

JANUARY 2013

Strategies to Improve the Housing Market

BOSTON CONSULTING GROUP

Shubh Saumya

Laurent Desmangles

Roland Kastoun

Lara Kostakidis-Lianos

This report was commissioned by The Pew Charitable Trusts.

This report is intended for educational and informational purposes. References to specific policy makers or companies have been included solely to advance these purposes and do not constitute an endorsement, sponsorship or recommendation by The Pew Charitable Trusts.

© 2013 The Pew Charitable Trusts. All Rights Reserved.

901 E Street NW, 10th Floor
Washington, DC 20004

2005 Market Street, Suite 1700
Philadelphia, PA 19103

Acknowledgments

The Boston Consulting Group is a global management consulting firm and the world's leading adviser on business strategy. We partner with clients from the private, public, and not-for-profit sectors in all regions to identify their highest-value opportunities, address their most critical challenges, and transform their enterprises.

Publications: http://www.bcg.com/expertise_impact/publications/default.aspx

Perspectives: <https://www.bcgperspectives.com/>

Strategy Institute: http://www.bcg.com/about_bcg/strategyinstitute/default.aspx

The Pew Charitable Trusts is driven by the power of knowledge to solve today's most challenging problems. Pew applies a rigorous, analytical approach to improve public policy, inform the public, and stimulate civic life.

<http://www.pewstates.org/housing>

THE BOSTON CONSULTING GROUP

Research and Writing

Shubh Saumya (Partner and Managing Director)

Laurent Desmangles (Partner and Managing Director)

Roland Kastoun (Principal)

Lara Kostakidis-Lianos (Consultant)

We would like to thank Pew Senior Adviser Sheila Bair, and Joe Davis, Monish Kumar, Ashwin Adarkar, John Miller, and Micah Jindal from The Boston Consulting Group for providing valuable input and feedback on this white paper. Our work benefited from the insights and expertise of all the authors, individuals, agencies, and firms who we interviewed as part of the process and who participated in the conference to develop practical solutions for the issues that were raised throughout the process.

Thanks are also due to Sue Urahn, Kil Huh, Kent Mitchell, Rebecca Alderfer, Demis Mavrellis, Scott Greenberger, and Jeremy Smith from Pew for their active engagement and partnership on the housing conference and paper. Additional thanks are due to consultants Charles Klingman and Harold Bunce. And a special thanks to the Pew team that organized the housing conference: Rosalinda Ortega, John Burrows, Nicole Dueffert, Emily Lando, Rashard Harrison, and Lindsey Weaver.

This white paper is a summation of recommendations from the conference discussions, the commissioned papers and interviews conducted by BCG of dozens of experts from mortgage origination, servicing and insurance, investors, industry associations, federal agencies and regulators, and nonprofits to further understand the “pulse” of the housing community. Although Pew supported and organized the conference, the recommendations in this paper do not necessarily reflect the views of Pew, its management, or board.

The views expressed herein do not necessarily reflect the views of The Boston Consulting Group, Inc. (“BCG”). To the fullest extent permitted by law, BCG shall have no liability whatsoever to any person or party, and any and all persons and parties hereby waive any rights and claims they may have at any time against BCG with regard to this report or other related materials, including the accuracy or completeness thereof.

Table of Contents

Executive Summary	5
1. Approach and methodology	13
2. The crash is over, but the crisis continues	16
2.1. Despite some recent improvements, the size of the crisis is very large	16
2.2. Creating a continuing strain on the economy, communities and individuals.	19
2.3. Despite significant efforts, key challenges remain	20
3. Structural challenges and real need for solutions	22
3.1. Systemic challenges	22
3.1.1. Servicer capabilities and incentives	22
3.1.2. State foreclosure processes	24
3.1.3. Second liens	25
3.1.4. Private label securitization agreements	25
3.1.5. Repurchase liability	26
3.2. Strategy-specific issues	26
3.2.1. Challenges with refinancing	26
3.2.2. Challenges with short sales	27
3.2.3. Challenges to scaling rental programs	27
3.2.4. Policies and economic obstacles for land banking	28
3.2.5. Obstacles to the return of private securitization	29
4. Opportunities for immediate action	30
4.1. Principles for recommended actions	30
4.2. Unlock value from the servicers	30
4.2.1. Programs to test and build on the effectiveness of “special” loan servicers on troubled loans	30
4.2.2. Coordinated national servicing standards	32
4.2.3. Access to data to assess principal forgiveness and servicer performance	32
4.2.4. Access to data for investors to assess loss mitigation strategies implemented by servicers	33
4.3. Develop options to streamline the foreclosure process in key states	33
4.4. Facilitate local, ‘bottom up’ solutions for REO disposition	34
4.4.1. Access to finance for small and mid-sized operators	34
4.4.2. ‘Rent-to-own’ programs	34

TABLE OF CONTENTS

4.4.3.	Clear ‘playbook’ for REO and broader stabilization strategies	35
4.4.4.	Sustainable bulk sale models	36
4.4.5.	Local level coordination of strategies	36
4.5.	Design the key tenets of the future housing market.	36
4.5.1.	Clarifying repurchase liability	37
4.5.2.	Alignment of servicing compensation to better manage loan performance across the cycle.	38
4.5.3.	Creation of a reserve fund structure for transfer of NPL to special servicers	38
4.5.4.	Compensation to servicers based on performance	39
4.5.5.	Clear rights for first and subordinate lienholders	40
4.5.6.	Practical infrastructure in place for the return of private label securitization	41
5.	Every stakeholder group has a role to play	42
5.1.	Servicers	42
5.2.	Investors	42
5.3.	FHFA and GSEs	43
5.4.	Other federal agencies	43
5.5.	State and local governments; NGOs	43
5.6.	Industry-wide collaboration	44
6.	Appendix	45
6.1.	Efforts to date	45
6.1.1.	Loan modification	45
6.1.2.	Refinance	46
6.1.3.	Hardest Hit Fund	47
6.1.4.	Neighborhood Stabilization Program	47
6.1.5.	Additional funding for stabilization activities	47
6.1.6.	REO disposition	48
6.2.	Perspectives on further intervention.	48
6.2.1.	Further intervention is warranted.	48
6.2.2.	It’s about tactical improvements, not big new ideas or big spending programs.	50
6.2.3.	Strategies should be targeted locally	50
6.2.4.	It is important to align strategies to objectives.	52
6.2.5.	Early and meaningful engagement with borrowers is critical	53
6.2.6.	Government can continue to play a useful role in standard setting.	53
6.2.7.	Policy stability is important	53
6.2.8.	Scaling initiatives significantly may require difficult trade-offs	53
6.3.	On principal reduction	54
6.4.	Round-table participants	55

Executive Summary

The housing crisis that started six years ago has yet to run its full course. While U.S. home prices are showing encouraging signs of stabilizing—with all 20 cities measured in a major housing index showing price gains in May and June of 2012¹—this stabilization is not occurring across the board and, as of September 2012, prices were still down nearly 27 percent from their peak in 2006.² Government and industry have made progress in minimizing losses for homeowners, and mortgage delinquency rates have improved significantly to around 7 percent from a high of almost 11 percent in January 2010.³ Still, experts suggest that we can expect a depressed market for at least three more years. Given the importance of housing to the broader economy, a depressed market is likely to be a continuing drag on economic recovery until the core problems in the housing market are addressed.

This raises a key question for policy makers and industry: What can be done now to address these problems in a way that quickens the pace of recovery and promotes the long-term health of the housing market and the broader economy?

Pew Conference and Research Focuses Attention on Pragmatic Strategies

“I hope that you will see today as an opportunity to fully engage in a pragmatic discussion regarding the ‘art of the possible’ in assisting housing market recovery.”

-Sheila C. Bair, Pew senior adviser and former chairman of the Federal Deposit Insurance Corporation, at Pew’s June 2012 conference

To help answer this question, the Pew Center on the States, with the leadership of Senior Adviser Sheila C. Bair, former chairman of the Federal Deposit Insurance Corporation, commissioned 13 research papers⁴ and, in June 2012, held a two-day conference on Strategies to Improve the Housing Market. On the first day of the conference, approximately 120 attendees from industry, government, and nonprofits heard three panels of experts discuss and debate the new research and potential policy solutions. The second day of the forum brought together a select group of representatives from industry and government in a round-table discussion.⁵ In the lead-up to the conference, The Boston Consulting Group was asked to interview dozens of experts from mortgage origination, servicing, and insurance; investors; industry associations; federal agencies and regulators; and nonprofits to further understand the “pulse” of the housing community and prepare this paper based on the research, interviews, and subsequent conference discussions.

Key Challenges and Frictions

In the lead-up to and during the conference, industry practitioners, federal agencies, not-for-profit organizations, and other stakeholders surfaced a set of challenges and frictions that they believe strongly reduce the effectiveness of existing initiatives and strategies to address the housing crisis.

Some of these challenges and frictions are systemic and impact a number of existing strategies. They create capacity constraints at servicers, drive operational complexity, create or allow conflicts of interest, and create uncertainty about the principles that will govern future action.

One leading example of such challenges is **servicer capabilities and incentives**. Stakeholders recognized that, while most servicers were simply unprepared for, and therefore overwhelmed by, the level of default activity that has been experienced during the crisis, there have been significant improvements. Nonetheless, there is an ongoing sense among stakeholders that, years into the crisis, many servicers are still in the process of developing the necessary operational capabilities to effectively engage with borrowers.

Other systemic challenges include the incentives for individuals created by various **state foreclosure processes**; the potential for **second liens** to cause obstacles to modification efforts; the heterogeneity **of existing pooling and servicing agreements (PSAs)**,⁶ which are individually complex and create operational challenges for servicers that may be dealing with hundreds of such agreements; as well as the lack of clarity around **repurchase liability**, which could quickly become a constraint on demand as the housing market recovers.

In addition to these systemic challenges, stakeholders identified challenges and frictions that are inherent to a range of specific strategies such as:

- refinancing, impacted by servicer capacity constraints and eligibility limits
- short sales, made more complex by the need to coordinate across multiple parties, reconcile diverging valuations, and the potential for fraud
- efforts to address REO and blight, with complications in **scaling rental program** and supporting broader use of **land banks**.

In addition, the lack of clarity around the end state of the housing finance market as well as the ongoing regulatory uncertainty were cited by most stakeholders as significant obstacles to **restarting private securitization**.

Four Recommended Strategies

With grounding provided by the commissioned research, the Pew conference offered an opportunity to discuss and debate the appropriate policy response with leading housing actors. There was convergence about the core principles that should drive action, and the conversations naturally turned toward common-sense strategies with broad-based support across government, industry, and nonprofits. We have identified four priority strategies based on the conference discussions, our interviews, and targeted research. In keeping with the conference focus on the “art of the possible,” we have focused on practical solutions that can readily be implemented by industry, agencies, and regulators working within existing mandates, or by nongovernmental organizations. We have typically targeted opportunities and solutions that do not require congressional action, have significant budgetary implications, or require substantial rethinking of policy. We acknowledge, nonetheless, that the change involved may be significant.

1. Unlock value from the servicers

Servicers are the key channel to implement any strategy that addresses the housing crisis. We recommend three main actions to help unlock value from the servicers:

- testing the effectiveness of “special” loan servicers on troubled loans
- implementing a consistent set of loan servicing standards
- expanding access to OCC and HAMP data on principal modifications and providing access to data for investors to assess loss mitigation strategies implemented by servicers.

“Special servicing” for troubled loans

There is some evidence that “special” loan servicers are better than traditional servicers at working with struggling homeowners—because they have unique capacity and a clear incentive to prevent foreclosure when they both own and service a loan. Pilot programs to test the effectiveness of these special servicers to understand the economic issues involved in engaging them would help expand their use and improve servicing quality.

There are three ways in which special servicers can be engaged for the complex and more expensive servicing of nonperforming loans: (1) the servicing obligations alone could be transferred to special servicers (with investor approval); (2) the underlying loans could be sold to them; or (3) servicers could set up their own in-house special servicing entities. If only the servicing is transferred, then operational interoperability and remuneration issues will need to be addressed. Existing servicer-fee arrangements are unlikely to pay for the more expensive special servicing required in these cases; hence, additional fees will need to be arranged. These particular economic and operational issues can also be addressed by sale of the underlying loans to the special servicer, but this likely triggers an immediate recognition of loss on sale for the owner of the loan. A third way would be for large servicers to create their own “special servicing” subsidiaries, dedicated to handling nonperforming legacy mortgages, possibly on a temporary basis. However, this would require the servicers to invest up front and manage two entities in parallel with different cultures, potentially lower scale, etc.

Given both the attraction of special servicers and the operational and economic complexity of utilizing them further, we recommend that the GSEs continue to use programs that require the transfer of servicing rights to a special servicer, and that private investors also make greater use of pilot programs requiring the transfer of distressed loans to special servicing. Optimally, the transfer should occur at a predetermined point, for instance, 90-day delinquency. Pilots would enable large servicers, special servicers, and investors **to better understand the trade-offs involved and, where possible, develop solutions for these issues, including the appropriate compensation and allocation of costs for special servicing.** In this regard, private investors should look carefully at the compensation schemes used by the GSE for special servicing.

With regard to loan sales, we encourage and support Fannie Mae’s plans to pilot a nonperforming loan sale through a competitive bidding process; and we recommend that both the government and private investors consider making greater use of sales, as they better facilitate fundamental restructuring, including principal write-downs, and avoid the complex compensation issues associated with simply transferring servicing rights. The desire to avoid loss recognition must be weighed against the risks that losses could increase without better, more specialized servicing. Presumably, substantial loss recognition will have already occurred on a seriously delinquent loan. Some consideration could also be given to contractual arrangements that allow the seller to retain an equity interest in distressed loans sold to special servicers.

Consistent set of loan servicing standards

Mortgage servicing is governed by a number of loan servicing standards—including standards under the DOJ settlement, OCC consent orders, FHFA Servicing Alignment Initiative, CFPB, as well as those of individual states—which vary in scope and individual provisions. A consistent set of loan servicing standards across the servicing life cycle can both ensure a basic standard of service for all homeowners and reduce the operational complexity of complying with multiple, varying standards for servicers.

Achieving this, however, requires significant alignment on standards across multiple stakeholders. We recommend **building on the recent settlement between DOJ and 49 states** as a template—and a precedent—for this work, to develop a more comprehensive set of standards. Both state policy makers and private investors should be included in the development process in order to align on standards, mitigate the need for state-specific alternatives, and facilitate voluntary adoption by investors. Once these standards are developed, policy makers and industry should systematically assess the costs and benefits of adding additional layers of servicing requirements through legislation or trust agreements.

Access to data on principal modifications and other loss mitigation strategies

Research suggests that principal modifications are the most effective at keeping struggling borrowers in their homes, and that such modifications are most successful if they are substantial in size and done early in the delinquency process. For instance, programs that allow borrowers with modified loans to earn principal forgiveness over time have met with some early success. A program initiated by the FDIC with BankUnited that services distressed loans acquired from the FDIC in a bank failure showed that 94 percent of borrowers were current after one year.⁷

However, publicly available data on principal modifications are very limited and do not allow effective data mining. In particular, it does not allow comparison of the effectiveness of principal forgiveness with principal forbearance. Expanded access to data on federal experience in principal modifications would allow researchers, servicers, and investors to assess the performance of the different types of principal modifications, understand what drives this performance, and know when they can be deployed most effectively. We recommend **expanded public access to OCC and HAMP data on principal modifications, including servicer identity**.

In addition, private investors know very little about modification activity, servicer performance, and the decision models servicers use to make choices on the loans they have invested in. This reduces the ability of investors to monitor servicer effectiveness and creates a perception that servicers don't always act in the best interest of investors. To address this, we recommend that **servicers voluntarily outline their decision processes and their net present value models to investors** via an independent coordinating mechanism set up for this purpose.

2. Streamline the foreclosure process in key states.

The long foreclosure process, particularly in judicial states, creates negative impacts on both lenders and communities, particularly when borrowers are “free riding.” While preserving the primacy of states and localities in foreclosure law, experts highlighted the desirability of working with them to develop a “model” foreclosure process based on best practices, to be adopted by states and localities on a voluntary basis. We recommend that **an NGO takes the lead on developing such a model**, based on best practices across jurisdictions, brings in key states and other relevant stakeholders to build consensus, and advocates for change with state policy makers and legislatures.

3. Manage the disposition of the glut of REO properties—especially by encouraging locally driven efforts.

REO dispositions are best done “bottom up,” driven by private investors and land banks with deep understanding of local context and a long-term commitment to these properties. Expanded access to financing and reduced investment restrictions for local investors could have a material impact on the pace of REO disposition. In addition, sharing best practices on a range of REO disposition strategies from bulk sales to conversion of REO to rental, to repurposing or demolishing housing stock, can help protect consumers and communities and allow both policy makers and investors to understand their options and develop an appropriate portfolio of actions.

To this end, we recommend **lifting caps on individual investor ownership** of REO properties (presently limited to 20 Fannie Mae and 4 Freddie Mac loans); new 7-to-10-year term **federal financing for promising REO strategies such as rent-to-own**, in order to stimulate private investment; **expanded financing for land banks** focused on managing low-value properties at risk of blight; **best practice standards for “bulk” REO sales** in order to prevent negative impacts on local housing markets; and **a comprehensive “playbook” for REO dispositions** that can be consistently relied on by local decision makers, NGOs, and private investors to prioritize what actions to undertake and best practices in execution.

4. Design the key tenets of the future housing market by addressing key issues dampening investor confidence.

Building on the work of the Federal Housing Finance Agency, experts highlighted four urgent priorities:

- establishing a clear “representations and warranties” framework for repurchase obligations
- reforming how servicers are compensated for their work
- clarifying first and subordinate lienholders’ respective rights to avoid a repeat of current frictions in the future
- creating the infrastructure necessary to enable a return of private-label securitization.

Repurchase Obligations

Repurchase obligations allow investors to “put back” loans that are not consistent with the representations made to them by sellers at the time of investment. A lack of clarity on when sellers (typically the lenders) will be held liable, as well as limited mechanisms to allow private investors to effectively enforce these obligations, have limited access to credit by making lenders more conservative in their lending and investors less eager to commit their capital. Clarifying standards on the treatment of these liabilities can help restore investor confidence, expand credit access beyond borrowers with the highest FICO scores, and reduce the cost of conforming mortgages.

Clarity on the nature and purpose of guarantees by sellers can help frame the scope of their liability. Standards and metrics based on observable data should be developed to ensure that sellers are held accountable only for factors reasonably within their control. High levels of loan-level transparency both at the time pools are created as well as through the life of a loan will help investors assess the quality of loans they are purchasing. In addition, mechanisms for investors to pursue their claims outside the courts will reduce cost and complexity, giving even small investors confidence that they can effectively pursue their rights if a seller has violated its obligations. FHFA, Fannie Mae, and Freddie Mac launched a new representation and warranty framework in September for loans sold or delivered after January 1, 2013. This framework includes many of the elements described in our recommendation, but some of these points remain open. We recommend that, as part of its contract harmonization efforts, **FHFA lead an industry stakeholder working group to further develop and test the new model of repurchase liabilities.**

Servicer Compensation

Servicers need to be compensated in a way that they can efficiently service loans in “normal” periods and effectively handle the more expensive special servicing requirements in periods of economic stress. The current servicing compensation structure does not create incentives for traditional servicers to build special servicing infrastructure or encourage them to take on servicing of the more complex nonperforming loans. Redesigning the servicer compensation model so that it can pay for servicing across the business cycle will materially improve servicing effectiveness.

Stakeholders identified two options to consider: either a “Reserve Fund” to finance use of special servicers in stressed periods, or a more radical “Pay for Performance” structure. Both involve significant change for market players. We recommend that, as part of its ongoing work on servicing compensation, **FHFA study these options with input from the industry, peer regulators, and NGOs.**

First and subordinate lienholder rights

In the context of continuing demand for home equity loans (second or subordinate liens), there is a need to clarify the rights of first and second lienholders to avoid a repeat of current frictions in the future and to restore investor confidence that first lienholders will have enforceable priority in the event of default. Any new framework put forward should achieve two key objectives:

- protecting first-lien priority
- standardizing treatment of seconds in loss mitigation efforts.

Conflicts between first and second lienholders have been a source of controversy and friction since the crisis began. It is unlikely that private investors will want to commit substantial new investment dollars to private securitizations until this issue is resolved. The **industry**, perhaps through the auspices of one of its trade association, **should take the lead on further developing these options**, in the first instance, with involvement from the FHFA, Treasury, and FDIC.

Infrastructure necessary for private-label securitization

Private-label securitization will need to be encouraged if the role of the GSEs is to decrease, which requires rebuilding investor confidence in origination and servicing practices. While several of the recommendations above will contribute to this process, there are two additional elements that stakeholders identified as important:

- Standardized provisions governing loss mitigation activities in PSAs, to ensure clarity and consistency around what servicers can and can’t do in executing loss mitigation strategies. **Industry participants should leverage the new standard PSA agreement that the GSEs and FHFA are developing** and build on it to include standard provisions around loan modifications and risk retention requirements.
- Effective monitoring and oversight of servicers as agents of investors, by defining clear and transparent expectations of trustees to include providing active oversight of servicers. There is a clear cost involved in this recommendation; however, this approach has the benefit of providing a transparent mechanism for pricing the cost of oversight. We call on **industry to convene and lead a working group to articulate a set of standards and recommend appropriate compensation.**

These strategies can be effective because they build on existing successes and bring about transparency, best practice standards, and process improvement. In so doing, they help address the current challenges posed by distressed and shadow inventory as well as begin designing the building blocks necessary for a revitalized future housing market.

The Time To Act Is Now

A wide range of government and industry programs and strategies have already been implemented; despite early missteps, the impact of these interventions appears to be steadily improving, though more can and should be done. Increased transparency is needed so that the best of what works can be held up and further applied. Increased transparency can also facilitate greater cooperation across industry and government so that improvements in servicing can be agreed upon and implemented. Whether working to keep homeowners in their homes or dealing with neighborhoods hardest hit by foreclosures, difficult trade-offs will be required, which experts acknowledged. But they also acknowledged that substantial benefits will accrue to the housing market as a whole, offering U.S. homeowners—and the broader economy—greater hope for recovery.

1 Approach and methodology

We started by asking two key questions:

- **What is the size of the issue?** We approached this question in two parts in order to understand the gravity of the issue and the value of additional intervention at this stage:
 - What are the scope, scale, and distribution of excess inventory and unrealized losses, and to what extent do these impede recovery in the broader housing market?
 - What is the “do nothing” (or “do nothing further”) time frame for recovery, and what are the risks of such an approach?
- **What are the priority strategies?** We developed a list of key strategies (see Exhibit 1) drawing on stakeholder interviews and research as outlined below, and sought to understand stakeholders’ views on priority strategies for clearing and revitalizing the housing market, with a focus on understanding whether and how each strategy promotes recovery.

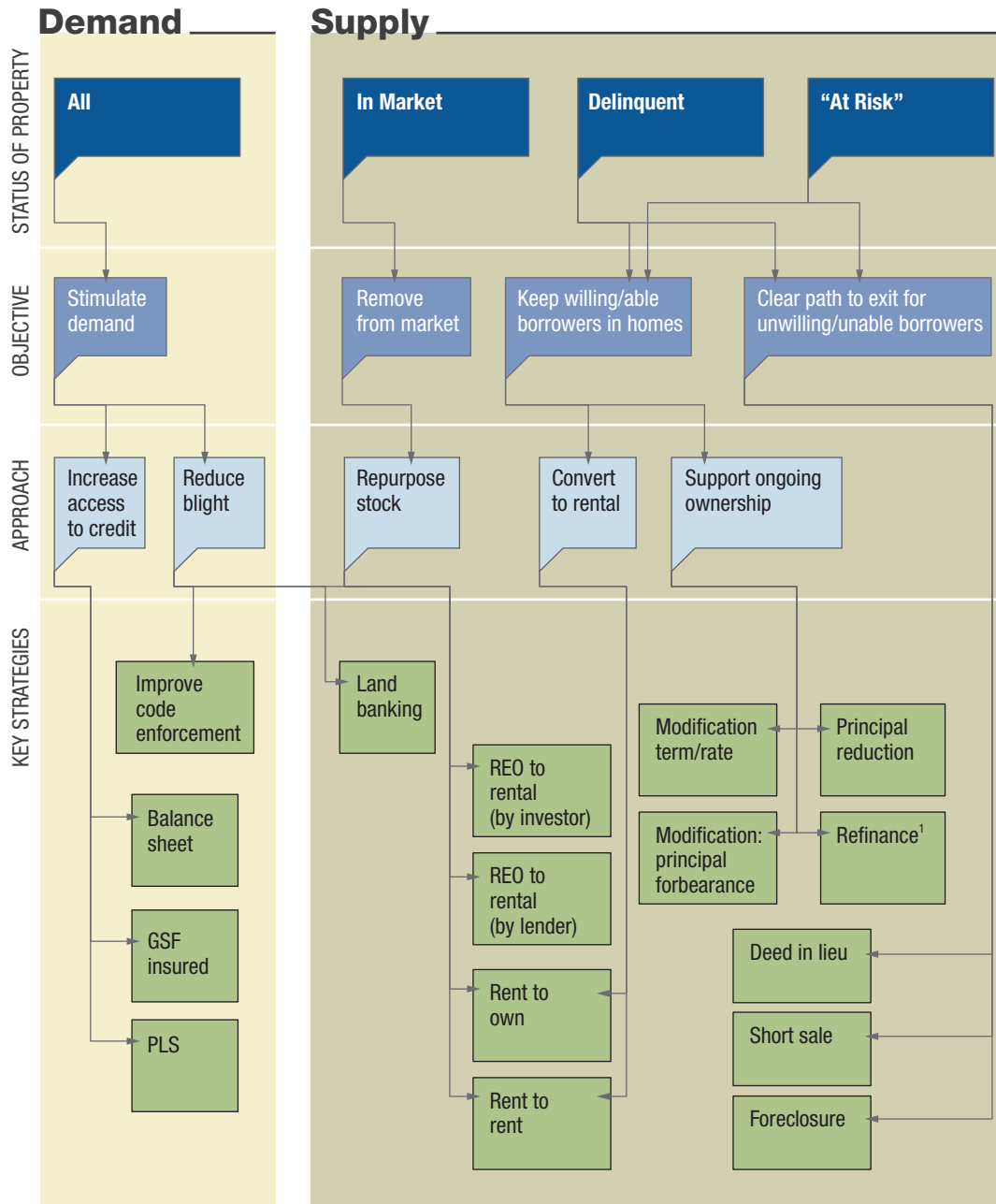
The answers to these questions frame our discussion of the key objective of this paper, which is to understand **what stands in the way of implementing or scaling priority strategies, and the key opportunities to address these obstacles**. We sought in particular to understand and learn from efforts to date. We focused on understanding near-term opportunities for coordinated action between the public, private, and nonprofit sectors to develop practical solutions and concrete actions.

There are two further principles that guided our approach and therefore the scope of this paper:

- **A focus on legacy mortgages.** While it is not possible to cleanly dissect the question of legacy mortgages from broader issues around future housing and housing finance policy, our primary focus has been on the former. In the process of our conversations, however, stakeholders identified a number of opportunities to prevent current frictions from recurring in future downturns, or to address factors that constrain the supply of credit and therefore have an impact on the broader market.
- **A preference for practical solutions** that can readily be implemented by industry, agencies and regulators working within existing mandates, or NGOs. We have typically targeted opportunities and solutions that do not require congressional action, have significant budgetary implications, or require substantial rethinking of policy.

**EXHIBIT 1:
IMPORTANT TO ALIGN STRATEGIES
TO A CLEAR SET OF OBJECTIVES**

Overview of pathways and programs to clear excess inventory and unrealized losses



1. Typically for 'at risk' borrowers only – not those currently delinquent.

This paper draws on three main sources:

- **Interviews:** We conducted an extensive program of 50 interviews with senior stakeholders and thought leaders across the private, public, and nonprofit sectors, as well as a handful of leading academics in the field. Interviewees included representatives from mortgage origination, servicing, and insurance; fixed-income and private equity investors; industry associations; federal agencies and regulators; and a range of nonprofit organizations.
- **Commissioned and independent research:** In advance of the conference, Pew commissioned 13 research papers⁸ by leading thinkers from across the country, and from a range of academics and industry participants, on the scope of problems in the housing market and the factors that must be considered to determine the feasibility of pragmatic policy solutions. We also conducted targeted independent research to supplement the insights and analysis presented in the commissioned work.
- **Expert forum:** Pew convened a two-day forum on June 20-21, 2012, bringing together experts from the public, private, and nonprofit sectors as well as academics and lawmakers. The first day of the conference was attended by approximately 120 participants from industry, government, and nonprofits who heard three expert panels discuss and debate the new research and potential policy solutions. The second day of the forum brought together a select group of representatives from industry and government in a round-table discussion. The participants are listed in Chapter 6.4 of the Appendix to this paper.

It will be no surprise that through this process we were presented with a range of opinions on almost every topic. Despite this diversity, views did converge around a few basic principles, which guided our work, as well as on a series of opportunities where dialogue across sectors could generate practical and meaningful solutions.

2 The crash is over, but the crisis continues

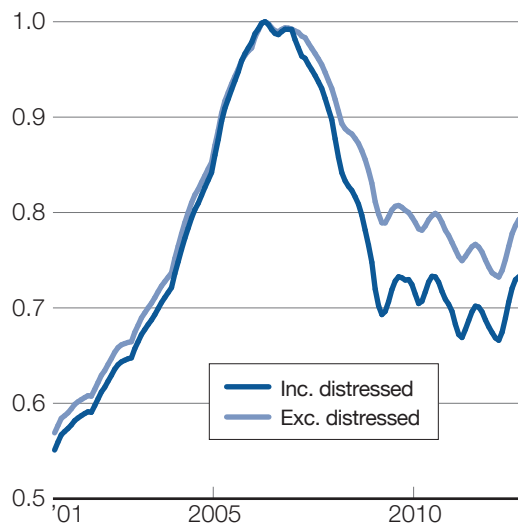
2.1. Despite some recent improvements, the size of the crisis is very large...

There are some signs of improvement in the housing market. Delinquency rates have come down significantly to less than 7 percent from a high of almost 11 percent in January 2010.⁹ As shown in Exhibit 2 below, national home prices have increased year over year for most of 2012,¹⁰ and housing affordability is near an all-time high, presenting (at least in theory) an opportunity for new homebuyers.

EXHIBIT 2: THERE ARE SIGNS OF IMPROVEMENT

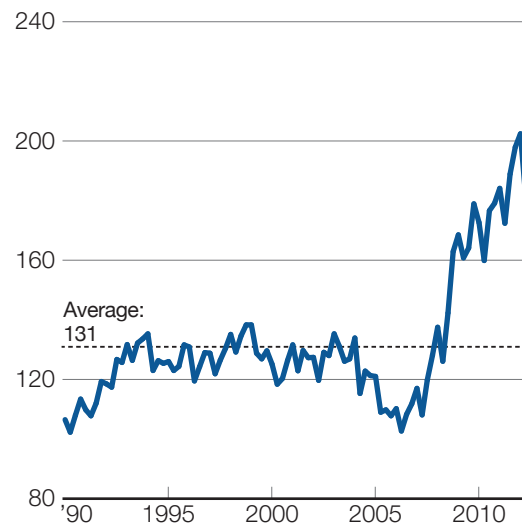
Prices starting to stabilize

House price index (Q1 2006 = 1)



Affordability high

Affordability index¹ to Sept. 2012



1. Distressed sales defined as REO and short sales 2. An index of 100 indicates a median income family has exactly enough income to qualify for a mortgage on a median-priced home assuming 20% down payment and qualifying ratio of 25%. An index above 100 signifies that a median income family has more than enough income to qualify for a mortgage on a median-priced home. Data seasonally adjusted.

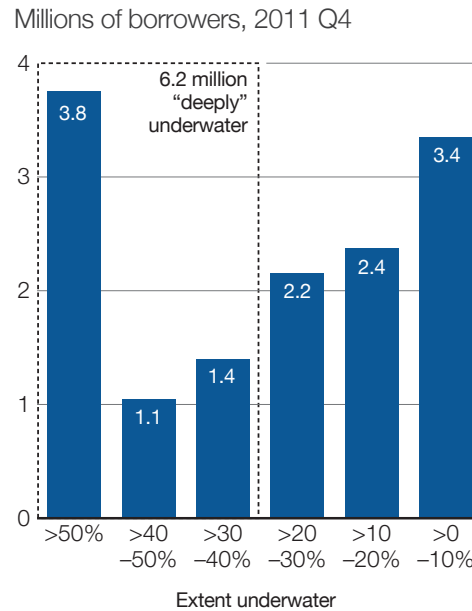
SOURCES: CoreLogic HPI data (September 2012); National Association of Realtors

However, on a number of dimensions, it is clear that we still have a long way to go to recovery.

“We’re no longer in free fall, but we are simply stabilizing, not healing”

Around 14 million homeowners are estimated to be underwater, by an average of almost \$50,000. While there is still great debate about the prevalence of people defaulting simply because they are underwater (known as strategic default), estimates are that 20 to 30 percent of defaults are strategic,¹¹ with propensity to strategic default higher in borrowers with high credit scores¹² and increasing the further underwater a borrower is. Recent research suggests that negative equity becomes an independent driver of default decisions at > 120 percent LTV; that at 150 percent LTV, about one-third of all defaults are strategic; and that the median borrower would walk away at LTV of ~167 percent.¹³ Stakeholders also suggested that there is an inflection point at 130 percent LTV,¹⁴ beyond which relatively small economic triggers (e.g., unexpected maintenance costs) may spark strategic default. As shown in Exhibit 3 above, more than 6 million homeowners are “deeply” underwater, by more than 30 percent. Default in underwater borrower populations may also be driven by life events—such as divorce, dismissal, death, etc.—that reduce a borrower’s ability to pay or require them to move at a time when sale of their primary asset would leave them with a considerable deficit.

**EXHIBIT 3:
~14M BORROWERS
UNDERWATER**



SOURCE: Moody's Analytics

Unemployment remains elevated at about 8 percent, with ~40 percent of people remaining unemployed for six months or more. Uncertainty both about prospects for re-employment and whether a borrower’s new wage will be sufficient to meet existing obligations hampers efforts to assist unemployed borrowers. There is also some evidence to suggest that a borrower’s perception of likely future unemployment increases the likelihood of strategic default in a statistically significant way.¹⁵

Access to credit is tight. The average FICO score of a Fannie Mae loan is 760, well above pre-boom levels.¹⁶ Credit scores affected by actions during the crisis may hamper the ability of new borrowers to access credit, as well as existing borrowers’ ability to access loan modifications or refinance. Bank portfolio lending is largely restricted to ultra-high-quality jumbo prime loans, and there is no private-label securitization market to speak of.¹⁷

“Homes are cheap, if you can get credit ... but there isn’t much around”

“Access to credit is a huge issue for the bottom third of the market”

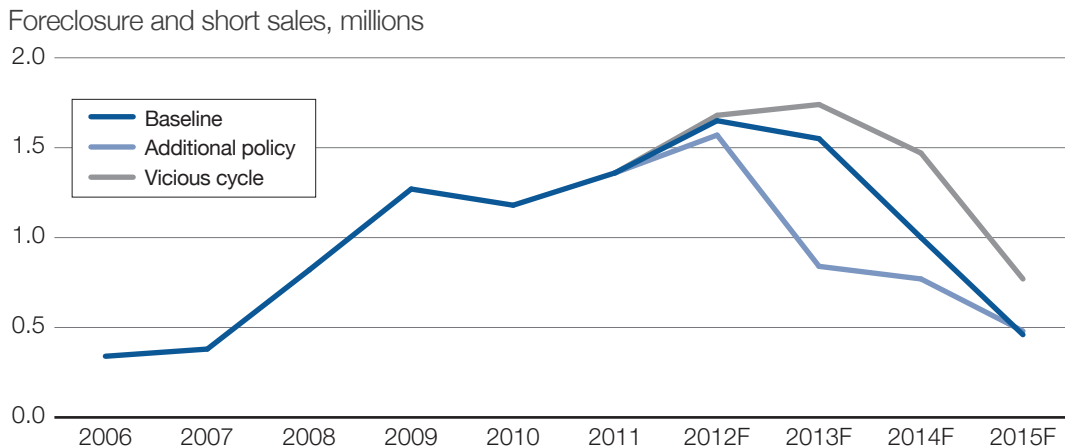
Banks and other lenders hold abnormally high levels of foreclosed property. This results when a property fails to sell at foreclosure or is transferred directly to the bank in exchange for the extinguishment of the mortgage (known as a “deed-in-lieu”). REO levels have declined substantially from a peak of around 650,000 in 2011 to slightly more than 500,000 in Q1 2012.¹⁸ While, as Gould Ellen notes, lower levels of REO stock provide hope that the situation could resolve itself, a range of indicators suggest this situation is likely to reverse: the foreclosure pipeline contains roughly four times the current REO stock; the conclusion of the National Mortgage Settlement is expected to drive an increased flow into REO; and there is evidence that in some counties, at least, the pace of REO outflow has slowed.¹⁹ High levels of REO continue to have an impact on industry (driving higher costs for banks) as well as the market: Jakobovics’ analysis of REO in Gwinnett County, Georgia, suggests that where REO is selling relatively quickly, it is crowding out other, non-distressed sales.²⁰

With around 5 million homes already lost to foreclosure, short sales, or deeds-in-lieu, estimates suggest we are at best halfway through dealing with the fallout of the crisis.²¹

Moody’s forecasts another 5 million distressed sales before the market normalizes in 2015 at ~ 500,000 distressed sales per year, with some modest further price declines expected as the volume of distressed sales peaks, as shown in Exhibit 4 below.²² Amherst Securities’ forecast is more pessimistic, predicting an additional 7 million to 9 million distressed sales.²³ Assuming that these properties flow through to market at a moderate (but still abnormally high) rate of 1.5M p.a., this estimate suggests a longer time frame for recovery—5 to 6 years. A key driver of the difference between these forecasts is differing assumptions about the impact of negative equity on default rates in the population of borrowers who have kept up with payments. Under any scenario, however, many borrowers will remain underwater for years after the level of distressed sales normalizes.²⁴

While the market for owner-occupied properties is flat or declining, the **market for rental properties has strengthened.** Average rents are up, and vacancy rates down, over the last three years.²⁵ Strong rental demand is expected to continue, driven by families who have lost their homes to foreclosure, tight credit conditions for new owners, and broader demographic shifts as the “echo boomers” enter the housing market.²⁶ A number of stakeholders emphasized that these factors are driving a shortage in affordable rental housing.

**EXHIBIT 4:
DISTRESSED SALES REMAIN ELEVATED**



SOURCE: LPS Applied Analytics; Moody’s analytics

2.2. Creating a continuing strain on the economy, communities, and individuals

Clearing the market of excess inventory is critical both to the recovery of the housing market and the broader economy. Distressed sales place downward pressure on prices simply by adding to supply, but also because the circumstances in which they occur may be pressured and the house condition poor.²⁷ The large shadow inventory (distressed sales that are not yet visible in the market) contributes significantly to price uncertainty, because it is unclear what the ultimate supply in the market will be. As long as there is uncertainty around price, markets will remain weak: neither borrowers nor lenders (whether the lender is a bank or a private investor) want to participate in a declining market.

“The overhang of property [and regulatory uncertainty] are the two key issues preventing private capital from reentering the market”

Weakness in the housing market is a significant drag on the broader economy. In a recent article, the Financial Times estimates that a “normal level of construction, removed from the boom, might be about 4 percent of GDP”; by comparison, current residential investments are a “little above 2 percent of GDP.”²⁸ Further, as outlined by Zandi and Wachter, the massive decrease in house prices is felt by:

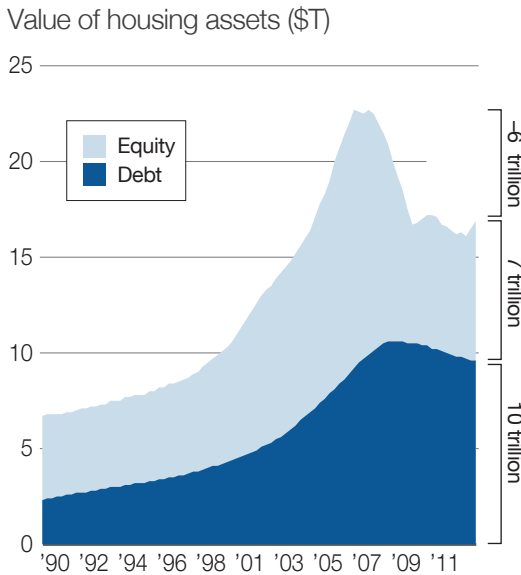
- **Consumers:** The crisis has wiped out \$6 trillion in household wealth. A reduction in wealth (independent of income) typically results in lower spending, as consumers feel less confident about their financial security.²⁹ Moody’s estimates the impact of this “wealth effect” as a 0.2 percent reduction in GDP in 2011.³⁰ As shown in Exhibit 5 on the next page, Moody’s estimates that the combined impact of falling house prices on household wealth and the “wealth effect” on consumer spending has subtracted between 0.4 and 0.6 percent of GDP per annum over the course of the recovery.³¹
- **Small businesses:** Homeowner equity is a traditional source of collateral for loans to support small business expansion. The fall in equity acts as a potential constraint on a key driver of job creation, with small business accounting for ~50 percent of private sector output and employment.³²
- **Local governments:** Property tax receipts—a key source of local government revenue, used to fund critical services such as emergency services and public education—decline with falling house prices. Revenue growth is likely to have slowed further in 2012 as tax assessments catch up with changes in price, while at the same time many local governments face increased costs of dealing with foreclosed and abandoned properties.³³

As Zandi et al. highlight, there is also a risk that negative equity limits labor mobility, which may also constrain economic recovery.³⁴

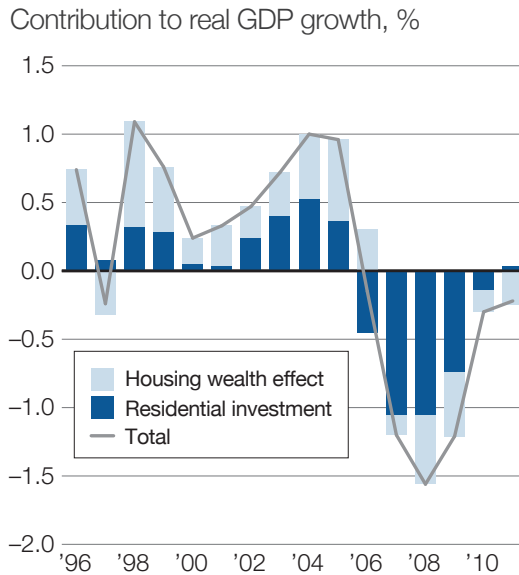
In addition, the crisis has significant personal and social costs. For an individual or family, foreclosure can mean loss of access to stable housing and disruption to schooling as well as family relationships, in the context of extremely stressful circumstances.³⁵ More broadly, there is also evidence that foreclosure, in particular the presence of vacant foreclosed homes in a neighborhood, contributes to blight by inviting squatters, vandalism, and increased levels of violent crime.³⁶

**EXHIBIT 5:
HOUSING HAS A SIGNIFICANT IMPACT
ON THE US ECONOMY**

Crisis has wiped \$6.2 trillion in value from housing assets ...



... having a negative impact on GDP



SOURCES: Federal Reserve Flow of Funds (data up to June 2012); Moody's Analytics

Fitzpatrick and Whitaker's research suggests that the issues are acute for weak markets, where vacancy and abandonment are bigger problems than foreclosure per se.³⁷ Numerous interviewees provided anecdotal evidence of investors and owners walking away from low-value properties—statements backed up by empirical research in Cleveland, which has a vacancy rate exceeding 8 percent.³⁸ The Federal Reserve, attempting to quantify the risk of blight, noted that nationally around 5 percent of REO inventory is “low value,” valued at under \$20,000.³⁹ The number is significantly higher in some markets, with low-value properties constituting more than 50 percent of REO in Detroit and Cleveland.

2.3. Despite significant efforts, key challenges remain

The review of current conditions in the housing market highlights the magnitude of the crisis and the impact it is having on the economy. The size of the problem has secured the attention of industry, associations, and regulators alike, and prompted new public policies to address the cause of the crisis and reduce systemic risk.

However, despite significant efforts, a number of challenges remain, impeding the effectiveness of the solutions put forward to date. Some of these challenges are driven by the operational complexity of the problem faced as well as the associated economic returns. Others are due to the competing

interests and inherent trade-offs across industry stakeholders (e.g., servicers, private-label securities investors), regulators, and public policy officials. Through our research and interviews, we have identified what we believe are the key challenges complicating efforts to resolve the crisis. In the following chapter, we articulate each of these barriers to understand the practical challenges impeding a full market recovery.

Drawing on the series of stakeholder interviews, research prepared for the conference, and the conference itself, we identified a range of practical challenges impeding the implementation or scaling of strategies devised to address the housing crisis.

These fall into two categories: systemic challenges and strategy-specific issues, outlined in turn below. Systemic challenges are those that impact multiple strategies and cause frictions as a result of:

- creating capacity constraints (servicer capabilities and incentives)
- driving operational complexity (second liens, foreclosure processes, private-label securitization agreements)
- creating or allowing conflicts of interest (servicer capabilities and incentives, second liens, foreclosure processes, private-label securitization agreements)
- leading to a lack of clearly understood principles to govern future action (repurchase liability, second liens, private-label securitization agreements).

The frictions are made worse by a set of conflicting standards and policies, which drive additional complexity for key market participants (e.g., multiple, overlapping servicing standards).

3 Structural challenges and real need for solutions

3.1. Systemic challenges

3.1.1. Servicer capabilities and incentives

There was general recognition among stakeholders interviewed that most servicers were simply unprepared for, and therefore overwhelmed by, the level of default activity that has been experienced during the crisis. This challenge has created significant complications for strategies aimed at resolving the housing crisis, as the servicers are at the front line of implementing these strategies.

There have been improvements: servicers have added staff, made investments, are leveraging marketing approaches to borrower outreach, and are simplifying the documentation for modification applications.⁴⁰ In addition, a range of stakeholders recognized that the introduction of servicing standards has been helpful in setting basic ground rules. Nonetheless, there is an ongoing sense among stakeholders that, many years into the crisis, many servicers are still in the process of developing the necessary operational capabilities to deliver effective engagement with borrowers, and that government has not used all tools at its disposal to improve servicer efficiency and effectiveness.

3.1.1.1. Operational challenges

A number of stakeholders recognized that the pace of policy changes and resulting system modifications has increased complexity and operational challenges for servicers, who have had little time to optimize internal operations.⁴¹ An additional concern is that work on servicing standards will require servicers to make ongoing operational adjustments, and may generate inefficiencies if not coordinated, given the range of standards either in existence or being developed, including the DOJ settlement⁴² and OCC consent orders at the federal level, specific servicing standards for GSE loans and CFPB standards focusing on consumer concerns. In addition, as of July 2012, half of the states had bills contemplating changes to laws governing the foreclosure process, which would impact servicing processes.⁴³

While the operational challenges and complexity are meaningful, stakeholders also recognized a range of structural issues that include

- the basic structure of the servicing business and servicing compensation
- servicer incentives and potential conflicts
- lack of transparency for private investors

3.1.1.2. Basic structure of the servicing business and servicing compensation

Servicing is a cyclical and bifurcated business. While there are a number of “special” servicers who focus on default servicing, the majority of servicers’ business was oriented toward standard servicing of performing loans. In the context of a cyclical business, servicers have little natural incentive to invest significantly in capabilities that will not be required in a few years’ time, particularly given that the direct economic benefit of improved performance accrues to the owner of the loan, not the servicer.

A range of programs are now paying servicers incentives to pursue modifications through HAMP, as well as more broadly on GSE loans.⁴⁴ However, concerns were raised that, particularly within “standard” servicers, these incentives are not “trickling down” to frontline staff, where low remuneration, high caseloads, and turnover contribute to suboptimal front line service delivery.

In this context, stakeholders identified that taking greater advantage of special servicer capabilities may be a mechanism for improving loan performance (or streamlining the path to exit).⁴⁵ While, in theory, transferring nonperforming loans (or the most challenging segments of NPL portfolios) to special servicers is attractive, stakeholders recognized that the structure of servicing compensation creates a basic economic obstacle to doing so. In the current servicing compensation structure, the standard servicing “strip” of 25 basis points overcompensates servicers for standard servicing, but undercompensates for default servicing. If the same entity conducts both, default servicing is subsidized by the excess earned on standard servicing. However, if nonperforming loans are transferred to a special servicer who continues to receive the same standard servicing strip, that entity will be undercompensated in relative terms because it won’t have received the benefit of excess compensation while the loan was performing.

3.1.1.3. Servicer incentives and potential conflicts

A number of investors raised ongoing concerns about the potential for conflicting incentives to hamper modification activity that would otherwise be beneficial to investors and borrowers alike. Some of these conflicts may arise as a result of layers of incentives; for example, while HAMP pays incentives to undertake modifications, servicers may face “compensatory penalties” under GSE guidelines for delaying foreclosures if a modification is unsuccessful. More broadly, there was concern that a servicer may prioritize actions that maximize servicing revenue (or minimize losses) over those that may deliver a better outcome for both the investor and the borrower⁴⁶—for example, foreclosing in order to recoup advanced payments rather than pursue a modification that may not succeed (and risk delaying recovery).⁴⁷ Some investors raised this agency issue as a particular concern where the servicer holds the second lien on a first that it services.

3.1.1.4. Lack of transparency for private investors

In the private securitization context, concerns about agency issues understandably flourish amid a lack of transparency around the servicing process. Investors and the trustees representing them receive very little, if any, detailed data on modification activity. In addition, modifications are made on the basis of decision models (net present value, or NPV, models) that are not transparent to investors. Servicers have some latitude to customize the HAMP NPV model and have a high degree

of latitude in calculating NPV on proprietary modifications: under either, key assumptions or inputs are not readily accessible to investors.⁴⁸ Without this information—which stakeholders noted was readily available in previous efforts⁴⁹—investors are unable to clearly ascertain whether the modifications that are made are within the limits of existing contracts (i.e., are in their best interests) and the extent to which beneficial modifications are not being made. Both servicers and investors at the forum recognized that there is value in increasing the transparency of the modification process. Recommendations for increasing transparency are outlined in Chapter 3 below.

“Many trusts prohibit write-downs below positive impact on NPV, but NPV models aren’t transparent, so investors can’t assess what’s going on”

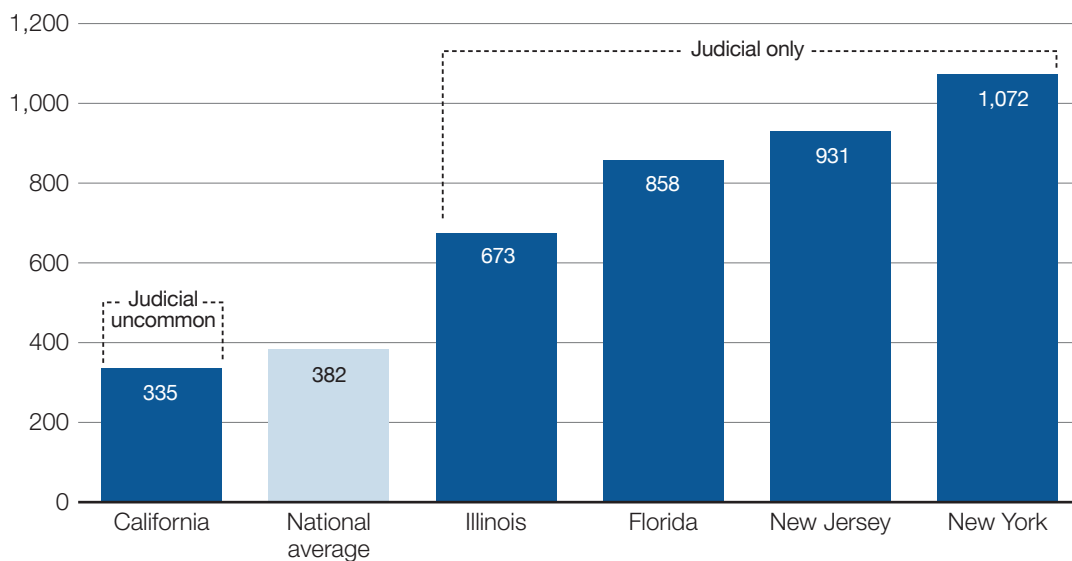
3.1.2. State foreclosure processes

The foreclosure process is regulated at the state and local levels, and both the process itself and the associated time frames vary significantly. While the correlation is not perfect, foreclosures typically take significantly longer in “judicial” states, which process foreclosures through the court system. California, predominantly nonjudicial, is currently sitting at an average of 335 days, compared with a national average of 382 days.⁵⁰ However, as shown in Exhibit 6 below, other hard-hit states such as Florida and Illinois are among those with the longest timeline to foreclosure. Longer foreclosure times are associated with greater loss severities for lenders, both because borrowers may stay in homes for years without making any form of payment, and because a borrower’s incentive to maintain the property decreases once the foreclosure process starts.⁵¹

EXHIBIT 6: FORECLOSURE TIME FRAMES VARY SIGNIFICANTLY BY STATE

Duration of foreclosure process (selected states)

Days to foreclosure (Q3 2012)



SOURCE: RealtyTrac: <http://www.realtytrac.com/content/foreclosure-market-port/september-and-q3-2012-us-foreclosure-market-report-7424>

In addition, lengthy foreclosure processes may change the incentives for borrowers to participate in modification activity or work out versus “ride out” the foreclosure process. There was, however, some recognition from the servicing industry that the majority of borrowers in foreclosure are still trying to “do the right thing.” Many stakeholders recognized the challenge of exploring alternatives, given the heterogeneity of regulation and the need to engage with a broad range of state policy makers and legislatures.

3.1.3. Second liens

The potential for second liens to cause obstacles to modification and workout activity has received significant attention since the start of the crisis. Commentators and stakeholders have recognized the potential for obstacles to arise where the agreement of the second lienholder is required (e.g., to resubordinate in the case of refinance, or to release the lien in the case of a short sale) or sought (in the case of modifications).

There was general consensus that securing the agreement of a second lienholder adds complexity to any workout process: at minimum, it adds another party to negotiations, and one who may not be readily identifiable.⁵² Some emphasize, however, the fundamental economic issues and incentives at work: a second lienholder may “hold out” in order to avoid recognizing the loss on the loan as long as it can be held at book value, or simply to extract some payment in order to avoid a full write-down.⁵³

Stakeholders acknowledged, however, that second liens are no longer seen as the critical threat they once were, in part due to a series of protocols implemented by both government and industry. Stakeholders recognized that additional work could be done to improve this process further, in particular to drive broader adoption of these protocols.

3.1.4. Private-label securitization agreements

Privately securitized loans are typically placed in a trust structure that comprises investors. The contract between the trust and the servicer is called a pooling and servicing agreement. It sets out the terms on which the loans are purchased, including various representations and warranties (“reps and warrants”) made by the originator of the loans, and governs how the loans will be serviced. Stakeholders recognized that the heterogeneity of PSA agreements, which are individually complex, itself creates an operational challenge, given that one servicer may be dealing with hundreds or thousands of agreements.⁵⁴

In addition, some stakeholders highlighted that there is no effective mechanism for investors to monitor servicers as agents. The trustee role as currently performed does not provide effective oversight. Stakeholders note that this manifests in multiple ways, including

- failure to pursue repurchase claims for defective underwriting
- failure to terminate servicing contracts for breach, including, for example, servicing that is not in the best interests of the investors.

The extent of trustees' obligations is currently under litigation.⁵⁵ It is not clear, for example, whether they are trustees in the traditional sense, with a fiduciary obligation to preserve the trust and act in investors' best interests, or whether they are subject to the much more limited contractual obligations set out in PSAs. In any event, a number of stakeholders commented that trustees, like investors, have little access to information that would enable them to properly perform a more robust set of duties, and that they are not compensated for doing so.

3.1.5. Repurchase liability

Stakeholders consistently identified lack of clarity around the circumstances in which originators will be liable for repurchase claims as the major obstacle to origination of GSE-insured loans.⁵⁶ In the context of uncertainty, lenders are applying credit "overlays," above the standard GSE, FICO, and LTV requirements, as lenders seek to avoid the risk of repurchase claims by writing only the highest-quality loans. While there is disagreement about whether this is acting as a current constraint on demand, there is broader concern that without action to clarify future liability, the use of credit overlays could quickly become a constraint on demand as the housing market recovers.

It is also an issue, however, for private-label investors, who found during the crisis that their rights to access data allowing them to assess the performance of loans and detect issues that might trigger a repurchase claim were very limited. This lack of transparency is another source of angst for investors and contributes to undermining investor confidence in RMBS securities.

3.2 Strategy-specific issues

3.2.1. Challenges with refinancing

There is evidence that HARP 2.0 has had a clear impact on refinance volumes for GSE loans.⁵⁷ However, in the context of historically low rates, a number of commentators suggest that we should be seeing more refinance activity and at lower rates.⁵⁸ Issues highlighted include

- a lack of competition for refinance activity, with streamlined underwriting processes and relaxed reps and warrants applying only to existing servicers;⁵⁹
- servicer capacity, with a number of servicers creating overlays (e.g., LTV caps) on applications outside their current servicing book as a way of managing demand;⁶⁰
- ongoing up-front costs (e.g., for valuations/appraisals);
- ongoing eligibility limits (to GSE borrowers with LTV over 80 percent);
- potential penalties if HARP loans go in default again.

Stakeholders emphasized the potential to use broader refinance to reduce negative equity (where borrowers refinance into a shorter-term loan with a similar monthly payment) as well as more simply to improve affordability and thereby reduce the risk of default.⁶¹ Some stakeholders referenced the Home Owners' Loan Corporation (HOLC), a New Deal agency established in 1933, as an example of such a large-scale refinancing to address a housing crisis. Its purpose was to refinance home mortgages currently in default to prevent foreclosure. Through its work it granted long-term

mortgages to more than a million people facing loss of their homes. Furthermore, Senator Jeff Merkley of Oregon introduced a bill in May 2012 to provide for the expansion of affordable refinancing of mortgages held by Fannie Mae and Freddie Mac.

3.2.2. Challenges with short sales

Short sales are typically seen as an attractive alternative to the foreclosure process, facilitating a faster resolution (particularly in judicial states), which may deliver a better ultimate sale price. While concerns about fraud and valuation were cited as potential obstacles, recent data suggest that servicers and investors are increasingly comfortable with short sales, which recently eclipsed foreclosure sales in volume, as shown in Exhibit 7 at right.

However, obstacles remain.⁶² The need to negotiate with and coordinate across multiple parties (buyer, seller, and lenders, as well as potentially second lienholders, insurers, and investors), typically within tight time frames, is

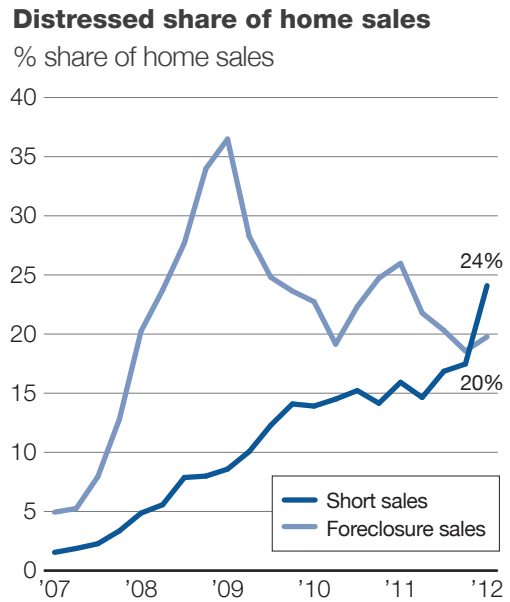
a key driver of ongoing operational complexity valuation; and appraisal processes are still cited as a source of friction, with low lender valuations undermining purchasers' ability to secure finance, high valuations (particularly late in the process) resulting in rejections of offers, and often no clear process to reconcile diverging valuations. Servicers also remain concerned about the potential for fraud in short-sale transactions, and they highlighted challenges in educating borrowers about the short-sale process and engaging with borrowers who are still emotionally attached to their homes.

“Short sale is an attractive strategy for seriously delinquent borrowers without the income to support even a modified loan, but a lot of stars need to align to make it happen”

3.2.3. Challenges to scaling rental programs

The fundamental obstacles to executing REO to rent programs vary depending on the scale and identity of the operator. For **larger-scale players** such as private equity funds, which have ready access to capital, the challenge is securing access to a geographically proximate portfolio of properties and managing the costs of building such a portfolio. For larger buyers in particular, bulk sales are of interest.⁶³ However, REO holders remain concerned about discount expectations on bulk sales and how to manage adverse selection, as well as the practicalities of when and how to remove REO from the retail marketing process.⁶⁴ While the completion of the FHFA pilot may encourage some private REO holders to enter the water, Jakobovics notes that a recent lull in REO volume has reduced the appetite of large financial institutions to address these challenges.⁶⁵ For **mid-sized**

**EXHIBIT 7:
SHORT SALES INCREASING
AS SHARE OF HOME SALES**



SOURCES: LPS; Moody's Analytics

and smaller players, both for-profit and nonprofit, the absence of financing on appropriate terms remains an obstacle. Stakeholders noted that the financing on offer from private institutions tends to be short term and adjustable rate, and as such does not match their midterm (7-to-10-year) investment horizon. While stakeholders identified large investors such as pension funds and life insurance companies as ideal sources of capital, given their investment horizons and target returns, such institutions are unwilling to enter an as yet untested asset class.⁶⁶ In addition, a range of GSE and FHA policies inhibit **individual investor** appetite by limiting, for example, the number of Freddie Mac-insured loans a single investor can hold to four,⁶⁷ or concentration in individual condominium projects.

There is also, however, growing attention to the day-to-day operational challenges of executing a “top-down,” large-scale rental program. Research conducted by Morgan Stanley highlights the significant maintenance and rehab requirements likely associated with any rental program, given the age and location of distressed housing stock.⁶⁸ The firm highlights that an operator’s rehab pipeline could readily become a constraining factor on turning purchased properties into productive rental units, and could undermine the economics of bulk sales from the purchasers’ perspective. Concerns were also raised by stakeholders that investors looking for quick returns may engage in substandard maintenance, generating significant downstream risks for buyers and communities left with poorly maintained properties.

In addition, stakeholders emphasized the importance of local knowledge to executing a successful rental program: ranging from neighborhood-by-neighborhood assessments of which properties to buy; to understanding local laws, codes, and ordinances; to having connections in the local rental and construction markets. For mid-size and larger investors, this means that local property management capabilities are critical, a factor recognized and substantially tested in the FHFA pilot.⁶⁹

3.2.4. Policies and economic obstacles for land banking

Successful land banks require a **flexible mandate and access to secure, long-term funding** in order to effectively manage properties for a range of ultimate purposes—neither of which are common, and which typically require legislation to implement.

A range of stakeholders also recognized that the **capabilities** required within local governments and nonprofits in order to run effective land banks (or other stabilization efforts) are not ubiquitous. These capabilities include knowledge of potential strategies to how to set up for success in the context of layers of federal, state, and local regulation. For example, the need to comply with varying levels of regulation may significantly impact the scale of work that can be achieved. In addition, processes for gaining control of properties (e.g., through municipal/tax foreclosure) may be time-consuming and costly, with no clear process for unwilling owners to “exit” from property ownership other than by abandoning their property.

“Dealing with the ‘bottom tranche’ of properties is a critical problem, and there is no real federal agenda to deal with it”

3.2.5. Obstacles to the return of private securitization

While the majority of interviewees took the view that restarting private securitization is necessary, they pointed to several significant obstacles, including a **lack of clarity around the future of housing finance**, and in particular the intended role of government, **ongoing regulatory uncertainty**, and new risk-based capital measures as significant policy obstacles to restarting private securitization.⁷⁰ Interviewees also highlighted a **fundamental economic barrier**: at current interest rates, investors simply cannot generate the required returns, particularly for senior debt tranches, to support securitization. In this context, the general view was that the return of private securitization is still some time away.

Stakeholders recognized, however, that there is also a series of operational frictions that will prevent the return of private securitization. **Lack of transparency in the market** (e.g., the absence of loan-level data for securitized pools) and lack of standardized documents (e.g., PSAs) were regularly cited as key operational barriers. In addition, as highlighted above, investors are also concerned about lack of clarity around their rights to pursue putback claims, the potential for the practical subordination of first-lien priority in workouts, as well as changing policy settings (e.g., HAMP eligibility criteria), which are seen as driving increased costs as investors seek a higher risk premium.

Given the frictions and challenges identified in Chapter 2, there are clear opportunities for action to improve information flows, enhance current processes, and change current business practices to facilitate strategies to clear the market of excess inventory and unrealized losses.

4 Opportunities for immediate action

4.1. Principles for recommended actions

There was broad consensus among conference participants that recommendations need to be driven in a coordinated way across the industry. We take the view, emphasized by a range of stakeholders, that at this stage in the crisis, having stability is in general more important than delivering an “ideal” policy. Any improvements or actions need to be designed and implemented in such a way that they build on existing efforts and contribute toward further harmonization and alignment.

We identified three priority objectives, described below, for action to address legacy mortgages, focusing wherever possible on impactful measures that require the least change and that can be driven by industry, nonprofit organizations, or policy makers acting within existing authority and policy frameworks. We recognize, however, that several of the priorities identified below nonetheless require meaningful structural change.

Also, in the course of our discussions, stakeholders identified four key forward-looking objectives, which aim to design the key tenets of the future housing market. These address practical issues that arise from existing contractual arrangements (e.g., servicing compensation and PSAs) and have created significant impediments to dealing with legacy mortgages. Because of their contractual nature, it is difficult if not impossible to address these issues in relation to legacy mortgages. It is, however, critical to address them going forward, both to avoid similar problems in the future and to lay the foundation for the return of private securitization by restoring investor confidence. There are also significant policy questions to be resolved—particularly in relation to the future role of government in housing finance—that are critical but are beyond the scope of this paper.

For each of the priorities below, we have outlined the key outcomes sought as well as a basic execution blueprint including who would need to drive the action, key implementation challenges, and questions still to be addressed.

4.2. Unlock value from the servicers

The first set of actions we recommend are focused on the role of the servicers, with an aim to address the obstacles facing servicer capabilities and incentives (Section 3.1.1) as well as the challenges with refinancing (Section 3.2.1).

4.2.1. Programs to test and build on the effectiveness of “special” loan servicers on troubled loans

There is evidence to indicate that “special” loan servicers are better than traditional servicers at working with struggling homeowners because they have unique capacity and a clear incentive to prevent foreclosure when they both own and service a loan. Pilot programs to test the effectiveness

of these special servicers to understand the economic issues involved in engaging them would help expand their use and improve servicing quality. There are three options that should be explored to facilitate greater use of special servicing to address legacy mortgages:

- **Transfer servicing of nonperforming loans to special servicers.** This can be prompted either by investors cancelling existing arrangements and transferring nonperforming loans to special servicers, or by existing servicers themselves employing special servicers as “sub-servicers” on nonperforming loans. As outlined above, however, there is likely an economic obstacle to scaling sub-servicing activities, which becomes even more acute for portfolios in later-stage delinquency, unless the transfer comes with additional remuneration for the special servicer. Servicers may also sell mortgage servicing rights (MSRs) to other entities, a process that is likely to be encouraged, at least for the largest servicers, by incoming Basel III restrictions on the application of MSRs to Tier 1 capital. Special servicers, often backed by private equity, are likely bidders for such portfolios.⁷¹
- **Sell the nonperforming loans (NPLs) to special servicers.** This addresses the economic barrier for special servicers by bringing ownership and servicing together at the special servicers. It obviates the need for servicing compensation contracts, giving the servicer the direct economic benefit of improved outcomes and avoiding potential agency issues and conflicts arising out of the current structure of servicing compensation. A potential obstacle to NPL sales, however, is that they may trigger the recognition of a loss for lenders based on the gap between what the purchaser is willing to pay (“fair market value”) and the lender’s current valuation of the portfolio based on expected loss recovery under GAAP. Bringing forward loss recognition is likely to pose an economic barrier to sales. Stakeholders believe, however, that this transparency will provide clarity on the financial position of lending institutions, which is beneficial to the housing market and the economy in general. For bank lenders, the need to recognize a loss is an issue to be weighed against the potential benefits of divesting NPL, including, for example, decreased regulatory scrutiny and an ability to focus on new business (for lenders).

While there are cogent arguments in favor of NPL sales, there is limited concrete data to support an argument for broad-scale NPL, given the likely costs involved.⁷² In this context, we support the conduct of a pilot by the FHFA, working with the GSEs, to test this opportunity further, including to

- assess the likely cost and benefits (including in comparison to transferring NPL servicing and simply paying special servicers to service delinquent portfolios)
 - identify other operational challenges to large-scale NPL sales and potential mitigation options.⁷³
- **Create “special servicing” subsidiaries.** Large servicers could create subsidiaries dedicated to handling nonperforming legacy mortgages, possibly on a temporary basis. Such a solution would enable improving outcomes on these loans while keeping economic interests aligned and without raising the risk of triggering the recognition of a loss. However, this would require servicers to invest up front in setting up the subsidiary and training dedicated staff. Given the different cultures of each type of servicing, it could be challenging for servicers to manage both in the same entity on an ongoing basis.

Other challenges to consider across all three options include the banks' ability to clearly separate nonperforming from performing loans and untangle other product-related relationships (e.g., checking accounts) that could be impacted by a potential transfer to a specialized servicer, even if that servicer is internal.

4.2.2. Coordinated national servicing standards

The broader introduction of servicing standards is important to address fundamental concerns about the quality of servicing during the crisis. It is critical, however, to take a coordinated approach to implementing such standards. Varying, overlapping, or inconsistent standards risk driving complexity into servicing organizations already straining to improve operational efficiency in the context of overwhelming numbers of defaults and waves of policy and regulatory change.

A single national standard should be developed, based on the standards incorporated into the DOJ settlement. This settlement, which was agreed to by a majority of states as well as the federal government, provides a strong foundation. Stakeholders identified an opportunity to build on the settlement, incorporating standards from loan origination to closure, for performing as well as nonperforming loans. They highlighted that a national standard could also usefully incorporate specific guidance on dealing with borrowers suffering from hardship and enshrine timelines for action.

An interagency working group is already driving efforts to coordinate across federal bodies to ensure consistency across federally mandated standards. Participants strongly support these efforts by the Department of the Treasury, FHFA, CFPB, OCC, and DOJ. There is an opportunity for this group to consider how to build on these efforts to develop a more comprehensive national servicing standard.

This is not an area in which the federal government can or should act alone. States and private investors are significant actors in this space. We recognize that coordinating across such a large and diverse group is a significant challenge for the working group, but are encouraged by the precedent set by the DOJ settlement. We encourage state policy makers to evaluate the costs and benefits of adding layers of servicing requirements through legislation or trust agreements independent of a coordinated process. We also urge investors to participate in the development of further standards and to incorporate any national standard into any private-label PSAs in the future.

4.2.3. Access to data to assess principal forgiveness and servicer performance

Stakeholders identified that the data to assess both principal forgiveness as a strategy and servicer performance across loss mitigation strategies exist in the OCC-OTS and HAMP databases, but are not readily available to researchers and analysts. In order to increase transparency and facilitate data-driven decisions on principal reduction:

- **the OCC should release the OCC-OTS database**, including modification data that distinguish principal reduction from principal forbearance modifications, and include the identity of the servicer;
- **Treasury should make HAMP data on principal reduction readily available.**

To the extent that there are any barriers to doing so, the OCC and the Treasury should explore options to address these barriers.

4.2.4. Access to data for investors to assess loss mitigation strategies implemented by servicers

There are two elements needed to satisfy this objective:

- **access to data on modification activity** (the number, type, and scale of modifications attempted and made) as well as **modification performance** (e.g., re-default rates)
- **access to NPV model structure and key inputs** (both data and assumptions)

While we recognize that there may be a systems cost involved in generating new reporting, stakeholders (including servicers and investors) agreed that increased transparency was a key opportunity and did not raise fundamental obstacles to making this information available. While servicers acting alone could provide additional information to investors, stakeholders highlighted a potential role for FINRA in setting and administering (voluntary) disclosure standards, given its role as the largest independent securities regulator in the United States.

4.3. Develop options to streamline the foreclosure process in key states

Stakeholders highlighted the desirability of streamlining the foreclosure process, particularly in judicial states where the timeline is drawn out, in order to avoid negative impacts on both lenders and communities. As outlined in Section 3.1.2, these problems are particularly acute where borrowers are “free riding” or have simply abandoned properties that subsequently fall into disrepair. However, the stakeholders also recognized the complexity of working across diverse state jurisdictions that regulate the foreclosure process.

We do not suggest federal action to create a national foreclosure process; foreclosure regulation should remain the province of local jurisdictions. However, there is an opportunity for a more targeted approach, led by an NGO, to:

- **develop a “model” foreclosure process** based on best practices across jurisdictions (e.g., mechanisms and time frames for steps of the foreclosure process, and how to balance protections for borrowers and lenders);
- **bring in key states as well as other relevant stakeholders** (e.g., servicers, investors, consumer organizations) to build consensus around workable models and assess how they could be implemented in each state;
- **advocate for change** with state policy makers and legislatures.

Work should progress with interested states on a voluntary basis, and we encourage the participation of states with long foreclosure timelines and significant pipelines, which stand to benefit from streamlined processes along with the servicers and owners of delinquent loans.⁷⁴

4.4. Facilitate local, “bottom-up” solutions for REO disposition

Given the issues posed by the REO stock and shadow inventory, stakeholders focused on practical solutions to address challenges to existing strategies such as scaling rental programs (Section 3.2.3) as well as policies and economic obstacles for land banking approaches (Section 3.2.4).

4.4.1. Access to finance for small and mid-sized operators

Financing is a key constraint on scaling “bottom-up” REO to rent/rent-to-own efforts. Stakeholders identified two critical actions that the FHFA/GSEs could take to address this challenge:

- **Lift GSE caps on the number of loans per investor:** Freddie Mac currently limits individual investors to 4 loans, while Fannie Mae increased its limit from 10 to 20 loans in September 2012.⁷⁵ While the doubling of Fannie Mae’s cap is a significant step, we encourage Freddie Mac to follow suit and increase the number of loans it allows. Further, we encourage the FHFA and GSEs to study whether these caps could be lifted completely to boost the capacity of local investors.
- **Provide GSE seller financing on a term basis to facilitate investment by small and mid-sized market participants:** In order to support sustainable activity, stakeholders repeatedly emphasized the need for “patient” capital, offered at a fixed term for 7 to 10 years. Prospective REO investors highlighted that this type of capital is not being offered by the private sector—banks are lending on shorter terms, while large investors such as pension funds will not participate in an as yet untested asset class. Stakeholders recognized an opportunity for GSE financing to “prime the pump”: GSE participation could help to create an asset class by financing and then securitizing the loans in a standard and transparent manner—for example, along the lines of Freddie Mac’s Multifamily K Certificates. This would serve the dual purpose of creating a “template” for private funders to follow as well as creating a product for institutional investors. Financing could be provided on a conservative leverage basis and attach basic conditions—for example, a minimum hold period (to facilitate more sustainable models)—as well as encourage partnership with smaller or local organizations. We understand that the FHFA considered implementing such a system with Freddie Mac but decided not to proceed in order to avoid competing with private funding. Given current market conditions, we encourage the FHFA and the GSEs to continue exploring the potential to support the financing of such deals to kick-start this effort.

We believe that these recommendations are consistent with the eventual wind-down of the GSEs. The reality is that, given the size of their portfolios, the GSEs or some successor entity will have a role to play for many years in the cleanup of troubled legacy loans.

4.4.2. “Rent-to-own” programs

A number of stakeholders expressed support for “rent to own,” which allows renters to apply a percentage of their rent to a future mortgage, as an interesting strategy—both from the perspective of investors looking for stable tenants and from the perspective of supporting people who may not currently qualify as borrowers (either because their credit is insufficient or they are first-time borrowers)—facilitating transition into ownership over time. However, the development of a viable

rent-to-own market is hampered by the complexity and lack of harmonization of rent-to-own agreements, and a lack of clarity among stakeholders over the risks, challenges, and implications of scaling rent-to-own schemes and managing a large rental portfolio.

To support the development of such programs, we call for a task force, comprised of industry, federal regulators, consumer representatives, and legal and accounting experts to

- **reach a clear understanding of the risks and benefits of rent-to-own** for each type of stakeholder, as well as the legal and regulatory implications;
- **develop clear guidelines and standards that can be used by participants in the REO rent-to-own marketplace**, such as eligibility guidelines and disclosure requirements for potential renter/owners, standard terms and disclosures for structuring rent-to-own agreements, and exit options for lenders and renters/owners.

4.4.3. Clear “playbook” for REO and broader stabilization strategies

There is much that NGOs and nonprofits can do to support a locally driven, bottom-up approach to sustainable strategies for REO and other vacant property disposition. Stakeholders described the need for a “playbook” for investors and operators (commercial, nonprofits, and land banks) that would outline

- **Strategies for dealing with REO and vacant/abandoned property**, including guidance on how to identify appropriate strategies, depending on local market/neighborhood characteristics and the value/type of property.
- **Best practices in each strategy**. For example, a number of stakeholders acknowledged that rent-to-own schemes are more likely to succeed if they create mechanisms for tenants to rebuild credit (by reporting rental payments to credit agencies) as well as build equity for a down payment (e.g., through setting aside a percentage of on-time rental payments), and if they provide financial counseling to tenants.
- **Relevant local regulation by market**. Basic regulations (e.g., fire codes) vary between markets. A repository of the relevant key local regulations would assist a range of players—from individuals looking to take advantage of the current market to become investors, to mid-sized and larger players—understand the local requirements and assess their economic impact. Such a resource would need to be updated regularly to keep pace with changes at the local level.
- **Roles for different players, and the capabilities required to execute**. This would include
 - potential roles for investors of different sizes, nonprofit organizations, land banks, and potential partnership models (e.g., partnerships between for-profits and nonprofits, between investors and property managers, and buying consortia);
 - financing options and key characteristics of the type of capital required to support different activities (e.g., term, fixed versus variable);
 - operational capabilities required (e.g., analytical capabilities to assess properties and neighborhoods, property management capabilities).

In creating such a “playbook,” we do not suggest reinventing the wheel. There are a number of NGOs, including the Center for Community Progress and the Thriving Communities Institute, to name two, that have elements of such a playbook already in place—particularly in relation to land banking and broader stabilization activities. A broader playbook should leverage and build on existing collections of best practices.

4.4.4. Sustainable bulk sale models

In anticipation of the growth of bulk sales, particularly with the completion of the Fannie Mae pilot in Q3 of 2012, it is worth considering models to encourage sustainable business practices that do not unduly dampen investor demand. There are two key elements for consideration here:

- **Requiring investors to “pre-qualify” to bid on properties should be further explored, drawing on lessons from the Fannie Mae pilot.** A number of stakeholders who participated in the qualification process said it was time-consuming but that the requirement to demonstrate basic financial and property management capabilities was reasonable and desirable. While such a process may deter smaller investors, it may not be necessary for investors below a threshold number of properties, where the potential for a single player to impact the characteristics of the rental market in a neighborhood is more limited. Any requirement could be structured to apply only to bidders of a given size/number of properties. The FHFA should provide guidance on models for pre-qualifying investors and should encourage private REO holders to adopt similar pre-qualification characteristics, leveraging standards set through the Fannie Mae pilot.
- **Examining models to contain the impact of bulk sales on surrounding property prices.** The FHFA/GSEs should take the lead in exploring options for ensuring that bulk sale transactions are recognized as such and treated appropriately in any future valuations of surrounding properties, building off the existing Fannie Mae pilot.

4.4.5. Local level coordination of strategies

As highlighted above, there are benefits to having a local coordinator, such as a mayor or governor, or an institution, such as a local land bank. We encourage individuals and organizations to consider taking an active role in forging relationships and driving local strategies. The development of a “playbook” as described above could greatly assist local coordination efforts.

4.5. Design the key tenets of the future housing market

While the focus of the conference and supporting work was on addressing the challenges of the legacy portfolio, stakeholders aligned on the need to build the future housing market on solid grounds and address some of the key challenges identified, such as repurchase liability (Section 3.1.5), second liens (Section 3.1.3), PSA structure and the lack of a general infrastructure to support private-label securitization (Sections 3.1.4 and 3.2.5).

4.5.1. Clarifying repurchase liability

Stakeholders emphasized that the first step in building a framework to clarify repurchase liability is to align on the nature and purpose of the underlying obligations, including the scope of activity delegated to originators.

In discussion at the forum, a group of stakeholders including representatives from originators, investors, and the public sector agreed to the following basic principles:

- Reps and warrants exist to facilitate a delegated underwriting model. In this model, an assessment of three things is delegated to the originator of the loan: the borrower’s credit, the borrower’s capacity to repay the loan, and the value of the underlying collateral.
- The scope of originators’ liability should be limited to
 - a guarantee of these three things only
 - factors within the borrower’s control (e.g., whether the borrower’s income is as stated, but not his or her subsequent job loss or incapacitation).
- Assessment of liability should be based on clear metrics and observable data whenever possible in order to limit disputes about interpretation:
 - clear underwriting standards around borrower credit and capacity
 - clear metrics to determine the bounds of liability when a borrower defaults; for instance, default within 90 days of origination is treated as a clear sign of underwriting failure and can be put back to the originator, while a period (e.g., 24 months) of continuous payment is treated as conclusive evidence of sound underwriting
 - clear metrics to quality check the valuation of the property at origination based on agreed standards; for example, the originators’ valuation must be within a specified percentage of the value assessed by GSE/lender valuation models
 - a requirement of “materiality” before repurchase claims can be made (except in defined circumstances, such as delinquency within 90 days of origination); materiality could be defined, for example, as a loss rate above the predetermined expected loss rate of the pool; for the purpose of assessing materiality, losses driven by a specified list of events outside the control of the originator (e.g., death, loss of employment) would be excluded
 - a sunset clause on any liability, including claims for fraud, for example
- Investors should be provided with data to assess the quality of the pool and risks over time.
- Both in order to make the model function and as a quid pro quo for the transfer of risk after an elapsed period of time, disclosure of loan level data is required to all investors, irrespective of tranche, at the time the pool is made, to assess the quality of the loans and underwriting, and during the life of the loans to understand behavior changes and anticipate risks.

Of course, clear rights and mechanisms to pursue repurchase claims are worth little if the originator no longer exists. Stakeholders suggested one potential solution: the creation of a fund to cover liabilities of defunct originators. This could further build private investor confidence in the system

and protect taxpayers by avoiding the need to rely on the backstop of GSE insurance. Further work is required to consider who should contribute and how much, to formulate rules on how and when the fund could be accessed, and to consider potential risks (e.g., moral hazard) and if/how they could be managed.

Stakeholders also noted that in the future it may be possible to develop a sliding scale for guarantee fees (g-fees) based on the scope of liability retained by the originator.

On September 11, 2012, FHFA, Fannie Mae, and Freddie Mac launched a new representation and warranty framework for loans sold or delivered after January 1, 2013. This framework includes many of the elements described above, but some of these points remain open. We recommend that the FHFA, as part of its ongoing work on contract harmonization, lead a working group to further develop and test this model, bringing in industry (originators, servicers, investors, and private mortgage insurers) as well as relevant regulators, including the FDIC, given the potential impact of any solution on bank balance sheets.

We call on industry to take an active role in working with the FHFA and GSEs to finalize this new model for repurchase liability as well as exploring these recommendations with a view to building consensus around a private-label model PSA and laying the groundwork for the return of private-label securitization. This could include, in addition to the points mentioned above:

- **Explore introducing a third-party reviewer with the institutional capacity** to conduct compliance audits and the bargaining power to negotiate with servicers, as individual private-label investors may not be large enough to test originators' compliance with reps and warrants and file effective suits. Such a mechanism would lend confidence to investors that their rights to put back loans in specific circumstances could be exercised in practice.
- **Identify potential venues to provide for arbitration as a dispute resolution mechanism** following independent review. The mechanics of an independent review mechanism and who would bear the cost are key questions for further examination.

4.5.2. Alignment of servicing compensation to better manage loan performance across the cycle

Two options raised at the forum are worthy of further exploration.

4.5.3. Create a reserve fund structure for transfer of NPL to special servicers

The first option is focused squarely on addressing the economic barrier to transfers between standard and special servicers. Discussion at the forum focused on the creation of a reserve account in order to address this fundamental barrier.⁷⁶ The basic objective of this approach is to provide a mechanism for reserving funds that would be transferred to a special servicer along with a portfolio of loans.

While there was significant support for this approach at the forum, stakeholders identified a range of open questions, including

- the appropriate level of payment into the reserve fund
- when the fund could be accessed
- when and how loans could be transferred
- the operational challenges of facilitating large-scale loan transfers.

Views at the forum were divided on important questions relating to these issues. These included:

- **Whether the ultimate decision on transfer of loans should rest with the servicer** (on the basis that the servicer would be the entity paying into the reserve fund) **or with the investors/GSEs**, who bear the ultimate risk of loss on a nonperforming loan and who could choose to provide additional compensation/incentives for special servicers to drive better performance of the pool of nonperforming loans.
- **Whether loans should be “returned” to their original servicer once they are performing again.** Stakeholders recognized an advantage to leaving them with the “special” servicer in order to maintain continuity of service and avoid further disruption to borrowers (who will have already experienced one transfer), but also a risk of eventually creating entities that look more like standard than special servicers as loans return to performing status.

4.5.4. Compensate servicers based on performance

There was substantial interest at the forum in exploring models for rewarding servicers based on performance. Moving from models that essentially pay for activity (including the model outlined above) to one that pays for outcomes is the “holy grail.” We recognize that this would constitute a fundamental change to the way in which the market is structured and compensated today. There are substantial open questions around how to structure an incentive scheme to drive the desired servicing behavior; the broader legal, accounting, and economic (balance sheet) impacts of changing the existing MSR structure; and the general implications of such changes on the overall market.

Clearly, significant further work is required to detail both models and resolve areas of ongoing debate. The FHFA is currently considering models to reform servicer compensation, and we encourage the FHFA to consider these models as options. We also urge bond investors and servicers/issuers to take a leadership role in developing performance-based models, with a view to building the foundation for a well-functioning private-label securitization market. We note that rules proposed by the federal regulatory agencies applicable to private securitizations require servicer compensation to be aligned with loss mitigation. Any efforts to develop performance-based compensation models need to be made consistent with the regulatory push to ensure that securitizers have “skin in the game” through proposed risk retention⁷⁷ rules.

4.5.5. Clear rights for first and subordinate lienholders

Discussion at the forum started from the assumption that demand for home equity loans (second or subordinate liens) will continue. In this context, servicers and investors (holders of first and second liens) recognized that clarifying the rights of lienholders is critical both to avoid a repeat of current frictions and to restore investors' confidence that they have enforceable priority in the event of default. There are, then, two key objectives:

- **Protect first-lien priority.** Stakeholders identified a range of options, including
 - requiring the originator of a subordinate lien to buy out the first lien
 - requiring first and subordinate liens to be serviced by a single servicer, who would distribute any payments made by the borrower according to lien priority
 - requiring the holder of the first lien to consent to the creation of a subordinate lien
- **Standardize treatment of seconds in loss mitigation efforts.** Options fell into two categories. The first was emerging “de facto” standards—for example, that resubordination of a second lien is not required where the modification is not detrimental to the holder of the second lien. Stakeholders suggested that this should be enshrined going forward. The second category, which involves agreeing on loss mitigation strategies up front, also address the basic objective of protecting the priority of the holder of the first lien.

One approach would see different loss mitigation strategies, depending on the equity position of the borrower. For example:

- Where a borrower who had equity at origination but is now underwater, the second lien would be eliminated in any workout before the holder of the first lien took a loss.⁷⁸
- Where a borrower still has some equity, loss mitigation would follow a 2MP⁷⁹ approach, with the holder of the second lien receiving some compensation for writing down the loan.

In addition, stakeholders identified options for minimizing overall losses—for example, legislating a maximum CLTV or making default on a first lien trigger an automatic freeze on any home equity loans.

Further work is required to detail these options and consider trade-offs. These include

- downstream impacts on the availability and cost of credit;
- operational feasibility, including the cost, of proposals, particularly where implementation would require transfer of information between first and subordinate lienholders. Stakeholders highlighted that operational complexity can be reduced to the extent that recommendations can be built into home equity product definitions.

We recommend that industry takes the lead on further developing these options in the first instance, with involvement from the FHFA, Treasury, and the FDIC. We note that rules proposed by the federal agencies applicable to private securitizations require that the documents specify how second liens will be dealt with when the first lien becomes delinquent.⁸⁰

4.5.6. Practical infrastructure in place for the return of private-label securitization

There was general consensus among stakeholders that securitization will remain necessary to provide housing finance in the United States, and that private-label securitization will need to be encouraged if the role of the GSEs is to decrease. Rebuilding investor confidence in origination and servicing practices is a key precondition to the return of private-label securitization that can and should be addressed while work continues to resolve major policy questions—for example, around the future role of government and the GSEs in housing finance.

A number of the recommendations already discussed will contribute to this process. These include broader implementation of servicing standards, greater transparency in loss mitigation activities, protection of priority for the holder of the first lien, and clearer rights and responsibilities in relation to repurchase claims. There are two additional objectives that stakeholders identified as important:

- **Standardized provisions governing loss mitigation activities in PSAs.** Clear and consistent standards in relation to what servicers can and can't do can reduce the operational complexity for servicers executing loss mitigation strategies, and thereby improve outcomes for investors. The FHFA has already tasked the GSEs with developing a model PSA. Industry participants should leverage this agreement as a template for private-label securitization, building on it to include standard provisions around loan modifications and risk retention requirements.
- **Effective monitoring and oversight of servicers as agents of investors.** Stakeholders and interviewees highlighted that this requires two things: defining clear and transparent expectations of trustees, to include providing active oversight of servicers; and setting compensation appropriate to the effort involved. While there is a clear cost involved in this recommendation, which will likely be passed on to consumers, this approach has the benefit of providing a transparent **mechanism for pricing the cost of oversight. We call on industry to** convene and lead a working group of investors, trustees, servicers, legal experts, and others to articulate a set of standards and recommend appropriate compensation. These standards should be incorporated into the private-label PSA of the future.

5 Every stakeholder group has a role to play

Addressing all of the recommendations highlighted in the previous chapter will require efforts and coordination across all stakeholders in the housing market ecosystem. Servicers are the main lever through which actions on legacy mortgages are applied, and their wholehearted participation in this effort is critical. The FHFA's and GSEs' involvement will be equally critical, given that the GSEs guarantee most of the outstanding loans and effectively set the standards for the future housing market. Furthermore, a common theme heard across most participants is the importance of stability and standards. This means regulators have a critical role to play in ensuring a coordinated and consistent response. Moreover, tailoring the recommendations and solutions to fit local needs will require strong leadership from local governments and NGOs. Finally, many of the initiatives identified require coordination across the overall industry and should involve all stakeholders. In this chapter, we will review the role each stakeholder would play in implementing each of the recommendations.

5.1. Servicers

Servicers have a key role to play in increasing the efficiency, quality, and transparency of servicing:

- First, servicers should explore the possibility of leveraging special servicing to improve outcomes on nonperforming legacy loans—for instance, by employing special servicers as “sub-servicers” on nonperforming loans or by selling mortgage servicing rights to other entities. Large servicers could consider creating their own subsidiaries dedicated to special servicing.
- Secondly, servicers should play a key role in increasing transparency in the market. In particular, they should enable investors to assess their loss mitigation strategies by releasing data on modification activity and modification performance, and by giving access to their NPV model structures and key inputs.

5.2. Investors

In addition to taking a key role in industry-wide initiatives, banks that hold private-label mortgage-backed securities and investors should consider individual actions to better handle legacy nonperforming loans. In particular, they should carefully assess the pros and cons of selling nonperforming loans to special servicers, which may trigger the recognition of losses but would conversely bring benefits by ridding their balance sheets of distressed assets, better enabling them to focus on new business.

5.3. FHFA and GSEs

In addition to leading several industry-wide initiatives as described below, the FHFA and the GSEs can take specific actions to encourage “bottom-up” REO-to-rent and rent-to-own efforts by improving the financing challenge these efforts currently face.

- They should lift GSE caps on the number of loans per investor, to boost the capacity of local investors and allow REO disposition strategies to scale appropriately.
- They can help small- and mid-sized market participants secure the fixed-term (7 to 10 years) capital they need and that the market does not provide today. By financing and securitizing such deals, they could “prime the pump” and encourage private investors to invest in this asset class.
- They can play an important part in encouraging sustainable business practices in anticipation of the growth of bulk sales. In particular, they should encourage private REO holders to require investors to “pre-qualify” to bid on REO sales, for instance by providing standard models, and explore options to limit the impact of REO sales on the valuation of surrounding properties.

5.4. Other federal agencies

While most of the initiatives described in this document can be driven primarily by the industry, FHFA and the GSEs, a number of other federal agencies including Treasury, CFPB, FDIC, SEC, OCC, DOJ and FINRA also play a crucial role in establishing a robust housing marketplace. In addition to taking part in the industry-wide initiatives described below, regulators can further improve transparency in the market by:

- Releasing some of the data they currently collect: HAMP data on principal reduction at Treasury and OCC database of modification data
- Setting and administering disclosure standards for market participants, for instance to encourage servicers to release data on their loss mitigation strategies to investors. The SEC could take a leading role in driving more transparency in the market, for example through its proposal to strengthen Reg AB, which provides disclosure guidance and requirements.

5.5. State and local governments, NGOs

Many of the key initiatives identified focus on “bottom-up” action, which gives state and local governments, as well as NGOs, an important role to play.

Local authorities are best placed to drive strategies and coordinate actions at the local level. NGOs, through their local and regional connections, are well placed to collect and spread information and best practices among local players:

- An NGO would be well placed to develop options for streamlining the foreclosure process, by developing a “model” process leveraging best practices across jurisdictions, driving the process to build consensus around this model and advocating for its adoption at the state level.

- Further, we encourage NGOs to support REO and disposition strategies by creating a “playbook” of possible strategies, best practices, and information on local context, including local regulations, which could be used by investors and operators interested in REO disposition.

5.6. Industry-wide collaboration

While different initiatives will require different stakeholders taking a leading role, improving the functioning of the housing market and addressing the issues that have created frictions during the crisis will require strong coordination across the industry as a whole, including servicers, originators, mortgage insurers, and investors, in addition to the FHFA, the GSEs, and federal agencies.

6 Appendix

6.1. Efforts to date

The government has implemented a range of programs, with varying levels of success. A range of programs are targeted at individual borrowers under the banner of the “Making Home Affordable” program. This includes the Home Affordable Modification Program (HAMP) and the Home Affordable Refinance Program (HARP), both of which are outlined below, as well as specific programs addressing second liens, principal reduction, short sales, and forbearance for unemployed borrowers. In addition, the FHA offers its own modification program; and HOPE Now, a private, voluntary loss mitigation initiative, advocates for and coordinates parties in proprietary modifications with federal government encouragement. The government has also sponsored programs providing funding to the states through the Hardest Hit Fund (targeting modification and relocation activity) and the Neighborhood Stabilization Program (targeting redevelopment of foreclosed and abandoned homes). Some stakeholders have highlighted that distinct from the features of any individual program, the multiplicity of programs to be navigated, combined with a reliance on borrowers to seek out the right program, have kept a cap on workout activity: one government agency commented that “we are paralyzed by the complexity and multiplicity of polity solutions.”

6.1.1. Loan modification

The government’s lead modification program, HAMP, pays incentives to encourage servicers and debt holders to modify loans. Initially targeting 2 million to 3 million borrowers, more than 1 million permanent modifications have been completed to date.⁸¹ Stakeholders identified the complexity of the HAMP process, compounded by evolving eligibility criteria, and the associated delays as key factors limiting the impact of the program. Stakeholders acknowledged that a significant part of the complexity of HAMP is driven by a desire to deliver fairness to individual borrowers. They highlighted, however, that complexity created challenges for already overstretched servicers, who were relied on to deliver a program based on individual borrower assessments, while the combination of complexity and delays created challenges for borrowers, who might give up partway through the process.

“Programs are so complicated that people can’t get through them”

“The modification process took so long that by the time you were ready to finalize the mod, they were no longer eligible”

While the success rate of early modifications was low, the quality of modifications is improving. The OCC reports that 12-month 60+-day delinquency re-default rates have come down from 57 percent in 2008 to 25 percent in 2011.⁸² Studies of PLS modifications show re-default rates have declined with each “vintage” of modification, driven by larger modifications: modifications made in the second half of 2011 are tracking at around 20 percent cumulative re-default, compared with

90 percent for modifications done in the first half of 2008.⁸³ Analysis shows that the success of a modification depends on the timing of intervention, size of monthly payment reduction, type of modification, and FICO score of borrower—with earlier intervention, larger payment reductions, principal modifications and higher FICO scores all correlated with more successful modifications.⁸⁴ The identity of the investor and servicer also matter, both to the likelihood of attaining a modification, and to its success. The modification program is also influential: HAMP modifications have outperformed proprietary modifications.⁸⁵ The OCC suggests that the better performance of HAMP modifications is driven by an emphasis on the affordability of monthly payments relative to the borrower's income, verification of income, and completion of a successful trial payment period—factors that also contribute to the complexity and time taken to implement HAMP modifications.

“You need to get to people while they are still emotionally attached to the concept of ownership... every delay makes success less likely”

There is some evidence to suggest that the level of modification activity is “subpar” in the sense that modifications that would reduce investor losses are not being made. Several studies have concluded that, all other things being equal, servicers are less likely to modify loans in privately securitized pools than those held in their own portfolios.⁸⁶ In addition, the Center for Responsible Lending has found that “current self-cure rates and re-default rates are within ranges that should lead to far more modifications,” with current re-default rates 35 to 50 percent lower than break-even re-default rates (for a range of payment reduction scenarios).⁸⁷

6.1.2. Refinance

HARP was introduced in 2009 with an initial target of 4 million to 5 million borrowers, but had reached only 1.5 million borrowers as of July 2012.⁸⁸ Eligibility criteria limiting access to GSE-insured loans with LTVs below 125 percent, up-front costs (e.g., appraisal costs), ongoing lender and servicer concerns about repurchase risk, falling home values, and conservative appraisals are cited as the key drivers of limited uptake.⁸⁹ Even though underwater borrowers were eligible, in practice only ~10 percent of those who participated in HARP were underwater.⁹⁰ Mayer et al. also noted that the constraints had a differential impact on middle-income borrowers with origination balances under \$200,000. These borrowers typically had poorer credit and were more likely to have had their employment impacted by the recession.⁹¹

HARP 2.0, which came into effect in March 2012, targeted many of these barriers. HARP 2.0 removed the 125 percent LTV cap, is open to borrowers with no more than one delinquent payment in the last 12 months, implemented streamlined appraisal and underwriting standards for loans refinanced by the existing servicer, limited the application of risk-based fees, and reduced risks for lenders by both eliminating repurchase liability on certain reps and warrants (for existing servicers) and negotiating with mortgage insurers to secure agreement to drop rights to rescind insurance on loans that default. There is evidence of increased HARP refinance activity in recent months in the context of historically low interest rates.⁹² Ongoing obstacles and opportunities for broader impact are discussed in Section 2.2.1 above.

6.1.3. Hardest Hit Fund

In addition to programs like HAMP and HARP, which directly target borrowers, Treasury made \$7.6 billion available to 18 states hardest hit by the crisis. The funds could be used for a range of initiatives, including assistance for unemployed/underemployed borrowers, principal reduction on first or second liens, and relocation assistance. As of the end of 2011, however, only \$217 million had been spent, driven in part by the need (and failure) to secure the participation of key stakeholders (GSEs and banks).⁹³ Announcements this year suggest that progress is being made, however, in key states: California and Nevada have announced the intention to use their funds to provide principal reduction for underwater borrowers.⁹⁴

6.1.4. Neighborhood Stabilization Program (NSP)

Commentators and stakeholders we interviewed have noted that dealing with the risk of blight and the “bottom tranche” of low-value properties has not been a focus in the federal response to the housing crisis.⁹⁵ The flagship program is the NSP, through which the federal government has committed \$7 billion to states to fund stabilization activities. A range of factors limited the uptake of these funds, including limitations on using the funds for demolition activities, compressed timelines and changing regulations as well as a lack of infrastructure at the state level (e.g., land banks) set up to effectively utilize the funds.⁹⁶ Practitioners we interviewed credited the program with funding effective rehabilitation efforts, but noted a clear trade-off: the program’s focus on rapid deployment favored a direct purchasing model. They expressed a desire to see any future programs allow longer lead times so that organizations can seek to obtain leverage in order to acquire and rehabilitate a larger number of properties.

There are, in addition, a range of state and local initiatives aimed at addressing blight. Fitzpatrick et al. outline, for example, a range of local ordinances in Cuyahoga County, Ohio (home to Cleveland), aimed at encouraging the proper care and maintenance of vacant properties. These include vacancy registration requirements, point-of-sale inspections, and requirements that owners establish an escrow account containing funds necessary to bring a home in line with any local code requirements at the point of sale. Fitzpatrick et al. find that only the latter has had a significant impact on the condition of vacant properties.⁹⁷ Another tool for managing property at risk of blight is the creation of a land bank: typically a public or nonprofit entity with a mandate to manage low-value properties at risk of blight. While there is limited evaluation of land banking, there is some evidence to suggest that reducing blight preserves or increases surrounding property values.⁹⁸ However, the prevalence and capacity of land banks is limited: about half of the GSE and FHA low-value inventory is in metropolitan areas with land banks, and the majority of these institutions can handle only a few properties a month.⁹⁹

6.1.5. Additional funding for stabilization activities

Two pieces of legislation that would provide additional funding for land banking and other stabilization activities were introduced in Congress in March 2012, although neither passed the committee stage. The Project Rebuild Act (S. 2162) would provide \$15 billion to purchase, rehabilitate, demolish, or redevelop foreclosed, abandoned, or vacant properties. It builds on NSP, but explicitly allows a broader use of funds (e.g., for demolition or for the rehabilitation of

commercial properties that may be critical to the longer-term sustainability and attractiveness of neighborhoods).¹⁰⁰ The program also facilitates partnerships between for-profits and nonprofits to deliver stabilization activities, and stakeholders anticipate that the structure of the program will allow federal funds to be leveraged in order to extend the scale of works completed. The Restore Our Neighborhoods Act (H.R. 4210), would provide \$4 billion in tax credits (which function essentially as interest-free loans) to allow states to undertake residential and commercial demolition.¹⁰¹ States or local organizations such as land banks could use the funds but would need to demonstrate an ability to repay the principal after 30 years.

6.1.6. REO disposition

To date, the disposition of REO properties has occurred largely through retail sales channels. In February 2011, the FHFA launched a bulk sale pilot, focused on the sale for rental of ~2,500 Fannie Mae properties, most of them already tenanted.¹⁰² The first transactions closed in the third quarter of 2012, and the FHFA announced that it was “encouraged by the results” and would remain “committed to pursuing efforts that build upon the success of this initiative.”¹⁰³ Bank of America and CitiMortgage recently announced rent-to-own pilots with the intention of offering borrowers a deed-for-lease option and ultimately selling the pool of tenanted properties to investors.¹⁰⁴ Meanwhile, the FHA has shifted its focus from REO disposition to selling delinquent notes prior to foreclosure.¹⁰⁵

6.2. Perspectives on further intervention

The crisis is continuing and significant challenges limit the effectiveness of current initiatives. Stakeholders have a range of views on the type and scale of further intervention required at this point, driven in part by a lack of consensus on the importance of different drivers of the ongoing crisis, as shown in Exhibit 8. For example:

- Stakeholders who are more concerned about the risk of strategic default tend to favor strategies such as principal reduction that address negative equity head on.
- Stakeholders who consider that a larger volume of distressed inventory is yet to come tend to support principal reduction as a strategy, and broader-scale programs in general (e.g., broad principal reduction, bulk REO sales).

While views on individual initiatives were rarely unanimous, there was convergence on a number of key issues outlined on the following page.

6.2.1. Further intervention is warranted

The majority of stakeholders agree that further intervention is necessary, with the predominant concern being to avoid the risk of further steep price declines. Multiple stakeholders emphasized the risk of “doing nothing”: while signs point to a slow recovery in housing, we remain vulnerable to global economic shocks and/or increases in unemployment, which could trigger a negative spiral. This is not to suggest that there was support for “artificially” propping up prices: stakeholders

**EXHIBIT 8:
DIFFERING VIEWS ON THE IMPORTANCE
OF INDIVIDUAL DRIVERS, AS WELL AS
HOW THEY SHOULD BE ADDRESSED**

← Typical range of views →

Price Stability	<p>“Stabilizing house prices is the single most important objective”</p> <p>“If we overshoot too much from here, it’s going to be a problem”</p>	<p>“We are at the end of seeing value from spending to prevent overcorrection on price”</p>
Negative Equity	<p>“The sheer volume of negative equity poses a significant risk ... life events (e.g., divorce, dismissal, disability and death) may yet drive significant numbers of borrowers into default”</p>	<p>“The anticipated wave of strategic defaults simply hasn’t materialized”</p> <p>“The probability of default declines as expectations improve, requiring a much larger financial trigger”</p>
Employment	<p>“Elevated unemployment will continue to drive default, and we still haven’t figured out what to do with unemployed borrowers”</p>	<p>“Addressing unemployment (head on) is critical. Unemployment precedes housing in the economic recovery.”</p>
Vacancy	<p>“Abandoned and blighted properties pose a threat to neighborhood stability, and are placing a significant drain on local resources”</p>	<p>“Low value properties are an issue, but one that is highly geographically concentrated”</p>
Affordability/ Access to Credit	<p>“Steep price declines and historically low rates should present an opportunity for new buyers”</p> <p>“Access to credit is a constraining factor, particularly for hardest hit communities”</p>	<p>“Access to credit isn’t a constraining factor on recovery ... but it’s important that a number of issues are resolved so that it doesn’t become an issue in 18-24 months time”</p>

typically recognized that prices may still need to fall in some areas in order to stabilize demand; instead, the concern is to prevent a significant overcorrection that would further constrain economic recovery.

“There is a serious risk still to be managed: if turmoil in Europe grows, if unemployment rises again, prices could drop another 10 to 15 percent and we could see a further significant round of defaults”

Other concerns motivating stakeholders were the need to ensure we have mechanisms in place to deal with ongoing waves of REO as distressed and shadow inventory works through the system, as well as the need to address a growing imbalance between stock available for ownership versus rental.

6.2.2. It’s about tactical improvements, not big new ideas or big spending programs

Stakeholder views on the nature of action required are a mixture of conviction and pragmatism. The majority view is that the appetite is small for big spending by government programs or making fundamental changes to programs—with some recognizing that there may have been opportunities missed (e.g., to repurpose unused TARP funds to fund principal reduction of first and/or second liens). This view is echoed by Adam Levitin in outlining potential obstacles to a broad-scale principal reduction program.¹⁰⁶

“The idea that there is a ‘grand bargain’ at the government level has passed”

However, others also emphasize that big, new programs are not necessary: we are making progress, and while the risk of further price declines is real and needs to be managed, it can be managed with incremental action.¹⁰⁷ In addition, in the context of an already complex policy environment, stakeholders highlighted that significant new programs or changes to existing programs risk creating confusion and inefficiency, undermining the basic goal. Given where we are, we should focus on identifying how to improve processes and existing mechanisms, drawing on lessons learned to date.

“We are making progress ... we don’t need ‘home runs’”

“The focus now should be on improving processes and efficiency”

6.2.3. Strategies should be targeted locally

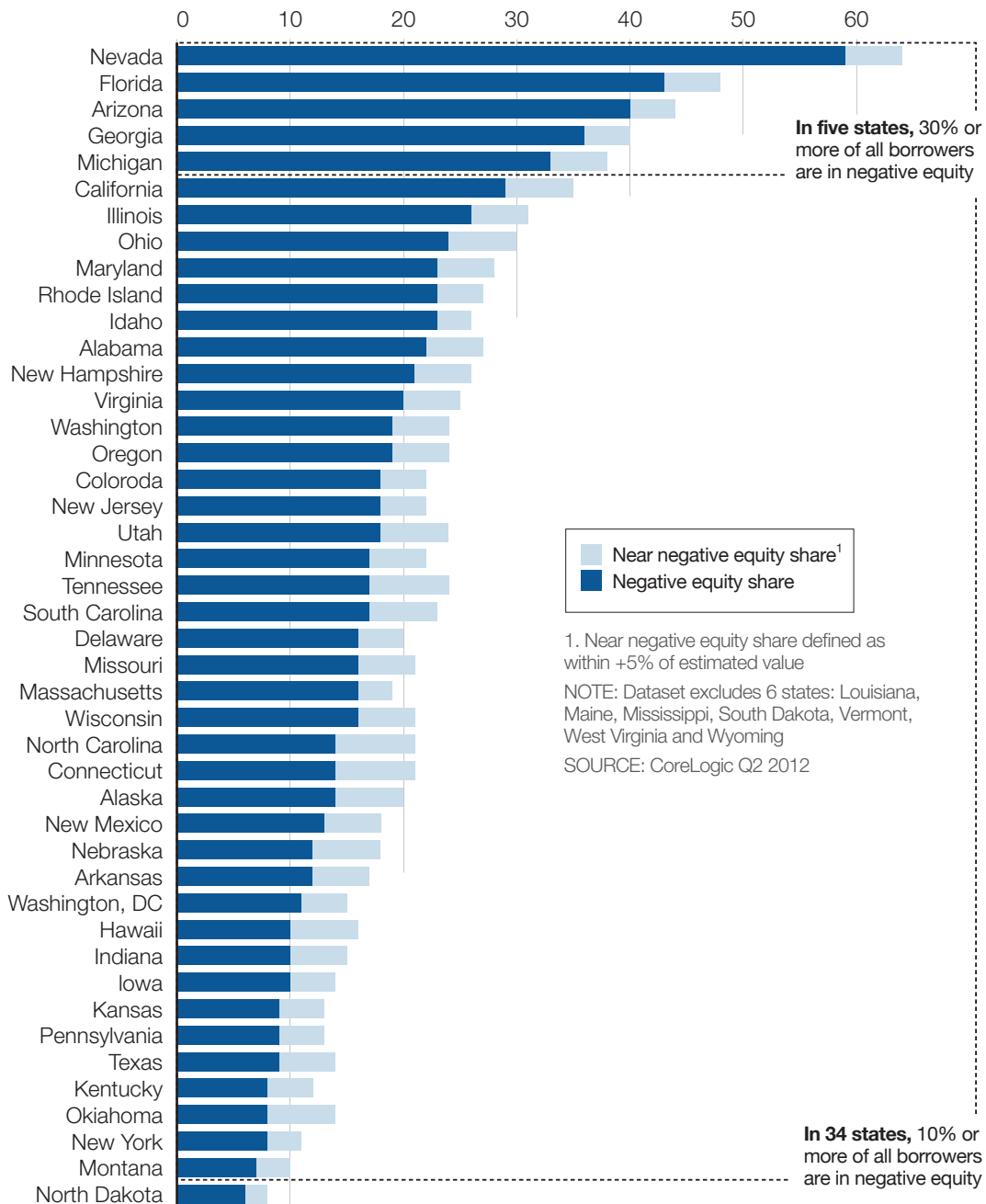
The impact of crisis varies widely between states, but also between and even within metro areas, driven both by the severity of price declines as well as projections of underlying demand that distinguish, for example, Sun Belt states from their Rust Belt counterparts. How much further intervention is required, as well as the types of intervention that are relevant, will depend on local conditions.

For example, in some states the main issue may be addressing inventory “frozen” in the foreclosure pipeline rather than dealing with a glut of REO. Meanwhile, principal modifications may be more attractive in areas still struggling under the weight of significant negative equity than in areas that experienced less steep declines. Stakeholders across the board emphasized that, in practice, the housing crisis today “is not a national issue.” The same solutions are not appropriate, or required, across the country.

Nevada, Arizona, Florida, Michigan, and California experienced the steepest price declines and are among the states with the highest proportion of underwater borrowers. Nevada has by far the most underwater borrowers, at almost 60 percent share, as shown in Exhibit 9 below.

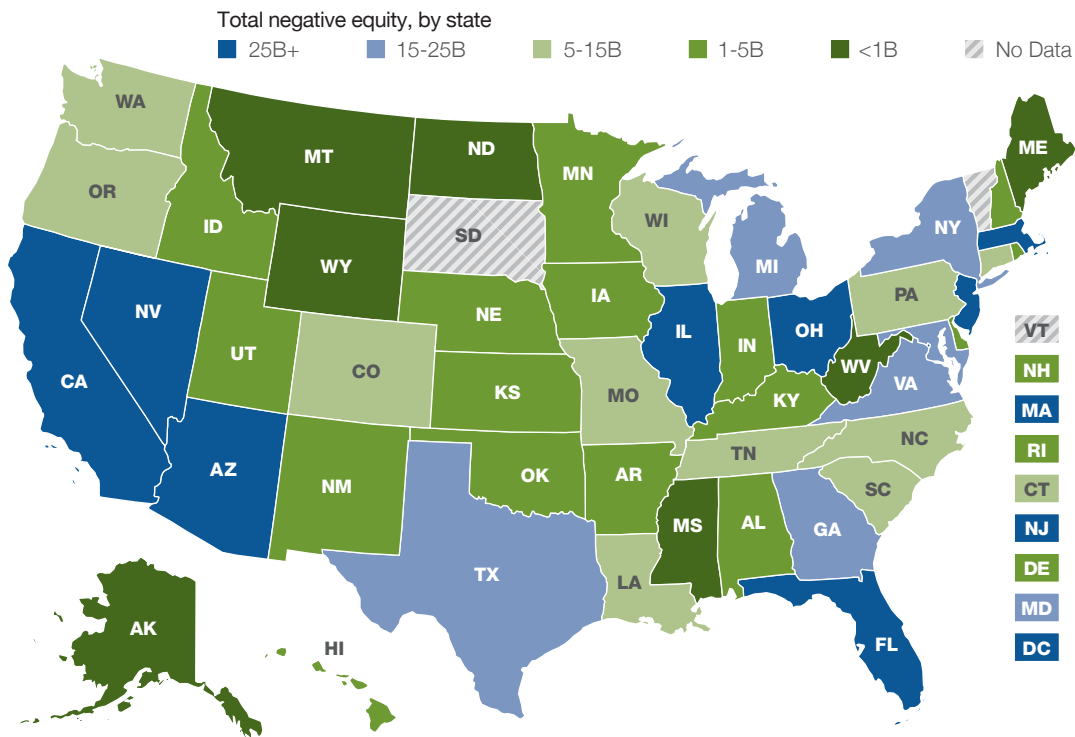
**EXHIBIT 9:
SHARE OF UNDERWATER BORROWERS
VARIES SIGNIFICANTLY BY STATE**

Negative equity share by state: Q2 2012
% of mortgages with negative equity



In terms of sheer dollar value, however, California holds the lion's share of negative equity, at just over 26 percent of national total; Massachusetts and Illinois each hold around \$30 billion of negative equity, as shown in Exhibit 10 below.

**EXHIBIT 10:
OVER 60% OF NEGATIVE EQUITY
IS CONCENTRATED IN SEVEN STATES**



SOURCE: CoreLogic March 1 2012 (Q4 2011 data)

6.2.4. It is important to align strategies to objectives

Given different geographic experiences, as well as borrower backgrounds and objectives, stakeholders across the board emphasized the need to define a clear set of objectives and align strategies to those objectives in order to design and target effective intervention. The framework in Exhibit 7 above bears this in mind, grouping effective strategies under four main objectives: keeping willing and able borrowers in their homes, clearing a path to exit for unwilling/unable borrowers, incentivizing demand for distressed stock, and removing housing stock from the market (e.g., through conversion to rental). There is, as we were frequently told, no silver bullet: a portfolio of strategies will be required across geographies and within any given area, based on individual borrower property characteristics. This is echoed by Jennings, who also emphasizes the need to take into account operational constraints—both in the sense of business needs and capacity to execute.¹⁰⁸

6.2.5. Early and meaningful engagement with borrowers is critical

Whatever the intervention, stakeholders repeatedly emphasized that the ability to engage borrowers in a timely and meaningful manner is critical: to identifying whether there is an appropriate workout (e.g., modification, short sale, conversion to rental) and to executing it while the borrower is still engaged and within any time frames required by modification programs. With servicers at the front line of this engagement, their capabilities, as well as the processes and standards they are working with, are central to effective interventions.

6.2.6. Government can continue to play a useful role in standard setting

Stakeholders have recognized that government has played a valuable role in setting standards in both the modification and securitization spaces, and agree that there is an opportunity to do more work in this space. Any future work should take account, however, of a desire within industry for greater transparency, coordination between efforts and processes, as well as cross-sector engagement to improve program design and facilitate effective implementation. There is a recognition that the constant flow of activity—whether program based, regulatory, or in the context of litigation—has kept industry in “response” mode for an extended period of time.

“HARP 2.0 was a good program because it was designed the right way, engaged with industry, and had sufficient time frames to allow for effective planning.”

6.2.7. Policy stability is important

In fact, industry stakeholders have emphasized the need for policy stability more broadly at this stage of the crisis. Policy makers themselves recognized that there are trade-offs in allowing policies to evolve and improve from a design perspective. From an operational perspective, evolving programs and processes drive complexity, particularly in servicing organizations already confronted by significant complexity and a challenging economic environment. Changes to deliver a more effective design may be self-defeating if the effect is to slow delivery of modifications and workouts. Stakeholders also noted that successive rounds of policy development may also suffer from diminishing returns if borrowers come to expect that another “release” is around the corner.

“The key thing is to avoid further program changes and allow servicers to work on delivering existing programs efficiently”

“You need to ensure you aren’t encouraging borrowers to wait for the next ‘deal’”

Investors also emphasized that the consequence of uncertainty is likely to be an increased cost of credit, as investors add a risk premium to required returns.

6.2.8. Scaling initiatives significantly may require difficult trade-offs

Trade-offs are a necessary part of any program design. Policy makers responding to the housing crisis have had to make decisions weighing, for example, the speed of action versus the cost of recovery (including the risk of creating perverse incentives or moral hazard), and the “efficiency” of outcomes versus fairness to individuals.

In identifying factors that have limited the success of existing initiatives, stakeholders frequently recognized that addressing these factors could require making different and difficult trade-offs, tolerating, for example:

- a greater degree of unfairness to individual borrowers—for example, by relaxing eligibility criteria for existing programs;
- a greater degree of unfairness to individual lenders—for example, by making payments to holders of second liens, which may be worthless in bankruptcy—in order to facilitate loan workouts;
- a greater risk of moral hazard—for example, by expanding access to principal reduction.

A plurality of stakeholders, motivated by a pragmatic desire to “get deals done,” actively called for greater tolerance.

“The entire discussion around intervention is fraught with moral hazard and unfairness: the question is which ones you can live with”

6.3. On principal reduction

Principal reduction strategy is being debated at length. Proponents as well as opponents have made their position very clear and publicly known. During the interviews and the conference, a number of stakeholders raised the **cost of principal reduction**, which requires the immediate and final recognition of a loss on the loan modified, as a basic economic obstacle to scaling the strategy. This issue is most acute in any discussion about performing loans: because they are still performing, lenders are not required to recognize any loss ahead of the write-down, and the full amount of principal reduction must be recognized at modification.

The risk of **creating perverse incentives** for borrowers to default (in order to qualify for a write-down) is front of mind for the FHFA and the private sector as a risk that could drive significant additional cost.¹⁰⁹ There was, however, some variation in views, with some stakeholders more optimistic about the potential to manage the cost of strategic default, for example, through limiting eligibility to those who were already in default,¹¹⁰ “earned forgiveness” schemes, or the use of nonperforming note sales to allow servicers to isolate principal reduction as a strategy. Shared appreciation is another generally recognized tool for managing hazard and minimizing losses more generally—however, a number of servicers remain skeptical, seeing operational complexity and downstream risks (including to their reputation) as outweighing the potential upside.¹¹¹

“Shared equity is fair and interesting, but it’s always going to be hard to get the consumer to understand it in the midst of what is typically a very stressful and emotional time. There’s a serious risk that either they will reject it outright or take it on without fully understanding the details, which will cause issues when it comes time to sell the property”

Stakeholders also raised concerns about fairness, noting that broad-scale principal reduction could provide a windfall to borrowers whether they have behaved in good faith (e.g., did not knowingly significantly overextend themselves, have made every effort to meet payments but have been beset by hardship) or not.

There was also a focus on a final key issue: there is **little data** on which to quantitatively assess both the efficacy and risks of principal reduction as a modification strategy. Stakeholders highlighted that data on the volume and performance of principal reduction modifications, broken out from principal forbearance, is included in the HAMP and OCC-OTS databases, but is not made readily available to researchers and analysts. In the absence of good data on the performance of principal reduction versus principal forbearance, debate about whether encouraging greater use of principal reduction is necessary is unlikely to be resolved. Given the cost of principal reduction as a strategy, as well as concerns about moral hazard and fairness outlined above, some suggested that forbearance should be the default option until it can be proven that reduction is more effective.¹¹²

6.4. Round-table participants

We would like to thank again the 23 participants who contributed to the round-table discussions:

- Alex Jung from BB&T Mortgages
- Andrew Miller from PNC
- Bill Sermons from the Center for Responsible Lending
- Bill Treacy from the Federal Reserve Board
- Bob Ryan from HUD
- Brian Faux from the FHFA
- Carol Larson from Deloitte and Touche
- Craig Nickerson from NCST
- Dan Magder from Rock Creek Capital Group
- Jim Rokakis from the Thriving Communities Institute
- John Brenan from the Appraisal Foundation
- Josh Rosner from Graham Fisher and Company
- Laurie Goodman from Amherst Securities
- Laurie Maggiano from Treasury
- Lew Ranieri from Ranieri Partners
- Matt Bass from Alliance Bernstein
- Meg Burns from the FHFA
- Michael Malloy from Bank of America
- Mike Heid from Wells Fargo
- Rich Brown from the FDIC
- Scott Simon from PIMCO
- Stephen Jackson from the OCC
- Tom Deutsch from the ASF

7 Endnotes

1 Shaila Dewan, “Hard-Hit Cities Show a Housing Rebound,” *New York Times*, August 28, 2012, available at <http://www.nytimes.com/2012/08/29/business/economy/home-prices-rise-survey-shows.html>.

2 CoreLogic, “CoreLogic September Home Price Index Rises 5 Percent Year-Over-Year” (November 6, 2012), available at <http://www.corelogic.com/about-us/news/corelogic-september-home-price-index-rises-5-percent-year-over-year.aspx>.

3 Historically, delinquency rates have ranged between an estimated 3 and 6 percent of loans. Lender Processing Services, “LPS Mortgage Monitor: May 2012 Mortgage Performance Observations” (June 2012), available at <http://www.lpsvcs.com/LPSCorporateInformation/CommunicationCenter/DataReports/MortgageMonitor/201204MortgageMonitor/MortgageMonitorApril2012.pdf>.

4 To view the Pew-commissioned research papers, visit <http://www.pewstates.org/research/featured-collections/strategies-to-improve-the-housing-market-85899400385>.

5 The round-table participants are listed in Chapter 6.4 of the Appendix to this paper.

6 Pooling and servicing agreements are the contract between the trust structure where privately securitized loans are placed and the servicer that manages them.

7 Memorandum from R. Brown to S. Bair re: Bank United PRA Mods, November 28, 2012.

8 To view the Pew-commissioned research papers, visit <http://www.pewstates.org/research/featured-collections/strategies-to-improve-the-housing-market-85899400385>.

9 Lender Processing Services, “LPS Mortgage Monitor: September 2012,” August 2012 data. Between 1995 and 2005, delinquency rates ranged between ~3 percent and 5 percent of loans.

10 CoreLogic, “CoreLogic September Home Price Index” (2012). The majority of states posted increases in the year to September 2012, with seven states still flat or declining.

11 Mark Zandi, Celia Chen, Cristian deRitis and Susan Wachter, “Assessing the Housing Threat and the Appropriate Policy Response” (Washington: Pew-commissioned research paper, 2012), p. 14; Andrew Jennings, “Crafting Effective Mortgage Loss Mitigation Strategies” (Washington: Pew-commissioned research paper, 2012), p. 6.

12 Jennings, pp. 6-9.

13 See Susan Wachter and others, “The Performance of New Private-Label Mortgage Loan Modifications After 2009” (Washington: Pew-commissioned research paper, 2012), p. 7, citing Neil Bhutta, Jane Dokko, and Hui Shan, “The Depth of Negative Equity and Mortgage Default Decisions.” Working Paper 2010-35 (Federal Reserve Board Finance and Economics Discussion Series, 2010).

14 Zandi and others, “Assessing the Housing Threat,” p. 14; Luigi Guiso, Paola Sapienza, and Luigi Zingales, “The Determinants of Attitudes Towards Strategic Default on Mortgages” (June 2011), available at http://www.kellogg.northwestern.edu/faculty/sapienza/htm/Guiso_Sapienza_Zingales_StrategicDefault.pdf.

15 Guiso, Sapienza, and Zingales, “The Determinants of Attitudes.”

16 For instance, in 2004 the average FICO score was 716. See “Fannie Mae 2012 Second-Quarter Credit Supplement” (August 2012), available at http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2012/q22012_credit_summary.pdf.

17 See, e.g., Equifax, “Sub-Prime Borrowers Gaining More Access to Credit as Lending Continues to Improve, Equifax Reports” (March 2012), available at <http://news.equifax.com/index.php?s=18010&item=126087>.

18 Zandi and others, “Assessing the Housing Threat,” p. 30.

19 On foreclosure pipeline versus REO stock, see Federal Reserve, “The U.S. Housing Market: Current Conditions and Policy Considerations” (January 2012), p. 11, available at <http://www.federalreserve.gov/publications/other-reports/files/housing-white-paper-20120104.pdf>. On expectations re: flow into REO, see Zandi and others, p. 30. See also Ingrid Gould Ellen, Josiah Madar, and Mary Weselcouch, “What’s Really Happening to the REO Stock? An analysis of three cities: New York, Atlanta, and Miami” (Washington: Pew-commissioned research paper, 2012), pp. 31-32 (approx.), noting that the pace of REO outflow slowed in two of the three counties analyzed, suggesting that any increase in in-flows would see inventories rise once more.

20 Andrew Jakobovics, “What Sells When: Analyzing Price and Time Patterns for Single Family Homes to Identify Best Practices for Aggregating REO Properties for Bulk Sales” (Washington: Pew-commissioned research paper, 2012), p. 2: 84 percent of REO ultimately sells, compared with 43 percent of non-distressed property.

21 Zandi and others, p. 3: estimate of houses lost to foreclosure, short sale, or deed in lieu since start of housing crash in 2006.

22 Ibid., pp. 3, 11-12.

23 Data provided by Amherst Securities.

24 Zandi and others, p. 5: expect 3 percent price appreciation per year in normal times; average price decline is more than 30 percent. In this context, Adam Levitin emphasizes that negative equity is an issue for performing as well as nonperforming loans. See Adam J. Levitin, “Clearing the Mortgage Market Through Principle Reduction: A Bad Bank for Housing (RTC 2.0)” (Washington: Pew-commissioned research paper, 2012), p. 5.

25 Bureau of Labor Statistics: Rent of primary residence CPI increased by 2.7 Percent in the 12 months to September 2012. See: <http://www.bls.gov/cpi/cpid1209.pdf>. U.S. Census Bureau, “Residential Vacancies and Homeownership in the Third Quarter 2012,” (October 30, 2012): Rental vacancy rate for

Q3 2012 is 8.6 percent versus 9.8 percent for Q3 2011, 10.3 percent for Q3 2010, and 11.1 percent for Q3 2009: <http://www.census.gov/housing/hvs/files/qtr312/q312press.pdf>.

26 Rolf Pendall, Lesley Freiman, Dowell Myers and Selma Hepp, “Demographic Challenges and Opportunities for U.S. Housing Markets” (Washington: Bipartisan Policy Center, March 2012), p. 6, available at <http://bipartisanpolicy.org/sites/default/files/BPC%20Housing%20Demography.pdf>.

27 Research suggests that foreclosed properties push down the values of nearby homes by 1 to 9 percent. See Patricia McCoy, “Barriers to Home Mortgage Modifications During the Financial Crisis” (Washington: Pew-commissioned research paper, 2012), p. 4 and the research cited there. Gould Ellen and others, pp. 4-6, note that the price impact of foreclosures can be driven by the poor condition of foreclosed properties, neighborhood blight (particularly where those properties are vacant/abandoned), and the use of REO sales as comparables in appraisals without proper examination of the condition of the property, as well as by simply swamping the market with supply.

28 Robin Harding, “Housing pickup unlikely to fuel growth,” *Financial Times*, October 18, 2012, available at <http://www.ft.com/intl/cms/s/0/e2288150-149e-11e2-aa93-00144feabdc0.html#axzz2HQLwfeBE>.

29 Zandi and others, p. 6, citing Mustafa Akcay, “The Wealth Effect,” *Regional Financial Review*, November 26, 2008. See also Mustafa Akcay and Christopher Cornell, “Scared Straight, U.S. Households Boost Savings,” December 2, 2009, available at http://www.economy.com/dismal/article_free.asp?cid=119772&src=datapoints.

30 Zandi and others, p. 6.

31 Ibid.

32 Liz Laderman and James Gillian, “Recent Trends in Small Business Lending” (Federal Reserve Bank of San Francisco, Economic Letter 2011-32, October 17, 2011), available at <http://www.frbsf.org/publications/economics/letter/2011/el2011-32.html>.

- 33 See, e.g., Thomas J. Fitzpatrick IV and Mary Zenker, "Municipal Finance in the Face of Falling Property Values" (Federal Reserve Bank of Cleveland, Economic Commentary, December 6, 2011), available at <http://www.clevelandfed.org/research/commentary/2011/2011-25.cfm>; G. Thomas Kingsley, Robin E. Smith, and David Price, "The Impacts of Foreclosure on Families and Communities: A Primer" (Washington: The Urban Institute, 2009), pp. 18-21, available at http://www.urban.org/UploadedPDF/411910_impact_of_foreclosures_primer.pdf.
- 34 Zandi and others, p. 7.
- 35 Kingsley and others, pp. 6-12; Dan Immergluck and Geoff Smith, "The Impact of Single-Family Mortgage Foreclosures on Neighborhood Crime," *Housing Studies* 21 (6) (2006), p. 851-866, available at <http://www.prism.gatech.edu/~di17/HousingStudies.pdf>.
- 36 See McCoy, p. 4 and the research cited. See also, generally, Immergluck and Smith.
- 37 Stephan Whitaker and Thomas J. Fitzpatrick IV, "The Impact of Vacant, Tax-Delinquent, and Foreclosed Property on Sales Prices of Neighboring Homes." Working Paper 11-23R (Federal Reserve Bank of Cleveland, (December 2011).
- 38 See O. Emre Ergungor and Thomas J. Fitzpatrick IV, "Slowing Speculation: A Proposal to Lessen Undesirable Housing Transactions" (Federal Reserve Bank of Cleveland, March 2, 2011), available at http://www.clevelandfed.org/forefront/2011/winter/ff_2011_winter_11.cfm.
- 39 Federal Reserve, "The U.S. Housing Market," pp. 14-15.
- 40 Participants noted, however, that outreach efforts continue to be frustrated by fraudulent solicitations. Borrowers who have been targeted with such solicitations may fail to respond to genuine outreach if they are unable to distinguish between them.
- 41 See, e.g., Levitin, p. 9.
- 42 The DOJ standards apply directly to the five largest servicers, but are expected to be incorporated in settlements with a broader range of banks. See, Carter Dougherty and Cheyenne Hopkins, "Four Regional Banks Discuss Settlement Over Foreclosure," September 7, 2012, available at <http://www.bloomberg.com/news/2012-09-07/four-regional-banks-discuss-settlement-over-foreclosures.html> (September 2012).
- 43 Nick Timiraos, "Banks Face Foreclosure Regulation by States," *Wall Street Journal*, July 1, 2012, available at <http://online.wsj.com/article/SB10001424052702304830704577497203174920444.html>.
- 44 Servicers are paid \$1,600 per modification completed within 120 days of delinquency, \$1,200 per modification completed between 120 and 210 days of delinquency, and \$400 per modification thereafter. Incentives are paid by Treasury for HAMP modifications and by GSEs on GSE loans modified under proprietary programs. See Freddie Mac, "Home Affordable Modification Program" (March 2012), p. 3, available at http://www.freddiemac.com/service/factsheets/pdf/mha_modification.pdf; Freddie Mac, "Servicing Alignment Initiative: Overview for Freddie Mac Servicers" (June 2012), p. 4, available at http://www.freddiemac.com/service/factsheets/pdf/servicing_alignment.pdf.
- 45 Special servicers are focused on default servicing and may have structural advantages driven by greater investment in systems and technology to facilitate more effective assessment of, and engagement with, borrowers in the context of default. There is some evidence that special servicers are delivering better results with distressed loans than are their standard servicer counterparts. In a recent earnings release, the special servicer Nationstar reported improving payment rates on 17 percent of its subprime loans originated between 2004 and 2007. A handful of other special servicers reported improvements on 13 to 15 percent of comparable loans, while Chase and Wells improved 10 percent and 7 percent, respectively. See Nationstar Mortgage, "Q1 2012 Earnings Presentation" (May 15, 2012), available at <http://investors.nationstarholdings.com/Cache/1500041589>.
- 46 McCoy, pp. 17ff.
- 47 See, e.g., testimony of Laurie Goodman, Amherst Securities before the U.S. Senate Subcommittee on Housing, Transportation and Community Development (May 12, 2011).

48 McCoy, p. 24, available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=484c5b2b-6924-459f-898e-3ae075feeb15 notes that lenders have significant discretion to assess the likely sales price in foreclosure, discount rate, and re-default rate in proprietary modifications, with the result that it is often possible to use the NPV test to proceed with or terminate a modification application. She notes that the same dynamic is present in the HAMP NPV model, though to a lesser extent.

49 For instance, such information was made available for the model used by the Resolution Trust Corporation to liquidate the assets of savings and loans associations that became insolvent during the savings and loan crisis in the 1980s, and for the one used by the Federal Deposit Insurance Corporation during the resolution of IndyMac Federal Bank, a large mortgage lender.

50 RealtyTrac U.S. market foreclosure report Q3 2012, available at <http://www.realtytrac.com/content/foreclosure-market-report/september-and-q3-2012-us-foreclosure-market-report-7424>.

51 Kristopher Gerardi, Lauren Lambie-Hanson and Paul S. Willin, “Do Borrower Rights Improve Borrower Outcomes? Evidence from the Foreclosure Process,” (Federal Reserve Bank of Boston, Public Policy Discussion Paper 11-9, June 15, 2012), available at <http://www.bostonfed.org/economic/ppdp/2011/ppdp1109.pdf>.

52 McCoy, pp. 31.

53 See, generally, Chris Mayer, Ed Morrison and Tomek Piskorski, “After the Housing Crisis: Second Liens and Contractual Inefficiencies,” (Washington: Pew-commissioned research paper, 2012), p. 7-8; McCoy, p. 31. Vicki Been, Howell Jackson, and Mark Willis, “Soft Seconds/Hard Problems: The Size and Scope of the Problems Second Liens Pose to the Recovery of the Housing Market,” (Washington: Pew-commissioned research paper, 2012) which notes that liens can be held at book value as long as a borrower is making some payment. They also note reports of banks encouraging small payments on day 89 to avoid a lien being treated as noncurrent.

54 Been and others, p. 15; McCoy, p. 24.

55 See, e.g., *Retirement Board of the Policemen’s Annuity and Benefit Fund of the City of Chicago et al. v. Bank of New York Mellon* (pending).

56 Originators and servicers of mortgages make certain “representations and warranties” to the purchaser/insurer of a mortgage. Under the terms of securitization and servicing contracts, they are liable to buy back mortgages if those representations and warranties are breached.

57 HARP refinancing volume in July was 96,400, more than double the 44,500 in February. See Department of Housing and Urban Development Housing Scorecards for June and September 2012, available at http://portal.hud.gov/hudportal/HUD?src=/initiatives/Housing_Scorecard.

58 See, e.g., Alan Boyce, Glen Hubbard, Chris Mayer and James Witkin, “Streamlined Refinancings to Help the Housing Market and Consumers” (Washington: Pew-commissioned research paper), p. 2; Laurie Goodman, cited in HousingWire, “Big banks win in HARP 2.0 as changes lock borrowers in to high-cost refis” (March 22, 2012), available at <http://www.housingwire.com/news/big-banks-win-harp-20-changes-lock-borrowers-high-cost-refis>.

59 See, e.g., testimony of Laurie Goodman, Amherst Securities before the U.S. Senate Subcommittee on Housing, Transportation and Community Development (April 25, 2012), available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=0b61bedc-0017-4a06-9798-29b55f7f63bc. and HousingWire, “Big banks win in HARP 2.0 as changes lock borrowers into high-cost refis” (March 22, 2012), available at <http://www.housingwire.com/news/2012/03/22/big-banks-win-harp-20-changes-lock-borrowers-high-cost-refis> citing statistics showing that GSE borrowers pay more on refinances than other types of borrowers; testimony of Christopher Papagianis before U.S. Senate Committee on Banking, Housing and Urban Affairs (May 24, 2012), available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=d6d9cb19-9279-4e07-8bcc-88133d77239c cited analysis suggesting that any discrepancy can be explained by LLPAs charged on GSE loans.

60 Kate Berry, “Competition Fierce, Profits Ample for Harp 2.0 Refis: Fifth Third,” *American Banker* (177) (2012).

61 See Boyce and others, p. 2; Zandi and others, p. 22.

62 See, e.g., Levitin, pp. 12-13.

63 For an analysis of where bulk sales of REO may be feasible, see Federal Reserve, “The U.S. Housing Market”, pp. 10-11.

64 See Jakabovics, pp. 6-10, for analysis of issues by REO holder.

65 Jakabovics, p. 10.

66 See, e.g., Morningstar, “RMBS Commentary: A Reality Check on either side not REO Rental Securitization,” June 2012, pp. 2-3.

67 Fannie Mae increased its limit from 10 to 20 loans per individual investor in September 2012 (see “Prospect Mortgage Named Financing Partner for HomePath Mortgage Program for Investors,” September 19, 2012, available at <http://www.prnewswire.com/news-releases/prospect-mortgage-named-financing-partner-for-homepath-mortgage-program-for-investors-170335266.html>.)

68 Morgan Stanley Research, “Housing Market Insights: An Investor’s Guide to Buy-to-Rent,” April 2012, available at <http://lifecycleassets.com/index.php/press-room/17-research-articles/35-morgan-stanley-report-housing-market-insights-an-investor-s-guide-for-buy-to-rent>.

69 “Investors were qualified to bid after a rigorous evaluation process and were evaluated on the basis of several factors, including financial strength, asset management experience, property management expertise, and experience in the geographic area”: Federal Housing Finance Agency, “FHFA Announces Next Steps in REO Pilot Program,” Press release, July 3, 2012.

70 For a comparison of U.S. and Canadian housing finance policy, including a view of the trade-offs involved in private securitization, see Arthur W. Donner and Douglas D. Peters, “Revitalizing the American Housing and Mortgage Markets: Are There Lessons to be Learned from Canada’s Recent Experience (Washington: Pew-commissioned research paper, 2012).

71 E.g., Nationstar, a special servicer owned predominantly by Fortress, has grown its servicing portfolio from \$21 billion to \$107 billion over four years, fueled by purchases from Bank of America. It lost the bid for Ally’s \$338 billion ResCap portfolio to Berkshire Hathaway in October 2012. See Ajay Makan and Shahien Nasiripour, “US mortgage servicers attract investors,” *Financial Times*, June 26, 2012, available at <http://www.ft.com/intl/cms/s/0/b6804486-bede-11e1-bebe-00144feabdc0.html#axzz2HVZxP1us>; and David McLaughlin, Dakin Campbell, and Noah Buhava, “Berkshire Wins ResCap Loan Auction With \$1.5 Billion Bid,” *Bloomberg*, October 25, 2012, available at <http://www.bloomberg.com/news/2012-10-25/berkshire-said-to-win-rescap-loan-auction-with-1-5-billion-bid.html>2102.

72 Wells Fargo and Citigroup are reported to have sold \$200 million and \$99 million portfolios of NPL, respectively, in 2012, but the number of transactions beyond these is hard to ascertain. See “The Secretive Nature of the NPL Market Continues, the FDIC Included,” *Managing REO/Mortgage Servicing News*, January 24, 2012, available at http://www.mortgageservicingnews.com/blogs/hearing/npl-market-fdic-1028483-1.html?site=default_reo. Data on the relative performance of the loans pre- and post-sale is scant.

73 Fannie Mae and Freddie Mac bought nearly \$270 billion of NPL out of their MBS pools in 2010 and have reportedly considered pilot NPL sales, with rumors that Fannie Mae is moving closer to launch. See “Fannie Mae Considers Auctioning Off NPLs,” *National Mortgage News*, December 3, 2010; “Fannie Mae Ready to Pick NPL Sale Advisor,” *Asset Securitization Report*, August 22, 2012.

74 New York, New Jersey, and Florida have the three longest foreclosure timelines—1,072, 931, and 858 days, respectively—and have the fifth-, third- and first-largest foreclosure pipelines (percent of noncurrent mortgages), respectively. See “Foreclosure Activity Drops to 5-Year Low in September,” October 9, 2012, available at <http://www.realtytrac.com/content/foreclosure-market-report/september-and-q3-2012-us-foreclosure-market-report-7424>, LPS Mortgage Monitor, September 2012.

- 75 See, e.g., “Prospect Mortgage Named...”, available at <http://www.prnewswire.com/news-releases/prospect-mortgage-named-financing-partner-for-homepath-mortgage-program-for-investors-170335266.html>.
- 76 Discussion of a “reserve account” built on a proposal put to FHFA by The Clearing House (TCH). In a letter to Mario Ugoletti et al. on June 10, 2011, TCH outlined a proposal for creation of a reserve fund to cover the increased costs of default servicing that would be funded by the servicers and transfer along with servicing rights to any new servicer. Available at <http://www.theclearinghouse.org/index.html?f=072886>.
- 77 Key features of the Risk Retention/Qualified Residential Mortgage proposal put forward by the Fed, OCC, FDIC, SEC, FHFA, and HUF are (1) for securitizer to retain not less than 5 percent of the credit risk of any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party; and (2) securitizer is prohibited from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain under section 15G and the agencies’ implementing rules.
- 78 The model discussed at the forum would provide even stronger protection for first lienholders than the approach set out by Mayer and others (“After the Housing Crisis.”) In their model, second liens would be stripped of the underlying collateral, becoming personal rather than collateralized debts, in certain workout situations. As such, the borrower would not escape the ultimate debt burden of the (former) second lien,
- 79 The Second Lien Modification Program (2MP) provides comprehensive solutions for homeowners with second mortgages through the Making Home Affordable Program by the departments of the Treasury and Housing and Urban Development.
- 80 As described in the QRM/Risk Retention proposal by the Fed, FDIC, OCC, SEC, FHFA, and HUD.
- 81 HUD Housing Scorecard for September 2012.
- 82 OCC Mortgage Metrics Report Q1 2012, p. 39-40, available at <http://www.occ.treas.gov/publications/publications-by-type/other-publications-reports/mortgage-metrics-2012/mortgage-metrics-q1-2012.pdf>
- 83 Goodman and others, p. 3.
- 84 See, generally, Goodman and others, Jennings, and Wachter and others.
- 85 Wachter and others, pp. 9, 12; OCC Mortgage Metrics Report Q1 2012, p. 41.
- 86 McCoy, p. 16.
- 87 Wei Li and Sonia Garrison, “Loan Modifications Return More Value Than Foreclosures” (Center for Responsible Lending, March 22, 2011), available at <http://www.responsiblelending.org/mortgage-lending/research-analysis/fix-or-evict.pdf>.
- 88 HUD Housing Scorecard for September 2012.
- 89 See, e.g., testimony of Christopher Mayer before U.S. Senate Committee on Banking, Housing and Urban Affairs (February 9, 2012) and Boyce and others, p. 2.
- 90 Zandi and others, p. 22.
- 91 Boyce and others, p. 2.
- 92 HARP refinancing volume in July was 96,400, more than double the 44,500 from February; HUD Housing Scorecard for June and September, 2012.
- 93 Nick Timiraos, “State Takes Fresh Crack at Mortgages,” *Wall Street Journal*, June 1, 2012, available at <http://online.wsj.com/article/SB10001424052702303552104577440262354719068.html>.
- 94 *Ibid.*
- 95 Thomas J. Fitzpatrick, Lisa Nelson, Francisca Richter and Stephan Whitaker, “What Impact do Anti-vacancy and Anti-blight Ordinances Have on Local Housing Markets?” (Washington: Pew-commissioned research paper, 2012), p. 4
- 96 *Ibid.*, pp. 8ff.
- 97 *Ibid.*, p. 7.
- 98 Nigel G. Griswold and Patricia E. Norris, “Economic Impacts of Residential Property Abandonment and the Genesee County Land Bank

in Flint, Michigan” (Michigan State University Land Policy Institute, report #2007-05, April 2007), available at <http://www.community-wealth.org/sites/clone.community-wealth.org/files/downloads/report-griswold-norris.pdf>.

99 Federal Reserve, “The U.S. Housing Market”, p. 14.

100 For a summary, see <http://blog.hud.gov/index.php/2012/03/06/project-rebuild-to-continue-revitalizing-neighborhoods-and-creating-jobs/>.

101 For a summary, see <http://fudge.house.gov/uploads/Summary%20of%20Restore%20our%20Neighborhoods%20Act%20of%202012.pdf>.

102 Jakabovics, p. 7.

103 Federal Housing Finance Agency, “FHFA Statement on REO Pilot Transactions” (November 2012), available at <http://www.fhfa.gov/webfiles/24609/REOCOLONY.pdf>.

104 Nelson D. Schwartz, “Bank of America Tests Rental Program As Alternative to Foreclosure,” *New York Times* DealBook, March 22, 2012, available at <http://dealbook.nytimes.com/2012/03/22/bank-of-america-tests-rental-program-as-alternative-to-foreclosure/>; Associated Press, “Bank of America to offer rentals as foreclosure alternative,” March 23, 2012, available at http://articles.nydailynews.com/2012-03-23/news/31231919_1_foreclosure-activity-highest-foreclosure-rate-realtytrac; Alan Zibel, “Citi launches pilot foreclosure-rental program,” *The Wall Street Journal* Market Watch, August 8, 2012, available at <http://www.marketwatch.com/story/citi-launches-pilot-foreclosure-rental-program-2012-08-08-154851725>.

105 Jakabovics, p. 7.

106 See, generally, Levitin paper.

107 See, e.g., Zandi and others.

108 Jennings, p. 17.

109 See, e.g., Edward J. DeMarco, Acting Director of FHFA letter to U.S. Congress, July 31, 2012, available at http://www.fhfa.gov/webfiles/24110/PF_LettertoCong73112.pdf.

110 See, e.g., Laurie S. Goodman, Lidan Yang, Roger Ashworth and Brian Landy, “Modification Effectiveness: The Private Label Experience and Their Public Policy Implications,” (Washington: Pew-commissioned research paper, 2012), p. 15, noting that hazard is an issue for any modification program, not just principal reduction.

111 See Levitin, p. 11, for a discussion of the complexities of implementing shared appreciation scheme.

112 Participants at the forum also highlighted that views on the effectiveness of principal reduction as a modification strategy are predicated on borrowers understanding whether they are underwater and, if so, by how much. It is, from a lender’s perspective, an expensive option that may not, in practice, reduce the risk of default. There is an opportunity for further research on borrower understanding of negative equity to inform a servicer’s assessment of the efficacy of principal reduction in reducing default.

