

# Global Financial Crisis Bulletin

## The “Home Affordable” Loan Modification Standards: What Loan Servicers and Investors Need to Know

March 10, 2009

### Introduction and Background

From a very early point in the housing crisis, lawmakers, regulators and many media observers have shared the strong belief that a large percentage of the foreclosures at the heart of the crisis are avoidable. In a letter to mortgage servicing industry executives dated October 8, 2008, House Financial Services Chairman Barney Frank (D-MA) wrote:

*My colleagues and I have repeatedly urged you and other mortgage servicers – in hearings, letters and conversations – to engage in an intense effort to modify troubled mortgages. We have stressed that mass modifications will help borrowers keep their homes, and will also help shore up our financial system by stemming the flood of foreclosures that began over a year ago. Unfortunately, our warnings and urgent appeals have not been sufficiently heeded, thus deepening the effects of the financial crisis on homeowners, communities and the economy as a whole.*

In response to the urging of lawmakers and regulatory agencies, a relatively small number of companies have undertaken aggressive, high-profile loan modification programs. However, in spite of broad-ranging support for such programs, it is clear that results thus far have fallen far short of expectations. According to the most recently available results of an ongoing study by the Office of the Comptroller of the Currency (OCC) and Office of Thrift Supervision (OTS), nearly 60 percent of modified loans had re-defaulted and were at least 30 days past-due within eight months after the modification.<sup>1</sup> Statistics like these have led many industry representatives to question whether the cost of implementing a loan modification program outweighs the benefit of doing so.

A few of the many possible reasons why loan modification efforts to date have produced disappointing results include:

- With few exceptions, servicers have not been required to implement loan modification programs. The lack of a uniform national standard has led to a patchwork of different programs and a great deal of confusion on the part of borrowers regarding the relief that might be available to them.
- Most programs offered thus far have focused exclusively or almost exclusively on borrowers who already were significantly (i.e., 90 days or more) past-due at the time that the modification was offered. Borrowers with this level of mortgage delinquency carry a significantly higher risk of re-default compared to modifications offered to borrowers for whom default is reasonably foreseeable, but who have not yet gone delinquent as of the date of the offer.
- Loans serviced on behalf of third-party investors are often subject to complex servicing agreements that significantly limit or prohibit the types and/or volume of modifications that can be performed.

<sup>1</sup> [http://www.occ.gov/mortgage\\_report/2008/q3/30\\_redefault\\_rates.htm](http://www.occ.gov/mortgage_report/2008/q3/30_redefault_rates.htm).

- The value to borrowers of the modifications offered to date (as measured, for example, by the amount by which the borrower's monthly payment was reduced) has in many cases been insufficient to make the loan permanently affordable.
- Most borrowers – even those who have been prequalified for modifications – fail to respond to offers to modify their loans.
- As housing prices continue to fall, many borrowers have little reason to continue to repay their loans, even if they are able to do so (or would be able to if their loan was modified). Even though as many as one in five<sup>2</sup> borrowers is now “underwater” (owing more than his or her property is worth), servicers have so far almost universally been unwilling to write down principal permanently.
- Even as many servicers have stepped up voluntary modification efforts, deteriorating economic conditions, especially a very large and rapid spike in the national unemployment rate to more than 8 percent, have increased the number of new delinquencies at a much faster rate than that at which homes are being “saved” by modifications.

### The “Home Affordable” Loan Modification Standards

In an effort to address many of these deficiencies and increase both the number and effectiveness of modifications being performed, the Obama administration announced a wide-ranging financial stability plan on February 10, 2009. Further details of the loan modification component of the plan, dubbed the “Home Affordable Modification” program, were released by the U.S. Treasury Department on March 4.

Broadly, key provisions of the program include:<sup>3</sup>

- A national standard is established that sets forth the process and methodology by which servicers should consider and execute loan modifications.
- Participation is technically voluntary, except with regard to firms that receive Financial Stability Plan (FSP) assistance going forward. Although not explicitly stated in the program documentation itself, we expect the FDIC will also require that buyers of failed institutions (or assets of those institutions) implement the guidelines, even if the acquiring institution is not an FSP recipient itself.
- If a servicer chooses to participate, all eligible loans, as defined in the program, must be serviced according to the terms of the program.
- In general, only first-lien mortgages of amounts less than \$729,750 secured by owner-occupied properties are eligible for the program.<sup>4</sup>
- Loans meeting the basic criteria described above must be considered for modification if they are at least 60 days delinquent; however, servicers are provided with additional cash incentives to modify loans for borrowers who are currently paying as agreed but face significant risk of default in the future.
- An incentive program is established that provides for direct cash payments to servicers, loan holders and borrowers for modifications performed under the program, with additional incentives to all parties when modified loans continue to be repaid as agreed for a period as long as five years following the modification.
- Participating servicers are required to bear the cost of reducing the borrower's first mortgage payment amount to a level that results in a 38 percent first-lien housing debt-to-income (DTI) ratio. The Treasury will then match on a dollar-for-dollar basis the additional cost of reducing the DTI to 31 percent.
- In order to arrive at the required DTI ratios, servicers are required to apply a “waterfall” approach, first temporarily reducing the interest rate on the loan to as low as 2 percent per year, then extending the amortization term to as long as 40 years from the date of modification, and finally agreeing to forbear a portion of the principal. Importantly, this does not mean permanently reducing the principal. The forbearance amount does not accrue interest and is not included for purposes of calculating the borrower's new monthly payment, but it still must be repaid when the loan reaches maturity, when it is

<sup>2</sup> Statistic from First American/Corelogic report published March 4, 2009.

<sup>3</sup> The provisions of the program that have been released to date are complex and subject to numerous conditions and exceptions, not all of which are detailed here. Readers are encouraged to review the full program guidelines available at [www.financialstability.gov](http://www.financialstability.gov).

<sup>4</sup> Higher limits apply to multifamily properties.

refinanced or when the borrower sells the property. Servicers can voluntarily reduce the principal amount on a permanent basis, but this would not be subject to the Treasury’s cost-sharing provision.

- After determining what waterfall steps are necessary to arrive at the required 31 percent DTI ratio, servicers are required to apply a standardized “net present value” (NPV) test to assess whether the expected value of a modification is greater than the expected value of foreclosing on the loan. If the NPV test is “passed” (i.e., the expected value of the modification is greater than that of foreclosure), the servicer is required to offer a modification. With a few exceptions for very large servicers, participants will be required to use the specific model criteria and values that the Treasury will establish.
- For loans serviced on behalf of third-party investors where the servicing agreement would restrict participation in the program, servicers will be required to make “reasonable efforts” to obtain the investors’ consent to modify the terms of the agreement.
- Incentives will be provided to encourage second-mortgage holders to release their liens, although the form that these incentives will take has not yet been disclosed.
- Servicers will be required to enter into an agreement with the Treasury and/or its designated agents that will more formally establish the terms and conditions of the program.
- Servicers also will be required to implement appropriate programs and controls to:
  - Respond to borrower inquiries concerning the program, and evaluate and document whether borrowers who inquire about a modification have experienced “financial hardship” and are at risk of what the guidelines define as “Imminent Default.”
  - Maintain documentation necessary to facilitate audits of compliance with the program.
  - Mitigate the risk of fraud in connection with modification requests.
  - Collect and report data necessary to verify compliance with the program and measure its effectiveness.
  - Ensure compliance with accounting and other legal requirements associated with modifications performed under the program.

### Outlook for Success

The administration projects that as many as three to four million homeowners may be helped by the program. More practically, the program will have “worked” if the rate of foreclosures falls or stabilizes and home prices begin to stabilize relative to broader economic conditions. It is also important to note that key elements of the plan (including, for example, the specific criteria behind the NPV model standards) have yet to be defined, and the final form of those could have a significant impact on the effectiveness of the program. With those objectives and caveats defined, let’s explore some of the reasons for optimism and pessimism regarding the plan:

Reasons to Think It Will Work	Reasons to Think It Won’t
The existence of a national standard in any form will likely cause many servicers to “get off the fence” and begin to offer modifications.	The “all or nothing” nature of the plan (in that all loans must be serviced according to the plan if a servicer chooses to participate) could give pause to many servicers and drive down participation rates. In theory, the NPV provision should mean that servicers would want to offer the program to all eligible borrowers, but in practice, we expect that many servicers would have preferred to evaluate the effectiveness of the plan with limited categories of loans before opening it up to their entire portfolios.
Aside from the explicit requirement that future FSP participants sign on, the federal banking and other regulatory agencies have already issued statements that “strongly encourage” their regulated institutions to participate in the program.	Similarly, the rigidity of the NPV guidelines could represent a concern for servicers that believe the national data that will be used to set the standards for components such as the likelihood of re-default or the expected direction of home price values is not comparable to the servicer’s own portfolio.

Reasons to Think It Will Work	Reasons to Think It Won't
<p>The 31 percent DTI standard is among the lowest used in large-scale modification programs to date, which bodes well for the long-term affordability of modifications completed under the program.</p>	<p>The value of the financial incentives to servicers and investors is not as great as many had hoped for. For example, a proposal set forth by FDIC Chairman Sheila Bair in 2008 called for the government to absorb up to half of the losses associated with the re-default and eventual foreclosure of a modified loan. In the final program, this proposal appears to have been replaced with a much more limited provision to provide servicers with ongoing cash payments in the event that property values continue to decline in general. Although decisions like this one will reduce the potential exposure to taxpayers, they also are likely to reduce the number of firms that participate in the program, as well as the number of individual loans that pass the NPV test and are offered modifications.</p>
<p>The cash incentives have, for the most part, been structured carefully to encourage solutions that minimize the risk of re-default.</p>	<p>The program does little, if anything, to address effectively the huge number of properties that are currently underwater. Administration officials have expressed the hope that borrowers want to stay in their homes even if they no longer have equity and have little prospect of regaining equity in the future. However, that view may prove to be overly optimistic, as home values continue to decline and other economic indicators continue to deteriorate.</p>
<p>The outlook for the program's effectiveness improves if it is viewed as the "carrot" in connection with the "stick" of proposed bankruptcy cramdown legislation. Various proposed versions of the latter would take into account whether the servicer had offered a reasonable modification before the borrower declared bankruptcy, and it seems safe to assume that a Home Affordable modification offer would meet this standard.</p>	<p>In addition to the point above, the likely effectiveness of the provision to pay borrowers who continue to make payments as agreed following modification is questionable. Borrowers can "earn" up to \$1,000 per year under this provision, but the payments must be used to reduce the principal balance of the loan, and are not made directly to borrowers. One could argue that this structure makes sense from a public policy perspective, but for borrowers who, for example, owe \$300,000 on a property worth only \$200,000, the prospect of having their principal balance reduced by a total of \$5,000 over five years is unlikely to provide much of an incentive on its own.</p>

Reasons to Think It Will Work	Reasons to Think It Won't
<p>Similarly, concurrent efforts to establish a program to indemnify servicers for investor claims associated with loan modifications performed under the plan could drastically increase the number of candidate loans.</p>	<p>The focus of the program eligibility standards on “front-end” (i.e., housing-only) DTI ratio creates a significant risk that even if a borrower’s mortgage payment was affordable on its own, the likelihood of repayment is very low as a result of an excess “back-end” or total DTI ratio. The program does require that borrowers with back-end DTIs in excess of 55 percent agree to receive credit counseling, but a) credit counseling on its own does nothing to reduce DTI, and b) borrowers only have to agree to counseling in the future – there is no provision in the plan to verify they actually have undergone counseling. Again, the hope is that borrowers would make their primary residence payment before paying any other debts, but this may not be an economically rational decision for borrowers who are underwater.</p>
	<p>The scope of the program has been significantly limited to ensure that it only helps “responsible homeowners.” For example, only owner-occupied properties are eligible for the program in the first place, and borrowers must demonstrate financial hardship in order to qualify. Again, one could make the argument that this is the best approach from a public policy perspective, particularly if the main objective of the program is to help individual borrowers. However, a foreclosure of an investor-owned property, or a property that a borrower perhaps never should have bought in the first place, likely has as much of a negative impact on the housing and financial markets as any other. As economic news continues to worsen by the day, the principles of fairness applied in the decision to limit the scope of the program need to be weighed against the pragmatic question of the best way to stem the tide of the crisis.</p>

**Conclusion**

For most loan holders and servicing executives, the question of whether the program will “work” from a macroeconomic perspective is likely less important than the immediate question of what impact the program will have on their organizations, and what steps they should be taking to prepare. With that in mind, we believe that industry leaders should be seeking answers to the following questions:

- 1) How many loans do we service that potentially would be eligible for the program (broken down by product type, geography, loan amount and LTV, credit quality, and other pertinent factors)?
- 2) Are these loans serviced on behalf of third-party investors? If so, would Home Affordable modifications be permitted under the terms of the servicing agreement? If not, what would we need to do in order to obtain approval from investors to modify the agreement?

- 3) Do we currently maintain all of the data elements that will be required to be collected and reported under the program? If so, how comfortable are we with the integrity of our existing data, and what steps should be taken to validate and/or “scrub” it prior to launching the program? If not, how much time and funding would be necessary to enhance our processes and systems to facilitate collection of the data?
- 4) If we offer a loan modification program today, how do the Home Affordable standards compare to what we are currently doing? If we were to participate in Home Affordable, can we project how that would change the number of modifications completed and the expected performance of loans post-modification?
- 5) If our current program includes an NPV component, how do the criteria and values currently used in our model compare to those that are soon to be released for the Home Affordable program? If we would qualify as a “large” servicer under Home Affordable, do we want to keep our current model (taking on the additional requirements that the program imposes for custom models), or replace it with the national standards?
- 6) As noted above, the program will require a significant investment on the part of servicers to develop appropriate documentation, reporting and risk management programs. What would be the cost and time required to put these programs in place, and what are the results when we compare those projected costs to the financial benefits we would expect to receive from participating in the program?
- 7) If we do not currently offer a modification program, what level of staffing (roles, skills, experience) will be necessary to design, implement and monitor the program; field borrower inquiries and applications for modifications; underwrite and render decisions on modifications, etc.?
- 8) Do we have or can we put into place an effective program to monitor the Fair Lending risks associated with loan modification efforts? How will we ensure that decisions to approve or deny modification requests are made consistently, and that prospective candidates for loan modifications receive a similar level of assistance without regard to prohibited bases?
- 9) If a purely objective cost/benefit analysis of Home Affordable would dictate that we not participate in the program:
  - a. Do we anticipate any possibility that we would need to apply for FSP assistance in the future?
  - b. What view would our regulatory agency examiners take of our decision not to participate in the program? Can we demonstrate alternative steps that we have taken or will take to mitigate our mortgage servicing risks from a safety and soundness perspective?
  - c. Firms that have large mortgage portfolios likely will face significant legislative and public pressure to participate. How are we prepared to address these concerns from a government and public relations perspective if we choose not to participate?
  - d. What is our exposure to bankruptcy cramdown legislation, and how would that exposure be impacted by a failure to offer modifications to borrowers who request them prior to filing for bankruptcy?

In closing, the long-awaited national modification standards are finally upon us, and they clearly represent a compromise among many competing viewpoints. Although industry representatives might have hoped for more flexible standards and more generous financial incentives from the government, the program does at least represent an improvement over the patchwork approach that has been employed to date. Moreover, organizations that hold or service a significant mortgage portfolio should expect a great deal of regulatory, legislative and public pressure to participate. Therefore, they should review the guidelines and begin to consider carefully what steps they would need to take in order to do so.

## About Protiviti Inc.

Protiviti ([www.protiviti.com](http://www.protiviti.com)) is a global business consulting and internal audit firm composed of experts specializing in risk, advisory and transaction services. The firm helps solve problems in finance and transactions, operations, technology, litigation, governance, risk, and compliance. Protiviti's highly trained, results-oriented professionals provide a unique perspective on a wide range of critical business issues for clients in the Americas, Asia-Pacific, Europe and the Middle East.

Protiviti has more than 60 locations worldwide and is a wholly owned subsidiary of Robert Half International Inc. (NYSE symbol: RHI). Founded in 1948, Robert Half International is a member of the S&P 500 index.

## About the Protiviti Financial Crisis Team

To assist companies with understanding the new landscape and managing the uncertain times ahead, we have formed the **Protiviti Financial Crisis Team**. This cross-disciplinary group is comprised of seasoned professionals with deep industry, financial risk management, restructuring and litigation support experience. Coordinated by Protiviti's global industry and solutions leaders, this strategic team provides clients with advice on responding to these market conditions, as well as updates about market and regulatory changes, and works closely with the firm's client service teams to help clients deal successfully with the unfolding global economic environment.

For more information, please visit [www.protiviti.com/economiccrisis](http://www.protiviti.com/economiccrisis) or contact:

Carol Beaumier  
Managing Director  
+1.212.603.8337  
[carol.beaumier@protiviti.com](mailto:carol.beaumier@protiviti.com)

Michael Brauneis  
Director  
+1.312.476.6327  
[michael.brauneis@protiviti.com](mailto:michael.brauneis@protiviti.com)