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 delinqudent 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

- FHA Secure 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);
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