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Mod Out of the Box: Mortgage Modifications for Main Street

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The current mortgage market meltdown has spawned a host of political and regulatory actions. With foreclosures still rising and home values falling to levels not seen in a generation, there is tremendous pressure for creative and effective solutions to help affected homeowners. For a number of political, policy and practical reasons, the government's tool of choice for dealing with at-risk borrowers is loan modification. While loan modifications have been used in varying degrees by institutions for more than a year, it was not until the failure of Indymac Bank ("Indymac") in July 2008 that the approach became firmly rooted as a viable programmatic, long-term strategy to deal with troubled borrowers. The reason for this, of course, is the Federal Deposit Insurance Corporation's ("FDIC") implementation of its "Mod in a Box" program in the aftermath of the Indymac failure. Since then, loan modifications have come to the forefront and are manifest in a number of different programs and proposals.

First, the FDIC continues to take an activist role in promoting modifications of troubled loans. Second, funds from the Trouble Asset Relief Program ("TARP") are being used to subsidize modifications for defaulting borrowers. Third, bankruptcy mortgage "cramdown" legislation is grabbing headlines on a daily basis as it makes its way through Congress. Finally, the Obama Administration has recently unveiled a new plan

to restructure mortgages to make them more affordable. Along the way, there have been numerous other hybrids that, for reasons having more to do with marketing than merits, have fallen by the wayside. These include the Office of Thrift Supervision's negative equity interest proposal, an approach put forth by New York University Economist Andrew Caplin based on Australia's experience with shared equity mortgages, and similar proposals to assist struggling borrowers while preserving lenders' ability to retain their interest in the future appreciation of homes financially underwater (i.e., up to the outstanding loan balance of a mortgage prior to its modification).

Following is a guide to the legislative, political, and regulatory activity in this area, along with a discussion on how financial services industry participants are being impacted by these sweeping changes to how we approach troubled mortgages.

FDIC Activism

In many respects, FDIC activism has set the stage for how legislators and policymakers now approach loan modifications. While some suggest that this point was inevitable, the FDIC's promotion of loan modifications based on its Indymac "Mod in a Box" program (the "Program") has served as a catalyst to encourage other programs that assist lenders

and servicers in implementing a streamlined and standardized loan modification process. In a number of recent high-profile cases, the FDIC Program was imposed on several institutions as a condition for receiving federal financial assistance.

In addition to its loan modification Program, the FDIC put forth a loss-sharing proposal to promote large-scale loan modifications. Under the proposal, the FDIC provided a loss-share guarantee on re-defaults of modified mortgages by leveraging available government funds in an effort to affect more mortgages than would be affected by outright purchases or specific incentives for every modification.

After the Program's release, FDIC Chairman Sheila Bair offered it to banks and servicers on a voluntary basis. Based on the FDIC's approach in its operation of Indymac, the Program provides a method for determining affordable mortgage payments for borrowers while protecting the interest of investors by ensuring that the cost of a modification is less than the cost of a foreclosure. Under the Program, once an affordable payment is determined for an eligible borrower, a loan modification is conducted through a series of steps involving interest reductions, term extensions, principal forbearances, or a combination of these actions. The process for lenders generally involves the following steps:

- **Determine eligibility for loan modification** – a loan is eligible if:
 - the loan is at least 60 days delinquent or a default is reasonably foreseeable;
 - a foreclosure sale is not imminent and the borrower is currently not in bankruptcy, or has not been discharged from Chapter 7 bankruptcy since the loan was originated; and
 - the loan was not originated for a second home or investment property.
- **Calculate affordable payment** – industry standards indicate a mortgage

payment is affordable based on a 31% to 38% housing-expenses-to-income ratio ("HTI"). The FDIC sets the maximum HTI at 38% and then requires a minimum reduction by 10% for any loan modification.

- **Modify loan terms** – the loan terms that can be adjusted to reach the maximum HTI plus 10% reduction are, in the order required by the FDIC program, interest rate reduction (to last for five years), amortization period extension (from 30 to 40 years), and partial principal forbearance.
- **Compare the cost of modification to the cost of foreclosure** – if a loan can be modified to achieve the required HTI plus 10% reduction, then the cost of the modification must be compared to the cost of foreclosure to determine which is less. Lenders are required to use a Net Present Value ("NPV") tool to make this determination. If the NPV of the loan modification versus foreclosure is positive, then the lender must approve the modification. If not, then the lender can proceed with foreclosure.

Features of the FDIC's "Mod in a Box" Program and loss-sharing proposal appear to be incorporated in the recently unveiled Making Home Affordable Plan (the "Plan"), put forth by the Obama Administration. For example, under the Plan, lenders are encouraged to work with the Treasury Department ("Treasury") to reduce monthly payments to 38% of the borrower's income through interest rate reductions, term extensions, and/or principal write-downs, after which the government has agreed to subsidize further reductions to bring the ratio down to 31%. The modified payment structure is to last five years under the Plan. Likewise, the FDIC mandates a similar set of actions, in the same order, to modify loan payments over a five-year period as part of its "Mod in a Box" Program. The Plan also creates a partial guarantee initiative that operates similarly to the FDIC loss-sharing proposal in that both are intended to discourage

lenders from opting to foreclose on potentially viable mortgages out of fear that home prices will decline further. This comes as no surprise given that the Administration has worked closely with the FDIC to develop a standardized process for loan modifications.

TARP Funding for Foreclosure Prevention

In an effort to amend TARP to increase accountability and transparency, on January 9, 2009, House Financial Services Committee Chairman Barney Frank (D-MA) introduced H.R. 384, the TARP Reform and Accountability Act of 2009. Among its provisions, H.R. 384 requires using a portion of the remaining TARP funds to address foreclosure mitigation and promote aggressive loan modifications and other restructurings. While the legislation passed the House, it is unlikely to face a Senate vote, primarily because it includes numerous provisions already agreed to by the Administration. In many respects, H.R. 384 fulfilled its purpose by serving as the blueprint for the Administration's recent actions. For example, \$50 billion of the Administration's recently announced \$75 billion foreclosure prevention plan is being financed by TARP funds. The remaining \$25 billion is likely to come from programs conducted by the two Government Sponsored Entities ("GSEs"), Fannie Mae and Freddie Mac.

Bankruptcy Mortgage "Cramdowns"

On March 5, 2009, by a vote of 234 to 191, the House passed H.R. 1106, the Helping Families Save Their Homes Act of 2009. The legislation, introduced by Rep. John Conyers (D-MI), makes a number of changes to the current law regarding bankruptcy. While the goal of the legislation is to prevent foreclosures and enhance credit availability, the legislation contains a controversial provision that alters the U.S. bankruptcy code by allowing bankruptcy judges to reduce the principal of a debtor's mortgage. This process, commonly referred to as a "cramdown," has been widely opposed by the financial services industry since it allows

borrowers to abdicate their contractual obligation to fully repay their loan.

Under the cramdown provision, Chapter 13 bankruptcy judges would have discretion to reduce the principal amount of a mortgage on a primary residence, except on certain government insured loans.¹ The provision also permits bankruptcy judges to reduce interest rates or lengthen the term of a mortgage (to 40 years) in an effort to reduce a borrower's monthly payment.

Opponents of the bill argue that cramdowns encourage debtors to file for bankruptcy, increase mortgage costs, and further jeopardize the value of mortgage-backed securities ("MBS"). By allowing bankruptcy to act as an avenue for reducing principal payments on a mortgage, opponents claim that the bill adds incentives for homeowners to enter Chapter 13 bankruptcy proceedings rather than seeking voluntary loan modifications through their lender or mortgage holder. Additionally, opponents worry that cramdowns make it more costly for other borrowers to purchase a home because lenders are likely to increase interest rates and down payments to offset losses resulting from bankruptcy loan modifications. These costs are expected to affect moderate-income and first-time home-buyers the most and may even price some families out of the housing market. While the cramdown provision only applies to mortgages originated prior to enactment of the bill, it could easily be amended at a later date to be made permanent – and applicable to all future loans. Some suggest that this is a change that many lenders would likely price into future mortgages.

Many Members of Congress are concerned that increased costs imposed on mortgage providers by cramdowns could further destabilize an already volatile housing market. The concern is that cramdowns will undermine the value of MBS by creating uncertainty as to whether the underlying mortgages will be fully repaid. If such uncertainty leads to downgrades, banks may be

forced to set aside additional capital reserves to cover potential losses, which may be an insurmountable challenge for some lenders in the current market.

To allow investors to share in the gains, H.R. 1106 requires any borrower that receives a cramdown to pay the mortgage holder a percentage of the sale price of the home if it is sold within four years of the cramdown and the borrower has not paid the entirety of the loan. H.R. 1106 also provides a safe harbor for lenders that enter into loan modifications. Currently, lenders that have sold MBS to investors are liable to such investors for losses suffered as a result of loan modifications. The safe harbor protects lenders from liability resulting from investor suits if lenders partake in loan modifications under certain conditions.² Lastly, the bill incorporates Sen. Dick Durbin's (D-IL) deal, cut in January of this year, requiring borrowers to try to contact their servicers for a workout before filing for bankruptcy.

While a Senate vote on the cramdown legislation is much anticipated, Senate Banking Committee Chairman Chris Dodd (D-CT), in a recent interview, warned that "it's hard to know" if the Senate has the 60 votes to pass the bill.

The Obama Administration's Making Homes Affordable Plan

On March 4, 2009, the Obama Administration issued detailed guidelines on its foreclosure prevention Plan to help "responsible homeowners" avoid losing their homes by providing affordable and sustainable mortgage loans. As highlighted previously, the Plan is a \$75 billion federal program designed to help up to 7 to 9 million families restructure or refinance their mortgages to avoid foreclosure.

The Plan, through its Home Affordable Modification ("HAM") program, provides extensive loan modifications for borrowers who have defaulted or are at imminent risk of default. The Plan also includes a refinancing component, the Home Affordable Refinance ("HAR") program, for

borrowers who are current on their mortgage payments but have been unable to refinance because their homes have decreased in value.

Using a combination of incentives and loan guarantees, the Plan forms an integral part of the President's comprehensive strategy to get the economy back on track. The key components of the Plan include refinancing opportunities for responsible homeowners suffering from falling home prices, loan modifications through a \$75 billion initiative, and increased funding to support low mortgage rates by Fannie Mae and Freddie Mac.

Refinancing

The HAR program is expected to provide refinancing opportunities for an estimated 4 to 5 million homeowners who received mortgages that are owned or guaranteed by Fannie Mae or Freddie Mac, and who are currently ineligible to refinance. Under the program, borrowers who are current on their mortgage but have been unable to refinance because their house has decreased in value will have the opportunity to refinance into a 15- or 30-year, fixed-rate loan. Through the HAR program, Fannie Mae and Freddie Mac, the two GSEs placed into federal receivership last year, will allow the refinancing of mortgage loans that they hold in their portfolios or that they guarantee in their own MBS.

Pursuant to this aspect of the Plan, borrowers are eligible to *refinance* their existing mortgage if:

- they are an owner-occupant of a one-to-four family unit property;
- their loan is owned by Fannie Mae or Freddie Mac;³
- they are current on their mortgage payments;⁴
- their first mortgage does not exceed 105% of the current market value of the underlying property; and
- they have a stable income sufficient to support the new payments.

Interested borrowers are encouraged to contact their mortgage servicer or lender to ask about the refinancing program. Lenders are expected to begin accepting refinancing applications soon.

Loan Modifications

The centerpiece of the President's Plan appears to be the \$75 billion HAM program aimed at helping up to 3 to 4 million homeowners who have defaulted or are imminently at risk of defaulting on their mortgage. The HAM program uses a variety of incentives to bring lenders, servicers, and borrowers together with the government to reduce foreclosures and help avoid further downward pressures on overall home prices. Loan modifications under the HAM program are limited to mortgages on primary residences that are below the Fannie/Freddie conforming limits. As noted previously, funds for the program are expected to come from a combination of sources – \$50 billion from the TARP, and up to \$25 billion from the GSEs.

Borrowers are eligible to *modify* their loan under the HAM program if they:

- are an owner-occupant of a one-to-four-unit property that is a primary residence;
- have an unpaid principal balance on their first mortgage that is equal to or less than \$729,750 (the current GSE conforming limit);
- have a loan that was originated before January 1, 2009;
- have a mortgage payment (including taxes, insurance, and homeowners' association dues) that is more than 31% of their gross (pre-tax) monthly income; and
- can no longer afford their mortgage payment.

Treasury, the Department of Housing and Urban Development, and other federal agencies are working with lenders and nonprofit housing counselors to put the systems in place to begin implementing their loan modification initiatives

as soon as possible. However, given the details of the guidelines, it is anticipated that lenders will need sufficient time to effectively implement the HAM program. Key elements of the program include:

- ***Shared efforts with lenders to reduce monthly payments*** – Treasury is to partner with lenders to reduce monthly payments to no more than 38% of a borrower's income. After that, the government is to match further reductions dollar-for-dollar to bring payments down to 31% of income. Lenders are to keep modified payments in place for five years.
- ***Incentives to servicers, investors, and borrowers*** – the Plan provides various incentives for servicers and lenders to perform modifications and borrowers to stay current on their loan. For instance, servicers receive "pay for success" fees for each month a borrower stays current on a modified loan, and borrowers who stay current on their mortgage receive a monthly balance reduction payment of up to \$1,000 per year. Additionally, both the servicer and investor receive a one-time bonus for modifying a mortgage while a borrower is still current on his or her payments.
- ***Partial guarantees*** – the Administration, in conjunction with the FDIC and Treasury, has created a \$10 billion partial guarantee program to discourage lenders from foreclosing on potentially viable mortgages due to fears that home prices will fall even more in the future.
- ***Clear and consistent guidelines for loan modifications*** – the Administration, again, working with the FDIC and Treasury, has provided detailed guidelines for loan modifications that are intended to serve as standard industry practice. All financial institutions receiving Financial Stability Plan (i.e., TARP) financial assistance are required to implement loan modifications consistent with the

Administration's guidance. Fannie Mae and Freddie Mac are also required to use these guidelines for loans they own or guarantee.

- **Judicial modifications during bankruptcy** – the Obama Administration is actively seeking to amend the bankruptcy code to permit bankruptcy judges to modify mortgages written in the past few years. This provision is similar, in many respects, to the cramdown provision in H.R. 1106 that is currently being debated in the Senate.

Servicer participation in the HAM program is voluntary. However, in light of the significant incentives the government is offering to servicers and investors, many expect major servicers to participate. Interested servicers will be required to sign a contract with Treasury's financial agent to participate in the HAM program, and participating servicers are required to review all potentially eligible borrowers who call or write to ask to be considered for the program unless expressly prohibited by contract. To determine if a loan modification is viable, servicers are required to perform a NPV test, parameters of which are spelled out in the guidelines, on each loan to determine the cash flows arising from a loan modification. If a servicer determines that a borrower is eligible and the cost of the modification (including incentives) is less than the cost of pursuing a foreclosure, the servicer must put the qualifying borrower on a trial loan modification for three months. If the borrower is current at the end of the trial period, the servicer must then execute a permanent modification agreement that will lower the modified rate to a fixed rate for five years.

Support for Fannie Mae and Freddie Mac

The President's Plan provides an extra \$200 billion in funding support to Fannie and Freddie to ensure the strength and security of the mortgage market and to help maintain mortgage affordability. Funding for the increased support was authorized by Congress in 2008 pursuant to the Housing and Economic Recovery

Act and is not taken from the TARP funds. The Plan also raises the cap on mortgages that the GSEs may hold in their portfolios by \$50 billion to \$900 billion. Treasury and the Federal Reserve Board are expected to continue purchasing Fannie Mae and Freddie Mac MBS to provide prolonged stability and liquidity in the marketplace. This is further underscored by the Federal Reserve's March 18, 2009 announcement that it intends to purchase an additional \$750 billion of GSE MBS, which will bring its total holdings of agency MBS to \$1.25 trillion.

Impact on the Industry

The President's Plan has been well received by the banking industry. The Securities Industry and Financial Markets Association's ("SIFMA") President and CEO, Tim Ryan, responded to the Plan by saying "we are encouraged by the creative and wide-reaching suite of programs . . . which are designed to restart our frozen banking system." American Bankers Association's ("ABA") Senior Executive Vice President and Chief Operating Officer Diane Casey-Landry called the Plan a "constructive, flexible, and multifaceted initiative likely to have a positive effect on preventing mortgage foreclosures." Additionally, representatives from financial institutions such as Wells Fargo, Bank of America, JP Morgan, and Citigroup all expressed their support for the Plan during Congressional hearings.

Notwithstanding this support, the banking industry may find itself overwhelmed by the "suite" of programs being implemented. Between evaluating loan portfolios to determining eligibility, fielding calls from interested borrowers, requesting appraisals, conducting additional underwriting analysis, and implementing the Administration's guidelines, lenders may find their hands tied for some time. Recognizing this, the Mortgage Bankers Association ("MBA"), in a recent letter to Treasury Secretary Timothy Geithner, expressly addressed concerns about industry capacity being strained by the volume of credit reports, income verification

correspondence, home appraisals, and other documentation that will be needed to screen borrower eligibility under the Plan.

In order to prepare for the deluge of new applications for loan refinancing and modifications that are expected to flow in during the coming months, servicers will need to build new systems to screen applications, verify borrower income and debt, determine the value of mortgaged property, and conduct underwriting analysis. Furthermore, servicers will need to tweak existing data systems to track performance of modified loans as well as

incentives expected to be paid to both servicers and borrowers by the government. For now, lenders may find it in their best interest to postpone foreclosure sales on all mortgages that may qualify for a modification in order to allow sufficient time to evaluate borrowers' eligibility. Notably, the threshold determination for lenders of whether to foreclose or modify will require a careful analysis of the costs and benefits – particularly in light of the risks posed by re-defaults and declining home values – of engaging in a traditional foreclosure or signing up for the President's new loan modification Plan.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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¹ Currently, only Federal Housing Administration, Department of Veterans Affairs, and Rural Housing Service guaranteed loans are exempt from cramdowns.

² The conditions are as follows: (1) default on the mortgage has occurred or is reasonably foreseeable, (2) the borrower occupies the home, and (3) the lender, reasonably and in good faith, believes that more money would be recovered through a loan modification or workout plan than foreclosure.

³ To help borrowers determine if their loan is owned or securitized by Fannie Mae or Freddie Mac, both entities have established toll-free numbers and web processes to make this data available.

⁴ Borrowers are deemed current if they have not been more than 30 days late on a mortgage payment over the last 12 months.