SPECIAL MASTER'S OVERVIEW

October 4, 2012

I today have submitted my second formal status report to you. I also want to take the opportunity to provide to you a less formal report containing a number of my observations and judgments. These are inherently subjective, but I hope they are of value in an overall assessment of what can fairly be termed the "mortgage crisis."

I. Background.

As the Court is aware, I was appointed Special Master in January 2012. I know it was the Court's hope that my background would provide a deep understanding of the mortgage process and mortgage securitizations, as well as engender a respect and comfort level among the corporate defendants. Conversely, as the Court commented to me, it hoped I would approach the situation, given my own civic and charitable engagements, with at least an ounce of human kindness.

From my perspective, I accepted the position with the hope of making a difference. My belief is the national economy fails to move forward as strongly as we would wish for two main reasons. One is the lack of a credible long-term approach to our national debt (a la Bowles-Simpson for example), which would provide stabilization and certainty. The other is the serious overhang caused by the excess housing stock, foreclosed properties and the existence of tens of millions of mortgages underwater and in default. The overhang and pendency of numerous foreclosures creates uncertainty and downward pricing pressure.

We both hoped that we would be a national model for resolution.

My initial expectation was in 3 to 6 months I would get a handle on the situation and predict how successful I could be. It has taken a bit longer, and a 6 to 9 month timeframe would have been realistic. I am now in a position to assess our situation.

II. Summary and Conclusion.

In a litigation context, the Special Master process has value. Through an organized process we were and are able to establish a settlement schedule, force meetings, prod follow up and bring matters to quicker resolution. Additionally, we were and are able to make the process and delays inherent in litigation "fairer" to the mortgage holders through the institution of a use & occupancy fee. Finally, we also have a substantive understanding of the size and locations of the mortgages before us, and some information as to the plaintiffs, their employment status and the value of their properties.

However, my personal hope had been higher. I really wanted to solve the problem. Through these months I have learned that we really face a Gordian Knot that is virtually impossible to unravel. Each participant behaves in a way that is explicable and (often) rational. But the total result is unreasonable, unwieldy and uneconomic.

III. The Gordian Knot.

A. The heart of the problem.

The reason the settlement process – nationally and in the Special Master process – has not been as productive as we want, is that the decision making corporate players – FNMA, FHLMC and the servicers – generally start from a premise that is largely uneconomic for an individual borrower. They do not forgive principal. Rather, they try to figure out what a defaulting borrower can "afford" to pay monthly, and by reducing the interest rate, stretching the amortization out to 40 years and putting a balloon on the back end, leave the principal balance of the mortgage intact.

May I say it directly: This is WRONG!

For the many borrowers who want to stay in their homes, they accept this solution, if offered. But just as these borrowers were probably not astute financially, overleveraged themselves and made imprudent or unrealistic economic decisions earlier, they remain naïve consumers. A defaulting borrower staying in a house which is significantly underwater is economic folly and can have serious adverse, longer-term personal consequences. And, unfortunately, just as the system before encouraged inappropriate overleveraging, the system now, for a variety of reasons, continues to promote poor economic decisions on the part of average borrowers.

1. The need for principal forgiveness.

One of the touchstones of America's economic success had been personal mobility. Take a Rhode Islander whose mortgage exceeds the value of his/her home by $100,000. What happens next month, next year or in five years to him/her if he/she gets a job offer in Pennsylvania? The overhang is a real problem.

Just recently (September 26) a CNN article contained an expert's view that the housing market would not return to its former highs until 2023 – and even later in certain states.

The outsized overhang is not a healthy situation for either the borrowers or our economy. Thus, even aside from the daunting nature of paying monthly on a restructured mortgage with limited, if any, chance of economic upside, borrowers, in effect, are living with the proverbial Sword of Damocles hanging over their head. If, at any time soon, they want or need to move, they owe a crushing amount. The average American has less than $100,000 saved in an IRA by age 60. Ninety-nine of 100 lack the resources to pay the kind of overhang our system is encouraging with refinancings containing no principal forgiveness.

The best way to restore mobility as well as a sense of hope (yes, the clichéd light at the end of the tunnel) is to RIGHT SIZE the mortgage to (more or less) the present value of the house through principal forgiveness. This forgiveness may be conditional, it may be only to reduce the mortgage to 110 or 120% of the current appraised value, but needs to happen.

2. The arguments against principal forgiveness.

At the macro policy-making level, the primary concern among those unwilling to forgive principal is the so-called "strategic default" issue. There is genuine concern that, given the tens of millions of underwater mortgages, if defaulting borrowers are given forgiveness, it will prompt a new wave of defaults among those paying.

The solution is NOT to refuse forgiveness. The solution is to modify, conditionally forgive to a reasonable level and take a "soft second" that provides that the bulk (say 75%) of the equity appreciation from the date of the modification goes to the mortgage holder. Additionally, the entire debt can be reinstated if the modified loan goes into default. Those elements should be sufficient to prevent widespread strategic default.

A few other factors support this approach. As noted above, most borrowers at age 60 have under $100,000 in their retirement account. Collecting these paper mortgage loan deficiencies simply does not happen. And why force bankruptcies that would tax our system and humiliate borrowers for no good reason? These restructures should be negotiated transactions. Finally, and importantly, the soft second would be structured so as to not bar arms-length sales to unrelated third parties at any time. The holder would collect its share of whatever appreciation, if any, was made and the balance of the mortgage forgiven and discharged. Thus mobility, and yes, hope, would be restored.

3. The lack of traction for the principal forgiveness approach.

One of my mentors once joked that it takes a person with bad business judgment three days to decide the exact opposite of what a person with good business judgment decides in three seconds.

I feel that way in dealing with the bulk of the servicers and mortgage holders.

A. FNMA / FHLMC

First, because of their size and reach, FNMA and FHLMC set the tone. They generally bar principal forgiveness. (FHLMC has recently started some small experiments with this in a limited number of states.) Besides the strategic default issue referenced earlier, they also are driven by political concerns. Congress does not want to appropriate more money; more money would be immediately required if loan modifications included principal reductions.

Ironically, nothing could be worse for FNMA / FHLMC than if every defaulting borrower today stopped litigating and either handed them deeds in lieu of foreclosure or allowed uncontested foreclosures. FMNA and FHLMC would be TOAST. All they would have is the present (reduced) value of the property, marketing and maintenance expenses and a worthless claim against the borrower(s). That would mean immediate and worse losses.

B. The Servicer Issue.

There are a variety of reasons the servicers are limited as well. As indicated earlier, virtually all the mortgages with which I am dealing are securitized product. The mortgages are serviced by large corporate servicers on behalf of investors who hold the mortgages. In reality the investors frequently can be pretty nameless and faceless, having bought tranches of pools held by trustees.

None of these servicing agreements envisioned the widespread default crisis we now face. I am told the servicing agreements generally provide that if the servicer agrees to a write-down of principal, the servicer bears the loss. Thus the servicer is dis-incented to adjust principal. And when a principal write-down does make sense, there is the problem of who to call for permission: one pool can have multiple investors.

The servicers vary widely on approach and flexibility.

Most are fairly rigid. They refuse principal forgiveness, claiming investor limitations and fall back to a series of formulas. Moreover, they see FNMA and FHLMC setting the policy “tone” in this area. However, at least some who process standard mortgage modifications have had the candor to say, “We can get a modification to work [on paper], but we do not think it makes [economic] sense for your client,” because of the overhang.

Of greater interest is one servicer with a proprietary algorithm that enables it to automatically propose a restructuring of the loan (without even receiving financial packages from the borrower), generally coupled with significant debt forgiveness. When asked how they were able to do this, its counsel explained:

1. We think our investors are better off with a performing asset now – as opposed to engaging in endless litigation or a lengthy foreclosure and sale process; and

2. We contacted the investors, explained the situation and they uniformly said to us, "Do what you think makes sense."

Thus, at least one servicer actually made the effort to contact investors and has moved expeditiously and effectively to resolve cases.

I can defend the lack of flexibility on the part of the servicers. First, as indicated above, they are keying off the lead of FNMA / FHLMC. Second, since many have millions of mortgages and thousands of employees, the servicer needs to have clear, consistent, written policies and procedures. You cannot have thousands of employees making individual, random judgments. If nothing else, inconsistency can lead to claims of unfair lending practices. And the reality is, on the ground level, their best and highest employees are negotiating deals for $400MM credits, not undervalued homes.

Finally, none of the people who attended on behalf of servicers in response to the settlement conference schedule appear to be senior enough to vary the approach and/or successfully recommend and advocate for fundamental policy changes.

One further note. Perhaps even more frustrating is running up against servicers' short sale / OREO process. There are a number of cases where an offer to buy can be produced. More often than not the response is, "We will have to put it through our OREO process."[1] That would take another six to nine months at a minimum.

C. The consumer advocates.

Even consumer advocates are uncomfortable with debt forgiveness. First, to the extent they are part of any agency holding mortgages, many of their mortgages are underwater. So they are concerned about strategic default. They also

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[1]OREO stands for "other real estate owned." By referencing this process, the lawyer was indicating there was no way to expedite sale of the property, and it would have to go through the servicer's regular process.

encourage people to pay on their underwater mortgages. So they ask why give those who have defaulted a better deal? Finally, they – personally – are uncomfortable giving "deals" to people who default when most of them – personally – have home valuation issues and still pay their mortgages.

D. U.S. Treasury

As the court is aware, I tried to put a mortgage loan program together to facilitate lending to people who would not qualify for modifications or who had been foreclosed. It would be a true public / private partnership, with the private sector – in this case "innocent" local lenders on a voluntary basis – coming up with $10MM to $12MM in mortgage funds. In order to do so, they would need to be provided with a low LTV on the house mortgage. I received a generally positive response from the local financial community.

I looked to the public sector for help, specifically in the form of second mortgages. The state housing agency again worked with the U.S. Treasury to obtain funding. While there was a draft offer of $3.5MM, the business terms were so onerous (and this is after 3 months of negotiations), I am not certain whether it is productive to proceed. The final condition of the draft term sheet said it all: this program could not be more favorable to the borrower than any other program available. As I was told, the U.S. Treasury always says, "Approach us with creative ideas," but when that happens Treasury declines them.

IV. Cutting the Gordian Knot.

I remember a line of verse that began, "If I had world enough and time…

A. Endorse Principal Forgiveness.

There is now more of a debate at the national level about principal forgiveness. It has to happen. Where the borrowers are employed and want to retain their homes, the opening question we need to ask in order to achieve successful mortgage modifications is, "What is a realistic size for the mortgage?" Then the question is whether the borrowers can afford it.

Other terms and conditions of the modifications can be as described above.

B. Force changes to servicer policies through investor contact.

Most major servicers understand how to do commercial workouts. Their banking arms routinely take significant (and timely!) write-downs of "bad" loans. The same must be done here.

Conversations at the CEO level or just below must take place at every major servicer to put in place workouts that make business sense and do not simply kick the can down the road in a way that is harmful to our economy or to the borrowers – with no real benefit to the investors.

Once those policies are in place, the servicers must begin conversations with the investors. There is no question in my mind that the investors will say, "Do what makes the most sense." And that will be the principal forgiveness approach that restores assets to performing status (and dials back litigation) much more quickly.

As Special Master I have not summoned servicer CEO's to appear, or asked defendants to identify all the trustees for the mortgage holders and, in turn, their respective investors and, in turn, their respective CEO's.

I have tried to respect process, contract rights and the room for people to make business judgments different from mine and still be considered operating in "good faith."

And, as is evident, I have been reluctant to impose my business judgment on others.

But without a fundamentally different approach from the servicing community, we will continue to face a mortgage crisis, and the nation will lag economically.