July 15, 2008

Douglas Shulman
Commissioner
Internal Revenue Service
CC:PA:LPD:RU (Rev. Proc. 2008-28)
Room 5203
PO Box 7604
Ben Franklin Station,
Washington, DC 20044

VIA EMAIL: Notice.Comments@irscounsel.treas.gov (Rev. Proc.2008-28)

Dear Commissioner Shulman:

The Center for Responsible Lending (CRL), the National Consumer Law Center, and the National Association for Consumer Advocates (NACA) appreciate the opportunity to comment to the Internal Revenue Service concerning Revenue Procedure 2008-28 regarding the impact of loan modifications on the tax status of securitization vehicles. We commend the IRS for its efforts to encourage modification of home mortgage loans in danger of default by reducing the obstacles occasioned by tax considerations.

CRL is a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. We are affiliated with a community development lender, Self Help, which provides carefully underwritten loans to people and small business who have been under-served by other lenders. Over its 27 years of operation, Self Help has provided over $5 billion of financing to 55,000 low-wealth families, small businesses, and nonprofit organizations.

NCLC is a non-profit organization specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of sixteen practice treatises and annual supplements on consumer credit laws, and its attorneys have written and advocated extensively on all aspects of consumer law affecting low-income people.

NACA is a nationwide, non-profit corporation whose more than 1,400 members are private and public sector attorneys, legal services attorneys, law professors, law students, and non-attorney consumer advocates. NACA's mission is to promote justice for all consumers and to provide a forum for information-sharing among consumer advocates across the country. From its inception, NACA has focused on issues concerning abusive and fraudulent practices by businesses that provide financial and credit-related services

A. The current foreclosure crisis threatens not just the housing market, but the entire economy.

As foreclosures reach an all-time high and are projected to grow higher,[1] the "worst case is not a recession but a housing depression."[2] At least two million American families are expected to lose their homes to foreclosures initiated over the next two years.[3] What's more, industry projections forecast that by 2012, 1 in 8 mortgages – that's all mortgages, not just subprime mortgages – will fail.[4] Robert Schiller recently noted that the meltdown and resulting crisis has erased any gains in the homeownership rate made since 2001, particularly among African-Americans and Latinos, and the rate stands to fall further yet.[5]

Recent data shows that 30% of families holding recent subprime mortgages now owe more on their mortgage than their home is worth.[6] "Negative equity" precludes the homeowner from selling, refinancing, or getting a home equity loan to weather any financial difficulty.[7] In other words, it traps homeowners in homes, and even if families keep their homes in such demoralizing circumstances, needed upkeep and maintenance may be deferred due to the lack of financing—thus further reducing the property value.

The negative effects of foreclosures are not confined to the families who lose their homes. Forty million of their neighbors will see their property values decline as a result

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[1] Renae Merle, *Home Foreclosures Hit Record High*, Washington Post (Mar. 6, 2008).

[2] David M. Herszenhorn and Vikas Bajaj, *Tricky Task of Offering Aid to Homeowners*, N.Y. Times (Apr. 6, 2008) (quoting Susan M. Wachter, a real estate finance professor at the Wharton School of the University of Pennsylvania: "In the market that we have in front of us, prices decline and supply increases, driving prices down further.").

[3] *See* Written Testimony of Mark Zandi, Moody's Economy.com before House Subcommittee on Commercial and Administrative Law (January 28, 2008), available at: http://judiciary.house.gov/media/pdfs/Zandi080129.pdf.

[4] Rod Dubitsky, Larry Yang, Wen Zhang and Thomas Suehr, *Foreclosure Trends – A Sobering Reality*, Credit Suisse, Fixed Income Research (Apr. 28, 2008).

[5] Robert J. Schiller, *The Scars of Losing a Home*, N.Y. Times (May 18, 2008) (noting that the homeownership rate has fallen from 69.1% in 2005 to 67.8% in the first quarter of 2008, nearly the 67.5% rate at the beginning of 2001).

[6] Edmund Andrews, *Relief for Homeowners is Given to a Relative Few*, N.Y. Times (Mar. 4, 2008) (loans originated in 2005 and 2006).

[7] A recent Los Angeles Times article has called into question the widespread industry claim that people are simply walking away from underwater mortgages. However, when homeowners who cannot afford their abusive loans also have no options to refinance or modify, they are ultimately pushed into defaulting. Michael Hilzik, *Walk Away Homeowners May Be Urban Myth*, Los Angeles Times (March 10, 2008).

by over $350 billion.[8] Governmental units with high concentrations of foreclosures will also incur devastating losses. Direct economic losses stemming from this crisis will likely top $500 billion. Consequential costs may total close to a trillion dollars.[9]

Sadly, many of the families losing their homes to foreclosure today might not have found themselves in this position if they had been given the type of loan that they actually qualified for. Last year, the Wall Street Journal found that of the subprime loans originated in 2006 that were packaged into securities and sold to investors, 61% "went to people with credit scores high enough to often qualify for conventional loans with far better terms."[10] Even those applicants who did not qualify for prime loans could have received sustainable, thirty-year, fixed-rate loans for – at most – 50 to 80 basis points above the “teaser rate” on the ARM loans they were given, which is much less than the average upward adjustment when the teaser rate resets.[11] Indeed, many consumers were charged 100 basis points more for “no-doc” loans when they had already handed over their W-2 statements or readily would have done so but for the broker’s desire to originate these riskier loans. The typical adjustable rate subprime loan is both more expensive and riskier than a comparable thirty-year fixed rate loan, even at the initial payment.

Wall Street’s appetite for risky loans incentivized mortgage brokers and lenders to aggressively market these highly risky ARM loans instead of the sustainable loans for which consumers qualified. Market participants readily admit that they were motivated by the increased profits offered by Wall Street in return for risky, higher-yielding loans. After filing for bankruptcy, the CEO of one mortgage lender explained it this way to the New York Times, “The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans,” he said. “What would you do?”[12] The chief economist of the Mortgage Bankers Association, when asked why lenders

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[8] See Center for Responsible Lending, The Impact of Court-Supervised Modifications on Subprime Foreclosures, (Feb. 25, 2008), *available at* http://www.responsiblelending.org/pdfs/us-info-with-fc-starts.pdf; for CRL’s methodology for computing spillover, *see Subprime Spillover, supra* note 3 (Rev. Jan. 18, 2008), *available at* http://www.responsiblelending.org/issues/mortgage/research/subprime-spillover.html.

[9] Christopher Swann, *IMF Says Financial Losses May Swell to $945 Billion,* Bloomberg.com (Apr. 8, 2008), *available at* http://www.bloomberg.com/apps/news?pid=email_en&refer=home&sid=aK1zAj5FZ9Io.

[10] Rick Brooks and Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy As Housing Boomed, Industry Pushed Loans To a Broader Market*, Wall Street Journal at A1 (Dec. 3, 2007).

[11] Letter from CFAL to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner (Jan. 25, 2007) at 3.

[12] Vikas Bajaj and Christine Haughney, *Tremors at the Door – More People with Weak Credit Are Defaulting on Mortgages*, N.Y. Times at C1, C4 (Jan. 26, 2007).

made so many loans that they knew were unsustainable, replied, "Because investors continued to buy the loans."[13]

B. Mortgage loan servicers are not making loan modifications at the rate necessary to stem the tide of foreclosures.

To date, Congress and the regulatory agencies have relied largely on voluntary efforts by servicers to reduce the number of foreclosures and have strongly lobbied against any effort to permit such modifications to occur in bankruptcy court. Yet despite the support for servicer loss mitigation efforts from President Bush,[14] the federal banking agencies, and the Conference of State Banking Supervisors,[15] voluntary efforts by lenders, servicers and investors continue to be insufficient to stem the tide of foreclosures. According to a recent report by the State Foreclosure Prevention Working Group, a collection of state Attorneys General and Bank Commissioners, only 24% of seriously delinquent borrowers were working with professionals in any type of loss mitigation activity that could lead to preventing a foreclosure.[16]

The most recent data from the Hope Now initiative and from the Mortgage Bankers Association further demonstrate that the current crisis in the housing market dwarfs the servicing industry's response. Seriously delinquent loans are at a record high for both prime and subprime loans**.**[17] The number of borrowers who lost their homes to foreclosure soared in May to 85,000 families, a 35 percent increase over three months and more than double the number from July of last year**.**[18] Almost four times as many families lost their home or are in the process of losing their home as received loan modifications from servicers.[19] The number of families in danger of losing their homes

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[13] *Subprime Loans Defaulting Even Before Resets*, CNNMoney.com (Feb. 20, 2008). *See also* Atif Mian and Amir Sufi, *The Consequences of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis*, NBER Working Paper 13936, http://www.nber.org/papers/w13936; Benjamin Keys, Tanmoy Mukherjee, Amit Seru and Vidrant Vig, *Securitization and Screening: Evidence From Subprime Mortgage Backed Securities*, working paper (Jan. 2008).

[14] White House press release, August 31, 2007. See also the Interagency Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages, http://www.federalreserve.gov/newsevents/press/bcreg/20070904a.htm (encouraging lenders to address subprime hybrid ARM resets by pursuing "appropriate loss mitigation strategies designed to preserve homeownership. . . . Appropriate loss mitigation strategies may include, for example, loan modifications, deferral of payments, or a reduction of principal.").

[15] Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages http://www.federalreserve.gov/boarddocs/srletters/2007/SR0716.htm.

[16] Analysis of Subprime Servicing Performance, Data Report No. 1, February 2008, http://www.csbs.org/Content/NavigationMenu/Home/StateForeclosurePreventionWorkGroupDataReport.pdf.

[17] Mortgage Bankers Association National Delinquency Survey, First Quarter 2008.

[18] Hope Now May 2008 Data Release, available at http://www.hopenow.com/site_tools/data.php.

[19] Furthermore, the data provided by HOPE NOW understates the number of loans in foreclosure, as it only includes those homes that entered foreclosure and those that completed foreclosure during the month, not

continues to be near record highs: an estimated 1,977,000 loans were 60-days or more delinquent or entered foreclosure in May, the second highest number since the program began reporting data last July.[20] This is an astonishing 43 percent increase since July of last year.

In particular, loan modifications thus far have not successfully reached the approximately 30% of recent subprime loans that are underwater—that is, borrowers owe more than the house is worth. Chairman Bernanke recently noted that loan modifications involving "reductions of principal balance have been quite rare."[21]

It has become clear that there are a number of reasons for this lack of loss mitigation activity, including the way servicers are compensated by lenders and the widespread existence of "piggyback" mortgages (second liens) on many homes. One important obstacle has been servicers' concern that loan modifications might have negative tax and accounting consequences for trusts and investors.

While the IRS cannot solve all of these problems on its own, by freeing servicers from fears of some of the tax consequences, Revenue Procedure 2008-28 will assist efforts to provide more loan modifications so that there are ultimately fewer foreclosures.

C. Answers to IRS questions regarding Revenue Procedure 2008-28

Before answering the specific questions posed, we reiterate our strong support for Revenue Procedure 2008-28. We are grateful that the IRS has recognized the critical need for servicers to modify unsustainable loans and are very pleased that that the IRS has taken action to promote modifications. Our suggestions below are meant to further the purposes of this Revenue Procedure and to help achieve the desired goals.

Should this revenue procedure be extended to loan modifications that are effected after 2010?

Yes, the revenue procedure should be made permanent. The problems in the market continue to deepen and spread beyond anyone's worst forecasts. Servicers need to be given the flexibility to continue to respond to the current crisis for as long as necessary, and also to respond to the next crisis, whenever it occurs.

We are already more than a year into the current foreclosure crisis. Action now is important and holds the prospect of saving many homes. There is always a lead time after a crisis occurs before measures such as this Revenue Procedure are taken. Had it been in place in early 2007, it is possible that more homes could have been saved and the

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the total number currently in the foreclosure process. In fact, 1.1 million families were in foreclosure at the end of March.

[20] Hope Now May 2008 Data Release, *supra* note 18.

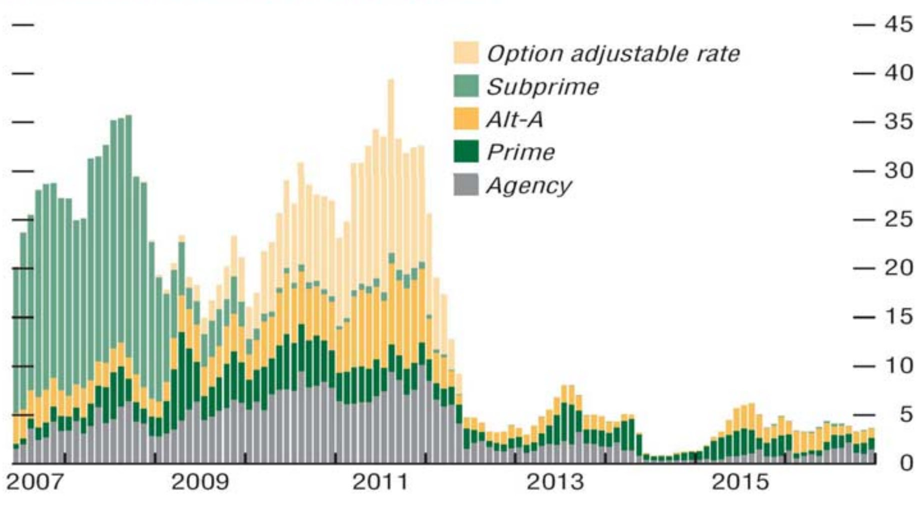
[21] Statement of Federal Reserve Chairman Ben Bernanke on March 4, 2008, reprinted by Bloomberg.com and available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=apeU.0IaETdM.

crisis could have been better contained. Making the rule permanent should permit servicers to respond more quickly to the next crisis, however and whenever it manifests itself, without a dangerous delay.

Revenue Procedure 2008-28 contains many safeguards against abuse, including requiring that the majority of loans be current when placed in the pool, that the modifications be made only on loans at risk of foreclosure, and that the modification must result in a loan whose terms are less favorable to the holder post-modification. When loans are in default and at risk of foreclosure, it serves no one's interest to prevent modifications. While making the rule permanent may pose a problem with conformity with FASB rules, those rules are already in the process of change.

Although subprime ARM resets are spiking in 2008 and 2009, the problems in the mortgage market will in no way be over by 2010. First, the subprime ARMs do not have just one reset, but one every six months for the remaining life of the loans.   Moreover, approximately two years after the subprime ARM spike, another type of dangerous loan product will experience a reset spike: the payment option adjustable-rate mortgage (POARM).   POARMs allow homeowners to make a "minimum" monthly payment that does not cover principal and interest, which means that the home experiences "negative amortization" – that is, the principal balance of the loan grows larger – during the period that the minimum payment is being made. Unfortunately, many lenders such as Countrywide offered these loans to borrowers for whom they were not suited, structured the products so that the payments substantially increase in five years (or less when they hit their negative amortization cap), used excessive teaser rates, and failed to document income. Unlike 2/28s, the POARMs that were poorly underwritten are largely Alt-A mortgages as opposed to subprime. The Credit Suisse chart below shows a spike in payment option ARM resets between 2009 and 2011 just after the 2008 spike in subprime hybrid ARM resets.

Figure 1.7. Monthly Mortgage Rate Resets
(First reset in billions of U.S. dollars)



Source: Credit Suisse.

Finally, while it is true that the subprime market has slowed considerably, there is strong evidence that abusive lending continued long after the crisis had become apparent. Among subprime loans that were originated and sold on the secondary market in 2007, a high proportion included loan terms that have been statistically demonstrated to increase risk of foreclosure: 69% had adjustable interest rates; 40% had not required proof of income; and 67% had prepayment penalties.[22]

Should the Service consider changing other provisions of this revenue procedure?

Yes. Below are a few suggestions for how to improve this revenue procedure. We have only referenced sections for which we have suggestions.

Section 2. Background - Foreclosure Prevention Programs

The IRS has taken an important first step in recognizing that both formal established foreclosure prevention programs and other systematic procedures can be used in assessing the eligibility of a loan for modification. We believe that Procedure 2008-28 should be used flexibly as servicers, in cooperation with other interested parties, including regulators, community groups, and housing counselors, continue to develop innovative procedures to identify appropriate modifications.

The IRS has wisely not blessed any existing foreclosure prevention program. Existing programs have produced only a paucity of loan modifications. Clearly, to stem the flood of foreclosures, we need more modifications, deeper modifications, and faster modifications. Servicers should be encouraged to use automated systems-based analysis. Servicers also should be encouraged to follow streamlined analyses and to work with community groups and counseling agencies to develop locale specific evaluation procedures. Procedure 2008-28 provides an important safe harbor to encourage servicers to take all of these steps. The IRS should continue to do all it can to encourage good-faith modifications.

Section 4. Background – Trusts.

We suggest that you address the applicability of this provision to trusts that are nontaxable "qualified REIT subsidiaries." Many lenders that had elected REIT status set up these types of trusts, i.e. New Century, Accredited, Novastar, Fieldstone, et al., and these trusts are experiencing delinquencies and defaults as well.

Section 5. Scope.

In Paragraph 04, we suggest that you change the first sentence from "significant risk of foreclosure" to "significant risk of default." As noted in Section 2.03 of Revenue Procedure 2008-28, many existing foreclosure prevention programs employed by servicers work towards modification before any default occurs. Underpinning the REMIC rules and the FAS 140 rules is a "reasonably foreseeable default" standard rather than a

[22] "Subprime Guidance Did Little to Diminish ARM Share," *Inside B&C Lending* (February 15, 2008).

“reasonably foreseeable foreclosure” standard. Changing the focus from foreclosure to default will facilitate consistency between the REMIC and FAS 140 rules. When a borrower is in default, a servicer may offer various loss mitigation plans to the borrower, or the servicer may proceed to foreclosure. Whether the borrower is in fact at significant risk of foreclosure is at least in part dependent on the servicer’s actions, attitudes, and procedures.

In short, systematic analyses should be based on the borrower’s circumstances and the loan, not on the servicer’s protocols or schedules. Such systematic analysis can be -- and currently is -- conducted within the framework of maximizing returns to the trust; the key point of focus in determining whether a modification is necessary and will be successful must be the borrower’s circumstances. The IRS should not impede the efforts to address promptly loans at risk of default, nor require a higher standard than those imposed by FAS 140. Please note that changing the standard here will require making corresponding changes in all other mentions of foreclosure prevention programs, such as in sentence 2 of this paragraph, by changing it to “default/foreclosure prevention program.”

We also suggest adding at the end of the second sentence, after “credible systematic determination,” the clarification “using adequate information that, in accordance with prudent mortgage servicing standards, is needed to make such a decision.”

We applaud the IRS’s requirement that the modification should result in a loan with terms less favorable to the holder than the existing terms. Paragraph 05 does not specify any way to measure how a modification may satisfy this requirement, i.e., over the life of the loan, net present value, etc. Existing servicing requirements have sometimes been interpreted overly narrowly. In all cases, the preference should be to make a modification, in accordance with the highest industry standards of a reasonably prudent servicer. Flexibility in this area should allow continued development of different forms of loan modification.

In Paragraph 06, to conform to our comments regarding paragraph 2, add “….presents a substantially reduced risk of **default and** potential foreclosure…”

Should the Service consider issuing any additional guidance regarding Federal tax issues that are raised by modifications of mortgage loans to reduce the risk of foreclosure?

Yes, we do have a suggestion for additional guidance. For homeowners, one of the most significant hurdles related to negotiating a loan modification is the handling of 1099-C reporting of the discharged debt. Most homeowners who need a write-down of mortgage principal are unlikely to be in a position to retain experienced tax counsel. Yet the IRS currently forbids the Tax Assistance Centers, Volunteer Income Tax Assistance sites, and Tax Counseling for the Elderly sites from assisting consumers with discharge of debt issues due to their complexity.[23]

Despite recent changes to the form and improved guidance by the IRS, Form 982 -- the form that must be filed by a taxpayer who seeks to exclude discharge of indebtedness income from taxable income -- remains difficult to complete and is primarily geared to commercial loans. Common exceptions to the taxability of discharged debt, including insolvency, purchase price infirmity doctrine and disputed debt or debt discharged by operation of law other than the expiration of the statute of limitations, are not adequately delineated on the form.

The IRS should provide clear guidance to lenders and servicers that there is no need to file a 1099-C if principal is reduced as part of a loan modification in a situation where the debt is genuinely disputed, where the reduction is made because of fraud by a third party in the sale of the house, or where the homeowner is insolvent. A lender or servicer who reduces the debt for any of these reasons will have access to documentation supporting the reasons for the reduction and will know that the discharged debt is unlikely to be taxable. The IRS has already ruled that, in cases of disputed debt, determination of the amount to be reported is fact-specific, and therefore it does not penalize lenders who do not report disputed discharged debt.[24] Requiring 1099-Cs for loan modifications made under these circumstances only imposes unnecessary costs on everyone, particularly those homeowners in the worst position to bear such costs.

Submitted by:

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[23] 2007 Nat'l. Taxpayer Advocate Ann. Rep. 28.

[24] Information Reporting for Discharges of Indebtedness, 61 Fed. Reg. 262, 267 (Jan. 4, 1996).