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California's Proposed Mortgage Modification Program

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California Governor Arnold Schwarzenegger recently announced a legislative proposal to stem foreclosures in the state by incentivizing lenders to offer "robust" loan modification programs. Although the proposal is limited to California, it could serve as a model for similar legislation by other states and the U.S. Congress.

The proposal uses a "carrot and stick" approach. The "stick" is a mandatory 90-day moratorium on foreclosures, applicable to first lien mortgages on owner-occupied primary residences as to which a notice of default has been filed. The "carrot" is a lifting of the moratorium only if the designated state regulator issues an order exempting the servicer. The state regulator will issue an order only if the servicer provides evidence that it has implemented a "robust" modification program.

To be "robust," the modification program must have three features. First, it must be intended to keep the borrowers in their homes where doing so represents a positive net present value to the investor or investors as compared with foreclosures. Second, it must require the servicer to solve for a housing related debt-to-monthly income ratio of 38%. Third, the 38% figure can be achieved by all or some combination of reducing the interest rate to as low as 3% for at least five years, extending the amortization period for the loan to 40 years from the original date, and deferral of principal until maturity of the loan. For purposes of the 38% ratio, the borrower's housing related debts include principal, interest, property taxes, and insurance.

A servicer with a "robust" modification program must submit evidence to the appropriate state regulator. If the regulator agrees, it will issue an order, which will allow the servicer to avoid the new 90-day delay in the foreclosure process. The state regulators will be authorized to adopt emergency regulations to clarify the process. The Commissioner of Real Estate is the appropriate state regulator for servicers that are licensed real estate brokers, the Commissioner of Corporations is the appropriate state regulator for servicers that are licensed under the California Finance Lenders Law or California Residential Mortgage Lending Act, and the Commissioner of Financial Institutions is the appropriate state regulator for servicers that are California commercial banks, industrial banks, savings associations and credit unions. For all other servicers, the appropriate state regulator is the Commissioner of Corporations. The proposal states that the new law will remain in place until January 1, 2013, after which it will be repealed, unless that date is deleted or extended by subsequent legislation.

It remains to be seen whether the legislation will be enacted, how much of the proposal will survive the legislative process, and how many servicers will be willing to adopt a robust modification program in return for the avoidance of a 90-day delay in the foreclosure process. If the program is successful, its "carrot and stick" approach may become a model for other states and the federal government. Some elements of the proposal, in particular the 38% ratio, are similar to the program that the FDIC has implemented for mortgage borrowers at IndyMac Federal Bank.

The proposal leaves many questions unanswered, including:

- If a servicer services loans for multiple investors, must the servicer's robust modification program be put into place for all of its investors' loans, or only for the investors holding the particular loans that would otherwise be subject to the new 90-day delay in the foreclosure process?

- What impact will the legislation have on national banks, federal savings banks and their respective operating subsidiaries? Can these institutions avoid the new law by use of the federal preemption doctrine? Is there an enforceable legal basis to require these federal institutions to seek an order from a state regulator?
- How will the proposal apply in the case of a borrower who refuses to communicate with the servicer, let alone sign a modification agreement?
- What standards will the three state regulators use to determine if a servicer's modification program is sufficiently robust?
- The servicer's modification program must be intended to keep borrowers in their homes where doing so represents a positive net present value to the investor or investors as compared with foreclosure. But, how will the net present value be determined, and what numerical assumptions will be employed to calculate the net present value?