Interview by Phil Hall Richard Rydstrom Chair Hot Neutral

Mega AG Settlement

1. Will this settlement really help move things forward?

Prices are still coming down. Uncertainty still abounds. Housing recovery is without visibility. The people and the industry need to believe that wrongs are now right. Big businesses run on operational and capital budgets which are not always in compliance with best practices or law. Historically, sometimes big businesses only change when faced with monetary pain or criminal consequences. Penalties, reforms and the threat of criminal consequences (if perceived real), should cause the industry to re-align its conflicts and income incentives in concert with servicing and borrower best interests. The dire need for realignment of incentives and conflicts is nothing new within industry discussions – but it will not take place until walls define the roadway. Servicers make money on outstanding (principal) balance. Therefore, servicers are motivated to delay loss mitigation resolution to increase its income. If the incentive was based on the investor's return, much less foreclosures would take place (as the loss to investors is substantial: 40-70%). But it's not only about income streams: a servicer is motivated ultimately to foreclose as a defensive strategy to limit legal or litigation liability. A servicer who can be accused of mismanagement of mortgage bonds, incompetent loss mitigation or pump and dump faces expensive litigation and enhanced litigation loss severity. The industry is missing an opt-in mechanism that optimizes risk and loss for all parties to the transaction. We are still using "litigation" as a business tool to resolve misaligned incentives. It's wasteful and foolish. It's like using a Viking hatchet in place of 21st century preventative care and or medical surgery.

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2. What are the downfalls of a settlement like this?

Having politicians (AGs with political ambitions) negotiate reforms for any industry is the least favored method of achieving meaningful best practices. From a practical point-of-view, the industry in cooperation with investors and borrowers, if equally motivated, would fashion a better mouse trap. But the industry continues to fail to step up and be proactive in any meaningful way. Leadership is non-existent.

Investors and bond holders were left out of the negotiation process for the settlement, and may be left holding the bag (in losses). Investors are saying that they are waiting to see what the consequences will be of the settlement. Herein lies the problem. This settlement (a non-comprehensive resolution) will result in investors suing banks for violating its interests pursuant to contract. Again, "litigation" is the resolution strategy of choice. But it doesn't have to be. If investors lost some $350 billion over the last five years on private mortgage investments, investors need to implement a different risk loss analysis. Investors should weigh probable losses without principal reduction techniques (which they should

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have an experience factor to rely upon) against probable losses with principle reduction mitigation (with shared appreciation devices). At some point, investors must come to realize that loss mitigation with claw-back (SAM) provisions would reduce losses substantially, and over time enhance gains. If the industry would step-up and desire to reconcile all diverse interests including the borrower and investor, principal reductions would not be resisted; they would be embraced. Loss mitigation has been adversarial. But that is unnecessary and ill-advised. Loss mitigation with claw-back or shared appreciation modification (SAM) provisions would reduce losses substantially, and over time enhance gains.

If **$10 billion** (of the $25 billion) has been allocated to principal reduction, it is insufficient to make a meaningful impact. In a congressional hearing on April 13, 2010, David Lowman, chief executive of Chase's mortgage business estimated that 'reducing loan balances so no homeowners would owe more than the value of their homes would cost up to **$900 billion** – with 150 billion of that borne by the government.' After the hearing, the police had to escort and protect Mr. Lowman out of the Rayburn House as consumer groups chased him through the hallways. Recently, Edward J. DeMarco, acting director, FHFA, released a report "concluding that principal forgiveness did not provide benefits that were greater than principal forbearance." He estimated that forgiving mortgage debt could cost the government-supported companies almost $100 billion.

If the average homeowner underwater owes approximately $52,500 over the current fair value of the home, then exposure is approximately $520.5 billion. We need more than $10 billion to deal with this issue.

3. Can principal reductions with this create strategic default problems?

Strategic default problems are already here. If there are an estimated 11,300,000 loans with Negative Equity (First American CoreLogic), default and strategic default will continue to materialize; especially as prices continue to decline and there is no housing recovery in sight. In this context, the question is whether principal reductions can be used to shift incentives to "stay and pay." The answer is simple: yes, if the borrower is offered a payment within a range of his true ability to pay, and equity is visible or realizable to the borrower within certain time parameters.

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Principal reductions and forgiveness can be a viable solution if all interested parties are incentivized therefrom. SAMs would be a key element of the success of such a solution.

Recently, Sen. Robert Menendez (D-New Jersey) introduced a bill entitled, **Preserving American Homeownership Act** which would have banks write down principal to 95 percent of the new fair market value. This reduction would take place over a three-year period upon the borrower continuing to make timely payments. In this proposal, the bank would get a fixed claw-back, not to exceed 50% of the appreciation at 1st transfer, and the percentage would be equal to the percentage of reduced principal (i.e.: 20% for 20%).

Principal Reduction/Forgiveness Examples:

If $900 billion of principal is underwater, 25% of Forgiven Principal (or $187,500,000,000) could result in 33% claw-back for each participant (or $187,500,000,000 to lender and $187,500,000,000 to investor/insurer, and same to borrower).

Principal Writedowns

Total Underwater Principal	**$900,000,000,000**
Government Cost (in $900b)	$150,000,000,000
Private Cost/Exposure	$750,000,000,000

Savings to Lenders / Investors

Example 1 - 25% Forgiven Principal - 33% Shared Appreciation

The following example assumes that 25% of the principal is forgiven and the remaining portion might be regained in future appreciation of properties and as such is held in quarantine to be shared equally by the lender, borrower and an Insurer/Investor. Under this scenario the Lender/Investors would save $187 billion using QBSam™.

Assume 25% Forgiven Principal - 33% Shared Appreciation

Forgiven Principal – Loss/Outset	25%	$187,500,000,000
Quarantined (Deferred) Principal / Remaining Negative Equity / Potential Shared Appreciation / Reduced Loss Write-off Amounts at Outset	75%	$562,500,000,000

QBSam™ Clawback Allocations / Reduced Loss Write-off Amounts at Outset

Borrower share of clawback	33.3%	$187,500,000,000
Lender/Investor share of clawback	33.3%	$187,500,000,000
Insurer/Investor (Govt; Private) share of clawback	33.3%	$187,500,000,000

Another solution would be the solution that Richard Rydstrom discussed with Wilbur Ross at the DC Executive Leadership Summit in June of 2008; which is as follows:

Public – Private Guarantee Solution: (Wilbur Ross and Richard Rydstrom June 2008)

- Set up an insurance guarantee program.
- The government would guarantee 50% of the mortgage that had been reduced to true net value after selling commissions, etc.
- The guaranteed amount (50% government amount) could be separately sold by holder/lender at a much lower yield than the mortgage itself.
- Enable the holder/lender to pay a 2 ½% per year Insurance Fee to the government.
- At first sale, share proceeds of appreciation as follows:

1/3rd to Government
1/3rd to Lender/Holder
1/3rd to Borrower (Homeowner)

- Making it transferrable/assumable will lessen the need for new replacement mortgage.
- The 50% can come over to the next owner from the government guarantee at low rates and supply liquidity to the original lender.
- It can be backed by reinsurance.

4. How will this settlement hold servicers accountable for any future similar abuses?

An historic settlement with the top 5 banks will set the tone for others to follow. New best servicing standards akin to the new **Homeowner Bill of Rights**, compounded by the threat of criminal consequences should cause servicers to re-think its business practices. It should act as a warning.

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