Federal Housing Finance Agency

FHFA'S ANALYSIS OF A PRINCIPAL REDUCTION MODIFICATION PROGRAM AND ENHANCED NON-PERFORMING LOAN SALES REQUIREMENTS

Introduction

FHFA has conducted an extensive evaluation of whether to implement a loss mitigation program that includes principal and/or arrearage forgiveness (referred to here as "principal reduction") for borrowers with seriously delinquent, underwater loans that are owned or guaranteed by Fannie Mae and Freddie Mac (the Enterprises). In conducting this review, FHFA sought to determine whether a program could accomplish the following:

- Provide seriously delinquent, underwater borrowers with a last chance to avoid foreclosure by providing principal reduction in a straightforward and timely manner;
- Minimize the operational burden required of servicers and the Enterprises in implementing the program; and
- Be economically feasible for the Enterprises, meaning it would be reasonably expected to be Net Present Value (NPV) positive.

FHFA has also been examining lessons learned from the Enterprises' non-performing loan (NPL) sales in the year since FHFA announced its first enhanced NPL sales requirements. This review has been focused on whether there were ways to improve borrower and neighborhood outcomes without adversely impacting the Enterprises' economic returns on the sale of these assets.

FHFA has completed the analysis of both of these issues and has reached the following determinations:

- **Principal Reduction:** FHFA has directed the Enterprises to implement a targeted Principal Reduction Modification program (described in detail in this document) that leverages the Enterprises' existing Streamlined Modification program. FHFA believes that this final crisis-era modification program will provide seriously delinquent borrowers a last opportunity to address negative equity and to avoid foreclosure and will also help to improve the stability of neighborhoods that have not yet recovered from the foreclosure crisis.

- **Additional NPL Sales Requirements:** FHFA has also directed the Enterprises to implement further enhancements to their NPL sales requirements. These further enhancements will require NPL buyers to evaluate underwater borrowers with mark-to-market loan-to-value (MTMLTV) ratios above 115 percent for modifications that include principal and/or arrearage forgiveness, will forbid NPL buyers from "walking away" from vacant homes, and will establish more specific proprietary loan modification standards for NPL buyers.

This analysis begins with a description of the Principal Reduction Modification. This analysis then summarizes FHFA's evaluation of whether and how to implement a principal reduction program and then describes the expected impacts of this modification on the Enterprises' finances. It concludes by detailing the additional enhanced NPL sale requirements approved by FHFA.

Principal Reduction Modification Details

FHFA has directed the Enterprises to implement a targeted, one-time Principal Reduction Modification program. The program will be modest in size, with approximately 33,000 eligible borrowers. Eligible borrowers must have been at least 90 days delinquent as of March 1, 2016 and must meet other eligibility criteria described below. All eligible borrowers will receive a Principal Reduction Modification solicitation no later than October 15, 2016.

Principal Reduction Modification design: Principal Reduction Modifications will be structured similarly to the Enterprises' existing Streamlined Modifications. In existing Streamlined Modifications, servicers capitalize outstanding arrearages into the loan's principal balance; set the loan's interest rate to the current market rate; extend the loan's term to 40 years; and, if a borrower has a MTMLTV ratio greater than 115 percent, forbear principal to 115 percent of the MTMLTV ratio or 30 percent of the unpaid principal balance (UPB), whichever is less. Principal forbearance defers payments on a portion of outstanding principal until the end of the loan and makes it non-interest-bearing. This reduces a borrower's monthly payment but, unlike principal forgiveness, does not reduce a borrower's overall indebtedness.

Under the Principal Reduction Modification, servicers will follow the same modification steps they currently follow for Streamlined Modifications, except that principal reduction will be used instead of principal forbearance. Consequently, the amount of principal and/or capitalized arrearages that would have been forborne under a Streamlined Modification will be forgiven instead. This will reduce the borrower's debt burden. Additionally, this will result in the same loan modification payment for borrowers as they would have received under a Streamlined Modification.

Borrower eligibility: To be eligible for the Principal Reduction Modification, borrowers must be: a) owner-occupants; b) 90 days or more delinquent as of March 1, 2016; c) have a UPB of $250,000 or less as of March 1, 2016 prior to capitalizing outstanding arrearages; and d) have a post-capitalization MTMLTV ratio of greater than 115 percent on the date that their servicer evaluates their eligibility. Other eligibility criteria are generally equivalent to the Streamlined Modification eligibility criteria.

No borrower who is current or less than 90 days delinquent on a mortgage will be eligible for the Principal Reduction Modification. Similarly, no borrower who is making payments on a Trial Period Plan with a first payment due date before May 1, 2016 will be eligible for principal reduction. These borrowers should continue to make payments on their mortgages.

Expected borrower impact: Approximately 33,000 of the Enterprise's underwater borrowers will be eligible for a Principal Reduction Modification under this program.

A number of factors have resulted in a substantial decrease in the population of seriously delinquent, underwater Enterprise loans since the height of the crisis. These factors include rising home prices, improving borrower performance, successful modification and refinance programs provided by the Enterprises, and, to a lesser degree, Enterprise sales of NPLs. In fact, the number of underwater homeowners with an Enterprise loan has dropped by over 80 percent in the last four years. The Enterprises owned or guaranteed about 800,000 loans with MTMLTVs over 100 percent without capitalizing arrearages as of January 2016. Of these loans, payments on approximately 720,000 were current or less than 90 days delinquent and approximately 76,000 of these loans were seriously delinquent (i.e. 90 days or more delinquent).

Implementation: Servicers are required to solicit all eligible borrowers for the Principal Reduction Modification starting no later than October 15, 2016. Like the Enterprises' Streamlined Modification program, this solicitation will not require borrowers to submit extensive documentation regarding their income or assets. To take advantage of a Principal Reduction Modification, eligible borrowers must make their first trial payment within the time required under the Trial Period Plan (generally, the month following their month of solicitation). For example, a borrower who is solicited on October 10 for a modification with a Trial Period Plan first payment due date of November 1 will be required to make the first payment no later than November 30. After fulfilling the requirements of the Trial Period Plan, which consists of making three timely trial payments and signing and returning the final modification documents, these borrowers will receive a Principal Reduction Modification.

Servicers will initially implement Principal Reduction Modifications as Streamlined Modifications and will subsequently convert the principal forbearance to forgiveness by writing off the forbearance amount after the eligible borrower has fully accepted a final modification. Eligible borrowers in Streamlined Modifications who do not want to have the principal forbearance converted to principal forgiveness will have an opportunity to opt out of the forgiveness component of the modification. Servicers will offer these modifications for a limited time only, so eligible borrowers will have a limited time to act to use this program to avoid foreclosure. Servicers may, but are not required to, solicit borrowers more than once for the program, but all solicitations must be sent no later than December 31, 2016.

Interim Streamlined Modification solicitations for borrowers who might be eligible for the Principal Reduction Modification: Servicers will require time to implement the Principal Reduction Modification. As an interim step before servicers are ready to solicit for the Principal Reduction Modification, servicers are required to solicit a list of potentially eligible borrowers for a Streamlined Modification no later than July 15, 2016. If a borrower who receives a permanent Streamlined Modification is later determined by his or her servicer to be eligible for the Principal Reduction Modification, the servicer will convert the modification's principal forbearance to principal forgiveness. Borrowers who are determined not to be eligible for the Principal Reduction Modification will remain in their Streamlined Modification, which will not include principal forgiveness.

Borrowers who believe they may be eligible for a Principal Reduction Modification and wish to pursue one before the program is fully implemented should accept an offered Streamlined Modification. Accepting a Streamlined Modification will halt foreclosure proceedings but will not guarantee principal forgiveness. All trial modifications with first payment due dates on or between May 1 and December 1 will be assessed for principal reduction eligibility.

Additional information: The Enterprises are announcing the full details of the Principal Reduction Modification program in their communications to servicers. FHFA and the Enterprises are also issuing responses to Frequently Asked Questions to explain eligibility criteria and help borrowers navigate this program.

FHFA's Principal Reduction Analysis

FHFA began the current analysis of whether to implement a principal reduction program in the spring of 2014. FHFA sought to determine whether a program that achieved a "win-win" result – one that benefited both borrowers and the Enterprises – could be designed. While the Principal Reduction Modification program announced today is modest in size due to continued home price appreciation, improvements in mortgage performance, and other factors, the program accomplishes both objectives – it will benefit some underwater borrowers and help them avoid foreclosure and it is expected to be NPV positive i.e., will result in a financial gain to the Enterprises.

In developing the Principal Reduction Modification program presented here, FHFA worked to address three primary questions:

1. Borrower Experience: Can a program be designed that provides borrowers a chance to avoid foreclosure by providing principal reduction in a straightforward, predictable, and reasonably timely manner?
2. Servicer and Enterprise Implementation: Can a program be designed that is operationally feasible, minimizes burdens on servicers and the Enterprises, and minimizes program delays?

3. Economic Feasibility: Can a program be designed that can reasonably be expected to benefit the Enterprises financially?

FHFA considered multiple options to answer these questions.

Borrower Experience

FHFA sought to design a program that, if it met other key feasibility standards, provided seriously delinquent, underwater Enterprise borrowers with principal reduction in a straightforward, predictable, and reasonably timely manner.

Streamlined approach minimizes borrower burdens: FHFA learned from the Enterprises' successful Streamlined Modification programs that simplicity improves both the borrower and servicer experience. Modeling the Principal Reduction Modification program on the Streamlined Modification means that eligible borrowers will not be required to submit complex documentation regarding their income and assets. After making three on-time trial payments, fulfilling the requirements of the Trial Period Plan, and executing and returning the modification agreement, borrowers will have earned a Principal Reduction Modification. The relative ease of the Streamlined Modification process is intended to make it easier to reach delinquent borrowers who have not responded to previous modification offers.

Solicitation no later than October 15, 2016: Servicers must solicit eligible borrowers starting no later than October 15, 2016. Servicers who are ready to solicit borrowers before that date are encouraged to do so. Servicers may continue to solicit eligible borrowers until December 31, 2016.

Additionally, borrowers who accept a Streamlined Modification under which the first trial payment due date is on or between May 1 and December 1, 2016 and who are later determined to be eligible for a Principal Reduction Modification will be able to receive principal reduction. They will receive a letter before December 31, 2016 allowing them to opt out of the conversion to a Principal Reduction Modification, if they desire to opt out.

Tax considerations: FHFA remains sensitive to the potential tax implications for borrowers who accept principal reductions. While FHFA sought to design a program that will enable eligible borrowers who meet the terms of the Mortgage Forgiveness Debt Relief Act to benefit from the exclusion of forgiven mortgage debt from taxable income, the Internal Revenue Service, not FHFA, has jurisdiction over the tax treatment of the Enterprises' Principal Reduction Modification. Consequentially, FHFA will encourage all borrowers to consult with a tax advisor regarding the tax consequences of accepting a Principal Reduction Modification.

Servicer and Enterprise Implementation

FHFA's analysis took into account the operational impact for servicers and the Enterprises to implement a Principal Reduction Modification. FHFA endeavored to develop and analyze program options that would minimize implementation burdens, wherever possible.

Leveraging the Streamlined Modification: The similarity of the Principal Reduction Modification to the current Enterprise Streamlined Modification will make implementation considerably less burdensome for servicers and the Enterprises compared to other implementation options that FHFA considered.

All Enterprise servicers have implemented the Streamlined Modification. However, servicers will still have to make process changes in order to identify eligible borrowers for the Principal Reduction Modification and generate solicitation letters and opt-out letters. The Enterprises will assist with both of these processes by providing language for borrower communication letters, property value data, and a list of potentially eligible borrowers for the Principal Reduction Modification. Servicers will have to develop the processes necessary to write off principal that is presently forborne under the Enterprises' other modifications. Despite the similarity of this modification to the Streamlined Modification, FHFA found that the time it will take for servicers to solicit eligible borrowers and provide loan modifications will vary from servicer to servicer.

The similarity of the Principal Reduction Modification to the Enterprises' current Streamlined Modification will ease implementation at the Enterprises as well because they will be able to follow a similar process for both programs. Implementation of this program will require the Enterprises to make some updates to their systems to enable them to check eligibility for modifications, handle principal reductions in their accounting systems, and implement the manual write-off process.

Alternative options posed serious implementation concerns: FHFA considered various program design options, several of which would have required the Enterprises and servicers to conduct full updates to their systems. The implementation burdens of these options were considerable for all parties and servicers generally would have required more than one year to implement them from the date of the program announcement. This would have resulted in long delays before borrowers were able to obtain permanent Principal Reduction Modifications and might have impacted borrower eligibility for favorable tax treatment under the Mortgage Forgiveness Debt Relief Act.

FHFA also considered a number of implementation options that relied on transferring loans from servicers for whom implementation was more time consuming and difficult to servicers with greater capacity to implement quickly. FHFA concluded that large-scale servicing transfers would ultimately extend, not shorten, the implementation timeline. FHFA also concluded that such an approach would increase the costs of the program, the likelihood of borrower confusion, and servicing transfer risks for servicers.

FHFA also considered whether to implement principal reduction though the U.S. Department of the Treasury's Home Affordable Modification Program Principal Reduction Alternative (HAMP PRA). However, FHFA concluded that the implementation of HAMP PRA would entail significant operational complexity for the Enterprises, result in long delays before borrowers could benefit, and entail additional implementation costs to the Enterprises.

Economic Feasibility

FHFA considered various options in an effort to design a program that is projected to be Net Present Value (NPV) positive for the Enterprise (i.e. the Principal Reduction Modification would save them money compared to foreclosure and compared to only providing their current foreclosure avoidance offerings). To meet this objective, the Principal Reduction Modification approved by FHFA adopts the following eligibility criteria related to delinquency, MTMLTV, UPB, occupancy, and trial modification status:

Program restricted to seriously delinquent borrowers as of March 1, 2016: The approved plan limits eligibility to borrowers who were 90 days or more delinquent as of March 1, 2016.

FHFA determined that reducing mortgage debt for the 90.5 percent of Enterprise underwater borrowers who are current or less than 90 days delinquent on their mortgages would be significantly NPV negative for the Enterprises. The agreements governing the Enterprises' mortgage-backed securities also do not permit the Enterprises to modify performing loans.

Underwater borrowers who are current on the mortgages and who have not already done so are eligible to refinance through the Home Affordable Refinance Program (HARP), which may reduce their monthly payment significantly. More than 3.3 million Enterprise borrowers have already taken advantage of HARP, saving an average of $2,200 a year, and 30 percent of these borrowers had LTVs greater than 105 percent when they refinanced. Borrowers are still able to take advantage of HARP until the end of 2016.

FHFA chose a 90-day minimum delinquency cutoff because it aligns with the date at which borrowers typically become eligible for a Streamlined Modification. Compared to a cutoff at more severe delinquency (e.g., 12 months), the 90 days delinquency cutoff has the benefit of including borrowers who are more likely to take up a modification.

FHFA also elected to limit the program to borrowers who were 90 days or more delinquent as of a fixed date in the past (March 1, 2016) to underscore the point that this is a crisis-era modification program to give seriously delinquent, underwater borrowers a final opportunity to avoid foreclosure and address negative equity remaining from the financial crisis. This criterion also ensures that the program does not encourage current borrowers to "strategically default" on their mortgages in order to obtain a Principal Reduction Modification.

Program restricted to underwater borrowers: FHFA has decided to limit eligibility to borrowers with post-capitalization MTMLTV ratios greater than 115 percent as of the date of evaluation for the modification.

In adopting the 115 percent MTMLTV cutoff, FHFA considered whether to include borrowers whose post-capitalization MTMLTV ratio was between 100 and 115 percent and whether principal should be reduced to 100 percent of MTMLTV rather than 115 percent. Both of these options, however, would have produced significantly negative financial outcomes for the Enterprises.

Additionally, utilizing the 115 percent MTMLTV cutoff has the benefit of aligning with the point at which the Standard and Streamlined Modifications offer principal forbearance. This allows the Principal Reduction Modification program to leverage the existing systems of servicers and the Enterprises and therefore reduces operational burdens. This MTMLTV standard is used in HAMP PRA and is widely accepted in the market. A 115 percent MTMLTV standard also provides borrowers a realistic prospect of reaching positive equity within a reasonable time.

Program restricted to lower-balance loans: FHFA elected to impose a UPB cap of $250,000 on eligible loans because modifications of lower-balance loans have a higher NPV than modifications of larger-balance loans. The large fixed costs associated with foreclosure make foreclosure a much less cost-effective option for lower-balance loans.

Program excludes investor properties: Because the Principal Reduction Modification program is intended to provide seriously delinquent, underwater homeowners (not investors) a final opportunity to retain their homes, eligibility is limited to owner occupants. Servicers will use loan purpose data as of origination to exclude investor loans, although borrowers can request that their servicer evaluate them for a Principal Reduction Modification if they have subsequently moved into a property previously held for investment purposes.

Program excludes borrowers in current trial modifications: Finally, FHFA elected not to include borrowers who had accepted trial modifications with payment due dates before May 1, 2016. This is exclusion is for two reasons. First, the program is intended to reach borrowers who were not being reached by current modification offerings. Second, the cost of including these borrowers in the Principal Reduction Modification program would have been significantly NPV negative for the Enterprises.

Projected Impact of the Principal Reduction Modification Program

Applying the above eligibility criteria, the Enterprises expect that approximately 33,000 borrowers will be eligible for the Principal Reduction Modification program. Although this number of eligible borrowers is modest, those who are eligible can be greatly assisted by receiving a Principal Reduction Modification and the foreclosures prevented by these modifications will help stabilize communities still hard-hit by the foreclosure crisis. Eligible loans are heavily concentrated in Florida, New Jersey, New York, Illinois, Ohio, Pennsylvania, Nevada and in hardest hit communities. Because many of these eligible loans are considerably delinquent and the borrowers have been solicited for existing modifications repeatedly without success, many of them are likely headed to foreclosure, a very costly outcome for borrowers, for communities, and for the Enterprises.

The following table presents FHFA's assessment of the Enterprises' projections of the Principal Reduction Modification program's impact on their finances:

Projected Economic Impact of the Principal Reduction Program		
Volume	Eligible Population	33,242
	Streamlined Mod Expected Take-Up Rate	9.5%
	Take-Up Count at Streamlined Mod Rate	3,155
	Take-up Count at Double Streamlined Take Up Rate	6,309
Break Even Analysis	Break Even Take-Up Rate	15.0%
	Break Even Take-Up Count	4,993
	Break Even Incremental Count	1,838
Economic Impact on the Enterprises	Versus Foreclosure at Streamlined Mod Take-up Rate (9.5%)	$30M
	Versus Streamlined Mod at Streamlined Mod Take-Up Rate (9.5%)	-$17M
	Versus Streamlined Mod at Double Streamlined Take-Up Rate (19%)	$14M

Fannie Mae data as of January 2016. Freddie Mac data as of February 2016. Percentages are weighted averages based on eligible population at each Enterprise.

The ultimate economic impact of the Principal Reduction Modification program will depend on the rate at which eligible borrowers take advantage of the program (take-up rates). Because the Enterprises do not offer a Principal Reduction Modification currently, they do not have an existing, comparable take-up benchmark to use in assessing the projected economic impact of a Principal Reduction Modification program.

As a result, the Enterprises have developed take-up rate assumptions building on the actual take-up rates experienced for the Streamlined Modification. If the take-up rate for Principal Reduction Modifications is equal to the take-up rate of the Streamlined Modification (9.5%) which forbears but does not forgive principal, the program will cost the Enterprises a relatively small amount (approximately $17 million) compared to the Streamlined Modification program. Compared with foreclosure, the program would save the Enterprises about $30 million.

However, there are reasonable grounds to believe that offering principal reduction will cause take-up rates to exceed the Streamlined Modification take-up rate and to exceed the breakeven rate (15%). The Enterprises will be offering Principal Reduction Modifications to borrowers for the first time, which is expected to persuade some borrowers who have not responded to modification solicitations in the past to accept this solicitation. The public interest in a Principal Reduction Modification program has remained high throughout the financial crisis, and continuing strong support from outside organizations increases the likelihood of higher take-up rates for the Principal Reduction Modification relative to the Streamlined Modification.

Additionally, private market participants regularly utilize principal forgiveness, in part because of its positive impact on modification take-up rates. In the first quarter of 2015, 50 percent of bank portfolio loan modifications included principal reduction (the share of portfolio loan modifications for *underwater* borrowers that contained principal reduction was likely even higher, as not all modified loans were underwater).[1] FHFA and the Enterprises also learned from conversations with approximately ten of the largest NPL investors that almost all voluntarily provide principal reduction and/or arrearage forgiveness.

Increased take-up relative to that of Streamlined Modifications will enable the Enterprises to save money overall through the program. Reaching this outcome will require relatively few incremental Principal Reduction Modifications because of the extremely high costs associated with loans that end up in foreclosure. Based on the Enterprises models and projections, if 5.5 percent more borrowers take up the Principal Reduction Modification than would have taken the Streamlined Modification, the program will be NPV positive compared with offering only Streamlined Modifications. If take-up rates are double the expected Streamlined Modification rate, the Principal Reduction Modification program is projected to save the Enterprises $14 million.

Enhanced NPL Sales Requirements

In an effort to reduce substantial inventories of non-performing loans (NPLs) and improve borrower outcomes, in 2014 FHFA approved a pilot program by Freddie Mac to sell NPLs. After gaining initial experience with these sales, FHFA announced enhanced requirements for the Enterprises' NPL sales in March 2015. These enhanced requirements were aimed at achieving more favorable outcomes for both the Enterprises and for borrowers by providing alternatives to foreclosure whenever possible. The further enhancements to NPL sale

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[1] Office of the Comptroller of the Currency, "Mortgage Metrics Report: First Quarter 2015." A recent paper published by the Urban Institute Housing Finance Policy Center offered the following explanation for the willingness of portfolio lenders to offer principal reduction: "An investor who both owns and services a mortgage behaves differently, attempting to maximize the return on its investment…. In most quarters, portfolio lenders provided the largest percentage of principal reduction. Were they altruistic? No; they calculated that principal reduction would give them the highest return on their loans, and they kept the upside." See Laurie Goodman and Dan Magder, "Selling HUD's Nonperforming Loans: A Win-Win for Borrowers, Investors, and HUD," (Washington: The Urban Institute, 2016).

requirements announced today make three changes that draw from the experiences Freddie Mac and Fannie Mae have gained with these sales over the past year.

Principal reduction: First, the new enhancements require investors to evaluate borrowers with MTMLTV ratios greater than 115 percent for modifications (HAMP or proprietary) that include principal and/or arrearage forgiveness. Most NPL buyers already routinely offer principal and arrearage forgiveness today. NPL buyers may use an NPV test to determine whether debt reduction is part of the modification offered to an individual borrower, and will not be required to offer principal and/or arrearage forgiveness to each individual borrower with MTMLTV ratios above 115 percent.

Preventing new buyers from walking away from vacant properties: Second, the new requirements prohibit NPL buyers from unilaterally releasing liens and "walking away" from vacant properties. Analysts and advocates have raised concerns that investors may walk away from the most challenging loans in NPL pools, leaving vacant houses in neighborhoods and contributing to blight and decay. If a foreclosure alternative is not possible, servicers for NPL buyers must complete either a foreclosure or a loan donation or sale, which may be to a non-profit or government entity. NPL buyers will, therefore, be prohibited from abandoning any vacant property secured by a loan sold in an NPL pool.

Establishing more detailed proprietary loan modification requirements: Third, the new requirements establish limits on interest rate increases in proprietary modifications after the initial modification period. The vast majority of NPL buyers currently offer fixed-rate proprietary modifications with no possibility of payment increases over the life of the loan. However, if an NPL buyer provides a proprietary modification in which the interest rate can increase in the future, the period of the initial reduced interest rate must last at least five years and subsequent interest rate increases are limited to 1 percentage point per year. This requirement is consistent with the standard currently applicable to HAMP Tier 1 modifications and will limit excessive payment increases to borrowers and improve the likelihood of long-term home retention.