Mortgage Loan Modification: Promises and Pitfalls

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I. INTRODUCTION

Problems in the US mortgage industry have led many disparate authorities to consider numerous ways to insulate borrowers from the effects of their loan paments, and therefore ameliorate the short-term economic impact of the current market crisis.

Clearly the problem is large. Leaving the alt-A and jumbo sectors aside, subprime mortgages alone currently amount to about 13% of total mortgage loans outstanding, or about $1.2 trillion. It is estimated that in 2007 alone, about $400 million in subprime loans will face adjustable-rate interest increases, which in some cases can result in payment increases of 150 percent or more and borrower pre-tax debt-to-income ratios of up to 65 percent (it is common to consider a debt-to-income ratio of 40 percent or below as prudent). As Figure 1 shows, 2008 is expected to be worse.

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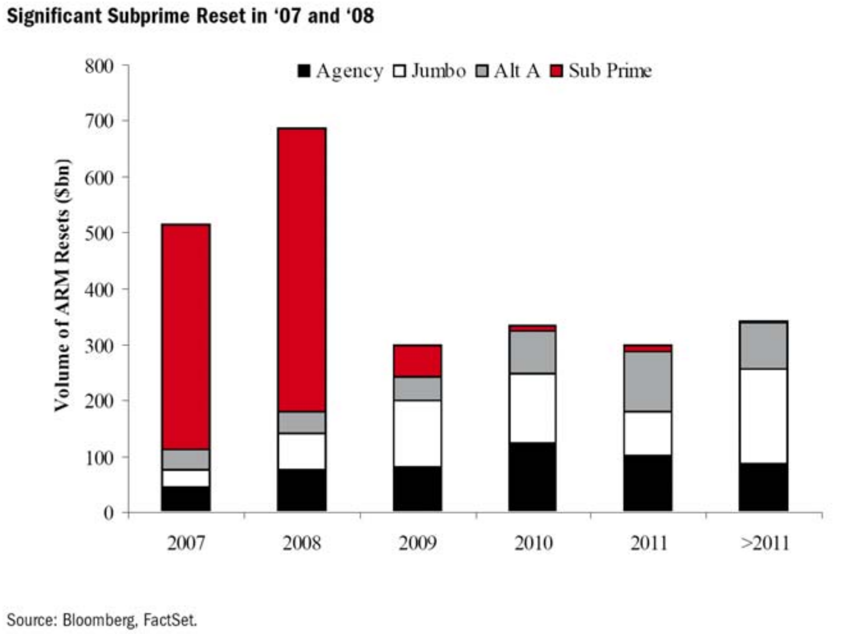
FIGURE 1: SUBPRIME MORTGAGE RESETS IN 2007 AND THE FUTURE



Source: Bank of America, "Subprime Mortgage Finance Weekly: Subprime Loan Modifications – not a Panacea," May 25, 2007.

The current subprime delinquency ratio is about 15 percent ($180 billion) of outstanding subprime mortgages, a 14-year high. Even if all subprime mortgage loans currently in delinquency do not go into foreclosure, it is easy to imagine the ratio rising further to create a crisis on par with the thrift crisis of the late 1980s, which is equal to about $150 billion in inflation-adjusted terms.[1]

Each delinquency and foreclosure is costly to administer. The cost of a typical foreclosure has been estimated to be about $60,000, or about 20-25 percent of the loan balance (legal fees alone can cost $4,000), and those costs are expected to be higher in times of home price depreciation.[2] Hence, it is logical for lenders to try to avoid foreclosures through loan modification.

Fitch Ratings recently suggested that as many as two-thirds of existing delinquencies can be expected to be modified over the next 12-18 months. Among such loans, modification might be the *only* viable alternative to foreclosure for as many as 50% of the loans in default or facing a default scenario.[3]

There are three major problems with this strategy. First, a modification effort of this magnitude is far beyond the existing modification capacity of the industry. Most servicers currently modify less than 1 percent of their loans, so increasing to 10 or 20 percent represents growth of 1,000- 2,000 percent. Second, while

1. Bank of America, *Subprime Loan Modifications – not a Panacea*, SUBPRIME MORTGAGE FINANCE WEEKLY, May 25, 2007. I derive this figure using $100 billion and adjusting for inflation from 1991-2006 with CPI.
2. *Id*.
3. Gabrielle Stein, *Loan Modifications Pick Up Pace Despite Speed Bumps*. ASSET SECURITIZATION REPORT, Jun. 18 , 2007.

modification may be less costly than foreclosure (although this is far from certain), the difference could well be negligible. Third, the authorities calling for massive modification efforts must realize that, "Payment deferral will not help people who inflated incomes or recklessly bought properties they could not afford." Since, by some estimates, borrowers inflated their stated income by 50 percent or more in 70 percent of loans, it could be that few of the loans currently experiencing difficulties can benefit from modifications that would preserve any reasonably economic lending arrangement for borrower and lender alike.[4]

If modifications are given to borrowers that are not well suited for homeownership in the long term the loan modification only serves to delay the inevitable while keeping the borrower in a (somewhat milder) state of financial distress. In such cases, the borrower may be better off moving to more affordable housing today rather than continuing to pressure their finances chasing the unobtainable chimera of "homeownership." Furthermore, modifications granted to unsuitable borrowers may be considered predatory. On top of all this, thin preliminary data (provided by those with successful modification programs) suggest that modified loans experience a 35-40 percent redefault rate over the following two years. Hence, predatory or not, relatively few loan modifications "work," that is, help the borrower ultimately afford the home.

It appears, therefore, that the main purpose of loan modification is to skew financial reporting of delinquencies. In other words, modifying loans helps borrowers to make a few payments, allowing lenders to aggressively reage the accounts and classify them as "current," instead of "delinquent." Such practices appear to have been a key mechanism in supporting paper earnings of many failed subprime lenders prior to bankruptcy. Hence, without regulatory oversight or increased transparency, it is hard to imagine that borrowers will benefit from modification in the long run.

The report that follows looks at the promises and pitfalls of loan modification. Section II illustrates the costs and benefits of modification. As stated above, while delinquencies and foreclosures are long and costly to the servicer, industry inexperience with modification, the potential lack of suitable loans for modification efforts, and the sheer cost of the efforts may limit the usefulness of the approach to a level far below that which can cushion the harmful economic effects precipitated by the current crisis. Section III shows that predatory servicing has been a problem in the recent past and modification, too, can be predatory if it does not truly help borrowers afford homes in any meaningful sense. Redefault rates from modifications are high, and modification has been misused in the past, in conjunction with reaging, to skew financial performance. With no regulatory authority to oversee modification and reaging policies and little transparency with respect to those arrangements, it is quite possible that extensive modification will hurt consumers and investors alike. Again.

4. Bank of America, *Subprime Loan Modifications – not a Panacea*, SUBPRIME MORTGAGE FINANCE WEEKLY, May 25, 2007 at 4.

II. THE COSTS AND BENEFITS OF MODIFICATION ARE NOT CLEAR

Loan modification is used to avoid defaults, which are costly to servicers. Mortgage loan servicers are typically remunerated on the basis of a servicing fee of between 12.5 and 50 basis points of the outstanding principal balance. The flat servicing fee can be augmented with equity incentives, residual first-loss investment stakes that give the servicer an incentive to maximize cash flow from the loans. The total value of the direct fees and equity incentives are included on servicers' balance sheets as mortgage servicing rights (MSRs). MSRs are the net present value of the series of uncertain direct service fee payments. MSRs are difficult to value with any degree of certainty and the valuations that result can be very volatile to actual conditions realized in the servicing pool.[5]

Default costs create not only large direct costs – in terms of increased telephone call, mailing, legal, and administrative costs – but also substantial cash flow difficulties. Cash flow difficulties arise because the legal and other costs related to foreclosing upon and selling repossessed real estate, while ultimately reimbursable from the trust, are only reimbursed when the collateral is sold. "Advancing" funds in such circumstances can substantially disrupt the cash flows of the servicing entity. If the servicer does not have cash on hand to cover the cash flows those advances must be funded in the interim through borrowings, and while the direct costs of the disposition are reimbursed, the funding costs are not. Advances can remain outstanding for a long time because the foreclosure process itself is lengthy, *averaging* almost a year-and-a-half from missed payment to sale of the property in a healthy market.[6]

Servicers, therefore, engage a variety of different strategies to avoid the costs of default, but modification incurs other, new, costs. Modification strategies in the most general sense include a wide range of proactive loss mitigation tools like payment plans[7] and loan modifications.[8] Loan modifications may include a permanent reduction in rates, extending the term of the loan to reduce monthly payments, deferring prior missed payments and adding them to the principal balance, and reset shock modification where the terms of the loan are adjusted to mitigate the payment shock.[9]

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5. The vast majority of bank failures since 1992 have involved substantial issues of MSR and residual valuations. Nonetheless, many of the top mortgage servicers derive a great deal of their value from equity incentives and MSRs. WaMu's MSRs amount to 23 percent of their capital, IndyMac's amount to 90 percent of their capital, and Countrywide's amount to 115 percent of their capital. Having MSRs worth more than the value of capital creates a high risk that valuation difficulties can wipe out a substantial portion of a firm's underlying capital with the stroke of a pen.

6. Moody's, *2004 Review and 2005 Outlook: US Servicer Ratings*, Jan. 12, 2005.

7. In the case of temporary financial hardship, servicers often put borrowers on repayment or forbearance plans to make up missed payments over a short period of time. These plans do not change the contractual obligations of the original loan terms.

8. Loan modifications are designed to assist borrowers in financial distress who are unable to meet their mortgage obligation under the existing contractual terms of the loan by providing more favorable terms which will enable the borrower to make monthly payments to stay current or cure the loan.

9. Merrill Lynch, *Mortgage Credit Losses: How Much, Where, and When?*, Jul. 20, 2007. *See also* Fitch Ratings, *U.S. RMBS Servicer Workshop*, May 18, 2007.

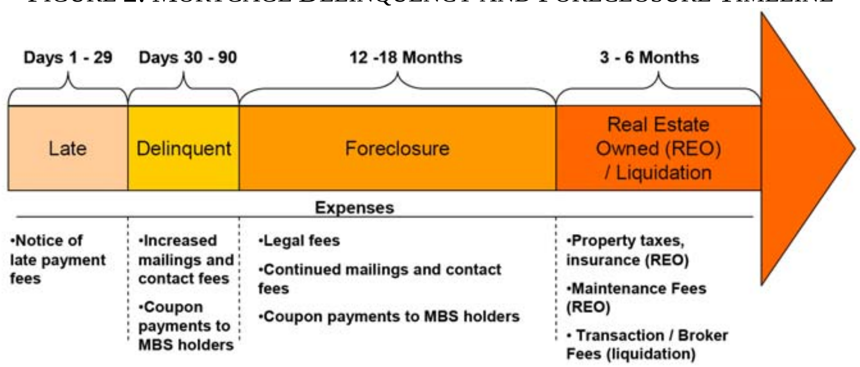
Each of those choices effectively reduces the borrower's loan payment, but not necessarily the total price paid by the borrower over the life of the loan. From the servicer's perspective, therefore, each alters cash flow expectations arising from the loan, therefore altering MSR and residual valuations.

The present section examines the magnitude of the cash flow disruptions that occur from default management and relate those to the potential for loan modification programs.

A. Servicers are Using Modification in Attempts to Avoid Costly Defaults, Foreclosures, and Advances

Figure 2 illustrates the default, foreclosure, and disposition process whose costs servicers attempt to avoid through modification. Note first that the process is lengthy, as mentioned above, taking an average year-and-a-half to complete in a healthy economic and real estate market environment. Note further that the servicer must not only advance legal fees, property taxes, maintenance fees (12 percent of principal balance), and transaction and broker fees during the process, but also maintain coupon payments to mortgage-backed securities investors until the process is complete, the losses can be properly accounted for.

FIGURE 2: MORTGAGE DELINQUENCY AND FORECLOSURE TIMELINE



Source: Bank of America, *The Hidden Credit Costs of Mortgage Servicers*, Specialty and Mortgage Finance Weekly Mar. 23, 2007.

Adding just the cost of temporarily *funding* those reimbursable default costs into Bank of America's servicing costs estimate raises the annual cost of servicing delinquent loans to over 2,000 percent the cost of servicing current loans and the cost of servicing foreclosed loans to 4,000 percent the level for current loans, or 20 to 40 times normal servicing costs. Bank of America gives the example of a $144,000 mortgage with a fixed interest rate of 7.5 percent. The servicer earns a fixed servicing fee of 35 basis points. The results of the exercise are illustrated in Figure 3.

FIGURE 3: TOTAL ANNUALIZED SERVICING COST PER MORTGAGE LOAN

	Delinquent	Foreclosure	Performing Loan
Servicing Costs	$51	$51	$51
Non-reimbursable	$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

Source: Bank of America, *The Hidden Credit Costs of Mortgage Servicers,* Specialty and Mortgage Finance Weekly Mar. 23, 2007 at 7-8.

When the loan goes into default, the servicer has to advance coupon payments of $10,798 per annum to investors and does not earn the annual servicing fee of $504. Both will be reimbursed when (if) the loans becomes current, but in the meantime the servicer incurs $659 annual funding costs at LIBOR plus 50 basis points. In foreclosure, the servicer also pays taxes and legal fees of $5,759 annually and a 12 percent standard annual maintenance fee (to keep the house in marketable condition) of $17,277. Funding those fees in addition to the coupon and servicing fee amounts to $1,086 per annum at a rate of LIBOR plus 50 basis points.

Matters are further exacerbated by the effect of defaulted and foreclosed loans on MSR values, a significant source of servicer enterprise value. In each case, a loan did not remain in the performing pool, so the servicing fee revenue ended. If the servicing fee cash flow ends before originally expected, the MSR must be written down to reflect the decreased value of the servicing contract. Assuming that the average life of the loan in the previous example is six years, if the loan goes immediately into delinquency followed by default two years later, that represents roughly 4 years of foregone servicing fees. Bank of America calculates the average annual cost for a simulated sample of foreclosed loans as a function of the MSR portfolio to be 0.46 percent (based on an assumed fair value as percentage of MSR portfolio of 1.38 percent). That equates to a cost of $662 per loan in foreclosure based on the example loan's unpaid balance of $144,000. The results are also presented in Figure 3.

In summary, servicers' contractual funding needs can cause the cash costs for defaulted loans to swell significantly for about a year-and-a-half, until the servicer can complete the foreclosure and recovery process and obtain reimbursement. Since those costs can be expected to be higher and the process longer in poor economic and real estate market conditions, servicers should expect to endure substantial earnings pressure as they are squeezed between market conditions and funding needs.

B. …but Modification, itself, is Expensive and the Benefits, for both Servicers and Borrowers, are Highly Uncertain

While most servicers claim that a well-managed loan modification program can save money over servicing through what has been illustrated above as an extremely costly delinquency and foreclosure process, loan modification is a relatively new function and, like the subprime mortgages that necessitate it, is untested in an economic downturn.

At Fitch's RMBS Servicer Workshop, held in May 2007, almost all servicers said that they "had not used modifications extensively as a loss mitigation tool in the past." And while "most indicated that they are preparing for significant increases in modification volume," the volume of modification necessary to address current market difficulties is unprecedented. Later Fitch Ratings reports that subprime servicers plan to resolve as many as 50-75 percent of defaults using various modification tools.[10]

Furthermore, not all borrowers will qualify for loan modifications. While the decision to modify a loan is not subject to oversight as is the decision to make the initial loan, modifications only make sense for a certain set of re-underwriting criteria. Moody's explains that servicers will have to, "…review the borrower's current financial situation and re-qualify the loan. It is not advantageous to modify a loan without knowing if the borrower can afford the modified obligations." Moody's also states that, "This will be particularly important for the large number of loans originated in recent years that were made to borrowers who merely stated their income and asset information instead of providing documented proof (so called "limited documentation" loans)."[11]

Even with income and qualifications, loan modifications will not be applicable to all problematic borrowers. Loans originated with little documentation of income, where borrowers still cannot document sufficient income to qualify under today's tighter credit standards are poor candidates for modification. Borrowers with no equity in their home are also poor candidates for modification, as decreasing home values may lead them to default notwithstanding the level of their loan payment. Interest only and other extremely low payment loan borrowers probably cannot support an amortizing obligation regardless of interest rate, and are, again, poor candidates for modification, as are borrowers who have 40- and 50-year mortgages that are already stretching out payments for a longer period of time.[12]

As Mark Adelson, formerly of Nomura, stated, "…modifying loans for distressed borrowers is a labor-intensive process because the servicer must carefully evaluate each borrower's capacity to pay. The full cost of processing a loan modification can be in the range of $500 to $600. It is often necessary to visit the subject property and to interact with the borrower face-to-face."[13] Because of the high cost involved, Litton Loan Servicing Vice President Shane Ross equates modification to "doubling-down" your bet: a highly risky proposition that you should not undertake without a full understanding of the risks. Ross points out that dramatic increases in loan modification work necessitate increasing, "your loss mitigation staff, your collections staff, your customer service staff,…your foreclosure staff," all at a time when servicing

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10. Fitch Ratings, *U.S. RMBS Servicer Workshop*, May 18, 2007; Bank of America, *Subprime Loan Modifications – not a Panacea*, SUBPRIME MORTGAGE FINANCE WEEKLY, May 25, 2007; Fitch Ratings, *Changing Loss Mitigation Strategies for U.S. RMBS*, Jun. 4, 2007.

11. Moody's, *US Subprime Mortgage Market Update*, Apr. 2007.

12. Moody's, *Challenging Times for the US Subprime Mortgage Market*, Mar. 7, 2007.

13. Nomura, *Securitization & Real Estate Update*, May 18, 2007.

costs are skyrocketing and cash advance and funding needs are spiking. A highly risky business proposition.[14]

Legislative or regulatory intervention can easily upset the balance of discretion in loan modifications, imposing high costs on that already risky proposition. According to Chris Flanagan, managing director and head of global research at JPMorgan Securities, the whole premise of loan modifications is to allow the servicer to exercise independent discretion and evaluate borrowers individually to determine appropriate options available to them. If legislators or regulators require modifications to some group of borrowers regardless of their fundamental ability to make the loan payments successfully well into the future, that balance will be upset.[15]

At the end of the day, however, even a successful loan modification is harmful to lenders. Loan modifications reduce yields and the yield reduction will negatively impact residual valuations due to lower cash flow accrued to the trust. Since the servicer often owns an equity stake in the trust, the servicer is bound to lose.[16]

III. SINCE MODIFICATION IN AN UNREGULATED ENVIRONMENT CAUSED THE PRESENT DIFFICULTIES, IT DOES NOT MAKE SENSE TO ENCOURAGE MORE

The servicing industry has experienced problems in the past that should make those pressing for greater use of loan modifications generally wary. First, not too long ago, the industry was battling allegations of predatory servicing, or foreclosing on one class of borrowers more aggressively than others. If some classes of borrowers are more likely to receive loan modifications than others with equal credit characteristics, loan modifications may contain a predatory component as well.

Second, a sizeable proportion of modification agreements fail, in the sense that the borrower redefaults within 24 months. In such cases, the servicer spends the greater costs of default and foreclosure on top of the costs of earlier modification. Furthermore, the servicer may recover far less from the collateral due the extended period of borrower difficulties. On net, therefore, even existing modification efforts may not ;provide servicer cost savings. Extending a losing business proposition will require massive government subsidies now and in the future.

Third, in the late 1990s many segments of the consumer credit industry were found to be reaging loans aggressively to mask delinquencies. It seems that many failed non-bank subprime mortgage lenders have similarly used modification in conjunction with aggressive reaging to support portfolio performance more recently.

Last, it is important for proponents of widespread modification to understand that the practice lies outside fair lending laws, and there are no regulatory monitoring or enforcement authorities prepared to guard against predatory

14. Amilda Dymi, *Need for Loan Mods Will Persist*, NATIONAL MORTGAGE NEWS, May 28, 2007.

15. Karen Sibayan, *Panelists Reject Mandatory Loan Modifications*, ASSET SECURITIZATION REPORT, May 21, 2007.

16. Bank of America, *Subprime Loan Modifications – not a Panacea*, SUBPRIME MORTGAGE FINANCE WEEKLY, May 25, 2007.

modification, ensure prudent redefault rates, and impose reporting rules promoting transparency on reaging policy. Given that none of these risks are new, advocates would be wise to propose a more prudent measured expansion, and only after thorough and thoughtful consideration of the promises and the risks of widespread loan modification.

A. Predatory Servicing can be Extended to Modification

Predatory servicing was a common concern among regulatory officials and servicers in 2003 and 2004. In November 2003, Select Portfolio Servicing, Inc. (formerly Fairbanks Capital Corp.) signed a consent order with the Federal Trade Commission and the Department of Housing and Urban Development due to predatory servicing concerns. In April 2004, Ocwen Federal Bank FSB reached a supervisory agreement with the Office of Thrift Supervision (OTS) based on similar concerns. Soon after that, Ocwen Financial Corporation, Ocwen Federal Bank FSB's parent company, filed an Application for Voluntary Dissolution with the OTS in November 2004 to explore the possibility of the bank terminating its status as a federal savings bank under OTS and Federal Deposit Insurance Corporation supervision.[17]

Following those regulatory actions, many servicers re-evaluated their operations to identify potential exposure to predatory servicing concerns. Servicers implemented 100 percent call recording, itemized monthly statements, and issued paper notification to borrowers when fees are charged. Servicers added transparency to force-placed insurance programs (hazard insurance coverage that is assigned to mortgaged property when the borrower fails to maintain his or her own coverage) and reduced or eliminated ancillary fees.

One big concern of consumer advocates with respect to predatory servicing was quick foreclosure, particularly for lenders that refer loans to foreclosure in a 60 to 75 day timeframe following delinquency. In response to concerns that early foreclosures were not warranted, servicers added pre-foreclosure activities to ensure that collection and loss mitigation attempts on a loan were thorough and that proper notices were provided to the borrower. Loans were also reviewed pre-foreclosure for potential legal issues and headline risk that could be associated with a foreclosure action. Foreclosure referrals are now more common beginning after the 90th day of delinquency. But the new pre-foreclosure activities also paved the way for servicers to make more detailed loan-level decisions, including using more loan modifications.[18]

The fact that the opportunities for more loan modification originated from attempts to more thoroughly investigate loans prior to foreclosure to avoid predatory servicing concerns should not be a source of comfort. Rather, that means the processes surrounding modification are still new enough that they can be mis-applied to consumers' detriment.

The decision to modify a loan is identical to a decision to refinance a loan, but the modification decision is not currently treated as a new loan decision. That means that the modification proposal and acceptance by the consumer are not required to generate any of the records, disclosures, and restrictions placed upon

17. Moody's, *2004 Review and 2005 Outlook: US Servicer Ratings*, Jan. 12, 2005.
18. Moody's, *2004 Review and 2005 Outlook: US Servicer Ratings*, Jan. 12, 2005.

the new loan process. Therefore modifications can impose exorbitant fees or back-end payments or other conditions upon consumers without adequate record-keeping to pursue even a legal remedy.

The reason for concern lies in the fact that major industry groups and regulatory officials, having characterized the conditions for a successful modification as raising the net present value of the loan, have effectively advocated maximizing income to the lender as the primary goal of modification. Fitch Ratings reports that servicers express, "the belief that that ultimate loss to the transaction should be the only consideration in determining the execution of the best loss mitigation strategy."[19]

Even Moody's recognizes, however, that if borrowers cannot meaningfully qualify for a modified loan under transparent and duly reported and defensible underwriting guidelines, the modification may, "simply serve to postpone an eventual foreclosure and increase, rather than decrease, the ultimate loss on the loan."[20] Work by JP Morgan prior to the present market difficulties illustrates that the kinds of flags that can indicate predatory modification are, "…liberal repayment terms with extended amortizations, moving accounts from one workout program to another, multiple re-aging and poor monitoring of performance. *Principal reduction should be the main goal of workout programs, not maximizing income recognition* [emphasis added]." Servicing that does not promote principal reduction can therefore be considered predatory.[21]

B. Significant Borrower Redefaults Hurt both Lenders and Homeowners

Modification does not always work. Fitch Ratings reports that a good modification program has only a 60-65 percent success rate. That means that some 35-40 percent of borrowers redefault on their loans within 12-24 months. Furthermore, as of June 2007, many servicers reported to Fitch Ratings that repayment and forbearance plan effectiveness is decreasing and that modification is not, "…expected to work for borrowers facing ARM resets, as many of the borrowers are expected to default upon reset because they will not be able to afford the new monthly payments."[22]

Figure 4 shows that the type of success illustrated by respondents to Fitch Ratings may be optimistic or unrepresentative. Moody's reports that strong servicers can achieve success rates of 52 percent or more following modification, but that average servicers only achieved a 31-40 percent success rate. Participants at a May 2007 American Securitization Forum panel on servicing opined that, "It seems reasonable to expect that a company of merely average abilities and operating during stressful times would experience a somewhat higher rate of re-defaults. Also, … a typical servicer does not have the incentive of first-loss credit exposure on the loans (i.e., no "skin in the game") and gets paid the same fee regardless of the effort and expense of servicing a loan. The $64,000 question is

19. Fitch Ratings, *U.S. RMBS Servicer Workshop*, May 18, 2007.
20. Moody's, *US Subprime Mortgage Market Update*, Apr. 2007.
21. JP Morgan, *ABS Monitor 2003 Year Ahead Outlook*, Dec. 23, 2003.
22. Fitch Ratings, *Changing Loss Mitigation Strategies for U.S. RMBS*, Jun. 4, 2007.

whether the higher re-default rate would be just a little higher than 35 percent (e.g. 40 percent) or much, much higher (e.g., 65 percent). Only time will tell."[23]

FIGURE 4: 12-MONTH LOAN RESOLUTION PERFORMANCE INDICATORS FOR SUBPRIME LOANS

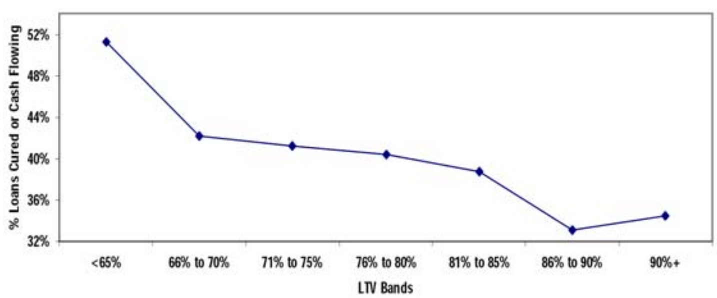
	Total Cure and Cash Flowing	Losses with Loss Mitigation
Strong	> 52%	> 23%
Above Average	41% - 51%	19% - 22%
Average	31% - 40%	9% - 18%

Note 1: The population of loans was seasoned between two and five years.
Note 2: "Total Cure and Cash Flowing" includes the percentage of loans that began a 12-month static pool analysis as 90+ days delinquent, in foreclosure, or in bankruptcy which were fully paid-off, current, performing on a forbearance plan, modified, 30 days delinquent, 60 days delinquent, or current on a bankruptcy plan at the end of the static pool period.
Note 3: "Losses With Loss Mitigation" includes the percentage of loans that were resolved from a short sale, short payoff, deed-in-lieu, or third-party sale as a percentage of total losses.

Source: Moody's, *2004 Review and 2005 Outlook: US Servicer Ratings*, Jan. 12, 2005.

Figure 5 shows that success varies significantly with the type of loan modified. Figure 5 shows that the highest success rates lie with loans below 66 percent LTV, hardly the borrowers most in need. Hence, the modification decision, like the original loan underwriting decision, is a complex multidimensional decision that needs to be made according to a set of transparent consistently-applied underwriting criteria.

FIGURE 5: AVERAGE 12-MONTH TOTAL CURE AND CASH FLOW RATES, BY LTV BAND

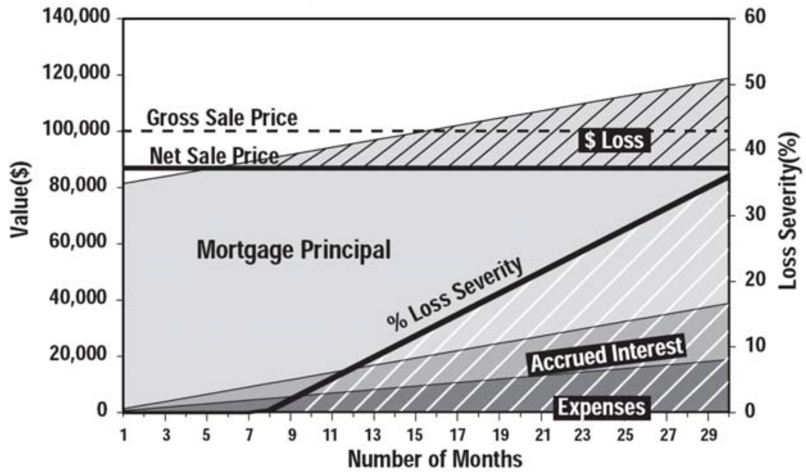


Source: Moody's, *2005 Review and 2006 Outlook: US Servicer Ratings*, Jan. 24, 2006.

One significant risk with respect to redefaults is that the eventual recovery rates of redefaulted modified loans will be far less than loans foreclosed immediately, without modification attempts. Figure 6 reflects the accepted wisdom that it is wisest to seize the collateral as soon as possible so that the collateral does not deteriorate unduly in the hands of a borrower who foresees the inevitable foreclosure. Hence, typical industry research like that by Moody's presented in Figure 6 shows that loss severity rises with time in distress.

23. Nomura, *Securitization & Real Estate Update*, May 18, 2007.

FIGURE 6: LOSS SEVERITY INCREASES WITH TIME: EXAMPLE WITH AN 80% LTV LOAN



Source: Moody's, Special Servicing and Default Management in the Subprime Mortgage Market: The Loan Doctors, April 1999.

Modification willingly gives up that extra time. If the redefault rate is 50 percent, but ultimate losses are twice as large, the financial effects of modification to the servicer are moot. Hence, the logic of modification flies in the face of traditional banking thought. It is not surprising that some servicers participating in Fitch's RMBS Servicer Workshop remain unconvinced by contemporary claims about modification, expressing concerns that, "redefaults for modified loans, …could result in higher ultimate losses to the trust."[24]

C. Modification and Reaging Work together to Skew Reported Delinquencies

Reaging policy has to do with when it is prudent to consider a once-delinquent borrower current again. Reage is defined to mean ''returning a delinquent, open-end account to current status without collecting the total amount of principal, interest, and fees that are contractually due.''[25] In prime loan portfolios with few delinquencies reaging policy has little effect on reported financial performance. But in subprime loan portfolios with large delinquencies reaging is a powerful tool to skew reported financial performance.

Before the advent of subprime lending, servicers typically had wide discretion to set and disclose aggressive or conservative reaging policies. Reaging is problematic because a lender that requires three consecutive on-time payments in order to reclassify borrowers as current will carry a lot more delinquencies on its books than a lender that requires only one on-time payment in order to reclassify borrowers as current. Modification policies can help pull delinquencies down even further by assisting the borrower in making that one on-time payment necessary to reclassify the loan under the aggressive reaging policy. Hence, it is not surprising that reaging policy remains of great concern to investors throughout the mortgage industry, including mortgage lenders, servicers, and MBS.

24. Fitch Ratings, *U.S. RMBS Servicer Workshop*, May 18, 2007.
25. *Notices*, 65 FEDERAL REGISTER 113, Jun. 12, 2000 at 36905-6.

Reaging policy was once an arcane backwater concern of a small segment of the industry that dealt with applying special servicing policies to defaulted loans. But that sector of the industry began to grow fast with the evolution of subprime home equity lending in the late 1990s and subprime first-lien lending more recently. According to Nomura, in 1998, there was already about $1 billion of RMBS issuance backed by "scratch and dent" mortgage loans (including re-performing, non-performing, sub-performing, out of guideline, and document deficient loans). By 2002, the sector had grown to about $9 billion of issuance, or about 5 percent of the subprime universe. Spreads on triple-A tranches can be from 10 bp to 50 bp wider than spreads on regular sub-prime RMBS, reflecting the greater risk involved.[26]

Early on in the development of subprime lending, it was commonly known that one way to spruce up scratch and dent pools was through aggressive reaging, which can skew financial ratios and mask true pool performance. After much regulatory wrangling with the problem, in 2000, regulators established reaging standards for federally-supervised financial institutions.[27]

Those regulations, however, did not affect non-bank mortgage lenders, non-bank servicers, or securitization trusts, which all lay outside federal regulatory authority and, we have recently learned, have underwritten the majority of recent subprime mortgages. They also did not alleviate the problem of interpreting delinquency levels among *federally-regulated* institutions, leading to a December 2005 rulemaking announcement that stipulated, "Policy exceptions made by servicing and collections personnel should be carefully monitored to confirm that practices such as re-aging, payment deferrals, and loan modifications are not inadvertently increasing risk."[28]

Re-Aging, Extensions, Deferrals, Renewals, and Rewrites [3]

Re-aging of open-end accounts, and extensions, deferrals, renewals, and rewrites of closed-end loans can be used to help borrowers overcome temporary financial difficulties, such as loss of job, medical emergency, or change in family circumstances like loss of a family member. A permissive policy on re-agings, extensions, deferrals, renewals, or rewrites can cloud the true performance and delinquency status of the portfolio. However, prudent use is acceptable when it is based on a renewed willingness and ability to repay the loan, and when it is structured and controlled in accordance with sound internal policies.

Management should ensure that comprehensive and effective risk management and internal controls are established and maintained so that re-ages, extensions, deferrals, renewals, and rewrites can be adequately controlled and monitored by management and verified by examiners. The decision to re-age, extend, defer, renew, or rewrite a loan, like any other modification of contractual terms, should be supported in the institution's management information systems. Adequate management information systems usually identify and document any loan that is re-aged, extended, deferred, renewed, or rewritten, including the number of times such action has been taken. Documentation normally shows that the institution's personnel communicated with the borrower, the borrower agreed to pay the loan in full, and the borrower has the ability to repay the loan. To be effective, management information systems should also monitor and track the volume and performance of loans that have been re-aged, extended, deferred, renewed, or rewritten and/or placed in a workout program.

Closed-End Loans

Institutions should adopt and adhere to explicit standards that control the use of extensions, deferrals, renewals, and rewrites of closed-end loans. The standards should exhibit the following:

- The borrower should show a renewed willingness and ability to repay the loan.
- The standards should limit the number and frequency of extensions, deferrals, renewals, and rewrites.
- Additional advances to finance unpaid interest and fees should be prohibited.

Management should ensure that comprehensive and effective risk management, reporting, and internal controls are established and maintained

26. Nomura Fixed Income *Research, Report from Arizona: Coverage of Selected Sessions of the February 2003 Securitization Conferences*, Feb, 18, 2003.

27. *Notices*, 65 FEDERAL REGISTER 113, Jun. 12, 2000 at 36905-6.

28. *Notices*, 70 FEDERAL REGISTER 249, Dec. 29, 2005 at 77257.

The problem is still a widespread industry concern, among both federally-regulated and non-federally regulated institutions. In 2003, well after the Federal regulatory rules, Nomura wrote that a key, "…problem for the sub-prime mortgage sector in general is that some servicers and special servicers characterize loans as 30-days delinquent when in fact they should be classified in more severe delinquency categories. The problem stems from lenders "re-aging" loans in forbearance and loans subject to payment plans or bankruptcy plans."[29]

Little has changed since 2003. In May 2007, Bank of America recently wrote, "…even in the case of successful workouts… true credit exposure will be masked because worked out loans are considered performing and will no longer be disclosed once they are disseminated into the performing loan pools. The credit ratios going forward should be distorted and are no longer reflecting the real credit exposure. For these reasons, going forward, we believe investors should focus on static pool yield changes, instead of credit ratios, as a credit performance indicator of the existing loan portfolios and static securitization pools."[30]

Nomura expressed similar concerns as early as 1997, in particular noting the incentive problems for servicers who may hold residual equity incentives. Nomura points out that, "…modifications favor the interests of subordinate and residual classes by delaying the recognition of losses and the writedown of those classes." Nomura notes further that, "…the treatment of modified loans under performance covenants (trigger tests) that allow the release of principal to subordinate and residual classes. If modified loans are treated as 'current,' a substantial amount of cash flow may be released to subordinate and residual classes while the risk to the senior classes rises. We think that the better approach is to treat modified loans as delinquent for purposes of trigger tests. We also think that this is the area that is most likely to spawn litigation, both between investors and servicers and among competing classes of investors."[31]

In summary, "The shortcomings of ABS/MBS disclosure have long been recognized. For example, in January 1996, Moody's emphasized the issue of ABS disclosure as a key challenge for the market."[32] In the eleven years since Moody's published that opinion, few of those concerns have been addressed. Modification has already been used in conjunction with reaging to mask financial condition and it is already an active concern for market participants, notwithstanding the small amount of modifications being used in today's marketplace. Hence, expanding modification efforts to ten or twenty times their existing level runs the risk of confusing MBS and mortgage lender investors even more, which will cause them to pull back from the marketplace even more dramatically than has already occurred.

29. Nomura Fixed Income *Research, Report from Arizona: Coverage of Selected Sessions of the February 2003 Securitization Conferences*, Feb, 18, 2003.

30. Bank of America, *Subprime Loan Modifications – not a Panacea*, SUBPRIME MORTGAGE FINANCE WEEKLY, May 25, 2007. See also Moody's, *Alternative Financial Ratios for the Effects of Securitization: Tools for Analysis*, Sep. 19, 1997..

31. Nomura, *Securitization & Real Estate Update*, May 18, 1997.

32. Moody's, *Challenges to the Asset-Backed Market in 1996…A Call for More Transparency*, Jan. 19, 1996.

D. There is No Monitoring or Enforcement to Guard against Adverse use of Modification

Like securitization, modification has evolved in a regulatory vacuum. Like securitization, the problem is not the lack of existing strictures that can be brought to bear on the practices, but that new business practices have evolved out of sight of regulatory and legislative authorities. Hence, little thought has been given to what can go wrong and how that can be most effectively dealt with (for example, transparency, functional regulation, or some other means). The servicing industry and, therefore modification practices, are touched by at least three existing monitoring authorities: the ratings agencies; the Securities and Exchange Commission's Regulation AB; and the Sarbanes-Oxley Act of 2002. None of those systematically monitors modification efforts on behalf of consumers, creating potentially big problems if modification efforts are rapidly expanded to ten to twenty times current industry levels.

Credit ratings agencies currently rate servicing quality for major mortgage servicers. Historically, credit rating agencies typically monitored operational cash flow considerations of servicers to better ensure remittances to investors over other factors. More recently, servicers have expanded their considerations to, "how effective a servicer is at preventing defaults and maximizing recoveries to a transaction when defaults occur."[33] Such monitoring, however, is still akin to judging modifications on the basis of maximizing cash flow to the servicer, rather than ability to reduce principal on behalf of the borrower, as explained above, and therefore is a poor means of addressing whether modification programs are built upon safe and sound business practices and satisfy potential predatory concerns.

In 2004, the Securities and Exchange Commission introduced Regulation AB, which includes enhanced reporting requirements for ABS issuers and servicers. In particular, Reg AB sets forth a new set of "best practices" servicing criteria, improving on the Uniform Single Attestation Program for Mortgage Bankers (USAP).[34] Like early ratings agency surveillance, however, that portion of Regulation AB focused primarily on investor remittance and reporting, rather than safe and sound business practices and potential predatory concerns.[35]

Regulation AB also imposed rules that, in the eyes of many investors, "represent historic steps in the evolution of financial regulation in the U.S. Under the new rules, investors will receive static pool data similar to what the rating agencies have received for years." The problem is that the new rules only went into effect in 2006, and markets will not see even the beginnings of their full impact until several years later, when static pool data will count as part of registration statements for liability purposes. In the mean time, the SEC still needs to improve its electronic filing system to replace "incorporation by reference to issuer web sites" as the vehicle for disclosure of static pool performance data. Even with improved SEC reporting, collateral-level data required under Regulation AB may still be available only at exorbitant expense from Loan Performance Corporation, which refuses to sell access to the "public"

33. Moody's, *Housing Research*, Sep. 1, 2007.
34. *See* http://www.campusmba.org/pdf/usap.pdf.
35. Moody's, *2005 Review and 2006 Outlook: US Servicer Ratings*, Jan. 24, 2006.

data to academic researchers or even bank regulatory authorities. Hence, although Regulation AB showed great promise, it has not been extended to modification issues and does not adequately provide for public reporting.[36]

The Sarbanes-Oxley Act of 2002, "…requires the management of publicly-owned companies to assess the effectiveness of internal controls over financial reporting. Because of the increased focus on maintaining strong internal controls, Moody's believes that Sarbanes-Oxley should have a meaningful impact on servicing stability. This will be true both for publicly-owned servicers as well private servicers that voluntarily take similar steps." Originators and servicers are very concerned about material disclosure provisions being applied to reaging and modification programs that may not have been properly disclosed in recent years.[37] Nonetheless, Sarbanes-Oxley has yet to be applied to reporting modification and reaging, which have certainly been material concerns.

FIGURE 7: FITCH'S SAMPLE OF NECESSARY STATISTICS TO BE REQUESTED FROM SERVICERS USING MODIFICATION AS A LOSS MITIGATION TOOL

Performing Modifications

Months Since Mod	Loan Count	Principal Balance at Mod	Projected Loss without Mod	Cost to Trust of Mod	Cash Collected at/after Mod	Net Value to Trust after Mod
< 3						
3–6						
6–12						
> 12						
Totals						

Redefaulted Modifications

Months Since Mod	Loan Count	Principal Balance at Mod	Projected Loss without Mod	Cost to Trust of Mod	Cash Collected at/after Mod	Value of Lost Time to Liquidate	Net Value to Trust after Mod
< 3							
3–6							
6–12							
> 12							
Totals							

Note: Statistics should indicate all mods since program began for RMBS. Tables should be developed by product and transaction

Source: Fitch Ratings, *Changing Loss Mitigation Strategies for U.S. RMBS*, Jun 4, 2007

In summary, since relatively few loan modifications took place prior to 2007, "…typical transaction documentation does not include standard or robust reporting language regarding loan modifications." Therefore, reporting varies significantly from transaction to transaction, even for the same issuer or servicer. Sometimes a loan being modified will continue to be reported as delinquent, based on its pre-modification terms. Other times, a delinquent loan that is modified will be reported immediately as "current." In addition, reporting mechanisms for modifications may or may not track the cumulative level of modifications. Industry participants like Moody's Investors Service advocate "…enhanced transparency in both loan-level reporting of modifications as well

36. Nomura, *ABS/MBS Disclosure Update #6: 24 Steps to Tighter ABS – Regulation AB*, Dec. 27, 2006)

37. Moody's, *2004 Review and 2005 Outlook: US Servicer Ratings*, Jan. 12, 2005.

as the cumulative impact of modifications on securitizations."[38] Fitch suggests a reporting format like that in Figure 7. Unfortunately, contemporary advocates from both the industry and politics, alike, are ignoring the practical realities of modification and pushing for the expansion of highly risky practices in an environment of little consumer protection and opaque financial reporting, precisely the conditions that are causing the current market crisis.

IV. CONCLUSIONS AND POLICY RECOMMENDATIONS

Servicing is costly, and increasing loan modifications increases the costs of servicing. While the practice of modifying loans shows promise, the practice is highly risky, both to the consumer and the lender, and substantially unproven. Moreover, there are currently no industry standards for modification and financial reporting, and no consumer safeguards to monitor or prohibit predatory practices.

Modification will not be suited to helping avoid the massive defaults expected as a result of ARM interest rate resets, which account for the majority of the industries problems into 2008. Legislative pushes to mis-apply the practice to those ends will substantially worsen industry performance.

One of the key reasons loan modification has grown has been to skew financial reporting of delinquencies, modifying loans to help borrowers make a few payments and then aggressively reaging the accounts to classify them as "current," instead of "delinquent." Such practices appear to have been a key mechanism in supporting the paper earnings of many failed subprime lenders prior to bankruptcy.

Regulators can already require modified loans to be reported as material considerations under Sarbanes-Oxley with standardized reporting practices promulgated by the Financial Accounting Standards Board and Regulation AB. Without applying even existing regulations toward regulatory oversight or transparency in loan modification practices, however, it is hard to imagine long-term positive benefits for borrowers.

It does not make sense, therefore, to push a broad unmonitored application of loan modification onto the industry or the public without serious consideration. Doing so runs a substantial risk of consumers being used to prop up the mortgage industry in the short term by keeping financially-strapped consumers in homes they cannot hope to afford.

It does make sense, however, to apply limited modification programs to appropriately-selected consumers while helping to smooth the transition to smaller homes or rentals for others. Regulators need to be aware that appropriately selecting borrowers for modification is an underwriting decision, which needs to be monitored for safe and sound underwriting practices. Regulators can monitor modification programs for predatory behavior and abuse by simply classifying a modification as a new loan, which subjects the practice to all the disclosure and record-collection requirements for other new loans. Hence, regulators can use existing regulations to monitor modification outcomes so that

38. Moody's Investors Service, *Loan Modifications in U.S. RMBS: Frequently Asked Questions*, Jun. 6, 2007.

lenders who use modification for short-term gain solely at the expense of consumers can be identified and censured.

With no regulatory authority to oversee modification and reaging policies and little transparency with respect to those arrangements, however, there is a distinct possibility that extensive modification will hurt consumers and investors alike. Again.

APPENDIX: THE BUSINESS OF LOAN SERVICING

Servicing is often viewed as the key element to loan value.[39] Poor servicing can result in uncollected payments from borrowers and missed payments to investors. Poor servicing may also result in unpaid property taxes and mortgage insurance premia, placing collateral at risk. Figure A1 lists the largest mortgage services as of 2006. These servicers are the companies that will be most affected by modification policy.

FIGURE A1: TOP 15 MORTGAGE SERVICERS, 2006

Top 15 Servicers - ($ in millions) Rank	2006	YoY Change		2005
1 Wells Fargo Home Mortgage	$1,341,870	33.5%	1 **Countrywide Financial Corp.**	**$1,111,090**
2 **Countrywide Financial Corp.**	**$1,298,394**	**16.9%**	2 Wells Fargo Home Mortgage	$1,005,410
3 **Washington Mutual**	**$710,797**	**-4.8%**	3 **Washington Mutual**	**$746,759**
4 JPM	$674,057	11.6%	4 JPM	$604,170
5 Citi	$521,509	17.6%	5 Citi	$443,510
6 GMAC	$456,150	16.1%	6 GMAC	$392,929
7 Bank of America	$419,497	13.9%	7 Bank of America	$368,352
8 ABN Amro Mortgage	$229,889	11.6%	8 ABN Amro Mortgage	$205,953
9 Wachovia	$175,244	10.8%	9 National City Mortgage	$169,557
10 National City Mortgage	$171,006	0.9%	10 Wachovia	$158,110
11 PHH Mortgage	$160,298	1.9%	11 PHH Mortgage	$157,302
12 **IndyMac Bancorp, Inc.**	**$147,994**	**63.1%**	12 SunTrust Mortgage, Inc.	$105,561
13 SunTrust Mortgage, Inc.	$129,974	23.1%	13 First Horizon Home Loans	$95,284
14 First Horizon Home Loans	$101,755	6.8%	14 **IndyMac Bancorp, Inc.**	**$90,721**
15 U.S. Bank Home Mortgage	$99,799	19.7%	15 U.S. Bank Home Mortgage	$83,403
Total	**$6,638,233**	**15.7%**	**Total**	**$5,738,111**

Source: National Mortgage News

Figure A2 illustrates the main functions of mortgage servicers. For the most part, those functions can be broken down into those relating to periodically collecting and remitting mortgage principal and interest payments, as well as tax, insurance, and mortgage insurance premium escrow payments (the bottom row in Figure A2) and those relating to dealing with delinquencies and foreclosures.

FIGURE A2: TYPICAL LOAN SERVICING ACTIVITIES

Primary Servicing Checklist

Collection/Workout	*Foreclosure/Bankruptcy*	*REO Management*
• Management and collector experience • Level of borrower contact • Formal collection strategy • Familiarity with industry and conduit guidelines • Tracking system	• Management and staff experience • Committee foreclosure approval • Familiarity with state requirements • Attorney selection and monitoring • Property inspections	• Marketing strategy • Compliance with industry, state, and conduit guidelines • Expense management • Security, protection, and repair of properties
Escrow Management	***Investor Accounting/Reporting***	***Custodial Account Management***
• Management experience • Escrow analysis method • Timely tax and insurance disbursements • Documented county guidelines • Servicing system capabilities • Disaster response plan	• Relationship to financial accounting • Management involvement • Documentation on industry and conduit guidelines • Servicing system capabilities • Timely reports and remittances	• Adherence to industry standards • Formal reconciliation process • Minimal acceptable ratings of institutions with principal and interest funds on deposit • Specific titling of accounts • Separation of principal and interest and taxes and insurance accounts

REO – Real estate owned.

Source: Fitch Ratings, *Mortgage and Housing Products Origination and Servicing Guidelines*, Jun. 3, 1997

[39] Moody's Investors Service, *Deal Sponsor and Credit Risk of U.S. ABS and MBS Securities*, December 2006.

There are three classes of mortgage servicers: master servicers, primary servicers, and special servicers. Master servicers oversee all the servicing processes and work directly for the trust that manages the loans on behalf of investors. Primary servicers manage the routine tasks on the bottom row of Figure 3 and sometimes the tasks related to delinquency and foreclosure on the top row. Special servicers specialize in delinquency and foreclosure-related tasks. Many transactions have all three types of servicers present, while others may only have one or two.[40] According to Fitch Ratings' "Ratings Definitions," some of the reasons for the various structures are age of the transaction, complexity of the loans, strength of the primary servicer, current or anticipated delinquency, and need for advancing funds on behalf of borrowers.

The sections that follow illustrate that even though servicers do not bear direct credit risk from the loans they service, credit deterioration can impose high costs and cash flow difficulties on servicers.

A. Loan Servicers are Paid Fees to Perform Routine Tasks Related to Loan Administration and Act on Investors' Behalf

Mortgage loan servicers are typically remunerated on the basis of a servicing fee of between 12.5 and 50 basis points of the outstanding principal balance, down substantially from 25-100 basis points in 1999. Direct servicing fees, however, do not always adequately compensate the servicer for costly services that are sometimes necessitated by the types of borrowers involved.

Over the years, therefore, loan servicers have attempted to charge directly for higher-cost servicing activities. One way to do this is through ancillary fees charged directly to the borrower. Such fees typically included escrow account maintenance fees, loan history fees, phone payment fees, loan document service fees, payoff statement fees, demand letter fees, and forbearance agreement fees. In recent times, however, servicers have moved away from those ancillary fees "due to concerns that this practice has been abused and the relationship between servicers and borrowers has been unfairly leveraged."[41]

The industry has now largely replaced ancillary fees with various incentive arrangements for personnel. The typical incentive arrangements, however, have distinct shortcomings. For instance, incentives based on loss severity can be affected by changes in property values, skewed initial appraisals, the LTV distribution of the loans, and other factors. Incentives to pursue more difficult long cases of delinquency can help pay for the greater costs involved, but can also be an incentive to draw out difficulties to generate revenue. Incentives based on resolution type can encourage loan reinstatements and modifications, but can affect the property disposition (the choice of short sale, foreclosure, or other variant, in different ways depending upon other terms in the loan).

The generally accepted solution to the flaws of these various incentive arrangements (on the level of the servicing entity as a whole) has been equity incentives. Generally, equity incentives take the form of residual first-loss investment stakes that are worth more in the event of solid servicing. The

40. Fitch Ratings, *Residential Mortgage Services Ratings*, Feb. 21, 2003.
41. Moody's, *Trends in Residential Mortgage Servicing Practices*, Aug. 9, 2004.

problem is that the value of equity incentives is murky, as is the total value of the mortgage servicing enterprise.

The total value of a mortgage servicing enterprise is the sum of the value of its contracts. The values of those contracts, called mortgage servicing rights (MSRs) is the present value of the series of uncertain direct service fee payments. The reason the fees are uncertain is that they rely crucially on how many mortgages remain with the servicer after prepayments and defaults. Since prepayments and defaults are not well understood,[42] MSRs are difficult to value with any degree of certainty and the valuations that result can be very volatile to actual conditions realized in the servicing pool. Residual first-loss investment stake valuations rely crucially upon the same conjectures about prepayment speeds and default rates, and are therefore similarly difficult to value.

It should not be surprising, therefore, that the vast majority of bank failures since 1992 have involved substantial issues of MSR and residual valuations. Nonetheless, many of the mortgage servicers listed in Figure A1 derive a great deal of their value from equity incentives and MSRs. WaMu's MSRs amount to 23 percent of their capital, IndyMac's amount to 90 percent of their capital, and Countrywide's amount to 115 percent of their capital. Clearly, having MSRs worth more than the value of capital creates a high risk that valuation difficulties can wipe out a firm's underlying capital with the stroke of a pen.

B. Loan Servicer's Costs Depend on how Much Work is Involved in Servicing

The two main types of operating costs associated with servicing mortgages are maintenance costs and mortgage default-related costs. Maintenance costs consist of basic elements of customer service (payment collection, mailings, systems, etc). These types of maintenance costs can be reduced on a per unit basis through scale economies and off-shoring. Mortgage-default related costs are all additional costs imposed on the servicer due to late payments and subsequent activities, including everything from additional calls and the human capital required to make those calls, to the legal and physical costs of foreclosure and sale.

Bank of America recently analyzed servicing costs per loan, starting with the Mortgage Bankers Association's (MBA) 2006 Servicing Operations Study and Forum and consulting with various servicing industry representatives. Because costs vary significantly by product with more complex and riskier products such as Option ARMs and subprime mortgages costing more to service, Bank of America used the MBA's "Mega" category, which essentially represents large, diversified mortgage servicers, as a rough guideline for mortgage servicing operating cost per loan estimates. The Bank of America study estimates that average annual operating costs per loan for performing loans range between $49 and $53 per loan. Average costs for loans in default and foreclosure may be reasonably expected to increase by over 700 percent.[43] Those costs can be

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42. *See* Joseph Mason & Joshua Rosner, How Resilient are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions, Hudson Institute Working Paper, Feb. 14, 2007.

43. Bank of America, *The Hidden Credit Costs of Mortgage Servicers*, SPECIALTY AND MORTGAGE FINANCE WEEKLY, Mar. 23, 2007.

expected to rise significantly in the current market environment with far greater defaults and rising home inventories making it difficult to sell foreclosed collateral.[44]

Servicers are already beginning to restructure their operations to achieve cost savings wherever possible, including consolidating operations, rather than outsourcing. As the American Banker explains, “In an effort to cut the costs associated with foreclosure, Wells Fargo & Co., JPMorgan Chase & Co., and Bank of America Corp. have all in recent months brought in-house certain default management and loss-mitigation work…. The moves by three of the top 10 home lenders to what is called a "direct sourcing" model are a blow to the major title companies and others whose default-management outsourcing units had handled their work (and still do for many other lenders).”[45]

The reason for such drastic measures is that default costs can also create substantial cash flow difficulties. Cash flow difficulties arise because the legal and other costs related to foreclosing upon and selling repossessed real estate, while ultimately reimbursable from the trust, are only reimbursed when the collateral is sold. “Advancing” funds in such circumstances can substantially disrupt the cash flows of the servicing entity. If the servicer does not have cash on hand to cover the cash flows those advances must be funded in the interim through borrowings, and while the direct costs of the disposition are reimbursed, the funding costs are not.

While servicers generally believe that the current level of servicing fees in transactions, particularly subprime deals, is currently “adequate to cover the increasing cost to service subprime loans,… unanticipated costs that could come from mandatory actions or moratoriums on actions like foreclosure, which are being discussed by regulators or legislative factions… may cause extensions or delays in processes and make it very difficult for servicers to accurately project actual costs.”[46] If servicers fail because servicing fees cannot cover costs, there may be no buyer for those servicing contracts in the event of servicer bankruptcy. Several such difficulties were experienced in the late 1990s, and led to protracted bankruptcies and high losses.

44. Fitch Ratings, *U.S. RMBS Servicer Workshop*, May 18, 2007.
45. Kate Berry, *Default Servicing Comes Back In-House*, AMERICAN BANKER, Jun. 1, 2007.
46. Fitch Ratings, *U.S. RMBS Servicer Workshop*, May 18, 2007.