LLB&L Client Alert

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TARP Update:

Emerging Regulatory and Legislative Trends Regarding Lending Requirements and Loan Modifications – Cramdowns, Writedowns and Lending Benchmarks

On January 12, 2009, President-elect Barack Obama called for President Bush to seek the release of the second half of the $700 billion financial bailout fund. President-elect Obama wants the funds to be available to him as he takes office as "ammunition" in the event of an economic emergency. Mr. Obama will seek changes in the distribution and administration of Troubled Asset Relief Program ("TARP") funds. The president-elect will ask the Department of the Treasury ("Treasury") to impose "strict and sensible conditions" on executive compensation and dividend payments until tax money is repaid, and direct more money to community banks.

Responding to Mr. Obama's statement that same day, the House Financial Services Committee Chairman Barney Frank stated it appears that he and President-elect Obama agree on the need for new rules to govern the release of the remaining $350 billion of funds under TARP. However, Congressman Frank reiterated the need to write those rules into law referring to his proposed legislation, H.R. 384, which would amend the Emergency Economic Stabilization Act of 2008 ("EESA") and the conditions Treasury places on TARP participants.

Treasury had previously come under fire for its failure to institute requirements or conditions for recipients of government assistance by leaders of the House and Senate and Treasury Special Investigator General Neil Barofsky. Further, a December 2008 Government Accountability Office report spotlighted Treasury's inability to monitor the use of TARP funds and the lack of appropriate measures to determine if the program is successful.

House Financial Services Committee Chairman Frank's bill seeks to (i) strengthen accountability of those entities which have or will receive TARP funds, (ii) close loopholes, (iii) increase transparency and (iv) require Treasury to take significant steps on foreclosure mitigation. The proposed bill would also open the door for smaller community financial institutions to TARP participation on the same terms as large institutions which previously received TARP funds.

Reporting, Monitoring and Accountability

Congressman Frank's plan would require Treasury, working with the appropriate federal regulator, to incorporate into any agreement with a bank receiving TARP assistance the manner in which TARP funds will be used and to establish benchmarks the bank is required to reach in respect of those funds. To monitor these benchmarks, TARP-assisted banks would be required to file quarterly reports on the use of TARP funds to be examined by Federal regulators to determine compliance. Each federal banking agency is required to prescribe regulations requiring TARP-assisted banks to establish and maintain procedures to assure compliance with these provisions.

TARP-Assisted Mergers and Acquisitions

Of special note, the bill provides that use of TARP funds is not permitted for a proposed merger or acquisition by a TARP-assisted bank of another bank unless the Treasury, in consultation with the appropriate federal regulatory agency, finds that a merger would reduce the risk to the taxpayers or the transaction could be consummated without TARP funds.

Executive Compensation

The plan calls for more stringent executive compensation plan restrictions for the period an institution receives TARP investment, including a prohibition on incentives which encourage excessive risks that threaten the value of the institution, "claw backs" of compensation based on earning statements found to be materially inaccurate and the banning of "golden parachute" payments.

Further, the executive compensation restrictions adopted for the auto industry bailout would apply consistently to all types of TARP-assisted institutions. Such restrictions include prohibitions on (i) bonuses and incentive compensation to the top 25 highest paid employees, (ii) compensation plans that encourage manipulation of earnings to enhance compensation and (iii) divestment of private aircraft or aircraft leases. *Notably, these executive compensation prohibitions would apply retroactively to existing recipients of TARP assistance.*

Lending Increases by TARP-Assisted Institutions

Under the proposed bill, a TARP-assisted bank is required to state, in its quarterly reports, the amount of any increase in lending *attributable to TARP assistance* or, if the bank can not quantify the effect to the TARP investment on its lending, the bank shall report the total amount of the increase in new lending during the reporting period.

Notably this concept is promulgated in an FDIC Financial Institution Letter issued January 12, 2009, whereby the FDIC advised state non-member institutions to implement a process to monitor how initiatives like Treasury's Capital Purchase Program and the FDIC's Temporary Liquidity Guarantee Program have helped support "prudent lending and/or supporting efforts to work with existing borrowers to avoid unnecessary foreclosures." State nonmember institutions were encouraged to summarize such information in their published annual reports and financial statements.

Availability of TARP Funds to Smaller Community Financial Institutions; Financial Stability Oversight Board

The proposed bill would also open the door for smaller community financial institutions to TARP participation on the same terms as large institutions which previously received TARP funds. Furthermore, the Financial Stability Oversight Board would grow by three members to include the Chairman of the FDIC and two independent presidential appointees. The Financial Stability Oversight Board is given veto authority over a policy determination by the Treasury Secretary with a 2/3 vote of all oversight board members.

Foreclosure Mitigation Measures

Of major importance, the proposed bill requires Treasury to take significant steps to mitigate foreclosures. Under Title II "Foreclosure Relief," Treasury is required, by March 15, 2009, to develop a comprehensive mitigation plan to prevent and mitigate foreclosures on residential properties. Use of the second $350 billion of TARP fund is conditioned upon Treasury, by April 1, 2009, committing a maximum of $100 billion, but in no event less than $40 billion, to foreclosure mitigation measures.

Required elements of the comprehensive mitigation plan are as follows: (i) the programs implemented under the plan apply to foreclosures on owner-occupied residential properties; (ii) any plan shall leverage private capital to the maximum extent possible consistent with maximizing prevention of foreclosures; and (iii) any action taken under the plan shall includes one or more of options set forth in Section 203. Under the bill, the comprehensive plan can include provisions tailored to address residential foreclosures in areas that are most seriously affected, as it stands today, Nevada, Ohio, Florida and California.

Under Section 203, the comprehensive plan can include one or more of the following programs: (i) a guarantee program for qualifying loan modifications under a systematic plan, which may be delegated to the FDIC or other contractor; (ii) a reduction in costs of Hope for Homeowner ("H4H") loans down (beyond mandatory changes in Title V of the bill), by coverage of fees, or by purchasing H4H loans to ensure affordable rates, or both; (iii) a loan pay-down option for second mortgages that are currently impeding loan modifications subject to any write-down of the loan amount that Treasury may require; (iv) Servicer incentives/assistance consisting of payments to servicers to encourage qualifying loan modifications; and (v) a loan purchase program for the purpose of modifying or refinancing the loans (with authorization to delegate to the FDIC).

The FDIC stands to gain significant power if this legislation were enacted which can be viewed as strong support for FDIC Chairman Bair's IndyMac loan modification program. Under the bill Treasury can delegate loan-modification planning to the FDIC, including offering loan guarantees and buying whole loans with the intent of modifying them.

Systematic Foreclosure Prevention and Mortgage Modification Plan

To encourage institutions to consummate loan modifications, Section 204 prescribes systematic foreclosure prevention and mortgage modification program, which provides lenders and loan servicers with certain compensation to cover administrative costs for each qualified loan modification and provides for loss sharing or a guarantee for certain losses if a modified loan subsequently defaults under a systematic plan.

Under the Section 204(a) systematic plan, only loans secured by owner-occupied loans are covered. Further, any loss sharing or guarantee program is available to a lender or loan servicer only after a borrower has made a specific minimum number of payments under the modified mortgage loan. Treasury is charged with

prescribing a standardized net present value analysis. Pursuant to the systematic loan review requirement, participating lenders and loan servicer will utilize this test to compare the expected net present value of modifying past due loans to the net present value of foreclosing on those loans.

Permitted modification to existing past-due loans include a reduction in the interest rate and fees, a term or amortization extension or forbearance or forgiveness of loan principal.

In furtherance of a systematic foreclosure prevention and mortgage modification program, Treasury In consultation with the Chairman of the FDIC and the Secretary of HUD and with the approval of the Board, Treasury may determine that modifications to an initial comprehensive plan are necessary to achieve the purposes of this act or that modifications to component programs of the plan are necessary to maximize prevention of foreclosure and minimize costs to the taxpayers.

Servicer Safe Harbor

Section 205 of the bill provides a safe harbor to liability to servicers who engage in loan modifications, regardless of any other provision of law or in a servicing agreement, so long as the servicer acts in a manner consistent with the duty established in Section 129A(a) of the Truth in Lending Act. A servicer is shielded from liability with respect to a qualifying loan modification to a borrower, a holder of a residential mortgage or an interest in a pool of residential mortgages or in securities that distribute payments out of such a mortgage pool, or any person that insures any loan or any interest in any loan.

Under the bill, notwithstanding any other provision of law or in a servicing agreement, a loan servicer has the ability to modify mortgages, the number of mortgages, the frequency of loan modifications or the range of permissible modifications. Further, a loan servicer is not required to repurchase any such loan or make payment to a securitization vehicle (i.e. an issuer of mortgage pass-through securities, participation certificates, mortgage-backed securities or otherwise) based on any loan modification to a qualified loan.

However, for a loan servicer to escape liability for modifying a mortgage, the modified mortgage must be a "qualified mortgage" having the following characteristics: (i) the mortgage must be in default or default is reasonably foreseeable; (ii) the mortgage is secured by property that is owner-occupied; and (iii) the anticipated recovery on the mortgage, as modified, would exceed, on an net present value basis, the anticipated recovery through foreclosure.

As a further protection, the bill requires that persons who bring suit unsuccessfully against loan servicers for engaging in loan modifications under the bill to pay the servicer's court costs and legal fees.

Furthermore, all loan servicers who modify loans under the safe harbor provisions of the bill are required to regularly report to the Treasury on the extent, scope and results of the loan servicer's modification activities.

The bill also requires that by July 1, 2009, the Congressional Oversight Panel submit a report to Congress on the actions taken by Treasury on foreclosure mitigation and the impact and effectiveness of the actions in minimizing foreclosures and minimizing costs to the taxpayers.

Other Notable Provisions

In connection with TARP matters, the proposed bill provides clarification and confirms Treasury's authority to provide assistance under the TARP umbrella to the domestic automobile manufacturers, including their related financing arms and in matters related to consumer loans, commercial real estate loans and MBS and municipal securities for new of existing auction rate securities.

Implications; Emerging Trends

As mentioned above, Congressman Frank's proposal would permit a loan servicer to modify a mortgage by reducing its principal, lower the interest rate or change the term of the mortgage. The mortgage lending industry term for this practice is known as a "cram down" and used in the context of a bankruptcy judge rewriting the loan terms in a Chapter 13 bankruptcy.

Recently, Senator Dick Durbin re-introduced his "Helping Families Save Their Homes in Bankruptcy Act" which would permit such a cram down in Chapter 13 bankruptcy cases. Opposition from congressional Republicans and mortgage lending industry groups has traditionally been strong; the opposition arguing that allowing such cram downs would add the cost of a mortgage for most consumers as lenders simply account for the added risk with higher rates and fees.

On January 8, 2009, Citigroup, Inc. issued a press release agreeing with a "cram down" plan allowing judges to modify the terms of a mortgage in bankruptcy, thereby breaking with the financial industry's strong opposing stance. Presumably, Citigroup's acquiescence on this point removes a substantial barrier to the passage of Durbin's legislation. It remains to be seen if Citigroup's agreement with key legislators on the "cram down" proposal will lead to other financial institutions to voluntarily write down more mortgages. Most all of the major banks, banking and housing trade groups remain opposed.

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A related issue with respect to a loan servicer consummality to a mortgage modification is triggered in the context of mortgage loans assigned to a securitized mortgage pool. As previously mentioned, the safe harbor provisions of Congressman Frank's bill would permit a servicer to modify the terms to a loan *provided that* the servicer acted in accordance with certain provisions of the truth in lending act and the loans to be modified met certain criteria

In August 2008, a number of State Attorney Generals thought they had found the solution in a suit for predatory lending practices against Countrywide Financial Corp. and related entities collectively,("Countrywide"), which ended in a quick settlement with Countrywide agreeing to modify over $8 billion in mortgages in some cases freezing the rate at the teaser rate.

Unfortunately for all parties, an investor, on behalf of all investors of a mortgage pool, brought a class action against Countrywide claiming that it was modifying loans that already had been transferred to pools in order to comply with the settlement. The plaintiff, Greenwich Financial Services Distressed Mortgage Fund 3, LLC and QED LLC (collectively, "Greenwich") alleges that any modification under the terms of the agreement between Countrywide, as originator seller, and the pool servicer/purchaser triggers the obligation of Countrywide to repurchase the mortgages loans at par.

The question remains as to whether any government modification program will succeed without the investors' approval. Under Frank's proposed bill, a loan servicer is not required to repurchase a mortgage loan or make payment to a securitization vehicle (i.e. an issuer of mortgage pass-through securities, participation certificates, mortgage-backed securities or otherwise) based on any loan modification. Seemingly, Congressman Frank's bill, should it became law, would shield loan servicers, such as Countrywide, from liability to investors, such as Greenwich, in future loan modification scenarios. Of course this raises a plethora of contract, property rights and constitutional issues which may complicate passage and/or implementation of this provision.

About the Authors

Douglas P. Faucette is a banking attorney in LLB&L's corporate department and co-head of the TARP Group. Mr. Faucette has more than 30 years of experience representing publicly and privately held companies in a variety of corporate and securities transactions.

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