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California's New Foreclosure Prevention Act Signed Into Law: Impact To Be Determined

Lauren Spiegel

As an add-on to the California budget package, Governor Arnold Schwarzenegger signed into law a 90-day moratorium on home foreclosures. This new law, which will become effective on May 22, 2009, requires that lenders wait an additional 90 days from the date of filing of a notice of default before the trustee can give notice of sale in a non-judicial foreclosure. Currently, lenders have to wait three months from the filing of a notice of default before providing the notice of sale, so this law, in effect, creates a six-month waiting period. This extended waiting period is intended to encourage lenders to work with their borrowers and enter into loan modifications. However, whether this aim will be achieved, and even whether this moratorium will apply in a significant number of foreclosures, remains to be seen since there are a number of requirements in the bill that must be satisfied for the moratorium to apply.

The moratorium applies only if:

(1) the loan in question is a first lien loan (though it need not be a purchase money loan);

(2) the loan was recorded against residential real property between January 1, 2003 and January 1, 2008, inclusive;

(3) the borrower occupied the property as the borrower's principal residence at the time the loan became delinquent;

(4) the loan is serviced by a loan servicer that has ***not*** implemented a "comprehensive loan modification program";

(5) the loan is ***not*** made, purchased or serviced by a California state or local public housing agency or authority and

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the loan is ***not*** collateral for securities purchased by any such agency;

(6) imposing such moratorium will not "require a servicer to violate contractual agreements for investor-owned loans;"

(7) the borrower has not surrendered the property, as evidenced by a letter confirming surrender or the delivery of keys to the lender;

(8) the borrower is not currently in bankruptcy; and

(9) the borrower has not contracted with "an organization, person or entity whose primary business is advising people who have decided to leave their homes regarding how to extend the foreclosure process and avoid their contractual obligations to mortgagees or beneficiaries."

Critics of the bill, who believe that it will not lead to enough loan modifications or prevent foreclosures, point to requirement (4) as a loophole. Any loan servicer that has implemented a comprehensive loan modification program does not have to comply with the 90-day delay on foreclosures. Such a modification program must (a) be intended to keep borrowers whose principal residences are homes located in California in those homes when the anticipated recovery under the loan modification or workout plan exceeds the anticipated recovery through foreclosure on a net present value basis, (b) target a ratio of the borrower's housing-related debt to borrower's gross income of 38% or less, on an aggregate basis in the program and (c) provide some combination of interest rate reductions, extensions of amortization periods, principal deferrals, reductions of principal and compliance with a federally mandated loan modification program.

The critics are correct in that any servicer worth its salt should be able to obtain an exemption under this bill by demonstrating that it has a loan modification program in place (though the actual regulations with respect to obtaining an exemption need not be issued until the beginning of June). The requirements are less stringent than those proposed by President Obama in which loan modifications would reduce payments to no more than 31% of a borrower's income. Also, under Obama's proposed housing plan, servicers are incentivized to implement a loan modification program since they will receive $1,000 for each modified mortgage (with an additional $500 for mortgages modified before the borrower misses a payment) and $3,000 over the next three years if the borrower successfully makes payments on the modified

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Beyond these payments from the federal government, servicers are already incentivized to enter into loan modifications where the anticipated recovery exceeds the recovery through foreclosure on a net present value basis. If the servicer is also the lender, then by definition it is recovering more through such a modification so that it would be motivated to pursue the modification instead of foreclosure. If the servicer is just the servicer (and not also the owner of the loan), then it also benefist through modification since is able to continue servicing the loan and receiving servicing fees. If the loan is foreclosed upon, there is no more loan to service and no more servicing fees.

The crux of the issue is not the speed of the foreclosure process (which, even without the 90-day moratorium in this bill, already takes at least 141 days from notice of default until sale) or servicers having no interest in loan modifications. The real bugbear is alluded to in requirement (6) above.

Requirement (6) is taken from Section 2923.53(i) of the new law, which Section provides that nothing in the new law "shall require a servicer to violate contractual agreements for investor-owned loans or provide a modification to a borrower who is not willing or able to pay under the modification."

Servicers simply do not have the ability to enter into loan modifications in many instances since they are often not the lender. As recognized by the Senate's legislative history for the bill, "[t]he take-off of the mortgage industry over the last decade was the product of the securitization process." If the loans are securitized, the documents vary widely regarding the servicer's right to enter into modifications with some documents prohibiting modifications, some documents containing vague language, some documents allowing modifications only with the consent of parties (such as insurers, master servicers and trustees) who are reluctant to provide consents, and some documents only allowing modifications to a certain percentage of loans in a pool. If the documents do allow for modifications, in order to comply with the rules governing Real Estate Mortgage Investment Conduits (or "REMIC's" which are the typical structure for securitization of residential mortgages in the United States), the servicer cannot enter into a modification unless the borrower is in default or default is imminent. So, in many instances, even if the servicer believes that a loan modification would be the most beneficial route, it cannot enter into a modification since it does not have the right to do so under the securitization documents or because there is a junior lender whose consent is required and not forthcoming.

The other issue raised by Section 2923.53(i) is that some borrowers simply cannot afford the cost of the house they are in (even with a loan modification that would bring the lender's recovery in line with what it would recover through foreclosure) or are so under water that they are not willing to make the payments even on a modified mortgage. Under the new bill, servicers are not being forced to make modifications in these instances even if they have the authority to do so.

As noted in requirement (5), California state and local housing agencies are required to comply with the provisions of the new bill since the state legislature has completely exempted loans in which they are the lender or hold an interest.

Whether this 90-day moratorium or the incentive provided by the bill for servicers to implement loan modification programs (or at least report on the existence of one to state regulators) will increase the number of modifications, despite the obstacles discussed above, remains to be seen. The state legislature hopes it will be seen via the web. One interesting aspect of the new law is that "within existing resources," the state regulators will collect from servicers data regarding loan modifications and make that data available on a website at least quarterly.

Before you run to open a new browser window, keep in mind that the loan modification website is not up and running just yet. Although the bill (introduced by Senator Ellen Corbett, D-San Leandro and Assembly Member Ted W. Lieu, D-Torrance) was signed into law on February 20th, it does not become effective until May 22, 2009. Once it becomes effective, state regulators have ten days to issue regulations explaining how lenders can apply for their exemption from the moratorium by showing that they have a loan modification program in effect. Once those regulations have been issued, the moratorium goes into effect 14 days later with respect to those loan servicers who have not applied for an exemption. If a loan servicer has applied for an exemption, it is temporarily exempt until either (a) its application is approved, in which case it is exempt until and unless its exemption is revoked due to a finding that its application was materially false or misleading or there is a material change in its loan modification program or (b) its application is denied, in which case it is exempt for 30 additional days after the date of denial.

The law will sunset on January 1, 2011.

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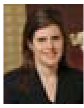

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