

U.S. Structured Finance Newsletter

Volume 3, Issue 30, July 30, 2007



Sharon McGarvey CFA, CPA
Senior Vice President, U.S.
Structured Finance Research
+1 212 806 3261
smcgarvey@dbrs.com

Michael Nelson
Managing Director,
U.S. Structured Finance
+1 212 806 3251
mnelson@dbrs.com

Toronto
DBRS Tower
181 University Avenue
Suite 700
Toronto, ON M5H 3M7
+1 416 593 5577

New York
140 Broadway, 35th Floor
New York, NY 10005
+1 212 806 3277

Chicago
101 North Wacker Drive
Suite 100
Chicago, IL 60606
+1 312 332 3429

London
1st Floor
25 Copthall Avenue
London EC2R 7BP
+44 (0)20 7562 5600

Paris
27, avenue de l'Opéra
75001 Paris
+33 (0)1 7038 5214

Frankfurt
Trianon Tower
Mainzer Landstrasse 16
60325 Frankfurt
+49 (0)69 9716 8144

RECENT DEVELOPMENTS IN LOAN MODIFICATIONS AND THE IMPACT ON U.S. SUBPRIME RMBS TRANSACTIONS

Given the challenges facing the subprime mortgage market, servicers are increasing the use of loss mitigation techniques to preclude foreclosure. One technique that has been widely discussed and debated is the use of loan modifications. In essence, loan modifications can entail a change in coupon, principal or term (see the U.S. Structured Finance [March 26, 2007, newsletter](#)). If successful, loan modifications can have a positive impact on RMBS securitizations by enhancing transaction cash flow and minimizing losses. According to the June 2007 ASF Guidelines, when the servicer concludes that the net present value from the payments on the modified loan is greater than the net recovery that would result from foreclosure of the loan, the modification may be "deemed to be in the best interest of investors."¹

Conversely, investors can be negatively impacted by the excessive use of loan modifications. Once a loan is modified, it is technically considered to be current under existing practices. Therefore, it would be excluded from the delinquency trigger calculation, which could result in the premature release of overcollateralization (OC) at the step-down date. Additionally, for modifications that ultimately default, loss deferral may adversely impact transaction performance given that (1) excess spread in prior periods could have been used to cover the default had the loss been realized sooner, (2) the absolute level of excess spread declines as a deal seasons and (3) property recovery values may further deteriorate in a declining market. Historically, loan modifications have had recidivism rates of 25% to 35%.²

Current industry proposals to address the risks associated with loan modifications include adjusting trigger calculations and increasing disclosure to investors. Changes to trigger calculations include the following:

- Delinquency trigger test: A modified loan should be included in the 60+ day delinquency calculation for trigger purposes until the borrower can demonstrate the ability to make scheduled payments on the modified terms. A loan modification performance test will be satisfied when the borrower makes the scheduled payments for not less than 12 consecutive months following the date of modification.
- Cumulative loss trigger: When a modification results in the reduction of a loan's unpaid principal balance, the reduction should be included in the cumulative loss trigger calculation.

The expansion of transaction reporting is under consideration. This will enable investors to better assess the long-term impact of loan modifications. Specifically, the following information should be disclosed:

- Number and dollar amount of loans that were modified during the reporting period by category (i.e., payment reset, note rate reduction, term extension, amounts capitalized or forgiven).
- Cumulative number and dollar amount of modified loans posting transaction closing date by category (i.e., payment reset, note rate reduction, term extension, amounts capitalized or forgiven).
- Total number of times that each loan in the deal was modified since inception.
- Cumulative recidivism rate for all modified loans since the closing date (as a percentage).
- The number and percentage of modified loans that are included and excluded from the delinquency trigger calculation.
- The cumulative number and percentage of loans that passed the modification performance test.

While DBRS believes that modifications can provide an optimal solution to borrowers who are experiencing temporary financial hardship, they are not a prudent alternative for borrowers who are fundamentally unable to afford their homes. Consequently, servicers should avoid a broad-based approach to modifications and grant them only after careful evaluation of the unique circumstances of the borrower.

For questions or comments, contact Sagar Kongettira at skongettira@dbrs.com, Quincy Tang at qtang@dbrs.com or Sharon McGarvey at smcgarvey@dbrs.com.

¹ June 2007, ASF *Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans*.

² Deutsche Bank.