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Salvage Plan

Beleaguered homeowners hope the administration's new program will break the logjam over mortgage loan workouts

May 2009 Issue

By Steven Seidenberg

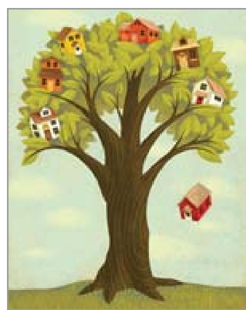

Illustration by Glorie Forliti

Note: Register for this month's CLE, "A New Landscape in Real Estate Law," from 1-2 p.m. ET on Wednesday, May 20.

Sharan and Stephen Powers want to pay the mortgage on their home in Fairfax, Va., a suburb of Washington, D.C. But like so many other homeowners around the country, they've run into some problems.

Stephen fell ill in July 2006. After two different surgeries, he returned to work as soon as he could—but his income as a salesman took a big hit. Then in 2007, a reorganization at his company cost him many of his most profitable accounts. To make ends meet, Stephen, then 50, took a second job at Best Buy.

It wasn't enough. The Powerses couldn't keep up with their mortgage payments. So in May 2007 they reached an agreement with their lender, SunTrust Banks, to modify their loan. But that only made matters worse. To account for accrued late fees, their mortgage payments actually increased by several hundred dollars, to more than $3,800 per month.

It didn't take long before the Powerses were once again behind in their payments. They've been trying for more than a year to reach a new deal with SunTrust. "I have a file 6 or 8 inches thick, with records of all the people I've talked to—all the letters, notes, legal papers," says Sharan Powers. "My attorney says I'm qualified to stay in my home. The credit counseling people say I'm qualified."

But no deal is materializing.

"For Sharan Powers, I called and e-mailed and finally got in touch with a consumer specialist at the bank, and then I never heard back from him. Nothing," says Nancy Ryan, a sole practitioner in Fairfax."It is almost impossible to get anyone on the telephone," says Ryan, voicing a complaint that is echoed by homeowners and their attorneys throughout the United States amid the continuing crisis in the real estate market. "I've tried to modify loans by sending big packets of information through the mail, by sending documents via e-mail and fax, but I've never been able to modify any loans. I feel like I'm sending the information into a big, black hole. It's a very frustrating process."

For the Powerses, it's more than just frustrating. It's frightening. "I'm worried that I may come back home one day and find a padlock on my front door," Sharan says.

DOUBLE TROUBLE

Some 3.3 million homes went into foreclosure during 2007 and 2008—accounting for about 5 percent of the mortgage loans in the United States.

Things are expected to get worse. Industry experts say they wouldn't be surprised to see more than 3 million homes go into foreclosure during 2009. Credit Suisse, an international financial services firm, projects that some 8.1 million homes—16 percent of all residential mortgages—will go through foreclosure during the next four years.

"America is in the midst of a home foreclosure catastrophe, unprecedented since the Great Depression," concluded the Congressional Oversight Panel in a March 6 report (PDF) addressing the foreclosure crisis. Congress created the panel in October to oversee the Treasury Department's distribution of funds under the Troubled Asset Relief Program.

"The foreclosure problem has grown so large that it threatens the entire economy," the panel states bluntly in its report.

Two programs introduced after the real estate crisis began did little to help homeowners avoid foreclosure.

The Hope Now program created in October 2007 is essentially a private initiative by lenders to keep people in their homes. The program reported that participating lenders modified 2.9 million loans between July 2007 and November 2008. But a report (PDF) issued in September by the State Foreclosure Prevention Working Group, a coalition of the Conference of State Bank Supervisors and attorneys general from 37 states, noted that only 20 percent of seriously delinquent borrowers were in the process of obtaining loan modifications.

Most of the loan modifications that did go through were of little help to homeowners. Fewer than 20 percent of the modifications actually reduced monthly mortgage payments, according to a report (PDF) issued in January by the Center for Responsible Lending, an advocacy group in Durham, N.C., that targets abusive financial practices. And the Congressional Oversight Panel notes in its March report that 63 percent of the loan workouts under Hope Now merely permit repayment of arrearages over time, and do not affect the terms of the loan going forward.

LEANING ON LENDERS

On Oct. 1, the bush administration unveiled a government program called Hope for Homeowners that encourages lenders to modify delinquent home loans.

Under the program, participating lenders agree to replace delinquent

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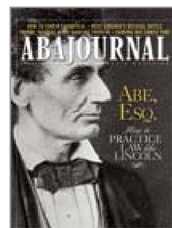

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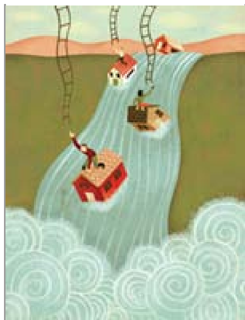
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mortgages with new loans that cut the principal to 90 percent of a house's current market value—which would usually be well below the original loan amount. The Federal Housing Administration insures the loans and administers the entire program.

Hope for Homeowners has been a colossal failure, modifying one solitary loan to date. Many major mortgage lenders are avoiding the program because they don't want to make big cuts in loan principal. The program also is unpopular with borrowers because of the conditions it imposes on them. One of the most onerous requirements would make a homeowner give the government half of any profits from a sale.

Now the question is whether the new Making Home Affordable plan introduced by the Obama administration will be any more effective in creating more loan restructurings and fewer foreclosures. The details of the plan (PDF) were released by the Treasury Department on March 4.

The plan offers a new program to modify loans. Fannie Mae, Freddie Mac and mortgage companies that receive TARP funds are required to participate in this program, but the administration hopes to lure others into participating by offering them financial incentives to modify loans. The government has issued guidelines for modifying loans under the program.

The Obama plan also provides a new program to refinance loans at current low interest rates. This program requires Fannie Mae and Freddie Mac, the mortgage finance companies created by Congress and now controlled directly by the government, to provide refinancing for some of the mortgages they own or have securitized.

The administration claims that between them, the two programs could help as many as 9 million homeowners.

Some experts aren't convinced the programs will meet expectations. They point out that the loan modification program is not mandatory for all loan-servicing companies, and that many homeowners facing foreclosure won't qualify to participate in either the loan modification or the refinancing schemes.

Still, many expect the programs to be more effective than previous efforts at encouraging lenders to help homeowners avoid foreclosure.

"After accounting for the costs of foreclosure and the lower prices foreclosure auctions bring, the lenders will lose an average of $60,000 per foreclosure and recover far less than the market value of the homes," the Congressional Oversight Panel states in its report on the foreclosure crisis.

Modifying home loans to reflect the properties' current value would allow millions of people to stay in their homes and give lenders a greater financial return than foreclosure, the report concludes.

Despite the benefits, however, financial services companies have been extremely cautious about re-structuring loans. "Creditors are too conservative in the type of relief they are offering, which is why so many debtors re-default," says Jason J. Kilborn, a professor at the John Marshall Law School in Chicago.

That caution is largely a byproduct of the mortgage lending structure that developed over the past several years and eventually caused the housing market to collapse. These are some of the key factors:

• *Securitization*. In the good old days, there were just two parties to a home loan: the borrower and the lender. Now, that is relatively rare. More than 66 percent of the residential mortgages originated since 2001 have been securitized. In short, these loans were bundled together and sold to a special purpose entity, usually a pooled trust. The trust paid for the loans by issuing bonds, which were backed by the underlying mortgages. These residential mortgage-backed securities usually were sold in slices, called tranches, with securities in each tranche having a different risk level.

So-called senior tranches could receive investment-grade ratings, which allowed them to be purchased by pension funds and other major institutional investors. The riskier tranches, however, were re-securitized and sold as collateralized debt obligations. The assets backing each CDO were the mortgage-backed securities, not the underlying mortgages. The process could be repeated again and again as riskier tranches were re-securitized into more and more pieces, each one further away from the original loan that helped someone finance a house purchase.

This securitization process greatly complicated homeowners' efforts to negotiate loan modifications. "No one can tell who owned these things because the loans were parceled out to many different owners," says Marc S. Stern, a Seattle attorney who serves on the council of the ABA's General Practice, Solo and Small Firm Division. "So if you want to talk to a lender and rationally discuss [loan modification], there is no one on the other end of the phone to answer."

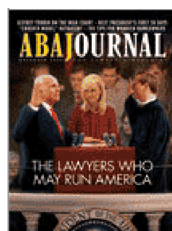
• *Overwhelmed servicers*. A trust may own thousands of securitized loans, but it doesn't collect loan payments or otherwise manage those loans. Those duties are performed by a loan servicer. But because servicers are organized to handle the routine, highly automated aspects of loan administration, such as processing loan payments, most of these companies have relatively few employees who are trained to handle the complex, time-consuming work of loan modifications. And those employees have been swamped by the huge number of people seeking modifications.

"You go through hours on phone lines," Stern says. "When you get through to someone, they don't have authority to do anything. The person is just an intake clerk. By the time you get to someone in authority, you're already in foreclosure."

• *Servicers' self-interest*. Companies that service loans have little reason to be accommodating when a homeowner seeks a loan modification. Negotiating a modification is time-consuming and, if it results in lower monthly payments, the servicer receives less money. Foreclosure, by contrast, means extra money for a servicer because it can tack on a variety of extra charges, such as late fees, inspection fees and process-serving fees. These charges can be considerable, and they are paid off the top from foreclosure recoveries. So while the holders of mortgage-backed securities incur the losses from foreclosures, servicers profit by them.

• *Contract limits*. The contracts between trusts and loan servicers are far from uniform, and the terms can prevent or significantly hamper a servicer's ability to modify loans. Some contracts forbid any modification of loans, while others allow only the interest rate to be modified. Some contracts cap the percentage of a trust's loans that can be modified; others put a ceiling on the permissible number of modifications per year—the list goes on and on.

• *Fear of litigation*. Even if a servicer's contract with a trust permits extensive loan modifications, the servicer may hesitate to make them, fearing that any loan modifications would invite a lawsuit by the



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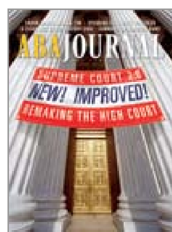

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holders of CDOs. The problem is that servicers are bound by contract to manage their loans for the benefit of the holders—and when it comes to modification, the holders of different tranches have opposing interests. Holders of the highest-rated securities would benefit from loan modifications, which increase the likelihood that they would be paid in full. Holders of the riskiest securities, however, would find their interests wiped out by modification. "It's tranche warfare," notes Kilborn.

• *Second mortgages*. Many homeowners seeking to modify their home loans have more than one mortgage on the property. If a first mortgage is modified, the benefit goes to the owner of the second mortgage; reducing the payment on the first mortgage leaves the borrower with more resources to pay the second mortgage. The first mortgage holder is thus unlikely to agree to modification unless the second mortgage holder waives its rights. But such a waiver probably would cause the second mortgage holder to face a 100 percent loss. Thus, a second mortgage holder does better financially by refusing to cooperate with modifications on the first mortgage and hoping the borrower makes a few more payments on the second mortgage before falling into foreclosure.

HOW TO IMPROVE THE ODDS

In the face of all these barriers, there aren't a lot of easy answers for lawyers representing homeowners who are seeking a loan modification. But experienced practitioners have a few suggestions on how to push the odds a little more in the homeowner's favor.

"The most important thing is for the attorney to do a detailed analysis of the client's assets and liabilities," says Jaime Lathrop, a sole practitioner who heads the Foreclosure Intervention Program at the Brooklyn Bar Association in New York. "Look at the client's tax returns and W-2s. Almost every lender requires a detailed financial analysis to ensure the loan modification will be successful and the borrower won't be back in the same position soon after the loan is modified."

A lawyer also should try to determine a house's current value, either by hiring an appraiser or by getting an informal valuation through websites such as Trulia, Zillow or PropertyShark.com, says Lathrop. Because this can show how little the house might fetch in a foreclosure sale, "it can provide a compelling argument to a servicer for keeping the borrower in his or her home," he says. "My personal favorite is PropertyShark.com because it gives an appraisal on the more modest end of the scale, and it provides comparable home sale prices, including foreclosure sale prices."

A lawyer can bolster the argument to let the borrower stay in the house by preparing a detailed present-value analysis of modifying the loan versus foreclosure. "Determine the total amount the lender will receive in 30 years, discounted for inflation, and compare that with what the lender would receive in foreclosure minus costs," Lathrop says. If the numbers show that the lender stands to recover more from a modified loan than from foreclosure, it may be more willing to agree to the modification.

Counsel also should check existing loan documents to see if they might violate any consumer protection laws. Since a violation could prevent the lender from foreclosing and expose it to possible penalties, a violation may give the borrower "leverage to get the loan modified," says Kurt James, who chairs the affordable housing and community development practice group at Rackemann, Sawyer & Brewster in Boston.

In addition, James says, the attorney should attend the closing to review the loan documents and make sure the borrower understands them.

THE MOD (AND REFI) SQUAD

The Obama administration's Making Home Affordable plan targets many of the obstacles to loan modification and refinancings.

The modification program—which the administration says will cost some $75 billion—covers only owner-occupied primary residences. The first mortgage must have an unpaid principal of no more than $729,750, not including any capitalization of arrearages for items such as accrued interest, past-due real estate taxes and escrow advances. (Higher limits apply for owner-occupied properties with two to four units.) The mortgage must have originated on or before Jan. 1, 2009.

Homeowners who meet those criteria may seek a loan modification if they are in default or in imminent danger of going into default. But an applicant for modification also must pass a net-present-value test, which compares the NPV of the current loan to what it would be if the loan were modified by reducing the interest rate (and possibly extending the loan term).

If the NPV of a modified loan exceeds that of the nonmodified loan, then the loan must be modified—if it is owned or serviced by Fannie Mae, Freddie Mac or a financial institution receiving federal assistance funds. (For servicers, that obligation may be nullified by agreements with trust shareholders.) Private lenders that don't receive any government bailouts do not need to modify the loans, although the federal government will strongly encourage these lenders to do so.

The program's goal is to reduce a homeowner's monthly mortgage payment to no more than 31 percent of the homeowner's gross monthly income. To reach this 31 percent ceiling, the interest rate is cut to as little as 2 percent. If that doesn't reach the target, the lender need not modify the loan.

There are provisions in the program to soften the blow for lenders. First, the lower interest rates for modified loans only must remain in effect for five years. After that, the interest rate can rise up to 1 percent per year until it reaches the lesser of the rate of the original loan or the rate for 30-year fixed-rate mortgages measured by the Freddie Mac Primary Mortgage Market Survey as of the date that the modification goes through.

Moreover, the program doesn't require lenders to bear the full financial brunt of loan modifications.

The Treasury Department will cover half the cost that a lender incurs by reducing the homeowner's payments from 38 percent of gross monthly income to 31 percent. These government payments continue for up to five years. A lender also receives an additional $1,500 if the loan is modified before the homeowner goes into default.

The program also gives servicers a financial incentive to modify loans. The Treasury Department will pay a servicer an upfront fee of $1,000 for each modification it makes under the program, plus an additional $500 if the modification is made while the homeowner still is current on the original loan.

In addition, the servicer gets an annual "pay-for-performance success payment" of up to $1,000 per year if the modification reduces the monthly loan payment by at least 6 percent and the borrower remains current on payments under the modified loan. Success payments end after three years.

The program rewards struggling homeowners who seek to restructure mortgages. A participating homeowner receives $1,500 for modifying a loan before falling behind in payments. If the modification reduces monthly payments by at least 6 percent and the homeowner keeps up payments under the modified loan, the government forks over an additional amount equal to half the reduction in the borrower's monthly payment—up to a maximum of $1,000 per year. This payment, available for up to the first five years of the modified loan's term, directly reduces the principal balance of the loan.

The plan includes provisions to resolve those pesky second mortgages. The government will pay servicers for negotiating with junior lien holders to extinguish their loans. For each second loan that is wiped out, the servicer receives $250 and reimbursement for the release pursuant to a schedule set by the Treasury Department.

The refinancing portion of the Making Home Affordable program is limited to those mortgages owned or securitized by Fannie Mae or Freddie Mac. Additional requirements are that a mortgage may not exceed 105 percent of the home's present value, and the homeowner must earn sufficient income to make the payments under the refinanced loan. The borrower also must have been current on most past mortgage payments.

BUT WILL IT WORK?

Time will tell whether the obama programs will work any better than their predecessors. But there already are concerns.

One major concern is that many homeowners are in too dire straits to qualify for rescue under these programs.

"Almost all of the houses in our area are below the underwater limit," says sole practitioner Ryan. "In my area—northern Virginia—the vast majority of people won't be eligible for help."

Many homeowners won't qualify for the administration's loan modification plan because they can't meet the NPV test. And even if the NPV test is met, many private lenders and servicers aren't required to participate in the plan.

While the Treasury Department has stated that it will work with regulators at the federal and state levels to encourage voluntary participation by lenders and servicers that don't receive TARP funds, the March report issued by the Congressional Oversight Panel cautions, "It is unclear how the federal regulators will enforce these new standards industrywide to reach the needed level of participation."

Another barrier to voluntary participation by servicers may be the fear of being sued by CDO owners concerned that their investments are being undermined by widespread mortgage restructurings and refinancings. "Safe harbor" legislation has been introduced in Congress, but it has not progressed very far.

And then there is the concern that it simply may be too late for the program to save a lot of homeowners from foreclosure.

Sharan and Stephen Powers fear that may be the case with their mortgage. "I talk at least once a week to someone in loss prevention to let them know I'm willing to do a workout," Sharan Powers says. "Sun-Trust says that because everything is so new, they don't yet have modification programs in place under the Obama plan."

But many lawyers in the field see the plan as a good first step.

"Obama's loan modification plan will take care of folks whose teaser rate went up or who can't refinance because of falling home values," says Boston lawyer James. "It will help some folks, but it's not intended as a solution for everyone."

That's why the administration has asked Congress to adopt legislation that would allow homeowners to modify their mortgage loans under Chapter 13 of the U.S. Bankruptcy Code. In effect, the legislation would allow bankruptcy judges to modify the key terms of mortgages.

A version of the legislation passed the House of Representatives in March, but its outlook in the Senate is uncertain. The measure is strongly opposed by lenders, but lawyers who represent homeowners are rooting for it. "We're all eagerly awaiting the proposed change to Chapter 13," says Karen Maxcy, an attorney with the Wagoner Bankruptcy Group in Kansas City, Mo. "That would help a ton of people."

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