

“The Determinants of Subprime Loan Performance Following a Modification”

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Summary and Findings: This paper examines the evolution of mortgage modification terms obtained by distressed subprime borrowers during the recent housing crisis, and the effect of the various types of modifications on the subsequent loan performance. Using a unique data set that contains detailed loan level information on mortgages, modification terms, second liens, and home values, we estimate a multinomial logit model in a hazard framework. Our results suggest that converting adjustable rate mortgages to fixed rates, reducing principal balances, and reducing total payment and interest (P&I) are the most effective at reducing the likelihood of subsequent redefault and foreclosure. Modifications that involve increasing the loan principal—primarily through capitalized interest and fees—are significantly more likely to redefault, even controlling for changes in P&I. We further find substantial variation in the likelihood of redefault across mortgage servicers.

Implications for Policy and Practice: This research provides estimates of which types of loan modifications are the most effective at reducing subsequent redefault and keeping borrowers in their homes. It attempts to quantify the relative effectiveness of, for example, a principal reduction relative to a reduction of the interest rate or extension of the amortization period. With this knowledge, policies can be developed to promote the most cost-effective strategies for mitigating foreclosures.