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Mortgage Relief Plan

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Introduction

On February 18, 2009, in a speech that took place in Mesa, Arizona, a suburb of Phoenix hit hard by the foreclosure crisis, President Obama unveiled his Homeowner Affordability and Stability Plan (the "Plan"). President Obama's Plan provides aid for up to 9 million struggling homeowners affected by falling home values and unaffordable monthly payments by allowing borrowers to modify or refinance their existing mortgages. The multi-pronged Plan, which could ultimately cost up to $275 billion, would (i) provide $75 billion to encourage lenders to modify loan terms for borrowers at risk of foreclosure or already in foreclosure and (ii) set aside $200 billion to back government-controlled mortgage giants, Fannie Mae ("Fannie") and Freddie Mac ("Freddie"), two key players in the President's Plan.

In his speech, the President attempted to garner the support of all Americans, not just troubled borrowers, but also those who are current in paying their debts. President Obama stated that the downturn in the housing market had claimed many companies and jobs. This, in turn, negatively impacted state and local tax revenues, which resulted in less money available for spending on infrastructure, education and other public services for all. The President declared:

> "In the end, all of us are paying a price for this home mortgage crisis. And all of us will pay an even steeper price if we allow this crisis to deepen, a crisis which is unraveling homeownership, the middle class, and the American Dream itself. But if we act boldly and swiftly to arrest this downward spiral, every American will benefit."

Financial Stability Plan - Comprehensive Housing Program

Treasury Secretary Geithner, in his February 10, 2009 announcement of the Financial Stability Plan ("Financial Stability Plan"), which seeks to restructure the current Troubled Asset Relief Program (TARP), referenced a comprehensive housing program but provided few specifics. In that speech, Secretary Geithner described a housing program that would provide an initial $50 billion for measures designed to stop the spiraling foreclosure crisis. He noted that the program would seek to accomplish this by devising policies to both drive down mortgage interest rates and reduce mortgage payments on owner-occupied mortgage loans via loan modifications. The Treasury Department ("Treasury") was to implement additional guidelines to assist banks in those loan modification transactions. Of particular note, Secretary Geithner declared that any bank receiving Financial Stability Plan assistance would be required to participate in foreclosure mitigation plans consistent with those guidelines. At the time, Secretary Geithner's proposal lacked the needed details to begin implementation. Accordingly, the President's Plan outlines the previously-lacking details and builds on the foundation of Secretary Geithner's comprehensive housing program.

Homeowner Affordability and Stability Plan

The Plan consists of three key components, which are: (i) refinancing for up to 5 million "responsible" homeowners to make their mortgages more affordable, (ii) a $75 billion Homeowner Stability Initiative for up to 4 million "at-risk" homeowners and (iii) supporting low mortgage rates by strengthening confidence in Fannie and Freddie.

Affordability

The central issue which currently prevents the majority of homeowners from taking advantage of historically low mortgage interest rates by refinancing is the decline in housing values. Typically, mortgage lenders will not refinance loans where borrowers have less than 20 percent equity in their homes. However, under President Obama's plan, homeowners who owe more than 80 percent of their home's value would be permitted to refinance and thereby reduce their monthly payments.

The Plan is designed to aid "responsible homeowners," meaning only those homeowners who are current on their payments. Once refinanced, the new loan balance, including refinancing costs, cannot exceed 105 percent of the current market

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value of the property. Unfortunately, this may exclude many borrowers in the hardest hit markets - California, Florida, Nevada and Arizona - as many borrowers in those areas hold loans that exceed their property's current value by more than 5 percent, due to the tumble in the value of homes nationwide, but particularly in those hard hit areas. Further, only those loans which are held or guaranteed by Fannie and Freddie are eligible for refinance. The 105 percent value limit may also lead to instances where appraisals are produced based on less than reliable analysis or questionable underwriting in order to allow borrowers to qualify for the program.

Under the President's Plan, beginning on March 4th, borrowers whose mortgages carry higher rates or those in adjustable-rate or interest-only loans, can refinance into 15-year or 30-year fixed-rate mortgages at the current market rate (currently hovering around 5 percent). However, the Plan will not reduce the loan balance.

The executive summary released by the Obama Administration in support of the Plan gave the following example of how such a refinance would lower monthly payments for borrowers:

> Consider a family that took out a $207,000 mortgage at 6.5 percent on a home originally valued at $260,000, but with a current value of $221,000, well below current lender-imposed refinancing guidelines. Under the Plan, they can refinance to a rate of 5.16 percent, thereby reducing their annual payments by more than $2,300.

Homeowner Stability Initiative

Administered under a joint effort among Treasury, Fannie, Freddie, the Federal Deposit Insurance Corporation ("FDIC") and other federal agencies, the Homeowner Stability Initiative (the "Initiative"), a key component of the President Plan, would help up to 4 million people who are struggling to afford their mortgage payments to stay in their homes. As proposed, this $75 billion Initiative would attempt to reduce monthly payments for at-risk borrowers to no more than 31 percent of a borrower's pre-tax income by subsidizing interest rates. Although the Initiative does not specify that lenders would be required to verify income, it appears likely that such verification would be a prerequisite. However, only homeowners who commit to staying in their homes are eligible and no relief is provided to speculators.

To aid a borrower who is either current or delinquent on his or her loan, the lender would reduce the loan interest rate so that the monthly payment is no more than 38 percent of that borrower's pre-tax income. This interest rate reduction would be in effect for a five-year period after which it could gradually be stepped up to the conforming loan rate in place at the time of the modification. The government would then provide matching funds to the lender, on a dollar-for-dollar basis, to bring payments down to 31 percent of the homeowner's pre-tax income. Lenders and their servicers can also reduce the loan balance to achieve these affordability levels with Treasury sharing the costs. However, the Initiative is limited to modifications on those loans where the cost of the foreclosure could be higher than the cost of modification. As the cost of foreclosures can vary drastically from state to state, the question presented is what standard measurement will be used by a lender to determine whether the cost of modification would be higher than the cost of foreclosure. Also, Treasury will only provide subsidies to reduce loan rates to a floor of 2 percent.

Critics suggest that the foreclosure crisis is compounded by the fact that some homeowners are carrying too much debt on top of their mortgages, making it difficult to make their mortgage payments, even if reduced, and stay current on other debt, such as car loans and credit card debt. Under the Initiative, as a condition to a loan modification, those borrowers with total debt, including credit cards and auto loans, equal to 55 percent of their monthly pre-tax income must enter a debt counseling program.

However, a question remains as to whether modifying loans for troubled borrowers is just delaying the inevitable. In general, the track record of loan modifications market-wide is not particularly great. A study released in the fall of 2008 by analysts at Keefe, Bruyette & Woods, using data provided by a prominent loan servicer, showed that, in general, 25 percent of recent loan modifications went delinquent after just one post-modification payment and more than half had become delinquent after multiple payments.

While participation in the loan modification program is voluntary for servicers and investors holding such loans, the Initiative provides "Pay for Success" incentives to loan servicers who participate. Loan servicers will receive an initial $1,000 for each loan modification, and another $1,000 each year for the following three years, provided that the borrower stays current on the modified loan. The Initiative also provides pre-default incentives to servicers ($500) and to mortgage holders ($1,500) if they agree to modify at-risk loans before the borrower falls behind. In addition to providing incentives to servicers and lenders, the Initiative provides borrowers with incentives in the form of a reduction in their loan balances by up to $1,000 a year for five years if they keep current on their payments.

The Initiative provides an innovative partial guarantee program by creating a $10 billion insurance fund, administered by Treasury, which will pay mortgage holders additional funds based on declines in a home price index. The goal of instituting this fund is to entice servicers and lenders to modify mortgages in the wake of continuing home price declines rather than opt for foreclosure. At this point, the specifics of how this fund would work or what a lender would need to do to obtain any money from it have not been provided.

To implement the Initiative, Treasury will also develop uniform guidelines for loan modifications. Further, all financial institutions receiving Financial Stability Plan funds are required to participate in the loan modification program. Also, all federal agencies that own or guarantee loans, including, among others, Ginnie Mae, the Federal Housing Administration, Treasury, and the FDIC, will have to apply the guidelines where appropriate.

Of particularly note, the Initiative calls for a change in the bankruptcy laws which would permit judges to modify residential mortgages during a bankruptcy proceeding, including reducing the loan balance, known as a "cram-down." Under the Plan, before a judge could order a loan "cram-down," borrowers would be required to first submit loan modification requests to their lender/servicer and then provide a certification that they provided their lender/servicer with "reasonable requests" to provide essential information to modify their loan.

Opposition by the mortgage lending industry to such "cram-downs" has traditionally been strong. Lenders have long argued that allowing such "cram-downs" would add to the cost of a mortgage for most consumers as lenders simply factor in for the added risk of a "cram-down" in their rates and fees. Conversely, supporters of this change say a "cram-down" provision is required to aid homeowners who otherwise cannot get help from their servicers and would incentivize lenders to negotiate modifications prior to the commencement of a borrower's bankruptcy. Should Congress pass such a "cram-down" provision as proposed under the Plan, supporters predict the result would be fewer bankruptcies because servicers would be more diligent in helping homeowners outside of bankruptcy court.

Breaking from the mortgage lending industry's stance, on January 8, 2009, Citigroup, Inc. issued a press release agreeing with a "cram-down" plan proposed by Senator Dick Durbin (D, IL) in separate mortgage relief legislation. Although Durbin's proposed "cram-down" provision was not enacted, it appears the Initiative's "cram-down" provision, if approved by Congress, will give bankruptcy judges the flexibility they need to "cram-down" residential mortgages but only to existing mortgages under Fannie and Freddie conforming loan limits.

As stated in the executive summary of the President's Plan, other comprehensive measures proposed to reduce foreclosures and strengthen communities include:

- Requiring oversight reporting and quarterly meetings with Treasury, Housing and Urban Development, the FDIC, the Federal Reserve to monitor performance;
- Providing $1.5 billion to relocation and other assistance to renters displaced by foreclosures and $2 billion in neighborhood stabilization funds; and
- Improving the flexibility of "Hope for Homeowners" and other FHA programs to modify and refinance mortgaged made to at-risk borrowers.

Keeping Mortgage Rates Low

Finally, the Plan seeks to implement lower mortgage rates utilizing the two mortgage giants, Fannie and Freddie, which were taken over by the federal government in September. The Treasury would inject another $100 billion into Fannie and Freddie to strengthen each company and permit each to buy and hold more mortgages by increasing the size of their portfolios to $900 billion from $850 billion. The Plan contemplates that these agencies would buy more loans and securities backed by mortgages from financial institutions thereby providing greater liquidity to banks, which would lead to the origination of new loans.

To keep prevailing mortgage rates low, the government intends to continue buying mortgage-backed securities issued by the agencies, expanding a $500 billion purchase plan announced in November. That November plan led to a drop in mortgage rates by nearly a percentage point.

Issues

Critics of the President's Plan point out that no assistance is provided to borrowers with jumbo mortgages and those whose mortgages are in private label securities (mortgage-backed securities created and sold by a company other than a government-sponsored enterprise).

Also, the Plan does not provide servicers with a viable safe harbor to avoid litigation stemming from possible breaches of contractual obligations it has with the investors or mortgage holders as a result of entering into such loan modifications on a non-conforming loan (e.g. a jumbo mortgage) or a non-Fannie or non-Freddie loan. Presumably such a safe harbor provision would permit a servicer to modify the terms of 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.

Absent such a safe harbor provision, servicers may be subject to lawsuits by investors such as in the *Greenwich* case (*Greenwich Financial Services Distressed Mortgage Fund 3 v. Countrywide Financial Corp.*, Case No. 1:2008cv11343, December 30, 2008, New York State Supreme Court (Manhattan)). In the *Greenwich* suit, which is currently pending, an investor, on behalf of all investors of a mortgage pool, brought a class action against Countrywide Financial Corp. ("Countrywide") claiming that it was modifying loans that already had been transferred to pools in order to comply with an August 2008 settlement for claims of predatory lending practices brought by a number of State Attorney Generals. The plaintiff alleged that any

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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 at par. It remains to be seen if the loan modification provisions of the President's Plan might trigger similar lawsuits from unhappy mortgage pool investors.

Additionally, the "cram-down" provision under the President's plan is a "hot-button" issue to those in the mortgage lending industry. Lenders fear judges will use "cram-downs" aggressively to shrink loans for troubled homeowners, which would boost losses not just for lenders, but for investors in mortgage securities. Lenders further argue that permitting "cram-downs" would cause loan-to-value ratios to decline and mortgage interest rates to rise because lenders would demand more collateral and higher yields to compensate for the greater risks. Furthermore, opponents of the "cram-down" provision aver it would create hundreds of separate mortgage modification policies (created by bankruptcy judges) and will foment further uncertainty in the housing market leading to higher interest rates.

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