Congressional Research Service

Troubled Asset Relief Program and Foreclosures

N. Eric Weiss
Specialist in Financial Economics

David H. Carpenter
Legislative Attorney

Darryl E. Getter
Specialist in Financial Economics

Edward V. Murphy
Specialist in Financial Economics

February 17, 2009

Congressional Research Service
7-5700
www.crs.gov
R40224

CRS Report for Congress
Prepared for Members and Committees of Congress

Summary

Increasing foreclosure rates and problems in financial markets are some of the issues addressed in the Emergency Economic Stabilization Act of 2008 (P.L. 110-343), which created the Troubled Asset Relief Plan (TARP). The law authorized $700 billion in spending. The initial $350 billion was appropriated. The second $350 billion would be appropriated unless Congress disapproved the request from the President for the funds. H.R. 384 was introduced in the House on January 9, 2009; it was passed and sent to the Senate on January 21, 2009. The legislation would provide for additional home foreclosure relief and broaden safe-harbor provisions affecting the modification of loans in mortgage-backed securities (MBS). Other provisions would require additional public reporting on Treasury actions under TARP, increase TARP oversight, authorize direct loans to the automobile industry, and provide additional housing and financial assistance. This report is concerned with Title II of the bill, which would require the Treasury to spend a minimum of $40 billion of the second $350 billion on foreclosure mitigation. The bill, as passed by the House, would require the Secretary of the Treasury to develop a plan by March 15, 2009.

Both H.R. 703 and H.R. 788 have the same safe-harbor provisions.

Three appendices describe the mortgage origination and securitization process, the net present value test, and the obstacles to loan modifications created by second mortgages.

This report will be updated as warranted.

Contents

Tables

Appendixes

Contacts

Introduction

Increasing foreclosure rates and turmoil in financial markets are some of the issues addressed in the Emergency Economic Stabilization Act (EESA) of 2008 (P.L. 110-343), which created the Troubled Asset Relief Plan (TARP). The law authorized $700 billion in spending. The initial $350 billion was appropriated. The second $350 billion would be appropriated unless Congress disapproved the request from the President for the funds. On January 15, 2009, the Senate rejected S.J.Res. 5 that would have disapproved the second $350 billion by a vote of 42 to 52.

H.R. 384, introduced on January 22, 2009, by Representative Barney Frank, would require the Treasury to spend a minimum of $40 billion of the second $350 billion on foreclosure mitigation.

Title II of the bill would require a new Treasury plan to provide foreclosure relief for owner-occupied homes that includes one or more of these features:

- cost reductions for mortgage modifications in the Hope for Homeowners (H4H) program;
- pay-off of second mortgages that are impeding modification of first mortgages;
- incentives for mortgage servicer to pursue more actively loan modifications;
- purchase of whole mortgages that would be modified or refinanced; and
- substitution of a modified mortgage in a mortgage-backed security trust.

In addition, H.R. 384 would broaden the safe harbor for servicers who modify mortgages that meet certain criteria contained in the bill.

Two other bills contain the same safe-harbor provisions: H.R. 703, which Representative Frank introduced on January 27, 2009, was referred to the House Financial Services Committee; this bill has provisions to make permanent increases to the federal deposit insurance limits and modify the HOPE for Homeowners program. H.R. 788, which Representative Paul E. Kanjorski introduced on February 4, 2009, was referred to the House Financial Services Committee and ordered reported (amended) by a voice vote the same day. On February 10, 2009, the bill was reported and placed on the Union Calendar (H.Rept. 111-13).

This report provides policy and legal analyses of the changes to the economic incentives included in H.R. 384, and a legal analysis of the safe-harbor provisions in the three bills. Three appendices describe the mortgage origination and securitization process, the net present value test, and the obstacles to loan modifications created by second mortgages.

This report will be updated as warranted by legislative and other developments.

Modifications to EESA

This section discusses modifications to EESA contained in the three bills.

Servicer Safe Harbor

The Housing and Economic Recovery Act of 2008 (HERA , P.L. 110-289) changed many laws that affect both the housing and mortgage markets. Section 1403 of the law states that any duty on servicers of securitized residential mortgages to "maximize the net present value [NPV][1] of the pooled mortgages in an investment" is owed to *everyone* having a direct or indirect interest in the pool, *as a whole* – as opposed to individuals or small groups of interested parties – unless the governing Pooling and Servicing Agreement (PSA) states otherwise. This provision is intended to clarify that servicers should take actions that benefit the trust as a whole, rather than being concerned with a minority of stakeholders whose interests may be divergent from the majority. Under HERA, a loan modification that meets three specified criteria shall be deemed to meet this duty to maximize NPV. The three criteria are (1) default on the mortgage has occurred or is reasonably foreseeable, (2) the property securing the mortgage is occupied by the homeowner,[2] and (3) the loan modification is expected to provide a greater return, based on the NPV test, than what would likely be realized through foreclosure. By establishing standards by which loan modifications may be performed, Section 1403 of HERA attempts to reduce the likelihood of successful lawsuits being raised against servicers that provide qualifying loan modifications. Limiting liability in this way may encourage servicers to voluntarily engage in loan modifications.[3]

Section 206 of H.R. 384, Section 6 of H.R. 703, and Section 1 of H.R. 788 would provide very similar liability protection for residential mortgage servicers as HERA. Servicers who modify loans would receive a safe harbor from any lawsuits resulting from an investment contract and a securitization vehicle as long as the modifications meet certain criteria, including that the loans are owner-occupied, the modification meets the net present value test, and default on the loan is reasonably foreseeable in the absence of modification.

The liability protection, however, would differ in five important ways. First, H.R. 384, H.R. 703, and H.R. 788 would require servicers to "reasonably and in good faith believe" that the return from the loan modification will be greater than the return from a foreclosure in order to qualify for the liability protection. This new language would add a subjective aspect to the NPV test. Second, the bills would protect servicers that provide qualifying loan modifications even if doing so would violate PSA terms that constrain the number, frequency, or range of modifications. Third, servicers also would not be compelled to buy mortgages out of a securitized trust or make any other payment to the trust because they provided a qualifying loan modification, as some PSAs may require. Fourth, H.R. 384, H.R. 703, and H.R. 788 would only extend the safe harbor to modifications *initiated*[4] before January 1, 2012. Finally, servicers that provide loan

1 **Appendix B** explains the net present value test.

2 It is unclear what would be required for a property to be considered "occupied by the mortgagor [homeowner] of such mortgage," because neither HERA nor H.R. 384 nor H.R. 703 nor H.R. 788 specifically define the term. Presumably, future regulations will answer questions such as, Would the provision only apply to a homeowner's primary residence? Would a homeowner have to occupy the property for a certain period of time in order to qualify under the provision? Would a multifamily property in which the homeowner resides qualify under the provisions?

3 However, HERA does not address other obstacles to voluntary loan modifications, namely tax regulations, accounting standards, and payment schedules. Moreover, the HERA safe harbor seems to apply only to mortgages governed by PSAs that do not place specific limitations on when and how mortgages may be modified.

4 It is unclear at what point a modification would be deemed "initiated." Presumably, initiation would occur before consummation of the modification.

modifications qualifying for the bill's safe harbor would have to report regularly to the Treasury on the "extent, scope and results" of their modifications. Such reporting could help track how many modifications have occurred, the types of modifications that have been successful, as well as the measures that failed to provide long-term relief to borrowers.

Explicitly Address the Obstacle of Second Liens

Section 203 of H.R. 384 addresses some of the obstructions to mortgage modifications.[5] H.R. 384 would explicitly allow TARP funds to pay off junior or piggyback loans to facilitate loan modifications from primary lien holders. Arguably, EESA already permits this. TARP funds could also be used to purchase entire loans for the purpose of loan modifications. By owning the entire mortgage, the federal government could modify the loan that a private lender might not. TARP funds also could be used to provide incentives to servicers to modify loans.

Other Provisions

Section 207 of H.R. 384 declares that it is the sense of Congress that any institution receiving TARP funds should voluntarily declare a moratorium on mortgage foreclosures for nine months or until a fully operational national plan is fully implemented. It establishes a duty of homeowners benefiting under the bill to maintain their homes and to respond to reasonable inquiries while a foreclosure is prohibited.

Section 208 of H.R. 384 would require the Secretary to develop a plan to assist tenants in foreclosed affordable rental housing.

Sections 209 and 210 of H.R. 384 would create reporting and data collection requirements.

Summary

The foreclosure relief provisions of H.R. 384 would provide additional guidance to the Secretary of the Treasury on the implementation of the Troubled Asset Relief Program. It makes explicit certain congressional concerns and priorities. H.R. 384, H.R. 703, and H.R. 788 each would make some important changes to the safe-harbor provisions that provide legal protection for mortgage servicers that modify existing mortgages in ways that might not be permitted under the relevant PSAs.

[5] **Appendix C** discusses some of the problems in loan modifications that H.R. 384 would address.

Appendix A. Mortgage Origination and Securitization Process[6]

This appendix briefly discusses the mortgage process, the creation of mortgage-backed securities (MBS), and the development of the secondary mortgage market and the legal issues that a servicer might face in modifying a mortgage held by MBS investors.[7]

To obtain a mortgage to purchase a home, an individual applies to borrow money from a mortgage originator (i.e., a lender). The originator, or an agent of the originator such as a mortgage broker, takes steps to verify the information that the individual has presented to obtain the mortgage. The originator wants a certain level of confidence based on the particular originator's measure of risk assessment, that the borrower is able to meet the obligations of the mortgage. This loan underwriting usually involves analysis of the individual's income and credit history. The originator or broker also generally requires an appraisal of the property in question to help ensure that the amount the individual wants to borrow is less than the value of the particular property. If the loan is approved, the originator loans the borrower money to purchase the property and places a lien on the property to secure the borrower's promise to repay the principal amount plus interest over a specified period of time. Traditionally, the originator would retain the payment rights of the mortgage until the end of the loan term, until the borrower sold the note or refinanced, or until the borrower defaulted. Under this traditional framework, the originator also would service the loan, which means it would collect payments and fees from the borrower and otherwise manage the terms of the mortgage as an individual asset.

However, in recent years, the vast majority of mortgages have been securitized in the secondary mortgage market.[8] When a mortgage is securitized, the originator transfers its rights to the mortgage to a trust, where it is held in a pool of dozens of other mortgages for the benefit of investors.[9] The cash flows of the many mortgages held in that trust are spliced into marketable securities, called mortgage-backed securities or MBS, so that investors may share in their gains or losses. These cash flows are determined by a fixed formula at the creation of the trust. The preset formula allows the trust to remain "passive" to obtain favorable tax treatment.[10] Those who invest in MBS generally are large, institutional investors, such as banks, hedge funds, sovereign wealth funds, and pension funds. All of the investors of a particular pool of MBS may not share the same interests, but rather may be invested in different pieces or slices of the MBS, called tranches. For example, cash flows may be split such that senior tranche holders are paid a specified amount first, while more junior tranche holders are paid what is left, if anything. There are virtually no

---

[6] The mortgage origination and securitization process outlined in this report is a generalization of a common practice. The process may vary to some degree based on a number of factors.

[7] Among the CRS reports analyzing these financial instruments in more detail are CRS Report RL34386, *Could Securitization Obstruct Voluntary Loan Modifications and Payment Freezes?*, by Edward V. Murphy, and CRS Report RL34379, *Constitutional Issues Relating to Proposals for Legislation to Impose an Interest Rate Freeze/Reduction on Existing Mortgages*, by David H. Carpenter.

[8] For a more detailed overview of the mortgage origination and securitization process, see Raymond H. Brescia, "Capital in Chaos: The Subprime Mortgage Crisis and the Social Capital Response," 56 Clev. St. L. Rev. 271, 289-91 (2008).

[9] The originator also may sell their rights to the mortgage to another entity that then sets up the trust.

[10] CRS Report RL34386, *Could Securitization Obstruct Voluntary Loan Modifications and Payment Freezes?*, by Edward V. Murphy.

limitations to how MBS may be sliced. However, each tranche receives a separate credit rating, and certain types of investors (e.g., pension funds) may have limitations on the credit rating levels in which they may invest.

A servicer collects the mortgage payments and deals with borrowers who have trouble meeting their obligations.[11] Pooling and Servicing Agreements (PSA) are the contracts that govern the legal relationship between MBS trustees, MBS investors, and servicers of the mortgages composing these trusts.[12] The borrowers of the mortgages held in trust are not parties to PSA. One relevant feature of typical agreements is the scope of permission for servicers to perform loss mitigation for borrowers. Many of the PSAs impose limitations on the circumstances in which modifications may be provided and on the types of modifications that may be made. Some PSAs may not allow servicers to perform loan modifications under any circumstances. Others may limit modifications to a certain percentage of the mortgages in the trust (e.g., 5%). Still others may be silent on when and how loan modifications may be provided. It is unclear what percentage of PSAs impose such limitations. The universe of the types of limitations is also unknown.

[11] The servicer is often the originator.

[12] These contracts also may be called Servicing Agreements (SA). The term "PSA" will be used in this report to refer to both PSA and SA.

Appendix B. Establishment of Consistent Net Present Value Test

The foreclosure mitigation plan contained in H.R. 384 employs a net present value (NPV) test to compare the expected costs and benefits of loss mitigation over a number of years. The present value of a future cost (or benefit) is the amount of money that could be invested today and earn compound interest in order to pay the future stream of costs (benefits). In evaluating a loan modification, the lender would compare the net present value of a modified mortgage to the net present value of a foreclosure and sale. Because state foreclosure laws differ, and because expectations of future costs and benefits could differ, the results of net present value tests could differ among loan servicers.

H.R. 384 requires the Secretary of the Treasury to establish standards for a net present value test to ensure consistent application. Lenders participating in TARP must systematically review their loan portfolios to identify candidates for modification. Modifications may include interest rate and fee reductions, extending the term of the maturity of the loan, forgiveness of loan principal, and other similar provisions.

Section 204 reiterates that qualifying loan modifications shall be done only for mortgages on owner-occupied housing, and excludes mortgages that go into delinquency before an administratively determined number of timely payments have occurred, which is sometimes called an early payment default.

Appendix C. Foreclosure and Difficulties Curtailing the Problem

There are no comprehensive national statistics for delinquent mortgage loans, but three authoritative sources agree that delinquency rates are increasing. **Table 1** shows that the number of 60-day delinquent loans increased during 2008, according to data collected by HopeNow (a mortgage industry alliance), the Government-Sponsored Enterprises (Fannie Mae, Freddie Mac, and the Federal Home Loan Banks), and the Office of Thrift Supervision (OTS) and Office of the Comptroller of the Currency (OCC). While the rates differ among the sources, all show increases from quarter-to-quarter.

Table C-1. 60-Day Delinquency Rate of Loans Serviced

Source	Loans Serviced	First Quarter, 2008	Second Quarter, 2008	Third Quarter, 2008
Hope Now	53 million	3.19%	3.31%	3.85%
Government-Sponsored Enterprises	31 million	1.46%	1.73%	2.21%
Office of Thrift Supervision/Office of Comptroller of the Currency	35 million	4.07%	4.54%	5.33%

Source: Federal Housing Finance Agency, http://www.fhfa.gov/webfiles/404/Q3ForeclosurePrevention.pdf, p 30.

Foreclosure occurs when a borrower is delinquent for three months. Typically, this happens when unanticipated financial disruptions, such as job loss, divorce, or unexpected medical bills, reduce the ability of borrowers to meet their mortgage payment obligations. In "normal" times, a financially challenged homeowner can usually sell the house for more than is owed and avoid foreclosure. Falling house prices in regions such as Michigan, California, Florida, and Nevada, have resulted in many homeowners facing a negative equity situation, in which the amount owed on the mortgage exceeds the value of the house.[13] The existing unsold inventory of homes is above its long-term average, making quick sales to avoid foreclosure more difficult.

Payment resets on mortgages may also contribute to rising foreclosures. [14] Many borrowers confronted with these interest rate increases took out mortgages that initially had below-market interest rates, experienced a large increase in home prices, and more recently home price declines.

The HOPE for Homeowners (H4H) program, which was created by the Housing and Economic Recovery Act of 2008 (HERA), was established to assist financially distressed homeowners to

[13] David Streitfeld, "A Town Drowns in Debt as Home Values Plunge," *New York Times*, Nov. 10, 2008, available at http://www.nytimes.com/2008/11/11/business/11home.html. See, also, the interactive state maps at http://www.nytimes.com/interactive/2008/11/10/business/20081111_MORTGAGES.html.

[14] For a contrary view see Christopher L. Foote, Kristopher Gerardi, Lorenz Goette, and Paul S. Willen, *Subprime Facts: What (We Think) We Know about the Subprime Crisis and What We Don't*, Public Policy Discussion Paper No. 08-2, Federal Reserve Bank of Boston. Available at http://www.bos.frb.org/economic/ppdp/2008/ppdp0802.htm.

refinance into loans insured by the Federal Housing Administration (FHA).[15] The Congressional Budget Office estimated that 400,000 mortgages would eventually be restructured to more affordable terms under this program.[16] At the close of business on December 31, 2008, however, the Department of Housing and Urban Development reported having received only 370 applications.[17]

There are several factors that may prevent more loan modifications. These factors are not mutually exclusive.

First, purchasing a home by using two mortgages, which became more common in recent years, complicates modification efforts.[18] When a home's value is below the value of the combined mortgages, the interest of the homeowner, the lender of the first mortgage, and the lender of the second mortgage are not aligned. The conflict arises because proceeds from the liquidation (whether sale or foreclosure) are paid first to the primary lender and then the junior lender. When a loan is modified or refinanced, the second mortgage holder release its lien; this release usually requires that the second mortgage be paid off in full. If the loan principal is written down or the home is sold for less than the combined mortgages, the second mortgage holder need not agree to release its lien. Consequently, the primary lender might be willing to write down the loan principal to get a delinquent loan to re-perform, but the second lender is unlikely to agree without some financial settlement from the primary lender. Moreover, according a Federal Reserve study, borrowers of two mortgages have a greater propensity to default because they have very little equity to lose.[19]

Second, investment properties are excluded from the HOPE for Homeowners program. These property types are thought to account for a substantial number of foreclosures. According to the 2007 American Housing Survey, 21% of single-family homes were renter occupied.[20] Anecdotal evidence suggests that investment properties compose a large share of recent foreclosures.[21]

---

[15] Rep. Nancy Pelosi introduced H.R. 3221, which became the Housing and Economic Recovery Act of 2008 (P.L. 110-289) on July 30, 2008. For more information see CRS Report RL34623, *Housing and Economic Recovery Act of 2008*, coordinated by N. Eric Weiss.

[16] Congressional Budget Office, "Federal Housing Finance Regulatory Reform Act of 2008," *Cost Estimate*, June 9, 2008, http://www.cbo.gov/ftpdocs/93xx/doc9366/Senate_Housing.pdf.

[17] Office of Housing, Deputy Assistant Secretary for Finance and Budget, Office of Evaluation, *Single Family Operations: December 16-31, 2008*, Federal Housing Administration, U.S. Department of Housing and Urban Development, Washington, DC, http://www.hud.gov/offices/hsg/comp/rpts/ooe/olcurr.pdf.

[18] Interest rates and other costs are lower on mortgages that are below the conforming loan limit (currently $417,000 nationally with exceptions in certain "high-cost" areas) and that meet certain other standards including a loan-to-value ratio of no more than 80%. Homebuyers lacking the 20% down payment can purchase mortgage insurance. In the past, a second mortgage could not be used to obtain the down payment to achieve either the 80% loan-to-value ratio or to bring the amount borrowed below the conforming loan limit, but this practice became acceptable in the late stages of the housing boom. The interest rate on the second mortgage would be higher than on the first mortgage, but the total interest paid would be less than for a non-conforming mortgage. In addition, mortgage interest, unlike mortgage insurance, is tax deductible.

[19] Robert Avery, Kenneth P. Brevoort, and Glenn Canner, "The 2007 HMDA Data," *Federal Reserve Bulletin*, December 2008, pp. A111-A120.

[20] U.S. Census Bureau, *American Housing Survey 2007*, Tables 2-1 and 4-1. Available at http://www.census.gov/hhes/www/housing/ahs/ahs07/ahs07.html and CRS calculations.

[21] Borrowers are required to disclose to lenders if the home being purchased is to be owner-occupied or an investment property, but this can be difficult for lenders to verify. Media reports on renters, as opposed to owner-occupied residents, facing foreclosure include John Leland, "Sheriff in Chicago Ends Evictions in Foreclosures," New York Times, October 9, 2008, p. A14, available at http://www.nytimes.com/2008/10/09/us/09chicago.html; Sara Lane, (continued...)

These two facts suggest that more than 21% of all single-family delinquencies are rental properties and ineligible for HOPE for Homeowner modifications.

Third, many loans that have already received modification become delinquent again. According to the Office of the Comptroller of the Currency, 53% of loan modifications that occurred during the first quarter of 2008 have re-defaulted.[22] There could be many reasons for the re-default. Some loan modifications may not have been sufficient to make the mortgage payments affordable. Continued or increased unemployment in the home could reduce the likelihood that a loan will be repaid after modification. Re-defaults increase losses—or the chance of losses—for servicers and investors. A lender who believes that a loan modification has a high probability of ultimately failing, might foreclose the first time a mortgage goes into default rather than to take the risk of a second default.

(...continued)

"Foreclosure fallout: Renters forced out of lost homes," November 30, 2007, available at http://www.cnn.com/2007/US/11/30/willis.rentervictims/index.html, and Carolyn Said, "Foreclosures leave renters in the lurch," San Francisco Chronicle, February 7, 2008, p. A1, available at http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2008/02/07/MN4NUOE27.DTL&type=business. Fannie Mae and Freddie Mac have introduced new policies to allow qualified renters to remain in foreclosed homes. See Fannie Mae, "Fannie Mae Announces National REO Rental Policy," press release, January 13, 2009, http://www.fanniemae.com/newsreleases/2009/4581.jhtml.

[22] Office of Comptroller of the Currency, "Comptroller Dugan Highlights Re-default Rates on Modified Loans," press release, December 8, 2008, http://www.occ.treas.gov/ftp/release/2008-142.htm.

Appendix D. Legislative History

Representative Frank introduced H.R. 384 on January 9, 2009. The bill was referred to the House Financial Services Committee, the House Ways and Means Committee, and the House Judiciary Committee. On January 14, 2009, H.Res. 62, providing for House consideration of the bill, was approved by the House with a vote of 235 to 191. On January 21, 2009, the House approved the bill with a vote of 260 to 166.

Representative Frank introduced H.R. 703 on January 27, 2009, with the same safe-harbor provisions as H.R. 384. The bill was referred to the House Financial Services Committee.

Representative Paul E. Kanjorski introduced H.R. 788 with the same safe-harbor provisions on February 2, 2009. By a voice vote, the House Financial Services Committee ordered the bill reported to the House on February 4, 2009. Unlike H.R. 703, H.R. 788 does not include certain other provisions, such as permanently increasing the maximum amount of federal deposit insurance on certain accounts to $250,000.

Author Contact Information

N. Eric Weiss
Specialist in Financial Economics
eweiss@crs.loc.gov, 7-6209

Darryl E. Getter
Specialist in Financial Economics
dgetter@crs.loc.gov, 7-2834

David H. Carpenter
Legislative Attorney
dcarpenter@crs.loc.gov, 7-9118

Edward V. Murphy
Specialist in Financial Economics
tmurphy@crs.loc.gov, 7-6201