The HOPE NOW Alliance/American Securitization Forum (ASF) Plan to Freeze Certain Mortgage Interest Rates

(name redacted)
Legislative Attorney

(name redacted)
Analyst in Financial Economics

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Summary

In response to the downturn in the U.S. mortgage market, the Bush Administration helped broker an alliance of mortgage lenders, servicers, counselors, and investors called the HOPE NOW Alliance, whose stated goals are to "maximize outreach efforts to homeowners in distress to help them stay in their homes" and to "create a unified, coordinated plan to reach and help as many homeowners as possible." One aspect of the alliance is the Statement of Principles, Recommendations and Guidelines for a Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans (the Framework or ASF Plan), as proposed by the American Securitization Forum (ASF).

Pursuant to the Framework, borrowers who meet certain requirements qualify for "fast track" loan modification, which may include an interest rate freeze at the rate prior to reset that, in most cases, lasts for five years. Because this type of modification is a deviation from the norm, servicers willing to perform loan workouts in accordance with the Framework's guidelines could worry that they would open themselves up to tax, accounting, and contract liability from secondary market investors and federal regulators of tax-exempt trusts. This potential liability could deter servicers from engaging in loss mitigation, even those measures outlined in the Framework.

The Internal Revenue Service (IRS) issued a revenue procedure (Rev. Proc 2008-28) on May 16, 2008, to clarify certain tax issues relating to modification of securitized mortgage loans. The IRS said that it would not challenge the tax status of the trusts that hold securitized loans, nor would the IRS assert that anticipatory loan modifications create a tax liability on prohibited transactions, if: (1) the mortgage is for a single-family (one- to four-unit) dwelling; (2) the dwelling is owner-occupied; (3) overdue mortgages make up less than 10% of the trust's assets at start-up; (4) there is reasonable belief that the original loan will result in foreclosure; (5) the loan modification is less favorable to the holder of the loan than the original loan; and (6) there is reasonable belief that the loan modification reduces the risk of foreclosure.

The data show that loan modifications and formal repayment plans have been increasing steadily in each successive quarter since the issuance of the Framework. However, it is difficult to identify which of these modifications were made pursuant to the ASF Plan and which occurred through alternative channels. The Framework only applies to certain mortgages that are current, which makes it distinct from Project Lifeline, a plan announced on February 12, 2008, for mortgages that are in serious default.

On June 17, 2008, the HOPE NOW servicers announced common measures to expedite resolution of short sales and second mortgages, which can require third-party approval.

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Introduction

In response to the downturn in the U.S. mortgage market, the Bush Administration helped broker an alliance of mortgage lenders, servicers, counselors, and investors, called the HOPE NOW Alliance,[1] whose stated goals are to "maximize outreach efforts to homeowners in distress to help them stay in their homes" and to "create a unified, coordinated plan to reach and help as many homeowners as possible."[2] One aspect of the alliance is the Statement of Principles, Recommendations and Guidelines for a Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans (the Framework or the ASF Plan).[3] The Framework was proposed by the American Securitization Forum (ASF), a professional forum for many organizations that participate in the securitization market and a member of the HOPE NOW Alliance.

This report first examines the details of the ASF Plan and then discusses the potential liability concerns that may arise for servicers who implement modifications under the Plan. Finally, the effectiveness of the Framework is analyzed based on the loan workout data provided by the HOPE NOW Alliance.

Features of the ASF Plan

The principles provided in the Framework are voluntary. The Framework's stated "overall purpose" is to

> provide further guidance for servicers to streamline borrower evaluation procedures and to facilitate the effective use of all forms of foreclosure and loss prevention efforts, including refinancings, forbearances, workout plans, loan modifications, deeds-in-lieu and short sales or short payoffs.[4]

The voluntary Framework structure may be applied to mortgages with the following characteristics: (1) subprime, (2) first-lien mortgages that (3) were originated in the one-and-one-half year period between January 1, 2005, and July 31, 2007, with (4) adjustable interest rates that have an introductory fixed-rate period of less than 36 months, where (5) the first interest rate resets are scheduled to occur between January 1, 2008, and July 31, 2010, and that (6) have been securitized on the secondary market.[5] It should be noted that the Framework does not apply to interest-only mortgages simply because payments (as opposed to interest rates) increase within the specified time period. Nor does it apply to prime mortgages or Alt-A mortgages.[6]

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[1] For more information about the HOPE NOW Alliance, see the program's Web page, available at http://www.hopenow.com/.

[2] Alliance Statement, HOPE NOW Alliance, available at http://www.fsround.org/media/pdfs/AllianceStatement.pdf.

[3] Available at http://www.americansecuritization.com/uploadedFiles/FinalASFStatementonStreamlinedServicingProcedures.pdf. Hereinafter referred to as "Framework."

[4] *Id.* at 2.

[5] *Id.* at 4.

[6] Alt-A refers to mortgages for borrowers with good credit but some other indicator of risk, such as lack of income documentation. Prime and Alt-A mortgages account for a considerable number of foreclosures in the United States. According to CRS calculations of the Mortgage Bankers Association National Delinquency Survey, approximately 40% of the foreclosures that took place during the third quarter of 2007 were of non-subprime mortgages.

Servicers of mortgages that meet all six of the above requirements may separate borrowers of these mortgages into one of three "segments." Segment 1 is for borrowers with loans that are current[7] and that qualify to be refinanced into an available FHA (Federal Housing Administration), FHA Secure, or private mortgage product. Servicers are encouraged to help borrowers of mortgages falling into this category to refinance if the borrowers are unable to afford the mortgage after reset, or if they are unwilling to pay for the reset.[8]

Segment 2 is for borrowers with mortgages that meet the six requirements above but that are not likely to qualify for refinancing, and where four additional requirements are met: (a) borrowers must be current[9] with their mortgage payments; (b) borrowers must reside in the residences securing the mortgage; (c) borrowers must meet the "FICO test," i.e., have credit scores below 660 and less than 10% higher than their scores at the time of origination;[10] and (d) borrowers' mortgage payments would have to increase by more than 10% after the scheduled reset. Borrowers who meet all of the requirements of Segment 2 qualify for "fast track" loan modification, which may include an interest rate freeze at the rate prior to reset that, in most cases, lasts for five years. This fast track rate freeze is designed to give borrowers and lenders time to refinance into more affordable loans in order to limit the number of mortgages going into default and reduce the number of homes for sale in an already saturated market.[11] In part because eligibility for this segment is defined by readily available financial data, servicers should be able to apply this fast track rate freeze to borrowers in a more efficient and streamlined fashion than is normally the case.[12]

The final segment is for all mortgages meeting the six requirements above, but that do not qualify for either Segment 1 or 2. Servicers may apply a more individualized analysis of these mortgages to determine the best way to mitigate losses "in a manner consistent with the applicable servicing standard...."[13]

Servicers of securitized mortgages who do not fall within the scope of the Framework may perform loan modifications in accordance with the governing service contracts.

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[7] "For purposes of this Statement, 'current' means the loan must be not more than 30 days delinquent, and must not have been more than 1 x 60 days delinquent in the last 12 months, both under the Office of Thrift Supervision (OTS) method. For servicers who determine delinquency under the Mortgage Banker's Association (MBA) method, 'current' means the loan must be not more than 60 days delinquent, and must not have been more than 1 x 90 days delinquent in the last 12 months, both under the MBA method." Framework at 5.

[8] *Id.* at 4-6.

[9] *See*, *supra* footnote 7.

[10] If the borrower meets all other requirements except the FICO test, then the servicer may conduct alternative analysis to determine if the borrower otherwise qualifies for loan modification. Framework at 6.

[11] *Id.* at 6-7. This fast track modification "is non-exclusive and does not preclude a servicer from using alternate analysis to determine if a borrower is eligible for a loan modification, as well as the terms of the modification." *Id.* at 8.

[12] The Framework's fast track modification, because it only applies to mortgages that are current, differs from Project Lifeline, a plan announced on February 12, 2008, that would impose a 30-day "pause" on foreclosure proceedings for certain mortgages that are "seriously delinquent," i.e., mortgage payments that are 90 or more days late. The HOPE NOW Alliance has not publicly released specific data on the implementation of Project Lifeline, nor has it provided guidance as to when a pause may be appropriate. One reason for the lack of specificity regarding this program is that servicers commonly slow the foreclosure process in situations in which borrowers contact the servicer.

[13] Framework at 8.

Potential for Servicer Liability

As described above, the Framework provides servicers guidance in identifying borrowers who are in danger of defaulting on mortgages and in helping them provide effective refinancing, loan modification, and loss mitigation measures for these borrowers in ways that likely are in accordance with governing Pooling and Servicing Agreements (PSAs).

PSAs are contracts that govern the legal relationship between mortgage-backed securities (MBS) trustees, MBS investors, and servicers of the mortgages comprising these trusts.[14] While not all PSAs are exactly alike, one relevant feature of typical agreements is the scope of permission for servicers to perform loss mitigation for borrowers who have yet to miss a mortgage payment. Industry standards issued in the summer of 2007 stated that servicers could modify loans if default was reasonably foreseeable, provided that such action increased the net present value (NPV) of the mortgage pool.[15] A fast track modification that freezes interest rates could potentially create gains for MBS trusts, thus increasing their NPV, by minimizing losses as a result of avoiding foreclosure expenses from the troubled borrowers, but also could potentially create losses by freezing rates for borrowers capable of paying the higher reset. Satisfying the NPV test generally would require a comparison of the likely gains and losses of a particular plan, which historically has been done through individual loan analysis. Loan-by-loan modification, however, is time consuming and expensive.

In the summer of 2007, many loan servicers and policymakers recognized that a large number of upcoming payment resets could potentially overwhelm the resources of servicers willing to conduct voluntary modifications. These servicers likely would not have been able to help applicable borrowers in need in a timely fashion if action only took place on a mortgage-by-mortgage basis. For this reason, one of the Framework's goals was to create a structure by which broad swaths of mortgages could be modified as a group, hence the fast track loan modification plan.

Because broad swath modification is a deviation from the norm, servicers willing to perform loan workouts in accordance with the Framework's guidelines could worry that they would expose themselves to tax, accounting, and contract liability from secondary market investors and federal regulators of tax-exempt trusts. For instance, some in the industry might have worried that a trust could cease to qualify as a tax-exempt REMIC if a significant portion of its qualified mortgages were modified in accordance with a broad-based plan, rather than on a loan-by-loan basis. This potential liability could deter servicers from engaging in loss mitigation, including making use of those measures outlined in the ASF Plan.

In an attempt to allay liability concerns, the HOPE NOW Alliance requested opinions from the Internal Revenue Service (IRS) on the tax implications of its particular modification plan, as well as from the Securities and Exchange Commission (SEC) on the accounting ramifications of modifications of loans held in securitization trusts. Tax implications depend on the interpretation of the Real Estate Mortgage Investment Conduit (REMIC) rules, which govern limitations on tax-

[14] These contracts also may be called Servicing Agreements (SAs). The term "PSA" will be used in this report to refer to both PSAs and SAs.

[15] "Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans," American Securitization Forum, June 2007.

exempt passive trusts. Accounting implications depend on the interpretation of Financial Accounting Standard (FAS) 140, which governs the treatment of asset sales to passive trusts.

The IRS stated in Revenue Procedure 2007-72 that it would not object to the Framework by challenging the tax status of affected trusts. This IRS statement assured participants of the ASF Plan that loan modifications provided in accordance with the Framework's specific criteria will not result in loss of the tax status of the REMICs and other trusts.[16] Rev. Proc 2007-72 was limited to the AFS Plan.

The IRS then issued a separate revenue procedure (Rev. Proc 2008-28) to clarify more general tax issues relating to modification of securitized mortgage loans.[17] The IRS identified conditions under which it would not challenge the tax status of the trusts that hold securitized loans, or assert that anticipatory loan modifications create a tax liability on prohibited transactions. The conditions enumerated in Rev. Proc 2008-28 are (1) the mortgage is for a single-family (one- to four-unit) dwelling; (2) the dwelling is owner-occupied; (3) overdue mortgages make up less than 10% of the trust's assets at start-up; (4) there is reasonable belief that the original loan will result in foreclosure; (5) the loan modification is less favorable to the holder of the loan than the original loan; and (6) there is reasonable belief that the loan modification reduces the risk of foreclosure.

The SEC, which has oversight authority over organizations that coordinate accounting standards, provided a letter dated January 8, 2008, stating that it would not object to loan modifications on the basis of FAS 140, but specifically abstained from passing judgment on possible alternative plans or the rights of third parties such as investors. Like the IRS's tax opinion, the SEC's accounting opinion might need to be supplemented if significant features of the plan are changed.

Although the SEC has stated that it would not object to the ASF Plan based on the NPV test, servicers who provide fast track loan modifications may still face from objections from other parties. Secondary mortgage market investors could still challenge servicers who provide these modifications on a contract violation theory if they could show that the gains from avoiding foreclosures have a reasonable probability of outweighing the losses from freezing payments at lower rates.[18] For example, if a secondary mortgage market investor could show that only 35% of loans in a particular trust that were modified under the fast track plan would have resulted in foreclosure in the absence of some kind of workout plan, while the remaining 65% of those modified mortgages would not have resulted in foreclosure, then that investor could argue that these modifications did not increase the NPV of the trust, and thus the fast track rate freezes were provided in breach of the governing PSA.

[16] Rev. Proc. 2007-72, *Internal Revenue Bulletin: 2007-52*, December 26, 2007.

[17] Rev. Proc. 2008-28, *Internal Revenue Bulletin: 2008-28*, May 16, 2008.

[18] As previously mentioned, the NPV standard is applicable to the typical PSA. Other standards may apply, which may affect liability pursuant to a contract violation claim.

Number of Loan Modifications

The HOPE NOW Alliance has accumulated data on the number of loan modifications and repayment plans that have been initiated by servicers per quarter. **Table 1** presents the quarterly statistics for prime and subprime loss mitigation, including both loan modification and formal repayment plans. The data show that loan modifications and formal repayment plans have been increasing steadily in each successive quarter since the issuance of the Framework. Total workout plans rose from 398,691 in the third quarter of 2007 to 502,520 in the first quarter of 2008. Second quarter 2008 data are not yet available but an additional 182,901 mortgages received workout plans in April 2008. The April results bring the total number of borrower workout plans to 1,558,854 compared with 573,133 foreclosure sales. However, it is difficult to identify how many of these measures were made pursuant to the ASF Plan and how many were performed through alternative channels.

It is unlikely that many of the loan modifications that occurred during the fourth quarter of 2007 or earlier came as a result of the ASF Plan because the plan was not announced until December 7, 2007; the IRS Bulletin was not published until December 27, 2007; and the SEC letter was not issued until January 2008. In addition, servicers would have needed time after the Framework's issuance to analyze their loan files, identify mortgages meeting the plan's standards, and set up policies necessary to implement the plan. Rather, the majority of the modifications and loss mitigation measures that had taken place up to the end of 2007 were probably based on individualized analysis and an agreement, similar to the ASF Plan but that apply exclusively in California, which was instituted prior to the Framework.

It is also unclear how many of the modifications from the first quarter of 2008 were fast track modifications. According to HOPE NOW, 431,171 subprime 2/28 and 3/27 mortgages in the U.S. were scheduled to reset to a variable rate at some point during the first quarter of 2008.[19] While approximately 203,000 of these loans were either sold or refinanced, only 14,418 of them were modified, either under the fast track plan or otherwise adjusted.[20] A partial explanation for this relatively low number of modifications of subprime mortgages with hybrid ARMs may be the decrease in short term rates, most notably of the London Interbank Offered Rate (LIBOR), the index to which the majority of these mortgages' rates are tied. In December 2007, the six-month LIBOR was around 4.8%. That rate had dropped to just over 2.8% by April of 2008.[21] This reduction has resulted in a diminished "reset shock," which likely has held many of these mortgage payments below the 10% increase necessary to qualify for a fast track modification. Additionally, the falling rates likely kept the payments of many of these subprime mortgages at an affordable level for borrowers who may not have been able to afford payments that reset to the higher December 2007 rate.

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[19] A 30-year mortgage with a 2- or 3-year introductory period is called a 2/28 and 3/27, respectively.

[20] HOPE NOW has not delineated how many of these 14,418 modifications were fast track modifications pursuant to the ASF Plan.

[21] Although, LIBOR is not the reference rate used for all adjustable rate mortgages, it is used for the majority of mortgages eligible for HOPE NOW according to industry data.

Table 1. Quarterly Loss Mitigation Actions, 2007

Repayment Plans Plus Loan Modifications	2007 Q1	2007 Q2	2007 Q3	2007 Q4	2008 Q1 (up to 04/28)
Prime	130,000	133,000	150,349	173,499	206,495
Subprime	184,000	202,000	248,342	301,244	296,025
Total	314,000	335,000	398,691	474,743	502,520

Source: HOPE NOW Alliance. The numbers from 2007 quarters 1 and 2 are estimates made by HOPE NOW based on industry data.

The arguably limited necessity of fast track modifications under current conditions illustrates how the limited scope of the ASF Plan could lead to proposals to change its features, which could lead to another round of requests for SEC and IRS letters. In addition, it can be argued that different root causes of mortgage problems in different parts of the country complicate the creation of a uniform solution. As an example, subprime loans make up a relatively small share of California's total loans as compared to other states, yet alternative mortgages made up a relatively large share of California's prime and Alt-A markets. Not only did many of these prime loans have adjustable rates, but some had introductory interest-only features. The rapid increase in prime and Alt-A loan delinquencies in California and other states that had experienced rapid runups in house prices could lead some to question limiting the scope to subprime loans or adjustable rate loans. Arguments may also be made for new programs that address the specific problems occurring in a particular geographic region.

Author Contact Information

(name redacted)
Legislative Attorney
/redacted/@crs.loc.gov, 7-....

(name redacted)
Analyst in Financial Economics
/redacted/@crs.loc.gov, 7-....

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