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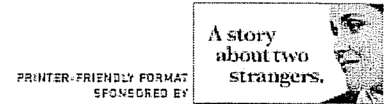

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TALKING BUSINESS

From Treasury to Banks, an Ultimatum on Mortgage Relief

By JOE NOCERA

Remember that infamous meeting last October at the Treasury Department, the one where then-Secretary Henry Paulson locked the chief executives of the nation's nine largest financial institutions in a room, and wouldn't let them out until they agreed to accept billions of dollars in government bailout money — whether they wanted it or not?

O.K., that's a bit of an exaggeration. But I was reminded of that meeting on Thursday night when I was shown a letter that the administration had just sent out calling for yet another big meeting at Treasury with yet another sector of the financial industry. Signed by Treasury Secretary Timothy Geithner and Shaun Donovan, the housing and urban development secretary, the letter demanded that representatives from the top 25 mortgage servicers assemble in Washington on July 28. It is likely to be every bit as painful for them as that Paulson meeting last October was for the bank C.E.O.'s.

The subject of the meeting is going to be loan modifications. Specifically, the government is going to be asking — in none-too-friendly fashion — why the nation's big servicers aren't doing more to modify loans for homeowners who are in danger of defaulting on their mortgages. Back in the spring, after all, they all signed onto the administration's new Making Home Affordable program, which uses a series of incentives — not the least of which is $1,000 to the servicers for every mortgage they modify — to help keep people in their homes and prevent foreclosures.

And yet, five months later — and two years into the housing bust — the rising tide of foreclosures remains the single biggest threat to economic recovery. In 2005, at the height of the bubble, there were some 800,000 foreclosures. This year, sadly, we are on pace to see 3.5 million foreclosures, with no end in sight. "On Main Street, the recovery will begin when foreclosures stop," said Senator Jack Reed of Rhode Island, who has been pushing the Treasury Department to get mortgage relief more quickly to homeowners at risk of foreclosure.

"It's not just California and Florida anymore," said Mark Zandi of Moody's Economy.com. "Foreclosures are taking place coast to coast. They're high-end homes, low-end homes, prime mortgages, jumbo loans, you name it. Foreclosure mitigation needs to be front and center." As of March, according to Mr. Zandi, some 15 million homes were "under water," meaning that their owners' mortgage balance was higher — often considerably higher — than the value of the homes. Not all of those people will default on their mortgages. But many will.

Inexplicably, the Bush administration ignored the mounting foreclosure threat. The Obama administration

came to office promising to do better; within a month it had announced the Making Home Affordable program, aimed at prodding the nation's big mortgage servicers to start modifying loans in large numbers. In addition, Congress passed a law immunizing the servicers from lawsuits that might arise for modifying mortgages.

So far, however, the results have been disheartening. As of July 6, according to some internal Treasury data I was given a peek at, a total of 131,030 mortgages had been modified under the program, on a three-month trial basis (the Obama program calls for three-month trials before the new loan terms are locked in). That may sound good — but it's a drop in the bucket compared with those 3.5 million potential foreclosures this year.

What's more, the anecdotal evidence strongly suggests that homeowners looking for assistance face enormous frustration, and even resistance, from servicers. A few weeks ago, this newspaper published a startling front-page story documenting the difficulty borrowers faced just getting basic information from their servicers. It's not uncommon to have to wait several months just to get a phone call returned.

"We believe there is a general need for servicers to devote substantially more resources to this program for it to fully succeed and achieve the objectives we all share," wrote Mr. Geithner and Mr. Donovan in their letter.

Having spent some time this week looking into the program, I'd have to classify that as the understatement of the year.

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"Servicers are just not equipped to do this," said William Kelvie, the chief executive of Overture Technologies, a company that sells underwriting software. If you want to understand why loan modifications have been so slow in coming, that's a pretty good place to start.

For most of its history, the mortgage servicing industry — which is dominated by big banks like Bank of America, Wells Fargo, and JPMorgan Chase — did relatively simple tasks: it collected mortgage payments, paid taxes on the properties and so on. Yes, it dealt with borrowers who were in arrears — which usually amounted to no more than 2 or 3 percent of their portfolio at any one time — but mainly it either prodded people to get current on their payments or initiated foreclosure proceedings.

Modifying loans — thousands upon thousands of loans, amounting to as much as 25 percent of a servicer's portfolio — is a much more complex task. For some servicers, the sheer numbers can "overwhelm the system," said Larry B. Litton Jr., the chief executive of Litton Loan Servicing, which is owned by Goldman Sachs — and which has long specialized in loan modifications. That is at least part of the reason why borrowers are having so much trouble getting their servicers to take their calls: many servicers can't cope with the volume.

More important, loan modification requires a lot of work. They can't be done in a blanket, one-size-fits-all fashion. Rather, loan modification is a one-on-one process that requires servicers to do something that should have been done in the first place: actually underwrite the loan.

Many of these mortgages, remember, were never properly underwritten, drawn up as they were back in the

heyday of no money down and no income verification. Even mortgages that were originally underwritten properly have to be underwritten again; quite often the homeowner is in trouble because he has lost his job or because the recession has cut deeply into his savings and income. The servicer has to figure out whether he'll be able to handle even a modified loan.

"Servicers have to become full-blown underwriting shops," said Mr. Litton. Alas, most of them so far are not.

I wish I could say that was the only reason the loan modification machinery is grinding so slowly. But the more I looked into it, the more I began to suspect there is another, darker reason. Although it would seem obvious that mortgage relief makes more sense than foreclosure for everyone concerned, the holders of the loans don't always see it that way. Many banks have less incentive than you'd think to sign off on large-scale loan modifications.

For instance, many times, when a mortgage holder falls behind, he will "self-cure" (as it's called in the trade) — and eventually get current with his mortgage. So the bank, or the servicer, often has a reason to simply wait him out. In addition, the rate of re-default on modified mortgages can be as high as 50 percent, especially if the modification is not underwritten carefully. In which case, the servicer hasn't avoided a foreclosure, but merely postponed it.

Many institutions also are reluctant to do large-scale mortgage modifications because they will hurt the balance sheets. After all, if a loan is modified, the bank has to take a write-down on the portion of the loan it is swallowing. If lots of loans are modified, that means a lot of write-downs.

At this moment in the financial crisis, banks are trumpeting their new-found profitability and racing to return bailout money to the Treasury. They've been able to do so in part by pretending that their loan portfolios, across the board, are healthier than they actually are. The government's willingness to ease the rules surrounding mark-to-market accounting have helped this effort. (This is not true of every bank, I should note: JPMorgan Chase, the healthiest of the big banks, has also been the most aggressive about modifying mortgages.)

Sure, foreclosure ultimately costs the bank more money than a modification would. But foreclosures these days take a long time — as much as 18 months in some states. And all that time the banks can keep the loans on their books at inflated values. Daniel Alpert, the managing partner of Westwood Capital, calls this practice "extend and pretend." In fact, he said, he has been hearing that banks aren't even willing to conduct so-called short sales anymore. Those are sales where the borrower asks the bank to sell the house for whatever it can get, and the bank in turn lets the borrower walk away from the loss that results from the sale.

"Banks are saying no because they don't want to take the loss," said Mr. Alpert. "They would rather foreclose. That is just wrong."

In truth, servicers and banks don't yet have powerful enough incentives to do large-scale mortgage modifications. The servicers and modification experts I spoke to this week all agreed that the $1,000-per-modification being dangled by the government was pretty meaningless, given the amount of time, money and effort they require.

So now that the carrot hasn't worked especially well, the government is taking out the stick. That letter the

administration sent out on Thursday did not mince words. It demanded that the servicers begin "adding more staff than previous planned, expanding call centers beyond their current size, providing an escalation path for borrowers dissatisfied with the service they have received, bolstering training of representatives, developing extra online tools, and sending out additional mailings to borrowers who may be eligible for the program."

And the laggards? Starting next month, the government plans to begin publishing data showing which servicers are doing well and which are doing poorly, thus trying to shame them into doing the right thing. And, of course, there is that July 28 meeting, in which all these points will be made, I suspect, rather forcefully.

Apparently, the only incentive left is a good swift kick in the rear.

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