Mortgage Modification Safe-Harbors?
HAMP, Are We There Yet?

The Silent Modification Killers:
Sanctity of Contract, The 100% Tax, The Lawsuit!
New Insured Tradable Principal Reduction Modifications
New Treasury/IRS Notice 2009-36 and Rev. Proc. 2009-23 (Step 3)

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April 10, 2009, New Regulations? Another one of those days!

We must reach an objective tax safe-harbor for REMICS and Trusts before we can reach true homeowner affordability with mortgage loan modifications and reduce costly re-default rates. Behind the success or failure of a government modification or refinance program is the silent modification killers: sanctity of contract, the 100% tax, and the lawsuit. We recently got a new champ called HAMP (*Home Affordable Modification Program)*, and today the Treasury/IRS issued Notice 2009-36 and Rev. Proc. 2009-23 in full support. To have a successful modification or refinance program it must rest in consonance with the IRS. Business or investor machines such as banks, lenders, servicers, REMICS and mortgage pool trusts will not, and cannot effectuate en mass modifications (or short refinances) if it will violate contracts and tax regulations which penalize its interests severely in terms of taxation and litigation for doing so.

If we can reach true monthly cash-affordability for the troubled homeowner, we can convert non-performing mortgage assets into performing ones, and increase the bank and lender balance sheet valuations for *mortgage servicing rights* to *mortgage portfolios*, including the so-called legacy or toxic assets. That would unchain the steel bars wrapped all round the banks' covenant and capital ratio impairments, freeing up capital ratios and the capacity to lend.

Why is that we haven't been able to realize the hype that surrounds government modifications or refinance programs? Other than being drawn too narrowly in terms of eligibility, the past programs have failed to provide objective safe-harbors in terms of *best practices, litigation and taxation risks and exposures*. In addition to all the hoops and hurdles contained in rules, regulations and guidance concerning eligibility, lenders/servicers and the holders or investors (REMICS/Trusts) have no duty or mandate to modify a mortgage loan, even under the governments 'voluntary mandatory' insistence. Generally, the government and Congress, although publically saying otherwise, cannot order a party to a contract to do something not agreed or contemplated in that contract, save certain bankruptcy powers. However, even a bankruptcy court cannot cram-down a homeowner's mortgage loan (a law that might or might not be changing soon). The sanctity of contract is a paramount public policy that must be upheld to distinguish the U.S.A. from third world counties that do unilaterally change contracts after the fact to serve the government or those in power at the time. Pooling and Servicing Agreements (P&S) ultimately cover the agreement as to who, what, when, why

and how a servicer can modify a mortgage loan. Most P&S agreements simply don't allow for en mass modifications of mortgage loan assets and for good reasons. Not only does an investor in a mortgage pool have a right to rely on the risk/benefit of the investment, but modifications or changes in the rights and obligations of the mortgage itself or mortgage assets in a pool, could cause a breach of the investor and P&S agreements, and a 100% tax under IRC 860 et al.

As the government trips and falls over recent 'years' on their journey to 'mandate' 'voluntary' mortgage modifications and refinances, the IRS is taking baby steps to supply a modification or replacement mortgage safe harbor from the 100% tax consequence of violating its 'prohibited transaction' law and regulations. Treasury and the IRS have used Rev. Proc. 2007-72, 2008-28 (2008-23 I.R.B. 1054), 2008-47 (2008-31 I.R.B. 272) and now Notice 2009-36 and Rev. Proc. 2009-23 to affect change in IRC sections 860 A-G, 1001, and its regulations, including 301.7701-2 (-3, -4). For a discussion of Rev. Proc. 2008-28 (see www.hotneutral.com/html/irs_rev_proc_2008-28.html). For Public Comments filed by the author on Rev. Proc. 2008-28 (see www.hotneutral.com/html/comments_rev_proc.html).

As our recent past saw the government and the IRS push us closer to a solution using the Hope Now model, the failure of the implementation of HR 3221 (calling for short refinance principal modifications) caused a shift in congressional gears resulting in new legislation, laws and Treasury guidance, namely *Home Affordable Modification Program or "HAMP"* (and Home Affordable Refinance Program or HARP), among others.

HAMP has become the new champ however. Why do I say that? Well, the Treasury and the IRS have issued new Notice 2009-36 and Rev. Proc. 2009-23 aimed at affecting change regarding IRC sections 860D, 860F, 860G, 1001, 1.860G-2, 1.1001-3, including 301.7701-2 (-3, -4). That is important because those sections control the permissibility of modifications in mortgages in REMICS and TRUSTS. Prohibited transactions or significant modifications result in a 100% tax as set forth in section 860G(d)(1). So proposed and final regulations are necessary to create a safe harbor for en mass modifications of mortgages in ***'default'*** or ***'reasonably foreseeable default'***, or conflictingly, when '***default is imminent'?***

Notice 2009-36

Notice 2009-36 states: The Internal Revenue Service (Service) and the Department of the Treasury (Treasury) intend to issue regulations regarding the application of section 860G(d) of the Internal Revenue Code to certain amounts that may be paid to real estate mortgage investment conduits (REMICs) as part of the Home Affordable Modification Program (HAMP). Additionally, in pertinent part the Notice states:

> .01 Section 860G(d)(1) states that, except as provided in section 860G(d)(2), "if any amount is contributed to a REMIC after the startup day, there is hereby imposed a tax for the taxable year of the REMIC in

which the contribution is received equal to 100 percent of the amount of such contribution."
.02 Section 860G(d)(2) provides that this tax does not apply to any cash contributions that are—
(A) Contributions made to facilitate a clean-up call or a qualified liquidation;
(B) Payments in the nature of a guarantee;
(C) Contributions made during the 3-month period beginning on the startup day;
(D) Contributions made to a qualified reserve fund by any holder of a residual interest in the REMIC; or
(E) Other contributions permitted in regulations.
.03 The question has arisen whether some of the payments that may be made to REMICs under the HAMP are "contributions" that are described in section 860G(d)(1) and, if so, whether they are covered by the exceptions in section 860G(d)(2).

The section .03 question is of great concern. However, how do ***payments*** differ from ***contributions***? To affect real change and supply a safe harbor from tax and litigation impediments, the regulations should not narrow the scope of the potential solution needed to bring about that change, moreover, the regulations should not design the "function" of the solution to this historic economic meltdown. The form of the regulations should follow function. Not only should "cash contributions" (.02 Section 860G(d)(2)) within the exceptions of section .02 A-E find an objective safe harbor, but payments, contributions, non-cash and cash equivalents should as well. For example, external and internal contractual and credit enhancements should fall under the exceptions as contemplated in sections: "(B) Payments in the nature of a *guarantee*;" and "(D) Contributions made to a *qualified reserve fund* by any holder of a residual interest in the REMIC;" or "(E) Other contributions permitted in regulations."

It may be necessary to broaden the language from 'cash contribution' or payment to include guarantees, non-cash or cash equivalents, reserve or guarantee funds, credit and contractual enhancements, etc. Some solutions to borrower monthly affordability may go beyond the reduction of interest rates and principal, and the extension of term amortizations/recasts to 40 years, and take the form of insurance or guarantees, deferred principal claw backs or equity sharing, property preservation payment fund guarantees, insured or guaranteed resale pieces necessary to revitalize the secondary liquidity market including the new U.S. covered-bond public policy, collateral enhancement devices, etc. How will additional collateral enhancements square in the proposed safe harbor, or the expressly mandated insurance guarantee provisions contained in the new laws such as: EESA of 2008 (HR 1424) sections, 102, 109, 110, 113, 123 (106) the FHA loan insurance guarantees for short-refinances (with principal reductions modifications per Section 257(e)(4)(c)) found in the Housing and Economic Recovery Act of 2008 (HR 3221), known as the Hope Program or other now public/private public policy programs?

For example, how would the principal reduction – shared appreciation modification solutions offered by Wilbur Ross in discussion with the author at the DC Executive Leadership Summit (Coalition for Mortgage Industry Solutions June 2008) reconcile with the new proposed regulations? How would the quarantined principal modification solutions (www.qbiesam.com) offered by the author reconcile with the new proposals? Moreover, how would the following expanded modification solution offered by Mr. Ross with Public/Private guarantees reconcile with the new proposal?

- Set up an insurance guarantee program.
- The government would guarantee 50% of the mortgage reduced to true net value after selling commissions, etc.
- The guaranteed amount (50% government amount) could be separately sold by holder/lender at a much lower yield than the mortgage itself.
- Enable the holder/lender to pay an Insurance Fee (2 ½% per year) to the government.
- At first sale, share proceeds of appreciation as follows: 1/3rdto Government; 1/3rdto Lender/Holder; 1/3rdto Borrower (Homeowner)
- Making it transferrable/assumable will lessen the need for new replacement mortgage. The 50% piece can come over to the next owner from the government guarantee at low rates and supply liquidity to the original lender. It can be backed by reinsurance.
- A similar version of this solution is also as follows:
  - the lender and insurer (FHA) are entitled to receive the lesser of 25% of gain appreciation or the amount forgiven or guaranteed, respectively,
  - the FHA to guarantee $1 of existing troubled mortgages on primary residences for each $1 forgiven by the lender,
  - the lender would be able to resell the guaranteed portion of its principal amount to create "liquidity"

If the key is to reduce borrower monthly payments greater than 20% to achieve significantly lower re-default rates, shouldn't the Treasury/IRS regulations support an architecture that is capable of achieving that goal? For example, both modifications with principal reductions of some 10 or 20% had re-default rates of 30% or 28% within 6 months, respectively. ***But, when payments decreased by 20% or more the re-default rate was only 21%. However, when payments were lowered only 10-20% the re-default rate was 49%*** *(Fitch quoted at* http://www.procouncil.com/html/cmis_emagazine.html ; CMIS Focus eMagazine www.cmisfocus.com).

Wouldn't solutions that reduce a borrower's monthly payments 20% or more serve all interests of a mortgage transaction including the borrower? Wouldn't this spark securitization and or covered bond liquidity in the mortgage/loan marketplace? Shouldn't the regulations allow for the capability of reconciling with the Pooling & Servicing Agreements, new laws including HAMP, and the changing FASB rules?

For references to the FASB Fair Value Hold-To-Maturity reconciliation debate, see:

> **A Spicket or Faucet? New Rules for 157 Fair Value Accounting**
> **April 2, 2009, The Delay That Will Live in Infamy|**
> The Time Has Come for the "Hold-To-Maturity Device" Products |
> Where can we find those things anyway? By Richard Ivar Rydstrom, Chairman
> [http://www.procouncil.com/html/fasb_ifrs.html]
>
> **October 22, 2008 FASB FAIR VALUE HOLD-To-MATURITY RECONCILIATION**: For more specific examples, see the AFN SPECIAL BROADCAST entitled *"Hidden Gems: Reconciling New Laws, Rules & Best Practices Guidance"* on October 22, 2008, as Richard Ivar Rydstrom delivers his 2nd update of the current changes in law, rules, regulations, and best practices guidance including new principal forgiveness solutions such as **QBieSam™ Modifications**, which is receiving widespread industry support. [http://www.procouncil.com/AFN_Rydstrom_10-22_1_.pdf]

The great news is that Notice 2009-36 states:

> If a payment is made to a REMIC under the HAMP, if the payment is described in section 860G(d)(1), and if the payment is not covered by any of the exceptions in section 860G(d)(2), then regulations to be issued by the Service and Treasury will provide an exception for that payment.

Consistent with the intent of Notice 2009-36 the final regulations should include broader language and specific examples that enhance the certainty that the industry is within an objective safe-harbor as it moves to create and implement solutions to the mortgage and economic crisis. For example, Notice 2009-36 also states: Pending the issuance of further guidance, taxpayers may rely on this Notice and, accordingly, *any payment* made to a REMIC under the HAMP will not be subject to the 100 percent tax set forth in section 860G(d)(1).

The ambiguity is introduced with the restrictive use of the word *payment* versus the expanding use of the concept *any payment*, contrasted with the use of the words *contribution* and *any cash contribution* elsewhere. Although it states *any payment*, clarity must be injected to avoid debate or uncertainty over whether a "contribution" is "any payment" or as stated herein, whether or not non-cash, cash-equivalent, or credit or contract enhancements meet the "any payment" or "Payments in the nature of a guarantee" definition.

The Need for Objectively Based Best Practice Standards

Accompanying Notice 2009-36 is Rev. Proc. 2009-23. Clarification is needed as to the uses of the terms "reasonably foreseeable default" versus "imminent default." The servicer is burdened with the business judgment as what constitutes a "reasonably foreseeable default" or "imminent default" and how each differs. The servicer is faced with the threat of creating a 'prohibited transaction' with a 100% tax and (investor) litigation exposure. An objectively based best practice standard in consonance with Rev.

Proc. 2009-23, other regulations and Pooling and Servicing agreements must be developed and accepted to achieve the public policy goal of effective loss mitigation or foreclosure prevention.

The current and past regulations have used both standards. In Rev. Proc. 2008-28 at section .08 Section 860F(a)(1) it indicates a REMIC is taxed equal to 100% of the net income derived from "prohibited transactions." It goes on to state:

> The disposition of a qualified mortgage is a prohibited transaction unless the disposition is pursuant to (i) the substitution of a qualified replacement mortgage for a qualified mortgage; (ii) a disposition incident to the foreclosure, default, or ***imminent default*** of the mortgage; (iii) the bankruptcy or insolvency of the REMIC; or (iv) a qualified liquidation. Section 860F(a)(2)(A).
>
> Rev. Proc. 2008-28 at section .07 states: Certain loan modifications, however, are not significant for purposes of § 1.860G-2(b)(1), even if the modifications are significant under the rules in § 1.1001–3 and thus cause section 1001 to apply. In particular, under § 1.860G–2(b)(3)(i), if a change in the terms of an obligation is "occasioned by default or a ***reasonably foreseeable default***," the change is not a significant modification for purposes of § 1.860G-2(b)(1), regardless of the modification's status under § 1.1001–3.
>
> Rev. Proc. 2008-28 generally applied to:
> 1. One to 4 unit single family residence
> 2. Owner occupied
> 3. Not more than 10% of stated principal of REMIC total assets are loans 30 days
> of more past due at time of securitization
> 4. Servicer reasonably believes a significant foreclosure risk is present
> 5. Terms of the modified loan are "less favorable" to the holder/lender
> 6. Servicer reasonably believes a modified loan will substantially reduce foreclosure risk.
>
> Rev. Proc 2008-47 (which replaced 2007-72) generally was consistent with 2007-72 principles as follows:
> 1. IRS will not challenge ...REMIC...as not within exception for modifications made in anticipations of default in IRS 1.860G-2(b)(3);
> 2. IRS will not assert ... disposition of qualified mortgage subject to 100% prohibited transaction tax;
> 3. IRS will not challenge ... REMIC on grounds that modification caused reissuance of REMIC regular interests;
> 4. If securitization is Grantor Trust, IRS will not assert ... modifications resulted in prohibited power to vary investments.

Effective for loan modifications on or after March 4, 2009, Rev. Proc. 2009-23 is a proposed safe harbor for modifications made pursuant to ***Home Affordable Modification Program or ("HAMP").*** Rev. Proc. 2009-23 at Section 2 at .02 it states in part:

> Delinquency is not a requirement for eligibility. Rather, because loan modifications are more likely to succeed if they are made before a borrower misses a payment, the HAMP is also intended to reach borrowers for whom ***default is imminent*** despite the fact that those borrowers are current on their mortgage payments. In determining whether ***default is imminent*** for a particular borrower, the HAMP takes into account a broad range of information, including whether the borrower has had a change in circumstances that causes financial hardship, or is facing a recent ***or imminent increase*** in the monthly mortgage payment that would likely create a financial hardship.

Rev. Proc. 2009-23 at Section 3 at .10 and .11 the concepts are both used without distinction. Section .10 and .11 state as follows:

> .10 Certain loan modifications, however, are not significant for purposes of §1.860G–2(b)(1), even if the modifications are significant under the rules in §1.1001-3. In particular, under §1.860G-2(b)(3)(i), if a change in the terms of an obligation is *"occasioned by default or* ***a reasonably foreseeable default****,"* the change is not a significant modification for purposes of §1.860G-2(b)(1), regardless of the modification's status under §1.1001–3.
> .11 Section 860F(a)(1) imposes a tax on REMICs equal to 100 percent of the net income derived from "prohibited transactions." The disposition of a qualified mortgage is a prohibited transaction unless the "disposition [is] pursuant to—(i) the substitution of a qualified replacement mortgage for a qualified mortgage …, (ii) *a disposition incident to the foreclosure, default,* ***or imminent default of the mortgage***, (iii) the bankruptcy or insolvency of the REMIC, or (iv) a qualified liquidation." Section 860F(a)(2)(A).

What is the distinction between an ***obligation that has a reasonably foreseeable default*** *and an* ***imminent default of the mortgage****?* We could all come up with an answer, albeit different, which is why we need an objective standard defined in the new final regs.

Section 3 it states the general qualification requirements of a REMIC interest as follows:

> .05 Under section 860D(a)(4), an entity qualifies as a REMIC only if, among other things, as of the close of the third month beginning after the startup day and at all times thereafter, substantially all of its assets consist of qualified mortgages and permitted investments. This asset test is satisfied if the entity owns no more than a *de minimis* amount of other assets. See §1.860D–1(b)(3)(i). As a safe harbor, the amount of assets

other than qualified mortgages and permitted investments is *de minimis* if the aggregate of the adjusted bases of those assets is less than one percent of the aggregate of the adjusted bases of all of the entity's assets. §1.860D–1(b)(3)(ii).
.06 With limited exceptions, a mortgage loan is not a qualified mortgage unless it is transferred to the REMIC on the startup day in exchange for regular or residual interests in the REMIC. See section 860G(a)(3)(A)(i).
.07 The legislative history of the REMIC provisions indicates that Congress intended the provisions to apply only to an entity that holds a substantially fixed pool of real estate mortgages and related assets and that "has no powers to vary the composition of its mortgage assets." S. Rep. No. 99–313, 99th Cong., 2d Sess. 791–92, 1986–3 (Vol.3) C.B. 791–92.
.08 Section 1.1001–3(c)(1)(i) defines a "modification" of a debt instrument as any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise. Section1.1001–3(e) governs which modifications of debt instruments are "significant." Under §1.1001–3(b), for most federal income tax purposes, a significant modification produces a deemed exchange of the original debt instrument for a new debt instrument.
.09 Under § 1.860G–2(b), related rules apply to determine REMIC qualification. Except as specifically provided in §1.860G–2(b)(3), if there is a significant modification of an obligation that is held by a REMIC, then the modified obligation is treated as one that was newly issued in exchange for the unmodified obligation that it replaced. See§1.860G-2(b)(1). For this purpose, the rules in §1.1001–3(e) determine whether a modification is "significant." See §1.860G-2(b)(2). Thus, even if an entity initially qualifies as a REMIC, one or more significant modifications of loans held by the entity may terminate the qualification if the modifications cause less than substantially all of the entity's assets to be qualified mortgages.

Section 5 states: This revenue procedure applies to a modification made pursuant to HAMP of a mortgage loan that is held by a REMIC or by an investment trust. Section 4 at 03 states that: Section 301.7701-4(c) provides that an "investment" trust is not classified as a trust if there is a *power under the trust agreement to vary* the investment of the certificate holders. Section 6 states:

.01 The Service will not challenge a securitization vehicle's qualification as a REMIC on the grounds that the modifications are not among the exceptions listed in §1.860G-2(b)(3);
.02 The Service will not contend that the modifications are prohibited transactions under section860F(a)(2) on the grounds that the modifications result in one or more dispositions of qualified mortgages and that the

dispositions are not among the exceptions listed in section 860F(a)(2)(A)(i)–(iv);
.03 The Service will not challenge a securitization vehicle's classification as a trust under §301.7701–4(c) on the grounds that the modifications manifest a power to vary the investment of the certificate holders; and
.04 The Service will not challenge a securitization vehicle's qualification as a REMIC on the grounds that the modifications result in a deemed reissuance of the REMIC regular interests.

Section 7 refers us to other authority for the treatment of mortgage loans modified pursuant to certain **foreclosure prevention programs** (see Rev. Proc. 2008-47, 2008-31 I.R.B. 272, and Rev. Proc. 2008-28, 2008-23 I.R.B. 1054). The regulations should clarify an objective safe harbor to overcome the .05 requirement that 'the terms of the modified loan are <u>*less favorable*</u> to the holder than were the unmodified terms of the original mortgage loan." Some solutions however, may be viewed less favorable, equally favorable or more favorable depending upon how its viewed. For example, although less favorable to the holder in terms of immediate cash flow, but more favorable in terms of avoiding a non-performing asset with losses inherent in foreclosure or forced sale, it may be more favorable to the holder if held-to-maturity even though in the short and intermediate term it is more favorable to the borrower in terms of reduced monthly cash burdens. To promote the public policy of reaching affordable modifications, the regulations should foster new solutions not restrict them.

The Final Regs Must Contemplate Safe Harbors for New Guaranteed or Insured Principal Reduction Devices Tradable in the Secondary Market

The need to reach true borrower monthly affordability and liquidity in the secondary market is now paramount to fulfill public policy. In doing so however, it is important that the modification, as a solution, is <u>not</u> viewed as a *re-issue or a new instrument* or that it is <u>not</u> regarded as *significant or a prohibited transaction*. Section 3 indicates that: .03 A regular interest is one that is designated as a regular interest and whose terms are fixed on the startup day. Section 860G(a)(1). In addition, a regular interest must (1) unconditionally entitle the holder to receive a specified principal amount (or other similar amount), and (2) provide that interest payments, if any, at or before maturity are based on a fixed rate (or to the extent provided in regulations, at a variable rate), and at .04: An interest issued after the startup day does not qualify as a REMIC regular interest.

It is important that certain modifications, especially those that forgive, reduce, or quarantine principal are <u>not</u> viewed as violating the regular interest rule requiring a *specified unconditional principal amount*. Principal modifications may not result in a specified unconditional principal amount (or other similar amount). If the FDIC/IndyMac principal reduction version creates a new first lien and a new (silent) second (or junior lien) more akin to a re-issuance of debt, and the deferred or silent second is only payable under shared appreciation conditions, would that satisfy the specified unconditional principal amount requirement? Quarantined principal modifications (which do not forgive principal but lower current payments on reduced principal) would generally not

create new issue debt and would retain its specified unconditional principal amount, which would seemingly satisfy that requirement if sufficient appreciation or equity exists at first sale or transfer. However, quarantined principal modifications with Hold-to-Maturity and Built-in-Equity provisions would satisfy all requirements because it would not forgive principal even if not repaid in full as specified at first sale/transfer. Private public guaranteed principal enhancements would provide a specified collateral substitute for the unpaid principal amount satisfying the requirements. Additionally, if guaranteed pieces were traded in the secondary market at discounts, it appears that the specified unconditional principal amount requirement would be satisfied even if the specified principal was not realized upon first sale/transfer or if held to maturity.

Final regulations should clarify these issues consistent with the intent of the new regulations for the REMIC and trust. Notice 2009-36 is clear in its intent to save the REMIC from adverse consequences as it clearly states:

> If a payment is made to a REMIC under the HAMP, if the payment is described in section 860G(d)(1), and if the payment is not covered by any of the exceptions in section 860G(d)(2), *then regulations to be issued by the Service and Treasury will provide an exception for that payment*…Pending the issuance of further guidance, taxpayers may rely on this Notice and, accordingly, any payment made to a REMIC under the HAMP will not be subject to the 100 percent tax set forth in section 860G(d)(1).

Final regulations which include objective safe harbors that allow for new and creative solutions consistent with HAMP and other programs would spark the genius of our democracy and lay the foundation and framework for creative and effective self-adjusting solutions for generations to come. Limitations that prohibit or hinder comprehensive solutions will preclude effective and efficient resolution of the pending economic challenges. To reach true borrower affordability we must create new products that pay for enhanced risk, but not necessarily in monthly cash terms. New modification products or devices will be necessary to reach affordability with non-cash or cash equivalents; with the use of Equivalent Risk Pricing ("ERP"). Credit Rating Agencies and new credit and contract enhancement product developers must be consulted prior to finalization of regulations, as such products are key for reaching our public policy goals. We are getting closer. The solution to the framework is within reach.

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