



Federal Housing Finance Agency

Office of the Director

July 31, 2012

The Honorable Tim Johnson
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, DC 20510

The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, DC 20510

Dear Chairman Johnson and Ranking Member Shelby:

I am writing in response to inquiries from you and other members of Congress, including the leadership of the Federal Housing Finance Agency's (FHFA) oversight committees, regarding whether FHFA will authorize Fannie Mae and Freddie Mac (the Enterprises) to implement the Home Affordable Modification Program (HAMP) Principal Reduction Alternative (PRA). I am also writing to report on the status of several initiatives underway at FHFA and Fannie Mae and Freddie Mac.

In this letter, I will summarize FHFA's analysis of HAMP PRA as a loss mitigation option for the Enterprises to use in assisting homeowners whose home values are less than the amount they owe on their mortgages. In conducting this analysis, FHFA took into consideration current loss mitigation tools; costs and benefits of using principal forgiveness including the economic benefit or costs to the Enterprises as well as to taxpayers; the impact on borrower behavior; direct and indirect implementation costs; and, the overall impact on the mortgage market.

After much study, I have concluded that Fannie Mae and Freddie Mac's adoption of HAMP PRA would not make a meaningful improvement in reducing foreclosures in a cost effective way for taxpayers. Yet there are continued improvements that can and should be made to strengthen the Enterprises' loss mitigation and borrower assistance efforts, and to improve the operation of the housing finance market. These efforts include further streamlining refinance opportunities, enhancing the short sale process, and reducing lender uncertainty that could inhibit new mortgage lending.

Background

FHFA has three core legal obligations that direct the agency's activities and decisions involving the Enterprises.

First, the Housing and Economic Recovery Act of 2008 specified that the agency may "take such action as may be (i) necessary to put the regulated entity in a sound and solvent condition; and (ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity."

FHFA has reported on numerous occasions that, with taxpayers providing the capital supporting Enterprise operations, this “preserve and conserve” mandate directs FHFA to minimize losses on behalf of taxpayers.

Second, although each Enterprise is in conservatorship, without statutory changes their mission of supporting a stable and liquid mortgage market remains the same as before. FHFA has a statutory responsibility to ensure each Enterprise “operates in a safe and sound manner” and that “the operations and activities of each regulated entity foster liquid, efficient, competitive, and resilient national housing finance markets.”

Third, under the Emergency Economic Stabilization Act of 2008, FHFA has a statutory responsibility to “implement a plan that seeks to maximize assistance for homeowners and use its authority to encourage the servicers of the underlying mortgages, and considering net present value to the taxpayer, to take advantage of ... available programs to minimize foreclosures.”

HAMP and the Enterprises’ other foreclosure prevention efforts have been important to meeting these obligations. Since its inception, HAMP focused on reducing borrowers’ monthly payments to 31 percent of their income. The original program focused first on reducing the interest rate, next extending the term, and finally on forbearance - not requiring payments on a portion of the principal. Principal forgiveness was permitted in the original HAMP at the investor’s discretion, but was rarely used.

In 2010, to encourage greater use of principal forgiveness for loans with loan-to-value ratios above 115 percent, the Treasury Department supplemented HAMP with HAMP PRA, in which principal forgiveness is the first step in the modification process to lower the loan payment, before reducing the interest rate or extending the term. Earlier this year Treasury announced its intention to triple its current payment incentives to investors who utilize HAMP PRA and for the first time offered to pay incentives to the Enterprises. Treasury also asked FHFA to consider the use of HAMP PRA as a loss mitigation tool to be used by the Enterprises, and subsequently FHFA has undertaken detailed analyses of the possible effectiveness of HAMP PRA for the Enterprises’ books of business.

Results of FHFA Analysis

FHFA’s detailed analysis of HAMP PRA is enclosed with this letter. The analysis has three key components – a model-based assessment of the benefit to the Enterprises and taxpayers of a fully operational program, a consideration of the costs of implementing such a program, and a review of borrower incentive effects and how changes in borrower behavior could affect program results. A brief summary of each of these components follows.

Modeling Work

The essence of the model-based analysis is to test whether reducing a portion of a borrower’s mortgage principal reduces the likelihood of default relative to loan modifications without forgiveness such that the Enterprise, and the taxpayer, is better off. The model employed assumes that the probability of default declines with a decline in the loan-to-value ratio created

by principal forgiveness. As with any model-based analysis, the results are sensitive to the underlying assumptions and the accuracy of the models.

The results of this analysis that are most favorable to employing principal forgiveness demonstrated that implementing HAMP PRA may result in approximately 74,000 to 248,000 borrowers being eligible for principal reduction modifications (based on a range of plausible take-up rates) at a positive financial benefit to the Enterprises. However, nearly all of this benefit is simply a transfer from taxpayers to the Enterprises, which would add to the over \$188 billion in taxpayer support the Enterprises have already received. Under other reasonable assumptions, implementing HAMP PRA would actually increase taxpayer costs.

The model-based projected net benefit to taxpayers is \$500 million in the best case, and the vast majority of this model-projected benefit comes from borrowers who have not made a mortgage payment in more than a year. Experience indicates that the likelihood of successfully modifying and reinstating these loans is small so that the anticipated net benefit is likely to be much less than \$500 million.

Implementation Costs

Although principal forgiveness may provide some financial benefit to Fannie Mae and Freddie Mac, it presents operational challenges for them and their servicers as well as a risk of loss to the taxpayer. The program would be costly and time consuming to implement. Whether the operational costs were paid by Treasury or the Enterprises, the effect would be an increase in taxpayer costs that would offset at least some portion of the model-projected benefits. There would also be an opportunity cost of shifting resources to this endeavor from other loss mitigation activities. Even when considering alternatives that might reduce the impact of strategic modifiers and simplify the operational issues, the general result was that the benefits would accrue to few homeowners and would not outweigh the significant costs and challenges to implement a program.

Incentive Effects on Borrower Behavior - Moral Hazard

A key concern with principal forgiveness has always been the borrower incentive effects, in particular, whether borrowers who are current on their loans and have the ability to pay will claim a hardship or actually become delinquent to capture the benefits of principal forgiveness. While some mortgage market participants can selectively offer principal forgiveness in cases tailored to their particular circumstances, objectives, and customers, the Enterprises would have to systematically implement HAMP PRA through public announcements, uniform program eligibility standards, and a set of published decision rules for more than a thousand mortgage servicers to apply. This could give borrowers who are current on their mortgages a message that the government endorses forgiving a portion of mortgage debt if hardship can be demonstrated, creating a broad incentive for underwater borrowers to seek ways to become eligible. If only a very small portion of the Enterprises' currently underwater but performing borrowers (3,000 to 19,000) strategically defaulted to seek principal forgiveness, HAMP PRA would result in a net loss to taxpayers, even using the model-based assumptions most favorable to the program.

Perhaps the greatest risk of the Enterprises' allowing principal forgiveness is one with far more significant long-term consequences for mortgage credit availability. Fundamentally, principal forgiveness rewrites a contract in a way that other loan modification programs do not. Forgiven debt owed pursuant to a lawful, valid contract risks creating a longer-term view by investors that the mortgage contract is less secure than ever before. Longer-term, this view could lead to higher mortgage rates, a constriction in mortgage credit lending or both, outcomes that would be inconsistent with FHFA's mandate to promote stability and liquidity in mortgage markets and access to mortgage credit.

Basis for the Decision

In summary, depending on what assumptions are made regarding borrowers' current debt-to-income (DTI) ratios, FHFA's modeling results suggest that the benefit to taxpayers of the Enterprises' adopting HAMP PRA could be either positive or negative. Using the DTI assumption that presents the best case for principal forgiveness, the projected taxpayer benefit ranges from \$100 to \$500 million, with 74,000 to 248,000 borrowers potentially eligible for HAMP PRA. All of these borrowers are already eligible for a standard HAMP modification, which would give them the same reduced monthly payment as HAMP PRA. The majority of these modeled taxpayer benefits accrue from borrowers delinquent for more than a year, a group that should already have been offered a HAMP modification and a group that has a low frequency of successful modifications.

Offsetting these model-projected benefits are the following costs and risks:

- Implementation costs of roughly \$70 to \$90 million for Fannie Mae and Freddie Mac plus costs imposed on more than a thousand servicers to implement HAMP PRA for Fannie Mae and Freddie Mac;
- Opportunity cost of staff resources at Fannie Mae and Freddie Mac and their servicers being diverted from current loss mitigation activities to develop and implement HAMP PRA;
- Borrower incentive effects such that only 3,000 to 19,000 borrowers who are current on their mortgage today defaulting in search of principal forgiveness would offset all taxpayer benefit in the best case scenario;
- Long-term implications for mortgage credit pricing and availability from weakening the reliability of the mortgage contract;
- Time required for implementing the program of a year or more; and
- Delayed resolution for troubled borrowers who reject a modification offer today in anticipation of some future availability of principal forgiveness once implemented.

FHFA weighed these potential benefits and costs, recognizing the inherent uncertainties associated with these estimates, and concluded that the potential benefit was too small and uncertain relative to known and unknown costs and risks to warrant the dedication of additional taxpayer resources to Fannie Mae and Freddie Mac to implement HAMP PRA. Fannie Mae and Freddie Mac today offer a suite of effective programs for underwater borrowers, programs that took several years and millions of dollars to develop and refine. FHFA remains committed to

ensuring that Fannie Mae and Freddie Mac work diligently to ensure the success of these programs.

FHFA carefully considered the views of experts who have said that the Enterprises should not leave the principal forgiveness tool out of their toolbox. There are two different responses to that view. On the one hand, it has been in the toolbox all along. FHFA has reported on pilot programs initiated at Fannie Mae to test principal forgiveness that experienced operational and other challenges. Short sales and deeds-in-lieu, which the Enterprises offer, result in principal forgiveness as part of exiting the house. Recently, the Enterprises have engaged with state housing finance agencies (HFAs) to accept principal payments from them (funded through the Hardest Hit Fund program) in conjunction with a HAMP or Home Affordable Refinance Program (HARP) transaction. In particular, compared to HAMP PRA, Enterprise participation with state HFAs on small-scale principal pay down programs addresses the concerns noted above: the Enterprises' receive full compensation for principal forgiveness; the payments are operationally simpler to administer; and, the potential for negative borrower incentive effects is minimized by the size of the funding for the programs and various screening tools (income and other tests) deployed by the HFA. On the other hand, understood in the context of implementing HAMP PRA, FHFA's analysis reported here found this tool inferior to ones already in use, insofar as FHFA measures the anticipated outcomes in light of its legal responsibilities.

FHFA's determination regarding HAMP PRA intends no judgment about the program outside of its application to Fannie Mae and Freddie Mac. These two companies in conservatorship pose unique issues and FHFA's statutory responsibilities affecting this determination do not exist for private lenders and investors. As we have said before, we will continue to monitor market conditions, new information, and new loss mitigation approaches and respond accordingly, consistent with our mandates.

Other Housing-Related Initiatives

In addition to our analysis of principal forgiveness, FHFA has been actively considering other initiatives to strengthen the Enterprises' loss mitigation and borrower assistance efforts, and to improve the operation of the housing finance market. We are nearing completion of our work on several of these. Recognizing that Congress will soon be in recess until September, I am providing this update so you may anticipate certain announcements during that time as we conclude our work.

Refinances

Today, Freddie Mac is issuing updated guidance to its seller/servicers regarding its streamlined refinance program. Specifically, Freddie Mac is aligning its policies with those of Fannie Mae for certain refinancing of mortgages with loan-to-value ratios less than 80 percent. These changes remove certain representation and warranty requirements similar to the steps taken previously for HARP. We also have been soliciting feedback from lenders on the implementation of recent changes to the Home Affordable Refinance Program (HARP 2.0) and have identified a few operational adjustments to further simplify this process and increase the number of loans approved for refinancing. Updated guidance to lenders will be released shortly.

Representation and Warranties

When lenders sell a mortgage to Fannie Mae or Freddie Mac, by contract they represent and warrant that the loan meets applicable standards and they agree to buy the loan back should that not be the case. The wave of poorly underwritten loans in the 2005 to 2008 period has led to unprecedented repurchase requests by the Enterprises. But it also reveals a flaw in how this business arrangement has traditionally worked. By waiting until bad mortgages emerge through mortgage delinquencies, the application of reps and warrants delays recognition of emerging weaknesses in loan origination. We want to change the focus going forward to ensure loan quality at the time of origination.

Under FHFA's oversight, Fannie Mae and Freddie Mac are developing new, consistent requirements for reps and warrants that will shift the focus of loan quality review to the time of sale to an Enterprise and to give lenders greater certainty that a loan that performs successfully for a period of time will not later be subject to repurchase except for very limited reasons. While this will result in greater scrutiny of performing loans near the time of origination, the intent is to reduce the risk for the Enterprises and lenders alike. We anticipate issuing these new standards by September.

Short Sales

FHFA and the Enterprises have been working with the Treasury Department and others to simplify and enhance short sales. Recently, the Enterprises announced shorter timelines for short sale approvals and changes to policies aimed at assisting military homeowners with short sales. Soon they will be aligning their short sale programs into a single program with more flexible terms that will include greater clarity of the rules governing short sales for underwater borrowers facing a hardship requiring out-of-area relocations.

Guarantee Fee Pricing

In December 2011, in the Temporary Payroll Tax Cut Continuation Act of 2011, Congress directed FHFA to increase guarantee fees by at least an average of 10 basis points and further directed that FHFA consider the cost of private capital and the risk of loss in setting guarantee fees. Congress also encouraged FHFA to require guarantee fee changes that reduce cross-subsidization of relatively risky loans and eliminate differences in fees across lenders that are not clearly based on cost or risk. Consistent with that legislation and with previous commitments FHFA has made, FHFA will be announcing by the end of August another set of gradual adjustments in guarantee fee pricing that will take effect late in the year.

REO Disposition

In August, Fannie Mae anticipates closing on the first set of real estate owned (REO) pilot transactions. Developed in conjunction with the Treasury Department, the Department of Housing and Urban Development, the Federal Deposit Insurance Corporation, and the Federal Reserve, these initial transactions involve REO properties most of which are currently occupied by renters. Further details regarding these transactions will be released after closing. Based on the success of this initial transaction, we are planning for additional sales in the near future.

Conclusion

The greatest future opportunity for the Enterprises to assist homeowners and add stability to housing markets is to ensure the continued successful implementation of the HARP. As you know, FHFA introduced numerous changes to HARP this past fall; the changes became fully operational last month. We are pleased by early returns on these program revisions and believe that the Enterprises and mortgage lenders should remain focused on ensuring implementation of this program, which gives more than a million underwater borrowers a meaningful opportunity to reduce their mortgage rate and hasten the pay-down of their mortgage principal so the borrower gets back to a position of positive equity.

FHFA will now move on to focus its resources and the collective efforts of Fannie Mae and Freddie Mac to use the tools at hand to maximize assistance to homeowners to avoid foreclosure while minimizing the cost to taxpayers. We recognize there are still many households hurting from the economic events of the past several years and we remain committed to effective implementation of the numerous programs in place to provide cost-effective assistance to avoid foreclosure and promote refinancing. To that end, the forthcoming announcements described above will improve upon existing practices and programs, and will provide more certainty to borrowers, lenders, and servicers.

My staff and I are available to discuss these matters with you or your staff. Please contact Peter Brereton, Associate Director for Congressional Affairs, at 202-649-3802.

Yours truly,

//s//

Edward J. DeMarco
Acting Director

Attachments