

CONSUMER FINANCIAL PROTECTION BUREAU

**DRAFT**  
02/14/11 8:05pm

# **Perspectives on Settlement Alternatives in Mortgage Servicing**

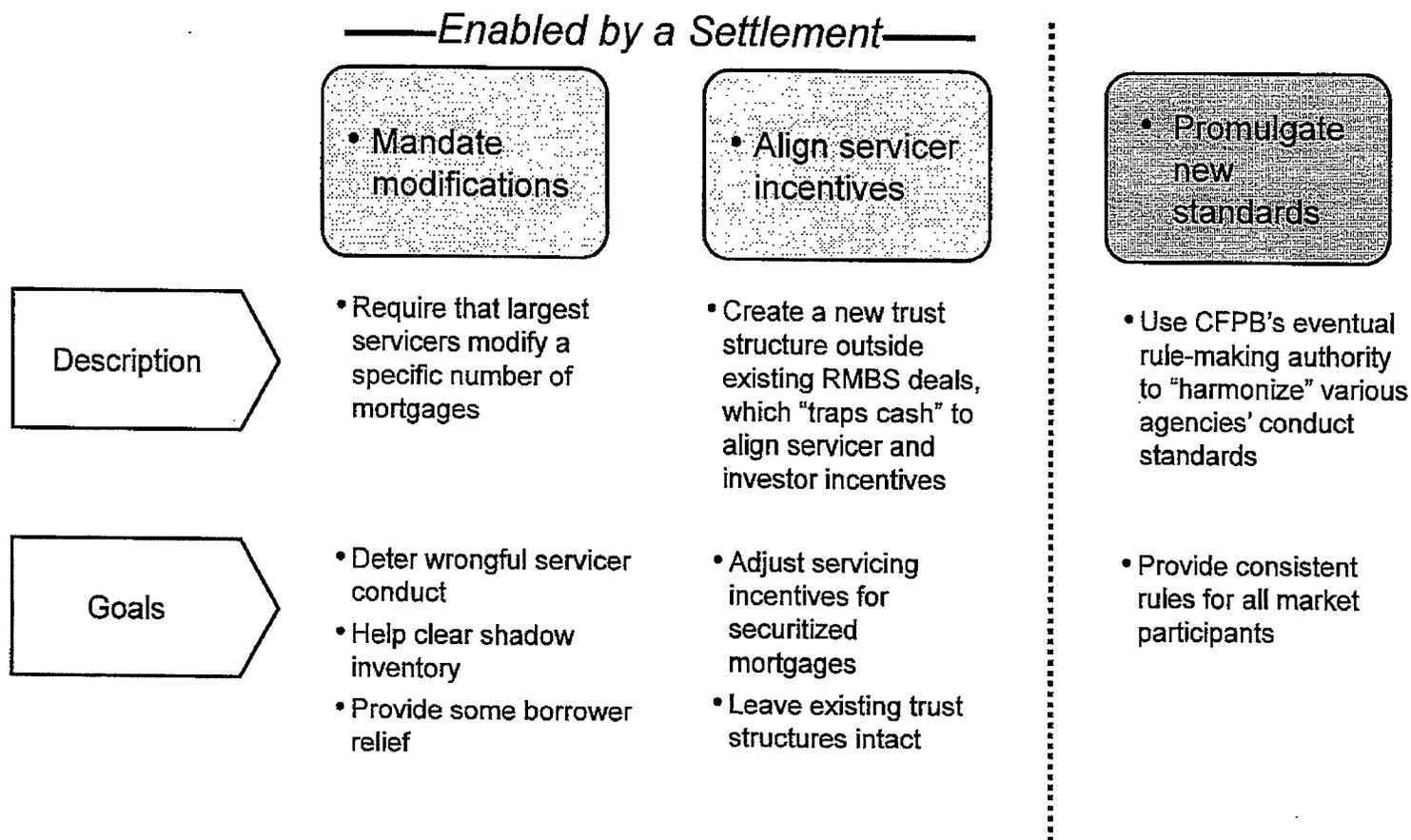
Discussion document

February 14, 2011

DRAFT—CONFIDENTIAL FOR AG MILLER

The prospect of a “global” settlement provides the potential for broad reform.

## MORTGAGE SERVICING SETTLEMENT IN CONTEXT



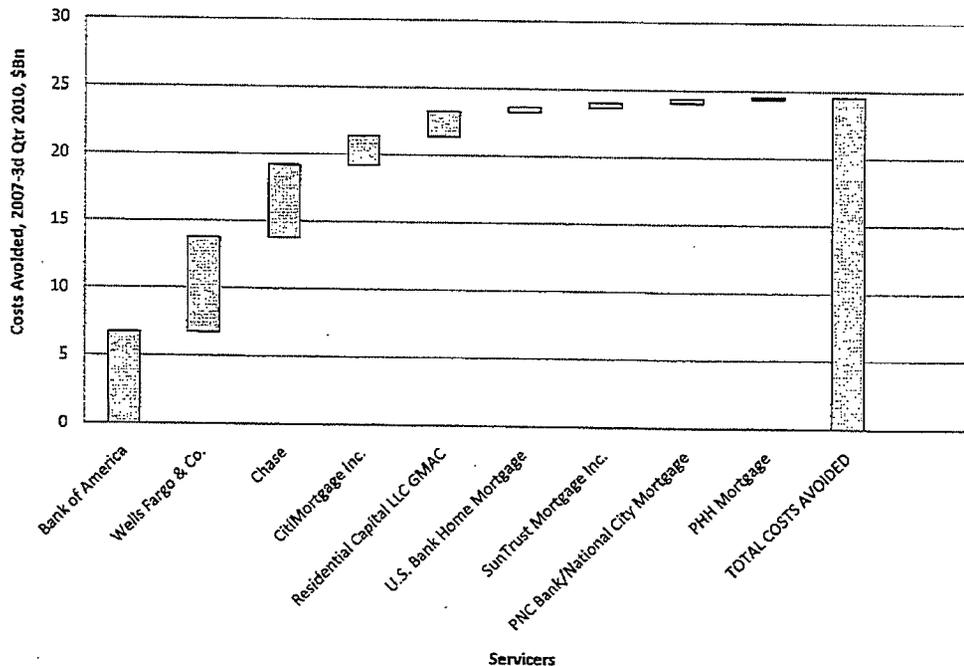
Rough estimates suggest that the largest servicers may have saved more than \$20 billion through under-investment in proper servicing during the crisis. As a result, a notional penalty of roughly \$5 billion would seem too low.

## CALIBRATING THE SIZE OF POTENTIAL PENALTIES

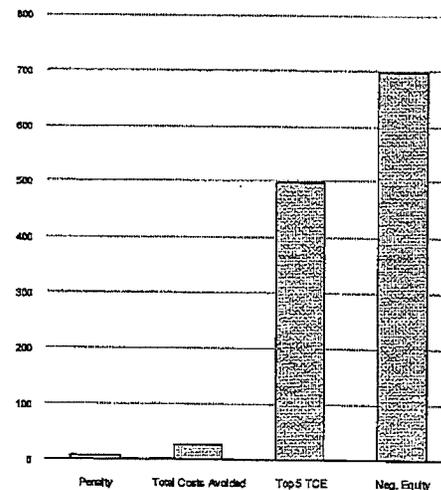
**Estimated Servicing Costs Avoided, 2007-3Q10**  
\$ Billions (Source: CFPB)

*Assumption:*

- Effective special servicing of delinquent loans would have cost 75 bps/yr more than the actual costs incurred



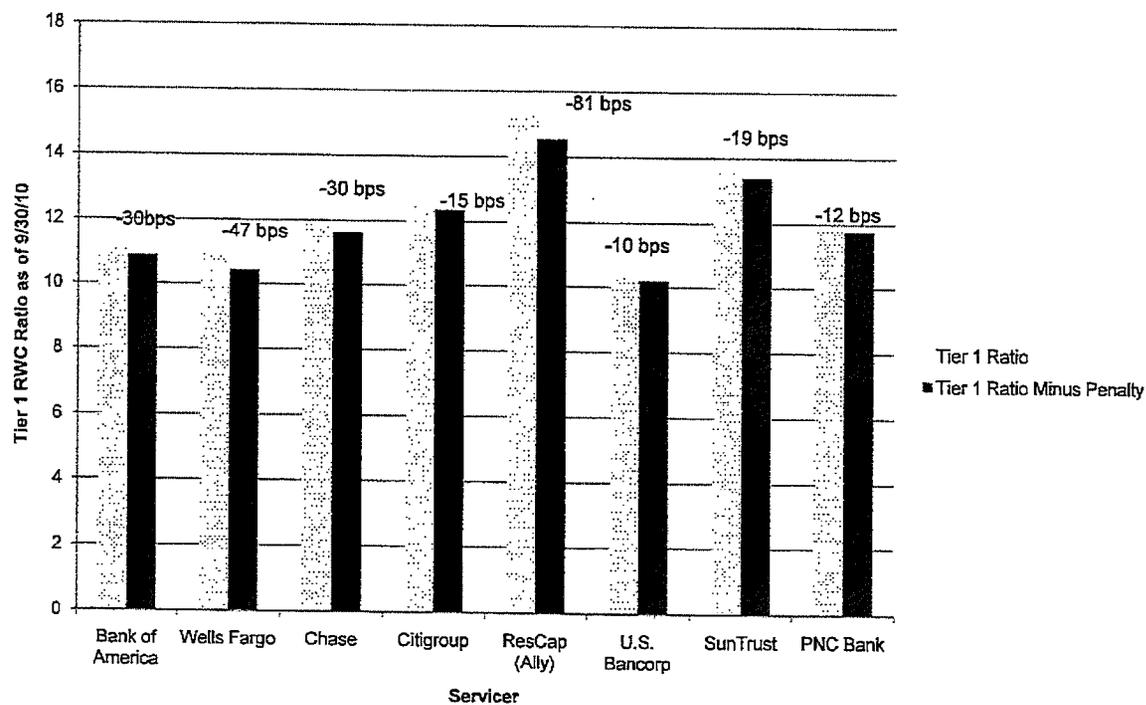
**Notional \$5 Billion in Context**  
\$ Billions



Source: CFPB

A penalty based on servicing costs avoided would have little effect on Tier 1 capital ratios.

## EFFECT OF PENALTY ON TIER 1 CAPITAL

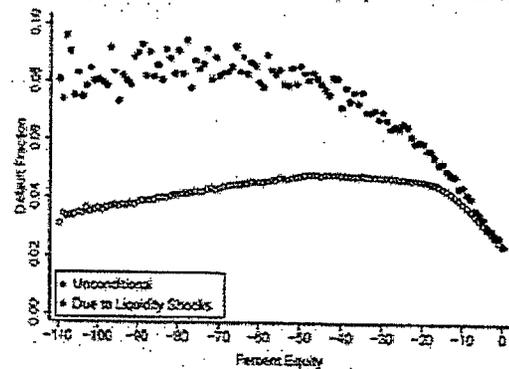


Source: CFPB

Given the magnitude of the "shadow inventory" problem, we have gravitated towards settlement solutions that enable asset liquidity and cast a wide net. In particular, we have focused on principal reduction-modifications and the short sales enabled by them. As borrowers become increasingly underwater, they are more likely to default. To date, though, principal reductions have been relatively under-utilized.

## NEGATIVE EQUITY, DELINQUENCY, AND PRINCIPAL REDUCTION

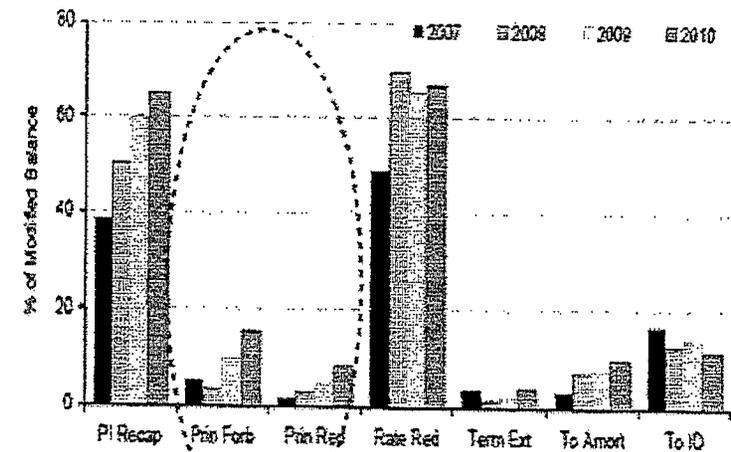
Figure 3: Decomposition of Default Probability by Percent Housing Equity



Note: Figure based on 1.9 million loan-month observations. Percent Equity is measured as a percent of current home value and is rounded to the nearest percentage point. Solid circles represent the unconditional probability of default at a given equity level. Hollow circles represent the probability of default due to experiencing a liquidity shock at a given equity level.

Bhutta, Dokko & Shan (2009).

Figure 8: Distribution by Modification Type (All Sectors)



Source: Citi, Loan Performance

The scope of a settlement-driven loan modification requirement can be roughly calibrated to the likely cost to servicers from principal forgiveness. Principal reductions would (1) make payments somewhat more affordable; (2) free underwater borrowers to sell or refinance their homes; and (3) thereby help the housing market clear. Notably, some fraction of the cost of modifications (for NPV-positive modifications) might legitimately be pushed from servicers onto MBS investors.

## CALIBRATING BREADTH AND DEPTH

### Example

- Require [3.0] million principal-reduction mods over six months (principal forgiven)
  - Apportion by market share
  - With or without short sale
- Simple eligibility standards
  - Residential owner-occupied
  - Current CLTV > [100%]
  - Not FHA or VA loans
- Principal must be written down to [95%] CLTV
  - Reduction in second lien mortgages held by any party to settlement
- Monitor compliance
- Make penalty for failure to execute big enough to encourage loan mods
  - Servicers fund write-down (makes investors whole)
  - But investors absorb write-down when NPV positive.



**Cost of Aggregate Principal Reduction**  
 (Assuming servicers modify *least* underwater borrowers)  
 \$ Billions

		Breadth: Millions of Loans Modified					
		0.5	1.0	1.5	2.0	2.5	3.0
Depth: Reduce each Loan CLTV	> 100% to 95%	\$7.0	\$13.9	\$20.9	\$27.9	\$34.8	\$41.8
	> 100% to 90%	\$10.6	\$21.1	\$31.7	\$42.3	\$52.9	\$63.4
	> 105% to 95%	\$7.1	\$14.3	\$21.4	\$33.3	\$51.9	\$70.5
	> 115% to 100%	\$13.4	\$28.1	\$51.5	\$74.9	\$103.9	\$135.2

**Note:** Assuming servicers modify *least* underwater borrowers; excludes FHA and VA loans

Source: CFPB analysis based on FRB staff research

A principal reduction mandate could be meaningfully additive to HAMP.

## PRINCIPAL REDUCTION MANDATE (PRM) VS. HAMP

Comparison of Borrower Universe, Eligibility, and Impact  
Millions

