

## The Freedom Recovery Plan for Distressed Borrowers and Impaired Lenders

### Overview

With the passage of the Emergency Economic Stabilization Act of 2008 (“EESA”), the twin housing and mortgage crises have now forced the government to directly battle, with massive financial intervention, the systemic implications for our banking (and shadow-banking) institutions. Notwithstanding the magnitude of government support that EESA will bring to the resolution of the credit and banking crises, the financial and social implications arising from the housing bubble, for homeowners and the broader economy, require the consideration of additional unconventional solutions that are not inconsistent with the rubric of our system of laws and property rights. Such solutions must also place less reliance on direct intervention from a heavily extended government (and its taxpayers). The Freedom Recovery Plan (the “Plan”) is a structured package of government and private-sector measures that amount to a national “workout” of the residential real estate elements of the overall crisis in the capital markets. The housing sector’s ongoing meltdown presents unique challenges that were not front and center in prior boom and bust cycles. Accordingly, special actions are necessary to limit the damage to vast population segments and the knock-on effects of such damage to our normally resilient financial sector and economy. That such actions should endeavor to maximize the role of the private sector should be self-evident to those with lingering concerns about the total costs to which the government has already committed.

The Plan is designed to promote accelerated settlement, between borrower and lender, of impaired mortgages (as such impairment is described below). Settlements under the Plan would involve homeowner/borrowers, with impaired mortgage loans, voluntarily surrendering the deeds to their homes to their mortgagees in consideration of the right of continued occupancy, as tenants, for a period of five years. The Plan would provide cost savings and incentives to both borrower and lender, as detailed below, so as to encourage them to settle without going through the very costly proceedings of foreclosure or bankruptcy. The federal government, in addition to providing certain tax incentives, would compel lender compliance with the Plan.

The Plan has been formulated to adhere to five basic principles that:

- (a) cause parties that took unwise risks to also take responsibility for their acts (i.e., no exacerbation of moral hazard; we’ve had enough of that with EESA’s passage);
- (b) rely as little as possible on the government/taxpayers;
- (c) strive to keep people in their homes;
- (d) save lenders and borrowers the enormous costs of adversarial foreclosures;
- (e) provide sufficient time for American families who are unable to afford continuing homeownership to work their way out of their mountain of debt and rebuild material savings.

Unlike other voluntary solutions to the current housing correction, proposed or enacted to date, it is “as of right” from the homeowner’s standpoint; the lender must accept deed surrender from a home with a qualifying impaired mortgage, without penalty, subject to the Plan’s considerations and requirements. While

**Contact:  
Daniel Alpert**



**dalpert@westwoodcapital.com  
Direct Dial: +1-212-953-6448**

this requirement may be somewhat controversial from the standpoint of property and contract law, it is substantially more legally benign than some recently advanced suggestions to grant courts the right to summarily reduce mortgage balances and interest rates on legally made and secured mortgage loans. In contrast, the Plan offers a complete workout solution that is equitable to the borrower and permits the lender to efficiently realize the full market value of its loan collateral. We are concerned that if performance in accordance with the Plan is not mandatory, lenders will continue to be resistant to realistic settlements – as has been the case under the several voluntary solutions promulgated to date.

### **The Origin of the Crisis, in Unprecedented Debt Creation, Requires a Bespoke Solution**

The problem that has overcome the economy has its most recent roots in the creation of nearly \$7 trillion of new residential real estate and consumer debt during the first six years of this decade. Much of this debt was created between 2004 and 2006, when U.S. savings rates turned negative. Simply put, this level of debt creation was unprecedented, more than doubling homeowner and consumer debt (credit cards and auto loans, for the most part) that existed at the end of 1999. The extension of this mountain of debt was enabled by a prolonged period during which the Federal Reserve Bank maintained its target Fed Funds rate at or below the rate of inflation, thus essentially providing a subsidy to borrowers (banks that borrowed from the Fed, and the institutions and individuals to which the Fed Funds were re-lent) and a massive incentive to borrow. The Fed's policy went well beyond offsetting the shock to the economy that followed the 2000 crash of the technology stock bubble and the horrific impact of 9/11; it also engineered a new, and quite dangerous, asset inflation bubble in residential real estate, as well as in the value of businesses and commercial real estate assets acquired with billions of dollars of leveraged acquisition loans. Finally, lax and irresponsible lending standards and underwriting criteria in the mortgage-lending and mortgage-backed securities industries eliminated virtually all credit-oriented constraints on lending, resulting in a total suspension of disbelief in continually rising home prices and the decoupling of homes' carrying costs from those of renting equivalent properties, all set against a backdrop of countervailing trends in personal incomes.

That the ready availability of trillions of dollars of cheaply priced, loosely originated loans pushed residential real estate prices to unjustifiable levels is now generally appreciated. The magnitude of the problem, its ultimate impact on our economy and society, and what can actually be done by government and the private sector to put this behind us as swiftly as possible, were, until last month, drowned out by a combination of blind optimists and well-meaning politicians who have suggested solutions that have proven to be either nonstarters or wholly inadequate. As with the debate, passage and enactment of EESA, the present situation demands a thorough understanding of what has transpired, the threats posed to our economy and financial security, and a path to resolution that can be employed with great dispatch—one that reduces the burden on the country's general common wealth (the ordinary citizen and taxpayer). In fact, as the Plan promotes and accelerates resolution and settlement of impaired loans, it should reduce the government and U.S. taxpayer exposure that arises from bank intervention and recapitalization actions being taken under EESA, as set forth below.

To resolve the U.S. housing crisis, it's critical for home prices to return from their bubble-era levels to one that is consistent with pre-bubble historical ratios of housing prices to comparable rents and of median home prices to median incomes. The supply of homes available for sale and demand for them can achieve sustainable equilibrium (relative to available inventories) only at prices that reflect reasonable rent and income multiples.<sup>1</sup>

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<sup>1</sup> Note that price-to-rent multiples remained in a band of 14x and 16x for decades prior to the current one. At the housing bubble's peak, price-to-rent multiples ballooned to more than 26x.

**Contact:  
Daniel Alpert**



**dalpert@westwoodcapital.com  
Direct Dial: +1-212-953-6448**

There is, however, a material risk that home prices will considerably overshoot the mark of parity with rent- and income-driven values, if wave after wave of foreclosures continue to swell for-sale inventories. We are already seeing signs of this in some badly affected markets. Furthermore, continuing foreclosures will place additional financial and societal strains on the economy: The cost of adversarial foreclosure has grown to more than 25%, on average, of outstanding loan balances, and the displacement of families affected by foreclosure engenders its own economic and social strains. The Plan is designed to dramatically reduce the need for adversarial foreclosure and to eliminate, in the case of qualifying mortgages, the displacement of households and the addition of new inventory to the for-sale backlog.

## **Plan Elements**

The Freedom Recovery Plan for Distressed Borrowers and Impaired Lenders will encourage homeowners to seek out and settle with their mortgagees, without fear of being immediately dispossessed of occupancy. It is designed, among other provisions, to give borrowers an opportunity to reverse the debilitating practices of dis-saving and over-consumption, as well as afford distressed homeowners a period within which to rebuild their financial lives and, ideally, redeem their homes.

At the heart of the Plan is the “Recovery Lease”: a fixed-term (5-year) right of occupancy lease that will have certain unique features to benefit both landlord (the former lender, or a subsequent assignee of title to the home and the Recovery Lease) and tenant (the former homeowner, with no right of assignment or sublease). The Recovery Lease is the result of a settlement under the Plan, in which the lender becomes the sole owner of the home, while granting the borrower the right to retain home occupancy for the Recovery Lease’s duration (with no right of renewal), as well as the right to reacquire the home, at the lease’s end, at its then-fair market value (i.e., the price a third party would pay at the time). Underlying the notion of the Recovery Lease is a practical consideration: As many homeowners invested little to no equity when purchasing their homes—or, during the bubble, refinancing their homes to the point of eliminating all equity—the borrower has been a “homeowner” in name only. There is therefore no benefit to continued ownership under such circumstances (and, conversely, there are continuing and material risks to any lender maintaining a loan to any such disenfranchised and disinterested borrower).

We expect that a combination of steady rental income, tax benefits and the potential for capital gains on the resale of the homes to former homeowners or third parties (at the expiration of the Recovery Leases) will result in an active market for debt and equity investment in Recovery-Leased property in the short to medium term.

The principal Plan elements, and the legislation required to enact them, would be as follows:

- I. **Eligibility** – Mortgage loans eligible for settlement under the Plan must involve some version of demonstrable impairment (a “Qualified Impaired Mortgage,” or “QIM”). The eligibility requirements’ intent is to eliminate, from the Plan’s mandatory settlement requirements, mortgage loans that are in default merely because of homeowner unwillingness to make payments, or are otherwise restructureable through ordinary nonmandatory, arms-length negotiation between lender and borrower.

Accordingly, to be considered a QIM, a mortgage loan must satisfy one or more of the following tests:

Contact:  
Daniel Alpert



dalpert@westwoodcapital.com  
Direct Dial: +1-212-953-6448

- a. It must satisfy **both** of the following criteria:
  - i. Have a prevailing accruing interest rate higher than [10]%;
  - ii. Have an outstanding principal balance higher than 90% of the value of the underlying home at the time of the settlement.

**OR:**

- b. It must satisfy **both** of the following criteria:
  - i. Have an outstanding principal balance that is equal to, or higher than, 110% of the value of the underlying home at the time of the settlement;
  - ii. Either:
    - 1. the borrower can demonstrate and certify (under penalties of perjury) that the total of mortgage debt service, real estate taxes and homeowner's insurance costs relating to the home constitute more than 40% of the homeowner's normalized family gross income; **or**
    - 2. the borrower can demonstrate and certify (under penalties of perjury) that the borrower or the borrower's spouse/partner has lost his or her job, suffered a disabling medical condition, suffered the death of a spouse/partner, or has been divorced from and abandoned by a former spouse/partner—in all cases, after the mortgage loan was originally made.

**OR:**

- c. The mortgage lender has issued to the borrower/homeowner a notice of default and intent to foreclose, and has commenced court proceedings for foreclosure.

Notwithstanding the foregoing, mortgage loans will not automatically qualify as QIMs (x) if it can be demonstrated that a borrower made a material misrepresentation on his loan application, (y) if the property securing the mortgage is not the borrower's primary residence; or (z) if at least three monthly payments were not received on the loan since its origination (i.e., the borrower does not have a history of making concerted efforts to pay).

Any mortgage loan satisfying the criteria in a, b or c, above, shall be a QIM and shall give the borrower the right to participate in a settlement under the Plan, with the lender mandated to effectuate such settlement on the borrower's request. Notwithstanding the foregoing, a settlement under the Plan shall be available to all borrowers and lenders, by mutual agreement, regardless of whether the above criteria are satisfied.

- II. **Surrender of Deeds and Settlement of Mortgage Loan Obligations** – Lenders will take title to homes settled under the Plan. The lender will release the borrower from any and all obligations associated with the former loan and will take title as-is and without recourse to the former borrower. No interest, penalties or fees may be assessed by the lender in connection with the settlement. Lender and borrower shall mutually release each other from any preexisting claims or threatened claims at the time of the settlement. The only continuing relationship between lender and borrower shall be set forth in the Recovery Lease pertaining to the subject home. Trustees and mortgage servicers of mortgage securitizations will be required to comply with the Plan's mandated settlement requirements, and the enacting legislation will contain a presumption that compliance with the Plan constitutes acting in the best interests of, and to maximize value for,

**Contact:  
Daniel Alpert**



**dalpert@westwoodcapital.com  
Direct Dial: +1-212-953-6448**

holders of mortgage securities, and that legal challenges to Plan compliance on the part of trustees and servicers shall be barred as a matter of public policy.

III. **The Recovery Lease** – Homeowners voluntarily surrendering the title to homes securing QIMs (or by mutual agreement between lender and borrower in the case of mortgage loans that are not QIMs) will be entitled to enter into Recovery Leases that provide for continued occupancy by the former homeowner. Recovery Leases will feature, among other provisions, the following terms and conditions:

**Term:** Five years from the date of settlement with the lender. No rights of renewal or extension, even by mutual agreement of the parties. Any renewals or extensions subsequently agreed to will not enjoy the special protections and features of a Recovery Lease.

**Rent:** Recovery Lease rents will be set at the level of comparable rents for the state, city and submarkets in which the leased property is located, with due respect given to the quality of the home. Critical to the Plan is the fact that the rental cost of homes in most markets is often significantly lower than the total carry costs of owning a home.<sup>2</sup> Therefore, setting rents and prevailing levels will generally result in significant relief to former homeowners in terms of monthly housing costs. The Department of Housing and Urban Development, along with the housing departments of each state, will, for the duration of the housing emergency, empanel Rent Review Boards that shall be responsible for developing and maintaining rent matrices by zip code. For each (five-digit) zip code, an average per-square-foot rent level for each of four quality levels of homes (low, medium, high and luxury) will be established and revised annually. These average rents are not meant to control them; rather, they are meant to provide a guideline that reflects a market appraisal of rents in the open market. Recovery Lease Rents shall be mandated to be appropriate for the market and home quality of a Recovery Leased property, but in all events may not exceed 110% of the average market rents established and published by the Rent Review Boards (the “Maximum Rent”). A lower rent may result from arms-length negotiation between the former lender and the former homeowner. Rents may increase biannually under Recovery Leases, but in no event be higher than the prevailing Maximum Rent. The Rent Review Boards—or local sub-panels—will hear appeals from any tenant disputing a landlord’s compliance with the rent limitations and will be

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<sup>2</sup> Mortgage debt service plus the costs of real estate taxes, insurance, and maintenance (and, in some markets, certain utilities) commonly borne by landlords.

**Contact:  
Daniel Alpert**



**dalpert@westwoodcapital.com  
Direct Dial: +1-212-953-6448**

empowered to mandate resetting of rents. All rents shall be “gross rents,” with the landlord bearing all real estate taxes, insurance premiums and maintenance expenses relating to the home. Utilities shall be borne by the parties to the Recovery Lease in accordance with local custom and practice.

**Transferability:** The Recovery Lease shall not be transferable from the tenant to any other lessee or sublessee. The tenant must remain in occupancy of the property. The property and the Recovery Lease, however, are to be fully transferable by the former lender/landlord to any other party, subject to existence of the Recovery Lease. It is an express objective of the Plan that former lenders be encouraged to dispose of Recovery Leased homes to real estate investors in an orderly manner, and certain tax benefits are to accrue to investors in Recovery Leased homes, as set forth below, to maximize the value of such Recovery Leased property (based on its value as a rental property investment).

**Right of First Offer:** 180 days prior to the expiration of the Recovery Lease, the tenant (former homeowner) shall have the exclusive right to acquire the home at the then-fair market value (determined by appraisal in absence of an agreement between landlord and tenant). In the event the tenant fails to acquire the home prior to the expiration of the Recovery Lease, there shall be no further obligation of landlord to tenant, and the home can either be sold to a different buyer, free and clear, or leased to any tenant, with a rent determined at the landlord’s sole discretion.

**Termination:** In the event the now-renting former homeowner is in arrears on rent for more than 30 days, he/she would be subject to eviction, as in the case of any lease.

**Sunset:** Recovery Lease arrangements shall have a well-defined sunset, and the Plan shall permit Recovery Lease arrangements to be entered into for a period ending 18–24 months from the passage of enabling legislation. The purpose of this provision is to accelerate settlements into the shortest possible period so as to rapidly and aggressively move to stabilize the housing market.

**IV. Tax Law Modifications** – To provide incentives to both lenders and homeowners to enter into settlements pursuant to the Plan, Congress shall enact legislation pursuant to which the following modifications shall be made to existing tax law:

- a. A new section of the Internal Revenue Code (“IRC”) shall be enacted to provide that lessees under Recovery Leases (former homeowners) shall be entitled to deduct from their ordinary income the rent paid on Recovery Leases. This provision is not intended to reverse the IRC Section 163(h)—the mortgage interest deduction—but is meant to level the playing field in connection with the former homeowner’s transition from homeowner to tenant. This provision will be revenue-neutral (or possibly revenue-enhancing) to the U.S. Treasury, inasmuch as the former homeowner was previously permitted to deduct all mortgage interest payable on his preexisting loan (whose interest payment is likely to have been greater than the rent payment under the Recovery Lease).
- b. The provisions of IRC Section 469, limiting losses from passive activity such as rental housing from offsetting ordinary income, shall be suspended in connection with the ownership of homes subject to Recovery Leases. Upon expiration or termination of a Recovery Lease for a property, further leasing activity in respect of such property will once again be governed in accordance with the existing provisions of IRC Section 469. While not necessarily revenue-neutral, the purpose of this provision is to enhance lenders’ ability to expeditiously sell Recovery-Leased property to third-party, noninstitutional investors.
- c. The provisions of IRC Section 1250 shall be amended to provide that homes leased pursuant to Recovery Leases may be depreciated over the following periods, in contrast to present depreciation allowances:
  - i. Rental property structural improvements (buildings) to be depreciated on a 17-year “double-declining” basis, as opposed to the 27.5-year straight-line basis currently permitted;
  - ii. Appliances and other nonreal property within Recovery-Leased homes to be depreciated over a 5-year “double-declining” basis, as opposed to the 5-year straight-line basis currently permitted;
  - iii. Landscaping and pavement on the site of Recovery-Leased homes to be depreciated on a 10-year “double-declining” basis, as opposed to the 15-year straight-line basis currently permitted.

While not revenue-neutral, this provision is intended to enhance lenders’ ability to expeditiously sell Recovery-Leased property to third-party investors. Depreciation periods for homes subject to Recovery Leases shall revert to current schedules at the termination or expiration of the Recovery Lease with respect thereto.

- V. **Regulatory Provisions** – Banking, insurance and other regulated lenders will be required to mark loans settled under the Plan to the market values of the homes they have taken pursuant to the settlement. Lenders will be motivated to monetize homes subject to Recovery Leases as soon as possible to get the assets off their balance sheets in exchange for cash to improve regulatory capital. Nevertheless, Federal and State legislation should be promulgated to permit institutions to hold homes subject to Recovery Leases as “real estate held for investment,” rather than “real estate owned.”
- VI. **Other Government Agencies** – It is expected that a combination of steady rental income, tax benefits and the potential for capital gains on the resale of the homes to the former homeowner or

**Contact:  
Daniel Alpert**



**dalpert@westwoodcapital.com  
Direct Dial: +1-212-953-6448**

third parties (at the expiration of the Recovery Leases) will result in an active market for debt and equity investment in Recovery-Leased property in the short to medium term. Nevertheless, the enabling legislation promulgating the Plan should direct Fannie Mae and Freddie Mac to institute a favorably priced program to purchase and/or guarantee loans of up to 80% of the value of Recovery-Leased properties to qualified investors therein.

## **Conclusion**

The housing bubble, and the contemporaneous overextension of \$7 trillion of new credit to the consumer and householder earlier this decade, has placed unprecedented strain on the vast U.S. middle class. Incomes during the decade have declined in real terms, and certain costs of everyday life—healthcare, education and energy—have increased materially.

This decade’s financial and economic tale includes two other factors that require emergency actions in the nature of the Plan:

- (i) a decline in net savings rates for the American middle class below zero (slightly below zero for the country as a whole, more so for the middle class)—meaning that U.S. citizens are, on average, dis-saving by going increasingly into debt: and
- (ii) the substantial likelihood that more than \$5–\$6 trillion of home value (25% to 30% of the \$20 trillion of aggregate home value at the peak of the bubble) will be eradicated as a result of the collapse in home prices—representing a devastating collapse of wealth in many U.S. markets, to say nothing of making millions of homes worth less than the mortgage loans outstanding against them.

While financial institutions can be rescued with capital infusions that allow credit to slowly be made available again, American families and their homes will require the benefit of considerable amounts of time to right themselves. Consumption must slow, along with reliance on credit, and savings and net worth must be painstakingly rebuilt. Homes will be revalued to the point of historical comparisons to rents and incomes, but such revaluation inherently runs the risk (actually, a certainty) of substantial disruption to the lives of families, if not their financial ruin, with the pendulum swinging considerably past the point of re-stabilization of home values and into the meltdown zone.

The Freedom Recovery Plan is designed to ease America’s 75+ million homeowners through the economic devastation, keep them in their homes and minimize the burden on general taxpayers, which would result from a wholesale “bailout” of all homeowners and lenders. At its core, the Plan fosters what the markets will force upon the residential real estate industry and mortgage lenders. In the absence of such an impact-buffering protocol, families, financial institutions and the U.S. government will suffer even greater pain and take longer to rebuild and move forward.