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FDIC'S Loan Modification Program and Loss Sharing Proposal

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On November 20, 2008, the Federal Deposit Insurance Corporation (FDIC) announced a new program, called "Mod in a Box," to assist lenders and loan servicers in the process of implementing systematic and streamlined loan modifications (Program). The FDIC also has advanced a loss sharing proposal in order to provide an incentive for large scale loan modifications, but it is unclear whether the US Department of the Treasury (Treasury) will adopt the proposal and provide the funds to support it. The FDIC is encouraging industry participants to adopt the Program as the standard approach to loan modifications in the hopes that it will stem reductions in housing prices and the recent rise in foreclosures.

The Program is designed to serve the dual purpose of improving the value of troubled mortgages for investors and helping borrowers remain in their homes through immediate payment relief and affordable long term mortgage payments. To accomplish these two goals, the Program contains a mechanism to determine a payment that the borrower can afford while protecting the investor's interest by requiring that the cost of that modification be less than the estimated cost of foreclosure. If these goals are met, eligible borrowers receive a loan modification, which may include interest rate reductions, extensions of term, and principal forbearance.

The Program is based on the approach that the FDIC implemented in connection with its operation of IndyMac Bank, FSB (IndyMac) after it failed on July 11, 2008, which, as of November 20, 2008, resulted in more than 5,300 modifications. The Program was required to be used by Citigroup, Inc., in connection with the recent government intervention and loss sharing arrangement with that company.

ELIGIBILITY

A loan may be eligible for modification under the Program if it is at least 60 days delinquent or if default is reasonably foreseeable. Loans are not eligible if a foreclosure sale is imminent or if the borrower is currently in bankruptcy or has been discharged from Chapter 7 bankruptcy since the loan was originated.

BORROWER AFFORDABILITY CALCULATION

If eligibility is established, any loan modification proposal is based upon a borrower's housing-to-income (HTI) ratio, which compares the borrower's monthly housing expenses to his or her gross monthly income. A borrower's housing expenses may include, among other things, the borrower's monthly modified principal, interest, taxes, and insurance (PITI) payments, and homeowners' association dues. The gross monthly income for all borrowers must be supported by either the previous year's tax returns or recent pay stubs. For borrowers with no recent income verification on file, a conditional offer may be extended, contingent upon income verification.

The Program proposes various modifications to loan terms designed to make the loan more affordable for the borrower. The Program sets a maximum affordable HTI of 38 percent and requires that any modification achieve a minimum payment reduction of 10 percent. The FDIC set 38 percent as the maximum HTI because industry standards set forth by certain Fair Housing Act lending programs indicate that a mortgage payment based on an HTI ratio between 31 percent and 38 percent is affordable. This maximum HTI is lowered in incremental steps from 38 percent, to 35 percent, to 31 percent, to see if the required 10 percent reduction in loan payments can be achieved.

The loan terms that can be modified under the Program to achieve the required HTI and the 10 percent loan payment reduction are as follows: (1) interest rate reduction, (2) extended amortization term, and (3) partial principal forbearance. These terms must be applied in that order under the Program's terms.

INTEREST RATE REDUCTION

First, lenders and servicers under the Program can see if the required HTI and loan payment reductions can be achieved by placing a cap on the interest rate at the Freddie Mac Weekly Survey rate (which on January 15, 2009, fell to its lowest level in more than 30 years at just under five percent), and then reducing the interest rate incrementally to as low as three percent for up to five years, after which the interest rate would increase by not more than one percent annually until the Freddie Mac Weekly Survey rate is reached.

EXTENDED AMORTIZATION TERM

If the required HTI and payment reduction cannot be achieved by reducing the interest rate alone, for loans with an original term of 30 years, lenders and servicers, under the Program, can re-amortize the adjusted unpaid principal balance (UPB) at the reduced interest rate over an extended amortization term of 40 years from the original first payment date. For securitized loans, the amortization may be extended to 40 years from the original first payment date, but the maturity date will not change, resulting in a balloon payment. For loans with an original term of less than 30 years, the amortization may be extended for only 10 years. Modification under the Program is contingent upon existing servicing and securitization contracts allowing such modification. Due to contractual restrictions in IndyMac's pooling and servicing agreements, IndyMac has not modified securitized loans where default is reasonably foreseeable.

PARTIAL PRINCIPAL FORBEARANCE

Finally, if the required HTI and payment reduction still cannot be achieved, lenders and servicers under the Program can reduce the adjusted UPB for amortization purposes and amortize over a 40 year period at the reduced interest rate. The repayment of the postponed principal will be due when the loan is paid in full.

INVESTOR PROTECTION

If a loan can be modified in such a way to achieve the required HTI and loan payment reduction, then the cost of that modification needs to be compared to the cost of foreclosure prior to any loan modification being offered to a borrower. To undertake that comparison, lenders and servicers under the Program are required to use a financial model, called the Net Present Value (NPV) Tool. If the modification results in a positive NPV, or in other words, is less costly than foreclosure, then, under the Program, the servicer must approve the modification.

MODIFICATION OFFER PROCESS

The FDIC has stated that lenders and servicers under the Program should use a two-tiered approach to making modification offers: bulk and point of sale. A bulk modification model processes large segments of delinquent loans. It performs automated loan level underwriting based on existing loan terms and recent financial information obtained from the customer, which is verified prior to completing the modification. The bulk modification process establishes modification eligibility and modification terms and uses a traditional marketing approach. Under this streamlined approach, the modification agreement is pre-populated and the loans are pre-qualified. In addition, if a borrower does not qualify for a streamlined modification, the borrower may still receive a personalized modification based on an individual loan review.

LOSS SHARING PROPOSAL

Separate from the Program, the FDIC has proposed to act as a contractor to Treasury to offer a loss share guarantee on re-defaults of modified mortgages. Under this proposal, if Treasury accepts the FDIC's offer, the FDIC would pay servicers $1,000 to cover expenses for each loan modified and share up to 50 percent of losses incurred if a modified loan should subsequently re-default. For loan-to-value ratios (LTVs) above 100 percent, the government loss share will be progressively reduced from 50 percent to 20 percent as the current LTV rises. Loss sharing will not be provided when the LTV for the first lien exceeds 150 percent. Furthermore, government loss sharing would only be available after the borrower has made six payments on the modified mortgage.

The loss sharing proposal includes a de minimis test that would exclude from loss sharing any modification that did not lower the monthly payment by at least 10 percent. In addition, the FDIC proposed an eight year limit on loss sharing payments.

OTHER RECENT LOAN MODIFICATION AND FORECLOSURE MITIGATION EFFORTS

In October 2007, Treasury helped establish the HOPE NOW Alliance, a coalition of mortgage servicers, investors, and counselors, to help homeowners avoid preventable foreclosures. HOPE NOW estimates that nearly 2.7 million homeowners have been helped since July 2007, and that it is helping approximately 225,000 homeowners a month avoid foreclosure.

On November 11, 2008, Treasury, HOPE NOW, the Federal Housing Finance Agency, Fannie Mae, and Freddie Mac announced a streamlined modification program (SMP) that builds on the loan modification protocol developed by the FDIC for IndyMac. The SMP became effective on December 18, 2008.

While the SMP is similar to the Program, it contains some notable differences. For example, under the SMP an eligible borrower must be 90 days delinquent, whereas under the Program the borrower must be only 60 days delinquent. Moreover, under the SMP modifications are available for mortgages in foreclosure, whereas under the Program modifications are not allowed if a foreclosure sale is imminent. Also, under the SMP a borrower's LTV must be 90 percent or higher, whereas the Program does not appear to establish a minimum LTV.

In addition to the SMP, on November 11, 2008, Fannie Mae and Freddie Mac issued a notice suspending foreclosure sales on occupied single family properties scheduled to occur between November 26, 2008 and January 9, 2009, which they subsequently extended to January 31, 2009, to help homeowners and servicers use the SMP.

CONCLUSION

The Program is voluntary, unless the FDIC requires it as part of a loss sharing package—as in the Citigroup case. In deciding whether to adopt the Program, lenders and servicers should compare the likelihood that a loan modification will succeed in leading to timely payments on the loan versus the likelihood that the borrower will re-default on the loan despite modification. In other words, lenders and servicers should conduct cost benefit analysis to determine whether modification with the possibility of re-default or prompt foreclosure would be the most cost effective.

It is not clear whether the loss sharing proposal will come to fruition. It appears that the FDIC wants Treasury to adopt and fund its loss sharing proposal, possibly with $24 billion from the Troubled Asset Relief Program (TARP) of the Emergency Economic Stabilization Act of 2008. However, Treasury may choose not to adopt the FDIC's proposal because it is already supporting the HOPE NOW modification program—the SMP—and some have suggested that the loss sharing proposal could be even more costly, ranging anywhere between $70 billion and $80 billion. Nevertheless, the Program and loss sharing proposal have received some congressional support. House Financial Services Chairman Barney Frank introduced legislation, that would, among other things, mandate that at least $40 billion of the TARP be spent on foreclosure relief programs, including the Program, which would incorporate the loss sharing proposal. Rep. Maxine Waters (D-CA), chair of the Subcommittee on Housing and Community Opportunity of the House Financial Services Committee, and Sen. Feinstein (D-CA) also have introduced companion bills (H.R. 38 and S. 73) to require participating servicers to implement the Program by systematically reviewing and modifying all suitable loans in their portfolios.

Whether lenders and servicers will adopt the Program is questionable even if Treasury were to adopt the loss sharing proposal, unless legislation were passed that mandates it. While in theory adoption of the loss sharing proposal would encourage lenders and servicers to adopt and take advantage of the Program, lenders and servicers still would be partially exposed to the risk of future default by borrowers who needed loan modifications to keep their payments current. In addition, in order to participate in the Program, lenders and servicers would be required to undertake a systematic review of each of the loans under their management, subject each loan to a standard NPV test to determine whether it is a suitable candidate for modification, and modify all loans that pass the NPV test. One reason a lender or servicer may elect not to participate in the Program if the loss sharing proposal is adopted is that it would restrict the lender or servicer's ability to exercise any discretion in determining which loans in its portfolio should be modified. A borrower may choose not to accept a loan modification under the Program because it may not cut the borrower's outstanding debt by a material amount.

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