The latest on servicing and modifications

By Michael Konczal
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Kevin Drum wants to know what the latest empirical work tells us about the servicer industry. Let's do this: Hot off the presses (October 2010), here's Sumit Agarwal, Gene Amromin, Itzhak Ben-David, Souphala Chomsisengphet and Douglas Evanoff on "Market-Based Loss Mitigation Practices for Troubled Mortgages Following the Financial Crisis." The abstract, my bold:

Using a unique dataset that precisely identifies loss mitigation actions, we study these methods -- liquidation, repayment plans, loan modification, and refinancing -- and analyze their effectiveness. We show that the majority of delinquent mortgages do not enter any loss mitigation program or become a part of foreclosure proceedings within six months of becoming distressed. We also find that it takes longer to complete foreclosures over time, potentially due to congestion. We further document large heterogeneity in practices across servicers, which is not accounted for by differences in borrower population. **Consistent with the idea that securitization induces agency conflicts, we confirm that the likelihood of modification of securitized loans is up to 70% lower relative to portfolio loans. Finally, we find evidence that affordability (as opposed to strategic default due to negative equity) is the prime reason for redefault following modifications.**

To continue:

We find that within six months after becoming seriously delinquent, about 31% of the troubled loans that enter our sample in 2008 are in liquidation (either voluntary or through foreclosure), 2.4% enter a repayment plan, 2.2% get refinanced, and 10.4% are modified. The rest (about 54%) have no recorded action. The staggering amount of delinquent loans that see no action from lenders/investors is consistent both with the idea of an industry overwhelmed by the wave of problem mortgages and with the difficulty in overcoming the severe asymmetries of information that inhibit active loss mitigation.

So both: They appear to be ineffectual in general but also doing a better job for themselves than for the mortgages they service. Bad information and conflicts of interest.

Speaking of conflicts: "In terms of magnitudes of the estimated coefficients, second lien loans are the least likely to be modified, controlling for all other loan characteristics. This is hardly surprising, as junior liens likely suffer most severe losses in modifications." The difference in the modification rate when a second lien is involved is on the order of 11-13%, significantly higher. Second liens are largely held by the four largest banks, who also do a disproportionate amount of the servicing (for a longer story about the conflict in junior and second liens have with first mortgages, valuation and the way servicing is carried out, see here for starters).

In case you are interested, here are the rates of re-default by modification type:

Panel G: Rates of Redefault within 6 Months, by Modification Type

	Quarter			
Modification type	2008Q1	2008Q2	2008Q3	2008Q4
Interest Rate Frozen	8.1%	24.5%	31.8%	31.2%
Interest Rate Reduction	24.9%	62.7%	54.0%	53.2%
Term Extended	6.2%	11.2%	23.4%	19.8%
Principal Deferred	0.3%	1.4%	6.5%	2.1%
Principal Writedown	0.0%	0.1%	1.3%	0.7%
Capitalization	15.1%	32.9%	46.5%	46.9%
Combination	30.1%	63.1%	65.8%	59.7%

Notice how low it is for those with principal write-downs.

Paul Willen of the Federal Reserve Bank of Boston points out that when we look at this we should focus more on the fact that there are so few modifications being carried out, so the conflict of interests -- that mortgages that are owned by the servicers get favorable treatment relative to other investors -- aren't huge in the aggregate. That's true, and points to both answers being correct. So a lot depends on your framing. While at the margins there is clear evidence that servicers are creating modifications for mortgages in their own portfolios but not those that they service for others, there aren't that many modifications going on in general.

Which goes to a broken system. As Georgetown University law professor Adam Levitin notes,

Mortgage servicing is a failed business model. Their solution? Attempt to automate default management by shuffling all defaulted loans off to foreclosure and to use robosigning and other corner cutting techniques to lower costs while charging junk fees on defaulted loans to increase income.

The critical thing to realize about servicers is that they are not subject to any oversight. Investors lack the information to evaluate servicer decisions, while securitization trustees are paid far too little to want to stick out their necks and supervise servicers (with whom they often have cozy business relationships). A securitization trustee is not a general purpose fiduciary; it is a corporate trustee with very narrow duties defined by contract, and entitled to rely on information supplied by the servicer. So we've got a case of feral financial institutions, a sort of servicers run wild, with both homeowners and MBS investors bearing the costs of unnecessary foreclosures, all because servicers misjudged the housing market and didn't charge enough to cover the costs of properly performing their contractual duties.

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