Feature Article:

The Case for Loan Modification

With a Foreword by Sheila C. Bair, Chairman
Federal Deposit Insurance Corporation

Foreword

Residential mortgage credit quality continues to weaken, with both delinquencies and charge-offs on the rise at FDIC-insured institutions.[1] This trend, in tandem with upward pricing of hybrid adjustable-rate mortgage (ARM) loans, falling home prices, and fewer refinancing options, underscores the urgency of finding a workable solution to current problems in the subprime mortgage market. Legislators, regulators, bankers, mortgage servicers, and consumer groups have been debating the merits of strategies that may help preserve home ownership, minimize foreclosures, and restore some stability to local housing markets.

On December 6, 2007, an industry-led plan was announced that will help avert foreclosure for certain subprime homeowners who face unaffordable payments when their interest rates reset. This plan provides for a streamlined process to extend the starter rates on subprime ARMs for at least five years in cases where borrowers remain current on their loans but cannot refinance or afford the higher payments after reset. An important component of the industry-led plan is detailed reporting of loan modification activity. Working with the Treasury Department and other bank regulators, the FDIC will monitor loan modification levels and seek adjustments to the protocols if warranted.

I have long advocated a systematic and streamlined approach to loan modification that puts borrowers into long-term, sustainable mortgages. I support the industry plan as a means to allow borrowers to remain in their homes, provide investors with higher returns than can be obtained under foreclosure, and strengthen local neighborhoods where foreclosures are already driving down property values. It is my hope that this plan will be implemented in a way that delivers real progress on these important policy goals.

Sheila C. Bair, Chairman
Federal Deposit Insurance Corporation

[1] *FDIC Quarterly Banking Profile*, Third Quarter 2007, http://www2.fdic.gov/qbp/2007sep/qbp.pdf.

The Case for Loan Modification

The text of this article is based on testimony delivered by Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, on December 6, 2007, before the U.S. House of Representatives Financial Services Committee.

Problems in the subprime mortgage market are affecting the U.S. housing market and the economy as a whole and pose a serious policy challenge for the industry and regulators. About 1.7 million hybrid loans worth $367 billion are scheduled to undergo their first reset during 2008 and 2009.[2] This wave of mortgage resets, in combination with the decline in home prices and limited refinancing options, could prompt hundreds of thousands of additional mortgage foreclosures over the next two years. These foreclosures will hurt individual borrowers and their communities, as they potentially could place further downward pressure on home values.

This article summarizes the current situation in the subprime mortgage market. It describes loan modification as a straightforward strategy the mortgage industry can undertake on its own to minimize unnecessary foreclosures and return some measure of stability to housing markets. Misconceptions about the effects of such an approach are also addressed.

U.S. Housing Markets and Mortgage Credit Performance Have Deteriorated

The U.S. housing boom of the first half of this decade ended abruptly in 2006. Housing starts, which peaked at more than 2 million units in 2005, have plummeted to just over half that level, with no recovery in sight. Home prices, which were increasing at double-digit rates nationally in 2004 and 2005, are now falling in many areas across the country (see Chart 1). As home prices decline, the number of problem mortgages, particularly in subprime and Alt-A portfolios, is rising.[3] As of third quarter 2007, the percentage of subprime adjustable-rate mortgages (ARMs) that were seriously delinquent or in foreclosure reached 15.6 percent, more than double the level of a year ago (see Chart 2).[4] The deterioration in credit performance began in the industrial Midwest, where economic conditions have been the weakest, but has now spread to the former boom markets of Florida, California, and other coastal states.

During the past year, investors and ratings agencies have repeatedly downgraded assumptions about subprime credit performance. A Merrill Lynch study published in July estimated that if U.S. home prices fell only 5 percent, subprime credit losses to investors would total just under $150 billion, and Alt-A credit losses would total $25 billion.[5] On the heels of this report came news that the S&P/Case-Shiller Composite Home Price Index for 10 large U.S. cities had fallen in August to a level that was *already* 5 percent lower than a year ago, with the likelihood of a similar decline over the coming year.

The complexity of many mortgage-backed securitization structures has heightened the overall risk aversion of investors, resulting in what has become a broader illiquidity in global credit markets. These disruptions have led to a precipitous decline in subprime lending, a significant reduction in the availability of Alt-A loans, and higher interest rates on jumbo loans (see Chart 3). The tightening in mortgage credit has placed further downward pressure on home sales and home prices, a situation that now could derail the U.S. economic expansion.

Subprime Hybrid Mortgages and Securitization

The crisis in subprime mortgage lending began with the rapid growth of two- and three-year adjustable-rate subprime hybrid loans after 2003. Between year-end 2003 and mid-2007, some 5 million of these loans were originated. Of these, slightly more than 2.5 million loans representing $526 billion of mortgage debt remain outstanding.

[2] Estimates are based on the LoanPerformance Securities database. They reflect data collected through August 2007 on first-lien mortgages secured by owner-occupied properties where the mortgage has been securitized in private mortgage-backed securities issues. These figures have been adjusted to include an estimate of subprime securitized loans that are not included in the LoanPerformance database.

[3] Alt-A loans are those made under expanded underwriting guidelines to borrowers with marginal to very good credit. Alt-A loans are riskier than prime loans because of the underwriting standards of the loans, not necessarily the credit quality of the borrowers.

[4] Mortgage Bankers Association, *National Delinquency Survey Q307.* Data cited are not seasonally adjusted.

[5] Merrill Lynch, "Mortgage Credit Losses: How Much, Where, and When?" July 20, 2007.

Chart 1

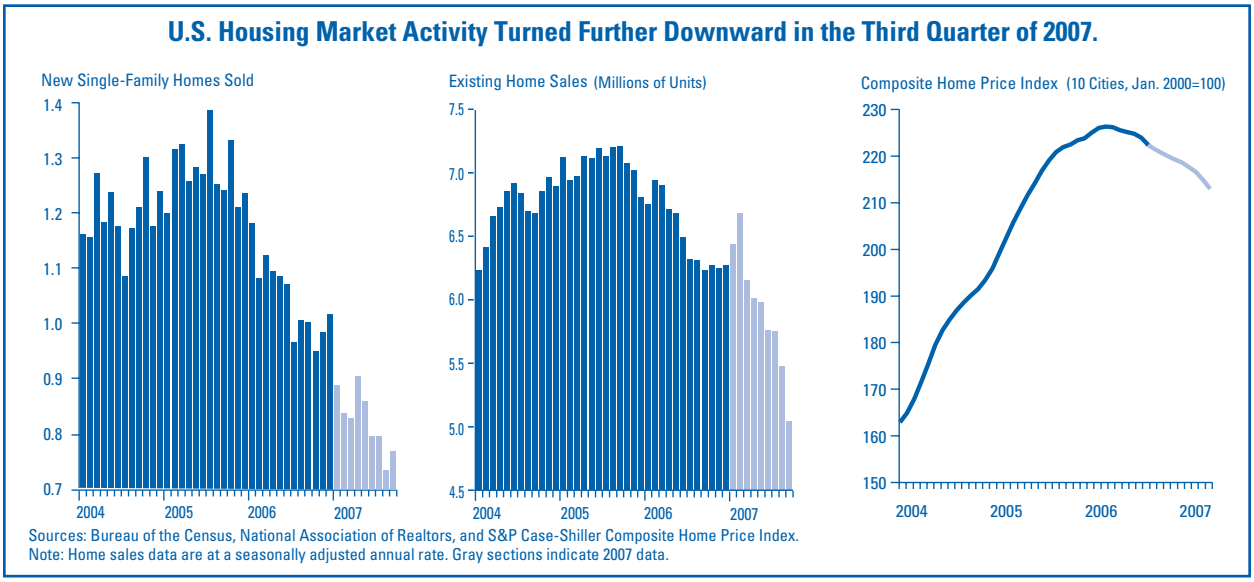


Chart 2

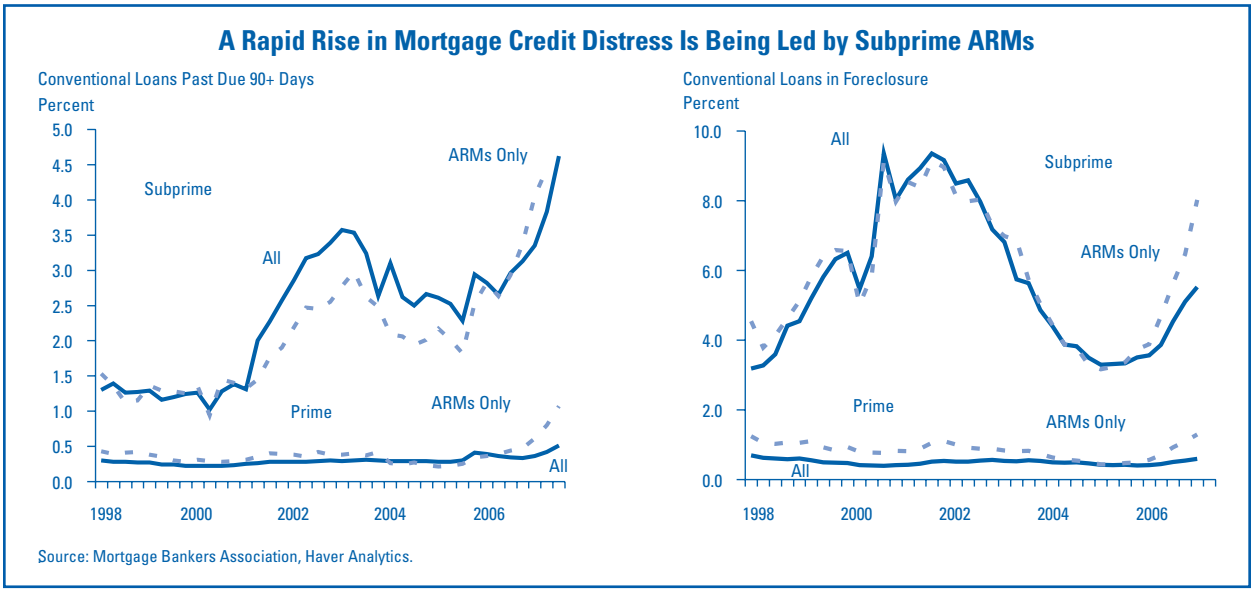
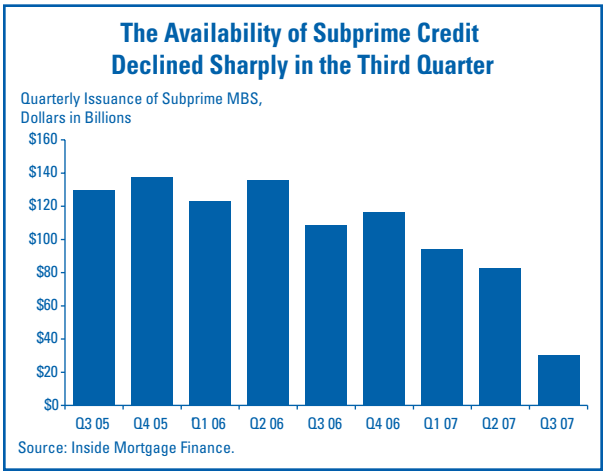


Chart 3



The typical structure of these loans provides for a fixed starter rate (typically between 7 and 9 percent) for the first 24 or 36 months, followed by a series of steep increases in the interest rate (typically 300 basis points during the first year after reset) and a commensurate rise in the monthly payment (see Table 1). Almost three-quarters of subprime mortgages securitized in 2004 and 2005 were structured in this manner, as were more than half the subprime loans made in 2006. Most of these loans, commonly referred to as 2/28 and 3/27 ARMs, also imposed a prepayment penalty if the loan was repaid while the starter rate was in effect.

Despite the steep "payment shock" built into these loans, they performed reasonably well until last year. As recently as second quarter 2006, just 6.5 percent of subprime ARMs were seriously delinquent. Rapid rates of home price appreciation in many areas of the country allowed even highly leveraged borrowers to refinance or sell their home when the loans reset without a loss to themselves or mortgage investors, masking the underlying weakness of the structure and underwriting of these loan products. However, in today's more challenging environment, the ability of borrowers to refinance is limited, and payment reset will more often lead to default and foreclosure.

Table 1

Hybrid Loan Borrowers May Experience a Series of Rate Reset Shocks

Weighted-Average Interest Rates for Two- and Three-Year Nonprime First Lien Hybrids

Origination Year	Average Initial Rate	Maximum Rate at First Reset	Maximum Lifetime Interest Rate
2003	7.37	9.79	13.67
2004	6.85	9.41	13.16
2005	7.23	9.79	13.53
2006	8.23	10.77	14.53

Source: LoanPerformance ABS database. Data for nonprime two- and three-year hybrids included in private label securitizations. Data current through August 2007.

All averages are weighted by loan origination amount.

The securitization of subprime hybrid ARMs has been very common in recent years and increases the complexity of achieving loan modifications. Once these loans are placed in a securitization trust, the assessment of borrower ability to repay is determined by the loan servicer. As stated in the pooling and servicing agreement (PSA), the servicer's primary objective is to maximize the value of the assets in the securitization trust; therefore, the servicer's interests are primarily aligned with the investor's.[6] When confronted with a distressed borrower who will impact the trust's cash flow, the servicer must (1) protect the interests of investors and (2) conduct a net present value (NPV) analysis to determine the appropriate loss mitigation strategy in a default scenario. Although initially there was concern that the securitization documents and the PSAs might constrain servicers' ability to modify loans in the pool, most documents provide the servicers with sufficient flexibility to do so. In practice, however, third-party servicers have been slow to exercise this flexibility on a large scale.

In addition to maximizing asset value, servicers must ensure that they pursue loss mitigation actions that will present the least amount of loss to the pool. Generally, servicers that conduct an NPV analysis and conclude that the NPV of the modified loan payments is greater than the anticipated net recovery in the case of foreclosure may assert that the modification is in the best interest of the securitization of the pool as a whole. In many circumstances, particularly in the case of a declining housing market, the cost of modification will be less than the cost of foreclosure.

A Proposal for Loan Modification

The seriousness of the problems in the subprime mortgage market points to the need for new and innovative strategies to limit the immediate fallout in a way that

[6] The PSA describes the servicer's roles and responsibilities. It also discusses the servicing of the mortgage loans and addresses foreclosure and loss mitigation alternatives, including modifications.

will not harm the credit markets over the long run. The proposal that has garnered the most support in recent months is *loan modification* targeted at the group of loans that remains current at the starter rate, but may face default and foreclosure after rates reset.

This approach applies the notion of triage to subprime borrowers. Conceptually, subprime borrowers can be divided into three basic groups:

- Loans already past due under the starter rate that either cannot be remedied or will need to be re-underwritten and restructured on a case-by-case basis;
- Well-structured and well-underwritten loans that can reasonably be expected to perform after reset without modification; and
- Marginal loans that have remained current prior to reset, but likely will not remain so after reset without modification.

Based on available data on securitized subprime loans, it is difficult to estimate precisely the size of each group. We do know that of the 1.7 million subprime loans worth $367 billion scheduled to reset during 2008 and 2009, some 221,000 loans are already at least 90 days past due or in some stage of foreclosure before reset.[7] This represents a reasonable estimate of the first group, which is made up of more difficult cases where problems go deeper than just the interest rate reset.

We can also roughly estimate the size of the second group—loans that can reasonably be expected to perform after reset without modification—in terms of loan characteristics at origination. However, because these loans were underwritten according to standards that were well below traditional industry norms, the number that can be expected to perform after reset appears to be small. Of loans scheduled to reset in 2008 and 2009 that remain current, only 2.9 percent (or about 50,000 loans) show a combined loan-to-value ratio below 80 percent and a debt service-to-income ratio below 30 percent at origination. This implies that the third group—loans that remain current prior to reset but face a higher likelihood of problems after reset—may range as high as 1.4 million loans.[8] A strategy of either streamlined refinancing or streamlined restructuring, or both, appears to offer the greatest potential to improve outcomes for all parties when applied to this third and largest group of subprime loans.

When feasible, the best option appears to be providing opportunities for borrowers to refinance their high-cost loans into affordable fixed-rate loans. Refinancing provides a near-term, full recovery of principal to investors and the potential for a long-term, stable source of financing to borrowers. However, the decision to refinance must take into account the availability and cost of credit to marginal borrowers, as well as the transactions cost to borrowers, including any prepayment penalties. The disruption of mortgage and credit markets that has taken place since mid-2007 has curtailed access to credit for many subprime and Alt-A borrowers, and sharply limited terms on credit for others. In response to these developments, private and government-related loan programs have been established to help expand refinancing options for subprime borrowers. For example, an estimated 240,000 subprime borrowers will eventually be able to refinance under the new *FHASecure* program.[9]

In the remaining cases where refinancing is not an option, servicers will be left with a very limited set of choices as they try to maximize the net proceeds of loans under their management. The standard procedure has been to wait until the loan enters default and then initiate foreclosure proceedings. While this strategy makes sense in an environment when defaults are relatively rare and home prices are stable, it becomes increasingly self-defeating in situations where defaults are common and home prices are falling. It is in these situations that a shift toward streamlined restructuring can help servicers maximize the amount of monthly payments that come in from borrowers and minimize the credit losses that arise from foreclosure.

The rapid pace of resets—nearly 100,000 per month at present—and the deterioration in housing market conditions argue for a systematic, rather than a one-

[7] Estimates are based on the LoanPerformance Securities database. They reflect data collected through August 2007 on first-lien mortgages secured by owner-occupied properties where the mortgage has been securitized in private MBS issues. These figures have been adjusted to include an estimate of subprime securitized loans that are not included in the LoanPerformance database.

[8] It should be noted that as we move into 2008, the total number of loans scheduled to reset will tend to decline as loans default or are paid down, and the proportion of loans that are seriously delinquent prior to reset will tend to rise over time. The net effect is likely to be a gradual decline over time in the number of loans considered candidates for restructuring.

[9] Federal Housing Administration press release, August 31, 2007. http://www.fha.gov/press/2007-08-31release.cfm.

at-a-time, approach to the problem. Moving forward on a wholesale basis in cases where reset is the problem will free up resources for servicers to concentrate on more difficult cases where the solutions may be more complicated and time consuming. The key issue is how to address mortgage loans for owner-occupied properties where the borrowers are current on their payments but will not be able to maintain the payments following reset. Where the homeowner has remained current at the starter rate, but cannot make the higher reset payments, a better strategy is to modify the loan to keep it at the starter rate for a period of five years or more.

Correcting Misconceptions about Mortgage Restructuring

Subprime hybrid loans represent a relatively recent development in mortgage lending, and one with which many people have little or no firsthand experience. In addition, loan restructuring represents a significant departure from the standard servicing practices that are pursued under normal market conditions. For these and other reasons, a number of popular misconceptions have arisen with respect to this strategy which, it can be argued, do not necessarily hold up well in light of present facts.

Misconception: Restructuring is a bailout of subprime borrowers and/or investors.

The emergence of large financial sector losses sometimes results in the failure of depository institutions. In these cases, losses that would have been borne by insured depositors are covered by the FDIC Deposit Insurance Fund (DIF) under applicable laws and administrative rules. However, financial distress also often results in proposals for and against other types of ad-hoc government "bailouts" in the interest of financial stability. The critics of financial bailouts are generally correct; in the end bailouts usually end up benefiting one group at the expense of another and undermining market discipline on risk taking.

In this case, however, those criticisms do not apply for the following reason: this is in no way a government bailout. The proposal being discussed is one where servicers attempt to restructure loans on their own in the interest of investors. If successful, they will have implemented a shift in servicing strategy to the benefit of all interested parties. But in no case is there a subsidy, implicit or explicit, of investors or borrowers that would result in cost-shifting or undermine market discipline. On the contrary, renegotiation of loan terms is a common private financial practice in times of distress; in this case the problem is convincing servicers that they have the legal flexibility to shift strategies and that doing so will improve the outcome for investors.

Misconception: Restructuring violates the contractual rights of investors.

Streamlined restructuring is a strategy that can be pursued voluntarily by servicers in the interest of investors under existing PSA agreements. The significant deterioration we have seen in mortgage credit performance and housing market conditions points to this strategy as a means to maximize the total net present value of securitized subprime mortgages. Given that this is the legal mandate of servicers, it is not surprising that they have begun to embrace this approach more often as conditions have worsened. But as long as this path is chosen voluntarily by servicers under their existing PSAs, and as long as they can demonstrate that their strategy is to maximize the proceeds of the pool, it is difficult to argue that doing so represents a violation of anyone's contractual rights.

Misconception: Restructuring will create a windfall for subprime borrowers.

Some have expressed concern that restructuring subprime loans to a fixed percent of interest at the starter rate will result in a windfall for subprime borrowers. This misconception is based on the belief that the starter rates for these loans are similar to the low 1 to 2 percent "teaser" rates that were aggressively advertised for prime borrowers. In fact, of subprime hybrid mortgages originated in the first quarter of 2006, the average starter rate was 8.28 percent, which exceeded the weighted-average rate on subprime fixed-rate loans made in that same quarter (7.93 percent) and was well above rates paid on prime fixed-rate loans. Therefore, these subprime borrowers will continue to pay subprime rates even after restructuring.

Misconception: Restructuring will deny investors their expected return.

Another popular misconception is that restructuring will deny investors a considerable stream of interest payments that would rightfully accrue to them after the loans reset to the full contract rate. The reality is that very few hybrid borrowers actually remain in the pools after reset and pay the full contract rate. Among such loans made and securitized in 2003, only one in 30 is

still paying the full contract rate after just four years (see Chart 4).

The amount of additional interest income that accrues to investors after payment reset, the so-called *excess spread*, depends on the ability and willingness of borrowers to make monthly payments over the long term. However, the fact is that these loans generally were never designed or underwritten to perform at the full contract rate after reset. Among subprime hybrid loans made in 2006, nearly half had loan-to-value ratios above 90 percent, and more than half had monthly debt service-to-income ratios above 40 percent. About a quarter of these loans met both criteria.

If these marginal borrowers cannot perform at the full contract rate on the loans, then what can lenders expect to recover in a short sale or a foreclosure? Studies show that foreclosure costs can run to more than half the loan amount.[10] These loss rates are only going to rise in today's troubled housing markets, particularly if more subprime borrowers are pushed into foreclosure. Studies also show that foreclosures tend to drive down the value of nearby homes.[11] As these loans reset from the starter rate to the full contract rate, credit losses will mount as more borrowers default and enter foreclosure.

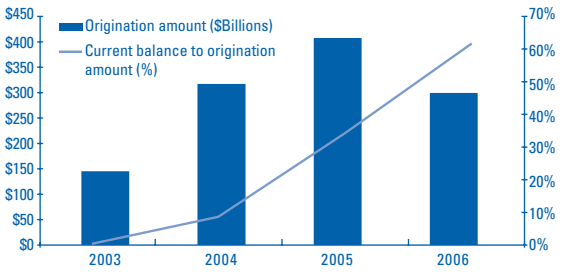
The basic math is this: given current conditions in housing and mortgage markets, as rates on these loans increase from the starter rate to the full contract rate, credit losses will rise faster than interest income. Thus, resets will be self-defeating for investors and will exert wider negative effects on local communities and the overall economy.

Misconception: Restructuring is unnecessary based on past levels of credit losses.

Some argue that based on past levels of credit losses, standardized and widespread restructuring of subprime hybrid ARMs is not needed at this time. However, previous experience with losses of subprime hybrid ARMs is a poor indicator of how these loans will perform going forward. For example, through August 2007, the cumulative default rate (CDR) for subprime hybrid loans originated in 2004 has been 10 percent; that is, of 1.6 million such loans originated that year, 162,000 have defaulted (see Table 2). However, these loans were made in a period of rapidly rising home prices in many parts of the country and underwent reset during a time of ready access to new subprime credit, making it relatively easy to repay 2004 vintage loans through refinancing or even the sale of the property.

Chart 4

The Dollar Volume of Hybrid Loans Remaining Current Diminishes Quickly With Seasoning



Source: LoanPerformance ABS database.
Note: Current ratio calculated as active dollar volume of loans current or less than 60 days past due to total origination dollar volume per year. Data include securitized nonprime first lien two- and three-year hybrid loans. Active status as of August 2007.

By contrast, loans resetting today are doing so in an environment of declining home prices in many areas of the country and a virtual absence of private subprime lending. Of hybrid loans originated in 2006, the CDR already has reached 10.5 percent—before any of these loans have reset. Under today's market conditions, interest rate reset likely will drive the CDR to levels much higher than experienced on previous vintages. This means that the benefits of restructuring cannot be measured against credit losses of prior years. Rather, the benefits must be viewed in the context of how many borrowers can afford to pay at the full contract rate when refinancing options are extremely limited and the value of the property has declined or not increased as anticipated.

Conclusion

Poor underwriting and abuses in the subprime mortgage market are exerting a significant negative impact on the housing markets and the U.S. economy. In the coming months, large numbers of subprime ARMs will reset to higher interest rates, and hundreds of thousands of borrowers will face default and possible foreclosure. The traditional approach taken by mortgage servicers is to wait for default and then pursue foreclosure.

[10] Karen Pence, "Foreclosing on Opportunity: State Laws and Mortgage Credit" (Federal Reserve Finance and Economics Discussion Paper 2003-16, May 13, 2003), p. 1.
[11] Dan Immergluck and Geoff Smith, "The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values," *Housing Policy Debate* (17:1) Fannie Mae Foundation (2006), www.fanniemaefoundation.org/programs/hpd/pdf/hpd_1701_immergluck.pdf.

Table 2

Performance of Two- and Three-Year Nonprime Hybrid Loans Has Deteriorated in Recent Vintages

Originations and Cumulative Default Rates for 2- and 3-Year Nonprime First Lien Hybrid Loans as of August 2007*				
Origination Year	**2003**	**2004**	**2005**	**2006**
Total number of 2- and 3-year first lien hybrids originated	827,347	1,620,924	1,928,064	1,330,900
Cumulative number of defaulted loans	82,924	162,099	226,124	140,297
Number of loans currently in foreclosure, bankruptcy, or REO	19,629	71,438	155,837	124,739
	As Percent of Loans Originated in Year			
Cumulative default rate	10.0%	10.0%	11.7%	10.5%
Percent currently in foreclosure, bankruptcy, or REO	2.4%	4.4%	8.1%	9.4%

*Default includes all loans which entered foreclosure, bankruptcy, or REO.

Source: LoanPerformance ABS database. Data for nonprime two- and three-year hybrids included in private label securitizations. Includes loans in subprime and Alt-A pools. Data current through August 2007.

While this may be the optimal approach for most loan types under normal market conditions, the large payment resets imposed on subprime hybrid borrowers will, in today's distressed housing market, require servicers to consider new strategies to limit credit losses and maximize the value of the mortgages they manage.

An emerging consensus suggests that a streamlined loan modification approach is not only feasible, but that it can reduce the cost and complexity of restructuring. On October 10, 2007, Secretary of the Treasury Henry M. Paulson, Jr., announced the formation of HOPE NOW, a private sector alliance of counselors, servicers, investors, and other mortgage market participants, that will maximize outreach efforts to homeowners in distress to help them stay in their homes and will create a coordinated plan to aid as many homeowners as possible.[12] In addition, on November 20, 2007, the Governor of California announced he has reached an agreement with several large loan servicers, including Countrywide, GMAC, Litton, and HomEq, to streamline "fast-track" procedures to help keep more subprime borrowers in their homes.[13] Developments such as these represent real progress on the part of the mortgage servicing industry in dealing with the ongoing mortgage credit crisis. They reflect a recognition of the benefits of restructuring and the potential costs of a business-as-usual approach to the problem. The ability of mortgage servicers to get ahead of the curve by embracing restructuring on a wider basis could, in the end, be one of the most important factors in limiting the depth and duration of the present mortgage credit crisis.

[12] For more information about the HOPE NOW alliance, see www.hopenow.com. The U.S. Department of the Treasury press release is available at http://www.ustreas.gov/press/releases/hp599.htm.

[13] "Gov. Schwarzenegger Works with Lenders to Help Homeowners Avoid Foreclosure," November 20, 2007 (press release available at http://gov.ca.gov/index.php?/press-release/8147).