



CR REPORT

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The Mortgage Debacle and LOAN MODIFI CATIONS

Summary of a November 2007 workshop held at the Federal Reserve Bank of Cleveland

by O. Emre Ergungor

In today's increasingly sophisticated financial markets, loan modifications are often complex processes that involve multiple players with competing legal and financial interests. To better understand loan modifications, the Federal Reserve Bank of Cleveland hosted a one-day workshop in November 2007 featuring four financial and legal experts—Tony Saunders from Arizona State University, Steven Schwarcz from Duke University, Joseph Mason from Louisiana State University, and Kathleen Engel from Cleveland State University—who shared their knowledge and recommendations for possible solutions to the mortgage lending debacle.

loan

Foreclosure is an expensive resolution to a mortgage delinquency, even in the best of times.

A typical foreclosure's cost to the lender (or investor) has been estimated at 20–25 percent of the loan balance, or about \$60,000 on average.¹ This includes fees for litigation (for example, nuisance lawsuits filed by neighbors if the property is vandalized or not properly maintained), maintenance costs, and property taxes. Beyond the costs borne directly by the lender are those imposed on the community; vacant and boarded-up homes may fall into disrepair and depress the prices of neighboring properties. Deterioration in the quality of the housing stock may make lenders more stringent in their lending standards and limit area homeowners' access to credit. Certainly the weakening housing market and growing number of vacant properties make it more difficult for investors to move these properties off their balance sheets—and turn some financial firms into real-estate-management companies. Any way you look at it, foreclosures are costly for lenders and investors, who might rather accept a lower return on their investment than own a piece of vacant real estate.

Simply stated, a loan modification is a permanent change in the terms of a mortgage loan that makes it more affordable for the borrower.

Loan modification has been suggested as a way to keep people in their homes as well as a lower-cost solution to lenders' delinquency problems. Simply stated, a loan modification is a permanent change in the terms of a mortgage loan that makes it more affordable for the borrower. Only a few decades ago, when lenders originated mortgages and kept them on their balance sheets until they were paid off, modification was a relatively simple process: If borrowers missed some payments, they and their lenders would get together, go over the finances, and find out whether a modification was in everyone's best interest. Today, however, mortgages are bundled and sold to investors around the world through the process of securitization. As a result, the modification process entails many legal complexities and involves many parties with differing, sometimes conflicting, interests.

Given the current home financing debacle, investors, homeowners, policymakers, and researchers are all asking the question, what happened? To understand where and how our mortgage financing system failed—and how these pitfalls may hinder loan modifications—it is helpful to consider several questions:

- **First**, who are the parties involved in securitization deals involving mortgage-backed securities (MBS) or collateralized debt obligations (CDOs)?
- **Second**, what went wrong in this securitization system?
- **Third**, what are the key legal issues in loan modifications? (In addressing this particular question, it is useful to also consider the alternatives to loan modification and their consequences.)
- **Fourth**, what incentives affect servicers in the modification process?
- **And finally**, where do we go from here?

¹Mason, Joseph R., *Mortgage Loan Modification: Promises and Pitfalls* (October 3, 2007).

modifications

Who are the parties involved in a securitization deal?

The securitization process often begins when an investment bank (the underwriter) purchases mortgages from various lenders and transfers ownership of the portfolio to a special-purpose entity, such as a corporation, a limited liability corporation, or a business trust (see Figure 1). It is also common for high-volume lenders, such as Countrywide, to create their own special-purpose entity and do their own securitization. The special-purpose entity creates securities that represent claims on the interest and principal payments of the pooled mortgages in its possession, and then sells those securities to investors.

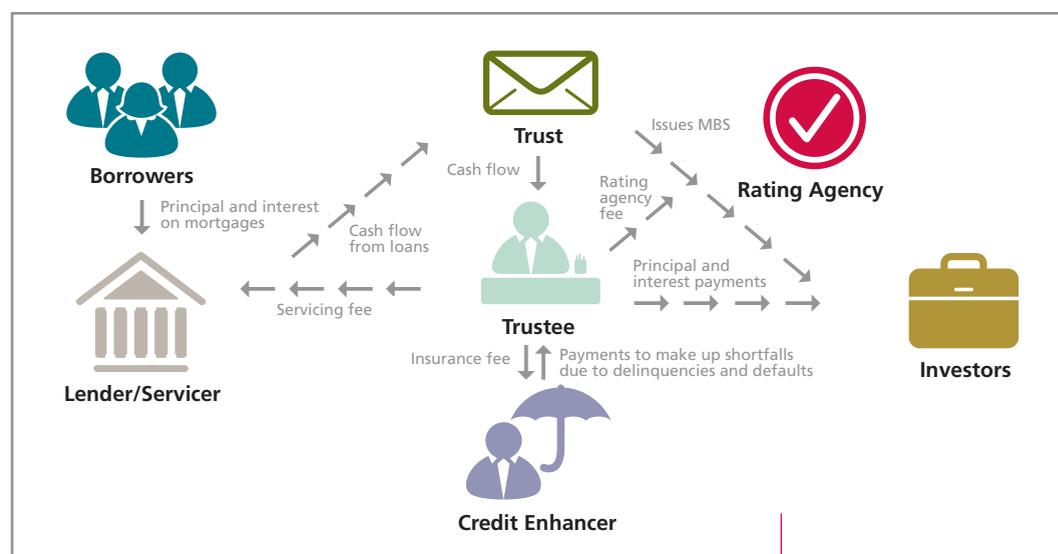


Figure 1.
Mechanics of
mortgage-backed
securities in a
trust model

Before any security backed by the mortgage pool can be issued, however, the underwriter hires a rating agency to determine how risky the pool is and to suggest credit enhancements necessary for raising the securities' ratings to the desired level. For example, as a condition for the highest grade (AAA), the rating agency may require the purchase of insurance against mortgage defaults from a credit enhancer. The rating agency does not necessarily monitor the underwriter after issuing the initial rating and does not investigate fraud as part of its rating. Once all the necessary credit enhancements are in place, the trust proceeds to sell the mortgage-backed securities that represent claims on the cash flows from the mortgages in the pool.

These securities can be very complex. It is possible to take a pool of highly risky mortgages or other mortgage-backed securities and actually create AAA-rated securities against them. This is accomplished not just by various credit enhancements like those described above, but by dividing these securities into risk classes, or tranches. This process involves assigning some of the securities a more senior claim on the cash flows from the mortgage pool. In other words, the securities differ in who gets paid first from the interest and principal payments collected in the pool. Holders of the most-senior claims are paid first, so any shortfall in the cash flow caused by a delinquency or loan write-off reduces the payment claims that are more junior. The most-senior tranche, which will not suffer any loss until all lower tranches are wiped out, will most likely get a AAA rating.

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securitization

There is typically a mezzanine tranche between AAA and BB, and then there is an equity tranche, made up of the most junior claims, that typically is unrated. Investors in high-risk securities may choose the lower-rated tranches, but they risk getting hit with the losses first (see Figure 2). These re-securitized mortgage-backed securities are known as mortgage-backed-security collateralized debt obligations, or MBS-CDOs.

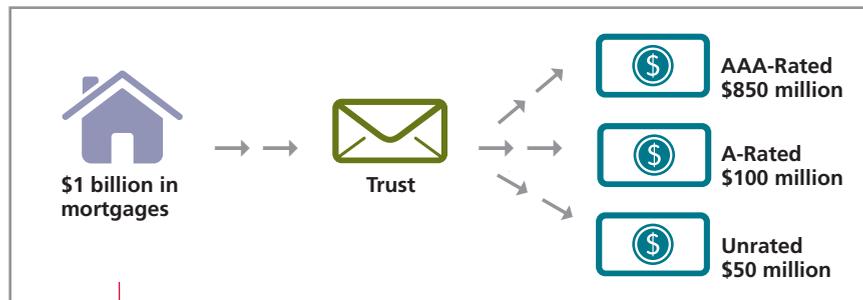


Figure 2.
The risk
tranches of a
securitization
deal

But the securitization process does not stop there. The securities from multiple issues (of any class) can be pooled again and re-divided into risk tranches, the most senior of which may again get a AAA rating. These arrangements are CDOs created using other CDOs and are known as CDO-Squares. And the process continues when the low-rated tranches of MBS-CDOs are repackaged and redivided into risk tranches (CDO-Cubes).

In theory, the system is set up to give each participant in the chain an incentive to fulfill his responsibilities properly. Given the distance between investors and homeowners, investors must be reasonably confident that lenders are underwriting home mortgage loans properly and that trustees are monitoring the performance of lenders or servicers. The market's primary mechanism for ensuring that all the links in the securitization process work properly consists of the representations and warranties in contracts, which require other parties in the securitization chain to repurchase loans that are alleged to have been inappropriately underwritten or serviced, or to have had other failures in due diligence. There are two critical representation and warranty documents in the securitization chain: the mortgage loan purchase agreement (MLPA) between the loan seller (the lender) and the underwriter (an investment bank, Fannie Mae, or Freddie Mac), and the pooling and servicing agreement (PSA) between the investors participating in the deal and the trustee. Both of these documents often have very strict guidelines for how loans should be originated, underwritten, and serviced. A breach of any provision may lead to repurchase requests for loans that allegedly have been tainted. In other words, *representations and warranties* are the investors' insurance against shoddy lending standards and securitization practices. Still, investors may engage in riskier transactions in exchange for higher returns; deals in which the underwriter states "we cannot assure the credit quality of the majority of the loans" are not unheard of.

The authority given to the trustee by the PSA, including the authority to modify the loan, is delegated to the servicer, a key player in these deals. At the most basic level, the servicer collects interest and principal payments and passes them on to the trustee (after deducting a fee for its services), maintains escrow accounts, and pays taxes and insurance premiums. The trustee, in turn, directs the cash flow to the investors. The stream of servicing income from a securitization deal and the right to service the mortgages in the pool constitute tradable assets known as *mortgage servicing rights*. The lender that originates the mortgage may choose to keep the servicing rights to the loans it sells to the securitization pool, or it may prefer to sell them. Therefore, the servicer is usually—but not always—the original lender.

process

What went wrong in this system?

Although mortgage finance securitization evolved with the assumption that there were enough contractual incentives to ensure that each participant in the process would perform his responsibilities properly, the experts at our workshop agreed that the system failed at several points. The strong housing market in the early part of this decade, along with the expectation that values would continue to rise, may have induced people to purchase too much housing and leave themselves exposed to a housing downturn. Then home prices fell and ARM resets approached. Homeowners and real estate speculators who had assumed that continuing appreciation would allow them to refinance their mortgages before their loans reset, either could no longer afford their payments or lost their incentive to make higher payments on properties whose value was often less than what was owed. In the end, investors or lenders who were holding those loans lost a significant amount of money. The price index in Figure 3 shows that BBB-rated residential-mortgage-backed securities, which were trading at \$97 in January 2007, traded as low as \$5 some 18 months later. The more troubling observation is that the safest, AAA-rated tranche, which was trading at \$100 in early summer 2007, lost more than 25 percent of its value within six months and as of July 2008 was down more than 40 percent.

Figure 3 raises the question of how a security capable of losing 25 percent of its value within a year of its creation could have been judged AAA by the rating agencies. Also worth asking is how investors—particularly sophisticated ones, including large institutional investors and hedge funds—could have so seriously misgauged the risk of these securities. Looking back, investors do not seem to have been fully aware of the risk of the securities they were buying. One explanation proposed by our workshop participants was that rating agencies misjudged the downside risks because their models lacked a sufficient history showing how securities backed by subprime mortgages or similar assets performed. An alternative explanation discussed by the participants centered on rating agencies' possible conflicts of interest. Such conflicts arise, they contended, partly because ratings are paid for by the issuer of the securities rather than the investor whose decision is based on that rating. Conceivably, the desire to bring in new business may have caused rating agencies to provide overly optimistic assessments of the risk of asset-backed securities, leading to artificially high ratings. Moreover, it was not uncommon for rating agencies to be consulted on the structure of the securitization; such involvement may have affected their objectivity. Less clear is why the potential loss of the agencies' reputation, and with it, their ability to sell their rating services, did not induce them to provide unbiased assessments of the risk of the securities they were rating.



Figure 3.
The price index
of RMBS (ABX.
HE) that were
packaged in the
first half of 2007
Source: [www.
markit.com](http://www.markit.com)

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Why securitize?

Excerpt from "Securitization,"
Federal Reserve Bank of Cleveland Economic Commentary
August 15, 2003

Banks began to securitize a large volume of their loan portfolios in response to changing regulations and market forces during the 1980s. Starting with the International Banking Act of 1978, and partially in response to debt problems of the less-developed countries during the early 1980s, federal regulators ratcheted up minimum capital requirements for commercial banks. By the mid-1980s, banks were required to hold primary capital (basically shareholder equity and reserves set aside for future loan losses) of at least 5.5 cents for every dollar of assets carried on the balance sheet. Capital requirements limit the risks banks will take by putting bank owners' own money at risk. However, raising capital is costly for the bank owners. For example, regulators may force the bank to raise equity when stock market conditions are not favorable for a new stock issue, or the bank may have to retain its earnings instead of distributing them to shareholders as dividends.

But there is a way to circumvent capital requirements, and it hinges on the fact that the

bank does not have to hold capital against the loans it originates, but only those it actually carries on its balance sheet. So, there is no capital requirement if the bank originates the loans and transfers their ownership to a special purpose entity, effectively removing them from its balance sheet. Unless there is an arrangement in the securitization deal whereby investors can demand compensation from the bank for loan defaults in the securitized asset pool (recourse), regulators allow banks to keep these loans off the balance sheet, reducing the need for additional capital.

The ability to remove loans from the balance sheet was especially handy for credit card banks because the Competitive Equality Banking Act of 1987 limited their total asset growth to 7 percent a year. Major lenders in this market had to find a way to remove their credit card receivables from their balance sheets. Securitizing those receipts helped banks to keep their asset growth under control, while they collected fees for servicing the securitized loans. It should not come as a surprise that credit card asset-backed securities first appeared in the public debt market in 1987.

In addition to these changes in the regulatory environment, the deposit market—banks' traditional funding source—went through significant changes in the 1980s. With the Great Depression and bank failures a distant memory, depositors were willing to take more risk in return for higher rewards by shifting their money into money market funds and other uninsured investments. As deposits became increasingly scarce and expensive, banks had few options. One was to give up lending opportunities—not a first choice. Another was (and still is) to finance loans with short-term borrowings from the money markets. Yet, unlike deposits, these are not a stable source of financing: Short-term lenders in this highly liquid market chase the highest rate of interest and pull their money out at the slightest sign of trouble. Under these circumstances, recycling existing resources—by selling existing loans and using the proceeds to make new loans—is an invaluable capability.

But the potential for these conflicts should have been clear to investors, who in turn should have priced the risk into the contracts. Where did the investors go wrong? One possibility suggested is that investors had all the information they needed about these instruments, but they failed to read it thoroughly or did not understand sufficiently what they were purchasing.

One possible explanation for such behavior is that these financial instruments were so complex that investors failed to do their homework, in part because they often had limited time in which to make a decision. The prospectuses for these securities are hundreds of pages long; the analyst, who has only a short time to make a decision, may ignore the prospectus and instead rely more heavily on the reputation of the underwriters for issuing good paper.

Shortcomings in the rating system aside, the investment banks who packaged these securities should have had the proper incentives to issue good paper. Like the rating agencies, their reputation and ability to sell paper in the future depend on it. Also, in all the CDO deals, the underwriters always took a piece of the equity tranche, the lowest-rated piece. Many investors may have believed that the underwriters would not issue bad paper given that they were first in line to face the losses. However, the incentive scheme offered no protection against the risk that underwriters themselves may have underestimated the risk of the assets backing the paper they were issuing.

In the end, not only the investors but also the underwriters lost large sums. The investors may also have over-relied on their contractual protections, such as the representations and warranties that require lenders to buy back their improperly originated loans. Loan repurchases may have been an effective threat when the number of requests was fairly small, but when the number increased, loan sellers became more reluctant to admit that there was a problem with the origination and underwriting. Instead, cases are now likely to go to court and may not be resolved for five or six years. In other words, a protection that works well when problem loans are few may become a perverse incentive for loan sellers when such demands for recourse multiply. In that case, investors' losses may be much larger than they first anticipated.

According to the workshop participants, lenders' reluctance to take back their problem loans under the terms of the representations and warranties may have more complex causes than a desire to avoid loss by dragging out the matter in court for years. Some lenders may lack the equity capital to admit to those losses and still stay in business. When a regulated depository institution (e.g., a commercial bank, savings and loan, etc.) makes a loan and keeps it on its balance sheet, it is *required* to fund a portion of the loan with its own capital. Presumably, lenders who have their own "skin in the game" are more careful with the risks they undertake. It is also assumed that if and when lenders suffer unexpected losses, they will have enough capital to take those hits and still survive. Securitization has prompted financial institutions to change the way they calculate how much capital is needed to support their activities. The Financial Accounting Standards Board's (FASB) Statement 140 stipulates that lenders securitizing their loans in qualified special-purpose entities (QSPEs) are allowed to remove them entirely from their balance sheets (most common securitization deals of the kind pictured in Figure 1 qualify as QSPEs). As in a traditional loan sale, FASB 140 allows lenders to sidestep the capital regulations on their pools of securitized assets because the loans are no longer on the balance sheet—and financial institutions are not responsible for the liabilities of the special-purpose entities.

What went wrong with rated securities?

How could top-rated securities lose their value so abruptly?

- Rating agencies did not have sufficient historical data to accurately assess risk.
- Rating agencies had conflict of interests, which may have affected their objectivity.

How could investors not assess risk accurately?

Rational views

- Information was available but complex; investors relied on rating and reputation of underwriter.
- Underwriters underestimated the risks given the securities' stellar performance in past years.
- Over-reliance on contractual protections (warranties and representations) that work well for a few bad loans but are counterproductive when most loans are problematic.

Bounded rationality

- During the housing bubble, investors and underwriters became disconnected from reality.
- Lured by CDOs' spread, investors engaged in herd behavior, paying less attention to the quality of the loans.

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In addition, growing numbers of mortgages are originated through mortgage brokers and other lenders not subject to regulatory capital requirements. One would expect that the market would require them to hold sufficient capital against unexpected losses as a precondition of funding their activities; however, if the risk of the underlying assets—in this case, subprime mortgages—is systematically underestimated, then the capital that markets require of mortgage originators might be too little to ensure prudent underwriting standards for the loans these lenders originate. From the market’s perspective, investors may have stopped demanding that institutions hold sufficient capital to cushion against an unexpected homecoming of bad loans because the risks seemed low during the housing boom and credit enhancements seemed sufficient.

The workshop experts also contemplated some explanations suggesting that lenders and investors may have behaved irrationally. One hypothesis was that the housing market went through a bubble, during which lenders, borrowers, underwriters, and everybody else may have seriously underestimated the risks they were undertaking. At any given time, one would expect some people to underestimate the risks and others to overestimate them; in theory, then, these people should cancel each other out. The compelling question in the case of the mortgage debacle is, how did everyone land on the over-optimistic side of the housing market? Psychologists and behavioral economists explain this phenomenon in terms of bounded rationality, or “herd behavior.” That is, a market with continuously declining interest margins, investors and lenders tried to benefit from the spread on the mortgage and mortgage-CDO products without paying close attention to what they were originating or buying. With everybody taking the same risks and making a lot of money—and nobody going bankrupt—lenders and investors thought these risks were worth taking. Our workshop experts observed that relaxed investor attitudes toward risk are not limited to the mortgage market. Bond covenants, which keep a tight rein on borrowers’ behavior in order to protect lenders’ interests, also became less restrictive in recent years, as lenders took on more risk in return for greater yield.

What are the key legal issues in loan modifications?

The financial system is currently recovering from an extended period of loosely supervised credit growth. As part of this process, financial institutions around the world are writing off large numbers of nonperforming loans. According to the Organization for Economic Cooperation and Development, these write-offs could reach hundreds of billions of dollars.¹ However, many financially troubled homeowners can still be put on a path to sustainable homeownership. Some have suffered from lenders’ poor underwriting standards and gotten into loans with much more costly terms than their income and credit history would warrant. To help these homeowners and to avoid the dead-weight losses associated with default and foreclosure, most mortgage servicers are ramping up their loan modification programs, which were originally designed to help the occasional borrower who experienced an economic shock, like sudden unemployment or health crisis.

A loan modification can take many forms. In one, the missed payments are tacked on to the loan. For example, if the borrower missed six payments on a loan that was originally scheduled to be paid off in 30 years, the loan can be restructured as a 30-year-6-month loan. Alternatively, the loan principal can be increased by the amount of the missed payments so that it is still paid off

Glossary

collateralized debt obligation (CDO)

diversified, multi-class security backed by pools of bonds, bank loans, or other assets. These securities are typically divided into several classes, or bond tranches, that have differing levels of credit risk exposure.

CDO-squares and CDO-cubes

CDO-squares are the result of pooling and re-division of multiple issues of collateralized debt obligations to create new CDOs based on risk tranches. With CDO-cubes, multiple issues of low-rated CDOs are pooled and re-divided to create new CDOs.

foreclosure

a process by which a homeowner who has not made timely payments of principal and interest on a mortgage loses title to the home. Statutory foreclosure is effected without recourse to courts, but must conform to laws (statutes). Judicial foreclosure submits the process to court supervision.

loan modification

an adjustment to the terms of a loan during its duration in a way not accounted for in the original loan contract, but accepted later by mutual consent of the lender and borrower. Usually a concession to the borrower in an attempt to avoid foreclosure.

mortgage-backed security (MBS)

a financial claim on the cash flow from a pool of mortgage loans

Adapted from *allbusiness.com*

¹*Reuters, November 21, 2007.*

modifications

in 30 years but each remaining monthly payment is larger. Another possibility is forgiveness. The missed principal, interest, and fee payments can be forgiven; even the principal can be reduced to make the loan more affordable. Other terms of the loan are also open to negotiation. For example, subprime loans almost always have prepayment penalties that prevent borrowers from refinancing into more affordable products; these penalties can be reduced or eliminated.

Loan modifications are not always the answer. Sometimes it is in neither the investor's nor the borrower's interest to restructure the loan. Even in such cases, it may still be in everyone's interest to resolve the loan default by avoiding foreclosure. That is, there are negotiated alternatives to foreclosure that do not involve renegotiating the loan terms themselves, but enable borrowers to simply hand in the keys without being foreclosed on. There was general agreement at the workshop that if borrowers give their deed in lieu of foreclosure, the blemish on their credit report is less severe than if there were a foreclosure.

Before securitizing mortgages became common practice, any of these alternatives could be negotiated between the borrower and lender and brought to a quick resolution. Today, securitization makes the process more difficult, costly, and laden with legal challenges. From a legal perspective, loan servicers have specific authority under pooling and servicing agreements to modify loans within limits. In other words, they are allowed to change loans at their own discretion to a certain extent, beyond which they must get special approval; often, such approval must come from the insurers who are providing a credit enhancement, as they are in the first-loss position.

An approval from the insurer, however, is not the end of the matter. If there is to be a modification, the servicer can justify it only if it is in the best interest of investors. In fact, servicers are expected to take the same financially responsible actions they would take if they owned the loans they service. In other words, there is no basis for modification if a loan is performing but the borrower was the victim of some type of mortgage fraud—for example, loan terms were changed at the last minute and the borrower wasn't informed. Modifications can take place only if they benefit the investors, even if there was wrongdoing in the origination of the loan.

The challenge is to define what is in investors' best interest. What criteria can the servicer use to justify a loan modification without getting sued by investors? Our experts considered some pooling and servicing agreements relatively easy to work with because they explicitly set the standards for loan modifications and specify which loans can be modified, how this may be done, and under what conditions. Some agreements permit the servicer to modify up to 5 percent of the loans in the pool or up to 5 percent of the pool's value, or a fixed number of loans per year. There are also standards for the length of the borrower's delinquency before the loan can be modified. Different rules may apply if the servicer believes that the borrower may default in the future, if the borrower is only a few days late, or if the borrower has been more than 90 days delinquent. Some pooling and servicing agreements state that the servicer may modify the loan only if it is in default or near default and may prevent proactive modifications that could take place as soon as

Glossary

mortgage servicing rights

a contractual agreement allowing the servicer to deduct a fee from the interest and principal payments it collects before passing them along to the trustee, as well as obliging the servicer to maintain escrow accounts and pay taxes and insurance premiums

pooling and servicing agreement (PSA)

the contractual agreement between investors in a MBS-CDO and the security's trustees detailing the gridlines on how the loans in a given MBS-CDO are originated, underwritten, and serviced

representations and warranties

the contractual agreement between the lender and the trustee that requires that loans in default that have been inappropriately underwritten or had failures in respect to due diligence be repurchased or replaced

securitization

the process of creating a security that is saleable in the capital markets and backed by a package of assets, such as mortgage loans

mortgage servicing

activity that consists of collecting monthly interest and principal payments, taxes, and insurance from borrowers, as well as assuring that taxes and insurance are paid to the assessor and insurer and that interest earned and principal are paid to the investor

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modification

the servicer realizes that the existing mortgage terms will become unsustainable. This restriction derives from tax code consequences: Most mortgage securitizations are REMICs (real estate mortgage investment conduits), which are not subject to tax liabilities as long as their mortgage pools remain constant—that is, there is not a lot of change. The only exception is that REMICs may change the composition of the pool if the underlying collateral is on the verge of, or in, default. In other words, if the administrators of REMICs allow proactive modifications, they may face a tax bill.

Some pooling and servicing agreements are difficult to work with simply because they are vague. They may state that servicers can modify loans as long as they comply with “acceptable servicing standards,” without defining “acceptable.”

As the discussion so far shows, servicers have no uniform, practical standards to follow across all types of pooling and servicing agreements. What is a servicer to do? The risk of misinterpreting the vague clauses of the pooling and servicing agreement and getting sued is only one of many factors that affect servicers’ decisions about how to deal with a delinquent borrower.

What are servicers’ incentives in the modification process?

Apart from the modification options that may or may not be spelled out in the loans’ pooling and servicing agreements, servicers have certain financial incentives to modify or foreclose on a loan. To better understand servicers’ overall incentives in this process, let’s consider their expenses and revenue flows in each of the following two scenarios.

It costs \$51 a year on average to service a mortgage paid on time; this covers the labor and paperwork associated with collecting payments and disbursing them to the trust. In this case, the servicer’s compensation from the trustee is about equal to the costs. However, when a loan goes into default, the process becomes a lot more expensive: The annualized cost per mortgage jumps from \$51 to \$1,026 for delinquent loans and \$2,115 for loans in foreclosure.

	Delinquent	Foreclosure	Performing Loan
Servicing costs	\$51	\$51	\$51
Non-reimbursable costs	\$316	\$316	
Funding costs for reimbursable expenses	\$659	\$1,086	
Reduction to MSR fair value		\$662	
Total annualized cost per loan	\$1,026	\$2,115	\$51

Figure 4.

Annualized servicing cost per mortgage

Source: Bank of America

Some of those costs are reimbursable. For example, while the borrower remains delinquent, the servicer must advance cash to investors as if the borrower had made the payment on time. In this case, the servicer must fund itself from the capital markets and incur interest costs. There are also expenses associated with placing the delinquent loan into special servicing. The servicer must make the extra phone calls, send the extra letters, and talk with the borrower. In the case of foreclosure, the servicer also must start the legal filings. The servicer expects to be reimbursed for these expenses only when the foreclosed property is sold, which takes an average of 18 months.

process

There are also nonreimbursable costs, such as the \$316 administrative costs of managing and monitoring special servicing programs to handle delinquent loans. This cost, which can not be passed on to the investors, is borne entirely by the servicer. Another nonreimbursable cost unique to foreclosures is the lost servicing income from the loan that has been written off. The loss of servicing fees that would have been paid had the loan remained active adds up to \$662. This is reflected on the servicer's balance sheet as a \$662 decline in the value of the mortgage servicing rights.

The cost of a mortgage modification is similar to that of servicing a delinquent loan, around \$750 to \$1,000. The main difference is that the way the servicer will be compensated for the costs of modification is typically *not* a part of pooling and servicing agreements; these agreements were not designed for such massive modifications, which have not often been necessary in the history of these contracts. As a result, the modification cost of \$750 to \$1,000 per loan is a nonreimbursable expense for the servicer.

On the positive side, although the cost of the modification is not reimbursable, the flow of servicing fees will resume once the loan becomes current again. In other words, the modification will mitigate the decline in the value of the mortgage servicing rights. Unfortunately, there is a significant chance that borrower will default again, this time on a modified loan. That is, a loan that has become current through modification is much more likely to default than a loan that has never been delinquent. Furthermore, if the modification has not resolved the borrower's distress in a meaningful way, the homeowner is likely to continue to defer maintenance on the property, eroding its value. So, if the modification merely delays an eventual foreclosure, the servicer will still bear the nonreimbursable costs of the foreclosure, and the investors will ultimately get less.

By comparison, a foreclosure is a much cleaner process for the servicer for three reasons: First, in a foreclosure the servicer gets paid. Second, foreclosure avoids the possibility of the servicer being sued for exceeding its authority under the pooling and servicing agreement in the event the servicer, attempting to work out a loan, exercises what might be viewed as unjustified or excessive modifications. By comparison, pooling and servicing agreements do not limit foreclosures. Third, foreclosure can help prop up rating agencies' grades of loan servicers, since their grading system rewards those who can extract the most cash out of the pool by minimizing or absorbing the losses. If a modification only delays foreclosure, and investors eventually get less than they would have if the property had been sold at the first sign of trouble, the rating agency can downgrade the servicer and reduce the flow of future business. In short, for a servicer, foreclosure is often the least troublesome solution to the delinquency problem.

Where do we go from here?

Our experts agreed that the financial and social costs of delinquencies and foreclosures will lead to improved regulatory and market-based discipline. On the regulatory side, policymakers will examine which gaps in our legal and regulatory structure led to careless lending. One issue in particular that requires a closer look is some mortgage lenders' apparent lack of capital.

One proposal that arose from the workshop discussion involved having lenders hold capital against their securitized loans, so that they are ready to realize their losses instantly if those loans are ever returned to them under the representations and warranties. This is the practice in the UK, where lenders must hold a nominal 1 percent of capital against their securitized loans. (The point here is not that 1 percent is the correct amount, but rather, that the practice exists outside the U.S.)

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mortgages

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Even without a change in accounting rules and regulations, the market is also likely to discipline mortgage lenders by forcing them to hold more capital or by increasing the over-collateralization of securitization deals. In fact, our experts believe that the main stimulus for change will be market discipline. For example, the market may disallow the sale and securitization of entire mortgage portfolios unless the original lender holds a first-loss position. This is what banks do when they sell commercial loan participations. No one would buy the loans if the bank tried to unload the entire portfolio. The same is likely to happen in the mortgage market, noted the seminar experts, who also expect to see more transparency in securitization deals. Currently, investors receive no information about the original lender's ability to honor its representations and warranties. If a lender lacks the capital base to take back a troubled loan, representations and warranties are useless to investors.

Investors will probably demand more economically meaningful grading from the rating agencies. Currently, ratings seem to have little to do with risk. For example, one can find municipal bonds at the BAA level that have a 0.097 percent default rate and, at the other end of the scale, BAA CDOs with a 24 percent default rate. Thus, one alphabetic rating encompasses a 270-time magnitude of risk difference. This type of low-quality information is unlikely to persist.

The experts at our workshop expressed the belief that the fastest way to restore financial markets' normal functioning is to let them feel the pain; however, they also recognized that this approach risks setting off a downward spiral. Large numbers of defaults could put severe downward pressure on housing prices, causing greater losses when defaults occur; such losses, in turn, could cause further declines in market liquidity and restart the default cycle. Although this risk is real, it may be better than postponing the pain and facing greater difficulties in the future.

At this point, the outlook remains uncertain, and the experts did not seem convinced that extensive modifications could mitigate the uncertainty. Although servicers have had some experience historically with performing loan modifications, it has never been on this scale, where so much money is at stake and so many borrowers are in trouble. Still, there is one principle that everybody agreed on: With any proposal relating to modifications, investors, servicers, and regulators need to make sure that the process can accomplish the objective of converting nonperforming loans into performing loans rather than simply forestalling the inevitable. It makes no sense to push defaults into the future, especially when housing prices are dropping and there is no sign that a turnaround is imminent.

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