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Client Alert

Financial Industry Recovery Center

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The "Missing Link" in Financial Stability Plan: President Obama Announces Homeowner Affordability and Stability Plan

Yesterday President Barack Obama announced his long-awaited foreclosure prevention and loan modification plan, referred to by many as the "missing link" in the Financial Stability Plan unveiled by Treasury Secretary Geithner last week. To address the problems of homeowners unable to refinance their loans or struggling to meet their mortgage obligations, the Homeowner Affordability and Stability Plan ("HASP") seeks to help by providing the following: (1) access for borrowers to low-cost refinancing on conforming loans owned or guaranteed by Fannie Mae and Freddie Mac, (2) a $75 billion homeowner stability initiative to prevent foreclosures and (3) additional commitments allowing the Treasury to purchase up to an additional $200 billion of preferred stock of Fannie Mae and Freddie Mac and allowing Fannie Mae and Freddie Mac to increase the size of their retained mortgage portfolios by $50 billion. The $75 billion homeowner stability initiative includes financial incentives to borrowers and servicers in connection with loan modifications, a partial guarantee of losses resulting from declines in the home price index following loan modifications, the development of "national standards" for loan modifications (to be announced by March 4, 2009) and support for the modification of bankruptcy laws to allow bankruptcy judges to modify residential mortgage loans. The White House's description of HASP was short on details and raises a number of interesting questions about how HASP could affect mortgage loans held by private label securitization trusts.

Highlighted below are some questions to consider, and our preliminary thoughts about some potential issues raised by HASP for the securitization industry.

1. Does HASP's proposal to require the adoption of foreclosure prevention and loan modification guidelines by (a) all Financial Stability Plan recipients and (b) all insured financial institutions supervised by the FDIC, OCC, OTS and the Federal Reserve who service or own mortgage loans signal the intention of the Administration to override private contracts?

HASP does not make clear how to reconcile financial institutions' contractual obligations as servicers under private securitization transactions with the mandate in HASP regarding adoption of a comprehensive loan modification regime. Many securitization deals restrict (and in some cases prohibit altogether) a servicer's ability to modify mortgage loans unless specified criteria are satisfied, and many securitization transactions limit the percentage or number of loans in a pool that can be modified. Although it is certainly possible that the loan modification guidelines, when announced in March, will apply only to loans that financial institutions hold for their own account and not apply to securitized loans, the language in HASP extending this requirement to "servicers," as well as owners, of mortgage loans suggests otherwise. To the extent that the requirements of loan modification guidelines are at odds with servicers' responsibilities under securitization documents, servicers could face the dilemma of how to comply with both the regulatory requirements and conflicting contractual responsibilities. The Treasury's establishment of loan modification guidelines may encourage securitization transaction participants to seek formal amendments to securitization deal documents to permit servicers to adopt the modification guidelines announced by the Treasury.

2. What is the effect of the proposed loan modifications for loans backing securities owned or guaranteed by Fannie Mae, Freddie Mac, Ginnie Mae, the Treasury or other governmental agencies or instrumentalities and, if applicable, to those backing private label securities?

HASP also does not make clear who will bear any loss resulting from loan modifications. Presumably, in the case of mortgage loans owned or guaranteed by a GSE or other governmental agency or instrumentality, that entity will cover any principal or interest shortfall resulting from the loan modifications, and thus the investors in guaranteed mortgage-backed securities will receive their principal and interest entitlements. The White House summary suggests, however, that lenders will bear the cost of some interest rate reductions with the "initiative" matching dollar-for-dollar the cost of further interest rate reductions.

3. How will the bankruptcy cramdown legislation affect securitization investors and the structuring of future securitizations?

Again, HASP is not clear whether the bankruptcy cramdown legislation is intended only for loans owned or guaranteed by Fannie Mae and Freddie Mac, in that the summary indicates that the cramdown would apply only to "existing mortgage loans under Fannie Mae and Freddie Mac conforming loan limits." Of course, some loans, such as subprime loans, are small enough in size to conform to agency limits, but fail to meet other criteria for sale to the agencies. Bankruptcy cramdown is not a risk that investors considered when investing in outstanding mortgage-backed securities, because at the time of issuance the cramdown rules did not apply to owner-occupied residential mortgage loans. If legislation is passed allowing for bankruptcy cramdowns of owner-occupied residential mortgage loans that have been securitized, expected losses on the related mortgage-backed securities will increase, perhaps significantly.

It is worth noting that some securitization transactions specifically provide that any bankruptcy losses above a relatively small threshold are to be allocated pro rata to all tranches in a securitization, including any AAA-rated tranche. The rating agencies approved the small threshold based on the view that the risk of bankruptcy cramdown was minimal under the laws in effect at that time. The introduction of cramdown risk could cause the rating agencies to downgrade the AAA-rated securities in these transactions, in anticipation of greater losses. Downgrades would lead to loss of value in the securities, straining the already distressed financial state of investors in these securities.

4. Would the purchase by the Treasury (or private investors) of defaulted loans from securitized pools be a viable alternative to foreclosure and loan modification efforts?

Although the Treasury has not advanced this course of action as a possible alternative, this kind of initiative would underscore the Administration's objectives to keep families in their homes. Undoubtedly, there are accounting ramifications, including the treatment under FAS 140 for off-balance-sheet securitizations, and possible tax ramifications, to address in connection with implementing this sort of initiative; however, if the Treasury purchased defaulted mortgage loans, it then would be able to modify the mortgage loans to assist troubled borrowers. If appropriate accounting and tax guidance were issued to allow short sales of defaulted and severely delinquent mortgage loans from securitized pools without adverse tax consequences for the securitization investors, a private market for these distressed mortgage loans could develop, and the purchaser could modify the distressed loans.

Fannie Mae, Bank of America, Citigroup, JPMorgan Chase and other major mortgage lenders announced foreclosure moratoriums and halted loan modification initiatives pending the implementation of HASP. It remains to be seen what impact yesterday's announcement regarding HASP will have on their activities and the securitization industry generally. We will have to stay tuned for the Administration's March 4th announcement for additional clarity on the HASP initiatives.

Click here for the HASP executive summary, click here for the fact sheet, and click here for three case studies. If you have questions about how HASP will impact securitization transactions you service, have sponsored or invested in, feel free to contact any of the individuals noted in this Client Alert.