Thanks to new readers joining us from Alltop.com we are re-posting an article from last month.

How to Stop Foreclosures

If I default on my $300,000 mortgage Bank of America will collect approximately $550,000 to $650,000. If my friend defaults on their $500,000 mortgage Goldman Sachs will collect $900,000 to $1.2 million (depending on interest rates, term of the mortgages, and credit ratings).

Why do they collect such a big payout? Because they have insurance on the Mortgage-Backed Securities that hold the mortgages. When an MBS goes into default, the insurance pays. Why do they collect so much more than the face value of the mortgage? Because, over the life of the loan the mortgage would have generated 2 ½ to 3 times the face amount in cash flow, minus discounts; the insurance covers that anticipated cash flow, not the nominal value of the original mortgage.

What is this insurance? Credit Default Swaps are essentially insurance for Mortgage-Backed Securities. If a certain percentage of mortgages held in the MBS go into default then the MBS defaults and the insurance is paid. AIG Financial Products was the largest writer/issuer of CDS contracts. With the government's backing AIG has paid out tens of billions in claims on CDS contracts.

CDS is not typical insurance; it is almost completely unregulated; an investor can purchase a CDS contract/insurance policy even though they have no insurable interest in the underlying mortgage or even the underlying MBS; if CDS insurance is purchased that covers my mortgage, I do not receive any notification. The homeowner has been unilaterally stripped of their mitigation rights as a party to the contract by the purchase of CDS contract. This, in effect, modifies the original contract without consideration to the homeowner for that modification.

We do not allow doctors to purchase life insurance policies on their patient's lives without the patient's knowledge and then be in charge of making life and death decisions for the patient's treatment. I trust my doctor but we all recognize that it is reckless and foolhardy to subject that trust to excessive temptation. We do allow mortgages investors to purchase default insurance policies without the homeowners' knowledge and, if delinquency occurs, we recklessly tempt these investors to make the decisions on whether the loan will be modified or go into default.

CDS insurance offers a clear incentive for the investors or holders of pooling and servicing agreements (PSAs) to force a "default" either through foreclosure, short sales, short payoffs, or deed in lieu transactions. PSAs place limits on the number of modifications a mortgage servicer can perform.

Less than 3% of seriously delinquent borrowers receive concessionary modification in the first year following the first serious delinquency; concessionary modifications may be reductions in the principal balance or interest rate or extension of the term, or all three. Less than 5% of serious delinquencies receive non-concessionary modifications; their payments actually increase (half of these redefault within 6 months). Approximately 30% of serious delinquencies go the route of short sale or deed in lieu transactions; essentially, the borrower loses their home. Approximately 50% of serious delinquencies result in foreclosure proceedings and 30% of seriously delinquent borrowers lose their home through foreclosure in the 12 months following the initial delinquency. To recap: approximately 80% of serious delinquent borrowers lose their homes, 5% get a bad modification, 3% get a good modification, and the others are stuck in modification limbo.

In the first 6 months of the Hope for Homeowners Program only 25 homeowners were able to get refinancing under the plan, despite a nationwide appeal by President Bush. Federal programs have improved in the past few months but show no sign of making major inroads to solve the problem of foreclosure.

There are frequent anecdotal examples of investors/PSAs/servicers not really trying to help homeowners. I personally know a real estate attorney who offered a $350,000 settlement on a $510,000 mortgage; that offer was turned down and the property was offered at $200,000 in an REO sale. I know one man who has been attempting modification for 16 months. I know another woman who has been attempting modification for 8 months but Bank of America has lost her application 5 times. Bank of America shows remarkable efficiency in tracking billions of daily check and charge transactions to the penny, yet they show stupefying incompetence in tracking a modification application. The lack of competence is a direct result of a lack of incentive to modify. These examples are the norm, not the exception.

It would be easy to suggest that most foreclosures cannot be prevented, yet there are some excellent proposals to keep homeowners in their homes and stabilize house prices; the Milken Institute has proposed a plan "How to Rebuild US Home Prices and Fix the Economy" that could eliminate negative equity and lower monthly mortgage payments, and the price for this plan is less than what has already been spent on the AIG bailout. Regrettably, we may never see this plan put in place unless we can remove the incentive for investors and holders of PSAs to force default, unless we can stop the big CDS insurance payout for defaults.

Have the investors/PSAs/servicers actually been forcing defaults? We know CDS contracts offer the temptation of the largest possible compensation when claims are paid. We know investors/PSAs/servicers are in a position of power to create hurdles to modifications and to deny modifications. We know that defaults outnumber modifications by more than 10 to 1. We know that several financial institutions have posted exceptionally large earnings despite the worst economic downturn since the Great Depression. We have not seen (publicly disclosed) investigations or research that revealed the smoking gun. We have seen motive, opportunity, and results.

AIG, with the backing of the government, has been treating CDS claims in a most un-insurance like manner – they have been paying the claims in full without conducting full investigations or audits. Never in history has an insurance company paid out tens of billions of dollars in claims without denying at least some part of the claims.

Simple forensic audits of the original mortgage loans could discover fraud, predatory lending, or other violations on the underlying mortgages and give cause to rescind the CDS contract. If the CDS contracts are determined to be insurance, the only proper action would be to deny the claim and return the premium. It is strange that so far, no claims have been determined to be fraudulent, none of the money paid out has been determined to be laundered, and apparently all taxes have been paid; yes taxes should be due because CDS contract is not officially recognized by any state insurance department as insurance and does not share the tax exemption of insurance.

Nothing will stop foreclosures, stabilize US home prices, and fix the economy more than removing the incentive to foreclose created by the CDSs. The investors will negotiate in good faith to make it attractive for the homeowners to start to pay their mortgages and with fewer REO properties on the market the homeowner will not have the incentive to walk away and buy a cheaper comparable property down the street. Markets will be more rational and not be propped up by illegal insurance that distorts true values. The taxpayers will save fortunes being flushed down the AIG black hole. And the added benefit to society is that people will stay in their homes without speculators and profiteers placing side bets on their home.