



# **Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior**

**Servicer Compensation  
and its Consequences**

*October 2009*

NATIONAL  
CONSUMER LAW  
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**Why Servicers Foreclose  
When They Should Modify  
and Other Puzzles of  
Servicer Behavior:  
Servicer Compensation  
and its Consequences**

*Written by*  
*Diane E. Thompson*  
Of Counsel  
National Consumer Law Center

## **ABOUT THE AUTHOR**

Diane E. Thompson is Of Counsel at the National Consumer Law Center. She writes and trains extensively on mortgage issues, particularly credit math and loan modifications. Prior to coming to NCLC, she worked as a legal services attorney in East St. Louis, Illinois, where she negotiated dozens of loan modifications in the course of representing hundreds of homeowners facing foreclosure. She received her B.A. from Cornell University and her J.D. from New York University.

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The National Consumer Law Center®, a nonprofit corporation founded in 1969, assists consumers, advocates, and public policy makers nationwide on consumer law issues. NCLC works toward the goal of consumer justice and fair treatment, particularly for those whose poverty renders them powerless to demand accountability from the economic marketplace. NCLC has provided model language and testimony on numerous consumer law issues before federal and state policy makers. NCLC publishes an 18-volume series of treatises on consumer law, and a number of publications for consumers.

## **ACKNOWLEDGEMENTS**

My colleagues at NCLC provided, as always, generous and substantive support for this piece. Carolyn Carter, John Rao, Margot Saunders, Tara Twomey, and Andrew Pizor all made significant contributions to the form and content of this paper. Thanks as well to Kevin Byers for reading and commenting on this piece. Particular thanks to Denise Lisio for help with the footnotes, to Tamar Malloy for work on the charts, and to Julie Gallagher for graphic design. All errors remain the author's.

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7 Winthrop Square, Boston, MA 02110  
617-542-8010    [www.consumerlaw.org](http://www.consumerlaw.org)

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## EXECUTIVE SUMMARY

The country is in the midst of a foreclosure crisis of unprecedented proportions. Millions of families have lost their homes and millions more are expected to lose their homes in the next few years. With home values plummeting and layoffs common, homeowners are crumbling under the weight of mortgages that were often only marginally affordable when made.

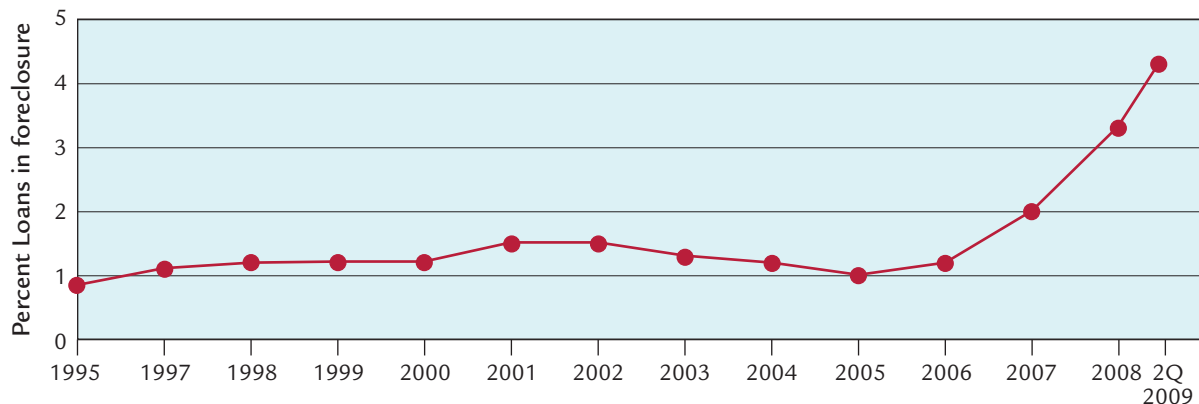
One commonsense solution to the foreclosure crisis is to modify the loan terms. Lenders routinely lament their losses in foreclosure. Foreclosures cost everyone—the homeowner, the lender, the community—money. Yet foreclosures continue to outstrip loan modifications. Why?

Once a mortgage loan is made, in most cases the original lender does not have further ongoing contact with the homeowner. Instead, the original lender, or the investment trust to which the loan is sold, hires a servicer to collect monthly payments. It is the servicer that either answers the borrower's plea for a modification or launches a foreclosure. Servicers spend millions of dollars

advertising their concern for the plight of homeowners and their willingness to make deals. Yet the experience of many homeowners and their advocates is that servicers—not the mortgage owners—are often the barrier to making a loan modification.

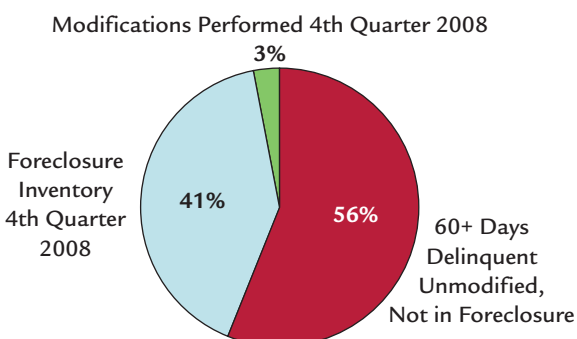
Servicers, unlike investors or homeowners, do not generally lose money on a foreclosure. Servicers may even make money on a foreclosure. And, usually, a loan modification will cost the servicer something. A servicer deciding between a foreclosure and a loan modification faces the prospect of near certain loss if the loan is modified and no penalty, but potential profit, if the home is foreclosed. The formal rulemakers—Congress, the Administration, and the Securities and Exchange Commission—and the market participants who set the terms of engagement—credit rating agencies and bond insurers—have failed to provide servicers with the necessary incentives—the carrots and the sticks—to reduce foreclosures and increase loan modifications.

**Percentage of Loans in Foreclosure, 1995–2009**



Sources: Inside Mortgage Finance, The 2009 Mortgage Market Statistical Annual; Mortgage Banker's Association, National Delinquency Survey, Q2 09

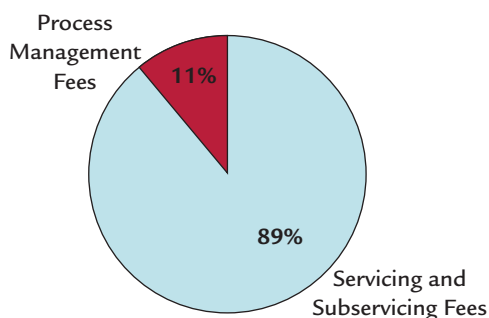
### Modifications, Foreclosures, and Delinquencies as a Percentage of 60+ Day Delinquencies in 4th Quarter, 2008



The 60+ day delinquency rate for 4th quarter 2008 was 8.08% of all loans.

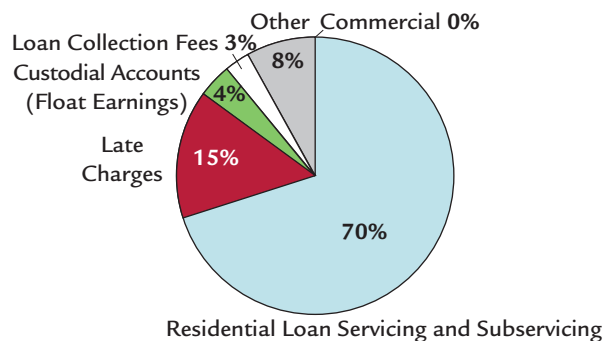
Sources: Mortgage Banker's Association, National Delinquency Survey, Q4 08; Manuel Adelino, Kristopher Gerardi, and Paul S. Willen, Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization, Table 3.

### Ocwen Asset Management Servicing Fees



Source: Ocwen Fin. Corp., Annual Report (Form 10-K) (Mar. 12, 2009)

### Ocwen Asset Management Breakdown of Servicing Fees



Source: Ocwen Fin. Corp., Annual Report (Form 10-K) (Mar. 12, 2009)

Servicers remain largely unaccountable for their dismal performance in making loan modifications.

Servicers have four main sources of income, listed in descending order of importance:

- The monthly servicing fee, a fixed percentage of the unpaid principal balance of the loans in the pool;
- Fees charged borrowers in default, including late fees and "process management fees";
- Float income, or interest income from the time between when the servicer collects the payment from the borrower and when it turns the payment over to the mortgage owner; and
- Income from investment interests in the pool of mortgage loans that the servicer is servicing.

Overall, these sources of income give servicers little incentive to offer sustainable loan modifications, and some incentive to push loans into foreclosure. The monthly fee that the servicer receives based on a percentage of the outstanding principal of the loans in the pool provides some incentive to servicers to keep loans in the pool rather than foreclosing on them, but also provides a significant disincentive to offer principal reductions or other loan modifications that are sustainable on the long term. In fact, this fee gives servicers an incentive to increase the loan principal by adding delinquent amounts and junk fees. Then the servicer receives a higher monthly fee for a while, until the loan finally fails. Fees that servicers charge borrowers in default reward servicers for getting and keeping a borrower in default. As they grow, these fees make a modification less and less feasible. The servicer may have to waive them to make a loan modification feasible but is almost always assured of collecting them if a foreclosure goes through. The other two sources of servicer income are less significant.

If servicers' income gives no incentive to modify and some incentive to foreclose, through increased fees, what about servicers' expenditures? Servicers' largest expenses are the costs of financing the advances they are required to make

to investors of the principal and interest payments on nonperforming loans. Once a loan is modified or the home foreclosed on and sold, the requirement to make advances stops. Servicers will only want to modify if doing so stops the clock on advances sooner than a foreclosure would.

Worse, under the rules promulgated by the credit rating agencies and bond insurers, servicers are delayed in recovering the advances when they do a modification, but not when they foreclose. Servicers lose no money from foreclosures because they recover all of their expenses when a loan is foreclosed, before any of the investors get paid. The rules for recovery of expenses in a mod-

ification are much less clear and somewhat less generous.

In addition, performing large numbers of loan modifications would cost servicers upfront money in fixed overhead costs, including staffing and physical infrastructure, plus out-of-pocket expenses such as property valuation and credit reports as well as financing costs. On the other hand, servicers lose no money from foreclosures.

The post-hoc reimbursement for individual loan modifications offered by Making Home Affordable and other programs has not been enough to induce servicers to change their existing business model. This business model, of creaming funds

### Effect of Components of Servicer Compensation on Likelihood and Speed of Foreclosure

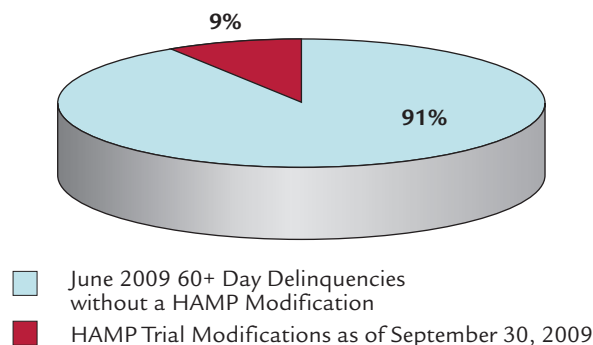
	Favors Foreclosure?	Likely Effect on Speed of Foreclosure?
<i>Structural Factors</i>		
PSAs	Neutral	Speeds Up
Repurchase Agreements	Neutral	Slows Down
REMIC rules	Neutral	Neutral
FAS 140	Slightly Favors Foreclosure	Neutral
TDR Rules	Slightly Favors Foreclosure	Neutral
Credit rating agency	Slightly Favors Foreclosure	Speeds Up
Bond insurers	Slightly Favors Foreclosure	Speeds Up
<i>Servicer Compensation</i>		
Fees	Strongly Favors Foreclosure	Slows Down
Float Interest Income	Slightly Favors Foreclosure	Neutral
Monthly Servicing Fee	Strongly Favors Modification (but not principal reductions)	Slows Down
Residual Interests	Slightly Favors Modification (but not interest reductions)	Slows Down
<i>Servicer Assets</i>		
Mortgage Servicing Rights	Neutral	Slows Down
<i>Servicer Expenses</i>		
Advances	Strongly Favors Foreclosures	Speeds Up
Fee Advances to Third Parties	Slightly Favors Foreclosure	Speeds Up
Staff Costs	Strongly Favors Foreclosures	Speeds Up



### HAMP Modifications as a Percentage of Delinquencies

Total 60+ Days Delinquencies  
as of June 30, 2009 5,360,961

HAMP Trial Modification Through  
September 30, 2009 487,081



Sources: Mortgage Banker's Association, National Delinquency Survey, Q2 09; Making Home Affordable Program, Servicer Performance Report Through September 2009

from collections before investors are paid, has been extremely profitable. A change in the basic structure of the business model to active engagement with borrowers is unlikely to come by piecemeal tinkering with the incentive structure.

In the face of an entrenched and successful business model, servicers need powerful motivation to perform significant numbers of loan modifications. Servicers have clearly not yet received such powerful motivation. What is lacking in the system is not a carrot; what is lacking is a stick. Servicers must be required to make modifications, where appropriate, and the penalties for failing to do so must be certain and substantial.

### Recommendations:

#### 1. Avoid irresponsible lending.

We are now looking to loan modifications to bail us out of a foreclosure crisis years in the making. Had meaningful regulation of loan products been in place for the preceding decade,

we would not now be tasking servicers with rescuing us from the foreclosure crisis. Any attempt to address the foreclosure crisis must, of necessity, consider loan modifications. We should also ensure that we are not permanently facing foreclosure rates at current levels. To do so requires thorough-going regulation of loan products, as we have discussed in detail elsewhere.

#### 2. Mandate loan modification before a foreclosure.

Congress and state legislatures should mandate consideration of a loan modification before any foreclosure is started and should require loan modifications where they are more profitable to investors than foreclosure. Loss mitigation, in general, should be preferred over foreclosure.

#### 3. Fund quality mediation programs.

Court-supervised mortgage mediation programs help borrowers and servicers find outcomes that benefit homeowners, communities and investors. The quality of programs varies widely, however, and most communities don't yet have mediation available. Government funding for mediation programs would expand their reach and help develop best practices to maximize sustainable outcomes.

#### 4. Provide for principal reductions in Making Home Affordable and via bankruptcy reform.

Principal forgiveness is necessary to make loan modifications affordable for some homeowners. The need for principal reductions is especially acute—and justified—for those whose loans were not adequately underwritten and either: 1) received negatively amortizing loans such as payment option adjustable rate mortgage loans, or 2) obtained loans that were based on inflated appraisals. As a matter of fairness and commonsense, homeowners should not be trapped in debt peonage, unable to refinance or sell.

The Making Home Affordable guidelines should be revised so that they at least conform to the Federal Reserve Board's loan modification program by



reducing loan balances to 125 percent of the home's current market value. In addition, Congress should enact legislation to allow bankruptcy judges to modify appropriate mortgages in distress.

**5. Continue to increase automated and standardized modifications, with individualized review for borrowers for whom the automated and standardized modification is inappropriate.**

One of the requirements of any loan modification program that hopes to be effective on the scale necessary to make a difference in our current foreclosure crisis is speed. The main way to get speed is to automate the process and to offer standardized modifications.

Servicers can and should present borrowers in default with a standardized offer based on information in the servicer's file, including the income at the time of origination and the current default status. Borrowers should then be free to accept or reject the modification, based on their own assessment of their ability to make the modified payments. Borrowers whose income has declined and are seeking a modification for that reason could then provide, as they now do under the Making Home Affordable Program, income verification. Only when a borrower rejects a modification—or if an initial, standard modification fails—should detailed underwriting be done.

The urgency of the need requires speed and uniformity; fairness requires the opportunity for a subsequent review if the standardized program is inadequate. Borrowers for whom an automated modification is insufficient should be able to request and get an individually tailored loan modification, at least when such a loan modification is forecast to save the investor money. Many of the existing loans were poorly underwritten, based on inflated income or a faulty appraisal. Borrowers may have other debt, including high medical bills, that render a standardized payment reduction unaffordable. Subsequent life events, includ-

ing the death of a spouse, unemployment, or disability, may also make a standardized modification unsustainable. These subsequent, unpredictable events, outside the control of the homeowner, should not result in foreclosure if a further loan modification would save investors money and preserve homeownership.

**6. Ease accounting rules for modifications.**

The current accounting rules, particularly as interpreted by the credit rating agencies, do not prevent modifications, but they may discourage appropriate modifications. The requirements that individual documentation of default be obtained may prevent streamlined modifications. The troubled debt restructuring rules may discourage sustainable modifications of loans not yet in default, with the unintended consequence of promoting short-term repayment plans rather than long-term, sustainable modifications that reflect the true value of the assets. Finally, limiting recovery of servicer expenses when a modification is performed to the proceeds on that loan rather than allowing the servicer to recover more generally from the income on the pool as a whole, as is done in foreclosure, clearly biases servicers against meaningful modifications.

**7. Encourage FASB and the credit rating agencies to provide more guidance regarding the treatment of modifications.**

Investors, taken as a whole, generally lose more money on foreclosures than they do on modifications. Investors' interests are not necessarily the same as those of borrowers; there are many times when an investor will want to foreclose although a borrower would prefer to keep a home. Investors as well as servicers need improved incentives to favor modifications over foreclosures. Still, there would likely be far fewer foreclosures if investors had information as to the extent of their losses from foreclosures and could act on that information.

Even where investors want to encourage and monitor loan modifications, existing rules can stymie their involvement—or even their ability to get clear and accurate reporting as to the status of the loan pool. Additional guidance by FASB and the credit rating agencies could force servicers to disclose more clearly to investors and the public the nature and extent of the modifications in their portfolio—and the results of those modifications. Without more transparency and uniformity in accounting practices, investors are left in the dark. As a result, servicers are free to game the system to promote their own financial incentives, to the disadvantage, sometimes, of investors, as well as homeowners and the public interest at large.

#### **8. Regulate default fees.**

Fees serve as a profit center for many servicers and their affiliates. They increase the cost to homeowners of curing a default. They encourage servicers to place homeowners in default. All fees should be strictly limited to ones that are legal under existing law, reasonable in amount, and necessary. If default fees were removed as a profit center, servicers would have less incentive to place homeowners into foreclosure, less incentive to complete a foreclosure, and modifications would be more affordable for homeowners.

# Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior

## *Servicer Compensation and its Consequences*

Diane E. Thompson  
National Consumer Law Center

### Introduction

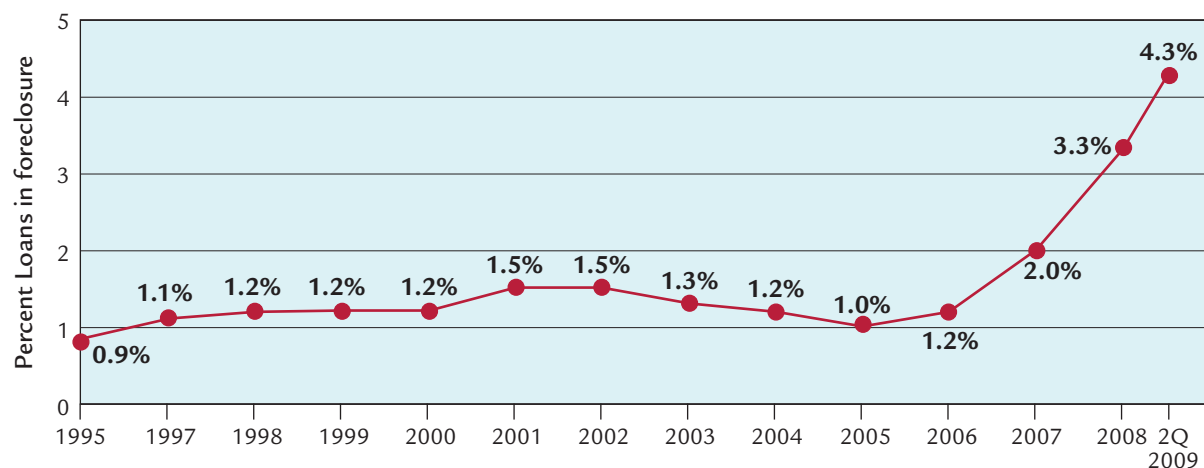
As the foreclosure numbers have spiraled upward over the last few years, policymakers and economists have come to a consensus that the national economy needs a massive reduction in the number of foreclosures, probably by modifying delinquent loans.<sup>1</sup> Everyone claims to be in favor of this: Congress, the President, the Federal Reserve Board, bankers. Yet the numbers of modifications have not kept pace with the numbers of foreclosures.<sup>2</sup>

At the center of the efforts to perform loan modifications are servicers.<sup>3</sup> Servicers are the companies that accept payments from borrowers. Servicers are distinct from the lender, the entity that originated the loan, or the current holder or investors, who stand to lose money if the loan fails. Some servicers are affiliated with the origi-

nating lender or current holder; many are not. Yet, while servicers normally have the power to modify loans, they simply are not making enough loan modifications. Why? One answer is that the structure of servicer compensation generally biases servicers against widespread loan modifications.

How servicers get paid and for what is determined in large part by an interlocking set of tax, accounting, and contract rules. These rules are then interpreted by credit rating agencies and bond insurers. Those interpretations, more than any individual investor or government pronouncement, shape servicers' incentives. While none of these rules or interpretations impose an absolute ban on loan modifications, as some servicers have alleged, they generally favor foreclosures over modifications, and short-term modifications over modifications substantial enough to

Percentage of Loans in Foreclosure, 1995–2009



Sources: Inside Mortgage Finance, The 2009 Mortgage Market Statistical Annual; Mortgage Banker's Association, National Delinquency Survey, Q2 09

be sustainable. Neither the formal rulemakers—Congress, the Administration, and the Securities and Exchange Commission—nor the market participants who set the terms of engagement—credit rating agencies and bond insurers—have yet provided servicers with the necessary incentives—the carrots and the sticks—to reduce foreclosures and increase loan modifications.

Servicers' incentives ultimately are not aligned with making loan modifications in large numbers. Servicers continue to receive most of their income from acting as automated pass-through accounting entities, whose mechanical actions are performed offshore or by computer systems.<sup>4</sup> Their entire business model is predicated on making money by lifting profits off the top of what they collect from borrowers. Servicers generally profit from: a servicing fee that takes the form of a fixed percentage of the total unpaid principal balance of the loan pool; ancillary fees charged borrowers—sometimes in connection with the borrower's default and sometimes not; interest income on borrower payments held by the servicer until they are turned over to the investors or paid out for taxes and insurance; and affiliated business arrangements.

Servicers, despite their name, are not set up to perform or to provide services.<sup>5</sup> Rather, they make their money largely through investment decisions: purchases of the right pool of mortgage servicing rights and the correct interest hedging decisions. Performing large numbers of loan modifications would cost servicers upfront money in fixed overhead costs, including staffing and physical infrastructure, plus out-of-pocket expenses such as property valuation and credit reports as well as financing costs.

Several programs now offer servicers some compensation for performing loan modifications, most significantly the Making Home Affordable program. Fannie Mae and Freddie Mac—market makers for most prime loans—have long offered some payment for loan modifications. Other investors have sometimes done likewise, and some private mortgage insurance

companies make small payments if a loan in default becomes performing, as does the FHA loan program. Yet none of these incentives has been sufficient to generate much interest among servicers in loan modifications.<sup>6</sup>

Post-hoc reimbursement for individual loan modifications is not enough to induce servicers to change an existing business model. This business model, of creaming funds from collections before investors are paid, has been extremely profitable. A change in the basic structure of the business model to active engagement with borrowers is unlikely to come by piecemeal tinkering with the incentive structure. Indeed, some of the attempts to adjust servicers' incentive structure have resulted in confused and conflicting incentives, with servicers rewarded for some kinds of modifications, but not others.<sup>7</sup> Most often, if servicers are encouraged to proceed with a modification at all, they are told to proceed with both a foreclosure and a modification, at the same time. Until recently, servicers received little if any explicit guidance on which modifications were appropriate and were largely left to their own devices in determining what modifications to make.<sup>8</sup>

In the face of an entrenched and successful business model and weak, inconsistent, and post-hoc incentives, servicers need powerful motivation to perform significant numbers of loan modifications. Servicers have clearly not yet received such powerful motivation.

A servicer may make a little money by making a loan modification, but it will definitely cost it something. On the other hand, failing to make a loan modification will not cost the servicer any significant amount out-of-pocket, whether the loan ends in foreclosure or cures on its own. Servicers remain largely unaccountable for their dismal performance in making loan modifications.

Until servicers face large and significant costs for failing to make loan modifications and are actually at risk of losing money if they fail to make modifications, no incentive to make modifications will work. What is lacking in the system is not a carrot; what is lacking is a stick.<sup>9</sup> Servicers

must be required to make modifications, where appropriate, and the penalties for failing to do so must be certain and substantial.

## The Rise of the Servicing Industry as a By-Product of Securitization

Once upon a time, it was a wonderful life.<sup>10</sup> In this prediluvian America, those that owned the loan also evaluated the risk of the loan, collected the payments, and adjusted the payment agreement as circumstances warranted. In this model, in most circumstances, lenders made money by making performing loans, borrowers had unmediated access to the holder of their loan, and both lenders and borrowers had in-depth information about local markets. Even if few bank owners or managers were as singularly civic-minded as George Bailey, they were at least recognizable individuals who could be appealed to and whose interests and incentives, if not always aligned with those of borrowers, were mostly transparent.

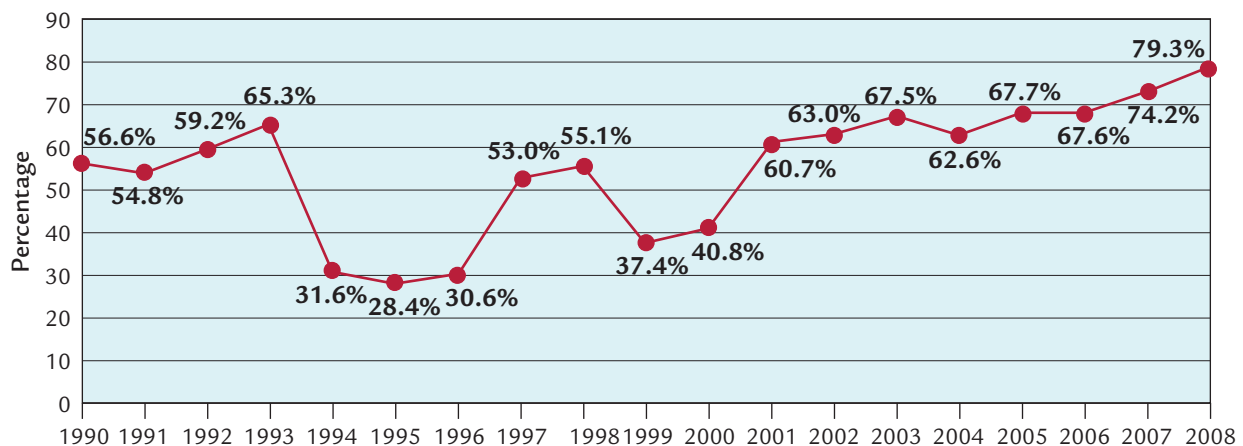
This unity of ownership, with its concomitant transparency, has long since passed from the

home mortgage market. Loans are typically originated with the intention of selling the loan to investors. Loans may be sold in whole on the secondary market, so one investor ends up with the entire loan, but, more commonly, the loans are securitized. The securitization process transforms home loans into commodities, with ownership and accountability diffused.

In securitization, thousands of loans are pooled together in common ownership. Ownership is held by a trust. The trust is usually set up as a bankruptcy-remote entity, which means that the notes cannot be seized to pay the debts of the originator if the originator goes bankrupt. Bonds are issued to investors based on the combined expected payment streams of all the pooled loans. Bonds may be issued for different categories of payments, including interest payments, principal payments, late payments, and prepayment penalties.<sup>11</sup> Different groups of bond holders—or tranches—may get paid from different pots of money and in different orders.<sup>12</sup> The majority of all home loans in recent years were securitized.

Securitization—and the secondary market for mortgage loans more generally—has created a relatively new industry of loan servicers. These entities exist to collect and process payments on mortgage loans. Some specialize in subprime loans; some specialize in loans that are already in

Securitization Rate, 1990–2008



Sources: Inside Mortgage Finance, The 2009 Mortgage Market Statistical Annual

default (so-called special servicers). Some companies contain entire families of servicers: prime and subprime, default and performing. Some of these servicers are affiliated with the originators—nearly half of all subprime loans are serviced by either the originator or an affiliate of the originator<sup>13</sup>—but many are not. Even when the servicer is affiliated with the originator, it no longer has exclusive control over the loan or an undivided interest in the loan's performance. Servicers are usually collecting the payments on loans someone else owns.

Servicers bid for the right to service pools of mortgages at the time the mortgage pool is created. Most securitization agreements (pooling and servicing agreements or PSAs) specify a master servicer, who coordinates the hiring of various subservicers, including default servicers as needed. Once the master servicer is set in the PSA, the master servicer typically is entitled to receive a portion of the payments on the pool of mortgages serviced until those mortgages are paid off. Usually, the master servicer cannot be replaced, absent both gross malfeasance in the performance of its duties and concerted action by a majority of investors.

Borrowers see none of this. Instead, a borrower typically knows who originated the loan and to whom the borrower sends her payments. Borrowers—and even judges, the press, and academics—often refer to the payment recipient as the “lender.” In fact, though, the entity receiving the borrower's payments is not necessarily “the” lender or even “a” lender. Instead, the payment recipient is a servicer. It is the servicer, not the lender or holder, who will have the records of payments; it is the servicer who will know of a default; and it is through the servicer that any request for a loan modification must pass.

The servicer's function is to collect the payments. Once the payments are collected, the servicer passes them on to a master servicer, a trustee, or the securities administrator,<sup>14</sup> which then disburses them to the investors. Although the servicer may have some connection with the loan originator, or some interest in the pooled

## INCOME GLOSSARY

**Affiliates** Related business organizations, with common ownership or control.

**Float Income** The interest income earned by servicers in the interval between when funds are received from a borrower and when they are paid out to the appropriate party.

**Mortgage Servicing Rights (MSRs)** The rights to collect the payments on a pool of loans.

**Residual Interest** A junior-level interest retained in the mortgage pool by a servicer, typically by a servicer who is an affiliate of the originator. These interests commonly pay out “surplus” interest income, left over after specified payments to senior bond holders are made.

loans, servicers are primarily neither originators of loans nor holders of loans.

Originators sometimes retain the servicing rights on loans they securitize. Not all originators have servicing divisions, however. Even those originators that have servicing divisions do not always retain the servicing rights.

Servicers affiliated with the sponsors of the securitization or originators of the pooled loans commonly retain at least some junior interests in the pool. In theory, retention of these interests increases servicers' incentives to maximize performance. These junior tranches held by servicers are usually interest-only: if there is “excess” or “surplus” interest, then the servicer receives that interest income. If the servicer collects no more interest income than is required to satisfy the senior bond obligations, then the servicer receives nothing.

Servicers' incentives thus are neither those of the investors—the beneficial owners of the mortgage note—nor the borrowers. Nor are their concerns necessarily the same as those of the loan originator.

Servicers are not paid strictly speaking on the performance of loans. Instead, servicers derive their compensation from a complex web of direct payments based on the principal balance of the pool of loans, fees charged borrowers, interest



income on the float between when payments are received from borrowers and when they are passed on, residual interests in the pool, and often some income from other hedging devices, including bonds on other pools of mortgages and more exotic financial instruments. Servicers may rack up extra compensation through affiliated businesses, such as insurance companies or property valuation and inspection companies, with whom they contract for various services, the costs of which are passed on to borrowers.<sup>15</sup> These affiliated companies sometimes specialize in providing services for loans that are in default—giving servicers a way of profiting even from loans that are belly up.<sup>16</sup>

Offset against servicers' income are their expenses, which servicers, as rational corporate

actors, attempt to keep as low as possible.<sup>17</sup> Expenses include financing the advances made to the trusts on nonperforming loans,<sup>18</sup> occasional obligations under repurchase agreements, and staff. Servicers' largest expense, albeit a noncash expense, is the amortization of their mortgage servicing rights.<sup>19</sup>

These competing financial pressures do not necessarily provide the correct incentives from the perspectives of investors, borrowers, or society at large. In particular, servicers' incentives generally bias servicers to foreclose rather than modify a loan.

#### EXPENSES GLOSSARY

**Advances** Under most PSAs, servicers are required to advance the monthly principal and interest payment due on each loan to the trust, whether or not the borrower actually makes the payment. The requirement to make these advances can continue until the home is sold at foreclosure.

**Repurchase Agreement** A clause in a contract for the sale of mortgages that requires the seller or servicer to repurchase any mortgage back from the buyer if any one of a number of specified events occur. Generally the specified events include borrower default or legal action and sometimes include modification.

## Securitization Contracts, Tax Rules, and Accounting Standards Do Not Prevent Loan Modifications But Discourage Some Modifications

### Overview

The large pools of securitized mortgages are governed by an interlocking set of tax and accounting rules, repeated in the trusts' governing documents. These rules do not forbid loan modifications. Some of these rules do, however, restrict the circumstances in which loans can be modified or create certain disincentives for loan modifications.

These rules are designed to ensure that the assets of the trust—the notes and mortgages—are passively managed. Passive management is required because the trusts receive preferential tax treatment. So long as the trust complies with these rules, the trust does not have to pay tax on its income, thus freeing more income for the ultimate investors. Compliance with the rules also provides investors in these trusts with some protection from the bankruptcy of the entity, usually the mortgage originator, that transfers the mortgages into the securitized trust. Without these protections from bankruptcy, creditors of the originator could seize mortgage loans from the trust to satisfy the originator's debts.

In the past, there was widespread concern that tax and accounting rules might prevent modifications. Servicers often cited these rules as a reason for their failure to perform modifications. The concern that the tax and accounting rules, and their embodiment in the trusts' governing documents, were preventing modifications was always largely overblown, at least for individual modifications of loans actually in default. Recent clarifications to both the tax and accounting rules have eased most significant limitations on modifications. Modification of a mortgage that is in default or for which default is reasonably foreseeable will seldom trigger adverse tax or accounting consequences.



## SECURITIZATION, TAX, AND ACCOUNTING GLOSSARY

**FAS** Financial Accounting Statement, issued by FASB. The Financial Accounting Statements, through their incorporation into private contracts and SEC regulation, have the force of law.

**FASB Financial Accounting Standards Board** FASB is a private organization, but the Securities and Exchange Commission often interprets FASB standards and requires compliance with the FASB standards by all public companies.

**FAS 140** Accounting rules governing transfer of assets to and from trusts, designed to limit discretion in trust management in exchange for preserving the bankruptcy-remote status of the trust.

**Junior Tranche, Junior Interest** An interest in a pool of mortgages that gets paid after more senior security interests.

**Pooling and Servicing Agreement (PSA)** The agreement between the parties to the securitization as to how the loans will be serviced. PSAs spell out the contractual duties of each party, the circumstances under which a servicer can be removed, and sometimes give guidance as to when modifications can be performed.

**REMIC** Real Estate Mortgage Investment Conduits are defined under the U.S. Internal Revenue Code, and are the typical vehicle of choice for the pooling and securitization of mortgages. The REMIC rules are the IRS tax code rules governing REMICs.

**Repurchase Agreement** A clause in a contract for the sale of mortgages which requires the seller or servicer to repurchase any mortgage back from the buyer if one of a number of specified events occur. Generally the specified events include borrower default or legal action and sometimes include modification.

**Tranche** One of a number of related classes of securities offered as part of the same transaction.

**Troubled Debt Restructuring (TDR)** An accounting term describing the modification of debt involving creditor concessions (a reduction of the effective yield on the debt) when the borrower is facing financial hardship.

**Trustee** The legal holder of the mortgage notes, on behalf of the trust and the ultimate beneficiaries, the investors in the trust.

Some PSAs impose restrictions on the nature or number of loan modifications. The most common limitation on modifications is a five percent cap on loan modifications, either of unpaid principal balance or number of loans, measured as of the pool's formation. Although some subprime pools surpass that percentage in default and foreclosure,<sup>20</sup> few, if any, servicers reach or even approach that percentage of modifications in the pool as a whole.<sup>21</sup> As a recent Congressional Oversight Panel determined, after reviewing several of the pools containing the five percent cap, "the cap is not the major obstacle to successful modifications."<sup>22</sup> A small percentage of PSAs forbid modifications, but many of these have been amended.<sup>23</sup> Some of the PSAs that limit modifications only do so for loans that remain in the pool. In that case, the servicer may modify as many loans as it chooses, so long as it is prepared to purchase the modified loans out of the loan pool.

None of the existing tax and accounting rules or PSAs yet provide clear and comprehensive guidance for servicers or investors in terms of how to account for modifications or which modifications are preferred.<sup>24</sup> The rules set some basic outer bounds: modifications must be done when default is actual or imminent; there must be some individual review and documentation of the impending default; no group of investors should dictate any particular loan modification; and modification should inure to the benefit of the trust as a whole. The rules have all been updated in the last few years to encourage modifications.

The following subsections take a detailed look at the contract, tax, and accounting rules, in that order.

## *Neither PSAs nor Investor Action Block Loan Modifications*

Pooling and servicing agreements (PSAs) spell out the duties of a servicer, how the servicer gets paid, and what happens if the servicer fails to

perform as agreed. What control investors exercise over the servicer is usually contained in the PSA. While much has been made of the limitations imposed by these PSAs, there is wide variation in how much detail they give. Most PSAs impose no meaningful restrictions—or guidance—on individual loan modifications.<sup>25</sup> Common types of loan modifications, including principal forbearance, are not even mentioned in most PSAs.<sup>26</sup> Modifications are generally permissible, so long as they are in accordance with the “usual and customary industry practice.” The result is that servicers are generally left to their own discretion in approving, analyzing, and accounting for modifications.

#### **Current PSA Limitations on Loan Modifications Are Few and Far Between**

Of those PSAs that do limit loan modifications, most provide only general guidance, such as limiting the total amount of loan modifications to five percent or requiring loans to be in default or at imminent risk of default before being modified.<sup>27</sup> Some PSAs, primarily those involving loans originated by Countrywide prior to 2007, require the servicer to buy all modified loans out of the pool, thus avoiding any potential REMIC or FAS 140 issues.<sup>28</sup> Even in the early Countrywide loan pools, the repurchase requirement has not posed a significant hurdle to modifications. In many instances, the repurchase requirement appears to be waived for loans in default.<sup>29</sup>

Probably no more than 10% of all subprime loans are in pools that originally prohibited all material modifications.<sup>30</sup> Where the PSAs provided meaningful limits on the abilities of servicers to perform modifications, those limits have been eased. Sponsors of securitizations have successfully petitioned the trustee to amend the provisions barring modifications to allow modifications generally, so long as the loan is in default or at imminent risk of default.<sup>31</sup> Similarly, although there is no evidence that the five percent cap on modifications was ever the reason

that servicers failed to perform modifications,<sup>32</sup> those limits are being lifted in PSAs as well.<sup>33</sup> Credit rating agencies have made clear that they will not count modified loans that are performing 12 months after modification against the five percent cap.<sup>34</sup> Thus, the modification caps are transformed from an absolute limit to a limit on the number that can be modified within any twelve-month period. Finally, securitizations of Countrywide loans in 2007 and later distinguished between modifications that triggered the “troubled debt restructuring” standard and more modest modifications that would permit loans to be repackaged and resecuritized, thus avoiding the repurchase requirement in the Countrywide securitizations.<sup>35</sup>

A more widespread—and persistent—problem is that many PSAs require the servicer to proceed with foreclosure at the same time that it pursues a loan modification,<sup>36</sup> increasing the servicer’s and borrower’s costs and potentially undermining any offered loan modification. This issue is discussed in more detail later in this paper.

#### **Investors Seldom Can or Do Influence the Servicer’s Actions on Loan Modifications**

Nominally, the servicer works at the behest of the investors, through the trustee. PSAs will usually set out the servicer’s duties and the remedies of the investors, acting through the trustee, should the servicer breach those duties.<sup>37</sup> Servicers are required by the PSA to act in the interests of the investors taken as a whole.

In large subprime pools there may be hundreds of investors, who have differing views of what the appropriate response to a pending foreclosure is.<sup>38</sup> Some investors may favor more aggressive loan modification to prevent foreclosures; others may prefer a quick foreclosure.<sup>39</sup> Nor do all investors share the pain of a default equally. For most subprime securities, different investors own different parts of the security—principal payments, interest payments, or prepayment penalties, for example—and get paid in different orders depending on their assigned priority. The higher

the priority of payment, the higher the certificate's credit rating, in general, and the more investors are willing to pay for it in relation to its return. Depending on the priority of payment and whether or not a modification reduces interest or principal payments, two investors in the same pool may fare very differently from a modification, with one investor seeing no change in payments and the other investor having its payments wiped out completely.<sup>40</sup>

Investors, unsurprisingly, are typically more focused on receiving the expected return on their certificates than the details of loan modifications, even where loan modifications have a large impact on the pool as a whole. Moreover, obtaining information about the nature and extent of loan modifications is not easy, even for investors.<sup>41</sup> Determining how those loan modifications impact the return on any one security may be even harder. Similarly, the sometimes substantial fees paid to servicers in foreclosure tend to be invisible to investors.<sup>42</sup>

Even when investors would favor modifications over foreclosure, they generally do not have authority to directly control servicer actions. Investors can usually only take action against a servicer through the trustee and then only if a majority of the investors agree.<sup>43</sup> Partly as a result of this common action problem, investors seldom give servicers guidance on how or when to conduct loss mitigation.<sup>44</sup> Trustees, on behalf of the trust, can in exceptional cases fire a servicer, but this right is rarely invoked, usually only when the servicer is no longer able to pay the advances of the monthly payments on the loans.<sup>45</sup> Thus, although servicers are nominally accountable to investors, investors have, in most cases, little control over the servicer's decisions about how to handle delinquencies and whether and how to offer loan modifications.<sup>46</sup>

### **Servicers Face No Realistic Threat of Legal Liability for Making Loan Modifications**

Servicers have claimed to fear investor law suits. Securitization, by design, favors some in-

vestors over others, depending on which piece of the securitization, or tranche, an investor has bought. Tranches are rated for their presumed credit-worthiness; the higher the rating, the more stable and predictable the return is presumed to be. Loan modifications that spread the loss evenly across all investors are likely to be met with howls of outrage from the highest-rated tranches.<sup>47</sup> Most influential investors would like the lower-rated tranches, often owned by the servicer, to bear the brunt of the cost of loan modifications. On the other hand, the servicer may have a financial interest in sparing the lower-rated tranches. Loan modifications that favor one group of investors over another could potentially give rise to a successful suit against a servicer by investors.

Fears of legal liability were always overblown. Such suits are vanishingly rare and face significant hurdles.<sup>48</sup> Among other hurdles, a significant number of investors have to agree to sue the servicer.<sup>49</sup> The PSAs themselves largely authorize modifications when doing so is in accordance with standard industry practices. Moreover, under recent federal legislation, servicers are now immunized from investor litigation when they make modifications in accordance with standard industry practice or government programs such as Making Home Affordable.<sup>50</sup> Of course, servicers often should—and occasionally do—make loan modifications that go beyond standard industry practice, and neither federal law nor most PSAs provide protection for innovative loan modifications, even if they are in the best interests of investors. Nonetheless, the fact remains that of all the lawsuits filed by investors in 2008, not a single one questioned the right of a servicer to make a loan modification.<sup>51</sup>

### **Reliance on Industry Standards Slows the Pace of Innovation in Loan Modifications**

But this standard creates a problem: how do you move an entire industry to begin making loan modifications when current standard industry practice is to do none? Reliance on standard industry practices as the benchmark of permissible

modifications, rather than either explicit guidance or a measure of the benefit to the investor, may chill innovation.

For example, some servicers have reduced the principal balance when a home is worth less than the loan amount (or “underwater”). In most cases, such a reduction will benefit the pool: the costs of foreclosure are avoided; the investors receive the actual value of the collateral, the most they could expect to recover after a foreclosure; and investors retain the right to receive interest payments over the life of the loan. Despite the apparent win-win nature of this result—the homeowner stays in place, the investors and servicer continue receiving income, and everyone avoids costly litigation—many servicers have been reluctant to do this, instead requiring the homeowner to sell the home in order to get a principal balance reduction. One reason is that principal balance reductions where the borrower stays in place, called partial chargeoffs, are not commonplace, and thus servicers prefer the more common short sale, where the homeowner sells the home for less than is owed and relinquishes ownership.<sup>52</sup> Short sales are more widely recognized as “usual and customary industry practice” than are partial chargeoffs. The GSEs<sup>53</sup> encourage short sales over modifications by paying several times more in compensation to a servicer for a short sale than for a modification.<sup>54</sup> The more punitive approach of short sales—the homeowner loses the home—may also reassure investors that a servicer is not soft on deadbeats and is aggressively looking out for the investors’ interests. The net result, however, is that servicers avoid an outcome that would save both homes for borrowers and money for investors.

### **Repurchase Agreements**

The repurchase agreements contained in PSAs present a special case. The servicer may in certain circumstances be required under the PSA to repurchase any nonperforming loans or, in some cases, loans that are substantially modified. Usually this obligation is only imposed on servicers who are either the originator or an affiliate of the

originator. Nearly half of all subprime loans are serviced by either the originator or an affiliate of the originator.<sup>55</sup> The servicer may have incentives to report the loan as performing for the duration of its repurchase agreement.

Since many PSAs limit the repurchase requirement to a few years, repurchase agreements may motivate servicers to push short-term loss mitigation approaches without any regard for their long-term sustainability. Forbearance plans with unrealistic repayment plans are one example. These short-term plans do not trigger repurchase requirements for modifications<sup>56</sup> and may delay the need to repurchase the loan until the repurchase time period has run.

### ***REMIC Rules Permit Loan Modifications***

Most mortgages now are held in Real Estate Mortgage Investment Conduits. These are special purpose trusts that are blessed by the IRS and given preferential tax status. A violation of the REMIC rules revokes the preferential tax treatment.

In order to achieve REMIC status, the IRS imposes certain requirements that can limit the possibility of loan modifications. The most significant limitations for our purposes are the following:

- The trust must be passively managed.
- All but a de minimis amount of assets of the trust must be “qualified mortgages.”<sup>57</sup>

Qualified mortgages must be put into the trust within three months of its start up date. If a mortgage goes into default before being put into the trust, it is “defective.” Other common examples of defective loans would include loans that were fraudulently obtained or do not comport with the representations and warranties in the PSA.<sup>58</sup> Once a loan is defective, either the default must be cured within 90 days or the loan must be disposed of to ensure that the loan does not lose its status as a qualified mortgage.<sup>59</sup> Mortgages



may be substituted, but only for the first two years of the REMIC's existence.

As the need for mass loan modifications in response to the foreclosure crisis became apparent in 2007 and 2008, many industry observers expressed concerns over the REMIC restrictions on when a mortgage loan could be modified.<sup>60</sup> Most significant modifications render a mortgage no longer qualified. Thus, if a servicer were to modify more than an incidental number of mortgages, so the reasoning went, the servicer would have to dispose of the mortgages, presumably through foreclosure or repurchase, in order to stay under the de minimis threshold.

However, the REMIC rules always offered one big escape clause: loans modified when they are in default or when default is "reasonably foreseeable" do not lose their status as qualified mortgages.<sup>61</sup> The IRS guidance issued in 2007 and 2008 reinforced and elaborated on that exception.<sup>62</sup> Under the guidance, a safe harbor is provided for modifications so long as they are done when default is either actual or reasonably foreseeable and modified according to a standardized protocol. In fact, there are no reports of the IRS revoking REMIC status based on the number of modifications in a pool. Thus, loan modifications should not generally trigger a loss of qualified mortgage status nor, by extension, a loss of REMIC status.

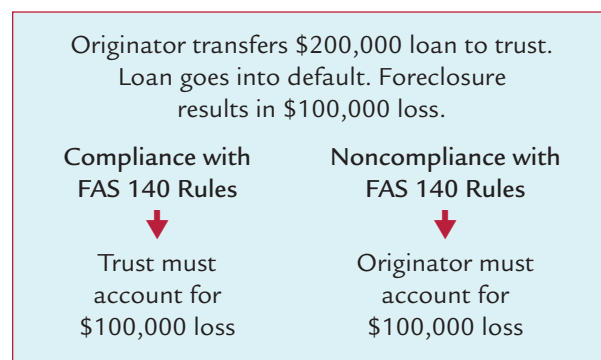
### ***FAS 140 Accounting Standards Authorize Modifications When Default Is Either Actual or Reasonably Foreseeable***

Financial Accounting Statement 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 140), like all the other Financial Accounting Statements, is promulgated by the Financial Accounting Standards Board (FASB).<sup>63</sup> FASB is a private organization whose work nonetheless has the force of market regulation. The Securities and Exchange Commission requires compliance with the FASB

standards by all public companies,<sup>64</sup> and the FASB standards are incorporated into the contracts governing the formation of the trusts.

Compliance with the FASB standards is essential to maintain the trust. If there is no compliance with the FASB standards then, as a matter of SEC regulation under the Securities and Exchange Commission Act of 1934 and as a matter of contract, the trust fails. Once the trust fails, it loses its REMIC status and the accompanying preferential tax treatment.

Compliance with the FAS 140 rules also protects the bankruptcy-remote status of the trust. Ordinarily, at least in some circumstances, if a lender filed bankruptcy, the lender's creditors might be able to seize assets, including mortgages, that the lender had previously sold to third-parties. Some transfers are automatically disallowed and others may be. Such uncertainty is anathema to the securitization process. Worse, from the standpoint of an originator, if the FAS 140 rules are not complied with, the mortgage loans and any liabilities connected with them revert to the originator or other transferor, for accounting purposes, without necessarily any change in legal title.<sup>65</sup> If this happens, the originator would have to account on its books for loans it no longer had any control over.



A servicer will want to shelter an affiliated originator from having to report these possible losses. Even if the losses are not actual, the originator will be required to report them, with the result that its financial status will look weaker to

investors and credit rating agencies. A servicer's financial position will suffer more and more directly from losses suffered by an affiliated originator than from losses suffered by the trust.

Like the REMIC rules, the accounting standards generally applicable to securitized mortgage trusts are meant to ensure that the mortgages are isolated from the originator and are passively managed, thus meriting their bankruptcy-remote status. FAS 140, in far more detail than the REMIC rules,<sup>66</sup> sets forth restrictions on active management. Among other restrictions, FAS 140 requires trustee discretion to be narrowly constrained in the governing documents of the trust.<sup>67</sup> Recent FASB guidance has expanded somewhat the range of servicer discretion in approving modifications.<sup>68</sup> Still, trustees—and their agents, servicers—cannot have untrammelled authority to modify a loan. Any modification must benefit the trust as a whole.

This focus on the benefit to the trust as a whole in theory allows servicers to ignore some of the complications caused by securitization. Servicers should be able to modify loans by analyzing the overall cash flow to the trust and not worry about which certificate holders will bear the cost. In general, servicers may modify loans that are in default or for which default is “reasonably foreseeable” without taking the loan out of the pool or jeopardizing the legal status of the securitization trust, provided that the modification does not involve new collateral, new extensions of credit, or an additional borrower.<sup>69</sup>

There is little question that most meaningful mortgage modifications undertaken when the borrower is in default comply with FASB standards.<sup>70</sup> What has been more difficult is the extent to which loans that are not in default may be modified. When, in other words, is default “reasonably foreseeable”? For example, default is not reasonably foreseeable under the FASB standards if refinancing is available.

Recent FAS 140 guidance from the Securities and Exchange Commission has loosened and clarified somewhat the restrictions on reasonably

foreseeable default for mortgage modifications. In particular, streamlined modification in accordance with the American Securitization Forum's guidance will not jeopardize the trust.<sup>71</sup> The ASF guidance is limited largely to modifications in anticipation of reset on an adjustable rate mortgage.<sup>72</sup> Practically, this means that the documentation burden is eased on servicers if the basis for anticipated default is a coming rate increase on an adjustable rate mortgage.

If the basis for anticipated default is something other than a rate reset, FAS 140 requires individual documentation of the default or the “reasonably foreseeable” prospect of default.<sup>73</sup> The servicer must contact the borrower and document that the borrower will be unable to make payments in the future.<sup>74</sup> Bases for anticipated default, including job loss, fraud in origination or servicing, a death in the family resulting in reduced income, or depleted cash reserves, must still be documented and individually determined, including some showing that there is no reasonable prospect of refinancing. Significantly, the relaxed guidance permits servicers to reach out to borrowers who are less than 60 days delinquent, at a time when a modification may have the most chance of success.<sup>75</sup>

FAS 140 also has rules governing repurchase agreements. The PSA may require originators to repurchase defective loans. So long as the repurchase agreement complies with the terms outlined in FAS 140, repurchase of a loan out of the trust should not endanger the trust. Forcing repurchase is sometimes the only way to get a modification of a performing but unconscionable loan.

The availability of repurchase may make FAS 140 limitations even less significant as impediments to loan modifications. While an originator may not want to repurchase a loan, so long as the PSA contains a repurchase agreement in accordance with the FAS 140 standards, an affiliated servicer may repurchase a loan and modify it without regard to the FAS 140 limitations. Such repurchase may well have a negative impact on the servicer's books, and the originator's as well.

Certainly originators that routinely repurchased large numbers of mortgage loans out of securitized pools would find disfavor with investors who purchased the mortgage-backed securities in expectation of high-yield payments spread over time. On the other hand, the repurchase rules underscore that the FAS rules, by themselves, are not a major impediment to loan modifications.

### ***FASB Requirements for the Immediate Recognition of Loss Discourage Permanent Modifications***

The accounting rules that govern when a loss is recognized can affect a servicer's willingness to modify a loan and the terms under which a loan is modified.<sup>76</sup> For example, FAS 15 generally requires immediate loss recognition of permanent modifications.<sup>77</sup> As a result, servicers have an incentive to characterize modifications as "temporary" or "trial" modifications in order to delay loss recognition.

When a loss is recognized, the total cost of that loss is generally allocated to the junior interests.<sup>78</sup> As a result, the junior interests are entitled to a smaller fraction of any subsequent income. Further, under the terms of many PSAs, once recognized losses reach a certain level, the most junior interests may be cut off from some sources of income, such as principal repayments, altogether. Since servicers often hold one or more of the junior interests,<sup>79</sup> if a loss is recognized immediately, the servicer will likely suffer most of the loss from the modification.

On the other hand, if recognition of the entire loss is delayed, accounting rules may allow the servicer to spread the loss to more senior tranches. For over-collateralization structures,<sup>80</sup> which most subprime securitizations are, the senior tranches are only entitled to principal payments after every class of certificate holder receives the pre-determined interest payments. Thus, a cut in income occasioned by a modification will likely cut into the principal payments to the senior tranches, but will not necessarily reduce the interest payments to the junior certificate holders.<sup>81</sup>

In addition to characterizing a modification as temporary, servicers may look to other methods to delay recognition of loss. For example, until recently, there was no industry consensus on how principal forbearance should be treated. At least some servicers were able to argue that recognition of the interest losses on principal forbearance should be delayed. A servicer could thus substantially modify the loan through principal forbearance without experiencing any drop in income on any junior certificates it might hold. This made principal forbearance attractive as a loss mitigation tool to servicers who were also holders of junior certificates. Most available industry guidance now requires principal or interest forbearance to be treated in the same manner as principal or interest forgiveness for accounting purposes.<sup>82</sup> As a result, principal or interest forbearance, like a principal reduction, will result in an immediate hit to the most junior level tranches. Thus, servicers have nearly the same incentive to offer principal forbearance as a principal reduction—and not much incentive to offer either.

### ***The Troubled Debt Restructuring Rules Discourage Sustainable Modifications***

Another set of FASB requirements that have a critical impact on servicers' willingness to modify loans are the troubled debt restructuring (TDR) rules found in FAS 15 and FAS 114. These rules discourage those modifications most likely to be successful. The rules do so in three distinct ways: they penalize the modification of loans before default, they favor temporary modifications over permanent ones, and they encourage shallow modifications.

FAS 15 generally requires all permanent modifications occasioned by the "borrower's financial difficulties" to be treated as "troubled debt restructurings."<sup>83</sup> Modifications can escape the reach of FAS 15 if they are temporary or do not involve "creditor concessions." While the TDR accounting rules only apply to loans held in portfolio,<sup>84</sup> maintenance of the off-balance sheet



bankruptcy-remote status of the trust has required that servicers generally categorize modifications using the TDR rules.<sup>85</sup> The TDR rules thus act as a curb on servicer discretion.

The FAS 15 rules apply whether the loan is current or delinquent when modified. Servicers can evade the reach of FAS 15 if they re-underwrite the loans and demonstrate that the terms of the loan modification reflect market realities, and not a concession.<sup>86</sup> But re-underwriting a loan is slow and cumbersome and interferes with streamlined modifications. As a result, a servicer who converts an adjustable rate mortgage to a

fixed rate, holding the current rate constant, in advance of a reset and without any default, may be stuck reporting a paper loss, even if the borrower was not in default and never missed or misses a payment. When a loan is modified in advance of default, it seems particularly harsh to many servicers to treat it as a troubled debt restructuring.<sup>87</sup> FAS 15 accounts in part for servicers' reluctance to modify loans before default, despite data that shows that modifications prior to default have the most chance of success.

The TDR rules encourage servicers to push borrowers into short-term repayment and for-

### A Simplified Example of the Benefit to Servicers of Short-term Versus Permanent Modifications

We assume a fixed monthly payment of \$300:

- \$250 in interest<sup>88</sup>
- \$50 in principal
- \$200 a month in interest income allocated to senior tranches
- \$50 a month in possible surplus interest income

*Compare the servicer's results from a short-term forbearance and a permanent modification:*

	3 month short term forbearance	Permanent modification
Payments for months 1–3	\$0	\$750
Payment month 4	\$1200	\$250
Payments made to senior bond holders months 1–3 <sup>89</sup>	\$750	\$750
Payments made to senior bond holders month 4	\$250	\$250
Surplus interest income generated for servicer <sup>90</sup>	\$200	\$0
<i>Further compare the results for a short-term payment reduction and a permanent modification, assuming no advances required on principal under the PSA:</i>		
	6 month short term payment reduction to \$225 a month	Permanent modification to \$250 a month
Payments for months 1–6	\$1,350	\$1,500
Payments allocated to interest	\$1,350	\$1,200
Payments allocated to principal	\$0	\$300
Payments made to senior bond holders	\$1,200	\$1,500
Surplus interest income generated for servicer	\$150	\$0

bearance plans, which do not involve creditor concessions, even though these plans are unlikely to forestall a foreclosure for long. Modifications such as these short-term plans that do not involve creditor concessions do not trigger the TDR requirements.

These short-term plans also generally benefit the servicer. The benefit to the servicer is particularly pronounced if the servicer can escape requirements to advance principal and is not required under the PSA to allocate payments to principal in the event of a TDR. (For loans subject to the TDR accounting rules, payments must be allocated to principal before interest). In addition to improving the servicer's income stream through its monthly servicing fee, allocating payments to interest instead of principal provides additional benefits to those servicers who hold junior-level interests in the pool. The result of allocating payments to interest instead of principal is, for most subprime securitizations, more money for the junior-level interest only and particularly the surplus interest only interests often held by servicers.

### **The Only Effective Oversight of Servicers, by Credit Rating Agencies and Bond Insurers, Provides Little Incentive for Loan Modifications.**

In theory, servicers should be responsive to the entity that can hire or fire it. And, in theory, investors would have that power over servicers. As we have seen above, however, few PSAs permit investors to exercise the power to hire and fire servicers in a meaningful manner. Instead of investors, servicers are more often responsive to the credit rating agencies and the bond insurers. Even organizations representing investors are likely to defer to the credit rating agencies and bond insurers.<sup>91</sup>

As discussed in the following sections, the credit rating agencies and bond insurers have

more power than either investors or borrowers.<sup>92</sup> Both credit rating agencies and bond insurers have weighed in with discussions of what loan modifications are and are not appropriate. What they approve in terms of loan modifications carries a great deal of weight.

In particular, the credit rating agencies have insisted that servicers adhere to a two-track system: pushing through foreclosures as fast as possible even while pursuing loan modifications. Bond insurers have been involved in restricting some of the most promising forms of loan modifications: principal reductions and forbearances.

### ***Credit Rating Agencies***

The major credit rating agencies provide the most meaningful oversight of servicers.<sup>93</sup> How much the servicer must bid for servicing rights depends to a large extent on the rating it is given by the credit rating agencies. A servicer with a poor credit rating from the agencies will likely have to discount its bids for servicing rights.<sup>94</sup>

Credit rating agencies exercise the most dramatic control over a servicer when the loan pool is created. At that point in time, their blessing can make or break a servicer's bid for the mortgage servicing rights. Yet credit rating agencies continue to monitor the performance of pools throughout their life, and those ratings impact both the servicers' ability to acquire new mortgage servicing rights and the servicers' ongoing cost of credit. Since interest can be a major or even the largest cost component for a servicer, the assigned credit rating matters. Moreover, a drop in the credit rating of the pool or of the servicer could be used as grounds for terminating a servicer or may prevent the servicer from bidding on new contracts.<sup>95</sup>

The credit rating agencies have been generally supportive of increased numbers of modifications.<sup>96</sup> At the same time, they have imposed rating criteria that can impede successful modifications. The credit rating agencies typically look at servicers' default rates, roll rates (the rate at which

loans move between various classes of delinquency), and resolution rates (how many of the delinquencies are resolved short of foreclosure).<sup>97</sup> Subprime servicers, in particular, are expected to show “strict adherence to explicit timelines,” offer and accept workouts from only a predefined and standardized set of options, and not delay foreclosure while loss mitigation is underway.<sup>98</sup> The rating agencies do not set benchmarks for any of these, but expect servicers to develop timelines and standardized loss mitigation options for each loan product, with reference to the industry standards as developed by Fannie Mae and Freddie Mac. The speed at which loans are moved from default through foreclosure is “a key driver in the servicer rating,”<sup>99</sup> encouraging servicers to compete for the fastest time to foreclosure.

Loan modifications take time to work out and often must be customized to fit the homeowner’s particular circumstances. Worse, the dual foreclosure and modification track causes havoc with homeowners. Homeowners engaged in negotiation often believe or are led to believe that they can safely ignore the foreclosure papers—only to discover that their home is sold out from under them. Other homeowners, under the pressure of an impending foreclosure deadline, agree to unsustainable modifications in a desperate bid to buy time. Even those homeowners who are somehow able to obtain a sustainable modification from the servicer’s bureaucracy before a foreclosure sale incur increased costs as the servicer passes on the expenses of proceeding with the foreclosure,<sup>100</sup> not to mention their own increased costs and stress of defending the foreclosure. The problems of the two-track system are exacerbated because foreclosures, deeds-in-lieu, and short sales have historically been given greater weight by the rating agencies than resolutions that result in saving the home.<sup>101</sup>

Other guidelines imposed by credit rating agencies make it disadvantageous for servicers to perform loan modifications. For example, Standard & Poors allows a servicer to reimburse itself for advances in a modification only from payments

made on the modified loan itself or principal payments made on other loans in the pool.<sup>102</sup> The interest payments made by other borrowers whose loans are in the pool must be left untouched for distribution according to the PSA, primarily to the benefit of the senior bond holders.<sup>103</sup> In contrast, most PSAs provide that the servicer recovers all costs, fees, and advances in full upon completion of a foreclosure, before the bond holders receive anything. Thus, a servicer faces a delay in recovering its advances when it modifies a loan compared to when it forecloses upon a loan.

Another example is the credit rating agencies’ requirement that modified loans count against the delinquency triggers in the PSA for twelve months.<sup>104</sup> Once delinquency triggers in a pool are reached, the servicer may be replaced, sometimes automatically. Servicers may also lose their rights to receive income from their residual interests.<sup>105</sup> As a result of the credit rating agencies’ rules, a servicer who converts an adjustable rate mortgage to a fixed rate, holding the current rate constant, in advance of a reset and without any default, is stuck reporting those modified loans as delinquent, while a servicer can report a borrower in a three-month forbearance agreement, during which time the borrower makes no payments, as current. The result is that servicers are discouraged from making sustainable modifications or addressing the need for modifications globally, prior to default. Under these rules, servicers lose less if they wait until a loan is already in default before modifying it.

### ***Bond Insurers***

Often, subprime junk mortgages were turned into gold through the use of bond insurance. Bonds based on a pool of, say, undercollateralized, subprime, hybrid ARMs achieved the AAA rating necessary for purchase by a Norwegian pension fund through bond insurance. If (or when) those bonds fail to deliver the above-average returns promised, bond insurers are on the hook to make up some or all of the difference.

Bond insurers, therefore, may have significant skin in the game as to the performance of the bonds. As a result, the bond insurers often maintain an active role and interest in the management of the pool of securities.<sup>106</sup> And they are large enough institutional players that their voice is heard. Many PSAs give bond insurers special rights with respect to approving waivers of limitations on modifications.<sup>107</sup>

Bond insurance generally exists only on the most highly rated securities. So long as the top-rated tranches continue to deliver the promised returns, bond insurers don't have to advance any money. Bond insurers need the top-rated tranches to perform; what happens to subordinate tranches is of, at best, secondary importance to the bond insurers. As a result, bond insurers seek to confine the cost of nonperforming loans to the lowest rated tranches. Thus, bond insurers will support modifications whose weight is primarily borne by the lowest-rated tranches but oppose modifications when the losses are spread evenly across all tranches.

For example, most PSAs are silent on the treatment of principal reductions or forbearance with regard to the timing of loss recognition.<sup>108</sup> As discussed above, the timing of the recognition of loss can make a large difference to a servicer, if the servicer holds junior-level security interests in the pool as most do. If recognition of the loss is delayed, and interest payments are deeply cut due to reduced principal obligations, then even senior bond holders may see their monthly interest payments shrink, reflecting the lower monthly income to the pool as a whole. This scenario is precisely what happened during 2007 when some servicers made deep principal reduction modifications. Senior bond holders, including AAA-rated bond holders, saw payments on their interest certificates drop. The bond insurers reacted swiftly. As leading industry analysts reported, shortly after these losses first appeared, despite the silence in the PSAs, there emerged an "industry consensus" that the losses from principal reductions should be charged first, in their entirety, to the bottom-rated tranches.<sup>109</sup>

The bond insurers, unlike investors, have enough leverage that their opposition matters—and the results of their intervention shape what modifications servicers are willing to accept. Since servicers usually hold some interest in the lowest-rated tranches, allocating the cost of principal reductions or forbearance in their entirety to the lowest-rated tranches discourages servicers from accepting modifications with principal reductions or principal forbearance.

### **Servicer Income Tilts the Scales Away from Principal Reductions and Short Sales and Towards Short-Term Repayment Plans, Forbearance Agreements, and Foreclosures**

Servicer compensation creates a web of incentives, some of which favor foreclosure and some of which favor certain types of loan modifications over others.<sup>110</sup> Among the factors favoring foreclosure are the following:

- Servicer fees (such as late fees, foreclosure fees, and broker price opinion fees) create some incentive to keep a borrower in default and ultimately give the servicer an incentive to complete a foreclosure.
- The servicer's float interest income may increase when a loan is prepaid due to refinance, sale, or foreclosure (the impact of this incentive is reduced because most PSAs require the servicer to turn over most of extra income generated by prepayments).

Among the factors favoring modification (although not necessarily a sustainable modification) are the following:

- The servicer's monthly servicing fee, computed as a percentage of the outstanding balance, gives the servicer some incentive to keep

a loan in the pool and avoid foreclosure or a short sale. These fees also give servicers an incentive to avoid principal reductions and to favor loan modifications that increase the principal.

- When a servicer owns a residual interest—typically the most junior tranche—it has an incentive to keep the loan performing, to delay foreclosure, and to resist modifications that reduce interest payments, whether directly or because they trigger the troubled debt restructuring rules.

Even more important than compensation, for most servicers, is the value of their mortgage servicing rights. Whether or not the servicer made the correct speculative investment decision when it bought the mortgage servicing rights to a pool of mortgages does more to shape its profitability than any other single factor. The way a servicer increases its net worth is not by doing a top-notch job of servicing distressed mortgages but by gambling on market trends.

These and other financial incentives are discussed in the following subsections.

## **Fees**

Most PSAs permit servicers to retain fees charged to delinquent homeowners and to collect them from the proceeds of a foreclosure sale, if the homeowner doesn't pay up. Examples of these fees include late fees that are paid directly to the servicer<sup>111</sup> and fees for "default management" such as property inspections that a servicer may retain or may pay to a third party and then recover from the homeowner.<sup>112</sup> While generally small in monetary amount, these fees generate substantial income when spread over an entire portfolio of loans.<sup>113</sup> These fees may become a profit center, particularly for those large servicers who are able to refer business to affiliated entities.<sup>114</sup>

Late fees alone constitute a significant fraction of many subprime servicers' total income and profit.<sup>115</sup> For example, late fees and loan collection fees made up almost 18% of Ocwen's 2008

servicing income.<sup>116</sup> Thus, servicers have an incentive to push borrowers into late payments and keep them there: if the loan pays late, the servicer is more likely to profit than if the loan is brought and maintained current. The very presence of these fees may later make a modification unaffordable to the homeowner.<sup>117</sup>

Usually the fees charged in a foreclosure are recovered completely by the servicer, once the foreclosure sale is completed, before the investors receive any funds.<sup>118</sup> As a result, a rational profit-maximizing servicer has a strong incentive to complete a foreclosure and recover the fees.<sup>119</sup>

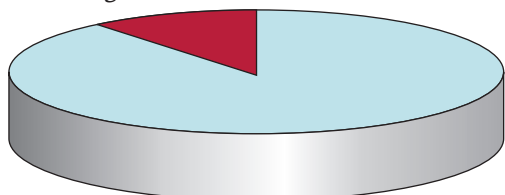
Servicers may also have an incentive to delay a foreclosure in order to impose more fees.<sup>120</sup> Depending on the interplay of the servicers' ability to charge additional fees during the foreclosure, on the one hand, and the servicer's interest costs for any hard advances and the time limits for proceeding through foreclosure imposed by the REMIC rules, FASB statements, the PSA, and the credit rating agencies, on the other hand, a servicer might draw out a foreclosure for as long as possible to maximize the amount of fees imposed and ultimately collected or speed through a foreclosure to recover the fees as soon as possible. If the servicer can juggle the time limits—perhaps by reporting the loans current a mite longer than is strictly true or re-aging the loans—the ultimate recovery of fees may outweigh the interim interest costs. Whether the servicer processes a foreclosure slowly or quickly, however, it has an incentive to complete foreclosure rather than process a modification once a loan is in default, so that it will recover its fees. The more fees it piles on, the greater that incentive becomes.

Many of the servicer's fees do not actually represent significant dollars out of pocket. For example, Wells Fargo reportedly charged a borrower \$125 for a broker price opinion when its out-of-pocket expense was less than half that, \$50.<sup>121</sup> With that kind of mark-up, a servicer can afford to incur interest costs for months before it starts to feel the pinch. The incentives to delay a foreclosure and maximize fees are compounded by the fact that many servicers subcontract with affiliates for fee-



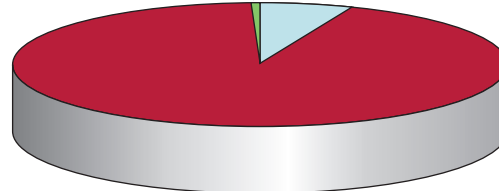
**Ocwen Asset Management Servicing Fees**

Process Management Fees 11%



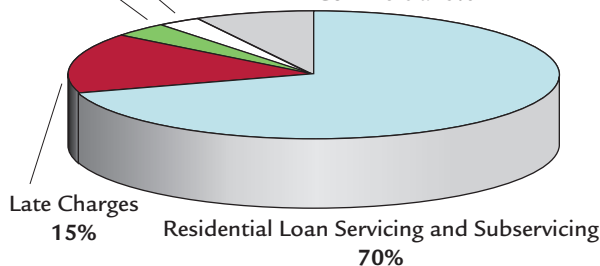
Servicing and Subservicing Fees 89%

Source: Ocwen Fin. Corp., Annual Report (Form 10-K)  
(Mar. 12, 2009)

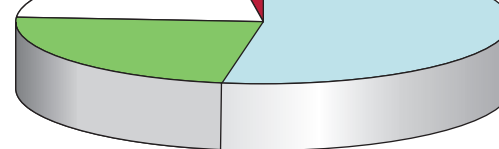
**Ocwen Solutions Mortgage Services Fees**Servicing and Subservicing 6%  
Other 1%

Process Management Fees 93%

Source: Ocwen Fin. Corp., Annual Report (Form 10-K)  
(Mar. 12, 2009)

**Ocwen Asset Management Breakdown of Servicing Fees**Custodial Accounts (Float Earnings) 4%  
Loan Collection Fees 3%  
Other 8% Commercial 0%

Source: Ocwen Fin. Corp., Annual Report (Form 10-K)  
(Mar. 12, 2009)

**Ocwen Solutions Process Management Fees Breakdown**Mortgage Due Diligence 0%  
Outsourcing 21%  
Other 2%  
Residential Property Valuations 53%

Title Services 24%

Source: Ocwen Fin. Corp., Annual Report (Form 10-K)  
(Mar. 12, 2009)

generating services, thus multiplying their sources of revenue from the same fees.<sup>122</sup>

Servicers' dependence on fees may also partly explain their reluctance to enter into short sales.<sup>123</sup> In a short sale, the borrower typically bears the cost of arranging the sale, thus depriving the servicer and its affiliates of the fees they could charge for default management, including selling the property.<sup>124</sup> Short sales are an example of a divergence in interests between the servicer and the investor: the investor saves money if the borrower, rather than the servicer, bears the cost of arranging the sale, since the investor must reimburse the servicer, but not the borrower, for the costs of the sale, even if the sale does not generate enough money to cover the outstanding principal balance. The servicer,

however, may lose some money and is unlikely to profit at all from the transaction. Only if the servicer's financing costs outweigh the foreclosure fees charged and a short sale is significantly faster than a foreclosure will a servicer profit by agreeing to a short sale over a foreclosure. This disjoint may explain in part investors' willingness to pay servicers greater incentives for short sales than for modifications.<sup>125</sup> As between a short sale and a foreclosure, the servicer's only incentive to favor the short sale are payments by the investor for performing a short sale. Only if those payments are larger than what the servicer expects to squeeze out in fees from the borrower and default management fees from the REO sale proceeds will the servicer's scales tilt towards a short sale.

### ***Float Interest Income***

Part of servicers' income comes from the interest paid during the period between when the homeowner pays and when the servicer turns over the payment to the trust or pays the taxes and insurance, in cases of escrowed funds.<sup>126</sup> Servicers who can stretch the time to turn over funds—by paying taxes or insurance late or at the last possible moment, for example—will have more float income.

Prepayments of loans can increase this float income since there are then larger amounts of money sitting in the float account, accumulating interest, until turned over to the investors.<sup>127</sup> This could give the servicer an incentive to favor any resolution that involves a prepayment, such as a refinance, a sale of the home, or a foreclosure. However, the PSA usually requires the servicer to remit "compensating interest" at payoff, or the difference between a full month's interest and the interest collected.<sup>128</sup> And, as discussed in the next section, the fact that the servicer's monthly servicing fee is based on the outstanding balance of the loans in the pool creates a strong countervailing incentive to avoid or at least postpone prepayment.

### ***Payment Based on Percentage of Outstanding Principal***

Most servicers derive the majority of their income based on a percentage of the outstanding loan principal balance.<sup>129</sup> The outstanding loan principal balance is typically calculated on all loans, even non-performing ones. For most pools, the servicer is entitled to take that compensation from the monthly collected payments, even before the highest-rated certificate holders are paid.<sup>130</sup> The percentage is set in the PSA and can vary somewhat from pool to pool, but is generally 25 basis points annually for prime fixed-rate loans, 37.5 basis points for prime variable-rate and Alt-A loans, and 50 basis points for subprime loans.<sup>131</sup> For a subprime loan having an average unpaid principal balance of

\$250,000, a servicer can expect to receive a total servicing fee of \$3,750 over a three year period (\$1,250 per year).

Servicers stand to benefit from any delay in reduction of the principal balance on any loan, whether by postponing a short sale or foreclosure or by refusing to provide a payoff statement upon request. Servicers may also benefit from the delay in principal reduction when they hold a borrower's payments in a suspense account instead of applying them to the borrower's account. The higher a servicer can keep the principal balance, whether by capitalizing arrears and unpaid fees or by refusing loan modifications with principal write-downs, the larger the servicer's main source of income, the monthly servicing fee, will be.

Loan modifications that increase the principal balance by capitalizing arrears and fees boost the servicer's monthly fee. The incentive this creates to stretch out a delinquency prior to modification is offset by the requirement that the servicer advance to investors the borrower's monthly principal and interest payment. These advances, discussed in detail below, are usually financed, and those financing costs may be substantial. The tradeoff between this cost of financing advances and the higher monthly servicing fee depends on how long it takes for the servicer to recover its advances.

Servicers suffer a permanent loss of income by agreeing to a principal reduction. Under this scenario, short sales, short payoffs, and realized principal reductions or forbearances as part of loan modifications are costly for both third-party and affiliated servicers. In fact, any reduction of principal, even by regular payments, represents a loss to servicers, compared to a result that keeps principal balances high. Thus, even interest-rate reductions may cut into a servicer's profit, by allowing homeowners to pay down principal more quickly. Prolonging the inevitable—and carrying high principal balances—may serve the servicer's financial interests better than a result that reduces the principal amount of payments, at least so long as borrowers continue to pay enough inter-



est to cover the servicer's ongoing advances obligation. Delaying payment of principal serves servicers' interests.

Principal forbearance, instead of an outright principal reduction, allows servicers to keep their monthly servicing fee high. Principal forbearance is generally less desirable than principal reduction from a borrower's viewpoint: it often leaves the borrower owing more than the house is worth and facing a large balloon payment at the end of the loan. Still, principal forbearance continues to be far more common as a tool in loan modification than principal reduction. This is despite the fact that, for purposes of the timing of loss recognition, principal forbearance and principal reduction must be treated the same.<sup>132</sup> As a result, when principal is forborne, just as when it is reduced, servicers' income from the residual interests may be reduced or cut off entirely. Nonetheless, residual income is usually negligible compared to the monthly servicing fee, and most PSAs appear to allow servicers to include in their calculation of the outstanding balance the amount of principal forbearance.<sup>133</sup> Principal write-downs, on the other hand, generally cannot be included in the amount of the outstanding principal balance. Thus, servicers have an incentive to agree to principal forbearance over reduction, even though both reduce the interest payments on the loan.

Principal forbearance may result in higher-rated bond holders being shorted on interest payments, but the servicing fee, the servicer's largest source of income, comes off the top, before the interest payments to bond holders. And principal forbearance does not reduce that source of income, and even allows it to stay artificially high throughout the remainder of the loan term, since borrowers will not be paying down the portion of principal which is forborne. Investors may lose money if principal repayment is delayed; servicers generally do not. For all of these reasons, servicers are likely to prefer principal forbearance as a loan modification tool over principal or interest rate reductions.

## ***Residual Interests***

Servicers often have an investment interest in the trust as a whole. Commonly, servicers affiliated with the originator of the loans holds the lowest level investment interests in the pool, called residuals.<sup>134</sup> This is particularly true for servicers who are affiliated with the loan's originator.

In most subprime securitizations, bond holders are paid designated amounts of interest income every month. If all borrowers make their payments, there will be some excess income. Residuals represent payment of this excess income after the senior certificate holders have been paid. If the pool shrinks, through foreclosure, prepayment, or principal reduction, or the interest rate drops on the loans in the pool due to modifications, there will be less of a surplus, and the servicer will suffer a loss. Since residuals always take the first hit, their interest may shrink to nothing if recognized losses on the pool rise too far. Under most PSAs, payment to residuals is cut off when certain performance triggers are not met. In particular, if overall losses in the pool reach a pre-defined level, the residuals can no longer receive the surplus interest income, even if the pool continues to generate surplus interest income. Modifications that reduce principal and interest count against these cumulative loss triggers.<sup>135</sup>

Ownership of residual interests is meant to encourage servicers to keep loans performing, and it does skew servicers' incentives. Servicers who hold residual interests delay foreclosures and resist modifications that reduce interest payments.<sup>136</sup> If a particular form of loan modification shifts the costs to higher-rated bond holders and away from the first-loss position residuals, a servicer may be more willing to pursue that form of loan modification. For example, principal reductions that are not recognized immediately as losses spread the cost of the modification out among all classes. Some industry analysts believe this dispersion of the cost of modifications was one reason Ocwen performed a large number of principal reductions during 2007.<sup>137</sup>

### A Simplified Example of the Impact on Residuals of Delayed Loss Recognition for Principal Reductions

We assume a fixed monthly payment of \$300:

- \$250 in interest
- \$50 in principal
- \$200 a month in interest income allocated to senior tranches
- \$50 a month in possible surplus interest income

	Principal Reduction with Delayed Loss Recognition	Principal Reduction with Immediate Loss Recognition
Total monthly payment after modification	\$250	\$250
Payment allocated to interest	\$250	\$210
Payment allocated to principal	\$0	\$40
Monthly interest payment to senior bond holders	\$200	\$200
Monthly payment to residuals	\$50, assuming other performance triggers are met	Possibly zero, if losses have reached a trigger point

Residual income is not the main source of servicer income nor the main driver of servicer behavior. But it likely still influences a servicer choosing between two closely balanced alternatives and helps frame the loss mitigation options a servicer makes available.

### ***Mortgage Servicing Rights***

Servicers buy mortgage servicing rights—and a percentage of the stream of money from the borrowers—by bidding on the rights at the time a pool is initiated. The decision of how much to bid for those servicing rights is based, much like an investor's decision, on projections as to the future performance of that pool. In the servicer's case, the projection is based primarily on default and prepayment forecasts.<sup>138</sup> The main source of revenue for servicers is the percentage payment on unpaid principal balance.<sup>139</sup> Default that ends in foreclosure and prepayment via refinancing both reduce that outstanding principal balance. High default rates will reduce the revenue stream, but may not significantly reduce the value of the mortgage servicing rights, depending on how

management chooses to account for those mortgage servicing rights.

The value of mortgage servicing rights is, for most servicers, the largest item on their balance sheets and the biggest driver of their net worth.<sup>140</sup> The amortization of the mortgage servicing rights is typically the largest expense on a servicer's books. Yet the valuation of mortgage servicing rights has little, if anything, to do with how the servicer services the pool,<sup>141</sup> and far more to do with the underlying strength of the mortgages—and the market valuation of that strength. Thus, servicers may be rewarded more for correctly predicting the market's moods—or manipulating market perceptions of the quality of the pool—than for actually making the mortgages perform.

Prior to 2007, there was no transparency in accounting for mortgage servicing rights; even today, management has considerable discretion over how to value mortgage servicing rights.<sup>142</sup> Such valuation may not reflect directly the actual experience of default and delinquency in the portfolio. Certainly the difference between the price paid and the current valuation has more to do with the

servicer's powers of prognostication (and manipulation of accounting standards) than performance of loans in the servicing portfolio.

Because the valuation of the mortgage servicing rights is so important to a servicer's bottom line, servicers have a strong incentive to camouflage any weaknesses in the pool.<sup>143</sup> One way servicers have camouflaged weaknesses in the pool has been by "re-aging" delinquent mortgages. Servicers accomplish re-aging by entering into short-term workout agreements that skirt the accounting rules that require that modified loans continue to be reported as delinquent for a period after modification.<sup>144</sup> These short-term workout agreements may allow the borrower to skip a few months of payments, or pay an elevated payment for as long as a year in order to make up an arrearage. Sometimes, the borrower pays a fee for the privilege of entering into the agreement; often at the end of a period of reduced payments, the borrower is expected to come up with a lump sum payment of all arrearages and fees. These short-term workout agreements help few borrowers, but they are a boon to servicers. In addition to boosting the market valuation of the mortgage servicing rights, re-aging also helps servicers in three other ways:

- a delayed recognition of losses to the residual interests in the pool, which reduces servicers' losses if they hold residual interests;
- avoidance of delinquency trigger thresholds in the PSA that may permit the trustee or master servicer to appoint a special servicer (or reapportion the allocation of payments, to the detriment of the residual interests); and
- avoidance of repurchase agreements.

Re-aging has been of signal concern to investors, since it obscures the true value of the pool.<sup>145</sup> Re-aging is about kicking the can down the road, not about sustainable modifications.

An example of both the impact of mortgage servicing rights' valuation and the disconnect be-

tween the value of mortgage servicing rights and the performance of the mortgage pool is contained in a major subprime servicer's recent annual report:

*Servicing continues to be our most profitable segment, despite absorbing the negative impact, first, of higher delinquencies and lower float balances that we have experienced because of current economic conditions and, second, of increased interest expense that resulted from our need to finance higher servicing advance balances. Lower amortization of MSRs [mortgage servicing rights] due to higher projected delinquencies and declines in both projected prepayment speeds and the average balance of MSRs offset these negative effects. As a result, income . . . improved by \$52,107,000 or 42% in 2008 as compared to 2007.*<sup>146</sup>

Here, the accounting treatment of the mortgage servicing rights more than offsets any loss attributed to high rates of delinquency and default. This is true in part because prepayment is such a drain on a portfolio. Prepayment offers a nominal bump in float income, but it slashes the unpaid principal balance and shortens the expected lifetime of the pool. Since a percentage payment on the unpaid principal balance of the pool is the single largest source of income for servicers, the decline in prepayments means more income for servicers. This effect may be enhanced because the high rates of default and delinquency mean that borrowers are not paying down their loans as quickly at the same time servicers are increasing some loan principal balances by capitalizing arrears and fees and realizing increased late fee income.<sup>147</sup> The decline in prepayments is related to the same macroeconomic trends producing high rates of default and delinquency. Those high rates of default and delinquency may cost the servicer something, but, on the servicer's bright side, borrowers currently aren't generally able to sell or refinance and thus prepay. The remaining loans in the pool, after accounting for historically high rates of default, have, paradoxically, longer lives.

And thus, with the decreased (non-cash) expense of amortizing mortgage servicing loans (since there is now a longer expected life to spread that expense over), servicers can still make money, even if they are not adding new bundles of mortgage servicing rights. For accounting purposes, then, valuation of mortgage servicing rights coupled with reduced prepayments and aggressive reimbursement of advances and fees may actually counterbalance high rates of default, at least if the servicer did not significantly overbid for the mortgage servicing rights.

At the outset of a pool, a servicer will decide whether or not it wants to service that pool, and how much it is willing to pay for the privilege. If prepayments increase above the servicer's expectations, it loses money. If foreclosures increase above expectations, the servicer may or may not lose money, depending on its ability to charge and recoup high fees in the foreclosure, either directly or through an affiliate. Financing of advances to cover payments to the trust, on the one hand, and fees, on the other, may shift the balance towards a profit or loss, but the fundamental driver of a servicer's profit is whether or not it paid too much for the mortgage servicing rights on a pool that is destined for the dumpster. One academic reviewing several failed servicers concluded that servicers who made a bad deal—who overbid on a pool with high defaults—are likely to lose money no matter what.<sup>148</sup> A servicer faced with high defaults can only mitigate its losses by squeezing borrowers for extra fees. Modifying the mortgages is unlikely to redeem a bad initial investment decision by the servicer.

Servicers with thin margins may need to squeeze all they can out of delinquent loans by increasing performance; servicers with stronger pools are likely to be less invested in the performance of the loans they manage.<sup>149</sup> This dynamic leaves many of the latter group of servicers indifferent to the performance of the loans they service and unmotivated to hire and train the staff needed to improve performance.

## **Servicer Expenditures Encourage Quick Foreclosures**

As shown in the previous section, the sources of servicers' income generally encourage servicers to perform short-term workout agreements and to pile on fees. Servicers' out-of-pocket expenditures weigh heavily towards speeding to a foreclosure once initiated. Servicers have two primary expenditures when a loan is in default: advances of principal and interest to the trust and payments to third parties for default services, such as property inspections. Since these costs are generally recovered in full upon the sale of the home post-foreclosure, and since servicers must finance their out-of-pocket expenditures, servicers are strongly incented to complete a foreclosure as quickly as possible. Servicers also have much larger staffing and infrastructure costs when they perform modifications than when they foreclose.

## ***Interest and Principal Advances to Investors***

Servicers typically, under their agreements with investors, are required to continue to advance interest on loans that have become delinquent.<sup>150</sup> Unpaid principal may or may not be advanced, depending on the PSA.<sup>151</sup>

Servicers may be exempted from this obligation once there is no longer any realistic expectation of recovering these costs from the borrower or the collateral. Thus, once a loan modification is done, and payments are permanently reduced, servicers generally no longer need make continuing advances. Servicers can also escape the requirement for advances if a borrower files for bankruptcy.<sup>152</sup>

In a small number of cases, servicers may be exempted from continuing to make advances once the loan is in foreclosure or more than five months delinquent.<sup>153</sup> Usually, the servicer must continue making advances throughout foreclosure

until the advances exceed the likely recovery from a foreclosure sale.<sup>154</sup> At that point, the advances are deemed “nonrecoverable” and servicers may begin to recover their advances from the general income on the pool. Servicers are usually empowered to withhold nonrecoverable advances from the funds sent to the trust or they may request reimbursement directly from the trust’s bank account of these nonrecoverable advances.<sup>155</sup> Reimbursement for nonrecoverable advances usually has super-priority in the securitization: servicers can recover their nonrecoverable advances before senior bond holders receive their interest payments. But even if servicers’ failure to make advances is in accord with the accounting rules and

not a breach of their contract, servicers who do so are likely to receive a black mark from investors.<sup>156</sup>

The cost of financing advances is one of the biggest risks servicers face.<sup>157</sup> Thus, it is against the servicer’s financial interest to permit lengthy forbearance periods or accept repayment plans that do not quickly bring in cash from the homeowner. Servicers generally recover all their advances once a foreclosure is completed, so a cash-strapped servicer has a strong incentive to push through foreclosures as quickly as possible to recover their advances.<sup>158</sup> Conversely, servicers may be willing to agree to workouts once a homeowner is delinquent if the workout results in a rapid repayment of the advances. Modifications,

### A Simplified Example of the Advantage of Modifications That Permit Recovery of Advances

We assume a fixed monthly payment of \$1050

- \$1000 in interest
- \$50 in principal
- \$950 a month in interest income allocated to senior tranches.

	3 month short term forbearance, with balloon payment, after 3 missed payments	6 month short term payment reduction, with balloon payment, after 3 missed payments	Permanent modification, after 3 missed payments, with \$3,150 of the missed payments added to the end of the note
Monthly payment during duration of workout agreement	\$0	\$1,000	\$1,000
Balloon payment at end of agreement	\$7,350	\$10,500	\$3,150 (arrearages added to end of note)
Total advances of principal and interest to senior bond holders	\$6,000	\$3,000	\$3,000
Monthly cost of financing advances, assuming a 5% interest rate	\$25	\$12.50	\$12.50
Cost of financing advances until repaid, assuming a 5% interest rate	\$62.85	\$87.52	\$4,063 (assuming that the advances can only be recovered from payments on this loan)
Amount of advances remaining to be recovered at the end of 6 months	\$0	\$0	\$3000



if quickly done, can also help servicers by stopping the ongoing requirement to make advances before a foreclosure would. Servicers favor modifications that reduce their interest advances.<sup>159</sup>

Even a period of time with no payments can be cheaper for a servicer than an extended period of time where payments do not cover the advances. The cost of financing advances drives servicers to offer short-term, unsustainable workout agreements.

Few PSAs specify how advances are treated in the event of a modification.<sup>160</sup> What clarity there is in how servicer advances are recovered has come largely from the credit rating agencies.<sup>161</sup> Further guidance from the credit rating agencies could alleviate some servicer uncertainty and encourage modifications. In general, servicers may recover their advances from payments on the modified loan alone, after the required payments of principal and interest are made to the trust. Only once the advances on a loan are deemed unrecoverable are servicers generally authorized to look to income from other loans in the pool to recover advances, and then servicers are often limited to the principal payments alone on other loans for recovering advances on modified loans. And determining that advances are unrecoverable is a black mark against servicers. Thus, servicers are likely to insist on recovering directly from the homeowner all interest and principal advances as a condition of agreeing to a modification. Modifications with principal reductions may be particularly tricky for servicers since they shrink the possibilities for recovering advances on any individual modified loan and on other modified loans.

Controlling delinquencies—and the accompanying advances—is a major factor that affects a servicer's profitability.<sup>162</sup> However, as noted above, the servicer's ability to impose fees on delinquent borrowers, the certainty of recovering fees and advances in any ultimate foreclosure, and the fact that delinquent loans may stay longer in the pool than a modified loan (since a modified loan may allow a borrower to rebuild credit and refinance or sell), creates countervail-

ing incentives to proceed with a foreclosure, despite the increased costs of advances.

### ***Fee Advances to Third Parties***

In addition to interest advances, servicers also advance expenses associated with default servicing, such as title searches, drive-by inspections, or foreclosure fees.<sup>163</sup> Taxes and insurance costs are also often advanced.<sup>164</sup> These advances are recovered either when the borrower catches up payments or when the house is foreclosed and sold. Usually, advances get taken off the top in a foreclosure, once the property is liquidated.<sup>165</sup> Generally, these fee advances are not eligible for pool-level recovery: the servicer must collect the fees from the borrower or from the sale of the home.<sup>166</sup> Some PSAs impose caps on these fee advances.<sup>167</sup>

Servicers, therefore, in order to avoid any ambiguity, will often require the payment of at least a portion of the advances as part of entertaining any loss mitigation option and usually require the payment to be made up front. Loss mitigation that waives advances, including the advance of past-due interest, or that delays repayment of advances results in lost money for servicers. Foreclosure may be the more profitable option for a servicer than loss mitigation that waives or delays the repayment of advances, depending on how long it will take to complete the foreclosure and ultimate sale of the property.<sup>168</sup>

## **Foreclosures vs. Modifications: Which Cost a Servicer More?**

### ***The Servicer's Duty to Advance Payments to Investors Favors Foreclosures and Unsustainable Loan Modifications***

As discussed above, servicers must advance interest and sometimes principal payments, even when the borrower is delinquent. Servicers get

repaid all advances when a foreclosure is concluded.<sup>169</sup> They can also recognize as revenue on their books after foreclosure all previously unpaid charges, such as late fees, and collect the costs of those unpaid charges from the foreclosure sale.<sup>170</sup> Moving to foreclose—and to sell the properties after foreclosure—can help servicers offset the costs of interest advances in two ways: first, once the property enters foreclosure and the servicer judges the loan can no longer be made performing, the obligation to continue making advances may cease, depending on various factors, and second, the advances can be recovered once the property is sold. Even if the investor takes a hit on the post-foreclosure fire sale, the servicer has stopped its bleeding and recovered any fees, costs, and advances.<sup>171</sup>

Servicers do not, however, get repaid the costs of funding those advances—their cost of credit—and those funding costs can drain the bank.<sup>172</sup> Thus, the servicer's decision whether to foreclose or modify a loan will shift towards modification the longer it takes for a foreclosure and, consequently, for the servicer's advances to be repaid, assuming of course that foreclosure fees do not outweigh the cost of financing advances.<sup>173</sup> When servicers are under extreme financial pressure due to advances, as many have been, servicers are motivated to expedite resolution of the delinquency—primarily by completing a foreclosure quickly but also by entering into a quick modification that moves the loan back into performing status and returns advances to the servicer. Such modifications, alas, are seldom sustainable, since few borrowers, having entered foreclosure, are in a position to make the large payments required to bring delinquent loans current and then continue making regular payments.<sup>174</sup> Often the result of these quick modifications is ultimately foreclosure—although the servicer may have recovered some of its advances early and avoided the black mark associated with finding advances “unrecoverable.”<sup>175</sup>

### ***The Reduction of the Loan Pool When a Foreclosure Occurs Is an Incentive Favoring Modifications***

On the other hand, foreclosures, like prepayments, shrink the overall pool of loans on which a servicer's income is based and reduce its long-term financial prospects, unless those loans—or the servicing rights to a different pool—can be quickly replaced at the same or lower price.<sup>176</sup> Replenishment of the loan pools is currently a slim prospect for most servicers.

### ***The Costs of Handling Loan Modifications, Including Staff Costs and Delays, Favor Foreclosure over Modification, but Institutional Inertia is a Greater Factor***

In a foreclosure, there is no question that the servicer gets reimbursed off the top for all of its advances and costs. How and when a servicer gets paid for costs incurred in a modification is much more problematic.<sup>177</sup> Advances made by the servicer can generally be recovered from payments made on that mortgage, if the borrower starts making payments again. They may also be recovered from the principal payments on other loans, at least once the advances are judged, by the servicer, as “nonrecoverable” from the borrower. These payments to the servicer for “nonrecoverable” expenses are paid to the servicer before any payments of principal to the bond holders.<sup>178</sup> Thus, servicers are certain of ultimately recovering advances on a loan modification, just as they are certain of recovering advances in a foreclosure. What is less certain in a modification is how long it will take to recover the advances.<sup>179</sup> Although all advances are ultimately recovered, depending on how deep the modification is and how the rest of the pool is performing, servicers can face a significant delay in recouping their advances.

This delay compounds the servicer's largest cost of performing a modification, the cost of financing advances. Each month that the loan is

not paying, the servicer must continue advancing the unpaid payments to investors. The servicer may also be advancing other fees to third parties. Even if those payments are all ultimately recovered as part of the modification, the servicer will have incurred the cost of borrowing the funds to make the payments. This interest expense is a large cost for most servicers facing either foreclosures or modifications, and not one that is clearly recoverable in either a foreclosure or a modification. The recent decline in the availability of financing for servicers—and the relative increase in the costs of financing advances—may have heightened some servicers' willingness to perform modifications, if they can do so quickly and cheaply.<sup>180</sup>

As discussed in the next section, modifications also require significant staffing, a sunk cost that cannot be charged off directly to any one modification and must be incurred before any modification is made. Most modifications prior to the Making Home Affordable plan did not compensate servicers for staff time in performing the modification. The costs attributable to performing a modification, according to the servicing industry, are between \$750 and \$1000 apiece.<sup>181</sup> The Making Home Affordable Plan provides incentives to both servicers and investors for performing loan modifications. Servicers can be paid by the government as much as \$2,000 for performing a Making Home Affordable modification, but this payment is post-hoc, after the modification has been performed and the increased staff costs have been incurred.

Mortgage insurers will also sometimes provide incentives for modifications in order to avoid paying out on a full claim post-foreclosure for those loans with mortgage insurance (most loans with original loan-to-value ratios over 80%). The government sponsored enterprises (the GSEs)—Fannie Mae and Freddie Mac—and HUD, for FHA loans—do require and reimburse for some loss mitigation activities.<sup>182</sup> Most investors, however, do not pay servicers for performing modifications.<sup>183</sup> In addition, even the GSEs have histori-

cally paid less than a modification costs.<sup>184</sup> Indeed, Fannie and Freddie have tilted the scales away from modifications in their compensation schemes: both pay servicers several times more for processing a short sale than for a loan modification.<sup>185</sup>

Prior to the roll-out of the Making Home Affordable plan under the Obama administration, which prohibits charging borrowers fees for a modification, mainstream servicers were increasingly charging borrowers hundreds to thousands of dollars in order to enter into a modification—above and beyond the reimbursement of advances and probably in excess of hard costs. Reports persist of servicers who continue to charge large downpayments before a modification will even be discussed, even though such practices are banned under the Making Home Affordable program.<sup>186</sup>

Nonetheless, the limited compensation for modifications is probably not a driving factor in servicers' decision making. A Federal Reserve Board working paper reports that few servicers expressed any interest in being compensated for doing modifications, at least by investors.<sup>187</sup> Indeed, the incentives offered by mortgage insurers and the federal government on insured loans appear not to have significantly increased modifications on those pools. Early returns on the incentive scheme under Making Home Affordable are also not promising: total modifications in the country fell in its first few months of operation.<sup>188</sup> Modifications of FHA loans, at least, often appear driven by the consequences of failing to make the modification rather than the incentives for making a modification. The FHA mandated loss mitigation activities have been held to be a pre-foreclosure requirement in many states.<sup>189</sup> And HUD can and has penalized servicers for not complying with its requirements to conduct loss mitigation activities prior to proceeding with a foreclosure.<sup>190</sup> The stick, rather than the carrot, appears to drive servicer behavior in this regard.

## Staffing

Even before the foreclosure crisis erupted in 2007, servicers struggled with adequate staffing of their loss mitigation departments. Staffing has always favored collection over loss mitigation,<sup>191</sup> in part because it is cheaper to hire and train line-level collections employees than line-level loss mitigation staff.<sup>192</sup> It is also not the case that servicers can simply transfer loss mitigation functions to collection and foreclosure departments. In fact, because servicers typically continue with the formal foreclosure process at the same time they are conferring with homeowners about loss mitigation options, additional staffing is needed to handle loss mitigation operations.<sup>193</sup> The existing inadequacy of the staffing of loss mitigation departments has become blatant in recent years, with an increasing number of delinquencies straining the system.

Since May of 2007, servicers have been publicly pledging themselves to increase their staffing. Many servicers actually have increased staffing,<sup>194</sup> yet virtually all observers agree that the efforts of servicers to date have been insufficient.<sup>195</sup> One commentator estimates that servicers would need to increase staffing 1000% in order to modify as few as 10% of the loans in default.<sup>196</sup>

At a time when the number of loans in foreclosure is increasing and even doubling year-to-year,<sup>197</sup> servicers are playing catch-up in staffing.<sup>198</sup> And the crisis itself may well exacerbate staffing problems: financial pressures may cause servicers to cut staff or staff may leave, fearing future layoffs occasioned by their employer's financial instability.<sup>199</sup> Ironically, the servicers with the worst loan pools may be the best positioned in terms of staffing: they may not have enough staff, but they have had to squeeze margins out of weak mortgage pools for a long time.<sup>200</sup> Lack of experience exacerbates staffing shortages: servicers often have redundant, time-consuming processes built into their loan modification process.<sup>201</sup>

While underwriting and foreclosure procedures have now become largely automated, most

loss mitigation is still done by hand. The process is slow and cumbersome, intensive in staffing and time.<sup>202</sup> Unlike foreclosure, most loan modifications rely on time-intensive direct borrower contacts. Moreover, while loss mitigation employees are generally more highly trained than collections employees, line-level loss mitigation employees are still not extensively trained, adequately supported, or given meaningful discretion as to the terms of a modification. Most servicers do not reward loss-mitigation employees for performance: staff are typically paid on an hourly basis, and only a few servicers offer bonuses for completing a modification.<sup>203</sup> At the same time, it is these relatively poorly-trained and -paid line level employees, fielding sometimes hundreds of calls a week or even a day, who must decide whether or not any particular borrower is eligible for an approved form of loss mitigation or not. These employees may or may not be aware of the servicer's formal matrix for evaluating loss mitigation options and may or may not be motivated to use it even if they are aware of the matrix. Turnover among line-level loss mitigation employees remains high.<sup>204</sup>

One partial solution to staffing shortages is to increase the use of automated loan modifications.<sup>205</sup> Automation can speed the process. An automated system works well for resolving quickly the easy, standard cases, thus conserving servicer resources for more time-intensive cases. It poses significant risks of failure, however, since an automated modification cannot be carefully tailored to a borrower's circumstances.<sup>206</sup> To be effective and fair, automation requires servicers to reassess failed modifications: the standard modification may not fit some borrowers and the need for a customized modification may only become apparent once the first, one-size-fits-all, modification has failed.

Some of the log jam is caused by the imposition of a double standard on loan modifications. Servicers insist on underwriting loss mitigation, even short sales and repayment plans, to a higher standard than the initial loan.<sup>207</sup> Stories abound



of homeowners turned down for a modification because they were unable to fully document their living expenses, yet many of these homeowners were approved for a loan without any documentation at all. While some of this drive for documentation is imposed by the FASB standards, servicers often go beyond the FASB requirements in what they ask of borrowers.

Full underwriting takes time and trained staff, both significant costs for servicers.<sup>208</sup> Indeed, the cost of full underwriting was one reason many lenders abandoned it in the years leading up to the market crash in 2007. Full underwriting also imposes significant hurdles for borrowers who do not have complete documentation. Requests for full documentation are often a source of friction between borrowers and loss mitigation staff.<sup>209</sup>

Both servicers and investors must be persuaded to change their mindsets as to the function of staff. In 2004, one credit rating agency described “communication techniques” as a “nonservicing area[]” of training.<sup>210</sup> Servicer employees are not expected to learn how to talk to borrowers. Getting information from borrowers and communicating information to borrowers is outside the defined core tasks performed by servicers. In order to do effective loan modifications, servicers and investors must see that there is value added in communicating with borrowers and that such work is part of core servicing work, not a marginalized afterthought.

## Refinancing and Cure

The cheapest option for a servicer is to do nothing. If the servicer does nothing, the borrower may resolve the situation on her own, one way or another. A borrower can cure in various ways—by refinancing, by borrowing money from friends and family, or by winning the lottery. Many servicers prefer to play those odds—historically around 1 in 4—rather than incur the costs of a modification.<sup>211</sup>

The availability of refinancing as an option reduces a servicer’s incentives to do loan modifications. In part, of course, if refinancing is available for an individual homeowner, a modification may not pass muster under the FASB rules, because then default is not “reasonably foreseeable.” More importantly, refinancing, even if it only “kicks the can down the road” for the homeowner, offers a full payoff to investors and spares the servicer the costs of all modifications.<sup>212</sup> A refinancing will not trigger repurchase requirements on the part of the servicer, nor require advances, or a loss of float income. Indeed, refinancings generate some float income for servicers, since they can earn interest on the payoff amount until it is turned over to the investor. Better still, all classes usually share in prepayments, at least after certain triggers are met.<sup>213</sup> If the servicer can engineer the refinancing with an affiliate or otherwise acquire the mortgage servicing rights to the refinanced loan, the servicer will not even suffer a net reduction of its mortgage servicing fees due to the prepayment. For servicers, refinancing may be the only form of modification that costs nothing upfront and provides, at least sometimes, a return.

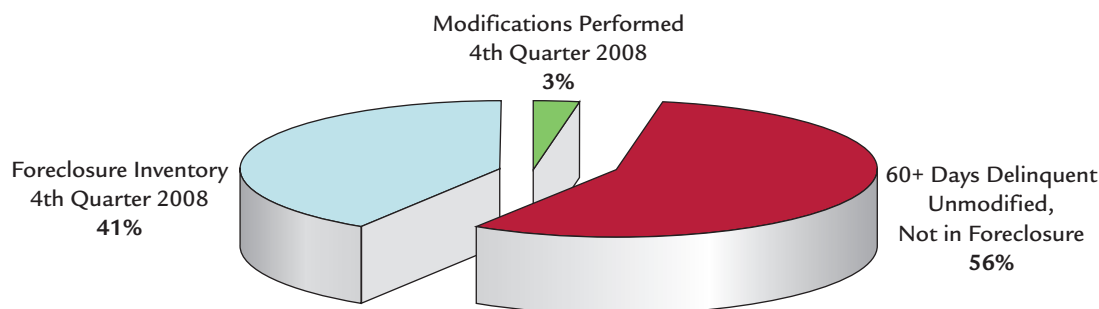
Until June 2008, refinancings exceeded even the total number of foreclosures.<sup>214</sup> As long as refinancing is an available option, servicers have little incentive to make their loss mitigation departments work. Only recently, as cure rates dropped below seven percent,<sup>215</sup> have servicers begun to realize that refinancing alone will not manage their escalating default rates.

## Conclusion and Recommendations

Foreclosures continue to outstrip modifications of all kinds. In part, this is due to the structure of servicers’ financial incentives. The compensation and constraints imposed on and chosen by servicers generally lead servicers to prefer refinancing,



### Modifications, Foreclosures, and Delinquencies as a Percentage of 60+ Day Delinquencies in 4th Quarter, 2008



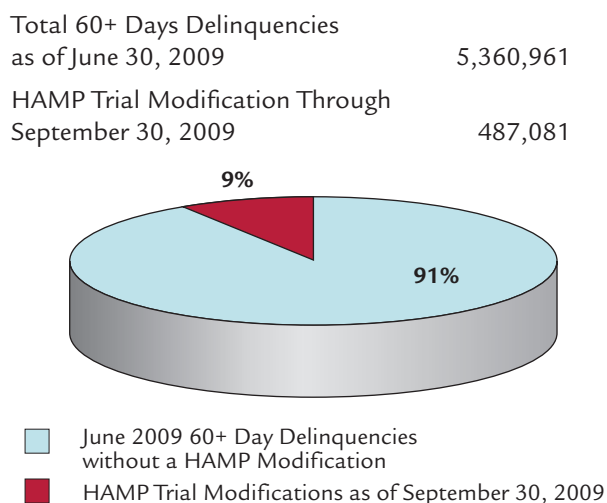
The 60+ day delinquency rate for 4th quarter 2008 was 8.08% of all loans.

Sources: Mortgage Banker's Association, National Delinquency Survey, Q4 08; Manuel Adelino, Kristopher Gerardi, and Paul S. Willen, Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization, Table 3

foreclosures, and short-term repayment plans to modifications.

Servicers recover all costs in a refinancing or foreclosure, without incurring unreimbursed expenses. Refinancing, where available, will always be preferred: the servicer incurs no costs in a refinancing, other than the staff cost of providing a payoff statement, and may gain some incidental float income from the prepayment.

### HAMP Modifications as a Percentage of Delinquencies



Sources: Mortgage Banker's Association, National Delinquency Survey, Q2 09; Making Home Affordable Program, Servicer Performance Report Through September 2009

A foreclosure is the next best option. The servicer's expenses, other than the costs of financing advances, will be paid first out of the proceeds of a foreclosure. Thus, unless the servicer's advances outstrip the value of the collateral, the servicer will recover all sunk expenditures upon completion of the foreclosure (even then, the servicer will be able to recover its remaining unpaid advances from the general income on the portfolio).<sup>216</sup> The servicer's costs of financing those advances will not be recovered—but all other costs, including those services provided by affiliated entities, like title and property inspection, will be.<sup>217</sup> The servicer is unlikely to lose money on a foreclosure, even if the investors do.<sup>218</sup>

Whether and when costs are recovered in a modification is more uncertain. While the credit rating agencies have made steps to improve clarity on the treatment of advances in a modification, there are still ambiguities. Existing PSAs provide at best spotty coverage of how a servicer should be paid for doing a modification and what kinds of modifications are preferred, relying on the vague "usual and customary practices" to provide guidance to skittish servicers. Some costs may take months to recover, depending on the size of the servicer's outlay. Other costs, particularly the sunk costs of staffing and time, are not recovered at all. Modifications are disfavored in part because of the large initial outlay in

### Effect of Servicer Incentives on Default Outcomes

This chart shows whether specific elements of servicers' compensation and expenses create positive, negative, or neutral incentives for them pursue different types of outcomes for homeowners in default.

	Short-Term Forbearance or Repayment Agreement	Interest Rate Reduction	Principal Forbearance	Principal Reduction	Short Sale	Foreclosure
Repurchase Agreements	Positive	Negative	Negative	Negative	Neutral	Neutral
TDR Rules	Positive	Negative	Negative	Negative	Neutral	Neutral
Fees	Positive	Neutral	Negative	Negative	Negative	Positive
Float Interest Income	Neutral	Negative	Negative	Negative	Positive	Positive
Monthly Servicing Fee	Neutral	Neutral	Positive	Negative	Negative	Negative
Residual Interests	Positive	Negative	Negative	Negative	Negative	Negative
Advances	Positive	Neutral	Negative	Negative	Positive	Positive
Staff Costs	Neutral	Negative	Negative	Negative	Negative	Positive

staffing and infrastructure. That there will be costs for a servicer of doing a modification is certain. The recovery of those costs is uncertain. And, in most cases, the servicer faces no penalty for avoiding the certain out-of-pocket expenditures and uncertain recovery of a modification.

If a servicer is going to do a modification, a short-term repayment plan is most attractive to the servicer. Such a plan requires little to no underwriting, does not require the servicer to recognize any long-term loss and, because it is quick, addresses servicers' largest expense: the black hole of financing principal and interest advances to investors. Time is money, perhaps even more for servicers than for others, given their acute dependence on financing. In order to be attractive to a servicer, a modification must provide for the quick and full recovery of all advances.

Modifications that respond more sensitively to borrowers' needs require more staff and more time, and may require the recognition of losses, either through a principal writedown or an interest rate reduction. Recognized losses can ripple through a servicer's incentive scheme, draining the residuals dry and reducing the monthly

mortgage servicing fee. Principal or interest rate reductions or forbearances—the sorts of modifications that most borrowers need to make the loans sustainable—will generally result in an immediate recognition of loss to the servicer and an elevated number of reported delinquencies, which can result in the servicer losing its most valuable asset, the mortgage servicing rights.

Other options pushed by investors and regulators, such as short sales, are no more attractive to servicers than foreclosure and perhaps less so. A short sale should return a higher sales price than an REO sale after foreclosure, but so long as the REO sales price is higher than the servicer's advances, that higher price does not benefit the servicer. The time to complete a short sale versus a foreclosure may be more attractive to a servicer facing high interest costs on advances. On the other hand, the servicer's obligation to make advances may be cut off by putting the loan in foreclosure, the servicer's affiliates may be able to charge and collect more fees for a foreclosure and REO than for a short sale, and, if the servicer is optimistic, a future foreclosure may take advantage of rebounding home prices.<sup>219</sup> Thus, in most

instances, a servicer has little to gain from agreeing to a short sale and potentially some loss.<sup>220</sup>

Given the complex web of incentives—and disincentives—servicers face in performing modifications and choosing among modifications, it is unsurprising that most servicers continue to follow the path of least resistance and surest returns: foreclosure or refinancing. All other paths require complex calculations and certain sunk costs without any guarantee of an offsetting return. Upfront payments to servicers without explicit mandates are unlikely to shift this dynamic, since such payments will not be sufficient for servicers to staff up nor will they cover servicers' large investment losses in the pools of toxic mortgages.

Patchwork incentives alone will not address the foreclosure crisis, nor ensure that the interests of investors, borrowers, and communities are served.<sup>221</sup> In the interest of maximizing profits, servicers have engaged in a laundry list of bad behaviors, which have considerably exacerbated foreclosure rates, to the detriment of both investors and homeowners.<sup>222</sup> The financial interests of servicers do not necessarily align with investors, nor are those existing financial incentives easily overcome by one-time incentive payments. Instead, specific steps must be taken if we want loan modifications performed when doing so would save investors money and preserve homeownership.

### ***1. Avoid irresponsible lending.***

It is easier to prevent Humpty Dumpty's fall than to put him back together again. Untangling servicer incentives would be much less important if we were not facing the current economic catastrophe. We are now looking to loan modifications to bail us out of a foreclosure crisis years in the making. Had meaningful regulation of loan products been in place for the preceding decade, we would not now be tasking servicers with rescuing us from the foreclosure crisis.

Any attempt to address the foreclosure crisis must, of necessity, consider loan modifications.

We should also ensure that we are not permanently facing foreclosure rates at current levels. To do so requires thorough-going regulation of loan products, as we have discussed in detail elsewhere.<sup>223</sup>

### ***2. Mandate loan modification before a foreclosure.***

Foreclosures impose high costs on families, neighbors, extended communities, and ultimately our economy at large.<sup>224</sup> Proceeding with a foreclosure before considering a loan modification results in high costs for both investors and homeowners. These costs—which accrue primarily to the benefit of the servicer—can make an affordable loan modification impossible. Moreover, the two track system, of proceeding simultaneously with foreclosures and loan modification negotiations, results in many “accidental” foreclosures, due to bureaucratic bungling by servicers,<sup>225</sup> as one department of the servicer fails to communicate with another, or papers are lost, or instructions are not conveyed to the foreclosure attorney.

If a servicer can escape doing a modification by proceeding through a foreclosure, servicers can choose, and in many instances have chosen, to forgo nominal incentives to modify in favor of the certainty of recovering costs in a foreclosure. Staying all foreclosures during the pendency of a loan modification review would encourage servicers to expedite their reviews, rather than delaying them. Congress and state legislatures should mandate consideration of a loan modification before any foreclosure is started, and should require loan modifications where they are more profitable to investors than foreclosure. Loss mitigation, in general, should be preferred over foreclosure.

### ***3. Fund quality mediation programs.***

Court-supervised mortgage mediation programs help borrowers and servicers find outcomes that benefit homeowners, communities and investors. The quality of programs varies widely, however, and most communities don't yet have mediation

available. Government funding for mediation programs would expand their reach and help develop best practices to maximize sustainable outcomes.

#### ***4. Provide for principal reductions in Making Home Affordable and via bankruptcy reform.***

The double whammy of declining home values and job losses helps fuel the current foreclosure crisis.<sup>226</sup> Homeowners who could normally refinance their way out of a lost job or sell their home in the face of foreclosure are denied both options when they owe more on their home than it is worth. Without principal reductions, homeowners who lose their jobs, have a death in the family, or otherwise experience a drop in income are more likely to experience redefault and foreclosure.<sup>227</sup> Existing data on loan modifications shows that loan modifications with principal reductions tend to perform better.<sup>228</sup> In order to bring down the redefault rate and make loan modifications financially viable for investors, principal reductions must be part of the package.<sup>229</sup>

Principal forgiveness is also necessary to make loan modifications affordable for some homeowners. A significant fraction of homeowners owe more than their homes are worth.<sup>230</sup> The need for principal reductions is especially acute—and justified—for those whose loans were not adequately underwritten and either: 1) received negatively amortizing loans such as payment option adjustable rate mortgage loans, or 2) obtained loans that were based on inflated appraisals. As a matter of fairness and commonsense, homeowners should not be trapped in debt peonage, unable to refinance or sell.

Making Home Affordable permits principal reductions, but does not mandate them, even in the most extreme cases. Making Home Affordable does require forbearance, but only as a method for reducing payments. While forbearance provides affordable payments, it prevents a homeowner from selling or refinancing to meet a needed expense, such as roof repair or college tuition, and sets both the homeowner and the loan modi-

fication up for future failure. For all of these reasons, the Making Home Affordable guidelines should be revised so that they at least conform to the Federal Reserve Board's loan modification program by reducing loan balances to 125 percent of the home's current market value.

In addition, Congress should enact legislation to allow bankruptcy judges to modify appropriate mortgages in distress. First-lien home loans are the only loans that a bankruptcy judge can never modify.<sup>231</sup> The failure to allow bankruptcy judges to align the value of the debt with the value of the collateral contributes to our ongoing foreclosure crisis. Permitting bankruptcy judges to modify first-lien home loans also provides a solution to the severe implementation problems homeowners face when they are forced to seek help directly from mortgage servicers. The exclusion of home mortgages from bankruptcy supervision dates back to the 1978 Bankruptcy Code, when mortgages were generally conservative instruments with a simple structure. The goal was to support mortgage lending and homeownership. Today, support for homeownership demands that homeowners have greater leverage in their effort to avoid foreclosure.

#### ***5. Continue to increase automated and standardized modifications, with individualized review for borrowers for whom the automated and standardized modification is inappropriate.***

Servicers are not originators. They lack staff, training, and software to underwrite loans.<sup>232</sup> Moreover, underwriting takes time—and the longer it takes to make a delinquent loan performing, the more money, generally speaking, servicers will lose. One of the requirements of any loan modification program that hopes to be effective on the scale necessary to make a difference in our current foreclosure crisis is speed.

The main way to get speed is to automate the process, and to offer standardized modifications. This was one of the key insights of the FDIC's

loan modification program on the Indymac mortgages.<sup>233</sup> This insight has been at least partially incorporated into the Making Home Affordable Program. Both programs allow the process to begin without any documentation from the borrower at all.

More could and should be done to automate the process.<sup>234</sup> We simply cannot afford the wait, delay, and confusion caused by failed contacts between servicers and borrowers.<sup>235</sup> Servicers can and should present borrowers in default with a standardized offer based on information in the servicer's file, including the income at the time of origination and the current default status. Borrowers should then be free to accept or reject the modification, based on their own assessment of their ability to make the modified payments. Borrowers whose income has declined and are seeking a modification for that reason could then provide, as they now do under the Making Home Affordable Program, income verification.

Only when a borrower rejects a modification—or if an initial, standard modification fails—should detailed underwriting be done. The urgency of the need requires speed and uniformity; fairness requires the opportunity for a subsequent review if the standardized program is inadequate. Borrowers for whom an automated modification is insufficient should be able to request and get an individually tailored loan modification, at least when such a loan modification is forecast to save the investor money.

Many of the existing loans were poorly underwritten, based on inflated income or a faulty appraisal. Borrowers may have other debt, including high medical bills, that render a standardized payment reduction unaffordable. A standardized approach cannot cure all reasons for default. But it will make many loans affordable, saving investors the costs of foreclosure and servicers the cost of detailed underwriting. The savings in speed and staffing created by using truly automated and standardized modifications to handle the easy modifications should more than compensate for the costs of underwriting modifications that require more individualized attention.

Additionally, borrowers may be unable to perform on a loan modification for many reasons—a spouse may die or the borrower may become unemployed or disabled. These subsequent, unpredictable events, outside the control of the homeowner, should not result in foreclosure if a further loan modification would save investors money and preserve homeownership. Foreclosing on homes where homeowners have suffered an involuntary drop in income without evaluating the feasibility of a further modification is punitive to homeowners already suffering a loss and does not serve the interests of investors. Some servicers provide modifications upon redefault as part of their loss mitigation programs. This approach should be standard and mandated, and should include continued eligibility for Making Home Affordable modifications rather than only specific servicer or investor programs.

## ***6. Ease accounting rules for modifications.***

The current accounting rules, particularly as interpreted by the credit rating agencies, do not prevent modifications, but they may discourage appropriate modifications. In particular, the requirement that individual documentation of default be obtained may prevent streamlined modifications. The troubled debt restructuring rules may discourage sustainable modifications of loans not yet in default and promote short-term repayment plans rather than long-term, sustainable modifications that reflect the true value of the assets. Finally, limiting recovery of servicer expenses when a modification is performed to the proceeds on that loan rather than allowing the servicer to recover more generally from the income on the pool as a whole, as is done in foreclosure, clearly biases servicers against meaningful modifications, particularly modifications with principal reduction or forbearance. The credit rating agencies and bond insurers should review their guidance on how servicers get reimbursed for advances when a modification is entered into.



Streamlined modifications should be allowed to proceed without full documentation, for the reasons discussed above. A standardized modification can and should be offered based on information in the servicer's files, to be followed with detailed individual documentation only where the standardized modification does not work for an individual borrower. Where a loan is already in default, individual documentation of default beyond noting the fact of default seems unnecessary. If the goal is the return to the investors, the reason for the default is largely irrelevant; what is relevant is whether or not the loan can be made performing.

FASB and the Securities and Exchange Commission could help by formalizing more flexible servicer discretion in determining "reasonably foreseeable default" and the ability to pursue sustainable, systematic, streamlined loan modifications without the threat of punitive regulatory or accounting consequences. The guidance issued by the Office of the Chief Accountant of the Securities and Exchange Commission permitting streamlined modifications in the event of a rate reset should be extended to all standardized programs, in line with the REMIC requirements.

The SEC and FASB should also review the relevant troubled debt restructuring, impairment, and recognition guidance to ensure that owners of 1–4 unit residential mortgages are not unduly penalized for undertaking modifications of loans prior to default. Such review could encourage servicers to modify more loans in a timely way. Such pre-default modifications are particularly important since they have a higher rate of success and fewer negative consequences for both borrowers and investors than post-default modifications.

## ***7. Encourage FASB and the credit rating agencies to provide more guidance regarding the treatment of modifications.***

Investors are losing mind-boggling large sums of money on foreclosures.<sup>236</sup> The available data sug-

gests that investors lose ten times more on foreclosures than they do on modifications.<sup>237</sup> In particular, leading investor groups have advocated broader use of principal reductions as part of the anti-foreclosure arsenal, but only a handful of servicers have obliged.<sup>238</sup> Part of the solution to the foreclosure crisis must be giving investors the tools they need to police servicers.

Investors' interests are not necessarily the same as those of borrowers. There are many times when an investor will want to foreclose although a borrower would prefer to keep a home. Investors as well as servicers need improved incentives to favor modifications over foreclosures. Still, there would likely be far fewer foreclosures if investors had information as to the extent of their losses from foreclosures and could act on that information.

Even where investors want to encourage and monitor loan modifications, existing rules can stymie their involvement—or even their ability to get clear and accurate reporting as to the status of the loan pool. Additional guidance by FASB and the credit rating agencies could force servicers to disclose more clearly to investors and the public the nature and extent of the modifications in their portfolio—and the results of those modifications. Without more transparency and uniformity in accounting practices, investors are left in the dark. As a result, servicers are free to game the system to promote their own financial incentives, to the disadvantage, sometimes, of investors, as well as homeowners and the public interest at large.

## ***8. Regulate default fees.***

Fees serve as a profit center for many servicers and their affiliates. They increase the cost to homeowners of curing a default. They encourage servicers to place homeowners in default. All fees should be strictly limited to ones that are legal under existing law, reasonable in amount, and necessary. If default fees were removed as a profit center, servicers would have less incentive to

place homeowners into foreclosure, less incentive to complete a foreclosure, and modifications would be more affordable for homeowners.

Making Home Affordable already requires the waiver of late fees in a modification. Servicers should be required to waive all default-related fees in a modification or in the event of cure, but these fees should be treated as nonrecoverable advances, subject to recovery from the pool. This treatment would spread the cost of doing modifications more uniformly across the pool, in line

with the loss allocations contemplated at the pool's origin. Borrowers would no longer be faced with large downpayments in order to make a loan modification financially viable for the servicer. Investors are in a far better position than borrowers to limit the imposition of default fees to circumstances when they are reasonable and necessary. Permitting servicers to recover waived default fees from all the income from a pool would give investors the incentive to monitor servicers' use of default fees as a profit center.

## Glossary of Terms

**Affiliates** Related business organizations, with common ownership or control.

**Advances** Under most PSAs, servicers are required to advance the monthly principal and interest payment due on each loan to the trust, whether or not the borrower actually makes the payment. The requirement to make these advances can continue until the home is sold at foreclosure.

**Basis Points** One basis point equals 1/100th of a percentage point. For example, an increase in an interest rate from 8.75% to 9.00% is an increase of 25 basis points.

**Bankruptcy-remote status** When the assets of a trust cannot be seized by creditors of the transferor (often the originating lender) in the event of the transferor's bankruptcy.

**Bond Insurance** Bond issuers pay bond insurers for the promise to make payments if the bond does not perform as advertised. Bond insurance may cover all or, more commonly, a portion, of the payments due on the bond. The larger the coverage, the higher the rating on the bond. Bond insurers will charge more the riskier they believe the underlying securities to be.

**Broker Price Opinion** A valuation of the property by a broker. As the name indicates, it is not a full appraisal, and not conducted by an appraiser, but simply an "opinion" by a broker as to the value of the home.

**Capitalizing Arrears** Adding past due amounts on the loan and adding them to the principal balance, with a resulting increase in the size of the monthly payment.

**Credit Rating Agencies** These are private companies that assign ratings to bonds and to corporate borrowers, such as servicers. Moody's, Standard and Poors, and Fitch are all credit rating agencies.

**Cure** To "cure" a default is to pay the full amount due, often by refinancing.

**Default Rates** The rate at which borrowers default on loans as compared to the total number of loans.

**Fannie Mae** The Federal National Mortgage Association, chartered by the U.S. government, provides liquidity to the mortgage market by purchasing loans, then packaging those loans into securities, and selling those securities on the secondary market. Fannie Mae primarily purchased prime loans.

**FAS** Financial Accounting Statement, issued by FASB. The Financial Accounting Statements, through their incorporation into private contracts and SEC regulation, have the force of law.

**FASB** Financial Accounting Standards Board. FASB is a private organization, but the Securities and Exchange Commission often interprets FASB standards and requires compliance with the FASB standards by all public companies.

**FAS 140** Accounting rules governing transfer of assets to and from trusts, designed to limit discretion in trust management in exchange for preserving the bankruptcy-remote status of the trust.

**Federal Reserve Board** The central bank of the United States, in charge of ensuring the flow of money throughout the financial system.

**FHA loans** The Federal Housing Administration insures, at 100% of any losses, home mortgage loans made to lower-income borrowers and others who do not qualify for prime loans without FHA insurance.

**Float Income** The interest income earned by servicers in the interval between when funds are received from a borrower and when they are paid out to the appropriate party.

**Freddie Mac** The Federal Home Loan Mortgage Corporation, chartered by the U.S. government, provides liquidity to the mortgage market by purchasing loans, then packaging those loans into securities, and selling those securities on the secondary market. Freddie Mac primarily purchased prime loans.

**GSE** Government sponsored entities. The GSEs help make the credit markets, including home mortgages

primarily through the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).

**HAMP** The Home Affordable Modification Program is a standard modification program designed by the U.S. Treasury. Participating servicers are required to review all eligible borrowers to determine whether or not they qualify for a modification. Modifications under HAMP can reduce the interest rate to as low as two percent for as long as five years, permit, but do not require, principal reductions, sometimes mandate principal forbearance and an extension of the term of the loan from 30 years to 40.

**Hybrid ARMs** Adjustable rate mortgages that have fixed rates for a period of time, usually two- or three-years, followed by a period where the rate can adjust in relationship to an index, usually every six months.

**Junior Tranche, Junior Interest** An interest in a pool of mortgages that gets paid after more senior security interests.

**Making Home Affordable Program** The Obama Administration's program designed to help millions of homeowners refinance or modify their mortgages to more affordable payments. The program created a loan modification program (HAMP) in which all major servicers of home mortgages agreed to participate. The plan establishes loan modification guidelines that require a loan modification when an analysis finds that the net present value of the costs of foreclosing on a home is will return less to investors than the net present value of the return from an affordable loan modification.

**Master Servicer** The Master Servicer is the servicer in charge of hiring, firing, and selecting special servicers and ensuring timely payments to the trust. The Master Servicer may or may not actually service any of the loans in the pool. Sometimes PSAs will require that servicing of loans in default automatically be transferred to a designated special servicer outside the Master Servicer's control.

**Mortgage Insurance** Insurance, paid for by the borrower, that covers some fraction of the investor's losses on a loan in the event of the borrower's default.

**Mortgage Servicing Rights (MSRs)** The rights to collect the payments on a pool of loans.

**Partial Chargeoff** When the servicer writes down the principal balance, but does not require the homeowner

to sell the property. A partial chargeoff can take place either through a refinancing or a loan modification.

**Passive Management** Management of a loan pool with discretion constrained to ensure no undue influence by the transferor, thus justifying the bankruptcy-remote status of the trust's assets.

**Pooling and Servicing Agreement (PSA)** The agreement between the parties to the securitization as to how the loans will be serviced. PSAs spell out the contractual duties of each party, the circumstances under which a servicer can be removed, and sometimes give guidance as to when modifications can be performed.

**Principal Forbearance** Principal on which no interest accrues and no payments are due until a specified event in the future occurs, usually the payment in full of the loan.

**REMIC** Real Estate Mortgage Investment Conduits are defined under the U.S. Internal Revenue Code (Tax Reform Act of 1986), and are the typical vehicle of choice for the pooling and securitization of mortgages. The REMIC rules are the IRS tax code rules governing REMICs.

**REO** Real estate owned. Often, a holder or servicer will acquire property at a foreclosure sale. The property is then listed as REO property until it is sold to a third party. Sales of REO property typically generate less income than sales of occupied property by the homeowner.

**Repurchase Agreement** A clause in a contract for the sale of mortgages that requires the seller or servicer to repurchase any mortgage back from the buyer if any one of a number of specified events occur. Generally the specified events include borrower default or legal action and sometimes include modification.

**Residual Interest** A junior-level interest retained in the mortgage pool by a servicer, typically by a servicer who is an affiliate of the originator. These interests commonly pay out "surplus" interest income, left over after specified payments to senior bond holders are made.

**Securities and Exchange Commission (SEC)** The federal agency charged with regulating securities.

**Securitization** Securitization combines groups of loans in pools, transfers those pooled loans to a different entity, and then sells securities based on the combined projected income on the loans in the pool.

**Servicer** The entity responsible for taking payments from the borrower and distributing them according to the terms of the pooling and servicing agreement.

**Short Sales** A sale of real estate in which the proceeds from the sale fall short of the balance owed on a loan secured by the property sold and the lender nonetheless releases the mortgage.

**Subprime Loans** Loans made at higher than prime rates, often with other less desirable terms.

**Tranche** One of a number of related classes of securities offered as part of the same transaction.

**Troubled Debt Restructuring (TDR)** An accounting term describing the modification of debt involving creditor concessions (a reduction of the effective yield on the debt) when the borrower is facing financial hardship.

**Trustee** The legal holder of the mortgage notes, on behalf of the trust and the ultimate beneficiaries, the investors in the trust.

**Underwriting** The lender's evaluation of the likelihood of repayment of the loan, including evaluation of the borrower's creditworthiness and the value of the security offered.



## Notes

<sup>1</sup> See, e.g., Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, Speech at the Federal Reserve System Conference on Housing and Mortgage Markets: Housing, Mortgage Markets, and Foreclosures (Dec. 4, 2008) [hereinafter Bernanke, Speech at Federal Reserve], available at <http://www.federalreserve.gov/newsevents/speech/bernanke20081204a.htm> (“Despite good-faith efforts by both the private and public sectors, the foreclosure rate remains too high, with adverse consequences for both those directly involved and for the broader economy.”).

<sup>2</sup> *The Worsening Foreclosure Crisis: Is It Time to Reconsider Bankruptcy Reform? Hearing Before the Senate Subcomm. on Administrative Oversight and the Courts of the Comm. on the Judiciary*, 111th Cong. 6–13 (2009) (testimony of Alys Cohen).

<sup>3</sup> Many of today’s servicers are third-party servicers, unaffiliated with a lender. Others may be affiliated with a lender, but may or may not be servicing loans originated by that lender. This paper will discuss the incentives common to both types and will attempt to distinguish between the two groups where appropriate.

<sup>4</sup> See *In re Taylor*, 407 B.R. 618 (Bankr. E.D. Pa. 2009) (describing the extreme reliance on a computer system to perform the servicing, to the point that the computer system was personified by the actual living employees of the servicer).

<sup>5</sup> Cf. Joe Nocera, *Talking Business: From Treasury to Banks, An Ultimatum on Mortgage Relief*, N.Y. Times, July 11, 2009 (characterizing work of servicers as “relatively simple” whose default servicing consisted largely of either “prodd[ing] people” to pay or “initiat[ing] foreclosure”).

<sup>6</sup> *Id.* (noting that servicers find the Making Home Affordable incentives “meaningless”).

<sup>7</sup> See, e.g., Bernanke, Speech at Federal Reserve, *supra* note 1 (“The rules under which servicers operate do not always provide them with clear guidance or the appropriate incentives to undertake economically sensible modifications.”).

<sup>8</sup> American Securitization Forum, Discussion Paper on the Impact of Forborne Principal on RMBS Transactions 1 (June 18, 2009) [hereinafter American Securitization Forum, Discussion Paper], available at [http://www.americansecuritization.com/uploadedFiles/ASF\\_Principal\\_Forbearance\\_Paper.pdf](http://www.americansecuritization.com/uploadedFiles/ASF_Principal_Forbearance_Paper.pdf).

<sup>9</sup> See *Helping Families Save Their Homes: The Role of Bankruptcy Law: Hearing Before the S. Comm. on the Judiciary*, 110th Cong., 2nd Sess. (Nov. 19, 2008) [hereinafter *Helping Families Save Their Homes: Hearing*], available at [http://judiciary.senate.gov/hearings/testimony.cfm?renderforprint=1&id=3598&writ\\_id=4083](http://judiciary.senate.gov/hearings/testimony.cfm?renderforprint=1&id=3598&writ_id=4083) (statement of Russ Feingold, Member, Sen. Comm. on the Judiciary) (“One thing that I think is not well understood is that because of the complex structure of these securitized mortgages that are at the root of the financial calamity the nation finds itself in, voluntary programs to readjust mortgages may simply be doomed to failure.”).

<sup>10</sup> See *It’s a Wonderful Life* (Liberty Films 1946) (narrating the adventures of a mid-20th century bank manager of a building and loan that provides home loans for the working poor).

<sup>11</sup> See, e.g., Prospectus Supplement, IndyMac, MBS, Depositor, IndyMac INDX Mortgage Loan Trust 2007-FLX5, at S-11 (June 27, 2007) [hereinafter Prospectus Supplement, IndyMac, et al.] (listing various certificates offered).

<sup>12</sup> A tranche is a portion of the securitization bearing a specific credit-risk rating. Riskier tranches have correspondingly higher rates of return but do not get paid until after less risky tranches do, thus giving rise to “tranche warfare.” Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 Creighton L. Rev. 503 (2002).

<sup>13</sup> State Foreclosure Prevention Working Group, Analysis of Subprime Mortgage Servicing Performance, Data Report No. 1, at 23 (2008), available at <http://www.csbs.org/Content/NavigationMenu/Home/StateForeclosurePreventionWorkGroupDataReport.pdf> (44.9% by number of loans, 42.85% by dollar volume).

<sup>14</sup> A securities administrator typically oversees the transfer of funds from one party to another.

<sup>15</sup> Peter S. Goodman, *Lucrative Fees May Deter Efforts to Alter Troubled Loans*, N.Y. Times, July 30, 2009 [hereinafter Goodman, *Lucrative Fees*].

<sup>16</sup> Ocwen Fin. Corp., Annual Report (Form 10-K), at 9 (Mar. 12, 2009).

<sup>17</sup> See Joseph R. Mason, Servicer Reporting Can Do More for Modification than Government Subsidies 17 (Mar. 16, 2009) [hereinafter Mason, Servicer Reporting Can Do More], available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1361331](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1361331) (noting that “servicers’ contribution to corporate profits is often . . . tied to their ability to keep operating costs low”).

<sup>18</sup> Under most PSAs, servicers are required to advance to investors at least a portion of the monthly payment due on a loan, whether or not the borrower is making payments. Sometimes interest only is advanced; sometimes principal and interest are both advanced. Advances are discussed in detail below, in text accompanying footnotes 150–162.

<sup>19</sup> Mortgage servicing rights are discussed below, in text accompanying notes 138–149.

<sup>20</sup> Alan M. White, *Rewriting Contracts, Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports*, Fordham Urb. L.J. 15 (forthcoming 2009) (reporting average delinquency rates in studied loan pools as reaching 35% in June 2008).

<sup>21</sup> See Manuel Adelino, Kristopher Gerardi, and Paul S. Willen, Fed. Reserve Bank of Boston, Why Don’t Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization 35 (Public Pol’y Paper No. 09–4, July 6, 2009), available at <http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf> (reporting that less than 8% of loans 60+ days delinquent modified during 2007–2008; at the end of 4th quarter 2008, according to the Mortgage Banker’s Association, 8.08% of all loans were 60+ days delinquent and 28.30% of subprime loans were delinquent, suggesting a modification rate for all loans of somewhere between 0.6% and 2.3% percent); Alan M. White, *Deleveraging the American Homeowner: The Failure of 2008 Voluntary Mortgage Modification Contracts*, Conn. L. Rev. 12–13 (forthcoming 2009), available

at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1325534](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1325534) (reporting a range of modifications performed by 47 servicers in November 2008 from a high ratio of 35% of loans in foreclosure modified to a low of 0.28% of loans modified; multiplying these numbers by the average rate of subprime loans in foreclosure for the last quarter of 2008 as reported by the Mortgage Banker's Association, 13.71%, the ratio of modifications performed by the servicer doing the largest percentage of modifications, is only 4.8%); cf. Gretchen Morgenson, *Fair Game—So Many Foreclosures, So Little Logic*, N.Y. Times, July 4, 2009 (reporting that modifications peaked in February 2009 and have since declined while the number of foreclosures and delinquencies has continued to rise).

<sup>22</sup> Congressional Oversight Panel, *Foreclosure Crisis: Working Toward a Solution* (March 6, 2009).

<sup>23</sup> See, e.g., Morgan Stanley Omnibus Amendment (Aug. 23, 2007) (on file with the author).

<sup>24</sup> American Securitization Forum, Discussion Paper, *supra* note 8, at 1.

<sup>25</sup> Adelino et al., *supra* note 21, at 28 (summarizing several different studies finding no meaningful PSA restrictions in a majority of securitizations reviewed); John P. Hunt, Berkeley Ctr. for Law, Business, and the Economy, *What Do Subprime Securitization Contracts Actually Say About Loan Modification: Preliminary Results and Implications* 6 (Mar. 35, 2009), available at [http://www.law.berkeley.edu/files/bclbe/Subprime\\_Securitization\\_Contracts\\_3.25.09.pdf](http://www.law.berkeley.edu/files/bclbe/Subprime_Securitization_Contracts_3.25.09.pdf) (reporting that the PSAs of 90% of subprime loans surveyed generally permitted modifications); Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang, & Eileen Mauskopf, Fed. Reserve Bd. Fin. & Econ. Discussion Series Div. Research & Statistical Affairs, *The Incentives of Mortgage Servicers: Myths and Realities* 22 (Working Paper No. 2008-46) (reporting that of 500 different PSAs under which a large servicer operated, 48% had no limitations on modifications other than that they maximize investor return; only 7.5% of the PSAs had meaningful limits on the types of modifications a servicer could authorize); Credit Suisse, *The Day After Tomorrow: Payment Shock and Loan Modifications* (2007), available at <http://www.credit-suisse.com/researchandanalytics> (finding that 65% of surveyed PSAs contain no meaningful restrictions on ability to modify loans); American Securitization Forum, *Statement of Principles, Recommendations, and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans* 2 (June 2007) (“Most subprime transactions authorize the servicer to modify loans that are either in default or for which default is either imminent or reasonably foreseeable.”).

<sup>26</sup> Investor Committee of the American Securitization Forum, *Mortgage Investors Endorse Treasury Department's Guidance on Accounting Treatment of Forborne Principal* 2 (Aug. 13, 2009).

<sup>27</sup> Hunt, *supra* note 25, at 7 (discussing various limitations and quantifying the frequency of limitations); American Securitization Forum, *supra* note 25, at 3; see also Mason, *Servicer Reporting Can Do More*, *supra* note 17, at 55 (discussing reasons for 5% limitation).

<sup>28</sup> Hunt, *supra* note 25, at 9–10; Mason, *Servicer Reporting Can Do More*, *supra* note 17, at 55.

<sup>29</sup> See, e.g., Prospectus Supplement, IndyMac, et al., *supra* note 11, at 72:

Notwithstanding the foregoing, in connection with a defaulted mortgage loan, the servicer, consistent with the standards set forth in the pooling and servicing agreement, sale and servicing agreement or servicing agreement, as applicable, may waive, modify or vary any term of that mortgage loan (including modifications that change the mortgage rate, forgive the payment of principal or interest or extend the final maturity date of that mortgage loan), accept payment from the related mortgagor of an amount less than the stated principal balance in final satisfaction of that mortgage loan, or consent to the postponement of strict compliance with any such term or otherwise grant indulgence to any mortgagor if in the servicer's determination such waiver, modification, postponement or indulgence is not materially adverse to the interests of the securityholders (taking into account any estimated loss that might result absent such action).

<sup>30</sup> Hunt, *supra* note 25, at 7.

<sup>31</sup> Morgan Stanley Omnibus Amendment (Aug. 23, 2007) (on file with the author). The securitization's sponsor in this case likely held some equity interest in the securitization.

<sup>32</sup> Congressional Oversight Panel, *supra* note 22.

<sup>33</sup> Moody's Investor Service, *No Negative Ratings Impact from RFC Loan Modification Limits Increases* (May 25, 2008).

<sup>34</sup> Monica Perelmuter & Waqas Shaikh, Standard & Poor's, *Criteria: Revised Guidelines for U.S. RMBS Loan Modification and Capitalization Reimbursement Amounts* 3 (Oct. 11, 2007).

<sup>35</sup> See Gretchen Morgenson, *Assurances on Buybacks May Cost a Lender*, N.Y. Times, Aug. 23, 2007, at C1 (reporting that as of April 1, 2007, Countrywide's securitization agreements removed the buyback requirement). See text accompanying footnotes 83–90, *infra* for a discussion of the troubled debt restructuring rules.

<sup>36</sup> Cordell, et al., *supra* note 25, at 9.

<sup>37</sup> See generally Michael Laidlaw, Stephanie Whited, Mary Kelsch, Fitch Ratings, *U.S. Residential Mortgage Servicer Bankruptcies, Defaults, Terminations, and Transfers* 2 (2007).

<sup>38</sup> Cordell, et al., *supra* note 25, at 22.

<sup>39</sup> See *id.* at 19 (reporting that, despite loss severity rates in excess of 50%, many investors remain unconcerned about whether the servicer is pursuing loss mitigation appropriately and uninterested in encouraging more loss mitigation activity).

<sup>40</sup> Cf. Maurina Desmond, *The Next Mortgage Mess: Loan Servicing? Claims of Fraud in the Subprime Mortgage Market Illuminate a Murky World*, Forbes.com, Mar. 20, 2009, available at <http://www.forbes.com/2009/03/20/subprime-mortgages-carrington-capital-business-wall-street-servicers.html> (noting that delaying foreclosures and concealing default helps junior investors but hurts senior investors).

<sup>41</sup> See Complaint at 6, Carrington Asset Holding Co., L.L.C.

v. American Home Mortgage Servicing, Inc., No. FST-CV 09-5012095-S (Conn. Super. Ct., Stamford, Feb. 9, 2009) (noting that information on the disposition of foreclosed property was available to junior investor only because of “special rights” bargained for by institutional investor).

<sup>42</sup> Goodman, *Lucrative Fees*, *supra* note 15.

<sup>43</sup> See, e.g., Prospectus Supplement, Asset-Backed Pass-Through Certificates, Series 2002-2, Ameriquest Mortgage Securities Inc., Depositor, Ameriquest Mortgage Company, Originator and Master Servicer 44-45 (June 3, 2002) (agreement of 51% of certificate holders required); cf. Complaint at 6, *Carrington Asset Holding*, *supra* note 41 (describing “special rights” Carrington allegedly bargained for as holder of the most junior certificates to direct the disposition of property after foreclosure and stating that certificate holders normally have no power to direct the actions of the servicer in property disposition).

<sup>44</sup> Cf. Cordell, et al., *supra* note 25, at 18 (reporting that servicers of private label securitizations receive little guidance from investors regarding loss mitigation). Once a pool is up and running, investors are usually constrained from giving active direction on the management of the assets under tax and accounting rules. *Id.* at 19.

<sup>45</sup> Indeed, PSAs usually allow a trustee to increase its monitoring of a servicer only in the case of a narrowly circumscribed list of triggering events, primarily financial defaults. Laidlaw, et al., *supra* note 37, at 2. Advances are discussed in detail below in text accompanying footnotes 151-162.

<sup>46</sup> See, e.g., Mason, *Servicer Reporting Can Do More*, *supra* note 17, at 14 (“The point is, the investor has to completely trust the servicer to act in their behalf, often in substantially unverifiable dimensions.”).

<sup>47</sup> See Rod Dubitsky, Larry Yang, Stevan Stevanovic, Thomas Suer, Credit Suisse, Subprime Loan Modifications Update 8 (2008) (reporting opposition from AAA rated tranches to principal reduction modifications when losses from principal reduction spread evenly through all tranches).

<sup>48</sup> A copy of the complaint in the high-profile suit brought by investors against Countrywide is available at <http://www.housingwire.com/wp-content/uploads/2008/12/countrywide-class-action-complaint.pdf>. The complaint was filed in an attempt to force Countrywide to repurchase loans modified pursuant to its settlement with several state attorneys general. The complaint explicitly states that it is not opposed to the settlement with the attorneys general but believes that Countrywide is required to repurchase those modified loans. Complaint at ¶ 3, *Greenwich Fin. Servs. Distress Mortgage Fund 3, L.L.C. v. Countrywide Fin. Corp.*, No. 650474 (N.Y. Sup. Ct., N.Y. Cty. Apr. 2008). The argument in this case is strengthened because Countrywide was, in most cases, the originator of the loans, and the attorneys general alleged deceptive acts and practices in origination. See also Adelino et al., *supra* note 21, at 4 (reporting that of more than 800 suits filed by investors by the end of 2008 not a single one questioned the right of a servicer to make a loan modification); Cordell, et al., *supra* note 25, at 23 (“servicers admitted that investors have rarely questioned a workout, or asked to see NPV worksheets, or threatened a lawsuit in the

past.”); Mason, *Servicer Reporting Can Do More*, *supra* note 17, at 15-16 (discussing legal hurdles for investors to recover from servicers).

<sup>49</sup> See Complaint at 17-19, *Carrington Asset Holding*, *supra* note 41 (detailing the difficulties a junior certificate holder had obtaining the names of other investors and the trustee and master servicer’s refusal to act) (25% of the investors must agree to suit); Complaint at ¶ 19, *Greenwich Fin. Servs. Distress Mortgage Fund 3, LLC v. Countrywide Fin. Corp.*, No. 65047 (N.Y. Sup. Ct., N.Y. Cty. Apr. 2008) (25% of investors must agree before litigation pursued). Other PSAs require a majority or super-majority of investors to agree before any action can be instituted against a servicer. See, e.g., Prospectus Supplement, Asset-Backed Pass-Through Certificates, *supra* note 43, at 44-45 (agreement of 51% of certificate holders required).

<sup>50</sup> See, e.g., 15 U.S.C. § 1639a (Pub. L. No. 111-22, div. A, tit. II, § 201(b) (May 20, 2009)). This provision rewrote an earlier servicer safe harbor provision contained in the HOPE for Homeowners Act of 2008, Pub. L. No. 110-289, div. A, tit. IV, § 1403 (July 30, 2008).

<sup>51</sup> Adelino et al., *supra* note 21, at 4 (reporting that of more than 800 suits filed by investors by the end of 2008 not a single one questioned the right of a servicer to make a loan modification).

<sup>52</sup> Letter from Charles E. Schumer, U.S. Senator, to Daniel Mudd, CEO of Fannie Mae, and Richard Syron, CEO of Freddie Mac (Feb. 6, 2008).

<sup>53</sup> GSEs stands for government sponsored entities. The GSEs create liquidity in the credit markets—and set the terms on which credit is issued, in many instances—through their purchase of debt instruments and securities on the secondary market. The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) are the principal actors in the secondary market for prime and near-prime rate home mortgage loans.

<sup>54</sup> See Freddie Mac Bulletin (July 31, 2008) (\$800 for loan modifications and \$2,200 for short sales); Fannie Mae, Announcement 08-20 (Aug. 11, 2008) (\$700 for loan modifications and \$1,000 to \$1,500 for short sales).

<sup>55</sup> State Foreclosure Prevention Working Group, Analysis of Subprime Mortgage Servicing Performance, Data Report No. 1, at 23 (2008), available at <http://www.csbs.org/Content/NavigationMenu/Home/StateForeclosurePreventionWorkGroupDataReport.pdf> (44.9% by number of loans, 42.85% by dollar volume).

<sup>56</sup> Adelino et al., *supra* note 21, at 6.

<sup>57</sup> The IRS regulations provide a safe harbor: anything with an adjusted basis of 1% or less the aggregate adjusted basis of the trust is de minimis per se. 26 C.F.R. § 1.860D-1.

<sup>58</sup> 26 C.F.R. § 1.860G-2(f)(1).

<sup>59</sup> 26 C.F.R. § 1.860G-2(f)(2).

<sup>60</sup> See, e.g., Thomas A. Humphreys, *Tales from the Credit Crunch: Selected Issues in the Taxation of Financial Instruments and Pooled Investment Vehicles*, 7 J. Tax’n Fin. Products 33, 41-42 (2008).

<sup>61</sup> 26 C.F.R. § 1.860G-2(b)(3)(i).

<sup>62</sup> Rev. Proc. 2008-28, Rev. Proc. 2007-72.

<sup>63</sup> FASB recently completed a five year project of codifying all



previously issued Financial Accounting Statements. The codification is effective September 15, 2009. For our purposes, we will refer to the pre-codification Statements.

<sup>64</sup> *Roles of the SEC and FASB in Establishing GAAP: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Fin. Servs.*, 107th Cong. (2002) (statement of Robert K. Herdman, Chief Accountant, U.S. Securities & Exchange Commission).

<sup>65</sup> Mortgage Banker's Ass'n, FAS 140 Implications of Restructurings of Certain Securitized Residential Mortgage Loans 2, available at [http://www.mortgagebankers.org/files/News/InternalResource/55315\\_MBAPositionPaperonFAS140Restructurings.pdf](http://www.mortgagebankers.org/files/News/InternalResource/55315_MBAPositionPaperonFAS140Restructurings.pdf).

<sup>66</sup> FAS 140 is 102 pages long; the REMIC rules, by comparison, are easily read at one sitting.

<sup>67</sup> Fin. Accounting Standards Bd., Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, Statement of Fin. Accounting Standards No. 140, § 35, 42–43 (2000); Stephen G. Ryan, Accounting for and in the Subprime Crisis 37 (Mar. 2008).

<sup>68</sup> Fin. Accounting Standards Bd., Accounting for Transfers of Financial Assets—An Amendment of FASB Statement No. 140, Statement of Fin. Accounting Standards No. 166 § A29 (2009). See generally Fitch Ratings, Off-Balance Sheet Accounting Changes: SFAS 166 and SFAS 167 (June 22, 2009).

<sup>69</sup> Letter from Office of the Chief Accountant, Securities and Exchange Commission, to Arnold Hanish & Sam Ranzilla (Jan. 8, 2008) [hereinafter Office of the Chief Accountant Letter], available at <http://www.sec.gov/info/accountants/staffletters/hanish010808.pdf>; Letter from Christopher Cox, Chairman, Securities and Exchange Commission, to Barney Frank, Chairman of House Financial Services Committee (July 24, 2007), available at [http://www.house.gov/apps/list/press/financialsvcs\\_dem/press072507.shtml](http://www.house.gov/apps/list/press/financialsvcs_dem/press072507.shtml).

<sup>70</sup> See Mortgage Banker's Ass'n, *supra* note 65.

<sup>71</sup> Office of the Chief Accountant Letter, *supra* note 69.

<sup>72</sup> American Securitization Forum, Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans (updated July 8, 2008), available at <http://www.americansecuritization.com/uploadedFiles/ASFStreamlinedFramework7.8.08.pdf>.

<sup>73</sup> See Mortgage Banker's Ass'n, *supra* note 65, at 5 n.13 (noting that the accounting standards for default are consistent with the REMIC definition).

<sup>74</sup> This restriction on modification builds on the American Securitization Forum's definition of "reasonably foreseeable." Ryan, *supra* note 67.

<sup>75</sup> Adelino et al., *supra* note 21, at 4.

<sup>76</sup> This discussion focuses on the rules governing loss recognition after a modification. We do not here consider the accounting rules requiring that the value of loans and other assets be reflected at market value, or the mark-to-market rules. Such rules and their implications are beyond the scope of this piece.

<sup>77</sup> Fin. Accounting Standards Bd., Accounting by Debtors and Creditors for Troubled Debt Restructurings, Statement of Fin. Accounting Standards No. 15 (1977).

<sup>78</sup> See American Securitization Forum, Discussion Paper, *supra* note 8, at 3–6.

<sup>79</sup> See *infra*, text accompanying notes 134–137, for a discussion of how servicer's incentives to perform loan modifications are influenced by a common type of junior interest, residuals.

<sup>80</sup> Generally and simplistically speaking, in an over-collateralization structure, each class receives a predetermined amount of interest in a specified waterfall, followed by a predetermined amount of principal payments. The most junior levels, often held by the servicer, can retain any interest left over after the first round of interest payments are made. In prime securitizations, in general, the distribution is based on predetermined percentage shares of the cash flow, and so even senior tranches may see their income fluctuate depending on the income from the pool. See American Securitization Forum, Discussion Paper, *supra* note 8, at 4–7.

<sup>81</sup> The junior tranches in most subprime securitizations are currently cut off from receiving any principal payments, due to the accumulated losses in the pool as a whole. For prime securitizations, where the distribution is based on cash flow and is not predetermined, subordinate and senior tranches may share equally in the reduction of principal payments, although subordinate tranches will continue to take the first hit on interest losses. See American Securitization Forum, Discussion Paper, *supra* note 8, at 3–6.

<sup>82</sup> See, e.g., Investor Committee of the American Securitization Forum, *supra* note 26, at 2; Monica Perelmuter & Jeremy Schneider, Standard & Poor's, Criteria: Structured Finance: RMBS: Methodology for Loan Modifications That Include Forbearance Plans for U.S. RMBS 2 (July 23, 2009).

<sup>83</sup> Fin. Accounting Standards Bd., *supra* note 77, at § 2.

<sup>84</sup> Fin. Accounting Standards Bd., Accounting by Creditors for Impairment of Loans, An Amendment of FASB Statement No. 5 and 15, Statement of Fin. Accounting Standards No. 114 (1993). These accounting rules require an immediate recognition of loss and a cessation of interest payments in favor of principal payments. Adelino et al., *supra* note 21, at 23–24.

<sup>85</sup> FASB has recently altered the rules protecting the bankruptcy-remote status of the trust. Instead of qualifying as a Special Purpose Entity, all "variable interest entities" now must be reviewed to determine the extent to which the transferring entity maintains control and appropriate disclosures provided. This is unlikely to impact the weight of the TDR rules directly, but it does change the formal mechanism by which bankruptcy-remote status is achieved and evaluated. See Transfers of Financial Assets, An Amendment to FASB Statement No. 140, Statement of Fin. Accounting Standards No. 166 (2009).

<sup>86</sup> Fin. Accounting Standards Bd., *supra* note 77, at § 7.

<sup>87</sup> Adelino et al., *supra* note 21, at 23–24.

<sup>88</sup> In reality, of course, the interest is likely to change month-to-month, and the servicer would be eyeing a bottom line of the combined expected interest on all the loans in the pool.

<sup>89</sup> This assumes that the servicer is required to make advances on the principal and interest payments. Advances are

discussed in detail below in text accompanying footnotes 150–162.

<sup>90</sup> Assuming that the servicer holds a surplus interest in income strip and ignoring the cost of financing the advances.

<sup>91</sup> Investor Committee of the American Securitization Forum, *supra* note 26, at 3 (investor committee of ASF citing potential rating agency downgrades as proof of the “intent and expectations of parties to the securitization.”).

<sup>92</sup> See, e.g., American Securitization Forum, Statement of Principles, Recommendations, and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans 3 (June 2007) (reporting that limits contained in the PSA on loan modifications may usually be waived either by bond insurers or credit rating agencies; only in rare cases is investor consent required to waive the cap and in no case is investor consent required to approve an individual loan modification otherwise permitted by the PSA).

<sup>93</sup> See, e.g., Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 Housing Pol’y Debate 753, 763–66 (2004) (chronicling the involvement of the ratings agencies in the reform of servicing practices at Fairbanks Capital Corporation).

<sup>94</sup> Diane Pendley, Kathleen Tillwitz, Karen Eissner, Thomas Crowe, Stephanie Whited, Fitch Ratings, Rating U.S. Residential Mortgage Servicers 2–3 (2006); cf. Mason, *Servicer Reporting Can Do More*, *supra* note 17, at 25–26 (pools serviced by higher-rated servicers require less credit enhancement).

<sup>95</sup> After an investigation by the Federal Trade Commission into the servicing practices of Fairbanks Capital Corp. (currently known as Select Portfolio Servicing), Moody’s Investors Service and Standard & Poor’s Corp. downgraded Fairbank’s servicer rating to “below average,” making it impossible for the servicer to bid on new contracts. Fairbanks was later able to resume bidding for new business when its servicer rating was changed to “average.” See *Fairbanks CEO Eager to Reenter Servicing Market*, Am. Banker, May 14, 2004.

<sup>96</sup> Moody’s Investor Service, *supra* note 33 (stating that it will not downgrade ratings on several pools with increased limits on the number of modifications since Moody’s believes “that the judicious use of loan modifications can be beneficial to securitization trusts as a whole.”).

<sup>97</sup> Pendley, et al., *supra* note 94, at 8.

<sup>98</sup> *Id.* at 11, 15; see also Michael Gutierrez, Michael S. Merriam, Richard Koch, Mark I. Goldberg, Standard & Poors, *Structured Finance: Servicer Evaluations* 15–16 (2004).

<sup>99</sup> Pendley, et al., *supra* note 94, at 9.

<sup>100</sup> See Katherine Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 Tex. L. Rev. 121 (2008) (reporting that servicers appear to be imposing often improper default-related fees on borrowers in bankruptcy proceedings).

<sup>101</sup> Pendley, et al., *supra* note 94, at 11–12.

<sup>102</sup> Advances are discussed in detail below in text accompanying footnotes 150–162.

<sup>103</sup> Perelmuter et al., *supra* note 34, at 3.

<sup>104</sup> See, e.g., Perelmuter et al., *supra* note 34.

<sup>105</sup> See text accompanying footnotes 134–137, *infra* (discussing residual interests).

<sup>106</sup> Laidlaw, et al., *supra* note 37, at 2 (bond insurers may be involved in oversight of the servicer), at 3 (bond insurers must be notified in the event of servicer default or termination), at 5 (bond insurer can initiate servicer termination).

<sup>107</sup> See, e.g., Prospectus Supplement, IndyMac, et al., *supra* note 11, at S-113 (authorizing the bond insurers to enforce the PSA and to waive limitations on modifications contained in the PSA).

<sup>108</sup> See American Securitization Forum, Discussion Paper, *supra* note 8, at 1.

<sup>109</sup> Dubitsky, et al., *supra* note 47, at 8.

<sup>110</sup> See generally *In re Stewart*, 391 B.R. 327, 336 (Bankr. E.D. La. 2008) (overviewing servicer compensation), *aff’d*, 2009 WL 2448054 (E.D. La. Aug. 7, 2009).

<sup>111</sup> See, e.g., Prospectus, CWALT, INC., Depositor, Countrywide Home Loans, Seller, Countrywide Home Loans Servicing L.P., Master Servicer, Alternative Loan Trust 2005-J12, Issuer 56 (Oct. 25, 2005) (“In addition, generally the master servicer or a sub-servicer will retain all prepayment charges, assumption fees and late payment charges, to the extent collected from mortgagors). *But see* Prospectus Supplement, IndyMac, et al., *supra* note 11, at S-11 (late payment fees are payable to a certificate holder in the securitization).

<sup>112</sup> See, e.g., Prospectus Supplement, IndyMac, et al., *supra* note 11, at S-73:

#### Default Management Services

In connection with the servicing of defaulted Mortgage Loans, the Servicer may perform certain default management and other similar services (including, but not limited to, appraisal services) and may act as a broker in the sale of mortgaged properties related to those Mortgage Loans. The Servicer will be entitled to reasonable compensation for providing those services, in addition to the servicing compensation described in this prospectus supplement.

<sup>113</sup> See *In re Stewart*, 391 B.R. 327, 343, n.34 (Bankr. E.D. La. 2008) (“While a \$15.00 inspection charge might be minor in an individual case, if the 7.7 million home mortgage loans Wells Fargo services are inspected just once per year, the revenue generated will exceed \$115,000,000.00.”), *aff’d*, 2009 WL 2448054 (E.D. La. Aug. 7, 2009).

<sup>114</sup> Goodman, *Lucrative Fees*, *supra* note 15.

<sup>115</sup> See, e.g., Ocwen Fin. Corp., *supra* note 16, at 34 (revenue from late charges reported as \$46 million in 2008); Eggert, *supra* note 93, at 758; Gretchen Morgenson, *Dubious Fees Hit Borrowers in Foreclosures*, N.Y. Times, Nov. 6, 2007 (reporting that Countrywide received \$285 million in revenue from late fees in 2006).

<sup>116</sup> Ocwen Fin. Corp., *supra* note 16, at 34.

<sup>117</sup> See Porter, *supra* note 100. Under the Department of the Treasury’s Home Affordable Modification Program, servicers are required to waive unpaid late fees for eligible borrowers, but all other foreclosure related fees, including, presumably, paid late fees, remain recoverable and are capitalized as part of the new principal amount of the modified loan. See Home Affordable Modification Program, Supplemental Directive 09–01 (Apr. 6, 2009).

<sup>118</sup> See, e.g., Prospectus Supplement, Chase Funding Loan Ac-



quisition Trust, Mortgage Loan Asset-Backed Certificates, Series 2004-AQ1, at 34, (June 24, 2004), *available at* <http://www.sec.gov/Archives/edgar/data/825309/000095011604003012/four24b5.txt> (“[T]he Servicer will be entitled to deduct from related liquidation proceeds all expenses reasonably incurred in attempting to recover amounts due on defaulted loans and not yet repaid, including payments to senior lienholders, legal fees and costs of legal action, real estate taxes and maintenance and preservation expenses.”).

<sup>119</sup> Adelino et al., *supra* note 21, at 6 (“In addition, the rules by which servicers are reimbursed for expenses may provide a perverse incentive to foreclose rather than modify.”).

<sup>120</sup> Goodman, *Lucrative Fees*, *supra* note 15 (“So the longer borrowers remain delinquent, the greater the opportunities for these mortgage companies to extract revenue—fees for insurance, appraisals, title searches and legal services.”).

<sup>121</sup> See *In re Stewart*, 391 B.R. 327, 346 (Bankr. E.D. La. 2008), *aff’d*, 2009 WL 2448054 (E.D. La. Aug. 7, 2009).

<sup>122</sup> See Peter S. Goodman, *Homeowners and Investors May Lose, But the Bank Wins*, N.Y. Times, July 30, 2009 [hereinafter Goodman, *Homeowners and Investors May Lose*]; Goodman, *Lucrative Fees*, *supra* note 15.

<sup>123</sup> See Goodman, *Homeowners and Investors May Lose*, *supra* note 122 (describing Bank of America’s refusal to entertain three separate short sale offers during two years of non-payment while its affiliate continues to assess property inspection fees).

<sup>124</sup> See, e.g., Prospectus Supplement, IndyMac, et al., *supra* note 11, at S-73 (noting that the servicer is entitled to retain the costs of managing the REO property, including the sale of the REO property).

<sup>125</sup> See Freddie Mac Bulletin, *supra* note 54 (\$800 for loan modifications and \$2200 for short sales); Fannie Mae, *supra* note 54 (\$700 for loan modifications and \$1000 to \$1500 for short sales).

<sup>126</sup> In 2006, one of the nation’s largest subprime servicers reported an additional \$48 million in revenue from float income which made up 15% of its servicing income. Due to a decline in both the average float balance and yield, Ocwen’s float income went down to \$29 million in 2007 and \$11 million in 2008. See Ocwen Fin. Corp., *supra* note 16, at 34; Eggert, *supra* note 93, at 761; *Follow the Money: How Servicers Get Paid*, 26 NCLC REPORTS *Bankruptcy and Foreclosures* Ed. 27 (2008).

<sup>127</sup> Ocwen Fin. Corp., Annual Report (Form 10-K), at 7 (Mar. 17, 2008).

<sup>128</sup> See, e.g., Prospectus Supplement, Deutsche Alt-A Securities Mortgage Loan Trust, Series 2006-AR6, Issuing Entity, DB Structured Products, Inc., Sponsor, Deutsche Alt-A Securities, Inc., Depositor, Wells Fargo Bank, N.A., Securities Administrator and Master Servicer (Dec. 14, 2006) (servicer must remit as compensating interest any interest shortfall on loans prepaid in the first 16 days of the month).

<sup>129</sup> See, e.g., Ocwen Fin. Corp., *supra* note 127, at 3 (typically receive 50 basis points annually on the total outstanding principal balance of the pool).

<sup>130</sup> See, e.g., Prospectus Supplement, IndyMac, et al., *supra* note 11, at 71.

<sup>131</sup> Anthony Pennington-Cross & Giang Ho, Fed. Res. Bank

of St. Louis, Loan Servicer Heterogeneity & The Termination of Subprime Mortgages 2 (Working Paper No. 2006-024A); *Follow the Money: How Servicers Get Paid*, 26 NCLC REPORTS *Bankruptcy and Foreclosures* Ed. 27 (2008); Cordell, et al., *supra* note 25, at 16.

<sup>132</sup> See, e.g., Investor Committee of the American Securitization Forum, *supra* note 26, at 2; Perelmuter, et al., *supra* note 82, at 2.

<sup>133</sup> See American Securitization Forum, Discussion Paper, *supra* note 8, at 8–9.

<sup>134</sup> See, e.g., Ocwen Fin. Corp., *supra* note 127, at 20; Joseph R. Mason, Mortgage Loan Modification: Promises and Pitfalls 8 (Oct. 2007) (servicers who own residual interests always lose money when loans are modified). In some cases, the servicer may even bet against itself, by purchasing a credit default swap on the pool, in which case it makes money if there is a foreclosure. See Patricia A. McCoy & Elizabeth Renuart, The Legal Infrastructure of Subprime and Nontraditional Home Mortgages 36 (2008), *available at* [http://www.jchs.harvard.edu/publications/finance/understanding\\_consumer\\_credit](http://www.jchs.harvard.edu/publications/finance/understanding_consumer_credit).

<sup>135</sup> Perelmuter, et al., *supra* note 82, at 2.

<sup>136</sup> Kurt Eggert, Comment on Michael A. Stegman et al.’s “Preventive Servicing Is Good for Business and Affordable Homeownership Policy”: What Prevents Loan Modifications, 18 Housing Pol’y Debate 279, 282 (2007); Mason, *supra* note 134, at 14 (servicers in a first-loss position delay instituting and completing foreclosures compared to servicers in a junior loss position); Mason, Servicer Reporting Can Do More, *supra* note 17, at 45 (servicers who hold residuals or interest only strips resist making loan modifications).

<sup>137</sup> Dubitsky, et al., *supra* note 47, at 7–8.

<sup>138</sup> See, e.g., Ocwen Fin. Corp., *supra* note 127, at 22.

<sup>139</sup> See, e.g., *id.* at 7–8.

<sup>140</sup> Mason, *supra* note 134, at 4.

<sup>141</sup> Cf. Mason, Servicer Reporting Can Do More, *supra* note 17, at 6–12 (noting that it is “generally recognized” that good servicing cannot improve the quality of a loan pool and may in fact only mask problems in valuation and analyzing three case studies of failed servicers); Eggert, *supra* note 93, at 769 (“Servicer’s reputation among borrowers does not, therefore, directly affect the ability to obtain new contracts or retain existing ones.”).

<sup>142</sup> David Moline, *Servicing Gets a Tune Up: FASB Amends Guidance on Servicing of Financial Assets*, Deloitte Heads Up (Mar. 20, 2006).

<sup>143</sup> Cf. Marina Walsh, *Servicing Performance in 2007*, Mortgage Banking 75 (Sept. 2008) (noting that “[m]anaging the MSR asset was a significant challenge for the high-default servicers” in 2007).

<sup>144</sup> Perelmuter, et al., *supra* note 82, at 2. See text accompanying footnotes 104–105, *supra*.

<sup>145</sup> Mason, *supra* note 134, at 13–14.

<sup>146</sup> Ocwen Fin. Corp., *supra* note 16, at 30.

<sup>147</sup> Walsh, *supra* note 143, at 71.

<sup>148</sup> See Mason, Servicer Reporting Can Do More, *supra* note 17, at 8–12 (reviewing case studies of several failed servicers).

<sup>149</sup> Vikas Bajaj & John Leland, *Modifying Mortgages Can Be Tricky*, N.Y. Times, Feb. 18, 2009 (reporting views of Credit

Suisse analyst that “[s]maller companies . . . that are under more financial pressure and have more experience in dealing with higher-cost loans have been most aggressive in lowering payments” than larger companies, who offer weaker modifications).

<sup>150</sup> Cordell, et al., *supra* note 25, at 16.

<sup>151</sup> See, e.g., Ocwen Fin. Corp., *supra* note 127, at 4 (advances include principal payments); Brendan J. Keane, Moody’s Investor Services, Structural Nuances in Residential MBS Transactions: Advances 4 (June 10, 1994) (stating that Countrywide was in some circumstances only advancing interest, not principal).

<sup>152</sup> Brian Rosenlund, Metropolitan West Asset Management RMBS Research 3 (Winter 2009).

<sup>153</sup> *Id.*

<sup>154</sup> Keane, *supra* note 151, at 3.

<sup>155</sup> See, e.g., Prospectus Supplement, IndyMac, et al., *supra* note 11, at 71.

<sup>156</sup> Rosenlund, *supra* note 152.

<sup>157</sup> Mary Kelsch, Stephanie Whited, Karen Eissner, Vincent Arscott, Fitch Ratings, Impact of Financial Condition on U.S. Residential Mortgage Servicer Ratings 2 (2007).

<sup>158</sup> See Complaint at 11–15, *Carrington Asset Holding*, *supra* note 41 (alleging that servicer conducted “fire sales” of homes in order to avoid its obligation to make advances and to speed its recovery of advances already made).

<sup>159</sup> Early accounting treatment of principal reductions may have given some servicers an incentive to do principal reductions over rate reductions. Most PSAs do not specify the treatment of losses from principal reduction. As a result, some trustees ascribed the entire amount of losses due to principal reductions against servicers’ interest advance requirements. Industry practice has now moved to treating principal reductions as a “realized loss,” as are rate reductions. Realized losses are allocated to each tranche as proscribed in the securitization documents, but usually in ascending order, from the most junior interests on up. See Dubitsky, et al., *supra* note 47, at 7–8.

<sup>160</sup> American Securitization Forum, Discussion Paper, *supra* note 8, at 1.

<sup>161</sup> See, e.g., Perelmuter et al., *supra* note 34, at 3.

<sup>162</sup> Ocwen Fin. Corp., *supra* note 16, at 5.

<sup>163</sup> Cordell, et al., *supra* note 25, at 17; cf. American Securitization Forum, Operational Guidelines for Reimbursement of Counseling Expenses in Residential Mortgage-Backed Securitizations (May 20, 2008), available at [http://www.americansecuritization.com/uploadedFiles/ASF\\_Counseling\\_Funding\\_Guidelines%20\\_5%20\\_20\\_08.pdf](http://www.americansecuritization.com/uploadedFiles/ASF_Counseling_Funding_Guidelines%20_5%20_20_08.pdf) (stating that payments of \$150 for housing counseling for borrowers in default or at imminent risk of default should be treated as servicing advances and recoverable from the general securitization proceeds).

<sup>164</sup> See, e.g., Ocwen Fin. Corp., *supra* note 127, at 4.

<sup>165</sup> Cordell, et al., *supra* note 25, at 11; Ocwen Fin. Corp., *supra* note 127, at 4 (advances are “top of the waterfall” and get paid first); Wen Hsu, Christine Yan, Roelof Slump, FitchRatings, U.S. Residential Mortgage Servicer Advance

Receivables Securitization Rating Criteria 1 (Sep. 10, 2009) (same).

<sup>166</sup> Prospectus, CWALT, INC., et al., *supra* note 111, at 47 (limiting right of reimbursement from trust account to amounts received representing late recoveries of the payments for which the advances were made).

<sup>167</sup> Walsh, *supra* note 143, at 72.

<sup>168</sup> Servicers under HAMP are not permitted to require an up-front payment of fee advances to obtain a loan modification, though they will be capitalized and paid by the borrower as part of the modified principal loan amount. See Home Affordable Modification Program, Supplemental Directive 09-01, at 6, 9, available at <https://www.hmpadmin.com/portal/programs/directives.html>.

<sup>169</sup> See, e.g., Prospectus Supplement, IndyMac, et al., *supra* note 11, at 71.

<sup>170</sup> The subprime servicer *Ocwen* stated in its annual report that its increase in late charges for 2008 “reflects higher delinquencies and collections of previously assessed late charges primarily on loans that have returned to performing status. The increase in late charges lags the increase in delinquencies because late charges are not earned and therefore not recognized as revenue until they are collected.” Ocwen Fin. Corp., *supra* note 16, at 34.

<sup>171</sup> See Complaint at 11–15, *Carrington Asset Holding*, *supra* note 41 (alleging that servicer conducted “fire sales” of foreclosed properties in order to avoid future advances and recover previously made advances); Goodman, *Lucrative Fees*, *supra* note 15.

<sup>172</sup> Mason, *supra* note 134, at 4. A large subprime servicer noted in its 2007 annual report that although “the collectibility of advances generally is not an issue, we do incur significant costs to finance those advances. We utilize both securitization, (i.e., match funded liabilities) and revolving credit facilities to finance our advances. As a result, increased delinquencies result in increased interest expense.” Ocwen Fin. Corp., *supra* note 127, at 18; see also Wen Hsu, *supra* note 165 (“Servicer advance receivables are typically paid at the top of the cash flow waterfall, and therefore, recovery is fairly certain. However, . . . there is risk in these transactions relating to the timing of the ultimate collection of recoveries.”).

<sup>173</sup> Tomasz Piskorski, Amit Seru & Vikrant Vig, Securitization and Distressed Loan Renegotiation: Evidence from the Subprime Mortgage Crisis 5 (Dec. 2008), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1321646](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1321646) (finding increased numbers of modifications when the foreclosure process is delayed); see also Eggert, *supra* note 93, at 757 (reporting that servicers sometimes rush through a foreclosure without pursuing a modification or improperly foreclose in order to collect advances).

<sup>174</sup> Cf. Hsu, et al., *supra* note 165, at 4 (finding that modifications do not appear to accelerate the rate of recovery of advances, in part because of high rates of redefault).

<sup>175</sup> Rosenlund, *supra* note 152, at 1.

<sup>176</sup> See, e.g., Ocwen Fin. Corp., *supra* note 127, at 7–8.

<sup>177</sup> Posting of Alan White to Consumer Law & Policy Blog,

<http://pubcit.typepad.com/clpblog> (Nov. 17, 2008, 10:15 CST).

<sup>178</sup> Perelmuter et al., *supra* note 34, at 3.

<sup>179</sup> Wen Hsu, *supra* note 165, at 4.

<sup>180</sup> See, e.g., Ocwen Fin. Corp., *supra* note 16, at 4–5, 12.

<sup>181</sup> Piskorski, et al., *supra* note 173, at 2 n.2; see also Mason, *supra* note 134, at 7 (citing a range of \$500–\$600 to complete a modification); cf. American Securitization Forum, *supra* note 163 (stating that payments of \$150 for housing counseling for borrowers in default or at imminent risk of default should be treated as servicing advances and recoverable from the general securitization proceeds).

<sup>182</sup> National Consumer Law Center, Foreclosures §§ 2.6, 2.7 (2d ed. 2007 and Supp. 2008) (reviewing GSE modification options) (reviewing HUD, VA, and RHS modification options); Cordell, et al., *supra* note 25, at 20.

<sup>183</sup> Cordell, et al., *supra* note 25, at 10, 17 (reporting that servicers of private label securitizations do not get paid for contacts with delinquent borrowers, unlike servicers for Fannie Mae or Freddie Mac loans).

<sup>184</sup> See *id.* at 20 (reporting that Freddie historically “paid fees of \$250 for a repayment plan, \$400 for a modification, \$275 for a deed in lieu of foreclosure, and \$1,100 for a short sale”; most of these numbers were doubled in July 2008).

<sup>185</sup> See Freddie Mac Bulletin, *supra* note 54 (for loan modifications, increase from \$400 to \$800; for repayment plans, increase from \$250 to \$500; for short sales, increase from \$1100 to \$2200; for deed-in-lieu, to remain at current level of \$275); Fannie Mae, Announcement 08–20, August 11, 2008 (for loan modifications, \$700; for repayment plans, \$400; for short sales, range from \$1000 to \$1500; for deed-in-lieu, \$1000, plus up to \$350 in expenses). The Fannie Mae Announcement 08–20 also provides that servicers may no longer charge the borrower \$500 to cover administrative costs incurred in connection with a modification, though certain out-of-pocket expenses such as credit reports and title searches may continue to be charged to the borrower.

<sup>186</sup> *Preserving Homeownership: Progress Needed to Prevent Foreclosures: Hearing Before the Senate Comm. on Banking, Housing & Urban Affairs*, 111th Cong. (July 16, 2009), at 25 (testimony of Diane E. Thompson).

<sup>187</sup> Cordell, et al., *supra* note 25, at 30–31.

<sup>188</sup> Morgenson, *supra* note 21; California Reinvestment Coalition, *The Ongoing Chasm Between Words and Deeds: Abusive Practices Continue to Harm Families and Communities in California* (2009) (reporting observations by housing counselors that loan modifications declined in the second quarter); cf. Nocera, *supra* note 5 (reporting that many servicers find the incentives “meaningless”).

<sup>189</sup> See generally National Consumer Law Center, Foreclosures §§ 3.2.2, 6.4.5 (2d ed. 2007 and Supp.).

<sup>190</sup> See generally National Consumer Law Center, Foreclosures § 2.7.3 (2d ed. 2007 and Supp.).

<sup>191</sup> Michael A. Stegman, Roberto G. Quercia, Janneke Ratcliffe, Lei Ding, & Walter R. Davis, *Preventive Servicing Is Good for Business and Affordable Homeownership Policy*, 18 Housing Pol’y Debate 243, 270–273 (2007) (reporting on the staff levels of 8 servicers; servicers universally employed more collectors

per loan than loss mitigators; the ratio between collectors and loss mitigators ranged from a low of 1.25 to a high of 25; the ratio of loss mitigators to loans ranged from one per 20,000 loans to one per 100,000 loans). If we assume a default rate of 10%, a conservative estimate for today’s subprime loans, the best case scenario would be one loss mitigation specialist for every two thousand loans in default.

<sup>192</sup> Cordell, et al., *supra* note 25, at 16; Ocwen Fin. Corp., *supra* note 127, at 19.

<sup>193</sup> Cordell, et al., *supra* note 25, at 15.

<sup>194</sup> Dubitsky, et al., *supra* note 47, at 5 (listing staff increases at several large subprime servicers from 2007 to 2008; servicers had year-to-year increases ranging from 20% to 100%); Peter S. Goodman, *Paper Avalanche Buries Plan to Stem Foreclosures*, N.Y. Times, June 29, 2009 (reporting that J. P. Morgan Chase added 950 “counselors” in the first six months of 2009, bringing the total to 3500).

<sup>195</sup> Goodman, *supra* note 194 (quoting Michael Barr, Asst. Sec’y of the Treasury for Fin. Institutions, “They need to do a much better job on the basic management and operational side of their firms.”); Cordell, et al., *supra* note 25, at 9–10; State Foreclosure Prevention Working Group, *Analysis of Subprime Mortgage Servicing Performance*, Data Report No. 3 at 8 (2008), available at <http://www.csbs.org/Content/NavigationMenu/Home/SFPWGReport3.pdf>; Preston DuFauchard, California Department of Corporations, *Loss Mitigation Survey Results 4* (Dec. 11, 2007); cf. Aashish Marfatia, Moody’s, U.S. Subprime Market Update November 2007, at 3 (2008) (expressing concern as to servicers’ abilities to meet staffing needs).

<sup>196</sup> Mason, *supra* note 134, at 2.

<sup>197</sup> Mortgage Banker’s Ass’n, *National Delinquency Survey Q3 2008*, (foreclosure inventory increased from 0.79% to 1.58% of outstanding loans third-quarter 2007 to third quarter 2008).

<sup>198</sup> Walsh, *supra* note 143, at 73 (subprime servicers report that the ratio of staff to foreclosure fell during 2007; reporting a servicer as saying, “We simply could not hire default and loss mitigation staff fast enough.”).

<sup>199</sup> Kelsch, et al., *supra* note 157, at 3; see also Eggert, *supra* note 93, at 768–69 (arguing that servicers can increase their profitability by cutting staff both because they save direct expenses on staff and because understaffing is more likely to lead to ancillary fees, such as late fees, that servicers may retain).

<sup>200</sup> Bajaj, et al., *supra* note 149 (reporting views of Credit Suisse analyst that “[s]maller companies . . . that are under more financial pressure and have more experience in dealing with higher-cost loans have been most aggressive in lowering payments” and bigger companies “need to be retooled to emphasize modifications over foreclosures”).

<sup>201</sup> Jack Guttentag, *New Plan to Jump-Start Loan Mods: Web Portal Would Centralize Communication, Break Logjam*, Inman News, July 20, 2009, available at <http://www.inman.com/buyers-sellers/columnists/jackguttentag/new-plan-jump-start-loan-mods> (noting that it should take no more than an hour for a servicer to process a loan modification request; at that rate, Chase’s 3500 loan modification counselors should be



able to process at least 70,000 loan modifications a week—approximately the number of Making Home Affordable modifications that Chase has processed in the first five months of the program).

<sup>202</sup> Cordell, et al., *supra* note 25, at 15–16; Diane Pendley & Thomas Crowe, FitchRatings, U.S. RMBS Servicers' Loss Mitigation and Modification Efforts 9 (May 26, 2009).

<sup>203</sup> Stegman, et al., *supra* note 191, at 271 (only two of eight servicers surveyed provided bonuses for staff successfully completing workout agreements with borrowers).

<sup>204</sup> Guttierrez, et al., *supra* note 98, at 6 (average turnover for all positions for residential mortgage servicers ranges from 15% to 25% over a six month period).

<sup>205</sup> Eggert, *supra* note 136, at 286; Guttentag, *supra* note 202.

<sup>206</sup> Walsh, *supra* note 143, at 73.

<sup>207</sup> Eggert, *supra* note 136, at 285 (“Ironically, servicers may be demanding far more documentation to modify a loan than the originator did to make it in the first place.”).

<sup>208</sup> Nocera, *supra* note 5.

<sup>209</sup> Eggert, *supra* note 136, at 285; cf. John Collins Rudolf, *Judges' Frustration Grows with Mortgage Servicers*, N.Y. Times, Sept. 4, 2009, at B1 (reporting Wells Fargo's admission in one bankruptcy case that it had failed to inform the homeowner of the information she needed to submit, even though it denied her application on the basis of the missing information, despite her repeated submissions of what the homeowner believed was a complete packet; judge in case described it as “certainly not an isolated case”).

<sup>210</sup> Guttierrez, et al., *supra* note 98, at 6.

<sup>211</sup> See State Foreclosure Prevention Working Group, *supra* note 195, at 8 (reporting that 23% of closed loss mitigation efforts in May 2008 were either refinancings or reinstatements in full by the borrower without any contact from the servicer); Goodman, *Lucrative Fees*, *supra* note 15 (reporting that a former Countrywide employee characterized the banks' strategy as waiting to see if the economy improved and borrowers cured on their own instead of performing modifications). For a general discussion of the value to a servicer of the possibility of the homeowner's independent cure of a default, see Adelino et al., *supra* note 21.

<sup>212</sup> Cf. Piskorski, et al., *supra* note 173, at 18 (finding that foreclosure rate for loans held in portfolio remains roughly constant, irregardless of housing price declines, but the foreclosure rate for securitized loans with servicers increases by over 60% when housing price declines, suggesting that servicers of securitized loans rely heavily on refinancing as a loan modification option).

<sup>213</sup> Dubitsky, et al., *supra* note 47, at 7–8; Mason, *Servicer Reporting Can Do More*, *supra* note 17, at 57.

<sup>214</sup> White, *supra* note 19, at 17–18; see also Marfatia, *supra* note 195, at 5 (reporting that half of all active loans facing reset in the first three-quarters of 2007 refinanced; more than one-quarter of all remaining loans refinanced after reset); State Foreclosure Prevention Working Group, *supra* note 195, at 8 (reporting that 23% of closed loss mitigation efforts in May 2008 were either refinancings or reinstatements in full by the borrower).

<sup>215</sup> *Fitch: Delinquency Cure Rates Worsening for U.S. Prime RMBS*, BusinessWire, Aug. 24 2009, <http://www.businesswire.com/news/home/20090824005549/en> (reporting that cure rates are now at historical lows for both prime, at 6.6%, and sub-prime, at 5.3%).

<sup>216</sup> See, e.g., Ocwen Fin. Corp., *supra* note 16, at 11 (“[I]n the majority of cases, advances in excess of loan proceeds may be recovered from pool level proceeds.”).

<sup>217</sup> See Adelino et al., *supra* note 21, at 6 (“In addition, the rules by which servicers are reimbursed for expenses may provide a perverse incentive to foreclose rather than modify.”).

<sup>218</sup> Goodman, *Lucrative Fees*, *supra* note 15.

<sup>219</sup> See Goodman, *Lucrative Fees*, *supra* note 15 (describing such optimism and consequent delay by one servicer).

<sup>220</sup> Affiliated servicers holding junior liens may be particularly reluctant to agree to a short sale, since the junior lien must usually be wiped out by a short sale. The junior lien could be erased in a foreclosure, as well, but in that circumstance the servicer would have at least the possibility of a deficiency judgment against the borrower. Additionally, if the foreclosure is delayed, an optimistic servicer may believe that the housing market will recover sufficiently to cover both the first lien and some of the second lien.

<sup>221</sup> See *Helping Families Save Their Homes: Hearing*, *supra* note 9 (“One thing that I think is not well understood is that because of the complex structure of these securitized mortgages that are at the root of the financial calamity the nation finds itself in, voluntary programs to readjust mortgages may simply be doomed to failure.”).

<sup>222</sup> See National Consumer Law Center, *Foreclosures* Ch. 6 (2d ed. 2007 and Supp.) (describing the most common mortgage servicing abuses).

<sup>223</sup> Comments of National Consumer Law Center and National Association of Consumer Advocates to the Federal Trade Commission on Advance Notice of Proposed Rulemaking, 16 C.F.R. Parts 317 and 318: *Mortgage Acts and Practices Rulemaking* (Aug. 4, 2009), available at [http://www.consumerlaw.org/issues/predatory\\_mortgage/content/FTCMortgageCommentsAug09.pdf](http://www.consumerlaw.org/issues/predatory_mortgage/content/FTCMortgageCommentsAug09.pdf).

<sup>224</sup> Bernanke, Speech at Federal Reserve, *supra* note 1.

<sup>225</sup> For some descriptions of all too typical bureaucratic bungling by servicers, see Goodman, *supra* note 194 and Guttentag, *supra* note 201.

<sup>226</sup> *Preserving Homeownership: Progress Needed to Prevent Foreclosures: Hearing Before the Senate Comm. on Banking, Housing & Urban Affairs*, 111th Cong., at 4–5 (July 16, 2009) (testimony of Paul Willen).

<sup>227</sup> This is especially so since the HAMP modification program does not permit a second HAMP modification for any reason, even if there is a subsequent, unavoidable drop in income. See *Making Home Affordable, Supplemental Documentation-Frequently Asked Questions-Home Affordable Modification Program*, Q. 80 (Aug. 19, 2009), available at [hmpadmin.com](http://hmpadmin.com).

<sup>228</sup> Roberto G. Quercia, Lei Ding, Janneke Ratcliffe, Center for Community Capital, *Loan Modifications and Redefault Risk: An Examination of Short-Term Impact* (Mar. 2009), available at [http://www.ccc.unc.edu/documents/LM\\_March3](http://www.ccc.unc.edu/documents/LM_March3)

\_%202009\_final.pdf; Diane Pendley, et al., *supra* note 202, at 2, 10–11 (modifications with principal reductions greater than 20% perform better than any other category of modifications, but few modifications with principal reductions done and redefault rates, even for loans with a 20% principal reduction, remain at 30%–40% after 12 months).

<sup>229</sup> See Bernanke, Speech at Federal Reserve, *supra* note 1 (“[P]rincipal write-downs may need to be part of the toolkit that servicers use to achieve sustainable mortgage modifications.”).

<sup>230</sup> See Renae Merle & Dina ElBoghdady, *Administration Fills in Mortgage Rescue Details*, Wash. Post, Mar. 5, 2009 (reporting that one in five homeowners with a mortgage owe more on their mortgages than their home is worth).

<sup>231</sup> Second liens can be modified if they are, as many are in the current market, completely unsecured because the amount of the first lien equals or exceeds the market value of the property.

<sup>232</sup> Nocera, *supra* note 5.

<sup>233</sup> See <http://www.fdic.gov/consumers/loans/loanmod/loanmodguide.html> (the FDIC web site containing all the information on its loan modification program); *A Review of*

*Foreclosure Mitigation Efforts Before the H. Comm. on Fin. Servs.*, 110th Cong. (2008) (statement of Sheila Bair, Chairman, FDIC) (discussing the importance of streamlined modifications in addressing the foreclosure crisis); see also Pendley, et al., *supra* note 227, at 9 (discussing the benefits of streamlined modification programs generally).

<sup>234</sup> See, e.g., Guttentag, *supra* note 201.

<sup>235</sup> *Preserving Homeownership: Progress Needed to Prevent Foreclosures: Hearing Before the Senate Comm. on Banking, Housing & Urban Affairs*, 111th Cong. (July 16, 2009) (testimony of Mary Coffin) (Wells Fargo experiences delays and difficulties in contacting borrowers).

<sup>236</sup> *Home Foreclosures: Will Voluntary Mortgage Modification Help Families Save Their Homes? Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 111th Cong. (2009) (testimony of Alan M. White) (65% loss severity rates on foreclosures in June 2009).

<sup>237</sup> *Id.*

<sup>238</sup> *Preserving Homeownership: Progress Needed to Prevent Foreclosures: Hearing Before the Senate Comm. on Banking, Housing & Urban Affairs*, 111th Cong. (July 16, 2009) (testimony of Curtis Glovier, on behalf of the Mortgage Investors Coalition).



