

Comment on Michael A. Stegman et al.’s “Preventive Servicing Is Good for Business and Affordable Homeownership Policy”: What Prevents Loan Modifications?

Kurt Eggert

Chapman University School of Law

Abstract

After discussing the article by Stegman et al., this comment describes the barriers to preventive servicing for securitized residential loans and assesses the importance of loan modifications, given the recent increases in default and foreclosure rates for subprime loans. Several hurdles slow or reduce such modifications, even those that help borrowers and investors alike. For example, self-interest may reduce servicers’ willingness to modify loans rapidly. In addition, underlying securitization agreements may impede servicers’ ability and discretion in this area. Further, tax laws that govern a common securitization entity may limit modifications, as may accounting standards. Finally, “tranche warfare,” the sometimes contradictory fiduciary duties servicers have toward investors holding different tranches of securitized pools, may decrease their ability or their willingness to modify loans.

This comment concludes that barriers to effective loan modifications should be reduced or eliminated where feasible, but that the securitization of subprime loans creates risks for borrowers.

Keywords: Mortgage servicing; Securitization; Subprime and predatory lending

Introduction

The Stegman et al. article comes at an important and dangerous time for the U.S. subprime mortgage market. Rising defaults, with their accompanying increase in foreclosures, endanger not only many homeowners, but also subprime lenders and investors in securities backed by subprime loans. The early default rate for loans originated in 2006 was 51.6 percent higher than it

was for loans of the same age originated in 2005 and 137 percent higher than for similar loans originated in 2004 (Collins 2007). One study estimated that one out of every five subprime mortgages made between 2004 and 2006 will end in foreclosure; this is double the estimated foreclosure rate for loans made in 2002 (Schloemer et al. 2006). Estimated loss rates may well keep increasing.

More than 50 subprime lenders have closed, declared bankruptcy, or otherwise exited the subprime market since the beginning of 2006 (Pierce 2007). According to one rating agency, investors in subprime loans face significant losses in their investments, since pools of 2006 subprime mortgages could have loss rates as high as 8 percent; this estimate is one-third higher than the estimate this agency did just six weeks earlier (Henry 2007).

Many commentators have tied the increase in defaults directly to loosened subprime underwriting standards, the riskier types of loans being made and then securitized on Wall Street, and the layering of different risks in making and securitizing these loans (Kornfeld 2007). The subprime market has transferred the risk of interest rate increases onto borrowers by supplying them with adjustable-rate rather than fixed-rate loans. Nearly 80 percent of all subprime loans that were securitized in early 2006 were adjustable-rate mortgages (ARMs) (Bair 2007a). Riskier loan products include hybrid ARM loans with low teaser rates that quickly reset after two or three years, often to above-market rates. These hybrid ARMs have made up a majority of subprime originations for the past several years (Thompson 2007). Such loans can cause “payment shock” if they quickly reset to unaffordable levels (Calhoun 2007a).

Some industry observers have predicted that defaults will continue to increase as more hybrid ARMs reset and that the defaults so far are “merely the tip of the iceberg” (Litton 2007). Faced with these rising defaults, federal agencies have attempted to force lenders to tighten their underwriting standards, issuing a guidance in October 2006 and a proposed statement in March 2007. Both discouraged stated income (as opposed to documented income) loans and would require regulated lenders to underwrite the loans based not on their teaser rate payments, but on the fully indexed and fully amortizing payments (Rushton 2007). A similar final Statement on Subprime Mortgage Lending was issued June 29, 2007 (Office of the Comptroller of the Currency et al. 2007).

The secondary market is enforcing its own version of the guidance, and subprime lenders are raising minimum credit scores and lowering maximum loan-to-value ratio (LTV) requirements (Pyburn 2007). With investors

increasingly wary of excessive default rates, subprime lenders have responded by cutting loan programs based on high LTVs, little documentation, and low credit scores (Credit Suisse 2007).

How much subprime underwriting has actually changed is difficult to determine, however, and some lenders could still be making loans with risky characteristics, such as stated income or interest-only loans (Calhoun 2007b). At the time of this writing, the subprime market is currently so volatile, it is difficult to predict from one month to the next what types of loans will be available to which borrowers and which subprime lenders will remain in business. By July 2007, securitization of subprime loans had almost shut down, falling to less than 12 percent of its average during the first half of 2007 (Leinfuss 2007). Stricter underwriting and fewer new subprime loans, while protecting new borrowers, may prevent some borrowers with existing subprime loans from refinancing. The subprime market had essentially used loan refinancing as a loss mitigation technique (Pyburn 2007). With the meltdown of the subprime market and the tightening of underwriting standards, borrowers may discover that they are not eligible for the refinancing they anticipated would save them (Kornfeld 2007). However, many existing subprime borrowers would be harmed if they refinanced into loans for which they would not be eligible under the new standards. Given that these new standards are designed to limit new loans to those likely able to pay them for the life of the loan, borrowers who refinance into new loans in violation of such standards would face significant risk of being unable to pay those loans and could face a new round of default and foreclosure. While they might have delayed foreclosure for a short time, they do so at the risk of having even more of their equity stripped and losing defenses that they might have had against the first loan.

Nor should they expect to be saved by housing price appreciation. One rating agency predicts that the median home price in the United States could fall “5% to 6% by the end of this year, on top of a 3% decline over the past 12 months” (Standard & Poor’s 2007). The tightening of underwriting, along with declining housing prices, may be one factor in the increased default rates, as borrowers default instead of refinancing (Fitch Ratings 2007a).

The importance of servicing in the face of defaults

To help borrowers with existing subprime loans, federal agencies have turned their attention to loan servicers. Borrowers often find that the way a loan is serviced affects them more than the way it was originated (Zalenski 2003). Federal regulators have emphasized to the entities they oversee that

no regulatory penalties will be imposed if entities engage in reasonable loan modifications to help borrowers with financial problems (Thompson 2007).

In April 2007, federal regulatory agencies released a document titled *Statement on Working with Mortgage Borrowers*, which seems to be intended to encourage loan modifications and other loss mitigation techniques that keep borrowers in their homes (Office of Thrift Supervision et al. 2007). That statement encourages financial institutions to pursue prudent workouts for “financially stressed” borrowers and lets institutions know that the “agencies will not penalize financial institutions that pursue reasonable workout arrangements with borrowers who have encountered financial problems.” However, many loans are not serviced by federally regulated financial institutions, so these efforts are hampered by the lack of coverage over the servicers that will make the crucial decisions on what loan modifications to offer borrowers.

The growing recognition of the importance of servicing and appropriate loss mitigation indicates the timeliness of the Stegman et al. article. The subprime market is facing what has been termed an “impending flood of loan modifications” (Credit Suisse 2007). Since borrower-friendly loss mitigation techniques represent one of the best available methods of lowering the foreclosure rates for existing subprime loans, it is important to determine which loss mitigation methods result in the lowest foreclosure rates.

Some research has already been done, both by academics and by industry participants. Pennington-Cross and Ho (2006) found that the servicer affected the chance of default to a strong degree and the possibility of prepayment to a lesser, but still substantial, degree. Gan and Mayer (2006) reviewed the actions of servicers to determine when they operate most efficiently and concluded that they alter their behavior depending on whether they own a first-loss position for the loans they service. When the loan pool contained more delinquent loans, the special servicer that owned the first-loss position appeared to delay foreclosure, perhaps to prolong the acquisition of fees or to share the loss with investors in other securities (Gan and Mayer 2006).

Others have studied whether forbearance plans and loan modifications prove helpful to borrowers. One study found that even controlling for such factors as the borrower’s credit condition, low- to moderate-income borrowers who engaged in loan modification programs were 68 percent less likely to lose their homes through foreclosure or a foreclosure alternative than borrowers without such programs and that the failure rate for other borrowers is reduced by almost 80 percent (Cutts and Green 2004). Capone and Metz (2003) studied the Federal Housing Administration’s policy of encouraging servicers to enter into forbearance agreements. Their study found that such

encouragement more than quadrupled the percentage of loans that went through a forbearance agreement after having been delinquent at least 90 days and at the same time dramatically reduced the number of such loans reaching foreclosure (from 77.6 percent in 1998 to 14.5 percent in 2002) (Capone and Metz 2003).

Rating agencies have also recognized the great effect that servicers have on the performance of the loan pools they oversee. One rating agency estimated that servicer performance affects loss severities so greatly that even where the pools are composed of similar loans with similar borrowers, loss severities can still vary by 30 percent (Eggert 2004, citing Fitch Ratings). Another rating agency opined that “servicer quality can increase or decrease loss levels by up to a total of 20%—plus or minus 10%” (Moody’s Investor Service 2001).

The article by Stegman et al. furthers this research by using a database of 28,000 affordable housing loans to determine whether the identity of the servicer affects the outcome when those loans go into default. The goal is to determine how much delinquency outcomes are affected by the loan servicer in an effort to discern what behavior has the most beneficial or detrimental effect on borrowers who become delinquent. Recognizing that the variation between servicers might be due in part to the different portfolios they hold, Stegman et al. attempt to control for those borrower characteristics that might themselves affect the outcome of delinquent loans, such as LTVs or credit scores, and economic conditions such as changes in property values. Controlling for these variables is challenging in that some of them are not independent.

In line with other studies on the effect of servicers on borrower outcomes, Stegman et al. find that different servicers appear to have significantly different odds of cure for borrowers in their portfolios, with one group exhibiting a 40 percent lower chance of cure than the other servicers studied. While the study deals with only a small number of servicers, it still provides more evidence that the servicer affects the outcome of a loan. In an effort to dig deeper, Stegman et al. try to discover what factors affect the cure rate of delinquencies. Using telephone interviews with the main servicers they study and supplementing those interviews with additional information from the servicing manager of Self-Help, they attempt to discern how large the servicer collections staff is, which timeline is followed, and which servicing technology is used. However, there appears to be so much variation among loss mitigation methods that the authors find it difficult to deduce what would constitute best practices. Further study with a larger number of servicers should focus on the methods that separate the servicers with higher cure rates

from their less successful counterparts. In this way, researchers can home in on best practices for preventing foreclosure.

The goal is to find the forms of “preventive servicing” and “smart servicing” that can best reduce the chance of foreclosure. “Preventive servicing” is defined as “delinquency management practices that emphasize early intervention and default management practices that help financially troubled borrowers avoid foreclosure” (245). “Smart servicing” means “technologies that enable preventive servicing” (245), including the use of “modeling software and scripted menu options to engage collector and borrower” (Fields 2001, 27, quoted on page 245). These seem to have at least some potential for helping certain borrowers avoid foreclosure. Effective loan modifications, which can result from preventive servicing, can both reduce borrowers’ payments, helping to keep them in their homes, and save investors from credit losses that result from foreclosure (Litton 2007). Loan modifications have been called the “number one tool... available to deal with the impending issue of ARM resets” (Litton 2007).

Limitations of preventive servicing

While the principles of preventive servicing can be useful to help borrowers in default, it is important to recognize their limitations. Early intervention and modeling software will not help a borrower who fundamentally cannot afford a loan. When a servicer determines that investors will benefit more from foreclosing on a loan than from modifying it, the servicer may be required by the securitization agreement to foreclose despite the damage this may do to the borrower (Bair 2007b). If because of predatory lending borrowers have been put in loans they cannot afford, they will need more than mere early contact and payment deferrals.

Servicers are reporting that the effectiveness of basic loss mitigation techniques such as repayment and forbearance plans is decreasing, and neither strategy is expected to work regularly when the underlying problem is an ARM reset (Fitch Ratings 2007b). More and more, troubled borrowers will likely need significant loan modifications, such as principal and interest reduction, which currently are difficult to obtain from servicers (“Subprime Workouts Will Be Difficult without Servicer Involvement” 2007). One rating agency estimates that in the next 12 to 18 months, up to 5 to 10 percent of the loans serviced might be modified, and loan modification may be the only reasonable loss mitigation strategy for as many as 40 to 50 percent of the loans that are in default or for loans where default is reasonably foreseeable (Fitch Ratings 2007b).

Even when servicers modify loans, the borrower may quickly default again if those modifications are not significant enough. In one review, 38 to 40 percent of borrowers redefaulted after loan modifications (Credit Suisse 2007), indicating that servicers often have not modified the loans enough to allow some borrowers to make their payments. The redefault rates could increase as the subprime market worsens (Fitch Ratings 2007b).

Worse yet, if the modification requires the borrower to waive claims involved in the origination and servicing of the loan, the modification may cause net harm to that borrower, because he or she may have lost the ability to obtain full relief from a predatory loan. Lenders and servicers often require such waivers for loan modifications, placing borrowers on the horns of a dilemma because they must decide whether to give up their claims against lenders and servicers in return for a modification that may stave off foreclosure but may be too little to save their house in the long run (Berenbaum 2007).

Further, the value of preventive servicing may be declining. Servicers report that it is increasingly difficult to contact borrowers and that their attempts at contact, both by letter and by telephone, are becoming less effective. Some servicers note that borrowers are less cooperative and more often go to foreclosure without communicating with the servicer (Fitch Ratings 2007b). This declining effectiveness, coupled with the barriers to loan modifications discussed later, may harm borrowers and investors alike.

Servicers' costs and self-interest

There are several barriers to effective preventive servicing and its attendant loan modifications. A primary hurdle is the cost of the hands-on techniques that such servicing would require. Loan modifications are labor intensive. The servicer must carefully determine how much the borrower can repay to maximize the return to investors while at the same time reducing the likelihood that the borrower will default again. Many servicers demand extensive and exact documentation of borrowers' assets and income to process a modification, essentially re-underwriting the loan (Credit Suisse 2007). Ironically, servicers may be demanding far more documentation to modify a loan than the originator did to make it in the first place. Also, modifications can be expensive for servicers, with costs estimated at between \$500 and \$600 (Nomura Fixed Income Research 2007).

As defaults and loan modifications increase, so too will servicing costs. Defaults drive servicing costs higher, since servicers have to engage in time-intensive loss mitigation and loan modifications. Also, as fewer loans are

refinanced, the ratio of performing to nonperforming loans decreases as the latter stay in pools longer, further increasing servicer costs (Fitch Ratings 2007b). One subservicer has stated that while servicers may receive fees of 35 to 50 basis points to oversee pools of subprime loans, they might actually need up to 125 basis points just to cover their costs under current conditions (Berry 2007b). According to Fitch Ratings, “Any servicer...which has predominantly subprime credit quality loans in portfolio, could find its timelines and overall cost to service facing increased levels not seen in recent history” (2007a). Not only will increasing defaults make subprime servicing more expensive, so too will the more complex, exotic loan products such as option payment or hybrid ARMS. These loans are more challenging for servicers, because of their varying interest rates, complicated payment plans, and the likelihood that they will be accompanied by customer disputes and claims of predatory lending (Dymi 2007).

Moreover, the income that servicers receive will not necessarily rise to pay for these extra costs. Typically, servicers’ income comes from the contractually set fee, plus the float on the mortgage payments that have been collected. In addition, servicers receive late fees and other fees from borrowers (Walsh 2005). Subprime servicers depend far more on ancillary income, such as late fees, than prime servicers do. While subprime servicers may receive 25 more basis points in servicing fees than prime servicers do, their costs were estimated to be 40 basis points higher than prime servicing costs even before the recent rise in defaults (Office of the Comptroller of the Currency 2003).

When faced with rising default rates, servicers may be tempted to cut costs by turning to automated, rules-based foreclosure decision making rather than increasing their personal contact with delinquent borrowers. Servicers can use automated software with predictive analytics to determine which borrowers should be contacted upon default and which should be allowed to proceed straight to foreclosure. The software relies on computer-generated property valuations, automated LTV calculations, refreshed credit scores, and “complex algorithms and cash-flow scenarios to assess different resolution paths” (Deloitte Financial Services 2006). If more servicers move to such automated programs, only a small percentage of loans rather than most of them would be reviewed by a person (Garritano 2007). Borrowers in default might find themselves subject to inflexible automated programs, without anyone they can contact to explain their position or appeal to for help.

Another potential barrier to loan modifications is servicers’ self-interest. Internal policies may discourage loan modification even when the underlying securitization agreements (discussed later) allow it and nothing else prevents

it (Credit Suisse 2007). While preventive servicing can at times help both borrowers and investors, servicers' self-interest can sometimes harm borrowers, even at investors' expense. Borrowers do not choose servicers, who therefore have little reason to spend time and money keeping borrowers happy (Eggert 2004) unless they hope to sell additional financial services ("Wells Wants to Double Cross-Sales" 2006). Some servicers have regularly engaged in abusive practices designed to increase their income to the detriment of borrowers. Such practices include improper foreclosures or attempted foreclosures; imposition of improper fees, especially late fees; forced-placed insurance that is not required or called for; and misuse of escrow funds (Eggert 2004).

Servicers have responded to the rise in their costs by seeking extra income, such as incentive payments for making loan modifications (Berry 2007b). Subprime servicers have long been able to make up for their shortfall in servicing fees with ancillary charges such as late fees. In 2006, subprime servicers collected about three times the late fees per loan as prime servicers (Cornwell 2007). Given their dependence on late fees, subprime servicers may be in no great hurry to help borrowers become current, even if they do not actively engage in abusive practices.

Faced with a borrower who is only 30 days delinquent, a servicer may have interests that conflict with a rapid resolution of the delinquency. First of all, the servicer may be deriving substantial income from the continuing late fees. Second, the servicer might hope to save money by doing nothing, in the hope that the borrower will bring the loan current without any action (Gan and Mayer 2006).

Structural barriers to preventive servicing

Securitization entails several structural barriers to effective loan modification for defaulting borrowers. The first is that the servicer is constrained by the terms of the initial pooling and servicing agreement (PSA) that created the securitized loan pool and documented the powers and duties of the servicer, as well as the limits of that entity's discretion in dealing with borrowers (Borod 1998). While PSAs often grant the servicer a certain amount of discretion in modifying loans, some agreements sharply limit such powers and others essentially bar loan modifications (Sinha 2007). Altering a PSA might require the consent of all or two-thirds of the investors, a particularly daunting prospect when many of the investors are foreign (Bair 2007b).

A common PSA gives discretion in crafting loan modifications, but requires the servicer to act in the best interests of the certificate holders (Credit Suisse 2007). Some add that the servicer must attempt to maximize

the net present value of cash flows, even if doing so mandates the foreclosure of a loan that a modification could have saved (Bair 2007b). Moreover, some PSAs have exact limitations on how many modifications can be made in the entire pool of loans governed by the agreement. Most older securitizations and even some more recent ones require servicers to obtain the approval of the bond insurer and rating agency and possibly even the credit enhancement provider before they can modify more than 5 percent of the loans in a securitized pool (Bair 2007b). A Bear Stearns analysis found that, in half of the mortgage securities making up an index that is followed widely, the servicer can modify the principal balance of the loan or its interest or maturity. In 40 percent of the securities, some modifications are allowed, but if more than 5 percent of the pool is changed, approval by the rating agency is required. In 10 percent of the loans, no modifications are allowed at all (Bajaj 2007).

Similarly, when Credit Suisse examined 31 transactions backed by sub-prime loans, it found that about one-third of the underlying bond deals limited to 5 percent the number of loans that could be modified. Other limitations included requiring specific loss mitigation procedures, limiting the number of modifications in any year or during the life of the loan, and restricting the amount that the interest rate could be reduced (Credit Suisse 2007). Servicers appear to be attempting to have these loan modification restrictions removed. The president and CEO of one servicer reported that his company was working with rating agencies to convince investors to allow such caps to be removed (Litton 2007).

Even the granting of some discretion may not necessarily lead to its exercise, however. For example, the wording may be so vague that the servicer is unwilling to test its limits and so does not use it to make loan modifications. Poorly drafted grants of discretion could also lead to disputes and litigation between the servicers and investors over the extent of servicers' powers (Simon 2007).

The servicing agreement may slow the loan modification process. The PSA may require the servicer to wait a set period of time, such as 30 days, before it can offer the borrower any meaningful relief (Simon 2007). A servicer may be required to wait even when it is clear to both the borrower and the servicer that the borrower will not be able to repay the loan under its original terms. Advocates for borrowers complain that many servicers wait at least three months before they are even willing to discuss loan modifications (Bajaj 2007).

Impediments in tax laws and accounting standards

Tax laws governing the entity holding a pool of loans may also delay effective modification. For tax reasons, many subprime loans are securitized as Real Estate Mortgage Investment Conduits (REMICs) (Kravitt 2005). Loan pools that are established as REMICs must follow the rules governing them or else lose their REMIC status, with disastrous tax results. One such rule requires REMICs to have a static loan pool, so that, with certain exceptions, loans cannot be added to or taken away or even significantly modified once a REMIC is established. In one such exception, loans can be modified if they are in default or if default is reasonably foreseeable (Kravitt 2005, citing Treasury Regulation §1.860G-2(b)(3)).

Whether a default is reasonably foreseeable must be determined on a case-by-case basis, and the Internal Revenue Service leaves this determination to servicers (Bair 2007b). Some securitization documents require servicers not only to determine that default is reasonably foreseeable, but also to supply a legal opinion that the loans can be modified without causing the pool to lose its REMIC status. Even where such an opinion is not required, the servicer may choose to obtain one to protect itself before finalizing a loan modification (Bair 2007b). Requiring legal opinions can delay the process and, by injecting expense, also makes loan modifications less common and more expensive.

Another obstacle is thrown up by accounting standards for the special-purpose entities (SPEs) that hold securitized loan pools. The Financial Accounting Standards Board (FASB) of the Financial Accounting Foundation has promulgated financial accounting standards (FASs) to govern the creation of these entities. Specifically, FAS 140 governs SPEs and determines which of them qualify for special accounting (FASB 2000). To qualify, the assets transferred to the SPE must be “passive in nature” (paragraph 35c(1) at p. 25), and an asset or instrument is passive “only if holding the asset or instrument does not involve its holder in making decisions other than the decisions inherent in servicing” (paragraph 39 at p. 27). Paragraph 61 (at p. 35), which defines servicing, says that it “commonly includes, but is not limited to” actions such as “monitoring delinquencies; executing foreclosure if necessary,” but is silent on loan modifications.

This silence has led to great consternation about whether and when loan modification by servicers would cause SPEs to no longer qualify under FAS 140, to “blow their ‘Q’ status,” in the industry jargon (Berry 2007a). If the SPEs do not qualify under FAS 140, then the transferors lose their ability to count the assets transferred as off-balance sheet and so lose some of the ben-

efits of securitization (Jeffrey 2002). One servicer reports that while it has an active loan modification program for unsecuritized loans, his unit is “waiting for FASB to make a ruling before we can modify loans in securitizations” (Berry 2007a, 1). Other industry representatives have argued, however, that loan modifications and other loss mitigation efforts by servicers are merely part of the passive ownership of loans and so should not threaten an SPE’s status as a qualified entity under FAS 140 (DeBoer 2006). In response to these concerns, Christopher Cox, chairman of the Securities and Exchange Commission (SEC), sent a letter to Barney Frank, chairman of the House Committee on Financial Services, with an enclosed memorandum prepared by the SEC’s Office of the Chief Accountant (Cox 2007). Both the letter and the enclosed memorandum assert that, based on an FASB “educational forum,” the SEC’s professional staff believes that loan modifications undertaken when default has either occurred or is reasonably foreseeable would not disqualify SPEs under FAS 140.

Barriers arising from “tranche warfare”

In addition to barriers in the securitization agreements and tax laws, the nature of securitization may also cause difficulties in making such modifications (Eggert 2002). Securitization takes what would normally be a unitary asset, a note secured by a deed of trust or mortgage, and subdivides it by pooling it with other loans and dividing the interest in the overall loan pool into different classes of securities. These different classes of securities, called tranches, may own different aspects of the note—for example, one the first payment of principal, another the payment of interest, and another the residual payments after all other classes have been paid off. Particular tranches may be affected very differently by early repayment or late payment (Downs and Fowler 1997).

A modification that saves a borrower by reducing the interest rate of the loan might benefit tranches with an interest in principal payments, but hurt other tranches that depend on high interest rates for their profits. If servicers delay the recognition of losses by modifying loans, this could help some tranches while harming others. Securitization deals may contain performance clauses whereby the principal is released to subordinate classes or overcollateralization of the loan pools is reduced if “trigger tests” of the pool’s performance are met (Fitch Ratings 2007b). Subordinate classes may then be helped and senior classes harmed if modified loans are treated as current and the loan passes the trigger tests (Nomura Fixed Income Research 2007). If, instead, modified loans are treated as delinquent for such trigger

tests, then an aggressive modification policy could harm subordinate classes by ensuring that a significant portion of the loans are deemed delinquent.

This conflict of interest between tranches, or “tranche warfare” (Eggert 2002, 560), could well make it more difficult for a servicer to engage in meaningful loan modification. While this fiduciary dilemma might not prevent loan modifications, it might slow them down or make a servicer less willing to engage in modifications that would significantly reduce the principal owed or the interest rate that would accrue. Some have predicted that tranche warfare may spawn litigation, not only between servicers and investors, but also between dueling classes of investors (Nomura Fixed Income Research 2007).

The confounding influence of other securitization interests

Another challenge for servicers making loan modifications might arise where various interests in the securitization pool have been split off and sold separately or securitized. For example, hedge funds and other investors can hold derivative interests in loan pools that increase in value as defaults mount and mortgage bonds are written down. A group of more than 25 hedge funds reportedly complained to a derivatives industry oversight group recently that banks that both service loans and sell derivatives based on those loans were entering into modifications to avoid paying off on derivative contracts as required when loans default (Scholtes 2007). If their claim is successful, banks that sell derivative contracts may be limited in their ability to modify mortgages in the affected pools.

The right to collect prepayment penalties from a pool of loans can also be split off from the right to collect the principal or interest payments on those loans. If prepayment penalty rights have themselves been securitized, then they would be owned by a completely separate group of investors than the remaining income stream. The owners of the rights to prepayment penalties could claim that a significant reformation of a loan, one that alters its principal and interest, is essentially refinancing the loan and should trigger their prepayment penalty (Engel and McCoy 2007). A sizable prepayment penalty, common in the subprime world, could sabotage much of the benefit of a modification. If loans are done as reformations rather than replacements and are not repaid in any way, modifications should not trigger prepayment penalties (Bair 2007b). However, the possibility of claims by the owners of prepayment rights might lower servicers' willingness to modify loans.

To the extent that securitization encourages the creation of residual interests, it also makes effective loan modification more difficult. Worse yet,

the holders of residual interests may have their own agreements with servicers, agreements that are relatively hidden from investors (Credit Suisse 2007). These third-party agreements may include additional limitations on modifications.

Conclusion

The current rise in subprime defaults shows the importance of understanding how preventive servicing and loan modifications can reduce the incidence of foreclosures in the subprime market. Creating a best practices standard for subprime servicing requires an understanding of which practices are most likely to cure defaults and which cures will last. Given the large number of subprime borrowers with loans that are resetting to significantly higher rates, servicers will often have to do more to prevent foreclosures than just make early contact and offer payment deferrals. Instead, they must also be willing and able to modify loan terms, including the interest rate and principal.

Lawmakers, regulatory agencies, and industry participants should reduce or eliminate barriers that prevent or slow effective loan modifications. Investors should be pressured into agreeing to changes in PSAs to allow modifications, and securitizers should be dissuaded from inserting such provisions in new PSAs. Tax laws governing REMICs and accounting standards should be amended and interpreted to give servicers the discretion they need to modify loans or, where such discretion cannot or should not be given, to prevent the affected loans from being securitized. Servicers should be as free as practicable to modify loans to reduce foreclosures.

However, the challenges that borrowers and servicers face in reaching effective loan modifications demonstrate that the securitization of subprime loans can harm borrowers. Policy makers should recognize this danger and the damage it can do when they decide whether to support or discourage the securitization of subprime loans. The complex webs that securitization weaves can be a trap and leave no one, not even those who own the loans, able effectively to save borrowers from foreclosure. With the loan sliced and tranching into so many separate interests, the different claimants with their antagonistic rights may find it difficult to provide borrowers with the necessary loan modifications, whether they want to or not. In the tranche warfare of securitization, unnecessary foreclosures are the collateral damage.

Author

Kurt Eggert is a professor of law at Chapman University School of Law.

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