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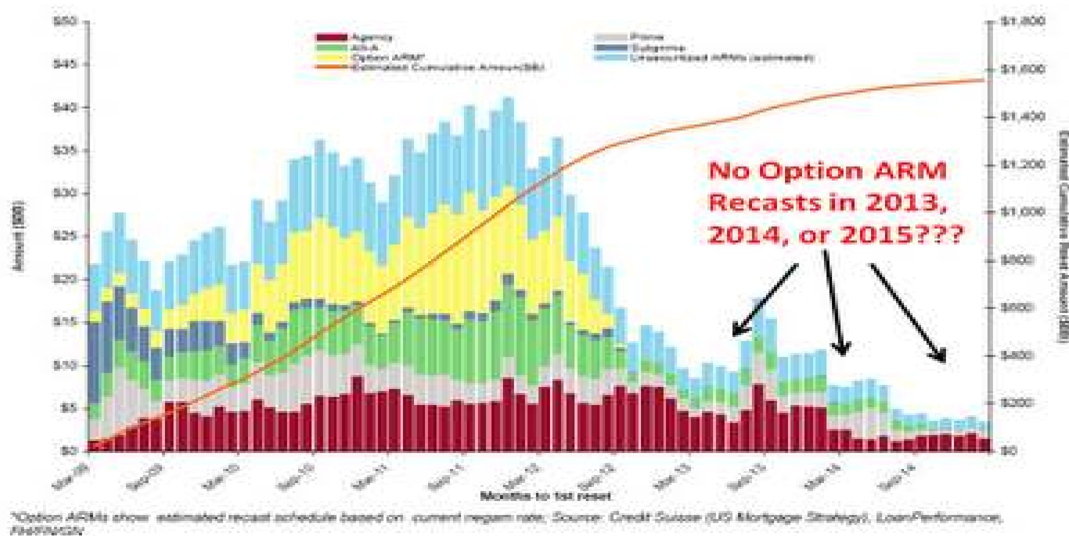
Do Loan Modifications Work?

Some pundits assert that because none of the U.S. Treasury's mortgage modification programs call for reducing the principal balance of a mortgage, they may do more harm than good "by delaying a wrenching yet cleansing process through which borrowers give up unaffordable homes and banks fully reckon with their disastrous bets on real estate", to quote a recent New York Times article on the subject.

Yet in my 29 years as a Mortgage Banker, it was been payment problems rather than lack of equity that have been the major cause of a default. Only when medical or jobs problems enter, and the home owner attempts to refinance to ease a payment problem, does the problem of negative home equity enter. But the pessimistic pundits make no distinction of the fact that mortgage payment problems usually precede one of negative equity.

In addition, with interest rates (and ARM indices) at record lows, most homeowners with ARMs find that their interest rates are most likely in the 3 percent range. In fact, a recent Credit Suisse study predicted that no second shoe would drop when those Alt-A and Option ARMs came due in 2013 to 2015, precisely because the principal and interest payments might even be less than the rental rate for a comparable dwelling (see enclosed graph).



A much-quoted study by hedge fund Amherst Securities that is the basis of much of the doom and gloom, asserts that up to 7 million homeowners could be in danger of

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defaulting on their loans, mainly because Amherst asserts that is the number of those who will have negative equity in their homes before the real estate bust is over. Yet even if such an inflated estimate of defaults were true, the long-term default rate on all home loans is around 4 percent, and the foreclosure rate 1 percent—so 25 percent of defaulted loans are foreclosed upon, historically. Since it takes an average of 2 years to foreclose a property--hence a 73,000 per month rate--it is less than the 99,000 homes per month currently being foreclosed upon.

But if the major reason for defaults is not negative equity, per se, but payment problems, then any improvement in the jobless rate means fewer homeowners with payment problems. And January's payroll employment report is expected to show the first actual jobs increase since December 2007.

And, banks have been unloading their bank-owned REOs at record rates, which is the major reason existing-home sales have skyrocketed of late, back to 2003 sales rates. In fact, with record low ARM rates, and the government's HARM loan modification program, we should see that both housing prices and sales will continue to improve in 2010, so that default rates decline rather than increase.

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