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California's Proposed Mortgage Modification Program – Updated

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This article updates our recent article regarding California Governor Arnold Schwarzenegger's legislative proposal to stem foreclosures in the state by incentivizing lenders to offer "comprehensive" loan modification programs. The Governor's bill, ABX 4, was introduced in the State Assembly on November 13, 2008. Although the proposal is limited to California, it could serve as a model for similar legislation by other states and the U.S. Congress.

As introduced, the California bill continues to use a "carrot and stick" approach. The "stick" is a mandatory 120-day moratorium on foreclosures (up from 90 days in the Governor's original proposal), applicable to certain first lien mortgages on owner-occupied primary residences as to which a notice of default has been filed. The specific types of first lien mortgages to which the moratorium applies are "higher cost loans," as defined in Federal Reserve Regulation Z, and "nontraditional loans," as defined in the Guidance on Nontraditional Mortgage Product Risks published on October 4, 2006. The reference to "higher cost loans" creates an ambiguity because Regulation Z does not use that term. The California bill may be referring to Section 226.35 of Regulation Z, which defines and governs "higher-priced mortgage loans," however this section will not be effective until October 1, 2009. If the California bill is, in fact, referring to "higher-priced mortgage loans," note that these loans have a relatively low threshold (*i.e.,* for a first lien mortgage, an APR that is 1.5% or more above the average prime offer rate published by the Federal Reserve Board, which is not a rate that has yet been published by the Federal Reserve). The reference to "nontraditional loans" includes, among others, interest-only mortgage loans, hybrid loan programs involving both interest-only and fully amortizing features, and payment-option adjustable rate mortgages.

The "carrot" offered by the California bill is an exception to the 120-day moratorium, but this exception will be available only if the Secretary of Business, Transportation, and Housing ("Secretary") issues an appropriate order. The Secretary will issue an order only if the servicer provides evidence that it has implemented a "comprehensive" modification program.

To be "comprehensive," the modification program must have three features. First, it must be intended to keep borrowers in their homes where doing so represents a positive net present value to the investor (or investors) in the mortgages as compared with foreclosures. Second, it must require the servicer to solve for a housing related debt-to-monthly income ratio of 38%. Third, the 38% figure can only be achieved by all or some combination of reducing the interest rate for at least five years, extending the amortization period for the loan to 40 years from the original date, deferral of principal until maturity of the loan, replacing any negative amortization feature with full amortization over 30 years, eliminating any second lien with a principal write down to a 90% loan-to value ratio, reducing the principal on the loan, and other factors approved by the Secretary. For purposes of the 38% ratio, the borrower's housing related debts include principal, interest, property taxes, and insurance payments.

A servicer with a "comprehensive" modification program must submit evidence to the Secretary, who will consult with the Commissioner of the Department of Corporations, Commissioner of the Department of Financial Institutions, and the Commissioner of the Department of Real Estate. If the Secretary agrees that the servicer's loan modification program is comprehensive, he will issue an order, which will allow the servicer to avoid the new 120-day moratorium in the foreclosure process. The California bill would empower the Secretary to issue necessary regulations to clarify the application of the law. The regulations are to provide a formula to apply to payments made by the borrower during the 120-day delay, as well as the manner for the servicer to deal with loans owned by investors who do not consent to loan modification.

The California bill also requires the Secretary to make periodic reports to the legislature on actions taken to implement the law, including data regarding loan modifications accomplished in accordance with the new law. The first report is due 45 days after the first exemption is granted under the new law, and subsequent reports are due every three months thereafter. The California bill states that the new law will remain in place until January 1, 2013, after which it will be repealed, unless that date is deleted or extended by subsequent legislation.

It remains to be seen whether the legislation will be enacted, how much of the proposal will survive the legislative process, and how many servicers will be willing to adopt a comprehensive modification program in return for the avoidance of a 120-day delay in the foreclosure process. If the program is successful, its “carrot and stick” approach may become a model for other states and the federal government. Some elements of the proposal, in particular the 38% ratio, are similar to the program that the FDIC has implemented for mortgage borrowers at IndyMac Federal Bank.

The proposal leaves many questions unanswered, including:

- If a servicer services loans for multiple investors, must the servicer’s comprehensive modification program be put into place for all of its investors’ loans, or only for the investors holding the particular loans that would otherwise be subject to the new 120-day delay in the foreclosure process?
- What impact will the legislation have on national banks, federal savings banks and their respective operating subsidiaries? Can these institutions avoid the new law by use of the federal preemption doctrine? Is there an enforceable legal basis to require these federal institutions to seek an order from a state regulator? If the new law is preempted, will it be preempted based upon the federal status of the owner of the loan or the federal status of the servicer of the loan?
- How will the proposal apply in the case of a borrower who refuses to communicate with the servicer, let alone sign a modification agreement?
- What standards will the Secretary use to determine if a servicer’s modification program is sufficiently comprehensive?
- The servicer’s modification program must be intended to keep borrowers in their homes where doing so represents a positive net present value to the investor or investors as compared with foreclosure. But, how will the net present value be determined, and what numerical assumptions will be employed to calculate the net present value?