

An Accounting Rule's Indirect Impact

American homeowners have enjoyed extremely low interest rates for the past 20 years, due in large part to the advent of mortgage securitization. The recent fluctuations in the housing market, however, have affected every facet of the home lending industry. There is an imminent crisis, as widespread default is inevitable and servicers are working diligently to avoid foreclosure and to find ways to keep people in their homes through a wide array of home retention strategies.

To some degree, however, servicers' hands are tied due to the securitization of the vast majority of subprime mortgages originated in recent years and the accounting rules that regulate such securitizations. The Financial Accounting Standards Board Statement 140 (FASB 140) specifies the requirements and restrictions for lenders to obtain the benefits of off-balance-sheet treatment of securitized mortgages.

FASB 140 clearly allows modification of mortgages once the borrower defaults on the loan. With certain loan products, it is imperative that servicers have

chairman of the U.S. House of Representatives Committee on Financial Services, wrote a letter in July to the Securities & Exchange Commission (SEC)

While Chairman Cox's letter does not offer clear guidance on the specific parameters for modifying the terms of a mortgage, his letter indicates that servicers, in certain circumstances, may modify borrowers' mortgages prior to the loan becoming delinquent. This is significant because it will allow servicers to work to keep borrowers in their homes, while still allowing the lenders to maintain the advantageous accounting and tax benefits of off-balance-sheet reporting.

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the authority to modify the terms of these mortgages when default is "reasonably foreseeable," without adversely affecting the favorable accounting treatment of the mortgages. In fact, it is such an important component to avoiding foreclosure that Congressman Barney Frank,

asking for guidance on this issue. Christopher Cox, chairman of the SEC, responded that "such loan modifications [where defaults are reasonably foreseeable] would not result in a requirement for entities to account for those securitized assets on their balance sheets."

The Business of Securities

Record-low interest rates and a steady rise in home values were the norm in recent years. Coinciding with that, subprime borrowers were increasingly offered 2/28 and 3/27 adjustable-rate mortgages (ARMs). First American LoanPerformance reports that nearly three-fourths of the securitized subprime mortgages originated in 2004 and 2005 were such hybrid products. Many of these



A Servicer's Ability to **Modify** May
Cause a **Stalemate** in Troubled
Borrowers' Quest to Avoid Foreclosure.

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adjustable subprime loans were underwritten based on a low introductory rate. When the rate adjusts to a higher rate, the borrower is not financially prepared for the corresponding increase in the monthly payment and loan default occurs.

According to Sheila C. Bair, chairman of the Federal Deposit Insurance Corporation (FDIC), investors saw the securitization of subprime mortgages as potentially profitable opportunities. Moreover, Bair recently testified to Congress that "securitization represents an essential process in U.S. mortgage markets. By packaging loans in a way that is attractive to investors, securitization has increased the volume of credit available to borrowers and improved the liquidity of the mortgage market." When a subprime residential mortgage is securitized, it is pooled with other residential loans and sold to a special purpose entity that issues bonds to investors. The homeowners' mortgage payments then pass through the servicer to the bondholders. Securitization provides considerable tax and accounting benefits to lenders, which, over the years, has translated into more available credit for homeowners. In fact, securitizations funded roughly 75 percent of the estimated \$600 billion in subprime loans that were originated in 2006, reports FDIC's Bair. The lenders that originated these securitized loans were able to treat the mortgages as "off-balance-sheet assets."

Lenders are governed by the rules established by FASB 140

in connection with mortgage-backed assets. If a lender violates the off-balance-sheet rules, the lender will suffer significant adverse accounting consequences.

Subprime Situation

First American Real Estate Solutions issued a recent study indicating that 1.1 million subprime loans are due to reset in 2007, and an additional 882,000 subprime loans will reset in 2008. As subprime mortgage homeowners continue to default on their loans, the mortgage industry is searching for solutions. It is more profitable for both the lenders and the bondholders to keep borrowers paying their mortgages instead of incurring the losses associated with taking ownership of foreclosed homes. Servicers are willing to work with borrowers to lock in lower fixed interest rates, but because of securitization, loans cannot simply be modified without considering the implications of FASB 140.

When a borrower defaults on a loan, a servicer may exercise limited discretion in restructuring or modifying the terms of the mortgage, as long as it is within the boundaries of the Pooling and Servicing Agreement (PSA). Loan modification typically may occur once the borrower is in default on the loan, or in some cases where the borrower is merely 60 days' delinquent. Many in the industry define "default" as when a borrower is 90 days' delinquent. But in the context of ARM products, lenders want to restructure a

mortgage before the mortgage adjustment occurs. In other words, a lender wants the authority to restructure a mortgage when default is "reasonably foreseeable," as opposed to waiting for the borrower to become 60 days' delinquent. Though it is impossible to redraft current PSAs, the Mortgage Bankers Association (MBA) is presently working with industry leaders to develop model language that can be inserted into new PSAs regarding loan resolution.

If, under FASB 140, modifications to securitized loans result in adverse tax consequences to lenders, then lenders may be discouraged from working with borrowers to modify the terms of their mortgages. Theoretically, FASB 140 is a major impediment to lenders' ability to modify at-risk loans and assist borrowers in avoiding foreclosure. Hence, Congressman Frank's request for an opinion from SEC Chairman Cox.

Chairman Cox's letter was supported by a July memo drafted by Conrad W. Hewitt, chief accountant of the SEC, which concludes that "entering into loan restructuring or modification when default is reasonably foreseeable does not preclude continued off-balance-sheet treatment under FASB 140." The SEC's letter demonstrates that in some circumstances, pre-delinquency modification will not prohibit off-balance-sheet treatment. However, the letter did not offer specific guidelines and rules for these pre-delinquency modifications.

Accounting Ambiguity

One of FASB 140's key restrictions is that the lender must relinquish control of the loan. The assets must be "distinct from the transferor" and its "permitted activities are significantly limited." Two considerations arise: 1) if a lender modifies the terms of a mortgage, is it isolated and has it really given up control of the mortgage, and 2) if a mortgage lender modifies a loan, has it engaged in activities that are impermissible under FASB 140? The SEC recognizes that modifying a mortgage that is in default will not violate these provisions. However, lenders seeking modification when default is reasonably foreseeable must consider these limitations.

Before examining the implications of Securities Chairman Cox's letter, it is important to try and define "reasonably foreseeable default." According to FDIC's Bair, "The IRS leaves it to servicers to determine what 'reasonably foreseeable' means as it relates to default." She adds that "some securitization documents indicated that once a loan is delinquent for a certain amount of time, for example, 60 days, modifications of the terms may be allowed."

When a borrower becomes delinquent by 60 days, a servicer does not have unfettered discretion to modify the terms of the mortgage; rather, the servicer must work within the allowable limits of the securities agreement. While modification is clearly beneficial to the borrower, it also significantly increases the

likelihood of cash-flow, which is extremely important to the mortgage bondholders.

The key question is whether modification before a borrower becomes delinquent is treated the same under FASB 140 as when default has actually occurred. If FASB 140 treats pre-delinquency modifications the same as when a borrower defaults, then a lender should be allowed to restructure a mortgage prior to an imminent rate adjustment that will most likely result in default.

While an argument could be made that allowing modification prior to a loan becoming 60 days' delinquent is the kind of activity that FASB 140 is designed to prevent, it is difficult to understand the distinction between a pre-delinquency loan modification and a loan

modification occurring after a loan becomes delinquent for 60 days. In its position paper, the MBA states that the same decision-making is involved whether the modification occurs before delinquency or after the borrower has become delinquent for 60 days.

Although SEC Chairman Cox's letter clearly indicates that modifications can be made, servicers are left wondering what kind of modifications may be made. Lenders should probably confine their pre-default modification accommodations to those that would have been offered if the borrower had defaulted on the loan.

Chairman Cox's letter presents a promising interpretation of FASB 140. While he does not specify guidelines and restrictions

for servicers to modify mortgages when default is reasonably foreseeable, in certain circumstances, lenders may begin working with borrowers on loan modifications before a borrower begins falling behind on payments. It is difficult to determine, based on Chairman Cox's letter, if servicers are given enough flexibility to impact homeowners. It will take time to determine how the SEC's decision will impact the proliferation of defaults on subprime mortgages. While almost all lenders have stopped offering poorly designed loan products (and investors have stopped purchasing such loans), the SEC's interpretation of FASB 140 might help tens of thousands of existing homeowners avoid foreclosure and keep their homes. **DS**



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