

## 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 crisis, 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 and place less reliance on the direct intervention of a government (and its taxpayers) that is now heavily extended. The Freedom Recovery Plan (the “Plan”) is a structured package of government and private sector measures that amount to a national “work-out” of the residential real estate elements of the overall crisis in the capital markets. The ongoing meltdown of the housing sector 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 segments of the population 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 all those who have lingering concerns about the total costs the government has already committed itself to.

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 to their mortgagees the deeds to their homes in consideration of the right of continued occupancy of their home for a period of five years, as tenants. 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 compliance with the Plan by lenders.

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

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

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Unlike other solutions to the current housing correction, proposed or enacted to date, it is “as of right” from the standpoint of the homeowner – the lender must accept the surrender of a deed from a home with a qualifying impaired mortgage, without penalty, subject to the considerations and requirements of the Plan. While 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 work-out solution that is equitable to the borrower and permits the lender to efficiently realize the full market value of its loan collateral.

### **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 that debt was created in the period of 2004 through 2006, during which savings rates in this country turned negative. Simply put, this level of debt creation was unprecedented – more than doubling the amount of homeowner and consumer (credit card and auto loan debt, for the most part) debt that existing 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 crash of the technology stock bubble in 2000 and the horrific impact of 9/11/2001, but 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 and resulted in the total suspension of disbelief in continually rising home prices and their decoupling of the carrying costs of homes from the costs of renting equivalent properties and the 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 September 2008, drowned out by a combination of blind optimists and well meaning politicians who have suggested solutions that have proven to be either non-starters or wholly inadequate to the unprecedented state of affairs. As with the debate, passage and enactment of EESA, the present situation on the ground in the housing market demands a thorough understanding of what has transpired, the threats posed to our economy and financial security, and a path to resolution of the problem that can be employed with great dispatch and does not further burden the general common wealth of this country (the ordinary citizen and taxpayer) with additional financial responsibilities for the crisis – beyond the enormous burdens we have already agreed to bear. In fact, as the Plan promotes and accelerates resolution and settlement of impaired loans, it should reduce the exposure to the government and the U.S. taxpayer that arise from bank intervention and recapitalization actions being taken under EESA, as set forth below.

In order to resolve the housing crisis in the U.S., it is critical that home prices return from their bubble-era levels to a level 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 the demand for homes can only achieve sustainable equilibrium (relative to available inventories) at prices reflecting reasonable rent and income

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multiples<sup>1</sup> 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 over 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 from their homes and the addition of new inventory to the for-sale backlog.

## **Elements of the Plan**

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 things, to give borrowers an opportunity to reverse the debilitating practices of dis-saving and over-consumption; and afford distressed homeowners a period of time within which to rebuild their financial lives and, hopefully, redeem their homes.

At the heart of the Plan is the “Recovery Lease.” The Recovery Lease is a fixed term (5 year) right of occupancy lease that will have certain unique features attributable to it that will benefit both the landlord (the former lender, or a subsequent assignee of title to the home and the Recovery Lease) and the 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 and the borrower is given the right to remain in occupancy of the home for the duration of the lease (with no right of renewal) and the right to reacquire the home, at the end of the lease, at its then fair market value (i.e. the price that would be paid by a third-party at the time). Underlying the notion of the Recovery Lease is the practical consideration that with many homeowners having invested little to no equity which they originally purchased their homes or, during the bubble, having refinanced their homes to the point where they have eliminated all of their equity, the borrower has in actuality been a “homeowner” in name only from a financial point of view and there is 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 the former homeowner 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 elements of the Plan, and the legislation required to enact the Plan, 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 intent of these eligibility requirements is to eliminate, from the mandatory settlement requirements of the Plan, mortgage loans that are in default merely because of an unwillingness of the homeowner to make

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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 peak of the housing bubble, price to rent multiples ballooned to over 26x.

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payments, or are otherwise restructureable through ordinary non-mandatory, 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:

- a. It must satisfy BOTH of the following criteria;
  - i. Have a prevailing accruing interest rate than is higher than [10]%; AND
  - ii. Have an outstanding principal balance that is 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; AND
  - 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 borrowers 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 since the mortgage loan was originally made.

- OR -

- c. It must be a mortgage loan in connection with which the 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 QIM's (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 having made a concerted effort 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 being mandated to effectuate such settlement on request of the borrower. Notwithstanding the foregoing, a settlement under the Plan shall be available to all borrowers and lenders, by mutual agreement, whether or not 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. Lender will release borrower from any and all obligations associated with the former loan and will take title as-is and without recourse to the former

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borrower. No interest, penalties of fees may be assessed by the lender in connection with the settlement. Lender and borrower shall mutually release each other from any pre-existing 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 mandated settlement requirements of the Plan, 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, 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 QIM's (or by mutual agreement between lender and borrower in the case of loans mortgage loans that are not QIM's) will be entitled to enter into Recovery Leases providing for the continued occupancy, by the former homeowner. Recovery Leases will feature, among other things, 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 sub-markets 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 market 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 which 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 rents, 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

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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.

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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 bi-annually under Recovery Leases but in no event 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 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 in order 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 an absence of agreement between landlord and tenant). In the event that 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 and a rent determined in landlord’s sole discretion.
- Termination:** In the event the now-renting former homeowner is in arrears on rent for more than 30 days, they 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 of time so as to rapidly and aggressively move to stabilize the housing market.

IV. **Tax Law Modifications** – in order 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 homeowners 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 pre-existing loan (which 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 the ability of lenders to expeditiously sell Recovery Leased property to third-party non-institutional 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 non-real property within Recovery Leased homes to be depreciated over on 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, the purpose of this provision is to enhance the ability of lenders 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 in order 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 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 over-extension of \$7 trillion of new credit to the consumer and householder earlier this decade, has placed unprecedented strain on the vast middle class of the United States. Incomes during the decade have declined in real terms and certain costs of everyday life – healthcare, education and energy – have increased materially.

The financial and economic tale of this decade 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 over \$5 to \$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 in order to right themselves. Consumption must slow along with reliance on credit and savings and net worth will need to 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, and having the pendulum swing considerably past the point of re-stabilization of home values and into the zone of meltdown.

The Freedom Recovery Plan is designed to ease America’s 75+ million homeowners through the devastation, to keep them in their homes, and not to burden general taxpayers with another “bailout.” At its core, the Plan is fostering what the markets will force upon the residential real estate industry and mortgage lenders – but in the absence of an impact buffering protocol, without which families, financial institutions and the U.S. government will suffer greater pain and take longer to rebuild and move forward, than with this Plan.