

HAMP: Doomed From The Start

by Marc Gans

Introduction

The collapse of the American housing market has had deleterious effects on not only the U.S. economy, but also the global economy, plunging much of the world into the worst financial crisis since the Great Depression.

In the U.S., a record 3.8 million foreclosure filings (default notices, scheduled auctions, and bank repossessions) were reported on 2.8 million properties in 2010.¹ This was an increase of almost two percent from 2009 and an increase of 23 percent from 2008.² 2.23 percent of all U.S. housing units received at least one foreclosure filing during 2010. This was up from 2.21 percent in 2009, 1.84 percent in 2008, 1.03 percent in 2007, and 0.58 percent in 2006.³ Foreclosures in 2011 were down 34 percent from the previous year – 2.7 million filings on 1.45 percent of all housing units – but these numbers still represent levels not seen before the recent financial crisis began.⁴ Moreover, this decrease is largely attributable to the documentation and legal issues plaguing the industry; foreclosure activity is actually projected to be higher in 2012.⁵ More than one in four American borrowers are currently underwater, and over four million borrowers owe at least twice as much as their homes are worth.⁶

The Bush Administration's attempts at stemming the foreclosure crisis are widely considered unmitigated failures. In 2007, President Bush announced that the Federal Housing Administration (FHA) would launch a program called FHA-Secure, which would allow homeowners with good credit history, but who could not afford their current payments, to refinance into FHA-insured mortgages.⁷ The number of delinquent conventional loans refinanced with FHA-insured mortgages was zero in fiscal 2007, 3,794 in fiscal 2008, and 316 in fiscal 2009 – a total of 4,110.⁸

In January 2008 President Bush created Hope for Homeowners, a program that set aside \$300 billion to refinance toxic loans.⁹ There were zero loans refinanced in fiscal 2008, 23 in fiscal 2009, and 48 in fiscal 2010 – a total of 71 loans over three years.¹⁰ A major reason for its failure is that lender participation was voluntary and new loans were limited to 90 percent of appraised value. Appraised value had already decreased significantly, so lenders were not willing to take losses.

In February 2009, the Obama Administration's response to the foreclosure crisis was

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¹ *Record 2.9 Million U.S. Properties Receive Foreclosure Filings in 2010 Despite 30-Month Low in December*, REALTYTRAC, Jan. 12, 2011, <http://www.realtytrac.com/content/press-releases/record-29-million-us-properties-receive-foreclosure-filings-in-2010-despite-30-month-low-in-december-6309>.

² *Id.*

³ *Id.* Nevada has the highest foreclosure rate in the U.S., with more than 9 percent of homes receiving at least one foreclosure filing in 2010. Arizona is next, at 5.73 percent, followed by Florida at 5.51 percent. Overall, five states – California, Florida, Arizona, Illinois, and Michigan – account for 51 percent of the nation's total foreclosure activity in 2010.

⁴ *2011 Year-End Foreclosure Report: Foreclosures on the Retreat*, REALTYTRAC, Jan. 9, 2012, <http://www.realtytrac.com/content/foreclosure-market-report/2011-year-end-foreclosure-market-report-6984>.

⁵ *Id.*

⁶ *Drowning or waiving: The policy options for alleviating America's huge negative-equity problem*, *The Economist*, Oct. 21, 2010, <http://www.economist.com/node/17305544>.

⁷ Peter G. Miller, *Obama Mortgage Modification Plan -- 100 Times Better Than Bush*, *The Huffington Post*, Aug. 25, 2010, http://www.huffingtonpost.com/peter-g-miller/obama-mortgage-modificati_b_694059.html

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

the Home Affordable Mortgage Program (HAMP), designed to help as many as 4 million borrowers avoid foreclosure by the end of 2012. HAMP was the largest part of a broad array of programs called Making Home Affordable (MHA), which itself was part of the \$700 billion Troubled Asset Relief Program (TARP) bailout. \$75 billion was originally set aside to fund MHA (\$50 billion under TARP and \$25 billion from Fannie Mae and Freddie Mac).¹¹ HAMP required participating loan servicers to reduce monthly payments to no more than 38 percent of the borrower's gross monthly income, with the government then chipping in to bring the payments down to no more than 31 percent of monthly income.¹²

This paper will critique the effectiveness of HAMP and its companion programs, and dissect what went wrong. This will include an analysis of strategic defaults, strategic defaults and the motivations of the servicers. Lastly, this paper will lay out proposed solutions and advocate what would have been the best solution from the start.

I. HAMP & Related Programs

HAMP is available to qualified borrowers to modify first liens on primary residences made before January 1, 2009. The first-lien mortgage payment must exceed 31 percent of the borrower's gross monthly income. Only single-family properties with mortgages no greater than \$729,750 for a one-unit property are eligible.¹³

Under HAMP, costs are shared between mortgage holders (investors) and the federal government. Investors take the first loss in reducing monthly payments to no more than 38 percent of the borrower's monthly income. Then, the U.S. Treasury uses TARP funds to reduce the monthly payment to no more than 31 percent of the borrower's monthly income.¹⁴ Modified monthly payments are fixed for five years or until the loan is paid off, whichever is earlier, provided that the borrower remains in good standing.¹⁵ After five years, investors no longer receive cost-sharing payments, and the borrower's interest rate may increase one percent per year up to a pre-determined cap.¹⁶ While the borrower's payment would increase because of the higher interest rate, this rate would then remain fixed for the remainder of the loan.¹⁷

In order to determine whether a loan servicer is required to make a modification, a net present value (NPV) model is used, which compares expected cash flows from a modified loan to the same loan without a modification. If the expected cash flows are greater with a modification than without, then the servicer is required to modify the loan.¹⁸

In order to accomplish the modification, a series of sequential steps are taken until the 31 percent debt-to-income threshold is met: reducing the interest rate to as little as two percent, extending the terms of the loan to up to 40 years, and finally forbearing loan principal at no interest. HAMP does not require servicers to reduce mortgage principal. Before borrowers can receive a permanent modification, they must make payments in a three-month trial period, and complete additional paperwork. To encourage participation, servicers are paid \$1,000 for each modification and \$1,000 each year for three years, as long as the borrower continues making payments.¹⁹

¹¹ U.S. Gov't Accountability Office, *Troubled Asset Relief Program: Further Actions Needed to Fully and Equitably Implement Foreclosure Mitigation Programs* 7 (2010), <http://www.gao.gov/new.items/d10634.pdf> [hereinafter *Further Actions Needed*].

¹² *Drowning or waiving: The policy options for alleviating America's huge negative-equity problem*, *supra* note 6.

¹³ U.S. Dep't of the Treasury, *The Making Home Affordable Program Handbook for Servicers of Non-GSE Mortgages (Version 3.0)* 41-44 (2010), https://www.hmpadmin.com/portal/programs/docs/hamp_servicer/mhahandbook_30.pdf, [hereinafter *MHA Handbook*]. While MHA applies to both government sponsored entity (GSE) and Non-GSE mortgages, this is the only publically available handbook with the various programs' specific details. Treasury advises servicers of mortgage loans that are owned or guaranteed by Fannie Mae or Freddie Mac to refer to any relevant guidance issued by the applicable GSE.

¹⁴ *Id.* at 65-67.

¹⁵ *Id.*

¹⁶ *Id.* at 66, 94.

¹⁷ *Id.*

¹⁸ *Id.* at 73-77.

¹⁹ *Id.* at 92-93.

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A. Results and Problems

HAMP is premised on the notion that homeowners will continue to make their monthly payments as long as they can afford to do so, regardless of how much negative equity they have in their home - this is its fundamental flaw. Home prices have dropped 33 percent from their 2006 peak.²⁰ As a result, more than one in four homes is currently underwater.²¹ In 2009, researchers estimated that 26 percent of defaults are strategic.²² As such, if homeowners owe more than the house is worth, they have an incentive to default. Thus far, principal has been reduced for only around six percent of HAMP cases.²³ Strategic defaults are discussed in more detail in Part II.

HAMP was also launched before being fully developed, which led to confusion and delays. Homeowners were put into trial modifications before servicers collected the required documentation.²⁴ This created a backlog of trial modifications, a great deal of which never became permanent. When the program initially got off to a slow start, the Treasury permitted servicers to enroll borrowers using stated income. As such, four of the five largest HAMP servicers relied on stated income to determine HAMP eligibility.²⁵ A JP Morgan Chase official told a congressional committee in December 2009 that while 71 percent of the firm's modified borrowers made all three trial payments, 72 percent of those failed to adequately produce the required documents for conversion into a permanent modification.²⁶ In January 2010, the guidelines were changed to require servicers to gather documented financial information before placing borrowers into trial modifications.²⁷

HAMP has also come under fire for not being marketed properly.²⁸ For example, it took the Treasury more than one year to develop its own public service announcements.²⁹ Meanwhile, officials conduct no oversight of servicers' marketing efforts. As of November 2009, less than half the participating servicers' websites even contained information about HAMP, and only a little more than one-third provided a link to the Making Home Affordable website. Additionally, the Treasury outsourced the responsibility for overseeing servicers to Fannie Mae and Freddie Mac, even though both companies have business relationships with the same servicers. This calls into question their impartiality and thus their ability to conduct stringent oversight.

2.82 million U.S. homeowners lost their properties to foreclosure in 2009.³⁰ As of February 2010, one year into the program, only 168,708 trial plans had been converted into permanent revisions, 1,421 of which had already defaulted. 835,194 more borrowers had received trial modifications.³¹ Wells Fargo, which had 379,357 eligible loans, led mortgage servicers in permanent modifications with 24,975 borrowers in such plans. Bank of America, despite accounting for almost one-third of the 3.4 million borrowers eligible for

²⁰ *Average Home Price One-Third Below Peak 2006 Levels*, National Mortgage Professional Magazine, Jan. 30, 2012, <http://nationalmortgageprofessional.com/news28185/average-home-price-one-third-below-peak-2006-levels>.

²¹ Octavio Nuiry, *Strategic Default "Only Choice" For Some*, REALTYTRAC, Jan. 18, 2012, <http://www.realtytrac.com/content/news-and-opinion/strategic-default-only-choice-for-some-6989>

²² *Id.*

²³ U.S. Dep't of the Treasury, *Making Home Affordable Program Performance Report Through December 2011* 2, 7 (2012), www.treasury.gov/initiatives/financial-stability/results/MHA-Reports/Documents/Dec%202011%20MHA%20Report%20FINAL.PDF.

²⁴ Office of the Special Inspector General for the Troubled Asset Relief Program, *Factors Affecting Implementation of the Home Affordable Modification Program 13* (2010), http://www.sig tarp.gov/reports/audit/2010/Factors_Affecting_Implementation_of_the_Home_Affordable_Modification_Program.pdf.

²⁵ *Id.*

²⁶ Luke Mullins, *Obama Housing Rescue Whiffs on 'Underwater' Headaches*, U.S. News and World Report, Dec. 8, 2009, <http://money.usnews.com/money/blogs/the-home-front/2009/12/08/obama-housing-rescue-whiffs-on-underwater-headaches>.

²⁷ Tami Luhby, *TARP watchdog slams Obama foreclosure program*, CNNMONEY, Mar. 24, 2010, http://money.cnn.com/2010/03/23/real_estate/sig tarp_foreclosure/index.htm?postversion=201003.

²⁸ *Id.*

²⁹ *Factors Affecting Implementation of the Home Affordable Modification Program*, *supra* note 24 at 27.

³⁰ Don Jeffrey, *Loan Modification Plan Sheds 8 Percent of Borrowers*, Bloomberg Businessweek, Mar. 12, 2010, <http://www.businessweek.com/news/2010-03-12/loan-modification-plan-sheds-8-percent-of-borrowers-correct-.html>.

³¹ U.S. Dep't of the Treasury, *Making Home Affordable Program Servicer Performance Report Through February 2010* 4 (2010), <http://www.treasury.gov/initiatives/financial-stability/results/MHA-Reports/Documents/feb%20Report%20031210.pdf>.

the program, placed second with just 20,666 borrowers in permanent modifications. JP Morgan, which had 437,323 eligible loans, modified 19,385.³²

It was not until March 2010 that the Obama administration announced new mortgage modification steps. In a seeming admission of the failure of the program's voluntary nature, the federal government doubled the incentive for servicers to complete a HAMP modification, increasing it to \$2,000.³³ It was at the same time that new programs were introduced, including a principal reduction program available for HAMP-eligible borrowers who owe more than 115 percent of their home's current value, which is discussed in more detail below. In addition, the federal government unveiled a program to aid the unemployed that required servicers to offer forbearance plans to all qualified jobless borrowers for three to six months.³⁴

Through June 2010, over 40 percent of the 1.28 million borrowers who had enrolled in HAMP had dropped out.³⁵ By September 2010, 51 percent of the borrowers in HAMP had dropped out.³⁶ The number of borrowers in permanent modifications was only 466,708. Those homeowners realized a median monthly payment reduction of 36 percent, or around \$520 per month.³⁷

A December 2010 Congressional Oversight Panel report predicted that HAMP will ultimately help just 700,000 borrowers, far short of the initial 4 million goal.³⁸ Treasury officials now claim that the initial goal applied only to offering trial modifications, as opposed to permanent help.³⁹ Additionally, officials are now taking credit for private loan modifications completely outside of the HAMP process.⁴⁰ It also appears that instead of the originally allotted \$75 billion for all of MHA, only \$4 billion will ultimately be spent. The Treasury has since reduced its obligation of TARP funds to \$45.6 billion, of which \$29.9 billion is allocated to MHA and \$15.7 billion is allocated to a FHA refinancing program and a state housing finance agency grant program.⁴¹ Of the \$29.9 billion allocated to MHA, the first-lien modification portion of HAMP is allocated as \$19.1 billion.⁴² By the end of 2010, the Treasury had only made HAMP incentive payments of less than \$800 million.⁴³ This number had risen to \$1.8 billion by the end of 2011, but it was still far short of the allocated \$19.1 billion.⁴⁴ Through November 2011, more homeowners had been denied permanent HAMP modifications than had received permanent modifications.⁴⁵ This trend reversed for the first time in December 2011, but only barely.⁴⁶ To be specific, there were 762,839 active permanent modifications, 761,961 trial modifications cancelled,⁴⁷ 170,488

³² *Id.* at 7.

³³ Tami Lubby, *Obama expands mortgage modification effort*, CNNMoney, Mar. 26, 2010, http://money.cnn.com/2010/03/26/news/economy/Obama_mortgage_relief/.

³⁴ *Id.*

³⁵ U.S. Dep't of the Treasury, *Making Home Affordable Program Servicer Performance Report Through June 2010 2* (2010), <http://www.treasury.gov/initiatives/financial-stability/results/MHA-Reports/Documents/June%20MHA%20Public%20Revised%20080610.pdf>.

³⁶ U.S. Dep't of the Treasury, *Making Home Affordable Program Servicer Performance Report Through September 2010 2* (2010), <http://www.treasury.gov/initiatives/financial-stability/results/MHA-Reports/Documents/Sept%20MHA%20Public%202010.pdf>.

³⁷ *Id.* at 3.

³⁸ Meena Thiruvengadam, *Oversight Panel: Obama's Mortgage Modification Program Falls Short*, *The Wall Street Journal*, Dec. 14, 2010, <http://blogs.wsj.com/developments/2010/12/14/oversight-panel-obamas-mortgage-modification-program-falls-short/>.

³⁹ Matthew Jaffe, *Mortgage Modification Program's Definition of Success Called 'Essentially Meaningless'*, *ABC News*, Mar. 23, 2010, <http://abcnews.go.com/Business/mortgage-modification-program-criticized-watchdog/story?id=10184813>.

⁴⁰ Arthur Delaney, *HAMP: White House Doubles Down On Mortgage Modification Spin*, *The Huffington Post*, Dec. 18, 2011, http://www.huffingtonpost.com/2011/10/18/white-house-hamp_n_1016420.html?ir=Business.

⁴¹ Office of the Special Inspector General for the Troubled Asset Relief Program, *Quarterly Report To Congress (January 26, 2012) 57* (2012), http://www.sigtar.gov/reports/congress/2012/January_26_2012_Report_to_Congress.pdf.

⁴² *Id.*

⁴³ Thiruvengadam *supra* note 38.

⁴⁴ *Quarterly Report To Congress (January 26, 2012)*, *supra* note 41.

⁴⁵ U.S. Dep't of the Treasury, *Making Home Affordable Program Performance Report Through November 2011 2* (2012), http://www.treasury.gov/initiatives/financial-stability/results/MHA-Reports/Documents/FINAL_Nov%202011%20MHA%20Report.pdf.

⁴⁶ *Making Home Affordable Program Performance Report Through December 2011*, *supra* note 23 at 2.

⁴⁷ Curiously, the cumulative number of trial modifications cancelled *dropped* from 764,340 in November 2011, which in turn *dropped* from a high of 767,321 in October 2011. This would appear to be an inapposite result. Using the high point in October, the number of trial modifications cancelled would still exceed the number made permanent. *Making Home Affordable Program Performance Report Through November 2011*, *supra* note 45; U.S. Dep't of the Treasury, *Making Home Affordable Program Performance Report Through October 2011 2* (2011), <http://www.treasury.gov/initiatives/financial-stability/results/MHA-Reports/Documents/October%202011%20MHA%20Report%20FINAL.pdf>.

permanent modifications cancelled, and 79,307 active trial modifications.⁴⁸ The number of new trial starts per month had also consistently fallen throughout the year.⁴⁹ While the Obama administration announced in January 2012 that the deadline for homeowners to apply for a HAMP modification had been pushed back one year, to December 31, 2013,⁵⁰ less than 900,000 homeowners even remain eligible.⁵¹

A glaring problem for HAMP is that the Treasury has failed to provide specific guidelines for servicers to follow. By lacking uniform standards, there is a high possibility for inequitable treatment of borrowers due to inconsistent outcomes. For example, the Treasury did not issue guidelines for soliciting borrowers until one year after announcing the program.⁵² Some servicers solicited borrowers after they were 31 days late on their payments, while others waited 60 days.⁵³ Additionally, although the Treasury had emphasized the importance of reaching out to borrowers before they default, there are no guidelines as to when a borrower is in “imminent default.”⁵⁴ Out of the ten servicers evaluated by the Government Accountability Office (GAO), seven used different sets of criteria for determining whether a borrower is in “imminent default.”⁵⁵

The Treasury has also not specified the consequences of a servicer not complying with the program requirements. As such, unsurprisingly the Treasury has yet to fine any servicers for non-compliance. This is despite the fact that the GAO advised the Treasury in a July 2009 report to implement policies, procedures, and guidelines for program activities.⁵⁶

In fact, the GAO found that 15 out of the largest 20 servicers did not comply with various aspects of the program guidelines for determining the NPV.⁵⁷ This is critical because the NPV test determines whether or not a borrower is eligible for a HAMP modification. As a result of the errors in running the test, there could be thousands of borrowers who were incorrectly denied modifications. Some servicers have even charged fees to borrowers that were prohibited by HAMP guidelines.

The GAO also found numerous other errors being committed by servicers. Half of the servicers evaluated experienced a 20 percent error rate for calculating borrower income. The servicers’ own established error thresholds were approximately three to five percent.⁵⁸ Without accurate income similar borrowers may be inaccurately deemed eligible or ineligible. Out of the ten servicers evaluated, six did not properly test their results to ensure compliance. Four servicers could not always provide evidence that potentially eligible borrowers that were supposed to be solicited were in fact solicited. There was also inconsistency in how complaints were tracked. Some servicers tracked all and some tracked only a subset.⁵⁹

The GAO concluded that the Treasury’s goal should be to “create uniform, clear, and consistent guidance for loan modifications across the servicing industry.”⁶⁰ They noted that the Treasury should also do more to hold servicers accountable, such as establishing benchmarks that they expect servicers to meet.

Oversight efforts remained secretive until June 2011, when the Treasury began publishing quarterly assessments of the ten largest servicers, measuring such things as error rates for

⁴⁸ Making Home Affordable Program Performance Report Through December 2011, *supra* note 23.

⁴⁹ *Id.*

⁵⁰ Jon Prior, *Treasury to pay investors triple for HAMP principle reductions*, HousingWire, Jan. 27, 2012, <http://www.housingwire.com/node/32363>.

⁵¹ *Id.*

⁵² Further Actions Needed, *supra* note 11 at 14.

⁵³ *Id.*

⁵⁴ *Id.* at 18.

⁵⁵ *Id.*

⁵⁶ U.S. Gov’t Accountability Office, *Troubled Asset Relief Program: Treasury Actions Needed to Make the Home Affordable Modification Program More Transparent and Accountable* 50-51 (2009), <http://www.gao.gov/new.items/d09837.pdf>.

⁵⁷ Further Actions Needed, *supra* note 11 at 20.

⁵⁸ *Id.* at 21.

⁵⁹ *Id.* at 23.

⁶⁰ *Id.* at 17.

calculating borrowers' income.⁶¹ Four servicers were determined to need "substantial" improvement for the first quarter of 2011, and financial incentives were withheld from three of them – Bank of America, Chase, and Wells Fargo.⁶² However, these banks had already been paid more than \$77 million, \$84 million, and \$68 million, respectively, for their roles as servicers.⁶³ Moreover, these sanctions did not come until more than two years after HAMP began, and after a majority of homeowners eligible for a modification – about three million – had already been evaluated.⁶⁴ Homeowners that were improperly denied a modification due to such servicer error have no recourse, and presumably many have already lost their homes. As of the third quarter of 2011, Chase and Bank of America are still having their incentives withheld, with the former still needing "substantial" improvement.⁶⁵

Modifications often leave homeowners in a worse position than they were before modification. The Congressional Oversight Panel found that 95 percent of HAMP participants end up with higher principal balances after receiving a modification.⁶⁶ This is because the modification process allows lenders to capitalize past-due interest, various fees, and escrow advances. So, while borrowers might have smaller monthly payments, those payments are stretched over a longer period and would result in a bigger total balance owed in the end. This is even more significant considering that 76 percent of all homeowners in HAMP have negative equity in their home. Borrowers in trial modifications have an average loan-to-value (LTV) ratio of 123 percent, while those in permanent modifications have an average LTV ratio of 128 percent.⁶⁷ While principal has been reduced under HAMP for only two percent of homeowners, before HAMP mortgage servicers were reducing principal in about ten percent of modifications.⁶⁸

The situation is even worse for those homeowners whose trial modifications ultimately failed. Servicers are permitted to impose on these homeowners back payments, penalties, and late fees that become due once the modification ends, even if these homeowners never missed a payment.⁶⁹ In essence, they are being penalized for attempting HAMP. The impact of these burdens is even greater when trial modifications continue past the three-month period.⁷⁰ In fact, that is often the case. At the peak in May 2010, 190,000 homeowners were still in trial modifications that were initiated at least six months earlier.⁷¹ At the time, this was approximately 40 percent of all active trials. By December 2010, there was still a backlog of 40,000 trials lasting longer than six months.⁷² By November 2011, the backlog numbered over 20,000.⁷³ Considering that there are more failed modifications than permanent modifications, it is not far-fetched to say that HAMP has hurt more homeowners than it has helped.

⁶¹ U.S. Dep't of the Treasury, Making Home Affordable Program Performance Report Through April 2011 14 (2011), <http://www.treasury.gov/initiatives/financial-stability/results/MHA-Reports/Documents/April%202011%20MHA%20Report%20FINAL.PDF>.

⁶² *Id.*

⁶³ U.S. Dep't of the Treasury, Home Affordable Modification Non-GSE Incentive Payments (Through May 2011) 1-2 (2011), <http://www.treasury.gov/initiatives/financial-stability/briefing-room/reports/tarp-transactions/DocumentsTARPTTransactions/HAMP%20Transactions%20Report%20as%20of%2006.03.2011-Final.pdf>.

⁶⁴ Paul Kiel, *Secret Docs Show Foreclosure Watchdog Doesn't Bark or Bite*, ProPublica, Oct. 4, 2011, <http://www.propublica.org/article/secret-docs-on-foreclosure-watchdog>.

⁶⁵ U.S. Dep't of the Treasury, Making Home Affordable Program Performance Report Through October 2011 18 (2011), <http://www.treasury.gov/initiatives/financial-stability/results/MHA-Reports/Documents/October%202011%20MHA%20Report%20FINAL.pdf>.

⁶⁶ Shahien Nasiripour, *Obama's Foreclosure Program Will Reach Less Than One Quarter Of Administration's Target*, The Huffington Post, Dec. 14, 2010, http://www.huffingtonpost.com/2010/12/14/obama-anti-foreclosure-program_n_796629.html.

⁶⁷ U.S. Gov't Accountability Office, Treasury Continues to Face Implementation Challenges and Data Weaknesses in Its Making Home Affordable Program ii (2011), <http://www.gao.gov/new.items/d11288.pdf>, [hereinafter Treasury Continues to Face Implementation Challenges].

⁶⁸ Factors Affecting Implementation of the Home Affordable Modification Program, *supra* note 24 at 17.

⁶⁹ Statement of Neil Barofsky, Special Inspector General Troubled Asset Relief Program, Before the Senate Committee on Banking, Housing and Urban Development 13, Mar. 17, 2011, <http://www.sigarp.gov/reports/testimony/2011/Testimony%20Before%20the%20Senate%20Committee%20on%20Banking,%20Housing%20and%20Urban%20Development.pdf>.

⁷⁰ *Id.*

⁷¹ U.S. Dep't of the Treasury, Making Home Affordable Program Servicer Performance Report Through May 2010 1 (2010), <http://www.treasury.gov/initiatives/financial-stability/results/MHA-Reports/Documents/May%20MHA%20Public%20062110.pdf>.

⁷² U.S. Dep't of the Treasury, Making Home Affordable Program Servicer Performance Report Through December 2010 1 (2010), <http://www.treasury.gov/initiatives/financial-stability/results/MHA-Reports/Documents/Dec%202010%20MHA%20Report%20Final.pdf>.

⁷³ Making Home Affordable Program Performance Report Through November 2011, *supra* note 45 at 8.

HAMP has also negatively affected credit scores. For the first six months of the program, lenders used an existing code when providing information to the credit bureaus to signal that borrowers were participating in the program.⁷⁴ The problem is that the existing code signaled that a customer had only made a partial payment, despite the fact that they paid the full amount they were directed to pay under HAMP. The Treasury estimated that use of the old code could have lowered the credit scores of participants anywhere from 30 to 100 points. It was not until November 2010 that a new code that would not negatively impact credit scores was developed to indicate that borrowers were participating in HAMP.

The most recent data indicates that HAMP modifications are actually about half as likely to redefault as other modifications implemented during the same period.⁷⁵ For example, for loans modified in the first quarter of 2010, the redefault rate nine months later was 17.4 percent for HAMP modifications and 31.9 percent for other modifications.⁷⁶ This is attributable to HAMP's emphasis on the affordability of its monthly payments. HAMP modifications during that quarter reduced monthly payments by an average of \$591 while other modifications reduced monthly payments by just \$233.⁷⁷ However, this result should not be particularly surprising because if other modifications were effective, there would be no need for HAMP in the first place. The real story is not that HAMP is better than nothing, but rather that HAMP has serious flaws in its design, management, and execution that leads to both a significant redefault rate on its own and also a failure to provide any form of assistance whatsoever to millions of homeowners. The criticism against HAMP has been so strong that in late March 2011, the U.S. House of Representatives voted 252-170 to terminate HAMP.⁷⁸ However, the bill is unlikely to pass the Senate (over a year later, it is still stuck in committee), and even if it did President Obama has threatened to veto it.⁷⁹

B. Second Lien Modification Program (2MP)

It has been estimated that as many as half of at-risk mortgages have second liens.⁸⁰ Any savings on the primary mortgage could end up going straight to the second-lien bill collector. The Second Lien Modification Program (2MP) provides incentives for second-lien holders to modify or extinguish a second-lien mortgage after a HAMP modification has been started on the property's first-lien mortgage.⁸¹ Servicers who agree to participate are required to offer to modify the second lien according to a defined protocol. Modifications work similarly to as they do under HAMP, and interest rates are generally reduced to one percent and the loan term extended to match the term of the HAMP-modified first lien. Additionally, if the HAMP modification included principal forgiveness, the 2MP modification must forgive principal in the same proportion.⁸² Servicers receive \$500 for each 2MP modification as well as \$250 per year for up to three years. The Treasury provides a lump-sum payment to investors in exchange for full extinguishment of the second lien, or a lesser lump-sum payment in exchange for a partial extinguishment and modification of the second lien.⁸³

2MP was first announced at the same time as the introduction of HAMP in March 2009. However, it was not until January 2010 that the first servicer signed the first

⁷⁴ *Mortgage Modifications Affect Credit Scores*, N.Y. Times, Jan. 5, 2010, <http://bucks.blogs.nytimes.com/2010/01/05/how-loan-modifications-impact-credit-scores/>.

⁷⁵ *Id.* at 36.

⁷⁶ *Id.*

⁷⁷ *Id.* at 31.

⁷⁸ The HAMP Termination Act of 2011, H.R. 839, 112th Cong. (2011).

⁷⁹ Matthew Jaffe and John R. Parkinson, *GOP House Terminates Dems' Foreclosure Prevention Program*, ABC News, Mar. 29, 2011, <http://blogs.abcnews.com/thenote/2011/03/gop-house-terminates-dems-foreclosure-prevention-program.html>.

⁸⁰ Mullins, *supra* note 26.

⁸¹ MHA Handbook, *supra* note 13 at 119.

⁸² *Id.* at 121-127.

⁸³ *Id.* at 137-138.

agreement to participate.⁸⁴ 2MP was not implemented until one year later, in March 2010. As of November 2010, 17 servicers were participating, which represents two-thirds of the second-lien mortgage market.⁸⁵ The GAO contacted five servicers, which represented the majority of potential covered second liens, and only one had actually begun doing 2MP modifications 18 months after the program was announced. Despite a funding allocation of \$133 million, by the end of 2010 only \$2.9 million in incentives had been paid.⁸⁶ This number had risen, though, to \$95.6 million by the end of 2011.⁸⁷ Servicers complained to the GAO that the program started slowly due to problems with the database that the Treasury required them to use to identify potentially eligible loans. The purpose of the database is to inform second-lien servicers when the corresponding first lien has been modified under HAMP. However, the accuracy and completeness of the data has been called into question by the servicers, citing everything from differences in abbreviations and spacings that could prevent matches from being found to outright wrong data.

In addition, borrowers might not be aware that they are eligible for the program. The Treasury does not even require first-lien servicers to inform homeowners about their potential eligibility for 2MP.⁸⁸ Delays or omissions in modifying the second lien increase the likelihood that borrowers will be unable to maintain their monthly payments and may ultimately redefault on their HAMP-modified first lien.

Another problem has been the lack of clear guidelines by the Treasury. 2MP was announced in March 2009, but specific guidelines were not published until August 2009. In March 2010, the first month of implementation, revisions to the guidelines were issued. Further revisions were issued in June and November of 2010.⁸⁹ Program revisions present the challenge of retraining staff and delayed the program's implementation.

C. Home Affordable Foreclosure Alternatives (HAFA)

The Home Affordable Foreclosure Alternatives (HAFA) program provides incentives for short sales and deeds in lieu of foreclosure as alternatives for borrowers who are either unable or unwilling to carry out the HAMP first-lien modification process.⁹⁰ Servicers receive \$1,500 for completing a short sale or deed-in-lieu of foreclosure, while borrowers receive \$3,000 for relocation assistance. Investors are also paid up to \$2,000 for allowing short-sale proceeds to be distributed to subordinate lien holders.⁹¹ If a borrower cannot be approved for HAMP, does not accept a HAMP modification, or defaults on a HAMP modification, then the servicer is required to evaluate them for HAFA. HAFA applies to mortgages owned or guaranteed by all non-GSE's, as well as Fannie Mae and Freddie Mac. FHA, VA, and USDA Rural Development have their own short-sale programs and are not participating in HAFA.⁹²

HAFA, like 2MP, was also originally announced back in March 2009. It was not implemented, however, until April 2010. Like the slow start to the second-lien program, despite a funding allocation of \$4.1 billion, only \$9.5 million in incentives had been paid under HAFA by the end of 2010.⁹³ The amount had risen to only \$99.5 million by the end

⁸⁴ Diana Golobay, *BoFA First to Join HAMP Program for Second Liens*, HousingWire, Jan. 26, 2010, <http://www.housingwire.com/2010/01/26/bofa-says-its-first-to-sign-up-for-hamp-second-lien-program>.

⁸⁵ Treasury Continues to Face Implementation Challenges, *supra* note 67 at 12.

⁸⁶ *Id.* at i.

⁸⁷ Quarterly Report To Congress (January 26, 2012), *supra* note 41 at 73.

⁸⁸ *Id.* at 14.

⁸⁹ *Id.* at 20-21.

⁹⁰ MHA Handbook, *supra* note 13 at 106.

⁹¹ *Id.* at 116-117.

⁹² Key Differences in HAFA Guidelines for Non-GSE, Fannie Mae, and Freddie Mac Mortgages 1 (2010), http://www.realtor.org/wps/wcm/connect/aff82b0043f0ce46b2a0fb34cfa6d66/gov_aff_hafa_mortgage_guidelines_0910.pdf?MOD=AJPERES&CACHEID=aff82b0043f0ce46b2a0fb34cfa6d66.

⁹³ Treasury Continues to Face Implementation Challenges, *supra* note 67 at i.

of 2011.⁹⁴ One reason for the slow start is unduly program restrictions. For example, even if borrowers have already identified a potential buyer for a short sale, they are still required to be evaluated for a first-lien modification. Borrowers may have difficulty submitting all of the proper documentation required for HAMP, such as verification of income, which is much more stringent than the typical short sale. Documentation aside, the additional time required for a HAMP evaluation might dissuade the buyer from purchasing the property. In late December 2010, eight months after implementation and 17 months after introduction, the Treasury finally updated HAFA guidance to no longer require a HAMP evaluation.⁹⁵

Another initial problem with HAFA was restrictive short-sale requirements. For example, the guidelines required a property to not be vacant for more than 90 days before the short sale agreement. The guidelines also specified that the only valid reason for a property to be vacant is if the borrower has located more than 100 miles away to accept new employment.⁹⁶ In late December 2010, the Treasury extended the vacancy period to 12 months and eliminated the requirement that the borrower moved to accept employment. Additionally, in order to be eligible HAFA guidelines require the mortgage insurer to waive any right to collect additional sums from the borrower.⁹⁷ This requirement has prevented some HAFA short sales from going through because of the challenge of obtaining approval from insurers. Depending on the coverage agreement and proceeds from the sale, the mortgage insurer could be responsible for paying the investor all or part of the losses incurred. Thus, there is no real incentive for the insurer to waive the borrower's personal liability.

D. Principal Reduction Alternative (PRA)

Also slow to get off the ground has been the Principal Reduction Alternative (PRA) program. PRA offers financial incentives to investors who agree to forgive principal for borrowers whose homes are significantly underwater.⁹⁸ PRA was announced in March of 2010, but not implemented until October 2010. \$2 billion is allocated towards the program, but it is unclear how much of that money will ultimately be used because PRA incentives are paid annually after 12 months of successful performance of the modified mortgage.⁹⁹ By the end of 2011, only \$8.8 million in incentives has been paid out.¹⁰⁰ Moreover, specific guidance for the NPV model used in PRA was not provided until October 2010, the month that PRA became effective. As a result of servicers' need to update internal systems, actual implementation did not occur until a later point in time.¹⁰¹

PRA guidelines require servicers to consider principal reduction for any HAMP-eligible borrowers with MLTV (mark-to-market loan to value ratio, which is the unpaid principal balance divided by property value at time of modification) greater than 115 percent. For example, if a home is currently worth \$100,000, a borrower with an unpaid principal balance greater than \$115,000 would qualify. The principal forgiveness occurs in increments over a three-year period, assuming borrowers remain current on their payments. Investors are paid anywhere from \$0.06 to \$0.21 for each dollar of principal reduction, depending on the MLTV range and delinquency status of the loan.¹⁰²

However, all that the guidelines require is that servicers consider principal forgiveness, not actually offer it. Even if the NPV value to modify the loan is greater when the principal

⁹⁴ Quarterly Report To Congress (January 26, 2012), *supra* note 41 at 71.

⁹⁵ *Id.* at 16.

⁹⁶ *Id.*

⁹⁷ *Id.* at 17.

⁹⁸ MHA Handbook, *supra* note 13 at 67-68.

⁹⁹ Treasury Continues to Face Implementation Challenges, *supra* note 67 at 18.

¹⁰⁰ Quarterly Report To Congress (January 26, 2012), *supra* note 41 at 69.

¹⁰¹ *Id.* at 21.

¹⁰² Home Affordable Modification Program: Modification of Loans with Principal Reduction Alternative (PRA) 3 (2010), https://www.hmpadmin.com/portal/programs/docs/hamp_servicer/paoverviewnongse.pdf.

is forgiven, servicers are not obligated to do anything. Half of the servicers that the GAO spoke with indicated that they would limit the conditions under which they would offer principal forgiveness. So, while there were over 842,000 active permanent and trial HAMP modifications as of December 2011, there were only around 56,000 active permanent and trial PRA modifications.¹⁰³ Perhaps aware of the program's relative ineffectiveness, the Obama administration announced in January 2012 that the financial incentives to investors would be tripled to between \$0.18 and \$0.63.¹⁰⁴ Another problem with PRA is that the HAMP NPV model does not use an LTV that reflects both first and second liens.¹⁰⁵ As a result, the NPV model might underestimate the likelihood of redefault by not using the combined LTV. Not taking second liens into account would also underestimate the population of underwater borrowers.

II. Servicer Motivations

The run-up to the foreclosure crisis saw the rapid expansion of large pools of securitized mortgages. With this has come conflicts of interest between borrowers, servicers, and investors and helps to explain why the number of modifications pales in comparison to foreclosures. Most securitization agreements (pooling and servicing agreements, or PSAs) specify a master servicer to be responsible for collecting and processing payments on mortgage loans.¹⁰⁶ These pools are governed by interlocking tax and accounting rules. These rules do not forbid loan modifications; however, some of the rules restrict circumstances in which loans can be modified or create disincentives to do them.¹⁰⁷

Probably the principal reason that mortgage servicers are reluctant to modify loans is that foreclosures are actually profitable for them. Once a loan is more than 90 days overdue, servicers charge processing and foreclosure fees as well as costs for attorneys, appraisers, and other services.¹⁰⁸ Often, these fees have incredibly high mark-ups.¹⁰⁹ In addition, servicers also collect a monthly late fee that can run as high as five percent of the mortgage payment. For example, a foreclosure on a \$200,000 mortgage might generate \$10,000 or more in income for servicers.¹¹⁰ When a foreclosure is concluded, these servicers get paid before mortgage investors. So, while the investors might take a loss from a foreclosure, the servicers will make a handsome profit. It is not hard to see why the \$2,000 (originally \$1,000) incentive offered to servicers for loan modifications through HAMP has failed to be a big enough carrot. By modifying and retaining the loans, they are just earning a small fee every month, which could take a decade or more to make up for the amount they could earn in the short-term foreclosures. Servicers typically earn between one-tenth and one-half of a percentage point of the loan's balance for administering the accounts.¹¹¹ Modifications also require significant staffing. According to the servicing industry, the costs attributable to performing a modification are between \$750 and \$1,000.¹¹² Thus, servicers have an incentive to push borrowers into late payments and draw out foreclosures for as long as possible.

Another possible reason for the low number of modifications is because the servicing industry is overwhelmed with defaults. The servicing industry was designed to deal 100,000 to 200,000 defaulted loans a year. Currently, they are handling upwards of four

¹⁰³ Making Home Affordable Program Performance Report Through December 2011, *supra* note 23.

¹⁰⁴ Prior, *supra* note 50.

¹⁰⁵ Treasury Continues to Face Implementation Challenges, *supra* note 67 at 19.

¹⁰⁶ National Consumer Law Center, Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior: Servicer Compensation and its Consequences Report 3 (2009), http://www.nclc.org/images/pdf/foreclosure_mortgage/mortgage_servicing/servicer-report1009.pdf.

¹⁰⁷ *Id.* at 5.

¹⁰⁸ Kathleen M. Howley, *Mortgage Servicer Profits May Threaten Obama Housing Programs*, Bloomberg Businessweek, Apr. 21, 2010, <http://www.businessweek.com/news/2010-04-21/mortgage-servicer-profits-may-threaten-obama-housing-programs.html>.

¹⁰⁹ National Consumer Law Center, *supra* note 128, at 17.

¹¹⁰ Howley, *supra* note 137.

¹¹¹ *Id.*

¹¹² National Consumer Law Center, *supra* note 128 at 27.

million.¹¹³ Simply put, the infrastructure is just not in place to handle the loans.

As for the lenders themselves, there are two main reasons why they are reluctant to modify. First is the self-cure possibility; more than 30 percent of seriously delinquent borrowers cure without receiving a modification.¹¹⁴ Thus, lenders are discouraged from modifying when a significant percentage of borrowers will simply make up the missed payments on their own. Second is the redefault risk; up to 45 percent of borrowers who receive modifications are back in serious delinquency within six months.¹¹⁵ In essence, the lender has simply postponed foreclosure. And, in an era of falling home prices, the lender will now ultimately recover less.

III. Possible Solutions

A. Cramdown

One potential solution to the foreclosure crisis is to amend bankruptcy law to allow judges to write down the value of a primary mortgage in Chapter 13, bifurcating it into secured and unsecured portions. This is a practice called “lien stripping,” more colloquially known as a “cramdown.”¹¹⁶ A bankruptcy judge would reduce the balance of the secured claim to the current market value of the house, and turn the remaining balance into an unsecured claim. Lien-stripping is already allowed on other consumer debt, including rental properties and vacation homes. Essentially, then, current bankruptcy laws actually afford relief to affluent borrowers that less affluent borrowers cannot receive; a person with three homes can receive lien-stripping on two of those homes, while a person with only one home receives nothing. To understand the consequences of lien-stripping, it is illustrative to look at an analogous situation from the past.

Quite similar to today’s crisis, in the 1970’s many farmers used variable-rate notes, underwriting standards eased, and a speculative bubble occurred. When that bubble burst in 1981, many farmers found themselves underwater.¹¹⁷ Chapter 13 of the Bankruptcy Code barred farmers from modifying debt secured by a primary residence, just as it does to homeowners today. Chapter 11 bankruptcy, designed for corporations, gave creditors legal means to block cramdowns. Also quite similar to the current situation, voluntary modification efforts subsidized by the government did not lead agricultural lenders to negotiate modifications. As a result, Congress in 1986 created Chapter 12, which allowed judges to restructure the farmers mortgages.¹¹⁸

This, however, was not without controversy. Critics of lien-stripping argued that it would spur many borrowers to declare bankruptcy, which would bog down the courts and make credit more expensive. In other words, it would result in higher interest rates that would make home ownership less affordable to low- and middle-income families. These are the same arguments used against lien-stripping today. These fears would prove to be unfounded. A 1989 GAO report found that after the creation of Chapter 12, no bankers raised interest rates to farmers more than 50 basis points. As this was consistent with increasing premiums due to the economic environment, this suggests that creation of the Chapter 12 lien-stripping did little to alter the cost and availability of farm credit.¹¹⁹ What did change, however, was the lenders willingness to negotiate modifications now that they faced the threat of lien-stripping. In fact, the GAO report states that while 30,000

¹¹³ Howley, *supra* note 137.

¹¹⁴ Adelino, Gerardi, & Willen, *supra* note 136 at 26.

¹¹⁵ *Id.*

¹¹⁶ *Drowning or waiving: The policy options for alleviating America’s huge negative-equity problem*, *supra* note 6.

¹¹⁷ Thomas J. Fitzpatrick IV & James B. Thomson, Fed. Reserve Bank of Cleveland, *Strippeddowns and Bankruptcy: Lessons from Agricultural Bankruptcy Reform* (2010), <http://www.clevelandfed.org/research/commentary/2010/2010-9.cfm>.

¹¹⁸ *Id.*

¹¹⁹ *Id.*

bankruptcy filings were anticipated in the first year, only 8,500 were filed in the first two years.¹²⁰ Thus, the agricultural crisis of the 1980's has shown us that lien-stripping poses a viable solution with nary any negative side-effects. Critics would still argue, however, that the lending market has changed considerably and also that judges are not as qualified as bankers to make mortgage modification decisions.

B. Principal Reduction

A foreclosed home typically sells for 35 percent below the mortgage value, compared to only 13 percent below when an underwater borrower sells on their own.¹²¹ Lenders are the ones that bear the brunt of the higher losses in foreclosure. It would be beneficial to both the lender and the borrower to write down the loan to a value above the likely foreclosure price. There is the moral hazard problem, though; borrowers, regardless of their ability to pay, would deliberately miss payments in order to get their loans adjusted. One way this could be addressed would be with a "contingent write-down." Loans would be written down in increments over a period of time, such as three years, but only if the borrower stays current on their payments.¹²² Another approach is a "shared appreciation" scheme. Principal reductions would be combined with an equity stake for lenders.¹²³ Subsequent price increases that result in equity gains would be split between borrowers and lenders once the home is sold.

Another variation of the "shared appreciation" scheme is for the government to attain an equity stake in the property as opposed to the lender. There is already precedent for this in the form of the "HOPE for Homeowners Act." Despite this Act failing miserably to actually help homeowners, as discussed earlier, it does provide a model for how such a "shared appreciation" scheme could work. Under the Act, the equity created by the write-down of the mortgage to less than the appraised fair market value of the property belongs 100 percent to the government in the first year. This equity percentage is reduced ten percent per year.¹²⁴ The equity created by subsequent appreciation in market value in excess of the appraised fair market value at the time of the write-down is divided 50-50 between the government and the homeowner.¹²⁵

The Agricultural Credit Act of 1987 (1987 Act) also provides precedent for mandating write-downs outside of bankruptcy.¹²⁶ The 1987 Act provided loan restructuring requirements for certain Farm Credit System (FCS) and Farmers Home Administration (FmHA) loans. The 1987 Act required the FCS and FmHA to notify each delinquent borrower that they could apply for restructuring. After a borrower applied, the agencies would analyze each loan to determine if the government's net recovery on a restructured loan would exceed the government's recovery through foreclosure. If this was the case, then the government was required to restructure. This included both debt write-down as well as debt write-off for borrowers in more dire straits.¹²⁷

While the 1987 Act allowed farmers to attain principal reduction without the stigma of bankruptcy (it was passed just one year after the creation of Chapter 12), it was not without controversy. In fiscal year 1989 alone, FmHA wrote off \$1.3 billion attributable to the 1987 Act.¹²⁸ Some of these very large write-downs were in excess of \$1 million and

¹²⁰ *Id.*

¹²¹ *Drowning or waiving: The policy options for alleviating America's huge negative-equity problem*, *supra* note 6.

¹²² *Id.*

¹²³ *Id.*

¹²⁴ 12 U.S.C.A. ' 1715z-23k(1)(A)-(E).

¹²⁵ *Id.* at 1715z-23k(1)(F).

¹²⁶ 7 U.S.C.A. ' 2001 et seq.

¹²⁷ Gov't Accountability Office, *Farmer's Home Administration's Farm Loan Programs 23-24* (1992), <http://archive.gao.gov/d36t11/148219.pdf>, [hereinafter *Farmer's Home Administration's Farm Loan Programs*].

¹²⁸ Gov't Accountability Office, *Financial Audit: Farmer's Home Administration's Financial Statements for 1989 and 1988 9* (1991) <http://archive.gao.gov/d20t9/143805.pdf>.

generated negative press.¹²⁹ The GAO also reported in 1990 that 18 of 30 non-delinquent borrowers they interviewed felt penalized for paying their debts and some were thinking about becoming delinquent so that they could qualify for debt reduction.¹³⁰ This criticism led to the Food, Agriculture, Conservation and Trade Act of 1990 (FACT Act).¹³¹ Under the FACT Act, write-downs were limited to a lifetime amount of \$300,000. The 1987 Act's effectiveness is also questionable, as 43 percent of the loans that were restructured between 1988 and 1990 (9,500 borrowers) became delinquent again.¹³² In addition, between 1989 and 1992 the GAO identified 6,222 borrowers who received multiple debt restructures.

An extreme variation of principal reduction is evident in a plan advocated by Yale economist John Geanakoplos. The key to the plan is to reduce the principal of the loan to below the current value of the house but above the value the note-holder could get by foreclosing.¹³³

This would give the homeowner equity again. Equity, in turn, would increase the homeowner's motivation to stay in their home. The bondholders, meanwhile, would maintain a steady income stream and would not lose as much money as they would through foreclosure. The subprime bond market trades as if it expects only 25 percent back on a loan when there is a foreclosure. Therefore, it would not cost the bondholders any money by lowering the principal because they have already taken the loss. In the aggregate, communities would benefit from fewer foreclosures in the area, leading to fewer houses for sale and thus less downward pressure on housing prices.

The program would be limited to borrowers who are current on their mortgages. Otherwise, homeowners are incentivized to fall behind on their payments. Additionally, homeowners with good credit scores typically value their good credit and would be more apt to continue making regular payments and not become delinquent. The plan is estimated to only cost between three and five billion dollars over three years.

C. Direct Payments

Another radical idea is that instead of offering money to lenders in order to goad them into offering modifications, simply give that money directly to homeowners.¹³⁴ Under this plan there would be no problem with servicer incentives to foreclose. Additionally, by not relying on a voluntary program, all of the \$75 billion allocated to HAMP could actually be used, instead of the current \$800 million of that amount being spent. This would certainly be a way to help out the broadest swath of the public. There would still be potential issues, though. Cutting a check directly to a homeowner would not guarantee that the money actually be used to make the mortgage payments. Perhaps it would be better to send the money to servicers on behalf of the homeowners. Another problem is that this proposal is vague and does not suggest which specific borrowers would receive money. So, the same moral hazards of motivating borrowers to default and helping out those who made the worst choices still arise. Additionally, in the long run this plan would not help out the millions of Americans severely underwater.

¹²⁹ James T. Massey, *Farmers Home Administration and Farm Credit System Update*, 73 Neb. L. Rev. 187, 196 (1994).

¹³⁰ Farmer's Home Administration's Farm Loan Programs, *supra* note 161 at 24.

¹³¹ Massey, *supra* note 165; Food, Agriculture, Conservation and Trade Act of 1990, Pub. L. No. 101-624, 104 Stat. 3359.

¹³² Farmer's Home Administration's Farm Loan Programs, *supra* note 161 at 24-25.

¹³³ John D. Geanakoplos & Susan P. Koniak, Op-Ed., *Matters of Principal*, N.Y. Times, Mar. 4, 2009, <http://www.nytimes.com/2009/03/05/opinion/05geanakoplos.html>.

¹³⁴ Jennifer B. McKim, *Lenders avoid redoing loans, Fed concludes*, The Boston Globe, July 7, 2009, http://www.boston.com/realstate/news/articles/2009/07/07/lenders_avoid_redoing_loans_fed_concludes/?page=1.

VI. The Best Solution

A. Ideal

The best solution to the foreclosure crisis is no solution. Foreclosing rapidly is vital to clearing the market. The economy will suffer as long as there is excessive real estate debt and capital is tied up in non-performing assets. A foreclosure freeze only extends the time that the loans go unpaid. The same can be said of a program like HAMP, which has cancelled more trial modifications than it has converted into permanent ones. In essence, HAMP strung along a majority of its participants and only delayed foreclosure. Despite helping some borrowers, HAMP merely spreads the foreclosure crisis over several years.

More than half the mortgages in the U.S. are insured by the federal government, leaving taxpayers on the hook. In the 23 states that permit judicial foreclosure, various forms of moratoriums are now in place.¹³⁵ U.S. properties foreclosed in the fourth quarter of 2011 took an average of 348 days to complete the foreclosure process.¹³⁶ A primary reason is that the system is already so clogged. Those that fight the eviction can last even longer, although they are unlikely to recover their homes even in the event of bad documentation.¹³⁷ Delaying foreclosures and allowing delinquent borrowers to live in their former homes for free is a cost borne by all taxpayers.

Experts seem to agree that foreclosures need to occur in order for the economy to improve. In September of 2010, the chief economist at Moody's Analytics predicted that a housing recovery would be underway by the third quarter of 2011.¹³⁸ After the foreclosure scandal began that winter and foreclosures came to a halt, he revised his prediction to indicate that the housing recovery could be delayed another few years. U.S. Treasury Secretary Timothy Geithner has said that a settlement between banks and U.S. authorities over foreclosure abuses needs to be reached quickly in order to help the housing market heal.¹³⁹ Karl Case, co-creator of the Case-Shiller index, has labeled anything that slows the foreclosure process a "bad thing."¹⁴⁰

B. Realistic - Guiding Principles

While doing nothing might make the most economic sense, it might not make the most political sense. Both lawmakers and the President do not want to be blamed by millions of people for losing their homes during the next election. Therefore, taking no action might be politically untenable. However, if action is going to be taken, it should be the right action. Clearly, HAMP was not the right action.

I propose the following guidelines for any attempt at halting the foreclosure crisis. The major underlying principle is that we should help out those with the most skin in the game. Everyone who did the responsible thing and put down the traditional 20 percent down payment should be helped before anyone who put down hardly any of their own money. Another principle is that we should help out those who actually need and deserve the help. In the era of loose or, in many cases, non-existent underwriting standards, countless "liar loans" were made to borrowers who had no realistic chance of ever paying back the mortgage. Yes, the often predatory lenders are culpable for this mess, but so are the homeowners; two wrongs do not make a right. Someone who can no longer afford

¹³⁵ Jane Bryant Quinn, *The Foreclosure Mills: How This Could Really Hurt the Housing Market*, CBS MoneyWatch, Oct. 4, 2010, <http://moneywatch.bnet.com/investing/blog/make-money/the-foreclosure-mills-how-this-could-really-hurt-the-housing-market/511/>.

¹³⁶ *2011 Year-End Foreclosure Report: Foreclosures on the Retreat*, *supra* note 4.

¹³⁷ Quinn, *supra* note 175.

¹³⁸ Michelle Conlin, *Foreclosure freeze could undermine housing market*, Yahoo! Finance, Oct. 11, 2010, <http://finance.yahoo.com/news/foreclosure-freeze-could-apf-3924319052.html>.

¹³⁹ Dave Clarke & Rachelle Younglai, *Geithner seeks swift foreclosure pact with banks*, Reuters, Mar. 15, 2011, <http://www.reuters.com/article/2011/03/15/us-financial-regulation-mortgages-idUSTRE72A63J20110315>.

¹⁴⁰ Conlin, *supra* note 178.

their payments because of job loss should be helped over someone who kept their job but cannot afford their payment simply because their “teaser” interest rate increased, which is something they knew was going to happen and should have been planned for.

Keeping with this principle, speculators should not receive any help whatsoever. They speculated, and they lost. They knew the risks. The same goes for any second-homes. So, only primary residences should qualify. There should also be a cap - the owner of a \$100,000 home should be helped before someone who owns a \$2 million dollar house. The \$760,000 upper loan limit of HAMP seems fair.

Another problem to avoid is the moral hazard of homeowners purposely defaulting in order to qualify for a program. So, only borrowers who are current on their payments should qualify. At the same time, it would be unfair to exclude a distressed borrower who defaulted for the first time right before the announcement of a program; this would leave out many deserving homeowners. Perhaps it would be better to provide a “grace period” of sorts - as long as a homeowner has been current in the previous three months, they would be eligible.

Any successful plan would have to deal with the negative equity problem. Simply reducing monthly payments for someone who was hundreds of thousands of dollars underwater makes little economic sense unless the goal is to help out lenders, not borrowers. Strategic defaults are on the rise, and will probably continue to rise as frustrations grow and people spread the word about how the consequences are not as severe as one would think. It is clear that for any plan to have a chance of succeeding, it cannot be voluntary. As discussed earlier, servicers have too high of an incentive to foreclose. A 2009 report from the Federal Reserve Bank of New York used statistical analysis to determine the impact of LTV on mortgage modification success. The authors analyzed the effects of a modification resulting in a ten percent reduction in monthly payment on mortgages with various LTV ratios. Compared to a modified mortgage with at least ten percent positive equity, a modified mortgage with an LTV between 100 and 104 has a predicted re-default rate that is 4.6 percentage points higher. For a modified mortgage with an LTV greater than 115, the re-default rate climbs to 33 percentage points higher.¹⁴¹ In other words, being significantly underwater significantly increases the chances that a homeowner will walk away even after a sizeable modification.

The authors used their model to illustrate the example of a homeowner whose current LTV is 118 percent on a \$200,000 loan under two different modification scenarios. In the first scenario, the monthly payment is lowered by reducing the interest rate from 9.17 percent to 6.29 percent so the debt to income ratio is reduced from 40 to 31 percent. This is essentially what a HAMP modification would achieve, and the report estimated that this would lower the re-default rate over the first year by 10.8 percent.¹⁴² In the second scenario, the principal is written down so that the LTV drops from 118 to 100 percent. To achieve the desired monthly debt to income ratio of 31 percent, the interest rate is then reduced from 9.17 percent to 7.95 percent. The impact of this combination approach is estimated to lower the re-default risk by 40 percentage points, meaning it is nearly four times as effective as the interest only strategy.¹⁴³ Now comes the issue of who to help. Widespread reducing of outstanding principal for underwater homeowners would immediately draw the ire, though, of those homeowners who are not underwater. This group would include mostly borrowers whose home values have fallen yet still retain positive equity, and those few whose home values remained relatively constant. Their gripe would essentially be that the people who made the worst investments are the ones getting help (although, to be fair, certainly some homeowners were in fact responsible yet ended up simply victims of circumstance due to the markets that they lived in). Relatively, the borrowers with positive equity would be punished with

¹⁴¹ Haughwout, Okah, & Tracy, *supra* note 81 at 23.

¹⁴² *Id.* at 24-25.

¹⁴³ *Id.*

a lack of a subsidy for making a better investment. This complaint would be *valid*. One way around this could be to provide some form of principal forgiveness to those who bought homes in the last few years that are not underwater. However, this would mean that there would then be less money to help out those who are underwater, and thus more foreclosures would occur. Effectiveness would be traded off for fairness. This might in turn spark complaints from those who bought their homes more than a few years ago and would receive no assistance. However, it would simply not be tenable to subsidize every single mortgage in the country. The line would have to be drawn somewhere.

Ultimately, this issue just shows the wisdom of doing nothing and letting the foreclosures clear the market on their own. But, assuming that something will be done, the reality is that there will be winners and losers in terms of who gets help and how much. In essence, no matter which method is chosen, the ones who made the good investments would be the ones subsidizing those who made the bad investments. Fundamentally, however, this is not much different from our progressive income tax system or welfare, and it is a reality that the public will simply have to accept.

C. Realistic - Plan Specifics

My specific plan would be called the Financial Assistance Incentives for Responsible Homeowners (FAIR) Act. Specifically, through federal funding FAIR would provide principal reduction and, if necessary, interest rate reduction, to borrowers who need and deserve help. To be eligible for assistance under the FAIR Act, borrowers' combined LTV ratio at the time of their home purchase must have been 80 percent or below; in other words, they must have put down at minimum 20 percent when purchasing. The initial loan must not have been for an amount in excess of \$760,000. Combined with the 80 percent LTV requirement, this means that only homes worth less than \$950,000 at purchase are eligible. The home must be the primary residence; second-homes are ineligible.

FAIR would be available for those current on their mortgage, as well as borrowers who are delinquent for no more than three months prior to the announcement of FAIR. If the borrowers' monthly debt-to-income ratio is already less than 31 percent, they are ineligible for assistance. For example, if a borrower's monthly income is \$5,000, their mortgage payment would need to already be above \$1,550 in order to qualify. If a borrower's family income is more than 4.5 times greater than the federal poverty line, they are also ineligible for assistance. For example, the current federal poverty level for a family of 4 is \$23,050.¹⁴⁴ So, if the income of that family is greater than \$103,725, they would not be eligible for assistance.

FAIR would be available to all homeowners with a current LTV ratio greater than 100 percent. For qualified homeowners, the principal would be reduced to the current fair market value of the home, leaving the LTV ratio at 100 percent. After this, if the monthly debt to income ratio is still above 31 percent, the interest rate would be lowered in order to achieve this threshold. However, the interest rate could not fall lower than the interest rate for a 30-year Treasury bond at the date of the modification. As of April 2012, this is around 3.3 percent.¹⁴⁵

The purpose of FAIR is to encourage homeowners to stay in their homes, not flip them for a quick profit, so 100 percent of any equity attained in the first year after the principal reduction would belong to the investor if the home is sold. If the home is sold during the second year, 75 percent of the equity would go to the investor and the homeowner would keep 25 percent. After two years, a more complex shared appreciation scheme begins. For appreciation between 100 and 110 percent of the fair market value at the time of reduction,

¹⁴⁴ The 2012 HHS Poverty Guidelines, <http://aspe.hhs.gov/poverty/12poverty.shtml>.

¹⁴⁵ Daily Treasury Yield Curve Rates, <http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield> (last visited on April 6, 2012).

the investor would keep 75 percent and the homeowner would keep 25 percent. For appreciation between 110 and 125 percent of the fair market value, the investor would keep 65 percent and the homeowner would keep 35 percent. All appreciation over 125 percent is evenly split between the homeowner and the investor. Thus, the homeowner would have an incentive to stay in the house for a long period of time, because the longer he or she stays the more equity he or she gets to share in.

FAIR would not be voluntary - servicers would be required to reduce the principal. FAIR would apply to all loans, whether held privately or by a GSE. The loss would be borne by the owner of the loan. For example, losses on Fannie Mae- and Freddie Mac-owned loans would be borne by them, i.e. the federal government. Losses on mortgage-backed securities would be borne by the investors. However, considering that a lender might lose even more money by foreclosing, FAIR is not that unfair. There would be a national hotline to call to complain about uncooperative or fraudulent servicers, and there would be stiff penalties if a servicer is found to have not reduced principal when they were required to. Specifically, the penalty would be five times the amount of the particular principle reduction.

FAIR would also address all junior liens (except judgment liens). Second liens would be written down at twice the percentage the first lien is written down. Third liens would be reduced by three times the percentage the first lien is written down. A fourth lien would be reduced 100 percent; in other words, it would be extinguished. Junior liens are by their very nature more risky, so that is why under FAIR they stand to lose more than first liens. In many cases, though, juniors would actually fare better under FAIR because if the home is foreclosed on then the junior liens would be completely extinguished and there would undoubtedly be no surplus to pay them off (and going after the borrower might prove difficult or impossible). Just like with first liens, writing down of second liens would be mandatory and any failure to do so would result in a penalty five times the amount of the particular reduction.

There is one caveat to FAIR - there simply might not be many underwater homeowners who actually put down 20 percent when purchasing. If the number of eligible homeowners is found to be sufficiently low, then the required initial LTV ratio should be adjusted downward to 75 percent (and possibly even 70 percent). If that is the case, then the maximum initial loan amount would be adjusted accordingly to \$712,500 and \$665,000, respectively, in order to maintain the \$950,000 value at purchase limit. Alternatively, it might be more palatable to define a goal of how many homeowners the government wishes to help, and then use that number to approximate the cutoff LTV ratio to achieve that goal. Or the government could also allocate a set dollar amount of debt it wishes to eliminate, and approximate the proper LTV ratio that way.

V. Conclusion

HAMP and its companion programs have been largely a failure. The fundamental flaw is the program's notion that borrowers will continue to make payments no matter how severely underwater they are, as strategic defaults are on the rise. And by making the program voluntary and offering only minimal compensation ensured that only a minimal amount of homeowners would receive help. The fact that the administration had to double the incentives to banks after a year indicates that a voluntary system in which banks are free not to participate was not nearly forceful enough. In addition, HAMP and the companion programs have been hampered by a lack of clear guidelines and quality assurance. Because of the incentives of servicers to foreclose, any successful plan to mitigate foreclosures would have to be mandatory and deal with the negative equity problem. Ideally, though, the sooner foreclosures go through the sooner the housing market will be able to recover, so the best solution would be no solution. However, if a solution must be put forth, it should make sure to reward the prudent over the profligate.

