HUNTON & WILLIAMS
CLIENT ALERT
FINANCIAL INDUSTRY RECOVERY CENTER

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Contacts

Rudene Mercer Bascomb
Riverfront Plaza, East Tower
951 East Byrd Street
Richmond, VA 23219-4074
(804) 788-7363
rbascomb@hunton.com

Kevin J. Buckley
Riverfront Plaza, East Tower
951 East Byrd Street
Richmond, VA 23219-4074
(804) 788-8616
kbuckley@hunton.com

Thomas Y. Hiner
200 Park Avenue
New York, NY 10166-0091
(212) 309-1302
thiner@hunton.com

Michael Nedzbala
Bank of America Plaza, Suite 3500
101 South Tryon Street
Charlotte, NC 28280
(704) 378-4703
mnedzbala@hunton.com

Vicki O. Tucker
Riverfront Plaza, East Tower
951 East Byrd Street
Richmond, VA 23219-4074
(804) 788-8779
vtucker@hunton.com

Amy McDaniel Williams
Riverfront Plaza, East Tower
951 East Byrd Street
Richmond, VA 23219-4074
(804) 788-7388

200 Park Avenue
New York, NY 10166-0091
(212) 309-1369
awilliams@hunton.com

The "Missing Link" Redux: Making Home Affordable

The Obama Administration's Financial Stability Plan, announced on February 10, 2009, promised to address the foreclosure crisis with a comprehensive plan to stem foreclosures and restructure troubled mortgage loans. That plan, announced on February 18 as the Homeowner Affordability and Stability Plan or "HASP," included access to low-cost refinancing for qualifying borrowers with conforming loans owned or guaranteed by Fannie Mae and Freddie Mac and a $75 billion homeowner stability initiative to prevent foreclosures. The details of the homeowner stability initiative, which would include a plan to encourage servicers to modify loans of homeowners who are delinquent on their loans or who are in danger of becoming delinquent, were to be released in early March.

On March 4, the Treasury released some of the details of these programs, now under the rubric "Making Home Affordable." Making Home Affordable includes both a refinance program and a modification program. The "Home Affordable Refinance" program allows homeowners subject to conforming loans owned or guaranteed by Fannie Mae or Freddie Mac to refinance their loans into more affordable and stable mortgages. The "Home Affordable Modification" program (the "Modification Program") consists of a set of loan modification guidelines that the Administration hopes will become standard industry practice for both GSE-owned or guaranteed loans and securitized residential mortgage loans.

Treasury's March 4 announcement also reiterated the Administration's support for legislation permitting judicial modifications to home mortgages in connection with consumer bankruptcies. On March 5, the U.S. House of Representatives passed H.R. 1106, which, if it becomes law, will allow bankruptcy judges to modify the outstanding principal balance of a borrower's primary residence to its current fair market value (the "Cramdown Legislation"). H.R. 1106 also insulates servicers from liability for modifying a loan on an owner-occupied property if the servicer reasonably and in good faith believes that the net present value ("NPV") of the loan modification will exceed the anticipated recovery realized through foreclosure. This "safe harbor" would apply to securitized loans notwithstanding any provision of law or contractual restrictions limiting the ability of the servicer to modify the securitized loans.

These measures could have a profound impact on the residential mortgage securitization market. The Modification Program and the Cramdown Legislation are of particular interest to participants in private market securitizations. How will these measures affect servicers, investors and trustees or bond administrators in current residential mortgage-backed securitizations, as well as the sponsors of future mortgage-backed securities offerings?

The Modification Program

Program Agreements

A principal feature of the Modification Program is its financial incentives to servicers, borrowers and lender/investors for successful loan modifications. No incentive payments will be made until the

servicer enters into program agreements with the Treasury. Servicers have until December 31, 2009, to enter into the program agreements, although the forms will not be available until April. Servicers will need time to set up and implement the wide-scale modification program, which is intended to apply to all qualifying mortgage loans serviced by a participating servicer (whether for its own portfolio or, to the extent possible, in securitized pools).

Contractual Restrictions on Loan Modifications

The Modification Program acknowledges that servicers must comply with any pooling and servicing agreement ("PSA") contractual restrictions for modifying loans, but participating servicers will be required to use "reasonable efforts" to "remove any prohibitions and obtain waivers of approvals from all necessary parties" to PSAs or other investor servicing agreements. Perhaps the program agreements will clarify what "reasonable efforts" means. Requiring a servicer to request that a bond insurer waive a restriction on the number of loan modifications that can be made in a wrapped deal should entail minimal cost and expense to the servicer. However, it is quite a different undertaking if the servicer concludes that an amendment to a PSA would be required in order to comply with the Modification Program.

Servicer Safe Harbor?

The Modification Program does not include a servicer "safe harbor" for modifications. The safe harbor included in H.R. 11.06 (or similar legislation), may, if it becomes law, eliminate the risk of compliance with the Modification Program. In the meantime, if there is any question about whether modifications of the types prescribed in the Modification Program are permissible under the applicable PSA or other servicing agreement, the servicer bears the risk of undertaking the modification. Correspondingly, the securitization trustee may be pressured by investors to "rein in" the servicer or challenged for permitting the servicer to make what the investors might argue are impermissible modifications.

The NPV Test

The Modification Program sets out certain of the assumptions to be used in the NPV analysis. For example, the Modification Program indicates that the NPV is to be calculated using cure rates and redefault rates based on government-sponsored enterprise analytics and program portfolio data, which generally will mean that these rates relate best to modifications of loans that conform to Fannie Mae and Freddie Mac guidelines. Because of significant differences in underwriting criteria and credit profiles of borrowers, those cure and redefault rates may not be the best benchmarks to use in connection with modifications of subprime or Alt-A loans. The Modification Program allows servicers with at least $40 billion of servicing to substitute their own cure and redefault rates based on the experience of their own portfolios, while smaller servicers must apply to make similar substitutions.

The NPV test must be applied on a loan-by-loan basis. This will make it difficult or impossible for servicers to implement streamlined modification programs that would apply an NPV test to modified loans in the aggregate.

The NPV Test Must Be Applied to Every Eligible Borrower

Every potentially eligible borrower (generally, a borrower whose loan was originated no later than January 1, 2009, is secured by first lien on owner-occupied property, and has an outstanding principal balance of not more than $729,750) who contacts a participating servicer in reference to a modification must be screened for hardship under the Modification Program. If the loan is 60-days delinquent, in default or the servicer determines that the borrower is at risk of "imminent default" (for example, as a result of a change in circumstances or a recent or imminent increase in monthly payments on the loan), then the servicer must apply the NPV test and, if the NPV test is satisfied, modify the mortgage loan in accordance with the Modification Program. If the NPV test is not satisfied and a Home Affordable Modification is not pursued, then the servicer must consider other foreclosure prevention alternatives, such as alternative modification programs or short sales.

Effect of Home Affordable Modification

A loan may be modified only once under the Modification Program, and any loan that was assumable prior to modification will no longer be assumable following the modification. Servicers will need to set up safeguards to prevent such actions for loans modified under the Modification Program.

In addition, in connection with a Home Affordable Modification, the servicer must establish an escrow for taxes and insurance, even if the borrower was not required to make such escrow payments prior to the modification.

Looking for Assistance under the Financial Stability Plan?

Any financial institution that is receiving assistance under the Financial Stability Plan is required to implement loan modification plans that are consistent with the Modification Program guidelines. The programs announced as part of the Financial Stability Plan include Treasury's "Capital Assistance Program" to provide additional capital to financial institutions under stress and the "public-private investment fund" to be developed to provide a means for financial institutions to sell troubled and illiquid "legacy assets." At present, there is no requirement that TALF participants adopt the Modification Program guidelines.

Will the Servicer Financial Incentives Compensate for

the Costs of Implementing the Modification Program?

Servicers' costs to implement the Modification Program are likely to exceed any incentive payments. Servicers will be subject to the additional costs of providing loan level standardized reports on modifications, borrower and property characteristics and outcomes to Freddie Mac (or any other entity appointed to audit compliance with the Modification Program). A participating servicer will incur screening costs under the Modification Program because it is required to screen every current borrower who contacts the servicer and meets the minimum eligibility criteria to determine whether such borrower is at risk for default. The servicer must perform the NPV test on all mortgage loans that are at risk of imminent default, in default or at least 60 days delinquent. The determination of debt-to-income ratio ("DTI ratio") for borrowers will require review and verification of the borrowers' proof of income. Servicers are further required to maintain records for compliance reviews. Servicers will have to bear the cost of the credit report for the borrower and forgo any unpaid late fees that the borrower owes the servicer (although modification fees and charges to a servicer will be reimbursable by applicable investors). Finally, no incentive payments will be made for any modification until the borrower successfully completes a three month trial modification.

The Effect of Loan Modifications on Securitization Cash Flows

Modifications of securitized loans will affect the monthly collections of interest, and perhaps principal, which are in turn distributed to investors. Most securitization PSAs do not contemplate how to treat distribution shortfalls related to modifications, and the Modification Program guidelines do not provide guidance on how and when losses associated with the modifications are to be allocated among investors. Should shortfalls from loan modifications be treated like "realized losses," or like debt service reductions or deficiency valuations, thereby potentially reducing payments to holders of subordinate securities? Or, should the shortfalls be distributed pro rata among investors, similar to the treatment of temporary interest shortfalls such as those resulting from the Servicemembers Civil Relief Act? The Cramdown Legislation would dictate that excess losses from modifications of loans in consumer bankruptcy cases be allocated to the most junior class of securities irrespective of the contractual provisions of related PSAs. No similar directive is included in the Modification Program, and each securitization trustee or bond administrator will be required to determine how best to apply any shortfall or loss resulting from each particular type of modification undertaken outside the context of the borrower's bankruptcy.

What's Missing?

While the Modification Program fleshed out some of the details of the Administration's plan to prevent foreclosures, it still leaves open several questions.

Logistics

We do not know the details of how and when incentive payments will be made to the various parties. For example, will participating servicers receive incentive payments on a loan-by-loan basis or periodically in the aggregate for all modified loans?

Home Price Depreciation Payments

To encourage lenders/investors to modify more mortgages, HASP and the Modification Program provide for compensation to at least partially offset losses from home price declines after a modification under the Modification Program. No further details were included in the Making Home Affordable announcement.

Payments for Short Sales, Deeds-in-Lieu and Extinguishing Second Liens

The Modification Program will include incentive payments for a short sale or a deed-in-lieu of foreclosure if a borrower fails the NPV test or fails to qualify under, or defaults under, the Modification Program. Incentive fees also will be paid for the elimination of junior liens subordinate to first-lien loans that are being modified under the program. It is unclear how the servicer is expected to extinguish junior loans; presumably, the details will be spelled out either in the program agreements to be executed by servicers or in further announcements from the Treasury.

New Securitizations

The Modification Program sunsets on December 31, 2012, which is the last day on which eligible borrowers may request a modification under the program. Going forward, sponsors in new securitization transactions should consider expanding servicers' abilities to modify loans to meet the requirements of the Modification Program. Similarly, sponsors should revisit servicers' reporting obligations and forms so as to enable servicers to capture losses and benefits associated with individual modifications. Perhaps the loan level data reports that servicers will be required to provide under the Modification Program will be useful templates for revising servicers' reporting obligations in new securitization transactions. Finally, sponsors in new securitization transactions, absent any guidance from the Treasury, will need to address how to distribute losses incurred as a result of modifications among investors and the timing of when losses are allocated.

The Cramdown Legislation

What Loans Does it Cover?

The provisions in the Cramdown Legislation allowing loan modifications in connection with Chapter 13 consumer bankruptcies will apply to

any mortgage loan that is secured by the borrower's principal residence.

How are Losses Applied?

The Cramdown Legislation provides that any provision in a securitization PSA or other servicing agreement that requires the pro rata allocation of "excess bankruptcy losses" that exceed a specified amount to all classes of securities will be unenforceable with respect to the new bankruptcy cramdowns authorized by the legislation. Presumably, any such losses would be allocated, contrary to the expectations of the investors, to the most junior class of securities to which bankruptcy losses are to be applied.

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The Modification Program and the Cramdown Legislation present parties to private securitization transactions with significant challenges in implementation of their provisions consistent with PSAs and other governing documents. Also, the Modification Program may raise significant challenges for off-balance securitizations unless relief is granted under FAS 140 by the Financial Accounting Standards Board. The industry will need to reach a consensus on how to treat these modifications under current agreements and, in particular, whether or how to revise securitization documents to address the implications of the Modification Program and the Cramdown Legislation.

Click here for the Treasury's announcement of the Making Home Affordable programs, including the Modification Program guidelines. If you have any questions about how Making Home Affordable will impact securitization transactions, feel free to contact any of the individuals noted in this Client Alert.

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