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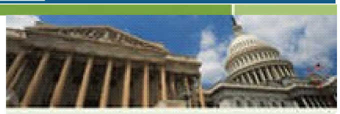

April 7, 2010

Obama Administration Announces New Mortgage Principal Reduction Plan

On Friday, March 26, 2010, in another effort to try to reduce the ever-increasing number of foreclosures, the Obama administration announced a $14 billion plan to provide lenders with incentives to reduce the outstanding principal balances on certain "underwater" mortgage loans.

Under the $50 billion voluntary Home Affordable Modification Program ("HAMP") that is currently in place, mortgagees receive federal incentive payments to reduce interest rates on existing home mortgages to as low as 2 percent or to extend repayment terms to 40 years. The administration's new plan would require mortgagees participating in HAMP to consider reducing the principal balance on a loan as part of the formula for reducing monthly payments for borrowers whose loans have a loan-to-value ("LTV") ratio exceeding 115 percent. The government intends for reductions in interest rates and extensions of loan terms under HAMP to now be provided only once the LTV ratio has been reduced to 115 percent or below.

According to the newest part of the administration's plan, a mortgagee would receive a payment from the government above a "standard" HAMP payment for reduction of principal. The principal reductions would at first be temporary, and only become permanent if the borrower made all required payments when due, over a period of time. A significant potential downside for investors is that, if the borrower's loan goes into default after the principal reductions become permanent, the investor will have a diminished ability to recoup the full loan amount because it had agreed to the principal reduction. Further, if real estate values were to appreciate, there is no method by which the lenders could then increase the principal balances to account for the appreciation in value of the property.

The second part of the administration's principal reduction plan is intended for borrowers who are still current in their payments, and who would qualify for a standard Federal Housing Administration–backed loan if their property had a lower LTV. To qualify for this part of the principal reduction plan, a borrower would need (1) a credit score of at least 500, (2) to be able to fully document his income, and (3) to occupy the mortgaged property as his primary residence. After the principal balance is reduced by at least 10 percent – to at most 97.75 percent of the property's current value – the borrower's mortgage would then be refinanced into an FHA-backed loan. The government would thereby compensate the mortgagee for the reduction in principal balance in part by taking on the future risk of the borrower's default – a significant potential benefit to the mortgagee, especially for loans that it considers likely to default. Participation in this element of the plan by lenders and investors would be voluntary.

Regarding properties encumbered by second-lien mortgages, the plan would require a reduction in total mortgage debt to 115 percent of the current property value.

The direct subsidy to mortgagees under the HAMP principal reduction program is projected to equal 10 percent to 21 percent of the principal balance reduced, depending on the degree to which the loan balance exceeds the property value. Twenty-one cents per dollar of principal reduction will be paid for mortgages with LTV ratios below 115 percent, 15 cents per dollar of principal reduction will be paid for mortgages with LTV ratios between 115 percent and 140 percent, and 10 cents per dollar of principal

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reduction will be paid for mortgages with LTV ratios in excess of 140 percent. The same incentives will be available under the FHA principal reduction program only for second-lien mortgages.

At least two large mortgage lenders have already moved independently to implement principal reduction programs for certain types of mortgages. The administration's principal reduction plan is modeled after that of Bank of America, which now has a program in effect to reduce principal balances for borrowers owing 120 percent or more of the value of their properties on subprime loans, adjustable rate mortgages that included low introductory interest rates, and payment-option mortgages with negative amortization features. Bank of America's program includes a 30 percent maximum principal balance reduction and involves the creation of interest-free forbearance accounts covering five-year periods. Under the program, a borrower's forbearance would become permanent if the borrower continues to make regular payments and if, by the fourth and fifth years, the property's value does not return to its original value.

Wells Fargo, the country's largest-volume mortgage lender, has also moved to selectively offer principal reductions for certain underwater payment-option loans.

Although the principal reduction plans are unlikely to take effect before the fall of 2010, counsel for mortgage lenders participating in HAMP should remain aware of the government's new guidelines and requirements regarding loan balance reduction, and all mortgagees should remain aware of the risk-reduction possibilities associated with shifting ownership of certain mortgages to the FHA via the government's principal reduction plan.

The benefit to be considered under the FHA principal reduction plan is the potential that the investor/servicer could end up in a better position by reducing a problematic or risky loan's principal balance with help from the government, and then transferring ownership of such a loan to the FHA. Potential drawbacks of the HAMP principal reduction plan include that the lender could ultimately have to foreclose on a loan with a lower principal balance, with a correspondingly diminished possibility of recovery.

One would expect that the success of this latest government-sponsored incentive will depend on the degree to which a lower principal balance provides an incentive to previously "underwater" borrowers to continue paying their mortgages, above whatever incentive is created by simply lowering monthly payments through reduced interest rates or extended loan terms. Its success will also depend on whether or not the lenders are willing to risk a permanent reduction in the loan amount in exchange for the hope that the loan will not go into foreclosure at a later date.

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