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Real Estate Research provided analysis of topical research and current issues in the fields of housing and real estate economics. Authors for the blog included the Atlanta Fed's [Jessica Dill](#), [Kristopher Gerardi](#), Carl Hudson, and analysts, as well as the Boston Fed's [Christopher Foote](#) and [Paul Willen](#).

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March 2, 2010

Should modifications 're-equify' borrowers? A look at the data

A [number of recent commentators](#) have called for a big change in government policy on mortgage modifications. Currently, the government's [Home Affordable Modification Program](#) (HAMP) pays cash incentives to servicers who reduce monthly mortgage payments to no more than 31 percent of the borrower's income. Most of the time, this reduction is accomplished by reducing the interest rate or by extending the loan term for up to 40 years. Modifications that forgive loan principal are rare.

And therein lies the problem, according to HAMP critics, who point to the strong empirical relationship between negative home equity and default. On the national level, the U.S. foreclosure rate started rising in 2006, the same time that house prices began to fall and negative equity began to emerge. Also, [in loan-level data](#), borrowers who are "underwater" on their mortgages default far more often than owners with positive home equity. Many of HAMP's critics argue that mortgage modifications will not work unless they reduce outstanding principal balances on mortgages so that positive equity is restored. Yet a closer look at the data shows that a "re-equification" policy implemented through large-scale principal reductions may not work as advertised.

Are won't-pay borrowers really behind the high foreclosure rate?

If negative equity drives default, then why shouldn't modifications start by reducing mortgage balances? The reason is that underwater borrowers default for one of two reasons—either they *can't* make their payments or they *won't* make their payments. ([You can read more about this here.](#)) Proponents of balance reductions seem to think that foreclosures are driven mostly by won't-pay borrowers, who would rather "walk away" from their underwater homes than continue paying. But these proponents provide little hard data about how prevalent won't-pay defaults really are.

Of course, walk-away borrowers do exist and are sometimes profiled in newspaper accounts ([like this one](#)). But these accounts often involve borrowers at the extreme end of the negative-equity spectrum, where the house is worth only 50–70 percent of the mortgage balance. For owners with more moderate levels of negative equity, [economic theory implies that staying current on the mortgage is usually the best policy](#). This theory is true even for cold-hearted homeowners who don't care about offending their lenders, damaging their credit scores, incurring any social stigma associated with default, or paying the [deficiency judgments](#) that can sometimes be levied against walk-away owners. The reason that moderately underwater homeowners should continue paying is that prices might rise and positive equity might be restored, so long as the current price is not too far below the mortgage balance. The benefit of staying in the house today is enhanced by the right to default in the future, if house prices stay low and equity remains negative.

Principal reductions may not keep can't-pay borrowers at home

For every homeowner who defaults because they won't pay on their mortgage, there are others who default because they can't pay. Among the can't-pay group are the many borrowers who have lost their jobs. Negative equity matters for this group because it limits their options when their economic situations become dire. Before the recent fall in house prices, homeowners who lost their jobs were likely to have positive equity in their homes. This equity allowed displaced workers to sell their homes and pay off their mortgages if they needed to; cash-out refinancing may also have been an option. But underwater owners cannot sell their homes for enough to pay off their mortgages, nor can they refinance. Foreclosures are therefore likely for can't-pay borrowers with negative equity, even if they want to stay in their homes.

Unfortunately, principal reductions will probably not help can't-pay borrowers retain their homes. Consider a borrower who is 10 percent underwater and who recently lost her job. A reduction of, say, 20 percent would restore positive equity for this borrower. But it would lower her monthly payment by only about 20 percent—too little to make a difference for someone with drastically reduced

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income. Consequently, if this borrower gets a 20 percent principal reduction, she will probably sell her house. Anti-foreclosure policy will not keep her in her home, which was the justification for the policy in the first place.

Some might argue that a principal reduction helps can't-pay borrowers who live in a state that allows lenders to seek deficiency judgments. Because the reduction would give these borrowers positive equity, they would have no deficiency when paying off the loan. But the can't-pay borrowers probably did not have the money to pay a deficiency judgment anyway, so the reduction does not provide much of benefit. The balance reduction would help the lender, as long as the reduction is paid for by the taxpayers. If the reduction allows a sale to take place, rather than a foreclosure, it may also reduce the "deadweight" costs of foreclosure (for example, damage to the house that sometimes occurs when a house is foreclosed). For the most part, though, if can't-pay borrowers are the problem, then a policy of subsidized balance reductions would simply reshuffle losses generated by the housing bust to different parties.

Area-level data, not national data, measure can't-pay defaults more accurately

Ideally, mortgage researchers would inform policymakers about the exact size of the can't-pay group. This is difficult to do, because borrower-level data on *both* unemployment *and* delinquency experiences do not exist. That means that we cannot measure the effect of an individual's unemployment spell on the probability of delinquency, controlling for other factors (like credit score). The best that researchers can do is match area-level unemployment rates with borrower-level mortgage data, and then see whether delinquencies rise when local unemployment goes up. According to [some of our research](#), they do. [This Congressional testimony](#) from Laurie Goodman, a respected mortgage researcher and a proponent of balance reductions, cites some of her work that also suggests a correlation between area-level unemployment and mortgage delinquency.

While using area-level unemployment rates isn't a perfect way to measure can't-pay defaults, it is far more helpful than correlating the *national* unemployment rate with the *national* delinquency rate, which is sometimes done by proponents of balance reductions. The U.S. unemployment rate started increasing rapidly in 2008. But mortgage delinquencies had already started rising for the riskiest mortgages (like subprime) during the previous year, when house prices began their descent. Proponents of balance reductions interpret this timing pattern as evidence that unemployment is a less-important determinant of foreclosures. Policy should therefore focus on restoring equity to prevent the won't-pays from walking away.

But the fact that national delinquency rates rose before the unemployment rate did is not conclusive. Because of the large amount of job creation and destruction that always takes place, can't-pay borrowers can still exist even when the aggregate unemployment rate is low and stable. Specifically, the Business Employment Dynamics program of the Bureau of Labor Statistics indicates that [gross job losses at private American firms totaled about 12.6 million](#) positions from March 2007 to March 2008. Positions that were eliminated via involuntary layoffs were likely to have led to a lot of can't-pay foreclosures for job losers with negative equity. But this large amount of job destruction did not cause the aggregate unemployment rate to rise. Over the same period, private-sector gross job creation totaled 12.7 million jobs, so that the net number of jobs in the economy rose by about 100,000. Correlating national unemployment and delinquency rates masks the massive amount of job churning that takes place at the level of individual workers, where default decisions are made.

Foreclosure-reduction assistance is necessary but should be temporary

We have been interested in the efficacy of mortgage modifications for some time; [our finding](#) that less than 10 percent of underwater borrowers lost their homes during the early-1990s Massachusetts housing bust is often interpreted (correctly, we think) as evidence that walk-away foreclosures are not the lion's share of today's problem. Moreover, given our research findings, my co-bloggers and I support a [foreclosure-reduction policy](#) that would offer significant but temporary help to unemployed borrowers. But we also think that disinterested parties should come away from this issue with the same verdict that we do. There have been news accounts about won't-pay borrowers walking away from their homes for [at least two years](#). Before policy encourages large-scale reductions in mortgage balances in modification programs, we believe more hard data is needed that show that won't-pay borrowers are quantitatively important.

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