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NY Fed: Most Successful Mortgage Modifications Reduce Borrowers' Principal

Borrowers who receive loan modifications that reduce loan balances and not simply interest rates are far less likely to re-default on their loans, according to a [new study](#) from the Federal Reserve Bank of New York.

While modifications that reduce monthly payments are far more likely to succeed than those that don't result in lower monthly payments, *how* that reduced monthly payment is achieved matters, too, according to the study.

The Fed study is the latest to suggest that principal write-downs are more successful in avoiding re-defaults. Modifications that write down loan balances "can double the reduction in re-default rates achieved by payment reductions alone," the study says.

The findings could have big implications on the government's current loan modification effort, which focuses on offering incentives to borrowers and loan servicers, which collect and manage loan payments, to reduce monthly payments by lowering interest rates and extending the loan term. (Although, the modification program doesn't preclude principal forbearance or forgiveness on the part of banks, and borrowers who succeed in keeping up with their reduced payments can receive further incentives towards reducing their loan balance.)

But the program has been off to a slow start, and there's considerable uncertainty heading into the new year over whether the program will be able to meet its ambitious goals to offer modifications to three to four million troubled homeowners.

The paper finds that principal reductions are more successful at avoiding re-defaults because they reduce negative equity and give the borrower a greater incentive to keep current on the loan. A loan modification that only reduces the interest rate, meanwhile, "creates an in-place subsidy to the borrower leading to a lock-in effect. That is, the borrower receives the subsidy only if he or she does not move."

The paper takes a hypothetical borrower with a home that is worth around \$30,000 less than the \$200,000 mortgage on the home. In two different modification scenarios, the monthly payments are reduced by the same amount but produce different probabilities of re-default.

In a modification that reduces the borrower's interest rate by 2.8 percentage points to lower monthly payments by 25%, the borrower's probability of defaulting within one year is reduced by 11%.

But under an alternate modification that lowers monthly payments by 25% by reducing the borrower's loan balance by 25% *and* through a slight interest rate reduction, the borrower's probability of defaulting within one year is reduced by 26.5%.

The New York Fed paper says that borrowers who owe 15% or more than their homes are worth have a 51% higher risk of re-defaulting in any given month. The borrowers' willingness to re-default also depends on "the prospect that further house price appreciation might bring the borrower back into positive equity."

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