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Foreclosures Are Often In Lenders' Best Interest

Numbers Work Against Government Efforts To Help Homeowners

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Government initiatives to stem the country's mounting foreclosures are hampered because banks and other lenders in many cases have more financial incentive to let borrowers lose their homes than to work out settlements, some economists have concluded.

Policymakers often say it's a good deal for lenders to cut borrowers a break on mortgage payments to keep them in their homes. But, according to researchers and industry experts, foreclosing can be more profitable.

The problem is that modifying mortgages is profitable to banks for only one set of distressed borrowers, while lenders are actually dealing with three very different types. Modification makes economic sense for a bank or other lender only if the borrower can't sustain payments without it yet will be able to keep up with new, more modest terms.

A second set are those who are likely to fall behind on their payments again even after receiving a modified loan and are likely to lose their homes one way or another. Lenders don't want to help these borrowers because waiting to foreclose can be costly.

Finally, there are those delinquent borrowers who can somehow, even at great sacrifice, catch up without a modification. Lenders have little financial incentive to help them.

These financial calculations on the part of lenders pose a difficult challenge for President Obama's ambitious efforts to address the mortgage crisis, which remains at the heart of the country's economic troubles and continues to upend millions of lives. Senior officials at the Treasury Department and the Department of Housing and Urban Development have summoned industry executives to a meeting Tuesday to discuss how to step up the pace of loan relief. The administration is seeking to influence lenders' calculus in part by offering them billions of dollars in incentives to modify home loans.

Still, foreclosed homes continue to flood the market, forcing down home prices. That contributed to the unexpectedly large jump in new-home sales in June, reported yesterday by the Commerce Department.

"There has been this policy push to use modifications as the tool of choice," said Michael Fratantoni, vice president of single-family-home research at the Mortgage Bankers Association. But "there is going to be this narrow slice of borrowers for which modifications is the right answer." The size of that slice is tough to discern, he said. "The industry and policymakers have been grappling with that."

The effort to understand the dynamics of the mortgage business comes as the administration is prodding lenders to do more to help borrowers under its Making Home Affordable plan, which gives lenders subsidies to lower the payments for distressed borrowers. About 200,000 homeowners have received modified loans since the program launched in March, while more than 1.5 million borrowers were subject during the first half of the year to some form of foreclosure filings, from default notices to completed foreclosure sales, according to RealtyTrac.

No doubt part of the explanation is that lenders are overwhelmed by the volume of borrowers seeking to modify their mortgages. Rising unemployment and falling home prices have added to the problem.

But a study released last month by the Federal Reserve Bank of Boston was downbeat on the prospects for widespread modifications. The analysis, which looked at the performance of loans in 2007 and 2008, found that lenders lowered the monthly payments of only 3 percent of delinquent borrowers, those who had missed at least two payments. Lenders tried to avoid modifying the loans of borrowers who could "self-cure," or catch up on their payments without help, and those who would fall behind again even after receiving help, the study found.

"If the presence of self-cure risk and redefault risk do make renegotiation less appealing to investors, the number of easily 'preventable' foreclosures may be far smaller than many commentators believe," the report said.

Nearly a third of the borrowers who miss two payments are able to self-cure without help from their lender, according to the Boston Fed study. Separately, Moody's Economy.com, a research firm, estimated that about a fifth of those who miss three payments will self-cure.

When Adrian Jones fell behind on the mortgage payments for her Dallas home earlier this year, her lender asked her to cut other expenses. Jones said she eliminated movies and coffee breaks. She turned to family members for loans. When that failed to raise enough, she sold her second car.

"It hurt, but it also made sense. The debt was my responsibility," Jones said.

But six months later, after catching up on the mortgage, Jones is again feeling pinched after her hours as an office assistant at an architecture firm were cut. This time, she's not sure she can fix the problem herself.

"I am going to try, obviously," she said. "But it is getting harder and harder."

Like Jones, those who are most determined to meet their obligations are often unlikely candidates for loan modifications.

"These are the people who will get a second job, borrow from their family to keep up," explained Paul S. Willen, a senior economist at the Federal Reserve Bank of Boston and an author of its report. ". . . From a cold-blooded profit-maximizing standpoint, these are the people the banks will help the least."

Lenders also worry that borrowers may re-default even after receiving a loan modification. This only delays foreclosure, which can be costly to the lender because housing prices are falling throughout the country and the home's condition may deteriorate if the owner isn't maintaining it. In some cases, lenders lose twice as much foreclosing on a home as they did two years ago, said Laurie Goodman, senior managing director at Amherst Securities.

American Home Mortgage Services, based in Texas, was willing to modify Edward Partain's mortgage on his Tennessee home last April after business at his beauty salon slowed and a divorce stretched his budget. But after months of negotiating with his lender, Partain said he was surprised to learn that it would only lower his payments by $90 a month, instead of the $250 decrease he expected.

"At $250, I would have had a chance, but after they added in late fees and payments, I couldn't do it," he said.

Partain soon fell behind on his payments again and went back to American Home Mortgage Services seeking a more affordable payment. Partain said he was told that he was ineligible for another modification because it had been less than a year since his last. A foreclosure sale was scheduled for late July.

After American Home Mortgage Services was contacted by The Washington Post about the case, the company said Partain would be considered for the federal foreclosure-prevention program and it delayed the sale by three months. Partain is relieved but anxious about the details.

"You want to wait and see what figures they come up with," he said.

Administration officials have not said publicly how many borrowers they expect to re-default under Obama's program.

But the experience of a separate program run by the Federal Deposit Insurance Corp. could be instructive. After taking over the failed bank IndyMac last year, the FDIC began modifying troubled mortgages held or serviced by the company. Richard Brown, the FDIC's chief economist, said the agency expects up to 40 percent of those borrowers to re-default.

Even at that rate, he said, the modification program is more profitable than doing nothing. "The idea that 30 to 40 percent re-default is a failure to a program is false," Brown said.

The administration has estimated that its foreclosure-prevention program would help 3 million to 4 million borrowers by 2012. But lenders' reluctance could limit the impact to less than half that, said Mark Zandi, chief economist for Moody's Economy.com. Coupled with re-defaults, this would mean that the number of people losing their homes to foreclosure could reach nearly 5 million by 2011, he said.

Mark A. Calabria, director of financial-regulation studies at the Cato Institute, warned that political rhetoric is driving the policy discussion. "What we really need to do is have an honest debate about what are the magnitudes of people we really can help," he said. But administration officials defended their program's progress, reporting that it has surpassed an initial goal of offering 20,000 modifications a week. These officials said they have taken into account the re-default risk and possibility for self-cure in designing the effort.

Michael S. Barr, assistant Treasury secretary for financial institutions, noted that the report by the Boston Fed does not cover the period since the administration launched its initiative. "We will continue to refine the program as new data becomes available," he said. "We are committed to studying the effectiveness and efficiency of the program, and we welcome outside analysis."

Willen, of the Boston Fed, said the government program could boost several-fold the number of seriously delinquent borrowers receiving modifications. But so few people had been getting their loans modified that even a dramatic increase in the percentage would still touch only a small fraction of troubled borrowers, he said.

"We're still not talking about a program that will stop a large number of foreclosures," he said. "We're talking about a program that, at the margins, will assist more people. It is unlikely we will see a sea change."

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