Improving Outcomes in the Obama Administration's Home Affordable Modification Program (HAMP)

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Background

The numbers are astounding. A family loses their home to foreclosure every 13 seconds.[1] Fifteen million homeowners owe more than their mortgages are worth.[2] With millions of option ARMs and Alt-A loans scheduled to reset in the next few years, coupled with rising unemployment, the numbers are likely to only get worse. The Center for Responsible Lending (CRL) estimates 9 million forecloses by the end of 2012 resulting in a $2 trillion loss in home property values in the United States.[3]

Mortgage servicing companies are key to addressing the foreclosure crisis because they occupy the unique niche of collecting payments and making decisions about foreclosures on behalf of investors who own pools of mortgage backed securities. Unfortunately, most workouts offered by servicers are not affordable to the homeowner, and many even fail to lower the monthly payment that led to the delinquency, thereby resulting in high re-default rates. This paper examines the Obama Administration's Home Affordable Modification Program (HAMP), which seeks to incentivize servicers to conduct affordable loan modifications, and provides recommendations for improving the effectiveness and long-term success of HAMP and ultimately, reducing the number of preventable foreclosures. Below are the report's key findings:

- **Unless key challenges to HAMP's implementation are addressed, HAMP will not succeed in combating foreclosures on a large scale**. Mortgage servicers remain woefully understaffed and overwhelmed by the large volume of borrowers seeking loan modifications. Consequently, servicers are violating terms of their HAMP contracts, such as proceeding to foreclosure while a borrower is under review for a loan modification, and refusing to go beyond the minimum requirements of the program when doing so would be beneficial to all parties and ensure long-term viability of the loan (e.g., opt for principal reduction rather than principal forbearance).

- **The Administration must create disincentives for servicers that fail to comply with HAMP or refuse to participate.** In order for HAMP to reach its goal of saving three to four million homes from foreclosure, the Administration must aggressively ensure that servicers participate and are in compliance with HAMP guidelines. To date, many incentives for participation have been provided to servicers, but none have faced any serious consequences for refusing to participate in HAMP or for outright violating the terms of the program.

- **More flexibility within HAMP is needed to ensure the maximum number of eligible borrowers receive loan modifications**. HAMP guidelines do not account for rising unemployment and falling property values. Any homeowner who falls 90 days behind on a HAMP modification is automatically terminated from the program, including homeowners who are laid off or have their work hours cut back. The Administration should permit the re-entry of a re-modified loan once timely payment is reached. Furthermore, where a homeowner has a viable modification proposal, but fails to meet a standard, such as the net present value (NPV) test, the Administration should pressure the servicer to waive these requirements (which in many instances, is permissible under HAMP) to keep the homeowner in his home.

The Obama Administration's Response to the Foreclosure Crisis

In April 2009 the Obama Administration introduced the federal government's most aggressive initiative to date – the Making Home Affordable program, which aims to help four to five million homeowners current on their government-backed loans to refinance to take advantage of historically low interest rates, while also helping three to four million delinquent borrowers receive a loan modification through a combination of subsidies to investors and incentives to mortgage servicers. This second component, Home Affordable Modification Program (HAMP), makes payments to servicers for modifications, offsetting the financial incentive to foreclose, and requires participating servicers to be bound by a rational loss mitigation protocol that will protect homeowners and investors, including reducing a borrower's total housing payment down to 31% of income. Most mortgage servicers have agreed to participate in HAMP and subsequently, have also increased hiring and improved their outreach to borrowers. Nevertheless, the industry is still foreclosing on too many homeowners when it would make more economic sense to modify their loans instead.

For the millions of Americans facing foreclosure, HAMP guidelines created enormous hope that the new Administration understood the barriers to loan modifications and that relief was on the way. However, housing advocates and housing counseling agencies soon realized that HAMP was far from perfect. In some areas the program actually called for weaker modification remedies than those already being secured for homeowners. For example, while the ACORN Housing Corporation (AHC) is often successful at negotiating permanent life-of-loan modifications for homeowners, the HAMP calls for temporary modifications with only a five year term. Also, the plan's assumption that servicers would voluntarily comply seemed to ignore the previous administration's experience with the Hope for Homeowners program. Nonetheless, these drawbacks are outweighed by the plan's basic promise: HAMP would replace the mortgage servicing industry's multiple, complex, and often contradictory maze of rules and procedures with a single, standardized, and fair set of guidelines, and the needs of homeowners would be balanced with the rights of servicers and investors.

Challenges to the Successful Implementation of HAMP

It has been only four months since HAMP was announced. For large government initiatives, four months is a blink of an eye, but for a family facing the imminent loss of their home, four months is an eternity. In addition to the slow implementation of the program, structural challenges remain that undermine the long-term success of the program. The existing barriers to the successful implementation of HAMP are outlined below:

- **Mortgage servicers remain severely understaffed and are not complying with the HAMP contracts they signed**. HAMP requires servicers to suspend all foreclosure activity until it can be determined if a homeowner is eligible for a modification; instead, servicers are proceeding with foreclosures before such determinations are made. Servicers are still working to get their computer and management systems ready for HAMP, which explains why on average, homeowners and housing counselors are experiencing delays of three to six months in obtaining responses from servicers. Until these systems are operational and servicers can accurately assess homeowner eligibility for HAMP, foreclosures on owner-occupied properties need to cease.

  In direct violation of the guidelines, some servicers also continue to 1) require homeowners to make large, up-front cash payments as a condition for being considered for a modification; 2) fail to apply the HAMP rules to all portfolios being serviced; 3) refuse to evaluate for HAMP modifications those distressed homeowners currently paying on time; 4) base the affordability calculations on interest-only or option-arm minimum payments, when HAMP requires affordability to be based on the loan's principal interest, taxes and insurance; and 5) neglect to offer principal forbearance when interest rate reductions are not enough to make the loan affordable.

- **HAMP guidelines do not account for rising unemployment and falling property values**. Any homeowner who falls 90 days behind on a HAMP modification is automatically terminated from the program, including homeowners who are laid off or have their work hours cut back. Even if a worker applies for a re-modification of a mortgage on the day their income is reduced, it is likely to take 120 to 180 days before a servicer makes a decision. If the servicer agrees to re-modify the mortgage, then HAMP should allow the homeowner to re-enter the program, which it currently does not.

  The Obama administration intends for the HAMP guidelines to serve as a floor, rather than a ceiling, but many servicers will not go beyond the minimum requirements. With unemployment on the rise and incomes falling, the guidelines must be changed to mandate principal reductions and to address the inaccurate, inflated property valuations resulting from the servicers' net-present-value tests. The HAMP minimum standard is a rate reduction for five years, but for those who experience a permanent decline in income, the servicers should fix the rate for the life of the loan, so that the homeowners do not end up with payment shock when the rate goes up again after five years.

Under HAMP, if a reduction in interest rate is not enough to make the mortgage payment affordable, then the servicer must forebear a portion of the loan's principal balance by putting it on the end of the loan as a balloon, payable when the house is sold or the mortgage is paid off. The HAMP allows a servicer/investor to substitute principal forgiveness for forbearance and will compensate investors for principal forgiveness the same amount they would have earned had the servicer used interest rate reductions to achieve an affordable payment. However, servicers stubbornly refuse to voluntarily offer principal reduction. Principal forbearance will lower the monthly mortgage payment, but it dooms those in situations where the loan amount far exceeds the fallen house value and no equity in the home remains.

Without the ability to build equity, many of the economic benefits of homeownership are lost. The homeowner will not qualify for a secured loan for home repairs, medical expenses, or college tuition and they will receive nothing at the settlement table when they sell their home. More importantly, they will have nothing to pass on to their children. Given the large number of first-time homebuyers in the last fifteen years, especially in African American and Latino communities, forbearance reverses many of the gains made in homeownership and familial net worth. By permitting the homeowner to financially recover and build some semblance of future wealth, principal reductions are far more likely than principal forbearance to stabilize distressed families and the housing markets in which they reside.

- **The Administration has offered plenty of carrots; it is time to add a few sticks**. Currently, there are plenty of incentives for servicers to participate in HAMP with little, if any, consequence if servicers choose not to participate (as is the case with Litton Servicing and Home Eq) or if they fail to abide by the program's guidelines. Unless servicers, and by extension investors, face significant disincentives for either a failure to participate or comply with HAMP, the program will never be fully operational and the maximum number of eligible homeowners will never be reached.

Recommendations to the Administration for Improving HAMP

With approximately two million households in jeopardy of losing their homes this year, the American public sorely needs HAMP to work. And the Administration needs the full cooperation of mortgage servicers to implement affordable loan modifications. The recommendations below would improve the program's effectiveness, resulting in fewer foreclosures and more stable housing markets, as well as preserve the value of homeownership in building long-term wealth for families and communities.

- **Establish HAMP as a program that sets minimum standards for affordable loan modifications, not maximum standards**. Servicers can do more than the provisions in the Treasury HAMP directive. The Administration should, therefore, put pressure on servicers to go beyond HAMP's minimum guidelines and consider improvements to the program that will ensure long-term success, including:

    - **Allow front end debt-to-income affordability ratio to go below 31% when needed**. Some households will be unable to sustain a front end ratio of 31% and will need a lower ratio. For example, low-income families at 31% may not have adequate residual funds to pay for essentials or high debts, such as medical expenses.

    - **Reduce the interest rate for the life of the loan, rather than just five years**. For homeowners whose rate is reduced, for example, to 2% after five years, the homeowner's rate will increase by one point each year until it reaches the Freddie Mac rate at the time the modification was originated (currently around 5%). This will result in a doubling of the interest rate, which can place the borrower into an unaffordable loan yet again. To sustain a steady income flow from the homeowner, life-of-loan resolutions should be provided for more affordable and effective results.

    - **Remove the 40 year term extension as an option in HAMP**. In the long term, a 40-year extension is a very expensive option for the homeowner resulting in a very small reduction in loan payments. Loan terms should remain the same on the loan or at the most extend to 30 years. Many private label securities prohibit term extension beyond the initial thirty years. The Supplemental Directive issued by Treasury under HAMP permits servicers to substitute additional principal deferment or forgiveness for the 40 year amortization if this action results in the best outcome for the borrower.

- **Enact principal reductions, instead of forbearance**. Under HAMP, if the interest rate reduction is not enough to make the mortgage payment affordable, then at a minimum, a portion of the principal will be placed at the end of the loan as a balloon payment to be paid when the house is sold or the mortgage is paid off. In practice, given the slow increase in property values predicted in most parts of the country, many homeowners will have no equity in the home, will not be able to get a secured loan for home repairs, will have nothing to pass on to their children, and will receive nothing at the settlement table if they sell their home. Given the number of first generation homebuyers in the last several years, especially in African-American and Latino communities, this will have a serious generational impact on wealth and homeownership levels. Reducing principal will permit the homeowner to recover from this crisis and obtain some form of homeownership wealth building. The Supplemental Directive allows a servicer or investor to substitute principal forgiveness and will compensate investors for principal forgiveness in an amount equal to the compensation they would have earned had the servicer used interest reductions to achieve an affordable payment.

- **Go below the NPV valuation when needed to qualify a homeowner**. Where a homeowner has a viable modification proposal, but fails the Net Present Value (NPV) test, the servicer should waive the NPV requirement to keep the homeowner in the home. The Supplemental Directive states that incentives may be paid for loans that failed the NPV test but were subsequently modified in a manner consistent with the HAMP terms.

- **Take into account vandalism and theft in neighborhoods when valuing properties in the NPV test.** The NPV test provides the property value to compare whether it will cost the investor less to modify the loan or to foreclose. The tests are seriously flawed because they only include the cost of vandalism and theft on a state or metropolitan level. Houses stripped of copper, appliances, and kitchen cabinets plummet in value. NPV tests need to appropriately discount properties in high vulnerability neighborhoods to prevent unnecessary foreclosures and significant investor loss.

- **Address violations of HAMP contracts**. While most servicers are routinely complying with their HAMP contracts, a few servicer practices are in clear violation of HAMP and threaten the success of the program. For example, several servicers continue to require a down payment from homeowners to obtain a modification although it is prohibited under HAMP. Treasury should ensure this practice is abandoned as it compromises a borrower's ability to receive a loan modification. Additionally, the following practices need to be addressed:

- **Servicers are cherry picking which loans to modify under HAMP**. The HAMP program applies to all portfolios; however, servicers are excluding some portfolios from relief under HAMP. The only explicit exception allowable under HAMP is if the term of a PSA specifically prohibits modifications or the use of specific steps in the HAMP analysis. In the instance that the PSA prohibits loan modifications, the servicer should make every effort to obtain a waiver from the trust to allow modifications under the plan and document those efforts. If a servicer cannot modify a loan based on explicit prohibitions in the PSA, the servicers should be prepared to explain the basis for the denial to the borrower and to Treasury's Compliance Agent, Freddie Mac. The Administration should also consider measures that would remove tax advantages or other benefits enjoyed by the trusts that hold mortgage-backed securities if the investors prohibit loan modifications.

- **Foreclosure activities are proceeding while a homeowner is undergoing a review for a loan modification**. Foreclosure proceedings must be stopped until the homeowner has been reviewed for HAMP eligibility. No foreclosure sale may take place or new foreclosure action be initiated on loans that are 60 or more days past due and meet the minimum eligibility profile for HAMP (i.e. owner occupied, loan balance under Fannie Mae's national cap, originated on or before January 1, 2009, etc.) until the servicer has evaluated the borrower to determine if the loan qualifies for HAMP. If a borrower who is current or less than 60 days delinquent or the borrower's counselor contacts a servicer to request consideration under the program, the servicer may not initiate foreclosure until the loan has been evaluated for HAMP. Despite these explicit guidelines, servicers are proceeding to foreclosure even if the homeowner meets the minimum HAMP requirements. Treasury should ensure that servicers are not initiating foreclosure proceedings against borrowers who are in the process of being reviewed for a loan modification under HAMP.

- **Servicers should re-modify HAMP loan modifications, if the homeowner's income decreases.** If a borrower re-defaults on a HAMP modification, the servicer should work with the borrower to reinstate the loan using any available tools including forbearance, debt forgiveness or restructuring of the modification terms. With increasing unemployment and underemployment, this will be an important part of the program and the Administration should urge common sense flexibility among servicers. Furthermore, the Administration should allow loans to be reinstated in the HAMP program. Currently, any HAMP modified loan which becomes over 90 days late is terminated from the program. The Administration should permit the re-entry of a remodified loan once timely payment is reached.

- **Create disincentives for not complying or participating in HAMP**. Investors in exotic mortgage derivatives who refuse to allow underlying loans to be modified under HAMP guidelines should be publicly identified and barred from doing business with the U.S. Corporations should be barred from receiving TARP funds, or from participating in other programs, such as the newly-created Public-Private Investment Program (PPIP), if they own mortgage servicing units that refuse to participate in HAMP or if they consistently fail to abide by the program's guidelines. State and local courts should also be authorized to adjudicate appeals from homeowners who believe they qualify for a modification but have been wrongly denied.

- **Utilize the experiences of HUD-certified housing counseling agencies***.* Mortgage documents can be very complicated, and indeed the lack of transparency in them confused many borrowers and contributed to the boom in predatory lending. Just as these homeowners would have benefited from having a counselor review their documents upon origination, so too will they benefit enormously from having a counselor advocate for them during the loan modification process. Housing counselors are knowledgeable about industry loss mitigation practices, and can also help determine how much in housing costs the homeowner can truly afford to ensure that any modification is sustainable over the long term. The servicers and investors should pay for nonprofit housing counseling agencies for the counseling and outreach work they do, just like other vendors are paid. The Administration should consider contracting with trusted HUD-approved housing counseling agencies to be subservicers under the HAMP program. They can collect the financials, perform the calculations, and obtain the document signatures. In fact, they do this already and the servicer is often just replicating their work. Every homeowner stabilized making timely payments moves us one more step out of the crisis.

- **Incorporate mandatory mediation as part of an appeals process, whereby borrowers can challenge their eligibility for a HAMP loan modification as well as the terms of their loan modification**. While the current program design attempts to balance the interests of servicers and borrowers, homeowners have little recourse should they be denied a HAMP loan modification or should they disagree with the terms of their loan restructuring. An appeals process would empower borrowers to obtain optimal loan modifications and encourage servicers to work in good faith to offer affordable loan modifications with fair terms. Mandatory mediation, a process that requires the borrower and servicer to come to the negotiating table under the supervision of a local court, has been adopted by states and localities to provide a process for both parties to hash out a mutually beneficial agreement resulting in an affordable loan modification. In particular, mandatory mediation has served as an instrumental foreclosure prevention tool in Philadelphia as well as a process through which homeowners can object to offers and terms made by their servicers. A year into its existence, the Philadelphia Foreclosure Diversion Program, is preventing more than three in four owner-occupied foreclosures and has proven to be the best model in the nation.[4] The federal government should invest in successful mandatory mediation programs as a necessary complement to the Administration's foreclosure prevention efforts.

Conclusion

Presently, the Administration's efforts to curb foreclosures are not living up to their potential or promise. Under HAMP, the Administration aims to save three to four million homes over the next three years; thus far, approximately 160,000 loan modifications have been made.[5] More must be done by servicers and the Administration to implement the program successfully and obtain significant results that will have an impact on reducing the high number of foreclosures. HAMP's success is critical. Without the stabilization of housing prices, an economic recovery is highly unlikely. Therefore, the Administration must ensure that servicers who participate in HAMP are complying with existing guidelines and pressure them to do more when in the best interest of the borrower and investors. Finally, unless servicers increase capacity and enhance operational efficiencies to meet demand, HAMP will fail to stem the rising tide of foreclosures.

Endnotes

[1] Center for Responsible Lending, http://www.responsiblelending.org
[2] www.moodys.com
[3] Center for Responsible Lending, http://www.responsiblelending.org
[4] http://www.acorn.org/fileadmin/ACORN_Reports/2009/Road_to_Rescue_Report.pdf
[5] Politico, "*W.H. foreclosure plan a bust so far*," July 17, 2009. http://www.politico.com/news/stories/0709/25095.html