

ViewPoint: Keeping Homeowners in Their Homes

A Proposal for Judicial Mortgage Restructuring

23 December 2009

We strongly favor keeping homeowners in their homes. It's good for homeowners. It's good for neighboring property values. It's good for lenders. It's good for the economy. It's good for America.

The real question is *how* to keep homeowners in their homes.

Over the past twenty-five years, homeowners have enjoyed the lower financing rates that resulted from the securitization of mortgage loans. In essence, homeownership was more affordable because mortgage rates reflected the strong demand from investors around the world for high quality securities backed by US mortgage loans.

Unfortunately, the credit crisis and its aftermath are fundamentally changing mortgages and the mortgage-backed securities markets, and threatening to make homeownership significantly less affordable. The Home Affordable Modification Program (HAMP) was created to encourage mortgage servicers to modify existing mortgage loans to make them more affordable. HAMP has not achieved its objectives. According to the program data released through November 2009, fewer than 900,000 mortgage loans have been modified on a trial basis. Of these loans, less than 35,000 have gone to a permanently modified status. According to the OCC and OTS Mortgage Metrics Report for Third Quarter 2009 (see Figure 1 below), default recidivism rates exceeded 30% nine months after loan modification even on loans where payments were lowered by at least 20%. And, the recidivism rates were substantially higher on loans where payments were decreased less than 20%.

What's Gone Wrong?

Even in the simplest situations, homeowners generally have multiple debts outstanding. It is not uncommon for a homeowner to have a first lien mortgage, a home equity loan (or second lien mortgage), credit card debts, auto loans, and/or student loans. Of these debts, the first lien mortgage is generally their lowest cost debt. Yet, HAMP focuses on modifying first lien mortgages without reducing what is often a crushing overall debt burden for the homeowner arising from the aggregation of all of their debts. Imagine a bankruptcy judge in a corporate Chapter 11 case reducing the company's secured and least expensive debt, not modifying the company's unsecured debts, and allowing the company to emerge from Chapter 11 with debts that they cannot service? Even with modification of the first lien mortgage, in many cases homeowners still have more debt than they can service based on their earnings, hence the high incidence of re-default.

In addition to not keeping homeowners in their homes, the HAMP approach rewrites the basics of creditor rights. Forbearance or modification of the first lien, whether in the form of reduced interest rates or forgiving principal, essentially puts the first lien holder in a "first risk" position rather than in a secured debtholder position. As a result, the holders of the home equity loans and unsecured consumer loans, such as credit cards, are benefiting at the expense of the investors in the first lien mortgage (see Figure 2 on the following page).

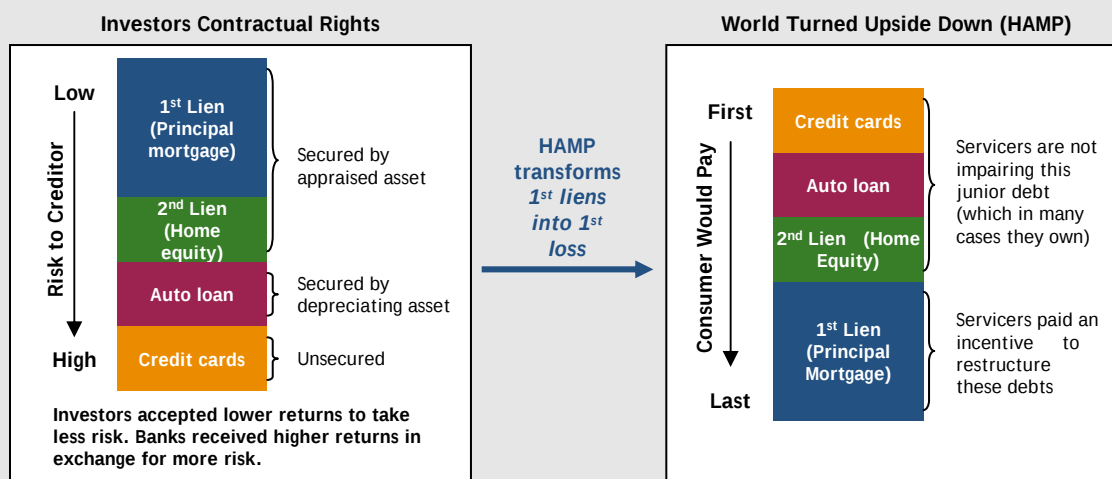
Figure 1: Re-Default Rates of Loans Modified in 2008-2009 by Changes in Payment (60 or More Days Delinquent)*

	3 Months after Modification	6 Months after Modification	9 Months after Modification	12 Months after Modification
Decreased by 20% or More	14.9%	26.7%	33.6%	38.6%
Decreased by 10% to Less than 20%	19.9%	32.9%	41.8%	47.7%
Decreased by Less than 10%	22.7%	39.7%	49.8%	55.1%
Unchanged	49.9%	58.7%	63.7%	66.0%
Increased	33.2%	53.6%	63.3%	68.7%

*Data include only modifications that have had time to age the indicated number of months.

The opinions expressed are as of December 2009 and may change as subsequent conditions vary.

Figure 2: Investor Concerns Regarding HAMP Modifications



Further, mortgage servicers who are charged with implementing HAMP may be inherently conflicted. It is quite common for a mortgage servicer to be affiliated with a bank who may also have extended credit to these homeowners in the form of a home equity loan and/or credit card debt. The four largest servicers of home mortgages are affiliates of banks which hold an estimated \$452 billion in home equity loans and \$231 billion in credit card receivables as of September 30, 2009. While we recognize the importance of maintaining and enhancing capital for these institutions, many of these other loans need to be written down to reflect the true credit quality of their loan portfolios. Under the current approach, pension funds, insurance companies, mutual funds, and other investors in residential mortgage loans are expected to indirectly subsidize the bailout of banks that are in the mortgage servicing business.

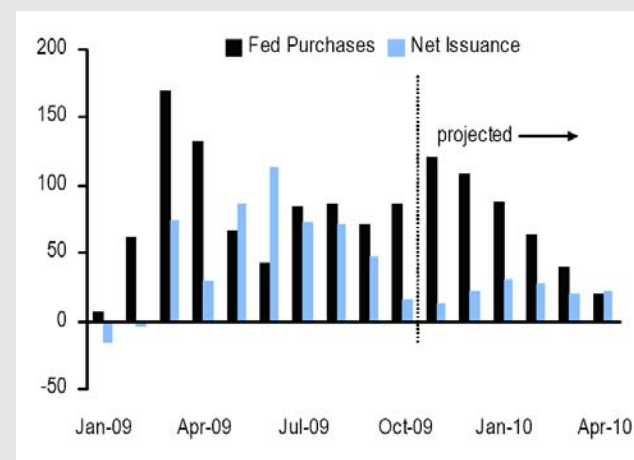
How about the Investors?

In this process, we have barely heard the voice of these investors. In 2009, the US Government became the largest purchaser of mortgages. Although Fannie Mae and Freddie Mac have reduced their retained portfolios by approximately \$50 billion this year, the Federal Reserve has invested over \$1 trillion and the US Treasury has invested approximately \$190 billion in residential mortgage securities. Given this purchasing demand from the government, mortgage rates have remained low. The problem is that in order to have a vibrant mortgage market, we need to have mortgage securities purchased by traditional investors such as pension plans and insurance companies, and these investors are not buying mortgages today. This problem may be exacerbated in 2010 when government holdings and purchases are expected to decrease (see Figure 3). Per the terms of the Treasury Senior Preferred Stock Purchase Agreement, Fannie Mae and Freddie Mac are scheduled to reduce their balance sheets by 10% per year until their retained mortgage and mortgage-backed securities portfolios reach \$250 billion. Likewise, the Federal Open Market Committee statement from September, 2009, indicated the Committee will gradually slow the pace of purchases of mortgage-backed securities in 2010 in order to promote a smooth transition in markets.

Capital markets thrive on certainty and transparency. HAMP introduces tremendous uncertainty about the relative position of creditors. Add to this the somewhat opaque "net present value" calculations used in determining the amount of forbearance to grant, and investors will seek alternative investments for their capital or much higher rates.

Why should investors accept a low interest rate on a mortgage that is subject to modification by a servicer who may have a conflict of interest? More importantly, what will happen if these buyers do not return to the market? Assuming this situation creates an imbalance of supply and demand, mortgage rates are likely to rise, perhaps significantly, which in turn will make housing less affordable for Americans.

Figure 3. Federal Reserve Agency MBS Purchase Program



Source: JPMorgan, Federal Reserve

How Should We Proceed Instead?

We need to make some difficult decisions. Some people have pointed out the “moral hazard” of helping homeowners who have over-extended themselves relative to Americans who have been more fiscally conservative. Unfortunately, regardless of the solution, we cannot completely avoid this outcome. Likewise, we need to recognize that some banks are facing significant losses which may require them to raise additional capital. The bank capital situation needs to be addressed directly rather than the current indirect approach which has investors in residential mortgage-backed securities effectively subsidizing banks.

Further, there has been much discussion around bankruptcy “cramdown”, and legislation introduced has met with strong resistance. Many objecting to “cramdown” point to the potential for an escalation in mortgage defaults by borrowers looking to avail themselves of mortgages rewritten in a bankruptcy court. Another objection focuses on the ability of the court to re-equitize homeowners at the expense of first lien mortgage holders by bifurcating the mortgage into secured and unsecured pieces based on the current value of the home, and then treating the “unsecured” piece as if it had originally been an unsecured loan along with the borrower’s other unsecured debts. In addition, many market participants are concerned that the court may rescind a loan on a technicality, such as a borrower alleging a minor violation of the Truth in Lending Act. Finally, bankruptcy can be costly and time-consuming for consumers and lenders, and has an uncertain outcome.

The critics of various “cramdown” proposals raise legitimate issues. However, we believe an alternative approach that addresses these concerns and provides a clearer path for both the homeowner and the mortgage investor to achieve a sustainable modification is preferable to current programs, including HAMP, and we believe that such a solution is achievable. We propose to create a new consumer bankruptcy option which we are calling “Judicial Mortgage Restructuring”. Under Judicial Mortgage Restructuring, the court would be instructed to target a total debt-to-income ratio that would result in affordable payments. In addition, the court would reduce the borrower’s debt in order of seniority similar to the priority applied in bankruptcy cases today. First, unsecured debt would be extinguished. Then undersecured debt would

be reduced. At the end of the process, if affordability had not been achieved, the court could then modify the first lien mortgage. This approach would eliminate the highest cost debt, would preserve the rights of first lien holders relative to less-secured or unsecured creditors, and would address the concern that “cramming down” first liens endangers the future of residential finance. Only as a last resort should the court refer a bankruptcy to Chapter 7 for foreclosure and liquidation thus also protecting homeowners. Unlike HAMP, all household income and all debts would be considered by the court in this process. Moreover, borrowers would face limitations on accumulating new debt, mitigating concerns about moral hazard.

It is also essential that a Judicial Mortgage Restructuring be processed quickly and efficiently, and provide certainty in outcome for the homeowner and the mortgage holder through transparent guidelines and proceedings. To this end, we propose that the court should be provided specific formulas for affordability that are not discretionary, and that only significant and material challenges to the validity of debts be allowed. Under this process, the court can use a mathematical process to determine affordability using specific inputs on income and indebtedness. Judicial Mortgage Restructuring would balance the public policy objective of keeping homeowners in their homes while respecting the rights of creditors and avoiding the potential conflicts of a servicer.

Conclusion

We support the government in its efforts to keep homeowners in their homes. As a fiduciary for investors and a major investor in the mortgage sector, we are concerned that the current approach is not achieving its objectives and is creating unintended negative consequences that have longer-term implications for both homeowners and the capital markets. Looking forward, we need to address these issues before the government reduces its support for the mortgage market by reducing its holdings of mortgages or mortgage-backed securities. Any solution needs to make homeownership truly affordable, reduce foreclosures, and provide certainty and transparency to attract investors back to the market.

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