Loan Modification Restrictions in Subprime Securitization Pooling and Servicing Agreements from 2006: Final Results

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This paper briefly summarizes the results of a document review designed to understand the contractual standards governing the modification of mortgages that are part of subprime securitizations from 2006. It is the author's understanding that this is the most comprehensive review of subprime securitization contract terms undertaken to date.

The review is designed to provide a fair reflection of the contract terms governing 65 largest subprime securitization programs, using the definition of "subprime" used by the Bloomberg Financial Information Service.[1] The review covered documents governing securities with $323 billion in aggregate principal at issuance, or about 75% of the dollar volume for subprime securitizations in 2006 about which Bloomberg has some information.[2]

Although the project team did not review the documents governing each and every transaction in the 65 programs, we did review the transaction documents for at least one transaction from each program. We reviewed the documents for several different deals in the largest programs to check our assumption that modification terms are consistent across deals in a program, and we found that this assumption generally holds true. Further information about the review process is given in the report on the preliminary results of the review, *What Do Subprime Securitization Contracts Actually Say About Mortgage Modification? Preliminary Results and Implications*.[3] We are happy to provide additional information about the design of our review process on request.

Findings

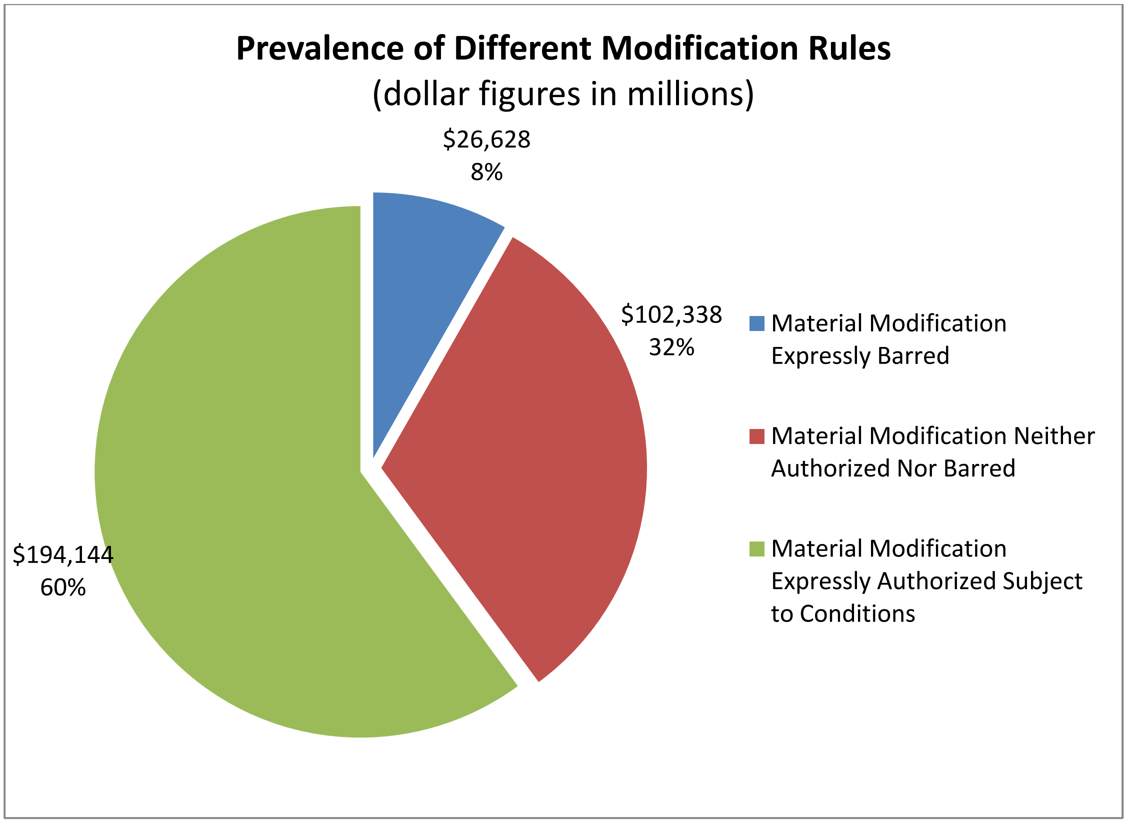
1. *Subprime securitization contracts may expressly bar, expressly authorize, or remain silent on material modification. Express authorization is the most common arrangement (60% of contract volume), followed by silence (32% of volume), and express bar (8%).*

The chart below shows the relative prevalence of the three types of contract term. Dollar figures refer to the principal balances of the loans in the collateral pools at issuance.

[1] Based on our interaction with Bloomberg representatives, it is our understanding that Bloomberg put each deal in the "Res B/C" category if the following three categories made up more than 50% of the dollar volume of principal in the deal at the time of classification: (1) "B- or C-rated loans." Bloomberg made this determination based on the loans' description in the prospectus; most frequently the prospectus described the loans as "subprime," "scratch-and-dent," "blemished-credit" or the like. (2) Home equity loans. Here the governing criterion was whether the loans' purpose was to take equity out of the home rather than for purchase, although apparently deals might also be put in this category if the arrangers described the deal as a home-equity deal. (3) Loans that were 30 days or more delinquent at the time of classification.

[2] Bloomberg has some information on 482 subprime issues from 2006. These 482 deals cover $435 billion of volume, which is similar to the $449 billion volume for 2006 subprime securitization reported by *Inside Mortgage Finance*. The 65 programs we reviewed cover 80% of this volume, but not all documents were available for our review for some programs, so the actual coverage is approximately 75%.

[3] http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1369286



Outright bans on material mortgage modification are relatively rare, but the situation where there is no *express* authorization to make material modifications is fairly common. "Material" modifications are defined here to include long extensions of loan maturity (more than a year or so) and reductions of principal or interest. Material modifications here do not include short extensions of time to pay or waivers of late fees or penalty interest. Many contracts provide for such minor modifications without authorizing more significant ones.

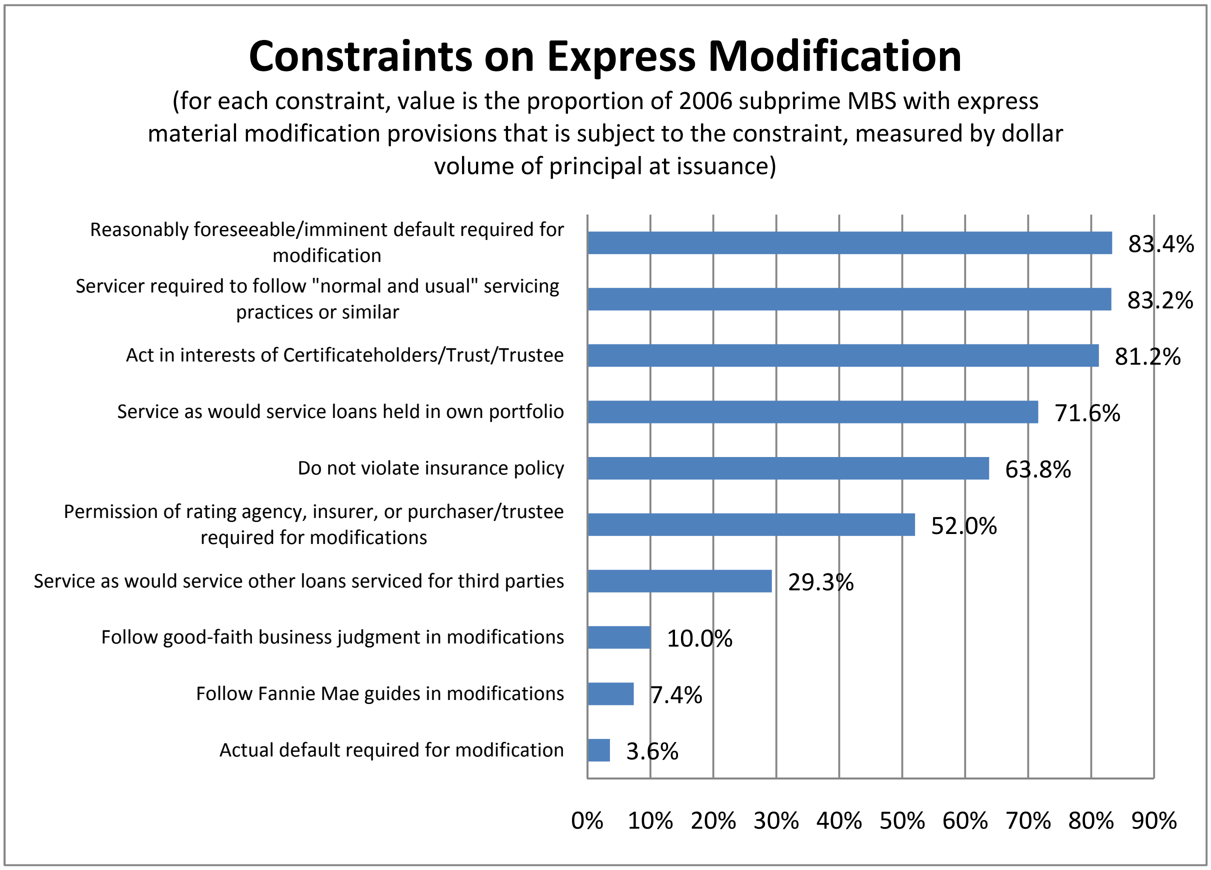
We discuss the two largest categories, the one in which material modification is expressly authorized, and the one in which material modification is neither expressly authorized nor expressly barred, in turn.

2. *When material modification is expressly authorized, it is subject to conditions.*

We did not find any contracts that simply authorized the servicer to modify contracts without conditions on the exercise of this authority.[4] The chart below illustrates the proportion of the dollar volume of 2006 subprime mortgage-backed securities subject to various conditions. The percentages are relative to the total volume of securities that have express modification

[4] One program, covering approximately 2% of the dollar volume, authorized modification if, in the servicer's reasonable and prudent judgment, the modification "could be in the best interest" of investors. This appears to be the most flexible standard we encountered.

provisions (that is, relative to the green 60% slice in the chart above). The total is much more than 100% because more than one constraint applies to the typical loan.



Certain general standards are extremely common: Servicers typically must follow normal and usual servicing practices, act in the interests of investors, and service loans in the same manner as they service their own loans. It is also common for securitization documents to require the servicer to service the loans that are the subject of the transaction in the same manner as other loans that it services for third parties, although this type of provision is less prevalent (29.3% of principal volume). If the objective is to make sure that unclear terms do not obstruct loan modifications by imposing litigation risk, these standards must be clarified.

Provisions that require reasonably foreseeable or imminent default before material modifications are allowed are also extremely common (83.4% of principal volume is subject to such provisions), and provisions requiring *actual* default as a prerequisite for material modification exist, though they are not common. Presumably, standards based on loan-to-value and debt-to-income ratios could supply an objective means of meeting this test.

It is also common to require permission from third parties involved with the transaction for material modifications. Such parties include the rating agency, the credit insurer, or the trustee. More than half the total principal volume we examined is subject to such a requirement. (Our figures include provisions that require permission only when 5% or more of the total volume or number of loans is modified). The importance of these provisions, and of the common provision that the servicer must make only modifications that are consistent with relevant insurance policies, may not have been appreciated.

3. *Even when material modification is expressly authorized, it is not always clear that all types of material modification are permitted.*

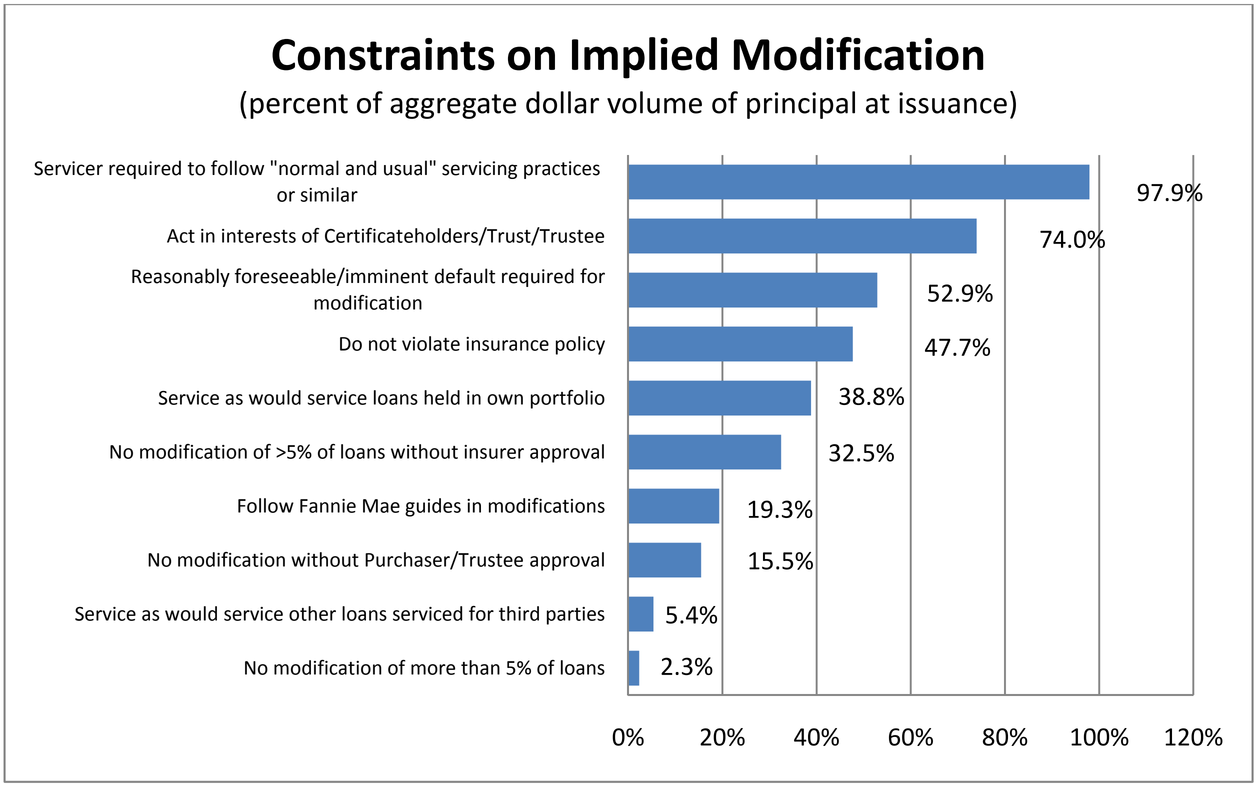
The most common form of express authorization to make material modifications takes the form of allowing the servicer to modify "any" term of the mortgage loan as long as specified conditions are met. However, not all authorizations take this form; some authorize only a subset of material modifications. We find that among 2006 subprime securitizations for which *some* material modification is permitted, 23% of the dollar volume of principal is governed by provisions that do not expressly authorize material term extensions, that do not expressly authorize principal reductions, or that expressly limit or do not expressly authorize interest rate reductions. Examples of the latter class of provision include provisions that prohibit loan modification to reduce interest below 5% or below half the rate otherwise applicable under the contract.

4. *When material modification is not expressly authorized, the contract typically contains a broad provision empowering the servicer "to do any and all things that may be necessary or desirable in servicing the loan," or words to that effect. Even when such language is absent, the grant of power to service is a basis for arguing that the servicer may modify the loans.*

Turning to the smaller group of securitized subprime mortgage loans for which modification is not expressly authorized (the burgundy slice of the pie graph above), approximately 2/3 of the dollar volume of principal in this class is covered by the broad, catch-all grant of power above, which seems to provide a contractual basis for making modifications that satisfy the other standards in the contract.

5. *In cases where material modification is not expressly authorized, there are contractual constraints on the power to modify, frequently arising from the agreements' general provisions.*

Where power to make material modifications is not express, if we assume that the power to make material modifications may be inferred from the general grant of power to the servicer to service the loans (and possibly to "do all things necessary or desirable" to do so), this implied power will be limited by the general servicing standards in the agreement and, frequently, by specific modification constraints as well.[5] The chart below illustrates the relative importance of various constraints on any *implied* power to modify. The percentages are expressed relative to the aggregate principal volume of securities that contain neither express authorization nor express prohibition of material loan modifications.



<u>Areas Not Covered in Our Review</u>

We have not systematically reviewed contractual constraints on waiver of prepayment penalties. Prepayment penalty waivers are typically subject to standards that are different from those governing other loan modifications, and our casual observation is that these standards are quite heterogeneous and often stringent. That would be consistent with the common perception that the industry was focused on prepayment risk rather than default risk in 2006.

We also have not reviewed contractual limits on servicer liability in any rigorous way. Our casual review suggests that these limits are both widespread and heterogeneous, suggesting that different servicers face widely varying levels of liability risk if they modify mortgage loans in a manner that is construed as inconsistent with the contract documents.

[5] Agreements that do not expressly authorize material modifications often expressly authorize minor modifications, such as short extensions of time to pay or waivers of late fees or penalty interest.