

PART TWO

Back to the Drawing Board?

Drafting Salient Workout Options Requires Implementing the Most Effective Tools of the Trade

Last month we reviewed the efforts servicers are making to align themselves with trusted third parties to publicize the availability of workout options and to improve contact rates with delinquent homeowners. We pointed out that defaults are rising, and that we are facing challenges due to the complex problems underlying these new defaults.

We expect that more borrowers will turn to counseling agencies and servicers for assistance in working through these problems, particularly with the publicity generated by local and national initiatives to promote financial counseling.

So where is the industry in its efforts to cope with this changing environment?

There are numerous initiatives under way to develop new workout options and to “retool” the ones we currently employ.

MBA: Over the last few months, the

Mortgage Bankers Association (MBA) sponsored several meetings to bring together servicers and capital markets experts to discuss creative approaches to loss mitigation. Servicers brainstormed loss mitigation options and focused on securitized loans and the particular legal and contractual challenges presented by this segment, including Internal Revenue Service (IRS) requirements and bond holder expectations for cash flow. The MBA also held a working meeting last month to look at refinance and new products for subprime borrowers with the intention to ensure salability into the secondary market.

Law Firms: There is increasing awareness of the critical role law firms can play in bringing together servicers and consumers seeking loan resolution. One law firm has called a working meeting to discuss workout options and the role attorneys can play in facilitating them. Providing incentives to law firms to engage in workouts is an active topic for discussion, as is building better communications and coordination between law firms and servicers to facilitate potential workouts. Homeowners will often call the servicer’s foreclosure attorney for basic

BLUEPRINTS FOR CHANGE

Drawing up effective workout options for beleaguered borrowers will help build positive change for homeowners and for servicers.



information once the demand letter has been issued. This is another opportunity to engage in conversation about workouts and one that should be explored. Considering the willingness of many law firms to engage in loss mitigation on behalf of their servicer clients, delegated authority may be something worth considering.

Secondary Marketing: Contributing to the effort to expand loss mitigation opportunities are people involved in secondary marketing and the law firms that draft Wall Street transactions. There has been discussion of creating model language that could be used, going forward, in new transactions. The language would allow for loan modifications or other forms of workouts. However, it

than just what is required by regulation. This would benefit all borrowers holding these types of loans.

States Step In: There may be help on the way with the emergence of state bond programs directed at refinancing low-to-moderate-income homeowners into fixed-rate mortgages. Some restrictions may apply, such as maximum mortgage amounts or income qualifications benchmarked to an area's income averages. An example is Ohio's program, administered by the Ohio Housing Finance Agency, that is making \$100 million available at rates in the 6 percent range. An additional program provides funds to assist with closing costs. Four hours of counseling are required.

their loan even when a few payments are past due. The rub is that the servicer has to advance its own funds for one full payment. To encourage more of these delinquent streamline refinances, perhaps HUD would consider waiving the servicer payment, which has been an impediment since this program was announced many years ago. Unfortunately, FHA is not permitted to refinance non-FHA delinquent borrowers at this time, but perhaps it would reconsider this limitation.

For those homeowners with damaged credit, refinancing is more difficult due to the constricting market for subprime and nonprime loans. Some homeowners are over-leveraged and may have the added whammy of a declining real estate market impacting

We need to address these issues head-on. We know we can help homeowners who have had a temporary setback by using our standard toolbox of workout options. We have a chance of helping them keep their homes if we can get them to work with us or through an intermediary.

would require a number of other parties, such as the ratings agencies, IRS, and investors, to effect such a change. Nonetheless, the parties are engaged and talking—and this is encouraging.

What Ideas Are Being Discussed?

Refinancing

One obvious solution has been to refinance. Homeowners who have cleaned up their credit since obtaining their subprime loan should of course consider refinancing a variable-rate or balloon mortgage to a fixed-rate loan at a prime interest rate. Servicers could promote this recommendation by giving much earlier warnings about the potential impact of upcoming adjustable-rate mortgage (ARM) adjustments and balloon resets

Recommendation: A servicer working with homeowners in the states offering these programs may want to suggest to homeowners who cannot qualify for a workout that they contact the appropriate state agency to be considered for this type of financing.

Streamline Refinances: The Department of Housing and Urban Development (HUD) currently allows mortgagees to do a "streamline" refinance of their FHA loan. Would investors allow such an option on conventional loans where the homeowner was in imminent danger of default? No qualifying, no appraisal, and, hopefully, a fixed-rate loan to stabilize payments? HUD borrowers in an ARM loan may want to consider a streamline refinance to a fixed-rate loan.

Delinquent Streamline Refinances: HUD also allows homeowners to refinance

the appraised value of their property. Some also have prepayment penalties.

100-percent Refinancing: This option might provide flexibility in working with homeowners who are fully leveraged. However, 100-percent financing has currently dried up. Perhaps Congress could take action to promote this type of lending, including providing such authority to FHA.

Another possibility might be a secured/unsecured refinance program. This would involve combining a new, more affordable first mortgage that was in line with the property's current value with a second mortgage for the shortfall. To create a truly marketable second mortgage product, however, the loan must bear interest and provide some level of credit enhancement and investor guaranty. Some issues to think about: The note would really

be unsecured, and these types of loans would have to be sold in the secondary market as unsecured credit, making them more difficult and costly, ultimately translating into a higher interest rate for the borrower.

Second or Home Equity Line

If homeowners still have equity in their properties, tapping into it may be one way to resolve a delinquency on the first mortgage. It is, however, not going to resolve an affordability problem and may compound the problem by adding an additional layer of debt on the homeowner. For people who have had a temporary setback or need additional time to refinance or sell their properties, it may be sufficient.

Repayment Plan

We do repayment plans when homeowners have excess income to pay toward the arrearage after a period of delinquency. This option is still good for those borrowers who can start chipping away at their past-due payments. Bringing someone current through a repayment plan is sometimes only a short-term fix, as it may not address the underlying cause of the delinquency. Counseling and financial education on budgeting and money management would seem to be a reasonable expectation for those who have sufficient income to make payments but have challenges prioritizing their debts. But for homeowners who in the long run can't afford their homes, it is just delaying the inevitable.

What about long-term repayment plans? The other challenge we have today is that some servicing contracts do not allow long-term repayment plans, which might be necessary to create a more affordable plan. Some subprime transactions do not allow long-term repayment plans or require the servicer under such long-term plans to cover the shortage to ensure the original income stream.

These issues are being discussed in some of the working groups mentioned above.

At a minimum, new “model” language if adopted by the industry (and if the IRS complications are resolved) could handle this for future homeowners.

Return of the “Advance Claim”

Years ago, mortgage insurance companies offered advance claim payments, which acted like HUD's partial claim program but were established for conventional loans. Mortgage insurers advanced funds to bring a loan current. Those funds were subtracted from any payout from a subsequent claim. The investor gained by having a performing loan, and the homeowner was able to stay in the property. Some of these transactions had interest-free second mortgages, which the homeowner would pay directly to the mortgage insurance carrier. This allowed the coverage to be restored. Could we do more of these?

Loan Modifications and Securities Deals

A formidable barrier to workouts is the perception that many loans cannot be modified because they were sold into a security. We can modify Fannie Mae, Freddie Mac, and HUD loans (once repurchased from Ginnie Mae pools), and many of us do so in large numbers. So how true is it that other types of loans, frequently subprime loans, cannot be modified or have long term-repayment plans entered into?

The answer is—check your agreements. The standard language varies but many permit loans to be modified. Some servicers are modifying 2/28 subprime loans back to the original rate (or something less than the adjusted ARM rate) for a two-year period of time in order to give borrowers more time to get their finances in order and potentially refinance into a fixed-rate loan. Others are modifying a variety of terms, with the expectation that these changes will permit the borrower to remain in his or her home and the loan remain in a positive cash flow.

Others simply create long-term forbearances at reduced rates.

In all cases, you need to check your agreements to see if your documents permit loan modifications or long-term repayment plans. Some may permit them, but the Catch-22 is that you may have to continue to advance the unmodified payment to the investor, even though you are not receiving the full amount from the borrower. And always, if in doubt, contact your legal department and master servicer for guidance.

Rescue Funds

A number of states have rescue funds available to help homeowners bring their loans current. Pennsylvania has its long-standing Homeowner's Emergency Mortgage Assistance Program program, which has stringent qualifying requirements, including a financial counseling component. Congress is looking at these types of programs as well.

Hopefully this article will stimulate more discussion about workout options. It clearly is not all-inclusive, and some of the ideas may not be easy (or reasonable) to implement.

We need to address these issues head-on. We know we can help homeowners who have had a temporary setback by using our standard toolbox of workout options. We have a chance of helping them keep their homes if we can get them to work with us or through an intermediary.

For those who find themselves in unaffordable loans, for whatever reason, our challenge is tougher. This is where we need to re-examine the constraints that limit our ability to offer options and work with all of the industry players to find a good resolution.

And finally, we need to maintain our support for financial education in our high schools. Learning to handle credit, managing a checking account, and building a savings plan is the foundation for a more financially secure America. **DS**