# Assessing the real impact of realized losses

**Rising default rates are making it harder for investors to apply realized losses on mortgage loans in their portfolios. Uniformity and consistency in their treatment by the market will be the best way to solve these new and unexpected problems. Bank of New York Mellon's Uri Burger explains.**

The growing subprime mortgage crisis has revealed a tricky and previously much ignored conundrum bondholders face: how should realized losses on mortgage loans be applied to the overall portfolio? It's not that investors aren't used to defaults. But in the past the pain has usually been easily absorbed by the safeguards put in place in securitizations precisely for this purpose: excess interest and overcollateralization (OC) — the difference between the amount of the mortgage pool and the deal's tranches.

The process ought to be relatively straightforward. For example the servicer first continues to pay any interest payments while trying to restructure a mortgage loan. Assuming a new deal is struck, the lower interest payments or reduced principal amount will affect the relevant part of the bond deal. If the house is sold in foreclosure, the servicer recoups its costs and passes on any remaining principal to the pool.

But default rates are now so high that the subordinate slices of subprime-backed deals are likely to be affected. And if the situation gets worse, the pain will creep higher up the capital structure.

Surveillance agencies, investors and other participants are beginning to acknowledge that greater realized losses could present unexpected problems and there has been much discussion about what happens next. We have heard many different suggestions involving how much of the loss to apply to a mortgage bond, how it should affect the pay down structure of MBS, whether higher losses could hit monthly interest payments, as well as what other factors within the deal may be affected.

Most obviously impacted by outsized realized losses is the pay down, often referred to as the waterfall. Any funds left over after making interest payments to bondholders are usually used, at least for the first 36 months, to pay off the principal balance of the most senior bonds in a sequential manner. Realized losses could obviously eat into that. But they could also create interest shortfalls.

How? That all depends on what is included in a current realized loss, or a loss associated with the sale of a property occurring during a specific collection period. Sifting through different documents yields a plethora of results. Realized losses are generally defined as the excess of the unpaid principal balance of a liquidated mortgage loan together with accrued and unpaid interest. On the whole, most pooling and servicing agreements also include any liquidation fees and interest advances associated with the defaulted loan as part of the loan's realized loss. But how much of this particular aspect of the realized loss is supposed to be applied to the principal remittance amount of the particular deal? There may be reason to believe that some of the realized loss will affect the interest remittance amount instead. This is a question that faces the trusts of these deals with every deal they pay out. For example, take a problem loan with a current balance of $1,000. After the scheduled monthly principal payment of $50 — more than likely advanced by the servicer — the loan balance would be reduced to $950.

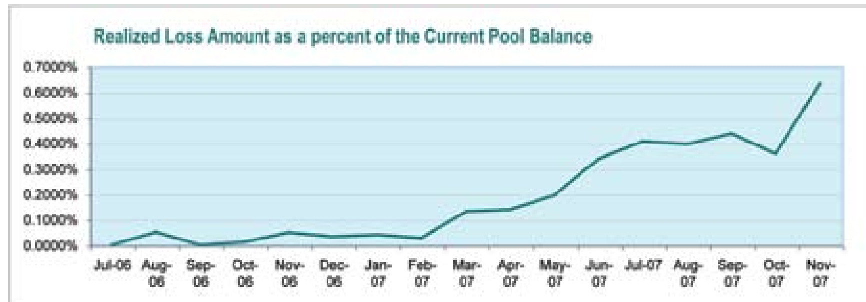
Now, if the realized loss is less than this remaining amount of $950, the difference between the remaining balance of the loan and the realized loss would be passed through as net liquidation proceeds, and the balance of the loan would subsequently be out of the pool, as its balance would be reduced to zero.

What would happen in the above example if the loss on that loan was greater than the amount of the remaining principal balance? This is where the problems arise. Some documents specify that the loss is only up to the amount of the stated principal balance. Therefore, any amount incurred by different fees or otherwise associated with the liquidation of that loan would have to be passed through to the deal as non-recoverable advances and would affect the interest remittance amount. If, in the above example, the amount of the loss being passed to the trust was $1,200, the amount of the principal realized

loss would only be $950, with the remaining $250 being passed through as non-recoverable advances that could potentially impact interest payments.

Many deals are structured so that the amount of remitted interest from the collateral is considerably greater than the amount of the interest that will need to be paid out to the bondholders on a monthly basis. Due to this structure, in many of these OC deals, any excess cash, principal or interest, will filter down to the excess interest bond (whether it be C, X, or R) or affect the amount of overcollateralization in the deal. As long as these credit enhancements are still in place, a realized loss can be absorbed without any of the bonds being affected.

There are some deals, however, that do not specify that the realized loss should be capped at the principal balance. For these deals, while it may still be beneficial for investors to see a distinction between the amount of the loss as it pertains to the balance and anything above the balance, the application of the realized loss would be uniform. Critically speaking, it is hard to understand how a realized loss could exceed the principal balance.




The answer to this question may lie in the fact that the pools of loans are securitized in order to create cross collateralization between the different loans. Just as a principal recovery in excess of the balance should affect the principal amount, so would a loss. This cross collateralization strengthens the collateral, allows for the realized losses to be aggregated on a deal level, as opposed to by individual loan. Therefore, for these deals, only the principal remittance would be affected.

## Trigger events

The pay down and interest remittance amount of the deal, however, are not the only parts that are affected by the classification of realized losses and non-recoverable advances. Within RMBS deals, different trigger events exist which can affect how the deal pays out after the step-down date, the first time that subordinate bonds will receive principal payment which usually occurs three years into the deal. The trigger events are mechanisms in the structure of the deal that are designed to protect senior bondholders. Generally speaking, only senior bonds will receive principal payments for the first three years, after which the subordinate bonds will begin to receive principal payments as well. These trigger events monitor the performance of the deal's collateral to ensure efficient credit enhancement of the senior, and most highly rated bonds.

Two of these trigger events, namely the rolling delinquency trigger event as well as the cumulative loss trigger event, have been deeply impacted by the growing subprime mortgage crisis. The rolling delinquency rate is a problem these days due to soaring delinquency rates. But the cumulative loss amount is actually more complicated as it relates to this discussion. There has been much debate as to what exactly needs to be included in this cumulative loss amount. Obviously, current realized losses are the starting point with any subsequent recoveries related to those prior losses being netted against the cumulative loss total.

This is where it can get a little ambiguous. When a loan that has already liquidated experiences a loss, it is termed a subsequent loss. Despite already liquidating, very often additional fees related to the loan's liquidation can be passed through to the trust later on. It is generally the practice to include these losses in the cumulative loss amount. But to what extent is this true? Based on what we have already described, in a deal that specifies that a realized loss is only up to the amount of the stated principal balance, a loan cannot experience a subsequent loss if the amount of the loss has already exceeded the amount of the liquidated balance.

These subsequent losses should actually, therefore, be classified as non-recoverable advances. This begs the question of where these non-recoverable advances should be included in the overall cumulative loss amount. On the one hand, they are specifically related to the default of the principal balance of the loan. On the other, they should affect the interest remittance amount and not the principal.

After much deliberation, it seems that in fact these non-recoverable advances would be included in the cumulative loss amount, assuming that the loss is not capped at the stated principal balance. This will then expedite triggers hitting and will protect the senior bonds over the life of the deal. Unless it is specifically stated otherwise, any losses associated with the loan's liquidation are termed realized losses. While this unpaid interest amount should be classified for reporting purposes differently from the principal portion, it should still be included in the cumulative loss amount. Consequently, even subsequent losses which have exceeded the amount of the liquidated balance would be included in the cumulative loss amount as well.

While these issues have always existed, they have been more prevalent as of late. As we continue to see loans defaulting and realized losses being passed through to the deals, it is incumbent on the industry as a whole to be uniform and consistent in how these losses are being treated.

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