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Preliminary Results and Implications

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Foreclosure rates in the United States are very high relative to historic levels and continue to be high despite a number of ad hoc foreclosure moratoria.[1] Foreclosures create personal hardship, and they may also create externalities that justify intervention to reduce the level of foreclosures.[2] Such an externality argument underlies the Treasury Department's explanation of its foreclosure relief plan.[3] Although other commentators argue that efforts to reduce foreclosure delay the bottoming-out of the housing market and thus delay recovery[4] or that efforts to keep borrowers in homes that are worth less than the principal threaten to create a generation of "mortgage slaves,"[5] the momentum is clearly toward trying to reduce foreclosures.

There is a widespread perception that securitization has contributed to the high level of foreclosures because "win-win" modifications (modifications that benefit both the borrower and the lender) are more difficult for securitized loans. When a mortgage is securitized, the borrower does not have a direct relationship with the person who is receiving the borrower's payments. Instead, the mortgage loans are gathered into a pool that is owned by a trust. The trust issues certificates that are purchased by investors and that entitle them to be paid according to specified terms and a specified seniority structure. A servicer is engaged to service the loans on behalf of the trust and the certificateholders. This servicer – sometimes a bank, sometimes an independent company – is charged with deciding whether to modify mortgage loans in order to prevent borrower default. The servicer makes the decision subject to rules set out in a servicing agreement.

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[1] *See, e.g.*, RealtyTrac, *Foreclosure Momentum Recovers in February*, FORECLOSUREPULSE, March 12, 2009 (reporting 290,631 U.S. properties with foreclosure filings in February 2009, up 30 percent from February 2008 and six percent from January 2009, and the third highest total since RealtyTrac began reporting monthly foreclosure figures in January 2005 and calling the increase from January "surprising, given that many of the foreclosure prevention efforts and moratoria in place in January were extended through most of February").

[2] *See* Anna Gelpern & Adam Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Mortgage-Backed Securities*, available at http://ssrn.com/abstract =1323546, at 34 (contractual rigidities in securitization servicing agreements create "four sets of negative externalities" via foreclosures: for communities, for other mortgagees, for the financial markets, and for the economy as a whole); Eric A. Posner & Luigi Zingales, *The Housing Crisis and Bankruptcy Reform: The Prepackaged Chapter 13 Approach*, available at http://ssrn.com/abstract =1349364, at 2 ("[F]oreclosure has some very negative spillover effects" by undermining neighborhood house values and, if widespread, reducing the stigma of default); Christopher Mayer, *et al.*, *A New Proposal for Loan Modifications*, available at http://www4.gsb.columbia.edu/null?&exclusive= filemgr.download&file_id=53861at 3 ("Foreclosures contribute to falling house prices and deteriorating communities.").

[3] See U.S. Department of the Treasury Press Release TG-48, *Relief for Responsible Homeowners One Step Closer Under New Treasury Guidelines*, March 4, 2009, http://www.treas.gov/press/releases/tg48.htm (citing "preventing neighborhoods and communities from suffering the negative spillover effects of foreclosure such as lower housing prices, increased crime and higher taxes" as reason for mortgage-modification program).

[4] *See, e.g.*, James Saft, *Let Housing Find Its Clearing Price*, http://blogs.reuters.com/great-debate/2009/02/20/let-housing-find-its-clearing-price/, Feb. 20, 2009.

[5] Ramsey Su, *Why Be a Nation of Mortgage Slaves?*, WALL ST. J., Jan 31, 2009.

Empirical evidence provides some support the proposition that securitization leads to lower levels of win-win loan modification, in that securitized loans are more likely to be foreclosed upon when they go into default than nonsecuritized loans.[6] There are at least two possible explanations for this: (1) express contract provisions forbid modification or fail to provide clear standards for when modification is permitted, exposing the servicer to liability in the event that it does modify the loans; (2) the compensation rules for the servicer under the agreements make it more attractive for the servicer to foreclose than to attempt a modification.

This paper focuses on the first issue. The Treasury has already announced plans to deal with the second issuer by paying servicers for successful modifications, but the status of the contract provisions addressing modification remains unclear. Academic proposals have called for abrogation of contract provisions that obstruct loan modification,[7] and pending legislation would do just that.[8] However, little useful information about what these contracts say is public. Although the contracts themselves typically are publicly available, the only summary information about their contents of which we are aware is found in two investment-bank studies based on limited samples.[9] We present interim results from an ongoing study of the contents of these documents.

The Review Program

BCLBE has undertaken a document review to determine what the contractual limits on subprime mortgage modification actually are. Due to resource constraints, this review covers a limited universe and does not cover each and every contract in that universe, as explained below. Nevertheless, it is our understanding that ours is the most systematic and comprehensive review of subprime deal documents conducted to date.

[6] Tomasz Piskorski *et al*., *Securitization and Distressed Loan Renegotiation: Evidence from the Subprime Mortgage Crisis*, December 2008, available at http://ssrn.com/abstract=1321646.

[7] *See* Gelpern & Levitin, *supra note* 2, at 65 ("The Gold Clause episode and the Supreme Court jurisprudence it produced suggest that it would be relatively simple to legislate away both the contractual and the [Trust Indenture Act] barriers to amending RMBS PSAs. Narrowly-targeted legislation could make the clauses unenforceable on public policy grounds.")

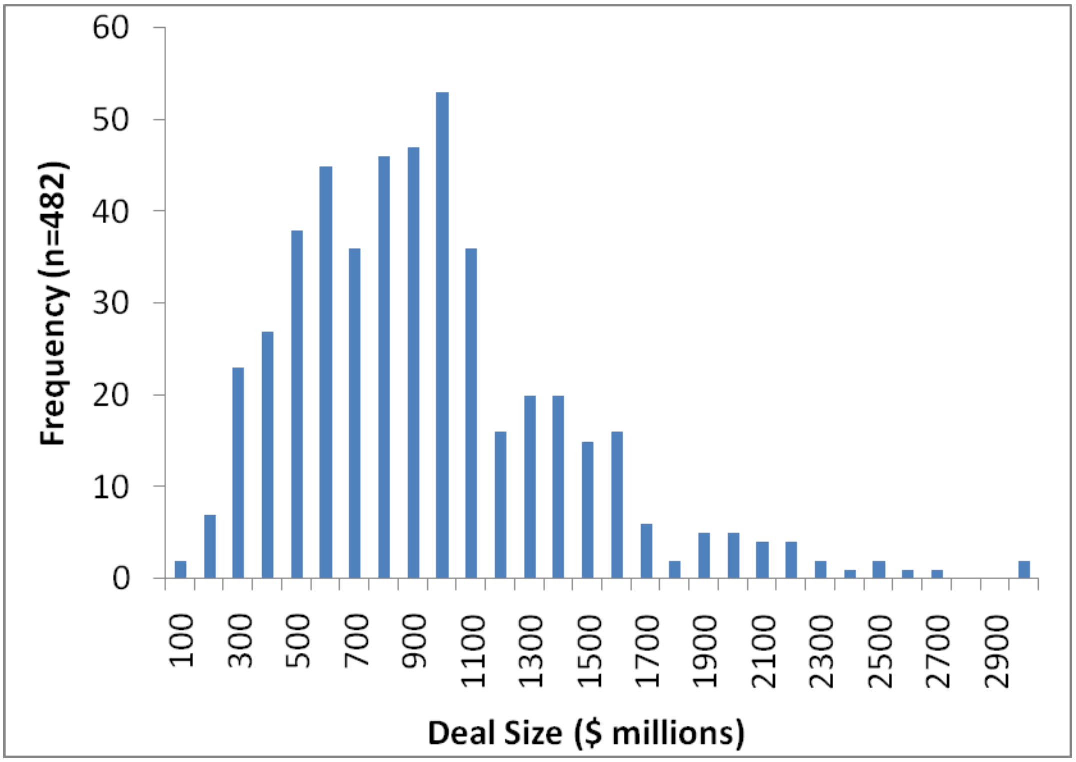
[8] *See* H.R. 384., § 206(a)(2)(A) ("Notwithstanding any other provision of law, and *notwithstanding any investment contract between a servicer and a securitization vehicle or investor*, a servicer – (i) shall not be limited in the ability to modify mortgages … ; and (ii) shall not be obligated to repurchase loans from or otherwise make payments to the securitization on account of a modification …" if the mortgage being modified meets criteria specified in the statute).

[9] *See* Gelpern & Levitin, *supra* note 2, at 15. One of the studies is by and is based on 31 deals from 2004 to 2007. Credit Suisse, *The Day After Tomorrow: Payment Shock and Loan Modifications*, April 5, 2007, at 5. The other is a Bear Stearns study cited in Vikas Bajaj, *For Some Subprime Borrowers, Few Good Choices*, N.Y. TIMES, March 22, 2007, at C1. Bajaj describes the Bear Stearns study as being of "a widely followed index," probably the ABX.HE index. That index, which is reconstituted every six months, consists of 20 deals at any given time. *See, e.g.,* http://www.markit.com/information/products/category/indices/abx.html

The Universe

We consider subprime home mortgage securitization deals from 2006. A deal is characterized as "subprime" based on its classification in the "Res B/C category" in the DQRP function of the Bloomberg Financial Information Service.[10]

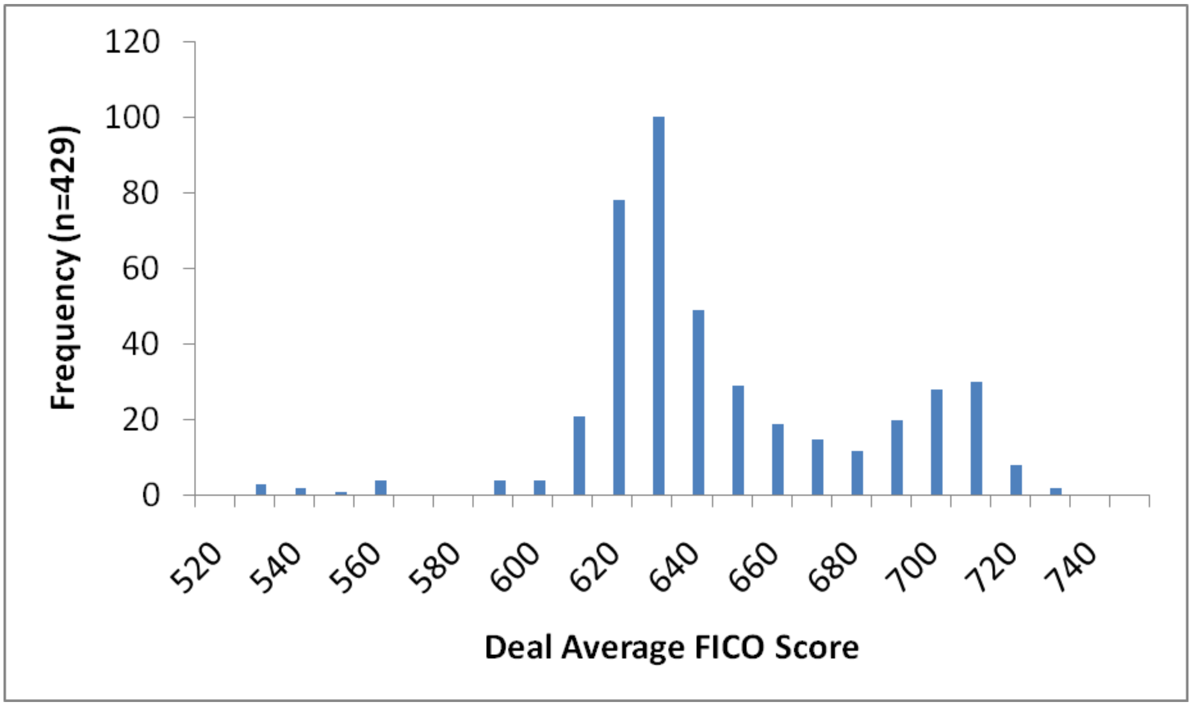
There are a total of 614 deals in this category, and Bloomberg has information on 482 of them. These 482 deals cover $435 billion of volume, which is similar to the $449 billion volume for 2006 subprime securitization reported by *Inside Mortgage Finance*.[11] The distribution of deals by size is shown below.



[10] Based on our interaction with Bloomberg representatives, it is our understanding that Bloomberg put each deal in the "Res B/C" category if the following three categories made up more than 50% of the dollar volume of principal in the deal at the time of classification: (1) "B- or C-rated loans." Bloomberg made this determination based on the loans' description in the prospectus; most frequently the prospectus described the loans as "subprime," "scratch-and-dent," "blemished-credit" or the like. (2) Home equity loans. Here the governing criterion was whether the loans' purpose was to take equity out of the home rather than for purchase, although apparently deals might also be put in this category if the arrangers described the deal as a home-equity deal. (3) Loans that were 30 days or more delinquent at the time of classification.

[11] Adam B. Ashcraft & Til Scheuermann, *Understanding the Securitization of Subprime Mortgage Credit*, Fed. Res. Bank of N.Y. Staff Reports No. 318, at 4 (citing *Inside Mortgage Finance* data). Due to the fact that there is no single definition of "subprime," we would not expect complete agreement on dollar volumes.

One important dimension of the deals is FICO scores. Bloomberg has information on FICO score at initiation for 429 deals. The distribution of FICO scores by deal is shown below.[12]



Generalizing Across Agreements in a Program

A fundamental assumption underlying our analysis is that it is likely that loan modification provisions will be similar across deals in the same "program" in the same year. This assumption is based on input from a major New York law firm that has extensive experience in securitization and from the American Securitization Forum, the leading industry group for the securitization business. A "program" is defined as a series of related deals with the same underlying "motive force." The motive force might be the mortgage originator, the underwriter, or another party. That definition is operationalized by assuming that deals in the same numerical sequence are part of the same program.[13]

The assumption that mortgage modification provisions are the same across deals in a program makes the review project much more manageable. The 482 deals about which Bloomberg has information fall into 152 programs, of which 119 consist of more than one deal.

[12] The chart shows a bimodal distribution with one peak in the low 600s (as would be expected given that it is often said that 620 is the FICO cutoff for "subprime" deals) and another in the low 700s. Potential reasons for this second peak include the classification of home-equity loans as subprime regardless of FICO score and the fact that loans might be classified as subprime based on loan-to-value (LTV) or debt-to-income (DTI) ratios regardless of FICO score.

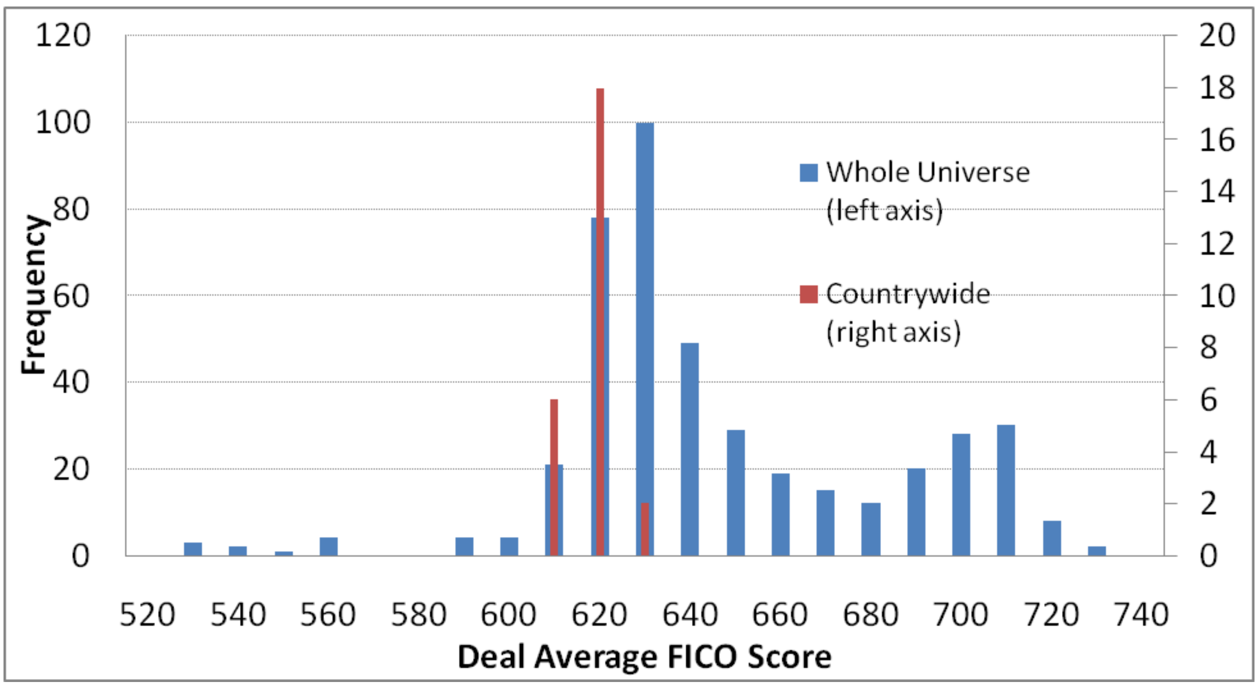
[13] In most cases, deals in the same numerical sequence have the same originator or underwriter, suggesting that same motive force is involved in each deal.

The 22 largest programs cover 50% of the dollar volume[14] and the 65 largest programs cover 80% of the dollar volume.

We recognize that there is likely to be some variation in modification provisions even within a program, and one of the reasons that the results presented here are preliminary is that we have not yet fully tested the assumption of within-program similarity. We have, however, undertaken some testing of the assumption.

First, we have reviewed half the deals in the two largest programs in our sample, a Countrywide program (CWL) and a First Franklin (FFML) program, to determine the contractual limits on material modification. The assumption has held in both cases: We found no significant differences in the material-modification provisions across those programs.

Second, we have looked for similarity within (as opposed to across) programs with respect to a key quantitative variable, the FICO score. As shown below, the deals in the largest single program, one of Countrywide's programs, are much less dispersed than the deals in the whole universe.

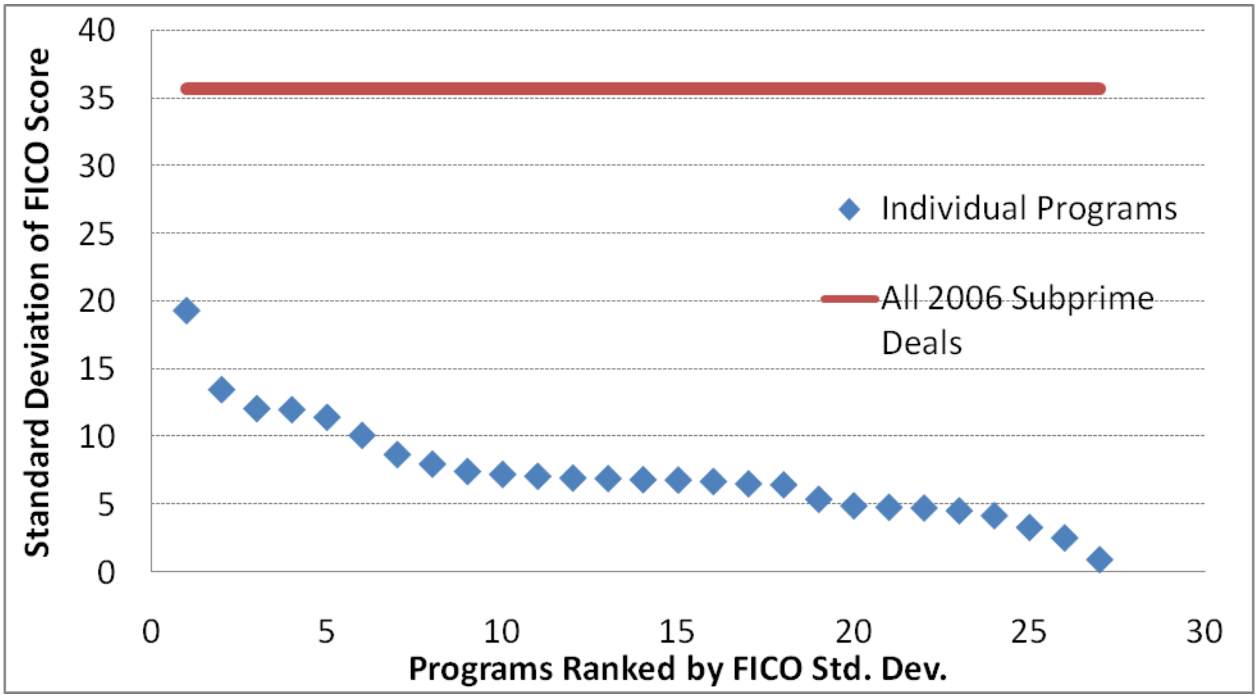


The chart below makes the point more comprehensively. FICO score variance is much less within programs than across the whole universe.[15] That suggests that deals within a program are much more similar to one another than randomly selected deals are. Although one might

[14] All dollar volumes are measured in terms of amounts of principal reported in the prospectus supplement for the deal.

[15] For example, using the Levene test for heterogenerity of variances of non-normal data (using the median as the measure of central tendency), we find that the Countrywide program (the largest program) shows smaller variance than the rest of the universe at the 5% significance level.

argue that not much can be inferred about modification provisions from FICO scores, this result is encouraging.



We stress again, that this assumption, which underlies our assumptions about the total dollar volume of deals covered by various modification provisions, needs to be checked further.

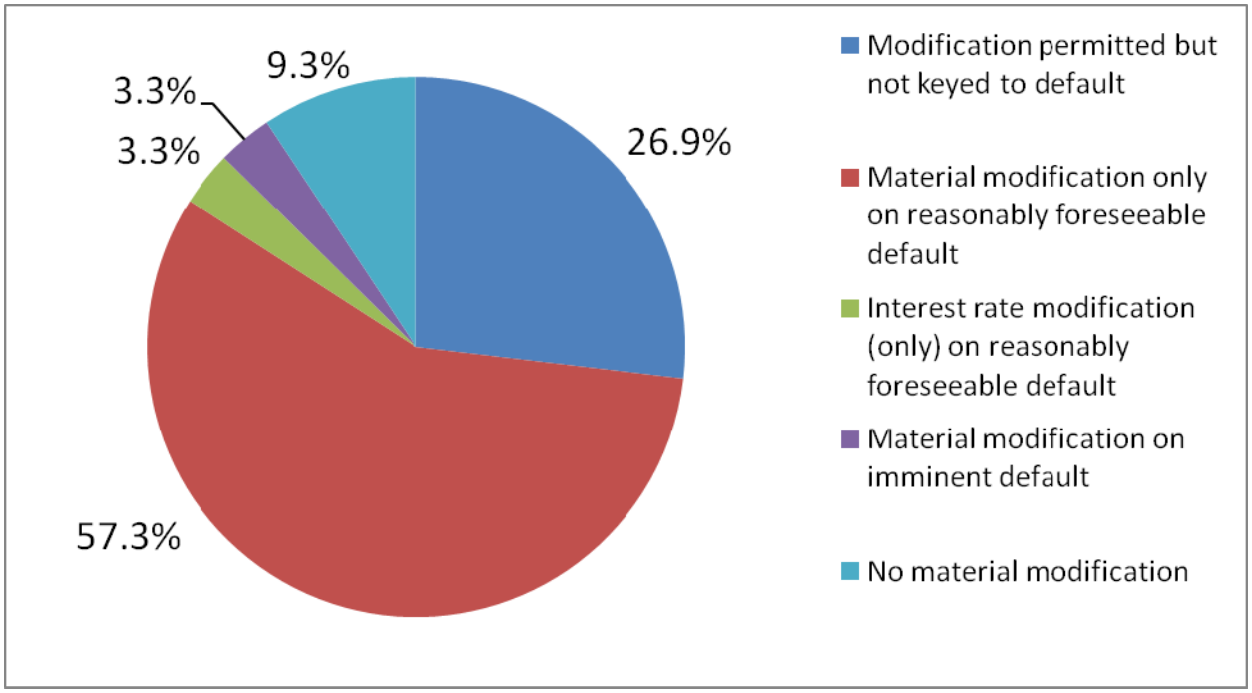
Review Status

The results about dollar volumes and percentages are based on a review of the 20 largest programs, which cover about $207 billion, or 48% of the dollar volume for which information is available. The currently planned ultimate scope of the 2006 review is to cover the top 65 programs, representing 80% of the dollar volume.

Findings About Mortgage Modification Provisions

1. *Outright bans on mortgage modification are rare.*

As shown below, outright, explicit bans on material modification are rare. Only 9.3% of the aggregate principal balance of loans we reviewed are subject to such express bans on material modification, and all of that dollar volume comes from two Morgan Stanley programs. Thus, around 90% of the loan volume we reviewed could be modified subject to the appropriate conditions.

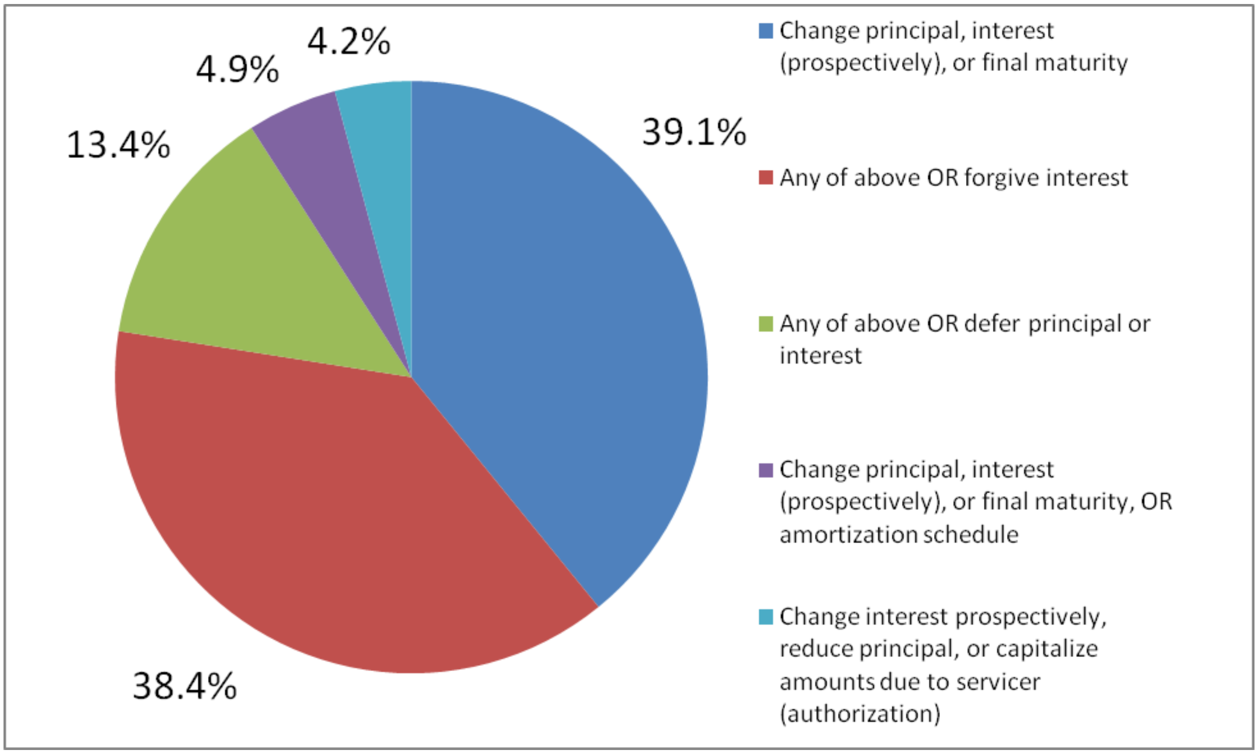


2. *Reasonably foreseeable default is required for material mortgage modification in most cases*.

As shown above, 63.9% of the dollar volume of deals requires reasonably foreseeable default for modification, and another 3.3% of the dollar volume requires imminent default. That fundamental distinction leads us to discuss the two cases, where reasonably foreseeable default is required and where it is not, separately.

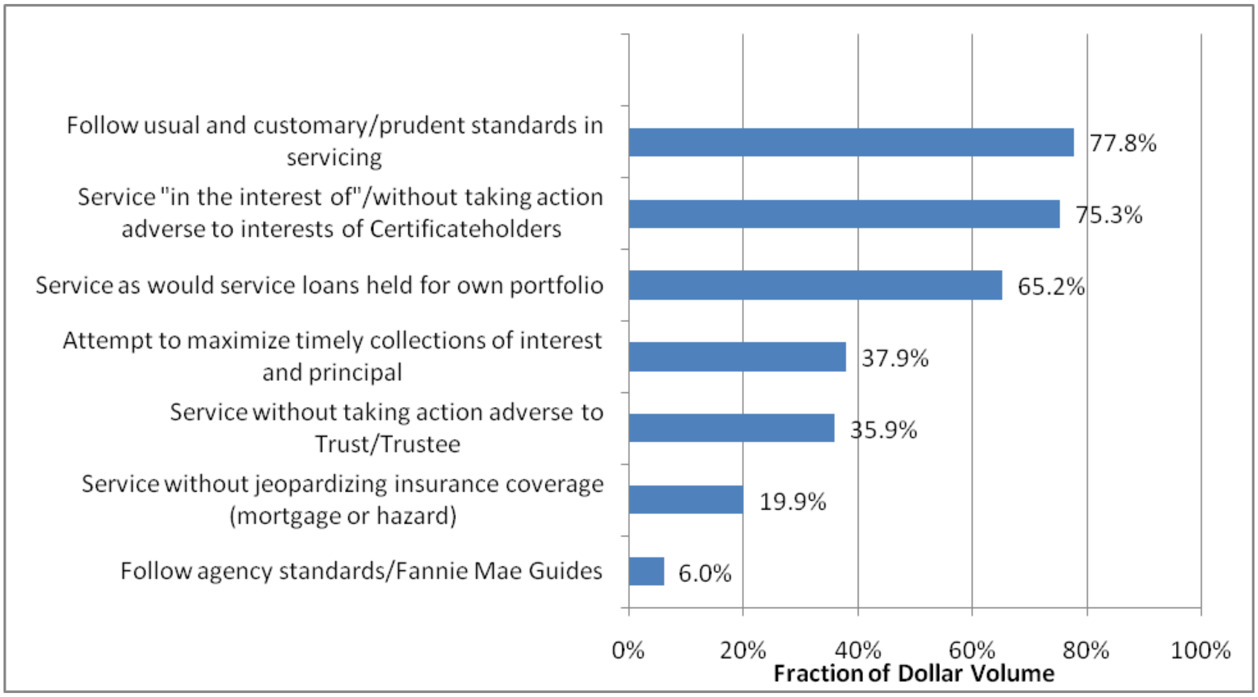
3. *"Material" modification has a fairly consistent definition across agreements: It includes changes to the principal, interest rate, or final maturity.*

Whenever materiality is relevant to modification, a change in principal or interest rate will qualify as material, as shown below. In around 95% of cases, a change in final maturity will qualify as material. Given the uniformity in the definition of "material," it appears that any meaningful modification program will have to comply with whatever restrictions exist on material contract modifications.



4. *In cases where reasonably foreseeable default is required for material modification, additional requirements apply. In broad strokes, these requirements seem intended to cause securitized loans to be modified when unsecuritized loans would be modified.*

We now turn to the case where reasonably foreseeable or imminent default is required for material contract modification. As noted above, that case accounts for about two-thirds of the dollar volume of the deals we have reviewed. A variety of additional restraints apply to contracts in this category, as shown below. The most common rules are that the servicer must follow generally applicable servicing standards, service the loans in the interest of the certificateholders and/or the trust, and service the loans as it would service loans held for its own portfolio. Notably, these conditions taken together can be read as attempting to cause the loans to be serviced as they would have been if they had not been securitized. This is most obvious when the lender to service the securitized loans as it would service loans held for its portfolio, but the other two major conditions can be interpreted in that light as well: The requirement that the servicer administer the loans in the interest of the beneficial owner attempts to recreate the fact that lenders administer the loans they own in their own interest, and most lenders presumably follow standard practices in servicing the loans that they own.



5. *Cases where reasonably foreseeable default is not required fall into two distinct groups: those issued by Countrywide and the others.*

5a. *The important "Countrywide" group* <u>*may*</u> *require the servicer to purchase materially modified loans and impose numerical limits.*

Two Countrywide programs were included in our review, and the larger of those two was the largest single program we reviewed. Together, the Countrywide programs account for $30 billion in dollar volume, or 15% of our sample. The Countrywide PSAs, which do not seem to have any important variation across deals, are the most difficult-to-interpret contracts we encountered. They contain a general authorization to "service and administer the Mortgage Loans in accordance with customary and usual standards of practice of prudent mortgage loan lenders," [16] coupled with two specific, and very limited authorizations to modify: First, they permit the servicer to make certain minor modifications, such as forgiving late fees and providing short extensions of due dates.[17] Second, they provide unqualified authority to modify

[16] *See, e.g.*,CWABS, Inc., Depositor, Countrywide Home Loans, Inc., Seller, PARK MONACO INC., Seller PARK SIENNA LLC, Seller, COUNTRYWIDE HOME LOANS SERVICING LP, Master Servicer, The Bank of New York, Trustee, and The Bank of New York Trust Company, N.A., Co-Trustee, Pooling and Servicing Agreement, Dated as of March 30, 2006, § 3.01. General authority to modify also may be inferred from the provision requiring the servicer to obtain insurer approval if it modifies more than 5% of the loans in the pool. *Id.* § 3.05(a).

[17] *Id.* § 3.05(a).

up to 5% of the dollar volume of the loans if a Countrywide entity purchases the loans from the pool.[18]

The circumstances under which Countrywide PSAs permit modification is the subject of a currently pending putative class action lawsuit, *Greenwich Financial Services Distressed Mortgage Fund 3, LLC v. Countrywide Financial Corporation*, 08-CV-11343 (S.D.N.Y.). In that suit, an investor in Countrywide RMBS asserts that Countrywide was required to purchase any loans it modified from any pools in the CWL and CWALT series,[19] arguing that the modify-up-to-5%-if-purchased provision is the exclusive source of power make material modifications . No substantive decisions have been rendered in this action and no substantive motions are pending.[20]

5b. *The other group of deals for which reasonably foreseeable default is irrelevant to whether loans can be modified is fairly permissive. Modifications are allowed when fairly relaxed requirements are met.*

Deals that (a) are not sponsored by Countrywide, and (b) do not make reasonably foreseeable default a condition for modification, make up $25 billion of volume , or 12% of our sample. These programs impose fairly lenient conditions on modification. Modifications that (a) are consistent with the certificate holder and trust interest, (b) are consistent with the servicer's practice in modifying its own loans, (c) are consistent with the standards of a prudent servicer servicing for its own account , and (d) are not disapproved by relevant insurers would pass muster under all these deals.

<u>Implications of Preliminary Findings</u>

If the deals we have reviewed to date are representative of the entire population of interest – and that is an important qualification – it appears that large-scale modification programs may be undertaken without violating the plain terms of PSAs in most cases. To the extent that contractual limits on modification are obstructing large-scale modification, it seems they are doing so because they are imprecise and servicers expose themselves to litigation risk by making mass modifications.

[18] *Id.* § 3.12(a).

[19] *See* Complaint, *Greenwich Financial Services Distressed Mortgage Fund 3, LLC v. Countrywide Financial Corporation*, N.Y. Cty. Sup. Ct., Index No. 650474/2008 (Dec. 1, 2008), ¶ 3. The named plaintiff asserts that it was an investor in the 2005 CWALT series and not the CWS series, but asserts that the modification provisions of all CWS and CWALT series securitization servicing agreements are materially identical. *Id.* ¶¶ 33-34.

[20] The action was removed from state to federal court; plaintiff moved to remand to state court and that motion has been fully briefed but not decided.

Excepting the 10% or so of agreements that flatly bar modification, it seems possible to craft specific, objective criteria that are consistent with the text of, and capture the apparent intent of, the PSAs. More specifically, legislative or administrative rules could state:

- Default is "reasonably foreseeable" when certain quantitative criteria relating to loan-to-value, debt-to-income ratios, and so forth are met.

- Modifications that satisfy prescribed NPV formulae that are reasonably calculated to produce win-win modifications are "in the interests of the Certificateholders" and "in the interests of the trust" as those terms are used in PSAs

- Modifications that satisfy the prescribed criteria are consistent with usual and customary practice and servicing standards, and satisfy similar PSA provisions.

- A servicer can establish consistency between its servicing of third-party loans and its servicing of its own portfolio loans by showing that loans that are similar in specified respects are treated with a specified degree of similarity. For example, if a servicer treats loans of the same debt-to-income and loan-to-value ratios similarly, it would satisfy the requirement to service securitized loans in the same way that it services portfolio loans.

- The authority to service includes the authority to modify loans in the interest of the beneficial owner in the event of reasonably foreseeable default absent any contractual bar on doing so.

Thus, it seems likely that contract-language impediments can be removed by clarification rather than abrogation. Thus it may be unnecessary either to create a special bankruptcy regime to permit the writedown of home mortgage liens in areas that have seen steep price declines[21] or to invoke the gold-standard cases to annihilate contract restrictions.[22] Instead, it seems possible to adopt clarifying interpretations on a mass basis that are reasonably calculated to capture the contracting parties' intent and that remove *contractual* impediments to win-win modifications.

The distinction between mass clarification and mass abrogation (either directly or through specialized bankruptcy changes) may strike some as semantic, as a similar loan modification program could end up in place under either approach. But we think the similarity of result is a *strength* of the proposal here. Abrogating private contracts in time of crisis for what

[21] *See* Zingales & Posner, *supra* note 2. Note that we are not commenting in this paper on proposals to change the treatment of home mortgages in bankruptcy.

[22] *See* Gelpern & Levitin, *supra* note 2.

could be seen as political reasons may be necessary in some circumstances, but it is a power that should be used exceedingly sparingly.

Another objection is that mass clarification is just mass abrogation under another name. But there is a difference between, on the one hand, adopting an interpretation that is consistent with contract text and what we know about contract purpose and making that interpretation controlling and, on the other hand, adopting a result that is known to be inconsistent with the contract. In the former case the parties' intent is respected to the extent it is known (although the process for ascertaining the intent is abrogated by adopting a standard across the board rather than conducting a judicial inquiry into every case), while in the latter case the parties' intent is disregarded. The former entails far less risk of long-term damage than the latter.

A third objection is that the proposal here will lead to arbitrary results. Homeowners who borrowed the 10% or so[23] of subprime mortgage loan volume that is subject to an absolute bar on material modifications will not get the same kinds of deals as other homeowners, who may be otherwise identically situated. It will be difficult to explain to these homeowners that they are not getting mortgage modifications because of who securitized their loans. This does seem inequitable, but if the problem is relatively small as it seems, then it does not seem dispositive. First, if 90% of the foreclosure crisis is solved, we will no longer have a foreclosure crisis in the same sense we now do. Second, although PSAs are difficult to amend, amendment typically is not impossible. Widespread, successful modification programs might spur the parties to inflexible deals to undertake amendments to allow modifications. Finally, it is important not to overstate the inequity to these homeowners as they are not being treated any worse than what their contracts provide.

This proposal does not address other factors that may be obstructing win-win modifications, such as the servicers' compensation structures under PSAs. Nor does it address the possibility that society as a whole could benefit from modifications that are not win-win in the sense that the increased likelihood of repayment compensates the investors for the reduction in the nominal amount of their claims. This could happen, for example, if foreclosures cause significant externalities as is often claimed. Both these issues can be handled by separate mechanisms, however.

[23] We stress again that the finding that 10% of the dollar volume of contracts is subject to an absolute bar on modification is a preliminary one based on an incomplete sample. It is broadly consistent with the findings of the Bear Stearns study, as reported in the *New York Times*, that 10% of mortgage deals permitted no modification. *See* Bajaj, *supra* note 9.