FHA Housing Stabilization and Homeownership Retention Act of 2008

Discussion Document

March 11, 2008

Bank of America
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Executive Summary

$400 billion, or 43% of subprime mortgages, could default in the next five years.

- The current size of the securitized non-agency US mortgage market is approximately $2.6 trillion.
- Declining house prices, higher interest rates, and a general tightening of credit have led to rapidly escalating levels of delinquency and default among borrowers, causing many Americans to lose their homes – and the possibility that an unprecedented number will enter foreclosure over the next several years.
- Approximately $339 billion, or 13% of all non-agency mortgages, are at high risk of default over the next five years due to payment shock from rate reset or payment reamortization loans.
  - $739 billion, or 28%, are at moderate to high risk of default over the same period.
- We expect $400 billion, or 43% of subprime mortgages, to default in the next five years.
- We believe that any intervention by the federal government will be acceptable only if it is not perceived as a bail-out of the bond market.

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Executive Summary (cont.)

The benefits of a federal government program would include slowing the rapid national decline in house prices.

- As a number of public and private individuals have suggested, the government can mitigate the social and economic costs of massive numbers of foreclosures by establishing a program with the mandate to:
  - Determine an acceptable short payoff amount based on the current appraised value of the home for eligible loans in imminent risk of default;
  - Refinance eligible loans through an approved lender into fixed-rate replacement mortgages with:
    - Current loan-to-value ("LTV") ratios less than or equal to 90%,
    - Reductions in monthly payment of at least 30% along with certifications of ability and willingness to pay, and
    - A "soft" second mortgage that protects the Government's investment in the property along with an agreement that lets the Government share in future appreciation of the property;
  - Use the proceeds of the refinancing to submit the short payoff to the current lender or servicer;
  - Insure the replacement mortgages through FHA; and
  - Package the new loans into pools and sell them into the capital markets in the form of mortgage-backed pass-through securities with a full faith and credit guarantee from Ginnie Mae.

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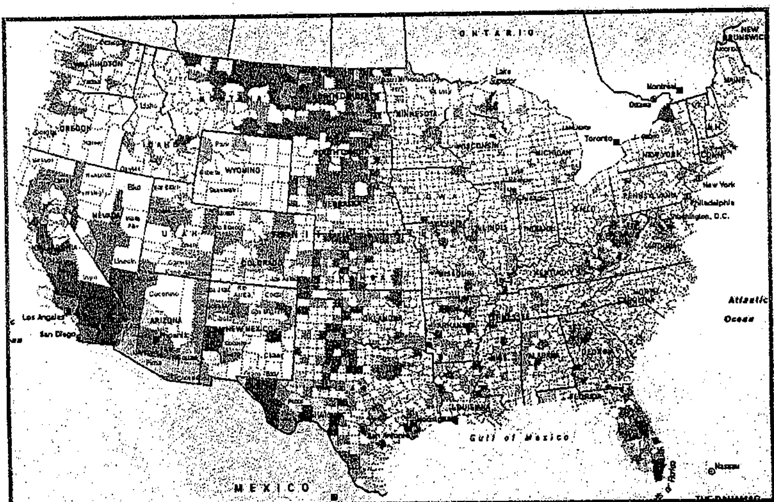
Executive Summary (cont.)

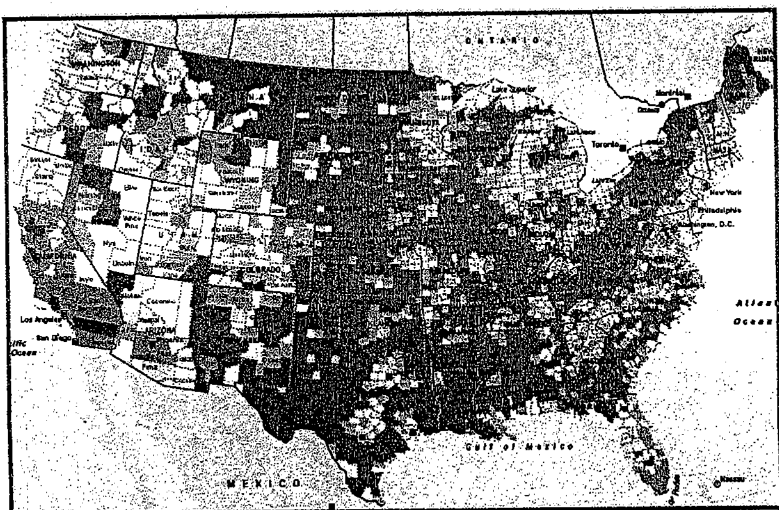
The benefits of a federal government program would include slowing the rapid national decline in house prices.

- Bondholders and portfolio lenders will experience virtually the same losses as they would have without government intervention since the short payoff amount is based on the current appraised value of the property and is economically equivalent to the value that would be recovered in a foreclosure – **thus no bailout of the bond market**.
- The cost to the government would equal:
  - The short payoff premiums over the refinanced loan balances,
  - Origination expenses,
  - Payments under the guarantees, and
  - Setup and maintenance expenses.
- The costs would be mitigated by the proceeds of:
  - Insurance premiums collected by FHA and Ginnie Mae,
  - Loan sales into the capital markets through GNMA trusts,
  - Payoffs of the soft second mortgage, and
  - Amounts collected under the agreement allowing the Government to share in the future appreciation of the property.
- By designing the premium structure appropriately, the Government can minimize the cost of the program and potentially run it on a revenue neutral basis.
- The benefits of the program would include:
  - keeping eligible borrowers in their homes;
  - maintaining the stability of at-risk communities; and
  - slowing the decline in house prices by reducing the increase in unsold housing inventories.

The Economic Backdrop

Reducing the loan balance reduces the LTV, and LTV is the most significant predictor of loss





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Eligibility Requirements

Eligibility requirements would be established to identify homeowners who need help and minimize the risk to the Government

- The program would establish eligibility requirements including:
  - Home must be occupied by the borrower as their principal residence;
  - Borrower and approved lender must certify borrower's need to refinance and ability and willingness to make payments on the replacement mortgage;
  - Maximum replacement loan amount must be less than or equal to the lower of 125% of the median MSA home price and $729,750;
  - Maximum LTV must be less than or equal to 90%
  - Loan balance must be reduced by at least 10%
  - New loan payment must be at least 30% lower than the existing payment

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High-Level Concerns

There are significant legal and regulatory hurdles, but most of them apply to pre-emptive remediation strategies for current loans rather than disposition strategies for delinquent loans.

- Remediation strategies would face a number of legal and accounting issues, including primarily the following:

  •**Contract Concerns:** Performing loans cannot be purchased out of REMICs; some Pooling and Servicing Agreements, however, allow the purchase of delinquent loans but only at a price equal to the face amount of the loan plus accrued interest.

  A more practical way of refinancing loans is by extinguishing the existing loan through a short payoff. The ASF has already established that servicers can accept short payoffs if the amount of the payoff is at least equal to the proceeds that would be expected from a foreclosure.

  •**Accounting**: Although selling loans out of trusts can cause FAS 140 consolidation concerns, servicers can accept short payoffs without jeopardizing QSPE status.

  •**Tax**: The refinancing of the loan must be tax neutral to the borrower. Amendments to the tax code at the end of December 2007 addressed this issue.

  •**Liability Issues**: Servicers will be focused on minimizing any liability they may have from participating in this program. Rather than addressing the risk through legislation, a better route may be to work with an industry association, such as American Securitization Forum ("ASF"), to develop market guidelines.

Avoiding Unintended Borrower Behaviors

A poorly structured program could encourage unintended behaviors among borrowers who aren't distressed.

Concern: Establishing a program to give relief to distressed borrowers could encourage other borrowers to stop making their monthly payments.

Mitigants:

- Most loans will enter the program through short payoffs, which are reported to the Credit Bureaus and have an adverse impact on a borrower's ability to be approved for new loans in the future;
- Every month of delinquency on a mortgage loan can lower borrowers' FICO scores by 25 to 40 points, also making it more difficult to be approved for credit in the future;
- The program will require the borrower to enter into an Equity Participation Agreement with the Government. Under the terms of this agreement, the Government will retain an interest in any cumulative price appreciation in the borrower's property. If the borrower sells or refinances the property and the proceeds of the sale or refinancing are higher than the appraised value at the time the replacement mortgage is originated, the borrower will be obligated to share a percentage of the appreciation with the Government. The percentage declines from 50% in year one to 10% in year four and later.
  - For example, if the borrower sells the house 10 years from now for $450,000 and the current appraised value is $250,000, the borrower would need to share 10% of the $200,000 appreciation ($20,000) with the Government.

Concern: Reducing the new loan amount below the appraised value of the property would give distressed borrowers the unintended ability to immediately sell the property and realize profit at the Government's expense.

Mitigant:

- FHA will hold a second lien on the property in an initial amount equal to the difference between the appraised value and the balance of the replacement mortgage.
  - The amount due on the second lien will decline over five years to give the borrower the ability to earn equity in the property, but the balance will not decline beyond 10% of its initial value
  - The principal balance of the second lien would be due on sale or refinancing of the property.

Dealing With Existing Second Liens

The Government would want to retire any existing second liens subordinate to the first mortgages it would be refinancing.

- While the program would be intended to provide relief to borrowers on their first mortgages, many borrowers also have second mortgages.
- Although second mortgage holders would be unlikely to foreclose on a property since there would be little to no recovery value on their loan, FHA would have an interest in cleanly retiring any exisitng seconds.
- Potential ways to retire seconds include:
  - Purchasing the second at a price of [two to three cents on the dollar], representing approximate recovery value;
  - Asking second mortgage lenders to forgive the debt in return for the right to participate as an approved FHA mortgage originator and servicer.

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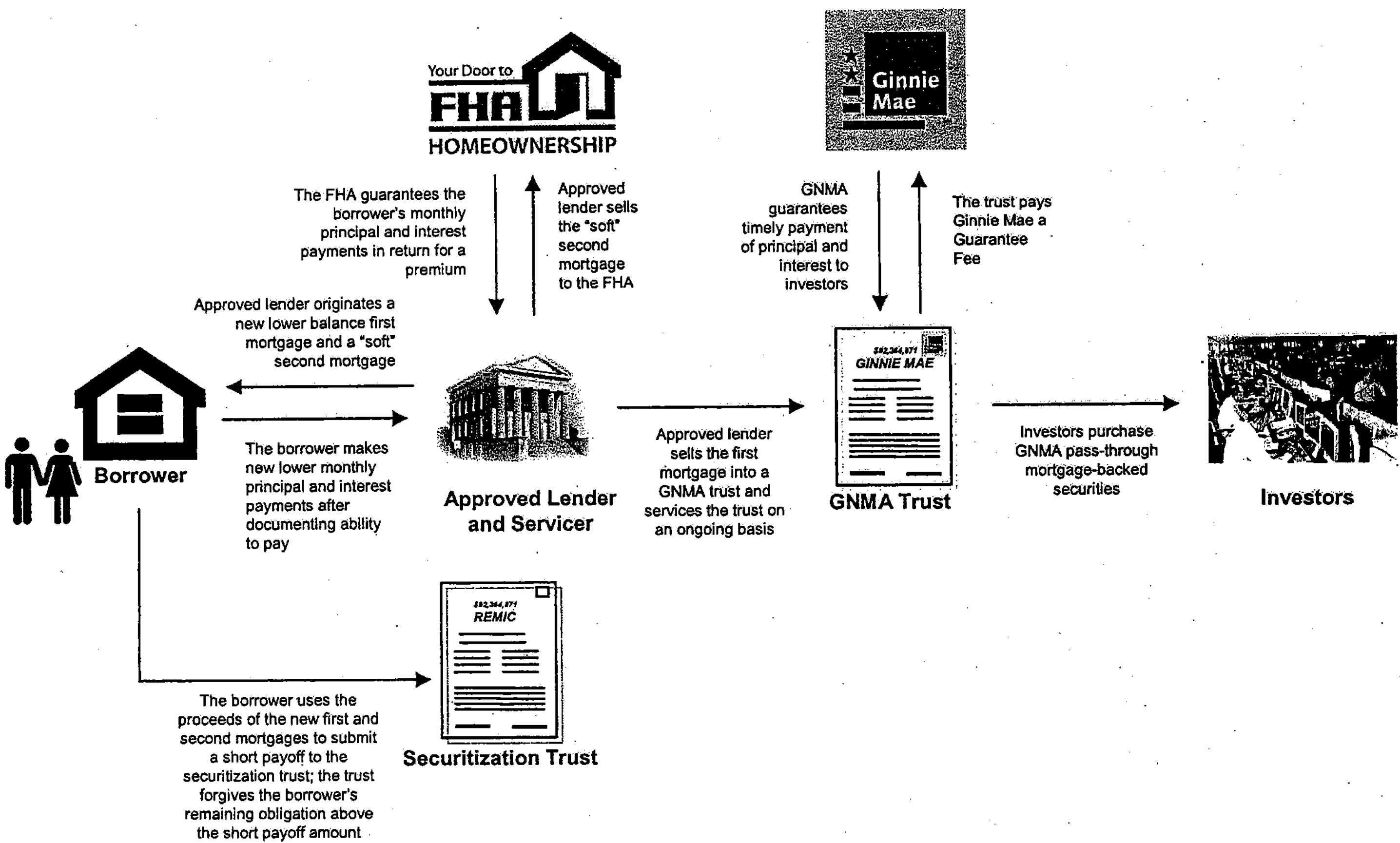
How the Program Works

The program works by letting investors realize the losses on the existing mortgages and taking advantage of the Government's unique ability to provide low cost financing for the replacement mortgages.



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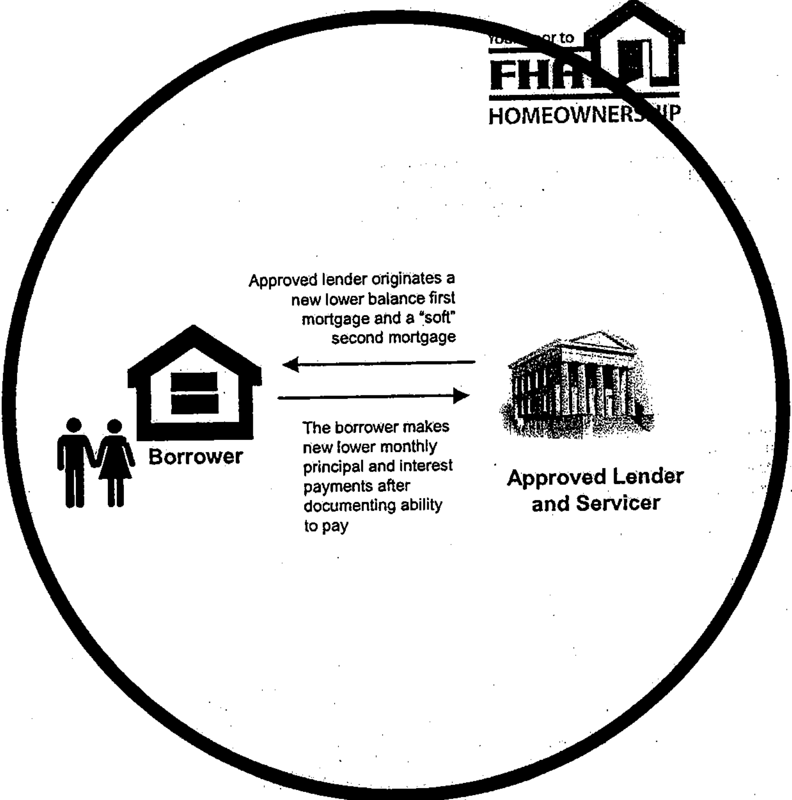
How the Program Works

Servicer, lender, and borrower establish short payoff amount



Step 1:
An approved lender works with the borrower and the current lender or servicer to determine an acceptable short payoff amount for the existing mortgage.

The approved lender originates a new first mortgage with a maximum LTV of 90% and a second mortgage covering the difference between the current appraised value of the property and the balance of the first mortgage.

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