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Steps for Lenders to Consider in Connection with Mortgage Modification Programs

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Banks are increasingly implementing mortgage modification programs in order both to settle class-action lawsuits and as a way to improve returns on their investments. With housing prices continuing to decline, some lenders have found it increasingly cost-effective to allow borrowers to modify mortgages, rather than foreclosing and having to maintain properties or dispose of them at a loss in a weak housing market. These programs have typically been available only for borrowers who are significantly (usually 60 days or more) behind in payments on first mortgages on their primary residences.

Although the specific features of these programs vary, certain elements are likely to become standard, such as waiving prepayment and restructuring fees associated with mortgage modifications and providing a stay from foreclosure to any potentially eligible borrowers while the programs are implemented. Some lenders have capped borrowers' monthly payments (including principal, interest, taxes, and insurance) at between 34% and 38% of the borrowers' gross income. Payments have been reduced by a combination of one or more of interest rate reductions, extended amortizations, and principal forbearance. Some lenders have also limited eligible mortgages to those with certain loan to value ratios.

Banks that engage in extensive mortgage modifications will face several challenges. Since many of the mortgages being modified have been pooled into mortgage-backed securities, obtaining the approval of investors holding the securities has been and will continue to be an important concern for lenders. As well as being reluctant to have their own returns diminish, investors may push to have loans and securities transferred to the Treasury's Troubled Assets Relief Program (TARP) rather than modified by lenders. Consequently, lenders that participate in modification programs will need to document the modifications properly and provide the appropriate regulatory disclosures. At a minimum, this will include:

- **Documenting the Modification:** Depending upon the circumstances and applicable law, this may involve modification of both the promissory note and the security instrument. The modification agreement should be recorded. Where appropriate, lenders should get an endorsement to the title insurance policy. If there are junior lienors, they may need to consent to the modification.
- **Investor Consent:** If there are investors on the loan, the lender should determine whether it has the authority to effectuate the modification without investor consent. If investor consent is required for a modification, this will need to be obtained.
- **Truth-in-Lending:** For a closed-end mortgage, a new Regulation Z disclosure ordinarily is required when an existing obligation is satisfied and replaced by a new obligation undertaken by the same consumer. Even if an existing obligation is satisfied and replaced by a new obligation, a workout of a delinquent loan will not require a new Regulation Z disclosure unless the rate is increased or the new amount financed exceeds the unpaid balance plus earned finance charges and certain insurance premiums. However, a new disclosure will be required if the rate is increased based on a variable-rate feature that was not previously disclosed or if a new variable-rate feature is added to the obligation. In either such event, a new ARM program disclosure and CHARM disclosure will be required if the transaction is secured by a principal dwelling with a term greater than one year.

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- **Non-Traditional Mortgages:** If the modified mortgage will be a non-traditional mortgage, the disclosure contemplated by the banking agencies' guidance for non-traditional mortgages should be provided at the outset.
- **Right to Rescind:** A new Regulation Z notice of the right to rescind should not be required for a modification of a closed-end mortgage by the original creditor. However, the right of rescission will apply to the extent the new amount financed exceeds the unpaid principal balance, any earned unpaid finance charge, and amounts attributed solely to the cost of the transaction.
- **Adverse Action Notice:** If the consumer requests a modification and the request is turned down, this should not trigger the obligation to provide an adverse action notice under Regulation B, provided that the loan is in default or delinquent. However, if the loan is not in default or delinquent, this will constitute an adverse action and it will be necessary to send a notice of adverse action under Regulation B. If the lender also relied on a consumer report in making its decision, the adverse action notice must include the disclosures required by the federal Fair Credit Reporting Act.
- **State Mandated Disclosures:** Lenders that are subject to state laws governing mortgage lending will be required to provide any disclosures required by applicable state law.

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