

Legal analysis to guide the mortgage industry and protect its interests.

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The Future of Foreclosure -- As Seen from 1600 Pennsylvania Avenue

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Credit Default Swaps. Collateralized Debt Obligations. Mortgage-Backed Securities. No television, radio or Internet newscast is complete today without multiple mentions of these buzz words. The part played by these key ingredients in our economic downturn is well-documented, as is the governmental bailout of our nation's financial institutions (although the implementation of that bailout seemingly changes on a daily basis). Less clear is what the future holds, especially after President-Elect Barack Obama takes office in January 2009.

When presidential hopefuls John McCain and Barack Obama hit the campaign trail almost two years ago, the economic plans proposed by both candidates were broad in scope and reach. Now that President-Elect Barack Obama is preparing his inaugural address with our mortgage crisis as a likely central theme, Americans are hopeful that the new administration will restore stability to our economy. The question for today is how will a President Obama address the challenges to the mortgage industry tomorrow? Read on...

President Bush's plan

On Nov. 11, 2008, a mere week after the presidential election, the Bush administration announced a plan to modify mortgages in an attempt to stabilize the fluctuating real estate market. The plan centers on Fannie Mae and Freddie Mac, but does not necessarily affect the mortgage industry as a whole.

Eligibility to participate in the Bush plan requires the homeowner to be 90 days or more late in his mortgage payments, owe at least 90 percent of his home's current value, reside in the home on which the mortgage was taken and have not filed for bankruptcy. The plan, however, may encourage homeowners who must choose between paying their mortgage payments or paying down other debt, to pay down the non-mortgage debt in order to avoid bankruptcy and, therefore, qualify for the plan. As a result, the plan may further worsen the mortgage industry's ability to collect payments.

The Bush plan does little more than what various courts and legislatures across the nation have attempted to achieve through mediation foreclosure programs. In states like Pennsylvania, Connecticut, New Jersey, Florida and Ohio, the legislatures or courts have enacted mediation foreclosure programs in which a foreclosure will be stayed until the parties attend mediation. These debt-friendly approaches do little for the mortgage industry and are unlikely to be adopted in non-judicial foreclosure jurisdictions.

With respect to Fannie Mae and Freddie Mac, the new Bush plan would permit mortgage payments to be adjusted through lower interest rates or longer repayment schedules, with the goal being to bring payments below 38 percent of a borrower's monthly household income. Interest rates could further be lowered for five years then raised to a predetermined level, and loan terms could potentially be lengthened to 40 years. While the Bush plan currently only affects loans owned and guaranteed by Fannie Mae and Freddie Mac, there is a small chance it could be adopted throughout the entire industry.

Banks and mortgage finance firms have an interest in halting foreclosures. With the market flooded with more homes for sale than available buyers, foreclosures will only further decrease home prices and lead to more foreclosures.

President-Elect Obama's proposals

When President-Elect Obama enters the White House on Jan. 20, 2009, he has promised to implement a number of plans in hopes to revive the economy and address the mortgage situation. Passage of another economic stimulus package is high on President-Elect Obama's priority list and will likely be his first major act as President.

Additionally, he is expected to ask Congress for an additional economic lift. Part of this quick economic plan would include a cut in tax rates so that refund checks would be sent to individuals before tax returns are filed in April 2009.

Included in President-Elect Obama's proposed stimulus package is a Stop Fraud Act, which is aimed at fighting mortgage fraud and protecting consumers against abusive lending practices. This Act, first introduced in 2007, would ensure accountability in the subprime mortgage industry by increasing funding for federal and state law enforcement programs, creating new criminal penalties for mortgage professionals found guilty of mortgage fraud and imposing industry standards for insiders to report suspicious activity.

Secondly, President-Elect Obama is expected to create a Homeowner Obligation Made Explicit score, a measure designed to give individuals the ability to better compare mortgage products and further their understanding of what home loans entail. Specifically, the score would provide potential borrowers with a simplified, standardized borrower metric for home mortgages. This score has been criticized as being too late to make any real difference. Yet, it will likely keep a check on abuses and overzealous lending so that the problem does not perpetuate or repeat itself.

President-Elect Obama, according to his website, also plans to tighten the standards for mortgage companies seeking to file for bankruptcy protection. He plans to achieve this by eliminating the provision that prevents bankruptcy courts from modifying an individual's mortgage payments. To permit courts to adjust the mortgage payments, the plan will help some struggling homeowners and will further allow federal bankruptcy judges to lower mortgage balances for homeowners who hold mortgages valued more than their homes. This type of change would provide borrowers an incentive to make payments, even if below their statement, rather than go into foreclosure. However, this proposed change is controversial with many on Wall Street claiming that the law would cause the mortgage market to seize up, as investors would stop buying mortgage-backed securities out of fear a judge could unilaterally change the terms of the loan. Future borrowers would also have to pay higher rates or fees to offset the risk that the judge would rework the loan and lower the value of the mortgage-backed security.

While tightening the standards for mortgage companies to file bankruptcy, President-Elect Obama would make it easier for individuals to file bankruptcy under certain circumstances, increase the homestead exemption for seniors, streamline the bankruptcy process for families who are recovering from a natural disaster and create a fast track process for military families. In 2005, the Bankruptcy Abuse Prevention Act (BAPCPA) gained Congressional approval, which made filing bankruptcy more difficult for individuals. President-Elect Obama's proposed plans will make the following amendments to BAPCPA: (1) require disclosure to consumers regarding the consequences of making only minimum required payments in repaying credit card debt; (2) protect service members and veterans by disallowing certain claims by lenders charging usurious interest rates to service members and allowing service members the right to exempt property based on the law of the state of their pre-military status; (3) exempt debtors from means testing if their financial problems were caused by identify theft, medical problems or a failure to receive alimony or child support; (4) discourage predatory lending practices; (5) limit the exemption for asset protection trusts; (6) protect employees and retirees from corporate practices that deprive them of their earnings and/or retirement savings when the business files for bankruptcy and (7) increase the accrual period for the employee wage priority in bankruptcy.

President-Elect Obama is also expected to create a universal mortgage credit of 10 percent to homeowners who do not itemize their tax deductions. It is expected to provide an average credit of \$500 to 10 million homeowners, many of whom earn an annual income of less than \$50,000. This credit is expected to jump-start the market for first-time homebuyers. It is unclear, however, how the plan is expected to work.

President-Elect Obama's proposed 90 day moratorium on foreclosures of delinquent mortgages will freeze foreclosures for borrowers making "good faith" efforts to pay their mortgage. Mortgage servicers warn that such a moratorium could have a reverse effect on the housing downturn by prolonging the situation. Pooling and servicing agreements require that servicers advance principal and interest payments, as well as tax, insurance, maintenance and foreclosure costs to investors regardless of whether the debtor is paying the debt. Servicers then get reimbursed for expenses incurred while the loan is delinquent, but only after the property goes into foreclosure.

Repayment can then take nine months to a year, the typical time it takes for a property to be foreclosed and sold by the mortgagee. A foreclosure moratorium would have the effect of indefinitely extending the advances that servicers pay to investors. While some large banks could handle this financial strain, independent servicers and special servicers already dealing with borrowers in default would be hard pressed to withstand such pressure. Some argue, however, that a blanket moratorium on foreclosures is needed because servicers are not modifying loans quickly enough to address the situation.

Time will tell

Homeowners across the nation face a steep and worsening decline in home values. Many either cannot afford their mortgage payments or have stopped making mortgage payments altogether, having lost hope that their home values will eventually recover. Make no mistake, the mortgage industry and the broader economy will be one of the first challenges addressed by a President on his first official day in the Oval Office. Those challenges will require more than damage containment, and President-Elect Obama will be faced with difficult decisions in his attempts to stabilize the housing market. His proposals present both benefits and problems. How successful President-Elect Obama will be in dealing with the potential problems and maximizing the benefits is yet to be seen.

But ultimately, no President can halt foreclosures forever; they will resume. Most agree that our current economic crisis was caused in large part by perceived flaws in our mortgage banking and securities systems, and further that the crisis must run its course. Included along that course are foreclosures and lawsuits, and lots of both. Federal funds and laws designed to stimulate our economy, rebuild public trust and shore up the foundation of the weakened credit markets may well reduce the volume of foreclosures and litigation, at least temporarily. If, however, the bailout fails, then the fallout will almost certainly make a significant impact on President-Elect Obama's economic plans. Time will tell how Obama — and the economy — will react.