Testimony
Of
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Domestic Policy Subcommittee
Oversight and Government Reform Committee
Friday, November 14, 2008
2154 Rayburn HOB
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"Is Treasury Using Bailout Funds to Increase Foreclosure Prevention as Congress Intended?"

Summary of Testimony:

Chairman Kucinich, Ranking Member Issa, and distinguished Members of the Subcommittee:

My name is Stephen Kudenholdt and I am the head of the Structured Finance Practice Group at the law firm of Thacher Proffitt & Wood, based in New York. Our firm has been a leader in residential mortgage loan securitization since the early 1980s. Since the credit crisis began last year, we have worked closely with industry groups such as the American Securitization Forum to improve awareness of the flexibility in existing securitization structures to perform loan modifications and other forms of loss mitigation.

In today's environment, residential mortgage loan servicers need to be able to use all possible avenues to minimize losses on defaulted loans, and to minimize foreclosures. We believe that there are significant opportunities under the Troubled Asset Relief Program to advance those goals.

My comments will focus on how TARP can be used to increase loan modifications and reduce foreclosures on residential mortgage loans that are included in "private label" securitizations, that is that are not in Ginnie Mae, Fannie Mae or Freddie Mac pools.

Existing provisions

Most private label (non GSE) securitization governing documents give broad authority to the servicer to service loans in accordance with customary standards, and in a manner that is in the best interests of investors. Many securitization governing documents specifically authorize loan modifications where the loan is in default, or where default is reasonably foreseeable. Generally, modification of loans that are not in default (or where default is not reasonably foreseeable) could violate REMIC restrictions and therefore are not permitted under the securitization documents.

Guaranty program on loans in securitizations

The final sentence of EESA Section 109(a) provides that "[T]he Secretary may use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures." If the Secretary were to make available credit enhancement under a guaranty program that covered specific loans that had been modified, this could alter the equation of the servicer's net present value determination. Under a typical loan modification program, the servicer takes the following steps: 1) a specific proposed loan modification is designed based on the borrower's current ability to pay, 2) the anticipated payment stream under the loan as modified is compared with the anticipated recovery from foreclosure and liquidation on a net present value (NPV) basis, and 3) the servicer chooses the alternative with the greater NPV. In comparing a loan modification with a foreclosure and liquidation, the servicer normally would assume some likelihood that the loan as modified would re-default, and this factor reduces the net present value of the modification alternative. But if credit support were added that eliminated the re-default risk, then for any given proposed loan modification the servicer would be more likely to choose the modification over foreclosure, as long as the guaranty premium was less than the NPV reduction that would have resulted from the assumed re-default risk. In this regard, it should be noted that observed re-default rates for loan modifications are generally in the 25 - 40% range.

In order to encourage modifications and protect the taxpayer's interests, the guaranty program should be limited to servicers who have demonstrated that they have a robust, systematic modification program, with sufficient staffing and resources to handle a high volume of modifications. The modification program should include procedures to verify current income and a reliable model for evaluating NPV of modifications as well as foreclosure.

This guaranty program would be a very effective way to encourage modifications. The program would have the effect of potentially changing servicer behavior to use modifications in more cases, without creating a mandate or changing the operative documents. And, the program would encourage servicers to work harder to develop systematic loan modification programs, so as to qualify for participation in this program.

Purchasing defaulted loans out of securitizations under TARP

We believe that it would be possible to develop a program under TARP whereby defaulted mortgage loans could be purchased from securitization trusts at a discounted price. An important issue in implementing such a program would be resolving any FAS 140 barrier.

Such a program would be helpful because there are borrowers who cannot meet their mortgage payments but would like to stay in the home, and who would not be able to qualify for a loan modification that satisfies the NPV test (as compared to foreclosure) because they could document sufficient income. Borrowers with these characteristics also might not be able to qualify for a short refinancing under the Hope for Homeowners program or other available lending programs.

Defaulted loans purchased under the TARP program could be subject to a wide range of workout options. The borrower could be given a low interest rate loan with a reduced principal amount based on what the borrower could afford. Alternatively, title to the property could be taken by an entity established as part of the TARP program, or by a non-profit organization, and the property could be rented back to the prior borrower with a purchase option. These options would not be available for loans retained within a securitization.

Although typical servicing authority provisions have been broadly interpreted to allow loan modifications and other loss mitigation alternatives, these provisions have not been interpreted to allow such sales for a number of reasons, primarily because FAS 140 does not appear to permit sales of loans out of securitization trusts, and therefore securitization documents have been interpreted as implicitly prohibiting such sales.

That being said, most RMBS operative documents are in fact silent on the issue of whether defaulted loans can be sold for a discounted price, although a small minority do contain an express prohibition on such sales. Where the documents are silent, there is a strong argument that sales could be made pursuant to the general authority to service in accordance with the general servicing standard and if in the best interests of investors, under the following circumstances:

* The loan is in default

* The loan is sold to the Secretary under TARP for a cash purchase price

* The cash price is greater than the NPV of the anticipated recovery under a foreclosure, or under other potential alternatives (if available)

The servicer safe harbor under Section 119 of EESA would provide some legal protection for a servicer that interprets securitization operative documents as permitting a sale of defaulted loans to TARP at a discounted cash price as described above. Such a sale under should be considered to be "reasonable loss mitigation actions" that would be deemed to be in the best interests of all investors in that securitized pool.

However, an essential element of a program under TARP to purchase defaulted loans from securitizations at a discounted price would be an authoritative clarification of FAS 140 to permit such sales without adverse accounting treatment. Otherwise, a servicer could interpret the operative documents as not having been intended to allow such sales of defaulted loans.

<u>Use of TARP to apply market pressure</u>

Under TARP, the Secretary does have a very meaningful opportunity to bring market pressure to bear on servicers to adopt specific approaches to loan modifications and workouts, not only for whole loan pools purchased under TARP but also for residential mortgage-backed securities. One way to achieve this would be to restrict RMBS purchases to those securities where the servicer maintains a systematic modification program that is acceptable to the Secretary. RMBS that are serviced by servicers with an acceptable program might have a greater market value as a result.

These incentives may in some cases be sufficient to cause investors to seek to have servicing transferred on existing RMBS away from servicers who do not have an accepted modification program to ones that do. Such servicing transfers can be negotiated between the parties to the transfer, and would typically involve a payment to the transferring servicer. Securitization operative documents typically permit transfers of servicing without the investors' consent, provided that the new servicer meets specified criteria.

Supplemental Written Statement:

A. Background

1. Loss mitigation powers within securitizations

Most private label (non GSE) securitization governing documents give broad authority to the servicer to service loans in accordance with customary standards, and in a manner that is in the best interests of investors. Many securitization governing documents specifically authorize loan modifications where the loan is in default, or where default is reasonably foreseeable. Generally, modification of loans that are not in default (or where default is not reasonably foreseeable) could violate REMIC restrictions and therefore are not permitted under the securitization documents.

Servicing of loans that are held in a residential mortgage loan securitization is governed by the operative documents for the securitization, typically either a pooling and servicing agreement or servicing agreement. These agreements employ a general servicing practice standard. Typical provisions require the related servicer to follow accepted servicing practices and procedures as it would employ "in its good faith business judgment" and which are "normal and usual in its general mortgage servicing activities," and/or procedures that such servicer would employ for loans held for its own account. Some transactions also require that the servicer adhere to specific loss mitigation plans.

Most transactions address forbearance or modifying loans in default scenarios, and in some cases non-default scenarios. The provisions may require an opinion as to the continued REMIC status of the related securitization trust in order to modify a non-defaulted loan, which would be difficult to obtain. The "real estate mortgage investment conduit" sections of the Internal Revenue Code of 1986 (the "REMIC Provisions") impose tax impediments to modifying loans, unless the loan is in default or default is reasonably foreseeable. In general, the operative document provisions that permit the modification of defaulted loans are much broader and also provide for the ability to modify a loan so long as default is imminent or reasonably foreseeable.

The imminent default standard reflects a long-standing industry practice. The REMIC Provisions introduced the concept of "reasonably foreseeable" default. In order to permit a modification that would not impair the REMIC status of a securitization trust, the REMIC Provisions generally provide that a loan either (i) be in default or reasonably foreseeable default or (ii) not result in a "significant modification". Most market participants interpret the two standards of future default – imminent and reasonably foreseeable – to be substantially the same.

The modification provisions that govern loans that are in default or reasonably foreseeable default also require that the modifications be in the best interests of the securityholders or not materially adverse to the interests of the securityholders, and that the modifications not result in a violation of the REMIC status of the securitization trust.

In addition to the authority to modify the loan terms, such as changing the interest rate on a prospective basis, forgiving principal, and extending the maturity date, many securitization documents permit loss mitigation techniques, including forbearance, capitalizing arrearages, repayment plans for arrearages and other deferments which do not reduce the total amount owing but extend the time for payment. In addition, these agreements may permit loss mitigation through non-foreclosure alternatives to terminating a loan, such as short sales and short payoffs. Even where these alternatives are not expressly laid out, the operative documents can reasonably be interpreted to allow these alternatives under the general servicing standard.

Certain transactions limit the total number of permitted occurrences of modifications for any individual loan. Certain provisions permit loans to be modified only once during any 12-month period and no more than three times during the life of the loan, or to modify a loan such that amounts owed are added to the principal balance of a loan only once during the life of that loan. Other transactions may limit the amount of modifications to a certain percentage of the initial size of the mortgage pool, or a certain percentage of individual loan groups within the total mortgage pool in some circumstances.

2. FAS 140 constraints

Statement of Financial Accounting Standards No. 140 ("FAS 140") may prohibit a qualifying special purpose entity ("QSPE") from having discretion to sell defaulted or delinquent loans. Most residential mortgage loan securitizations are structured as QSPEs. As a result, for securitizations structured as sales under FAS 140, it may not have been intended that the operative documents authorize the servicer to sell defaulted loans for cash at a discount, as a loss mitigation alternative. Most residential securitization operative documents do not contain an express prohibition on taking this action, although a small minority of them do. Nevertheless, if the practical effect of taking this action (or interpreting the documents as permitting such action) would be to retroactively disqualify the securitization as a FAS 140 sale, then a servicer may reasonably interpret the documents to not authorize this action. However, if FAS140 is amended or authoritatively interpreted to provide that the sale of delinquent or defaulted mortgage loans, where this action provides the best recovery on a net present value basis, would not prevent the related trust from qualifying as a QSPE, we believe that most securitization operative documents could be interpreted (or potentially amended without investor consent) to permit such sales consistent with the servicer's obligations to act in the best interests of such investors.

3. Provisions under the Emergency Economic Stabilization Act of 2008 (EESA)

Section 109(a) of EESA gives the Secretary of the Treasury, with respect to its purchase of certain assets under the Troubled Asset Relief Program (TARP), the following authority:

"To the extent that the Secretary acquires mortgages, mortgage-backed securities, and other assets secured by residential real estate, including multifamily housing, the Secretary shall implement a plan that seeks to maximize assistance for homeowners and use the authority of the Secretary to encourage the servicers of the underlying mortgages, considering net present value to the taxpayer, to take advantage of the HOPE for Homeowners Program under section 257 of the National Housing Act or other available programs to minimize foreclosures. In addition, the Secretary may use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures."[1]

We interpret this reference to "other available programs" to include programs for modifying loans within existing securitizations, in addition to programs such as Hope for Homeowners, which would involve a short refinancing of a loan in a securitization (thereby removing the refinanced loan from the securitization).

4. Servicer safe harbors under HERA and EESA

Section 1403 of the Housing and Economic Recovery Act of 2008 created a safe harbor for servicers of residential mortgage securitizations, under which, "except as may be established" in the securitization governing documents, a servicer owes any duty to maximize recoveries to all investors in the pool rather than any specific investors, and a servicer is deemed to act in the best interests of all investors if it agrees to a modification or workout plan, where (A) default has occurred or is reasonably foreseeable, (B) the property is owner occupied, and (C) the anticipated recovery under the modification or workout "exceeds, on a net present value basis, the anticipated recovery… through foreclosure."[2] Section 119(b)(2) of EESA contains a similar provision as follows:

"Except as established in any contract, a servicer of pooled residential mortgages owes any duty to determine whether the net present value of the payments on the loan, as modified, is likely to be greater than the anticipated net recovery that would result from foreclosure to all investors and holders of beneficial interests in such investment, but not to any individual or groups of investors or beneficial interest holders, and shall be deemed to act in the best interests of all such investors or holders of beneficial interests if the servicer agrees to or implements a modification or workout plan when the servicer takes reasonable loss mitigation actions, including partial payments."[3]

This provision does not appear to directly supersede Section 1403 described above, but it does broaden the protection to servicers in two important ways. First, the standard "maximize the net present value" is broadened to determining whether the net present value of the loan as modified is "likely to be greater" than the foreclosure recovery, which is an easier standard to meet. Secondly, a modification or workout is deemed to be in the best interests of investors when the servicer merely "takes reasonable loss mitigation actions", which is again an easier standard to meet. This provision effectively opens up the safe harbor to situations where the loan is not in

[1] Emergency Economic Stabilization Act of 2008 at § 109(a).
[2] Housing and Economic Recovery Act of 2008 at § 1403; *see also* 15 U.S.C. 1601(129)(a).
[3] Emergency Economic Stabilization Act of 2008 at § 119(b)(2).

default, and also to non-owner occupied properties. Moreover, additional types of loss mitigation actions could be covered by this provision, such as selling a defaulted loan out of a pool to a distressed loan investor, for a discounted cash price that results in a better net present value recovery than a foreclosure.

One interpretive issue is whether Section 119(b)(2) was intended as a safe harbor applicable to all servicers in securitizations, or if the protections of this section were intended only to apply to transactions that are related to TARP. On its face the language appears to be broadly applicable, but the language may have been added to EESA primarily to facilitate the purchase of defaulted loans from securitizations under TARP.

5. Emerging trends in loan modification programs

Prior to the start of the credit crisis, loan modifications were used by servicers in limited circumstances. Since most first lien loans had enough equity to result in minimal losses on foreclosure, and since in many cases a borrower with payment difficulty could refinance into a new loan with lower payments, loan modifications were rarely used to address long term problems. Most loan modifications were actually forbearances, under which a borrower who had a short term difficulty in making payments would have a relatively short period of time to come current and repay arrearages.

Because modifications were not needed in large volumes and were made on a case by case basis, servicers did not need to follow a systematic program.

In today's environment, with high default rates and falling property values, loan modifications will be the best option for loss mitigation in a relatively high percentage of cases. This requires that the servicer follow a systematic approach in order to effectively design, evaluate and implement modifications. A servicer needs to have sufficient staff, as well as systems, procedures and models. In addition, there must be a detailed set of guidelines for designing and evaluating loan modifications.

Following are some key elements of a systematic loan modification program:

> Default or imminent default: the program should be limited to borrowers who are currently in default, or for whom default is reasonably foreseeable based on the original loan terms. Steps should be taken to confirm that the borrower did not deliberately default in order to be eligible for a modification.
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> Income verification: there should be procedures for gathering specific information about the borrower's current income and expenses. Some programs omit income verification where the borrower is not likely to be able to afford projected increased monthly payments, for example on a hybrid ARM at its reset date.

Occupancy verification: there should be procedures for verifying that the property is being used by the borrower as its primary residence. Most loan modification programs are limited to owner occupied primary residences.

Defining affordability: there should be guidelines that define what payment level is considered affordable. For example, some programs use a 38% debt to income ratio to set a payment amount for a proposed loan modification.

Systematic modifications: the program should use a tiered approach in designing a proposed loan modification based on the borrower's income. For example, the following features could be applied, until an affordable payment level is reached: term or amortization period extension; interest rate reduction to a specified floor over a set period of time; and then principal reduction through partial forgiveness or forbearance. Most modification programs would set a reduced interest rate over a 5 year period, followed by a fixed rate over the remaining term of the loan which is a market rate as determined at the time of the modification.

NPV test: the net present value of the anticipated payment stream from the proposed modification should be compared with the net present value of the anticipated recovery that would be obtained from a foreclosure and liquidation of the property. The modification NPV should take into account a reasonable assumed re-default rate. The foreclosure NPV should take into account the estimated current property value, home price depreciation during the time required for liquidation, and other factors. Some streamlined programs use a current loan-to-value ratio floor instead of an NPV analysis.

Principal reductions: the modification program should contemplate a partial principal reduction as a way to reach affordability. Principal reductions should not be made solely because the property value has declined to below the mortgage balance, but rather should only be made for borrowers who have defaulted or who cannot afford the loan's original terms.

Forgiveness v forbearance: in making a partial reduction of the loan amount as part of a modification, either forgiveness or forbearance should be used. Forgiveness is a permanent reduction of the principal amount. The advantages of this approach are that the borrower perceives himself to be no longer underwater, and a "renter's mentality" under which the borrower might be disinclined to maintain the property is reduced. Forbearance would involve maintaining some or all of the amount that would have been forgiven as a lien on the property, in effect as a non-interest bearing balloon payment which is made only when the property is sold or refinanced. This approach has the advantage of allowing the lender or investor to share in the potential upside if the property value increases in the future. In addition, if there was a second lien on the property prior to the modification, forbearance prevents putting the second lienholder in a position where it can recover its loan at the expense of the first lienholder.

B. Ways to increase loan modifications and foreclosure prevention going forward

1. Guaranty program on loans in securitizations

The final sentence of EESA Section 109(a) provides that "[T]he Secretary may use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures." If the Secretary were to make available credit enhancement under a guaranty program that covered specific loans that had been modified, this could alter the equation of the servicer's net present value determination. As described in A 5 above, under a typical loan modification program, the servicer takes the following steps: 1) a specific proposed loan modification is designed based on the borrower's current ability to pay, 2) the anticipated payment stream under the loan as modified is compared with the anticipated recovery from foreclosure and liquidation on a net present value (NPV) basis, and 3) the servicer chooses the alternative with the greater NPV. In comparing a loan modification with a foreclosure and liquidation, the servicer normally would assume some likelihood that the loan as modified would re-default, and this factor reduces the net present value of the modification alternative. But if credit support were added that eliminated the re-default risk, then for any given proposed loan modification the servicer would be more likely to choose the modification over foreclosure, as long as the guaranty premium was less than the NPV reduction that would have resulted from the assumed re-default risk. In this regard, it should be noted that observed re-default rates for loan modifications are generally in the 25 - 40% range.

There are a number of issues to consider in designing a program for guarantying modified loans held within securitizations. First, should the guaranty amount be the entire amount of the loan as modified, or a portion of the loan balance? It may be that guarantying only a portion of the balance is needed to achieve the desired effect of enabling the servicer to choose the modification. In calculating NPV of the loan as modified, if the guaranty was limited to an amount needed to cover any loss on liquidation if there was a re-default (based on an estimate of the property value after a re-default), that might be enough to mitigate the re-default risk. If as part of the loan modification there was a partial principal reduction, that would reduce the amount of coverage needed under the guaranty. The program could be structured to offer a range of options for a guaranty based on different assumptions as to the amount of any principal reduction included in the modification. The program could offer risk based premiums set on a loan by loan basis, and tied to factors including the current loan to value ratio of the loan immediately after the proposed modification. The guaranty would not cover any principal reduction included in the modification, whether the reduction is made by forgiveness or by forbearance.

The program could also include a feature under which, if and when a claim is made under the guaranty on a modified loan that re-defaults, the Secretary would have the option to purchase the loan from the securitization pool at its face amount (as modified at the time the guaranty was placed). The loan could then be liquidated, modified or otherwise worked out under a wide variety of options as described under B 2 below. This would enable the Secretary to avoid foreclosure and minimize loss to the taxpayers.

One question is whether the Secretary's loan guaranty authority under Section 109 is within the overall TARP program limit. Although that may have been intended, there is no clear link within EESA between this guaranty authority and the program limit.

Another major issue for the guaranty program would be, to whom would the program be available? In order to encourage modifications and protect the taxpayer's interests, the guaranty program should be limited to servicers who have demonstrated that they have a robust, systematic modification program, with sufficient staffing and resources to handle a high volume of modifications. The modification program should include the features described in A 5 above, including procedures to verify current income and a reliable model for evaluating NPV of modifications as well as foreclosure. There could be a procedure under which a servicer's loan modification program is reviewed, following which the servicer may be approved for purchasing loan guarantees under this program. In this regard, there should be flexibility to allow differing approaches to key program elements, such as the definition of affordability, the tiers for proposed loan modifications, the models used to estimate NPV and the key assumptions used in the model, as these matters may vary from servicer to servicer.

This guaranty program would be a very effective way to encourage modifications. It could be available both for loans that are within securitized pools, as well as loans held in portfolio. The program would have the effect of potentially changing servicer behavior to use modifications in more cases, without creating a mandate or changing the operative documents. And, the program would encourage servicers to work harder to develop systematic loan modification programs, so as to qualify for participation in this program.

Moreover, this additional credit enhancement should increase the market value of the related RMBS, because the re-default risk on loans in the securitization which had been modified would be mitigated by the guaranty.

2. Purchasing defaulted loans out of securitizations under TARP

We believe that it would be possible to develop a program under TARP whereby defaulted mortgage loans could be purchased from securitization trusts at a discounted price. The advantages of such a purchase program and its legal basis are discussed in this section. An important issue in implementing such a program would be resolving any FAS 140 barrier.

Under EESA, the Secretary may purchase troubled assets under TARP, including residential mortgage loans, from any “financial institution”. While the definition of a financial institution does not explicitly include common law trusts (the typical form used for residential securitizations), legal title to the mortgage loans in residential securitizations is held by a trustee, which is clearly an eligible “financial institution” under EESA. If however the definition were not so interpreted, a defaulted loan purchase program could be structured so that loans would be bought from securitization trusts through financial institution intermediaries.

Such a program would be a very helpful development because it could provide relief to borrowers who could not be helped under the other forms of loss mitigation available, including

loan modifications, short sales and short refinancings. There is currently no program available for sale of defaulted loans at a discounted value out of a securitization trust, and it is generally thought that servicers do not have the authority to do so.

This program would be helpful because there are borrowers who cannot meet their mortgage payments but would like to stay in the home, and who would not be able to qualify for a loan modification that satisfies the NPV test (as compared to foreclosure) because they could document sufficient income. Borrowers with these characteristics also might not be able to qualify for a short refinancing under the Hope for Homeowners program or other available lending programs.

For borrowers in default for whom foreclosure or short sale is the only option available to the servicer, it would be consistent with the investors' best interests to be able sell the loan out of the securitization trust at a discounted cash price, where the cash price is greater than the net present value of the anticipated recovery from foreclosure. If defaulted loans could be sold under these circumstances into a government or non-profit program the purpose of which was to maintain the borrower in the home pending an economic recovery, RMBS investors would be indirectly benefited because this would reduce foreclosure sales and the downward pressures on home values that they cause.

Defaulted loans purchased under the TARP program could be subject to a wide range of workout options. The borrower could be given a low interest rate loan with a principal amount set at e.g. 85% or 90% of the property's current market value. The rate could be set to an amount the borrower could afford, with an adjustment to a market rate in 5 years. This would encourage a sense of ownership and give the borrower a fresh start. Alternatively, title to the property could be taken by an entity established as part of the TARP program, or by a non-profit organization, and the property could be rented back to the prior borrower with a purchase option. These options would not be available for loans retained within a securitization, to the extent that the NPV of the recovery under these options was less than the NPV of a foreclosure.

The question then arises as to whether a servicer under typical securitization operative documents would have the authority to sell a defaulted loan at a discounted cash price under TARP. Although typical servicing authority provisions have been broadly interpreted to allow loan modifications and other loss mitigation alternatives (see A 1 above), these provisions have not been interpreted to allow such sales for a number of reasons. First, such sales to date have not been a standard servicing practice. Second, typical provisions direct the servicer to itself foreclose on or otherwise liquidate or workout defaulted loans, and do not appear to contemplate selling the loan for cash to a third party such as a collection agency or a distressed asset investor. Third, some securitization documents contain an express provision allowing the servicer to purchase for its own account a defaulted loan, but these provisions typically specify a par price. Finally, as described under A 2 above, FAS 140 does not appear to permit sales of loans out of securitization trusts, and therefore securitization documents have been interpreted as implicitly prohibiting such sales.

That being said, most RMBS operative documents are in fact silent on the issue of whether defaulted loans can be sold for a discounted price, although a small minority do contain an

express prohibition on such sales. Where the documents are silent, there is a strong argument that sales could be made pursuant to the general authority to service in accordance with the general servicing standard and if in the best interests of investors, under the following circumstances:

* The loan is in default

* The loan is sold to the Secretary under TARP for a cash purchase price

* The cash price is greater than the net present value of the anticipated recovery under a foreclosure

* The cash price is greater than the net present value of other potential alternatives (if available) including the servicer's modification program, a short sale or any available short refinancing.

The servicer safe harbor under Section 119 of EESA (see A 4 above) would provide some legal protection for a servicer that interprets securitization operative documents as permitting a sale of defaulted loans to TARP at a discounted cash price as described above. Such a sale under the conditions listed above should be considered to be "reasonable loss mitigation actions" that would be deemed to be in the best interests of all investors in that securitized pool.

However, a servicer could not rely on the safe harbor, and should not engage in the sale of defaulted loans at a discounted cash price, if the securitization operative documents expressly prohibit such actions.

Finally, before participating in a program for the sale to TARP of defaulted loans at a discounted cash price, the servicer should consider whether taking that action would cause the entity that sold the loans into the securitization to no longer be able to treat that transaction as a sale under FAS 140. For the reasons described above, a servicer could interpret the operative documents as not having been intended to allow such sales of defaulted loans if that adverse accounting treatment would result.

For these reasons, an essential element of a program under TARP to purchase defaulted loans from securitizations at a discounted price would be a clarification of FAS 140. We note that on July 18, 2007 the Office of the Chief Accountant (OCA) of the Securities and Exchange Commission issued a memorandum that gave broad support for the proposition that "entering into loan restructuring or modification activities (consistent with the nature of activities permitted when a default has occurred) when default is reasonably foreseeable does not preclude continued off-balance sheet treatment under FAS 140". In addition, the OCA issued a letter dated January 8, 2008 that provided similarly helpful guidance under FAS 140 as to the ASF’s Streamlined Foreclosure and Loss Avoidance Framework.

We would hope that the OCA or the Financial Standards Accounting Board could issue favorable guidance on the FAS 140 issue under a TARP defaulted loan purchase program. Such guidance could be limited to sales under the TARP program, under the circumstances outlined above.

3. Use of TARP to apply market pressure

Under TARP, the Secretary does have a very meaningful opportunity to bring market pressure to bear on servicers to adopt specific approaches to loan modifications and workouts, not only for whole loan pools purchased under TARP but also for residential mortgage-backed securities. One way to achieve this would be to restrict RMBS purchases to those securities where the servicer maintains a systematic modification program that is acceptable to the Secretary (see A 5 above for a discussion of key features of a systematic loan modification program). For example, a review could be performed of existing modification/workout programs of the major residential loan servicers, and the Secretary could publish a list of those servicers that maintain a program acceptable to the Secretary. (This review process could be part of, or in addition to, the review process for the modified loan guaranty program discussed in B 1 above.) Financial institutions holding substantial blocks of RMBS that are serviced by servicers that do not have such an acceptable program, would then have an economic motivation to pressure those servicers to adopt enhanced modification/workout programs. Also, RMBS that are serviced by servicers with an acceptable program might have a greater market value as a result.

These incentives and economic considerations may in some cases be sufficient to cause investors to seek to have servicing transferred on existing RMBS away from servicers who do not have an accepted modification/workout program to ones that do. Such servicing transfers can be negotiated between the parties to the transfer, and would typically involve a payment to the transferring servicer. Securitization operative documents typically permit transfers of servicing without the investors' consent, provided that the new servicer meets specified criteria.

4. Potential changes to REMIC

As discussed in A 1 above, most residential mortgage backed securities are structured as REMICs for federal income tax purposes. The REMIC Provisions include a number of restrictions, including that loan modifications are effectively prohibited unless the loan is either in default or default is reasonably foreseeable. The question arises, whether any amendments to the REMIC Provisions would be necessary or helpful in enhancing the ability of servicers to engage in more loan modifications.

One change that could be made would be to permit loan modifications where the loan is not in default and where default is not reasonably foreseeable. However, this change would not necessarily result in more loan modifications. In deciding whether to modify a loan, the servicer must compare the modification to a foreclosure and liquidation scenario, which is not realistic unless default is at least reasonably foreseeable. Generally, securitization operative documents would not permit a loan modification if the borrower was able to pay the loan under its original terms.

5. Amending existing securitization documents

The ability to amend any securitization document to allow modifications and workouts (or to change express restrictions thereon) is very limited, other than for amendments that are made under limited provisions that allow changes without investor consent for matters such as curing errors or ambiguities in the documents. In most cases, an amendment would require a supermajority approval from each separate class outstanding. It should also be noted that some transactions do impose express restrictions on modifications, such as number of loans that may be modified, or a limit on rate reductions. Further, most transactions would restrict a maturity extension. These express restrictions are not superseded by either of the servicer safe harbors described in A 3 above, and would not be overridden by any provision of EESA.