



## Relieving Wall Street of Debt Does Not Translate into the Right to Stop Foreclosures

CRL Issue Brief

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As Congress considers the \$700 billion bailout proposal, some argue that if the government acquires mortgage-backed securities (MBS) that include distressed loans, the government will have the right to modify those loans to prevent foreclosures. Unfortunately, this simply isn't true. Just as corporate bond holders have no right to control the bond issuer's management decisions, so too do MBS holders have no right to control how the trust manages the mortgages.

***The government will rarely become the owner of individual mortgage loans.***

80% of subprime and Alt-A loans are securitized—the types of loans most likely to be distressed now. Therefore, for the most part, the assets the government is acquiring are not the mortgages themselves; they are securities issued by a trust that is the owner of the mortgages.

***In any case, the government will be one of many owners.***

On any given security, there are potentially hundreds of owners that have a right to the cash flow generated by the mortgages. Importantly, the trust strictly limits owners' rights to control how the mortgages are handled or the owners' right to cause the servicer to undertake widespread modifications.<sup>1</sup> An example of such language is included at the end of this discussion.

***Any party modifying loans must rely on servicers, who aren't—and can't—get the job done.***

The trust hires a loan servicer to actually carry out the day-to-day tasks related to the mortgage, such as collecting payments, foreclosing, and handling any requests for loan modifications. To date, loan servicers have granted relatively few effective modifications—for many reasons, including being seriously understaffed to handle massive foreclosures, fear of lawsuits from securities holders and financial incentives to foreclose.

***Roughly half of all subprime loans have second mortgages attached.*** Another major complicating factor is that second mortgages are commonly attached to distressed loans. Servicers of a first mortgage will not voluntarily reduce principal or interest payments that would simply flow to a formerly worthless second mortgage.

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<sup>1</sup> Generally, a 2/3 vote is required to alter provisions in the contract governing a trust. If such a vote results in reducing the cash flow to any holder, then any holder affected must consent to the change. Such consent is virtually impossible to obtain.

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### ***Restructuring Through Courts Overcomes Obstacles, Allow Large-Scale Foreclosure Prevention***

- Only a court-ordered modification can **require** the trust to go along with a loan modification and deal with the second mortgage problem.
- Giving homeowners access to the courts will also make voluntary modifications more likely, because a trust could defend any lawsuit by asserting that the borrower could have gotten the same deal (or one less favorable to the trust) in bankruptcy.
- Thus, permitting bankruptcy relief will mean that very often that option won't be necessary.

### ***Sample Trust Language***

Here is sample trust language clarifying that the trust agreement cannot be changed by a security holder if it reduces cash flows to other security holders, as widespread modifications must:

This Agreement or any Custodial Agreement may also be amended from time to time by the Depositor, the Master Servicer, the NIMS Insurer, the Trustee and, if applicable, the Custodian, with the consent of the NIMS Insurer and the Holders of Certificates entitled to at least 66% of the Voting Rights for the purpose of adding any provisions to or changing in any manner or eliminating any of the provisions of this Agreement or any Custodial Agreement or of modifying in any manner the rights of the Swap Provider or Holders of Certificates; provided, however, that **no such amendment shall (i) reduce in any manner the amount of, or delay the timing of, payments received on Mortgage Loans which are required to be distributed on any Certificate without the consent of the Holder of such Certificate**, (ii) adversely affect in any material respect the interests of the Swap Provider or Holders of any Class of Certificates (as evidenced by either (i) an Opinion of Counsel delivered to the Trustee or (ii) written notice to the Depositor, the Master Servicer and the Trustee from the Rating Agencies that such action shall not result in the reduction or withdrawal of the rating of any outstanding Class of Certificates with respect to which it is a Rating Agency) in a manner other than as described in (i), or (iii) modify the consents required by the immediately preceding clauses (i) and (ii) without the consent of the Holders of all Certificates then outstanding. [emphasis added]

(PSA for Park Place Securities, Inc., Series 2005-WHQ4, serviced by Homeq and with Wells Fargo as Trustee).