DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

July 31, 2012

Federal Housing Finance Agency
Office of the Director
400 7th Street S.W.
Washington, D.C. 20024

Dear Acting Director DeMarco,

I am writing in response to the decisions announced in your letter to Congress today. While I was encouraged that the Federal Housing Finance Agency (FHFA) is making progress on some initiatives we have discussed that will help the housing market recover, I am concerned by your continued opposition to allowing Fannie Mae and Freddie Mac (GSEs) to use targeted principal reduction in their loan modification programs.

FHFA is an independent federal agency, and I recognize that, as its Acting Director, you have the sole legal authority to make this decision. However, I do not believe it is the best decision for the country, because, as we have discussed many times, the use of targeted principal reduction by the GSEs would provide much needed help to a significant number of troubled homeowners, help repair the nation's housing market, and result in a net benefit to taxpayers.

Indeed, notwithstanding the selective numbers cited in your letter, FHFA's own analysis, which you have shared with us previously, has shown that permitting the GSEs to participate in the Principal Reduction Alternative program (HAMP-PRA) could help up to half a million homeowners and result in savings to the GSEs of $3.6 billion compared to standard GSE loan modifications. Furthermore, if the GSEs were to participate in HAMP-PRA, taxpayers would save as much as $1 billion on a net basis. In view of the clear benefits that the use of principal reduction by the GSEs would have for homeowners, the housing market, and taxpayers, I urge you to reconsider this decision.

I have asked Michael Stegman of my staff to restate in writing for you the case for principal reduction, consistent with FHFA's mandates as conservator and regulator of the GSEs, that the Treasury has made to you and your staff over the last several months. His memorandum is enclosed. Treasury stands ready to provide any additional analytical support to make a targeted principal reduction program at the GSEs successful.

We welcome the positive steps you announced today regarding further refinancing opportunities, providing clarity to lenders on legal exposures, aligning short sale practices, and putting foreclosed properties back on the market. All of these have the potential to help advance recovery of the housing market. As we have previously discussed, the impact of these steps will depend on the speed with which you act and the extent of the changes you make.

Five years into the housing crisis, millions of homeowners are still struggling to stay in their homes, and the legacy of the crisis continues to weigh on the market. You have the power to help more struggling homeowners and help heal the remaining damage from the housing crisis. I hope you will move to address these problems with a sense of urgency and force commensurate with the scale of the remaining challenges.

Sincerely,

Timothy F. Geithner

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

July 31, 2012

MEMORANDUM
TO: Acting Director Ed DeMarco
FROM: Michael Stegman, Counselor for Housing Finance Policy
RE: The Case for Principal Reduction

Secretary Geithner asked me to summarize below the case for using principal reduction in a targeted manner that the Treasury has made to you and your staff over the last several months.

Principal reduction benefits individual homeowners and the housing market as a whole.

The use of targeted principal reduction is beneficial for several reasons. It provides relief to a significant number of underwater troubled homeowners, helps repair the housing market and minimizes taxpayer losses. The basis for this judgment, which is consistent with Fannie Mae's study of Home Affordable Modification Program (HAMP) performance data and the behavior of private lenders and investors, is that a carefully designed, targeted program of principal reduction is effective in reducing the risk of re-default by borrowers who receive loan modifications.

In June 2010, Treasury introduced principal reduction as part of the Making Home Affordable program (HAMP-PRA) to help certain underwater borrowers who are struggling to avoid foreclosure and improve community and housing market stability. Under this program, financial incentives are paid to investors as a percentage of each dollar of principal reduction. Borrowers are eligible only if they face a financial hardship and demonstrate an ability to pay the modified mortgage amount. Moreover, participating servicers are encouraged to reduce principal only when the modification makes economic sense for the investor, taking into account the cost of modification and the risk (and potential cost) of foreclosure.

The available evidence on HAMP-PRA, as well as industry practice, indicates that targeted principal reduction makes economic sense for the holder of the credit risk, be it a bank holding the loan in portfolio, investors in private label securities, or Fannie Mae and Freddie Mac (GSEs) for loans they guarantee.

Fannie Mae, acting as Treasury's agent, analyzed HAMP modification performance data with and without principal reduction.[1] This analysis shows that six months following modification, controlling for loan and borrower characteristics, the re-default rate was lower for loans that were modified with principal reduction than the re-default rate for loans that were modified with

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[1] U.S. Department of the Treasury, The Effects of the Principal Reduction Alternative (PRA) on Re-default Rates in the Home Affordable Modification Program (HAMP): Early Results, July 2012. Summary of research performed by Fannie Mae.

comparable payment reductions but without principal forgiveness. This early positive difference in re-default rates in favor of principal reduction is expected to increase further as the loans age.

Fannie Mae's analysis suggests that using principal reduction to reduce the loan-to-value (LTV) ratio not only increases a borrower's *ability to pay*, but for these selected borrowers, it also increases the likelihood that they will *continue to pay*.

Principal reduction would provide additional benefits to households, communities, and taxpayers if Fannie Mae and Freddie Mac were to implement it as part of their modification programs.

Treasury believes that principal reduction is consistent with the Federal Housing Finance Agency's (FHFA) mandates as conservator and regulator of the GSEs because analysis shows it is economically beneficial to both the GSEs and taxpayers. Indeed, even FHFA's own analysis shows that permitting the GSEs to participate in a principal reduction program could help up to half a million homeowners and benefit the GSEs up to $3.6 billion and save taxpayers as much as $1 billion.

The 2008 law that created the FHFA as conservator and regulator of the GSEs gave the agency several responsibilities. One is to "preserve and conserve" the assets of the GSEs. A second is to help the housing market recover. Specifically, FHFA is to "ensure... that the operations and activities of each [GSE] foster liquid, efficient, competitive, and resilient national housing finance markets."[2]

In passing the Emergency Economic Stabilization Act of 2008 (EESA), Congress made it clear that FHFA's obligation to help the housing market heal involves helping homeowners avoid foreclosure. Under that law, FHFA is required 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."

We believe that implementation of the principal reduction alternative under Treasury's mortgage modification program is not only consistent with FHFA's statutory responsibilities, but is also the most prudent way for FHFA to meet its obligations.

The targeted use of principal reduction will help preserve the assets of the GSEs, as well as minimize foreclosures and maximize assistance for homeowners. GSE loans represent more than half of the outstanding mortgages in the country. This means that the reach and impact of our housing programs depend to a significant degree on the participation of the GSEs. When the GSEs participate, as they have in the programs that give homeowners the chance to reduce their monthly mortgage payment, they have had a very substantial impact. When the GSEs do not participate, the impact of these programs is much more limited. Because of the importance of the GSEs to the housing market overall, FHFA's decision not to allow the GSEs to participate

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[2] Federal Housing Finance Regulatory Reform Act of 2008, enacted as Division A of the Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (Jul. 30, 2008)

substantially limits the effectiveness of the programs. Recognizing this, we have tried to make it easier and more compelling for the GSEs to align their programs with those in the private mortgage market.

Specifically, Treasury supports the use of principal reduction not for Fannie Mae and Freddie Mac's entire portfolios, but on a loan-by-loan basis. Principal reduction should only be used when the modified loan has a positive net present value (NPV) that is *greater* than any other modification.

FHFA's original analysis of principal reduction was not performed in this manner, showing instead that HAMP-PRA, when applied to the entire GSE portfolio of underwater borrowers, would generate negative NPV results as compared to other modifications. This, of course, is not how the program was designed to work, so the finding was not relevant to an adequate assessment of its benefit. Once performed correctly on a loan-by-loan basis, principal reduction would apply in a limited number of cases and show a positive NPV result for both GSEs and taxpayers.

FHFA's corrected analysis showed the following:

- Almost a half-million troubled, underwater borrowers with Fannie Mae or Freddie Mac loans could benefit from principal reduction.

- Applying HAMP-PRA to this eligible universe with full participation would result in net savings to the GSEs of $3.6 billion compared to standard GSE loan modification processes.

- After deducting Treasury incentives of $2.7 billion, there would still be a net savings to taxpayers overall of up to approximately $1 billion.

FHFA also found that a significant share of the economic benefits to the GSEs from their participation in HAMP-PRA would come from borrowers who are more than 12 months delinquent. While these loans may have a lower probability of curing, each borrower who gets back on track as a result of receiving principal forgiveness generates disproportionately large savings to the GSEs. Moreover, borrowers only receive principal reduction once they have successfully returned to making on-time payments and completed a trial modification. Even if these longer-delinquent loans are not included in the program, by FHFA's estimate, there are still almost 300,000 loans that can participate in HAMP-PRA at zero cost to the taxpayer.

Finally, the number of troubled, underwater borrowers who will ultimately benefit from GSE participation in HAMP-PRA depends on overall take-up. But even if only a portion of those eligible are helped, it is very important for those homeowners where it means the difference between keeping and losing their homes.

Concerns about the cost and administrative burden to the GSEs of implementing principal reduction can be addressed with support offered by the Treasury Department.

FHFA has expressed concern that implementation of HAMP-PRA would be an administrative and financial burden on the GSEs and would divert management attention from higher priority objectives. Treasury has offered to help FHFA address that problem by paying the additional administrative costs required to implement HAMP-PRA. We also have offered to work with the GSEs to rearrange Treasury priorities for other HAMP-related administrative projects to free up both human and technical resources to help accelerate implementation of a principal reduction program.

Concern regarding strategic default has been carefully addressed in the design of HAMP-PRA.

Critics of principal reduction argue that large numbers of currently performing underwater borrowers would strategically default on their loans, in the hope of getting principal reduction, and potentially raise the future cost of mortgage credit.

We believe the design of HAMP addresses this concern. First, there are a series of eligibility requirements that a borrower must meet. In order to qualify for a modification of any kind, a borrower must have a demonstrated financial hardship and must be delinquent or at risk of imminent default and sign an affidavit attesting to an economic hardship. The NPV model discloses whether a modification with principal reduction is more cost-beneficial to the investor than a standard HAMP modification without principal reduction. In addition, the borrower's modified mortgage payment must meet certain debt-to-income criteria. In essence, a borrower who defaults cannot be certain that he or she will obtain a HAMP modification, much less a HAMP modification with principal reduction. Therefore, a borrower would take a substantial risk by deliberately defaulting: they would have to choose to damage their credit for years to come and perjure themselves on the chance that they would be found eligible for the program. For these reasons, we do not believe implementation of HAMP-PRA by the GSEs alongside other mortgage relief programs would negatively affect the future cost and availability of credit.

Nevertheless, we have indicated to FHFA our willingness for the GSEs to include an asset test or other type of hardship screen to maximize the likelihood that only borrowers with genuine hardships receive principal reduction.

Importantly, banks are using principal reduction on loans in their own portfolios. Even before Treasury announced tripling incentives to encourage participation in HAMP-PRA, the use of principal forgiveness was on the rise in non-GSE modifications. Private lenders (including many who are not party to the national foreclosure settlement) are providing substantial sums of principal reduction through HAMP-PRA for a very high percentage of eligible borrowers on their own portfolios. Thus, facing the very factors faced by FHFA, including the risk of strategic default, private lenders have determined that the judicious use of principal reduction makes financial sense.

A recent Fitch Ratings analysis of strategic default within principal forgiveness programs operated under the national mortgage settlement finds little evidence of strategic default.[3] FHFA is also working closely with the California and Nevada Hardest Hit Fund programs to implement limited principal reduction programs (one in connection with a refinancing under the GSEs' own Home Affordable Refinance Program) that suggest that strategic default concerns can be adequately addressed.

The attached table was excerpted from FHFA's June 25, 2012, analysis.

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[3] Jon Prior, "Fitch Sees No Sign of Strategic Default for Rising Principal Reductions"; *Housing Wire* (July 9 2012), http://www.housingwire.com/news/fitch-sees-no-sign-strategic-default-rising-principal-reductions

Federal Housing Finance Agency

Model Results Selecting Optimal HAMP Modification Based on Net Present Value (NPV)

Standard HAMP Modifications versus Optimal HAMP Option ($ in billions; loan counts rounded to nearest thousand; totals may not add due to rounding)	**Expected Losses, No Modification**	**Reduction in Losses, Standard HAMP**	**Reduction in Losses, Optimal HAMP Modification**	**Enterprise Benefit, Optimal HAMP Modification vs. Standard HAMP**	**Treasury Subsidy**	**Taxpayer Benefit**
Eligible Pool # of Loans: 497,000 UPB: $99.3 billion	$45.0	$6.6	$10.2	$3.6	$2.7	$1.0
Assumption: 50 percent take-up # of Loans: 248,000 UPB: $49.7 billion	$22.5	$3.3	$5.1	$1.8	$1.3	$0.5

Notes:

- Each loan tested for maximum NPV based on HAMP-PRA, traditional HAMP, or no modification. Loan assigned to category yielding the highest NPV, per the model.
- Pre-modification DTIs adjusted to reflect DTI distribution of loans that received HAMP modifications (delinquent loans only).
- Model results are still just that – model results based on assumptions about behaviors for which we lack much historical data.

Source: Federal Housing Finance Agency – Meeting with Treasury Secretary Geithner – June 25, 2012

Definitions:
UPB – Unpaid principal balance
DTI – Debt-to-income ratio
Standard HAMP Mod – A HAMP modification that uses forbearance for underwater homeowners rather than principal reduction. The protocol is to reduce the rate to 2 percent, extend term out to 40 years, and forbear principal. The protocol stops at any point in the process as soon as the target DTI of 31 percent is reached.
Optimal HAMP Mod – A HAMP-PRA modification that uses principal reduction for underwater homeowners. The protocol is to reduce principal until the LTV is reduced to 115 percent, then follow the steps in the Standard HAMP modification. Again, the protocol stops at any point in the process as soon as the target DTI of 31 percent is reached.