TROUTMAN SANDERS ADVISORY

Subprime Crisis – Update on Federal Government Response

With Congress in a brief recess, now is an opportune time to provide a brief update on federal activities surrounding the continuing subprime mortgage crisis. As you know, from headlines just this week (*i.e.*, Bear Stearns), the affect this crisis is having on the Nation and the economy continues to mount.

The government continues to respond as new issues arise or problems develop. We provide the following overview and summary of recent actions:

Federal Programs:

● As noted in our prior memorandum, the Federal Housing Authority's FHASecure program continues to offer refinancing options to move delinquent hybrid ARM borrowers into reasonable, fixed-rate loans. FHA has stated that since FHASecure was initiated, FHA has helped more than 120,000 families stay in their homes by refinancing about $17 billion worth of mortgages.

● In addition, effective March 6, 2008, the Department of Housing and Urban Development (HUD) began offering temporary FHA loan limits that range from $271,050 to $729,750. This change in loan limits is intended to help provide economic stability to communities and give nearly 240,000 additional homeowners and homebuyers a safer, more affordable mortgage alternative. The maximum amount of $729,750 will only be applicable to extremely high-cost metropolitan areas. Previously, FHA's loan limits in these very high-cost areas were capped at $362,790.

This action is the result of the passage of the Economic Stimulus Act of 2008 (*see* below) which permits FHA to insure loans on amounts up to 125 percent of the area median house price, when that amount is between the national minimum ($271,050) and maximum ($729,750). The change in loan limits are applicable to all FHA-insured mortgage loans endorsed with HUD's publication of the increased loan limits today, and it lasts until December 31, 2008. By increasing loan limits nationwide, FHA has stated that it hopes to provide liquidity and stability to housing markets across the country.

● On March 14, 2008, HUD Secretary Jackson proposed reforms to the Real Estate Settlement Procedures Act (RESPA). Under this proposal, home buyers would be presented for the first time ever with a standard form disclosing the important aspects of a loan. This new disclosure would ensure that home buyers are provided complete, accurate, and understandable information about their mortgages. This would include the interest rate, loan amount, fees, and the possibility that their monthly payments could rise dramatically over time. This purpose of this proposal is to make the home buying process more transparent and reduce the likelihood that current lending problems will happen again in the future. Specifically, it would:

-Consolidate closing costs into major categories to prevent "junk fees" and display total estimated settlement charges prominently on the first page, allowing consumers to easily compare loan offers and shop for the best deal.

-Specify what charges can and cannot be changed at settlement so home buyers are not surprised.

-Save the typical homebuyer almost $700 in closing costs, according to HUD estimates.

● On March 19, 2008, the Office of Federal Housing Enterprise Oversight (OFHEO), along with Fannie Mae and Freddie Mac announced a major initiative to increase liquidity in support of the U.S. mortgage market. The initiative is meant to provide up to $200 billion of immediate liquidity to the mortgage-backed securities market. This move reduces that amount of capital that these federal enterprises must maintain as a cushion against losses, and as a result will enable them to buy more mortgages.

OFHEO estimates that Fannie Mae's and Freddie Mac's existing capabilities, combined with this new initiative and other recent efforts, should allow these federal enterprises to purchase or guarantee about $2 trillion in mortgages in 2008. This capacity will permit them to do more in the jumbo temporary conforming market, subprime refinancing and loan modifications areas.

To support growth and further restore market liquidity, OFHEO announced that it would begin to permit a significant portion of the GSEs' 30 percent OFHEO-directed capital surplus to be invested in mortgages and Mortgage-Backed Security (MBS). As a key part of this initiative, both companies announced that they will begin the process to raise significant capital. Both companies also said they would maintain overall capital levels well in excess of requirements while the mortgage market recovers in order to ensure market confidence and fulfill their public mission.

This may be a significant development, particularly if the housing market does not soon stabilize. Both Fannie Mae and Freddie Mac have already lost billions of dollars and are predicting that their losses from defaults and foreclosures will continue. And, in November 2007, Freddie Mace temporarily fell below its capital requirement. With this new initiative, Fannie Mae's capital requirement was reduced to $38.3 billion from $41.5 billion, and Freddie Mac's requirement was reduced to $31.8 billion from $34.4 billion. Critics in the past year have warned that existing and mounting losses by these two enterprises could require a bailout. OFHEO Director James Lockhart III has recently stated that both companies are financially stable.

<u>Congressional Legislation</u>:

On February 13, 2008, the President signed the Economic Stimulus Act of 2008 (H.R. 5140, now Pub. L. No. 110-185) which contained more than $152 billion for economic growth. In addition to the individual tax rebates provided for, as noted in our prior memo, the law as enacted did contain provisions which temporarily increase the loan limits Fannie Mae and Freddie Mac may purchase or guarantee. These provisions are intended to assist the securitization of mortgages in areas where housing costs are higher than the national average. This aspect of the law covers mortgages originated during the period beginning on July 1, 2007, and ending at the end of December 31, 2008.

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Pending legislation pertaining to the subprime crisis is, at this point, voluminous, with bills seeking to modernize the Federal Housing Administration, Freddie Mac and Fannie Mae, and to otherwise address the subprime mortgage crisis through various forms of bonds, refinancing or other forms of federal loan or grant programs. What follows is a summary of the many proposed bills.

● Legislation to modernize the Federal Housing Administration (FHA) remains before the Congress despite calls by President Bush and Speaker Pelosi to pass legislation which would grant FHA appropriate down payment and pricing flexibility to help families and bring stability to the housing market. The House of Representatives and Senate both passed related legislation in 2007 (S. 2338, H.R. 1427 and H.R. 1852); however, no further progress has been made in 2008.

● In addition, there have been calls to pass legislation allowing bonds guaranteed by the Federal home loan banks to be treated as tax exempt bonds, to permit state and local governments to help troubled borrowers by issuing tax exempt bonds for refinancing existing home loans, or to allow other uses of qualified mortgage bonds proceeds for subprime refinancing loans. Such legislation covering these similar, but varying, purposes has been introduced (for example, H.R. 2091, H.R. 5239, S. 12, S. 1963, S. 2517, S. 2636, S. 2734), but none has not moved out of the relevant Congressional committees to which they were referred for consideration.

● Both the Congress and President Bush also indicate a desire to reform the regulation of Government Sponsored Enterprises (GSEs), such as Fannie Mae and Freddie Mac, so that these entities are ensured to be adequately capitalized and focused only on their stated missions. Much of the above-cited legislation incorporates provisions which would accomplish such reform. Legislation, such as H.R. 3777, H.R. 3838, S. 2036, S. 2169, and S. 2346, has also been introduced which would temporarily increase the portfolio caps applicable to Freddie Mac/Fannie Mae and provide the necessary financing to curb foreclosures by facilitating the refinancing of at-risk subprime borrowers into safer, more affordable loans. Again, however, none of these bills has moved beyond the committees to which they have been assigned for consideration.

● Proposed legislation by Chairman Barney Frank -- On March 13, 2008 House Financial Services Chairman Frank announced that he would shortly introduce the "FHA Housing Stabilization & Homeownership Retention Act". The bill would allow the Federal Housing Administration to insure and guarantee refinanced mortgages that have been significantly written down by mortgage holders and lenders. Under the current "discussion draft" of the bill, the program would permit FHA to provide up to $300 billion in new guarantees that would help to refinance at-risk borrowers into viable mortgages. In exchange for the acceptance of a substantial write-down of principal, the existing lender or mortgage holder would receive a payment from the proceeds of a new FHA loan if the restructured loan would result in terms that the borrower can reasonably be expected to pay. The existing lender or mortgage holder would have a cash payment and no further credit exposure to the borrower. This could potentially refinance between 1 and 2 million loans, protect neighborhoods and help stabilize the housing market.

In addition, the bill would permit the loan program described above to be used to refinance and guarantee mortgages through an FHA Bulk-Refinance facility that would provide for auction or other mechanism to refinance loans on a bulk basis.

At the state level, Frank's bill would make available certain loans and grants to states for foreclosure relief and/or mitigation. The plan would provide $10 billion in loans and grants for the purchase and rehabilitation of vacant, foreclosed homes with the goal of occupying them as soon as possible. Each state's loan and grant authority would be based on the state's percentage of nationwide foreclosures adjusted to account for the state's median home price. States could allocate funds to government entities (*e.g.*, housing authorities), nonprofits, and private-sector entities for the purchase and resale of homeownership housing. However, only government entities and nonprofits could receive these funds for rental housing developments. Loans would be non-recourse, zero-interest loans to finance acquisition and rehabilitation costs. The government would be paid back from resale or, in the case of rental properties, refinance proceeds. Loans for homeownership properties would have to be repaid within two years. For rental properties, the maximum loan term would be five years. In addition, the federal government would receive 20 percent of any appreciation a property owner realizes at resale.
25 percent of the state's funding authority could be used grants, for purposes which include property taxes and insurance during the pre-occupancy phase; operating costs such as property management fees, property taxes and insurance during the period a property is rented costs incurred related to property acquisition; and administrative costs by the state and grantees to run the program. Grants could also cover down payment and closing cost assistance. Homes purchased for resale would have to be sold to families having incomes that do not exceed 140 percent of area median income. Properties purchased for rental would have to serve families having incomes at or below area median income. However, states would be required to give preference to entities that will use the funds to serve the lowest income individuals for the longest periods.

● Proposed legislation by Chairman Chris Dodd – On March 13, 2008, Senate Committee on Banking, Housing, and Urban Affairs Chairman Dodd, announced his intention to introduce the "HOPE for Homeowners Act of 2008". The Act would create a new program within FHA to back FHA-insured mortgages to distressed borrowers. The new mortgages offered by FHA-approved lenders would refinance abusive loans at a significant discount for homeowners facing difficulty meeting their mortgage payments.

Draft text of this bill is not yet available, but Committee staff indicates that the program is built on the following five principles:

1. Long-term Affordability. The program is built on the idea, expressed by Federal Reserve Chairman Bernanke, that creating new equity for troubled homeowners is likely to be a more effective way to avoid foreclosures. New loans will be based on a family's ability to repay the loan, ensuring affordability and sustainable homeownership.

2. No investor or lender bailout. Investors and/or lenders will have to take significant losses in order to benefit from the proceeds of the loans refinanced with government insurance. However, these losses would be less than the losses associated with foreclosure.

3. No windfall for borrowers. Borrowers will share their new equity and future appreciation equally with FHA. Borrowers will pay for the FHA insurance.

4. Voluntary Participation. This will be a voluntary program. No servicers will be compelled to participate.

5. Restore confidence, liquidity, and transparency. Credit markets are fearful and frozen in part because banks and other financial institutions do not know what their subprime mortgages and related securities are worth. The uncertainty is forcing lenders to hoard capital and stop the lending necessary for economic growth. This program will create certainty and get markets flowing again.

● On the Republican side, Senator Kit Bond (R-Miss.) on March 10, 2008 introduced the "Security Against Foreclosure and Education (SAFE) Act of 2008" (S. 2734) to provide targeted housing relief to families and neighborhoods in need. Under the SAFE Act, state housing finance agencies would be authorized to issue $10 billion in tax-exempt bonds and use the proceeds to help refinance subprime mortgages. The new loans would have a much lower interest rate than the high adjustable subprime rate. Bond's legislation would also help struggling neighborhoods by providing $15,000 in tax credits available over 3 years for purchasing a home in or approaching foreclosure in the neighborhood.

Overall, the legislative front with regard to the subprime crisis remains very fluid. In fact, after the collapse of Bear Stearns, we expect even more legislation to be introduced in both chambers over the course of the next several weeks.

In response to the latest developments, Democrats in Congress have indicated that they plan to move quickly on legislation aimed at stabilizing financial markets and to help homeowners avoid foreclosure. House Financial Services Committee Chairman Barney Frank (D-Mass.) on March 18 announced a hearing for April 9 on his economic, mortgage and housing rescue plan (*see* above legislation). In the Senate, Majority Leader Harry M. Reid (D-Nev.) plans to work with Banking Committee Chairman Christopher J. Dodd (D-Conn.) to bring similar legislation to a vote as quickly as possible.

In the past, the Bush administration has resisted Democratic proposals to intervene on behalf of distressed homeowners. But in dealing with the Bear Stearns crisis, there are indications from Treasury Secretary Henry Paulson that the administration may be open to some type of plan along the lines being discussed by Rep. Frank and Sen. Dodd. President Bush, however, remains resistant to any large-scale legislation to bail out homeowners. He reportedly would prefer more limited legislation to modernize the FHA, and provisions to help new home buyers and small investors by strengthening the rules that govern mortgage lending.

Congressional Republicans also appear to remain less than supportive of any major homeowner bailout. Sen. Richard Shelby (R-Ala.), the senior Republican on the Banking Committee, has repeatedly stated that he will oppose "any taxpayer bailout of lenders or borrowers."

Hopefully, over the course of the next month, Congress will settle on a legislative plan to help address the subprime crisis. But, unlike the Federal Reserve's quick action last week to stabilize financial markets, legislative action attempting to address homeowners and consumer benefits are likely to progress much more slowly as they will likely face some resistance from the Bush administration.

Federal Reserve:

The Federal Reserve Board's move over the weekend of March 15-16, 2008, in which it supported J.P. Morgan Chase's acquisition of Bear Stearns was significant and helped to calm the U.S. financial market.[1] In supporting this move, the Federal Reserve agreed to take the risk of up to $30 billion in troubled assets on Bear Stearn's books.

Also on March 16, the Federal Reserve announced two initiatives designed to bolster market liquidity and promote orderly market functioning. First, the Board voted unanimously to authorize the Federal Reserve Bank of New York to create a lending facility to improve the ability of primary dealers to provide financing to participants in securitization markets. This facility will be in place for at least six months and may be extended as conditions warrant. Credit extended to primary dealers under this facility may be collateralized by a broad range of investment-grade debt securities.

Second, the Federal Reserve unanimously approved a request by the Federal Reserve Bank of New York to decrease the primary credit rate from 3½ percent to 3¼ percent. This step lowers the spread of the primary credit rate over the Federal Open Market Committee's target federal funds rate to ¼ percentage point. The Board also approved an increase in the maximum maturity of primary credit loans to 90 days from 30 days.

However, after its latest meeting in which the interest rate was again lowered, the Board acknowledged that "financial markets remain under considerable stress, and the tightening of credit conditions and the deepening of the housing contraction are likely to weigh on economic growth over the next few quarters."

With regard to regulatory actions, the Federal Reserve has proposed the new regulations under the Home Ownership and Equity Protection Act (HOEPA). These proposals, announced in December 2007, focus on four specific areas: assessment of repayment ability; low- and no-documentation lending; escrowing for taxes and insurance; and, prepayment penalties. These proposed new rules seek to ban practices that the Board has found to be unfair or deceptive. Significantly, bans on such unfair or deceptive acts and practices would apply to the entire mortgage industry, not just to institutions directly regulated by the Board.

In addition, the Federal Reserve has another proposal which seeks to ban seven specific advertising practices deemed unfair or deceptive. Under this proposal, for example,

[1] With regard to Bear Stearns, it is acknowledged that the investment firm will be faced with a multitude of lawsuits in the coming months by both investors and employees. What may also occur is an SEC investigation, and possibly even enforcement actions, over the accuracy of the firm's financial statements in the months before it fell apart.

mortgage originators would not be allowed to advertise a mortgage as having a "fixed" rate unless the advertisement also states clearly how long the rate or payment is fixed, and they could not advertise loans in one language but have important consumer disclosures in another. The proposal would also require that consumers receive loan-specific Truth in Lending Act disclosures early in the application process, when they can use the information to shop more effectively.

The public comment period for these proposed rules closes on April 8.

<u>Bush Administration Actions</u>:

As noted in our previous memorandum, Treasury Secretary Paulson and HUD Secretary Jackson assembled a private-sector HOPE NOW alliance. As of March 3, 2008, the alliance stated that approximately 1,035,000 homeowners have received loan workouts and been able to stay in their homes since July 2007.

On March 4, 2008, the U.S. Office of the Comptroller of the Currency (OCC) encouraged all national bank mortgage servicers to utilize the HOPE NOW alliance's loan modification reporting standards for subprime adjustable rate residential mortgages. It indicated that a standard reporting format will help investors in securitization trusts, including financial institutions, monitor foreclosure prevention efforts related to subprime mortgage loans. Also, OCC believes that consistent loan modification reporting will foster transparency in the securitization market and provide standardized data across the mortgage industry. The Federal Deposit Insurance Corporation (FDIC) also issued a similar statement.

The OCC has also called for an amendment to the Community Reinvestment Act (CRA) regulation to provide CRA consideration for community development investments in middle-income communities that are distressed as a result of mortgage foreclosures and related economic factors affecting the area. Comptroller of the Currency John Dugan has stated, "With this change, we would give favorable CRA consideration for – and encourage – loans, services, and investments in more communities suffering from the consequences of foreclosures."

On March 13, 2008, the President's Working Group on Financial Markets (lead by Treasury Secretary Paulson) issued a policy statement with recommendations to improve the future state of U.S. and global financial markets. The statement offered the group's insight on causes of recent market issues and next steps for mitigating systemic risk, restoring investor confidence, and facilitating stable economic growth. The proposals call for changes to nearly every segment of the credit markets and mortgage industry, including the creation of national standards for mortgage brokers, tighter oversight of credit-rating firms and stricter capital requirements for financial institutions making risky investments

The report from the Working Group addresses six major issues that have contributed to the market crisis. What follows are only some of its recommendations:

- Implement strong licensing standards for mortgage brokers and make mortgage terms easier for consumers to understand and compare.
- Encourage investors to assess the risks of mortgage securities and similar assets rather than relying on credit ratings.

- Require credit-rating agencies to reduce conflicts of interest, make it easier to understand ratings, ensure that ratings are adequately monitored and differentiate ratings of complex securities and traditional bonds.
- Ask bank regulators and the Securities and Exchange Commission to advise investment firms on how to improve their risk assessment procedures and alter compensation policies to discourage reckless behavior.
- Provide incentives for financial institutions to hold enough capital in case of market downturns and require them to make more transparent disclosures of off-balance-sheet or complex holdings.
- Push for Wall Street to set new standards to improve transparency in the trading of derivatives that are bought and sold privately.

The next step is implementation of the recommendations by the Department of the Treasury, the Federal Reserve Board, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, who all participated as part of the Working Group. As this is a forward looking, long-term policy and planning strategy, we attach the Working Group's statement for your review.

In releasing the policy statement, the Working Group also indicated that it will work with foreign regulators, finance ministries, and central banks through the international Financial Stability Forum and other venues to address these ongoing challenges globally.

In connection with the release of the Working Group policy statement, Treasury Secretary Paulson announced as yet unspecified moves that will raise consumer and investor confidence in U.S. markets without constricting capital markets. The recommendations will supposedly strengthen oversight of the mortgage industry; improve the way credit ratings are determined for securities; and, ensure proper risk management at financial institutions.

The firm will continue to monitor and generally report on developments in response to this continuing subprime mortgage crisis. If there is a particular issue, proposed policy, legislation or administrative action that you need additional information on or closer monitoring of, please contact me.

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