WHO RECEIVES A MORTGAGE MODIFICATION? RACE AND INCOME DIFFERENTIALS IN LOAN WORKOUTS

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Loan modifications offer one strategy to prevent mortgage foreclosures by lowering interest rates, extending loan terms and/or reducing principal balance owed. Yet we know very little about who receives loan modifications and/or the terms of the modification. To learn more about the nature of mortgage modification, my co-author and I examined a sample of subprime loans made in 2005 among borrowers in Oregon, California, and Washington. Our results suggest, first, that loan modifications are a rarely used option among the servicers in our data. Second, we find no evidence that minority borrowers are less likely to receive a modification or less aggressive modification than white borrowers. In addition, we find that most modifications involve reductions in the loan's interest rate, and an increase in principal balance. We also find that modifications reduce the likelihood of subsequent default, particularly for minority borrowers.

In 2008, the federal government launched the Making Home Affordable Modification Program, which allocated $75 billion to support loan modification efforts, with a goal

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of reaching 9 million distressed borrowers by December 2012. Although there are many variations in the way loans can be modified, loan modifications change the terms of a loan (for example, by reducing the interest rate, monthly payments, or amount of the loan) in an effort to help distressed borrowers prevent foreclosure. In theory, both borrower and investor are better off if a foreclosure is avoided. However, in practice it has proven to be much more difficult to modify loans, and the number of modifications—both temporary and permanent—has fallen significantly short of the number of distressed borrowers. As of October 2011, the HAMP program has resulted in approximately 880,000 permanent and 1.7 million trial modifications.[1] While falling short of expectations, these loan modifications still have the potential to prevent foreclosures and their negative impacts on borrowers, communities, and the overall U.S. economy.

Surprisingly, we know very little about who received these loan modifications and whether or not they were successful in helping these borrowers prevent foreclosure. The lack of data on borrower race and income is particularly troubling. Advocates and housing counselors have raised the concern that the loan modification process presents challenges for historically underserved borrowers—lower-income and minority borrowers in particular—who lack experience and knowledge of dealing with a lending institution. For example, borrowers who do not speak English or who may distrust banking institutions may fail to pursue a loan modification entirely, despite being eligible for a HAMP modification. Lack of knowledge could also result in the increased likelihood of submitting incomplete paperwork; complete documentation is a critical part of the HAMP modification process and is required to move from a trial to a permanent modification. Race or perceived race could also serve as a proxy that servicers use for decision-making on modifications, especially if these borrowers are deemed less sophisticated, more time consuming and therefore more costly to serve.

To understand if there might be systematic differences in who gets loan modifications and how well those loan modifications work, we analyzed a unique dataset that merges data on the loan performance of subprime home mortgages that are managed by Corporate Trust Services (CTS) of Wells Fargo Bank[2] with data on borrowers (including race/ethnicity and income) reported as part of the Home Mortgage Disclosure Act (HMDA). With these merged data, we were able to provide some initial insights into who is receiving loan modifications, what types of loan modifications they are receiving, and whether or not loan modifications are helping to prevent subsequent default. In our analysis, we focused on loans originated in 2005 in

[1] Hope Now Alliance, Industry Extrapolations and Metrics (October 2011), available online at http://is.gd/gj0Xfe.

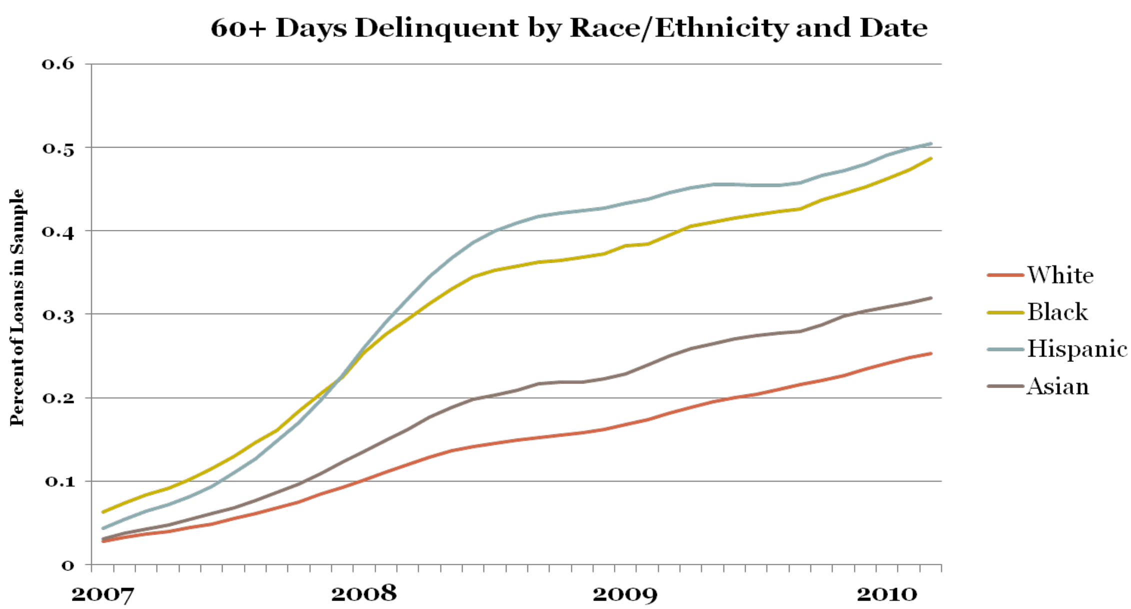
[2] CTS is a service of Wells Fargo Bank, N.A. that provides information on a variety of investment vehicles administered by the bank. The CTS data covers securitized mortgages for which Wells Fargo serves as the trustee, and includes mortgages with different interest rate structures, different purposes, different property types, and different lien statuses. These investor report files are available at www.ctslink.com, administered by the Corporate Trust Services group of Wells Fargo Bank, N.A.

three states: California, Oregon, and Washington, and measure their performance through May 2010.

WHAT DID WE FIND?

First, we find that the highest delinquency rates have been among Latino and African American homeowners. (Figure 1). These findings are consistent with other research that has examined the same question, and document the impact that the foreclosure crisis is having in communities of color. Researchers trying to understand the disparate impact of foreclosures on lower-income and minority communities have increasingly focused on the failings of the "dual mortgage market," in which lower-income and minority neighborhoods and borrowers were served primarily by subprime lenders (even when they could have qualified for a prime loan), and as a result were more likely to receive subprime loans or loans with other risky product features, even after controlling for borrower and neighborhood risk characteristics.[3]

Figure 1

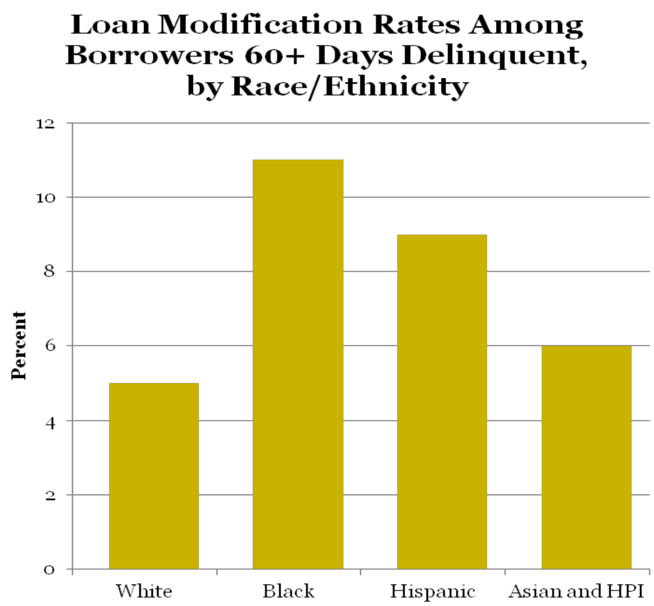


However, we did not find any significant racial and/or ethnic differences in who receives a loan modification. (Figure 2) In fact, African Americans were slightly more likely to receive a loan modification than whites, although we did not find the same effect for Latinos. This finding persists when we control for borrower, loan and other factors that might influence loan modification rates. While these results sug-

3. D. Immergluck (2009). *Foreclosed: High-Risk Lending, Deregulation, and the Undermining of America's Mortgage Market*. Ithaca, NY: Cornell University Press.

gest that loan modifications are relatively evenly distributed across borrowers—regardless of race and/or ethnicity—it does not entirely erase the possibility of disparities in who gets a loan modification. One thing we cannot assess in these data is whether there are differences in who gets a loan modification among those who applied for one. If Black or Hispanic borrowers applied for a loan modification at higher rates than white borrowers, and were either denied a permanent modification or were thwarted by the lengthy and confusing application process, racial and ethnic disparities in the loan modification process could still exist. In other words, we do not see loan modification denial or non-completion rates.

Figure 2



Second, we also didn't find any significant racial and/or ethnic differences in the type of modifications received. The most common form of loan modification is one that reduces the interest rate on the loan. On average, modifications reduced a loan's interest rate by between 1.7 and 1.8 percentage points. We also did not find evidence of racial disparities in who gets an interest rate reduction. While on average, African Americans paid a slightly higher interest rate, approximately 11 basis points, than whites, blacks who received a loan modification paid a bit less—an additional drop of 17 basis points (although not statistically significant). Latinos and Asians who received a modification also saw an added reduction in their interest rates. However, we find no evidence that borrowers are being offered modifications that reduce their principal balance, or how much they owe on the loan.

Third, and this is important from the perspective of preventing foreclosures and stabilizing the housing market, we found that modifications work. Loans that received a modification were more than two-thirds less likely to end up in foreclosure than loans that did not receive a modification. The strength of this effect may be due in part to the fact that we only considered permanent modifications, which would select for borrowers with both the motivation and capacity to stay in their homes over the long term. But we also find that loan modifications greatly decreased the likelihood that African Americans, Latinos, and Asian/Hawaiian Pacific Islanders would go back into foreclosure. Our results suggest that loan modifications are an effective way of preventing foreclosure for these populations, an important outcome that can help to minimize the impacts of the crisis on these communities.

These findings suggest efforts to improve the loan modification process and help more borrowers restructure their loans to make them affordable over the long-term deserve policy-makers attention. But there are also some important caveats to these findings. As mentioned earlier, we can't see modification applications in our data, so we have not excluded the possibility that some groups are having a more difficult time getting modifications. In addition, the CTS data only include loans that are privately securitized, and our research is focused only on a small slice of the overall mortgage market. So we cannot be sure that our findings are representative of all loan modifications. As more data on loan modifications become available, it will be important to revisit these questions to ensure that the federal HAMP program is benefiting distressed homeowners of all races and ethnicities.

Despite the positive findings in this research, it is worth emphasizing that the scale of loan modifications is still falling well short of impending foreclosures, and despite some improvements in recent months, delinquency and foreclosure rates remain at historically high levels. Poor loan servicing practices, for example, continuing the foreclosure process while the borrower is pursuing a modification (known as dual tracking), are also contributing to unnecessary foreclosures. Cutbacks in funding for housing and foreclosure counseling are further hurting efforts to reach distressed borrowers; recent studies examining the role of counseling for mortgage borrowers in default suggest that counseling and related interventions play an important role in preventing foreclosure.[4] Finally, as we found in this study, modifications that reduce principal balance are rare. Modifications that reduce principal and are net present value positive would enhance income streams for investors and servicers while keeping families in homes, especially in markets hard hit by the housing downturn. ■

[4] Collins, J.M., Schmeiser, M.D., 2010. Estimating the effects of foreclosure counseling for troubled borrowers. Available at SSRN: http://ssrn.com/abstract=1670859. Neil Mayer et al. (2011). National Foreclosure Mitigation Counseling Program Evaluation: Final Report Rounds 1 and 2. Washington, D.C.: The Urban Institute.