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Capital Markets

## Capital Markets Client Alerts

# New Second Lien Program and HOPE for Homeowners Initiatives Under the Making Home Affordable Plan

**April 29, 2009**

We are writing to update our previous alert summarizing President Obama's Homeowner Affordability and Stability Plan (the "Plan") which was first announced on February 18, 2009. Following that first announcement, we also provided a summary of the additional guidelines (the "Guidelines") which were published by the Treasury Department on March 4, 2009 to implement the Plan's objectives. We are now writing to provide a summary of two new initiatives that were announced by the Obama Administration on April 28, 2009, specifically the establishment of the Second Lien Program (the "SLP") under the Plan, and the integration of HOPE for Homeowners Program (the "HOPE Program") into the Plan.

As we previously stated, the Plan is aimed at accomplishing three key objectives: (i) refinancing mortgages for up to 4 to 5 million "responsible homeowners" in order to prevent additional foreclosures; (ii) providing a $75 billion initiative to help up to 3 to 4 million "at-risk homeowners" primarily through the use of uniform loan modifications; and (iii) keeping mortgage rates low by strengthening confidence in the government-sponsored entities ("GSEs"), Fannie Mae and Freddie Mac. ***The latest announcement from the Obama Administration on April 28, 2009, provides guidelines for the modification of second lien loans in instances where the first lien has been modified, and seeks to encourage servicers and lenders to facilitate the refinance of at-risk loans into new loans under the HOPE Program***. The Treasury Department will share the costs of these second lien modifications with investors, and also pay each investor who is willing to extinguish principal on a second lien an upfront amount according to a pre-set formula. Servicers and borrowers will also receive pay-for-success fees for second lien modifications in a similar fashion as those already provided with the modification of first liens under the Plan. Finally, servicers and lenders will also receive upfront pay-for-success fees for any at-risk loan that is refinanced under the HOPE Program. Please reference below Section II(D) of this alert for details on the establishment of the SLP, and Section II(E)(iv) for details on the incorporation of the HOPE Program.

**I. Refinance of "Responsible Homeowners"**

As originally announced under the Plan, the Administration seeks to refinance the mortgages of up to 4 to 5 million "responsible homeowners." *Responsible homeowners are those borrowers with conforming loans that are currently owned or guaranteed by Fannie Mae and Freddie Mac, and who are current with their mortgage payments, but have a greater than 80% loan-to-value ratio ("LTV").* Due to the depreciation of housing values, these borrowers are ineligible for most government and private refinance programs because their LTVs have been greater than 80%. Under the Plan, Fannie Mae and Freddie Mac will allow the refinance of these loans that they hold in their portfolios, or that they placed in mortgage-backed securities. These responsible homeowners will have the opportunity to refinance at today's low rates, which are generally lower than what the borrowers qualified for in the past couple years when their loan was originated.

The refinancing program would include loans where the new first mortgage, including any refinancing costs, *will not exceed 105% of the current market value of the property.* Note that borrowers with two liens on the property will still be eligible for the refinance program as long as the amount due on the first mortgage is less than 105% of the value of the property. In the case of two liens, the borrower's eligibility for the program will depend in part on the second lien holder agreeing to subordinate and remain in the second lien position. The current value of the property will be determined after the borrower has made the application to refinance. To qualify, each borrower must prove sufficient income to make the new refinance payment and provide proof of an acceptable mortgage payment history with their current lender.

## II. Loan Modifications for "At-Risk Homeowners"

### A. Overview

The Guidelines extensively detail the implementation of the loan modification program (the "Program") for "at-risk homeowners." At-risk homeowners are those borrowers in owner-occupied homes with conforming loans who have high combined mortgage debt compared to income or who are "underwater." Significantly, as the Plan was originally announced, only first mortgages that were originated on or prior to January 1, 2009 were eligible for a loan modification. Though, the Guidelines contained incentives (cash payments up to $1,500) to encourage servicers to eliminate second mortgages or other liens on the modified loan. However, the Obama Administration announced new details on April 28, 2009, that incorporated modifications for second liens under the Plan. These details are provided in Section D below.

In addition to borrowers that are already in default, the Plan also includes borrowers who are current on their payments but who are at risk of imminent default. Further, borrowers who have *high total debt* (i.e. not just housing debt, but also including car loans, credit card debt, etc.) equal to 55% or more of their income may still qualify for the Plan, but will be required to enter a Department of Housing & Urban Development ("HUD") approved counseling program as a condition for the loan modification. All borrowers must fully document income, including signed IRS 4506-T, two most recent pay stubs, and most recent tax return, and must sign an affidavit of financial hardship.

Importantly, benefits to borrowers participating in the Plan ***include the temporary suspension of any foreclosure action for the first three months of the Plan*** and the absence of any minimum or maximum LTV ratio for participation in the Plan. However, loans may only be modified once under the Plan. ***Eligibility for the Program will sunset on December 31, 2012.***

### B. Details on Modifications Methods and Incentives to Parties

The Plan will have five primary components, as described below.

#### i. Joint Effort to Reduce the Borrower's Monthly Payment

The United States Treasury Department will work with financial institutions and investors to reduce the homeowners' monthly mortgage payments to an affordable level, which the Program targets as equal to a 31% "front-end" *debt-to-income ("DTI")* ratio. Under the Guidelines, the lenders must first reduce the current interest rates on mortgages down to a 38% front-end DTI. The Treasury will then match further reductions in interest payments, dollar-for-dollar with the lender, down to the 31% DTI target ratio. The reduction in interest rates must be accomplished in increments of 0.125%, to as low as 2% in order to achieve the target 31% DTI. Lenders are required to keep the modified payments in place for five years to ensure long-term affordability. After five years, the payments can increase annually by a rate of 1% until the modified rate is the lesser of the fully indexed contractual rate or the Freddie Mac Primary Mortgage Market Survey rate for 30-year fixed rate conforming loans.

If the reduction of the interest rate to the 2% floor is insufficient to bring the front-end DTI to 31%, then the lender must extend the term of the loan up to 40 years from the date of modification (if a term extension is not permitted, the amortization period must be extended). If the interest rate reduction and the term extension fail to achieve the target 31% DTI, the lender must forbear principal. No interest will accrue on any forbearance amount but the forbearance principal will become due on the first to occur of: (i) the maturity date; (ii) the sale of the property; or (iii) upon payoff of the balance.

Importantly, the Plan also allows, ***but does not require***, lenders to bring down monthly payments to these DTI affordability targets by providing principal reductions (i.e. principal forgiveness). The Plan will provide a partial share of the costs of this principal reduction, up to the amount the lender would have received for an interest rate reduction.

The foregoing modifications are subject to the lenders' determination that modification under the Program is less costly than the process of foreclosing on the loan. ***Each lender is required to apply a Net Present Value ("NPV") test on the loans which compares the NPV of cash flows expected from a modification of the loan to the NPV of cash flows expected in the absence of a loan modification. If the NPV is greater with the modification, the lender must modify the loan. If the NPV is greater without the modification, the lender does not have to participate in the Plan but must seek other foreclosure prevention alternatives including deed-in-lieu of foreclosure or short sale programs.***

**ii. Incentives to Servicers**

The Plan calls for an up-front fee of $1,500 to lenders/investors and $500 to servicers for each eligible modification that meets the Guidelines. Servicers will also receive "pay for success" fees, which will be awarded monthly as long as the borrower stays current on the loan and remains in the Plan. These pay for success fees are capped at $1,000 each year for three years. To qualify for the "pay for success" fees, the modification must satisfy a *de minimis* test where the monthly PITIA payment, as modified, is reduced by 6% or more of the monthly PITIA payment prior to modification.

**iii. Incentives in Cases Where Default is Imminent**

The Plan also includes an incentive payment of $1,500 to mortgage holders and $500 for servicers for loan modifications made in cases where the borrower is current on his or her payments, but is at risk of imminent default. Because the Administration believes it is essential to provide at-risk homeowners with assistance prior to imminent default, the Administration wants to incentivize modifications in these instances.

**iv. Incentives to Borrowers**

The Plan also provides an extra incentive for borrowers to keep current under the modified loan, by giving a monthly balance reduction payment on the borrower's behalf that goes directly towards reducing the principal balance on the modified mortgage loan (the "pay for performance success payment"). *If the borrower stays current on his or her payments, the borrower may receive up to $1,000 each year for five years in principal reductions.* To qualify for the "pay for performance success payment", the modification must satisfy a *de minimis* test where the monthly PITIA payment, as modified, is equal to 6% or more of the monthly PITIA payment prior to modification.

Borrowers are also eligible to receive a payment of $1,500 in relocation expenses in order to effectuate short sales and deeds-in-lieu of foreclosure if they fail to qualify for loan modification under the Plan.

**v. Home Price Decline Reserve Payments**

The Administration, together with the Federal Deposit Insurance Corporation (the "FDIC"), has created a partial guarantee program. *The Plan calls for an insurance fund to be established by the Treasury Department in an amount up to $10 billion dollars.* The insurance fund will be designed to discourage lenders from opting to foreclose on mortgages that could be viable in the present day, due to fear that home prices will fall even more in the future. This fund would incentivize lenders to make additional modifications in the present day by assuring that if home valuations decline more going forward, lenders will have access to insurance reserves. The Plan states that owners of loans that are modified would be provided with an additional insurance payment on each modified loan that will be tied to declines in the S&P/Case-Shiller home price index. These payments could be set aside as reserves, providing a partial guarantee in the event that home price declines, and therefore losses in cases of default, are higher than expected.

**C. Additional Key Points to the Modification Program**

Note that the Plan will focus on creating "sound modifications." *Under the Plan, if the total expected cost of a modification for a lender taking into account the government payments is expected to be* *higher than the direct costs of putting the homeowner through foreclosure, that borrower will not be eligible for modification. Moreover, Treasury will not provide subsidies to reduce interest rates on modified loans to levels below 2%.* Finally, note that unless lenders received funds available under the Financial Stability Plan (announced by the Administration on February 10, 2009), they are not required to participate in the Plan. On April 28, 2009, the Administration announced that twelve servicers, including the five largest, have signed contracts to date to begin loan modifications. Thus, the Plan is being widely implemented. Additionally, pending the results of the forthcoming stress tests, the Treasury Department will require that all Financial Stability Plan fund recipients participate in the Program.

Under the Guidelines, servicers must adhere to any existing express contractual restrictions with respect to modification of loans. ***Significantly, this guidance contrasts sharply with the language under another legislative proposal, H.R. 788, sponsored by Congressman Paul Kanjorski, which would expressly permit servicers to disregard pooling and servicing agreements for purposes of loan modifications.***

**D. Second Lien Modification Program**

The new SLP under the Plan will provide additional help to at-risk borrowers who have more than one lien on their property. The Obama Administration estimates that up to 50 percent of at-risk mortgages have second liens. After evaluating industry concerns that the Plan did not address the issues with existing second liens, the Administration decided to create and implement the SLP under the Plan. The Administration believes that the SLP will help to keep an additional 1 to 1.5 million Americans in their homes by creating an affordable mortgage payment for those borrowers that qualify for the first lien mortgage modification, but still have trouble affording their monthly payments because of the second mortgage.

The SLP will be a corresponding program to the first lien modification program under the Plan, and will automatically modify the borrower's second lien when the first lien is modified. ***For amortizing loans, the Treasury Department will share the cost of reducing the interest rate on the second mortgage to 1 percent***. All participating services will be required to follow these steps in connection with the modification of amortizing second loans: (i) reduce the interest rate to 1 percent; (ii) extend the term of the modified second mortgage to mirror the term of the modified first mortgage; (iii) forbear principal in the same proportion as any principal forbearance on the first mortgage (with the option of extinguishing principal as discussed below); (iv) after five years, step-up the interest rate to the then current interest rate on the modified first mortgage; and (v) then re-amortize the second mortgage over the remaining term at the higher interest rate(s). Investors will receive an incentive payment from Treasury equal to half the difference between: (i) the interest rate on the modified first lien as modified; and (ii) 1 percent (subject to a floor).

***For interest-only loans, the Treasury Department will share the cost of reducing the interest rate on the second mortgage to 2 percent***. All participating services will be required to follow these steps in connection with the modification of amortizing second loans: (i) reduce the interest rate to 2 percent; (ii) forbear principal in the same proportion as any principal forbearance on the first mortgage (with the option of extinguishing principal as discussed below); (iii) after five years, step-up the interest rate to the then current interest rate on the modified first mortgage; and (iv) then amortize the second mortgage over the longer of the remaining term of the modified first lien or the originally scheduled amortization term (with amortization to begin at the time specified in the original contact). Investors will receive an incentive payment from Treasury equal to half the difference between: (i) the lower of the contract rate on the second lien and the interest rate on the first lien as modified; and (ii) 2 percent (subject to a floor).

The SLP will also have a pay for success fee that is similar to the first lien program under the Plan. Under the SLP, servicers can be paid $500 upfront for a successful modification and then future success payments of $250 per year for 3 years, as long as the modified *first lien* remains current. Borrowers are also paid a success fee of up to $250 per year for as many as 5 years. These payments to the borrower get automatically applied to the principal on the first lien in order to help the borrower build equity in the home.

***Further, under the SLP, a lender or investor has an option to writedown principal on the second lien in exchange for an immediate payment from Treasury under a formula developed by Treasury.*** Under the formula, for loans that are more than 180 days delinquent at the time of modification, the lender or investor will be paid 3 cents per dollar of unpaid principal balance extinguished. The below table provides the other applicable formulas *for loans that are less than 180 days past due* depending on the borrowers back-end DTI ratio under the Plan, and the current LTV ratio on the secured property:

| | **Second Lien LTV Range** | | |
|---|---|---|---|
| **Borrower's Back-End DTI** | **< 110** | **110 to 140** | **> 140** |
| **> 55%** | 0.09 | 0.06 | 0.04 |
| **< 55%** | 0.12 | 0.09 | 0.06 |

Note that the SLP will be a voluntary parallel program to the first lien modification program, and servicers can choose not to participate in the SLP. However, if a servicer is participating in the SLP, then when it modifies a borrower's first lien, the second lien will also automatically be modified in accordance with the guidelines set forth above. It is expected that most participating servicers will add-on to the SLP once the participation contracts are available through Treasury. Finally, it is expected that the implementation of the SLP will take roughly 30 days.

**E. Other Salient Aspects of the Plan**

**i. Uniform Guidelines for Loan Modifications**

In connection with the Plan, the Administration will work with the FDIC, the Federal Housing Administration (the "FHA"), the Federal Housing Finance Agency (the "FHFA"), and the federal banking agencies, to develop uniform guidelines for sustainable mortgage modifications for all federal agencies and the private market.

The Guidelines published today reference further uniform guidelines to be published by each agency.

**ii. Bankruptcy Cramdown Provisions**

Importantly, the Plan notes that the Administration will seek careful changes to bankruptcy law regarding individual bankruptcy filings. Under the changes the Administration feels are necessary, when an individual enters personal bankruptcy proceedings, their mortgage loans in excess of the current value of their property would be treated as unsecured debt. This change would allow a bankruptcy judge to develop an affordable plan for the homeowner to continue making payments. The Plan seeks to permit bankruptcy judges to modify mortgages originated in the past few years as a last resort when borrowers have exhausted other options. The Plan states that this "cramdown provision" will apply only to existing mortgages under Fannie Mae and Freddie Mac conforming loan limits.

***Please note that the Obama Administration's more measured approach to bankruptcy cramdown legislation is at odds with Congressional Democrats' more aggressive stance on the issue. For example, Senator Richard Durbin (D-IL) is currently proposing an aggressive bankruptcy cramdown amendment to S.B. 896, the Helping Families Save Their Homes Act of 2009, that is expected to be on the Senate Floor later this week.***

**iii. Oversight and Quarterly Meetings**

Loan-level data from modifications made under the Plan will be gathered in order for the government and the private sector to measure success and make necessary changes, where required. To this end, the Treasury Department will meet quarterly with the FDIC, the Federal Reserve, HUD, and the FHFA, to ensure that the Plan is on track to meeting its goals.

**iv. HOPE for Homeowners and Local Programs**

Upon the announcement of the Plan on February 18, 2009, the Administration stated that it would be a goal to increase the utility of the HOPE Program. The Administration stated that in order to ensure that more borrowers participate in the HOPE Program, it would seek changes legislative changes to allow the FHA to reduce fees paid by borrowers, increase flexibility for lenders to modify troubled loans, permit borrowers with higher DTIs to qualify, and allow payments to servicers of the existing loans. In addition at the outset of the Plan, the Administration stated that as part of the American Recovery and Reinvestment Act (the "Recovery Act") signed by the President on February 17, 2009, HUD will award $2 billion in competitive Neighborhood Stabilization Program grants for innovative programs that reduce foreclosure. The Recovery Act also includes an additional $1.5 billion to provide renter assistance, reducing homelessness and avoiding entry into shelters.

***The new initiative announced by the Obama Administration on April 28, 2009, provides a framework for the HOPE Program to be directly incorporated into the Plan.*** According to the new details, when a borrower is being evaluated for a trial modification under the Plan, ***the servicer will be required to evaluate the borrower for a HOPE Program refinance and to offer the refinancing opportunity to the borrower if they qualify.*** In circumstances where the servicer determines that the borrower qualifies for the HOPE Program refinance***, the servicer is required to offer the refinance at the same time as the trial modification offer.*** Servicers and lenders who refinance borrowers into HOPE Program loans will also receive pay for success fees similar to the other incentive payments under the Plan. Servicers can receive a $2,500 upfront incentive payment for a successful HOPE Program refinance. Further, lenders who originate new HOPE Program refinances are eligible for success fees of up to $1,000 per year for up to 3 years as long as the refinanced loan remains current. Note that these pay-for-success fees are only eligible to participants in the Plan, and not other lenders who solely make HOPE Program refinances.

The HOPE Program requires that the holder of the current lien accept the proceeds of the new insured loan as full payment. Thus, the investor typically must writedown principal in order to allow a HOPE Program refinance. By adding the HOPE Program to the Plan, the Administration is assuming that some investors will want to take the loss today for some guaranteed amount of principal, instead of entering into an extended modification with the borrower.

The Administration also announced on April 28, 2009, that either the Treasury Department or the GSEs will purchase special HOPE Program Ginnie Mae IIs wrapped by the GSEs. The goal of these purchases is to increase liquidity in the secondary market for new HOPE Program loans. The Administration also indicated that it will continue to push for legislative reform of the HOPE Program that will enable FHA to reduce fees paid by borrowers, increase flexibility for lenders, permit borrowers with higher DTI to qualify, and strengthen and enhance the HOPE Program overall. A large part of any success of the HOPE Program's integration into the Plan depends on the overhaul of the current HOPE Program requirements that have only successfully refinanced less than 100 borrowers to date.

**III. Strengthening Fannie Mae and Freddie Mac**

The third part of the Plan provides more strength and resources to Fannie Mae and Freddie Mac. The Plan announced that the Treasury Department is increasing its Preferred Stock Purchase Agreements with Fannie Mae and Freddie Mac to $200 billion each from their original level of $100 billion each. The Treasury Department notes that it will also continue to purchase Fannie Mae and Freddie Mac mortgage-backed securities to promote stability and liquidity in the marketplace. Simultaneously, the Treasury will begin increasing the size of the GSEs' retained mortgage portfolios by $50 billion to $900 billion (along with corresponding increases in the allowable debt outstanding). The Administration will work with Fannie Mae and Freddie Mac to support state housing finance agencies in serving homebuyers across the nation on the state-level. *Finally, the Administrations emphasizes that the $200 billion in funding commitments are being made under the Housing and Economic Recovery Act and do not use any money from the Financial Stability Plan or the Emergency Economic Stabilization Act or the TARP programs.*

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We will continue to keep you apprised of any further developments as they unfold.

Please contact Stephen Ornstein, Matthew Yoon, John Holahan, or Roy G. Locke, Jr. at (202) 408-6400 if you have any questions regarding this alert.

1. Loans with principal balances exceeding the Fannie Mae and Freddie Mac conforming loan limits are not eligible for refinance under the Plan. Under the Guidelines, such loan limit is set at $729,750 for a single family residence.
2. Loans with principal balances exceeding the Fannie Mae and Freddie Mac conforming loan limits are not eligible for modification under the Program. Under the Guidelines, such loan limits range from $729,750 for a single family residence to $1.4mm on a four unit residence. Loans on multi-unit residences are eligible for modification provided that the borrower's primary residence is in one of the units.
3. "Underwater" means borrowers who have a combined mortgage balance higher than the current market value of their house.
4. The front-end ratio is the ratio of monthly principal, interest, taxes insurance and association fees ("PITIA") to Monthly Gross Income. Mortgage insurance premiums are excluded from the PITIA calculation.
5. This rate step-up is subject to the Interest Rate Cap on the first lien, set equal to the Freddie Mac Survey Rate.
6. This rate step-up is subject to the Interest Rate Cap on the first lien, set equal to the Freddie Mac Survey Rate.