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Clients&FriendsMemo

Highlights of the Homeowner Affordability and Stability Plan

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Introduction

On February 18, 2009, President Obama announced the Homeowner Affordability and Stability Plan, which is designed to help 7 to 9 million families restructure or refinance their mortgages to avoid foreclosure. According to information released by the Treasury Department,[1] the Homeowner Affordability and Stability Plan consists of three initiatives:

- Refinancing current loans owned or securitized by Fannie Mae and Freddie Mac that do not currently qualify for refinancing because current loan-to-value ratios exceed 80% (the "**Refinancing Program**");
- A $75 billion "Homeowner Stability Initiative" to encourage lenders and servicers to make sustainable mortgage modifications (the "**Modification Program**"); and
- Strengthening confidence in Fannie Mae and Freddie Mac (the "**GSE Stabilization Program**").

Refinancing Program

The Refinancing Program provides access to low-cost refinancing for certain homeowners who are current in their mortgage payment, but are unable to refinance due to falling home prices. Complete eligibility details are expected to be announced on March 4, 2009. Included among the requirements that homeowners must satisfy to be eligible for refinancing under the Refinancing Program are:

- The existing mortgage loan is a first lien loan on a primary residence that is owned or securitized by Fannie Mae or Freddie Mac;
- The existing mortgage loan is current;

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1 See www.ustreas.gov/press/releases/tg33.htm; http://www.treasury.gov/initiatives/eesa/homeowner-affordability-plan/ConsumerQA.pdf.

- The new mortgage loan (including any refinancing costs), without regard to any second mortgage, will not exceed 105% of the current market value of the mortgaged property;
- If the homeowner has a second mortgage, the second mortgage lender agrees to remain in a second position; and
- The homeowner must have sufficient income to make the new payment and "acceptable mortgage payment history" based on the specific eligibility details to be announced.

Modification Program

The Modification Program consists of various initiatives to provide sustainable mortgage loan modifications to homeowners who are in default or at risk of imminent default.

Eligibility for Modifications

Detailed guidelines on eligibility for loan modifications is expected to be available on March 4, 2009. Eligibility requirements will include the following:

> Homeowners at Risk of Default. The homeowner (i) has a high combined mortgage debt to income ratio (greater than 31%), (ii) is "underwater" (has a combined mortgage balance that exceeds the current market value of the mortgaged property) or (iii) shows other indications of being at risk of default. It is unclear from the preliminary guidance whether an adverse event (such as job loss or interest rate reset) is also required for eligibility. If no such adverse event is required, a borrower whose income and mortgage payment has not changed would appear to be eligible for a modification if the mortgage debt-to-income ratio exceeds 31%, even if this had been the case at origination of the loan.[2]
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> Delinquency Not Required. The homeowner is not required to have missed a loan payment. The homeowner must be at risk of imminent default. To the extent a mortgage loan is included in a securitization, the servicer will need to be sensitive to requirements under the Real Estate Mortgage Investment Conduit ("REMIC") rules or grantor trust rules, as most residential mortgage securitizations elect REMIC or grantor trust status for tax purposes. Under the REMIC rules and grantor trust rules, a servicer cannot make a "significant" modification (e.g., reduce interest rate, extend term, forgive principal) unless the mortgage loan is in default or default is reasonably foreseeable. As such, a servicer may take a conservative position with respect to making "significant" modifications unless

[2] The example provided by the Treasury Department in its fact sheet in support of the Modification Program was for hypothetical Family C. In this case, the homeowner is underwater and one of the family members was moved from full-time to part-time work, causing a significant negative shock to income.

the loan is actually in default for fear of running afoul of the REMIC rules. To encourage servicers to modify loans when default is reasonably foreseeable, it would be helpful for the Treasury Department to issue guidance providing more certainty to servicers that a modification under the Modification Program would not cause adverse tax consequences under the REMIC or grantor trust rules. The Treasury Department provided similar guidance in connection with the streamlined modification procedures under the ASF Guidelines[3] and "foreclosure mitigation programs" meeting certain criteria.[4]

Owner Occupied. The home must be owner-occupied (including two-four family homes where the borrower occupies one unit).

Modification to Result in Higher Expected Recovery Than Foreclosure. The homeowner will not be eligible for modification if the total expected cost of a modification for a lender, taking into account the government payments, is expected to be higher than the direct costs of putting the homeowner through foreclosure.

Loan Balance Limitations. The mortgage loan balance may not exceed the current Fannie Mae and Freddie Mac loan limits.

Required Counseling for High Total Debt Levels. Homeowners with total debt (housing, car, credit cards and other) equal to 55% or more of their income are required to agree to enter a HUD-certified counseling program.

Sunset After Three Years. Eligibility for the Modification Program will sunset after three years.

With respect to homeowners not otherwise eligible for modifications under the Modification Program, the final guidelines to be issued by the Treasury Department are expected to set forth the incentives that lenders can receive for pursuing alternatives to foreclosure, like short sales or taking deeds in lieu of foreclosure.

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3 Rev. Proc.2007-72, 2007-52 I.R.B. 1257, amplified and superseded by Rev. Proc.2008-47, 2008-31 I.R.B. 272.

4 Rev. Proc.2008-28, 2008-23 I.R.B. 1054.

Incentives to Modify Loans

The Modification Program provides incentives to servicers, borrowers and mortgage holders to make sustainable modifications of mortgage loans that are in default or at risk of imminent default.

> Pay for Success Incentives to Servicers. Servicers will receive $1,000 up-front for each eligible modification, plus $1,000 per year, payable monthly, for up to 3 years, as long as the borrower stays current on the modified loan.
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> Pre-Default Incentive Payments. The Modification Program also encourages servicers and mortgage holders to modify mortgage loans at risk of imminent default. Servicers that modify at-risk loans prior to the occurrence of a default will receive $500 and mortgage holders that agree to such modifications will receive $1,500.
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> Incentives to Borrowers. Borrowers who enter into eligible modifications will receive $1,000 per year, payable monthly, for up to 5 years, as long as the borrower stays current on the modified loan. Payments to borrowers under this program will directly reduce the outstanding principal balance of the mortgage loan.

The incentive payments to servicers and mortgage holders raise potential tax issues for mortgage loans included in securitizations that elected REMIC status. The REMIC rules restrict the types of payments that a REMIC may receive and/or pay. Because the incentive payments to servicers and mortgage holders under the Modification Program are not contemplated by the REMIC rules, it would be helpful for the Treasury Department to clarify that such incentive payments would not cause adverse tax consequences under the REMIC rules.

Shared Effort to Reduce Loan Payments

The objective of the Modification Program is for mortgage loans to be modified to bring monthly payments to sustainable levels.

- Lenders will initially be required to reduce the mortgage interest rate until a borrower's monthly mortgage payment does not exceed 38% of such borrower's monthly income.
- Further reductions of the borrower's interest rate would be shared equally by the lender and the Treasury Department to bring the percentage down to 31%.
- The Treasury Department will not provide subsidies to reduce interest rates to levels below 2%.

- The modified interest rate must be kept in effect for 5 years, after which it can gradually be stepped up over time to the conforming loan interest rate at the time of the modification.
- Lenders can also reduce a borrower's monthly payment by reducing the outstanding principal balance of the mortgage, with the Treasury Department sharing the cost up to the amount the lender would have received for an interest rate reduction.

Similar to the potential tax issues with the incentive payments discussed above, the shared payment to be made by the Treasury Department under the Modification Program also raises uncertainty over whether a securitization receiving such payment would have adverse tax consequences under the REMIC rules. As such, it would be helpful for the Treasury Department to clarify that such shared payments made by the Treasury Department would not cause adverse tax consequences under the REMIC rules.

Home Price Decline Reserve Payments

In order to discourage lenders from opting to foreclose on mortgages that could be viable out of fear that home prices will fall even further later, the Treasury Department will create an insurance fund of up to $10 billion to provide insurance payments to holders of modified mortgages linked to declines in the home price index. The insurance payments will serve as reserves, providing a partial guarantee for mortgage holders to fall back on in the event that losses resulting from home price declines are higher than expected.

Other Features of the Modification Program

Judicial Modification of Mortgage Loans. The Obama Administration will seek changes to the personal bankruptcy laws that will allow judicial modifications of home mortgages in Chapter 13 proceedings for borrowers who have run out of other options. Similar legislation has been introduced in Congress at different times over the past year and a half.[5] Current bankruptcy law prohibits modification of mortgages secured by principal residences. Under the proposed legislation, when a borrower enters bankruptcy, the amount by which the borrower's mortgage loans exceed the current value of the mortgaged property will be treated as unsecured debt. The bankruptcy judges would also be given power to modify the terms of (i.e., "cram down") mortgages secured by principal residences to allow for the development of affordable plans for homeowners to continue making payments. To be eligible for judicial modification, homeowners must have requested a modification from their lender or servicer and certify that they have complied with all

[5] The House Judiciary Committee and the House Financial Services Committee on February 23, 2009 released details of a new bill, H.R. 1106, which will include provisions to allow bankruptcy judges to modify mortgages on primary residences. See http://docs.house.gov/rules/111_hr_housing.pdf.

reasonable requests to provide essential information. The Obama Administration would seek to limit judicial modifications only to existing mortgage loans with balances less than those under Fannie Mae and Freddie Mac conforming loan limits, which limitation is not included in any of the bankruptcy cram down bills currently pending in Congress. For a discussion of the impact that cram down legislation would have on private-label residential mortgage-backed securities, see *Bankruptcy Cramdown and its Impact on Private-Label RMBS*.[6]

Development of Uniform Loan Modification Guidelines. The Treasury Department, working with the FDIC and other bank agencies, will develop uniform guidance for loan modifications across the mortgage industry. The guidelines will include detailed protocols for loss mitigation as well as for identifying borrowers at risk of default. The guidelines are expected to be announced on March 4, 2009.

While the Q & A released by the Treasury Department regarding the Modification Program indicates that participation by lenders in the Modification Program is voluntary, the Treasury Department's fact sheet states that all financial institutions receiving financial assistance under the Financial Stability Plan going forward will be required to implement loan modification programs consistent with the Treasury Department's guidance. In addition, these guidelines will apply to loans owned or serviced by insured financial institutions supervised by the OCC, OTS, Federal Reserve, FDIC and the National Credit Union Administration. Read literally, these guidelines could apply to mortgage loans in securitizations, to the extent the servicer is supervised by one of the enumerated regulatory bodies. Any requirement to implement the modification guidelines in the securitization context could, in many instances, result in a conflict between the terms of the securitization contracts and the modification guidelines with respect to permissible or required mortgage loan modifications. The Treasury Department should resolve any potential conflict by providing that (i) the modification guidelines are not required in the securitization context, or alternatively, (ii) absent the enactment of legislation providing the servicer a safe harbor from litigation, the servicer is not required to modify loans in accordance with the guidelines if such modifications would result in a breach of the servicer's obligations under the securitization contracts. Legislation has been introduced in Congress at different times over the past year to provide servicers with a safe harbor from litigation in connection with modifying loans included in securitizations.[7]

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[6] *Total ASF 2009*, February 10, 2009, Lisa J. Pauquette, Frank Polverino and Jordan M. Schwartz. See http://www.cadwalader.com/assets/article/021009PauquettePolverinoSchwartzTotalASF.pdf.

[7] H.R. 1106, the new House bill discussed in footnote no. 5 above, will include provisions providing servicers a safe harbor from litigation in connection with modifying loans included in securitzations.

Hope for Homeowners Program. The Modification Program is intended to ease restrictions in the Hope for Homeowners program by (i) reducing fees paid by borrowers, (ii) increasing flexibility for lenders to modify troubled loans, (iii) permitting borrowers with higher debt loads to qualify and (iv) allowing payments to servicers of the existing loans.

Local Neighborhood Stabilization Programs. The Modification Program is intended to strengthen communities hardest hit by the financial and housing crises by awarding $2 billion in neighborhood stabilization grants for programs that reduce foreclosure and providing $1.5 billion for renter assistance, reducing homelessness and avoiding entry into shelters.

GSE Stabilization Program

The GSE Stabilization Program is intended to strengthen confidence in Fannie Mae and Freddie Mac in order to support low mortgage rates. Under the GSE Stabilization Program, the Treasury Department will increase its preferred stock purchase agreements with GSEs to $200 billion from an original amount of $100 billion. In addition, the Treasury Department will continue purchasing Fannie Mae and Freddie Mac residential mortgaged backed securities and will increase the size of its portfolio to $900 billion from $850 billion. The administration will also work with Fannie Mae and Freddie Mac to support state housing finance agencies servicing homebuyers.

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