



American Securitization Forum

Trust Market Practices and Tax Alternatives for Modified Loans

July 6, 2010



American Securitization Forum
Trust Market Practices and Tax Alternatives for Modified Loans

In order to increase transparency and standardization in the securitization market, the American Securitization Forum (“ASF”)¹ endorses the establishment of best practices for market participants, especially in cases where governing contracts do not address a particular issue. To this end, the ASF has held joint meetings of our Master Servicer and Trustee Subforums to facilitate discussions concerning potential standard market practices for their securities administration duties with respect to modifications of mortgage loans under the Treasury Department’s Home Affordable Modification Program (“HAMP”). These conversations have resulted in the following market views and practices.

▪ **Securitization Trust Accounting for Investor Incentive and Subsidy Payments**

When a securitized loan is modified under HAMP, investors in the related securitization trust may be entitled to certain incentive and subsidy payments (the “Current Borrower One-Time Incentive,” the “Monthly Payment Reduction Cost Share,” the “Home Price Depreciation Reserve” and collectively, the “Investor Payments”). The Treasury Department has not issued guidance² on how these payments are to be applied within a securitization trust and nearly all outstanding pooling and servicing agreements (“PSAs”) do not address this issue³. With no guidance from Treasury or the applicable PSA, master servicers and trustees believe that the Investor Payments should be applied as interest payments received from the loans such that they flow from the top of the waterfall in accordance with the distribution priorities set forth in the applicable PSA. Master servicers and trustees believe that they should not account for these Investor Payments as principal payments to the securitization trust because the Investor Payments do not result in a write down of the principal balance of the borrower’s loan.

▪ **Federal Income Tax Treatment of Investor Incentive and Subsidy Payments**

The Treasury Department has not yet provided guidance on whether Investor Payments are to be treated in securitization transactions as income (or on the character or timing of such income to

¹ The American Securitization Forum is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests on important legal, regulatory and market practice issues. ASF members include over 340 firms, including issuers, investors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and other professional organizations involved in securitization transactions. The ASF also provides information, education and training on a range of securitization market issues and topics through industry conferences, seminars and similar initiatives. For more information about ASF, its members and activities, please go to www.americansecuritization.com.

² As of the date hereof, FAQ #2404 on the HAMP Administrative Website for Servicers states: “Treasury is not providing guidance on how those funds are to be passed through to security holders of securitization trusts.”

³ To the extent a PSA addresses Investor Payments or contains provisions which would otherwise incorporate them, master servicers and trustees should account for them accordingly.

investors) or as a return of capital for federal income tax purposes.⁴ Similarly, guidance has not yet been provided on the effect of Investor Payments on the computation of gain or loss to the securitization vehicle in connection with “significant” HAMP modifications of a securitized loan. Until further guidance is issued by the Treasury Department, the following description is intended to provide a general discussion of potential alternative treatments. In the discussion below, “lender” refers to the securitization vehicle.

- **Current Borrower One-Time Incentive (“CBOI”).** This is a payment of \$1,500 to lenders of non-GSE loans that are current at the beginning and end of the three-month trial period, and conditioned on at least a 6% reduction in the borrower’s monthly payment and achievement of a 31% or lower debt-to-income (“DTI”) ratio. The CBOI could be treated as consideration to the lender for the loan modification. If the loan modification is significant under applicable tax regulations, the CBOI would likely reduce the lender’s adjusted issue price (“AIP”) of the modified loan for purposes of computing gain or loss on the deemed exchange and of accruing original issue discount income after the modification. If the modification is not significant, the CBOI is likely recognized as income to the lender at the end of the trial period. Alternatively, the CBOI could be treated as a payment included in the stated redemption price at maturity of the modified loan for purposes of computing original issue discount.
- **Monthly Payment Reduction Cost Share (“MPRCS”).** If the 31% DTI ratio is achieved, the borrower’s monthly payment has been reduced by at least 6% and the borrower is current at the end of the trial period, a monthly payment of one-half of the difference between the borrower’s new monthly payment and the lesser of (a) the borrower’s old monthly payment and (b) what the borrower’s monthly payment would be at a 38% DTI ratio will be made. The MPRCS terminates if the borrower fails to remain in good standing. The MPRCS may be treated as a substitute for the amount the borrower would have paid had the monthly payment not been reduced or deferred under the loan or as a payment of past due amounts, e.g., interest reduced under the modification, unpaid interest, principal deferred under the modification or principal forgiven under the modification. Alternatively, the MPRCS may be treated similarly to the CBOI (i.e., as consideration for entering into the loan modification, with the treatment depending on whether the modification is or is not significant, or alternatively as payments included in the stated redemption price). It is unclear how an adjustment to AIP would be computed. Although less likely, the MPRCS could be considered a contract right treated as a debt or other financial instrument.
- **Home Price Depreciation Reserve (“HPDR”).** This is a formula amount paid to lenders to offset potential losses due to home price declines if the borrower’s payment

⁴ The Treasury Department has confirmed that modifications of mortgage loans under HAMP will not cause the IRS to challenge the status of REMICs or investment trusts that hold these loans (Rev. Proc. 2009-23, 2009-17 I.R.B. 884) and that payments made to REMICs under HAMP will not be treated as “contributions” that are subject to tax under IRC Section 860G(d) (Notice 2009-36, 2009-17 I.R.B. 883). In addition, Treasury has confirmed that “pay-for-performance” success payments made on behalf of borrowers to lenders under HAMP will not constitute gross income to the borrowers. Rev. Rul. 2009-19, 2009-28 I.R.B. 111.

has been reduced by at least 6%. The HPDR accrues over 24 months beginning at the end of a successful trial period and is paid on the first and second anniversaries of that date. Payments cease to accrue if the borrower loses good standing, but accrued unpaid amounts will be paid. Since the HPDR is not conditioned on the actual recognition of a loss, it is likely treated as income or as an adjustment to AIP, depending on whether the loan modification is significant. It is unclear how an adjustment to AIP would be computed. Although less likely, the HPDR could be treated as a substitute payment for foregone interest, unpaid accrued interest, deferred principal or forgiven principal.

- **Other Issues.** A significant HAMP modification, with or without one or more of the foregoing payments, raises issues as to the methodology and timing of reporting of any resulting gain/loss or original issue discount income on the modified loan to the REMIC vehicle compared with the unmodified loan or pool of loans prior to the modification. Unless guidance can be obtained on these issues from the IRS, REMIC tax return preparers will be required to adopt positions on such methodology and timing.

- **Effect of Modifications on Delinquency Triggers**

Delinquency triggers in securitizations affect the rate at which the senior and subordinate bonds receive payments. When delinquencies on loans reach the amount of the specified trigger, payments may be redirected from subordinate bonds to senior bonds in order to build up available subordination in the transaction. These triggers can be affected by loans that have been modified. After a loan has been modified, servicers will report whether the loan is current or delinquent according to the loan's modified terms. Master servicers and trustees will use the servicer's determination of "current" or "delinquent" to determine whether a particular loan should be considered delinquent for purposes of the delinquency trigger. Therefore, if the servicer reports a loan as "current" such loan will not be factored into the delinquency trigger calculation.⁵ However, in response to guidelines issued by Standard & Poor's in October 2007⁶, many issuers revised their PSAs to specifically include modified loans, whether delinquent or not, in delinquency trigger calculations for 12 months after the loan had been modified. To the extent a particular transaction includes these provisions, master servicers and trustees will apply them accordingly.

- **Reporting of Loan Modification Activity**

The ASF Master Servicer and Trustee Subforums are developing a standardized set of data elements to provide in their monthly investor reporting for modifications.

⁵ Trial Modifications under HAMP are reported as "delinquent" until the end of the trial period, so those loans would be included for purposes of the delinquency trigger calculation.

⁶ See <http://www2.standardandpoors.com/portal/site/sp/en/ca/page.article/3,1,1,0,1148449894265.html>.