Securitization Trusts & Loan Modifications At Odds

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A major factor complicating private, voluntary loan modification efforts is securitization. The vast majority, somewhere upwards of 80%, of residential mortgages are securitized. Understanding securitization is key to understanding why private, voluntary efforts at mortgage modification will inevitably fail and why bankruptcy modification presents the only sure method of preventing preventable foreclosures.

Securitization transactions are technical, complex deals, but the core of the transaction is fairly simple. A financial institution owns a pool of mortgage loans, which it either made itself or purchased. Rather than hold these mortgage loans (and the credit risk) on its own books, it sells them to a specially created entity, typically a trust (SPY). The trust pays for the mortgage loans by issuing bonds. The bonds are collateralized (backed) by the loans now owned by the trust. These bonds are so-called mortgage¬backed securities (MBS).

Because the trust is just a shell to hold the loans and put them beyond the reach of the financial institution's creditors, a third-party must be brought in to manage the loans. This third-party is called a servicer. The servicer is supposed to manage the loans for the benefit of the MBS holders. The servicer performs the day-to-day tasks related to the mortgages owned by the SPY, such as collecting payments, handling paperwork, foreclosing, and selling foreclosed properties. These servicers are the entities that actually consider loan modification requests. Confusingly, the servicer is often, but not always, a corporate affiliate of originator; most of the major servicers are subsidiaries of bank holding companies: Countrywide Home Loans (Bank of America); CitiMortgage and CitiFinancial (Citigroup); Select Portfolio Servicing (Credit Suisse); Litton Loan Servicing LP (Goldman Sachs); Chase Home Finance and EMC Mortgage (JPMorgan Chase); Wilshire Credit (Merrill Lynch); Wells Fargo Home Mortgage and Homeq Servicing (Wells Fargo).

Securitization creates numerous obstacles to voluntary loan modifications, but they may be reduced to three broad categories: contractual, practical, and economic.

Securitization Creates Contractual Limitations on Private Mortgage Modification

Securitization creates contractual limitations on private mortgage modification.

These limitations cannot be bypassed except through bankruptcy modification or a taking ofMBS holders' property rights.

Servicers carry out their duties according to what is specified in their contract with the SPY. This contract is known as a “pooling and servicing agreement” or PSA. Although the decision to modify mortgages held by an Spy rests with the servicer, and servicers are instructed to manage loans as if for their own account, PSAs often place restrictions on servicers’ ability to modify mortgages. Almost all PSAs restrict modifications to loans that are in default or where default is imminent or reasonably foreseeable in order to protect the SPY’s pass-thru REMIC tax and off-balance sheet accounting status.

PSAs often further restrict modifications: sometimes the modification is forbidden outright, sometimes only certain types of modifications are permitted, and sometimes the total number of loans that can be modified is capped (typically at 5% of the pool). Additionally, servicers are frequently required to purchase any loans they modify at the face value outstanding (or even with a premium). This functions as an anti¬modification provision.

No one has a firm sense of the frequency of contractual limitations to modification for residential MBS (RMBS). A small and unrepresentative sampling by Credit Suisse indicates that almost 40% of RMBS PSAs have limitations on loan modification beyond a near universal requirement that the a loan be in default or imminently defaulting before it may be modified.33 The Credit Suisse study, however, did not track all types of modification restrictions, such as face-value repurchase provisions, so the true number of restrictive PSAs is likely higher. Nonetheless, there are still a large number of homeowners whose mortgages are held by securitization trusts with restrictive PSAs. This includes both private-label securitizations and GSE securitizations; some Fannie Mae securitizations, for example, prohibit any reductions in either principal or interest rates.

It is virtually impossible to change the terms of a restrictive PSA in order to allow the servicer greater freedom to engage in modifications. The PSA is part of the indenture under which the MBS are issued. Under the Trust Indenture Act of 1939,35 the consent of 100% of the MBS holders is needed in order to alter the PSA in a manner that would affects the MBS’ cashflow, as any change to the PSA’s modification rules would.

Practically speaking, it is impossible to gather up 100% of any MBS issue. There can be thousands of MBS certificates from a single pool and these certificate holders might be dispersed world-wide. The problem is exacerbated by collateralized mortgage obligations (CMOs), second mortgages, and mortgage insurance. MBS issued by an Spy are typically tranched-divided into different payment priority tiers, each of which will have a different dividend rate and a different credit rating. Because the riskier tranches are not investment grade, they cannot be sold to entities like pension plans and mutual funds. Therefore, they are often resecuritized into what are known as CMOs. A CMO is a securitization in which the assets backing the securities are themselves mortgage¬backed securities rather than the underlying mortgages. CMOs are themselves then tranched, and the senior tranches can receive investment grade ratings, making it possible to sell them to major institutional investors. The non-investment grade components of CMOs can themselves be resecuritized once again into what are known as CM02s. This process can be repeated, of course, an endless number of times.

The upshot of this financial alchemy is that to control 100% of an MBS issuance in order to alter a PSA, one would also have to own 100% of multiple CMOs to alter the CMOs' PSAs and of multiple CM02s to alter the CM02s' PSAs. .

The impossibility of modifying PSAs to permit modification on a wide scale is further complicated because many homeowners have more than one mortgage. Even if the mortgages are from the same lender, they are often securitized separately. If a homeowner is in default on two or three mortgages it is not enough to reassemble the MBS pieces to permit a modification of one of the mortgages. Modification of the senior mortgage alone only helps the junior mortgage holders, not the homeowner. In order for a loan modification to be effective for the first mortgage, it is necessary to also modify the junior mortgages, which means going through the same process. This process is complicated because senior lenders frequently do not know about the existence of the junior lien on the property.

A further complication comes from insurance. An SPV's income can exceed the coupons it must pay certificate holders. The residual value of the SPY after the certificate holders are paid is called the Net Interest Margin (NIM). The NIM is typically resecuritized separately into an NIM security (NIMS), and the NIMS is insured by a financial institution. This NIMS insurer holds a position similar to an equity holder for the SPY. The NIMS insurer's consent is thus typically required both for modifications to PSAs and modifications to the underlying mortgages beyond limited thresholds. NIMS insurers' financial positions are very similar to out-of-the-money junior mortgagees¬they are unlikely to cooperate absent a payout because they have nothing to lose.

Thus, the contractual structure of securitization creates insurmountable obstacles to voluntary, private modifications of distressed and defaulted mortgages, even if that would be the most efficient outcome.

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