

# Clients & Friends Memo

## Obama Administration Releases Details of the Homeowner Affordability and Stability Plan

March 10, 2009

### Introduction

On March 4, 2009, the Obama Administration released additional details on its Homeowner Affordability and Stability Plan, which was first announced on February 18, 2009.<sup>1</sup> The plan is designed to help seven to nine million families restructure or refinance their mortgages to avoid foreclosure. The 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 “Home Affordable Modification Program” 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 creditworthy homeowners who are current in their mortgage payments, but are unable to refinance due to falling

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<sup>1</sup> For information on the plan, see <http://www.financialstability.gov>. For a fact sheet describing the plan, see [http://www.treas.gov/press/releases/reports/housing\\_fact\\_sheet.pdf](http://www.treas.gov/press/releases/reports/housing_fact_sheet.pdf). For the Modification Program Guidelines, see [http://www.treas.gov/press/releases/reports/modification\\_program\\_guidelines.pdf](http://www.treas.gov/press/releases/reports/modification_program_guidelines.pdf). For Borrower Q&As, see [http://www.financialstability.gov/docs/borrower\\_qa.pdf](http://www.financialstability.gov/docs/borrower_qa.pdf). For Housing Counselor Q&As, see [http://www.financialstability.gov/docs/counselor\\_qa.pdf](http://www.financialstability.gov/docs/counselor_qa.pdf).

home prices. To be eligible for refinancing under the Refinancing Program, homeowners must satisfy the following requirements<sup>2</sup>:

- 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 (the homeowner has not been more than 30 days late on a mortgage payment in the last 12 months);
- 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 stable income sufficient to support the new mortgage payments.

Homeowners who satisfy the requirements of the Refinancing Program are eligible to refinance into 15- or 30-year mortgages with fixed interest rates based on market rates in effect at the time of refinancing, plus any associated points and fees quoted by the lender. Aside from refinancing costs, the borrower will not be able to increase the amount of the original loan in the refinancing (i.e., cash-out refinancing is not permitted). Refinanced loans will have no prepayment penalties or balloon notes.

### **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.

#### *Participation by Servicers*

Participation in the Modification Program by servicers is voluntary. However, participation will be mandatory for any servicer that accepts funding from the United States Department of the Treasury's (the "**Treasury Department**") Financial Stability Program after March 4, 2009. In addition, the Treasury Department expects that the OCC, OTS, Federal Reserve, FDIC and the National Credit Union Administration, where possible and appropriate, will encourage the institutions they supervise to participate in the Modification Program. Participating servicers must

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<sup>2</sup> A self-assessment tool is available to borrowers on the [financialstability.gov](http://www.financialstability.gov) website to determine if they are preliminarily eligible for the Refinancing Program or the Modification Program. See [http://www.financialstability.gov/makinghomeaffordable/refinance\\_eligibility.html](http://www.financialstability.gov/makinghomeaffordable/refinance_eligibility.html).

enter into a contract with the financial agent of the Treasury Department no later than December 31, 2009. As contracts are signed, a list of participating servicers will be available at <http://www.financialstability.gov>. No incentive payments will be made to the borrower, servicer or mortgage holder until the servicer has entered into a contract with the Treasury Department.

Participating servicers must consider all eligible loans under the Modification Program guidelines for modification. Participating servicers must modify all eligible loans that pass the NPV Test (discussed below) unless (i) there is reasonable evidence indicating the borrower submitted false or misleading information or otherwise engaged in fraud in connection with the modification or (ii) the servicing contract prohibits the modification.

It is unclear how the exception for servicing contract prohibition on modifications would interact with the servicer safe harbor legislation that was recently passed by the House of Representatives.<sup>3</sup> Under that proposed legislation, notwithstanding provisions in servicing contracts prohibiting loan modifications, servicers would be permitted to modify loans if certain criteria are satisfied, including that the loan is in default or default is reasonably foreseeable and the servicer determines that recovery of principal under the modification will exceed, on a net present value basis, recoveries of principal through foreclosure. In addition, servicers would be protected from lawsuits filed in connection with making a modification under such legislation. It is not clear whether a loan modification in contravention of the servicing contract in reliance on the servicer safe harbor proposed legislation, but otherwise in accordance with the guidelines of the Modification Program, would be entitled to the benefits of the Modification Program (e.g., the incentive and other payments to be made by Treasury Department). If servicer safe harbor legislation is enacted, clarification from the Treasury Department on this point would help to maximize the reach of the program.

In addition, participating servicers are required to use reasonable efforts to remove any prohibitions or to obtain waivers from all necessary parties to such relevant servicing agreements. In the event that the servicer safe harbor legislation or some form of it is enacted into law, it is unclear how useful it would be to require participating servicers to seek to remove prohibitions on loan modifications in contracts. Requiring servicers to remove such prohibitions in contracts would be, at best, superfluous, since the servicer safe harbor legislation would give servicers the ability to modify loans in contravention of express contractual provisions to the contrary, and, at worst, costly and time consuming, since effecting such changes would, in many cases, require the consent of investors and rating agencies.

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<sup>3</sup> See H.R. 1106, 111th Cong. (2009), § 201. The House of Representatives passed H.R. 1106 on March 5, 2009. The Senate is expected to undertake consideration of similar legislation some time in March 2009. See [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111\\_cong\\_bills&docid=f:h1106eh.txt.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h1106eh.txt.pdf).

*Eligibility for Modifications*

Eligibility requirements for the Modification Program include the following<sup>4</sup>:

- **Origination Date.** The mortgage loan must have been originated on or before January 1, 2009.
- **First Lien.** The mortgage loan must be a first lien mortgage.
- **Owner Occupied.** The property must be owner-occupied (including two-four family homes where the borrower occupies one unit) as the homeowner's primary residence (as verified by a tax return or credit report with other supporting documentation). The property may not be vacant or condemned.
- **Loan Balance Limitations.** The mortgage loan balance may not exceed \$729,750 for one unit properties, \$934,200 for two-unit properties, \$1,129,250 for three-unit properties or \$1,403,400 for four-unit properties.
- **Homeowners at Risk of Default.** The homeowner must have (i) a payment on the first mortgage (including taxes, insurance and homeowners association or condominium fees) that is more than 31% of the homeowner's gross monthly income and (ii) experienced a change in circumstances that causes financial hardship, or is facing a recent or imminent increase in the payment that is likely to create a financial hardship (i.e., payment shock).

Homeowners will be required to verify income, including by submitting a signed IRS Form 4506-T (Request for Transcript of Tax Return). Homeowners will also be required to sign an affidavit of financial hardship.

- **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 the loan is actually in default for fear of running afoul of the REMIC or grantor trust rules.

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<sup>4</sup> See footnote 2 above.

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<sup>5</sup> and “foreclosure mitigation programs” meeting certain criteria.<sup>6</sup>

- **NPV Test.** Each servicer participating in the Modification Program will be required to perform a net present value test (“**NPV Test**”) on each loan that it determines is in imminent default or is at least 60 days delinquent. The NPV Test will compare the net present value (“**NPV**”) of cash flows expected from a modification (consideration of principal forgiveness is not required for this purpose) with the NPV of the cash flows expected from foreclosing on the mortgage loan.<sup>7</sup> If the NPV of the modification scenario is greater, the NPV Test is positive, and the servicer will be required to offer the homeowner a modification under the Modification Program. If the NPV Test is negative, the servicer may, at the servicer’s option, offer the homeowner a modification under the Modification Program unless prohibited by the relevant servicing agreement. If the NPV Test is negative and a modification is not pursued under the Modification Program, the servicer is required to seek other foreclosure prevention alternatives, including alternative modification programs, deed-in-lieu of foreclosure and short sale programs.
- **Sunset After 2012.** Eligible borrowers will be accepted until December 31, 2012.
- **No Prior Modification Under the Program.** Loans can only be modified once under the Modification Program.

#### *Process to Determine Modifications*

**Standard Waterfall.** Servicers modifying loans under the Modification Program are required to follow the standard waterfall described below to reduce the monthly payment so that the borrower’s mortgage debt-to-income ratio (“**DTI**”) is reduced to 31%:

- **Step1: Capitalize Arrearages.** The servicer will first add any accrued interest, past due taxes and insurance, delinquency charges paid to third parties and escrow advances by the servicer (but not late fees or other default fees charged by the servicer) to the principal balance of the loan.

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<sup>5</sup> Rev. Proc.2007-72, 2007-52 I.R.B. 1257, amplified and superseded by Rev. Proc.2008-47, 2008-31 I.R.B. 272.

<sup>6</sup> Rev. Proc.2008-28, 2008-23 I.R.B. 1054.

<sup>7</sup> For parameters of the NPV Test, see Home Affordable Modification Program Guidelines, at 16 (March 4, 2009), available at [http://www.treas.gov/press/releases/reports/modification\\_program\\_guidelines.pdf](http://www.treas.gov/press/releases/reports/modification_program_guidelines.pdf).

- **Step 2: Interest Rate Reduction.** The servicer will then reduce the interest rate down to a floor of 2%, in increments of 0.125%, until the borrower's DTI is as close as possible to, without going below, 31%.
- **Step 3: Extension of Term.** If the borrower's DTI exceeds 31% at the interest rate floor of 2%, the servicer will then extend the term of the loan (or, if extension of the term is not permitted under the servicing contract, extend amortization) up to a maximum of 40 years (minus the amount of time the loan has been outstanding).
- **Step 4: Principal Forbearance.** If the borrower's DTI still exceeds 31%, the servicer will forbear principal as necessary until the borrower's mortgage payment equals 31% DTI. If the lender forbears principal, a balloon payment in the amount of the deferred principal will be due on the maturity date, upon sale of the property or upon payoff of the interest bearing balance, but the balloon payment will not accrue interest.
- **Principal Reduction Option.** In addition, servicers may, at their option, forgive principal until the borrower's DTI equals 31%. If the modification does not pass the NPV Test and the servicer chooses to modify the loan, the modified loan balance must be no lower than the current property value.
- **Modified Interest Rate.** If the interest rate is reduced below the Freddie Mac Primary Mortgage Market Survey Rate on the date the modification was executed, the modified rate will be fixed for a maximum of 5 years. Beginning in the 6th year, the rate will increase by 1% per year until it reaches the lesser of (i) the fully indexed and fully amortizing original contract rate or (ii) the Freddie Mac Primary Mortgage Market Survey Rate, as of the date the modification was executed. If the modified rate exceeds the Freddie Mac Primary Mortgage Market Survey Rate as of the date the modification was executed, the modified rate will be the new note rate for the remaining loan term.

#### *Conditions to Approve Modifications*

- **Trial Modification Period.** The borrower will be placed on a trial modification period for three months. If the borrower is current at the end of the three month period, the servicer will execute a modification agreement on the revised terms. No incentive fees will be payable to the investor, servicer or mortgage holder until a modification agreement is executed at the end of the trial period. Foreclosure proceedings against homeowners will be suspended during the trial period.
- **No Modification Fees Payable by Borrower.** No modification fees or charges will be borne by the borrower with respect to a modification. Any such modification fees will be reimbursable to the servicer by the investor to the extent and in accordance with applicable contract provisions.

- **Required Counseling for High Total Debt Levels.** Homeowners with total debt (housing, auto, credit cards and other) equal to 55% or more of their income are required to certify that they agree to enter a HUD-certified counseling program. National Foreclosure Mitigation Counseling Program funds and HUD Housing Counseling Grant funds can be used to pay counseling agencies for such counseling.
- **Escrows.** The modification agreement will include escrows for taxes and insurance even if the prior loan did not provide for escrows.
- **Redefaulting Loans.** A loan modified under the Modification Program will be considered to have redefaulted when the borrower reaches a 90-day delinquency status (using the Mortgage Bankers Association delinquency calculation). With respect to redefaulted loans, no further incentive payments will be made to the borrower, servicer or mortgage holder.

#### *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 up to \$1,000 up-front for each eligible modification, plus up to \$1,000 per year for up to 3 years, beginning 12 months after the effective date of the trial period, as long as the borrower stays current on the modified loan, subject to the *de minimis* constraint discussed below.
- **Pay for Success Incentives to Borrowers.** Borrowers who enter into eligible modifications will receive up to \$1,000 per year for up to 5 years, beginning 12 months after the effective date of the trial period, as long as the borrower stays current on the modified loan, subject to the *de minimis* constraint discussed below. The equivalent of three months of incentive payments will be made to borrowers upon successful completion of the trial period. Pay for success incentives paid to borrowers will directly reduce the outstanding principal balance of the mortgage loan.
- **Pre-Default Incentive Payments to Servicers and Mortgage Holders.** The Modification Program 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, subject to the *de minimis* constraint discussed below, mortgage holders that agree to such modifications will receive \$1,500. The guidelines indicate that, with respect to modifying mortgage loans that are current, the servicer must comply with any express pooling and servicing contractual restrictions applicable to modifications of current loans. Without further clarification from the Treasury Department that the pre-default incentive payments are permitted where servicers modify current loans in

accordance with the Modification Program guidelines and the servicer relies on the servicer safe harbor proposed legislation (because the servicing contract prohibits modifications), the intended effect of the incentive payments may not be realized to its full potential.

- **Second Lien Termination Incentive Payments to Servicers and Mortgage Holders.** According to the simultaneously released Housing Counselor Q&As<sup>8</sup>, servicers are eligible to receive an additional \$500 incentive payment for efforts to extinguish second liens on loans modified under the Modification Program. An additional incentive payment of up to \$1,000 is available to pay the holder of the second lien loan in an attempt to extinguish the second lien.
- **Shared Efforts to Reduce Loan Payments between Mortgage Holders and the Treasury Department.** Reductions of the borrower's monthly payment due to interest rate reduction or principal forgiveness to bring the borrower's DTI from 38% down to 31% will be shared equally by the mortgage holder and the Treasury Department, in each case, for up to five years. The Treasury Department is required to pay the mortgage holder its portion of the shared monthly payment reduction, but it will not make payments to the mortgage holder to reduce interest rates to levels below 2%. Mortgage holders and investors will only be compensated if the borrower's DTI under the modified loan is less than or equal to 31%. It would be helpful for securitized transactions if the Treasury Department would clarify when, during the course of each month, these payments to mortgage holders and investors would be made.
- **Home Price Decline Payments to Mortgage Holders.** In order to discourage mortgage holders 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 make payments totaling up to \$10 billion in the aggregate to holders of modified mortgages under the Modification Program. Payments will be linked to declines in the home price index and will partially offset losses by mortgage holders in the event that losses resulting from home price declines are higher than expected. Based on the limited information provided to date, it is unclear how this program will be administered. More information on this program is required to be issued in order to understand how payments to mortgage holders will be calculated and when payments will be made.
- **De Minimis Constraint.** To qualify for pay for success payments to servicers and pay for performance success payments to borrowers, a modification must reduce the borrower's monthly payment by a minimum of 6%. Annualized pay for success payments to servicers and pay for performance success payments to borrowers will equal the lesser of (i) \$1,000

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<sup>8</sup> See Housing Counselor Q&As, para. 22, available at [http://www.financialstability.gov/docs/counselor\\_qa.pdf](http://www.financialstability.gov/docs/counselor_qa.pdf).



or (ii) half the reduction in the borrower's annualized monthly payment. The *de minimis* constraint does not apply to up-front servicer incentives, payment reduction cost-sharing or home price decline payments.

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.

Similar to the potential tax issues with 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.

#### *Other Features of the Modification Program*

- **Alternatives When Modifications Don't Work.** If a modification is not required under the Modification Program and not otherwise pursued, the servicer is required to seek other foreclosure prevention alternatives, including alternative modification programs, deed-in-lieu of foreclosure and short sale programs. In addition, borrowers who are ineligible for the Refinancing Program or the Modification Program may receive a payment of \$1,500 for relocation expenses in order to effectuate short sales or deeds-in-lieu of foreclosure. Foreclosure proceedings against homeowners will be suspended while homeowners are considered for alternative prevention options.
- **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 was passed by the House of Representatives on March 5, 2009.<sup>9</sup> Under the legislation, bankruptcy judges would be given power to modify the terms (including interest rate, principal balance and term) of (i.e., "cram down") of mortgages secured by principal residences to allow for the development of affordable plans for homeowners to continue making payments. For a discussion of the impact that cram down legislation could have on

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<sup>9</sup> See H.R. 1106, which includes provisions to allow bankruptcy judges to modify mortgages on primary residences, available at [http://docs.house.gov/rules/111\\_hr\\_housing.pdf](http://docs.house.gov/rules/111_hr_housing.pdf).

private-label residential mortgage-backed securities, see *Bankruptcy Cramdown and its Impact on Private-Label RMBS*.<sup>10</sup>

- **Mortgage Insurer Participation.** The Treasury Department has indicated that the major mortgage insurance firms have agreed to develop a mechanism by which they will make partial claims on modified loans where appropriate in order to help prevent avoidable foreclosures. More information is needed to understand the mechanics of how and when partial claims will be made and how the amounts of those claims will be determined.
- **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 foreclosures 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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<sup>10</sup> *Total ASF 2009*, February 10, 2009, Lisa J. Pauquette, Frank Polverino and Jordan M. Schwartz. See <http://www.cadwalader.com/assets/article/021009PauquettePolverinoSchwartzTotalASF.pdf>.

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