

**ASSET MANAGEMENT GROUP  
of the  
SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION**

**GUIDING PRINCIPLES  
FOR  
LOAN MODIFICATION PROGRAMS**

**Overview**

*Who we are.*

The Asset Management Group (AMG) of the Securities Industry and Financial Markets Association (SIFMA) is an organization of the oldest, largest, and most trusted investment advisers in the United States. Our clients include individuals with 401(k), 529, mutual fund and other holdings, public and corporate pension funds, university endowments, hospitals and charitable organizations. The group's members manage the pension, IRA, mutual fund, or personal investments for more than 112 million American workers and retirees. Our clients depend on us to help them meet their obligations, provide for their retirements, to have funds available to educate their family members, and to meet other responsibilities. In our role as investment advisers, we have a fiduciary duty to put our clients' interests first and to advocate for their interests where appropriate.

*The AMG supports proactive loan modifications and preventive loss mitigation programs to promote home retention and home values.*

Like many homeowners, the beneficiaries of our clients (which include endowments, charities and pension funds) have been negatively impacted by the housing crisis. The increase in foreclosure rates, along with the corresponding decline in housing values and the credit and more general economic crises have been devastating to many of our clients' economic well-being. At the same time, countless individuals have also experienced significant losses in their investment or retirement accounts, because residential mortgage-backed securities (RMBS) are widely owned by pension funds, endowments and individuals, and the performance of RMBS has been severely impacted because these securities depend on the monthly repayments of homeowners pursuant to their mortgage obligations. Many individuals must alter retirement or education plans and businesses and public institutions must deal with unfunded pension liabilities instead of creating new jobs.

Our clients' interests align with homeowners. All do best if foreclosures are minimized and at-risk borrowers can be efficiently placed into products that are sustainable over the long term. Unfortunately, all do badly if loan modifications result in increased re-default rates: with homeowners struggling to sustain unaffordable homes; investors facing uncertain returns that limit reinvestment in new mortgages; and an economy hamstrung in large part due to the seizure of the credit markets. No large scale approach to solving the mortgage delinquency situation will be perfect; however, any such approach should be efficient and not impose undue barriers on homeowners. We wholeheartedly endorse a diligent method of underwriting loan modifications,

coupled with innovative principal forbearance structures, and believe that such an approach can benefit homeowners and improve performance for investors.

*Loan modification programs that understand and address investor interests and rights will benefit homeowners and the economy.*

AMG is committed to being a productive contributor to the ongoing discussions regarding loan modification programs. Thus, the AMG has developed the following set of Guiding Principles which it feels should be reflected in any large scale loan modification program. These principles do not conflict with an efficient and streamlined loan modification program, but to the contrary, bolster any and all such programs by aligning the interests of homeowners and investors and improving the larger economy in the process. It is important to underscore that any modification program that undermines the confidence and contractual rights of investors risks raising the financing costs for homeowners. Accordingly, the AMG recommends taking these Guiding Principles into account when evaluating and developing loan modification programs.

*Well constructed and effectively executed loan modification programs will be essential to widespread foreclosure avoidance and will serve to maximize the outcomes for all stakeholders.*

AMG submits that fully harnessing the combined power and ingenuity of the public and private sectors is likely to generate the best outcome. Collaboratively integrating the best aspects of Hope for Homeowners, the FDIC's initiatives, the robustness of TARP and future policy initiatives, with the principles and insights articulated in the Guiding Principles below will best serve borrowers, taxpayers and our clients. Moreover, the AMG's Guiding Principles are premised on the presumption that the most effective "streamlined" loan modification programs will be those where modified loans would be guaranteed or purchased under government programs (e.g. TARP, FDIC) pursuant to guidelines to be adopted by government officials. Streamlined modifications would be acceptable to AMG member firms so long as re-default rates are minimized either through effective data-driven loan modifications or a meaningful guarantee, as set forth herein below.

## **Loan Modification Guiding Principles**

*A streamlined loan modification process should carefully consider likelihood of take-up (i.e., the total number of homeowners helped by the program).*

- The AMG believes that the best way to achieve large scale loan modifications and move forward in the mortgage-backed securities market is for the Treasury Department to use TARP as originally intended (i.e., to purchase or insure troubled assets). The use of TARP funds to repurchase modified loans from securitizations, or to guarantee modified mortgage loans against re-default, would remove the greatest impediments to making modifications a unanimously economically superior alternative to foreclosure.
- With respect to risk-sharing proposals, take-up will increase with (1) the level of modified loan guarantees; (2) the timing of the guarantee (i.e., the date the guarantee attaches); and (3) the likelihood that the modified loan will be sustainable over the long term.

*Programs should be based on a reasonable monthly payment using justifiable debt-to-income (DTI) and loan-to-value (LTV) ratios.*

- Modification programs should assist distressed borrowers with the ability to make a reasonable monthly payment based on current sustainable income.
- Modifications should target reasonable DTI ratios to allow for consistent monthly borrower payments. In order to align the homeowner's incentives with that of our investors, the AMG could possibly support even lower DTI ratios than the 38% targeted by the FHFA when, and to the extent, such ratios are coupled with higher re-default protection and/or guarantees from the Government.
- The AMG notes that many recent modification programs propose a DTI that is significantly lower than the DTI ratios at which regulated financial entities continue to write new business. This suggests an inconsistent standard whereby originators are permitted to earn a higher income stream based on one prudent lending standard, while investors' income stream is reduced under a separate arbitrary lending standard.
- Servicers should be encouraged to continue to allow short-sales, short-refinancing, and other loss-mitigation strategies even after the implementation of a streamline loan modification. These options are much better than foreclosure for homeowners, neighbors and other participants. Servicers should also be encouraged to maintain appropriate staffing levels to maintain these programs.

*Streamlined Loan modifications should only be made for occupied primary residences.*

- Loan modification programs, including streamlined programs, should be carefully designed to provide assistance only to homeowners occupying the property as a primary residence. All loan modification programs should be thoughtfully structured so as not to reward those who committed fraud.
- With respect to *non-owner occupied properties*, servicers should continue their existing servicing practices consistent with the agreements already in place and, when appropriate, offer case-by-case loan modifications.

*Re-default rates are lowest when all information used to underwrite a loan modification (e.g., income, occupancy, etc.) is fully verified. Verification should include:*

- Occupancy verification, including a thorough analysis of the credit bureau report(s) of all borrowers to determine the appropriate occupancy status and potential ownership of multiple properties.
- Income verification of all borrowers using IRS Form 4506T or documentation of the loss of income of the borrower (e.g. delivery of a hardship letter).
- Loan modifications should only become permanent upon the receipt and verification of income documentation, executed modification agreements, and a demonstrated ability to make payments (e.g., 3 of 3 consecutive modified payments).

*A net present value calculation should be made for each modification to determine the best economic solution for the troubled loan (understanding that a guarantee may maximize NPV for a class of modified loans).*

- The AMG advocates the use of a Net Present Value analysis to determine the best economic solution for the trust based, at least in part, on appropriate discount rates, supportable estimates of re-default risk, and reasonable assumptions of future home prices.

- i. The appropriate NPV test is the comparison of the net liquidation proceeds which would be expected from foreclosure to the expected value of a modification. The expected value of a modification should be based on the probability that reduced payments produce sustained performance versus the probability that the modified loan re-defaults. In conjunction with appropriate estimates of the re-default rate and discount rates, a reasonable estimate of the loss upon re-default requires (a) an assumption of the average time to re-default and (b) a fair estimate of liquidation price at the time of re-default.
- ii. Estimates of future re-default rates should be based on actual recent servicing performance data considered to be the most relevant to the types of borrowers, loans, the type and strength of modification employed, and homes pertaining to the modified loans and re-calibrated on a quarterly basis.

The AMG would support principal forgiveness where a refinance to the FHA or FHFA mortgage lending programs are viable solutions for the borrower and the proceeds from the refinance are greater than the anticipated proceeds from foreclosure and liquidation<sup>1</sup>. However, any principal forgiveness program must have adequate guidelines designed to mitigate the risk of moral hazard.

*Programs should address re-default risk.*

- Re-default risk for modifications is significant (in some cases they have been greater than 40%), a fact that no government or private sector program has fully addressed.
- To minimize re-default and moral hazard, AMG supports giving consideration to a borrowers' total sustainable income and debt.
- At a minimum, the Net Present Value (NPV) model utilized by servicers should include a re-default rate assumption consistent with the factors listed above.

*Additional loan resolution programs to consider.*

- Unfortunately, the loan modification data show that despite the best intentions and efforts of mortgage servicers and the cooperation of investors, some borrowers will still not be able to perform under any reasonable loan modification scenario.
- When the servicer acts in good faith to modify a loan and the borrower fails to perform without a change in circumstances, the AMG supports a cooperative loan resolution strategy whereby the servicer would offer relocation assistance in exchange for a deed in lieu of foreclosure or a short sale to a third party.
- Arbitrary foreclosure moratoria, unconnected to specific seasonal considerations or other meaningful circumstances directly associated with borrowers' prospects, are counterproductive for all parties to the transaction, delay a timely market recovery and should be avoided.

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<sup>1</sup> Some AMG members also support principal forgiveness to target reasonable Loan-to-Value (LTV) ratios even if the loans are not refinanced or the properties sold. These members believe that the data shows that homeowners who have equity in their home are significantly less likely to default or redefault than those who do not.

*Programs should address the issues raised by second liens.*

- Seriously delinquent loans are more likely to have second liens. Twenty-eight percent of all residential mortgage loans have second liens, while 41% of seriously delinquent residential mortgage loans have second liens. Second liens are associated with increased monthly payments (which generally are not captured by traditional housing-debt ratios) and increased combined LTV ratios. Consequently, ignoring second liens fails to address a significant part of the housing problem.
- In the event a modification requires the servicer to record the modification, the AMG supports a mandate to require second lien holders to re-subordinate.
- Procedural delays caused by the negotiation of the second lien holder will delay and potentially prevent a workable loss mitigation solution for borrowers and investors. We encourage the FDIC and other governmental agencies to assist in this issue – an innovation to consider is a no-fault, no-cost foreclosure to eliminate the second lien (which is not recorded by the credit bureaus as a derogatory credit or public record). With the second lien out of the way, the borrower can be made a new no-cost loan under the conditions appropriate to their circumstances.
- In the event the modification involves a reduction in principal, we support an industry mandate requiring second liens held or serviced by an affiliate of the servicer of the first lien to release the second lien. For other second liens, holders of such second liens should be required to re-subordinate or accept a nominal payment to release the lien.

*Programs should not create moral hazard. Modification programs should be structured to avoid encouraging intentional defaults by a borrower.*

- AMG advocates that servicers perform adequate diligence on the borrower and property to affirm that the default was not intentionally designed to take advantage of opportunities provided by loan modification programs.
- Borrowers deemed to have intentionally defaulted on their mortgages should not benefit from loan modification programs and should be subject to the full penalties and late fees provided for pursuant to the terms of their mortgages.

*To minimize intentional default (or re-default) and speed market recovery, loans should only receive one substantial streamlined restructuring in the absence of significant financial hardship.*

- In the absence of changed circumstances outside the borrower's control, borrowers who default on an already substantially restructured loan should be processed in a case-by-case manner. Encouraging re-default will further erode existing asset values, diminish new lending and delay a market recovery.

*Programs should be transparent and provide full details of modifications to security holders.*

- The AMG supports the reporting templates proposed by the ASF and FDIC.

*Programs should make every attempt to help borrowers experiencing economic hardship and should provide incentives for borrowers to work cooperatively with servicers.*

- The AMG supports amending the Mortgage Forgiveness Debt Relief Act of 2007. The Act currently allows borrowers to exclude from their gross income gains from the discharge of mortgage principal indebtedness. This Act currently expires at the end of 2009. We support extending the Act through the end of 2011, but modifying it to apply to borrowers who in good faith cooperate with servicers.
- The AMG further suggests that Fannie Mae and Freddie Mac shorten their prohibition on new loans to borrowers with foreclosures from a period of five years to two years for homeowners who in good faith fully cooperate with their servicers. However, for those homeowners who do not act in good faith with servicers, Fannie and Freddie should extend the prohibition to a period of seven years.

*Programs should respect the repurchase obligations that depositors and originators have when they breached the representations and warranties as part of the securitization process.*

- The loan modification process offers new opportunity to underwrite the loan file and credit/income profile of the borrower. To the extent this process uncovers loan origination characteristics that are inconsistent with the representations and warranties of an originator, the servicer is obligated to disclose such finding to investors.
- Costs of unethical or illegal lending or servicing practices should be borne by lenders or servicers, not investors.

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Any suggestions or questions from interested parties concerning the above-mentioned “Guiding Principles” would be most welcome.

Please direct inquiries to Joseph Sack, Staff Advisor to the Asset Management Group, at (212) 313-1165 or [jsack@SIFMA.org](mailto:jsack@SIFMA.org).

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