Foreclosure crisis phase 2: The negative equity dilemma

Many prime borrowers are being caught between devalued homes and job losses. Will Congress step in?

A Boston homeowner struggling to make payments has lived in her home since 1985.
(Taylor Weidman/The Christian Science Monitor)

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Boston —
For almost a quarter century, Cynthia Johnson, a Boston homeowner, has paid the mortgage on her three-bedroom single-family house on time.

But in July, for the first time, she'll miss a payment.

"I'm on [the bank's] doorstep at this point, saying, 'The savings are gone. I can't pay you as promised,' " she said.

Unless something changes, Ms. Johnson (not her real name) is set to join the nearly 2.4 million Americans with prime loans seriously delinquent on their mortgages. They are the new face of the housing crisis. Unlike subprime borrowers, most of these homeowners did everything right. They bought houses they could afford and used standard mortgages. But falling home prices and a protracted recession have pushed them into a classic squeeze: They can't keep up their mortgage payments because someone in the household has lost his or her job. They can't sell because they owe more than the home is worth.

"In the next 12 months it's going to be tragic – most people are just starting to fall behind now," said Avi Liss, a lawyer helping homeowners avoid foreclosure in the Boston area. According to the Center for Responsible Lending, a nonprofit research and policy group, as many as 9 million homeowners could go into foreclosure between 2009 and 2012.

Is there a solution? Yes, but it's controversial. Congress would have to force banks to write off part of homeowners' troubled loans as a way to keep them in their homes.

There are plenty of reasons to avoid this course. Chief among them is the moral hazard. If banks write down one homeowner's loans because of hardship, what's to keep other homeowners from claiming hardship, too? And the losses don't accrue to some faceless bank; they add up for individual shareholders and pension funds that have money tied up in mortgage loans.

"In a way, reducing principal is like rewarding [homeowners] for backing out of an obligation," said Stan Longhofer, director of the Center for Real Estate at Wichita State University in Wichita, Kan.

But the current program isn't working either, critics say. And the debt write-down happens anyway, whether a homeowner goes through foreclosure or the house is relinquished in a short sale. So isn't it better, they ask, for the bank to take its losses early and keep the owner in his home?

Foreclosed on, but kept his home

Osazee Egharevba, a Nigerian immigrant who came to the Boston area in 2000 after his wife passed away, worked two jobs and saved enough to bring over his five children in 2006. That same year he purchased a two-family home. He could afford the $3,950 monthly payments by renting out the first floor.

Then Mr. Egharevba lost one job, and the extra $800 a week it brought in, and started missing payments. Deeply "underwater" on the $510,000 property (owing more than it was worth), he was foreclosed on this past winter, after five failed attempts at attaining a loan modification.

"My children were going to be on the street because there was no way, there was no home," he said.

But he stayed in the house. In April 2010, a nonprofit called Boston Community Capital was able to buy the home and sell it back to him for $296,000 – the home's current value. His monthly payment has fallen to a manageable $2,300. Egharevba doesn't get off scot-free. He is bound to share with BCC any profit he makes when he sells the property.

"There's no incentive for someone to do this to make money," says Patricia Hanratty, who runs the loan program at BCC. "This is for people who desperately want to save their homes."

In the year that the program's been running, almost 70 homes have been either sold back or rented to foreclosed homeowners. None have redefaulted. When the group buys a foreclosed property, it routinely asks the selling bank if it wants to participate in the shared equity deal. Every one has declined the offer.

"They said it was too complicated; it wasn't something they were used to doing, they didn't want to get involved in it," said Ms. Hanratty. "Maybe that will turn, that will change in time."

A lesson from the farm?

There is a precedent for widespread principal reduction on property loans. During the farm crisis of the 1980s, young farmers who had bought farmland at inflated prices suddenly saw crop prices plunge and, soon after, land prices fall as well. It was a debt squeeze not unlike today's crisis for underwater homeowners who have lost their job. Seeing the unfolding rural disaster, Congress created a new chapter in the bankruptcy code. It allowed bankruptcy judges to modify loans, including partial debt write-downs, so family farmers could stay on their farm.

"People who will pull themselves out of trouble and be good credit risks again, those are the people who merit this kind of intervention and who will also help stabilize the markets," said Neil Harl, an agricultural economist at Iowa State University who helped write the bankruptcy language.

In 2008, Sen. Harry Reid (D) of Nevada introduced a similar bill for the housing crisis. But the measure languished, in large part because, at the time, subprime borrowers were in the eye of the storm and many of them had stretched to buy homes they really could not afford. Will the new foreclosure wave of prime borrowers change the political calculus? Professor Harl isn't optimistic.

"Unfortunately, people in Congress listen to [lobbyists]" said Harl. "They tend to drown out those that don't have as much money."

Instead, homeowners facing foreclosure can try to get their loan modified through the administration's Home Affordable Modification Program, or HAMP. Typically, the bank servicing the loan tries to make monthly mortgage payments affordable by extending the mortgage to a 40-year loan and reducing the interest rate. One year into the program, however, only about 300,000 of an estimated 4 million eligible homeowners have received permanent loan modifications.

"It is pretty much not working," said Nadine Cohen, a lawyer with Greater Boston Legal Services, which helps homeowners obtain loan modifications.

Why modification requests get denied

That's partly because loan servicers were unprepared for the massive influx of loan modification requests. It's also because a loan modification is difficult to qualify for. This is particularly true for owners with big mortgages whose income has decreased, like Cynthia Johnson.

Her spiral toward foreclosure began with a divorce in 2006, which halved her $160,000 a year household income. She took equity out of her home to buy her husband out of the mortgage. When she was forced to take a $22,000 pay cut, her $2,000 monthly mortgage payments became impossible to manage.

She's gone through about $14,000 in savings to keep paying her mortgage – which now eats up more than 40 percent of her paycheck. Still, she's about $60,000 underwater and, because of that, she can't refinance again or borrow off the equity on her home. Johnson appealed to her loan servicer to adjust her monthly payments, but because she is not yet in arrears, her request was denied.

Lenders test to determine whether it is more beneficial for the investor to modify the loan and get a lower monthly payment or foreclose on the home.

"In many cases where the person's income has dropped substantially, they decide it's better to foreclose," explained Ms. Cohen.

For homeowners who do qualify for a modification, few are offered principal reductions. Because less than 30 percent of the mortgages modified so far (about 98,000) included any reduction in the loan amount, many homeowners with modifications remain underwater. Some blame continued negative equity for HAMP's high redefault rate – about half of the loans modified through the program go into default.

The Treasury Department has taken sweeping steps to address problems with the program. In late March it announced a new initiative for unemployed homeowners – starting this month they will be given a three-month forbearance period before applying for a loan modification.

Underwater homeowners current on their loans will also be able to apply for refinancing from the Federal Housing Administration. This is the first time that modifications for people not yet in arrears will be performed as part of the program.

Perhaps most significantly, HAMP will now incorporate principal reduction into the refinancing process. Servicers will be required to consider the advantages of reducing principal to match the current value of the home. As an incentive, banks that reduce principal on loans will also get a fee based on how much debt was forgiven, and how deeply underwater the modified loan was beforehand.

The changes to HAMP have been hailed by housing and consumer lending advocates as a move in the right direction. But some insist that Treasury's reluctance to make one key change could significantly limit the revamped program's reach: principal reductions remain voluntary for banks.

As long as servicers can opt out of reducing principal, they will, say housing advocates – even when the only other options are a foreclosure or a short sale, which ultimately results in the property being devalued to the current market price.

"The way loan servicers get paid is that they earn a percentage of the principal balance of their book of business," said Julia Gordon, a Washington-based senior policy counsel for the Center for Responsible Lending. So when the dollar value of the principal outstanding on a mortgage is reduced, so are the bank's fees, she added. "You can see right there why the servicer doesn't want to write down principal."

Balancing risks

Mortgage bankers, though, insist that that argument is misguided.

"The servicer would find some very minimal reduction [in fees] if a principal reduction is made," said Jay Brinkman, chief economist for the Mortgage Bankers Association. "But they're not the one making that decision – they make the recommendations, but the principal reduction has to be made by the investor."

Ultimately, the issue boils down to balancing risks: the possibility that banks are pushing too many people into foreclosure versus the danger that banks' leniency will encourage more homeowners to default so they can get their mortgage principal reduced.

There are effective ways to modify loans (like reducing interest) that won't encourage such defaults, Mr. Brinkman says. "While [principal reduction] might improve things for one borrower, will it help the economy if 10 more homeowners default and ask for a reduction?"

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