

Supplemental Directive 10-05

June 3, 2010

Home Affordable Modification Program – Modification of Loans with Principal Reduction Alternative

Background

In Supplemental Directive 09-01, the Treasury Department (Treasury) announced the eligibility, underwriting and servicing requirements for the Home Affordable Modification Program (HAMP). Under HAMP, servicers apply a uniform loan modification process to provide eligible borrowers with sustainable monthly payments. This Supplemental Directive provides guidance to servicers on a Principal Reduction Alternative (PRA) to give servicers additional flexibility to offer relief to borrowers whose homes are worth significantly less than the remaining amounts owed under their first lien mortgage loans (negative equity). Under PRA, servicers are required to evaluate the benefit of principal reduction for every HAMP eligible loan with high negative equity, defined herein, and are encouraged to offer principal reduction whenever the net present value (NPV) result of a HAMP modification using PRA is greater than the NPV result without considering principal reduction. Treasury is introducing an alternative modification waterfall to perform this evaluation and financial incentives for principal reduction. This Supplemental Directive also provides that the Second Lien Modification Program (2MP) will now require principal reduction in an amount at least proportional to any principal reduction offered on a corresponding HAMP modified first lien mortgage loan.

In addition, this Supplemental Directive expresses Treasury's position regarding the applicability of the servicer safe harbor (Servicer Safe Harbor) set forth in Section 129A of the Truth In Lending Act, 15 U.S.C. 1639a (TILA), to residential loan modifications under HAMP and 2MP, as well as to short sales and deeds-in-lieu of foreclosure under the Home Affordable Foreclosure Alternatives (HAFA) Program. This Supplemental Directive also expresses Treasury's position regarding the accounting treatment to be employed by servicers and other transaction parties for HAMP modifications that include principal forbearance.

This Supplemental Directive provides guidance to servicers of first and second mortgage lien loans that are not owned or guaranteed by Fannie Mae or Freddie Mac, or insured or guaranteed by a federal agency, such as the Federal Housing Administration.

This Supplemental Directive covers the following topics:

- PRA Requirements
- Alternative Waterfall
- Net Present Value Model
- Application of Principal Reduction
- Documentation Requirements

Servicer Reporting
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PRA Requirements

Beginning on the later of (i) October 1, 2010; or (ii) the implementation date for version 4.0 of the HAMP NPV model (PRA Effective Date), servicers must evaluate any loan that is being considered for HAMP with a mark-to-market loan-to-value (MTMLTV) ratio greater than 115 percent using both the standard HAMP modification waterfall (Standard Waterfall) and an alternative modification waterfall that includes principal reduction as the required second step in the waterfall (Alternative Waterfall). When determining the loan's unpaid principal balance (UPB), servicers should include any amounts that would be capitalized in accordance with HAMP guidelines. Servicers should follow regulatory and investor guidance when selecting the appropriate valuation method to determine the mark-to-market value of the property and use this value for both the NPV model and the PRA MTMLTV ratio calculation.

Servicers may immediately offer HAMP modifications utilizing PRA as of the date of this Supplemental Directive in accordance with the guidance set forth herein. Guidance relating to principal reduction and related investor incentives for first lien mortgage loans in HAMP trial period plans or permanent HAMP modifications prior to the date of this Supplemental Directive will be provided in a future Supplemental Directive.

Alternative Waterfall

Under the Alternative Waterfall, servicers use principal reduction between Step 1 (capitalization) and Step 2 (interest rate reduction) of the Standard Waterfall set forth in Supplemental Directive 09-01 as follows:

- Reduce the UPB by an amount necessary to achieve either the target monthly mortgage payment ratio of 31 percent or a MTMLTV ratio equal to 115 percent, whichever is reached first;
- If the UPB is reduced to create a MTMLTV ratio of 115 percent and the target monthly mortgage payment ratio of 31 percent has not been achieved (based on a fully amortizing principal and interest payment over the remainder of the current loan term and using the current mortgage interest rate), continue with the standard HAMP modification waterfall steps of interest rate reduction, term extension and principal forbearance, each as necessary, until the target monthly mortgage payment ratio of 31 percent is achieved.

The servicer must use the NPV model to evaluate the proposed modifications generated by application of both the Standard Waterfall and the Alternative Waterfall.

- As set forth in Supplemental Directive 09-01, if the NPV result for the proposed modification generated by applying the Standard Waterfall is positive, servicers must modify the loan.
- If the NPV result for the proposed modification generated by applying the Alternative Waterfall is positive, servicers are encouraged, but are not required, to perform a HAMP loan modification utilizing PRA, even in instances where the NPV result from the Standard Waterfall is negative or is less than the NPV result generated by application of the Alternative Waterfall.
- If neither the Standard Waterfall NPV nor the Alternative Waterfall NPV is positive, the servicer is not required to modify the loan.

The primary purpose of completing the Alternative Waterfall analysis is to demonstrate whether reducing principal on loans with MTMLTV ratios greater than 115 percent results in a positive NPV. However, when making the determination to reduce principal, servicers may, consistent with investor guidelines and contractual obligations, reduce the UPB of a loan to an amount that results in a MTMLTV ratio that is greater or lesser than the 115 percent target ratio in the Alternative Waterfall. Because servicers have this discretion in offering principal reduction, servicers must develop and adhere to a written policy for making principal reduction determinations that treats all similarly-situated loans in a consistent manner and in compliance with fair lending and other applicable laws and regulations.

Servicers will qualify for PRA investor incentive payments as set forth in this Supplemental Directive for reductions creating a MTMLTV ratio as low as 105 percent, even if the reduction results in a monthly mortgage payment ratio below the 31 percent target. Servicers are not precluded from reducing principal below a 105 percent MTMLTV ratio; however, PRA investor incentives will not be paid on the portion of any principal reduction that reduces the MTMLTV ratio below 105 percent. Additionally, pursuant to Supplemental Directive 09-01, Investor Payment Reduction Cost Share Incentives will only be paid based on modification terms that reflect the target monthly mortgage payment ratio (31 percent).

Net Present Value Model

Pursuant to Supplemental Directive 09-01, all loans that meet the HAMP eligibility criteria must, prior to offering a trial modification using verified borrower income, be evaluated using a standard NPV model that compares the NPV result with a modification to the NPV result without a modification. An updated NPV model (“NPV 4.0”), under development by Treasury, will reflect principal reduction incentives and will compare the NPV result of modifications with and without principal reduction with the NPV result without modification. The software application for NPV 4.0 will be available on the Home Affordable Modification Program servicer web portal accessible at www.HMPadmin.com. On this portal, servicers will have access to NPV 4.0 as well as detailed guidelines for submitting proposed modification data.

In addition to the evaluation using NPV 4.0, servicers may conduct other evaluations to determine the level of principal reduction that is in the best interest of investors. However, servicers must only submit the results of the Standard Waterfall and Alternative Waterfall evaluations completed with NPV 4.0 to Treasury's system of record.

Application of Principal Reduction

PRA is a deferred principal reduction program that allows a borrower to earn principal reduction over a three-year period by successfully making payments in accordance with the modified loan terms. If the loan is modified pursuant to PRA, the principal reduction amount should be initially treated as non-interest bearing principal forbearance (PRA Forbearance Amount). The PRA Forbearance Amount is separate and exclusive of any other forbearance that may be offered in conjunction with a HAMP modification.

If the borrower is in good standing (as defined in Supplemental Directive 09-01) on the first, second and third anniversaries of the trial period effective date, the servicer must reduce the UPB of the loan on each anniversary date in installments equal to one-third of the initial PRA Forbearance Amount.

If a borrower is in good standing and pays the loan in full (i) at any time more than 30 calendar days after the HAMP modification effective date; (ii) after the PRA reporting and payment processes are made available; and (iii) prior to application of the entire PRA Forbearance Amount, the borrower shall immediately be fully vested in and entitled to the unapplied PRA Forbearance Amount as a curtailment. When the servicer receives a payoff request on behalf of a borrower that meets these requirements, the unapplied PRA Forbearance Amount shall be deducted from the payoff balance.

Documentation Requirements

The documents for PRA are the same as those required under HAMP. However, the Trial Period Plan Notice and the Home Affordable Modification Agreement must be modified to include language regarding the deferred principal reduction terms. This language will be set forth in the revised documents that will be available on www.HMPAdmin.com prior to the PRA Effective Date. This language will include a notification to the borrower that principal reduction is reported to the Internal Revenue Service and may have tax consequences. The language will also advise borrowers to seek guidance from a tax professional.

Servicers that offer HAMP modifications utilizing PRA prior to issuance of the revised documents must modify the Home Affordable Modification Agreement to include the deferred principal reduction terms.

Borrower Notice

Upon receipt of a written request from a borrower or an authorized representative of the borrower related to principal reduction, the servicer must, within 30 calendar days of receipt of the request, respond in writing. The response, when applicable, must include the reason(s) that principal reduction was not offered to the borrower.

Servicer Reporting

The PRA reporting and payment processes are currently under development by Fannie Mae, in its capacity as Treasury's financial agent. Subsequent guidance will be provided describing the PRA reporting and payment processes and when they will be available (the time period between the date of this Supplemental Directive and the date the PRA reporting and payment processes are available shall be referred to herein as the Interim Period). Servicers who offer loan modifications with PRA during the Interim Period will be required to report the transaction to the Treasury system of record. Any PRA principal reduction on Interim Period loans should be reported in the existing principal write-down field. Servicers should not, however, reduce the UPB by the amount of any PRA principal reduction in the Treasury system of record for Interim Period loans (though servicers should reduce the UPB by any principal reduction that is not related to PRA). When the PRA reporting and payment processes are implemented, servicers shall submit a correction transaction that will move the PRA principal reduction to a new PRA specific principal forgiveness field. During the Interim Period, Servicers must collect and retain PRA specific information so that the necessary data can be reported when the processes become available.

The HAMP Data Dictionary and Supplemental Directive 09-06 Data Dictionary will be revised to reflect new and modified edits for PRA and will be posted on www.HMPAdmin.com. Servicers will be required to report the Standard Waterfall NPV model inputs, the Alternative Waterfall NPV model inputs, final modification terms, and NPV outputs for both NPV evaluations.

Credit Bureau Reporting

Servicers should report a "full-file" status report to the four major credit repositories for any loan modified pursuant to this Supplemental Directive in the same manner they report a loan modified under HAMP as set forth in Supplemental Directive 09-01. In addition, as each installment of the PRA Forbearance Amount is applied to the UPB of the loan, the servicer should update the credit repositories with the current balance owed and amend the K-4 segment to reflect the reduced UPB.

The "due date" in the K4 Segment should reflect the scheduled maturity date of the HAMP modified loan. However, if the Principal Forbearance Amount no longer applies after the portion of the loan is forgiven, the servicer should no longer report the K4 Segment.

Incentive Compensation

No incentives of any kind will be paid if the servicer has not executed the Servicer Participation Agreement to participate in HAMP. The calculation and payment of all incentive compensation will be based strictly on the borrower's verified income. Servicers must apply or remit, as applicable, all borrower and investor incentive compensation it receives with respect to any PRA modified loan within timeframes as required by applicable law, but in no event later than 30 calendar days after receipt.

Additionally, as detailed in Supplemental Directive 09-01, if a borrower loses good standing it cannot be restored even if the borrower subsequently cures the default. A loan that is not in good standing is not eligible to receive borrower, servicer or investor incentives and/or reimbursements and such payments will no longer accrue for that mortgage loan. If a borrower loses good standing before the entire PRA Forbearance Amount has been applied to the UPB, the unapplied PRA Forbearance Amount shall remain as non-interest bearing principal forbearance for the remaining life of the loan.

Investor Incentive Compensation

For each loan modified under PRA, investors receive the Investor Payment Reduction Cost Share and if applicable: (i) the one-time current borrower incentive payment described in Supplemental Directive 09-01 and (ii) the Home Price Decline Protection incentive payments described in Supplemental Directive 09-04.

Additionally, investors will receive PRA investor incentive payments based on the delinquency status of the loan, the MTMLTV ratio used to complete the Alternative Waterfall analysis and the amount of principal reduction installment actually applied by the servicer.

**Principal Reduction Incentive Schedule:
Per Dollar of UPB Forgiven in MTMLTV Ratio Range
(Loans Less than or Equal to Six Months Past Due)**

MTMLTV Ratio Range		
<u>105% to <115%</u>	<u>115% to 140%</u>	<u>>140%</u>
0.21	0.15	0.10

With respect to loans which were less than or equal to six months past due at all times during the 12 month period prior to the NPV evaluation date, investors will be entitled to receive \$0.21 per dollar of principal reduction equal to or greater than 105 percent and less than 115 percent MTMLTV ratio; \$0.15 per dollar of principal reduction equal to or greater than 115 percent and less than or equal to 140 percent MTMLTV ratio; and \$0.10 per dollar of principal reduction in excess of 140 percent MTMLTV ratio.

With respect to loans which were more than six months past due at any time during the 12 month period prior to the NPV evaluation date, irrespective of MTMLTV ratio range, investors will be paid \$0.06 per dollar of principal reduction and will not be eligible for incentives in the above extinguishment schedule. PRA investor incentive payments will be earned by investors in the month in which the applicable principal reduction amount is actually applied to reduce the borrower's UPB as set forth above.

While servicers may reduce principal below 105 percent MTMLTV ratio, no PRA incentive, including PRA incentives paid for Interim Period loans, will be paid for that portion of the principal reduction amount that reduces the MTMLTV ratio below 105 percent. Also, as provided in Supplemental Directive 09-01, servicers may substitute principal reduction for any step in the waterfall and may reduce principal at any time during the life of the loan. However, PRA investor incentives will only be paid in conjunction with principal reduction that is deferred over three years in accordance with the requirements of this Supplemental Directive.

Interim Period Incentive Compensation

Loans with a premodification MTMLTV greater than 115 percent that are permanently modified under HAMP during the Interim Period and include PRA principal reduction may be eligible for PRA investor incentives in compliance with the prior section. PRA investor incentives will be paid so long as (i) the loan remains in good standing on the implementation date of the PRA reporting and payment processes by Treasury's financial agent; (ii) the modification otherwise complies with HAMP requirements; (iii) the modification terms are accurately entered into the Treasury system of record at the time of modification in compliance with the guidance set forth above in the "Servicer Reporting" section; and (iv) when the PRA reporting and payment processes become available, a correction transaction is submitted moving the PRA principal reduction to the new PRA specific principal forgiveness field and all additional PRA specific data retained by the servicer is reported to the Treasury system of record. Servicers providing principal reduction during the Interim Period will not be required to perform an Alternative NPV evaluation for loans modified prior to the PRA Effective Date. All servicers must, as indicated above, have written policies governing the consistent application of principal reduction. Notwithstanding the foregoing, Interim Period loans that are fully satisfied prior to implementation of the PRA reporting and payment processes are not eligible for PRA investor incentives.

Compliance

Treasury has selected Freddie Mac to serve as its compliance agent (MHA-C) for HAMP. Supplemental Directive 09-01 describes the overall roles and responsibilities of both servicers and the compliance agent in performing servicer reviews and oversight, which are unchanged by this Supplemental Directive. As compliance agent, MHA-C will incorporate an evaluation of documented information to assess PRA implementation, processes, and controls into its servicer reviews. Additional information will be provided to servicers as part of the conduct of the compliance agent's reviews. The scope of the assessments will include among other things, an evaluation of documented evidence to confirm adherence (e.g., accuracy and timelines) to PRA requirements with respect to the following:

- The documented process for evaluating and approving borrowers for principal reduction under the guidance set forth in this Supplemental Directive.
- The standard policies and guidelines for completing principal reduction and consistent application of same.
- The execution of NPV/Waterfall processes, and retention of all applicable data, including accurately uploading required data into IR2 when the functionality exists.
- The timely and accurate payment of borrower and investor incentive payments.
- The appropriate treatment of second liens modified under 2MP where the modification of the first lien utilizes PRA.

As with earlier versions of the NPV model, servicers wishing to recode the NPV model into their own processing systems will be required to undergo certification testing by MHA-C and receive authorization prior to implementing the recoded model.

Document Retention

Servicers are required to maintain appropriate documentary evidence of their HAMP-related activities, pursuant to Supplemental Directive 09-01, and to provide that documentary evidence to MHA-C upon request. With respect to PRA, documentation that should be maintained by the servicer includes, but is not limited to, the following:

- Policies and procedures relating to PRA, including but not limited to those ensuring consistent application of PRA and the circumstances under which the servicer would reduce principal below 105 percent MTMLTV ratio or create a modification with a payment below the target monthly mortgage payment ratio of 31 percent.
- Determination of eligibility for PRA
- Evidence of application of each applicable step in the Alternative Waterfall
- Application of both the Standard NPV and Alternative NPV Models

For phone contact with borrowers related to PRA, well-documented servicer system notes (including but not limited to date, names of contact persons, and conversation summaries) will constitute appropriate documentation. Written correspondence should be retained in an accessible manner and made available to MHA-C upon request.

Servicers must retain detailed records to document the reason(s) for any trial modification failure and the associated communication with borrowers. Servicers must retain required documents for a period of seven years from the date of the document collection.

Impact on Second Lien Modifications

When a first lien mortgage loan is modified under PRA and a servicer that has executed a Servicer Participation Agreement for the Second Lien Modification Program (2MP) services a second lien mortgage loan secured by the same property (whether or not that servicer also services the first lien mortgage loan), that 2MP servicer must also reduce principal in conjunction with the modification of the second lien. As of the publication date of this Supplemental Directive, the text below replaces in its entirety the text in Supplement Directive 09-05 Revised, Update on the Second Lien Modification Program (2MP), describing “Step 4: Principal Forbearance”.

Step 4: Principal Forbearance and Forgiveness

If there was principal forbearance or forgiveness on the HAMP-modified first lien, a servicer must forbear or forgive principal on the second lien in the same proportion, based on the ratio of the principal forbearance or forgiveness amount of the HAMP-modified first lien to the total UPB of the HAMP-modified first lien on its modification effective date. If the servicer has deferred accrued interest in lieu of capitalization in Step 1, the deferred amount will be in addition to any principal forbearance or forgiveness required under this Step 4. The servicer may, at its discretion and as permitted under the applicable pooling and servicing agreement, choose to forgive any amounts that are required to be forborne. All principal forgiveness required or provided under 2MP will be applied at the time of the permanent 2MP modification and will not be deferred.

Example: The total unpaid principal balance plus the forgiveness amount of the HAMP-modified first lien on its modification effective date is \$100,000, the amount of principal forbearance on the first lien is \$5,000 and the amount of principal forgiveness is \$5,000. Therefore, the servicer must forbear five percent of the second lien and must forgive five percent of the second lien. If the total unpaid principal balance of the second lien on the modification effective date is \$40,000, the servicer must forbear \$2,000 and must forgive \$2,000, or the servicer may elect to forgive a larger amount.

Additionally, the first two sentences from the section titled “Principal Forgiveness Option” in Supplemental Directive 09-05 Revised, are deleted and replaced with the following sentence:

In addition to any required forgiveness in Step 4 of the standard modification waterfall, servicers may, at their discretion and when permitted under the applicable pooling and servicing agreement or other investor servicing agreement, agree to forgive additional principal as part of a 2MP modification and will be eligible for both modification incentives and extinguishment incentives on any partial amount of principal that is forgiven so long as the unpaid principal balance of the second lien (at initial consideration for the second lien modification) is equal to or greater than \$5,000 and has a premodification scheduled monthly payment equal to or greater than \$100.

Servicer Safe Harbor

As part of Helping Families Save Their Homes Act of 2009 (HFSTHA), Congress established the Servicer Safe Harbor by amending TILA for the purpose of providing a safe harbor to enable such servicers to modify and refinance mortgage loans under a “qualified loss mitigation plan.” Treasury has determined that each residential loan modification under HAMP (including PRA modifications) and 2MP, as well as each short sale and deed-in-lieu of foreclosure under HAFSA, is a “qualified loss mitigation plan” as defined in the Servicer Safe Harbor. In addition, Treasury anticipates that the “FHA Program Adjustments to Support Refinancings for Underwater Homeowners,” which were previously announced by Treasury on March 26, 2010,¹ will also constitute a “qualified loss mitigation plan” as defined in the Servicer Safe Harbor.

Treatment of Principal Forbearance in HAMP

Except under the circumstances described in the next paragraph, when a mortgage loan within a securitization vehicle is modified under HAMP, the following parties will take the respective actions:

- (i) the servicer must report to the trustee or securities administrator any forborne principal as a realized loss;
- (ii) the trustee or securities administrator must allocate any such reported forborne principal as a realized loss to the trust;² and
- (iii) the servicer must act consistent with the presumption that such allocation has occurred, and may conclusively rely that it has.

The direction to the servicer and the trustee or securities administrator to take the actions described in clauses (i) through (iii) above shall apply to any mortgage loan within a securitization vehicle unless the applicable securitization pooling or trust agreement: (A) explicitly provides for or allows repayment of principal to be postponed or forborne for a long period of time; (B) explicitly provides for or allows interest on such principal amount to be permanently forgiven; and (C) explicitly and affirmatively directs that such forborne principal not be treated as a realized loss. Although securitization pooling or trust agreements often use the term “principal forbearance” in addressing the postponement for short periods of the dates on which certain payments of principal are due, the exception set forth in this paragraph will only apply if the relevant agreement specifically addresses principal forbearance in the manner set forth in (A) through (C) in the immediately preceding sentence.

¹ http://makinghomeaffordable.gov/docs/FHA_Refinance_Fact_Sheet_032510%20FINAL2.pdf

² The reported forborne principal should be allocated as a realized loss such that, for purposes of calculating distributions to securityholders, such forborne amount is no longer outstanding under the amortization schedule applicable to the related mortgage loan.

The HFSTHA also states that qualified loss mitigation plan guidelines issued by Treasury under the Emergency Economic Stabilization Act of 2008 (EESA) shall constitute standard industry practice for purposes of all Federal and State laws. The qualified loss mitigation plan guidelines issued by Treasury under EESA include this Supplemental Directive. Accordingly, actions described in clauses (i)-(iii) above, when taken by a servicer pursuant to this Supplemental Directive, shall constitute “standard industry practice” within the meaning of the Servicer Safe Harbor, and, when taken by any other person pursuant to this Supplemental Directive, including a trustee or securities administrator under a securitization pooling or trust agreement, shall constitute “cooperation of such person with a servicer when such cooperation is necessary for the servicer to implement a qualified loss mitigation plan” within the meaning of the Servicer Safe Harbor.