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Could Securitization Obstruct Voluntary Loan Modifications and Payment Freezes?

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Summary

Securitization is the process by which a group of similar assets, such as mortgages, is transformed into marketable securities. Securitization could present a challenge for loan servicers who anticipate that the average default rate will rise among a group of borrowers who are current on their mortgages, but who face a large payment reset due to the expiration of an introductory adjustable rate mortgage (ARM) or interest-only (I/O) period. The loan servicers may be willing to modify these loans, for example, freeze the introductory payment, and avoid the costs of foreclosure, but securitization may carry the risk of costly litigation even if the servicers ultimately expect to win the lawsuits. Although loan servicers often have discretion to modify loans for borrowers already delinquent, industry standards create a fact-sensitive net-present-value (NPV) test for modifying large groups of loans in anticipation of defaults due to higher reset payments.

The special purpose trusts that hold the loans are required to remain passive in order to comply with the Real Estate Mortgage Investment Conduit (REMIC) tax rules and the Financial Accounting Standards Board's (FASB) accounting standards, specifically FAS 140. Loan servicers have a fiduciary duty to the trust and must abide by the original service agreement. Industry standards issued in June 2007 state that anticipatory loan modifications meet the servicers' fiduciary duty to the trust as long as the loan defaults were reasonably foreseeable, and as long as the net result is likely to have greater benefits than costs for the trust (the NPV test). Relying on the NPV test, servicers of subprime ARM loans have accelerated the pace of loan modification. The Securities and Exchange Commission (SEC), which oversees the FASB, and the Internal Revenue Service (IRS) have issued letters stating that they would not challenge anticipatory subprime ARM interest-rate freezes that are part of the Administration's HOPE NOW voluntary plan.

The IRS and SEC letters do not provide any comfort for servicers considering any other broad anticipatory modification plan. Consideration of rate freezes for prime ARM borrowers would require new NPV tests, which could be less favorable. Similarly, freezing interest-only payments could require a new, and less favorable, analysis. This report will be updated as conditions warrant.

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Introduction

Efforts to modify a large number of home mortgage loans with resetting payments have increased among private, state, and federal institutions. In September 2007, federal and state financial regulators issued a guidance to lenders encouraging loan restructuring for troubled borrowers to avoid foreclosure where feasible.[1] Loan servicers were instructed to review their full authority to modify loans for borrowers already delinquent and for borrowers likely to default in the near future. In November 2007, the state of California negotiated a voluntary interest rate freeze plan with four large servicers.[2] In December 2007, a national voluntary rate freeze plan was formed among private loan servicers, community organizations, loan counselors, the Department of Housing and Urban Development (HUD) and the Department of Treasury under the HOPE NOW Alliance.[3] The pace of voluntary loan modification has begun to accelerate after an initial period during which the pace of loan modifications was less than anticipated. Some observers had worried that the pace of modification may have been slowed by the number of loans sold to secondary mortgage markets and sliced into marketable securities (securitization).

Securitization could present a challenge for loan servicers who anticipate that the average default rate will rise among a group of borrowers who are current on their mortgages, but who face a large payment reset due to the expiration of an introductory adjustable rate mortgage (ARM) or interest-only (I/O) period. The loan servicers may be willing to modify these loans, for example, freeze the introductory payment, and avoid the costs of foreclosure, but securitization may carry the risk of costly litigation, even if the servicers ultimately expect to win any lawsuits. Although loan servicers often have discretion to modify loans for borrowers already delinquent, industry standards create a fact-sensitive, net-present-value (NPV) test

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[1] "Federal Financial Regulatory Agencies and CSBS Issue Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages," FDIC Press Release, September 4, 2007. The agencies included the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), the National Credit Union Administration (NCUA), the Office of Thrift Supervision (OTS), and the Conference of State Bank Supervisors (CSBS), available at [http://www.fdic.gov/news/news/press/2007/pr07073.html].

[2] "Governor Schwarzenegger Works with Lenders to Help Homeowners Avoid Foreclosure," Press Release, California Governor's Office, November 20, 2007, available at [http://gov.ca.gov/index.php?/speech/8157/].

[3] A Bush Administration fact sheet is available at [http://www.whitehouse.gov/news/releases/2007/12/20071206-7.html].

for modifying large groups of loans in anticipation of defaults due to higher reset payments.[4] In this context, fact-sensitive refers to the probability that small changes in the facts can significantly change the probability of avoiding costly litigation.

Anticipatory loan workouts did not seem to be happening in large numbers prior to October 2007, despite recognition since January 2006 of the upcoming subprime adjustable rate mortgage (ARM) problem. The chair of the FDIC, Sheila Baer, had expressed frustration that modification efforts undertaken during the first three quarters of 2007 had helped less than 1% of troubled borrowers.[5] More recent information shows significant acceleration as the California plan and the HOPE NOW Alliance efforts expand. The increase in fourth quarter 2007 California loan modifications appears to be confirmed by a February 6, 2008, HOPE NOW Alliance press release that shows the number of California loan modifications jumped from 3,151 in the third quarter of 2007 to 10,199 in the fourth quarter of 2007. The press release does not, however, distinguish modification for borrowers already delinquent from modifications in anticipation of delinquency; therefore, it is difficult to know if these servicers had resolved questions about the usage of broad-based freezes that do not contact individual borrowers.

Recognizing potential limitations on borrower workouts due to securitization, the House Financial Services Committee sent a letter (June 15, 2007) to the Securities and Exchange Commission (SEC) requesting clarification of Financial Accounting Standard FAS 140, which governs transfers of assets in securitization, sometimes referred to as true sales. The SEC, which oversees the Financial Accounting Standards Board, responded (July 24, 2007) that a servicer who modified the loan of a borrower likely to become delinquent would not lose off balance sheet status. (See discussion in "Accounting Issue: FAS 140 and Anticipatory Defaults" section). These letters addressed situations in which a servicer examines the likelihood of default on a case-by-case basis but did not address broad based modification plans in which the servicer will not have analyzed the particulars of individual loans or attempted to contact the affected borrowers.

In December 2007, the Administration announced the HOPE NOW Alliance plan for freezing some subprime interest rates. This plan would allow servicers to freeze the interest rates of many subprime borrowers, even those current on their payments, in anticipation of foreseeable default without examining the particulars of each loan and without negotiating with each borrower. The HOPE NOW Alliance sought comfort letters from the SEC and from the Internal Revenue Service (IRS) to assure loan servicers that their participation would not violate accounting standards or tax laws. The responses of the SEC and the IRS state that neither agency would object to the HOPE NOW initiative, but advocates of more comprehensive mortgage

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[4] "Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans," American Securitization Forum, June 2007, available at [http://www.americansecuritization.com/uploadedFiles/ASF%20Subprime%20Loan%20Modification%20Principles_060107.pdf].

[5] Initial disappointment was expressed by FDIC Chairman Sheila Bair at Clayton Holding, Inc. Investor Conference, New York, NY, October 4, 2007, available at [http://www.fdic.gov/news/news/speeches/archives/2007/chairman/spoct0407_2.html].

modification plans cannot rely on the comfort letters issued for the original HOPE NOW plan.

Accounting Issue: FAS 140 and Anticipatory Defaults

Some lenders choose to sell their loans into the securitization process because selling the loan improves their balance sheet, but the lender may continue as the loan servicer.[6] The servicing contract often specifies the range of activities permitted to cure bad loans. Lender-servicers who exceed permitted activities risk being forced to return the loans to their own balance sheets. Furthermore, continued responsibility to cure the mortgages could, under some circumstances, undermine a true sale and force the seller to place the loans back on the balance sheet. To take full advantage of securitization, lenders need to know which activities they can pursue, and under what circumstances, to modify troubled loans and still consider a mortgage transfer a true sale for balance sheet purposes. Of current interest is the ability of a lender-servicer to modify large numbers of loans in anticipation of default without conducting a loan-by-loan review.

The accounting rules for pass-through trusts that are typically used in securitization of subprime mortgages are contained in FAS 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities."[7] FAS 140 sets, among other things, the conditions under which loans transferred to a special purpose entity (SPE) qualify as a true sale and can be removed from the seller's balance sheet.[8] It also helps distinguish between permitted activities that are consistent with a passive trust and activities that are not permitted because they constitute "active management."

Among the conditions placed on qualified SPEs, FAS 140 presents three restrictions on permitted activities related to borrower workouts. Permitted activities, including loan modification, must be (1) significantly limited; (2) entirely specified in the legal documents that created the SPE; and (3) significantly changed only with the approval of at least a majority of the interests held by entities other than the institution that transferred the debt to the SPE. The issue is whether these three

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[6] One reason lenders may wish to sell their loans is that removing a risky loan from the balance sheet reduces the risk-based capital requirement monitored by financial regulators.

[7] FASB is not a government agency, however, the SEC has oversight of accounting rules issued by FASB, and in some cases, accounting standards such as FAS 140 play an important role in legal disputes involving balance sheet activity, misrepresentation, or fraud.

[8] Securitization trusts for mortgage backed securities are often formed as entities with the special purpose of holding the mortgages and distributing the payments to investors according to a pre-arranged formula, thus the term special purpose entities (SPE). They may not actively manage the assets in the trust, nor may they typically acquire new assets. Other off-balance sheet instruments, such as structured investment vehicles (SIVs), in contrast, are not necessarily limited to an initial pool of assets.

requirements of FAS 140 limit the discretion of servicers to modify loans in anticipation of default without conducting a loan-by-loan analysis.

It can be difficult to identify the impact of a particular loan modification plan on the "majority of interests held by entities other than the institution that transferred debt to the SPE." The SEC comfort letter to HOPE NOW recognized that "...Statement 140 regarding servicer discretion can be complicated to apply in practice and that specific accounting and disclosure guidance does not exist in Statement 140 regarding the nature of permitted modification activities...."[9] The January 8, 2008 SEC Office of Chief Accountant (OCA) comfort letter also engaged in fact-sensitive net-present-value analysis, which could be problematic for proposals to extend freezes to troubled prime ARM or interest-only mortgages. Default rates for some subprime loans are expected by some observers to triple to more than 30% of subprime ARMs issued in 2005, but a similar tripling of prime ARM defaults would result in default rates of less than 3%. In some parts of the country, especially in certain California cities, ARMs made up a large share of mortgages outside the subprime sector in 2005. Given that there are so many more prime loans than subprime loans, the external effects of prime loan resets could be as large as subprime, but lender-servicers might not feel confident that prime ARMs are reasonably foreseeable to end in default when 97% are paying on time.

REMIC Tax Status

A broad-based modification plan could result in loss of the favorable tax status of the Real Estate Mortgage Investment Conduit (REMIC) or trust holding securitized loans. The REMIC structure, which was part of the 1986 tax reform, allows a pass-through trust to divide the flow of mortgage payments into varying classes of securities without triggering corporate taxation.[10] Prior to 1986, a trust that used a formula to assign financial flows to diverse classes of securities, or tranches, would be subject to corporate tax. The 1986 law exempted this assignment of funds function and allowed multiclass securitization. Since 1986, many mortgages have been financed using this REMIC structure.

The IRS issued Revenue Procedure 2007-72 on December 7, 2007, to provide comfort to HOPE NOW Alliance loan servicers that adherence to the rate freeze plan would not result in loss of tax status by affected trusts. As with the SEC, the IRS did provide comfort for the specifics of the December 2007 plan but provided no comfort to anyone else considering a voluntary rate freeze or to those considering an expansion of the December 2007 plan. The IRS was largely silent on its reasoning and limited its discussion to subprime ARMs. Proponents of expanding the plan to include prime ARMs or to interest-only resets will likely need to seek further guidance from the IRS.

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[9] SEC Office of Chief Accountant letter, January 8, 2008, p. 3, available at [http://www.sec.gov/info/accountants/staffletters/hanish010808.pdf].

[10] Tax Reform Act of 1986 (REMIC provisions), P.L. 99-514, 100 Stat. 2085.

Divergent Investor Interests

Even if market participants agree that the SEC and IRS comfort letters are a solution to the "active management" definition in cases of anticipatory default, modifications may result in private lawsuits because of divergent investor interests. The holders of different securities from the same mortgage pool are often paid different amounts — interest vs. principal, or paid-first vs. paid-last, to name two examples. Furthermore, it is possible that some investors could gain more from a borrower terminating the mortgage early, including default, while other investors only gain if the loan fully performs. The loan servicer that renegotiates the loan may have the effect of benefiting some investors and hurting others, rather than sharing gains and losses evenly. Consequently, the holders of some tranches of securities may object to the renegotiation. Some observers are concerned that the possibility of this "tranche warfare" could prevent private solutions to unsustainable mortgages, even if all parties agree that keeping the current family in the home minimizes the total losses compared with paying the expenses of the foreclosure process.

Analysis of Private Bargaining Solutions: The Coase Theorem and its Limits

A general economic principle, called the Coase Theorem, holds that private bargaining can lead to efficient outcomes if (1) property rights are well defined; (2) information is available to participants; and (3) transaction costs are low.[11] Sometimes, the efficient solution may be to keep the current mortgage borrower in the home even though the borrower is unable to sustain the current mortgage. If foreclosure is costly and local home prices are falling, for example, then renegotiating with the current occupant may minimize losses compared to paying the costs of foreclosure and finding a new buyer in a falling market. Under these circumstances, the Coase Theorem would predict that minimizing total loss would allow investors as a group to compensate any potentially objecting investors and approve the loan modification. The prohibition on active management, however, could make bargaining difficult among investors to keep the current borrower in the home, even though in many cases that would be the efficient outcome.

The Coase Theorem suggests that private bargaining could lead to the creditors renegotiating with the current borrower even if the creditors have conflicting interests due to the multiclass structure. The reason is because the investors as a group could always compensate an objecting investor that would prefer an outcome that results in a net lower return. The multiclass structure and the limits on active management for tax and accounting purposes may make direct private bargaining by investors in different tranches impractical.

The NPV test advocated by the industry appears to be consistent with this bargaining outcome. As long as the probable gains from avoiding costly foreclosures

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[11] Ronald Coase, "The Problem of Social Cost," *Journal of Law & Economics*, vol. 3 (1960), p. 1.

are greater than losses from freezing capable borrowers at lower rates, private bargainers could in theory compensate investors in hurt tranches. The difference is that there is no assurance that investors in diminished tranches actually would be compensated. The result could be investor lawsuits, and both the IRS and the SEC recognized that the NPV test is fact-sensitive. The cost of potential litigation could be significant.

Evidence of Increasing Voluntary Loan Modification

The HOPE NOW Alliance issued a statement on February 6, 2008, summarizing the current pace of loan modification. **Table 1**, drawn from that statement's appendix, shows that loan modifications were more than twice as high in the fourth quarter of 2007 than in the first quarter. The pace of prime loan modifications also accelerated. These results do not distinguish between anticipatory loss mitigation and negotiations on a loan-by-loan basis. The results in the first two quarters of 2007 are presumably dominated by loan-by-loan modifications as they occurred prior to the state and federal rate freeze initiatives.

Table 1. Quarterly Loan Modifications, 2007

Selected States	Q1	Q2	Q3	Q4
U.S. Total	54,049	65,910	76,648	142,717
Arizona	416	674	812	2,261
California	1,111	2,077	3,151	10,199
Florida	2,257	3,173	4,169	9,328
Michigan	2,716	3,775	4,313	9,116
Ohio	3,245	3,941	4,493	7,536

Source: Hope Now Alliance, available at [http://www.fsround.org/media/pdfs/nationaldatafeb.pdf].

Note: Data were extrapolated by HOPE NOW Alliance to estimate the number of loan modifications, excluding repayment plans, completed by all servicers participating in the survey.