DechertOnPoint

February 2009 / Issue 14

A legal update from Dechert's Finance and Real Estate Group

Homeowner Affordability and Stability Plan and Bankruptcy Cram-Down Legislation

President Obama announced his Homeowner Affordability and Stability Plan[1] (the "Plan") in an address[2] on Wednesday, February 18, 2009. The Plan aims to: (i) expand low rate refinancing eligibility for homeowners with mortgages held or guaranteed by Fannie Mae or Freddie Mac; (ii) create new incentives for lenders to cooperate with borrowers in modifying the terms of loans that are at risk of default and/or foreclosure; (iii) maintain mortgage rates at low levels to encourage the issuance of new mortgages; (iv) implement a wide range of reforms to avoid foreclosures and homeowner displacement. The Obama administration has identified loan modifications to be a crucial component of federal assistance for borrowers who are currently delinquent on their mortgage loan payments or are at risk for delinquency. The Plan supports the passage of legislation that would enable bankruptcy judges to modify homeowners' mortgage loans in a procedure that is commonly referred to as a "cram-down." In this issue, we examine key elements of the Plan as well as certain bills recently introduced in the U.S. House of Representatives (the "House") that permit bankruptcy cram-downs (the "cram-down legislation"). The Plan and the cram-down legislation serve to supplement existing efforts of the Obama administration to stabilize the economy under the American Recovery and Revitalization Act (aimed at decreasing unemployment rates) and the Financial Stability Plan ("FSP") (aimed at increasing access to credit).

1 For additional information on the Plan, see the Treasury's Homeowner Affordability and Stability Plan Fact Sheet, available at: www.treas.gov/initiatives/eesa/homeowner-affordability-plan/FactSheet.pdf.

2 *Remarks by the President on the Mortgage Crisis*, available at: www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-the-mortgage-crisis/.

Homeowner Affordability and Stability Plan

The Plan's first initiative is directed at providing access to low-cost refinancing for responsible homeowners who have been impacted by falling real estate values. This initiative serves to expand eligibility requirements for refinancing for homeowners who have made timely payments on their mortgages, but may not be eligible for refinancing because they owe more than 80% of the value of their homes. To this aim, the Federal Housing Finance Agency (the "FHFA") announced on February 20, 2009 the "Fannie Mae and Freddie Mac Refinance Initiatives" to assist homeowners with high current loan-to-value ratio mortgage loans. These initiatives will make refinancing available to homeowners with mortgage loans held or guaranteed by Freddie Mac or Fannie Mae with current loan-to-value ratios of up to 105%.[3]

The second piece of the Plan (the "stability initiative") is a multi-part strategy aimed at (i)

3 Additional information is available at: www.fhfa.gov/webfiles/1257/FNFRERefiInitiatives22009.pdf.

Dechert LLP

providing housing stability, (ii) providing clear and consistent guidelines for loan modification (including a requirement that FSP recipients use these guidelines for loan modifications), (iii) allowing judicial modifications of home mortgages during bankruptcy, (iv) strengthening Federal Housing Administration ("FHA") programs, (v) providing support for local communities, and (vi) enhancing oversight and reporting to monitor the performance of the various aspects of this initiative.

The stability initiative proposes a shared partnership between the United States Treasury (the "Treasury") and financial institutions, whereby temporary financial assistance will be provided to homeowners who commit to make reasonable monthly mortgage payments to avoid foreclosure and displacement. Under this initiative, lenders that receive FSP funds will be required to reduce interest rates to a specified affordability level (resulting in a monthly mortgage payment no greater than 38% of a borrower's income), and the Treasury would then match such reductions in interest payments dollar-for-dollar with the lender, down to a 31% mortgage debt-to-income ratio for the borrower. Lenders are also permitted to lower monthly payments by reducing the amount of outstanding principal on the borrower's mortgage loan. Modifying lenders will be required to keep such modified payments in place for five years. All financial institutions that receive FSP funds will be required to implement loan modification programs consistent with this guidance.

The stability initiative also provides additional incentives to cooperating borrowers and servicers in the form of annual payments, provided that the borrower remains current on the loan during the first three to five years of the loan modification. In addition, there are incentives for lenders in the form of partial guarantees to be provided as an alternative to foreclosure. Any homeowner with high combined mortgage debt (compared to the borrower's income) and who has a combined mortgage balance higher than the current market value of the borrower's house may be eligible for a loan modification. Only owner-occupied homes will qualify for this relief, and owners with high total debt will be required to agree to enter a counseling program as a condition for eligibility for a modification. Homeowners do not need to be delinquent on their mortgage loan payments in order to qualify for assistance. We note that if the foregoing modifications are made to loans securitized in a REMIC trust, such modifications may affect the REMIC status of the trust. As discussed in a prior issue of *DechertOnPoint*, legislation has been introduced that would revise existing REMIC rules to permit government-sponsored modification programs without compromising the REMIC status of the trust or causing adverse consequences to REMIC certificate-holders.[4]

Another goal of the stability initiative is to create clear and consistent guidelines for foreclosure prevention. The guidelines drafted by the FHA and the FHFA, scheduled to be announced on March 4, 2009, will include detailed protocols for loss mitigation and the identification of at-risk borrowers. The Treasury will require all FSP recipients to participate in foreclosure mitigation plans consistent with the Treasury's loan modification guidelines.

The stability initiative also calls for the modification of current personal bankruptcy laws to assist homeowners whose mortgage loans exceed the current value of their property. These revisions to the bankruptcy laws (commonly referred to as "cram-downs") are intended to permit judges to develop an affordable plan for the homeowner to continue making payments and to modify the homeowner's mortgage loan accordingly. In a cram-down, the amount of the borrower's mortgage loan in excess of the current value of the property would be treated as unsecured debt. President Obama's stability initiative would allow cram-downs only on existing mortgage loans with original principal balances under Fannie Mae and Freddie Mac conforming loan limits, regardless of whether such a mortgage loan has been securitized or is held on the balance sheet of a GSE, a bank, or a mortgage company (whereas the cram-down legislation discussed below does not impose this limit). Cram-downs, however, would only be permitted in instances where homeowners have requested a modification from their servicer or lender and can certify that they have complied with reasonable requests from the servicer or lender to provide essential information.

Finally, the stability initiative will ease restrictions on FHA programs by reducing fees paid by borrowers, increasing flexibility for lenders to modify troubled loans, permitting borrowers with higher debt loads to qualify, and allowing payments to servicers of the existing loan. The initiative will also permit the Department of Housing and Urban Development to award up to $2 billion in competitive Neighborhood Stabilization Program grants for innovative programs that reduce

4 For additional information, please see the issue of *DechertOnPoint* related to the proposed Real Estate Mortgage Investment Conduit Improvement Bill of 2009, available at: www.dechert.com/library/Fnance_and_Real_Estate_02-09_13_Proposes_TARP_Legislation.pdf.

foreclosure, and up to $1.5 billion in grants to provide renter assistance.

The third component of the Plan is targeted directly at the securitization market. It increases the Treasury's Preferred Stock Purchase Agreement commitment to $200 billion (funded completely under the Housing and Economic Recovery Act) for each of Fannie Mae and Freddie Mac, in an effort to ensure the strength and security of the mortgage market and to help maintain mortgage affordability. In addition, the Treasury will continue to purchase mortgage-backed securities to promote stability and liquidity in the marketplace as well as increase the size of the GSEs' retained mortgage portfolios by $50 billion to $900 billion.

Bankruptcy Cram-Down Legislation

Several bills introduced recently in the House include provisions that permit bankruptcy judges to modify residential mortgage loans of borrowers in bankruptcy (the "cram-down legislation").[5] If enacted, the cram-down legislation would amend Section 109 of Title 11 of the United States Code (the "Code") to permit a debtor to propose a plan that would to treat debt on a principal residence in excess of its current value as unsecured debt. It also would amend the Code to allow bankruptcy judges to modify the terms and conditions of mortgage loans secured by borrowers' principal residences to (i) extend the repayment period to a period not to exceed 40 years and (ii) reduce the interest rate to a lower fixed annual rate. Unlike President Obama's stability initiative describe above, which focuses on mortgage loans with principal balances under Fannie Mae and Freddie Mac conforming loan limits, the cram-down legislation permits any mortgage loan secured by a borrower's principal residence to be modified, regardless of the original principal balance of such mortgage loan.

Bankruptcy judges' authority to modify mortgage loans pursuant to the cram-down legislation or the stability initiative discussed above may result in losses for banks, investment funds, and other holders of securities backed by such loans. When a bankruptcy judge modifies a mortgage loan that has been included in a securitization, provisions in the related transaction documents may cause all investors in such securitization to share losses related to the cram-down equally, meaning that senior certificateholders will bear such losses pro-rata with more junior certificateholders, contrary to the normal priority for the allocation of losses.[6] One of the proposed bills, however, would make the provisions in certain securitization documents that require a pro-rata allocation of losses related to cram-downs unenforceable as being contrary to public policy.[7] If a pro-rata allocation of losses is permitted, the expected result of such modifications is that credit rating agencies will downgrade ratings on potentially affected certificates (in some cases, from investment grade to non-investment grade), which could result in severe consequences for the holders of such certificates. Banks with regulations that require them to hold only investment grade instruments may be forced to sell these downgraded certificates into an illiquid market at a substantial loss. Even if the downgraded certificates may be retained, banks and other investors could be required to set aside additional capital to manage their heightened risk of loss, and to write down the value of such certificates on their balance sheets.

Dechert attorneys are working with several industry groups to assure that all ramifications of the cram-down legislation are fully understood by lawmakers and to avoid any unintended consequences that might compound the significant issues currently facing the mortgage securitization market.

■ ■ ■

5 Representative Conyers of Michigan introduced on January 6, 2009 H.R. 200, a bill that focuses on cram-downs. H.R. 200 was immediately referred to the House Judiciary Committee, where it remains under consideration. The full text of H.R. 200 legislation is available at: www.opencongress.org/bill/111-h200/text. Members of the House Judiciary Committee and the House Financial Services Committee introduced on February 23, 2009 H.R. 1106, a bill that combines cram-down provisions similar to those contained in H.R. 200 with other housing-related initiatives such as servicer safe harbors, Hope for Homeowners, FHA changes, and reforms to the FDIC insurance fund. H.R. 1106 was immediately referred to the House Financial Services Committee, the House Judiciary Committee and the House Veterans' Affairs Committee, where it remains under consideration. The full text of H.R. 1106 is available at: http://docs.house.gov/rules/111_hr_housing.pdf.

6 Holders of potentially affected mortgage-backed securities should examine the relevant pooling and servicing agreements in order to assess their risk of loss under any proposed cram-down legislation; not all securitization documents provide for bankruptcy losses to be allocated pro-rata among senior and subordinate certificates.

7 *See* Section 124 of H.R. 1106.

Dechert LLP

This update was authored by Steven Molitor (+1 215 994 2777; steven.molitor@dechert.com), Ralph Mazzeo (+1 215 994 2417; ralph.mazzeo@dechert.com), Ryan McNaughton (+1 212 698 3848; ryan.mcnaughton@dechert.com), Molly Light (+1 215 994 2270; molly.light@dechert.com), and Kira Brereton (+1 212 698 3574; kira.brereton@dechert.com).

Practice group contacts

If you have questions regarding the information in this legal update, please contact the authors, one of the attorneys listed, or the Dechert attorney with whom you regularly work. Visit us at www.dechert.com/finance&realestate.

Timothy J. Boyce
Charlotte
+1 704 339 3129
timothy.boyce@dechert.com

Lewis A. Burleigh
Boston
+1 617 654 8601
lewis.burleigh@dechert.com

Katherine A. Burroughs
Hartford
+1 860 524 3953
katherine.burroughs@dechert.com

Lawrence A. Ceriello
New York
+1 212 698 3659
lawrence.ceriello@dechert.com

Steven Choo
London
+44 20 7184 7370
steven.choo@dechert.com

Laura G. Ciabarra
Hartford
+1 860 524 3926
laura.ciabarra@dechert.com

Patrick D. Dolan
New York
+1 212 698 3555
patrick.dolan@dechert.com

Malcolm S. Dorris
New York
+1 212 698 3519
malcolm.dorris@dechert.com

Dr. Olaf Fasshauer
Munich
+49 89 21 21 63 28
olaf.fasshauer@dechert.com

Steven A. Fogel
London
+44 20 7184 7444
steven.fogel@dechert.com

David W. Forti
Philadelphia
+1 215 994 2647
david.forti@dechert.com

William Fryzer
London
+44 20 7184 7454
william.fryzer@dechert.com

John J. Gillies, Jr.
Hartford
+1 860 524 3938
john.gillies@dechert.com

Joseph B. Heil
San Francisco
+1 415 262 4510
joseph.heil@dechert.com

Bruce D. Hickey
Boston
+1 617 654 8602
bruce.hickey@dechert.com

Geoffrey K. Hurley
New York
+1 212 698 3598
geoffrey.hurley@dechert.com

Andrew Hutchinson
London
+44 20 7184 7428
andrew.hutchinson@dechert.com

Richard D. Jones
Philadelphia
+1 215 994 2501
richard.jones@dechert.com

Andreas Junius
New York
+1 212 698 3578
andreas.junius@dechert.com

David M. Linder
San Francisco
+1 415 262 4511
david.linder@dechert.com

Ralph R. Mazzeo
Philadelphia
+1 215 994 2417
ralph.mazzeo@dechert.com

Steven J. Molitor
Philadelphia
+1 215 994 2777
steven.molitor@dechert.com

Sean H. Porter
New York
+1 212 698 3579
sean.porter@dechert.com

Jason S. Rozes
Philadelphia
+1 215 994 2830
jason.rozes@dechert.com

Timothy A. Stafford
New York
+1 212 698 3504
timothy.stafford@dechert.com

William C. Stefko
New York
+1 212 698 3895
william.stefko@dechert.com

Barry J. Thorne
London
+44 20 7184 7413
barry.thorne@dechert.com

John M. Timperio
Charlotte
+1 704 339 3180
john.timperio@dechert.com

Stephanie M. Tita
New York
+1 212 698 3896
stephanie.tita@dechert.com

Cynthia J. Williams
Boston
+1 617 654 8604
cindy.williams@dechert.com

Jay Zagoren
Philadelphia
+1 215 994 2644
jay.zagoren@dechert.com

www.dechert.com

U.S. Austin • Boston • Charlotte • Hartford • Newport Beach • New York • Philadelphia Princeton • San Francisco • Silicon Valley • Washington, D.C. • **EUROPE** Brussels London • Luxembourg • Munich • Paris • **ASIA** Beijing • Hong Kong