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Home Affordable Modification Program Recommendations[1]

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Introduction

The Administration's new loan modification program is a significant step toward sustaining communities by providing homeowners with affordable loans. The program:

- Supports affordable loan modifications based on modest debt-to-income ratios with substantial decreases in payments and interest rates;
- Stops foreclosures while loan modification analyses are occurring;
- Requires participating institutions to apply the program to their whole portfolio and to take reasonable steps to secure additional authority where needed;
- Provides loan modifications to borrowers in default and those facing the risk of imminent default;
- Incentivizes principal forgiveness as well as interest rate reduction;
- Requires escrow;
- Waives any partial prepayment penalties when principal is modified;
- Permits servicers to make and counselors to recommend more aggressive modifications when appropriate; and
- Addresses second lien issues.

Within this strong program, there are still several issues that need further attention. Following are our recommendations.

Recommendations

1. Default servicing fees should be waived in the HAMP process.

In the Guidelines, step two of the Waterfall states with regard to capitalization of arrears: "[D]elinquency charges paid to third parties in the ordinary course of servicing and not retained by the servicer" may be capitalized. Default servicing fees can increase a borrower's outstanding loan balance by a substantial amount. A recent study of debtors in bankruptcy found that such fees constituted 20% of the amount owed, on average. This increase in the balance alone may make the difference between a borrower reaching an affordable monthly payment or not. Many of these fees are attributable to abusive valuation practices and high attorney and title fees. Additionally, often fees nominally paid to third parties are in actuality paid to a captive subsidiary of the servicer and form an important profit center for the servicer. If default servicing fees are not waived in total, those allowed under the "ordinary course of servicing" should be limited to one valuation not exceeding a sum certain (for example, $400).

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[1] This analysis was produced by Alys Cohen, Staff Attorney, and Diane Thompson, Counsel.

2. **Borrowers with loans unaffordable at the outset should qualify for loan modifications based on risk of imminent default, even if they have not yet defaulted.**

The explicit definition now only relates to reset or change of life circumstances; however, many borrowers who received subprime ARMs never were able to afford the initial payments and face extraordinarily high rates of default long before the reset. *(See attached ARM bibliography.)* They may be scraping by on their payments by borrowing money from family members, draining savings, foregoing payment on other debt or utilities, or running up their credit cards. These families should have a chance to obtain sustainable loan terms and regain financial stability without significant barriers. Otherwise, the program incentivizes default among these borrowers (which affects their credit score) and also increases the likelihood that high credit card debt will make the success of a loan modification more remote. In addition, borrowers who received loan modifications that are unsustainable should not be required to wait before becoming eligible for HAMP. Some servicers still have a policy of requiring a 12-month wait after an initial loan modification or even repayment plan before providing additional loan modification review.

3. **HAMP program agreements should explicitly require participating institutions to apply the loan modification NPV analysis to the whole portfolio prior to foreclosure and to use all reasonable means to reach out to borrowers to obtain necessary information for the analysis.** *(See attached proposed language.)*

Where the servicer has not conducted such review, the homeowner should be able to use the institution's contract language to halt the foreclosure and obtain such an analysis, and, where appropriate, a loan modification. This process would augment any regulator oversight and ensure maximum compliance. Where foreclosure would be more profitable, the completed NPV analysis should be provided to the homeowner. This requirement would not apply to homeowners who are 90 days or more delinquent on an affordable loan modification previously provided. Because the program will focus on modifications that are more profitable for the investors than foreclosure, this rule should apply to any loan owned, partially or fully, by the institution, as well as any loan serviced by the institution.[2] Additionally, correspondence from the servicer to homeowners eligible under the HAMP should notify the borrower of the loan's eligibility.

4. **Waivers of claims and defenses are still being required by servicers and should be prohibited, even for borrowers not in active litigation.**

The HAMP program rollout language appears to prohibit waivers only for borrowers already in active litigation. Borrowers not in active litigation should not have to waive their

[2] The program should be required of all investors in a loan pool, even those who have not received TARP funds or who have not directly committed to the HASP loan modification program. As the program only approves loan modifications which are better for investors overall than foreclosure, there should be no equitable objection to a change in terms. To the extent investors in some tranches may receive less in a particular loan modification than others, Congress has already required that such a distinction not be the grounds for denying a modification. *See* 15 U.S.C. 1639a.

rights to better relief, particularly since there are potential abuses in the modification process and because the modifications themselves have limits and may not provide sufficient relief going forward to some classes of borrowers. Borrowers who are not in active litigation need protection from waivers even more than borrowers in litigation, since borrowers not in active litigation are less likely to be represented by counsel and advised of what rights they are waiving.

5. **Servicer incentive payments should not favor higher-income borrowers with higher loan amounts.**

As long as at least a 6% payment reduction has been provided, an incentive is paid. The incentive is $1,000 or ½ of the reduction in the monthly mortgage payment, whichever is less. Thus, the incentive of $1,000 only applies to borrowers receiving a $2,000 decrease in the monthly payment. This disfavors participation by institutions with portfolios that include a high proportion of lower income borrowers because the incentive payments are lower, even where the work itself is substantially equal or perhaps even greater.

6. **Mortgages should remain assumable as between spouses, children, and other persons with a homestead interest in the property.**

Federal law, the Garn-St. Garmain Depository Act of 1982, specifically forbids acceleration when the property is transferred from one spouse to another and permits a spouse or child to assume the mortgage obligations.[3] Freddie Mac has long allowed mortgage assumptions by relatives as one method of working out delinquent mortgages. Such transfers are most likely to occur upon death or divorce; they may happen in the context of domestic violence. Home owners who have just suffered the death of a loved one should not find themselves immediately faced with foreclosure or suddenly elevated mortgage payments.

7. **Borrowers who suffer an involuntary drop in income after a loan modification should not be refused a second evaluation under HAMP**.

Even after a loan modification is done successfully and is performing, borrowers may still become disabled or spouses may die. These subsequent, unpredictable events, outside the control of the borrower, should not result in foreclosure if a further loan modification would save investors money and preserve homeownership. Servicers can and should do an affordability and NPV analysis when a borrower defaults on a HAMP modification, and, where appropriate, make available a second modification. Foreclosing on homes where borrowers have suffered an involuntary drop in income without evaluating the feasibility of a further modification is punitive to homeowners already suffering a loss and does not serve the interests of investors.

8. **Public disclosure of the participating institutions is critical.**

Currently, the HAMP materials instruct borrowers to contact their servicer in order to determine their eligibility. Advocates report widespread confusion as to whether or not any

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[3] 12 U.S.C. §1701j-3(d)(6) (2008) (transfer from borrower to spouse or children); 12 U.S.C. §1701j-3(d)(6) (2008) (transfer to spouse pursuant to divorce decree or legal separation agreement).

servicers are participating in the program. Borrowers may face long waits on the telephone only to be told that their servicer is not participating. Public disclosure would simplify the process for borrowers, housing counselors, and other advocates and provide accountability for servicers and other institutions.

9. Tax Consequences for Borrowers Receiving Loan Modifications Should Be Eliminated.

Borrowers receiving substantial decreases in interest rates and borrowers receiving principal reductions should not face negative tax consequences, however current tax law still results in such outcomes for borrowers who have refinance loans that were not used for substantial home renovations. While eliminating such tax consequences is best done legislatively, many steps also can be taken by the Administration to address this pressing issue, including:

- issuing guidance on how principal forbearance is treated, when it gets reported (and when not);
- amending regulations regarding "yield" to address interest rate reduction issues;
- issuing broad regulations interpreting indebtedness and financial condition of the borrower so that any loan mod on residential property of a first mortgage is assumed to be acquisition indebtedness; and
- creating a separate, simple form with only one check box instead of Form 982 to deal with loan modifications.

National Consumer Law Center
Selected ARM Bibliography

I. Subprimes reach high rates of foreclosure before the reset.

Susan E. Barnes, Patrice Jordan, Victoria Wagner & David Wyss, Standard & Poor's, Standard & Poor's Weighs in on the U.S. Subprime Mortgage Market 12 (Apr. 5, 2007), available at http://www2.standardandpoors.com/spf/pdf/media/TranscriptSubprime_040507.pdf (increase in early payment defaults within four months of origination).

Joint Center for Housing Studies, State of the Nation's Housing 2007 at 20, *available at* http://www.jchs.harvard.edu/publications/markets/son2008 (subprime ARM 60 day delinquency rates reach 10% to 28%, depending on the origination year, for loans made in 2002-2007, 18 months after origination, at least 6 months before reset)

Anthony Pennington-Cross & Giang Ho, The Termination of Subprime Hybrid and Fixed Rate Mortgages 15-17 (Federal Reserve Bank of St. Louis, Working Paper No. 2006-042A, 2006) (hybrid 2/28 ARMs have a higher probability of default at any age and the rate of default increases during the first two years, even before any payment shock).

Morgan J. Rose, Predatory Lending Practices and Subprime Foreclosures – Distinguishing Impacts by Loan Category 25, 32 (Dec. 2006), available at http://www.chicagofed.org/cedric/2007_res_con_papers/car_62_morgan_j_rose_foreclosures_draft.pdf (average purchase money ARM that entered foreclosure taking only 12.4 months to enter foreclosure from origination)

State Foreclosure Prevention Working Group, Analysis of Subprime Mortgage Servicing Performance, Data Report No. 1, Feb. 2008, at 10-11 http://www.csbs.org/Content/NavigationMenu/Home/StateForeclosurePreventionWorkGroupDataReport.pdf (ARMs foreclosing at high rates before reset).

State Foreclosure Prevention Working Group, Analysis of Subprime Mortgage Servicing Performance, Data Report No. 3, Sept. 2008, at 4 http://www.csbs.org/Content/NavigationMenu/Home/StateForeclosurePreventionWorkGroupDataReport.pdf (one third of suprime ARMs facing reset in the third quarter of 2009 were delinquent in May 2008, more than a year before reset; only 4.15% of subprime and Alt-A loans after reset in May 2008 were delinquent).

II. Subprime ARMs foreclose at higher rates than subprime fixed rate mortgages.

Ellen Schloemer, Wei Li, Keith Ernst & Kathleen Keest, Ctr. For Responsible Lending, Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners 21 (Dec. 2006), available at http://www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf.

Roberto Quercia, et al. The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments (Jan. 2005), at 28-29 available at www.kenan-flagler.unc.edu/ assets/documents/foreclosurepaper.pdf.

III. Subprime ARMs foreclose at higher rates than prime ARMs.

Sumit Agarwal & Calvin T. Ho, Comparing the Prime and Subprime Mortgage Markets, Chicago Fed. Letter (Aug. 2007), available at http://www.chicagofed.org/publications/fedletter/cflaugust2007_241.pdf.

IV. Subprime ARMs reduce housing values.

Andrey Pavlov & Susan Wachter, Aggressive Lending and Real Estate Markets (Dec. 20, 2006), available at http://realestate.wharton.upenn.edu/newsletter/pdf/feb07.pdf 13 (each 1% increase in purchase adjustable rate mortgages leads to housing value decline—itself a risk for foreclosure—of 1.3%).

V. Consumers do not understand ARMs.

Brian Bucks & Karen Pence, Do Homeowners Know Their House Values and Mortgage Terms? 18-22 (Fed. Res. Bd. of Governors Fin. & Econ. Discussion Series Working Paper No. 2006-3) (borrowers, particularly low-income borrowers, underestimate caps on life time interest rates), available at http://www.federlreserve.gov/pubs/feds/2006/200603/200603pap.pdf.

Consumer Fed'n of Am. press release, Lower-Income and Minority Consumers Most Likely to Prefer and Underestimate Risks of Adjustable Mortgages 3, July 26, 2004, available at http://www.consumerfederation.org/releases.cfm#Consumer%20Literacy (consumers cannot calculate the increase in the payment in an adjustable rate mortgage and minimize the interest rate risk by understating the increase in the payment).

Elizabeth Razzi, Mortgage Ignorance Rampant (March 26, 2007), *available at* http://www.bankrate.com/brm/news/Financial_Literacy/March07_mortgage_poll_ _a4.asp?caret=18a (borrowers don't know what kind of loan they have; borrowers with ARMS have no plan for reset,

VI. ARMs predominate in the subprime market.

Ellen Schloemer, Wei Li, Keith Ernst & Kathleen Keest, Ctr. For Responsible Lending, Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners 26 (Dec. 2006), available at http://www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf (over 80% of subprime loans in 2006 were ARMs).

VII. Borrowers make only minimum payments on payment option ARMs.

Joint Center for Housing Studies, State of the Nation's Housing 2007 at 17 (three-quarters of all borrowers make only minimum payments).

VIII. Lenders should do underwriting on the fully indexed rate.

Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37569 (July 10, 2007)

Truth-in-Lending Rules, 73 Fed. Reg. 44,522 (July 30, 2008).

IX. Cases on POARMs

Andrews v. Chevy Chase, 240 F.R.D. 612 (E.D. Wis. 2007), *rev'd on other grounds,* 2008 WL 4330761 (7th Cir. Sept. 24, 2008) (disclosing rate as 2% fixed on the Truth in Lending disclosure form undermines the clear and conspicuous disclosure of the APR).

Buick v. World Savings Bank, 2008 WL 2413172 (E.D. Cal. June 12, 2008) (discussing "Pick-a-Payment SM Equity Builder SM Mortgage," with three month fixed rate of 1.95%; dismissing unfair and deceptive acts and practices claims because of federal pre-emption and lack of proof that the broker was the lender's agent).

Fed'l Trade Comm'n v. Chase Financial Funding, Inc., No. SACV04-549 (C.D. Ca. 2004), *available at* http://www.ftc.gov/os/caselist/0223287/040602comp0223287.pdf (describing adjustable rate mortgage with initial minimum payment, based on interest at 3.5% amortized over 30 years, advertised as "3.5% fixed payment 30 year loan").

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Proposed Language for HASP Contracts Ensuring Loan Modification Analysis Prior to Foreclosure and Related Issues

"By receipt of funds under the HASP, the receiving institution agrees to engage in and to instruct its agents to engage in, loan modifications, as to any loans in which it holds either a whole or fractional interest, or over which it otherwise has authority to pursue modification, as, for example, a servicer under a pooling and servicing agreement. Review to determine eligibility for loan modifications shall be conducted pursuant to regulations issued under HASP, by any federal agency or regulator. The recipient further agrees that no foreclosure shall be initiated on an owner occupied residential property until a review has been conducted under HASP to determine if the borrower is eligible for a loan modification under HASP and that, if the borrower is eligible for a loan modification under HASP, no foreclosure may proceed unless the borrower is offered and rejects the loan modification under HASP. Borrowers of owner-occupied residential properties are intended third-party beneficiaries of this clause.

"Recipient institutions, in order to further the purposes of HASP, further agree that all reasonable attempts will be made to obtain necessary information from borrowers prior to determining that a loan modification is not feasible due to non-contact with the borrower. Such reasonable attempts shall include but are not limited to 1) a minimum of four phone calls to the most recent number of record, over a two week period, at different times of the day, and, where the borrower is not reached, a voicemail message left where such option is available; 2) two certified mail and regular mail mailings; and 3) personal service upon the borrower. Any contact with eligible borrowers, whether by phone, mail, personal service or otherwise, must advise borrowers that they may be eligible for a loan modification, that a loan modification will stop any threatened foreclosure, must clearly state what information the servicer needs to complete the loan modification analysis, must provide a toll-free number at which the information may be provided between 8 a.m. and 8 p.m., local time, and the deadline when the information must be provided in order to preserve the opportunity for a loan modification. Such information shall be provided in the borrower's language, if the servicer has information that the borrower is a non-native English speaker, and, when in writing, must be provided in no more than a 6th grade reading level, and 12 point font. Borrowers are intended third-party beneficiaries of this clause.

"Nothing in this contract is intended to limit a servicer or investor from offering a more generous loan modification than explicitly authorized by the HASP regulations. This contract is not intended to and does not restrict the offering of these or other loan modifications."

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