Bankruptcy Cramdown And Its Impact On Private-Label RMBS

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Several bills[1] have been recently introduced in Congress (collectively, the "Bankruptcy Legislation") that would amend the U.S. Bankruptcy Code to, among other things, give bankruptcy judges in Chapter 13[2] cases the power to modify terms of certain mortgages secured by principal residences, including forcing principal reductions. This practice is known as "cram down" because it forces the mortgage holder to accept terms as modified by the bankruptcy judge. Under current bankruptcy rules, a judge has cram down power with respect to a debtor's loans secured by second homes and certain other assets, but not principal residences. Although other attempts in Congress to pass similar legislation in the past year have failed, it appears that momentum is gaining in Washington for some form of cram down legislation to be passed in the near-term. Considerable impetus to the passage of legislation was given by Citigroup's announcement of its conditional support, subject to certain revisions that have subsequently been made to the legislation.[3]

Since mid-2007, the residential mortgage markets have been characterized by steeply rising foreclosures, as declining home prices and deteriorating economic conditions have left many homeowners without equity in their homes and/or unable to pay their mortgages, particularly adjustable rate mortgages. Proponents of the Bankruptcy Legislation believe that current voluntary foreclosure-prevention programs are falling short of providing adequate relief to distressed borrowers and have suggested that securitization may partially explain the paucity of loan modification activity. Some securitization governing documents prohibit all or certain types of modifications or place quantitative limits on the number of modifications. Further, even where the servicer has clear authority to modify troubled loans, the servicer may generally do so only if the modification is in the best interests of investors. Given the limited history of large scale modifications, there is not, as yet, a clearly evolved consensus by market participants about the degree of underwriting activity to be performed by the servicer in connection with a modification or about what type of modifications are in the best interests of investors. Although investors prefer a hierarchy of modifications that avoids principal forgiveness, some recent data suggests that principal forgiveness, rather than interest rate reductions or principal forbearance, may be more effective at preventing redefault by the borrower. Regardless of the reason for the current pace of loan modification activity, the Bankruptcy Legislation's supporters hope that it will spur modification efforts by making securitization investors more amenable to the servicer implementing systematic pre-bankruptcy modifications, including those involving principal forgiveness, rather than risk a more severe principal writedown in a bankruptcy proceeding.

This article examines the impact that enactment of the Bankruptcy Legislation would have on private label (non-GNMA and non-agency) securitizations of residential mortgage loans and investors in securities ("RMBS") issued in such securitizations.

Proposed Changes to the Bankruptcy Code

The proposed legislation would allow individuals with higher debts to have access to Chapter 13 proceedings. To be eligible for filing under Chapter 13, an individual must have a regular income and unsecured debts of less than $336,900 and secured debts of less than $1,010,650. The Bankruptcy Legislation would exclude from computation of debts: (1) the debts secured by the debtor's principal residence if the current value[4] of that residence is less than the secured debt limit; or (2) the debts secured or formerly secured by debtor's principal residence that was either sold in foreclosure or surrendered to the creditor if the current value of such real property is less than the secured debt limit.[5] Accordingly, if a borrower owns a principal residence with a "current value" less than $1,010,650, regardless of the unpaid balance of the mortgage loan, the entire mortgage debt is disregarded for the computation of debts calculation.

The proposed legislation would provide bankruptcy judges in Chapter 13 proceedings with power to modify terms of mortgages originated before the enactment of the Bankruptcy Legislation[6] and secured by principal residences (including mortgage loans secured by subordinate interests in such residences) as follows[7]:

Reduce the principal amount of the mortgage loan secured by the principal residence to the value of such residence. The principal reduction would become an unsecured claim that would be paid consistent with the provisions of the debtor's confirmed Chapter 13 plan.[8]

For adjustable-rate mortgages, prohibit, reduce or delay the interest rate adjustment. This could be used to prevent a very low introductory "teaser" rate from adjusting, in effect fixing such teaser rate for the life of the loan.

Reduce the interest rate to a fixed rate equal to the recent annual yield on conventional mortgages published by the Board of Governors of the Federal Reserve System[9], plus a reasonable premium for risk.[10]

Extend the mortgage loan term up to the longer of (i) 40 years (less period loan has been outstanding) and (ii) the remaining loan term.

A bankruptcy judge may not effect any such modifications unless:

1. the debtor has received prior to the bankruptcy filing, notice that a foreclosure proceeding may be commenced (thereby preventing a borrower who is current on his mortgage loan from taking advantage of these modification provisions);
2. the debtor makes certain certifications regarding


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its attempt to request a modification from the servicer within a specified period prior to the bankruptcy filing; and

3. the court finds that:

such modification is in good faith[11], and the debtor did not obtain the mortgage loan by misrepresentation, false pretenses or actual fraud[12]. The proposed legislation would also allow for the waiver of any prepayment penalty on a mortgage loan secured by the debtor's principal residence regardless of whether the first two conditions are met.[13]

In addition, the bill recently approved by the House Judiciary Committee provides that if the principal balance was reduced by the bankruptcy judge, the mortgage holder, under certain circumstances, will share in any appreciation of the residence that is sold by the debtor during the period prior to receiving a discharge under Chapter 13.[14] If the residence is sold in the first year following the effective date of the plan, debtor has to pay the mortgage holder from the net sale proceeds 80% of the difference between the sales price and the amount of the mortgage holder's claim (plus costs of sale and improvements), not to exceed the allowed secured claim calculated had the bankruptcy judge not reduced the principal balance. The applicable percentages are 60%, 40%, and 20% if the residence is sold in the second year, third year and fourth year, respectively, following the effective date of the plan.

The claim of a mortgage holder will be disallowed if such claim is subject to a rescission remedy due to violations of the Truth in Lending Act, regardless of whether a foreclosure judgment has been previously entered.[15]

Impact of Bankruptcy Legislation on Private-Label RMBS

The effect of a reduction of the principal balance or interest rate of a mortgage loan by a bankruptcy judge on an investor in a RMBS transaction will be determined by the specific terms of the related securitization documents and whether the transaction utilizes the "shifting interest" structure (used by virtually all of the prime and much of the Alt-A market) or the overcollateralization structure (used by virtually all of the subprime and a portion of the Alt-A market). In general, principal losses resulting from a bankruptcy cram down will be allocated to the most subordinated class of securities in "shifting interest" transactions or first to the overcollateralization and then the subordinated certificates, if any, followed by a monoline insurance policy, if any, in overcollateralized transactions. However, in certain "shifting interest" transactions, bankruptcy losses in excess of a specified "excess bankruptcy loss amount" will generally be allocated pro rata among all classes of senior certificates and subordinated certificates. The excess bankruptcy loss amounts, which were established by the rating agencies, vary from transaction to transaction based on the volume of second, vacation and non-owner occupied homes in the pool, which have always been subject to cram down risk, but did not take into account the possibility of cram down on mortgage loans secured by principal residences. These excess bankruptcy loss amounts can be as low as $100,000.

The potential surge in Chapter 13 bankruptcy filings that may result from passage of the Bankruptcy Legislation raises the previously unanticipated consequence that principal losses, which may be significant, will be realized by the senior and more highly rated subordinated classes in shifting interest transactions that incorporate an "excess bankruptcy loss" feature. This may in turn result in ratings downgrades and further erosion of security prices. Further, the downgrade or allocation of principal losses to those classes may cause them to be considered "other than temporarily impaired" for accounting purposes, resulting in writedowns of securities classified as "held to maturity" or "available for sale" and capital charges to financial institution holders.

Regardless of how principal losses are allocated to the related certificates, a question of timing arises. Does the loss arise at the time that the secured amount of the mortgage loan is reduced to the value of the property or only when the unsecured excess, to which the lender is entitled ratably with other creditors, is discharged upon performance by the debtor of his payment plan? This may depend on how the related securitization agreements[16] address this matter and the extent to which it is clearly specified in final Bankruptcy Legislation whether a cram down is permanent or subject to reinstatement if the debtor defaults on the payment plan. In the event that the loss is not allocated in full at the time of the cram down, additional interest shortfalls or losses could be created as interest accrues on the crammed-down principal amount, which interest, even if advanced, would ultimately not be collected from the borrower.

With respect to interest reductions resulting from a modification of the mortgage terms by a bankruptcy court, most commonly these reductions would result in (i) shortfalls to the most subordinate classes in a transaction where all or most of the classes of certificates have fixed rates or (ii) a lower interest rate payable to certificates that have interest rates payable based on the weighted average net mortgage rate of the loans in the transaction. However, many variations exist and reference must be made to the terms of the specific securitization documents.

First lien mortgage loans secured by principal residences with loan-to-value ratios in excess of 80% at origination generally have the benefit of private mortgage insurance ("PMI"), covering a portion of the loss incurred upon foreclosure. However, the existence of private mortgage insurance will not necessarily protect RMBS investors against principal cram downs effected by bankruptcy judges. The typical PMI policy does not require the insurer to pay for losses resulting from a principal reduction by a bankruptcy judge at the time such cram down occurs. The insurer will only be obligated to cover the principal reduction if the borrower subsequently defaults on his modified mortgage loan. Accordingly, if the borrower pays off the modified mortgage loan (including by way of sale of the property), the insurer will not be obligated to cover the losses resulting from the principal cram down. ■

Notes

1 (S. 61) Helping Families Save Their Homes in Bankruptcy Act of 2009; (H.R. 200) Helping Families Save Their Homes in Bankruptcy Act of 2009. Similar legislation was also introduced in the House of Representatives by Representative Brad Miller – Emergency Homeownership and Equity Protection Act (H.R. 225).

2 A debtor filing under Chapter 13 of the Bankruptcy Code would have the ability to adjust her debts pursuant to a plan without having her assets liquidated. A debtor under Chapter 7 of the Bankruptcy Code would have her assets liquidated and debts discharged.

3 On January 27, 2009, the House Judiciary Committee approved (H.R. 200) Helping Families Save Their Homes in Bankruptcy Act of 2009, which amended the original bill to incorporate the provisions that Citigroup requested, as well as certain other amendments that will be discussed in the article.

4 Note, it is not clear from the language in the legislation when "current value" is to be measured. Presumably it is as of the date of the bankruptcy filing.

5 Section 109(e) of the Bankruptcy Code, as amended by the Bankruptcy Legislation.

6 On January 27, 2009, the House Judiciary Committee approved (H.R. 200) Helping Families Save Their Homes in Bankruptcy Act of 2009, which limits the legislation's applicability to mortgages in existence at the time the legislation is enacted.

7 New Section 1322(b)(11) to be added by the Bankruptcy Legislation.

8 As currently drafted, if a debtor were to fail to make payments in accordance with the terms of the Chapter 13 plan and the case is dismissed, the terms of the mortgage could revert back to the original unmodified terms. The National Conference of Bankruptcy Judges submitted a letter to the sponsors of the legislation addressing certain ambiguities with the text of the legislation. One such ambiguity concerned whether it was the intent of Congress to have the cram down modification be permanent, regardless of the debtor's performance under the payment plan. Language was suggested that could make the modification permanent (notwithstanding the debtor's failure to make payments in accordance with the plan) if Congress so intends.

9 The substitute version of (H.R. 200) Helping Families Save Their Homes in Bankruptcy Act of 2009, approved by the House Judiciary Committee on January 27, 2009, amends this fixed rate to equal the currently applicable average prime offer rate corresponding to the applicable repayment term, as published by the Federal Financial Institutions Examination Council, plus a reasonable premium for risk.

10 The proposed legislation does not define "reasonable premium for risk".

11 New Section 1325(a)(11) to be added by Bankruptcy Legislation.

12 New Section 1325(a)(11) to be added by revised House bill recently approved by the House Judiciary Committee.

13 New Section 1322(c)(5) to be added by the Bankruptcy Legislation.

14 New Section 1322(g) to be added by the House bill.

15 New Section 5.02(b)(10) to be added by the bill approved by the House Judiciary Committee on January 27, 2009. In the original version of the Bankruptcy Legislation, claims would also be disallowed for violations that resulted in a remedy of damages (in addition to rescission) and would be triggered by violations of other State or Federal consumer protection laws.

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