



A Loan Modification Case Study

The Wall Street Journal ran an article December 10, 2009, titled “America Dream 2: Default, Then Rent” which gave two case studies in strategic default. We’ll use one of these cases here to illustrate the potential benefits of our loan modification system.

Richey Family Facts

The Richey Family bought a house on Caspian Drive in Palmdale CA in 2004. They put nothing down. As of 2009 their mortgage was 430,000 with a monthly payment of 3,700. The mortgage was serviced by Wells Fargo’s America’s Servicing Co. In early 2009 the value of the house was down to \$200,000. The Richey’s requested a modification and Wells Fargo approved a modified payment of \$3,300. The family turned it down. Wells Fargo said it was the lowest payment they could offer. The family found a house larger than the house they owned and they rented it for \$2,195 per month. Ultimately they did a short sale at a gross sales price of 195,000 and Wells Fargo accepted the net proceeds to settle the loan.

Richey Family Analysis

After sales commissions and costs, Wells Fargo netted \$181,350 and it probably took at least 6 months from the initial default. Discounting back at 6%, the present value of recovery is roughly \$176,000. This is a much better result than if the borrower had let it go through foreclosure. In that case the recovery would probably have been at least \$20,000 lower. Let’s compare this to their “best offer” modification. Assuming the payment includes property taxes and insurance, the implied interest rate on the remaining balance of the loan (with net loan payments of \$3,017 over the remaining 25 years) is 6.92%. If we discount these payments back at 6% we get present value of \$468,259 - more than twice the property’s value. This is the lowest they would go to avoid foreclosure. It is clear from the alternative rent choice of the family and the statements in the story that the family is unlikely to accept an after-tax housing cost much more than \$2,195 to stay in their house. If we assume they qualified for the original mortgage with payments at 38% of income we can estimate their marginal tax rates. Taking into account property tax, insurance, and tax savings, the family could pay a fully amortizing 6% mortgage payment of \$2,697 and achieve the same after tax cost as renting; Wells asked for \$600 more. If the goal is maximizing recoveries, the bank made a poor decision for this particular loan.

Recovery Company Recommendation and Expected Results

Besides the current monthly after-tax cost of housing, home owners may also care about the magnitude of negative equity in the home. We take this into account to set modified terms to optimize loan value. Based on the circumstances of this case, and assuming a forecast of a further 10% drop in house prices in this neighborhood, our system calculates the optimal loan principal offer at \$284,000. All our modifications use a 6% loan rate and 30 year amortization – but this can change depending on conditions. Our modified terms require a loan payment of \$1,703 per month. Adding in property tax, insurance, and maintenance, the family’s pre-tax cost of housing is \$2,053. After tax savings, this nets out to approximately \$1,487 per month - more than \$700 cheaper than the rental. We estimate that there is more than a 90% probability that the family would pay this rather than default and rent. On a risk adjusted basis, we value this modified loan at \$277,800. Thus Wells Fargo could have boosted the present value of their recovery by more than \$100,000 if they had used our system to set modification terms. Based on industry wide statistics, this is not an unusual case.