

# Mitigating

## *Losses* on *Subprime* Mortgage Loans

*The prospect of millions of subprime borrowers facing unaffordable interest-rate hikes in the coming months worried the mortgage industry, regulators and government. ASF has played a leading role in developing a streamlined framework for mitigating losses for investors and keeping as many individuals in their homes as possible. Below we outline how ASF got there.*

Can anything be done to help subprime borrowers who face unaffordable interest-rate hikes on their loans in the next few years? The question has circulated for some time. As early as the last few months of 2006, a number of analysts and policy makers put forward worrying estimates about the number of loans resetting, and by how much.

But how should the various mortgage market participants tackle such a large, looming and unique crisis? Many lenders had gone out of business, while the servicers were only just realizing the magnitude of the problem after years of low default rates. And it wasn't even clear, as *American Securitization* pointed out in its last edition, that servicers would necessarily have the capacity to modify large numbers of loans in any event.

There is still no quick and easy salve to the problems. But in the last few months the American Securitization Forum (ASF) has been at the forefront of crafting a balanced solution, and has done much to overcome the fear, and prejudice, that the process of securitization itself could hinder attempts to help homeowners.

ASF's first major step was back in June, when it issued its *Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans*. In October, ASF was a founding member of HOPE NOW, an alliance of lenders, servicers and debt counselors whose aim is to provide advice to struggling homeowners.

ASF has also been in constant contact with the various participants in the market including lenders, servicers, underwriters, ratings agencies and investors; with the four federal bank regulators: the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve and the Office of Thrift Supervision; and with the Bush Administration and the Treasury Department.

This culminated in December's announcement of the *Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans*. ASF took the lead in developing the framework, and it marks one of the most important pieces of work in the organization's six-year history. As such, we feel it merits publishing the executive summary in this edition of *American Securitization*. But we start with some background to highlight the work leading up to the announcement: excerpts from an open letter sent in October 2007 to ASF from FDIC chairman Sheila Bair.

*...The American Securitization Forum and its members have made tremendous efforts to identify strategies that will help maximize returns to investors in securitizations by restructuring existing subprime mortgages and avoid unnecessary foreclosures...*

*[W]e have worked together to identify flexibilities that mortgage servicers can exercise under existing pooling and servicing agreements to ensure continued cash flows through the securitization trust by avoiding defaults on securitized mortgages, where appropriate. These flexibilities include acceptable practices under accounting and the REMIC tax rules. Along with other regulators, we initiated a dialogue with ASF and other participants in the mortgage and securitization industry that has yielded tangible results toward eliminating many of the perceived obstacles to restructuring securitized loans.*

*Importantly, the Statement of Principles [you issued in June] confirmed that servicers can be proactive and do not need to wait until high-risk customers become delinquent to take action. Early action by servicers is essential to preserve investor value and achieve sustainable results. In addition, the Principles confirmed that servicers' obligations are to the securitization pool as a whole...*

*The framework for achieving proactive and responsible modifications has been developed — now we need the industry to implement it... A strategy that avoids increasing defaults will benefit investors and help promote stability for the overall securitization market. That alone should provide all parties with the incentives necessary to work together to continue developing practical solutions to these pressing problems.*

*I believe that a more systematic approach to modifications is urgently needed, particularly for the 2/28 and 3/27 hybrid ARM loans since the bulk are expected to reset in the very near term. Of course, the likelihood of default needs to be determined on an individual loan basis, but this process can be streamlined through the use of systematic criteria...we encourage servicers to utilize debt-to-income ratios and other analytic methods that may be applied on a systematic basis to determine loan affordability for individual borrowers. Moreover, where the inability to pay at the reset rate has been determined, the servicer should be able to create categories of borrowers who would qualify for loan modifications. Such actions should add efficiencies to the modification process without violating the standards governing the securitization process.*

*In this regard, I have suggested that priority should be given to borrowers who occupy their homes and who have remained current during the starter-rate period. For this group of borrowers, conversion of their hybrid ARM to a fixed-rate mortgage at their starter rate or current rate, if affordable, will provide the best likelihood of long-term continued mortgage payments to investors. The application of this type of systematic approach could be decided by servicer staff based on a set of standards using matrices developed by servicer management.*

*...In most cases, this approach will benefit both the borrower and the investors and should result in the maximization of recoveries to the pool as a whole. I have made specific suggestions for loan modifications because I am concerned that the industry's current efforts on modifications are not addressing the problem.*

*...Clearly more work with servicers is required in order to achieve workable solutions to this mounting problem... We need to make sure that more servicers are aware of the flexibilities permitted under the accounting and REMIC rules, and we need to ensure that they receive guidance on a more systematic approach to loan restructuring for subprime borrowers. We also believe that it is vital to investors to pursue greater transparency on loan modifications, and we strongly support the ASF's initiatives on this issue.*

*A full copy of the letter can be found at [www.americansecuritization.com](http://www.americansecuritization.com)*

A few weeks later, in a letter updating chairman Bair on ASF's recent progress on these issues, ASF made the point that lenders, servicers and investors were already cooperating much more on helping struggling homeowners than they ever had in the past:

*Much of this outreach is being centralized and coordinated through the HOPE NOW Alliance, in which ASF and many of our member firms are active participants. This initiative is designed to connect borrowers with servicers and non-profit counseling organizations more efficiently, and on a national scale.*

ASF also lent support to the FDIC's detailed position on

streamlining the loss mitigation process:

*In short, ASF agrees with the observations and recommendations. We are actively working with our servicer members to lever their existing efforts, and to encourage and facilitate their ability to implement more streamlined approaches to meeting the loan modification and broader loss mitigation challenge they now face.*

In fact, ASF noted that it was working with the industry to develop procedures similar to some of those chairman Bair had outlined in her October letter:

*While this effort is designed to streamline servicers' decision-making processes, it preserves the essential requirement that loan affordability and maximization of recovery to investors must be determined on an individual, loan-by-loan basis, including through the systematic application of presumptive criteria in appropriate circumstances.*

*In contrast, ASF is opposed to any categorical approach to loan modifications (or other loss mitigation measures) that does not involve a loan-level determination of a borrower's likelihood of default, and their ability and willingness to repay.*

*However, as we understand them, your recommendations would not involve such a categorical approach because they also involve a*



*FDIC chairman Sheila Bair at ASF's 2007 Annual General Meeting*

*loan-level determination that the borrower cannot make payment at the reset rate through streamlined loan evaluation procedures. As a result, we have supported your recommendations for streamlined loan modifications to borrowers for owner-occupied properties who are not able to refinance into other products, who have been current at the introductory rate on subprime hybrid ARMS, but who the servicer determines it is "reasonably foreseeable" cannot make payments at the reset interest rates.*

It was precisely this type of discourse with the FDIC and other regulators and market participants that allowed the ASF to develop as comprehensive an approach to subprime mortgage loss mitigation as possible. And the upshot of this latest correspondence with the FDIC was that it embodied the ideas behind what, a few days later, formed the basis of ASF's *Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans*. It was issued on December 6, 2007, and the executive summary is reprinted below.

## Executive Summary of Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans

### Scope

This streamlined framework applies to all first lien subprime residential adjustable rate mortgage (ARM) loans that have an initial fixed rate period of 36 months or less (including “2/28s” and “3/27s”), referred to below as “subprime ARM loans” that:

- were originated between January 1, 2005 and July 31, 2007;
- are included in securitized pools; and
- have an initial interest rate reset between January 1, 2008 and July 31, 2010.

This streamlined framework would be applied to subprime ARM loans in advance of an initial reset date. Typically, servicer/borrower communication should begin 120 days prior to the initial reset date.

### Overarching Principles

The servicer will not take any action that is prohibited by the pooling and servicing agreement (PSA) or other applicable securitization governing document, or that would violate applicable laws, regulations, or accounting standards. ASF’s *Statement of Principles, Recommendations and Guidelines for a Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans*, published concurrently with this document, analyzes how the framework described in the executive summary is consistent with typical PSA provisions. The ASF urges readers of this executive summary to review the full statement.

The ASF believes that this framework is consistent with the authority granted to a servicer to modify subprime mortgage loans in typical PSAs. The ASF expects that the procedures in this framework will constitute standard and customary servicing procedures for subprime loans. The servicer will expeditiously implement the *Investor Reporting Guidelines for the Modification of Subprime ARM Loans* recommended by the ASF.

LTV and CLTV will be determined based on information at origination. If an origination LTV is below 97%, a servicer may obtain an updated home value by obtaining an AVM, BPO or other means.

All servicers of second liens to subprime borrowers should cooperate fully with this framework by providing information needed by first lien servicers and by agreeing to subordinate the second lien to any new first lien resulting from a refinance (with no cash out) under this framework.

All existing contractual obligations and remedies related to fraudulent mortgage origination activity should be strictly enforced.

The streamlined framework outlined in this framework represents the consensus view of the membership of the ASF, acting through its Board of Directors, as to the parameters used to

determine the segmentation of subprime ARM loans, including the numeric values included in those parameters. It is understood by the ASF’s members that the numeric values included in the parameters are not based on historic data, but rather simply represent a consensus view as to appropriate numeric values for use within this framework for the purpose of supporting a streamlined approach to loan modifications that complies with typical securitization governing documents. The ASF, acting through its board of directors, may in the future change these numeric values or further refine these parameters as experience is gained and market conditions evolve.

### Borrower Segmentation

Under this framework, subprime ARM loans are divided into three segments.

Segment 1 includes current (as defined below) loans where the borrower is likely to be able to refinance into any available mortgage product including FHA, FHA Secure or readily available mortgage industry products.

Generally, the servicer will determine whether loans may be eligible for refinancing into readily available mortgage industry products based on ascertainable data not requiring direct communication with the borrower, such as LTV, loan amount, FICO and payment history. Servicers will generally not determine current income or DTI to determine initial eligibility for refinancing.

If the borrower also has a second lien on the property, this framework contemplates that the borrower is able to refinance the first lien only, on a no cash out basis. In order for the loan to fall into this segment, the second lien does not have to be refinanced; however, any second lien holder will need to agree to subordinate their interest to the refinanced first lien.

Segment 2 includes current loans where the borrower is unlikely to be able to refinance into any readily available mortgage industry product.

Current: for purposes of this framework “current” means the loan must be not more than 30 days delinquent, and must not have been more than 1 x 60 days delinquent in the last 12 months, both under the OTS method. Corresponding tests would apply under the MBA method if the servicer uses that standard.

LTV test: all current loans with an LTV (based on the first lien only) greater than 97% are deemed not to be eligible for refinance into any available product, and thus are within Segment 2. (97% is the maximum LTV allowed under FHA Secure.)

Not FHA Secure eligible: all current loans that otherwise do not satisfy FHA Secure requirements, including delinquency history, DTI at origination and loan amount standards for this program, are within Segment 2 unless the servicer can de-

termine whether they may meet eligibility criteria for another product, by reviewing eligibility criteria without performing an underwriting analysis.

Segment 3 includes loans where the borrower is not current as defined above, demonstrating difficulty meeting the introductory rate.

### Segment 1 – Refinance:

It is expected that borrowers in this category should refinance their loans, if they are unable or unwilling to meet their reset payment. However, a servicer may evaluate each borrower in this category on a case by case basis or apply any framework consistent with the applicable servicing standard in the transaction documents for a loan modification or other loss mitigation outcome.

The servicer will facilitate a refinance in a manner that avoids the imposition of prepayment penalties wherever feasible. This may be accomplished by timing the refinance to occur after the upcoming reset date.

Servicers should take all reasonable steps permitted under the PSA and other governing documents to encourage or facilitate refinancing for borrowers in Segment 1, or to borrowers in Segment 2 who become eligible for a refinance, including, where permitted, providing borrowers with information about FHA, FHA Secure and other readily available mortgage industry products, even if that servicer is not able to provide those products through any affiliated originator.

### Segment 2 – Loan Modification

The servicer will determine the following for each Segment 2 borrower: current owner occupancy status (based on information known to the servicer, including billing and property address), current FICO score and the FICO score at origination of the loan.

If the current FICO score is less than 660 and is less than a score 10% higher than the FICO score at origination, the borrower is considered to have met the “FICO test.” If the borrower meets the FICO test, the servicer will generally not determine the borrower’s current income.

If either a) the current FICO score is 660 or higher, or b) the current FICO is at least 10% higher than the FICO score at origination, the borrower is considered to not meet the “FICO test.” If the borrower does not meet the FICO test, the servicer will use an alternate analysis to determine if the borrower is eligible for a loan modification.

Segment 2 loans will only be eligible for a fast track loan modification if:

- the borrower currently occupies the property as his or her primary residence;
- the borrower meets the FICO test; and
- the servicer determines that, at the upcoming reset, the payment amount would go up by more than 10%.

Borrowers in this segment and eligible for a fast track loan modification as described above may be offered a loan modification under which the interest rate will be kept at the existing rate, generally for five years following the upcoming reset.

As to Segment 2 loans eligible for a fast track loan modification, the servicer may make the following presumptions:

- the borrower is able to pay under the loan modification based on his or her current payment history prior to the reset date;
- the borrower is willing to pay under the loan modification, as evidenced by a) an agreement to the modification after being contacted or b) in the event that the affirmative agreement of the borrower cannot be obtained, the borrower’s payment of two payments under the loan as modified after receiving notice of the modified terms;
- the borrower is unable to pay (and default is reasonably foreseeable) after the upcoming reset under the original loan terms, based on the size of the payment increase that would otherwise apply.

The modification maximizes the net present value of recoveries to the securitization trust and is in the best interests of investors in the aggregate, because refinancing opportunities are likely not available and the borrower is able and willing to pay under the modified terms.

For borrowers that do not meet the FICO test, the servicer will use an alternate analysis to determine if the borrower is eligible for a loan modification, as well as the terms of the modification (which may vary). This may include a) conducting an individual review of current income and debt obligations, debt-to-income analysis, and considering a tailored modification for a borrower, or b) applying any other framework consistent with the applicable servicing standard in the transaction documents to determine if a borrower is eligible for a loan modification.

For borrowers that are eligible for a fast track modification, the fast track option is non-exclusive and does not preclude a servicer from using an alternate analysis to determine if a borrower is eligible for a loan modification, as well as the terms of the modification.

### Segment 3 – Loss Mitigation

For loans in this category, the servicer will determine the appropriate loss mitigation approach in a manner consistent with the applicable servicing standard in the transaction documents, but without employing the fast tracking procedures described under Segment 2. The approach chosen should maximize the net present value of the recoveries to the securitization trust. The available approaches may include loan modification (including rate reduction and/or principal forgiveness), forbearance, short sale, short payoff or foreclosure.

These borrowers will require a more intensive analysis, including where appropriate current debt and income analysis, to determine the appropriate loss mitigation approach. ▼