

Clients & Friends Memo

Making Home Affordable Expanded to Second Lien Mortgages and to Incorporate Hope for Homeowners

May 1, 2009

Introduction

Earlier this week, the Obama Administration announced the expansion of the Making Home Affordable modification program (“**Making Home Affordable**”) (i) by introducing a new program (the “**Second Lien Program**”) that will expand Making Home Affordable to second lien mortgages of homeowners that qualify for a first lien modification under Making Home Affordable and (ii) to require servicers to seek refinancing under Hope for Homeowners in tandem with a Making Home Affordable trial modification.¹ The Second Lien Program will require modifications on second liens if the first lien is modified through Making Home Affordable and the second lien servicer is participating in the Second Lien Program. In addition, at the time the first lien is in the “trial period” for the Making Home Affordable modification, servicers will be required to evaluate the loans for refinancing under Hope for Homeowners, and, if the borrower is eligible, offer the refinancing at the same time as the first lien trial modification offer.

Expansion of Making Home Affordable to Second Lien Loans

Making Home Affordable provides incentives for servicers, lenders and borrowers to modify mortgage loans for borrowers in default or at risk of imminent default. For a detailed description of Making Home Affordable, see our Clients & Friends Memo, dated March 10, 2009, titled “*Obama Administration Releases Details of the Homeowner Affordability and Stability Plan*”.²

¹ For a fact sheet describing the extension of Making Home Affordable to second lien loans, see <http://www.financialstability.gov/docs/042809SecondLienFactSheet.pdf>.

² See http://www.cadwalader.com/assets/client_friend/031009HomeownerAffordabilityStabilityPlan.pdf For information on Making Home Affordable, see <http://www.financialstability.gov/roadtostability/homeowner.html>. For an updated detailed program description describing the Making Home Affordable, see 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. For Borrower FAQs, see http://www.financialstability.gov/docs/borrower_qa.pdf. For Housing Counselor Q&As, see http://www.financialstability.gov/docs/counselor_qa.pdf.

Prior to the expansion of Making Home Affordable to second liens, first lien lenders would bear all the economic impact of rate reductions, principal forbearances and modifications, with no corresponding rate reductions, principal forbearances or modifications required for the related second lien lenders, which are in a subordinate lien priority position. Additionally, the existence of a second lien can increase the aggregate monthly payments beyond affordable levels for borrowers, increasing re-default risk, even if the borrower's first lien mortgage payment has been modified to be affordable. The intent of the Second Lien Program is to ensure that both first and second lien holders are treated fairly and consistently with the priority of their liens and to decrease the likelihood that the borrower will default under the modified first lien mortgage loan.

Second Lien Modifications

The Second Lien Program will facilitate automatic modification of a second lien where the second lien servicer is participating in the Second Lien Program when a first lien is modified under Making Home Affordable. However, the Second Lien Program is a voluntary parallel program to the first lien modification program under Making Home Affordable. Therefore, if the second lien servicer does not elect to participate in the Second Lien Program, automatic modification of the second lien loan will not be required.

The release issued by the U.S. Treasury Department ("**Treasury**") does not address the circumstances where the modifications required under the Second Lien Program are prohibited under the terms of the related servicing contract. Under the Making Home Affordable first lien program, participating servicers may not make modifications called for under the program if such modifications would be prohibited under the servicing contracts. If a similar restriction is not built into the Second Lien Program, participating second lien servicers would face the prospect of having to breach their servicing contracts in order to comply with the requirements of the Second Lien Program.

In addition, the release does not provide any detailed procedures for notification and information to be exchanged between unrelated first and second lien servicers to enable the servicers to coordinate in effecting the first and second lien modifications. Treasury should provide additional guidance as to who is responsible for notifying the second lien servicer and providing the information to the second lien servicer regarding the first lien modification necessary to effect the second lien modification (e.g., first lien servicer or borrower) and the timing with respect to such obligations.

In connection with Making Home Affordable modifications on first lien mortgages, servicers participating in the Second Lien Program are required to modify related second lien mortgages in accordance with the following procedures:

For amortizing loans:

- first, reduce the interest rate to 1 percent;
- second, extend the term to match the term of the modified first mortgage by amortizing the unpaid principal balance over a term that matches the term of the modified first mortgage;
- third, forbear principal in the same proportion as on the first lien mortgage, with the option of extinguishing principal under the Extinguishment Schedule (set forth below);
- after 5 years, the interest rate will step up to the then current interest rate on the modified first mortgage, subject to the interest rate cap on the first lien mortgage at the Freddie Mac Survey Rate; and
- the second lien will then re-amortize over the remaining term of the second lien loan at the higher interest rate.

As an incentive for modifications of amortizing second lien loans, Treasury will share the cost with second lien holders by making incentive payments to such holders equal to half the difference between (i) the interest rate on the first lien mortgage as modified and (ii) 1 percent, subject to a floor.

For interest-only loans:

- first, reduce the interest rate to 2 percent;
- second, forbear principal in the same proportion as on the first mortgage with the option of extinguishing the second lien based on the Extinguishment Schedule; and
- after 5 years, the interest rate will step up to the then current interest rate on the modified first mortgage, subject to the interest rate cap on the first mortgage at the Freddie Mac Survey Rate.

The second lien interest-only loans will amortize over the longer of the remaining term of the modified first lien mortgage or the originally scheduled amortization term, with amortization to begin at the time specified in the original contract. While the fact sheet released by Treasury indicates that a modified second lien interest-only loan will begin amortization at the time specified in the original contract, based on the case study³ provided by Treasury and the language in the release, it is unclear when amortization will begin for loans that would have begun to pay principal during the 5-year period during which the interest rate is reduced to 2%. Specifically, if amortization would have commenced prior to the expiration of the 5-year period, should amortization still begin then?

³ See *Helping Homeowners with the Second Lien Program: Two Cases*, April 28, 2009, <http://www.financialstability.gov/docs/042809HousingExamples.pdf>.

This would perhaps require the second lien loan to be re-amortized at the end of the 5-year period when the interest rate increases. Additionally, although the language in the release indicates that amortization would begin at the time provided in the original contract, based on the case study provided by Treasury, it is unclear if amortization will commence at the end of the 5-year period or, at the original contract point, if the original contract did not provide for amortization to commence until a date after the 5-year period.

As an incentive for modifications of interest-only second lien loans, second lien holders will receive an incentive payment from Treasury equal to half of the difference between (i) the lower of the contract rate on the second lien and the interest rate on the first lien as modified and (ii) 2 percent, subject to a floor.

Payment to Compensate Lenders for Extinguishing Second Mortgages

Instead of modifying a second lien, second lien lenders/investors may elect to extinguish the second lien and receive a payment from Treasury. Treasury should clarify that this is a one-time up-front payment that will not be subject to any requirement that the first lien remain current over a specified time period. This option will allow second lien holders to target principal extinguishment where most appropriate. For second lien loans more than 180 days past due at the time of modification, Treasury will pay second lien holders 3% of the unpaid principal balance extinguished. For loans less than 180 days past due, Treasury will pay second lien holders the amount set forth in the following chart (the “**Extinguishment Schedule**”) for each dollar of unpaid principal balance extinguished:

	Second-Lien Loan-to-Value Range		
Back-End Debt-to-Income Ratio	< 110%	110% to 140%	> 140%
> 55%	9%	6%	4%
< 55%	12%	9%	6%

The release provides no details on what dates the back-end debt-to-income ratios and second-lien loan-to-value ratios should be determined and what method should be employed to determine property values. Presumably, the back-end debt-to-income ratio will be the same as is determined under the first lien program. Treasury should release guidance on how and as of what date these values should be determined.

Pay-for-Success Incentives for Servicers and Borrowers

Similar to first lien modifications under Making Home Affordable, the Second Lien Program includes incentive payments for second lien servicers participating in the Second Lien Program and borrowers to better align their interests.

- Servicers will be paid \$500 up-front for a successful modification plus success payments of \$250 per year for three years, as long as the modified *first* lien mortgage stays current.
- Borrowers will be paid success payments of up to \$250 per year for up to five years, which will be used to pay down principal on the *first* lien mortgage.

However, it is unclear whether servicer incentive payments will be made to servicers who are not participating in the Second Lien Program, but choose to voluntarily modify the second lien loans they own in accordance with the Second Lien Program.

Incorporation of Hope for Homeowners into Making Home Affordable

Servicers participating in the Making Home Affordable program will be required to evaluate all borrowers eligible for modifications under Making Home Affordable for refinancing under Hope for Homeowners. If a borrower is eligible for refinancing under Hope for Homeowners, the servicer is required to offer to refinance the borrower under Hope for Homeowners.⁴ Additionally, servicers are required to evaluate for refinancing under Hope for Homeowners those borrowers that are in trial modification periods under Making Home Affordable and offer those borrowers refinancing if they qualify.

Under Hope for Homeowners, a borrower may not be refinanced into a loan insured by the Federal Housing Administration (“FHA”) unless subordinate lien holders release their liens on the related property. Accordingly, if a borrower has subordinate liens, the usefulness of integrating Hope for Homeowners into Making Home Affordable may be limited if the second lien holders do not voluntarily release their subordinate lien. If the second lien holders would be entitled to a payment under the Extinguishment Schedule by extinguishing the second lien under Making Home Affordable, but not as a result of extinguishing a second lien in connection with a refinancing, this would be an incentive for second lien holders (on whose behalf the second lien servicer acts) to opt not to extinguish the second lien under Hope for Homeowners. Treasury should clarify whether the Extinguishment Schedule payments apply to refinancing under Hope for Homeowners as well. It should also be noted that if the Extinguishment Schedule payments are not available to second lien holders who extinguished their second liens to facilitate a refinancing under Hope for Homeowners,

⁴ For a fact sheet describing the integration of Hope for Homeowners into Making Home Affordable, see <http://www.financialstability.gov/docs/042809SecondLienFactSheet.pdf>.

this could create a conflict of interest between servicers and holders of second lien loans. Such potential conflict could arise because all of the incentives in connection with a refinancing under Hope for Homeowners are payable to the servicer of the refinanced first lien loan (who, in many cases, will also be the servicer of the related second lien loan) and the lender who originates the Hope for Homeowners loan (who, in many cases, will also be the servicer or an affiliate of the servicer). Payments to second lien holders under the Extinguishment Schedule in connection with refinancings under Hope for Homeowners would eliminate this conflict and align the interests of servicers and second lien holders.

Recent news reports have indicated that, as of April 16, 2009, more than six months after the introduction of Hope for Homeowners, only one homeowner has made it all the way through the program and refinanced into a FHA-insured loan.⁵ To further improve the effectiveness of Hope for Homeowners, the Obama Administration has indicated that it intends to support legislation to, among other things, reduce fees required to be paid by borrowers to FHA and permit borrowers with higher debt loads to qualify. Presumably, this would make Hope for Homeowners a more viable and accessible option.

Pay-for-Success Incentives Similar to Other Making Home Affordable Modifications

Servicers and lenders participating in Making Home Affordable that help borrowers refinance under Hope for Homeowners will be eligible to receive the following pay-for-success incentives:

- Servicers can receive a \$2,500 up-front incentive payment for a successful Hope for Homeowners refinancing; and
- Lenders who originate new refinanced Hope for Homeowners loans are eligible for success fees of up to \$1,000 per year for up to three years, so long as the refinanced loan remains current.

IRS Guidance on Second Lien Program

Many second lien loans are included in securitization vehicles that elected to be treated as Real Estate Mortgage Investment Conduits (“REMICs”) for tax purposes. As such, presumably the IRS will provide guidance with respect to the Second Lien Program similar to its guidance issued last month in connection with the Making Home Affordable first lien program, which provided comfort

⁵ See Chris Arnold, *Investors Support Overhauling Homeowner Program*, NPR.ORG, April 16, 2009, <http://www.npr.org/templates/story/story.php?storyId=103148855>.

that modifications of mortgage loans and payment of certain incentives under such program would not result in adverse tax consequences to REMICs.⁶

* * *

Please feel free to contact any of the following if you have any questions about this memorandum.

New York Office

One World Financial Center, New York, NY 10281-0006

Michael S. Gambro	+1 212 504 6825	michael.gambro@cwt.com
Karen B. Gelernt	+1 212 504 6911	karen.gelernt@cwt.com
Anna H. Glick	+1 212 504 6309	anna.glick@cwt.com
Robert O. Link	+1 212 504 6172	robert.link@cwt.com
Lisa J. Pauquette	+1 212 504 6298	lisa.pauquette@cwt.com
Frank Polverino	+1 212 504 6820	frank.polverino@cwt.com
Patrick T. Quinn	+1 212 504 6067	pat.quinn@cwt.com
Y. Jeffrey Rotblat	+1 212 504 6401	jeffrey.rotblat@cwt.com
Jordan M. Schwartz	+1 212 504 6136	jordan.schwartz@cwt.com
Neil J. Weidner	+1 212 504 6065	neil.weidner@cwt.com

North Carolina Office

227 West Trade Street, Charlotte, NC 28202

Stuart N. Goldstein	+1 704 348 5258	stuart.goldstein@cwt.com
Henry A. LaBrun	+1 704 348 5149	henry.labrun@cwt.com
Robert L. Ughetta	+1 704 348 5141	robert.ughetta@cwt.com

Washington Office

1201 F Street N.W., Washington, DC 20004-1218

Charles E. Bryan	+1 202 862 2212	charlie.bryan@cwt.com
Gregg S. Jubin	+1 202 862 2485	gregg.jubin@cwt.com

London Office

265 Strand, London, England WC2R 1BH

Angus Duncan	+44 (0) 20 7170 8640	angus.duncan@cwt-uk.com
--------------	----------------------	-------------------------

⁶ See our Clients & Friends Memo, dated April 13, 2009, titled "IRS Guidance on the Home Affordable Modification Program" at http://www.cadwalader.com/assets/client_friend/041309_IRSGuidanceHomeAffordableModification.pdf.