

Mortgage Loan Delinquencies and Foreclosure Prevention: The FDIC Announces Modification Program

On Wednesday of this week, the Federal Deposit Insurance Corporation (FDIC) announced a plan to modify several thousand delinquent loans serviced by IndyMac Federal Bank (“IndyMac”), a federal savings bank that the FDIC now controls as conservator. The significance of the program may depend, in the end, on the extent to which loans serviced but not owned by IndyMac may be modified without the consent of the owners of the loans.

The FDIC clearly intends the plan as an impetus to modification efforts by lenders and servicers outside the agency’s control. As a model for the mortgage loan industry, the FDIC plan is an alternative to the refinancing program provided for in the recently enacted HOPE for Homeowners Act (included in the Housing and Economic Recovery Act of 2008),¹ as well as to loan modifications underway in the private sector HOPE NOW program and to proposals supported by trade groups in the mortgage loan industry.

The premise of the FDIC plan is the same as those of the other programs — modifications of delinquent or defaulting mortgage loans can preserve more value for lenders and investors than foreclosure proceedings. Also like the other programs, the FDIC plan will involve loan-by-loan determinations of appropriate modifications. The FDIC plan is distinctive, however, in that it sets two modification benchmarks that are not part of the other programs. First, a modification should result in an affordable loan, and the metric for affordability is a debt-to-income (DTI) ratio of 38 percent or less. Second, the presumptive modification is an adjustment in the interest rate on a loan to a fixed rate that is the current Freddie Mac survey rate — approximately 6.5 percent today.

The framework of the FDIC plan is fairly clear, although the detailed policies governing how a particular loan may be modified are not public. The prerequisites for the FDIC to consider a loan for modification are as follows:

- **Targeting.** The FDIC already has identified several thousand loans as potentially eligible for modification. According to press accounts, the agency will have IndyMac reach out immediately to 4,000 of the borrowers, and efforts to contact another 20,000 to 25,000 will follow shortly. IndyMac likely will contact additional borrowers later.

¹ The HOPE for Homeowners Act appears as Title IV of the Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289. The HOPE for Homeowners Act and other provisions of the Housing and Economic Recovery Act of 2008 were discussed in our advisories of July 23 and 30, 2008.

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- **First lien on primary residence.** The program is limited to first-lien loans on the borrower's primary residence. The FDIC has said it may be willing to modify other mortgage loans, but these are not part of the program itself. Given the FDIC chairman's public statements about the desirability of keeping borrowers in their homes, the modification of loans secured by property other than a primary residence would appear to be a decidedly lower priority.
- **Delinquency status.** The FDIC's announcement of the program refers broadly to loans that are "seriously delinquent or in default." *The American Banker* has reported that the FDIC has focused on loans that are 60 days or more past due.
- **Ownership of loans.** All delinquent loans appear to be eligible for modification, regardless of whether IndyMac or a third party investor owns the loan. If the FDIC is prepared to have IndyMac modify substantial numbers of loans that it services but does not own, then the plan may mark a substantial step forward on loan modifications. According to press accounts, the FDIC has discussed the plan with Fannie Mae, Freddie Mac and representatives of other investors. The nature of investor reaction is not clear, but no investor has so far sought to block the plan.

If a loan is within the FDIC's targeted class or otherwise becomes eligible for consideration, the FDIC has not made it entirely clear if or how it will modify the loan. There are several factors that the FDIC will take into account, including the following:

- **DTI ratio.** The FDIC's goal is to effect modifications that result in a debt-to-income ratio no higher than 38 percent.
- **Interest rate.** The FDIC presumptively will modify the rate on a loan at the current Freddie Mac survey rate of approximately 6.5 percent. The agency apparently is willing to modify loans to somewhat lower rates if the 6.5 percent rate were to result in a DTI greater than 38 percent. We assume that the FDIC also has a floor rate — not yet announced — and if the DTI at the floor rate still exceeds 38 percent, then the FDIC may not be willing to modify the loan. For loans that are modified to a rate below the survey rate, the FDIC will have its own rate reset process.
- **Principal.** The FDIC FAQs state that "principal forbearance" is another remedial measure that may be available, but the scope of such forbearance is unclear. Presumably, the agency could choose to forgive and write off a certain outstanding principal amount. The forbearance concept also would support a modification program with interest-only payments for some period of time.
- **Maturity.** The term of a loan also is subject to modification, although the FDIC has not identified the parameters for this kind of change.
- **Equity sharing.** There is no equity sharing provision whereby a homeowner with a modified loan is required to relinquish a portion of any net gain upon the sale or other, later refinancing of his or her residence, in contrast to the refinancing program under the HOPE for Homeowners Act.

As readers may recall, the HOPE for Homeowners Act attempts to prevent or reduce home foreclosures through voluntary refinancings into mortgage loans guaranteed by the Federal Housing Administration (FHA). In very broad terms, the FHA program differs from the FDIC plan in that FHA loans are refinancings, not modifications, which gives lenders and investors a different choice. An FHA refinancing may result in a participating investor taking a write-off of some amount of the loan — but otherwise the loan is paid and the credit risk extinguished. The FDIC plan attempts to reduce credit risk (and enhance saleability) through modification, but some risk remains. The FDIC plan potentially may cover a larger number of borrowers than the FHA program, in part because the FHA program is limited to conforming loans.

The FDIC plan is not necessarily inconsistent on a conceptual basis with positions on loan modifications taken by the Mortgage Bankers Association (MBA) and the American Securitization Forum (ASF). That is, the MBA and the ASF believe that, as part of its duty to maximize the value of a pool of loans for investors, a servicer may modify a defaulted loan or one in which default is reasonably foreseeable, where the modification is likely to preserve more value than foreclosure — and provided that the securitization and servicing documents give the servicer such discretion. The FDIC plan largely adopts this view, although it is not entirely clear whether or how the FDIC has determined that its proposed modifications will uniformly be better for investors than foreclosure actions. (For loans that the FDIC owns, the Deposit Insurance Fund and its member institutions are the real parties at risk.) The FDIC plan does go further than either the MBA or the ASF in identifying a target interest rate for modifications — the Freddie Mac survey rate — and in using the 38 percent DTI ratio as the specific measure of an affordable loan.

At the very least, the FDIC plan is an interesting loan modification approach for mortgage loan servicers and investors to consider. As the FHA rolls out its refinancing program, these parties will have a number of options to consider.

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