

Subprime Securitization: What's a Servicer To Do?

by Samuel D. Friedman

Those of us with good credit and traditional mortgages have no reason to worry about the subprime mortgage problem, right? Maybe not, yet it is hard to ignore the daily barrage of doom-and-gloom subprime headlines. The subprime crisis has the potential to change the landscape of the world economy due largely to the proliferation of mortgage-backed securities. Ironically, theorists originally suggested that the securitization of mortgages would lead to greater economic stability as the risk of these securities would be spread out among different entities. Recent turmoil in the financial market has proven otherwise.

As we enter high-tide of the election season, the economy has become one of the central campaign issues. Numerous politicians, on both the national and state levels, have proposed solutions to the subprime problem, and modification of troubled mortgages is at the center of most of these plans. However, due to the securitization of these mortgages, modification is 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, including adjustable rate mortgages (ARMs) with attractively low “teaser rates” that reset to higher fixed rates. Experts estimate that in 2008 and 2009, anywhere between 1.7 million and 2 million ARMs will reset at higher interest rates, and the delinquency rate on subprime mortgages is growing at an astounding pace.

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.

Securitization and FASB 140

The problem is complicated by the fact that many subprime mortgages have been securitized — bundled and sold to investors. According to FDIC Chairman Bair, securitization funded approximately 75 percent of the estimated \$600 billion in subprime mortgages originated in 2006. Arguably, securitization has been one of the most complicating factors in the subprime crisis because, as explained below, lenders must theoretically abdicate control of the loan.

Under the current securitization model, when a lender securitizes a residential mortgage, it no longer “owns” the mortgage. Mortgage lenders sell the loans to qualified special purpose entities (QSPEs), and those QSPEs offer bundles of residential mortgages to third-party investors. This securitization structure is regulated by the Financial Accounting Standards Board Statement 140 (FASB 140). Lenders may continue to service the loans, 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 servicers do not 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. Having to reaccount for the loan is a serious consequence for mortgage servicers.

Modification under FASB 140

When read literally, FASB 140 seems to prohibit servicers from modifying securitized assets since QSPEs' activities must be "significantly limited," and the QSPEs must be "demonstrably distinct" from the transferors. However, interpretive guidance indicates that, in some circumstances, servicers may modify certain securitized mortgages within the FASB 140 framework.

FASB 140 allows servicers to modify the terms of certain mortgages when a borrower is in default. And, in 2007, SEC Chairman Christopher Cox issued a letter recognizing that 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."

Servicers, however, were reluctant to embrace pre-default modification because Chairman Cox's statement gave little guidance on when and under what circumstances modification may occur. Understandably, servicers avoided testing the limits of FASB 140 for a variety of reasons, including the fear of investor backlash and the threat of re-accounting for securitized assets. This uncertainty was compounded by the Financial Accounting Standards Board's decision that required the industry to account for "troubled debt restructurings" under the more stringent FAS 114 rather than the less cumbersome FAS 5.

In light of these concerns, in December 2007, the American Securitization Forum (ASF) issued its "Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans." The framework divided first-lien residential subprime mortgages into three segments: 1) when the borrower is likely to be able to refinance; 2) when the borrower is "current" but cannot refinance; and 3) when the borrower is not current and cannot pay even the introductory rate. The framework designates that if Segment Two borrowers

meet certain objective criteria, they would be eligible for fast-track modification that could freeze the interest rates for five years, and servicers would not have to individually evaluate each loan. These fast-track modifications should be compatible with most PSAs since such modifications would be in the best interest of the investors.

The ASF framework still requires servicers and borrowers to operate within the parameters of FASB 140, and the final modification decisions are still within the servicer's discretion. However, Conrad Hewitt, chief accountant of the SEC, confirmed that the Segment Two fast-track modifications would not violate FASB 140.

The future of FASB 140

FASB 140, on one hand, creates strict limitations that prevent servicers from exercising too much control; on the other hand, the statements and guidelines mentioned above indicate that servicers, in some circumstances, may modify securitized loans prior to default. Because of these two competing principles, servicers are still struggling to develop widespread modification plans.

In light of these concerns and the larger subprime problem, at the April 2008 meeting of the Financial Accounting Standards Board, the board voted to make significant amendments to FASB 140. One such change is that the board voted to remove the concept of a QSPE from the rule. A draft of the proposed rule is expected to be released soon. While it is unclear when and how the new rules will affect securitized residential mortgages, it is clear that the changes are intended to respond to the current credit crisis and the inherent problems surrounding modification within the current securitization structure.

Subprime in the political sphere

Despite the potential minefield created by FASB 140's requirements, politicians have been working to encourage widespread modification of subprime mortgages. In December 2007, President Bush unveiled a collaborative effort from the government, investment firms and the mortgage industry that proposed freezing interest rates on certain qualifying subprime securitized mortgages. The Bush administration followed up the first proposal with Project Lifeline, a plan that attempted to help those borrowers already in default. The problem with these plans, though, was that they did not mandate action with the force of law. Rather, servicers were still constricted, to a certain extent, by the PSA and FASB 140. In December 2007, Congress and the President took a further step and passed the Mortgage Forgiveness Debt Relief Act, which allows borrowers to exclude the value of certain mortgage modifications from federal income taxes.

Critics argued that the Bush administration's approach simply did not help enough borrowers. U.S. Treasury Secretary Henry M. Paulson, Jr. acknowledged these criticisms but explained, "[The 2007 Plan] is not a silver bullet.... We face a difficult problem for which there is no perfect solution."

Congress has also attempted to offer its own fix. In mid-May 2008, Senate Bank Committee Chairman Christopher Dodd (D., CT) and ranking-Republican Senator Richard Shelby (R., AL) agreed on a bipartisan mortgage aid bill that would allow the Federal Housing Administration to insure \$300 billion in new loans for certain borrowers. If borrowers default on their payments, the funds would be paid by Fannie Mae and Freddie Mac.

The presidential candidates have also proposed plans to deal with the housing crisis, and the subprime problem has become a key campaign issue in the 2008 election. Senator Barack Obama (D., IL) proposed a comprehensive plan involving tax credits, rescue funds, bankruptcy law changes, fraud prevention and mandatory disclosures, while Senator John McCain (R., AZ)

recommended a plan that would allow certain distressed borrowers to convert their mortgages to more manageable loans. 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 remains that, according to First American CoreLogic, an estimated \$260 billion in prime ARMs and \$376 billion in subprime ARMs are scheduled to reset through Fourth Quarter 2009. Many commentators believe that the fallout could have a devastating impact on the economy. Securitization only makes the problem more complicated and the solution more elusive.

At this point, modification seems to be the name of the game, and the government and industry participants are examining ways for borrowers to avoid the higher interest rates when their ARMs reset. However, the conflict between modification and securitization accounting rules has created substantial challenges. In some situations, PSAs have been amended to provide more modification authority to servicers. However, conventional wisdom suggests that widespread modification of securitized subprime mortgages probably will not be realized until servicers gain confidence that they are acting within the scope of their contractual and legal obligations. As ARMs begin to reset, the economy continues to worsen and the November election nears, it is safe to assume that the subprime problem will become one of the predominant political issues. The bottom line is that it will take a collaborative, interdisciplinary effort to keep borrowers in their homes and paying their mortgages.