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Options for Principal Forgiveness in Mortgages Involving Fannie Mae and Freddie Mac

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Abstract

The Congressional Budget Office (CBO) examined three options under which Fannie Mae and Freddie Mac would provide principal forgiveness to certain distressed borrowers—specifically, to borrowers who are eligible or could become eligible for the Home Affordable Modification Program (HAMP). Such borrowers represent about 4 percent of all those with mortgages involving Fannie Mae or Freddie Mac, CBO estimates. The options would reduce the amount owed by borrowers to as low as 115 percent (through the HAMP Principal Reduction Alternative), 100 percent, and 90 percent, respectively, of the value of their homes. Any gain or loss arising from the way the distressed mortgages are handled by Fannie Mae and Freddie Mac under the options would ultimately accrue to taxpayers because, in CBO's judgment, the federal government is now the effective owner of those enterprises. CBO finds that all three options would probably result in small savings to the government, slightly reduce mortgage foreclosure and delinquency rates, and slightly boost overall economic growth. Designing a program that affected a larger number of borrowers and had a greater impact on the housing market and the economy would require a significant departure from HAMP's current eligibility rules.

Summary

At the end of 2012, housing prices were 30 percent below their peak in 2006, and about one-fifth of borrowers with residential mortgages were “underwater,” owing more than the value of their homes. Default rates are particularly high among such borrowers. One of the primary ways that the federal government has assisted underwater borrowers is through the Home Affordable Modification Program (HAMP). That program, administered by the Department of the Treasury, has facilitated lower payments on some mortgages by providing incentives for mortgage holders and servicers to help borrowers avoid foreclosure.

In 2010, the Treasury Department expanded the program to include the possibility of principal forgiveness, a reduction in the amount the borrower owes. Before then, the program had been limited to other ways of reducing payments. (This report refers to HAMP without principal reduction as “standard HAMP.”) For the borrower, principal forgiveness provides not only a lower monthly payment, but also, unlike standard HAMP, an improved equity position as a result of the lower loan balance. Having equity (the difference between the value of the home and what the borrower owes) allows a borrower to more easily refinance or sell the home to avoid default and strengthens his or her incentive to continue to pay off the mortgage. Since the introduction of that alternative, one in four borrowers participating in HAMP has received a principal reduction, the Congressional Budget Office (CBO) estimates. However, that program is small—fewer than 120,000 borrowers had obtained a principal reduction through HAMP as of the end of 2012.

The approach of using principal forgiveness has not been adopted by Fannie Mae and Freddie Mac. Those two government-sponsored enterprises (GSEs) own or guarantee more than half of the outstanding residential mortgages in the United States. CBO estimates that nearly 13 percent of underwater borrowers with mortgages owned or guaranteed by the GSEs have missed three or more mortgage payments (in other words, are “seriously delinquent”), which is more than six times the rate for borrowers who owe less than the value of their homes. But Fannie Mae and Freddie Mac have not been allowed to implement principal forgiveness out of concerns about fairness, implementation costs, and the incentive that approach could provide for people to become delinquent in order to obtain principal forgiveness.

Fannie Mae and Freddie Mac incurred large losses from the surge in mortgage defaults that began in 2007, as did other investors in mortgages, which resulted in the GSEs’ being taken into conservatorship in September 2008 by their regulator, the Federal Housing Finance Agency (FHFA). Because the federal government is now the effective owner of the enterprises, any gain or loss arising from a change in the way the distressed mortgages are handled by the GSEs would ultimately accrue to taxpayers.

This report examines three options for the GSEs to use principal forgiveness for borrowers who are

- Slightly boost overall economic growth.

Designing a program that affected more borrowers and had a greater impact on the housing market and the economy would require a significant departure from HAMP's current eligibility rules.

What Options Did CBO Analyze?

CBO compared the GSEs' current approach (standard HAMP) with three options involving principal forgiveness for HAMP-eligible borrowers. (Such options could be adopted through legislation or by an administrative change.) Under each option, the GSEs would select for each eligible borrower a standard HAMP modification or a modification that includes principal forgiveness, depending on which one lowered the government's expected costs more. The options that CBO analyzed were the following:

- *Option 1.* GSEs choose between standard HAMP and the HAMP Principal Reduction Alternative; the latter reduces the monthly mortgage payment to 31 percent of the borrower's gross monthly income, primarily by decreasing the outstanding loan balance to as low as 115 percent of a home's current assessed value;¹
- *Option 2.* GSEs choose between standard HAMP and principal forgiveness that would reduce the outstanding loan balance to 100 percent of a home's current assessed value; and
- *Option 3.* GSEs choose between standard HAMP and principal forgiveness that would reduce the outstanding loan balance to 90 percent of a home's current assessed value.

How Many Borrowers Might Qualify for Assistance?

On the basis of detailed data about outstanding mortgages and FHFA's review of the potential effects of implementing principal forgiveness at the GSEs, CBO estimates that 610,000 borrowers with mortgages owned or guaranteed by the GSEs already are or, over the assumed two-year period of the program, would become delinquent and would meet all other eligibility criteria for HAMP under current policy.² CBO expects that another 550,000 borrowers will meet all HAMP eligibility criteria except for being in financial distress (defined as being delinquent or at reasonable risk of becoming delinquent); under a change in policy to introduce principal forgiveness, some of those borrowers might become delinquent. In total, those 1.2 million borrowers constitute the population that CBO considers to be eligible or potentially eligible for a principal forgiveness program. They represent approximately 40 percent of all underwater borrowers and 4 percent of all borrowers with mortgages backed by the GSEs as of December 31, 2012.

¹ The HAMP Principal Reduction Alternative increases principal forgiveness to a floor of 115 percent of a

How Would the Options Affect the Number of Defaults and the Federal Budget?

The key findings of CBO's analysis are the following:

- Under **current policy** (assuming extension of HAMP at least through December 2014), 227,000 borrowers with mortgages owned or guaranteed by the GSEs will receive a standard HAMP modification (37 percent of the eligible population of 610,000 borrowers and none of the 550,000 potentially eligible participants) over a two-year period. Approximately 600,000 of the 1.2 million borrowers, including some receiving a HAMP modification, are expected to default (see Table 1).
- Under **Option 1**, which includes the possibility of reducing the principal balance to as low as 115 percent of a home's assessed value, an additional 29,000 mortgages would be modified, leading to 18,000 fewer defaults and generating a savings to the government of \$0.2 billion. About 73 percent of the modifications under Option 1 would involve principal forgiveness.
- Under **Option 2**, which includes the possibility of principal forgiveness to 100 percent of a home's current value, the number of modifications would increase by 26,000, slightly fewer than under Option 1, but more defaults would be avoided (43,000). Savings to the government—at \$2.8 billion—would be the largest among the three options. About 85 percent of the modifications under Option 2 would involve principal forgiveness.
- Under **Option 3**, which includes the possibility of principal forgiveness to 90 percent of a home's current value, 57,000 more mortgages would be modified than under current policy, leading to 95,000 fewer defaults (the largest reduction under any of the three options) and savings to the government of \$2.2 billion. About 78 percent of the modifications under Option 3 would involve principal forgiveness.

CBO estimated the cost of the policy alternatives on a fair-value basis—that is, reflecting the estimated change in the market value of the portfolio of eligible mortgages.³ CBO's findings are based on the agency's best estimates of values for key parameters of relevant economic behavior, but there are many uncertainties. CBO analyzed the three options using higher and lower values for key parameters in the analysis. The agency found that combining standard HAMP with principal forgiveness under all three options would reduce defaults across the entire range of those alternative estimates. The budgetary savings are less certain, however. Nevertheless, Options 2 and 3 would reduce the federal budget deficit under nearly all alternative scenarios that CBO analyzed.

Introduction

The large number of people who now owe more on their mortgages than the current value of their homes and the deep recession of 2008 and 2009 have affected certain households, the federal budget, and the overall economy in various ways:

- Millions of people have been unable to make their mortgage payments, and as a result many have lost their homes to foreclosure.
- Consumer spending and economic growth have been constrained.
- The federal government assumed control of Fannie Mae and Freddie Mac, providing explicit government guarantees to investors against losses on more than half of the outstanding mortgages in the United States and adding substantially to the federal budget deficit.

Because of those and other impacts, policymakers have expressed interest in policies that would modify mortgages, potentially increasing consumers' disposable income, reducing the financial distress of households, and stemming the government's losses on mortgages. Current policies focus on lowering borrowers' monthly payments by reducing interest rates, extending loan repayment periods, and offering forbearance. This paper examines options for another type of loan modification known as principal forgiveness—that is, permanently reducing loan amounts. The analysis focuses on mortgages involving Fannie Mae and Freddie Mac because of the direct effects on the federal budget deficit of such options and the preexisting federal commitment to losses on those mortgages.

Why Are Underwater Borrowers More Likely to Default?

Of the more than 40 million borrowers with a mortgage in the United States, nearly 3.1 million borrowers were delinquent on their mortgage payments (more than 30 days late) and 1.6 million were in some stage of losing their homes to foreclosure at the end of the fourth quarter of 2012.⁴ Borrowers who are “underwater” on their mortgages—those whose loan balances are greater than the value of their homes or, equivalently, whose loan-to-value (LTV) ratios are greater than 100 percent—are more likely to be delinquent. For example, more than 20 percent of borrowers with LTV ratios greater than 125 percent have missed three or more mortgage payments (in other words, are “seriously delinquent”) compared with the national average of 7 percent.⁵ Delinquency rates are higher among underwater borrowers for three main reasons:

- Local economic weakness associated with lower housing values,
- Fewer options in the event of unexpected hardship, and

The number of underwater borrowers grew dramatically from 2007 to 2009 (and has remained fairly constant since then), translating those higher delinquency rates into much higher total numbers of distressed underwater borrowers.

Reasons for Delinquency. In the fourth quarter of 2012, about one-third of underwater borrowers were from five states: Arizona, Florida, Georgia, Michigan, and Nevada. Those states all had unemployment rates greater than or equal to the national average of 7.8 percent in that quarter. Nevada had both the highest fraction of borrowers underwater (52.4 percent) and the highest unemployment rate (10.2 percent).⁶ The weakness of those local labor markets illustrates that underwater borrowers tend to live in areas where they are more likely to experience reductions in income or job loss, which cause higher delinquency rates on mortgages.

In the event of unanticipated hardship, borrowers without sufficient income to make their mortgage payments or assets to pay off the mortgage have fewer options when they are underwater. Qualifying for refinancing of their mortgages, which would lower monthly payments and reduce hardship, is more difficult for underwater borrowers. Likewise, selling their homes and paying off their mortgages is more difficult because additional funds are needed beyond those available from the sale of the home.

In addition, some underwater borrowers decide that being relieved of the financial loss from the decline in their home's value is worth more to them than the costs of default, even though they have sufficient income to make their mortgage payments or assets to pay off the mortgage. Such decisions are sometimes called "strategic defaults." For example, consider a borrower with a \$200,000 mortgage and a home worth \$150,000. If the borrower believes that home values will not recover for many years and she has the opportunity to rent an equivalent property for less than her mortgage payment, she may compare the net benefits of maintaining her creditworthiness as a borrower in the future by continuing to pay her mortgage with the net benefits of defaulting on that mortgage or otherwise not paying off her lender in full. (In some states, borrowers remain liable for a portion of unpaid mortgage debt even if they default.) Borrowers who are not underwater can more easily lower their monthly payments by refinancing their mortgages and have no such incentive to default.

Number of Underwater Borrowers. The more than 10 million residential properties underwater at the end of the fourth quarter of 2012 represent 21.5 percent of homes with a mortgage (see Table 2).⁷ The number of underwater borrowers in 2012 is similar to the number at the beginning of the economic recovery (specifically, at the end of the third quarter of 2009), when 11.1 million borrowers (24 percent)

were underwater.⁸ In contrast, the fraction of homes underwater was more than 2 times higher in 2009 than in the 10-year period between 1997 and 2007.⁹

Approximately 1.6 million underwater borrowers were seriously delinquent in the fourth quarter of 2012, CBO estimates. Although those borrowers represent only 15 percent of all underwater borrowers, they constitute nearly 50 percent of all seriously delinquent borrowers.

The GSEs own or guarantee nearly 60 percent of all loans but have a smaller proportion of both loans to underwater borrowers (29 percent) and seriously delinquent loans (28 percent) (see Figure 1). The share of underwater GSE-backed loans that are either eligible for or potentially eligible for a principal forgiveness modification is only 4 percent, CBO estimates, as it excludes both those borrowers with GSE-backed loans who are not underwater (89 percent of all GSE-backed loans) and those underwater borrowers who do not meet one or more of the modification eligibility criteria used in this analysis (7 percent of all GSE-backed loans).

How Do Distressed Borrowers Affect Economic Growth?

CBO attributes about one-third of the slow recovery from the recession that began three years ago to weak overall demand for goods and services in the economy—in particular, fewer purchases by state and local governments (accounting for the largest portion) and fewer purchases by the federal government, less residential investment, and lower consumer spending (each accounting for roughly equal portions).¹⁰ CBO estimates that distressed and underwater mortgage borrowers have contributed to weak consumer spending through at least three channels. First, the value of households' wealth has improved only modestly (compared with gains after past recessions) in the wake of the unusually large drop during the recession; that modest improvement primarily reflects continued weakness in the value of real estate assets. Second, the efforts of some households to pay down debt and resist taking on new debt may have surpassed the typical reaction of household spending to changes in wealth and income.¹¹ Third, concentrated foreclosures on homes of distressed borrowers depress the prices of nearby properties, which appears to amplify the effects of wealth loss in reducing consumption.¹²

⁸ Ibid.

⁹ George R. Carter III, "Housing Units With Negative Equity, 1997 to 2009," *Cityscape*, vol. 14, no. 1 (2012), pp. 149-165, www.huduser.org/portal/periodicals/cityscpe/vol14num1/index.html.

¹⁰ Congressional Budget Office, *What Accounts for the Slow Growth of the Economy After the Recession?* (November 2012), www.cbo.gov/publication/43707.

¹¹ For example, see Atif R. Mian, Kamalesh Rao, and Amir Sufi, *Household Balance Sheets, Consumption, and the Economic Slump* (working paper, June 2012), <http://dx.doi.org/10.2139/ssrn.1961211>; and Karen Dynan, "Is a Household Debt Overhang Holding Back Consumption?" *Brookings Papers on Economic Activity* (Spring 2012),

How Would Principal Forgiveness Affect the GSEs and the Budget?

Fannie Mae and Freddie Mac, two government-sponsored enterprises (referred to throughout this paper as “the GSEs”), set standards for the types of loan modifications mortgage servicers can offer borrowers who miss a scheduled mortgage payment. Before 2007, when the housing crisis began, most delinquencies were resolved without a modification, either through the sale or refinancing of a home. Between 2007 and early 2009, during the early stages of the housing crisis, the GSEs increased their use of modifications to help avert foreclosures, but most of those modifications did not reduce borrowers’ monthly mortgage payment. More recently, the GSEs and others have developed a number of new modification options, including the Home Affordable Modification Program (HAMP), one of the main modification programs used by servicers of loans backed by the GSEs, which provides larger and longer-term payment relief to eligible borrowers. Because, in CBO’s judgment, the federal government effectively owns and controls the GSEs, any gains or losses associated with expanding the available options for distressed borrowers to include principal forgiveness would affect the federal budget.

The Cost-Effectiveness of Principal Forgiveness. The goal of all loan modifications is to reduce the expected default costs of a loan by an amount greater than the value lost by offering a borrower a lower monthly payment. From the borrower’s perspective, principal forgiveness provides both a lower monthly payment and, unlike standard HAMP, an improved equity position as a result of the lower loan balance. Having equity (the difference between the value of the home and what the borrower owes) strengthens borrowers’ ability to avoid default and their incentive to continue to pay the mortgage. Principal forgiveness is cost-effective for an individual loan only if the expected savings from averting a possible foreclosure are large enough to offset the lost value of the principal forgiven. However, principal forgiveness may cost more than other alternatives across an entire portfolio of loans if it is made available to and taken up by too many borrowers for whom standard HAMP would offer a lower-cost modification alternative or who would not have defaulted without the possibility of such forgiveness.

Effects on the Federal Budget. After the U.S. government assumed control of the GSEs in 2008, CBO concluded that the institutions had effectively become government entities whose operations should be included in the federal budget.¹³ Under the terms of that conservatorship, the government has financial responsibilities to the GSEs but also benefits from improvements in their net worth. Thus, the financial performance of the GSEs has an impact on the federal budget, and that performance depends importantly on the GSEs’ management of mortgages in default or at significant risk of default.

CBO produces two primary types of assessments of the budgetary cost of the GSEs. First, it projects the cost of new loans expected to be guaranteed over a 10-year period as part of its report on the economic and budget outlook used in the Congressional budget process. Second, it produces cost estimates of the potential impact of changes to current law on either the existing portfolio of loans owned or guaranteed by the GSEs or new loans expected to be guaranteed over the 10-year budget window.

implemented as the result of an administrative action by the Federal Housing Finance Agency (the conservator of the GSEs, which oversees all aspects of their operations), CBO would reflect that action in its next set of 10-year baseline projections. In contrast, if the changes were mandated by legislation, CBO would report, in a cost estimate for the legislation, any change in the estimated cost of GSE-insured loans from the change in policy and subsequently incorporate that estimate in its baseline projections.

The Office of Management and Budget (OMB) treats the GSEs as outside the budget, and it records and projects their budgetary cost on the basis of the cash transfers and dividend payments generated under the terms of the Senior Preferred Stock Purchase Agreements entered into with the Department of the Treasury in 2008.¹⁴ As a result, the Administration has not included in its budget figures costs that would be directly comparable to CBO's estimates of budgetary costs. In addition, the changes to HAMP analyzed by CBO, whether mandated by legislation or administrative action, would probably cause the projected cash flows received by the GSEs on existing loans to change and would, therefore, affect OMB's estimates of the budgetary impact of the GSEs.

Current Policy and Options

CBO's analysis contrasts the costs and impact on borrowers of the current policy of HAMP with three options augmenting HAMP with a principal forgiveness modification. Each of those options would reach a target level of payment reduction or loan balance through different mechanisms and would involve a variety of other design choices (about which CBO made certain assumptions in order to estimate the effects of the options).

Each policy option analyzed by CBO could be implemented under current law on the basis of FHFA's authority as conservator of the GSEs. As such, the GSEs and FHFA could make an administrative change to implement one of the policy options. Alternatively, the Congress could write legislation to direct the GSEs to adopt a certain option.

Approaches the GSEs and Others Have Used to Manage Mortgage Delinquency and Foreclosure

Federal policymakers and industry participants have developed various approaches to reduce the costs and disruptions of foreclosure proceedings, which can end with borrower eviction and sale of the property at auction. Some of those approaches focus on keeping borrowers in their homes, and others focus on transitioning borrowers out of their homes. Both types of approaches provide incentives from the government to servicers (say, a bank that originated the mortgage and then sold it to the GSEs but remained as the point of contact with the borrower for making payments) to take actions designed to reduce costs to the government, because servicers are largely insulated from the costs of foreclosures by

Approaches Keeping Borrowers in Their Homes. If modifications to a mortgage result in payments from the borrower, they can reduce the present value of the government's cost in comparison to such costs under foreclosure. The most important program supporting such modifications for distressed borrowers is HAMP, administered by the Treasury. HAMP specifies a method to lower a borrower's monthly payment (by reducing the interest rate, extending the loan's duration, or offering principal forbearance) and provides incentive payments to mortgage holders and servicers to implement the modifications. As of November 2012, more than 560,000 permanent HAMP modifications have been started on first mortgages for GSE-backed loans, representing nearly 2 percent of the 28 million loans serviced on behalf of the enterprises.¹⁵

An alternative solution for borrowers who owe more than the current value of their homes (that is, those with "negative equity") looking for payment relief is to refinance their existing mortgages into loans with lower monthly payments. Approximately 15 percent of the 15 million loans refinanced by the GSEs since April 2009 were originated under the Home Affordable Refinance Program (HARP), which helps borrowers who are unable to receive a traditional refinancing because of house price declines.¹⁶ HARP allows borrowers with negative equity to refinance and provides cost savings and streamlining with respect to private mortgage insurance, underwriting requirements, and property valuations.¹⁷

A key distinction between a loan modification and a refinancing is that the GSEs generally require borrowers to be current on their existing loans to be eligible for a refinancing, whereas HAMP rules require that borrowers must often be delinquent or show signs of distress to receive a loan modification. As a result, the different options have different target populations of borrowers and consequences for the timing and size of the GSEs' costs to the government.¹⁸

Approaches Transitioning Borrowers from Their Homes. In collaboration with the government, the GSEs have designed a number of programs that provide borrowers with ways to leave their homes through means other than foreclosure. In one approach, a short sale, the borrower arranges for an arm's-length sale of the home at a price lower than the outstanding balance of the mortgage. In another approach, known as a "deed-in-lieu," the borrower cedes ownership of the home to the owner of the mortgage in exchange for being released from the mortgage obligation; sometimes the borrower then

¹⁵ Federal Housing Finance Agency, *Foreclosure Prevention Report* (November 2012).

¹⁶ Federal Housing Finance Agency, *Refinance Report* (December 2012).

¹⁷ With a traditional GSE refinance, borrowers are usually required to obtain private mortgage insurance (PMI) for loans with a LTV ratio greater than 80 percent. That coverage is based on the current LTV ratio, and it increases (in terms of both the amount of coverage and the cost to the borrower) as the LTV ratio increases. Under HARP, PMI

rents the home instead of leaving. Since 2008, the GSEs have completed close to 440,000 actions of those two types; more than half have occurred since the start of 2011.¹⁹

Approaches Using Principal Forgiveness. Modifications for delinquent borrowers with non-GSE mortgages have increasingly used principal forgiveness. Thirty-eight percent of modified loans owned by private investors and held on banks' balance sheets were provided some amount of principal forgiveness in the third quarter of 2012.²⁰ Those percentages are up from the fourth quarter of 2010, when private investors and banks used principal reductions on 2 percent and 18 percent of loans, respectively.²¹ Some portion of that increased use of principal forgiveness is related to HAMP PRA. Incentive payments made by the Treasury, based on the delinquency status of the borrower and the LTV ratio before modification, reimbursed investors from 18 cents to 63 cents per dollar of principal forgiven. Since HAMP PRA's inception, servicers have started nearly 120,000 permanent principal forgiveness modifications, forgiving a median amount of nearly \$68,000 per loan.²² To date, FHFA has not used principal forgiveness to lower GSE-backed mortgages, concluding that principal forgiveness does not achieve the agency's goals of minimizing losses to the government and supporting the mortgage market as effectively as other options available to borrowers with GSE-backed loans.

Concerns About Principal Forgiveness. The primary factors behind FHFA's opposition to principal forgiveness for GSE-backed loans are possible costs from delinquencies that would not occur without principal forgiveness, questions over fairness, and potentially high operational and technical costs.²³

Moral Hazard. Moral hazard is a tendency for people to be more willing to take risks for which the potential costs or burdens will be borne in whole or in part by others. If borrowers become delinquent in order to gain access to a principal forgiveness modification—a form of moral hazard—then the cost of principal reduction increases. For example, borrowers may know that they are very unlikely to default on their mortgages because they have access to funds that the lender does not know about. Under those circumstances, offering principal forgiveness to those borrowers, which generates a cost to the GSEs from the principal reduction but little to no offsetting benefit from reducing the likelihood of default, results only in an increase in expected costs to the GSEs.

Several approaches to program design would address concerns about the costs stemming from moral hazard. The most effective approach would be to offer principal forgiveness only to borrowers who were

¹⁹ Federal Housing Finance Agency, *Foreclosure Prevention Report* (November 2012).

²⁰ Office of the Comptroller of the Currency, *OCC Mortgage Metrics Report: Third Quarter 2012* (December 2012), www.occ.gov/publications/publications-by-type/other-publications-reports/mortgage-metrics-2012/mortgage-metrics-q3-2012.pdf.

²¹ *See* FHFA, *Foreclosure Prevention Report* (November 2012).