform addresses the obstacles that junior liens and accounting considerations pose to constructive loss mitigation. These two problems together drive home the need for regulators and accountants to require banks to take prompt write-downs of distressed loans. Mark-to-market accounting will help dismantle the incentives for banks to resist permanent loan modifications. Write-offs of worthless junior liens will also remove the impediments to workouts that many of those liens pose.

Finally, it is time to revise investor servicing agreements and guidelines to institutionalize the lessons from servicing reforms that worked. In particular, pooling and servicing agreements and servicing guidelines need to incorporate the standardized waterfall approach of the Home Affordable Modification Program (“HAMP”), the importance of early intervention, and the importance of lowering monthly payments, particularly through principal reduction. These changes will go far to address the stark differences that currently exist among servicers in their individual foreclosure prevention efforts. The anticipated reform of the nation’s housing finance system, moreover, presents a rare and historic opportunity to implement these changes industry-wide.

Part I opens by exploring the rationales for foreclosure prevention. In Part II, the Article chronicles the history of foreclosure prevention initiatives from 2007 to date. Part III describes the disappointing track record of those initiatives. In Part IV, the Article turns to its main task, which is to analyze which of the competing hypotheses actually explain the barriers to an optimal level of loan modifications.

Part V closes by discussing the larger implications of this analysis for policy reform.

I. RATIONALES FOR FORECLOSURE PREVENTION

During the financial crisis, policymakers advanced two main justifications for foreclosure prevention: first, the economic self-interest of investors, and second, minimizing the harmful spillover effects to society from foreclosures.³

Interestingly, redressing wrongs to injured borrowers was not a central rationale for loss mitigation, mostly due to concerns that protracted legal proceedings to resolve alleged wrongs to borrowers would have mired the loss mitigation process in protracted delays. Backlash against borrowers who defaulted on their loans also played a role.⁴

A. Potential Benefits to Investors and Other Holders

Most observers agree that under the right circumstances, investors can reduce their losses on distressed home loans by agreeing to workouts instead of proceeding to foreclosure.⁵ Loss severities on subprime residential foreclosures average around 50% and can be even higher for loans with steep initial loan-to-value ratios or declining property values.⁶

3. See, e.g., BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE U.S. HOUSING MARKET: CURRENT CONDITIONS AND POLICY CONSIDERATIONS 1–2 (2012) [hereinafter FED. RESERVE, WHITE PAPER], available at <http://www.federalreserve.gov/publications/other-reports/files/housing-white-paper-20120104.pdf>; John Kiff & Vladimir Klyuev, *Foreclosure Mitigation Efforts in the United States: Approaches and Challenges*, INT'L MONETARY FUND, 7–8, 14 (2009), <http://www.imf.org/external/pubs/ft/spn/2009/spn0902.pdf>.

4. Federal Reserve Chairman Ben Bernanke repeatedly took pains to counteract that backlash, stressing that foreclosures injure neighborhoods and communities, regardless of who is to blame. FED. RESERVE, WHITE PAPER, *supra* note 3, at 1–2; see also Kiff & Klyuev, *supra* note 3, at 14.

5. See, e.g., Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Speech at the Federal Reserve System Conference on Housing and Mortgage Markets, Washington, D.C.: Housing, Mortgage Markets, and Foreclosures (Dec. 4, 2008), <http://www.federalreserve.gov/newsevents/speech/bernanke20081204a.htm>.

6. See, e.g., *id.*; Dennis R. Capozza & Thomas A. Thomson, *Subprime Transitions: Lingering or Malingering in Default?*, 33 J. REAL EST. FIN. ECON. 241, 241 (2006); Shaila Dewan, *U.S. Agency to Sell Off Loans to Stem Foreclosures*, N.Y. TIMES, June 9, 2012, at B4 (reporting FHA loss severities of 64%); Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang & Eileen Mauskopf, *Designing Loan Modifications to Address the Mortgage Crisis and the Making Home Affordable Program 7* (Fed. Reserve Bd., Fin. and Econ. Discussion Series, Working Paper No. 2009-43, 2009) [hereinafter Cordell et al., *Designing Loan Modifications*], available at <http://www.federalreserve.gov/pubs/feds/2009/200943/200943pap.pdf>; Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang & Eileen Mauskopf, *The Incentives of Mortgage Servicers: Myths and Realities* 3, 11–12 (Fed. Reserve Bd., Fin. and Econ. Discussion Series, Working Paper No.

This high loss severity results largely from the heavy deadweight costs attending foreclosure. The biggest deadweight costs are missed mortgage payments during the period leading up to foreclosure.⁷ In addition, the holder incurs assorted transaction costs during the course of foreclosure, including realtor commissions, legal fees, utilities, taxes, insurance, and maintenance. These costs can consume 10% to 15% of the loan balance. Finally, foreclosed homes sell at a 27% discount on average compared to normal homes, due to the fire sale nature of liquidation, poor maintenance by distressed borrowers, and vandalism to vacant foreclosed homes.⁸

Loss mitigation can also improve investors' cash flow. Every time a delinquent borrower seeks to become current by making a mortgage payment, that payment boosts investors' net revenue. This effect is even more pronounced for subprime loans to the extent that borrowers pay premium rates on those loans.⁹ This potential revenue effect, combined with the high loss severities on distressed loans, creates room for investors and banks to cut their losses by agreeing to workouts of troubled loans.

B. Avoiding Harmful Spillover Effects

In tandem with investor welfare, avoiding harmful spillover effects to society from foreclosures is the other major reason for loss mitigation programs. This objective gained urgency in 2007 as falling housing prices dragged down the larger economy.

Starting in 2007, the national decline in home prices created a negative feedback effect that triggered, and then exacerbated, the ensuing recession.¹⁰ As housing prices dropped, more and more homeowners found themselves in a negative equity position after the value of their homes fell below the balances on their mortgages. During the housing boom, many of these households had taken out loans with little or nothing down, including subprime or exotic adjustable-rate mortgages ("ARMs")¹¹ with payments that were ultimately unmanageable. Once their home equity evaporated, "underwater" borrowers who had difficulty making payments discovered that they could not refinance or sell their homes for enough

2008-46, 2008) [hereinafter Cordell et al., *Myths and Realities*], available at <http://www.federalreserve.gov/pubs/feds/2008/200846/200846pap.pdf>.

7. Generally, servicers are contractually obliged to advance principal and interest to the trust pending foreclosure. Once a foreclosure proceeds to sale, however, servicers can recoup those advances from the sale proceeds. Cordell et al., *Myths and Realities*, *supra* note 6, at 11.

8. John Y. Campbell, Stefano Giglio & Parag Pathak, *Forced Sales and House Prices*, 101 AM. ECON. REV. 2108, 2110, 2117-2121 (2011); *see also* Bernanke, *supra* note 5; Cordell et al., *Myths and Realities*, *supra* note 6, at 11-13; Cordell et al., *Designing Loan Modifications*, *supra* note 6, at 6-8.

9. Capozza & Thomson, *supra* note 6, at 243.

10. Kiff & Klyuev, *supra* note 3, at 4-5.

11. Most notably hybrid 2/28 or 3/27 ARMs, interest-only ARMs, and option payment ARMs.

money to retire their loans. The result was a sharp spike in residential mortgage delinquencies and foreclosures.¹²

Mounting foreclosures further depressed housing prices. On the demand side, foreclosures fueled tighter credit requirements as banks raised their underwriting standards to avoid more delinquencies.¹³ Losses from foreclosures also eroded bank capital, constraining their capacity to lend. The resulting dearth of credit stifled buyer demand for houses.¹⁴ By early 2012, U.S. housing prices had fallen 33% since their 2006 high, wiping out about \$7 trillion in household equity. It was the nation's most severe housing price decline since the Great Depression.¹⁵

Foreclosures also had supply side effects. As foreclosures flooded the market, those homes sold at steep discounts, depressing home prices. Foreclosed properties lower the values of nearby homes by anywhere from 1% to 9%.¹⁶ That, in turn, can reduce property tax revenues on neighboring homes.¹⁷

Eventually, the severely depressed property values pulled down the larger economy. As households became unable to tap their home equity to spend, consumer purchases declined.¹⁸ Consumption fell and employers laid off workers,

12. See, e.g., Maureen Maitland, *First and Second Mortgage Default Rates Fall in February 2012*, HOUSING VIEWS (March 20, 2012, 11:45 AM), available at <http://www.housingviews.com/2012/03/20/first-and-second-mortgage-default-rates-fall-again-in-february-2012/>. Negative equity also harmed job mobility. Some underwater borrowers had to turn down job offers in other cities because they could not sell their homes for enough to retire their mortgages. Fernando Ferreira, Joseph Gyourko & Joseph Tracy, *Housing Busts and Household Mobility*, 68 J. URB. ECON. 34, 43–44 (2010); Fernando Ferreira, Joseph Gyourko & Joseph Tracy, *Housing Busts and Household Mobility: An Update* (Fed. Res. Bank of N.Y., Staff Report No. 526, 2011), available at http://www.newyorkfed.org/research/staff_reports/sr526.pdf (owners with negative equity were 25% to 30% less likely to move than comparable homeowners with positive equity).

13. See, e.g., BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE APRIL 2009 SENIOR LOAN OFFICER OPINION SURVEY ON BANKING LENDING PRACTICES 1 (2009), available at <http://www.federalreserve.gov/boarddocs/snloansurvey/200905/fullreport.pdf>.

14. See, e.g., FED. RESERVE BANK OF ATLANTA, *Housing May Have Finally Turned Around in 2012*, in 2012 ANNUAL REPORT (2013), available at <http://www.frbatlanta.org/pubs/annualreport/12ar/housing.cfm>.

15. See FED. RESERVE, WHITE PAPER, *supra* note 3, at 3.

16. See, e.g., Kiff & Klyuev, *supra* note 3, at 5; Campbell et al., *supra* note 8, at 2111, 2124–29; John P. Harding, Eric Rosenblatt & Vincent Yao, *The Contagion Effect of Foreclosed Properties*, 66 J. URB. ECON. 164, 165 (2009); Dan Immergluck & Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, 17 HOUSING POLICY DEBATE 57, 69 (2006).

17. Vacant foreclosed homes also generate negative externalities in the form of squatters, vandalism, and crime, sending neighborhoods into tailspins and requiring higher municipal outlays for police and social services. Kiff & Klyuev, *supra* note 3, at 13; Bernanke, *supra* note 5, at 3.

18. See MARTIN H. BAILY ET AL., MCKINSEY & CO., WILL US CONSUMER DEBT REDUCTION CRIPPLE THE RECOVERY?, 3, 5–7 (2009), available at http://www.mckinsey.com/insights/global_capital_markets/able_Modification_Program.pdf.

causing household incomes to contract.¹⁹ Shrinking paychecks and falling house prices forced more households—including growing numbers of prime borrowers—to default on their mortgages after they could not make their loan payments and could not sell their homes for the balance of their mortgages.²⁰ By the end of 2009, serious delinquencies had skyrocketed. In December 2009, 7.01% of all prime mortgages were 90 days delinquent or more, compared to 3.74% in December 2008. Over that same period, the percentage of subprime mortgages that were 90 days delinquent or more soared from 23.11% to 30.56%.²¹ Meanwhile, foreclosure inventories rose to new highs, further depressing home prices. Beginning in early 2010, serious mortgage delinquencies and foreclosures slowed and continued to decrease. However, the amount of foreclosure inventory remained high as of January 2013.²² Almost one million homes in some stage of foreclosure were sold during 2012, and 43% of all home sales that year were distressed sales.²³ Starting in 2007, the devastating level of foreclosures after the burst of the housing bubble exerted pressure on the federal government to increase foreclosure prevention efforts.

II. FEDERAL FORECLOSURE PREVENTION POLICIES

Foreclosure prevention seeks to break the negative feedback loop between falling property values and foreclosures by keeping borrowers in their homes and restoring them to current status on their loans. Starting in 2007, the federal government cycled through three basic models for achieving foreclosure prevention. The first model consisted of convening market actors to coordinate and facilitate foreclosure prevention by private industry. Second, the government offered subsidies to induce foreclosure prevention. Third, the government took specific actions to increase the costs to market participants of pursuing unnecessary foreclosures.

For the most part, during the recent economic crisis, the federal government pursued the first and second models, with sparing use of the third. At any given point during the crisis, the model that was chosen depended on the

19. See, e.g., FED. RESERVE, WHITE PAPER, *supra* note 3.

20. See, e.g., *id.* at 5.

21. Press Release, Mortg. Bankers Ass'n, Delinquencies, Foreclosure Starts Fall in Latest MBA National Delinquency Survey (Feb. 19, 2010), <http://www.mortgagebankers.org/newsandmedia/presscenter/71891.htm>.

22. Press Release, CoreLogic, *supra* note 2, at 1–2 fig.1; see also LENDER PROCESSING SERVICES, LPS MORTGAGE MONITOR: MAY 2013 MORTGAGE PERFORMANCE OBSERVATIONS 18 (2013), <http://www.lpsvcs.com/LPSCorporateInformation/CommunicationCenter/DataReports/MortgageMonitor/201305MortgageMonitor/MortgageMonitorMay2013.pdf>; U.S. DEP'T OF HOUS. & URBAN DEV. & U.S. DEP'T OF THE TREASURY, THE OBAMA ADMINISTRATION'S EFFORTS TO STABILIZE THE HOUSING MARKET AND HELP AMERICAN HOMEOWNERS 3 (2013), http://portal.hud.gov/hudportal/documents/huddoc?id=MayNat2013_Scd_FINAL.pdf.

23. See, e.g., *Non-Foreclosure Short Sales Increase 4 Percent, Account for 22 Percent of All Sales*, REALTYTRAC.COM (Feb. 26, 2013), <http://www.realtytrac.com/content/foreclosure-market-report/us-foreclosure-and-short-sales-report-year-end-and-q4-2012-7609>.

primary objective—refinancing or loan modification—and the administration that was in power.

The federal government’s policy on foreclosure prevention evolved with the diagnosis of the underlying problem. Initially, policymakers were mainly concerned about the payment shock from impending rate resets on hybrid ARMs, interest-only ARMs, and option ARMs.²⁴ After ARM indices such as the London Interbank Offered Rate (“LIBOR”) plunged in the fall of 2008,²⁵ however, concerns about payment shock diminished and attention turned to rising unemployment and its contribution to mounting delinquencies. Starting in late 2010, vigorous debate ensued over the role of negative equity in decisions to default and the best way to address that problem.

A. Refinance Programs for Delinquent Borrowers

During the summer of 2007, the private-label market for residential mortgage-backed securities (“RMBS”) crashed, setting the stage for a tsunami of foreclosures. Once private-label financing vanished, many financially stressed borrowers were no longer able to refinance their loans. The paucity of refinance options was especially severe for borrowers with delinquent or underwater loans. With no way to escape impending rate resets on their ARMs or to reduce their household expenses by selling their homes and paying off their mortgages, millions of households were soon in default.

After private-label financing was no longer an option, the federal government initially sought to stave off foreclosures by refinancing some delinquent mortgages into FHA-insured loans. The first major refinance program was FHA Secure, which the George W. Bush administration launched in August 2007. Under FHA Secure, borrowers who faced high payment shock from imminent rate resets on subprime adjustable-rate loans were given the opportunity to refinance into FHA-insured fixed-rate loans. Participation by servicers was voluntary, but servicers shunned the program because, for borrowers to qualify, the servicer had to take a write-down of 3% or 10%, depending on the circumstances. Eventually, after only about 4,200 borrowers qualified for the loans, the federal government shut down the program at the end of 2008.²⁶

In October 2008, the Bush administration rolled out another refinance program, called Home for Homeowners (“H4H”). H4H was designed to refinance delinquent borrowers with underwater loans into FHA-insured mortgages. Again, under H4H, servicers had to first write down the principal, this time to no more

24. Adjustable-rate mortgages pose the risk that the interest rate on the mortgage could rise in tandem with the index tied to the loan. Such an interest-rate adjustment is known as a “rate reset.”

25. See, e.g., *LIBOR Rates: Historical Charts*, FEDPRIMERATE.COM, http://www.fedprimerate.com/libor/libor_rates_history-chart-graph.htm (last visited July 23, 2013).

26. See Cordell et al., *Designing Loan Modifications*, *supra* note 6, at 18; see also Michael Corkery, *Mortgage ‘Cram-Downs’ Loom as Foreclosures Mount*, WALL ST. J., Dec. 31, 2008, at C1.

than 96.5% (initially 90%) of appraised value. In addition, servicers had to pay a 3% upfront FHA insurance premium and waive prepayment penalties and late fees. Borrowers were required to share any future property appreciation at resale with the FHA. Like FHASecure, these terms were no more attractive to servicers than going to foreclosure. The program was an abysmal failure: By May 2009, only one borrower had been refinanced into an H4H loan.²⁷

These refinance programs were the main time the Bush administration offered subsidies²⁸ to promote foreclosure prevention. Nevertheless, both programs had a dismal track record because they depended on cooperation by servicers on unattractive terms. In both programs, the government tried to navigate competing goals without success. For instance, the government imposed the write-down requirements to avoid rewarding lenders for inflating the amounts of loans. But with participation voluntary, servicers were unwilling to swallow large and certain write-downs rather than gambling on foreclosure.²⁹ Similarly, the government made servicers, not borrowers, pay the FHA insurance premium on the usually correct assumption that distressed borrowers lacked that kind of cash. This hefty premium, along with the mandatory waiver of prepayment penalties and late fees, were an added reason why servicers shunned H4H refinancing.

The government had good reason to insist on these tough terms. Because housing values were continuing to decline, refinancing underwater loans at the full appraised value would have eventually saddled the government with unwanted losses while rewarding lenders and investors for making inflated loans. Nonetheless, nothing required servicers and investors to swallow the required write-downs and they refused to do so.

Given the mortgage industry's resistance to reducing principal, any future government refinancing program will confront hard choices.³⁰ For a voluntary

27. See Kiff & Klyuev, *supra* note 3, at 21–22; Cordell et al., *Designing Loan Modifications*, *supra* note 6, at 18–19; Renae Merle, *Face-Lift for Foreclosure Prevention*, WASH. POST, May 26, 2009, at A10. Congress subsequently amended the program in the Helping Families Save Their Homes Act in May 2009 to provide HUD greater flexibility in the program's design. HUD then modified the program to allow the holder of the loan to share in any future housing price appreciation. See Cordell et al., *Designing Loan Modifications*, *supra* note 6, at 19.

28. The federal government insures FHA loans, which operates as a subsidy to lenders who make those loans. In addition, disbursements exceeded revenues in fiscal years 2009 through 2012 for the FHA program, amounting to a further subsidy. See, e.g., U.S. DEP'T OF HOUS. & URBAN DEV., ANNUAL REPORT TO CONGRESS: FISCAL YEAR 2012 FINANCIAL STATUS, FHA MUTUAL MORTGAGE INSURANCE FUND 8, 32 (2012); U.S. DEP'T OF HOUS. & URBAN DEV., ANNUAL REPORT TO CONGRESS REGARDING THE FINANCIAL STATUS OF THE FHA MUTUAL MORTGAGE INSURANCE FUND 7 (2009); Jacob Goldstein, *Hidden Housing Subsidy May Soon Come Out of Hiding*, NPR PLANET MONEY (Nov. 16, 2012, 10:52 AM), <http://www.npr.org/blogs/money/2012/11/16/165207561/hidden-housing-subsidy-may-soon-come-out-of-hiding>.

29. Cordell et al., *Designing Loan Modifications*, *supra* note 6, at 19.

30. In March 2010, for example, the Obama administration announced a new set of liberalized FHA refinance rules for borrowers with underwater loans. Press Release, U.S.

program to work, the government would probably have to eliminate a principal write-down requirement. Alternatively, the government could compel servicers to sell loans to the government at a mandatory haircut and then refinance some or all of those loans into new FHA loans. That type of compulsion has not found support.

In 2009, the Federal Housing Finance Agency (“FHFA”) unveiled a new refinance program, called the Home Affordable Refinance Program (“HARP”). HARP targeted performing Fannie Mae and Freddie Mac borrowers who lacked sufficient equity to qualify for a traditional refinance.

In 2011, FHFA liberalized the program to eliminate or reduce loan level pricing adjustments that increased borrowers’ closing costs.³¹ Under this new version—known as HARP 2.0—the government-sponsored enterprises (“GSEs”) reduced the putback risk³² on certain HARP loans and eliminated the old loan-to-value ceiling of 125% that had discouraged HARP refinances for fixed-rate loans. With HARP 2.0, the take-up rate nearly doubled from fourth quarter 2011 to first quarter 2012.³³ As of November 2012, however, only 2.1 million mortgages had been refinanced in total through HARP.³⁴ This disappointing track record prompted President Obama to call for further expansion of HARP to private-label and jumbo borrowers in his State of the Union address in January 2013.³⁵

The President’s proposal—dubbed HARP 3.0—had yet to be enacted as of June 1, 2013. Meanwhile, HARP 2.0’s disappointing numbers reflect the fact that HARP does not assist delinquent borrowers. In addition, underwater borrowers who do not have Fannie Mae or Freddie Mac loans cannot avail themselves of HARP—even if they are current—and usually lack other refinance

Dep’t of the Treasury, Housing Program Enhancements Offer Additional Options for Struggling Homeowners (Mar. 26, 2010), <http://www.treasury.gov/press-center/press-releases/Pages/tg614.aspx> (last visited July 26, 2013).

31. See News Release, Fed. Hous. Fin. Agency, Federal Housing Finance Agency, FHFA, Fannie Mae and Freddie Mac Announce HARP Changes to Reach More Borrowers (Oct. 24, 2011), <http://www.fhfa.gov/webfiles/22722/HARP%20release%20102411%20Final.pdf>. Loan level pricing adjustments are added fees on specific loans to compensate for the higher risk profiles posed by individual borrowers. Lower credit scores and low down payments are some of the factors that can result in LLPAs. See Dan Green, *Explaining Loan-Level Pricing Adjustments*, THE MORTGAGE REPORTS (Mar. 22, 2011), <http://themortgagereports.com/2770/llpa-loan-level-pricing-adjustments>.

32. “Putback risk” refers to the risk that a lender will have to buy back a loan it sold to Fannie Mae or Freddie Mac due to violation of GSE guidelines. See, e.g., Ronald D. Orol, ‘Put-back’ Relief at Center of HARP Mortgage Fix, MarketWatch (Nov. 14, 2011, 4:11 PM), <http://www.marketwatch.com/story/put-back-relief-at-center-of-harp-mortgage-fix-2011-11-14>.

33. Tara Siegel Bernard, *Hope and Frustration in New U.S. Effort to Help Homeowners*, N.Y. TIMES, May 26, 2012, at B1.

34. U.S. DEP’T OF HOUS. & URBAN DEV. & U.S. DEP’T OF THE TREASURY, *supra* note 22, at 5.

35. See President Barack Obama, State of the Union Address (Jan. 27, 2013).

options in the private market. For them, in the absence of new congressional legislation, refinancing is generally not an option.

B. Loan Workouts

Federal programs encouraging loan workouts formed the other major approach to foreclosure prevention during the crisis. Under the George W. Bush administration, the federal government used moral suasion to try to prod servicers to modify distressed loans, to little avail. In contrast, the Obama administration offered subsidies to servicers to modify distressed loans.

During the early stages of the crisis, in 2007 and the first part of 2008, public policy was mostly concerned with impending rate resets on ARMs. Starting in December 2007, the American Securitization Forum responded by recommending a framework for voluntarily freezing interest rates on securitized subprime adjustable-rate mortgages.³⁶ Few if any servicers, however, adopted that framework.

As the crisis progressed, however, early payment defaults experienced a spike, making it clear that increasing numbers of homeowners could not afford their monthly mortgage payments even at the initial interest rates. Some of these loans were infected with fraud or were sloppily underwritten from the start,³⁷ especially reduced-documentation loans. The widening recession also took its toll. Between May 2007 and November 2009, unemployment soared from 4.4% to 10%.³⁸ Others who remained employed suffered lower wages due to reduced hours or pay cuts. By 2009, lost income surpassed all other reasons for seeking loan workouts, including rate resets and illness.³⁹ As this evidence amassed, it became

36. See AM. SECURITIZATION FORUM, STREAMLINED FORECLOSURE AND LOSS AVOIDANCE FRAMEWORK FOR SECURITIZED SUBPRIME ADJUSTABLE RATE MORTGAGE LOANS: QUESTIONS AND ANSWERS 1–4 (2007), available at: <http://www.americansecuritization.com/uploadedFiles/ASFStreamlinedFrameworkQA121707.pdf>.

37. See, e.g., Paul Carrillo, Fools or Crooks: Testing for Fraud in the Residential Mortgage Market 2 (unpublished manuscript) (Dec. 2009), available at <http://business.gwu.edu/creua/research-papers/files/fools-or-crooks.pdf>.

38. See *Labor Force Statistics from the Current Population Survey: Seasonal Unemployment Rate*, BUREAU OF LABOR STATISTICS, <http://data.bls.gov/timeseries/LNS1400000> (search from 2003 to 2013) (last visited July 30, 2013).

39. The Treasury Department reported that in 2009, lost income was the single biggest reason why borrowers sought loan workouts under the Obama administration's Making Home Affordable program. Roughly half of all borrowers who received permanent loan modifications under that program did so due to loss of income. By January 2013, that percentage had increased to 68%. U.S. DEP'T OF THE TREASURY, MAKING HOME AFFORDABLE: PROGRAM PERFORMANCE REPORT THROUGH JANUARY 2013 7 (2013) [hereinafter U.S. DEP'T OF THE TREASURY, MHA: PROGRAM PERFORMANCE REPORT THROUGH JAN. 2013], available at <http://www.treasury.gov/initiatives/financial-stability/reports/Documents/January%202013%20MHA%20Report%20Final.pdf>.

increasingly clear that lower monthly payments were essential to successful loan workouts.⁴⁰

When loans become delinquent or in danger of default, servicers have a variety of workout techniques to resolve those loans short of foreclosure.⁴¹ This large choice of options gives servicers discretion about which technique to use.

Like refinancing, some workout techniques allow the homeowner to retain ownership of the home. Of those, some lower monthly payments, while others do not. *Capitalization* takes the borrower's arrears and tacks them onto the principal, thereby increasing the monthly payments, either immediately or later on. When capitalization includes *forbearance*, the servicer temporarily lowers the borrower's monthly payments but adds the forbore sums to the loan balance, meaning that the loan payments will eventually become even higher. When capitalization does not involve forbearance, the monthly payments immediately rise. One way or the other, capitalization alone does not involve modification of any loan terms.

Loan modifications, in contrast, alter the loan terms by extending the term of the loan, reducing the interest rate, and/or lowering the principal. Many loan modifications have the effect of lowering monthly payments.

Capitalization and modifications share the ostensible objective of keeping homeowners in their homes. Other workout techniques result in liquidation and normally require homeowners to vacate their homes. In a *short sale*, for example, the servicer allows a borrower to sell the home for less than the outstanding loan balance and often forgives the remaining amount due. In a *deed in lieu of foreclosure*, the borrower deeds the house to the servicer and moves out in exchange for full forgiveness of the debt. In some cases, however, the servicer may lease the home back to the borrower, relieving any need to vacate the home.

The Bush administration rolled out an initial federal loan modification program called HOPE Now in mid-2007. With President Obama's election, the federal government altered its approach to loan modifications, and that approach continues to evolve as of this writing.

40. See, e.g., Manuel Adelino, Kristopher Gerardi & Paul S. Willen, *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization* 3 (Fed. Res. Bank of Bos., Public Policy Discussion Papers No. 09-4, 2009), available at <http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf>; CONG. OVERSIGHT PANEL, MARCH OVERSIGHT REPORT: FORECLOSURE CRISIS—WORKING TOWARD A SOLUTION 49 (2009), available at <http://cybercemetery.unt.edu/archive/cop/20110402010739/http://cop.senate.gov/documents/cop-030609-report.pdf>.

41. In this article, I use the term "loan workout" broadly to refer to the full spectrum of techniques to resolve distressed loans short of refinancing or foreclosure.

*1. Bush Administration***a. HOPE NOW**

The HOPE NOW Alliance, a private, voluntary program operated by the mortgage industry, formed the heart of the Bush administration's foreclosure prevention efforts. The industry launched the Alliance in mid-2007 at the urging of the U.S. Departments of the Treasury and Housing and Urban Development. HOPE NOW's purpose was to coordinate servicers, loan counselors, and the securitization industry to identify distressed borrowers promptly, refer them to mortgage counseling, and persuade servicers to grant proprietary modifications where appropriate to their loans. Its original members included Fannie Mae and Freddie Mac, credit counselors, eleven servicers covering about 60% of subprime loans, and other mortgage market participants.⁴² By officially embracing the program, the Bush administration made HOPE NOW the focus of its repeated calls for servicers to modify more loans.⁴³

HOPE NOW was strictly voluntary in nature: Nothing required servicers to participate in the program or modify loans that met its guidelines. In tandem with the American Securitization Forum, HOPE NOW introduced the "Teaser Freezer" plan, which envisioned a five-year extension of the initial rates on subprime ARMs for certain distressed borrowers.⁴⁴ However, these and other HOPE NOW guidelines did not mandate use of any loan workout formula or numerical loan payment targets,⁴⁵ spawning wide variation in the relief granted and the processing of borrower requests. Between July 2007 and December 2012, the program reported completing almost 18.7 million loan workouts. However, 57% of those workouts (10.65 million) resulted in liquidation or deferred or rescheduled borrowers' payments temporarily without permanently lowering those payments. The remaining 43% (8 million) were loan modifications, many of which lowered the interest rate, reduced the principal, or extended the maturity date of the loan.⁴⁶

42. In February 2013, HOPE NOW reported that 67% of the mortgage servicing industry participated in the HOPE NOW program. *Industry Extrapolations and Metrics (February 2013)*, HOPE NOW 3 (2013), available at [http://www.hopenow.com/industry-data/2013-04-08-HopeNow.FullReport\(February\)v.1.pdf](http://www.hopenow.com/industry-data/2013-04-08-HopeNow.FullReport(February)v.1.pdf).

43. Press Release, U.S. Dep't of the Treasury, Secretary Paulson Remarks Following Hope Now Meeting (Oct. 31, 2007), <http://www.treasury.gov/press-center/press-releases/Pages/hp659.aspx>; Press Release, U.S. Dep't of the Treasury, Remarks by Secretary Henry M. Paulson, Jr. on Current Housing and Mortgage Market Developments Georgetown University Law Center (Oct. 16, 2007), <http://www.treasury.gov/press-center/press-releases/Pages/hp612.aspx>.

44. See Cordell et al., *Designing Loan Modifications*, *supra* note 6, at 18.

45. *Mortgage Servicing Guidelines*, HOPE NOW 3-5 (2008), available at http://www.hopenow.com/press_release/files/Mortgage%20Servicing%20Guidelines.pdf.

46. *Industry Extrapolations and Metrics (Dec. 2012)*, HOPE NOW 4 (2013), available at [http://www.hopenow.com/industry-data/2013-02-07-HOPENOW-Full-Report-\(December\)v2.pdf](http://www.hopenow.com/industry-data/2013-02-07-HOPENOW-Full-Report-(December)v2.pdf).

Furthermore, the 43% statistic masks the fact that the proportion of HOPE NOW workouts consisting of loan modifications started at a somewhat higher level and then declined. In December 2008, roughly half of all of HOPE NOW's workouts were loan modifications. By December 2012, that percentage had fallen to 35%.⁴⁷ Meanwhile, the success rate of HOPE NOW modifications is unknown, because the program does not report that statistic.

b. Streamlined Loan Modification Programs by the FDIC and the GSEs

In 2007 and 2008, Sheila Bair, Chairman of the Federal Deposit Insurance Corporation ("FDIC"), took a different approach, calling for a uniform, streamlined template for loan modifications that was better designed to process the growing volume of distressed loans. The FDIC took the opportunity to put such a plan into effect after it inherited the servicing of over 60,000 seriously delinquent loans in 2008 as conservator of the failed mortgage lender IndyMac.⁴⁸ Unlike HOPE NOW, the FDIC was able to mandate participation in its program using its power as conservator.

Under the FDIC's "Mod in a Box" program, all borrowers who were 60 days or more delinquent on owner-occupied loans and had combined loan-to-value ratios of more than 75% were considered for loan modifications.⁴⁹ The program's objective was to maximize net present value relative to foreclosure while reducing the borrower's front-end debt-to-income ("DTI") ratio to 38%. The program sought to achieve this through a standardized "waterfall" of workout steps that was designed to lower the borrower's loan payments. First, the program capitalized arrears. Then, the program sought to get the DTI ratio below 38% by reducing the interest rate. If that was not enough, the term was extended, and if more was needed to meet the 38% target, the principal could be reduced through forbearance.⁵⁰ The servicer received \$1,000 for each modified loan.

47. *Compare Appendix - Mortgage Loss Mitigation Statistics: Industry Extrapolations (Monthly for Dec 2008 to Nov 2009)*, HOPE NOW 6-7 (2009), available at [http://www.hopenow.com/industry-data/HOPE%20NOW%20National%20Data%20July07%20to%20Nov09%20v2%20\(2\).pdf](http://www.hopenow.com/industry-data/HOPE%20NOW%20National%20Data%20July07%20to%20Nov09%20v2%20(2).pdf), with *Industry Extrapolations and Metrics (Dec. 2012)*, *supra* note 46.

48. Richard A. Brown, Chief Economist, Mortgages and the Future of Housing Finance, The FDIC Loan Modification Program at IndyMac Federal Savings Bank 2-4 (Oct. 2010), http://www.fdic.gov/bank/analytical/cfr/mortgage_future_house_finance/ppt/Brown.PDF (PowerPoint presentation). OneWest Federal Savings Bank, as IndyMac's successor, eventually assumed the servicing of those loans. OneWest changed from "Mod in a Box" to the Home Affordable Modification Program (HAMP) protocols after HAMP took effect. FDIC OFFICE OF INSPECTOR GENERAL, EXECUTIVE SUMMARY: AUDIT OF ONE WEST BANK'S LOAN MODIFICATION PROGRAM (2011), available at <http://www.fdicigo.gov/reports11/11-004EV.pdf>.

49. See Breck Robinson, *An Overview of the Home Affordable Modification Program*, CONSUMER COMPLIANCE OUTLOOK (3d Qtr. 2009), http://www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/2009/third-quarter/q3_02.cfm.

50. Brown, *supra* note 48, at 2.

Between August 20, 2008, and February 1, 2009, 9,901 or about 26% of IndyMac's seriously delinquent loans were modified.⁵¹ As the program gained experience, later cohorts of modified loans had markedly lower redefault rates compared to those modified before April 2009.⁵²

In the latter part of 2008, the new Federal Housing Finance Agency introduced a similar streamlined loan modification program with slightly different triggers and targets for delinquent loans guaranteed by the two GSEs Fannie Mae and Freddie Mac.⁵³ Both streamlined loan programs had their limitations. The FDIC's program suffered from narrow coverage. The GSEs' program applied to more loans, but did not cover the private-label securitization market, which contained the bulk of subprime loans. Commentators queried why the programs were limited to serious delinquencies and did not take negative equity into account. They also asked whether the DTI targets were realistic or took sufficient account of the borrowers' other debts.⁵⁴ Despite these issues, the two streamlined programs would later form the template for the Obama administration's loan modification initiatives.

2. Obama Administration

a. Bankruptcy Cram-down Legislation

By the time the Obama administration took office in January 2009, foreclosure starts were mounting while permanent loan modifications were lagging.⁵⁵ As one of its first actions, the new administration sought legislation to increase the bargaining power of homeowners facing foreclosure. At the urging of the new administration, in March 2009, the House of Representatives voted to allow federal bankruptcy judges to reduce the outstanding principal on first-lien, owner-occupied mortgages of bankrupt debtors. The banking industry lobbied heavily against a bankruptcy cram-down, however, and the Senate defeated the bill.⁵⁶ The failed bankruptcy cram-down campaign was the first major instance

51. Kiff & Klyuev, *supra* note 3, at 16–18.

52. Brown, *supra* note 48, at 5, 11.

53. Kiff & Klyuev, *supra* note 3, at 16–18; U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-634, TROUBLED ASSET RELIEF PROGRAM: FURTHER ACTIONS NEEDED TO FULLY AND EQUITABLY IMPLEMENT FORECLOSURE MITIGATION PROGRAMS 18 (2010), available at <http://www.gao.gov/new.items/d10634.pdf>; Cordell et al., *Designing Loan Modifications*, *supra* note 6, at 19; News Release, Fed. Hous. Fin. Agency, Foreclosure Prevention & Refinance Report, Third Quarter 2009 2 (Jan. 8, 2010), available at <http://www.fhfa.gov/webfiles/15345/3Q2009ForeclosurePreventionRefinanceRpt10810.pdf>.

54. See, e.g., CONG. OVERSIGHT PANEL, *supra* note 40; Kiff & Klyuev, *supra* note 3, at 19. The FDIC later lowered its DTI ceiling to 31%. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-634, *supra* note 53, at 18.

55. See, e.g., Cordell et al., *Designing Loan Modifications*, *supra* note 6, at 19–20; *Industry Extrapolations and Metrics (Feb. 2013)*, *supra* note 42 (showing a decrease in the ratio of permanent modifications to foreclosure starts).

56. Tara Siegel Bernard, *Losing Homes in the Wait for a Rescue*, N.Y. TIMES, May 14, 2009, at B1.

where the federal government sought to increase the cost to servicers for threatening foreclosure.

b. Home Affordable Modification Program (“HAMP”)

Had the bankruptcy legislation passed, it would have given distressed homeowners a potent stick⁵⁷ to bargain for more loan modifications. Servicers might have agreed to more loan modifications in order to avoid a possible cram-down in bankruptcy court. With the legislation’s defeat, the Obama administration turned to subsidies to achieve its goals. Its major innovation was revamping federal loan modification policies in two respects: standardizing loan modification protocols in order to bring loan modifications to scale and paying servicers to modify more loans.

The result was the “Making Home Affordable” program, which the Treasury Department unveiled in February 2009.⁵⁸ The program’s central plank was the HAMP. HAMP sought to alter the financial incentives of servicers by paying them to modify loans where the net present value of a HAMP modification would exceed the net present value of going to foreclosure.

Initially, HAMP offered servicers \$1,000 to modify a first mortgage that was at least 60 days delinquent and \$500 to modify a home loan at imminent risk of default.⁵⁹ In addition, the program rewarded servicers with up to an additional \$1,000 per year for the first three years following a modification if the borrower did not redefault.⁶⁰ The federal government financed the subsidies with \$36.9 billion in Troubled Asset Relief Program (“TARP”) funds.⁶¹

HAMP built on the basic streamlined design of the FDIC’s “Mod in a Box” program, but with more generous parameters. To qualify for HAMP,

57. Some commentators argued that the stick was too potent, criticizing bankruptcy cram-downs, among other things, for giving debtors a windfall if home prices later rose and for straining the already over extended bankruptcy court system. *See, e.g.*, Eric A. Posner & Luigi Zingales, *A Loan Modification Approach to the Housing Crisis*, 10 AM. L. & ECON. REV. 575, 583–84 (2009).

58. Press Release, U.S. Dep’t of the Treasury, President Obama, Treasury Secretary Tim Geithner, and Housing and Urban Development Secretary Shaun Donovan Unveil the Homeowner Affordability and Stability Plan (Feb. 18, 2009), <http://www.treasury.gov/press-center/press-releases/Pages/2009218954476942.aspx>.

59. Press Release, U.S. Dep’t of the Treasury, Homeowner Affordability and Stability Plan Fact Sheet (Feb. 18, 2009), <http://www.treasury.gov/press-center/press-releases/Pages/20092181117388144.aspx>.

60. *Id.*

61. U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-10-634, *supra* note 53, at 6. There were special incentives for modifying loans of borrowers who were current on their loans but at imminent risk of default. For these modifications, mortgage holders received \$1,500 and servicers received \$500. U.S. DEP’T OF THE TREASURY, HOME AFFORDABLE MODIFICATION PROGRAM GUIDELINES (2009), *available at* http://www.treasury.gov/press-center/press-releases/Documents/modification_program_guidelines.pdf; Press Release, U.S. Dep’t of the Treasury, Making Home Affordable Updated Detailed Program Description (Mar. 4, 2009), www.treas.gov/press/releases/reports/housing_fact_sheet.pdf.

borrowers had to be owner-occupants with first-lien loan balances no larger than the conforming limits and have a housing debt-to-income ratio of over 31%.⁶² They also had to be in default (defined as 60 days late or more on their loans) or at risk of imminent default.⁶³ At the outset, HAMP sought to lower borrowers' monthly payments to 31% of gross monthly income for five years using three means: (1) by reducing interest rates to as low as 2%; (2) then by extending the loan term to up to forty years; and (3) then, if necessary, by forbearing (or, at the servicer's option, forgiving) part of the principal.⁶⁴ Any forbore principal would be due at the end of the loan term, but no interest would be charged on that amount.⁶⁵ If the net present value of a HAMP modification exceeded that with no modification—calculated using a standardized net present value formula—then HAMP required a loan modification.⁶⁶ Significantly, HAMP did not require servicers to permanently reduce principal in order to hit the 31% target.⁶⁷ Nor did HAMP take high total debt-to-income ratios into account.⁶⁸

Borrowers seeking HAMP loan modifications had to go through two steps. Initially, qualifying borrowers received a trial modification. If they stayed current on their trial modifications for three months and submitted full documentation of qualifying incomes and financial hardship, then they qualified for permanent loan modifications.⁶⁹

62. U.S. DEP'T OF TREASURY, *supra* note 61, at 2–3.

63. The Government Accountability Office found that servicers have widely varying definitions of the term “risk of imminent default.” As a result, a borrower may qualify for HAMP with one servicer, but not another. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-933T, TROUBLED ASSET RELIEF PROGRAM: CONTINUED ATTENTION NEEDED TO ENSURE THE TRANSPARENCY AND ACCOUNTABILITY OF ONGOING PROGRAMS, STATEMENT OF RICHARD J. HILLMAN, MANAGING DIR. FIN. MARKETS & COMM. INV. 11-12 (2010), available at <http://www.gao.gov/new.items/d10933t.pdf>; see also OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM, SIGTARP-10-005, FACTORS AFFECTING THE IMPLEMENTATION OF THE HOME AFFORDABLE MODIFICATION PROGRAM 26 (2010), available at http://www.sig tarp.gov/Audit%20Reports/Factors_Affecting_Implementation_of_the_Home_Affordable_Modification_Program.pdf.

64. U.S. DEP'T OF TREASURY, *supra* note 61, at 6–8.

65. Cordell et al., *Designing Loan Modifications*, *supra* note 6, at 22; Edmund L. Andrews, *U.S. Sets Big Incentives to Head Off Foreclosures*, N.Y. TIMES, Mar. 5, 2009, at A1; U.S. DEP'T OF TREASURY, *supra* note 61, at 9; Press Release, U.S. Dep't of the Treasury, *supra* note 61.

66. See, e.g., Cordell et al., *Designing Loan Modifications*, *supra* note 6, at 23. HAMP modifications could also proceed for Fannie Mae or Freddie Mac loans where the net present value of the modification was less than that of foreclosure, so long as the GSE bought the loan out of the pool. *Id.*

67. U.S. DEP'T OF TREASURY, *supra* note 61, at 8.

68. See FITCH RATINGS, U.S. RMBS SERVICERS' LOSS MITIGATION AND MODIFICATION EFFORTS UPDATE 6 (2009), <http://www.realestateconomywatch.com/wp-includes/upload-files/musr1020.pdf>.

69. Andrews, *supra* note 65, at A1; U.S. DEP'T OF TREASURY, *supra* note 61, at 4–5, 9, 10, 13; Press Release, U.S. Dep't of the Treasury, *supra* note 61.

Participation in HAMP was widespread. All servicers who serviced loans guaranteed by Fannie Mae or Freddie Mac were automatically eligible to participate in HAMP. A handful of servicers who received more than one bailout under TARP had to participate in the program.⁷⁰ Later, as part of the Helping Families Save Their Homes Act in May 2009, Congress extended HAMP to FHA loans.⁷¹ As of June 2010, 109 servicers, servicing the vast majority of eligible mortgages, had signed on to HAMP.⁷²

c. Other Foreclosure Prevention Programs

Many borrowers were not suited for loan modifications under HAMP because they could not afford the reduced monthly payments even at the target 31% DTI ratio.⁷³ This was a particular problem for the growing number of borrowers who had lost their jobs.⁷⁴ Similarly, it was questionable whether HAMP contained significant incentives to discourage deeply underwater borrowers from defaulting on their mortgages. For borrowers in either situation who were otherwise eligible for HAMP, Making Home Affordable proposed a new program called Home Affordable Foreclosure Alternatives (“HAFA”). HAFA offered financial incentives to servicers to accept short sales and deeds in lieu of foreclosure instead of going to foreclosure. As of February 2013, only 126,240 HAFA transactions had been completed, most of which were short sales.⁷⁵ Meanwhile, many individual servicers continued to offer their own proprietary loss

70. Andrews, *supra* note 65, at A1; U.S. DEP’T OF TREASURY, *supra* note 61, at 14; Press Release, U.S. Dep’t of the Treasury, *supra* note 61.

71. Press Release, U.S. Dep’t of Hous. & Urban Dev., HUD Secretary Donovan Announces New FHA-Making Home Affordable Loan Modification Guidelines (July 30, 2009), http://portal.hud.gov/hudportal/HUD?src=/press/press_releases_media_advisories/2009/HUDNo.09-137 (last visited Sept. 7, 2013).

72. U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-10-933T, *supra* note 63, at 9–10.

73. See CHRISTOPHER L. FOOTE, JEFF FUHRER, EILEEN MAUSKOPF & PAUL WILLEN, FED. RESERVE BANK OF BOS., A PROPOSAL TO HELP DISTRESSED HOMEOWNERS: A GOVERNMENT PAYMENT-SHARING PLAN 3–4 (2009), <http://www.bos.frb.org/economic/ppb/2009/ppb091.pdf>.

74. See Cordell et al., *Designing Loan Modifications*, *supra* note 6, at 9–11.

75. U.S. DEP’T OF TREASURY, *supra* note 61; Press Release, U.S. Dep’t of the Treasury, *supra* note 61; Home Affordable Modification Program, HAMP Update: New Program Offers Borrowers Foreclosure Alternatives (2009), <https://www.hmpadmin.com/portal/news/docs/2009/hampupdate113009.pdf>; U.S. DEP’T OF THE TREASURY, MAKING HOME AFFORDABLE: PROGRAM PERFORMANCE REPORT THROUGH FEBRUARY 2013, at 4 (2013) [hereinafter U.S. DEP’T OF TREASURY, MHA PERFORMANCE THROUGH FEBRUARY 2013], available at <http://www.treasury.gov/initiatives/financial-stability/reports/Documents/February%202013%20MHA%20Report%20Final.pdf>. A survey of the eight largest servicers showed that only 6.2% of all homeowners rejected for HAMP trial modifications were in the process of short sales or deed in lieu of foreclosure transactions as of July 2010. U.S. DEP’T OF THE TREASURY, MAKING HOME AFFORDABLE PROGRAM: SERVICER PERFORMANCE REPORT THROUGH AUGUST 2010 (2010) [hereinafter U.S. DEP’T OF THE TREASURY, MHA SERVICER PERFORMANCE REPORT THROUGH AUGUST 2010], available at <http://www.financialstability.gov/docs/AugustMHAPublic2010.pdf>.

mitigation programs, often under the HOPE NOW umbrella.⁷⁶ The Federal Housing Administration offered a separate loss mitigation program for borrowers with FHA loans who do not qualify for HAMP.⁷⁷

During the six-year period starting in 2007, the federal government's response to the foreclosure crisis substantially evolved. Over time, Washington's response shifted from coordinating a voluntary, unfunded system of foreclosure, to prevention, and finally to sponsoring one that was still voluntary but heavily subsidized. As the quid pro quo for subsidies, the government required servicers to analyze loan modifications under a standardized waterfall that was designed to lower monthly payments. Under the Obama administration, the federal government also took enforcement action and negotiated the mortgage servicing settlement to correct servicing abuses.⁷⁸ These efforts, taken together, resulted in improvement but a mixed record of success.

III. THE PACE OF FORECLOSURE MITIGATION TO DATE

Throughout 2008, the pace of loan workouts and modifications remained frustratingly slow. It was only when the Obama administration introduced HAMP that those numbers began to improve.⁷⁹

A. *The Early Phase of the Crisis in 2007 and 2008*

During 2007 and 2008, when HOPE NOW was the leading modification program, only a paltry percentage of mortgages at least 60 days past due received a workout of any kind. A Federal Reserve Bank of Boston study of those loans reported that only 3% experienced an interest rate reduction, a principal reduction, and/or an extension of the loan term in the first 12 months following the first serious delinquency. Only 8.5% received any workout at all (including a principal increase, a short sale, or a deed in lieu of foreclosure).⁸⁰

These are aggregate numbers, however, and over the course of that two-year time span, the success rate improved. Servicers of nonconforming home mortgages agreed to more loan workouts with each passing quarter in 2007 and 2008. In the fourth quarter of 2008, there were seven to eight times more loan workouts than in the first quarter of 2007.⁸¹ Over the period from 2007 through 2008, the mix of workout techniques also changed. Workouts that reduced monthly payments became more common and workouts that increased monthly

76. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-634, *supra* note 53, at 18.

77. U.S. DEP'T OF HOUS. & URBAN DEV. & U.S. DEP'T OF THE TREASURY, THE OBAMA ADMINISTRATION'S EFFORTS TO STABILIZE THE HOUSING MARKET AND HELP AMERICAN HOMEOWNERS, *supra* note 22, at 1; U.S. DEP'T OF HOUS. & URBAN DEV., LOSS MITIGATION, available at http://portal.hud.gov/hudportal/HUD?src=/hudprograms/loss_mitigation (last viewed July 17, 2013).

78. See *infra* text accompanying notes 79–129.

79. See, e.g., Cordell et al., *Designing Loan Modifications*, *supra* note 6, at 6, 18–20.

80. Adelino et al., *supra* note 40, at 13–18, 37 tbl.5.

81. *Id.* at 11–12, 35 tbl.3.

payments declined.⁸² Nevertheless, over this period, workouts that reduced monthly payments often still resulted in higher principal balances because they capitalized arrears.⁸³

Despite this encouraging trend, these numbers mask the fact that the bulk of loan modifications in 2007 and 2008 actually *increased* borrowers' monthly payments instead of reducing them. In two path-breaking studies that brought this problem to light, law professor Alan White reported that over two-thirds of the loan workouts studied increased both the borrowers' loan payments and principal by adding in overdue interest and fees without taking other steps to reduce monthly payments. The average principal increase was a whopping \$10,800.⁸⁴

The Federal Reserve Bank of Boston study confirmed White's findings. By the end of 2008, plans increasing principal remained the most common type of workout by far. Such capitalization plans accounted for 61.5% of all loan workouts in the fourth quarter of 2008. Interest rate reductions came in second (26.7%) and principal reductions remained rare (1.4%).⁸⁵ Loans from earlier vintages were

82. FITCH RATINGS, *supra* note 68, at 10; *see also* Andrew Haughwout, Ebiere Okah & Joseph Tracy, *Second Chances: Subprime Mortgage Modification and Redefault* (Fed. Reserve Bank of N.Y., Staff Report No. 417, 2010), *available at* http://www.newyorkfed.org/research/staff_reports/sr417.pdf; Roberto G. Quercia & Lei Ding, *Loan Modifications and Redefault Risk: An Examination of Short-Term Impacts*, 11 CITYSCAPE 171, 180, 181 exhibit 3 (2009), *available at* <http://www.huduser.org/portal/periodicals/cityscpe/vol11num3/ch8.pdf>.

83. *See, e.g.*, J.M. Collins & C.K. Reid, Who Receives a Mortgage Modification? Race and Income Differentials in Loan Workouts 18 (Jan. 2011) (unpublished manuscript), *available at* <http://ssrn.com/abstract=1743159> (average balance of modified loans rose from \$7,400 to \$8,160); Haughwout et al., *supra* note 82, at 12; Quercia & Ding, *supra* note 82, at 181.

84. Alan M. White, *Deleveraging the American Homeowner: The Failure of 2008 Voluntary Mortgage Contract Modifications*, 41 CONN. L. REV. 1107, 1114 (2009); Alan M. White, *Rewriting Contracts, Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports*, 36 FORDHAM URB. L.J. 509 (2009).

85. Adelino et al., *supra* note 40, at 11–12, 35 tbl.3. According to the authors, as of 2009, Ocwen Loan Servicing, LLC and Litton Loan Servicing, LP were the only servicers who granted principal reductions in nontrivial amounts. *Id.* at 12 n.17. Agarwal et al. reported that of pre-HAMP loans serviced by the 10 largest depository institution servicers from January 2008 through May 2009, only portfolio loans received principal deferrals, not private-label securitized loans. Only 3% of portfolio modifications had principal deferral and only 1% had principal write downs. Interest-rate reductions were deeper for private-label securitized loans than for bank-held loans and modifications of GSE and private-label securitized loans were more likely to capitalize interest arrears than modifications for bank-held loans. Sumit Agarwal, Gene Amromin, Itzhak Ben-David, Souphala Chomsisengphet, & Douglas D. Evanoff, *The Role of Securitization in Mortgage Renegotiation* 22-23 (Fisher Coll. of Bus., Working Paper No. 2011-03-002, 2011). *See also* Collins & Reid, *supra* note 83, at 17 (interest rate modifications lowered interest rates by 165 to 175 basis points); Laurie S. Goodman, Roger Ashworth, Brian Landy & Lidan Yang, *The Case for Principal Reductions*, 17 J. STRUCTURED FINANCE 29, 34 (2011) (over 98% of all GSE and FHA loan modifications capitalized arrears); Joseph R. Mason, *Subprime Servicer Reporting Can Do More for Modification than Government Subsidies* 32

especially likely to receive temporary forbearance plans restricted to capitalization.⁸⁶ Many of those workout plans failed and later had to be redone.⁸⁷

These findings had profound implications. The prevalence of capitalization plans at the end of 2008 indicated that servicers were kicking the proverbial can down the road by temporarily delaying foreclosures instead of preventing them. Increasing monthly payments for cash-strapped borrowers was usually a recipe for failure, given the long average stint of unemployment during this recession coupled with negative equity.⁸⁸ More was needed to induce servicers to lower monthly payments.

B. The Evolution of HAMP

HAMP sought to alter servicers' fee calculus by handing them cash for modifying loans with lower monthly payments. This worked well enough that HAMP's advent heralded a big uptick in interest rate reductions. By the latter half of 2009, for approved workouts, interest rate reductions surpassed capitalizations that increased principal. In the third quarter of 2009, for example, 81.1% of workouts by national banks and thrifts reduced interest rates.⁸⁹ Fitch Ratings found similar patterns for private-label securitized mortgages.⁹⁰ By August 2010, all permanent HAMP modifications featured interest rate reductions.⁹¹ As of February 2013, the median Tier 1 HAMP loan modification cut the monthly payment by

(Mar. 19, 2009) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1361331; Quercia & Ding, *supra* note 82, at 181 (for Columbia Collateral File modified private-label loans in Q2 2008, 8.4% received principal reductions, but only 3% received principal reductions of over 20%).

86. J. Michael Collins & Christopher E. Herbert, Abt Assoc., *Loan Modifications as a Response to the Foreclosure Crisis: An Examination of Subprime Loan Outcomes in Maryland and Surrounding States* 19 (Dec. 17, 2009), *available at* http://www.preservehomeownership.org/uploaded_files/0000/0041/loanmodstudy09.pdf (comparing likelihood of foreclosure or loan modification for distressed private-label loans in mid-Atlantic states in November 2008 and June 2009).

87. Laurie S. Goodman, Roger Ashworth, Brian Landy & Lidan Yang, *Mortgage Modification Activity—Recent Developments*, 21 J. FIXED INCOME 55, 58 (2012).

88. In December 2012, for instance, the average unemployed worker took 38.1 weeks (slightly over 7 months) to find new work. News Release, Bureau of Labor Statistics, *The Employment Situation – December 2012*, 26 tbl.A-12 (Jan. 4, 2013), *available at* http://www.bls.gov/news.release/archives/empisit_01042013.pdf.

89. Adelino et al., *supra* note 40, at 11–12, 35 tbl.3; OFFICE OF THE COMPTROLLER OF THE CURRENCY & OFFICE OF THRIFT SUPERVISION, U.S. DEP'T OF TREASURY, OCC AND OTS MORTGAGE METRICS REPORT: DISCLOSURE OF NATIONAL BANK AND FEDERAL THRIFT MORTGAGE LOAN DATA, THIRD QUARTER 2009 23, 28 (2009) [hereinafter OCC & OTS MORTGAGE METRICS REPORT, THIRD QUARTER 2009], *available at* http://www.ots.treas.gov/_files/482114.pdf.

90. FITCH RATINGS, *supra* note 68, at 10.

91. See U.S. DEP'T OF THE TREASURY, MHA SERVICER PERFORMANCE REPORT THROUGH AUGUST 2010, *supra* note 75; *but see* OCC AND OTS MORTGAGE METRICS REPORT, THIRD QUARTER 2009, *supra* note 89, at 25 (reporting much lower principal reduction rates for HAMP modifications by national banks and federal thrifts).

\$546 or 38%.⁹² This record and HAMP's superior redefault rates⁹³ influenced servicers to reduce payments in their proprietary loan modifications as well.

HAMP also produced growing numbers of trial loan modifications. From HAMP's inception through the end of 2009, over 1.1 million borrowers were offered trial loan modifications. But of the 900,000-some borrowers who accepted those trial modification offers in calendar year 2009, only 66,465—less than 8%—graduated into permanent modifications. Servicer performance was all over the lot: CitiMortgage had modified 47% of its eligible seriously delinquent loans as of December 31, 2009, while Wachovia had only modified 3%.⁹⁴ This low rate of permanent modifications caused Fitch Ratings to conclude, “[T]he conversion from trial mod under HAMP to actual finalized modification status has been disappointing.”⁹⁵

Reportedly, several issues stymied permanent modifications. Some borrowers failed to complete their paperwork; other times, servicers lost their files.⁹⁶ Other borrowers who did complete their paperwork turned out to be ineligible for HAMP based on their verified income.⁹⁷ There were reports that the government also paid servicers to do trial modifications,⁹⁸ leading some to ask whether servicers had adequate financial incentives to carry through with permanent modification plans. Some even accused servicers of deliberately approving trial modifications, collecting incentive payments, and proceeding to foreclosure to maximize their fees.⁹⁹

In November 2009, the Obama administration turned up the heat, pressing servicers to grant more permanent modifications. To raise the costs of not making permanent modifications, the Treasury Department threatened to publicly name and thereby shame servicers who dragged their feet and to subject them to

92. U.S. DEP'T OF TREASURY, MHA PERFORMANCE THROUGH FEBRUARY 2013, *supra* note 75, at 6.

93. *See infra* Section III.C.

94. U.S. DEP'T OF THE TREASURY, MAKING HOME AFFORDABLE PROGRAM: SERVICER PERFORMANCE REPORT THROUGH DECEMBER 2009, 3–5 (2010), *available at* <http://www.makinghomeaffordable.gov/news/latest/Documents/report.pdf>; *see also* OCC AND OTS MORTGAGE METRICS REPORT, THIRD QUARTER 2009, *supra* note 89, at 43–44 (among servicers that were national banks or thrifts, only 4.1% of seriously delinquent borrowers and borrowers in foreclosure received new loan modifications).

95. FITCH RATINGS, *supra* note 68, at 2.

96. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-556T, TROUBLED ASSET RELIEF PROGRAM: HOME AFFORDABLE MODIFICATION PROGRAM CONTINUES TO FACE IMPLEMENTATION CHALLENGES, STATEMENT OF GENE L. DODARO, ACTING U.S. COMPTROLLER GENERAL, 8 (2010); Olga Pierce & Paul Kiel, *By the Numbers: A Revealing Look at the Mortgage Mod Meltdown*, PROPUBLICA (Mar. 8, 2011, 12:37 PM), <http://www.propublica.org/article/by-the-numbers-a-revealing-look-at-the-mortgage-mod-meltdown>.

97. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-556T, *supra* note 96, at 8.

98. *See* Peter S. Goodman, *U.S. to Pressure Mortgage Firms for Loan Relief*, N.Y. TIMES, Nov. 29, 2009, at A1.

99. *See id.*

sanctions including fines. Additionally, the government announced that it would withhold incentive payments until modifications became permanent. The following month, the number of permanent loan modifications more than doubled.¹⁰⁰ In January 2010, the government streamlined borrowers' documentation requirements, making it easier to convert temporary modifications into permanent ones.¹⁰¹

These measures, taken together, helped increase the permanent modification rate. Still, the federal government remained dissatisfied. In March 2010, it took more aggressive steps to boost permanent loan modifications. One provision was designed to assist delinquent homeowners who had lost their jobs. For the first time under HAMP, unemployed borrowers who qualified for HAMP could have their mortgage payments cut to 31% of gross income for three to six months while they looked for work.¹⁰²

In March 2010, the administration also took its first steps to address the growing problem of negative equity. In the Principal Reduction Alternative ("PRA"), the administration offered first-time incentives to servicers to approve principal write-downs and to extinguish junior liens.¹⁰³ Going forward, under PRA,

100. U.S. DEP'T OF THE TREASURY, MAKING HOME AFFORDABLE PROGRAM: SERVICER PERFORMANCE REPORT THROUGH DECEMBER 2009, *supra* note 94, at 3; Press Release, U.S. Dep't of the Treasury, Obama Administration Kicks off Mortgage Modification Conversion Drives (Nov. 30, 2009), *available at* <http://www.treasury.gov/press-center/press-releases/Pages/tg421>.

101. Press Release, U.S. Dep't of the Treasury, Administration Updates Documentation Collection Process and Releases Guidance to Expedite Permanent Modifications (Jan. 28, 2010), *available at* http://portal.hud.gov/hudportal/HUD?src=/press/press_releases_media_advisories/2010/HUDNo.10-021.

102. To qualify, the loan in question had to be for the borrower's owner-occupied principal residence, have a mortgage balance of less than \$729,750, and be originated before 2009. In addition, the borrower had to prove financial hardship and have a monthly mortgage payment exceeding 31% of his or her income. After six months, if the borrower found work with lower pay or did not find work at all, he or she would respectively be considered for a permanent HAMP modification or a short sale combined with relocation assistance. Fact Sheet, U.S. Dep't of the Treasury, Making Home Affordable Program Enhancements to Offer More Help for Homeowners 2 (Mar. 25, 2010), http://www.makinghomeaffordable.gov/programs/Documents/HAMP%20Improvements_Fact%20Sheet_032510%20FINAL2.pdf. The results of the program, dubbed HAMP-UP, were disappointing, with only 30,525 forbearance plans reported as of January 2013. This low take-up rate is probably attributable, at least in part, to the fact that HAMP-UP provides no subsidies to servicers. U.S. DEP'T OF TREASURY, *supra* note 39, at 4. In another initiative in February 2010, called the "Hardest Hit Fund," the administration expanded cash assistance to states with the highest unemployment rates to funnel temporary grants to unemployed homeowners to help them pay their mortgages. The administration expanded that relief to unemployed borrowers in August 2010. Press Release, U.S. Dep't of the Treasury, Obama Administration Announces Additional Support for Targeted Foreclosure-Prevention Programs to Help Homeowners Struggling with Unemployment (Aug. 11, 2010), http://portal.hud.gov/hudportal/HUD?src=/press/press_releases_media_advisories/2010/HUDNo.10-176.

103. Fact Sheet, U.S. Dep't of the Treasury, *supra* note 102, at 2.

for any underwater borrower owing more than 115% of the current value of his or her home (except for borrowers with GSE loans), HAMP servicers had to calculate the borrower's net present value using both the standard approach plus an alternative approach containing incentives for writing down principal. If a principal write-down was needed to reduce the borrower's monthly payment to 31% of income, the servicer could—but was not obliged to—reduce principal. To induce principal write-downs, the federal government offered to pay 10 to 21 cents for each dollar of unpaid principal written down (depending on the loan-to-value ratio).¹⁰⁴ In January 2012, the administration substantially hiked that subsidy from 18 to 63 cents and, for the first time, offered principal reduction incentives for GSE loans.¹⁰⁵ By February 2013, only 8.2% of the permanent HAMP modifications ever made featured principal reductions. Still, 70% of the HAMP trial modifications of private-label and portfolio loans approved in February 2013 featured principal forgiveness. That rise in principal reduction modifications was partly due to the mortgage servicing settlement and the government's decision to triple the subsidies to investors.¹⁰⁶

Another part of the March 2010 measures was designed to assist relocation for delinquent borrowers who failed to qualify for loan modifications. To encourage more short sales, the government increased subsidies to junior lien holders to 6% of the outstanding loan balance to induce them to release their liens. Additionally, incentive payments to servicers for short sales rose from \$1,000 to \$1,500. The government also announced plans to double relocation payments to up to \$3,000 for borrowers who successfully completed short sales or deed-in-lieu transactions.¹⁰⁷

Other measures in the March 2010 initiative were meant to lower the administrative barriers to HAMP modifications. In those provisions, the Treasury Department prohibited HAMP servicers from pursuing foreclosure during loan modification negotiations and trial modification periods. Servicers were also

104. If the servicer opted to reduce principal, it would initially treat the reduction as forbearance. To encourage borrowers to remain current on their new, lower loan payments, servicers would then forgive the forbore amount in three equal steps over three years, so long as the homeowner remained current on the payments. Fact Sheet, U.S. Dep't of the Treasury, *supra* note 102, at 3.

105. Tim Massad, Making Home Affordable, *Expanding our Efforts to Help More Homeowners and Strengthen Hard-Hit Communities*, TREASURY NOTES BLOG (Jan. 27, 2012), <http://www.treasury.gov/connect/blog/Pages/Expanding-our-efforts-to-help-more-homeowners-and-strengthen-hard-hit-communities.aspx>.

106. See U.S. DEP'T OF TREASURY, MHA PERFORMANCE THROUGH FEBRUARY 2013, *supra* note 75, at 3–4.

107. Fact Sheet, U.S. Dep't of the Treasury, *supra* note 102, at 3–4. Two years later, the Federal Housing Finance Agency announced additional strategies to facilitate the number of short sales, including a 60-day deadline for responding to short sale offers and enhancements addressing borrower eligibility, documentation, appraisals, antifraud safeguards, payments to junior lienholders, and mortgage insurance. Press Release, Fed. Hous. Fin. Agency, Fannie Mae and Freddie Mac to Streamline Short Sales to Help Borrowers and Communities (Apr. 17, 2012), available at http://www.fhfa.gov/webfiles/23887/Short_Sales_release_041712.pdf.

required to start considering borrowers in bankruptcy for HAMP relief upon request and HAMP was extended to homeowners with FHA loans. No foreclosure sale could proceed without written certification that the borrower was ineligible for HAMP. Finally, the government increased the incentive payments to servicers for making permanent loan modifications.¹⁰⁸

The next major development in HAMP came in June 2011, when the Treasury Department carried out its threats to sanction HAMP servicers for poor performance. Earlier that year, the Treasury Department had evaluated the ten largest HAMP servicers. Following the assessments, the Treasury Department concluded that all ten servicers had deficiencies. Four of those servicers—Bank of America, N.A., J.P. Morgan Chase Bank, N.A., Ocwen Loan Servicing, LLC, and Wells Fargo Bank, N.A.—were in need of substantial improvement, and the other six servicers needed moderate improvement. The Treasury Department withheld financial incentives from Bank of America, J.P. Morgan Chase, and Wells Fargo pending future improvements.¹⁰⁹

These things stood until January 2012, when the administration made the latest changes to HAMP. That month, the administration extended the deadline to apply for HAMP modifications one more year, to year-end 2013; relaxed the DTI test to take account of nonmortgage debt; and extended HAMP relief to certain rental properties.¹¹⁰

C. Evaluating HAMP's Record of Success

Despite the Obama administration's reforms, criticisms persist that HAMP (and its proprietary counterpart, HOPE NOW) produced disappointingly low levels of loan modifications. Initially, the administration forecasted that three to four million distressed homeowners would receive HAMP loan modifications by the end of 2012.¹¹¹ As of year-end 2012, however, only 1,136,482 permanent HAMP modifications had been granted.¹¹² Meanwhile, the quarterly number of

108. Fact Sheet, U.S. Dep't of the Treasury, *supra* note 102, at 1.

109. See Press Release, U.S. Dep't of the Treasury, Obama Administration Releases May Housing Scorecard Featuring New Making Home Affordable Servicer Assessments, Regional Spotlight on Phoenix Housing Data (June 9, 2011), <http://www.treasury.gov/press-center/press-releases/Pages/tg1205.aspx>; U.S. DEP'T OF THE TREASURY, MAKING HOME AFFORDABLE, PROGRAM PERFORMANCE REPORT THROUGH APRIL 2011 7–16 (2011), available at <http://www.treasury.gov/initiatives/financial-stability/results/MHA-Reports/Documents/April%202011%20MHA%20Report%20FINAL.PDF>.

110. Massad, *supra* note 105. Later, in May 2013, the administration extended HAMP's deadline to the end of 2015. See, e.g., Clea Benson, *Treasury Extends HAMP Mortgage-Modification Program Through 2015*, BLOOMBERG (May 30, 2013), <http://www.bloomberg.com/news/2013-05-30/treasury-extends-hamp-mortgage-modification-program-through-2015.htm>.

111. Press Release, U.S. Dep't of the Treasury, *supra* note 59.

112. U.S. DEP'T OF THE TREASURY, MAKING HOME AFFORDABLE, PROGRAM PERFORMANCE REPORT THROUGH DECEMBER 2012 (2013), available at <http://www.treasury.gov/initiatives/financial-stability/reports/Documents/December%2012%20MHA%20Report%20Final.pdf>.

loan modifications (both HAMP and proprietary) mostly slumped after 2010.¹¹³ Given that trend, it is not surprising that foreclosure starts outpaced permanent modifications (HAMP and otherwise) every quarter in 2011 through the fourth quarter of 2012, usually by a margin of two to one or more.¹¹⁴

Another way to measure the success of loan modifications is by examining redefault rates. In a properly designed loan modification, the borrower will be able to afford the new payments. But during the early days of the financial crisis, the redefault rates on loan modifications were profoundly disheartening, suggesting that the loan modifications issued initially were poorly designed. The Office of the Comptroller of the Currency (“OCC”) and the Office of Thrift Supervision reported that loans serviced by the largest depository institutions in the first quarter of 2008 had a discouraging total 12-month, 60-plus day redefault rate of 52.1%.¹¹⁵ As servicers gained experience with loan modifications, however, the 12-month, 60-plus day redefault rate fell during each succeeding year of loan modifications, down to 21.9% for modifications made in the fourth quarter of 2011.¹¹⁶

Subsequent research showed that the right workout technique substantially lowered the risk of redefault. As discussed above, the bulk of loan workouts during the early years of the crisis involved capitalizing arrears with no offsetting payment reductions, which ended up increasing borrowers’ monthly mortgage payments.¹¹⁷ For borrowers with cash-flow problems—especially

113. See OFFICE OF THE COMPTROLLER OF THE CURRENCY, OCC MORTGAGE METRICS REPORT: DISCLOSURE OF NATIONAL BANK AND FEDERAL SAVINGS ASSOCIATION MORTGAGE LOAN DATA, FOURTH QUARTER 2012 22 (2013), available at <http://www.occ.gov/publications/publications-by-type/other-publications-reports/mortgage-metrics-2012/mortgage-metrics-q4-2012.pdf> [hereinafter OCC MORTGAGE METRICS REPORT, FOURTH QUARTER 2012]; OFFICE OF THE COMPTROLLER OF THE CURRENCY, OCC MORTGAGE METRICS REPORT: DISCLOSURE OF NATIONAL BANK AND FEDERAL SAVINGS ASSOCIATION MORTGAGE LOAN DATA, SECOND QUARTER 2011 23, 25 (2011) [hereinafter OCC MORTGAGE METRICS REPORT, SECOND QUARTER 2011], available at <http://www.occ.gov/publications/publications-by-type/other-publications-reports/mortgage-metrics-2011/mortgage-metrics-q2-2011.pdf>. Proprietary modifications turned upwards during the last half of 2012, probably due to the mortgage servicing settlement and related developments. See OCC MORTGAGE METRICS REPORT, FOURTH QUARTER 2012, *supra* note 113, at 22.

114. OCC MORTGAGE METRICS REPORT, FOURTH QUARTER 2012, *supra* note 113, at 22, 24 (comparing HAMP modifications and other modifications to newly initiated foreclosures); OCC MORTGAGE METRICS REPORT, SECOND QUARTER 2011, *supra* note 113, at 23.

115. OFFICE OF THE COMPTROLLER OF THE CURRENCY, OCC AND OTS MORTGAGE METRICS REPORT, FIRST QUARTER 2009 (2009), available at <http://www.occ.treas.gov/publications/publications-by-type/other-publications-reports/mortgage-metrics-q1-2009/default-rates-mod-lons-60days-2009-1-quarter.html> (last viewed Aug. 1, 2013). This metric refers to the number of loan modifications that became 60 days delinquent or more during the first twelve months following the loan modification.

116. OCC MORTGAGE METRICS REPORT, FOURTH QUARTER 2012, *supra* note 113, at 34.

117. See *supra* text accompanying notes 80–87.

problems that were indefinite or permanent in nature—those workouts were doomed to fail.

In contrast, the evidence consistently shows that loan modifications that lower monthly payments, either by reducing interest, reducing principal, or extending the maturity date, substantially lower redefault rates.¹¹⁸ Workouts that cut interest rates perform better than workouts that only capitalize arrears. Further, the bigger the interest rate cut, the lower the redefault rate.¹¹⁹ Principal reductions have the lowest redefault rate of all three techniques, probably because they reduce the role of negative equity as an independent driver of default while also lowering monthly payments.¹²⁰

As these numbers came to light, a dramatic shift ensued toward interest rate reductions and principal reductions. According to the OCC, the proportion of loan modifications with interest rate reductions grew markedly following the introduction of HAMP, reaching an 87% high before falling slightly in 2011 and 2012.¹²¹ Over that same period, principal reductions and principal deferrals also grew quickly, although from very low levels. By the fourth quarter of 2012, the OCC reported that 20.0% of loan modifications reduced principal and another 20.5% deferred it.¹²² That trend was especially pronounced in the private-label

118. OCC MORTGAGE METRICS REPORT, FOURTH QUARTER 2012, *supra* note 113, at 40–43; U.S. DEP'T OF THE TREASURY, MAKING HOME AFFORDABLE, PROGRAM PERFORMANCE REPORT THROUGH DECEMBER 2012, *supra* note 112, at 7; Goodman et al., *supra* note 85; Quercia & Ding, *supra* note 82 (for Columbia Collateral File private-label securitized loans during the second quarter of 2008, lowering the monthly payment by 30% to 40% reduced the 30+ day delinquency rate by 18%); Ioan Voicu, Vicki Been, Mary Weselcouch & Andrew Tschirart, *Performance of HAMP Versus Non-HAMP Modifications—Evidence from New York City* 27–28 (N.Y.U. L. & Econ., Working Paper 11-41, 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1950430; Adelino et al., *supra* note 40, at 19 (implying that lowering payments cuts redefault rates by as much as 30%); Agarwal et al., *supra* note 85 (for every 10% drop in the monthly payment, the 60-plus day delinquency rate dropped 4.3 percentage points (11% in relative terms), down from an average base rate of 49%); Haughwout et al., *supra* note 82 (for every 10% drop in the monthly payment, the 90-plus day delinquency rate dropped 8% (4.5 basis points) from the average 12-month redefault rate of 56%); Brown, *supra* note 48.

119. Agarwal et al., *supra* note 85; Voicu et al., *supra* note 118, at 27.

120. Goodman et al., *supra* note 87, at 55; Goodman et al., *supra* note 85, at 32; Quercia & Ding, *supra* note 82, at 188–90; Patrick Bajari, Chenghuan Sean Chu & Minjung Park, *An Empirical Model of Subprime Mortgage Default from 2000 to 2007* 32–33 (Nat'l Bureau of Econ. Research, Working Paper No. 14625, 2008); Haughwout et al., *supra* note 82, at 24–25; Voicu et al., *supra* note 118, at 35; *see also* FED. RESERVE WHITE PAPER, *supra* note 3, at 20–21.

121. *See* OCC MORTGAGE METRICS REPORT, FOURTH QUARTER 2012, *supra* note 113, at 26; OFFICE OF THE COMPTROLLER OF THE CURRENCY & OFFICE OF THRIFT SUPERVISION, OCC AND OTS MORTGAGE METRICS REPORT, FOURTH QUARTER 2010 23 (2011).

122. OCC MORTGAGE METRICS REPORT, FOURTH QUARTER 2012, *supra* note 113, at 25.

space, where principal reductions and principal deferrals made up 81.2%—over four-fifths—of all private-label loan modifications in fourth quarter 2012.¹²³

While the spurt in principal relief is notable—and may temporarily grow as the principal reduction provisions of the mortgage servicing settlement take effect—the fact that interest rate reductions still outpace principal reductions by more than two to one, despite their higher redefault rates,¹²⁴ suggests continued resistance to principal modifications. Furthermore, the OCC reported, over 84% of loan modifications made in fourth quarter 2012 involved capitalization of arrears.¹²⁵ That undercut the growth in principal reductions by increasing the outstanding principal of the capitalized loans and thereby boosting the default risk of underwater borrowers.¹²⁶ Thus, servicers continue to resist principal reductions, despite their superior redefault rates.

As this discussion suggests, HAMP had some successes. Its insistence on standardization and lower monthly payments produced markedly lower redefault rates. Furthermore, the redefault rate of HAMP permanent modifications is lower than that of proprietary modifications,¹²⁷ probably due to HAMP's emphasis on mandatory payment reductions. That superior track record—and publicity about that track record through studies and monthly government reports—likely contributed to servicers' decisions to lower monthly payments in their own proprietary loan modifications. Nevertheless, HAMP's take-up rate was disappointing, as was its graduation rate from temporary to permanent modifications.¹²⁸

In sum, at the outset of the crisis, the federal government's foreclosure prevention efforts experienced a painfully slow start. Only later did those efforts become more aggressive, particularly under the Obama administration.

The federal government's early lukewarm response was a serious mistake. Research shows that early intervention with troubled borrowers significantly cuts defaults and redefault rates.¹²⁹ Aggressive loss mitigation from the outset of the crisis might have slowed the spread of the nation's housing woes,

123. *Id.* at 28; *see also* Goodman et al., *supra* note 87, at 56–57. In contrast, Agarwal, Amromin, Ben-David, Chomsisengphet, and Evanoff reported that from January 2008 to May 2009, no private-label loan modifications in the OCC Mortgage Metrics dataset featured principal deferral or write downs, while only 3% and 1% of portfolio loan modifications respectively did. *See* Agarwal et al., *supra* note 85, at 22.

124. *See* OCC MORTGAGE METRICS REPORT, FOURTH QUARTER 2012, *supra* note 113, at 25.

125. *Id.*

126. *See id.*; Collins & Reid, *supra* note 83, at 3.

127. *See* OCC MORTGAGE METRICS REPORT, FOURTH QUARTER 2012, *supra* note 113, at 39.

128. Through January 2013, 1,151,340 (58%) of all HAMP trial modifications graduated to permanent modifications, while 42% did not. U.S. DEP'T OF TREASURY, MHA: PROGRAM PERFORMANCE REPORT THROUGH JAN. 2013, *supra* note 39, at 3.

129. *See, e.g.*, Brown, *supra* note 48, at 6; Laurie S. Goodman, Roger Ashworth, Brian Landy, & Lidan Yang, *Modification Success—What Have We Learned?*, 21 J. FIXED INCOME 57, 57 (2011); Quercia & Ding, *supra* note 82, at 189.

which instead triggered the deepest recession since the Great Depression. By stopping unnecessary foreclosures early on, home values would have stabilized more quickly, helping to halt the negative feedback loop leading to the widespread loss of jobs. Large-scale loss mitigation would have been easier before so many people became unemployed.

IV. POSSIBLE OBSTACLES TO OPTIMAL LEVELS OF LOAN MODIFICATIONS

Although HAMP increased the number of loan modifications (including workouts with lower payments and higher success rates), the level of permanent loan modifications remains disappointingly low and well below the federal government's projections. There is reason to believe that servicers have refused at times to make loan modifications even when those modifications would have avoided losses relative to foreclosure. At least four multivariate regression studies have concluded, for instance, that servicers are less likely to modify the private-label mortgages that they administer than their own loans held in portfolio, other things being equal.¹³⁰ Servicers act as agents for loans they administer for other investors, who are the principals. Because servicers are more reluctant to grant modifications for investor-owned private-label loans, compared to loans that servicers themselves own, principal-agent problems may be impeding higher numbers of cost-effective modifications of private-label loans.

In addition, servicers exhibit large and unexplained variations in their propensity to modify loans with similar features and payment histories.¹³¹ Because some of those loans were modified while other, equivalent loans were not, this

130. Sumit Agarwal, Gene Amromin, Itzhak Ben-David, Souphala Chomsisengphet & Douglas D. Evanoff, *Market Based Loss Mitigation Practices for Troubled Mortgages Following the Financial Crisis* 16 (Fed. Reserve Bank of Chi., Working Paper No. 2011-03, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1690627; Agarwal et al., *supra* note 85, at 5, 17; Vicki Been, Mary Weselcouch, Ioan Voicu & Scott Murff, *Determinants of the Incidence of Loan Modifications* 20 (N.Y.U. L. & Econ., Working Paper No. 11-37, 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1941915; Tomasz Piskorski, Amit Seru & Vikrant Vig, *Securitization and Distressed Loan Renegotiation: Evidence from the Subprime Mortgage Crisis* 27 (Chi. Booth Sch. of Bus. Research, Working Paper No. 09-02, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1321646; accord, Christopher Mayer, Housing, Subprime Mortgages, and Securitization: How Did We Go Wrong and What Can We Learn so This Doesn't Happen Again? 19 (2010) (unpublished manuscript), available at http://www.law.yale.edu/documents/pdf/cbl/Housing_Subprime.pdf ("Overall, the evidence seems to support the likelihood that servicers of securitized mortgages foreclosed on properties at a much higher rate than portfolio lenders did."); OCC MORTGAGE METRICS REPORT, FOURTH QUARTER 2012, *supra* note 113, at 23; but see Adelino et al., *supra* note 40, at 6 (reporting no difference).

131. See, e.g., Agarwal et al., *supra* note 85; Been et al., *supra* note 130, at 22; Collins & Herbert, *supra* note 86, at 11; Goodman et al., *supra* note 87, at 57–58. For statistics on the modification activities of individual large servicers, see generally U.S. DEP'T OF TREASURY, MHA PERFORMANCE THROUGH FEBRUARY 2013, *supra* note 75, at 9–10.

suggests that more loan modifications could have been made. Similarly, the number of principal reductions remains artificially low in light of their superior effectiveness in preventing redefaults. Finally, following the robo-signing scandal in the fall of 2010 involving questionable practices by the largest mortgage servicers that were designed to hasten foreclosures, federal banking regulators sanctioned 14 of them for safety and soundness and consumer protection violations.¹³² In the aftermath of that scandal, the largest servicers eventually agreed to a massive mortgage servicing settlement in early 2012 with the federal government and state attorneys general.¹³³ This illegal rush to foreclosure by the nation's biggest servicers indicates that some of those foreclosures could have been avoided by properly designed loan modifications.

Taken together, these findings provide strong evidence that servicers regularly turned down efficient loan modifications in favor of foreclosure even though the modifications would have maximized recovery while keeping borrowers in their homes. This evidence is just the beginning of the inquiry, not the end. The question remains: What makes servicers so reluctant to grant cost-effective loan modifications and how can this problem be addressed?

In this Section, I evaluate the explanations commonly given for the low level of loan modifications. Initially, the slow pace of loan modifications partly reflected the changing nature of the causes of default as the crisis deepened, plus servicers' lack of experience with effective models of foreclosure prevention. But other, more fundamental explanations have been advanced for the low rate as well. These include manipulation of the net present value formula, the high cost of loss mitigation, servicer compensation agreements, restrictions in pooling and servicing agreements with private-label investors, moral hazard concerns, investor threats of lawsuits, accounting considerations, junior liens, and tax treatment. Some of those explanations focus on obstacles in the market for private-label residential mortgage-backed securities, given rigidities in that market and its high level of delinquent loans.¹³⁴ Other reasons, such as accounting and tax rules, apply to the servicing industry across the board. As it turns out, some of those hypotheses are more valid than others.

A. Manipulation of the Net Present Value Analysis

A common barrier to loan modification relief involves the servicer's analysis of the cost effectiveness of a loan modification. Most servicers, before

132. FED. RESERVE SYS., OFFICE OF THE COMPTROLLER OF THE CURRENCY & OFFICE OF THRIFT SUPERVISION, INTERAGENCY REVIEW OF FORECLOSURE POLICIES AND PRACTICES 3 (2011), available at <http://www.occ.treas.gov/news-issuances/news-releases/2011/nr-occ-2011-47a.pdf>.

133. See, e.g., *Overview of Mortgage Servicing Settlement*, DEP'T OF HOUS. & URBAN DEV., <http://portal.hud.gov/hudportal/HUD?src=/mortgageservicingsettlement> (last visited Aug. 3, 2013).

134. In 2008, for instance, private-label securitized subprime, Alt-A, and jumbo prime loans accounted for more than half of foreclosure starts, even though they comprised only 15% of all outstanding mortgages. Christopher Mayer, Edward Morrison & Tomasz Piskorski, *A New Proposal for Loan Modification*, 26 YALE J. ON REG. 417, 417-18 (2009).

they agree to modify a loan, first determine whether a modification will increase the net present value (“NPV”) of the loan relative to foreclosure. Pooling and servicing agreements (“PSAs”)¹³⁵ normally impose this NPV test for private-label loans and require servicers to maximize the recovery for the benefit of the investors in the trust as a whole. Servicers are to implement this requirement by choosing the higher NPV, as between a loan workout and foreclosure. HAMP and the GSEs also impose an NPV test, and many servicers similarly apply their own NPV test to distressed loans held in portfolio.

Although the NPV requirement sounds formulaic, PSAs give servicers of private-label residential mortgage-backed securities a high degree of latitude in how to calculate it. This discretion allows the servicer to select the values for the likely sales price from a foreclosure, the discount rate to apply to the reduced revenue stream from a loan modification, and the likelihood that the borrower will redefault. Investors rarely monitor these choices or question them.¹³⁶ As a result, for many distressed private-label loans, servicers can produce an NPV calculation to support either a loan modification or foreclosure. This same dynamic, to a lesser extent, affects the NPV test for HAMP modifications and for GSE loans.

There are three key factors in servicers’ NPV determinations.¹³⁷ First, some distressed loans self-cure. Second, servicers are concerned about the risk that a modified loan may redefault. Third, the higher the discount rate—in other words, the more eager servicers are for cash today—the higher the likelihood of loan modifications.¹³⁸ These last two factors are within servicers’ control to some extent.

The cure rate is the rate at which seriously delinquent borrowers independently resume payments. This rate has a direct effect on NPV calculations. Cure rates can retard loan workouts by giving servicers hope that borrowers will repay with no further intervention, either by making up their arrears or paying off their loans in full.¹³⁹ In many instances of cure, the servicer’s recovery is higher from doing nothing than it would be from granting a loan modification with a lower monthly payment.

135. PSAs are the agreements between private-label investors and the servicers who work for them that define, among other things, a servicer’s responsibilities with respect to loan modifications. *See id.* at 423.

136. Cordell et al., *Myths and Realities*, *supra* note 6, at 18; Diane E. Thompson, Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior: Servicer Compensation and its Consequences 6–9 (Nat’l Consumer Law Ctr. Inc., Oct. 1, 2009), available at <http://ssrn.com/abstract=1502744>; *see also* Kiff & Klyuev, *supra* note 3, at 8 n.10 (discussing market forces affecting choice of discount rates). For GSE loan pools, this discretion is more limited. Fannie Mae and Freddie Mac require servicers to use standardized software to calculate NPV. Cordell et al., *Myths and Realities*, *supra* note 6, at 18.

137. *See* Cordell et al., *Designing Loan Modifications*, *supra* note 6, at 9–11, 23, 25–28; Cordell et al., *Myths and Realities*, *supra* note 6, at 17–19.

138. *See* Adelino et al., *supra* note 40, at 7.

139. *See, e.g., id.*

Up through 2006, the cure rates on distressed mortgages were substantial. From 2000 through 2006, prime loans had an average cure rate of 45%; for subprime loans, the average cure rate was 19.4%. During the financial crisis, however, cure rates plunged. By 2009, cure rates had plummeted to 6.6% for prime loans and 5.3% for subprime loans.¹⁴⁰ The tight market for refinance loans and the rising tide of underwater mortgages helped explain this decline. As of January 2013, the percentage of loans curing from foreclosure was less than 1%.¹⁴¹ The sharp fall in cure rates may be another reason why servicers became more receptive over time to modifications and other types of workouts.

In contrast, redefault rates probably had the opposite effect. The likelihood that a borrower will redefault on a loan following a workout will directly affect the NPV calculus. Servicers have discretion over the type of loan modification offered, and that choice will significantly affect the anticipated redefault rate. As the chance of redefault increases, servicers will prefer to foreclose as soon as possible instead of delaying the inevitable. Rapid foreclosure also has the effect of accelerating the servicer's final payout. Furthermore, when housing prices are falling, any delay in an inevitable foreclosure would depress the ultimate sales price at the sheriff's sale. These dynamics can work to discourage loan workouts.¹⁴²

Finally, servicers of private-label securitized mortgages had broad discretion in choosing the discount rate. Where a servicer is desperate for cash, it may choose a more aggressive discount rate in order to rush to foreclosure.

In short, NPV calculations are subject to manipulation and servicers can tilt them in favor of foreclosure. The NPV test has the additional drawback of focusing solely on the benefit to the investor. This approach does not take into account the social benefit from avoiding high spillover costs of foreclosures on communities, the housing market, and the economy at large.¹⁴³ Consequently, to the extent that the NPV test is malleable or that results under the NPV test diverge from the larger society's welfare, there may be fewer loan modifications than socially optimal. These problems with the NPV reflect larger problems with the cost structure and compensation of servicers.

B. Agency Problems and Servicer Compensation in Private-Label Loans

As the problems with the NPV test suggest, whenever servicers administer loans held by investors instead of their own loans held in portfolio, there is potential for a classic agency problem vis-à-vis the investors who own those loans.¹⁴⁴ In the case of private-label securitized loans, this agency problem

140. Press Release, Fitch Ratings, Delinquency Cure Rates Worsening for U.S. Prime RMBS (Aug. 24, 2009), http://www.fitchratings.com/creditedesk/press_releases/detail.cfm?pr_id=504898; see also Brown, *supra* note 48, at 11.

141. Press Release, CoreLogic, *supra* note 2, at 2 fig.4.

142. See Adelino et al., *supra* note 40, at 21–22.

143. See, e.g., FED. RESERVE, WHITE PAPER, *supra* note 3, at 20.

144. See Michael Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FINAN. ECON. 305, 312–

stems partly from the fact that the owners of private-label RMBS are diffuse, making it hard for them to monitor servicers who have the day-to-day decision-making responsibility for how to collect delinquent loans.¹⁴⁵ An agency problem can materialize when servicers reject modifications that would improve the net present value of loans relative to foreclosure.

Exacerbating this agency conflict, pooling and servicing agreements between investors and servicers for private-label loans were designed to reward servicers for administering performing loans, not for handling large quantities of delinquent loans in need of workouts. One of HAMP's main assumptions was that securitization compensation structures make servicers more likely to resist loan modifications. HAMP sought to correct this incentive structure and the resulting agency problem by subsidizing servicers to approve more loan modifications.

HAMP's diagnosis is at least partially correct, even if its solution falls short. In private-label RMBS, servicers have four main sources of revenue: fixed servicing fees, float, default fees, and income from residual interests in the loan pool. This compensation structure has numerous moving parts and creates disparate incentives. Generally, however, the private-label compensation structure tilts private-label RMBS servicers away from making principal and interest reductions toward foreclosures and capitalization of arrears.

1. Fixed Servicing Fees

The single largest component of servicer compensation paid by investors is the fixed monthly servicing fee. The GSEs pay a similar fixed servicing fee for loans serviced on their behalf.¹⁴⁶ In the case of RMBS, the fixed fee is computed as a percentage of the outstanding principal balance of the loan pool. Typically, annual fees are 25 basis points ("bps") for prime fixed-rate loans, 37.5 bps for prime ARMs, and 50 bps or more for subprime loans. The servicer takes this fee off the top of borrowers' monthly payments before remitting the principal and income to the trustee to pass on to investors.¹⁴⁷

Sometimes, the fixed-fee structure cuts in favor of a workout. A workout that keeps a loan on the books allows the servicer to continue to collect the servicing fee on the loan. Furthermore, the fixed-fee structure favors workouts that raise monthly payments instead of lowering them. Capitalizing arrears and default fees are more attractive because they pump up the unpaid balance of the loan pool

14 (1976); cf. Yingjin Hila Gan & Christopher Mayer, *Agency Conflicts, Asset Substitution, and Securitization* (Nat'l Bureau of Econ. Research, Working Paper No. 12359, 2006) (documenting agency conflicts in commercial mortgage-backed securities).

145. ADAM B. ASHCRAFT & TIL SCHUERMANN, UNDERSTANDING THE SECURITIZATION OF SUBPRIME MORTGAGE CREDIT 16–18 (now publishers Inc. 2008); Mayer, *supra* note 130, at 16–17.

146. See News Release, Fed. Hous. Fin. Agency, FHFA Announces Joint Initiative to Consider Alternatives for a New Mortgage Servicing Compensation Structure (Jan. 18, 2011), available at http://www.fhfa.gov/webfiles/19716/Servicing_model11811.pdf.

147. Cordell et al., *Myths and Realities*, *supra* note 6, at 15.

and thus increase the servicing fee. Principal write-downs are less appealing to servicers because they lower the unpaid balance of the loan pool.¹⁴⁸

In other respects, the fixed-fee structure militates against workouts in favor of foreclosure. In private-label securitizations, investors do not pay servicers anything extra for completing loan workouts. Instead, servicers must pay the high cost of overhead and labor for loss mitigation out of their fixed monthly servicing fees. The higher those costs, the more reluctant servicers will be to pursue loss mitigation over foreclosure.¹⁴⁹

HAMP seeks to reverse this incentive structure by paying servicers for every completed loan modification. Similarly, Fannie Mae and Freddie Mac pay servicers bonuses for executing workouts.¹⁵⁰ Lingering questions about the effectiveness of these steps, however, prompted the GSEs' regulator, the Federal Housing Finance Agency, to begin overhauling GSE servicer compensation in early 2011.¹⁵¹

Bottom-line, the fixed-fee structure can promote workouts, but those of a certain kind. The structure makes servicers averse to principal write-downs. Conversely, it causes servicers to favor capitalizations, while making them indifferent to interest rate reductions.

2. *Float*

Servicers also collect "float," which consists of the interest earned on mortgage payments held in escrow. Servicers collect this interest between the date when borrowers send in their payments at the beginning of the month and the 25th of the month, when the payments are usually passed through to investors.¹⁵² There is no evidence that float has any significant effect on incentives to do loan modifications.

3. *Default Fees*

Servicers charge borrowers default fees, including late fees and default management fees, for late loan payments. Under the PSAs for securitized trusts, servicers can keep all or part of these default fees and collect them out of the proceeds from foreclosure.

The ability to assess default fees creates incentives favoring foreclosure and capitalizing arrears. Default fees are highly lucrative and servicers want to collect them as soon as possible. In a loan workout, servicers often condition an agreement on immediate upfront payment of those fees or capitalize those fees as arrears, either of which will increase the borrower's payments without some other

148. Thompson, *supra* note 136, at vi, 19–20.

149. Cordell et al., *Myths and Realities*, *supra* note 6, at 23.

150. *Id.* at 17, 20–22.

151. Press Release, Fed. Hous. Fin. Agency, *supra* note 146.

152. Bill McBride, *Tanta: Mortgage Servicing for UberNerds*, CALCULATED RISK, Feb. 20, 2007, 12:26 PM, <http://www.calculatedriskblog.com/2007/02/tanta-mortgage-servicing-for-ubernerds.html>.

form of payment reduction. But at some point a workout will become impractical if default fees continue to mount. At that point, servicers will generally initiate foreclosure in order to collect the default fees.¹⁵³ The rush to collect default fees also encourages the common practice of “dual tracking,” in which servicers who are considering loan modification applications simultaneously proceed with foreclosure.

4. *Income from Residual Interests*

Some servicers of private-label RMBS own the residual tranche of the loan pool, also known as the “B piece.”¹⁵⁴ Usually, the B piece only pays excess interest. In other words, the B piece only pays out if the interest payments by the borrowers exceed the monthly interest payments due to the senior tranche holders. As the junior tranche, the B piece holds the first-loss position, which means that it stands first in line to absorb any losses from a delinquent loan.

Servicers who hold the B piece may favor loan workouts over foreclosure to avoid losses to the residual tranche. At the same time, they are likely to resist interest rate reductions that would eat into their excess interest payments.¹⁵⁵

To summarize, most aspects of private-label servicer compensation cause servicers to favor foreclosure over loss mitigation, even when loss mitigation would increase the return to investors. To the extent that servicers do loan modifications, the fixed monthly servicing fee helps explain why servicers prefer interest rate reductions to principal reductions and capitalization of arrears most of all. Furthermore, servicers who own the B piece may resist interest rate reductions as well.

C. *The Cost Structure of Loss Mitigation*

The high cost of loss mitigation also helps explain the low level of permanent loan modifications. Loss mitigation is significantly more expensive than servicing performing loans. While this is true for all mortgages, it is most pronounced in the private-label context, where servicers’ standard compensation arrangements with investors do not pay additional compensation for the higher costs of loss mitigation. This makes foreclosure more attractive in relative terms.

153. *Id.*; Thompson, *supra* note 136, at 17. This component of compensation is also subject to abuse. Disreputable servicers have incentives to manufacture late fees by not posting on-time payments until after the due date or delaying initiating collection until late fees can be assessed. Servicers may also take the opportunity to assess junk fees at exorbitant rates for out-of-pocket expenses that are nonexistent or trivial in amount. Thompson, *supra* note 136, at 17.

154. Thompson, *supra* note 136, at 4. A tranche is “one of a number of related classes of securities offered as part of the same transaction.” *Id.* at 6. For a description of the role that tranches place in the payout and loss allocation structure of private-label RMBS, see Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 *FORDHAM L. REV.* 2039, 2045–48 (2007).

155. Thompson, *supra* note 136, at 3–4, 7–8, 20.

Similarly, servicers' contractual obligation to advance interest and sometimes principal payments on delinquent loans to private-label investors predisposes those servicers toward foreclosure.

1. Expenses Associated with Loss Mitigation

From a servicer's perspective, loss mitigation is costly compared with foreclosure. Workouts require dealing one-on-one with individual borrowers, each with unique circumstances. Furthermore, for a loan modification to be successful, loss mitigation needs to re-underwrite the borrower's income and assets and order a property appraisal. This involves the same expertise as origination and requires a different and costlier skill set than processing payments and collecting loans.¹⁵⁶

Servicers who undertake loss mitigation often incur many of the costs associated with foreclosure because they typically pursue foreclosure simultaneously while loss mitigation is underway. Credit rating agencies encouraged this practice of dual tracking by conditioning servicers' ratings on prompt foreclosure of distressed loans.¹⁵⁷ The March 2010 revisions to HAMP grappled with this issue by prohibiting foreclosure proceedings against HAMP-eligible borrowers during loan modification negotiations.¹⁵⁸ More generally, rules adopted by the Consumer Financial Protection Bureau in January 2013 prohibit servicers from initiating foreclosure if a borrower files a timely application for a loan modification or other type of workout.¹⁵⁹

The monthly servicing fee structure of pooling and servicing agreements between servicers and private-label investors does not reward servicers for the higher costs associated with loss mitigation. That is because the servicing fee remains fixed even when overhead and labor costs start to rise. Further, under PSAs, servicers cannot recoup overhead or labor costs at payoff or at foreclosure.¹⁶⁰ Consequently, absent subsidies or penalties, servicers have little incentive to incur added overhead or labor costs. Servicers thus favor foreclosure because of the substantially higher cost of workouts.

In view of this cost structure, it is not surprising that the top servicers did not properly staff their loss mitigation operations and instead cut corners in order to speed foreclosure proceedings along. These problems became so severe that federal banking regulators sanctioned some of the nation's largest servicers in 2011 for safety and soundness as well as consumer protection violations and later

156. See, e.g., Goodman et al., *supra* note 85, at 31–32.

157. Cordell et al., *Myths and Realities*, *supra* note 6, at 15; Thompson, *supra* note 136, at 15.

158. Fact Sheet, U.S. Dep't of the Treasury, *supra* note 102, at 1.

159. See Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act (Regulation X), 78 Fed. Reg. 10,696 (Feb. 14, 2013).

160. At payoff or foreclosure, a servicer can recover all principal and interest payments advanced, as well as out-of-pocket costs such as legal fees, title searches, and appraisals that are associated with foreclosure or loan workouts. In contrast, PSAs do not pay servicers for overhead and labor, except out of the fixed monthly servicing fee. Kiff & Klyuev, *supra* note 3, at 11.

negotiated the mortgage servicing settlement with many of those servicers in tandem with the states.¹⁶¹

As a result of this underinvestment in loss mitigation activities, most servicers lacked the staff or expertise to handle the flood of loan workout requests during the mortgage crisis. Borrowers and housing counselors reported chronic difficulties in getting servicers to answer phone calls and servicers often lost documents submitted by borrowers.¹⁶² Servicers dragged their feet in automating their systems to streamline loan modifications.¹⁶³ In sum, the fixed-fee structure of servicers, combined with the high cost of loss mitigation, resulted in a business model that was sorely unprepared to accommodate the unprecedented spike in delinquent loans and workout requests.

HAMP made headway into this compensation and cost structure problem by standardizing modification procedures and paying servicers bonuses for approving permanent loan modifications. Judging from the unexpectedly low number of permanent HAMP modifications to date, though, HAMP subsidies alone were not enough to alleviate the problem.

2. *The Cost of Advancing Payments*

In private-label securitizations, advancing delinquent payments and financing those advances are another factor in servicers' cost calculus. Under the typical private-label PSA, servicers must advance interest payments (and sometimes principal) for delinquent loans to investors for the time period specified in the PSA. Some PSAs require advances until a loan becomes 90 days delinquent; others require advances until the home is liquidated after foreclosure.¹⁶⁴ In addition to making advances, servicers must pay property taxes and insurance on all delinquent loans until the loans are paid off or the properties are sold.

The advance payment requirement often encourages servicers to pursue foreclosure because servicers can recoup all advance payments from the sales proceeds of foreclosure quickly. While servicers can also recover their advances in loan modifications, unlike foreclosure, the speed of recovery in loan modifications is uncertain and often slow. To the extent that servicers agree to loan modifications, they are likely to condition those modifications on quick repayment of all advances.¹⁶⁵ That may boost the borrower's monthly payments, at least temporarily.

161. FED. RESERVE SYS., OFFICE OF THE COMPTROLLER OF THE CURRENCY & OFFICE OF THRIFT SUPERVISION, *supra* note 132, at 3, 8; *see also* FED. RESERVE, WHITE PAPER, *supra* note 3, at 22–23.

162. Cordell et al., *Myths and Realities*, *supra* note 6, at 9.

163. *Id.* at 23.

164. The GSEs have similar advance requirements. Historically, for GSE loans, servicers only had to make advances through the fourth month of delinquency, after which the GSEs purchased the loans out of the pool. At the end of 2007, however, Fannie Mae and Freddie Mac both curtailed such purchases. *See id.* at 16.

165. McBride, *supra* note 152; Thompson, *supra* note 136, at 23–26.

The advance payment requirement entails another major cost consideration. Servicers must finance the advances that they pay, and this debt service can be substantial. Moreover, servicers cannot recover the cost of financing those advances from the proceeds of foreclosure, unlike the advances themselves. Consequently, servicers have an interest in terminating advance payments as quickly as possible. In states where the foreclosure process is fast (generally nonjudicial foreclosure states), this will augur in favor of foreclosure.¹⁶⁶ In states where foreclosure proceedings are slow (judicial foreclosure states), servicers are more likely to pursue quick workouts to restore the loan to current status and stop making advances.¹⁶⁷ Unless those workouts reduce the borrowers' monthly payments, however, they are not likely to succeed in the long run.¹⁶⁸

D. Contractual Limitations in PSAs for Private-Label Securitizations

In addition to hurdles posed by revenue and cost considerations, there has been much debate over the role of PSAs in limiting servicers' discretion to modify loans.¹⁶⁹ For nonconforming loans that are securitized, the servicer's ability to negotiate a workout is subject to the constraints in the PSA for the loan pool. However, the vast majority of PSAs permit material loan modifications to some degree in the event of default, imminent default, or reasonably foreseeable default.¹⁷⁰

Most PSAs give servicers broad discretion to negotiate forbearance that temporarily extends delinquent payments but does not require a change of loan terms, so long as the servicer timely forwards the missed payments to investors.¹⁷¹ While PSAs are usually stricter about permanent loan modifications, they vary widely from deal to deal.¹⁷² A small percentage of PSAs—roughly 10%—prohibit

166. See Thompson, *supra* note 136, at 26.

167. See *id.*

168. *Id.* Piskorski et al. found that servicers of delinquent securitized loans proceeded to foreclosure more often in states with fast foreclosure tracks than in states with slow foreclosure procedures, relative to servicers of delinquent loans held in portfolio. Piskorski et al., *supra* note 130, at 16–17.

169. See, e.g., Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage-Backed Securities*, 82 S. CAL. L. REV. 1075, 1088 (2009).

170. Credit Suisse, *The Day After Tomorrow: Payment Shock and Loan Modifications* 6 (2007) (on file with Author); John P. Hunt, *What Do Subprime Securitization Contracts Actually Say About Loan Modification? Preliminary Results and Implications* 7 (Berkeley Ctr. Law & Econ., Working Paper, 2009), available at http://www.law.berkeley.edu/files/Subprime_Securitization_Contracts_3.25.09.pdf. Among other things, this has the salutary benefit of allowing servicers to contact borrowers before any payments are missed to determine the borrower's ability to handle the new payments and, if not, to explore other options.

171. Credit Suisse, *supra* note 170, at 6; see also Hunt, *supra* note 170, at 7.

172. See Kurt Eggert, *Comment on Michael A. Stegman et al.'s "Preventive Servicing Is Good for Business and Affordable Homeownership Policy": What Prevents Loan Modifications?*, 18 HOUSING POL'Y DEBATE 279, 287–88 (2007).

any material loan modifications.¹⁷³ The remaining PSAs do permit material loan modifications, but only when they are in the best interest of investors.¹⁷⁴ In such cases, the servicer's precise latitude to negotiate a loan modification will depend on the PSA. Many PSAs permit modification of all loans. About 35% of PSAs limit modifications to 5% of the loan pool (measured by the loan amount or number of loans). PSAs may contain other restrictions on loan modifications, such as mandatory trial modification periods, use of specific resolution procedures, caps on interest rate reductions, restrictions on the types of eligible loans, and limits on the number of modifications in any one year.¹⁷⁵

For the 90% or so of private-label securitizations that allow loan modifications to some degree, it is questionable whether limits on those modifications were binding. One survey of PSAs concluded that "large-scale modification programs may be undertaken without violating the plain terms of PSAs in most cases."¹⁷⁶ Even for securitizations that prohibit loan modifications outright or cap them at 5%, some of those PSAs have been amended to allow more modifications.¹⁷⁷ In addition, credit rating agencies no longer count modified loans that are current 12 months after modification against the 5% cap where such a cap exists.¹⁷⁸ Consequently, it is doubtful that the limitations in PSAs per se explain the low level of permanent loan modifications, at least for the 90% of securitized trusts that allow modifications. While servicers face very real challenges in complying with multiple PSAs containing a hodgepodge of provisions, for the most part those agreements do not constrain their ability to modify distressed loans.

E. Moral Hazard

Moral hazard concerns are another reason why servicers and investors may resist loan modifications and principal reductions in particular. Servicers and investors frequently voice fears that loan modifications will induce other borrowers who are able to pay their mortgages to strategically default (or threaten to default) in order to negotiate lower loan payments.¹⁷⁹ When the debate over

173. Credit Suisse, *supra* note 170, at 5–6; *see also* Hunt, *supra* note 170, at 6.

174. Hunt, *supra* note 170, at 7–9. In general, any change in the principal balance, the interest rate, or the final maturity will constitute a "material" modification. *Id.* at 7.

175. Credit Suisse, *supra* note 170, at 6–7, 20; Kiff & Klyuev, *supra* note 3, at 11.

176. Hunt, *supra* note 170, at 10. *See also* Adelino et al., *supra* note 40, at 13–18, 37 tbl.5; Thompson, *supra* note 136, at 6.

177. Most PSAs allow caps on loan modifications to be waived upon consent by a rating agency or a bond insurer; only a few require investor approval. Kiff & Klyuev, *supra* note 3, at 11. HAMP requires servicers to make reasonable efforts to obtain a waiver where a PSA would otherwise prohibit a HAMP modification. *Making Home Affordable Program—MHA Extension and Expansion, Supplemental Directive 12-02, HOME AFFORDABLE MODIFICATION PROGRAM 16* (Mar. 9, 2012), https://www.hmpadmin.com/portal/programs/docs/hamp_servicer/sd1202.pdf.

178. Thompson, *supra* note 136, at 6–7.

179. *See, e.g.*, Brent W. Ambrose & Charles A. Capone, Jr., *Cost-Benefit Analysis of Single-Family Foreclosure Alternatives*, 13 J. REAL EST. FIN. & ECON. 105, 107 (1996); Quercia & Ding, *supra* note 82; Posner & Zingales, *supra* note 57, at 577.

principal reduction began in 2011, there were growing concerns about strategic default given that so many borrowers—over 11 million, or more than one out of every five homeowners¹⁸⁰—had underwater mortgages.¹⁸¹ The extent of negative equity, combined with fears of strategic default, make servicers especially reluctant to reduce principal. This also helps explain the relatively low—albeit growing—levels of principal modifications to date. Fears about strategic default by currently paying borrowers also explain the rarity of loan modifications to borrowers who claim they are at risk of imminent default.

Goodman et al. argued that the potential moral hazard from principal reductions was less than expected because the number of borrowers who would likely engage in strategic default had substantially declined by late 2011. Additionally, there are techniques for managing moral hazard that do not require turning down loan modifications altogether.¹⁸² One way is to limit loss mitigation to borrowers with proven cash-flow problems. This requires full financial disclosure to identify true hardship cases. Another technique, in the case of principal modifications, is to design those modifications so as to discourage redefault. For example, the special servicer Ocwen grants principal modifications to underwater borrowers using three methods to reduce moral hazard. First, Ocwen writes down eligible loans to 95% of the current appraised value, in order to restore the borrower to positive equity and thus reduce incentives to default. Second, one-third of the write-down is forgiven each year for three years, so long as the borrower continues to perform. Finally, the borrower must agree to share 25% of any future home price appreciation with the investor.¹⁸³ Other times,

180. See, e.g., FED. RESERVE, WHITE PAPER, *supra* note 3, at 4; Press Release, CoreLogic, CoreLogic Reports Negative Equity Increase in Q4 2011 1 (July 1, 2012), available at http://www.corelogic.com/about-us/news/asset_upload_file365_15650.pdf.

181. Several studies found evidence of strategic default by deeply underwater borrowers. See Goodman et al., *supra* note 85, at 35–41; Bajari et al., *supra* note 120, at 33–34; Neil Bhutta, Jane Dokko & Hui Shan, Consumer Ruthlessness and Mortgage Default During the 2007-2009 Housing Bust 3–5 (Dec. 2011) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1626969; Ronel Elul, Nicholas S. Souleles, Souphala Chomsisengphet, Dennis Glennon & Robert Hunt, What “Triggers” Mortgage Default? (Fed. Reserve Bank of Phila. Research Dep’t, Working Paper No. 10–13, 2010), available at <http://www.philadelphiafed.org/research-and-data/publications/working-papers/2010/wp10-13.pdf>; Haughwout et al., *supra* note 82, at 3. *But see* Christopher L. Foote, Kristopher Gerardi & Paul S. Willen, *Negative Equity and Foreclosure: Theory and Evidence*, 64 J. URB. ECON. 234, 234 (2009) (finding little evidence of strategic default during the Massachusetts housing downturn in the early 1990s). This tendency is tempered, however, by underwater borrowers’ deep aversion to walking away from their mortgages until they reach high levels of negative equity. Bhutta, *supra*, at 3–5; Luigi Guiso, Paola Sapienza & Luigi Zingales, *The Determinants of Attitudes Toward Strategic Default on Mortgages*, 68 J. FIN. 1473, 1475 (2013); Luigi Guiso, Paola Sapienza & Luigi Zingales, *Moral and Social Constraints to Strategic Default on Mortgages 2* (Nat’l Bureau of Econ. Research, Working Paper No. 15145, 2009), available at <http://www.nber.org/papers/w15145>.

182. See Goodman et al., *supra* note 85.

183. Jon Prior, *Ocwen Unveils New Principal Reduction Program*, HOUSING WIRE (July 26, 2011, 11:37 AM), <http://www.housingwire.com/news/2011/07/26/ocwen-unveils->

servicers who write down principal may insist on short sales that require borrowers to move out instead of granting principal reductions designed to keep borrowers in their homes. This too is intended to discourage strategic defaults.¹⁸⁴

In sum, moral hazard concerns are real. At the same time, servicers often overstate these concerns and ignore design modifications that could discourage moral hazard. The categorical nature of moral hazard objections by many servicers suggests that something else is at work beyond moral hazard concerns themselves.

F. Tranche Warfare

In the debate over the reason for the low number of permanent modifications, some commentators point to the fear of litigation from modifying loans in private-label securitized portfolios. This hypothesis arises from the fact that a servicer's decision to choose loan modification over foreclosure affects tranches differently. Modifications that return loans to performing status benefit the junior tranche by helping it avoid sustaining losses from foreclosure. At the same time, modifications that cut the monthly payments hurt the senior tranches by reducing their revenue stream. Instead, senior tranche holders may prefer foreclosure because the junior tranche will absorb the loss first while the senior tranche holders will often receive their principal back in full.¹⁸⁵

These dynamics have fueled speculation that servicers avoid loan modifications to limit the risk of "tranche warfare," i.e., lawsuits against them by tranche holders.¹⁸⁶ There is scant evidence that tranche warfare has been a real impediment to loan modifications. Few, if any, investors have sued servicers to date for agreeing to loan modifications. In part, this is because of safe harbor protection and also because a sufficient number of investors must consent before suit can be filed.¹⁸⁷ Meanwhile, servicers report that investors rarely question workouts, examine NPV calculations, or even threaten to bring a lawsuit.¹⁸⁸

new-principal-reduction-program-0. Posner & Zingales advanced a similar equity sharing proposal. Posner & Zingales, *supra* note 57, at 575.

184. Thompson, *supra* note 136, at 9.

185. Kiff & Klyuev, *supra* note 3, at 11–12.

186. Eggert, *supra* note 172, at 290–91.

187. Thompson, *supra* note 136, at 8. The PSAs for certain Countrywide securitizations contained a unique clause allowing Countrywide to modify up to 5% of the loan pool in dollar terms only if Countrywide bought back the modified loans from the loan pool. Hunt, *supra* note 170, at 9–10. In *Greenwich Financial Services Distressed Mortgage Fund 3, L.L.C. v. Countrywide Financial Corporation*, No. 650474/2008 (N.Y. Sup. Ct., N.Y. Cty., filed 2008), an investor in a securitized Countrywide trust sued Countrywide to force it to buy back any loans that it modified under a settlement agreement with state attorneys general. Despite surface appearances, the *Greenwich* suit is not an actual case of tranche warfare because Greenwich concurred that Countrywide had the latitude to modify the loans. Instead, Greenwich simply demanded that Countrywide buy back the loans it modified pursuant to its agreement. Thompson, *supra* note 136, at 42 n.48. Another anomalous case revolved around a series of lawsuits between the Carrington hedge fund as the residual trancheholder of MBS and American Home Mortgage Servicing, the servicer. Carrington had negotiated a PSA provision called the "rights of the CE holder" that allowed

The safe harbor likely contributed to the relative quiet on the tranche warfare front. In 2008 and 2009, Congress alleviated any concern that tranche warfare might affect servicers' attitudes toward loan modifications by enacting a safe harbor for servicers from investor suits for modifications that comport with standard industry practice or government modification programs.¹⁸⁹ These statutory provisions did not raise the level of loan modifications in any obvious way, reinforcing the conclusion that tranche warfare is not the reason for low levels of loan modifications.

G. Accounting Treatment

The choice of workout techniques can also have consequences for the accounting treatment of loans and the need for write-downs. Current accounting rules make servicers reluctant to reduce principal and interest. These rules also encourage servicers to grant temporary modifications instead of permanent ones.

Financial Accounting Standard 15 ("FAS 15"), on troubled debt restructurings, is the main accounting standard on point. Under that provision, permanent reductions of principal or interest for troubled loans require immediate write-downs. To the extent the servicer owns the residual tranche or the loans in portfolio, it will likely absorb all or part of that loss.¹⁹⁰ In contrast, temporary modifications do not trigger the need for any write-down. Thus, FAS 15 encourages temporary loan modifications over permanent ones and short-term repayment plans with dubious success rates over modifications that permanently reduce principal or interest.¹⁹¹

it to determine the foreclosure and foreclosure sales process for every loan Carrington bought from the originators. After American Home declined to enforce the rights of the CE holder clause, Carrington sued to enforce the provision. Jacob Gaffney, *Straight Up: The Vindication of Carrington Mortgage Services*, HOUSING WIRE (Aug. 2012), <http://www.housingwire.com/articles/straight-vindication-carrington-mortgage-services?v=preview>. Unlike the typical tranche warfare scenario involving passive investors, here the dispute was between the servicer and an investor who asserted his own ability to directly service distressed loans.

188. Cordell et al., *Myths and Realities*, *supra* note 6, at 22–23.

189. HOPE for Homeowners Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654; Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, 123 Stat. 1632 (codified at 15 U.S.C. § 1639a).

190. See Engel & McCoy, *supra* note 154, at 2047.

191. Thompson, *supra* note 136, at 12–14, 22; see also Piskorski et al., *supra* note 130, at 37 fig.3. A short-term repayment plan suspends terms or full monthly payment requirements for a brief period of time to allow the borrower to catch up on missed payments. After the period expires, the payment schedule reverts to the original schedule for the mortgage. In 2007, the Securities and Exchange Commission laid to rest a separate question surrounding the accounting treatment of modified loans. Under FAS 140, a securitized pool limited to assets that are "passive in nature" receives two benefits. The loan pool is protected from claims by creditors against the underwriter or sponsor of the loan pool. In addition, the transferor of the assets does not need to hold capital against those loans. Previously, there had been concern that modifying loans before they became delinquent would disqualify a loan pool from favorable treatment under FAS 140. In a letter

FAS 15 is likely another reason why permanent HAMP modifications lagged, because permanent modifications of distressed loans impose a stiff added cost in the form of loss recognition. Additionally, servicers subject to federal banking regulation may avoid write-downs of their distressed loans in order to preserve capital¹⁹² and avoid the need for additional loan loss reserves.¹⁹³ Servicers are especially prone to act this way when they think they can avoid or postpone a markdown by rejecting a loan modification request.

However, federal banking regulators have authority to require write-downs of distressed loans anyway, even before consideration of a modification.¹⁹⁴ When regulators are vigilant about enforcing the accounting standards for distressed loans, they can help equalize the accounting treatment for distressed loans without regard to modification and make servicers more receptive to workouts. In July 2012, for instance, the Office of the Comptroller of the Currency brought this issue to a head by amending the OCC's bank accounting standards to require write-downs if the servicer no longer expected principal and interest to be paid in full on particular loans.¹⁹⁵ The ruling applied to national banks and federal savings associations, which accounted for at least 60% of the nation's servicing industry. In response to the ruling, JP Morgan Chase & Co. and Wells Fargo & Co. wrote down almost \$1.4 billion on distressed home-equity and mortgage loans in third quarter 2012 and moved another \$3.1 billion in distressed home loans to nonaccrual status.¹⁹⁶ Other major servicers followed suit.¹⁹⁷ That quarter, after the

dated July 24, 2007, however, then-Securities and Exchange Commission Chairman Christopher Cox wrote Congressman Barney Frank, then Chairman of the House Banking Committee, assuring Frank that modifications before delinquency would comply with FAS 140 so long as default was "reasonably foreseeable." Alan Rappeport, *Prodded by Congress, Cox Finds Flexibility in FAS 140*, CFO, (July 27, 2007), <http://www.cfo.com/article.cfm/9564784?f=related>.

192. See Posner & Zingales, *supra* note 57, at 599; Cordell et al., *Myths and Realities*, *supra* note 6, at 21, 24–25; Haughwout et al., *supra* note 82, at 25–28. Capital must be held against loans held in portfolio and loan modifications may require more capital. See Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements, 77 Fed. Reg. 52,888, 52,900 (Aug. 30, 2012) (to be codified at 12 C.F.R. pt.324). In addition, the anticipated capital treatment of mortgage servicing rights under Basel III may affect the profitability of servicing operations. See FED. RESERVE, WHITE PAPER, *supra* note 3, at 7.

193. Under FAS 15, permanent concessions to allay a borrower's financial difficulties must be treated as troubled debt restructurings in order to preserve the bankruptcy-remote status of a securitized trust. Anything classified as a troubled debt restructuring requires the establishment of additional loan loss reserves under FAS 114.

194. See OFFICE OF THE COMPTROLLER OF THE CURRENCY, NR 2012-114, BANK ACCOUNTING ADVISORY SERIES UPDATED (July 25, 2012); OFFICE OF THE COMPTROLLER OF THE CURRENCY, BANK ACCOUNTING ADVISORY SERIES 10-11 (2012), available at <http://www.occ.gov/publications/publications-by-type/other-publications-reports/baas.pdf>.

195. See OFFICE OF THE COMPTROLLER OF THE CURRENCY, NR 2012-114, BANK ACCOUNTING ADVISORY SERIES UPDATED, *supra* note 194.

196. Dawn Kopecki & Michael J. Moore, *JP Morgan, Wells Fargo Write Down Home-Equity Loans*, BLOOMBERG BUSINESSWEEK (Oct. 12, 2012, 1:11 PM),

largest OCC-regulated servicers had taken those write-downs, the number of portfolio loans held by the largest thrifts and national banks that received an interest rate reduction, principal reduction, or term extension rose.¹⁹⁸

To conclude, servicers' desire to avoid write-offs, higher capital requirements, and additional loan loss reserves poses a powerful barrier to loan modifications. More aggressive enforcement by banking examiners of the accounting standards for distressed loans can help level the playing field by eliminating any accounting advantage for denying loss mitigation.

H. Junior Mortgages

Distressed junior mortgages are also cited as an obstacle to loan modifications. Over half of outstanding U.S. mortgages have junior liens.¹⁹⁹ Borrowers with private-label first mortgages are especially likely to have junior liens. Over half of private-label mortgages had second liens at year-end 2009, compared to 18% of GSE loans.²⁰⁰ Similarly, junior liens are prevalent in borrowers with negative equity, which comes as no surprise since junior liens boost combined loan-to-value ratios. As of the fourth quarter of 2011, 4.4 million underwater borrowers had second liens, with an average combined loan-to-value ratio of 138%.²⁰¹

In situations involving a second lien, the total debt-to-income ratio post-modification may still be too high for a distressed borrower to manage unless the second lien is modified along with the first. HAMP statistics confirm that this problem is real, reporting a high average back-end DTI ratio of 52.4% following tier 1 HAMP modifications in February 2013.²⁰² Since first mortgages with junior

<http://www.bloomberg.com/news/2012-10-12/occ-forced-jpmorgan-wells-fargo-to-write-down-home-equity-loans.html>.

197. See, e.g., Press Release, Bank of America, Bank of America Reports Third-Quarter 2012 Net Income of \$340 Million, or \$0.00 per Share (Oct. 17, 2012), http://investor.bankofamerica.com/phoenix.zhtml?c=71595&p=irol-newsArticle&ID=1746326&highlight=#fbid=djajsUTft_L; Press Release, Citigroup Inc., Citigroup Report Third Quarter 2012 Earnings per Share of \$0.15; \$1.06 Excluding CVA/DVA, on MSSB and Tax Benefit (Oct. 15, 2012), available at <http://www.citigroup.com/citi/investor/data/qer312.pdf?ieNocache=391>.

198. Compare OCC MORTGAGE METRICS REPORT, FOURTH QUARTER 2012, *supra* note 113, at 28, with OFFICE OF THE COMPTROLLER OF THE CURRENCY, OCC MORTGAGE METRICS REPORT, SECOND QUARTER 2012 30 (2012). While the mortgage servicing settlement probably also played a role in the surge, Wells Fargo cited the OCC's write-down ruling as one reason for its write-down. See Kopecki & Moore, *supra* note 196.

199. Compare Laurie S. Goodman, Roger Ashworth, Brian Landy & Ke Yin, *Second Liens: How Important?*, 20 J. FIXED INCOME 19, 20 (2010), with Donghoon Lee, Christopher Mayer & Joseph Tracy, *A New Look at Second Liens* 4 (Fed. Reserve Bank of N.Y.C., Staff Report No. 569, 2012).

200. Goodman et al., *supra* note 199, at 20.

201. Press Release, CoreLogic, *supra* note 180, at 2.

202. U.S. DEP'T OF TREASURY, MHA PERFORMANCE THROUGH FEBRUARY 2013, *supra* note 75, at 6.

liens default more often than first mortgages without²⁰³—and since negative equity is a strong predictor of default²⁰⁴—workouts of junior mortgages are critical to a comprehensive solution to the backlog of distressed mortgages.

The ownership pattern for junior liens creates the potential for principal-agent conflicts for servicers of first-lien securitized mortgages. In the first quarter of 2011, securitized trusts held only 2% of the outstanding \$929 billion in closed-end junior mortgages and home equity lines of credit (“HELOCs”). That same quarter, four of the nation’s largest banks—Bank of America, Wells Fargo, JP Morgan Chase, and Citigroup—held 43% of all outstanding closed-end mortgages and HELOCs in portfolio. Other depository institutions and credit unions held most of the rest.²⁰⁵

The predominance of banks as owners of junior liens creates principal-agent conflicts for banks that service other investors’ private-label first liens plus their own junior liens. Investors argued that servicers should write down their own second liens before modifying distressed private-label first liens.²⁰⁶ However, servicers were reluctant to do so, at least until the 2012 OCC ruling on accounting treatment discussed earlier,²⁰⁷ because write-downs would have reduced their earnings as well as bank capital. The capital implications were significant, in view of the fact that total outstanding second mortgages on banks’ books equaled over half of all bank capital in 2011.²⁰⁸

Evidence suggests that this principal-agent problem is real and that junior liens impede loan modification. In general, it is difficult to study the effect of the presence of junior liens on a distressed homeowner’s prospects for loan modification because most datasets do not allow researchers to identify which second liens are linked to particular first-lien loans. One innovative study of New York City loans was able to overcome that hurdle, however, and found that first-lien mortgages with junior liens were less likely to be modified than first-liens with none.²⁰⁹ Another study reported that junior liens were 11.3% less likely to be modified,²¹⁰ which suggests that distressed borrowers with junior liens have more difficulty in negotiating a comprehensive loan modification package.

203. Goodman et al., *supra* note 199, at 20, 22–25.

204. See, e.g., Bajari et al., *supra* note 120, at 32–33; Bhutta et al., *supra* note 181, at 1; Elul et al., *supra* note 181, at 2, 8; Haughwout et al., *supra* note 82, at 1–3.

205. Goodman et al., *supra* note 85, at 38–40; see also Goodman et al., *supra* note 199, at 25–27.

206. See, e.g., Al Yoon, *Mortgage Investors See Headway on 2nd-Liens*, REUTERS (Apr. 12, 2010, 6:39 PM), <http://www.reuters.com/article/2010/04/12/us-mortgages-investors-idUSTRE63B63F20100412>.

207. See *supra* Part IV.G.

208. Lee et al., *supra* note 199, at 2.

209. Sewin Chan, Claudia Sharygin, Vicki Been & Andrew Haughwout, *Pathways After Default: What Happens to Distressed Mortgage Borrowers and Their Homes?* 5 (N.Y.U. Law & Econ., Working Paper No. 281, 2011).

210. Sumit Agarwal, Gene Amromin, Itzhak Ben-David, Souphala Chomsisengphet & Douglas D. Evanoff, *Market Based Loss Mitigation Practices for*

There are several reasons why first-lien loan modifications are harder to negotiate with junior liens present. A surprising proportion of junior liens continue to perform after borrowers default on their first mortgages.²¹¹ Other junior liens are both underwater and delinquent and thus often lack real worth apart from possible recourse or demanding payment from the first lienholder in order to approve a workout.²¹² Junior lienholders may perceive leverage in that situation. Although many legal commentators believe that term extensions, interest rate reductions, and principal write-downs on first-lien loans do not require junior lienholders' approval, the rights of junior lien holders "have not been fully worked out in the common law."²¹³ For this reason, first lien holders generally require junior lien holders to sign an agreement to continue to subordinate their claims before agreeing to modify a first mortgage. As a further complication, there is no central registry of junior liens, making obtaining assent impossible if the junior lien holder cannot be found. Even when they can be located, junior lien holders are often reluctant to agree or demand several thousand dollars in payments in order to resubordinate.²¹⁴

HAMP offers a second lien modification program ("2MP") to pay servicers to modify or extinguish second mortgages, but participation is voluntary. As of February 2013, only six of the nine largest servicers participated in the second lien program.²¹⁵ The Obama administration predicted that 2MP would help up to 1.5 million borrowers,²¹⁶ but so far 2MP barely made a dent in the second-lien problem: As of February 2013, 107,400 second lien modifications had been started under 2 MP and only 27,296 second liens had been extinguished.²¹⁷ Without more—and especially without resolving banks' accounting and capital concerns—HAMP subsidies will not be enough to untie the Gordian knot of junior liens.

Troubled Mortgages Following the Financial Crisis 13, 33 tbl.3 (Fed. Reserve Bank of Chi., Working Paper No. 2011-03, 2010).

211. See Goodman et al., *supra* note 199, at 28; Julapa Jagtiani & William W. Lang, *Strategic Defaults on First and Second Lien Mortgages During the Financial Crisis*, 20 J. FIXED INCOME 7, 7 (2011); Lee et al., *supra* note 199, at 7.

212. See Cordell et al., *Myths and Realities*, *supra* note 6, at 27.

213. Patrick A. Randolph, Jr., & Edwin F. Pierson, Mortgage Modification and Alteration of Priorities Between Junior and Senior Lienholders (Jan. 28, 2010) (unpublished manuscript), available at dirt.umkc.edu/alterationofpriorities.htm. A first lienholder may forfeit senior status for increasing the interest rate but not for decreasing it. Increasing the principal balance will also often lead to forfeiture. Extending or shortening the payment schedule will usually not jeopardize senior status. *Id.*

214. Cordell et al., *Myths and Realities*, *supra* note 6, at 26–27.

215. U.S. DEP'T OF TREASURY, MHA PERFORMANCE THROUGH FEBRUARY 2013, *supra* note 75, at 16, 18.

216. *Second Lien Modification Program (2MP): Overview*, HOME AFFORDABLE MODIFICATION PROGRAM, https://www.hmpadmin.com/portal/programs/second_lien.jsp (last viewed Aug. 3, 2013).

217. U.S. DEP'T OF TREASURY, MHA PERFORMANCE THROUGH FEBRUARY 2013, *supra* note 75, at 5.

I. Tax Considerations

Previously, there was concern that tax considerations might have played a role in loan modification decisions, but those considerations have been allayed by the Internal Revenue Service. Virtually all securitized trusts are structured as pass-through entities under the Real Estate Mortgage Investment Conduit (“REMIC”) provisions of the Internal Revenue Code to avoid double federal income tax liability.²¹⁸ At one time, it was thought that the REMIC tax rules penalized loan modifications.²¹⁹ This concern arose from the fact that REMICs must be limited to static loan pools to keep their tax-favored status. Servicers feared that loan modifications would destroy the static nature of the loan pool. On May 16, 2008, however, the Internal Revenue Service laid this concern to rest by ruling that loan modifications for owner-occupied homes would not endanger REMIC status so long as the loan was in default or the servicer reasonably believed there was a significant risk of default. In addition, under the IRS ruling, any modification had to follow a standard protocol in order to receive this tax-favored status.²²⁰ Due to this IRS ruling, tax considerations no longer pose a significant obstacle to modifications of distressed home loans.

V. THE REAL OBSTACLES TO LOAN MODIFICATIONS

During the early years of the crisis, there was rampant speculation about the obstacles to worthwhile loan modifications. Six years out, we are now in a better position to identify the real friction points and to implement measures to address them. The most powerful impediments to loan modifications are the current system of servicer compensation, the presence of junior liens, and the accounting treatment of permanent loan modifications.

Economic studies suggest that principal-agent problems in the private-label securitization market create a bias toward foreclosures and against loan modifications. The real question is, why? One of the leading causes is our current broken compensation system for private-label servicing. These same perverse incentives affect GSE compensation arrangements for servicers, albeit to a lesser extent. In addition, the high-cost nature of loss mitigation encourages going to foreclosure, regardless of the type of investor. Indeed, as the recent federal enforcement actions showed, this dynamic was so strong that numerous servicers resorted to robo-signing and other disreputable foreclosure practices in order to spare expense, regardless of whether the loans in question were private-label loans, GSE loans, or loans held in portfolio.

Another widely aired theory, involving restrictions on modifications in PSAs, lost credence over time. It is true that those restrictions present

218. See, e.g., Thompson, *supra* note 136, at 9.

219. See, e.g., *id.* at 9–10. See generally Michael S. Barr & James A. Feldman, *Issue Brief: Overcoming Legal Barriers to the Bulk Sale of At-Risk Mortgages*, CENTER FOR AM. PROGRESS, Apr. 2008, available at http://www.americanprogress.org/issues/2008/04/pdf/reimc_brief.pdf.

220. Rev. Proc. 08-28, 2008-23 I.R.B. 6; see also Rev. Proc. 07-02, 2007-52 I.R.B. 6.

administrative headaches for servicers and prove binding in a small minority of cases. Additionally, some PSAs prohibit principal reductions despite allowing other types of modifications. However, most PSAs give wide latitude for loan modifications, including principal reductions,²²¹ and do not pose significant hurdles to intelligent workouts.

Similarly, early concerns about adverse tax implications and tranche warfare by investors did not pan out. In contrast, servicer delays in recognizing losses under accounting rules were a powerful impediment to optimal levels of loan modifications. These efforts to avoid loss recognition fueled servicers' preference for temporary modifications over permanent ones and were a powerful reason why the largest banks resisted write-downs of their worthless second mortgages.

When servicers grant loan modifications, their compensation system and concerns about accounting treatment cause them to prefer types of modifications with higher redefault rates. If servicers were truly concerned about minimizing redefault rates on loan modifications, they would make principal reductions a priority and avoid capitalizing arrears. However, virtually all loan workouts capitalize arrears, even though that increases the risk of redefault. Similarly, fixed servicing fees and accounting rules—combined with restrictions in some PSAs, the Federal Housing Finance Agency's opposition to principal reductions for GSE loans, and many servicers' unwillingness to use design elements in principal modifications to reduce moral hazard—have all slowed the adoption of principal forbearance and forgiveness. As a result, interest rate reductions have outpaced principal reductions, probably because fixed servicing fees and default fees have a neutral effect on servicers' incentives to cut interest rates.

There are three reasons why we need to care about the barriers to foreclosure prevention. First, needless foreclosures inflict heavy losses on borrowers, investors, and communities that could otherwise be avoided with well-designed loan modifications. Second, removing unnecessary obstacles to interest rate and principal reductions will produce loan modifications with higher success rates. Finally, the right diagnosis is important because the policy response depends on what needs to be fixed.

First and foremost among those policy responses is servicer compensation reform, which still has not occurred. Today's system pays too much to servicers for servicing current loans and too little for crafting workouts. Going forward, servicer compensation needs to be overhauled to cover the cost of competent loss mitigation activities and to reward servicers for granting workouts, when appropriate, of loans in default. Properly paying servicers for approving NPV-positive loan modifications would go a long way toward avoiding another wave of needless foreclosures. In coming years, as policymakers debate whether to wind

221. The recent spurt in private-label principal reductions shows that many PSAs allow them. See Goodman et al., *supra* note 87, at 57; see also OCC MORTGAGE METRICS REPORT, FOURTH QUARTER 2012, *supra* note 113, at 28 tbl.20.

down the GSEs and privatize the system of housing finance,²²² a window of opportunity will open to adopt those reforms.

Concerns about accounting treatment and loss recognition are another major impediment to modifications of certain types of loans. This problem affects portfolio loans and securitized loans in particular where the servicers hold the residual tranches. Relaxing the accounting rules for troubled debt restructurings is not the answer, because doing so would undermine the transparency and reliability of servicers' financial statements. Instead, auditors and regulators need to put consistent pressure on servicers to mark down distressed loans promptly. There was a noticeable uptick in loan modifications—particularly in interest rate and principal reductions, with their lower redefault rates—after the Comptroller insisted on more aggressive write-downs for troubled loans. Prompt write-offs of impaired and worthless loans will also remove the obstacle to workouts that distressed junior loans now pose.

Finally, the wide variation in loss mitigation records for different servicers cries out for attention.²²³ As the financial crisis showed, unnecessary foreclosures inflict devastating costs on surrounding communities. These costs are too high to entrust loss mitigation to private contracting alone. Instead, the time has come to incorporate the lessons of the foreclosure crisis into the servicing industry's institutional design. In particular, pooling and servicing agreements and other comparable servicing guidelines must be rewritten to adopt the aspects of HAMP that worked, particularly: the standardized waterfall, the stress on early intervention, and the emphasis on lower monthly payments, including through principal reduction. Similarly, PSAs and seller/servicer guidelines should be altered to include principal reduction as a permissible loss mitigation method.

Right now, the federal government has a historic opportunity to accomplish these changes because our system of housing finance is in dire need of reform. Whichever direction housing reform takes, the federal government needs to seize the opportunity to standardize loss mitigation protocols going forward. If, for example, housing finance continues to be conducted by federal instrumentalities—as it is for the most part today—then the federal government will have the power, by virtue of its control over those instrumentalities, to require them to incorporate the beneficial lessons from HAMP's design and the principal reduction experience into their servicing guidelines going forward. Alternatively, if the federal government dismantles the GSEs in favor of private-label securitization, investor demand for more effective loss mitigation protocols, plus the probable need for a federal guarantee for catastrophic loss,²²⁴ will create a

222. See, e.g., DEP'T OF THE TREASURY AND DEP'T OF HOUS. AND URBAN DEV., REFORMING AMERICA'S HOUSING FINANCE MARKET 24 (2011), available at <http://www.treasury.gov/initiatives/documents/reforming%20america's%20housing%20finance%20market.pdf>.

223. See, e.g., Goodman et al., *supra* note 87, at 57–59; Agarwal et al., *supra* note 85, at 15, 28; Been et al., *supra* note 130, at 7; Collins & Herbert, *supra* note 86, at 11.

224. See, e.g., BIPARTISAN POL'Y CTR., HOUSING AMERICA'S FUTURE: NEW DIRECTIONS FOR NATIONAL POLICY 50–58 (2013), available at <http://bipartisanpolicy.org/>

prime opportunity to write optimal foreclosure prevention standards into the PSAs of the future. However the housing finance system is reformed, it is crucial for regulators, investors, the servicing and securitization industries, and the public at large to take this opportunity to institutionalize the changes needed to improve foreclosure prevention for once and for good.