Regulatory Update: Mortgage Foreclosures

Wisconsin Moves Forward to Address Foreclosures

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Fed Announces Expansion of new Term Securities Lending Facility

- Fed will lend up to $200 billion of Treasury securities to primary dealers.
- Securities pledged to the Fed can include federal agency debt, federal agency residential mortgage backed securities (MBS), and non-agency AAA/Aaa-rated private-label residential MBS.

Fed Announces Expansion of new Term Securities Lending Facility

- The TSLF is intended to promote liquidity in the financing market for Treasury and other collateral and thus foster the functioning of financial markets.
- Just like the current program, securities will be made available through an auction process.

The Rise in Mortgage Delinquencies and Foreclosures

- Mortgage delinquencies began to rise in mid-2005.
- Subprime ARMs have had the worst payment problems (more than 20% of the 3.6 million loans outstanding were seriously delinquent as of 12/31/07).

The Rise in Mortgage Delinquencies and Foreclosures

- Delinquency rates reached 8% for subprime fixed-rate loans and 6% on ARMs secured in alt-A pools.
- Roughly 1.5 million foreclosures last year, versus less than 1 million in 2006 and 2005.

Subprime Delinquencies Linked to Lack of Equity

- Nearly 40% of 2006 subprime loans had loan-to-value ratios exceeding 90%.
- Recently, small downpayments were combined with lack of documentation.

Delinquencies and Foreclosures will Continue to Rise

- Excessive numbers of houses on the market.
- Many subprime borrowers are facing resets of their interest rates.
- In 2008, 40% of subprime ARMs are scheduled to reset.
- Interest rates will reset from about 8% to about 9.25%; raising payment by 10%.

Subprime Borrowers are Facing Strong Headwinds

- The refinancing market has closed down.
- Tighter credit conditions in the market.
- New securitizations of nonprime mortgages have halted.
- Commercial banks have tightened their standards.
- Evidence suggests that there are very few nonprime loans being originated.

A Vigorous Response is Needed

- Reducing preventable foreclosures is key.
- For communities, foreclosures reduce house prices and lower tax bases.
- Nationally, foreclosures are adding to the inventory of vacant unsold homes, further pressuring house prices and the housing industry.

Helping Distressed Borrowers

- Expanding refinancing opportunities and increasing the pace of loan workouts is key.
- Solutions must be sustainable and consistent with the safety and soundness of the lender.
- An effective response must also be fair.

Recent Efforts to Help Distressed Borrowers Refinance

- FHASecure plan is targeted to qualified borrowers who are delinquent because of an interest rate reset.
- FHA temporarily increased the maximum loan value eligible for FHA insurance up to $729,750 in the highest-cost areas.
- These higher caps also apply to mortgages purchased by Fannie Mae and Freddie Mac.

Loss-Mitigation Arrangement between Lenders and Borrowers

- Board of Governors of the Federal Reserve System (2007), "Working with Mortgage Borrowers," Division of Banking Supervision and Regulation, Supervision and Regulation Letter SR 07-6 (April 17);
- Board of Governors of the Federal Reserve System (2007), "Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages," Division of Banking Supervision and Regulation, Supervision and Regulation Letter SR 07-16 (September 5).

Loss-Mitigation Arrangement between Lenders and Borrowers

- For the lender or servicer, working out a loan makes sense if the NPV of payments under the strategy exceeds the NPV of payments under foreclosure.
- Loss mitigation is made more attractive because foreclosure costs are often substantial.

Foreclosure Losses are Growing

- For subprime mortgages foreclosed in 4Q 2007, total losses exceeded 50% of principal.
- As the time to liquidation increases, so does uncertainty about the losses.
- Uncertainty about expected losses in a foreclosure suggest considerable room for negotiating a mutually beneficial outcome.

Workout Options Face Serious Constraints

- Mortgage securitization and the constraints faced by servicers may make workouts less likely.
- Trusts vary regarding modifications, and this raises operational compliance costs and litigation risks.
- Therefore, servicers may not pursue workout options that are a win-win for investors and borrowers.

Servicers Substantially Increased Loan Workouts

- Surveys indicate that servicers substantially increased the number of loan workouts during late 2007.
- The Hope Now Alliance estimates that workouts of subprime mortgages rose from about 250k in 3Q 2007 to about 300k in 4Q 2007.
- Workouts of prime mortgages rose from 150k to 175k during the same period.

Repayment Plans have been the Preferred Loss-Mitigation Technique

- Lenders and servicers have relied on repayment plans, where borrowers typically repay the mortgage arrears in addition to making regular payments.
- These plans work if the borrower has suffered a reversible setback.
- Anecdotal evidence suggests that borrowers on repayment plans re-default at a high rate.

Loan Modifications with Permanent Changes may be Preferred

- Loan modifications that involve a permanent change to the mortgage contract, may be preferred when the borrower can’t make the repayment plan’s higher payments.
- The monthly payment is reduced through a lower interest rate, an extension of the maturity, or a write-down of the principal balance.

Principal Reductions may be More Effective

- Permanent modifications typically involved a reduction in the interest rate, while principal reductions are rare.
- However, with low or negative equity, stressed borrowers have less incentive to stay in the home.
- Principal reductions that restore some equity may be more effective at avoiding delinquency and foreclosure.

Reduction in Interest Rate or Principal Writedown?

- Understandably, lenders are reluctant to write down principal.
- Interest rate reductions are favored because most mortgages terminate before maturity.
- However, principal reduction may increase expected payoffs for “under water” mortgages by reducing the risk of default and foreclosure.

Preventable Foreclosures Could be Reduced by Short Payoffs

- A short payoff is a transaction where the lender agrees to accept less than it is owed to permit a sale of the property, i.e., the sale is “short” of the amount owed.
- Servicers could accept a principal write-down in order to enable a refinance.
- Writedowns that enable refinancings remove downside risk to investors.

FHA Modernization May be Key

- FHA could help more borrowers if they were allowed to set underwriting standards and risk-based premiums for mortgage refinancing.
- Servicers might refinance only their riskiest borrowers into FHA, but careful underwriting could prevent this.

Contact Information

Steve Kuehl

Consumer Regulations Director

Federal Reserve Bank of Chicago

Consumer & Community Affairs - 11th Floor

230 South La Salle Street

Chicago, IL 60604-1413

steven.w.kuehl@chi.frb.org

Direct: (312) 322-5015

Fax: (312) 913-2626