Mortgage Servicers: Impediments and Possibilities

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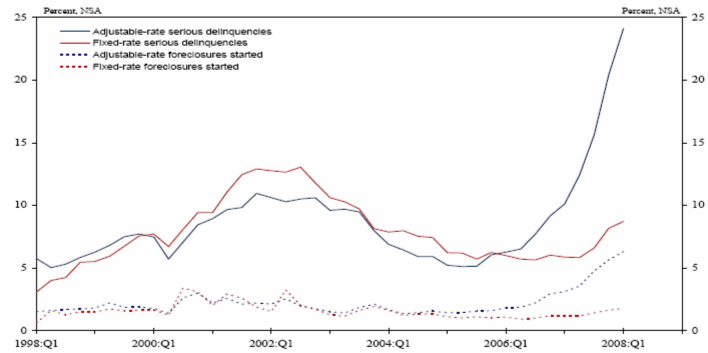
Figure 2
Subprime Mortgage Serious Delinquency & Foreclosure Start Rates
1998:Q1 to 2008:Q1



Source: Mortgage Banker's association.
Notes: Foreclosures started is the percentage rate of loans for which a foreclosure was initiated. Serious delinquencies are loans 90+ days past due plus those in foreclosure.

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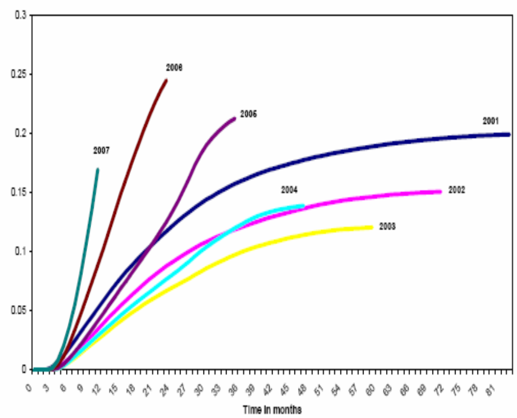
Figure 8
Cumulative Default rates on Subprime 2/28 ARMs by Origination Year: 2001-2007



Source: Federal Reserve Board staff calculations from First American LoanPerformance data (as of January 2008).
A default is a mortgage entering the foreclosure process.

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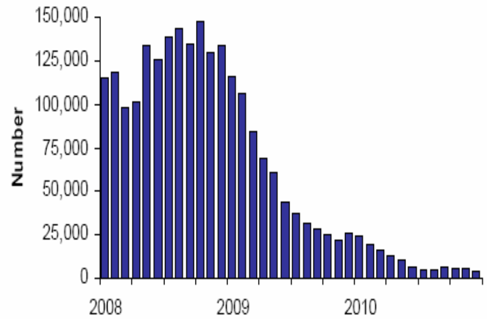
Number of Subprime ARM Resets
(as of 4th quarter 2007)



Source: Federal Reserve Board calculations from First American LoanPerformance data.

Paulson Plan

- What initiated the Paulson Plan?
  - Increasing number of defaults in the subprime sector
  - Large volume of ARM resets in 2008
  - Declining home prices

- December 6, 2007, Treasury Secretary Paulson announced a streamlined process to help facilitate loan modifications for a segment of subprime borrowers.
  - Voluntary plan to modify ARMs that are held in securitized pools => prior to the interest rate reset
    - Interest rate freeze at the introductory rate for 5 years
  - Help align the interests of investors and homeowners
  - Lenders were expected to modify loans held in portfolio if so desired.

Paulson Plan

- Who could be modified?
  - Adjustable rate mortgages which includes 2/28s and 3/27s hybrid loans
  - Loan must be originated between January 1, 2005 and July 31, 2007
  - Interest rate reset must occur between January 1, 2008 and July 31, 2010
  - Borrower must be current or at worst 30-days delinquent and have no more than 1 60-day delinquency over the past 12 months
  - Borrower must occupy the property
  - FICO score must be less than 660 and cannot increase more than 10% from the original FICO
  - No apparent fraud
  - Borrow cannot be eligible for FHA Secure loan program.
    - An original loan-to-value ratio greater than 97% on 1st lien
    - Or if delinquency history, debt-to-income ratio or loan balance makes borrower ineligible

Paulson Plan by the Numbers

- How many borrowers will be impacted?
  - Securitized ARMs that are owner occupied and originated between 1/1/05-7/31/07
    - ***Number of loans = 2,177,876***
  - Loans that will experience an interest rate reset between 1/1/08-7/31/10
    - ***Number of loans = 1,615,197***
  - Loans that are more than 30 days delinquent and had more than 1 sixty day delinquency in the past 12 months
    - ***Number of loans = 1,202,487***
  - Loans not eligible for FHA Secure program
    - **Number of loans = 941,887**

The Role of Mortgage Servicers

- Bill and collect payments and fees from mortgage holders
- Monitor non-discretionary payments (e.g. taxes, insurance)
- Manage delinquencies to minimize losses and maximize asset recoveries, acting as the agent of the trustee
- Manage mortgage insurance recoveries, if applicable
- Advances on delinquent loans
- Remit payments to trustee
- Provide required information to trustees/investors regarding the performance of asset pools

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Economic Incentives

- MAXIMIZE CASH FLOWS TO INVESTORS
    - Foreclosures may maximize cash flows on a NPV basis
- Compensation structure for servicers
    - Revenues: receive 25 (prime) to 50 (subprime) basis points to oversee mortgage pools, plus float and fees
        - Servicers in the subprime sector are more heavily dependent on fees to cover costs
    - Expenses: current market environment significantly increases costs
        - Labor intensive process => increasing customer service may require increasing other parts of the process => customer service to REO management
            - The need to hire extra personnel and other costs may require 125 basis points to cover the cost of doing business in this market
                - For example: loan workouts cost $1,000 per workout

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Modifications May Not Help

- Investor may be worst off after a loan is modified
  - A large percentage of modified loans may eventually default
    - Estimates ranging from 40% to 60%
  - Other problems with modifying loans:
    - Class warfare => mortgages tend to be held in securitized pools where investors have different incentives based on where they are in the capital structure
      - Complicates how servicers should respond => increases risk of litigation

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Accounting Rules

- FAS 140 allows the following:
  - Requires giving up control of the assets. Securitizing under FAS 140 transfers assets into a "special purpose entity"
    - Provides for regulatory capital relief for originators
  - These SPEs have to be "brain dead." If they make business decisions (or if servicers make them on their behalf) it violates FAS 140 and the originating bank has to bring the assets back on balance sheet
    - Need for more regulatory capital
  - A modification is a business decision. Previously, rules were interpreted to mean that servicers could not modify loans unless they are in default
    - SEC clarification: loan restructurings or modifications when default is reasonably foreseeable does not preclude an institution from continuing to treat serviced mortgages as off-balance sheet exposures

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What Is Working?

- Need more data
  - Generate data at the community and neighborhood level
    - Ex: inventory levels, the direction housing prices are moving, absorption rates, home price indices,…
  - Markets can be very different within a county or MSA
    - Can lead to inappropriate solutions to resolve troubled loans
  - Risk managers need data when formulating an appropriate loss mitigation strategy

What Is Working?

- Aggressive outreach
  - Partnering with community-based and non-profit organizations to reach out to borrowers
    - Helps to increase response rate of borrowers
      - Letterhead
      - Contact borrowers
  - Use risk models or risk metrics to identify borrowers that are potentially at risk before they get into trouble
    - Ex: Pre-emptive loan modifications

What Is Working?

- Customize servicing model
  - The previous housing environment may have created an economic incentive for some lenders to use third party servicers
    - Third-party servicing => is a volume business where representatives handle 500 to 1,000 files at a time
  - The current housing environment requires servicers to be flexible and focused
    - Servicers have to spend more time with each borrower
      - Fewer files increases the likelihood of a successful resolution => 150 files at a time

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What Is Working?

- Sell loans
  - Lenders can sell distressed loans by taking haircuts
    - Move poorly performing loans off the books
  - Investors who purchase distressed loans are now in a better position to work with borrowers to keep them in the home=> built in capital cushion
    - Problem: Lenders may be reluctant to take haircuts on loans and incur a capital expenditure when lenders are capital constrained on the balance sheet and external capital is expensive or in short supply

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What Do We Know?

- Loan modifications as a percentage and share of loan workouts are increasing
- The current housing environment is unusual and servicers are being forced to learn on the job
  - Challenges continue to outweigh successes
    - Some actions by servicers/lenders appear to be slowing down foreclosures
- Interest rate cuts helped reduce the number of borrowers needing assistance

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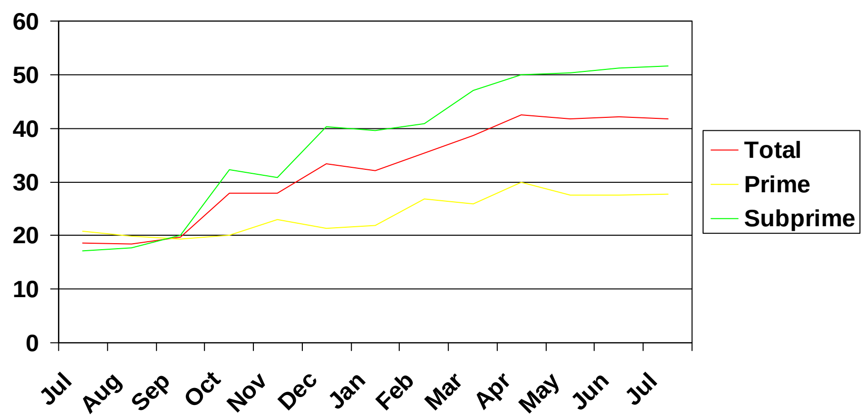
Modifications as a Percentage of Workout Plans (2007-2008)



Source: Mortgage Banker's Association

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Loan Modification Example

- ***Loan characteristics:***
  - 30 year loan
  - $250,000 loan amount
  - Zero down payment
  - 8% interest rate for 3 years and 12% interest rate for the remainder of the loan
- ***Unmodified loan:***
  - Borrower defaults 6 months after loan reset and the house is sold 3 months later for a 50% recovery rate
    - **Total NPV = $61,343.19**
- ***Modified loan:***
  - Servicer allows the borrower to keep paying 8% interest rate after the loan was expected to reset
  - Borrower defaults nine months after the interest rate was suppose to reset
  - House is sold 3 months later for a 50% recovery rate
    - **Total NPV = $60,875.60**
- **This example shows that modification can decrease NPV of cash flows**

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Questions?

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