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SUBPRIME SECURITIZATION

Easier to Say Than It Is to Fix



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Those of us with good credit and traditional mortgages have no reason to worry about the subprime mortgage problem, right? Wrong.

The potential fallout from the subprime crisis could change the landscape of the world economy; and, seemingly overnight, the subprime problem has become a major issue in the 2008 election. One of the reasons that the subprime crisis is expected to have a widespread impact is because of the prevalence of mortgage backed securities. Many proposed solutions to the subprime problem focus on modifying subprime mortgages; however, due to the securitization of these mortgages, modification is more complicated and even impossible in some circumstances.

THE SUBPRIME PROBLEM

Over the last few years, lenders offered borrowers with imperfect credit history a variety of mortgage products. Many of these loans were in the form of adjustable rate mortgages (ARMs) that offered attractively low "teaser rates" before resetting to a higher fixed rate. In 2007 and 2008, as many as two million ARMs are scheduled to reset at higher

interest rates, and the delinquency rate on subprime mortgages is growing at an astounding rate (market estimates have found that as many as 20 percent of subprime mortgages could be delinquent).

For many mortgage lenders it is more cost effective to keep homeowners in their houses. Sheila Bair, Chairman of the FDIC, explained, "Loss mitigation techniques that preserve homeownership are generally far less costly than foreclosure...." But it isn't that easy.

THE SECURITIZATION PROBLEM

The problem is compounded by the fact that many subprime mortgages have been bundled and sold to investors (i.e.—"securitization").

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-Editor -

According to FDIC Chairman Bair, securitization funded approximately 75 percent of the estimated \$600 billion in subprime mortgages originated in 2006. When a lender securitizes a residential mortgage, it no longer “owns” the mortgage. Mortgage lenders sell the loans to special purpose entities (“SPEs”), and those SPEs offer bundles of residential mortgages to third-party investors. The benefit is that securitization allows lenders to account for the mortgage immediately instead of carrying the outstanding debt for the full term of the mortgage.



This securitization structure is regulated by the Financial Accounting Standards Board Statement 140 (“FASB 140”). Lenders can continue to act as “servicers” (i.e.—collect monthly payments and deal with delinquencies and foreclosures), but the payments flow through to the investors. A servicer’s rights and obligations are governed by the pooling and service agreement (“PSA”). FASB 140 limits the servicer’s discretion and servicing activities because the lenders/servicers no longer own the assets. If a servicer exercises excessive control over the mortgage, FASB 140 nullifies the sale, and the lender must reaccount for the mortgage on its balance sheet. The threat of having to reaccount for the loan deters servicers from aggressively modifying securitized mortgages.

While a servicer’s discretion is limited by the PSA and FASB 140, in certain circumstances, a servicer may modify the terms of a mortgage when a borrower is in default by offering benefits, concession, and workouts to the borrower to avoid foreclosure. However, this exception to the rule was thought only to apply to mortgages that were already in default. Recently, Christopher Cox, Chairman of the SEC, issued a letter stating FASB 140 would allow servicers to modify mortgages when default is “reasonably foreseeable,” in certain situations, as long as the “modifications... [are] consistent with the nature of modification activities that would have been permitted if default had occurred.”

The SEC’s interpretation seems to offer help to the securitization problem; it indicates that pre-default modification would not force lenders to reaccount for the

sold mortgages. However, as a practical matter, servicers have not overwhelmingly embraced pre-default modification. Chairman Cox’s statement gave little guidance on when and under what circumstances modification may occur, and servicers have avoided testing the limits of FASB 140. Servicers also fear investor backlash and inconsistent judicial interpretations of the scope of FASB 140. Consequently, widespread pre-default modifications have not been realized leaving FDIC Chairman Bair “frustrated that the servicing restructuring has not reached the level that [she] had hoped it would.” According to an analysis by Moody’s in autumn 2007, as reported by CNN, only about one percent of resetting ARMs have been modified last year.

Industry participants have recognized servicers’ reluctance to embrace pre-default modification. In early December 2007, the American Securitization Forum (“ASF”) issued its “Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans.” The Framework established guidelines for streamlined modification of certain classes of securitized subprime residential mortgage. In a January 8, 2008 letter, Conrad Hewitt, Chief Accountant of the SEC, stated that some of the ASF proposed standardized modifications would not violate FASB 140. Mr. Hewitt’s letter has limited application (and as he noted, servicers are still restricted by contractual provisions); however, this opinion could give servicers confidence to begin systematic and widespread modification. Only time will tell.

SUBPRIME IN THE POLITICAL SPHERE

Politicians are also focusing their attention on pre-default modification. In December 2007, President Bush unveiled a collaborative effort from the government, investment firms, and the mortgage industry that proposed freezing interest rates on subprime securitized mortgages that are scheduled to reset this year and next year. The plan would lock in lower interest rates on mortgages taken out between January 1, 2005, and July 30, 2007. However, the plan's scope is limited—homeowners whose rates reset before January 1, 2008, would not be able to take advantage of the automatic rate freezes, and those borrowers who can afford to pay the higher interest rates would not be granted relief under the plan. Also, the plan only applies to homeowners whose payments are not more than 30 days late when the mortgage is to be modified or whose payments have not been 60 days late within the previous 12 months. The President has also encouraged Congress to pass legislation to help homeowners. While President Bush's proposed plan would not automatically freeze rates on all subprime loans, servicers may still choose to modify mortgages as long as they do not violate FASB 140.

Many have criticized President Bush's plan. Some have argued that scope of the plan is too narrow since it would only help an estimated 240,000 mortgage holders according to Barclays Capital as reported in the New York Times. Others have argued the plan is a bailout, and they believe that borrowers and lenders should face the consequences of their financial decisions. Another criticism is that the plan does not carry the force of law, and there is no guaranteed protection for servicers. Theoretically, if a modification exceeds the scope of the PSA, a servicer could be liable to investors. Treasury Secretary Henry M. Paulson, Jr. acknowledged these criticisms but explained, "[The proposed plan] is not a silver bullet.... We face a difficult problem for which there is no perfect solution."

Still, the Democratic presidential candidates have criticized the plan for not helping enough homeowners—and the subprime problem could potentially become a key campaign issue in the 2008 election. Senator Hillary Clinton (D-NY) suggested a rate freeze and short-term moratorium on foreclosures, while Barack Obama (D-IL) proposed a comprehensive plan involving tax credits, rescue funds, and bankruptcy law changes. Former Senator John Edwards recommended a seven-year interest rate freeze, delaying some foreclosures, funds to help borrowers, and changes in the bankruptcy law. Debate over the subprime issue has not been as prevalent among the Republican presidential candidates; although, recently,



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most of the Republican candidates have started discussing the housing crisis. As November nears, we will undoubtedly hear more discussion from both parties.

Lenders, for the most part, have stopped offering many subprime mortgages, and underwriting standards have changed. The problem is, though, that there are almost two million subprime ARMs that are scheduled to reset in 2007 and 2008, and as default rates rise, many commentators believe that the fallout could have a devastating impact on the economy. Securitization only makes the problem more complicated. At this point, many believe there must be widespread modification, specifically, the government and industry participants are looking for ways for borrowers to avoid the higher interest rates when their ARMs reset. While the SEC's interpretation of FASB 140 leaves a lot of unanswered questions, with President Bush's proposal, it offers a starting point for servicers to begin working to keep borrowers in their homes and paying their mortgages.

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