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Consumer Finance



HURRICANE KATRINA – MORTGAGE INDUSTRY PERSPECTIVE

Effects on Mortgage Origination and Servicing

Most new estimates place the damage from Hurricane Katrina over \$100 billion, making it the most devastating natural disaster in U.S. history. Unlike the tragic events of September 11, 2001, where the majority of property damage was done to commercial buildings in a concentrated area, the effects of Katrina have impacted a heavy number of residential homes in addition to commercial real estate all along the Gulf Coast. Within a year of the 9/11 disaster, the Insurance Information Institute reported that a total of 33,000 individual claims were filed. In comparison, the current estimate is that over 360,000 homes valued at up to \$48 billion were damaged by Katrina, according to the Mortgage Bankers Association. Officials in Louisiana have estimated that 160,000 homes have been damaged in that state alone. It is a reasonable assumption that the majority of these properties will have insurance claims filed.

Such widespread and severe property loss has prompted many banks, mortgage servicers and investors to take action in the face of the expected surge in default rates and insurance claims. As noted in a Mortgage Bankers Association letter dated September 7, "Policies differ from company to company; however, most mortgage bankers are offering extended grace periods and are postponing any foreclosure action. This means that any borrower who lives within the zip codes published by FEMA as being federal disaster areas will not – during the grace period – be charged late fees, nor have late payments reported to credit agencies which can negatively impact their credit scores."

Freddie Mac Guidance

On September 8, 2005, Freddie Mac released an advisory letter to its 2,600 servicers requesting the servicers to refund the September payments already received prior to the storm to mortgagors located in areas affected by Katrina. Furthermore, Freddie Mac has suspended the collection of affected loans for 90 days, hoping that relieving the monthly payment burden from borrowers will allow them to focus on repairing the damage brought by Katrina. At the end of the 90 day forbearance period, servicers may elect to extend the period for as long as a year on a case-by-case basis. In addition to the payment refund and forbearance guidance, the advisory letter also instructs Freddie servicers:

- Not to report to credit bureaus any reversed and suspended payments on Freddie Mac-owned loans as a result of Hurricane Katrina during the suspension period;
- To suspend all late fees, collection and foreclosure activities in the storm-affected areas during the three-month suspension period; and
- That they have the option not to advance interest on any Freddie Mac mortgage granted forbearance under the company's special Hurricane Katrina policies.

As posted on Freddie Mac's website, Freddie Mac and the Freddie Mac Foundation are also contributing a total of \$10 million to organizations supporting relief efforts in the areas devastated by Hurricane Katrina, such as the American Red Cross.

Fannie Mae Guidance

Before Hurricane Katrina had hit, Fannie Mae released changes to their natural disaster relief procedures, primarily for disbursing insurance claims and proceeds. Announcement 05-06, dated August 24, 2005, outlined streamlined procedures that are based primarily on the status of the mortgage at the time of the disaster and the extent of the damage. New policies require servicers to temporarily discontinue reporting delinquencies to credit bureaus if they are aware that a borrower's delinquency is attributable to hardships as a result of natural disaster. Servicers may now use reports provided by property inspectors to document the property inspections. These requirements also pertain to mortgages in bankruptcy. Fannie's position is clearly outlined in the announcement:

We expect that servicers will make every effort to work with borrowers who are victims of natural disasters to prevent (or minimize) delinquencies and foreclosures for the mortgages they service on our behalf... Servicers are encouraged to consider waving any late payment charges if the borrower's payment is late because the borrower has incurred added expenses or loss of income due to the natural disaster, or if the borrower needs additional time to receive a pending insurance settlement.

In statements subsequently released on August 29 and August 31, Fannie Mae announced it has mortgage relief provisions in place for borrowers in Mississippi, Louisiana, Alabama, Florida and other states facing hardships as a result of widespread damage caused by Hurricane Katrina. Under Fannie's relief provisions servicers may:

- Suspend mortgage payments for up to three months
- Reduce payments for up to 18 months, or in more severe cases, creating longer loan payback plans

Fannie Mae has also announced that Fannie Mae and the Fannie Mae Foundation will contribute \$1 million to the disaster relief efforts with \$500,000 going directly to the American Red Cross and the remainder to medium- and long-term efforts supported by the housing industry and housing organizations.

HUD/Ginnie Mae Guidance

The office of Housing and Urban Development (HUD) has also released guidance for mortgage originators and servicers as a result of Katrina. In Mortgagee Letter 2005-33, dated August 31, 2005, Federal Housing Commissioner Brian Montgomery outlined some of the policies to be followed in the disaster areas. With respect to new loan originations, HUD has allowed for some changes to current policy:

- Section 203(k) Rehabilitation Mortgages do not apply to properties in disaster area.
- Underwriting – Victims of disaster will be allowed to have a total fixed payment to gross income ratio of 45 percent without compensating factors. The 45 percent ratio can also be exceeded with appropriate compensating factors. This provision applies to all FHA insured mortgages regardless of the insurance program.
- Submission of closed loans – For lenders located in affected areas, the Department is extending the time for submission of closed loans for insurance endorsement from 60 to 90 days after the date of closing. This is necessary due to the fact that most hazard insurance providers have lost binding authority for placement of new insurance policies on affected properties.

- Endorsement of delinquent mortgages – Homeownership centers have been granted authority on a case-by-case basis to endorse mortgages that are delinquent, provided the delinquency is due to disaster-related circumstances.

HUD has also announced changes to policy as it relates to the servicing of FHA insured mortgages:

- Moratorium on foreclosure – A moratorium on foreclosures on property directly affected by the disaster is in effect for a ninety (90) day period from the date the President declared a disaster to have existed. The moratorium applies to the initiation of foreclosures AND foreclosures already in progress.
- HUD also strongly encourages the following actions as assistance to homeowners whose properties were directly affected by the disaster. This includes :
 - Special forbearance
 - Mortgage modifications
 - Refinancing
 - Waiver of late fees
- Subsequent to foreclosure moratorium, lenders are encouraged to consider other alternatives to foreclosure such as pre-foreclosure sales and deeds in lieu of foreclosure if the homeowner is not in a position to “cure” the mortgage delinquency.
- For loans on properties affected by the disaster, the maximum pre-foreclosure sales period is extended an additional two months and the minimum appraised as-is value of the property is reduced to 58 percent, without requiring the lender to seek a variance approval from HUD’s National Servicing and Loss Mitigation Center in Oklahoma City.

In addition to the consumer directed guidance from HUD, servicers should refer to the Ginnie Mae All Participant Memorandum (APM) 05-15, which outlines assistance that may be available for servicers in the affected areas. The APM provides for issuer pass-through relief in some cases:

Ginnie Mae will assist issuers with pass-through payments if the issuer has more than five percent (5%) of its Ginnie Mae loan portfolio in the affected areas. However, Ginnie Mae should only be asked to provide assistance as a “last resort.” Those issuers who have large numbers of mortgagors unable to make loan payments because of the disaster, and who, as issuers, cannot obtain private market financing to cover the delinquencies may be eligible for Ginnie Mae assistance. Issuers must request assistance within one year from the date the President declares an area a disaster. Such disaster relief will be available for a period not to exceed 90 days.

Effects on Retail Banking in Louisiana and the Surrounding Area

The effects of Hurricane Katrina have not only affected the largest originators, servicers and investors – individual banks and thrifts will also feel the impact of the storm. Countrywide, the nation’s top mortgage servicer with a portfolio that now surpasses \$1 trillion, has estimated the effects of Katrina alone will surpass the company’s 2004 total hurricane losses of \$70 million. More directly impacted by the storm was Hibernia National Bank, headquartered in New Orleans. Hibernia has approximately a 38% market share in the New Orleans metro area, but on September 9, 2005 it was reported that 60 of its 321 bank branches were still closed, some with significant damage. Prior to Katrina, Hibernia’s central operations center was located in downtown New Orleans. Since the storm Hibernia has been forced to relocate its operations across centers in other areas of Louisiana and Texas and has reported that all systems are up and running. To compound the problem for this regional bank it is estimated that approximately 3,000 of Hibernia’s employees have been

displaced from their homes. Hibernia has established policies to provide relief for their customers, as reported on their website:

- Hibernia has made arrangements to automatically defer payments on consumer and small-business loans and lines of credit for Hibernia customers in Louisiana and Mississippi zip codes affected by the storm until January 2006. All automatic deduction payments from checking accounts related to these loans and lines will be suspended during the deferment period.
- Hibernia has made arrangements to automatically defer mortgage payments for Hibernia customers whose residential first mortgages are with Hibernia and have been impacted by Hurricane Katrina.
- The bank will suspend up to three months of first mortgage payments. There will be no credit reporting on these accounts during this period. The bank also will grant up to 18 months of temporary forbearance to repay suspended payments, also with no credit reporting.

Insurance Coverage Concerns

As the water begins to recede in areas of Louisiana and damage assessment begins to take place there will undoubtedly be a debate as to the true nature of the disaster, at least from a legal perspective as it relates to insurance policy coverage. Most hazard insurance policies are in place to cover property damage as a result of wind, rain and fire, but most do not include provisions for damage due to flooding. Separate flood insurance policies are required for agency purchased and government insured loans where the property lies within a FEMA designated flood zone. For non-agency and non-government insured loans it is generally the individual lender/servicer that is responsible for establishing a flood insurance requirement. Across the Gulf Coast, many homes may have been damaged by both hurricane force winds and subsequent flooding either from storm surge or the breakdown of the New Orleans' levee system. The actual failure of the levee system in and of itself will probably introduce another debate on the subject of natural disaster vs. manmade disaster, which could further complicate the insurance claims process. Taking all of this into consideration, the assessment of what constitutes flood damage vs. hurricane damage will be central to the insurance claims recovery process.

Servicers need to be prepared for the significant number of insurance claims that will need to be filed and the potential for debate as to coverage between property and flood insurers. The concerns around insurance coverage will also impact some banks, mortgage companies and brokers directly as their own property, plant and equipment have been damaged.

Financial Statement Assessment

Katrina's impact will also be evident in the financial reporting processes of many mortgage companies with loans and/or servicing rights in the affected areas. Many companies are struggling to assess the full breadth of potential effects Katrina may have had on their loans, leases, servicing assets, deposits and related accounts. Most believe a third quarter charge to earnings is likely. In general, lenders are attempting to first isolate the population of loans that could have potential loss using FEMA flood maps, satellite technology and zip code indicators of areas declared disaster areas. Secondly, they are attempting to bifurcate the affected loans into various buckets for default and loss severity evaluation. In doing so, we believe they should be considering multiple factors in the loss assessment including:

- What is the extent of insurance coverage on the property?
- Was flood insurance in place on properties that required it?
- Is the home uninhabitable, or can it be repaired (e.g., one view is that habitable/repairable homes may actually experience strong demand)?
- Even if the home is habitable, will the borrowers' loss of employment or income lead to bankruptcy or default?
- What impact might rebuilding restrictions have on underlying land values?

- Are there potential environmental impacts that may preclude the lender from taking title to the asset?
- Where loss forecast models are based on delinquency statistics, how will forbearance programs artificially influence model results in the short term?
- Will forbearance programs and/or other government assistance impact the loss emergence period for loans in the affected areas?

Given the uncertainty surrounding many of the above issues, many companies may be inclined to estimate a range of potential exposure. Clearly, it will take time to make a full and granular assessment of expected loss. Companies should keep in mind that FIN 14 requires management to adequately support its best estimate within the range, or else default to the lowest point in the range. This applies to SFAS 5 losses. For loans impaired under SFAS 114, management may estimate ranges for timing and amount of possible cash flows, and can evaluate the likelihood of the outcomes, but must select a best estimate.

In addition to the loan loss analysis, companies will need to evaluate the impact on related asset classes, many of which may in fact require a “life of loan” consideration in valuing the underlying cash flows. Assets that come to mind include mortgage servicing rights (impacted by higher delinquencies, defaults and involuntary prepayments); retained interest and first loss cash flows (impacted by losses and involuntary prepayments); service fee accruals; late fee accruals; and other such cash flows that are likely to be disrupted by forbearance and other related programs. Further complicating the estimation process will be consideration of a customer’s inability to make future payments as a result of unemployment or displacement.

As companies grapple with financial reporting and disclosure decisions and issues they should look to existing guidance; some of which was released following the events of September 11, 2001. Specific reference is made to the following authoritative guidance:

- FAS 5 – Accounting for Contingencies
- FAS 114 – Accounting by Creditors for Impairment of a Loan
- FIN 14 – Reasonable Estimation of the Amount of a Loss
- EITF 01-10 – Accounting for the Impact of the Terrorist Attacks of September 11th, 2001, which also includes references to other appropriate literature
- AICPA SOP 94-6 - Disclosure of Certain Significant Risks and Uncertainties
- AICPA Technical Practice Aid 5400.05 – Accounting and Disclosure Guidance for Losses from Natural Disasters – Nongovernmental entities

In addition to the above guidance, each company should also consult with its external auditors and regulators as needed. Further guidance is expected to be issued, so attention should be paid to updated and new announcements and guidance from various governing and advising authorities.

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This bulletin is only intended to point out highlights from the various announcements to date and should not serve as a substitute for reading the official guidance from the various agencies, investors and companies. The contents of this document are not intended to provide accounting advice and should not be taken as such. All readers are strongly encouraged to consult with their investors, regulatory agencies and auditors prior to making any change in policy.

If you have any questions related to the information contained in this letter, please contact any of the following members of PwC’s Consumer Finance Practice:

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