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Is Securitization an Obstacle to Subprime Borrower Workouts?

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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 an obstacle to borrowers and lenders seeking to work out more manageable terms to avoid foreclosure because 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. A private servicer, sometimes the original lender, typically administers the loans on behalf of the trust according to a prearranged set of rules. The passivity requirement could be interpreted as barring the trusts from granting servicers additional discretion to modify loans to cope with unanticipated market conditions. These issues are further complicated by accounting rules that lenders comply with when transferring the loans to the trusts, particularly FAS 140, which governs the definition of a true sale. A lender that is contracted as the loan servicer could be considered actively managing if it modifies the loan, thus violating FAS 140 and undoing the sale of the loan for balance sheet purposes. Fear of balance-sheet ramifications and lawsuits by frustrated investors could discourage some servicers from restructuring loans on a large scale.

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 FAS 140, asking if servicers could modify loans to prevent likely defaults, or are they required to wait until loans are in default. The SEC, which oversees the Financial Accounting Standards Board, responded (July 24, 2007) that a servicer who modified the loan of a borrower who was likely to become delinquent would not be considered to be actively managing the loans.

This correspondence did not address another potential problem caused by securitization, conflicts of interest among investors who receive differing payment schedules. To date, the industry does not appear to have responded to these letters with a significant increase in borrower workouts.

This report will be updated as conditions warrant.

Introduction

Federal and state financial regulators have issued a new guidance to regulated lenders encouraging loan restructuring for troubled borrowers to avoid foreclosure where feasible.[1] The agencies included the Federal Deposit Insurance Corporation, the Federal Reserve, the Office of the Comptroller of the Currency, the National Credit Union Administration, the Office of Thrift Supervision, and the Conference of State Bank Supervisors. Loan servicers were instructed to review their full authority to modify loans for borrowers already delinquent and for borrowers likely in the near future to default. Despite recognition of subprime problems since January 2006, loan workouts do not appear to be occurring in large numbers. The head of the FDIC, Sheila Baer, has expressed frustration at the relatively low level of loan modification.[2] She pointed out in a recent speech that less than 1% of troubled subprime loans have been restructured in any meaningful way.

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 FAS 140, which is the accounting standard that 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 be considered to be actively managing the loans. To date, the industry does not appear to have responded to these letters with a significant increase in borrower workouts. It is unclear whether the apparent lack of borrower workouts is due to industry inertia or to lingering fears of exposure to investor lawsuits, despite the SEC letter.

FAS 140, True Sales, and Curing Bad Loans

Some lenders choose to sell their loans into the securitization process because selling the loan improves their balance sheet.[3] The securities issuers often specify in the securitization documents the terms under which the debt-sellers will repurchase, or otherwise attempt to cure, some of the loans in default. 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 to cure bad loans and still consider a mortgage transfer a true sale for balance sheet purposes.

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

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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.

[2] Remarks by FDIC Chairman Sheila Bair at Clayton Holding, Inc. Investor Conference, New York, NY, October 4, 2007.

[3] 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.

Servicing of Financial Assets and Extinguishments of Liabilities." 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. 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 requirements of FAS 140 limit the discretion of servicers to modify loans when market conditions are worse than was expected when the SPE was created.

The correspondence exchanged between the House Financial Services Committee and the SEC focused on the ability of servicers to modify loans in anticipation of likely defaults, rather than just for loans already in default. The letters stated that it is common for the SPEs created in securitization to be granted general authority to modify loans in default when used appropriately to maximize the value to bondholders. The SEC responded that modification in anticipation of default would not constitute active management under FAS 140. The SEC reply, however, did not address the potential problem of divergent interests among the securities holders.

REMICs, Divergent Investor Interests, and Tranche Warfare

The tax laws and securitization may present an obstacle to loan modification, even if servicers modify loans in anticipation of probable defaults, because investors may have conflicting interests. The Real Estate Mortgage Investment Conduit (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.[4] Prior to 1986, a trust that used a formula to assign financial flows to diverse classes of securities, or tranches, would be considered an "active manager" and subject to corporate tax. The 1986 law exempted this assignment of funds function from the definition of "active manager," while retaining the overall concept. Since 1986, many subprime mortgages have been financed using this REMIC structure.

Even if market participants agree that the SEC letter is a solution to the "active management" definition in cases of anticipatory default, renegotiation may not occur because of divergent investor interests under the REMIC tax law. 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 tranches and hurting others rather than sharing gains and losses evenly. Consequently, the holders of some tranches of securities may object to the renegotiation. The possibility of this

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[4] Tax Reform Act of 1986, (REMIC provisions), PL 99-514, 100 Stat. 2085.

"tranche warfare" could prevent private solutions to unsustainable subprime 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; and (3) transaction costs are low.[5] 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 REMIC rule's prohibition on active management, however, could make bargaining difficult among investors to keep the current borrower in the home, even though that is the efficient outcome.

In the following illustrative example, the costs of foreclosure and falling house prices combine to give creditors the incentive to keep current borrowers in their homes, even though another buyer might be willing to pay more for the house than the current borrower could afford. Suppose that a borrower took out a $200,000 loan to buy a house valued originally at $200,000. The borrower's payments were structured with a two-year introductory monthly payment that would cover a $170,000 loan if the introductory payment continued for the whole mortgage term, then the loan resets to a higher monthly payment after two years to a payment rate that would more than cover a $200,000 loan if the post-reset payment had been for the entire mortgage term. Together, the introductory-period payments and the post-reset payments will exactly cover the $200,000 loan. It is expected that the borrower will be able to pay the higher payment when the introductory period expires and keep the house. Even if the borrower can't sustain the mortgage when it resets to a higher monthly payment, the borrower could move out of the house and retain good credit if the house price rises enough to pay the $200,000 mortgage plus any transaction costs.

The outcome is different if the borrower cannot sustain the higher payments, the house price falls, and foreclosure is costly. Suppose the house price falls to $180,000, and the creditor's costs to foreclose are $20,000. It is then in the interest of the creditor to renegotiate and allow the current borrower to continue to pay at the $170,000 rate even though another borrower would be willing to purchase the house for $180,000. If the creditor spends $20,000 to foreclose, then the lender receives only $160,000 (which is $180,000 sale price minus $20,000 foreclosure costs) from a replacement buyer, compared with $170,000 from the current borrower.

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

In the above example, 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 REMIC structure. The reason is because the investors as a group could always bargain to divide $170,000 in a way that would compensate an objecting investor that would prefer an outcome that only returns $160,000 to the group as a whole. For example, suppose there is a tranche that would receive $50,000 in the $160,000 outcome (foreclosure), but only receive $10,000 in the $170,000 outcome (renegotiation). This tranche would have to receive at least $40,000 to remove its objection to renegotiation ($50,000-$10,000). The other tranches would be able to compensate because they gain by more than $40,000 because they as a group receive whatever the objecting tranche does not. In this case, the tranches wishing to renegotiate would receive $110,000 in foreclosure ($160,000-$50,000), and would receive $160,000 from renegotiation ($170,000 - $10,000). The pro-renegotiation tranches would gain by $50,000 ($160,000-$110,000) to compensate the objecting tranches by at least $40,000. Since the $50,000 gain to pro-renegotiation tranches is greater than the $40,000 loss by objecting tranches, the Coase Theorem predicts that renegotiation will occur if rights are well defined, information is available, and transaction costs are low.

The REMIC structure, however, could make bargaining among securitization participants difficult. First, information on the identity and interests of fellow securities holders is unavailable. Second, servicers and SPEs that attempt to renegotiate with borrowers and rearrange securities payments to compensate objecting investors could be accused of active management. If Coasian bargaining constitutes active management, then (1) the trust could be subject to corporate taxes; and (2) the sellers may not have achieved a true sale for their balance sheets. Because either of these two outcomes can be extremely costly, securitization participants may refrain from loan modification.

Conclusion

The FDIC reports that less than 1% of troubled subprime loans have been modified in any meaningful way, despite encouragement from financial regulators and recognition by the industry that keeping some current borrowers in their homes may be the most efficient outcome. One possible reason for this apparent lack of loan modification may be limits caused by the accounting and tax rules that govern securitization. Although the July 24, 2007 letter from the SEC to House Financial Services Committee clarified the ability of servicers to provide borrower workouts for anticipatory defaults as they would for actual defaults under FAS 140, the letters did not address the issue of tranche warfare under the REMIC law. Further clarification may be required to assure servicers and trusts that they will not be subject to investor lawsuits if they provide workouts to troubled borrowers.