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ClientAdvisory

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Housing and Economic Recovery Act

On July 30, in response to the continuing housing and credit crisis, the Housing and Economic Recovery Act of 2008 (H.R. 3221) (the "Act") was signed into law. The Act is the most comprehensive federal response to the housing crisis to date and provides for greater regulation and potential financial support of the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac") and the Federal Home Loan Banks (together with Fannie Mae and Freddie Mac, the "Regulated Entities"). The Act also expands the target population served by the FHA and creates the "Hope for Homeowners" voluntary FHA-insured mortgage refinance program. As analyzed below by members of Katten's Credit Crisis Solutions Group, the Act's housing finance reform, foreclosure prevention and tax provisions may significantly affect many participants in the primary and secondary residential mortgage markets, including the residential securitization market.

Housing Finance Reform

Safety and Soundness Regulation of the Regulated Entities

Treasury Authority to Purchase Debt and Equity of Regulated Entities

A primary objective of the Act is a sweeping improvement of the safety and soundness of the Regulated Entities. One of the Act's core methods of addressing this issue is a new provision giving the Treasury Secretary discretionary authority, through December 31, 2009, to purchase equity or debt obligations of each of the Regulated Entities if it makes an "emergency determination" that the action is needed to provide stability to financial markets, prevent disruptions in the availability of mortgage finance and protect the taxpayer.

Creation of New Regulator of Regulated Entities

The second core "safety and soundness" reform is the creation of a single new regulator of the Regulated Entities, the Federal Housing Finance Agency (the "Agency"). The director of the Agency (the "Director"), who is appointed by the President to serve a term of five years, is vested with broad authority and control over the Regulated Entities, including the following: (i) enhanced authority to raise capital standards; (ii) ability to set strict prudential standards, including internal controls, audits, risk management and management of the portfolio; (iii) review and approval (after notice and comment) of new product offerings; and (iv) new and more flexible authority to establish minimum risk-based capital requirements. The Director also has broad power to approve, disapprove, or modify the executive compensation of the Regulated Entities, order cease and desist proceedings, and impose substantial civil monetary penalties.

In addition to the Director, the Act establishes the Federal Housing Finance Oversight Board, which is composed of four members—the Secretary of the Treasury, the Secretary of the Department of Housing and Urban Development, the Chairman of the Securities

For Additional Information

If you have any questions about the Housing and Economic Recovery Act or how it affects your business, please contact one of the Katten Muchin Rosenman LLP attorneys listed below:

Hays Ellisen
Co-Chair, Credit Crisis Solutions Group
212.940.6669
hays.ellisen@kattenlaw.com

Terra Atkinson
Residential Mortgage Banking
704.344.3194
terra.atkinson@kattenlaw.com

Reid Mandel
Tax
312.902.5246
reid.mandel@kattenlaw.com

Jim Smulkowski
Tax
312.902.5651
ziemowit.smulkowski@kattenlaw.com

and Exchange Commission and the Director of the Agency. The board must testify annually before Congress on the safety and soundness of the Regulated Entities, any material deficiencies in their operation, and other related matters.

Capitalization Levels and Required Actions for Undercapitalized Entities

The Act requires the Director to set critical capital levels for the Regulated Entities and to classify them as (a) adequately capitalized, (b) undercapitalized, (c) significantly undercapitalized or (d) critically undercapitalized. Regulated Entities are prohibited from making capital distributions if after doing so they would be undercapitalized.

If a Regulated Entity becomes undercapitalized, the Director is required to monitor the situation, restrict asset growth and give prior approval of any acquisitions and new activities. If a Regulated Entity becomes significantly undercapitalized, such entity may not pay any bonus or give raises to executive officers, and the Director must (a) order a new election of the board of directors, (b) fire directors or executive officers that have been in place for 180 days, (c) require the entity to employ qualified executive officers or (d) take other appropriate action. If a Regulated Entity becomes critically undercapitalized, the Director may, and in some cases must, appoint the Agency as the conservator or receiver of such entity, and proceed with conservatorship/receivership proceedings according to the detailed provisions of the Act.

Additional 1934 Act Reporting Requirements

The Act adds a new Section 38 to the Securities Exchange Act of 1934 (the "Exchange Act"), which provides that no class of "equity securities" (as defined in the Exchange Act) of Fannie Mae or Freddie Mac will be exempt from the provisions of the Exchange Act relating to registration, books and records, internal accounting controls, beneficial ownership reporting, proxies, tender offers, insider reporting, and short-swing trading. The Federal Home Loan Banks are also directed by Section 38 to register a class of their common stock under the Exchange Act within 120 days of enactment and to maintain such registration thereafter.

Fraudulent Loans or Financial Instruments

The Act requires the Regulated Entities to submit to the Director a report upon discovery that they have purchased or sold a fraudulent loan or financial instrument, or suspect a possible fraud relating to the purchase or sale of any loan or financial instrument. The Act requires each Regulated Entity to establish procedures designed to discover any such transactions and provides a safe harbor for any Regulated Entity making a good faith report on fraudulent loans or financial instruments.

Mission Improvement/Affordable Housing Goals

The Act aims to improve the missions of the Regulated Entities and expand the number of families they serve by streamlining current affordable housing goals, raising the loan limits in high-cost areas (not to exceed $625,500), and creating a new housing goal for serving low-income homebuyers. The Act puts an emphasis on affordable housing goals and rewrites them to ensure that the Regulated Entities provide liquidity to both ownership and rental housing markets for low- and very low-income families. The Director is required to monitor the Regulated Entities' housing goal performance, and can issue cease and desist orders and impose substantial monetary penalties for noncompliance with housing plans to meet such goals.

Housing Trust Fund/Capital Magnet Fund/HOPE Fund

The Act also requires Fannie Mae and Freddie Mac to set aside 4.2 cents of each dollar of the unpaid principal balance of their respective totals for new business purchases, and allocate 48.75% of such amount to the Housing Trust Fund, 16.25% of such amount to the HOPE Fund, and 35% to the Capital Magnet Fund (each of which is newly created and discussed below).

Amounts in the Housing Trust Fund are to be used by HUD to provide grants to states to improve and preserve the supply of rental housing and to increase homeownership for extremely low- and very low-income families, including homeless families. The grants are to be allocated to states according to a needs-based formula, with a minimum $3 million grant for each state, and no more than 10% of any state's grant may be used for down payment assistance, closing cost assistance or similar homeownership assistance. However, 100% in 2009, 50% in 2010, and 25% in 2011 of the amounts in the Housing Trust Fund will be used to cover defaults on mortgages insured by the FHA under the HOPE Program (discussed below).

Amounts in the Capital Magnet Fund are to be used by the Treasury Department to carry out a competitive grant program to attract private capital to assist community development financial institutions and other nonprofits to develop affordable housing and related economic development activities.

HOPE Program

One of the Act's core reforms is the creation of the HOPE for Homeowners Program (the "HOPE Program"), funded by the HOPE Fund. The HOPE Program authorizes the FHA to guarantee up to $300 billion in new loans to refinance existing loans to distressed borrowers. The HOPE Program requires the voluntary participation of both the lender and borrower, and will begin on October 1, 2008 and sunset on September 30, 2011.

In order to qualify for the HOPE Program, the mortgaged property must be the borrower's primary residence and the borrower must not have an ownership interest in any other residence. Borrowers must certify, under penalty of law, that they have not intentionally defaulted on their loan to qualify for the HOPE Program, and that they did not knowingly submit false information to obtain the original mortgage. The borrower must have a mortgage debt-to-income ratio greater than 31 percent as of March 1, 2008, and the original mortgage must have originated on or before January 1, 2008. The refinancing lender must be able to document and verify the borrower's income for the previous two years, which may not be possible for the large percentage of borrowers who originally qualified under stated-income loan products. The new FHA-insured loan cannot exceed 90% of the current value of the home and all loans must be refinanced into a 30-year, fixed-rate product. Loans under the HOPE Program are capped at a maximum loan amount of $550,440 (for a one-unit property).

Upon the borrower's sale of the home or refinance of the FHA-insured mortgage loan, the borrower must share any newly created equity and future appreciation of the property with the FHA according to a five-year phase-in schedule, as set forth in the Act, and appreciation in the value of the property must be shared equally with the FHA. After five years from the date of insurance, the FHA maintains a 50% stake in any equity and appreciation in value.

Participating lenders should expect to incur significant losses upon the refinancing of the original loan into an FHA-insured mortgage loan, assuming the original loan qualifies for the program. Depending upon the age of the loan or the loan-to-value ratio ("LTV") for the original loan, the 90% LTV limitation could require a substantial reduction in the principal balance. Before participating in the program, all subordinate liens against the property must be extinguished. The Act provides for a share to junior lien holders of the FHA's recovery of shared equity and appreciation, but the junior lien holder may be unwilling to release the lien without a negotiated payoff from the first lien holder. Finally, the ultimate amount received by the original lender cannot include penalties for prepayment of the mortgage loan or any fees or penalties related to default or delinquency, and will be reduced by an insurance premium of 3% of the new loan amount, which must be paid from the proceeds of the mortgage being insured.

In addition to the eligibility requirements above, the Board of the HOPE Program has yet to establish underwriting criteria for these "rescue" loans. The Act provides that the Board can direct the Secretary of HUD to take such actions as may be necessary to contract for the establishment of underwriting criteria and other factors related to the eligibility of mortgages insured under the program; however, there is no time frame for creation of such requirements. The Board is also required to establish standards and policies related to certain representations and warranties that must be provided by the underwriting lender of the refinance loan, and can establish additional standards or policies to protect against adverse selection of loans, such as a required payment history for higher risk loans. Based on the requirements above, which have yet to be established, it is possible that the FHA will not be prepared to fund loans under the HOPE Program on the October 1 effective date.

Effect of the HOPE Program on Existing Residential Mortgage-Backed Securities

To the extent that servicers of securitized mortgage loans voluntarily choose to participate in the HOPE Program, the resulting prepayments and allocated losses may have a material effect on related holders of residential mortgage-backed securities ("RMBS"). Certain holders of RMBS that were purchased at a premium or that are only entitled to payments of interest may be adversely affected by such prepayments, and certain securities that are subordinated with respect to allocation of losses may be adversely affected by such prepayments and loss allocations. Various factors may mitigate the impact of the HOPE Program on RMBS, including the fact that the HOPE Program (i) only applies to owner-occupied properties and to borrowers who meet DTI tests, have documented and verified income, and the ability to repay the new loan; (ii) requires all holders of junior liens to extinguish those liens; and (iii) only provides for a maximum loan amount of $550,440 (for a one-unit property).

Servicer Safe Harbor

The Act sets forth a safe harbor for servicers of pooled residential mortgages that applies unless a Pooling and Servicing Agreement or other contract governing the servicing of securitized mortgage loans has conflicting provisions. The safe

harbor provisions state that a servicer will be deemed (a) to owe its duty to maximize the net present value of the pooled mortgages to all investors and parties having a direct or indirect interest in the pool, and not to any individual or group of parties, and (b) to be acting in the best interests of all investors if it agrees to a modification or workout plan, including one pursuant to the HOPE Program, where (i) a default has occurred or is reasonably foreseeable, (ii) the mortgaged property is owner-occupied and (iii) the anticipated recovery of the modification or workout plan exceeds the anticipated net foreclosure proceeds.

S.A.F.E. Mortgage Licensing Act

The Act requires licensing of all "loan originators" (which is defined broadly) by setting minimum licensing standards for states. This provision of the Act builds upon the Nationwide Mortgage Licensing System ("NMLS") created in 2004 by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators. In addition to fingerprint and background check requirements, loan originators will be required to complete 20 hours of pre-licensing education, pass a written test and maintain eight hours of continuing education annually. Should any state fail to participate in the NMLS, or enact its own licensing and registration system that meets the requirements in this section within a certain time period, the law grants HUD the authority to regulate that state's loan originators. The Act also requires federal bank regulators to establish a parallel registration system for FDIC-insured banks.

Foreclosure Prevention

FHA Modernization Act of 2008

The Act attempts to expand the reach of the FHA program by increasing the FHA loan limit to 115% of area median home prices, with a cap at $625,000 (which becomes effective upon the expiration of the Economic Stimulus Act). The Act also increases the amount of available financing to a maximum of 100% of the appraised value, but such limit is strictly enforced and may not be expanded to include the amount of the mortgage insurance premium. In order to qualify for an FHA-insured loan, effective October 1, the borrower must make a down payment of not less than 3.5% of the appraised value of the property. The Act prohibits the seller of the property or any other interested person (with certain limited exceptions for family members) from providing down payment assistance.

Home Equity Conversion Mortgages (Reverse Mortgages)

The Act sets forth a number of new requirements for Home Equity Conversion Mortgages ("HECMs" or "Reverse Mortgages") insured by the FHA. Specifically, the Act (i) requires that mortgagors receive adequate counseling services, (ii) prohibits tying the receipt of an HECM with the required purchase of any additional financial or insurance products, and (iii) limits origination fees to 2% of the maximum claim amount up to the first $200,000, and 1% of any amount in excess thereof, up to a maximum origination fee per HECM of $6,000 (subject to periodic adjustment for inflation).

Servicemembers Civil Relief Act

The Act provides additional protections for service members facing foreclosure. Pursuant to the Act, through December 31, 2010, a lender must wait nine months, as opposed to 90 days, after a servicemember returns from service before starting foreclosure. The Act also provides returning servicemembers with one year of relief from increases in mortgage interest rates above 6%. The Act includes a provision that temporarily increases the VA loan guarantee amount until December 31, 2008.

Moratorium on Risk-Based Premiums

The Act provides for a one-year moratorium, beginning on October 1, 2008, on the implementation of risk-based premiums, which had been designed to allow mortgage lenders to offer borrowers an FHA-insured product providing a range of mortgage insurance premium pricing.

Emergency Funds to Redevelop Abandoned and Foreclosed Homes

The Act appropriates $3.92 billion to be allocated by a needs-based formula to communities hardest hit by foreclosures and delinquencies to purchase foreclosed homes, at a discount, and rehabilitate or redevelop the homes to stabilize neighborhoods. The Act is silent as to allocation between local governments and states. For five years following enactment, any revenue generated by use of the funds shall be used by the state or local government for the same purpose. The Act requires a jurisdiction to "use" all of its funds within 18 months of receipt but does not elaborate on whether this requires actual use of the funds through spending or merely a commitment to use the funds within 18 months.

Foreclosure Prevention Counseling and Related Services

To help at-risk borrowers avoid foreclosure, the Act provides $180 million in funding for housing counseling, attorneys fees and other foreclosure mitigation activities. These funds will be distributed by the Neighborhood Reinvestment Corporation.

Truth in Lending Act Changes

The Act adds refinance loans to the list of mortgage loans subject to early disclosures under the Truth in Lending Act ("TILA"), and requires preliminary disclosures to be provided no later than seven business days prior to closing. The Act also revises TILA to provide for additional disclosures if the loan carries a variable interest rate, and doubles the range of statutory damages for TILA violations to $400-$4,000. The general changes to TILA are not effective until 12 months following the effective date of the Act, and the variable rate disclosure requirement becomes effective on the earlier of (i) the compliance date established by the Board for such purpose or (ii) 30 months after the enactment date of the Act. The Act is silent with respect to the effective date for the increased civil liability.

Tax Provisions

With respect to a real estate investment trust ("REIT"), the Act: (i) provides guidance as to the treatment of foreign currency and foreign currency gains (the Act excludes passive foreign currency gains from gross income for purposes of the 95% gross income test and excludes foreign currency gains attributable to real estate transactions from gross income for purposes of the 75% and the 95% gross income tests); (ii) increases the percentage of REIT assets that may be comprised of the securities of taxable REIT subsidiaries from 20% to 25%; (iii) reduces the holding period for property to qualify for the prohibited transactions safe harbor from four years to two years and allows the 10% sale limitation for purposes of the safe harbor to be calculated based on the fair market value of the REIT's assets; and (iv) extends the related party rent exception that applied to lodging facilities to cover healthcare facilities. Certain changes are effective after the date of enactment, and others begin in calendar year 2009.

With respect to the Foreign Investment Real Property Tax Act ("FIRPTA") non-foreign affidavit, the Act provides an alternative procedure whereby, instead of the transferee providing the required affidavit to the transferor, a qualified substitute can certify to the transferee that it has received the necessary affidavit from the transferor.

The Act allows an additional $11 billion of private activity housing bond volume cap for bonds issued after the date of enactment, tax credits, bond recycling on multifamily housing projects and refinancing of subprime mortgages for calendar year 2008 with the ability to carry forward through calendar year 2010. Particularly important are the changes in treatment for alternative income tax purposes. All new housing bonds issued after the date of enactment are exempted from alternative minimum tax. The low-income housing credit is allowed as a credit against alternative minimum tax for buildings placed in service after December 31, 2007. Qualifying rehabilitation expenditures properly taken into account for periods after December 31, 2007 are also allowed as a credit against alternative minimum tax.

For the full final text of the legislation, please see
http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:h3221enr.txt.pdf

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KattenMuchinRosenman LLP www.kattenlaw.com

CHARLOTTE CHICAGO IRVING LONDON LOS ANGELES NEW YORK PALO ALTO WASHINGTON, DC

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