March 2012 Interview of Richard Rydstrom, Chair, HotNeutral@gmail.com by Phil Hall Mortgage Orb News

FHFA & GSE (DeMarco) Resistance to Principal Reductions

1. How would you compare the regulatory performance of the FHFA versus its OFHEO predecessor?
2. The FHFA has not had a full-time director since August 2009 - has this been a problem, or is Edward DeMarco functioning as a director in everything but official title?

In an environment when borrowers have readily available solutions that reach true monthly cash affordability, re-performance is enhanced, time and duration of re-performance is enhanced, market certainty is enhanced, and the circumstances for price stabilization are enhanced.

A comparison would not serve as a useful tool as the circumstances are quite different. James B. Lockhart III found himself riding into the problem with many inter-agency related restrictions. Edward DeMarco finds himself in an interim position at a point in time when the most critical decisions in our financial history are definitionally overwhelming. The FHFA is now presented with new powers along with actual historic data to assist it in defining the problem – and solution. Interim leadership is not acceptable at this time in our history - when uncertainty abounds. It is uniquely incumbent upon it to act to find real-life solutions.

Is DeMarco and the FHFA Correct to Resist Principal Reductions?

No. The FHFA has a safety and soundness duty to define the problem and available solutions *comprehensively*. There is no justification for not considering all available solutions including principal reduction techniques (in conjunction with other solutions) to maximize the performance of the national mortgage portfolio, for the purpose to stabilize housing/finance and mitigate overall taxpayer losses or interests. That analysis cannot be limited to whether or not one solution (principal reduction) will cause a loss of taxpayer money. ***Safety and soundness of the mortgage industry cannot be determined one issue or solution at a time with blinders as to other solutions or conditions. To oversimplify the principal reduction analysis with reliance on the moral hazard and taxpayer loss arguments is simply no longer acceptable.*** To ignore the various and diverse available solutions, that may work alone or in conjunction with any other solution, is no longer acceptable.

Principal reduction techniques are extremely valuable to the consumer, GSE, (investor, bank), and insurer (MI insurer). Principal reduction techniques may very well maximize asset value and be in the best financial interest of the taxpayer, the housing finance industry, the borrower, and the country. First step is to understand that principal reduction techniques include (1) principal forgiveness and or (2) principal forbearance, and should be part of a comprehensive solution package; not implemental as stand-alone tools. These categorical options should not be viewed as an 'either-or' scenario. To optimize the economic benefit for all parties to the transaction, it is probable that a combination of both and other solutions must be employed. Moreover, other available solutions must be used in concert with the option to reach true borrower affordability, enhanced market pricing and certainty.

<u>Moral Hazard False Premise of Available Solutions</u>: ***As a preliminary flaw in the resistance to principal reduction techniques, serious consideration must be given to the false premise that only borrowers who default should be given principal reduction consideration. Default should not be the trigger for eligibility to principal reduction or forbearance, or loss mitigation in general.*** As I (Richard Rydstrom) noted in my 110th Congressional Statement, (from my October 2006 predictive solutions paper), embedded (and risk tested) loss mitigation solutions are better contained in the mortgage (or modification) itself as an organic internal credit and risk enhancement device (Safe Harbor Intelligent Loan Options™ (SHILO™)). Robert J. Shiller (Price Shiller Real Estate Prices Index) published a forceful endorsement of embedded mortgage contracts in April 2011 and the industry should revisit the ratable cost/benefits of using such devices.

A. The moral hazard argument is flawed. It is based upon a flawed analysis by too narrowly defining the problems and the available solutions. There are available solutions which include options that are more likely to decrease loss and increase gain, and as such they must be considered. In such cases, there would be no reason to require *default* as a program trigger. Shared appreciation claw back techniques (SAMs) will not only allow the borrower-benefit of enhanced or optimized affordable monthly payments (i.e.: reaching true ability-to-pay while reducing re-default rates), but will enhance events of gain by infusing <u>time</u> (<u>and certainty</u>) into the performance factor of the re-performing mortgage, which enhances the likelihood of appreciation gain at transfer.

B. The moral hazard argument is also based upon a false premise that borrowers will deliberately default to obtain principal reductions (when in fact 90% of GSE loans are current), and even 75% of borrowers who are severely underwater are current. ***However, if it is true that borrowers would default to seek principal reductions, why would a program be designed with a trigger to entice strategic defaults? Why wouldn't the program broaden its initial eligibility pie and allow review based upon imminent default or actual default? Why wouldn't the program include embedded and ratable solutions that would accept or reject certain applications based upon known factors and criterion? It is not the borrower we should fear, it's the policy behind poorly designed programs***. Borrowers are trying to hang-on while they wait for a better economy and solutions from the industry (or government). So if you fail to offer the life-raft, defaults will come with certainty, and market prices will continue with uncertainty.

<u>Failed FHFA Principal Reduction Analysis:</u>

The director and the FHFA had a duty to use actual data, not only hypothetical modeling, and not silo type analysis. Actual and now historic data must be considered, using actual HAMP, HAFA, and HARP data (and re-default rates from modification servicers). Moreover, ignoring claw back or SAM options, create loss scenarios for MI portfolios without consideration to loan level factors and other options. A SAM on a re-performing mortgage that continues to perform *longer in time*, in an overall market that has stabilized (due to added certainty and available solutions for its consumer (the borrower)), may very well result in lower-default rates, lesser losses or elimination of losses. ***Losses from sales realized on***

portfolios with mortgage insurance appear to lose the principal forgiveness amounts, notwithstanding the mortgage insurance, in environments when sales prices (or market valuations) are decreased below the amount of the net reduced mortgage balance (or prior current market). That should only be the start of the analysis and search for a solution. If other solutions could lessen the reduction in market price or sale price (by adding certainty into the finance and housing markets, where prices would tend to stabilize; and or by using other internal and or external credit risk devices, and or revised flexible mortgage insurance products), then the lesser net sales proceeds (after default/foreclosure) would not result in a dollar for dollar loss equal to the amount of the principal reduction. <u>Further, simply by optimizing the amount of principal reduction along with principal forbearance with a claw back feature (SAM), would not result in a dollar for dollar loss equal to the amount of the principal reduction.</u> Moreover, if principal reduction and principal forgiveness with a SAM component are employed, to the extent that a borrower receives a substantial lessening of his monthly ***payment amount***, default rates substantially lessen. I believe Litton used principal reductions in 33% of its modifications to reach 31% DTI; 2009), American Home Mortgage (20% when OCC and OTS reported 45-55% re-default rates) and Ocwen; all with proven results. First American Loan Performance has long reported (2009) that principal reduction itself is not the determining factor in reducing re-default rates. When payments decreased by 20% or more re-default rates were lower or some 21%; when payments were lowered only 10-20% re-default rates were 49% (2009). Diane Pendley (Fitch) has long reported that “Some combination of payment reduction and either principal forbearance or forgiveness may be the most effective approach to mortgage modifications as it may increase borrower ability and willingness to repay the modified amounts (Servicing Management March 2009).

In an environment when borrowers have readily available solutions that reach true monthly cash affordability, re-performance is enhanced, time and duration of re-performance is enhanced, market certainty is enhanced, and the circumstances for price stabilization are enhanced. Under these conditions, principal reduction and forgiveness will result in lesser losses to taxpayers, over time. However, without testing and implementation of a comprehensive plan and borrower friendly environment, housing recovery, and industry and taxpayer losses will continue.

<u>Available Solutions Abound</u>:

Wilbur Ross and Richard Rydstrom

Back in June 2008, at the DC Leadership Summit, Richard Rydstrom and Wilbur Ross discussed modification solutions with principal reduction and SAM claw back components which also spark the secondary and securitization market (by selling reduction pieces at Xbps over the 10-year treasury (www.CMISfocus.com; AFN Video). One such solution is as follows:

Public – Private Guarantee Solution: (Wilbur Ross and Richard Rydstrom June 2008)

- Set up an insurance guarantee program.
- The government would guarantee 50% of the mortgage that had been reduced to true net value after selling commissions, etc.

- The guaranteed amount (50% government amount) could be separately sold by holder/lender at a much lower yield than the mortgage itself.
- Enable the holder/lender to pay a 2 ½% per year Insurance Fee to the government.
- At first sale, share proceeds of appreciation as follows:

  1/3rd to Government
  1/3rd to Lender/Holder
  1/3rd to Borrower (Homeowner)

- Making it transferrable/assumable will lessen the need for new replacement mortgage.
- The 50% can come over to the next owner from the government guarantee at low rates and supply liquidity to the original lender.
- It can be backed by reinsurance.

<u>Do you believe that Fannie, Freddie and the FHLBanks are better run under the FHFA's conservatorship?</u>

If FHFA cannot see a charter to apply comprehensive solutions to the current problems, without concluding that moral hazard and taxpayer loss preclude it to act, then the answer is no. That would be a reason to restructure the GSEs so that the conservatorship or the FHFA is not restricted from acting in a comprehensive manner.

<u>Was DeMarco correct in defending the GSE compensation packages last year?</u>

We are at a point in history where the appearance of impropriety creates distrust for banks and the government which translates into more relenting uncertainty, hurting the recovery. If GSE compensation issues are perceived as abuses by the public, then the FHFA should avoid that appearance. The FHFA should keep its eye on the primary problem and solution facing the country and economy within its powers and refrain from making any other issues, its perceived focus.

<u>Was DeMarco correct in rejecting the PACE program loans as being too risky?</u>

All solutions should be considered. Each should be considered alone and in context with other solutions and problems. Adding senior liens to property during times that prices and values are soft and the portfolio is burdened with negative equity is a serious reason to reconsider its employment. As a standalone, it may at this time pose substantial concerns, but as part of a comprehensive solution at another point in time, it could be a solution.