



Transforming Foreclosed Properties into Community Assets

Session 3: Partnering with Lenders to Reuse Distressed Properties

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American Securitization Forum

The American Securitization Forum is a broad-based professional forum of over 370 organizations that are active participants in the U.S. securitization market. Among other roles, ASF members act as servicers, institutional investors, issuers, financial intermediaries, rating agencies, bond insurers, and professional advisers working on securitization transactions.

ASF's mission includes building **market consensus**, pursuing advocacy initiatives and delivering education on behalf of the securitization markets and its participants.

Presentation Overview

- ▶ **DISCLAIMER**
- ▶ Securitization Background
- ▶ Scope of National Housing/REO Inventory Issue
- ▶ Securitization Legal Background
 - ▶ Accounting and Tax Considerations
 - ▶ Pooling and Servicing Agreements (PSAs)-Contracts
 - ▶ Market Practices under PSAs
- ▶ Current Proposals & Securitization
- ▶ Challenges to Overcome for Short Sales & Discounted Sales

What Is a Securitization?

- ▶ A security or other investment
- ▶ Payable from the “issuer’s” assets
- ▶ Structured to avoid “originator’s” bankruptcy risk
- ▶ Investors purchase these securities because they can focus solely or primarily on specific credit risks, rather than corporate risks of originators.

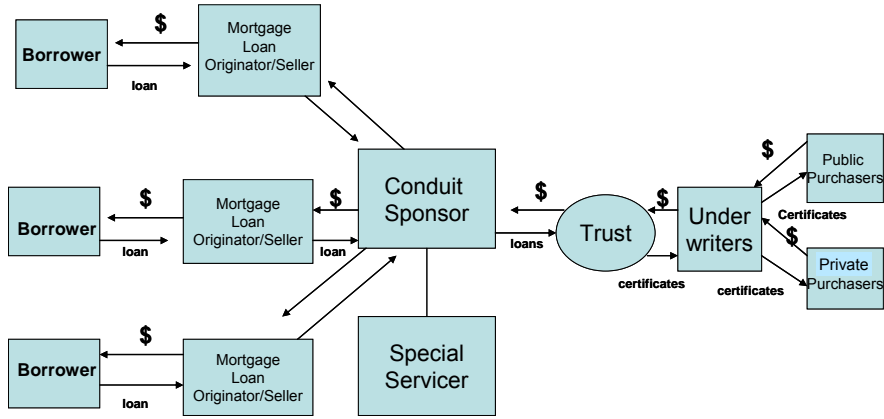
Securitization Transaction Parties

- ▶ Originator
- ▶ Special purpose subsidiary
 - a/k/a the “Seller”
 - Limited purpose, bankruptcy remote entity
- ▶ Issuer
- ▶ Servicers
 - Master Servicer
 - Primary Servicer**
 - Back-up servicer
 - Special servicer
- ▶ Liquidity providers
- ▶ Credit enhancer
- ▶ **Trustee**
- ▶ Custodian
- ▶ **Investors**
- ▶ Underwriters

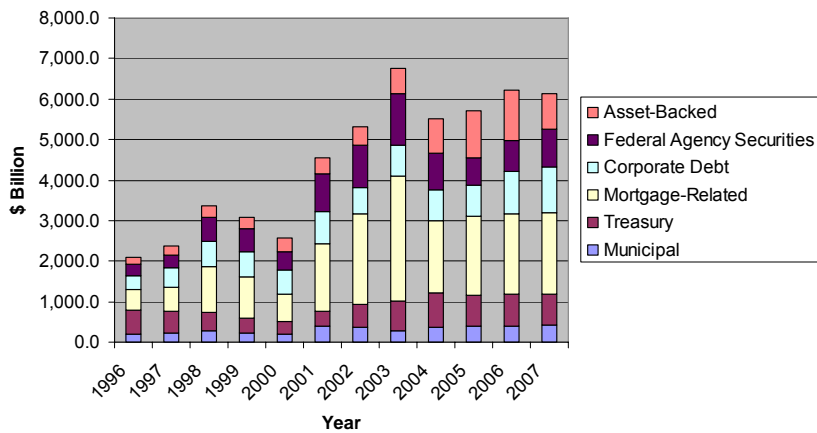
Securitization Servicing

- ▶ Servicer collects payments, enforces the contracts
- ▶ Most, but not all, transactions are serviced by the originator/sponsor
- ▶ Servicer can be replaced upon certain events
 - ▶ Bankruptcy
 - ▶ Poor Performance
 - ▶ Servicing Transfer Prior to Securitization

Aggregator MBS Structure

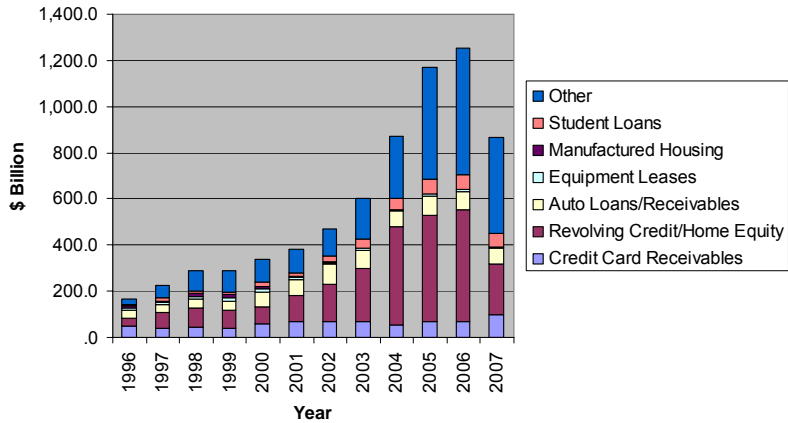


Total Issuance in the US Bond Markets



Source: U.S. Department of Treasury, Federal Agencies, Thomson Financial, Inside MBS & ABS, Bloomberg

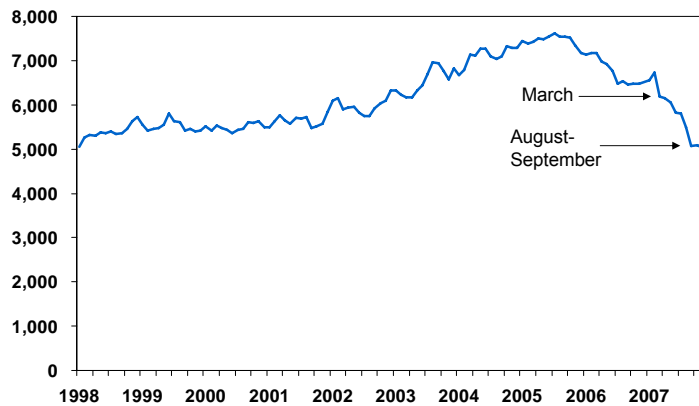
ABS Issuance by Sector



Source: Thomson Financial, Securities Industry and Financial Markets Association

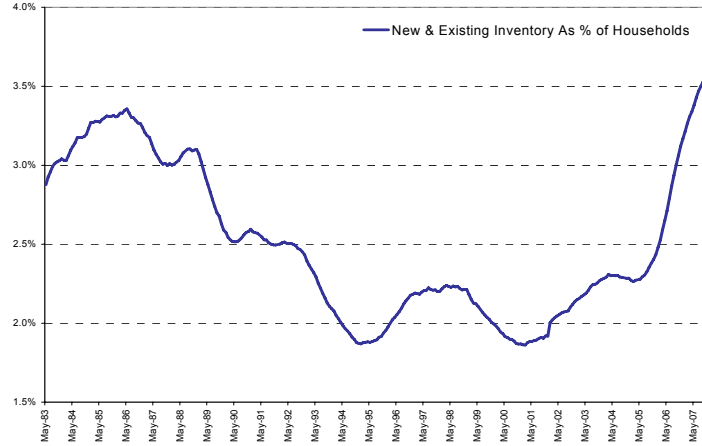
REO Concerns for Secondary Market; Home Sales Declining Significantly

Total Single Family Home Sales, SAAR (000)



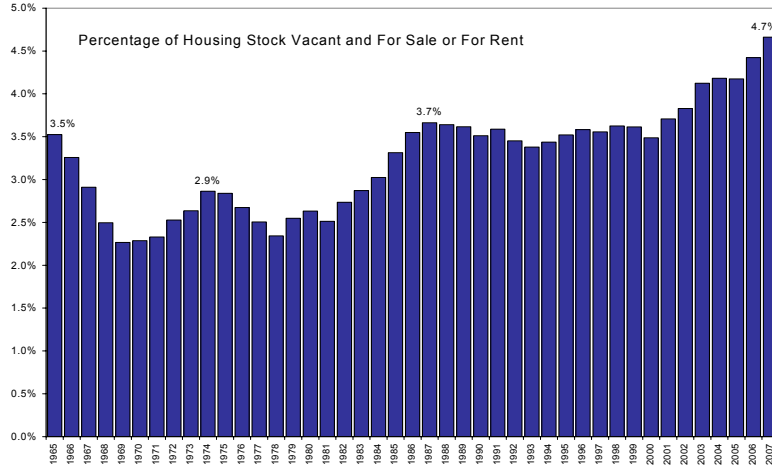
Source: Freddie Mac

Inventory Overhang is Immense



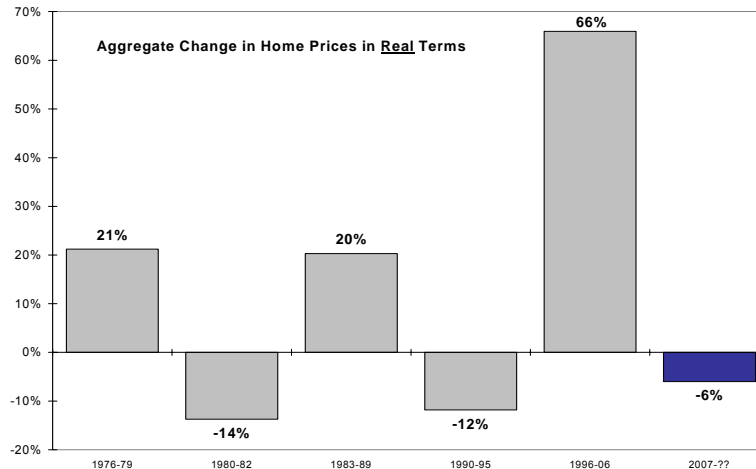
Source: Census Bureau, NAR, Zelman & Associates

And Too Much of It Is Vacant



Source: Census Bureau, Zelman & Associates

Home Price Bubble Points to Tough Times Ahead



Source: Zelman & Associates

Tax Considerations

- ▶ REMICs
 - ▶ A “REMIC” is a “real estate mortgage investment conduit.” It is a vehicle created under the Internal Revenue Code in order to securitize mortgage loans in a way that avoids entity level tax.
 - ▶ If the requirements of a REMIC under the Code are met, a REMIC will not be subject to an entity-level tax and the “regular interests” in the REMIC will be treated as debt for tax purposes
 - ▶ The REMIC must issue a class of equity referred to as the “residual interest,” which is frequently non-economic.
 - ▶ Substantially all of a REMIC’s assets must be obligations principally secured by interests in real property or regular interests in other REMICs.
 - ▶ **REMICs generally must be passive vehicles, so after the initial start-up period, qualified mortgage loans may not be added, removed or amended except in limited circumstances.**
- ▶ Servicers never run afoul of REMIC restrictions
 - ▶ Consequence would be trust entity level tax i.e. double taxation

Accounting-QSPEs (FAS 140.35)

- ▶ A QSPE is a trust or other legal vehicle that meets **all** of the following criteria:
 - ▶ Demonstrably distinct from the transferor
 - ▶ **Permitted activities are significantly limited**
 - ▶ May hold only certain assets
 - ▶ May hold only certain derivatives
 - ▶ May only sell or dispose of noncash assets in certain circumstances
- ▶ If an entity qualifies as a QSPE, no party is required to consolidate
- ▶ If an entity ceases to qualify as a QSPE, the depositor will be required to consolidate the assets back onto balance sheet

Permitted Activities (FAS 140.37 - .38)

- ▶ Must be significantly limited
- ▶ Must be entirely specified in legal documents that created the QSPE
- ▶ May be significantly changed **only** after approval of a majority of the third party BI holders (transferor **cannot** vote)
- ▶ Agents (e.g., servicers) are not permitted to perform activities on behalf of a QSPE or direct the QSPE to perform activities that otherwise would not be permitted activities of a QSPE

Permitted Activities (FAS 140.37 - .38)

- ▶ Servicing activities
 - ▶ Discretion for servicer to work out a defaulted loan is consistent with the limited powers permitted a QSPE
 - ▶ Servicer may not initiate new lending through the QSPE
 - ▶ Decision to initiate foreclosure is a servicing activity and not a disposal
 - ▶ Servicer allowed some discretion over managing and disposing of foreclosed assets, as long as it is limited and fully documented at inception of the transaction
 - ▶ **Servicers do not have discretion to dispose of defaulted loans except in automatic response to specific conditions for disposal documented in the servicing agreement**

FAS 140 Amendment Project

- ▶ FASB is re-visiting all aspects of sales of financial assets, including:
 - ▶ Type of continuing involvement a transferor may have in order to derecognize assets
 - ▶ Whether QSPEs should be allowed
 - ▶ Whether to use “linked presentation” for transactions that do not qualify for sales treatment
- ▶ After ASF issued the “Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans” the SEC asked FASB to address QSPE issues ASAP but not known what FASB plans to do
- ▶ Stay tuned...

Servicing Standards under PSAs

- ▶ Principal-Agent Contractual Relationship of Investor and Servicer
- ▶ Servicer must service loans:
 - ▶ “in its good faith business judgment”
 - ▶ “normal and usual in its general mortgage servicing activities”
 - ▶ “procedures that such servicer would employ for loans held in its own account”

Typical Loss Mitigation Contractual Provisions

- ▶ Most subprime PSAs permit, in addition to loan modifications, other loss mitigation procedures for defaulted loans, including:
 - ▶ Forbearance
 - ▶ Capitalization of delinquencies
 - ▶ Repayment plans for arrearages
 - ▶ Short sales
 - ▶ Short payoffs
- ▶ Investor consent is generally not required for loan modification or loss mitigation

ASF June, 2007 Guidance

- ▶ Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans
 - ▶ Loan modifications are an important servicing tool in addition to other methods
 - ▶ PSAs should be interpreted to the maximum extent possible to allow for loan modifications
 - ▶ **Loan mods must be done on a loan-by-loan basis**
 - ▶ Color related to interpreting contractual language
 - ▶ “in the best interests of the securityholders”
 - ▶ Loan mods have different consequences for different tranches (risk slices)
 - ▶ Interpreted as securityholders in the aggregate

Helping Borrowers and Investors through Loan Modifications

- ▶ Foreclosure is bad for borrowers and investors where preventable
- ▶ Particularly for ARM loans, loan modifications can prevent foreclosures
- ▶ Loan Modifications can only occur:
 - ▶ “best interests of the securityholders” by “maximizing the net present value (NPV) of the loan” and
 - ▶ when loans are “in default or default is reasonably foreseeable”
 - ▶ In accordance with accepted servicing practices and procedures that are normal, usual or customary

Three Issues in Case Studies

- ▶ “Systematic” Solutions
 - ▶ ASF Streamlined Framework
- ▶ New Assets in Trusts
 - ▶ OTS “Negative Equity” Proposal
- ▶ Principal Writedowns/Discounted Sales
 - ▶ Frank/Dodd FHA Legislation

ASF Streamlined Framework

- ▶ ASF Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans (December 6, 2007)/Paulson Plan
- ▶ **Streamlined loan-by-loan approach for initial resets on subprime ARMs**
- ▶ Addresses ability to pay at reset (as opposed to willingness to pay i.e. ‘underwater’ borrowers)

ASF Streamlined Framework

► Why the Framework

- ▶ Introductory rates expiring on 1.8 million subprime ARMs in 2008 & 2009
- ▶ Borrowers assume ability to refinance at reset
- ▶ If borrowers pay on time, they could refinance into prime loans
- ▶ Q3 & Q4, 2007 credit tightening; Irrational exuberance ends; HPA declines
- ▶ **Servicer capacities constrained-transactions costs**
- ▶ Not answer to all housing market ills; doesn't solve fundamental US housing supply and demand disequilibrium

ASF Streamlined Framework

► Subprime ARM Reset Example

- ▶ Borrower takes out 2/28 Loan in December, 2005
- ▶ In December, 2007, ARM reset “shock” to
 $5.5\% + (6 \text{ Month LIBOR}(\sim 5\%)) = 10.5\%$
Avg. payment increase was ~\$450
Range of % increases was ~20-30%

Three Segments of ASF Streamlined Framework

1. Refinance
2. Fast Track Loan Mod-5 criteria for NPV & reasonably foreseeable presumptions
 1. Owner Occupied
 2. Generally Current
 3. FICO Measurements
 1. Not above 660 and
 2. No 10% upward migration since origination
 4. Not able to refinance (FHA or private product)
 5. Payment increase (“shock”) of 10% or more
3. Comprehensive Analysis for Customized Solution

Other Proposals

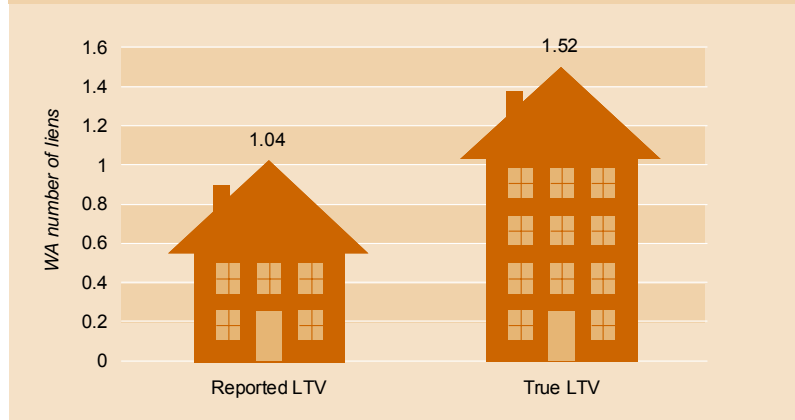
- ▶ New Assets in Trusts
 - ▶ OTS “Negative Equity” Proposal
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Challenges to Overcome

- ▶ 1. Volume of Properties & Market for REO
- ▶ 2. Community vs. National
 - ▶ Loans in a given community are serviced by dozens of servicers
 - ▶ Securitized loans are intentionally spread to different trusts to avoid regional concentrations and the corresponding regional risks
 - ▶ Challenge is coordination of servicers and different portfolio/owner/trust work rules
 - ▶ Emphasizes critical role of local community to contribute to coordination

Adding public record data shows substantially higher average number of liens per property

ABX 2006-2 – weighted average number of liens per property



Source: LoanPerformance

Challenges to Overcome

- ▶ 4. REO loans need to come out of the securitization trust
- ▶ 5. Servicer's capabilities and resources re-underwriting loans balanced with contractual obligation for loan-by loan determinations

- ▶ Conclusion