Congressional
Oversight
Panel

Foreclosure Crisis: Working Toward a Solution

March Oversight Report
Executive Summary

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Title 1 of the Emergency Economic Stabilization Act of 2008,
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Executive Summary*

For as long as there have been mortgages, there have been foreclosures. The reasons are well documented. Job losses, medical problems, and family breakups can leave families strapped for cash, unable to meet their monthly payments.

Foreclosures have now skyrocketed to three times their historic rates. But the causes of this foreclosure crisis are very different than the foreclosures of the past. Since the late 1990s, mortgage lending, once considered the safest of all investments because of the well-researched decision-making that carefully documented the ability of a borrower to repay, morphed into an assembly-line business that looked nothing like mortgages of the past. This new approach to mortgage lending included steering high-priced mortgages to people who may have qualified for lower-priced fixed rate mortgages and aggressive marketing of high-risk loans to people whose incomes made it clear that they could not possibly repay over the life of the loan. In effect, such mortgages could be repaid only if the housing market continued to inflate at historic rates and borrowers could endlessly refinance their loans. After dizzying price increases in many parts of the country, housing prices flattened, refinancing became impossible, and the bubble burst.

Now millions of Americans find themselves unable to meet their monthly mortgage payments. Millions more people who can make their payments now recognize that they owe far more than their houses are likely to be worth for many years, and some are walking away. Over the next few years, an estimated one in every nine homeowners is likely to be in foreclosure, and one in five will likely have a mortgage that is higher than their house is worth, making default a financially rational alternative.

Mortgage foreclosures pose a special problem. Millions of people could make market-rate payments on 30-year fixed mortgages for 100% of the current market value of their homes. But these can-pay families are driven into foreclosure because they cannot pay according to the terms of the higher-priced mortgages they now hold, and refinancing options are limited or nonexistent. After accounting for the costs of foreclosure and the lower prices foreclosure auctions bring, the lenders will lose an average of $60,000 per foreclosure and recover far less than the market value of the homes. Foreclosure for can-pay families destroys value both for the family forced out of its home and for the investor who will be forced to take a larger loss.

For decades, lenders in this circumstance could negotiate with can-pay borrowers to maximize the value of the loan for the lender (100% of the market value) and for the homeowner (a sustainable mortgage that lets the family stay in the home). Because the lender held the mortgage and bore all the loss if the family couldn't pay, it had every incentive to work something out if a repayment was possible.

* This report was adopted by a 4-1 vote on March 5, 2009. Rep. Jeb Hensarling voted against the report.

But the mortgage market has changed. A series of impediments now block the negotiations that would bring together can-pay homeowners with the investors who hold their mortgages. In this report we identify those impediments. These are structural problems, created as the mortgage business shifted. They include fallout from securitizing mortgages, the arrangements with mortgages servicers that encourage foreclosures over modifications, and severe understaffing of workout departments. Because of these impediments, foreclosures that injure both the investor and the homeowner continue to mount.

Like the crisis in the banking system, the foreclosure problem has grown so large that it threatens the entire economy. Foreclosures depress housing and commercial real estate prices throughout neighborhoods, imposing serious costs on third parties. Each of the eighty closest neighbors of a foreclosed property can suffer a nearly $5,000 property value decline as a result of a single foreclosure. Communities with high foreclosure rates suffer increased urban blight and crime rates. When families have to relocate, community ties are cut, affecting friendships, religious congregations, schooling, transportation and medical care. Numerous foreclosures flood the market with excess inventory that depress other sale prices. Thus, foreclosures can harm other homeowners both by encouraging additional foreclosures and by reducing home sale prices, while decreased property values hurt local businesses and reduce state and local tax revenues.

To help individual families and to stabilize the economy, Congress has pressed Treasury to devise a plan to deal with foreclosures.[1] The Congressional Oversight Panel was explicitly instructed to review "the effectiveness of foreclosure mitigation efforts" undertaken by Treasury under the authorization of the Emergency Economic Stabilization Act.[2]

To develop this report, we explored the available data and discovered how little is known about the current state of mortgage performance across the country. The ability of federal banking and housing regulatory agencies to gather and analyze this data is hampered by the lack of a nationwide loan performance data reporting requirement on the industry. Consequently, there is no comprehensive private or government source for accurately tracking loan delinquencies and loss mitigation efforts, including foreclosures and modifications, on a complete, national scale. No federal agency has the ability to track delinquencies and loss mitigation efforts for more than 60% of the market. Existing data are plagued by inconsistencies in collection methodologies and reporting, and the numbers are often simply unverifiable. Worse still, the data that are collected are often not the data needed for answering key questions, such as, what are causing mortgage defaults and why loan modifications have not been working. The United States is now two years into a foreclosure

[1] Emergency Economic Stabilization Act of 2008 (EESA), Pub. L. No. 110-343, at § 109.

[2] *Id.* at § 125(b)(1)(A)(iv).

crisis that has brought economic collapse, and federal banking and housing regulators still know surprisingly little about the number of foreclosures, what is driving the foreclosures, and the efficacy of mitigation efforts. The Panel endorses a much more vigorous plan to collect critical foreclosure data.

To evaluate plans to deal with foreclosures, we identified the main impediments to economically sensible workouts. From there, we developed a checklist to evaluate the likely effectiveness of any proposal to halt the cascade of mortgage foreclosures.

Checklist for Mortgage Mitigation Program
Will the plan result in modifications that create affordable monthly payments?
Does the plan deal with negative equity?
Does the plan address junior mortgages?
Does the plan overcome obstacles in existing pooling and servicing agreements that may prevent modifications?
Does the plan counteract mortgage servicer incentives not to engage in modifications?
Does the plan provide adequate outreach to homeowners?
Can the plan be scaled up quickly to deal with millions of mortgages?
Will the plan have widespread participation by lenders and servicers?

On February 18, 2009, President Obama announced the Homeowner Affordability and Stability Plan intended to prevent unnecessary foreclosures and strengthen affected communities. The Plan focuses on payment affordability through an expanded refinancing program involving Fannie Mae and Freddie Mac and a modification program targeting a wide range of borrowers at risk. The Plan also includes financial incentives to encourage both lenders and borrowers to strive for sustainable outcomes. It also encourages servicers to modify mortgages for at risk homeowners before they are delinquent. There are additional incentives available to extinguish junior mortgages.

The Administration estimates that the Plan's expanded refinancing opportunities for Fannie Mae and Freddie Mac mortgages could assist four to five million responsible homeowners, some of whom otherwise would likely have ended up in foreclosure.

While these projections are encouraging, the Panel has additional areas of concern that are not addressed in the original announcement of the Plan. In particular, the Plan does not include a safe harbor for servicers operating under pooling and servicing agreements to address the potential litigation risk that may be an impediment to voluntary modifications. It is also important that the Plan more fully address the contributory role of second mortgages in the foreclosure process, both as it affects affordability and as it increases the amount of negative equity. And while the modification aspects of the Plan will be mandatory for banks receiving TARP funds going forward, it is unclear how the federal regulators will enforce these new standards industry-wide to reach the needed level of participation.

The Plan also supports permitting bankruptcy judges to restructure underwater mortgages in certain situations. Such statutory changes would expand the impact of the Plan. Without the bankruptcy piece, however, the Plan does not deal with mortgages that substantially exceed the value of the home, which could limit the relief it provides in parts of the country that have experienced the greatest price declines.

The Administration released additional guidelines for the Plan on March 4, as this report was prepared for publication. The Panel will promptly pursue any outstanding issues with the Treasury Department and will keep Congress and the American people advised of its ongoing evaluation of the Administration's Plan.

The foreclosure crisis has reached critical proportions. The Panel hopes that by identifying the current impediments to sensible modifications that we can move toward effective mechanisms to halt wealth-destroying foreclosures and put the American family—and the American economy—back on a sound footing.