



The Rear View Mirror: Mortgage Finance and Mortgage Modification Efforts

Given the scope and complexity of the financial crisis, it is sometimes difficult to recall that the precipitating event related to defaults on subprime mortgages. Although many worried that rapidly rising home prices were creating an unsustainable housing “bubble,” few actually predicted the impact of a sustained decline in home values. Beginning in 2007, as adjustable rate mortgages reset to higher interest rates, subprime borrowers with underwater home values found they were unable to refinance at affordable rates. The resulting delinquencies and foreclosures led to startling losses in the mortgage-related securities markets, spreading quickly to the broader credit markets. Looking back, the historic U.S. emphasis on home ownership fueled the development of a capital-raising superstructure that relied on the creation and sale of mortgage-related securities.

The Federal government’s reaction to the current crisis includes legislative, policy and program development efforts to increase mortgage modification, prevent foreclosures and address the economic impact of the mortgage crisis. These efforts have been hampered by practices in the mortgage finance industry, notably the securitization of mortgages. Although mortgage securitization is credited with lowering mortgage rates and increasing available credit for home buyers, its structure and legal framework is inhibiting systemic mortgage modification attempts. To the extent that government efforts continue to promote widespread home ownership as a central tenet of the “American dream,” we will be compelled to develop a new, more flexible framework for financing mortgage loan originations.

Below, we look at how the structure of mortgage securitization transactions limits the success of recent mortgage modification efforts and poses unique challenges for the creation of a uniform system of foreclosure prevention. We then review federal mortgage modification and foreclosure prevention programs, including the current Administration’s Homeowner Affordability and Stability Plan, announced on February 18, 2009.

For more information about the government’s response to the financial crisis, please see our [Financial Crisis Website](#).

Mortgage Securitization Has Impeded Large Scale Modification Efforts

The majority of mortgage lenders sell the mortgage loans that they originate. Mortgage loans are bundled together into pools (usually by an aggregator or a financial intermediary) and the pools are sold to specially-created legal entities that then issue and sell mortgage-backed securities. By selling the mortgage loans, the mortgage loans are removed from the lender’s balance sheet—raising cash (from the sale) that supports new lending and creating “room” for new mortgage loan originations. These transactions may be executed privately by the lender, or through government sponsored enterprises (GSEs) like Fannie Mae and Freddie Mac. In order to minimize the transaction costs associated with moving thousands of mortgages from the balance sheets of lenders into specially-created entities, transaction structures and terms are highly consistent across the industry. As the mortgages are pooled and sold, a servicer is hired pursuant to a contract, typically a pooling and servicing

agreement. That agreement requires action from the servicer, such as collecting mortgage payments made on the underlying mortgage loans deposited into the special purpose vehicle and distributing payments to trust security holders. The agreement generally prohibits the servicer from taking other actions, such as imposing limitations on mortgage modification. These provisions are designed to protect the interests of the new indirect owners of the mortgage loans, the purchasers of the trust securities. Restrictions on mortgage modification may include a cap on the number of mortgages that may be modified, requiring a default on the mortgage loan to be “reasonably foreseeable” before modification is permitted, mandating security holder approval for certain actions and a general obligation to act only in a manner beneficial to the security holders. Should the mortgage pool experience any losses, the servicer’s actions will be judged in hindsight against these imprecise standards, raising the risk of potentially costly litigation. Consequently, servicers construe the provisions contained in these agreements narrowly.

Limitations on mortgage modifications also arise under the tax code provisions for REMICs,¹ or real estate mortgage investment conduits, a widely used securitization structure. REMICs are passive entities not subject to taxation. A REMIC is a pass-through structure. This structure offers lenders a highly cost-effective approach for pooling residential mortgage loans. Significant modification² of mortgages by the servicer of a REMIC would be seen as active management, causing the entity to lose its REMIC status, resulting in the imposition of a significant tax penalty.

Additionally, servicer compensation and staffing is based on historically expected losses for similar pools of mortgage loans. As delinquency rates outstripped expectations, creating a need to modify an unprecedented number of mortgages, servicers experienced extreme staffing shortages. Designed for efficiency and homogeneity of product, the mortgage finance industry’s legal, contractual and operational structure is ill-suited to manage widespread mortgage modification efforts. As we discuss below, the Federal government is developing programs and proposing legislation to address these constraints.

Federal Foreclosure Prevention Efforts

Given the limited success of the private sector to engage in widespread mortgage modification, the Federal government has undertaken a series of efforts to address the foreclosure crisis.

HOPE NOW Alliance

The HOPE NOW Alliance (HOPE NOW) was formed in the fall of 2007, at President Bush’s request, in response to mounting foreclosures. HOPE NOW is public-private partnership, an alliance between Fannie Mae, Freddie Mac, mortgage counselors, lenders, mortgage insurance companies, trade associations and other mortgage market participants. Its goals are maximizing outreach efforts to distressed homeowners to keep them in their homes and creating a unified, coordinated plan to reach as many homeowners as possible. The organization established a Homeowner’s HOPE Hotline that offers free counseling to homeowners seeking to avoid foreclosure. The Homeownership Preservation Foundation, an independent nonprofit, takes calls and directs homeowners to counselors approved by the U.S. Department of Housing and Urban Development. The organization also reaches out directly to at-risk homeowners through mailings and events.

There has been some criticism that HOPE NOW favors lenders over borrowers and that most of the help provided to borrowers has been in the form of temporary repayment plans rather than permanent mortgage modifications. HOPE NOW, however, highlights the over one million homeowners it helped to avoid foreclosure. HOPE NOW

¹ For a complete discussion of the REMIC rules and related tax considerations, see “Tales From the Credit Crunch: Selected Issues in the Taxation of Financial Instruments and Pooled Investment Vehicles,” Thomas A. Humphreys, *Journal of Taxation of Financial Products*, Volume 7, Issue 3, 2008, available at http://www.mofo.com/news/updates/files/Tales_from_the_Credit_Crunch.pdf.

² Under the REMIC rules, certain changes would not be considered significant modifications. The rules expressly permit the following modifications: (1) changes in the terms of an obligation occasioned by default or a reasonably foreseeable default; (2) assumption of the obligation; (3) waiver of a due-on-sale clause or a due on encumbrance clause; and (4) conversion of an interest rate by a mortgagor pursuant to the terms of a convertible mortgage.

worked closely with the U.S. Treasury, the Federal Housing Finance Agency, Fannie Mae, Freddie Mac, and mortgage loan servicers on other mortgage relief initiatives, such as the Streamlined Modification Plan.

Housing and Economic Recovery Act of 2008

The Housing and Economic Recovery Act of 2008 (HERA), an omnibus housing bill, combines regulatory reform of GSEs, modernization of the Federal Housing Administration (FHA) and provisions to help troubled borrowers. Within HERA, the Federal Housing Finance Regulatory Reform Act of 2008 created the Federal Housing Finance Authority (FHFA), a new regulator for Fannie Mae, Freddie Mac and the Federal Home Loan Banks.³ The FHFA has the authority to establish capital, management and risk standards; to enforce its directives through cease and desist orders; to put a regulated entity into receivership; and to review and approve new product offerings.

Another law within HERA, the Foreclosure Prevention Act of 2008,⁴ modernizes many aspects of FHA lending, including increasing the FHA loan limit, authorizing \$3.92 billion in supplemental Community Development Block Grant Funds for communities hardest hit by foreclosures, providing funds for housing counseling and modifying loan disclosure requirements.

HERA also included the Hope for Homeowners Act of 2008, establishing the HOPE for Homeowners program to help troubled borrowers.

Hope for Homeowners Act of 2008

The HOPE for Homeowners Program (H4H) is a temporary program within FHA designed to refinance distressed mortgage loans. The program began on October 1, 2008 and is scheduled to expire on September 30, 2011. H4H goals include ensuring that (1) homeowners can afford their mortgages over the long-term, (2) there will be no bailout of investors and lenders, who will have to accept significant losses resulting from modified mortgages, (3) borrowers share any future equity and appreciation with the FHA, (4) lender, servicer or investor participation in the program is voluntary and (5) the program will restore confidence, liquidity and transparency. Although the government estimated that 400,000 households would benefit from the program, to date, far fewer borrowers have successfully used the program. An FHA spokesman recently announced that, as of February 2, 2009, the FHA received only 451 H4H applications and only 25 modified mortgage loans had closed.

H4H targets borrowers already in, or soon to be in, distress. Borrowers do not need to be delinquent on their mortgage payments in order to participate in the program. Other eligibility requirements include:

- the mortgage is for a one- to four-unit primary residence, where the borrower does not own other residential real estate;
- the mortgage was originated on or before January 1, 2008, and the borrower has made at least six mortgage payments;
- the monthly mortgage payments are unaffordable, which is defined as exceeding 31% of the borrower's monthly gross income; and
- the borrower will require assistance to continue making mortgage payments.

H4H works with borrowers and lenders to refinance existing mortgages with FHA-insured fixed-rate mortgages. The borrower is required to have equity in the home when refinanced into the H4H loan. Given the decline in housing prices, in most cases, lenders will be required to write down their original mortgage. Borrowers are required to share with the government any new equity created in the refinancing and any future house price

³ In September 2008, the FHFA was appointed as conservator of Fannie Mae and Freddie Mac under authority created in the Federal Housing Finance Regulatory Reform Act and replaced senior management at each institution.

⁴ Pub.L. 110-289, 122 Stat. 2830.

appreciation. The new FHA-insured mortgage will be a 30- or 40-year fixed-rate mortgage loan that does not exceed 96.5% of an updated appraisal value. The FHA collects up-front insurance premiums.

Mortgage modification efforts under H4H have been hampered by the existence of second mortgages on many borrowers' homes. Second mortgage lenders must consent to modification of the first mortgage, resulting in the extinguishment of their second lien on the related property. H4H provides that these second liens can only be eliminated through equity sharing arrangements, an approach that investors and servicers find cumbersome and impractical. A recent amendment to H4H permits upfront payments to second lien holders to satisfy their claims against the borrower.

Proposals to Amend H4H

Market participants and members of the government recommended changes to H4H to improve its effectiveness. The American Banker's Association (ABA) proposed several recommendations to improve H4H, including: (1) streamlining the underwriting process, (2) providing second lien holders greater incentives to extinguish or subordinate their interests, (3) providing lenders and servicers protection against litigation when they act reasonably and in good faith, and (4) offering incentives to participate for borrowers with no equity, including eliminating or significantly reducing the equity and appreciation sharing components of the program.

Federal Reserve Governor and member of the H4H oversight board, Elizabeth A. Duke, noting that H4H has had only limited impact in part due to the "general reluctance of servicers and lenders to write down the principal of delinquent mortgages,"⁵ recently suggested that the government engage in bulk purchases of delinquent or at risk mortgages for refinancing through H4H to reach more homeowners.

Barney Frank, Chairman of the House Financial Services Committee, called for relaxing H4H standards and providing a safe harbor for mortgage servicers. Chairman Frank's proposals are now included in the proposed Helping Families Save Their Homes Act of 2009,⁶ which would amend H4H by:

- reducing and permitting the elimination of the premium charged to the borrower modifying a mortgage;
- reducing the minimum amount of the write-down of the original mortgage to 93% of the original principal amount; and
- providing a safe harbor from litigation for mortgage servicers who engage in specified mortgage loan modifications.

Emergency Economic Stabilization Act of 2008

The Emergency Economic Stabilization Act of 2008 (EESA) allocates \$700 billion to programs developed by the Treasury Secretary (Treasury) to stabilize the economy. EESA programs were expected to purchase or insure mortgage-related troubled assets and other assets identified by Treasury. Treasury is required, in implementing its programs, to consider the protection of home values, the preservation of home ownership and the stabilization of communities. Additionally, EESA includes provisions encouraging foreclosure mitigation efforts, for example, by giving broad authority to Treasury to manage and modify mortgage-related assets it acquires. Treasury must coordinate with the Federal Reserve, the FHFA and the Federal Deposit Insurance Corporation (FDIC), each in its capacity as an owner of mortgages and mortgage-related securities, to identify opportunities for the purchase of classes of troubled assets that will improve Treasury's ability to improve mortgage modification and the restructuring process. Modifications of existing mortgages are encouraged through use of H4H, as well as by effecting term extensions, rate reductions and principal write-downs, and by amending contracts to permit an increased proportion of mortgage loans in a pool to be modified, or removal of other limitations on mortgage

⁵ Governor Duke's comments at the "Global Association of Risk Professionals' Risk Management Convention" on February 11, 2009 are available at: www.federalreserve.gov/newsevents/speech/duke20090211a.htm.

⁶ A copy of H.R. 1106, Helping Families Save Their Homes Act of 2009, is available at: http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h1106ih.txt.pdf.

modifications. Additionally, EESA requires Treasury to consent, where appropriate, to any reasonable mortgage modification requests.

Despite Congress' efforts to include broad provisions in EESA to address the mortgage crisis, the initial programs under the act did not target mortgage-backed securities or foreclosure prevention. Faced with unforeseen challenges in implementing such programs and rapid degradation of the interbank credit and other markets, Treasury launched a series of programs designed at restoring confidence in the banking system and preventing the collapse of the auto industry. In January 2009, seeking authorization from Congress for the allocation of the final amount available under EESA, the incoming Administration committed to spend at least \$50 billion on foreclosure prevention programs. On February 18, 2009, the Administration released the Homeowner Affordability and Stability Plan (Homeowner Plan), which we describe below. Funding for the stability initiative under the Homeowner Plan will come from EESA.

FDIC's Mod in a Box

On August 20, 2008, FDIC Chair Sheila Bair announced the implementation of a systematic Loan Modification Program (Modification Program) used by the FDIC as receiver of IndyMac Bank, F.S.B. The Modification Program, also called "Mod in a Box"⁷ by the FDIC, is described as a solution for servicers struggling to negotiate modification terms on a case-by-case basis with individual borrowers. The program addresses one of the challenges of mortgage modification by establishing consistent standards.

The Modification Program was adopted by several banks and the Streamlined Modification Program, discussed below, incorporates many of its provisions. In November 2008, U.S. Bancorp adopted the Modification Program for mortgages acquired from two failed California banks, Downey Savings and Loan and PFF Bank & Trust, under an FDIC loss-sharing agreement. Additionally, as a condition to participating in Treasury's Targeted Investment Program and Asset Guarantee Program under EESA, Citigroup and Bank of America agreed to use the Modification Program. On February 3, 2009, Citigroup announced expanded use of the program; the program had previously only been used for borrowers 60 days past due. Citigroup announced it would be used for all future modifications.

The Modification Program sets the range of affordability for mortgages from 38% to 31% of the borrower's gross income and establishes a net present value floor, requiring that the cost of modification be less than the cost of foreclosure. Eligible mortgages include those at least 60 days delinquent, where the borrower is not in bankruptcy or facing imminent foreclosure and the mortgage is for the primary residence. The modification may include reducing the interest rate, extending the life of the mortgage loan and partially forbearing principal forbearance, in each case to create a modified loan affordable for the life of the mortgage.

Mortgage lender groups recommended improvements for the Modification Program, including a proposal to require a current debt-to-gross-income ratio of at least 38%, to prevent borrowers from "gaming" the system. The proposal recommends that lower ratios, down to 31%, be addressed through other modification programs or through more traditional mortgage loan workouts.

Fannie Mae & Freddie Mac Streamlined Modification Program

On November 11, 2008, Fannie Mae and Freddie Mac announced the creation of the Streamlined Mortgage Modification Program (SMP)⁸ for modification of mortgages owned by Fannie Mae, Freddie Mac, private mortgage lenders and servicers. Approximately 31 million mortgages, 59% of all single-family mortgages, are either owned or guaranteed by Fannie Mae and Freddie Mac. These mortgages only account for 20% of all serious delinquencies, but the SMP developers believe it will provide a useful tool for private lenders and their servicers.

⁷ Additional information on the FDIC's Loan Modification Program can be found at <http://www.fdic.gov/consumers/loans/loanmod/loanmodguide.html>.

⁸ Fannie Mae announcement 08-33 providing SMP program information is available at <https://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2008/0833.pdf>.

Treasury, FHFA, Fannie Mae, Freddie Mac, and HOPE NOW collaborated to develop the SMP, which became effective on December 15, 2008.

Similar to the Modification Program, SMP streamlines the mortgage modification process for participants by defining uniform borrower eligibility requirements. An eligible borrower must (1) be at least 90 days delinquent, (2) have a mortgage that closed on or before January 1, 2008, (3) occupy the related property, which must be a one-unit primary residence, (4) have a mortgage with a marked-to-market, loan-to-value ratio of at least 90% and (5) not have filed for bankruptcy. Servicers will reach out to potentially qualifying borrowers and receive \$800 for each mortgage modified under the SMP. The goal of the SMP is to provide the borrower an affordable modified mortgage, with affordability defined as no more than 38% of monthly gross household income. Affordability can be achieved through a lowered interest rate, term extension of up to 40 years from the date of origination and forbearance of principal.

Federal Reserve's Homeownership Preservation Policy for Residential Mortgage Assets

On January 30, 2009,⁹ the Federal Reserve announced the Homeownership Preservation Policy for Residential Mortgage Assets (Preservation Policy), a protocol for managing the residential mortgages it owns or controls. Under the Preservation Policy, the Federal Reserve will seek mortgage modifications and advise distressed homeowners as to the availability of other modification programs such as H4H. Federal Reserve Banks will reach out to borrowers that are 60 days delinquent and will offer a modification if the net present value of the new mortgage will exceed the proceeds from foreclosure. The tools that the Federal Reserve Bank may employ to modify mortgages are similar to those under H4H, including a combination of interest rate reduction, term extension of up to 40 years, and partial forbearance of outstanding principal to create an affordable mortgage loan. The Federal Reserve's standard of affordability is less forgiving than that of other programs, and it will consider a modified mortgage sustainable if the debt-to-income ratio is no more than 43%.

Homeowner Affordability and Stability Plan: Making Home Affordable

On February 10, 2009, Treasury unveiled the Financial Stability Plan (Stability Plan),¹⁰ broadly outlining the new Administration's multi-pronged strategy to stabilize the economy and address a root cause of the financial crisis - the mortgage meltdown. Shortly thereafter, on February 18, 2009, the Administration announced the Homeowner Affordability and Stability Plan (Homeowner Plan), the mortgage-related prong of the Stability Plan. The Homeowner Plan includes three programs.

First, the Home Affordable Refinance program permits refinancing of mortgages owned or insured by Fannie Mae or Freddie Mac that may not have previously qualified for refinancing as a result of high loan-to-value ratios. Next, the Home Affordable Modification program was launched on March 4, 2009 when Treasury published detailed mortgage modification guidelines. Each program is described more fully below. The final component of the Homeowner Plan is enhancing confidence in Fannie Mae and Freddie Mac through direct government support. These confidence-building efforts include Treasury and Federal Reserve programs to purchase securities issued by Fannie Mae and Freddie Mac and Treasury's commitment to provide up to \$200 billion to each of Fannie Mae and Freddie Mac, an increase over the commitments made on September 7, 2008. These three programs are now titled Making Home Affordable.

Home Affordable Finance

Treasury estimates that the Home Affordable Refinance program will be available to 4 to 5 million homeowners. Borrowers with good payment histories and whose mortgages are owned or guaranteed by Fannie Mae or Freddie Mac will be eligible to refinance, even if their current home value exceeds 80% of their mortgage. The refinanced

⁹ The Federal Reserve's press release announcing the adoption of the policy is available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20090130a1.pdf>.

¹⁰ Please see our Client Alert on the Financial Stability Plan, available at <http://www.mofo.com/news/updates/files/090210Treasury.pdf>.

mortgages may offer lower fixed interest rates, which may include the opportunity to move from an adjustable rate mortgage to a fixed-rate mortgage. This program is scheduled to end in June 2010.

Home Affordable Modification

Home Affordable Modification provides standardized guidelines for mortgage modification, reflecting the input of numerous government agencies and industry groups. As launched on March 4, 2009, the program is in a trial period, and we expect additional fine-tuning over the coming weeks. Entities using the guidelines must execute Treasury's program agreements no later than December 31, 2009, and modifications under the program may be made through December 31, 2012.

Treasury has received commitments that the following will use the program for owned or managed mortgages: Fannie Mae, Freddie Mac, Ginnie Mae, the FHA, the Federal Reserve, the FDIC, the Department of Veterans Affairs and the Department of Agriculture. Additionally, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Reserve, the FDIC and the National Credit Union Administration are expected to encourage use of the program by institutions they supervise. Going forward, participants in Stability Plan programs will be required to use Home Affordable Modification.

Key features of Home Affordable Modification are highlighted below and the full guidelines are available at www.financialstability.gov.

- **Mortgage Eligibility:** mortgage originated on or before January 1, 2009, one- to four-family residence that is owner-occupied, no previous modification under the program, no automatic exclusions based on commenced bankruptcy proceeding or pending litigation, no minimum or maximum loan-to-value ratio, unpaid principal balance of single unit home may not exceed \$729,750
- **Shared Loss:** lender/investor must absorb any losses through modifications from reducing current payments to 38% of the borrower's debt-to-income ratio. Thereafter, Treasury will share losses on a dollar-for-dollar basis on modifications reducing current payments to 31% of the borrower's debt-to-income ratio
- **Servicer Incentives:** (1) \$1,000 for each modified mortgage, (2) \$1,000 per year for each borrower of a modified mortgage that remains current on the mortgage loan (for up to three years) (3) \$500 for modifications made prior to a delinquency, (4) \$250 and additional compensation based on a scale to be published by Treasury for the release of a second lien and (5) where modification is not feasible, compensation to encourage alternatives to foreclosure, including permitting a sale for less than the unpaid amount of the mortgage loan or deeds-in-lieu of foreclosure
- **Borrower Incentives:** monthly payments, up to \$1,000 each year for five years, will be applied to reduce the principal balance of the mortgage as long as the borrower remains current
- **Lender/Investor Incentives:** \$1,500 payment for each modification made prior to a delinquency and payments to offset probable losses from home price declines
- **Modified Mortgage Targets:** 31% front-end debt-to-income ratio,¹¹ interest rate no lower than 2%, modified interest rate is fixed for five years with 1% per annum increases thereafter up to the interest rate cap determined using the guidelines at the time of modification and term extensions (40-year mortgages)
- **Underwriting:** income verification is required; property value determined within 60 days of modification based on the government sponsored enterprises' automated valuation model or a brokers price opinion
- **H4H:** participating servicers are required to consider borrowers for H4H; loans may enter the Home Affordable Modification trial period pending completion of a H4H modification

¹¹ The front-end debt-to-income ratio is the ratio of PITIA to monthly gross income, where PITIA is principal, interest, taxes, homeowners, hazard and flood insurance and homeowners association or condominium fees, but does not include mortgage insurance premiums.

- Trial Period: Borrower must remain current for 90 days, or three monthly mortgage payments, before incentive payments will be made
- Transparency Provisions: Servicers required to maintain records covering borrower eligibility, underwriting, incentive payments and property verification; Fannie Mae and Freddie Mac will audit compliance

The program addresses many of the concerns raised with prior mortgage modification programs, and reflects the experience to date with H4H. The guidelines require compliance with any express pooling and servicing contractual restrictions for modifying current loans. Treasury hopes that widespread use of consistent and clear guidelines that include net present value and other objective measurements will enhance servicers' ability to modify mortgages. Concerns regarding the reasonableness of proposed modifications should be mitigated through use of a program that achieves industry-wide acceptance. In addition, the Administration supports legislative efforts to provide servicers a safe harbor from litigation. Recently proposed H.R. 1106 includes protection from legal liability for servicers performing loan modifications in compliance with the Trust in Lending Act and H.R. 1106's proposed standards.

The program's incentives include payments for each mortgage modified prior to the borrower becoming delinquent. The Administration believes requiring a borrower to be 60 or 90 days delinquent, a current requirement of many servicing agreements, encourages borrowers to cease making mortgage payments. Additionally, servicers are frequently unable to contact borrowers who abandon their residences during this 60 to 90-day period.

Many lenders have expressed reluctance to engage in modifications in geographic areas experiencing steep ongoing declines in real estate values, fearing modified mortgages will quickly return to under-water status. To address this concern, the Homeowner Plan includes a \$10 billion partial insurance program to make additional "Pay for Success" payments in the event of more marked declines in housing values. The mechanism for paying the insurance is unclear. Treasury's announcement states that the insurance payments could be set aside as reserves, providing a partial guarantee in the event that the home price declines (and therefore losses in cases of default) are higher than expected. It is not clear how a decline in home value will be measured or how much of a decline will be necessary to trigger a payment by Treasury.

In addition to the guidelines discussed above, the Home Affordable Modification program has other features designed to encourage modifications. For example, the following were outlined in Treasury's March 4, 2009 updated program description: required participation in loan modification programs by participants in other Financial Stability Plan programs, permitting judicial modifications of home mortgages during bankruptcy and improving the flexibility of H4H and other FHA Programs to aid at-risk borrowers wishing to modify or refinance their mortgages.¹² Additional details are expected from Treasury in the coming days and weeks.

Tax Initiatives

Given the importance of combating foreclosures, the White House announced a proposal in December 2008 that would freeze the initial "teaser" interest rates on adjustable rate mortgages subject to reset.¹³ In conjunction with the proposal, the Internal Revenue Service (IRS) issued Rev. Proc. 2007-72, which provided that, under certain conditions, the IRS will not challenge a REMIC's status as a pass-through tax-exempt entity for U.S. Federal income tax purposes in connection with "fast track modifications" of certain subprime mortgage loans under a framework recommended by the American Securitization Forum (ASF). A fast-track modification program is a program that permits servicers to modify eligible troubled mortgage loans subject to certain broad parameters.¹⁴

¹² The updated term sheet for Making Home Affordable is available at http://www.treas.gov/press/releases/reports/housing_fact_sheet.pdf.

¹³ The plan, popularly known as the "Paulson-Jackson Plan," was announced as a private sector initiative brokered by former Treasury Secretary Henry Paulson and Housing and Urban Development Secretary Alphonso Jackson.

¹⁴ Specifically, Rev. Proc. 2007-72 provided that the IRS would not (1) challenge a securitization vehicle's qualification as a REMIC on the grounds that the loan modifications are not permitted under the REMIC rules; (2) contend that the loan modifications are prohibited

Rev. Proc. 2007-72 was issued in an effort by Treasury and the IRS to stem foreclosures by removing barriers imposed by tax laws, arguably too restrictive in light of prevailing economic and market circumstances, to broad-based mortgage modification plans.¹⁵

Rev. Proc. 2008-47, issued in July 2008, provides that the IRS will not challenge the tax status of a REMIC or assert that a REMIC is engaged in a “prohibited transaction” when certain mortgage loans – primarily adjustable rate mortgages with teaser rates – held by a REMIC are modified by freezing rates prior to their reset in accordance with the American Securitization Forum’s “Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans” (also issued in July 2008). The Rev. Proc. amplifies and supersedes Rev. Proc. 2007-72. Despite this limited tax relief, however, a number of other serious tax questions remained that could create disincentives for mortgage modification programs.

On February 4, 2009, a bill was proposed in the United States Senate that would require that each securitization seeking tax-free REMIC status permit its servicer or trustee to “reasonably” modify or dispose of distressed mortgages or otherwise suffer the penalty of losing tax-free REMIC status.¹⁶ The bill also provides that any modification or dispositions made under EESA’s Troubled Asset Relief Program will not be treated as prohibited transactions. Terminating REMIC status could have far-reaching consequences, not the least of which would be subjecting the securitization to an additional layer of tax. Accordingly, the bill is expected to face stiff criticism from the ASF and other industry participants and is not expected to pass in its current form.

Pending Proposals

Mortgage modification in bankruptcy: Cram-down¹⁷ Legislation

In personal bankruptcy cases, bankruptcy judges do not have the authority to modify the mortgage for the petitioner’s primary residence. Because there is no risk that a bankruptcy court could change the terms of a residential mortgage for owner-occupied property, there is one less risk of disrupted cash flows in mortgage finance transactions. The mortgage finance industry asserts that this creates reduced risk of loss for investors and, as a result, reduced mortgage financing costs. These reduced costs lead to lower interest rates and more affordable mortgages.

Consumer advocates, on the other hand, have long argued for bankruptcy code changes to permit bankruptcy modifications, increasing the likelihood that borrowers can retain their homes under more affordable terms. Given the unprecedented need to facilitate widespread mortgage modifications and limit ongoing housing price declines resulting from waves of foreclosures, there is renewed interest in amendments to the bankruptcy code. Two bills have been proposed to provide bankruptcy courts with more flexibility to effect mortgage modifications.

Several bills were recently proposed to authorize mortgage modifications in bankruptcy. On March 5, 2009, the Helping Families Save Their Homes Act (H.R. 1106) was approved by the House of Representatives. H.R. 1106 combines several earlier efforts, including the Helping Families Save Their Homes in Bankruptcy Act of 2009 (H.R. 200) and its companion, the Emergency Homeownership and Equity Protection Act of 2009 (H.R. 225). If enacted, bankruptcy courts could modify residential mortgage loans for a borrower in a Chapter 13 proceeding.¹⁸

transactions under the REMIC rules; and (3) challenge a securitization vehicle’s qualification as a REMIC on the grounds that the loan modifications resulted in a “deemed reissuance” of the REMIC regular interests.

¹⁵ For more information, see “Tax Talk” published by Morrison & Foerster LLP, December 2008, Vol. 1, Issue 4.

¹⁶ The “Real Estate Mortgage Investment Conduit Improvement Act of 2009” is available at: <http://www.opencongress.org/bill/111-s376/text>. Senators Jack Reed (D-RI), Christopher Dodd (D-CT), John Kerry (D-MA), Charles Schumer (D-NY) and Debbie Stabenow (D-MI) introduced the bill. The bill originally was proposed as an amendment to the Senate’s version of the American Recovery and Reinvestment Act of 2009 (the “stimulus bill”) but was not part of the final bill that was signed into law on February 17, 2009).

¹⁷ Detractors of proposals to permit bankruptcy court judges to modify the terms of mortgage loans on owner-occupied primary residences refer to bankruptcy modification as “cram-downs,” as the modified mortgage terms are crammed down the lender’s throat.

¹⁸ In general, to qualify for Chapter 13, a consumer’s secured debts (excluding a mortgage on primary residence) cannot exceed \$1,010,650, and unsecured debts cannot be more than \$336,900. Chapter 13 allows the debtor to pay creditors over time, generally five years, an amount on each secured claim and unsecured creditors at a rate higher than what creditors would receive in a Chapter 7 liquidation using a “plan”

In addition, H.R. 1106 includes provisions (1) authorizing bankruptcy judges to extend the mortgage repayment period and to reduce the mortgage interest rate, (2) waiving the bankruptcy counseling requirement for borrowers nearing foreclosure, (3) requiring lenders to provide notice when assessing fees and allowing bankruptcy judges to waive prepayment penalties, and (iv) maintaining debtors' legal claims against predatory lenders while in bankruptcy.

H.R. 1106 also includes a safe harbor from litigation for servicers engaging in loan modifications in a manner consistent with HERA, regardless of servicing agreement provisions. To satisfy the HERA standard (1) the servicer's actions must maximize the net present value of pooled mortgages to all investors as a whole, (2) the mortgage must by in default or default must be reasonably foreseeable, (3) the property must be owner-occupied and (4) the anticipated recovery must exceed, on an net present value basis, the anticipated recovery through foreclosure.¹⁹

H4H amendments and new authorizations to the FHA and the Rural Housing Service are included in H.R. 1106. The bill encourages lender participation in H4H by: (1) reducing the upfront fee from 3% to no more than 2% and the annual fee from 1.5% to no more than 1%, (2) providing that profit be shared based on a scale up to 50%, but terminating the fixed 50% sharing requirement, and allowing profit sharing with the original mortgage lender to encourage principal reductions, (3) authorizing payments to servicers of up \$1,000 for each refinanced mortgage loan, (4) permitting auctions to refinance loans on a wholesale or bulk basis and (5) reducing the administrative burdens by making the requirements more consistent with standard FHA practices. Finally, H.R. 1106 would expand the FHA's mortgage loan modification abilities by allowing increased reductions of interest payments.

These proposed bills, and prior efforts to modify the bankruptcy prohibition on mortgage modification, are generally lobbied against by the mortgage finance industry. In a break from its industry peers, on January 8, 2009, Citigroup announced its support for recently proposed cram-down legislation. Consistent with the positions previously taken, industry groups such as the ABA and the Mortgage Bankers Association have raised concerns with the proposals to permit mortgage modification in bankruptcy. The ABA opposes the proposal "because it will leave in place overly broad mortgage cram-down authority and other provisions that will harm thousands of banks across the country that have made, and continue to make, good loans."²⁰ The Mortgage Bankers Association believes the legislation will have a "destabilizing effect ... on an already turbulent mortgage market"²¹ and should be limited to subprime mortgage loans.

Systemic Foreclosure Prevention and Mortgage Modification Act

On November 14, 2008, the FDIC announced its loss sharing proposal to promote affordable mortgage modifications. The FDIC proposed to serve as a Treasury contractor to implement a program of systematic mortgage modifications, and proposed a government loss share guarantee on re-defaults of modified mortgages. The FDIC claims that a loss share guarantee would provide the incentive necessary to modify a large number of mortgages, while leveraging available government funds to affect more mortgages than outright purchases or specific incentives for each modification.

Introduced as the "Systemic Foreclosure Prevention and Mortgage Modification Act," H.R. 37 is pending in the House Committee on Financial Services, and S. 73 is pending in the Senate Committee on Banking, Housing and Urban Affairs.

proposed by debtor and approved by the bankruptcy court. An important aspect of every Chapter 13 proceeding is the debtor's ability to establish a current value for secured collateral that is often lower than the loan amount and "cram-down" the secured claim to such lower amount. The remainder of the secured loan is paid at the same rate as that received by unsecured creditors.

¹⁹ H.R. 1106 requires mortgage servicers who modify loans under the safe harbor to regularly report to Treasury on the extent, scope and results of the servicer's modification activities.

²⁰ The ABA release is available at <http://www.aba.com/Press+Room/010909MortgageCramDownLegislation.htm>.

²¹ The [Mortgage Bankers Association](http://www.mbaa.org/NewsandMedia/PressCenter/67030.htm) statement is available at <http://www.mbaa.org/NewsandMedia/PressCenter/67030.htm>.

Conclusion

The recently announced Homeowner Affordability and Stability Plan is the most comprehensive interagency federal action to date to address the mortgage crisis. Although the current financial crisis began with the mortgage crisis, recent recovery efforts have been focused on the downstream impact of the mortgage market melt-down. The \$700 billion authorized under EESA will be overwhelmingly spent to address problems other than foreclosure. The \$787 billion American Recovery and Reinvestment Act of 2009 similarly targets the broader economic challenges that resulted from the mortgage crisis. Even the most pessimistic of observers expects that the market will ultimately stabilize. Prior to that, we expect to see a growing wave of reform efforts focused on the mortgage industry, including mortgage finance, to prevent a similar crisis from recurring. We also anticipate that additional attention will need to be focused on alternative approaches to finance mortgage loan originations, as well as a new rubric for securitization type structures. Ultimately, the credit markets would be too constrained without a “securitization-like” funding approach; however, it is not yet clear how this market will return. Reform efforts will be widespread, addressing not only the root causes of the initial downturn, but the inability of markets and others to manage the spreading impact from the declines in the mortgage market.

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