

CHAPTER 1

PREVENTING FORECLOSURES

Retooling HUD
for a Catalytic Federal Government:
A Report to Secretary Shaun Donovan

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EXECUTIVE SUMMARY

Since 2007, more than 2 million families have lost their homes and Credit Suisse recently projected that more than 8 million more will do so over the next four years. These losses have been a major contributing factor in the economy's decline. Foreclosures have decimated homeowners' equity and economic security. Values of homes across the country have plunged under the pressure of foreclosures. In some communities, the concentration of foreclosed homes has reversed years of public and private reinvestment and replaced thriving communities with blocks of abandoned homes. The U.S. Department of Housing and Urban Development (HUD) can and should play a central role in resolving the foreclosure crisis. It can do so through direct action using tools and authorities it already has; through new initiatives that it can lead; and through leadership across the government.

Over the past two years, the mortgage servicing industry, Congress, and the Administration have all promoted voluntary attempts to address the foreclosure crisis. These initiatives have included the creation of the Hope Now Alliance; encouragement to servicers and investors to allow and promote individual modifications of existing loans to cure delinquencies and forestall defaults; streamlined and standardized modification efforts like those promoted by the Federal Deposit Insurance Corporation (FDIC) and the Federal Housing Finance Agency (FHFA); and new Federal Housing Administration (FHA) programs like Hope For Homeowners and FHA Secure. Yet, the overall impact of these efforts has been very modest. The FHA Hope for Homeowners program has foundered badly.¹ Voluntary and individual modification efforts are time consuming and, according to the Office of Comptroller of the Currency (OCC), often lead to redefaults.

Clearly, more aggressive action is necessary to make significant impact, and only an extremely coordinated, comprehensive effort of complementary parts will begin to stabilize housing prices, restore consumer confidence, revalue and liquefy "toxic assets" that remain outstanding, and help replace fear with hope in the credit markets. Both the pace of defaults and consensus estimates of further house price declines have risen since the fourth quarter of 2008. These higher forecasts increase the urgency of action. They also argue for significantly larger and more dramatic interventions than might have been assumed only months ago.

Our recommendations stress the most cost-effective means of making a big impact, keeping people in their homes, stabilizing home prices, offering stimulative fiscal relief to beleaguered homeowners, and restoring stability to the housing market. We support different approaches to resolving the dilemmas facing performing borrowers and those facing borrowers who already are in delinquency or default. We believe that the moral hazards of helping delinquent borrowers and thereby encouraging performing borrowers to become delinquent in order to receive consideration and relief can be mitigated through a market-driven refinancing opportunity for performing borrowers and strategic use of FHA and Troubled Assets Relief Program (TARP) resources.

We set forth our recommendations below, outline a range of other possibilities, and attach some further information as Appendices. Whatever the final menu, it should be fair, bold, and aggressive and help borrowers stay in their homes; help improve consumer sentiment; and help reliquefy the mortgage market. Actions that create effective modifications or enable performing borrowers whose loans are in private label securities to refinance will help reset the values of the securities, which could provide important capital relief to the banks and others now holding these at deeply discounted mark to market values.

¹ "Rep. Frank, Administration Battle Over Housing Blame," *The Hill*, December 22, 2008

We are operating under the following strategic premises: first, any plan should serve principally owner-occupied housing; second, cases of gross fraud would be ineligible, as well as those cases where income is insufficient to carry any mortgage; as should mortgages where the modified loan-to-value ratio exceeds 120 percent or a net present value calculation makes the proposed solution impractical.

However, all other owner-occupied housing, including where owners are currently paying their mortgages, should be eligible for loan modifications or refinancing to take advantage of lower interest rates and to enable borrowers to escape from onerous reset triggers. Not all performing borrowers will be eligible for the opportunities we propose, but a significant number will be, with broad economic and social benefits. Furthermore, first lien mortgage loans should be subject to judicial modification in a bankruptcy proceeding under our recommendations. Taken together, these strategies present the possibility of helping every current household that is able and willing to pay a fair amount for their home.

While HUD does not have direct jurisdiction to implement all the components we think necessary to avert the worst of the foreclosure crisis, the Secretary will of course be a key player in determining the Administration's response to the crisis. Accordingly, we set forth the full plan below and distinguish between those recommendations in which HUD would be the lead agency and those in which the Secretary's role would be to advocate for the adoption of a recommendation.

The full report contains a series of related recommendations that together form a coherent and comprehensive approach to the current crisis. In this section we highlight only the four most significant of these linked recommendations.

Recommendation: The HUD Secretary should support the direct purchase of delinquent and defaulted mortgage loans held in private label securities (PLS) through the Treasury, the Federal Reserve Bank (the Fed), the government-sponsored enterprises (GSEs) or some combination of these.

The rapidly deteriorating forecasts of house price declines, mortgage delinquencies and borrower failure rates convinces us that dramatic action is necessary to create the widespread and effective modifications needed to save borrowers and their homes. We strongly believe that the most efficient and cost-effective way to manage these loans is for the federal government to purchase them at a discount on an all-or-nothing portfolio basis and then apply sweeping modification strategies with a view to holding the loans for as long as necessary to bring them current or to recover their maximum realizable value. Only this approach will create significant, widespread modifications at the scale and on the pace necessary to arrest this rapidly deteriorating situation.

TARP originally was promoted as a means to this end in order to permit the modification and restructuring of the loans. Acquisition of the mortgage loans would eliminate the complications of the bond structures. Government would become the new asset owner and have the same scope of action for modifications available to lenders holding mortgages in their own portfolios.

There are some legal and accounting issues that would have to be resolved in order to make these purchases necessary and these are detailed in the text.

Recommendation: If the purchase strategy cannot be pursued, or in the event some investors decline to sell to the government, the Secretary should urge Treasury to implement the streamlined loan modification plan proposed by the FDIC and authorized by TARP, whereby the government would pay an administrative fee to servicers and guarantee 50 percent of the outstanding balance if sustainable loan modifications made following the plan's protocols fall into default again.² FDIC estimates that their plan could reduce foreclosures by one-third. We believe that any financial institution that accepted TARP funding should be mandated or, at a minimum "strongly encouraged" to participate as a condition of the TARP funds.

We also recommend a series of related strategies and policy changes to facilitate modifications by addressing obstacles that have proven to be troublesome to date, including compensation for servicers, protection from legal liabilities, and changes to the conditions governing Real Estate Mortgage Investment Conduit (REMIC) tax treatment.

² Details of the plan can be found at <http://www.fdic.gov/consumers/loans/loanmod/index.html>

Recommendation: HUD should provide an FHA credit enhancement backed by an allocation of TARP or other appropriated funds to enable borrowers whose loans are held in PLS and who are currently paying their mortgages but are underwater because of house price declines to refinance their homes by guaranteeing the principal up to 120 percent of a current appraisal.

Borrowers with mortgage debts totaling roughly \$1 trillion held in private label securities are current in their payments, but an estimated 41 percent are unable today to refinance into lower rates or more stable mortgages because their property is “upside down.” This 41 percent is estimated to increase to 62 percent over the next two years. Other modification plans assist only delinquent borrowers, leaving these performing borrowers with no avenues through which to reduce their payments or escape burdensome terms. This insurance would enable them to benefit by refinancing their loans to gain the advantage of lower monthly payments. The insurance would cover a maximum of 40 percent of the outstanding balance if a currently performing borrower defaulted.

On the investor side, this credit enhancement would help re-stabilize prices for securities backed by these performing loans and provide capital relief for the institutions holding them at mark-to-market values that are currently lower. Finally, the run off of performing loans out of these private label securities spurred by insured refinancings may prove to be a powerful incentive for investors to authorize servicers to more aggressively modify nonperforming loans to shore up their value as the net present value (NPV) valuations of the shrinking pools shift.

Eligible borrowers should have at least 12 consecutive current payments on their loan; have a new loan balance not greater than the FHA loan limit; have no outstanding late payments on any other credit lines; and agree to automatic payment of the new loan amount through a draft on their checking accounts. No cash-out refis would be permitted. The borrower would be required to pay a fee for this new coverage,

We believe that this refinancing could be accomplished on a streamlined basis with low costs to consumers and lenders compared to other alternatives, and could take advantage of the core competencies of current servicers and Fannie Mae and Freddie Mac, which we elaborate in the text.

The take out of performing and nonperforming loans from PLS should be linked to the greatest extent possible, as the advantage to the trust of the former counteracts the possible disadvantage of the latter. Given deteriorating economic circumstances, and the high rates of defaults possible because of income reductions and other credit burdens, modifications without sale of the performing loans may yield negative NPV results, whereas a comprehensive approach that includes refinancing of the performing loans always will result in a positive NPV for the trust’s loans as a whole, and as well limits adverse selection.

Recommendation: The HUD Secretary should support legislation permitting judicial modification of mortgages in Chapter 13 bankruptcy.

Another effective way to break through the barriers put up by servicers and investors to effective and fair modifications is to empower a court to implement an economically rational solution where the parties cannot do so on their own. This would solve the servicers’ fear of investor lawsuits (no liability can arise from compliance with a court order), would solve servicers’ financial incentives and lack of qualified staff, and would solve the problem of junior lien holders, whose cooperation can be compelled by the court. This is what bankruptcy courts do every day, for all manner of debts, except for the mortgage on the primary residence.

Bankruptcy is not a solution of first resort. But if all other efforts by borrowers, government agencies and others fail, then consumers should have the right to the full protection of a bankruptcy court as an ultimate recourse. Simply knowing that a loan could be restructured by a bankruptcy court if the borrower and servicer/investor cannot find an equitable accommodation earlier likely will change the servicers’ and investors’ cost-benefit analysis in ways that could favor more aggressive efforts to modify loans.

Recommendation: The HUD Secretary should support legislative changes to the tax treatment of REMICs to facilitate asset sales and modifications.

Congress should pass legislation permitting government purchase of loans under REMIC tax rules and providing that continued REMIC tax-free status is contingent on pooling and servicing agreements (PSAs) being modified to permit

(but not require) participation in this process.³ In addition, Congress, the Securities and Exchange Commission (SEC) or Financial Accounting Standards Board (FASB) would need to ensure that accounting standards change to permit these sales. The current application of Financial Accounting Standards No. 140 (FAS 140) appears to be a significant obstacle to the sale of mortgage assets out of these trusts, but one that could be remedied fairly easily through the FASB and SEC.

Congressional adoption of the REMIC pass-through changes recommended above also would provide an important incentive for investors, servicers and trustees to cooperate in any government sponsored purchase plan.

HUD's Role

We believe that HUD can and should play a major role in addressing this problem.

- First and foremost, HUD must reclaim its role as champion of American homeowners and their communities. No other federal agency has a comparable chest of complementary tools to support comprehensive community focused plans for recovery, or the experience and tools in credit enhancement, mortgage underwriting, and asset management that FHA does.
- HUD immediately should ensure that it is facilitating loan modifications within its own FHA portfolio. Current rules require servicers to buy FHA-insured loans out of Ginnie Mae pools before any modifications can be made, and FHA will not honor full or partial claims that might otherwise result if the loan is not put into foreclosure. This makes FHA a significantly less flexible partner than many private portfolio lenders or private mortgage insurers. Given the rapid increase in FHA's market share since 2006, and the subsequent increase in troubled loans in its portfolio, rectifying this problem should be a very high priority. A solution would be to allow partial claims on a modification, repaying the net present value difference between the new loan vs. the unpaid balance of the old loan, since the servicer will only be able to sell the new loan at a discount to the original UPB if the modification actually reduces the borrowers' obligation, rather than simply extending arrearages.
- FHA can provide credit guarantees on newly modified conventional loans as a means of increasing servicers' willingness to carry out modifications.
- FHA can provide new forms of credit enhancement to facilitate the refinancing by private lenders of more than \$1 trillion in mortgage debt that is currently performing but where the mortgaged properties are underwater because of falling property values. Effective action to enable performing borrowers to take advantage of historically low interest rates would greatly increase these borrowers' likelihood of success as well as provide significant stimulative relief through an immediate lowering of interest payments.
- FHA should examine ways to work through Fannie and Freddie in carrying out various options outlined above to enable the capacity needed to expedite these initiatives.

³ See Center for American Progress, Issue Brief: Overcoming Legal Barriers to the Bulk Sale of At-Risk Mortgages, April 2008, available at http://www.americanprogress.org/issues/2008/04/reimc_brief.html.

INTRODUCTION

Millions of Americans have already lost their homes through foreclosures. These losses have been a major contributing factor in the economy's decline. Foreclosures have decimated homeowners' equity and economic security. Values of homes across the country have plunged under the pressure of foreclosures. In some communities, the concentration of foreclosed homes has reversed years of public and private reinvestment and replaced thriving communities with blocks of abandoned homes. HUD can and should play a central role in resolving the foreclosure crisis. It can do so through direct action using tools and authorities it already has; through new initiatives that it can lead; and through leadership across the government.

Since 2007, more than 2 million families have lost their homes. Credit Suisse recently projected that more than 8 million will do so over the next four years.⁴ While losses to date have staggered the economy, reliable estimates project that significantly higher losses are on the way in 2009 and 2010 because of a combination of factors. At first these losses were the result of poorly underwritten loans and overextended consumers. Now, as the housing and credit debacle extends into the "real" economy, more and more owners are missing mortgage payments and risking foreclosure because of job losses or declining incomes as a result of shorter hours and reduced pay. The Hope Now Alliance recently reported that 42 percent of the calls received on their hotline in 3Q08 were from owners under pressure because of a job loss.⁵ While this figure is not necessarily from a representative sample, or evidence of an acceleration in this segment, it signals that the market is now straining under a toxic mix of underwater and unaffordable mortgages combined with increased economic strains through job losses or declining incomes.

To add to this nearly perfect storm, millions of so-called Alt-A loans with option payment plans and other features are moving into the years with the highest projected losses. Payments on nearly one-half of the \$200 billion in outstanding payment option adjustable-rate mortgages (ARMs) tracked by Fitch Ratings will jump nearly 63 percent in the next two years, for instance.⁶

Older Americans, who are more likely to be living on fixed incomes and have less economic resiliency, comprise a significant share of those facing mortgage difficulties. A recent study by the American Association of Retired Persons (AARP) estimates that "...Americans age 50 and over represent about 28 percent of all delinquencies (30 to 180 days late) and foreclosures..." and that "Over 684,000 older Americans (age 50 or older) were either delinquent or in foreclosure at the end of 2007."⁷

As the task force focusing on mitigating the effects of the foreclosure crisis delineates in greater detail, foreclosures have had a devastating effect on home prices. Nationally, prices have declined an average of 7-9 percent in 2008 and Fannie Mae projected in their 3Q08 10-Q filing with the SEC that the "peak-to-trough" decline will be in the 15-19 percent range before prices stabilize.⁸ The Case-Schiller index, based on a sample of about 20 cities, estimates a decline nationally of 15-16 percent 2008 and 27-32 percent peak-to-trough.⁹ These projections have been worsening since the start of 2009. This swing from one extreme to the other is reducing consumer confidence; preventing families from taking advantage of historically low interest rates through refinancing because their homes are now appraised at less than their mortgage balances; preventing new homebuyers from entering the market due to fear of future declines; and choking off spending and credit at a time when the economy is faltering.

Millions of renters also face eviction and possible homelessness because of the mortgage crisis. While Fannie Mae and others recently have amended their policies to permit renters who are not delinquent in their rent to remain in homes after a foreclosure, this is not a universal policy. As a result, millions of renters also are exposed to eviction and

⁴ "Foreclosure Update, More than 8 Million Foreclosures Expected," Fixed Income Research, Credit Suisse, <http://www.credit-suisse.com/researchandanalytics>, December 4, 2008

⁵ Ms. Colleen Hernandez, President, Home Ownership Preservation Foundation, in December 22, 2008 conference call to announce Hope Now Alliance's year end results.

⁶ "Option ARMs: It's Later Than It Seems," Fitch Ratings, Structured Finance Residential Mortgage Special Report, September 2, 2008, www.fitchratings.com. "The potential average payment increase on this recasting population is 63 percent, representing on average an additional \$1,053 due each month on top of the current average payment of \$1,672. Data suggest that these large payment increases could cause delinquencies to more than double after recast." These payment increases result primarily from amortization over 25 years as principal repayment requirements kick in.

⁷ *A First Look at Older Americans and the Mortgage Crisis*, Insight on the Issues 9, AARP Public Policy Institute, September, 2008

⁸ Form 10-Q, Federal National Mortgage Association, for the quarterly period ending September 30, 2008, p. 8

⁹ Ibid

homelessness as a result of the mortgage crisis. This devastating blow comes at a time of a critical shortage of affordable rental housing as well as continuing declines in new production and preservation of such homes. While this problem is outside the scope of this paper, it is a critical problem in many communities. HUD could play a major role in addressing it through vouchers, FHA insurance and Neighborhood Stabilization funds.

Every month that goes by brings more and more pessimistic forecasts of sinking home values and mortgage delinquencies and defaults. This trend increases the need for urgent, dramatic and comprehensive action.

A. Taking into Account the Diverse Nature of the Problem

The development and rapid growth of sophisticated capital market funding designs in the early part of this decade have contributed to the complexity of resolving this crisis. Home mortgages today can be divided into three rough categories, based on the ultimate investor in the mortgage:

1. *Loans held in bank and thrift portfolios.* This category is estimated to include roughly 27 percent of all mortgage debt outstanding and about 10 percent of all loans 90 or more days delinquent. Because they have an undivided interest in the mortgages, these holders have broad freedom to design and execute mortgage modifications. They also have a direct financial interest in avoiding foreclosure and the subsequent hit against their capital. Because they own these loans, these holders can more quickly identify potential solutions and have the discretion to adopt a wide range of solutions, including principal reduction and streamlined refinances. However, modifications may require the banks to write down the value of the assets immediately, which is a disincentive to modification.
2. *Loans held or controlled by Fannie Mae and Freddie Mac.* The GSEs hold or guarantee securities backed by roughly 51 percent of total single family mortgage debt in the U.S., and account for about 17 percent of all delinquent mortgage debt. The two companies are currently in conservatorship and, with the initiation of the U.S. Treasury's intervention in September, 2008, they are effectively owned by the U.S. Government. These radical changes to their ownership and management make them potentially powerful tools to address the mortgage crisis.
3. *Loans in private label securities.* An estimated 80 percent of all loans originated as subprime or through Alt-A terms were sold into private securitization trusts. These loans together make up about 16 percent of all outstanding mortgage debt, but since they comprise 58 percent of all serious delinquencies (SDQs), they are driving the foreclosure crisis. Resets on payment option adjustable rate mortgages and interest only loans are fast approaching, as noted above. PLS loans have proven to be the most difficult to address because of the obstacles noted above. Resolution of these loans also has been complicated by recent litigation, *Greenwich Financial Services Distressed Mortgage Fund 3, LLC v Countrywide et al.*, that seeks to require repurchases of whole loans out of mortgage pools before modifications are made.¹⁰

The loans themselves can be further classified into several groups:

1. First lien loans
 - a. To owner-occupants
 - b. To investors who acquired them in order to rent the units
 - c. To investors speculating in real estate
2. Second liens
 - a. To owner-occupants
 - b. To investor owners

¹⁰ Mortgage debt outstanding includes non-government first liens. Delinquencies include conventional conforming first liens. Jumbos account for an additional 2.7 percent of SDQs and Government insured loans account for 11.7 percent of the SDQ loans. Source for mortgage debt outstanding is Global Economics Paper No. 177, *Home Prices and Credit Losses*, Goldman Sachs Global ECS Research, January 13, 2009. Source for SDQ rates is industry interviews. These data are all from the latter quarters of 2008. Since then, new forecasts have shown steady deterioration in the outlook for all of these critical indicators.

B. Voluntary Efforts Have Not Stemmed the Tide

Over the past two years, the mortgage servicing industry, Congress, and the Administration have all promoted voluntary attempts to address the foreclosure crisis. These initiatives have included the creation of the Hope Now Alliance; encouragement to servicers and investors to allow and promote individual modifications of existing loans to cure delinquencies and forestall defaults; streamlined and standardized modification efforts like those promoted by the FDIC and the FHFA; and new FHA programs like Hope For Homeowners and FHA Secure. Yet the overall impact of these efforts has been very modest. The FHA Hope for Homeowners program has foundered badly.¹¹ Voluntary and individual modification efforts are time-consuming, and there is strong evidence that modification plans that do not reduce borrowers' monthly obligations are much more likely to suffer additional delinquencies and possible re-defaults than those that do so.

The reasons that voluntary modifications have failed are the lack of trained servicing staff to respond to the increased demand, the presence of second liens that complicate modification of the first mortgage, as well as the additional issues associated with securitization: contractual limitations imposed by investors on servicers' modification actions; servicer financial incentives to foreclose rather than modify; investor requirements for servicers to use loss-mitigation approaches that result in the highest NPV for the investor, without providing standardized means for determining this; tax and accounting restrictions; the fact that some trusts require consent of a supermajority of each class of investors to agree to amending contract terms.¹² Most disappointing, the Treasury Department has not used its TARP in a comprehensive way that will reduce foreclosures. Nor has the Treasury used the authority granted it by Congress to promote loan modifications using a guarantee program.

BROAD RECOMMENDATIONS

The steadily deteriorating state of the economy, house prices, and mortgage performance, coupled with the increasing documentation of very high non-housing debt loads that make successful mortgage loan modifications increasingly difficult to engineer argue for a dramatic and bold intervention by the federal government to directly purchase nonperforming mortgage loans in order to gain control of them to structure effective modifications for current borrowers with an expectation of long-term asset holding in order to facilitate the kinds of modifications that may be necessary.

Recommendation 1: Using the Treasury, the Fed, the GSEs or some combination of the three, the government should offer to purchase nonperforming loans held in private label securities at a set discount.

This price should be slightly higher than current marked-to-market estimates in order to incent sales, and should require investors to sell all such loans in order to be eligible for the program. Upon acquisition of these loans, the government can sort through them and create modified payment plans that will offer maximum flexibility to enable borrowers to stay in their homes.

We believe this approach offers the greatest chance of staunching the flood of delinquencies and foreclosures that are helping to drive the current economic crisis. It gives the government control over the loans. As a long-term investor/holder, the government can undertake modifications on far more flexible terms than any private servicer or investor. And as the economy improves and borrowers' ability to repay debts increases, the government will be able to recoup a sizeable share of its initial outlay.

It also is critical to adopt policies to increase the utility and take up rates of private mortgage modification plans. Modifications can successfully avert foreclosures and the borrower's loss of a home. They can result in lower economic loss to the investor and lender than default and foreclosure. Through proper design, modification plans can ultimately give the investor a stake in the owner's future success through the use of Shared Equity provisions. By reducing the flow of foreclosed properties into neighborhoods, the free fall of housing prices can be slowed or arrested.

¹¹ "Rep. Frank, Administration Battle Over Housing Blame," *The Hill*, December 22, 2008

¹² See <http://www.federalreserve.gov/pubs/feds/2008/200846/revision/200846pap.pdf> for a good discussion on servicer incentives. Resolution of securitized loans also has been complicated by recent litigation, *Greenwich Financial Services Distressed Mortgage Fund 3, LLC v Countrywide et al*, that seeks to require repurchases of whole loans out of mortgage pools before modifications are made.

A combination of related and complementary policy tools are needed to have large scale impact. These approaches are outlined in three basic areas: changing servicer incentives to encourage more loan modifications, creating standards for what constitutes a sustainable and fair loan modification, and eliminating legal barriers to effective modification.

However, should the government not choose to buy nonperforming loans, it should aggressively set a program of loan-modification based upon the principles outlined below and tie its offer with a refinancing of performing loans also offered below.

Recommendation 2: Change servicer incentives to encourage more loan modifications.

Currently, servicers have few incentives to make loan modifications instead of foreclosing on a loan. HUD should take the lead in encouraging the federal government to take a multi-pronged approach to incentivize loan modification. First, the government should guarantee loan modifications that meet prescribed standards for loan modification measures and decision rules and pay an administrative fee to servicers for costs involved in sustainable modifications. These two approaches should be the first step tried – with the government actively working with servicers and investors in all three of the types of loans mentioned above, loans held in portfolio, loans controlled by Fannie Mae and Freddie Mac, and loans in private label securities – to use these approaches to encourage voluntary modifications on a large scale. Assuming good lender cooperation, one estimate is that these approaches have the potential to create approximately 2 million stable loan modifications over the next two years.

Finally, as an important parallel to the first two tracks that should be implemented immediately, Congress should modify Chapter 13 bankruptcy to permit judicial modification of mortgages. Bankruptcy provides an important last resort for homebuyers, in addition to changing the cost/benefit ratio for servicers in a way that will encourage voluntary loan modifications to occur.

Recommendation 3: Establish consistent standards for sustainable and fair loan modifications.

All loan modifications should proceed according to a prescribed set of loan modification measures and decision rules. These standards must be embedded in all relevant program regulations and legislation:

- Government incentives to servicers should be provided conditioned upon adherence to these standards
- In instances where the government acquires mortgages, or controls these mortgages in other ways (e.g. through FHFA conservatorship of the GSEs), these standards should also apply

Recommendation 4: Eliminate legal barriers to effective modification.

The final two recommendations provide important additional steps to make all of the above recommendations more possible. Currently, modifications can lead to severe tax consequences for both the homeowner and the investor. Homebuyers may have to pay taxes on what the Internal Revenue Service (IRS) characterizes as forgiven debt. Investors may be concerned about losing favorable pass-through REMIC tax status; more generally, the public benefits conferred by REMIC status have not produced sufficient public return in terms of resulting in modifications rather than foreclosures. As such, the Administration should work with Congress to modify two aspects of tax law and encourage more modifications.

Recommendation 5: Ameliorate tax consequences of modifications.

At present, when a servicer provides a homeowner with a loan modification containing a principal write-down (the type of write-down contemplated to occur under the FHA Hope for Homeowners program) or, in certain circumstances, a significant interest rate reduction, the IRS considers the homeowner to have received taxable cancellation of indebtedness income unless the mortgage debt is “qualified” under the terms of the Mortgage Forgiveness Debt Relief Act of 2007 or the homeowner is insolvent. In many instances, especially where the difference between the original loan amount and the current value of the house is large, the prospect of tax liability could discourage homeowners from seeking a modification, or, if such a modification is obtained, the resulting tax liability could cause the homeowner to default again on the new loan. To prevent this perverse result, Congress should amend the Mortgage Forgiveness Debt Relief Act of 2007 in two ways: (1) lenders should not be required to file a Form 1099 with the IRS when cancelling any mortgage-related debt; and (2) the definition of “qualified mortgage debt” should be extended to include all home equity debt.

Recommendation 6: Congress should make its favorable REMIC tax status contingent on changing the PSAs to remove artificial obstacles to modifications.

REMIC status should also require public reporting of modification activities.

OVERARCHING PRINCIPLES

We believe that first priority should be given to first-lien mortgages to owner-occupants. We also believe there is an important claim by innocent occupants of 1-4 unit rental properties whose homes are at risk because of investor defaults.

Some portion of troubled loans were originated or obtained through fraudulent or abusive lending practices. We strongly encourage aggressive enforcement against brokers, lenders and others who engaged in such practices. Federal Housing Finance Agency (FHFA) Director James Lockhart recently estimated that Fannie Mae and Freddie Mac will require lenders to buy back more than \$1 billion in fraudulent or ineligible loans in 2009.¹³ Other federal, state and local agencies should vigorously enforce their own and consumers' rights in such cases.

Within these groups there are further distinctions:

1. Owners who are current in their mortgages but unable to refinance into lower rates because they are "upside down" due to reduced home values
2. Owners who have missed some payments
3. Owners who have missed more than 3 payments
4. Owners who are in default

There are also different groups of approaches to the problem, which run along a continuum of modifications, starting with the current owners and moving through executive modifications to judicial modifications. These can roughly be defined as:

1. Acquisition of mortgage loans through some form of auction or negotiated purchase program in order to gain control of them to carry out modifications through a new owner, such as Treasury, HUD, a GSE or other investor.
2. Acquisition of mortgage loans using eminent domain authority to forestall damage to the overall economy and to reduce or stem blighting effects of concentrated foreclosures by acquiring the loans and modifying them.
3. Mortgage-by-mortgage modifications between servicers and borrowers that are tailored to the specific circumstances of the borrower and the specific terms of the investors.
4. Wholesale modifications applied to existing borrowers, much like that proposed by FDIC Chair Sheila Bair, or as adopted by the FHFA and Fannie Mae and Freddie Mac, as well as by various lender/servicers, such as Citimortgage, JP Morgan Chase and others. Under these systematic approaches, standard modification conditions, such as a 31 percent housing debt-to-income ratio, are applied to all owners, regardless of specific circumstances.
5. Judicial modification through bankruptcy proceedings.

Other difficult concerns include the following:

- Moral hazard that those that can pay will default in order to qualify for assistance.
- Adverse selection by borrowers or servicers/investors if offer is overly generous, e.g., servicers/investors will seek assistance only for those loans with the worst outlook, increasing the chances for redefault and lowering success rates overall, while leaving other homeowners with unreasonable burdens.
- Effect on the bank capital (e.g., if any scheme to purchase mortgage securities does so at a discount to their mark to market value, accounting rules may force a writedown of all such bonds, leading to potential further writedowns in bank capital).
- Early redemption of loans held in bank portfolios through an effective refinance option could cause these banks to have to lower the value of the servicing on these mortgages due to potential early run off of the loans. These banks also could experience reduced income as a result of the refinancings because of the lost servicing.

¹³ FHFA: 09 Buybacks Will Surpass \$1 Billion, *National Mortgage News*, December 15, 2008

This could be ameliorated somewhat if the same institutions added new loans to their books through the refinancings.

- Total cost of program to taxpayers — Outlays vs. value of collateral plus any value of upside potential if a silent lien or equity sharing of any appreciation is applied on taxpayers' behalf.
- Increasing the flexibility of trustees and reducing their fear of lawsuits.
- How to demonstrate that a modification maximizes net present value (as required in PSAs).
 - Legal threats to modifications.
 - Problem of “waterfall” where servicers first try to work out a repayment plan that minimizes economic loss to the investor. Interest and principal reductions are last resorts.
 - Difficulty of comparison to value of an unmodified loan, including calculating the value if foreclosed [consists of current market value (which generally is less than the mortgage amount), minus the cost of foreclosure minus cost of going through the REO process (includes time value of money and maintenance costs for period it takes to resell plus any cost of rehab)].
 - How to establish “standard industry practice” which is a defense to accusations by investors that trustee is not performing properly.
- How to deal with second liens when trying to refinance (can be ignored when doing a modification).
- How (or whether) to distinguish between investors who are speculators and those who are legitimate landlords.
- Loans that remain underwater (e.g., with silent lien) even after a modification so potentially more likely subsequently to go to foreclosure once a current default is cured.
- Potential for fraud in resell price in cases, for example, where there is equity sharing or where borrower misrepresents his/her income, etc.
- Increased purchase of homes through an easing in home price declines may be offset by decrease in demand by consumers for other products.

Interventions in the mortgage process should have one or more objectives. First, interventions should be aimed at keeping people in their homes by mitigating an undershooting of housing prices to a normalized trend line and forestalling the elimination of trillions of dollars of net worth and its effect on consumer confidence. Second, interventions should be aimed at helping to stimulate economic recovery. Third, interventions should aim at stabilizing and stimulating the housing market to eliminate potential “market overhang”, reach realistic numbers for pricing collateralized debt obligations (CDOs), and return investor confidence. Doing so will help the larger economy, since the multiplier effect in housing expenditures is estimated in the range of 10:1. It also will help rebuild home values broadly by re-establishing a market for homes that can bring prices more in line with historical, rather than bubble-era, trends.

ALTERNATIVE STEPS

There are a host of related and complementary steps and strategies laid out below that the government could take either to further incent servicers and investors to more aggressively pursue modifications or to acquire the mortgage loans themselves in order to gain control of them and carry out modifications directly. The latter path would involve significant outlays to acquire the mortgages and immediately raise issues of how deep a discount to pay for these loans. Establishing a current market price is very difficult, given their uncertain payment futures and the lack of any market to purchase them.

Another alternative would focus on using government resources to refinance distressed as well as performing mortgages using FHA insurance to take advantage of current historically low market rates on 30-year fixed rate loans. This path would expose the government to some significant risk if the loans re-default, depending on the risk sharing with the original issuer, or if the remaining balance is not recovered when the home is ultimately sold. It also would provide a full payoff of current balances to investors, raising potential concerns about “windfalls” for currently nonperforming loans.

However, such concerns about potential overpayments to current investors, or convictions that investors who financed unsustainable loans in the first place should be punished before loans are stabilized must be balanced against the urgent need to adopt a broad and effective strategy to stop the rising wave of foreclosures. Our primary focus is

finding effective solutions that will enable borrowers to stay in their homes and, where possible, lower their monthly costs so they can succeed over the long term. No solution is likely to satisfy every potential issue that this crisis has raised. We fall on the side of doing more rather than less. Trying to craft a solution that successfully balances each and every interest in each and every case will delay bold action and undercut the chance to succeed. We believe that the deteriorating economy demands quick action on a scale that will have a meaningful impact on consumers’ ability to stay in their homes.

The table below lays out the various alternative approaches that could be adopted and summarizes the pros and cons of each approach. Specific recommendations are outlined in the following section.

CATEGORY	STRATEGY	PROS and CONS
<p>Servicer Ability To Modify Give PLS servicers the ability to modify loans without regard to legal restrictions in PLS contracts.</p>	<p>Expand Safe Harbors for Servicers Housing and Economic Recovery Act of 2008 (HERA) and Emergency Economic Stabilization Act (EESA) provide limited safe harbors for servicers by establishing guidelines that servicers can follow and be deemed to have acted in the best interest of investors. Expand safe harbors to provide more protection to servicers, such as broaden the guidance regarding “reasonably foreseeable default” and NPV calculations</p> <p>Enact Legislation Regarding Mods Remove obstacles to modifying Pooling and Servicing Agreements by conditioning favorable REMIC tax treatment on such changes, and provide authority for the government to indemnify servicers to do reasonable modifications.</p>	<p>Pros</p> <ul style="list-style-type: none"> • Gives PLS servicers ability to pursue loan modifications more efficiently • Standardize PLS loan mitigations <p>Cons</p> <ul style="list-style-type: none"> • With regard to new safe harbors, legislation overriding contractual terms may cause investors to lose faith in sanctity of financial contracts and reduce investor demand for all forms of securitization. This is less likely for changes to REMIC treatment. • In the case of safe harbors, could result in investor lawsuits, which will cost taxpayers and delay results. Lower likelihood for REMIC treatment changes
<p>Servicer Incentive to Modify Provide incentives for PLS servicers to modify loans within existing contractual framework</p>	<p>Guarantee Modified Loans Government would provide a partial guarantee in the event that modified loans re-default. A premium for the guarantee could be paid from a portion of new payments from the modified loan or the guarantee could be fully carried by the government. This would mitigate the need to factor in a re-default risk in calculating NPV.</p>	<p>Pros</p> <ul style="list-style-type: none"> • Government and taxpayer could receive a premium payment for guarantee. • Guarantee would enhance the NPV calculation of a modification for investors <p>Cons</p> <ul style="list-style-type: none"> • Relatively high rate of re-defaults so far suggest that overall losses would exceed premium income, if any. • Could be perceived as an investor bail out if principal amounts are not reduced.
	<p>Purchase Loans From PLS Trusts The Government would buy defaulted or delinquent loans from the trust. The purchase price could be based on the greater of NPV with a loan mod or foreclosure. Acquisition of the loan would enable the government to take a wide range of modification options.</p>	<p>Pros</p> <ul style="list-style-type: none"> • Investors receive highest NPV <p>Cons</p> <ul style="list-style-type: none"> • Congress must change REMIC law and change PSAs through maintaining REMIC status. May need FASB and SEC approval to sell loans out of the trusts. • Potentially higher cost to taxpayers than for other approaches
	<p>Eliminate NPV Shortfall For defaulted or delinquent loans, government makes up the shortfall to investors in any NPV calculation.</p> <p>Subsidize Interest Rates on Modified Loans for Delinquent Borrowers</p>	<p>Pros</p> <ul style="list-style-type: none"> • Investors receive highest NPV and servicers have flexibility to modify. • Potentially lower cost vs. guarantee against re-default

CATEGORY	STRATEGY	PROS and CONS
	<p>Investors would write down interest rates to one level, forgive interest to reduce the borrower's obligation further, and receive an compensation from the government for the forgiven amount. Writedowns should be restricted to what's necessary to meet the NPV calculation.</p> <p>Purchase Master Servicing Rights and Second Liens</p>	<p>Cons</p> <ul style="list-style-type: none"> • Could be perceived as a bail out of investors • Need to prevent investor or borrower windfall • Forgiven interest could be a tax event for the borrower.
Market Based Approach	<p>Obtain Controlling Interest to Amend Purchase enough securities on a deal-by-deal basis for a controlling interest and amend PLS contracts to eliminate restrictions on modifications.</p> <ul style="list-style-type: none"> • Leverage Fannie and Freddie holdings to quickly obtain controlling interests in issues where they have overlapping shares • Target PLS with small remaining sub classes • Prioritize purchases for products with highest defaults <p>Acquire Delinquent Mortgages as a Reverse Mortgage, in Return for Equity Stake</p>	<p>Pros</p> <ul style="list-style-type: none"> • Potential control of loan servicing • Enables modifications within legal framework <p>Cons</p> <ul style="list-style-type: none"> • May be impractical to achieve on a widespread basis. • May be difficult to obtain enough bonds to gain the necessary share. • May have to overpay for “control” bonds • Legal challenges from minority holders
Refinance	<p>Develop A Government Refi Program for Delinquent Loans Create a workable program for troubled borrowers to obtain more affordable loans.</p> <p>Offer Federal Loans for Portion of Unpaid Balance of Delinquent or New Loans</p>	<p>Pros</p> <ul style="list-style-type: none"> • PLS investor fully paid – no complication with PLS contract terms. <p>Cons</p> <ul style="list-style-type: none"> • May be seen as investor bailout, as no haircut is required • May assist borrowers who committed fraud or encourage performing borrowers to default in order to qualify
	<p>Develop a Government Refi Program for Performing Loans Refinance borrowers who are current on loans where resulting loan to value (LTV) would be >100 percent.</p>	<p>Pros</p> <ul style="list-style-type: none"> • Provides program similar to those already available to GSE borrowers <p>Cons</p> <ul style="list-style-type: none"> • Explicitly moves risk of loans to government balance sheet. • Current investors receive full unpaid principal balance (UPB), could be perceived as a bail out.

SPECIFIC RECOMMENDATIONS FOR ACTION

We believe that a combination of related and complementary approaches is needed to have a large-scale impact. These approaches combine acquiring mortgage loans in order to restructure them; voluntary efforts carried out in a streamlined, standardized manner; using insurance in a number of different ways to incent private participation and mitigate risk tails; and judicial modification for borrowers who cannot be rescued through the other methods and are forced into bankruptcy as a result.

This section first makes recommendations for distressed assets and then makes recommendations for dealing with performing but threatened assets.

These recommendations focus primarily on mortgages that are held in PLS. These represent the majority of the loans that are in delinquency, default and foreclosure. In addition, loans held in bank or GSE portfolios, or in GSE securities, are currently subject to much more flexible treatments by the portfolio owners. Indeed, the most innovative and extensive modification and forbearance plans to date have been advanced and executed by these holders. Because these holders already have extensive scope of action, they are not addressed specifically in these recommendations, except with respect to the tax treatment of modifications or forgiveness of debt or principal, which should apply equally to any borrower or lender regardless of whether the asset is in a security or is a whole loan held in portfolio.

A. Nonperforming Assets

Recommendation 7.1: Government Purchase of Mortgage Loans

The scale of the problem and the deteriorating outlook for mortgages held in PLS argues strongly for the outright purchase of outstanding nonperforming mortgages backing the bonds. TARP originally was promoted as a means to this end in order to permit the modification and restructuring of the loans. Acquisition would eliminate the complications of the bond structures. Government would become the new asset-owner and have the same scope of action available to lenders holding mortgages in their own portfolios.

Any plan to acquire these mortgage loans must consider the different broad groups of loans that are held in these trusts. These include the following:

- Performing loans
- Loans that are currently performing but that are likely to become delinquent as resets come due.
- Currently delinquent loans (30-90 days delinquent)
- Loans in default (>90 days delinquent)

The biggest obstacle to this alternative is arriving at a fair value for the loans, especially considering these critical differences, and inducing current owners to sell at that price. Current market conditions make it difficult, if not impossible, to calculate a “fair market value” for the loans. It is possible; however, to use a NPV calculation similar to the FDIC’s to generate a fair estimate of the loans’ values based on current performance, market prices for homes, and costs of foreclosure. A sample term sheet for such a calculation is included as Addendum 1.1, comparing such an approach to the current FHA Hope for Homeowners program. We recommend that government offer a discounted purchase price for these loans and require sales to be on an all-or-nothing basis, to gain control of as many loans as possible and to eliminate the potential for adverse selection by current investors in offering only some of their current portfolio.

Gaining control of these delinquent mortgage loans would give the government complete control over their disposition and yield large benefits for consumers and communities while exposing the government to potentially modest costs. It would eliminate one nagging problem presented by many of these loans that have second mortgages. Current modifications can be stymied by first lien holders demanding that second lien holders give up some or all claim to the property. Without the second lien holders’ consent, modifications can be frustrated. With the government as the sole first lien holder this question no longer applies and aggressive actions can be taken directly by the government.

There are roughly \$573 billion in loans held in PLS that are 30 days or more delinquent or in foreclosure as of September, 2008.¹⁴ If we focus only on owner-occupied, non-vacant properties and assume these equal roughly \$400 billion in total volume (an estimate only, for illustrative purposes), and assume the government purchased the loans at seventy five cents on the dollar, the entire amount could be acquired for \$300 billion ($\$400 \times .75 = \300). Further assume that 60 percent of the loans ultimately default, a very high number, with a severity of 25 percent of the discounted value, which would be comparable to market estimates of roughly 40 percent on these loans without the initial discount.¹⁵ This would leave the government with a net loss cost of \$45 billion ($.6 \times .25 = .15$, $.15 \times 300 = 45$) to clear all of these currently delinquent loans out of securities structures.

¹⁴ Figures from the fourth quarter of 2008 are almost certainly going to show even higher shares of these loans in delinquency, default or foreclosure. All current forecasts show more, not less, failures and loss severities because of the deteriorating economy and the continuing flood of failing mortgages and properties coming into an already declining market.

¹⁵ Goldman Sachs, op. cit.

With control over the loans, the government could modify loans that meet its criteria with unfettered flexibility. Payments could be written down to whatever the borrower can manage, with the government acting as a patient investor. As borrowers' circumstances improve over time, their payment plans can be further modified to the point of full amortization of the remaining amount. With these dramatic approaches, it is likely that default and foreclosure rates could be reduced significantly below the estimates used above, further reducing the ultimate cost to the government.

While requiring a large outlay upfront, this approach could resolve many otherwise intractable problems at a relatively low ultimate cost to the government. The loans could be acquired directly the Treasury, through the Fed, or using the GSEs to act on their behalf.

However, should the government not choose to buy nonperforming loans, it should aggressively set a program of loan-modification based upon the principles outlined below and tie its offer with a refinancing of performing loans also offered below.

Recommendation 7.2: Use Government Powers to Rebalance Conflicting Interests

The failure of the trustees/servicers of the private securitization trusts to adopt loan modification policies that would seem to maximize the net present value of the troubled mortgages (i.e., those in default or imminent danger of default), or the possible unwillingness of investors to sell loans to the government as outlined above suggests that stronger measures also should be considered.

One such approach that would be controversial but potentially effective would be to use the federal government's power of condemnation under 40 U.S.C. 3113 and 3114 and funding from TARP to gain control of the loans and hence of the servicing of those loans.¹⁶

This approach has three major advantages. First, the government would not have to pay a premium to entice the private sector to go along; it would simply have to pay "just compensation." Second, the government would be able to modify the loans immediately, even if determination of the price to be paid ends up in litigation. Third, if the property has additional liens, e.g., a home equity loan, the government can condemn them as well, eliminating the need to involve additional parties in the negotiation of the loan modification.

The lack of a fully functioning market for these securities and mortgages may mean that the courts will have to rely on alternative ways to establish value such as the framework laid out by the FDIC. Using their approach, the value would be the higher of: 1) the current market value of the collateral, i.e., the house, minus any losses likely to be experienced through continued servicing of the loan, including costs of foreclosure, of maintenance, of any rehabbing/repairing that is appropriate, and of any other costs (including the time value of money) incurred until the house is likely to be sold, or 2) the net present value of the income stream after the mortgage has been modified to a level that could be affordable to the borrower on a long term basis.¹⁷

While the government could take all troubled mortgages, it might be able to accomplish its goal through a more limited program which would condemn only enough mortgages to accelerate the market process for valuing troubled loans (and the securities they are in) and would also encourage trustees to modify the loans themselves in lieu of risking even lower proceeds in a condemnation procedure. The federal courts regularly deal with condemnation actions and would presumably be able to adapt their existing procedures to determine "just compensation" for these

¹⁶ While it appears that the Treasury has the authority to invoke these powers based on language in the Economic Emergency Stabilization Act of 2008 and that the courts would be willing, as they have been in the past, to take a broad view of the term "land," it may be useful to eliminate any legal uncertainty and potential litigation on these points by having Congress pass special authorizing legislation.

¹⁷ The legal standards for determining "just compensation" when the government exercises its power of eminent domain are fairly clear. The measure of how much the owner must be paid – i.e., the measure of "just compensation" — is "the market value of the property at the time of the taking." *United States v. 50 Acres of Land*, 469 U.S. 24, 29 (1969) (quoting *Olson v. United States*, 292 U.S. 246, 255 (1934)); see *United States v. Clarke*, 445 U.S. 253, 258 (1980). "Under this standard, the owner is entitled to receive 'what a willing buyer would pay in cash to a willing seller' at the time of the taking." *United States v. 564.54 Acres of Land*, 441 U.S. 506, 511 (1979) (quoting *United States v. Miller*, 317 U.S. 369, 374 (1943)). "The Fifth Amendment does not require any award for consequential damages." *50 Acres of Land*, 469 U.S. at 33. It is worth noting, however, that, in determining the fair market value of property that is taken, the increased value that is attributable to the government's own actions is not taken into account. See, e.g., *Miller*, 317 U.S. at 377 ("The owners ought not to gain by speculating on probable increase in value due to the Government's activities."). The authors are grateful to Jim Feldman for his contributions and insights in this section.

cases. Hopefully, the prices being set through this process would hasten the time for the development of a market for these troubled mortgages and for the securities they are in.

Use of eminent domain is a controversial alternative. Under current legal standards, the government fairly clearly has the power to take mortgages or interests in mortgage under its power of eminent domain, given appropriate legislation to ensure that Congress has authorized it. The primary constitutional restriction is that the land has to be taken “for public use.” In *Kelo v. City of New London*, 545 U.S. 469 (2005), the Supreme Court held that the “public use” or “public purpose” requirement was satisfied when a real property interest was taken for purposes of economic development of a community, even though the effect was to transfer the land to a private developer. In *Hawaii Housing Authority v. Midkiff*, 467 U.S. 229 (1984), the Court held that the same requirement was satisfied when a state took title from some lessors and gave it to lessees, because the concentration of land ownership in the state’s view “created artificial deterrents to the normal functioning of the State’s residential land market.” 467 U.S. at 242.

The current system of securitized mortgages often leads to the result that *no one* has authority to make mortgage modifications that would be beneficial to borrowers, most lenders, neighbors, and the community as a whole. Under *Kelo*, and even more clearly under *Midkiff*, the public purpose of returning to normal and effective functioning of the mortgage market is sufficient to find that condemnation of mortgages (or interests in mortgages or mortgage pools) would be for a “public purpose,” even if those interests, once condemned and modified, were simply sold to other private parties and not held by the government. While it is not impossible that there would be a legal challenge on this basis, the Supreme Court is unlikely to overturn or substantially limit a precedent as recent as *Kelo* at this time. The five-Justice majority in *Kelo* (Stevens, Kennedy, Souter, Ginsburg, Breyer) remains on the Court today. The legal risk that a condemnation would be held to be unconstitutional is minimal.

Condemnation of mortgages or interests in mortgages or mortgage pools has one clear advantage over any other means of removing the obstacles that prevent reasonable modifications of mortgages: it could operate quickly, since the government could condemn and take control of the mortgages or mortgage interests before the conclusion of judicial proceedings to determine how much the government must pay. But it also has significant disadvantages: the cost to the government could be uncertain, the litigation process necessary to determine the cost to the government could take years and be very complex, and the ultimate cost could potentially be very high. Valuation in general is a notoriously tricky matter, and there are ordinarily multiple ways at arriving at the value of a piece of property, especially an abstract property interest such as a mortgage or an interest in a mortgage. Especially given current market conditions, it is difficult to predict just how a court would value mortgages or interests in mortgages, and a court in a condemnation case may be tempted to give the benefit of the doubt on at least some occasions to the owner whose property has been taken.

Recommendation 7.3: Legal Changes to Facilitate Resolution

Another obstacle to sales is that, because trusts are intended to be purely passive entities, there are restrictions against them selling assets at a discount. Congress should pass legislation permitting government purchase of loans under REMIC tax rules and providing that continued REMIC status is contingent on pooling and servicing agreements (PSAs) being modified to permit (but not require) participation in this process as well as in modifications.¹⁸ Finally, Congress, the SEC or Financial Accounting Standards Board would need to ensure that accounting standards change to permit these sales. The current application of FAS 140 appears to be a significant obstacle to the sale of mortgage assets out of these trusts, but one that could be remedied fairly easily through the Finance Accounting Standards Board and SEC.

Congressional adoption of the REMIC pass-through changes recommended above also would provide an important incentive for investors, servicers and trustees to cooperate in any government-sponsored purchase plan.

¹⁸ See Center for American Progress, Issue Brief: Overcoming Legal Barriers to the Bulk Sale of At-Risk Mortgages, April 2008, available at http://www.americanprogress.org/issues/2008/04/reimc_brief.html.

B. Modifying Distressed Mortgage Assets

In lieu of the government acquisition plan outlined in Recommendation 7.1, or as a complementary approach for those investors who cannot be persuaded to participate in such an acquisition initiative, we believe there are other important steps to consider to facilitate the preservation of homes secured by troubled or nonperforming mortgages.

Recommendation 8.1: HUD should urge Treasury to implement the streamlined loan modification plan proposed by the FDIC and authorized by TARP whereby the government would pay an administrative fee to servicers and guarantee sustainable loan modifications made following the plan's protocols at a 50% level.¹⁹

FDIC estimates that their plan could reduce foreclosures by one-third. This plan could be quickly implemented by Treasury and could lead servicers to implement a systematic and streamlined process to substantially reduce foreclosures. It addresses a number of concerns that have limited loan modifications to date: its net present value analysis, using more standardized assumptions that are transparent and clearly explained, would demonstrate to investors why a successful modification is a better outcome than foreclosure; the administrative payments to servicers offset countervailing incentives to foreclose that are built into the structure of the servicing industry; the modifications can be made with second liens remaining in place because of its consideration of first mortgage affordability; the initial six-month performance requirement will weed out participants with no chance of succeeding and ensure that modifications will provide a reasonable level of affordability; the focus on first-mortgage debt-to-income makes it easy for servicers to administer; and the requirement that servicers apply the protocols to all loans in a servicer's portfolio removes any chance of their adverse selection of loans.

The FDIC's prescribed loan modification measures involve a three-step, transparent process to try to bring the borrower's payment down to an affordable level:

1. First, the interest rate is reduced. The rate may be no higher than the Freddie Mac weekly survey rate at the time of the modification, but can be reduced down to 3 percent. Beginning five years after the loan modification date, the interest rate is gradually increased over time until it again reaches the Freddie Mac weekly survey rate that was in effect at the time of the modification.
2. If this approach is insufficient, the term of the modified loan may also be extended, from 30 up to a maximum of 40 years.
3. Finally, if reducing the interest rate and extending the term is still not enough, the lender may employ "Partial Principal Forbearance." With Partial Principal Forbearance, the lender splits the debt into an interest-bearing, amortizing portion (at 3 percent, 40 years) and a zero-percent, zero-payment portion of the loan. FDIC continues: "The repayment of the 'postponed' principal will be due when the loan is paid in full. For loans within securitizations, this principal forbearance should be passed as a write-off of principal to the trust, with any future collections at time of pay-off submitted to the trust as a recovery."

It is true that some modifications under the FDIC protocol may be less sustainable than a more careful, case-by-case analysis. The FDIC approach does not consider the full debt picture and residual income of the homeowner, does not make permanent principal reductions, and does not require cancellation of second mortgages. However, there would be nothing to stop participating servicers from taking these additional steps. In the end, we believe the urgent need to do streamlined modifications on a mass scale outweighs those concerns.

One estimate is that roughly 3.2 million loans would qualify for this mass modification approach over the next 2 years, at an estimated cost of \$40 billion in insurance pay-outs to servicers, and that around 2 million of these modifications would be successful in enabling borrowers to keep their homes by keeping their loans current.

Banks, Fannie Mae and Freddie Mac, along with the FDIC, are already carrying out streamlined modifications like this model, without the insurance guarantee of revenue streams. Servicer response to Fannie Mae's model is reported to be very high.

Recommendation 8.2: Remove Securitization Obstacles by Modifying REMIC laws

Roughly half of subprime PSAs have restrictions that limit servicers' and trustees' discretion to modify mortgages even when such modifications are in the best interests of investors.²⁰ As a result, many investors are being ill served by their

¹⁹ Details of the plan can be found at <http://www.fdic.gov/consumers/loans/loanmod/index.html>

²⁰ See Kevin Byers, CPA, "Summary of Analysis: Loss Mitigation Provisions in Selected Subprime Securitizations," 12/20/08

servicers, because the net present value of a modification often is greater than the costs if the loan is foreclosed, even factoring in the possibility that the modified loan will redefault in a declining market. Such restrictions include limits on the type of modification that can be done (such as prohibiting principal reduction, interest rate reduction or term extensions) or requiring approval by a third party (National Incident Management System [NIMS] insurer, ratings agency, master servicer or subordinate tranche holder) before doing any modification at all or exceeding a 5% cap on a pool's number of loan modifications. An additional type of restriction is the imposition on servicers of an obligation, either expressly or through implication, to maximize a mortgage pool's assets for the benefits of each class of investors, rather than for investors as a group. This type of restriction – or even uncertainty concerning the servicer's obligations in this area – can also be addressed by making REMIC treatment contingent on clarifying that the servicer's obligation to maximize value in modifying mortgages extends to all investors as a group, not to any particular class of investor.

Congress should make its favorable REMIC pass-through tax status contingent on changing the PSAs to remove artificial obstacles to modifications where servicers and trustees do not need investor approval to do so.

In addition, REMIC status should require public reporting of modification activities, including protocols, inputs to its NPV analysis, and outcomes. The modification protocols are important to understand. NPV inputs are simply a black box for servicers and can easily be manipulated to justify foreclosing with assumptions of unrealistically high discount rates, redefault assumptions, or property decline rates. And reporting on outcomes has failed to tie performance to the specific type of modification chosen, which reduces the ability to learn what works best.

Recommendation 8.3: Examine the Value of Incorporating a Form of Shared Appreciation Into Modifications

Partnership Mortgages (PM), a form of shared appreciation mortgages, are an attractive loan modification approach that allow homeowners to stay in their homes while providing a mechanism for lenders to recover some or all of their investments. PMs incorporate two essential elements:

1. A current-pay obligation that can be prudently underwritten, given current loan-to-value and homeowner affordability constraints. The homeowner makes regular monthly payments on this portion of the existing mortgage.
2. A deferred obligation representing the remaining balance of the existing mortgage which requires no current payments of principal or interest. This portion is due to the lender upon resale of the property, along with a share of appreciation in the home over the value at the time of modification.

Note that the FDIC's Partial Principal Forbearance mechanism is effectively a Partnership Mortgage with a zero percent appreciation share. Taking some share of potential appreciation along with the return of the 'postponed' principal will increase NPV and therefore increase the number of loans for which modification is preferred to foreclosure from the investor perspective. The consumer will pay more at that point than if they did not have to share appreciation, but the solution is far preferable for them than going to foreclosure.

Moreover, there is ample reason to include a shared appreciation approach within the FDIC-prescribed measures even in those instances where Partial Principal Forbearance is not employed. Specifically, the reduction in interest rate (the first step in the FDIC process) also reduces the investor return. There is no reason that the investor could not have the opportunity to recover some of this discount by charging a share of the appreciation upon resale. There is actually a federal government program that provides a precedent for exactly this idea, namely the U.S. Department of Agriculture (USDA) Rural Development Section 502 loan program. This loan program helps homebuyers purchase a home at a steeply reduced interest rate (sometimes as low as 1 percent) – but keeps track of the amount of interest the homebuyer has saved compared to a market rate loan. This amount of discounted interest can then be recovered by the USDA by taking a share of appreciation (USDA typically takes 75 percent of appreciation, up until the discounted interest is fully recovered).

A model for integrating the Partnership Mortgage approach within the FDIC loan modification system might therefore work as follows:

- The investor takes a share of appreciation in the home – for example, 50 percent of future appreciation above the current market value at the time of the modification – to recover interest rate discounts provided as a part of the modification.

- This shared appreciation is capped at no more than the value of the interest rate discounts provided.
- If Partial Principal Forbearance has also been employed, the investor may continue to take a 50% share of appreciation above this cap to earn a return on the Partial Principal Forbearance. If desired, a second cap could be applied on this additional shared appreciation (e.g. at no more than a certain return on the amount of the Principal Forbearance).
- Any appreciation that must be used in order to satisfy the borrower's obligation to repay the principal amount of the Partial Principal Forbearance is taken out of the basis used for the above shared appreciation calculations. In this way, the homebuyer is assured that they will not owe any shared appreciation payments if they must use all of the appreciation in the property to pay off the principal amount of the Partial Principal Forbearance.
- Shared appreciation payments would be due upon the refinance or actual sale of the property (as is the case with the return of principal of the Partial Principal Forbearance).

One could readily integrate a house price appreciation forecast and length-of-tenure assumption into the FDIC NPV model to determine the expected value of shared appreciation payments. Note that the expected value of adding a share of appreciation to the modified loan is always positive. (If property values are flat or declining, the shared appreciation is worth zero; if they increase the shared appreciation is worth a positive number; therefore the expected value is never negative and likely will be positive at least some of the time.) Thus, by definition, this approach will boost the expected investor NPV of the modification approach by some factor and therefore likely increase the number of loans that go to modification under FDIC's decision rule.

Importantly, this shared appreciation mechanism would also act as a way to reduce the moral hazard fear that borrowers will intentionally default on their loans if they believe it will lead the lender to offer them a favorable modification.

Recommendation 9: Ameliorate tax consequences of foreclosure crisis.

Loan modifications containing a principal write-down or, in certain circumstances, a significant interest rate reduction, potentially cause tax liability for borrowers. Such taxes owed could threaten loan modifications with the best chance of succeeding. The Mortgage Forgiveness Debt Relief Act of 2007 is narrowly written and therefore will not help most homeowners who have refinanced their mortgages and/or consolidated any other debts into their mortgages. A legislative solution should ensure that homeowners are protected more broadly against extra taxes, which will prevent later problems when struggling families are surprised by a tax bill they cannot pay.

Recommendation 10: Permit judicial modification of mortgages in Chapter 13 bankruptcy.

Another effective way to break through the barriers put up by servicers and investors to effective and fair modifications is to empower a court to implement an economically rational solution where the parties cannot do so on their own. This would solve the servicers' fear of investor lawsuits (no liability can arise from compliance with a court order), would solve servicers' financial incentives and lack of qualified staff, and would solve the problem of junior lien holders, whose cooperation can be compelled by the court. This is what bankruptcy courts do every day, for all manner of debts, except for the mortgage on the primary residence.

Bankruptcy is not a solution of first resort. But if all other efforts by borrowers, government agencies, and others fail, then consumers should have the right to the full protection of a bankruptcy court as an ultimate recourse. Simply knowing that a loan could be restructured by a bankruptcy court if the borrower and servicer/investor cannot find an equitable accommodation earlier likely will change the servicers' and investors' cost-benefit analysis in ways that could favor more aggressive efforts to modify loans.

Currently, a loan on a family's primary residence is the only secured debt that cannot be restructured in a chapter 13 payment plan bankruptcy.²¹ The home mortgage exception dates to the enactment of the current Bankruptcy Code in 1978, and was included in the Code to advantage mortgage lending. Mortgage lending then was a conservative business, and home mortgages were nearly all fixed-interest rate instruments with low loan-to-value ratios. If a family ran into financial trouble, the home mortgage itself was rarely the source of the distress. Moreover, lenders held mortgages on their own books and so had the incentive and ability to modify loans when appropriate.

²¹ The relevant provision is found at 11 USC §1322(b)(2), which empowers the court to "modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or of unsecured claims."

Whatever the merits of the exclusion in 1978, the mortgage market has shifted considerably since then. First and foremost, lenders typically no longer hold the loans and so no longer have the ability to modify where appropriate. Further, in the last six years, loan originators aggressively marketed complicated loans that started with affordable payments that were set to increase substantially. These subprime and Alt A loans could not be sustained absent repeated refinancing, which depended upon a rising housing market. In these circumstances, the home mortgage exception does not make sense. Moreover, in the current economic downturn, homeowners across the economic spectrum are more vulnerable to foreclosure because fallen property values and stressed credit markets limit the ability to sell or refinance. If borrowers cannot restructure these debts, they will be forced into foreclosure. Today, the home mortgage exception is contributing to the downward economic spiral. The recent announcement of a compromise proposal endorsed by Sen. Richard Durbin (D-IL), the measure's Senate sponsor, and Citigroup, limiting the bill to existing loans and requiring borrower contact to receive a modification before filing, is a positive development that should accelerate adoption of this change.²²

There is clear precedent for eliminating the home mortgage exception. Congress implemented a similar measure in response to the farm crisis of the 1980s when an economic downturn and depressed land values were pushing family farmers into foreclosure. Congress enacted the Family Farmer Bankruptcy Act of 1986, for the specific and express purpose of permitting bankruptcy judges to modify mortgages on family farms, permitting adjustment of interest rates and the reduction of principal to fair market value, in order to help distressed farmers avoid foreclosure, including on their primary residence. Chapter 12 proved effective in helping farmers through the crisis, and did not give rise to any of the problems, discussed below, that are now raised as concerns about the current bill. In fact, after being extended several times, the Act was made a permanent part of the Bankruptcy Code, with bipartisan support, in 2005.

C. Addressing Performing Mortgage Assets

Market conditions have brought mortgage interest rates to historically low levels. Yet millions of current homeowners have been unable to take advantage of these lower rates. Some borrowers have positive equity in their homes, but plunging home values have reduced these to an extent that a refinancing would require a loan-to-value ratio above 90 percent. Such loans typically require mortgage insurance or some other form of credit enhancement in order to be eligible for sale to Fannie Mae or Freddie Mac. But private mortgage insurance is either unavailable or too costly because of the mortgage crisis' impact on mortgage insurers. Other borrowers had positive equity in their homes before the downturn, but falling home prices now mean that they are effectively underwater, with their outstanding loan balance higher than the home's current appraised value.

Lenders who own whole loans in this situation have a strong incentive to facilitate refinancings through streamlined modifications because they already hold the credit risk on the loans. Reducing monthly payments on the current outstanding balance only improves the likelihood that the loan will repay. Fannie Mae and Freddie Mac have similarly aligned interests with the homeowner when they own the loans. But these interests are not clearly aligned on mortgage debt held in private label securities on homes that are "underwater" where borrowers are current in their payments and making every effort to continue to do so. These borrowers are locked out of the refinance market because servicers and investors will not modify current interest rates on performing loans, and new lenders are unable to offer financing for underwater properties. Billions of dollars of potential consumer demand is locked up in older home loans that could be released through a refinancing of performing loans.

Recommendation 11: Create an FHA-insured streamlined program that would insure refinancings of performing loans up to 120 percent LTV.

There is an estimated \$1 trillion in outstanding, current Alt-A and subprime debt held in private label securities, and about 42 percent of these are underwater.²³ Mortgage rates are at historic lows, and many of these borrowers are currently carrying mortgages that are 200 basis points or more above these rates. In addition, some of them are facing adjustable mortgage rate resets or other features that could reduce their ability to repay. These performing mortgagors

²² "Citi Reaches Deal with Lawmakers on Home Loans," *Washington Post*, January 9, 2009, <http://www.washingtonpost.com/wp-dyn/content/article/2009/01/08/AR2009010802368.html>

²³ The largest portion of these underwater loans are in a handful of seven states that have experienced the most dramatic house price declines – CA, NV, FL, AZ, MI and OH. Estimates of underwater loans are taken from *Inside B & C Lending*.

in many cases are victims of steep house-price declines caused by irresponsible credit decisions by others and are unable to refinance their current loans to take advantage of these lower rates and better terms as a result. Leveraging FHA insurance to help these borrowers refinance into lower cost, stable loans would achieve several important objectives:

1. It would have an immediate stimulative effect by reducing mortgage payments, in some cases by significant amounts. If a borrower is able to refinance out of a 7 percent \$200,000 loan into a 5 percent loan, both amortizing over 30 years, the monthly savings would be roughly \$250 per month, or \$3,000 per year in additional cash.
2. By encouraging continued repayment of outstanding mortgages, it would reduce the potential stream of foreclosures and the attendant reductions in surrounding property values.
3. Enabling refinancings would immediately reset the value of mortgage bonds in which these loans are held by providing a greater assurance of principal repayment above currently deeply discounted mark-to-market values. This would reliquefy the mortgage-backed securities (MBS) market, provide capital relief to institutions holding the instruments by enabling them to assign them a higher value, and deleverage the chain of transactions like credit default swaps and CDOs that are priced against these securities.

FHA would provide mortgage insurance to enable performing borrowers whose loans are underwater to refinance their current loans into new 30-year fixed rate loans. Loans would be limited to the applicable FHA maximum loan amount with no cash-out refinances allowed. Premiums for this insurance would be paid by the borrower. TARP funds could be used to provide contingent funding in the event that charged premiums for this coverage did not cover losses. Insurance would be capped at a maximum level of 120 percent LTV, and should only cover losses down to 80 percent of principal balance (so the loans could be bought by the GSEs). This coverage would provide an effective 40 percent guarantee of principal against a possible borrower default. This is 20 percent less of a guarantee than is proposed under the FDIC modification plan, which would offer a 50 percent government guarantee against a redefault.

Eligible borrowers would be restricted to owner-occupants current for at least the last 12 payments on their current loan. This is a high credit quality standard. It could be set to something lower to engage more borrowers, but the overall credit quality of the guaranteed book would be lower as a result. It also is possible that additional factors, such as liquid cash reserves on hand, overall debt to income ratios and other common underwriting standards could be used to further screen and qualify potential participants. However, the more terms are required, the more complex the underwriting of the new loan will become, slowing down turnover.

In return for the new credit insurance, borrowers would have to pay a fee and agree to have new payments automatically drafted from their checking accounts, to strengthen repayment performance.²⁴

This refinancing scheme could achieve several policy objectives. First, it could assist any current owner to take advantage of historically low interest rates and provide a stimulative effect in the economy by releasing cash from current mortgage payments. Second, it could give consumers a market-based escape from current Alt-A or subprime mortgages that servicers are unwilling to modify unless borrowers have missed payments. There are anecdotal reports of many homeowners struggling to make mortgage payments on time who are told by servicers that no modifications are possible on their loans unless they have become delinquent. This is a perverse incentive for borrowers to miss payments simply to achieve a more reasonable payment amount. FHA insurance could give these borrowers a clean exit strategy and convert Alt-A and subprime loans to 30 year fixed rate loans. Third, it provides performing borrowers with relief at a time when nonperforming borrowers are the focus of most policy initiatives. It rewards the good behavior of current, performing borrowers and incents their continued performance in an uncertain market environment. The initiative would help alleviate the moral hazard concern that assisting nonperforming borrowers will incent more borrowers to miss payments in order to benefit from some relief from their current obligations. Fourth, providing a means for these loans to refinance would enhance the value of the bonds now backed by them by providing a higher degree of certainty for a principal repayment on a portion of the outstanding book. This could have a positive capital impact on the institutions holding the bonds, inject new liquidity into the markets through

²⁴ Such automatic payment plans have proven to have a very high performance factor, with significantly lower delinquencies and defaults than on loans that are similar in all other respects. Such a requirement would ensure that mortgage debt is the highest priority in a consumer's spending and would effectively put such payments in the premier position for payment. Such a restriction is an appropriate trade off for the benefit of the new loan insurance.

more active trades, and deleverage the chain of other investments like credit default swaps and CDOs that are based on these securities.

It also could create new incentives for investors to undertake modifications of nonperforming loans remaining in the pools. These government-supported refinancings will generate pay-offs to investors in line with the subordination structures of the PLS. While the share of distributions will vary between different specific securities, the subordinated investors will get smaller amounts. As these “in the money” assets run off, the subordinated bondholders’ likelihood of receiving further returns diminishes, and the refinancings increasingly leave a much weaker remaining book of business. This decreasing prospect of any further return from the remaining loans could have the effect of realigning the interests of all the bondholders in favor of modifications or discounted sale to the government, as proposed earlier in this paper, in order to secure the highest possible return in the shortest possible time. In other words, by stripping out the performing assets, the refinancing initiative also could make the nonperforming loans easier to acquire and/or modify.

These refinancings could be accomplished using streamlined procedures to minimize costs and maximize participation by eligible borrowers. Servicers holding the current notes would use modified and streamlined approaches to modify the notes to reflect the new interest rate and then bundle the notes to swap into a new Fannie Mae or Freddie Mac security. The FHA insurance could be applied by the servicer if it has delegated underwriting authority, or FHA could authorize Fannie and Freddie to do so. The new securities could be sold to the Fed, or to Treasury at the new rates, and the cash then passed back through the trust to liquidate the original loan to the investors. The Fed or Treasury as the ultimate investors would receive the new interest payments. FHA would bear the risk of up to a maximum of 40 percent of the loss on a foreclosure, with the Fed or Treasury bearing the balance beyond ultimate sales recovery. Fannie and Freddie could also guarantee the remaining portions of the notes and charge a guarantee fee to do so, or the government could agree to purchase these notes without the traditional GSE guarantee. This would lower costs further to consumers, since the note rates would not include a guarantee fee, but would increase the ultimate risks to the government. Given the current capital constraints facing the GSEs, and the nature of the Treasury’s backstop arrangement with them, it isn’t immediately clear which path is likely to provide both the fastest execution and the best long-term value to the government.

Key concerns for FHA would include the following:

1. Adverse selection risk
2. Insuring in weak markets and risking steeper losses through further price declines
3. Potential high severity risk from defaults

Costs

There are an estimated \$1 trillion worth of currently performing Alt-A and subprime mortgages held in private label securities (*as of the end of 3Q2008*). Given the proposed limits on the program, significantly less than this amount would refinance using the insurance. Assuming a take up of half the total amount in this group for purposes of illustration, or \$500 billion, and a default incidence rate of 15 percent, higher than in normal times but significantly below current overall high levels in subprime and Alt-A loans, and a severity rate roughly calculated at a maximum of a 40 percent exposure, potential losses over 5 years in this program could range up to \$30 billion for FHA. This level of severity is consistent with market estimates of expected losses from these loans; if they are higher, the Fed or Treasury would be exposed to possible further loss. If they are smaller, or if home prices rise sufficiently while the loans are outstanding, there could be much smaller losses to both FHA and the ultimate investor. It is also unlikely that all borrowers will have severities at these highest rates, or that the amount of insurance coverage would be at the maximum level for all loans. But this calculation assumes the worst for all borrowers, thereby yielding an estimate that is more likely to reflect the worst case outcome. If a 1 point fee were charged to the borrower on the assumed outstanding balance of \$500 billion, \$5 billion would be raised to insure against losses. TARP funds or some other source of backstop would have to be available to augment insurance premiums for such coverage.

Recommendation 12: Use the GSEs.

Fannie Mae and Freddie Mac provide ready-made tools with high degrees of sophistication and expertise in the mortgage modification and asset acquisition/management business. Both companies have extended new tools to assist borrowers whose loans they own or guarantee, including Home Saver Advances[©] that provide borrowers who have missed payments a personal loan that allows them to become current; a standardized modification program for

loans that have been taken out of mortgage security pools; a foreclosure moratorium²⁵; and allowing renters to remain in foreclosed properties. Fannie Mae recently announced an extensive effort to enable renters to stay in homes and to offer them the opportunity to buy the homes. Freddie Mac has indicated it has similar plans.

Under Conservatorship and the terms of the Treasury investment in September, 2008, both firms are laboring under certain restrictions that make their greater involvement problematic. These include limitations on their overall debt; expectations that they will begin shrinking their portfolios by 10 percent per year beginning in 2010; and large amounts of long-term maturing debt that may prove difficult to roll over because of regulatory and market conditions. However, if these problems could be remedied and the GSEs given a clear mission by the Conservator to engage aggressively in modifying mortgage assets, exploring innovative ways to standardize servicing through acquisition of a platform, and other means, we believe that they could be a powerful tool in this effort.

The GSEs could be used as the principal means to acquire mortgage assets in Recommendation 7.1.

The GSEs also could be the source of liquidity for the refinancing of performing assets. While these would now carry an FHA credit enhancement, they could be held in either of the GSE portfolios, or the GSEs could be used as the purchase conduit to create securities for the Fed or Treasury to buy and hold.

FHA could authorize the GSEs to place FHA insurance on loans they acquire through the proposed performing borrower refinance program when originating lenders are not delegated underwriters. FHA also could do this to encourage new borrowers who need loans with above 90 percent LTV who cannot obtain private mortgage insurance, by allowing FHA insurance to be placed by the GSEs on such loans that receive “approve” recommendations from the GSEs’ automated underwriting engines.

The GSEs also could be used to create or acquire and support a special servicing platform that would provide “best in class” models of servicing distressed assets and increasing the success of modification efforts. Because of their large participation in the market and ability to use such a platform across a potentially large universe of loans, especially if they are used to acquire mortgage assets, they could have a significant impact. There likely would be industry resistance to this effort because of concerns about expansions in the GSEs’ approved activities, and fear of their potential competitive advantages. However, given servicers’ myriad failures to effectively address the current crisis, establishing such a capacity within the GSEs is a reasonable step.

²⁵ Both Fannie Mae and Freddie Mac have extended this moratorium until January 31, 2009

ADDENDUM 1.1

A. Foreclosure Mitigation Using Net Realizable Value and Second Lien Mortgages

- A mitigation approach that provides beneficial incentives for both financial institutions and homeowners
 - Preserves homeownership by allowing owners to refinance to an affordable new mortgage.
 - Financial institutions retain an equity share in the property with the possibility of sharing in future home appreciation rather than writing-off losses today.
- New Refinanced First Mortgages will be offered to households in foreclosure and will be sized based on the lesser of:
 - the Market Value, as determined by an appraisal, broker’s price opinion or automated valuation model,
 - the Net Realizable Value, as calculated based on the savings to a lending institutions associated with refinancing the property today rather than assume the uncertainty of carrying a property for some indeterminate time in a declining market and selling on the open market through a broker, or
 - the maximum affordable mortgage based on the gross income and household size of the homeowner.
- Financial institutions will establish second lien mortgages on the properties, sized based on difference between first mortgage and outstanding debt.
- A wide variety of mortgage sources:
 - New first mortgage could be funded through tax-exempt bonds, Federal Housing Administration (FHA), Fannie, Freddie, etc.
 - Second lien mortgages could be purchased by Troubled Assets Relief Program (TARP) or a secondary market could be created.

B. Foreclosure Mitigation Term Sheet

Term	FHA Hope Provisions	Proposed Program
Qualifying Property	No limit on the home price. But, the maximum amount of the new mortgage must not exceed 132% of the 2007 FHA limit. FHA 2007 Loan Limit = \$417,000. Max new Loan limit would be equal to 417,000 x 132% = \$550,440.	[Same] [Property in good repair] [Single family, condominium] [No manufactured housing]
Qualifying Income	No Limit.	[Same]
Qualifying Loan	No qualifying loan provisions – presumably any type of loan could be refinanced. The program does not begin until 10/1/2008 and ends 9/30/2011.	[No qualifying loan provisions; any loan can be refinanced; program start and end date TBD]
Owner Occupied	Must be principal residence of the borrower.	[Same]
Qualifying Borrower	Borrower must “lack capacity to pay existing mortgage.” <ul style="list-style-type: none"> • Borrower must certify that i) has not intentionally defaulted on mortgage or ANY other debt and ii) hasn’t furnished materially false information to obtain a mortgage; • As of 3/1/2008 borrower must have a ratio of total mortgage to debt income of at least 31%. Borrower must not have been convicted of fraud, including mortgage fraud.	[Additional requirement: Must be 90 days delinquent or foreclosure action begun] [Debt/Income ratio of 31%?]

Term	FHA Hope Provisions	Proposed Program
Voluntary Program	All lienholders must agree to the refinancing.	[Same]
Waiver of Prepayment Penalties and Fees on Existing Mortgage	Prepayment/refinancing fees and all fees/penalties related to default/delq on the existing mortgage must be waived or forgiven.	[Same]
Determination of Principal Amount of New Mortgage	No greater than 90% of the appraised value of the property to which the existing mortgage relates. Any appreciation is shared between FHA and borrower.	[New mortgage is sized on the lesser of (a) the Net Realizable Value of the property based on the attached pricing formula or (b) the current appraised value of the property or (c) the maximum amount of debt the homeowner can afford based on the underwriting criteria of the Program]
Sharing Losses Between Existing Lienholders	The HOPE Board will establish procedures by which all lienholders will share losses. The Board is also permitted to establish policies to allow for payment to existing subordinate lienholders of a portion of the future appreciation that is owed to FHA. (See comment above related to FHA's share of appreciation.)	[Existing loan is bifurcated into New Mortgage sized as above and a new 2 nd mortgage equal to the difference between the Original Mortgage and the New Mortgage]
Terms of New Mortgage	Fixed rate with a principal amortization term not less than 30 years.	[Same]
Extinguishment of Existing Loans	ALL holders of outstanding mortgage liens shall agree to accept proceeds of new mortgage as payment in full.	[Same]
New Second Mortgage: Terms	N/A	Co-terminus with New Mortgage. Due on sale or refinance. Equity share with homeowner in proportion TBD.
Prohibition on Second Liens	No new second liens for the first 5 years of the new mortgage (See comments.)	[Same]
FHA Insurance Premium	3% upfront mortgage insurance premium (MIP) and 1.5% annual MIP	[FHA and other sources of financing for New Mortgage are allowable.]
Tax-Exempt Bond Authority	No such provision.	[Eligible]
Duration of the Program	No new commitments for refi may be entered into after 9/30/2011.	[TBD]

C. Key Assumptions Used in Valuation Worksheet

- The Valuation Worksheet provides an illustrative example of how a loan mitigation might be restructured.
- The analysis assumes an original purchase price of \$300,000 with a 100% loan-to-value loan.
- Three periods are depicted:
 - Pre-foreclosure: the period in which debt service payments are delinquent. This model assumes a 90-day delinquency period.
 - Foreclosure: the period in which a foreclosure action is taken. This model assumes that the process takes 120 days.
 - Real estate owned (REO): the period after foreclosure when the financial institution has taken title to the property. This model assumes that it takes 120 days for the financial institution to sell the property through a broker from the time that they take title.
- The analysis assumes mitigation action in the fourth month, in lieu of foreclosure proceedings.
- The analysis assumes that the market value of the property declines by 2% per month, as determined by an appraisal, a broker's price opinion or an automated valuation model.
- Holding costs during the pre-foreclosure and foreclosure periods include debt service, real estate taxes, insurance, utilities, and maintenance. Additional holding costs after foreclosure include interim repairs, which presumably have been deferred, administrative costs, third party costs and a broker's fee upon sale.
- The new First Mortgage is calculated based on the lesser of:
 - Market Value,
 - The Net Realizable Value, as calculated based on the savings to a lending institutions associated with refinancing the property today rather than assume the uncertainty of carrying a property for some indeterminate time in a declining market and selling on the open market through a broker, or
 - The maximum affordable mortgage based on the gross income and household size of the homeowner.
- The Second Lien Mortgage is calculated based on the difference between the Original Outstanding Debt and the First Mortgage.

ADDENDUM 1.2

The following paper is included particularly because of its lucid explanation of the ways in which mortgage bonds have been leveraged through the use of collateralized debt obligations (CDOs) and credit default swaps (CDS). We do not endorse the paper's recommendations, but believe their analysis is a helpful supplement to the information we have provided, and we drew on their observations in formulating our recommendations.

MEMORANDUM ON REMEDIATION OF SUBPRIME MORTGAGES

By Verum Capital, www.verumcapital.com

One of the most prevalent misconceptions about the bailout is the assumption that the government must decide whether to use its limited resources to help Main Street (the homeowners) or Wall Street (the institutions that own the mortgages). Ironically there is no tension between these two objectives: *the most efficient means of bailing out Wall Street would be for government to shore up Main Street by fixing mortgages*. Momentum has been building to refinance borrowers current on subprime mortgages into affordable fixed rate loans as a means of preventing foreclosures and stabilizing the housing market. The government should also encourage the private sector to remediate delinquent loans in subprime securitizations. By allowing borrowers current on subprime mortgages to refinance into GSE-style loans and encouraging banks to work together to purchase and modify delinquent securitized loans, the government would help homeowners, boost the real estate market, inject capital into the banking system, and cleanse the balance sheets of institutions that hold illiquid structured assets exposed to subprime risk.

Verum Capital has been working for the past year on the remediation of securitized non-performing mortgages. Our examination of the banking sector's levered exposure to certain Residential Mortgage Backed Securities (RMBS) has led us to conclude that the remediation of non-performing mortgages is a taxpayer efficient means of enabling the banking system to help homeowners by reducing foreclosures while reversing significant mark-to-market losses.

Leveraged Exposure to Subprime Mortgages

The government should encourage the banking system to purchase and modify delinquent mortgages from RMBS to which banks have a leveraged exposure. This will cause the same leverage that contributed to the current credit crisis to work in favor of the bailout initiative. Purchasing mortgages at Par from certain RMBS securitizations will return more principal to investors than the cost of any losses on such purchases. By focusing on the underlying mortgages, the bailout can repair the RMBS that hold the mortgages, the derivatives that refer to the RMBS, the collateralized debt obligations (CDOs) that are invested in RMBS, and the derivatives that refer to these CDOs.

Financial institutions acquired exposure to RMBS by investing directly, by unwinding Structured Investment Vehicles (SIVs), and by taking risk to senior tranches of CDOs that invested in RMBS which, given the erosion of the subordinate classes of a CDO, is now equivalent to owning each of the RMBS in which the CDO invested.

CDOs gave rise to the leverage that makes it cost effective to buy delinquent mortgages from certain subprime securitizations. Starting in mid-2005, collateral purchased by CDOs tended to include not only cash RMBS securities but also Credit Default Swap (CDS) contracts that referenced these securities. This is illustrated by considering the \$55 billion of mezzanine CDOs underwritten in 2006. These CDOs purchased approximately \$50 billion of mezzanine RMBS collateral, despite the fact that only \$14 billion of mezzanine RMBS securities were issued. The difference was comprised almost entirely of CDS contracts. The advent of CDS in CDOs made it possible for the market as a whole to build up an exposure to a given class of an RMBS securitization that was larger than the size of that class, in particular the classes rated A3 through Baa3. The total notional of CDS referencing a cash bond often exceeds the notional of the cash bond, in some cases by a multiple of 40 to 50 times. The total amount of CDS on RMBS written by CDOs was over \$125 billion.

Suppose that a given subprime securitization comprises a mezzanine bond with \$10 million outstanding and a senior bond with \$90 million outstanding, and suppose that speculators shorted the mezzanine bond by entering into CDS on an outstanding amount of \$50 million. Then the exposure multiple¹ for the securitization is 1.5. Suppose the market price of the mezzanine bond is 20% and the price of the senior bond is 70%, with a resulting weighted average bond price of 65%. The Mark to Market (MTM) loss to the Street as an aggregate investor in the bonds of this RMBS securitization is $\$90 \times (\text{Par} - 70\%) + (\$10 + \$50) \times (\text{Par} - 20\%)$, or \$75, which is 75% of the "tower" (i.e., 75% of the aggregate outstanding balance of the bonds in the securitization). The MTM gain on the CDS "short" positions (the net buyers of CDS protection) is $\$50 \times (\text{Par} - 20\%)$, or \$40, which is 40% of the tower.

Private Sector Subprime Remediation

Subprime remediation is a private-sector initiative to be performed with the encouragement of the government that will eliminate much of the leverage that magnifies the banking system's subprime exposure while reducing the cost of mortgage defaults. The purchase of delinquent loans out of the RMBS, or remediation of the RMBS, would allow participating financial institutions to avoid losses on the group's aggregate exposure to the RMBS in return for taking losses on the underlying loans purchased from the RMBS. The participants would remediate securitizations where the benefit (avoided losses on the aggregate exposure to the RMBS) exceeds the cost (expected losses on the underlying loans) under severely stressed scenarios.

Under standard RMBS documentation, the servicer is allowed to sell delinquent loans to a third party at Par. A consortium of banks that in aggregate have a leveraged exposure to an RMBS securitization could use this mechanism to purchase delinquent loans from a subprime RMBS trust to be serviced outside the securitization. Some important consequences of remediation would be:

1. After being removed from the securitization, mortgages can be more readily modified, including significant write-downs of principal, in order to prevent foreclosures.
2. Because no significant losses are realized within the securitization, bonds will not be written down.
3. MTM losses on the Street's levered exposures to bonds in the securitization will be reversed.
4. MTM gains on speculators' short positions will be reversed.
5. The remediation activity will incur mortgage workout losses expected to be as much as 40% on 2005 vintage subprime loans and as much as 50% on the 2006 vintage.
6. Because losses avoided on the Street's levered exposures are conservatively projected to outweigh losses incurred on mortgage workouts, remediation of levered subprime exposures will result in capital creation for the banking system.
7. The costs of recapitalization through remediation will be shared by the Street (the "longs") and speculators (the "shorts").

Recall the example mentioned above, in which the weighted average bond price of every tranche of a subprime RMBS was 65%. Ignoring any subordination in the form of overcollateralization the expected value of the loan collateral supporting the deal should also be equal to 65%. If loans worth 65% are purchased at 100%, this will produce an expected cost of remediation of 35% (loans purchased at 100% that should be MTM at 65% would result in a cost of 35%). Recall also that the loss implied by the MTM of the street's exposure to the RMBS calculated above was 75%. Avoiding a loss of 75% at a cost of 35% will *result in a gain to financial institutions exposed to the RMBS of 40% (or 75% - 35%) of the tower.*

Financial Statement and Capital Considerations

Many financial institutions have taken enormous mark-to-market losses on U.S. RMBS. While the realized losses on mortgage collateral held by subprime securitizations are still quite low, expected future losses are substantial. The current convention for marking-to-market a bank's RMBS exposure is to calculate the present value of a tranche's projected cash flows, adjusted for expected future losses, at a rate of approximately 20%. Marking to market RMBS exposures given these assumptions (extreme losses and high discount rates) has been the major cause of the erosion in capital of U.S. banks and broker dealers. A contractual agreement among a consortium of banks that commits the banks to purchase delinquent collateral at par from an RMBS servicer *should enable the banks to immediately realize mark-to-market gains on certain RMBS exposures.*

What is Required of Treasury

In order to facilitate large scale remediation, the Treasury should:

1. encourage regulated financial institutions to participate in RMBS remediation
2. give these institutions comfort on possible anti-trust and market-manipulation concerns
3. require participating institutions to take write-downs or provide mortgage insurance sufficient to qualify delinquent borrowers meeting certain criteria to refinance into government-sponsored enterprise (GSE)-style loans

Benefits

Encouraging large scale remediation would have the effect of contributing to the recapitalization of the banking system without requiring additional Government investment. For example, there are 120 subprime securitizations that have a current outstanding of a little over \$35 billion. The market's long exposure to these securitizations is \$73 billion, and most of this exposure is held by the banking system. The estimated mark-to-market of this long exposure is approximately \$23 billion, and the resulting loss is approximately \$50 billion (\$73 billion minus \$23 billion). Large scale remediation would allow the banking system to reverse this loss, at a projected cost of \$10 - \$15 billion in losses on the underlying loans. The resulting gain to financial institutions after marking to market the expected cost of remediation would be approximately \$35 - \$40 billion. Even if participation were limited to as few as six financial institutions, the gain resulting from remediation to this group would be about \$10 billion.

Government Assistance Can Leverage Private Sector Investment

Although remediating \$35 billion of RMBS would result in a significant return of capital to the banking system, it would involve only a small percentage of the total amount of subprime RMBS outstanding. The following three government initiatives would increase the amount of RMBS susceptible to remediation:

1. encourage widespread participation in remediation as mentioned above
2. facilitate refinancing for large numbers of subprime borrowers *current* on existing mortgages
3. purchase delinquent loans from existing securitizations under the TARP program

The senior bonds of later vintages of subprime securitization (2006 and 2007) have not amortized as much as the senior bonds of the earlier vintages (2004 and 2005). The market is currently very pessimistic as to the performance of these senior bonds. Allowing performing borrowers in 2006 and 2007 securitizations to refinance will cause the senior bonds in these vintages to amortize. One consequence of this will be to return principal to investors thereby injecting capital into the banking system. Another result will be to make a greater number of 2006 and 2007 subprime securitizations susceptible to remediation, which will result in a further creation of capital for the banking system at no expense to the U.S. tax payer.

In the following pages we have attached diagrams of Leveraged exposure and remediation as well as an example of the possible accounting treatment of the remediation of a specific RMBS.

Notes:

1. An investor may hold subprime risk in any of the following forms: whole loans, RMBS bonds (or CDS thereon), and through an investment in a tranche of a CDO. In the case of the default of an unsecuritized mortgage (a whole loan), an investor will experience a loss equal to the loss severity. In the case of the default of a securitized mortgage (a loan in an RMBS trust), there may be multiple investors who experience a loss as a result of the default: the holder of the affected cash RMBS bond, the holder of a CDS referencing this bond, and the holder of a tranche of a CDO owning such bonds and/or CDS.

The combined loss to all investors affected by a securitized mortgage default will be a multiple of the loan loss severity equal to:

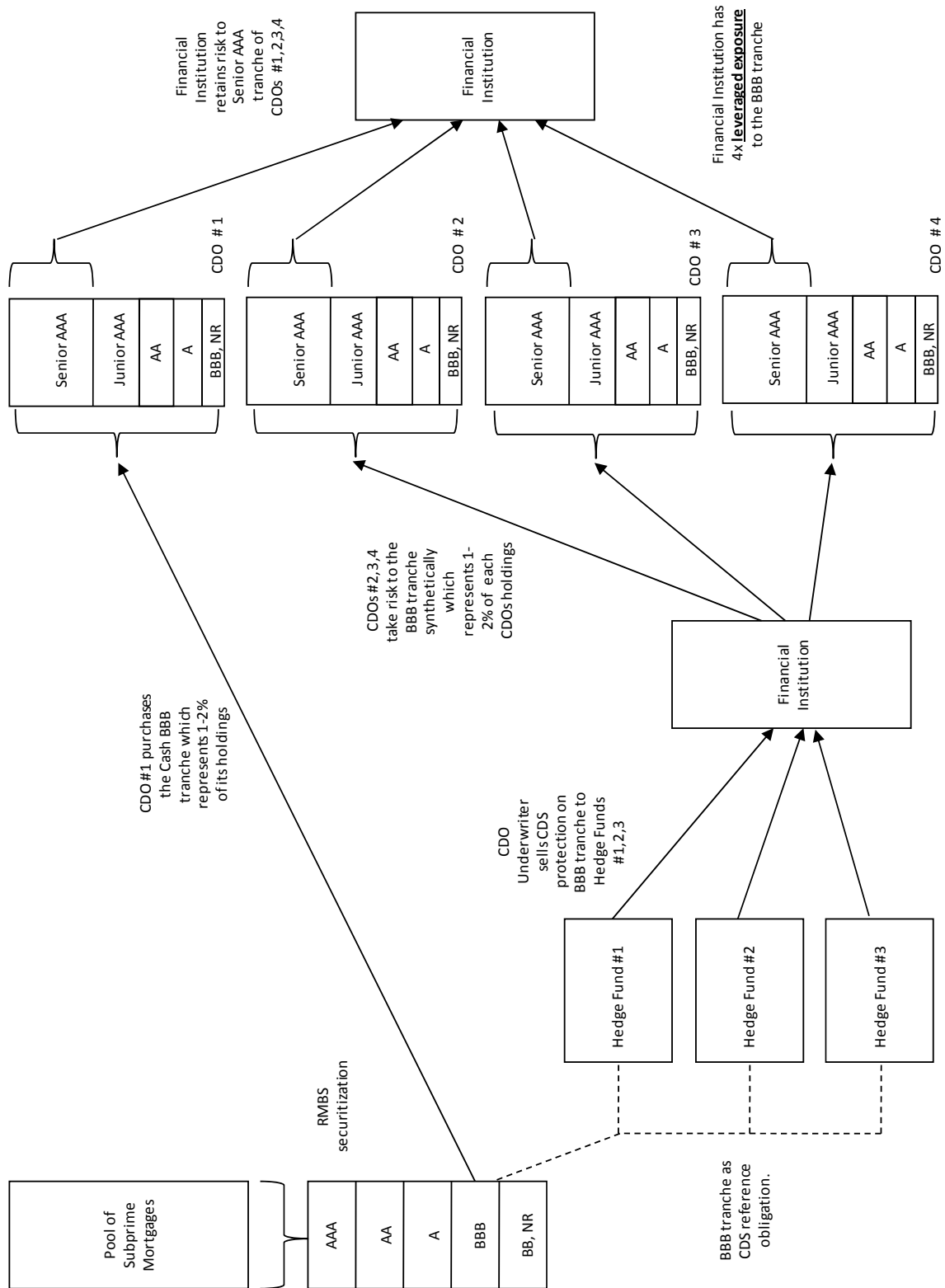
$$\text{Security loss multiple} = 1 + (\text{aggregate affected CDS size}) / (\text{affected RMBS bond size})$$

The potential exposure to loan losses for all investors in all the bond classes of a given RMBS securitization (the "exposure multiple") is equal to:

$$\text{Exposure multiple} = 1 + (\text{aggregate size of all CDS referencing any bond in the securitization}) / (\text{aggregate size of all bonds in the securitization})$$

The Street has a "levered exposure" to any RMBS securitization with an exposure multiple greater than one.

CDS written by CDOs gave rise to leveraged exposure to RMBS



Financial institutions now have direct leveraged exposure to RMBS

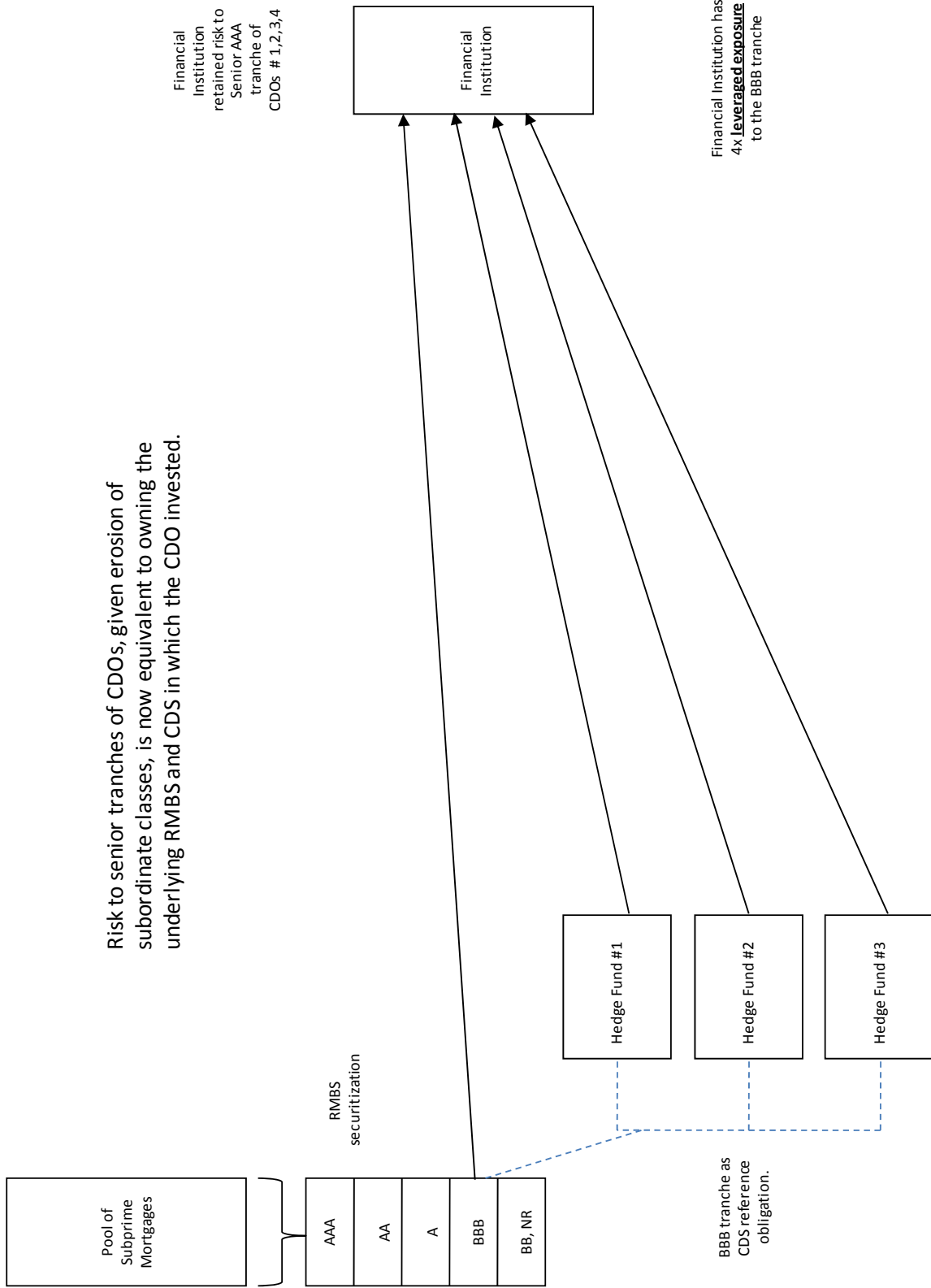
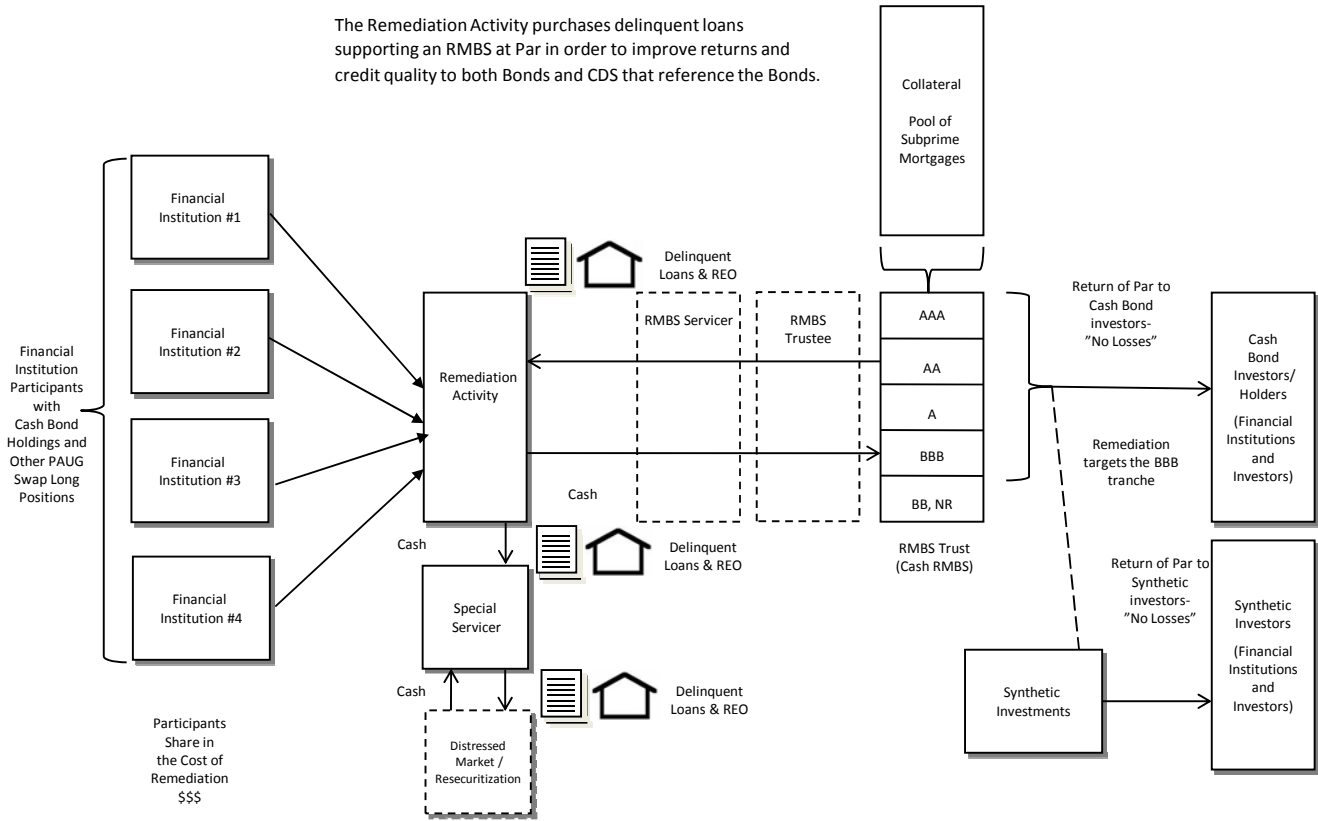
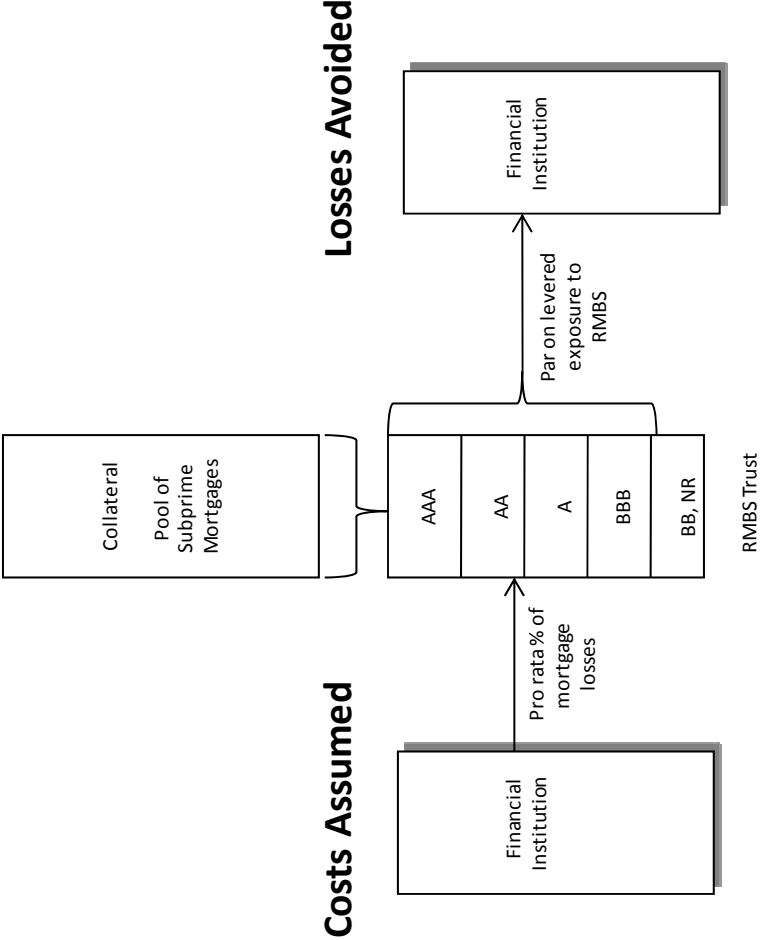


Diagram of Remediation

The Remediation Activity purchases delinquent loans supporting an RMBS at Par in order to improve returns and credit quality to both Bonds and CDS that reference the Bonds.



Economics of remediation to a participating financial institution



The Financial Institution’s leveraged exposure to tranches of the RMBS becomes riskless once the Financial Institution commits to remediation and agrees to assume a pro rata share of losses on defaulted mortgages purchased from the RMBS.

Cost/Benefit Analysis of the remediation of a specific RMBS by a group assumed to consist of six major Financial Institutions.

RFC05KS7 remediated by: 6 major Financial Institutions

Class	Original Rating	ABX Mapped Px	Outstanding	Group Exposure	Group Benefit (1-Px) X Exposure	Bank Exposure	Bank Benefit (1-Px) X Exposure	Bank % of Benefit	Group Cost (1-Px) X		Bank Benefit - Bank Cost
									Outstanding	Bank % of Cost	
a2	Aaa	87.14%	27,486,106	-	-	-	-	30%	3,534,713	1,056,908	
a3	Aaa	87.14%	10,388,000	-	-	-	-	30%	1,335,897	399,444	
m1	Aa1	69.97%	14,802,000	3,000,000	900,900	3,000,000	900,900	30%	4,445,041	1,329,104	
m2	Aa2	52.80%	13,202,000	5,500,000	2,596,000	-	-	30%	6,231,344	1,863,223	
m3	Aa3	41.94%	8,001,000	-	-	-	-	30%	4,645,647	1,389,087	
m4	A1	31.07%	7,401,000	-	-	-	-	30%	5,101,263	1,525,320	
m5	A2	20.21%	6,801,000	-	-	-	-	30%	5,426,518	1,622,574	
m6	A3	16.62%	6,401,000	2,000,000	1,667,533	2,000,000	1,667,533	30%	5,336,940	1,595,789	
m7	Baa1	13.04%	5,801,000	2,551,000	2,218,435	-	-	30%	5,044,743	1,508,420	
m8	Baa2	9.45%	5,001,000	67,501,000	61,122,156	10,000,000	9,055,000	30%	4,528,406	1,354,031	
m9	Baa3	8.73%	4,601,000	113,851,000	103,911,808	43,750,000	39,930,625	30%	4,199,333	1,255,635	
Sub Total			109,885,106								
Other subordination (m10 and OC)			12,827,155								
Total			122,712,261	194,403,000	172,416,831		51,554,058		49,829,844	14,899,535	36,654,523
Collateral Performance											
DQ 90 days		6.26%									
Foreclosure		14.11%									
REO		6.72%									

Possible accounting treatment of the impact of remediation of RFC05KS7 on one participant

Tranches	ABX Mapped Px	MTM prior to remediation	MTM @ 100 post remediation	Gain
m1	69.97%	2,099,100.00	3,000,000	900,900
m6	16.62%	332,466.67	2,000,000	1,667,533
m8	9.45%	945,000.00	10,000,000	9,055,000
m9	8.73%	3,819,375.00	43,750,000	39,930,625
Gross MTM Gain on Tranche positions				51,554,058
MTM of remediation obligation				(14,899,535)
Net MTM Gain				36,654,523