IndyMac and the FDIC Got It Right

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by David L. Solomon, President

IndyMac Bank was closed by the Office of Thrift Supervision, with control transferred to the FDIC, on July 11, 2008. The successor operation, IndyMac Federal, FSB, has announced that it will not be selling non-performing residential mortgage loans in the bank's portfolio. Instead, FDIC regulators, who now are in charge of running IndyMac Federal, decided that they would seek to modify them.

Let me first state that I make my living in the mortgage loan market. While we generally sell loans after purchase, there are various resolution strategies, and it might be said that the profit in our business is in the "buy" side of the deal. If nobody sold another loan, I would have to brush off my CPA Certificate and find an accounting job (my "10-key by touch" is still relatively solid). That is why it is anything but self serving when I say, **IndyMac and the FDIC Got It Right.**

Did IndyMac and the FDIC conclude that selling loans to hedge funds and private equity firms, who might push foreclosures, thereby resulting in more empty homes, did not follow current bi-partisan goals of the Congress and the administration (particularly in an election year)? "Hope Now" and the Dodd-Frank FHA Refinance Program are two examples of the Government's goal of keeping people in their homes.

Or, is it possible that IndyMac and the FDIC saw that non-performing residential loan prices in California have a "3 handle" (a purchase price of between 30% and 39% of the unpaid principal balance of a subject loan) and concluded that because California has seen these types of swings in home values in earlier economic downturns that it would make more sense, economically, to modify borrower payments for a couple years and wait and see if liquidity returns to the housing market? The net recovery to IndyMac (and, by extension, to US taxpayers) could be much better under a **modification and refinance,** instead of a foreclosure and sale, plan.

Mark down the date August 20, 2008: It may turn out to be the bottom of the California housing market. That was the date IndyMac Federal and the FDIC went public with its systematic loan modification plan as an alternative to foreclosure. "Foreclosure is often a lengthy, costly and destructive process. Avoiding foreclosure not only strengthens local neighborhoods where foreclosures are already driving down property values, it makes good business sense," as declared by FDIC Chairman Sheila C. Bair. It may turn out to be the bottom of the California housing market.

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Let's explore the modification process in more detail:

- Only owner occupied borrowers should be modified, not Investor or non-owner occupied homes. Lenders should figure out quickly what it will take in terms of dollars for non-owner occupied home buyers to hand over their deeds in lieu of foreclosures. If there are "renters" in a home, Lenders should help them, providing funds if necessary, for them to move to a new home. As a buyer of non-performing loans, I can tell you from extensive experience that it is far better to pay borrowers and renters to relocate than it is to fight them in foreclosure and eviction court proceedings. One very big reason for this conclusion is that I have witnessed that borrowers and renters can cause tremendous property damage if they feel they have been treated unfairly. In this regard, imagine the painful lesson learned when I surveyed the damage to a manufactured home after its defaulted borrower cut a hole in the roof of the home, rented a crane, and tore out the fireplace he had installed.

- Manufactured Housing was the first time I experienced loan servicers modifying non-performing loans rather than foreclosing. "Just keep 'em paying" was—and continues to be—the marching order. When there's no good resale market, why repossess a house and recover 25 cents on the dollar when you can simply modify and extend? This same concept applies equally today to non-performing residential mortgage loans on traditional housing because recovery rates are low and getting lower.

- Even with modifications, some borrowers still cannot afford their homes. So, what should be done with these borrowers? As a rule of thumb, if the borrower cannot afford a monthly payment equal to one-twelfth of the result of multiplying 5% and the current market value of the subject home, then the home is not affordable, and the Lender should provide relocation funds to the borrower in order to help his / her relocation to a new home. At the same time, the Lender should move quickly to find a new borrower for the home or sell it. Not-for-profit community development organizations can be very helpful in this situation. In any event, a long term "hold" of a vacant house is likely to yield disastrous results.

You have probably noted that I do not support the use of foreclosure as a debt resolution tactic. In fact, we are finding that some non-performing loan borrowers, particularly those located in states with long foreclosure timelines (like some in the Northeast) are "gaming" the system in order to live in their homes for free as long as they can. In addition to pushing for modifications as the highest and best resolution tactic, I advocate that Congress should crack down on "gamers" who make no attempt to pay or cooperate with the servicers of their mortgage loans. Fortunately, to this point, gaming the system has been the exception and not the rule.

How about an example to show why the decision by IndyMac Federal and the FDIC to modify—rather than foreclose—makes sense given current economic conditions?

A borrower purchased a home in Riverside, California, in February 2006 for $375,000 by taking out a $300,000 first lien mortgage loan and $75,000 "piggyback" second lien loan. The first lien mortgage loan was a 2/28 adjustable rate loan with a 30 year term and an initial rate of 8%. On the initial rate adjustment date in February 2008, the interest rate did not change very much as a result of a drop in LIBOR rates. Even though the rate did not change, the borrower's household income had dropped, and the monthly first lien payment of $2,200 was no longer affordable. The borrower fell behind 3 payments and was facing foreclosure. The household could only afford $1,100 per month. An updated appraisal of the home obtained by the loan servicer revealed that the home value had dropped by 40% (from $375,000 to $225,000) since the original appraisal date.

Option A Sell the Non-Performing Loan in the Current Market:

Unpaid Principal Balance of Loan	$ 295,000
Sale Price (high end of range)	X 39%
Net Recovery	$115,050

The purchase price of 39% was determined by taking the net present value of the projected recovery following a reasonable foreclosure and sale period using a high internal rate of return that reflects the lack of liquidity in the current market for non-performing loans, and that buyers/investors are levered, high rates of return.

Option B Modify the Loan to a Payment of $1,100 per month, pay the second lien holder 5% of the unpaid principal balance for their note, and re-evaluate the borrower and the market on an annual basis. If the housing market improves only 10% from its current level over the next two years, the subject home's value will increase from $225,000 to $247,500. In addition, as a result of making the borrower's payments affordable, the borrower reasonably may be expected to make 24 payments in a row, thereby gaining an improved credit score. After two years of perfect performance, and an improved credit score, the borrower should be able to qualify for an FHA loan equal to 95% of current market value. Under the circumstances, the borrower's request for a short payoff equal to 95% of current market value would make sense to the lender.

24 Monthly Payments of $1,100	$ 26,400
Less, Cost of Second Lien	3,750
Plus, 95% of $247,500	235,125
Net Recovery	$257,775

Why not try and refinance the borrower into an FHA loan immediately rather than waiting two years? The answer is that the borrower needs to show an ability to pay on time for a period of time in order to be considered for an FHA loan.

Option A: Sale of Non-Performing Loan – net recovery is $115,050, and Option B: Modification and Refinance – net recovery is $257,775. Option B resulted in more than 124% greater net recovery than Option A. The fact that it takes two years to generate Option B's recovery is not a big deal given that the first lien holder is a bank whose cost of funds is approximately 2% per annum.

What other impact will modifications have on the housing market? "For sale" housing inventories should start to decline. When available supply declines, home prices should stabilize. Then, when liquidity returns to the market, home prices should begin to increase. The reversal of a downward curve in housing prices and growing market inventory will yield increased net recoveries for banks like IndyMac Federal.

For information about WMD Capital's Affordable Loan Modification and Foreclosure Prevention Program, please contact me at (805) 969-6300 or dsolomon@wmdcapital.com.

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