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LOSS MITIGATION and FORECLOSURE – Lender Strategies

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Fixing the Foreclosure System

Federal Reserve Bank of Minneapolis

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Current Environment

Federal Housing Policy

- Home Ownership creates positive public externalities.
  - The American Dream
  - Civic and Neighborhood quality and stability
  - Demonstrable positive benefit for children
- Low-income and minority households have inequitable access to ownership.
  - Barriers include income, savings, credit history
  - Legacy of discrimination
- Owner-occupied housing is associated with the stability of the broader economy.
  - A public good.

Can there be too much of a good thing?

Mortgage Environment

- Old School
  - Lack of availability and access
    - Banking system highly regulated
      - did not provide incentives to lend in areas, and to borrowers who were, not perceived as good underwriting risks
- Yesterday
  - Bank deregulation and financial services disintermediation
    - Community Reinvestment Act
    - Development of the Secondary market
    - Advances in credit scoring and risk based pricing models
- Today (well, uh, until a couple of months ago)
  - Housing boom made it logical for lenders, buyers, and investors to take big risks.
  - Lots of mortgage product and credit available
    - Half of all recent low-income African-American and Hispanic home buyers had first mortgages in excess of 90% LTV.
      - Use of opportunity or invitation to disaster?
  - High risk borrowers can get credit
- Tomorrow
  - Tighter credit markets, higher OC levels, and less leverage
  - More risk today equals more defaults in the future
    - Foreclosures already at record levels

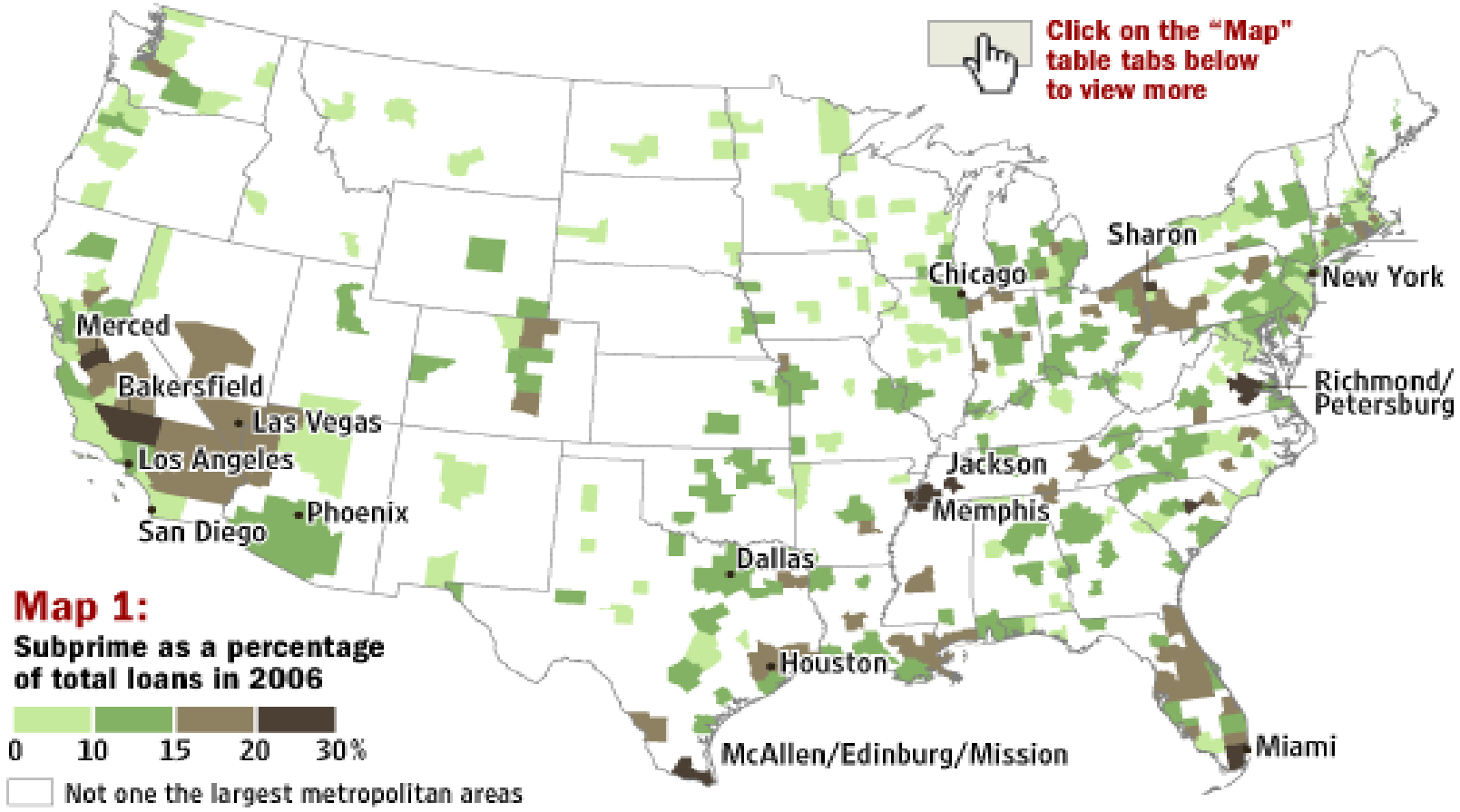
Circle of Life or fraud and abuse?

High Risk Borrower Attributes

- Consumer Knowledge
- Property Instability
  - Condition and location
- Payment Shocks
  - Less ability to manage
- Trigger Event Impacts
  - Lack of cushion
- Neighborhood Concentrations
  - Hot spots destabilize neighborhoods

What is an "acceptable" level of risk?
Who sets or measures and how?

Subprime Mortgage Concentration



SUBPRIME MORTGAGES

Not just old urban areas.
Go West Young (wo)man!

Source: Wall Street Journal

FRB Report on 2006 HMDA Data

- The report notes that refinancing actually fell 12% in 2006 from the previous year
  - a weakening real estate market "likely diminished the attractiveness of refinancing, or the borrower's ability to refinance."
- There was not a big leap in "higher priced" loans that exceed the HMDA reporting rate threshold.
  - Unlike the September 2006 report describing the 2005 data.
    - Rising interest rates a significant factor.
- The report appears to identify a correlation between higher priced loans and loan performance
  - ***geographic areas with similar economic factors but with more higher-priced loans have a higher foreclosure rate than ones with fewer subprime loans***.

Complex, mulitple and overlapping risk

Capital Market Environment

- Increased mortgage deliquency rates
  - Increase in loan repurchase demands
  - Increase in margin calls from warehouse lenders
- Non-prime market in decline
  - Warehouse lenders terminating funding
  - Lenders unable to fund new loans or operate business
  - Reduced Pricing in the Secondary Market
- Servicers facing a shortfall in their remittance obligations to securitization trusts
- Bonds declining in value and become illiquid

IT REALLY SUCKS OUT THERE!

Economics Matter in Pricing

- The percentage of loans labeled as "high cost" is partially a product of the yield spread curve.
- When the difference in interest rates for long bonds shrinks in comparison to five or ten year bond terms, more loans break the 300 basis point barrier.
  - 2005 and 2006 were very difficult years for lender CFOs.

HUG A CFO!

What Housing Bubble?

- In a December 2002 speech, former FRB Chair Greenspan deflected any argument that the FRB monetary policy was inflating a housing bubble.
  - Greenspan acknowledged that mortgage debt was high relative to household income by historical norms.
  - But "*low interest rates*" were keeping the servicing requirements of the mortgage debt manageable.
  - "Moreover, owing to continued large gains in residential real estate values, equity in homes has continued to rise despite very large debt-financed extractions.“
- The FRB Open Markets Committee on September 18, 2007, upon cutting a key FRB rate 50bp:
  - ". . . the tightening of credit conditions has the potential to intensify the housing correction and to restrain economic growth more generally."

Oops?

FRB Use of Monetary Policy during Economic Shocks or Crises

- "When this moral hazard is present, credit flows rapidly into inelastically supplied assets, such as real estate. Rapid appreciation is the result, until the inevitable albeit belated regulatory crackdown stops the flow of credit and leads to an asset-price crash."
  - (then) FRB Gov. Bernanke
    - Speech from 2002 on *Deposit Insurance* crises in 1990s

Hmmmm . . . . Looks familiar . . . .

A Shift in Variables

- Subprime mortgages are a larger factor in new markets.
  - Loans to home buyers with the weakest credit formerly concentrated in lower-income or economically depressed areas.
  - The meta-narrative from the press and the politicians portrays those in arrears as victims of “predatory” salesmen targeting the unsophisticated.
    - the situation is a good deal more complicated with multiple and overlapping causes.
- Larger portions of the subprime market shifted to higher-income metropolitan areas and the delinquency rate has increased quickly.
  - Sacramento, CA SMSA has a median household income ranking in the top 10th of major metropolitan areas
    - Level of subprime mortgages delinquent for 60 days or more reached 14.1% in December 2006
      - more than four times the level a year earlier.
- Other SMSAs in California, and SMSAs in Florida and Massachusetts -- especially those areas of high price appreciation – are seeing rapid increases in delinquencies.
- U.S. now has 10 months of housing inventory.
  - 6 months deemed optimal balance between buyers and sellers.

Old rules and assumptions don’t apply.
One size solution won’t fit all.

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Default Options

Goals of Loss Mitigation

- Loss Mitigation seeks to resolve loan delinquencies and avoid repossession/foreclosure of the properties.
  - Requires early recognition by lender ***AND*** borrower
- Philosophy is to resolve loan delinquencies without resorting to legal action when possible through the use of a range of available loss mitigation tools.
  - Once such tools have been exhausted or they become inappropriate due to the circumstances, collateral recovery process will be initiated.
- Ensure that strategies to collect delinquent payments, protect the security interest, and, if necessary, obtain possession of the collateral, are followed.

Lenders have an big economic interest in avoiding foreclosure too!

Intervention Timeline

Time

slow pay

- **Preventing** problems with targeted counseling, phone calls, workshops

15-30 days late

- Making **contact** with delinquent borrowers (sooner is better)
  - Hotlines are helpful, but not enough for long-run

30-90 days late

- Managing **expenses** to pay mortgages
  - Often consumer just needs help prioritizing
- Restructuring consumer **debt**
  - Debt management plans can help free up cash flow for mortgages

60-120 days

- **Repairs** to the home
  - Unexpected costs of repairs are frequent problem
- **Modifying** the loan
  - If partnership with lender is in place, mods are possible and very helpful

90+ days

- Bridging an **income** shortfall (short-term)
- Exit strategies if ownership is **unsustainable** (e.g. health crisis, divorce)

180 days+

- Managing REO properties to avoid **vacancies**
  - Maintaining a stable neighborhood
  - Turning over homes to new buyers

Time is rarely a cost benefit to anyone

Source: http://policylabconsulting.com/presentations.asp

Loan Servicer Strategy

- The loan servicer reviews a defaulted loan to determine the available foreclosure avoidance strategies and seeks to select the most appropriate action for each loan.
  - Maximize homeownership retention
  - Reduce foreclosure
  - Securing and liquidation of the collateral in a commercially feasible manner.
  - Establish controls and measures to limit exposure to further loss and liability.

More available outcomes more likely with early intervention

Four Dimensions of Delinquent Borrower Circumstances	
DURATION OF INCOME LOSS	
Temporary Income Crisis • Job loss • Income reduction • High potential to be able to resume payments in 12 to 24 months	**Long-Term Income Loss** • Disability • Family health crisis • Death in family • Divorce
CREDIT QUALITY	
Good Credit History/Low Debt-to-Income Ratio • Qualify for refinance loans • Ability to restructure debt and savings • Potential to reduce expenses	**Poor Credit History/High Debt-to-Income Ratio** • Past history of foreclosure or bankruptcy • Missed payments • Unqualified for most refinance loans • Reducing expenses or selling home only options
QUALITY OF PROPERTY AND COLLATERAL	
Good Home Value/Condition • Well maintained • High possibility of sale prior to foreclosure • Positive net equity	**Poor Home Value/Condition** • Significant code or structural problems • High levels of deferred maintenance • Negative equity results in low possibility of sale prior to foreclosure
BORROWER KNOWLEDGE AND BEHAVIOR	
Strong Knowledge and Personal Financial Management • Understand their mortgage • In contact with lender • History of savings and management of expenses	**Poor Knowledge and Personal Financial Management** • Lack of understanding succession of mortgages borrowed • Avoid contact with lender • No history of savings and expense management

Borrower calculus is complex

Source: http://policylabconsulting.com/presentations.asp

Many risk model tools available

- Example: Risk Profiler is FNMA's behavioral scoring model designed to predict the likelihood of delinquency and subsequent foreclosure.
  - Risk Profiler provides a risk profile for a mortgage before delinquency based on certain key elements:
    - payment history, credit report, current value of the security, etc.
  - Risk Profiler will stratify loans into three risk levels with separate work rules for each:
    - Lowest risk of foreclosure
    - Moderate risk of foreclosure
    - Highest risk of foreclosure

Triage: focus resources for optimal results and best possible outcomes

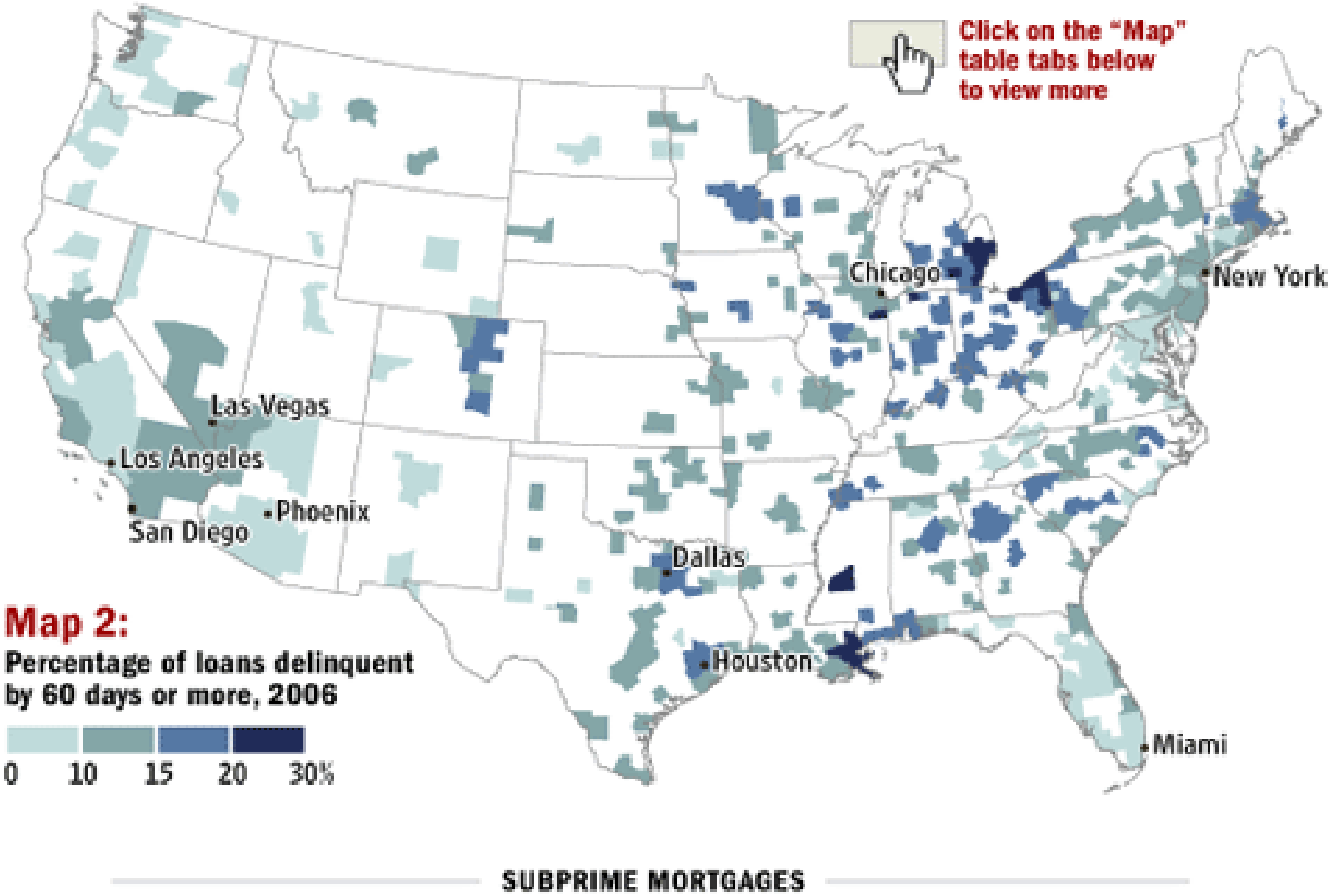
Causes of Delinquency/Default

- Curtailment of income/job loss: ~50%
- Illness/Medical: ~20%
- Excessive Obligations: ~15%
- Divorce: ~8%
- Other: ~7%
  - One study showed 72% of defaults were on refinanced loans and 32% were in Ch. 13 Bankruptcy

Job loss is consistently the primary cause of loan default

Source: Freddie Mac, Countrywide, and PolicyLab surveys

Delinquency Concentration



Shift to High Growth Areas in the West

Source: Wall Street Journal

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Foreclosure

What is the Cost?

- Cost to Lenders
  - average loss of $50K per loan
    - Tax and Insurance advance burden
      - One large lender has advanced more than $1 billion
- Cost to Borrowers
  - Loss of home, equity and credit rating
- Cost to Communities
  - $30K or more
  - Public Safety
  - Neighborhood investment and quality of life

Nobody wins with foreclosure

Foreclosure Averages

- Proceedings for about 320,000 foreclosures - or repossessions - were begun in each of the first two quarters of 2007
  - an average of 225,000 per quarter in the past six years.
- Typically, about half of homeowners given repossession notices end up losing their homes.

Foreclosure starts are way up in 2007

Shift in Default Characteristics

- **From "Rust Belt"**
  - Ohio, Michigan, and Indiana still account for 19.9% of foreclosures
    - Despite being home (npi) to only 8.7% of all U.S. mortgages.
- **To "New Economy"**
  - California, Florida, Nevada, and Arizona are seeing a significant rise in delinquencies
    - Speculators abandoning ARM loans in SMSAs with declining home prices.
      - Estimated as high as 50% in certain markets
- Subprime adjustable-rate mortgages (15.75 percent of these loans are delinquent)
- MBAA data on 3rd Quarter 2006 delinquent loans:
  - Subprime loans at 12.56%.
  - FHA loans at 13.54%.
    - Evidence suggests that interest rates not the primary factor for delinquencies

Policy or Process Changes Needed?

Top States for Foreclosure Starts: 2006 v. 2007

- Ohio (J only)
- Indiana (J only)
- Louisiana (J only)
- Mississippi (NJ common)
- Michigan (NJ only)
- Kentucky (J only)
- South Carolina (J only)
- West Virginia (TS only)
- Oklahoma (J common)
- Nebraska (J only)
- Tennessee (NJ only)
- Pennsylvania (J only)

- Nevada (TS common)
- California (J not common)
- Florida (J only)
- Georgia (J not common)
- Ohio (J only)
- Michigan (NJ only)
- Arizona (J not common)
- Colorado (J not common)
- Texas (NJ common)
- Indiana (J only)

Shift from Rural/Rust Belt to Speculation and Fraud Belt

Foreclosure Starts: August 2007

- 243,947 foreclosure starts in August 2007
  - 179,599 in July 2007
  - 113,300 in August 2006
- 42,789 repos “bought in” by lenders in August 2007
  - 20,116 in August 2006
- One filing for every 510 households in U.S.
- Nevada, California and Florida are experiencing the highest foreclosure rates:
  - Nevada had one filing for every 165 households.
    - 3 times rate for August 2006 (TS common)
  - California had one filing for every 224 households.
    - 3 times rate for August 2006 (Judicial not common)
  - Florida had one filing for every 243 households.
    - 2 times rate for August 2006 (Judicial only)
- Too many starter homes, subprime and ARM loans, speculators, fraud, and "no-doc" loans in NV, CA, FL and TX

Foreclosures Highest in Construction Bubble and High Fraud States

Source: Data from RealtyTrac

Judicial Foreclosure Availability

- Judicial Foreclosure only: 20 states
  - CT, DE, FL, IL, IN, KS, KY, LA, ME, MD, MA, NE, NJ, NM, NY, ND, OH, PA, SC, VT
- Judicial Foreclosure common: 6 states
  - AR, HI, OK, SD, WI
- Judicial Foreclosure not common: 19 states
  - AL, AK, CA, CO, GA, ID, IA, MN, MS, MO, MT, NV, NC, OR, RI, TX, VA, WA, WY
- Judicial Foreclosure not available: 6 states
  - DC, MI, NH, TN, UT, WV

Does Judicial Foreclosure make any difference?

Deficiency Judgments

- Possible and Practical: 37 States
- Not Practical: 12 States
  - AK, AR, CA, HI, IA, MN, MT, OR, PA, SC, WA, WI
- Not Possible: 1 State
  - North Dakota

Typically not pursued by lenders on cost/benefit analysis basis

Easiest v. Hardest Foreclosure States

- Texas (#14)
  - 27 days/NJ common
- Georgia (#7)
  - 37 days/NJ common
- Virginia (#34)
  - 45 days/TS common
- Washington, DC (#50)
  - 47 days/TS only
- New Hampshire (#32)
  - 59 days/NJ only
- **No redemption period**

- Wisconsin (#33)
  - 290 days/J common
- Idaho (#22)
  - 150 days/TS common
- North Dakota (#48)
  - 150 days/J only
- Kentucky (#31)
  - 147 days/J only
- Kansas (#37)
  - 130 days/J only
- **One year redemption period**

Most difficult states not economically dynamic – a coincidence?

Data: RealtyTrac 1st Half 2007 ranking

Easiest v. Hardest Foreclosure States

- Texas (#14)
  - W: 71%, B: 56% (I: 58%)
- Georgia (#7)
  - W: 76%, B: 37% (I: 61%)
- Virginia (#34)
  - W: 74%, B: 44% (I: 62%)
- Washington, DC (#50)
  - W: 49%, B: 23% (I: 29%)
- New Hampshire (#32)
  - W: 71%, B: 36% (I: 83%)
- **No redemption period**

- Wisconsin (#33)
  - W: 72%, B: 38% (I: 49%)
- Idaho (#22)
  - W: 74%, B: 52% (I: 96%)
- North Dakota (#48)
  - W: 68%, B: 33% (68%)
- Kentucky (#31)
  - W: 74%, B: 35% (I: 68%)
- Kansas (#37)
  - W: 72%, B: 51% (I: 65%)
- **One year redemption period**

Does Foreclosure impact homeownership rates by race?

Data: RealtyTrac 1st Half 2007 ranking

State Response to Foreclosure

- Maine (#46*) recently passed a bill repealing its strict foreclosure laws.
- Lenders previously had 3 options to foreclose a residential mortgage loan in Maine:
  - foreclosure by civil action;
  - foreclosure without possession; and
  - foreclosure by possession.
- Residential mortgage loans in Maine may only be foreclosed on by civil action after September 20, 2007.
- State foreclosure laws do affect the risk of residential mortgage lending.
  - A judicial procedure and statutory right of redemption extend the foreclosure and liquidation process and add to loan losses.

Increase in costs to both the lender and the consumer – any benefit?

*U.S. ranking 1st half 2007, but up 660% over 1st half 2006.

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Conclusions

WWCD?

. . . . with this moral hazard

Source: IMDB.com

The Market is doing its job

- Capital was being misallocated.
  - However, it is arguable that the parties were rational to be exuberant given FRB monetary policy.
- Major subprime players are out of business.
- Bonds being downgraded.
  - Losses exacerbated by securitization and investor use of high leverage rates
- Many parties directly or indirectly took a speculative position.
  - Municipal land use policies encouraging sprawl to grow tax base.
  - Lender risk management/layering of risk/lax underwriting.
  - Investors relied on excess leverage for higher returns
  - Borrowers bet their house on the come.
    - Many borrowers were too aggressive -- and too hopeful – particularly in high growth markets
    - Borrowers essentially planned for economic perfection
    - Negative deviations from that plan is sending borrowers into default and foreclosure.
      - an unexpected drop in overtime earnings for an hourly worker or a reduction in an expected annual bonus for a salaried worker

Occam's Razor now in play?

Responsibilities

- **Lenders and Investors**
  - Education
  - Risk management and underwriting
    - Avoid layering of risks in loan origination
  - Servicing
    - Early intervention and contact with borrower
- **Borrowers**
  - Education
  - Early intervention and contact with lender
    - The earlier the contact the more options available for workout
- **Federal, State and Local Government**
  - Education
  - Counseling

Cooperation and Collaboration Required from All Parties

Thank You!

- Questions?

Speak up now . . . . Don’t be shy . . . .

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The Future of Subprime

How Did Subprime Get Here?

- Risk Layering
  - Increasingly sophisticated products
  - Too much optimism
- According to an FRB study, consumers focus on three things:
  - Interest rate
  - Monthly payment
  - Amount due at closing

Too much risk taken by all parties

How to Adjust to the New Reality

- Don’t be afraid of vanilla products
- Discipline, focus and execution
- Eliminate or limit policy exceptions
- Set strict tolerances
- Make informed choices about products and risk
  - Don’t let brokers drive the bus

Return to Discipline and Execution

New Origination Paradigms

- Management of Pricing Discretion
- Discretion needs to be constrained
- Pricing Decisions need to be documented
  - Especially mitigating factors
    - Lower LTV and DTI ratios
    - Liquid Assets
    - MI or other credit enhancement
    - Competitive factors

Focus on Risk Management

New Servicing Paradigm

- Aggressive Collection efforts required
- Be proactive
  - Call early and often
- Intervene early
- Don’t let small problems become big problems
- Early intervention allows flexibility and increases options for resolution

Early intervention is key.

How to Survive the Meltdown

- Portfolio and Risk Management is paramount
- Internal controls must be strong
- Adequate capital levels
- Appropriate stress testing
- Vendor management/due diligence
- Lots of re-underwriting

Discipline, Discipline, Discipline . . .

Don's Crystal Ball

- The future will bring:
  - Fewer players
  - Shrinking advance rates
  - Higher capital costs
  - Limited Wall Street appetite
  - Conservative rating agencies
  - Shrinking consumer demand

Flight to Quality

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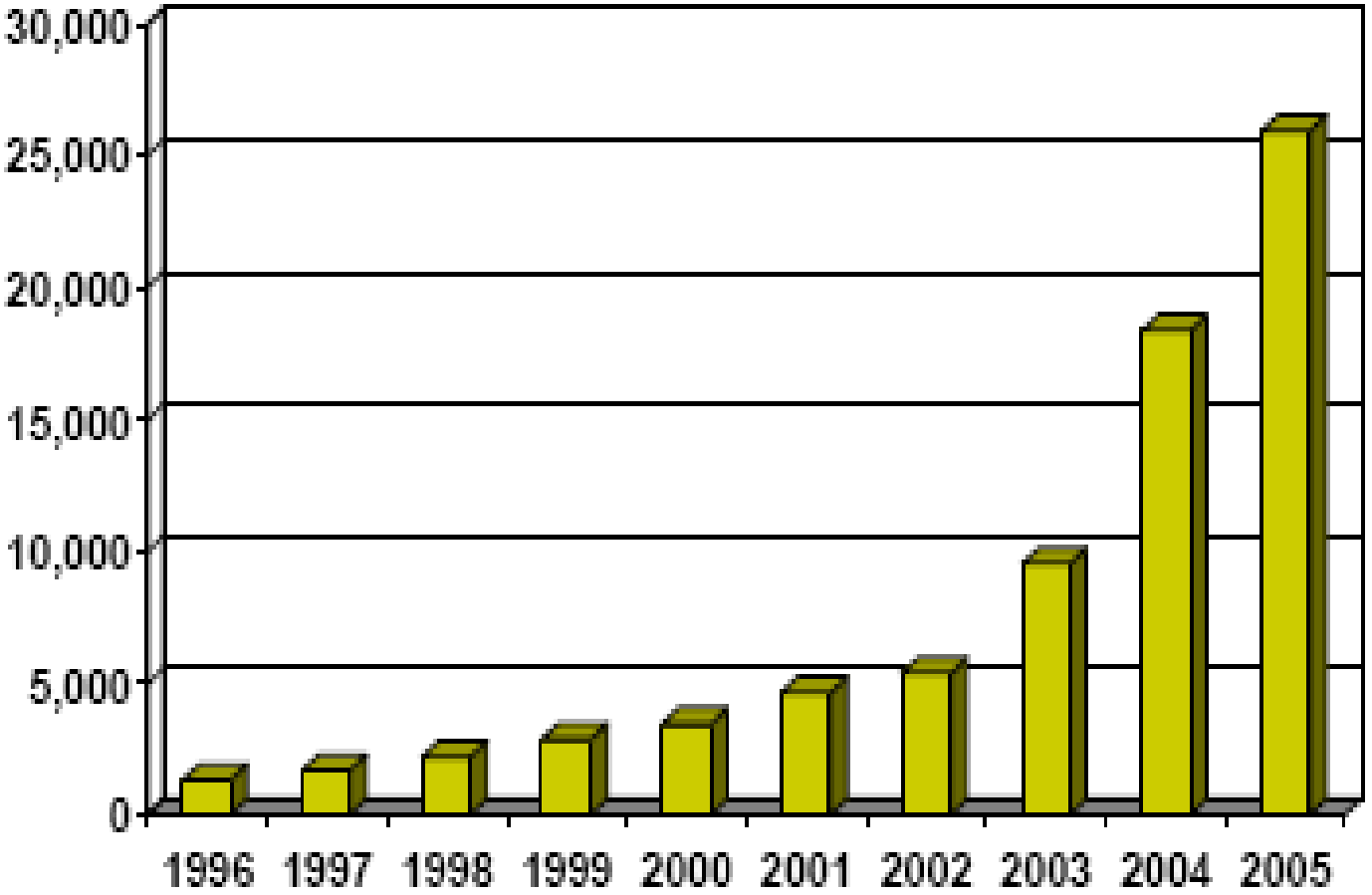
Fraud

FBI: 10 Mortgage Fraud Hot Spots

- California
- Colorado
- Florida
- Georgia
- Illinois
- Michigan
- Missouri
- Nevada
- South Carolina
- Utah

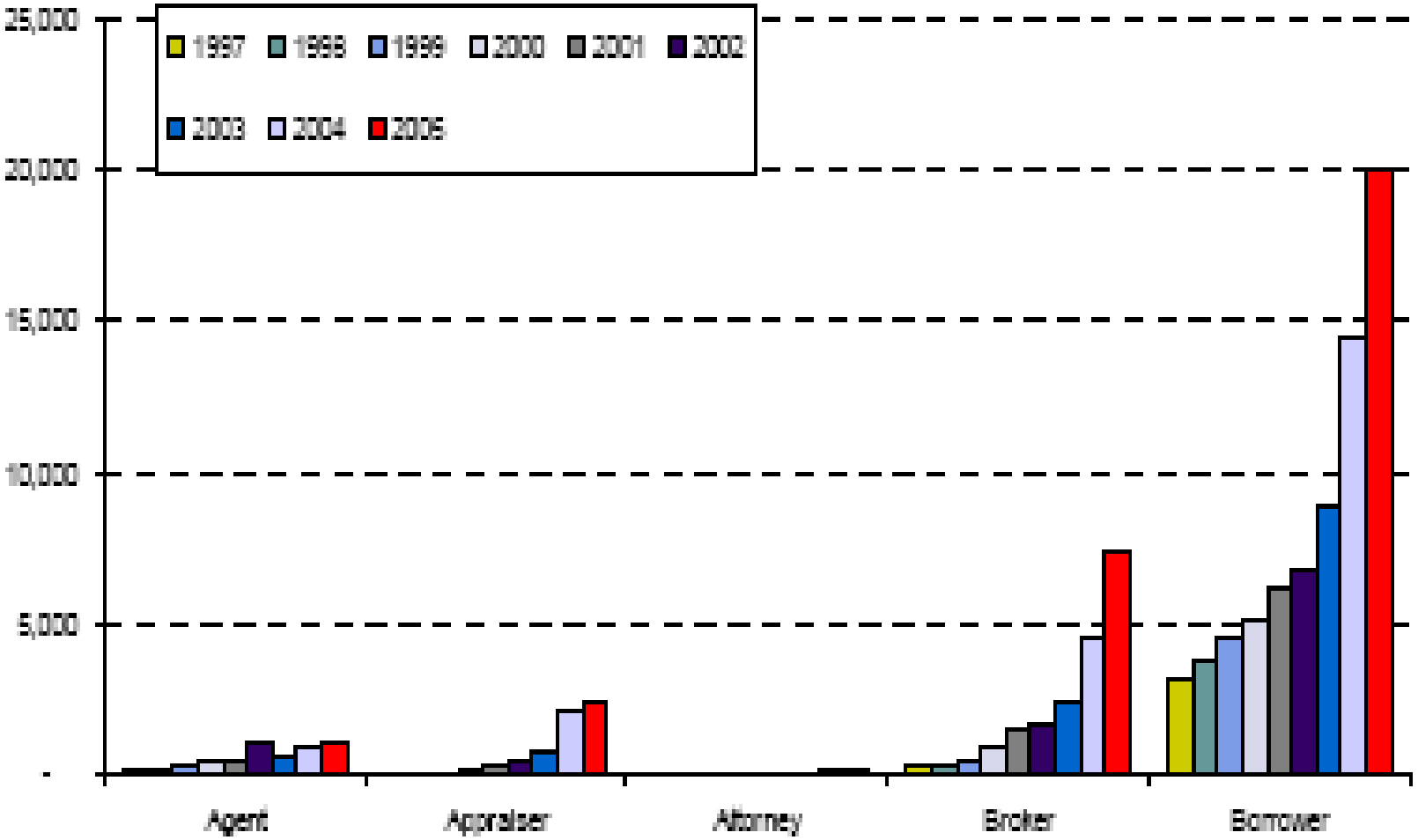
Most have high growth rate SMSA's

Growth in Mortgage Fraud



Suspicious Activity Report (SARS), Federal Bureau of Investigation, 2005

Most Reported Scams Involve Borrower or Broker Fraud



SARS Fraud Reports: Lending Related Activity

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Resources

Minnesota Foreclosure Assistance

- Family Housing Fund Web site: http://www.Familyhousingfund.org
- Foreclosure Prevention Providers Web site: http://www.hocmn.org/map.cfm?pageID=7
- Minnesota Home Ownership Center Web site: http://www.hocmn.org
  - Minnesota Home Ownership Center. "Foreclosure Prevention Assistance Program: Statewide Service Assistance Report Results, October 1, 2003–September 30, 2004."
- Lutheran Social Services of Minnesota Web site: http:/www.lssmn.org
- Minnesota Housing Finance Agency Web site: http://www.mhfa.state.mn.us
  - Foreclosure Prevention Assistance Program Web site: http://www.mhfa.state.mn.us/homes/homes_foreclosure.htm
  - Minnesota Housing Finance Agency. "You Can Get Mortgage Foreclosure Assistance." Brochure for Foreclosure Prevention Assistance Program.
- Minnesota Mortgage Foreclosure Prevention Association Web site: http://www.mmfpa.org
  - Minnesota Mortgage Foreclosure Prevention Association. "Minnesota Mortgage Foreclosure Prevention Association Presents: Solving the Foreclosure Puzzle." Training brochure.

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