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Equitable Reformation of Mortgages: An Alternative Approach To Stabilizing The Housing Market

GIL SANDLER

The author reviews the background of the "Subprime Meltdown" and offers a non-bankruptcy solution.

The loose lending and cheap, easy money that formed the Federal Reserve's solution to the 2000-01 technology bubble fueled an even worse housing bubble. It should have come as no surprise to anyone watching the U. S. economy that this bubble would inevitably burst when the Fed jacked up rates when it returned to its primary "day job" of controlling inflation. Unfortunately, neither the Fed, the credit rating agencies, nor the financial institutions involved in the global capital markets anticipated several key factors that caused or contributed to the current crisis:

- The massive volume of poorly underwritten sub-prime, Alt. A, and other aggressive mortgages made for high fees to unqualified borrowers.
- The probability that housing prices would flatten or decline as interest rates rose, leading to an inability on the part of even qualified bor-

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rowers with real incomes to afford higher monthly payments or to refinance ballooning payment mortgages, like Option ARMs whose below-market teaser rates doubled and tripled.

- The global impact of the mortgage origination and validation process. By allowing mortgage loans to be originated and documented by fee-driven, largely unregulated, and often ill-trained mortgage brokers, junkpiles of "no-doc" and overstated income loans, backed by inflated appraisals, were dumped into pools created by larger intermediaries and Wall Street securitization machines. These supposedly diverse mortgage-backed securities ("MBS") were, in turn, sliced and diced into tranches of collateralized debt obligations ("CDOs"), with scaled seniority ranking to absorb defaults. The result was more than a trillion dollars of MBS and CDOs, rated AAA, AA, and BBB obtained through highly structured over-collateralization, that were sold to conservative high-grade investors. "CDO squareds" reflected the added leverage of investing CDO bond proceeds in other CDOs, thus increasing the ultimate exposure to the lowest tranches of poorly underwritten RMBS. Yet, many of these CDO issues were rated AAA/Aaa and wrapped with AAA/Aaa bond insurance to achieve the appearance of safety for investors.
- The lack of careful loan and documentation review, or "due diligence," which was increasingly outsourced and not well-monitored by Wall Street MBS groups in the feeding frenzy to generate ever more sales volume.
- The liquidity crisis caused by a massive oversupply of devalued MBS and CDOs.
- The simultaneous draws on bank credit lines by investors and bank-sponsored structured investment vehicles ("SIVs") investment funds unable to meet redemptions or roll over maturing obligations, requiring balance sheet absorption and additional capital.
- The unimaginable effect of CDO downgrades on monoline bond insurers whose diversification from low margin municipal bond insurance into asset back and structured finance eroded their highly leveraged capital base.

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- The unforeseen disruptions in the credit-default swaps, derivatives, and auction-rate securities markets that were heavily dependent upon Aaa/Aaa rated bond insurers.
- The virulent spread of MBS and CDO infections into nearly every major financial institution in the US, Europe, and Asia.

To unravel this tangled, multi-layered web will ultimately require a lot more money and creativity than interest rate reductions and the injection of anti-recession vaccines. The long overdue banking reforms now seem counterproductive when credit needs to be made available to refinance millions of unworkable mortgages. Regulatory and legal actions against lenders and Wall Street may recoup some scattered investor losses, and rate freezes on ARMs may offer another band-aid, but none of these stop-gap measures will help the real victims. So long as the housing market continues to be disrupted by forced sales into a declining market, with no end in sight, all homeowners — even those not forced to sell or refinance — will remain understandably insecure and limit their spending. In short, the housing and mortgage crunch is a pretty good recipe for recession.

Legal liability and the payment of damages should follow the path of the tainted mortgages and their proceeds. Thus, subprime and even Alt. A mortgages that were improperly originated by their sale to unsuitable or unqualified borrowers, or through misrepresentation, over-appraisal, or otherwise, should, in effect, be "puttable" by each entity in the securitization funding chain to its successor down the line who chose to accept the mortgage loan at face value with little, if any, due diligence. Many of the mortgage broker culprits will have closed their doors, and filed Chapter 11 or sold remaining assets to others, after their principals and brokers have slated away cash or stock option rewards. The funding sources left standing — mostly large financial institutions — are left to absorb many of these losses, and should be required to step up to refinance or reform these defective mortgages sold to innocent homeowners now struggling to avoid foreclosure.

Regulators and government leaders will take some time to deal with the complicated issues of which some players are more culpable than others, and which can better afford to be targeted by class action lawyers and

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state attorneys general. Meanwhile, lenders are belatedly working with borrowers and non-profit counselors to negotiate extensions and payment forbearances, as ARM rates reset. As indicated above, the Fed's market-slashing will help on rate resets, but it won't stop declining property.

THE SUPPLY-DEMAND IMBALANCE

A forest fire of this magnitude needs more than one fire truck and many collaborative rescue teams. New legislation to provide tax credits, expand Fannie and Freddie Mac lending limits, increase FHA coverage, and Fed actions to promote liquidity and lower consumer rates are all important. Eventually, class actions and state consumer advocates may compensate some of the victims of the "Subprime Meltdown," as it has come to be known. The Federal Reserve and banking and insurance regulators can and should encourage investments to provide liquidity and shore up the badly frayed capital of our domestic banks, investment banks, and financial guarantors, whose downgrades will ultimately affect trillions of dollars of municipal bonds, and reduce their value. The abandoned campaign to create a Super-SIV to build a floor value for CDOs held by bank-supported SIVs may be replaced by other market-oriented programs to stabilize securities' valuations.

Meanwhile, pressures continue to build for monoline bond insurers — whose core trillion dollar municipal insurance business requires a perpetual AAA/Aaa ratings — to beg for additional capital at virtually any price. New York Insurance Superintendent Dinalo has been cajoling the major banks into investing or providing back-up lines to the insurers and licensed Warren Buffet's newly formed AAA/Aaa insure, but nothing seems to be working. As a striking example of how far the unscathed financial institutions are from the insurers infected by Subprime Fever — contracted airborne from CDO insurance — Buffett's Berkhsire Hathaway unit offered to reinsure the least risky municipal issues in the monoline insurers' portfolio at a cost of 150 percent of the original collected premiums. Of course, no reinsurance was offered to cover CDO exposure, which is what has magnified the capital requirements to retain those precious AAA/Aaa ratings.

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However, none of these proposals has directly addressed the fundamental problem of stabilizing the housing market. While the Fed, economists, regulators, and bankers are only just beginning to understand the far-reaching effects of their collective folly, Congress and commentators are suggesting a wide variety of reforms and market-supporting programs. Some are focused on replacing the billions of depleted capital of our banks, investment banks, and insurers — particularly the AAA/Aaa-rated bond insurers who insured CDOs and sold credit-default swaps. Other reforms are pressing major lenders like Countrywide — soon to be acquired by Bank of America — to gently renegotiate subprime loans. Class action lawyers and state attorneys general are seeking recourse against the once deep-pocket Wall Street firms who packaged and sold these poorly underwritten loans. All of those activities seem focused on stabilizing the bond markets and/or compensating for investment losses.

But what about the real estate market, and the millions of homeowners whose property values are dropping as a result of auctions, foreclosures, bankruptcies and short sales? The housing market won't stabilize until the supply-demand imbalance is reversed. Lower mortgage and consumer rates triggered by Fed rate reductions will help to qualify some extra buyers, but so long as the number of unsold units continues to be increased by more distressed sales, the vicious cycle will continue, and could drive the economy into a real estate recession deeper than experienced in the past 30 years. Recent reports reflect a loss in real estate vale of 10 percent to 20 percent in several markets and many observers are predicting another 10 percent to 15 percent loss, particularly in the overbuilt markets like Florida, Las Vega, Arizona, and parts of California.

With more than 100 million owner-occupied residential units, the U. S. housing market in normal times is remarkably resilient to fluctuations in our economy. Downturns and recessions don't invariably lead to price declines in housing, though they often lessen upward trends and flatten or reduce rents, as alternatives to home purchases. What is so devastating about the current housing market is the supply-demand imbalance. The supply side is inflated by the inventory surplus from unsold new units begun during the bubble and forced sales due to mortgage defaults — many caused by unsustainable mortgage loans resetting at higher month-

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ly payments after low teaser rates. The demand side is reduced by the disappearance of qualified buyers caused by tighter credit and income qualification (in turn, flowing from bank capital losses from CDOs), higher equity requirements which are more difficult to meet in the imminent recession as "move-up" buyers' face an inability to commit while their homes remain unsold, and buyers' fear of overpaying in a down market.

As we have seen with the 2001-2006 housing inflation, as much as 30 percent of our economy was directly or indirectly fed by real estate, construction, and related jobs and spending fueled by "cash-out" mortgage refinancings and home equity growth. However, starting with the Fed's 18 consecutive rate increases, spendable income has been pinched and new and old jobs have been lost not only in construction, brokerage, and mortgage financing, but across the board in home improvement, retail, entertainment, and even healthcare. In a bit of poetic justice, the once invincible banks and investment banks that invented CDOs and spread the Subprime Fever will also be shedding jobs, cutting bonuses and dividends and begging for new capital. Can there be any doubt that, regardless of GDP measurement, the recession of 2008 has arrived?

Amid the cacophony of constructive efforts to compensate abused CDO investors, an effective revival program must bolster housing values by addressing the oversupply problem. To be fair, the Administration's rate freeze will help some borrowers stay in their homes, and adverse publicity and governmental "jawboning" seem to have softened some lenders' attitudes towards workouts. Still, these palliatives won't help all, or even most, borrowers who were either misled or mistakenly assumed they could refinance in an ever-rising market. Regardless of who was more at fault — and there's plenty of blame to pass up the line — if we can lessen the volume of distressed sales and sellers, property values can begin to find a floor. At that point, qualified buyers, armed with lower-rate conventional mortgages (meeting expanded FNMA, FHMLC, or FHA limits) can begin to jump in to buy properties that might otherwise suffer mortgage defaults. As a result, the securities markets will suffer fewer MBS and CDO losses, and billions of bank write-offs and extra reserves can be converted into profits and capital to support increased lending.

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The moral justification for aiding certain borrowers, rather than all borrowers or all or some investors suffering losses from the Subprime Meltdown, requires a fairly complex analysis. It may be that the courts or administrative tribunals will have to sort through the circumstances of each loan origination to decide who was misled. They should also consider which borrowers were invited to apply, then routinely accepted, unverified "no-doc," "stated income," Option ARMs, usually with low "teaser" rates, and high reset, high fee loan that was unsuited to either or both the inflated property or a limited-income borrower. Oddly enough, we expect, a healthy percentage — possibly as much as 40 percent — of these first-home borrowers in or near delinquent status to have the motivation and ability to keep their homes if their mortgages can be adjusted to current values and standards.

If these borrowers, who were victims of either direct misrepresentation or a system breakdown, can afford currently reduced conventional rates on a reduced mortgage amount based on current market values and standards, why not give them the chance?

As recently proposed in a bi-partisan initiative, Congress should immediately amend the bankruptcy laws to allow for the bankruptcy courts to reform residential mortgages — a remedy already available to commercial property owners, but abandoned in the bank-sponsored, anti-consumer amendments of 2004. Moreover, in order to avoid the taint and expense of bankruptcy, Congress should devise a new system to administer the equitable reformation of these mortgage loans. Rather than rely on good will gestures by lenders that will be much too late to avoid the glut of auctions, "short sales," or foreclosures, or wait for inconsistent state action, why not establish a national, uniform program to reform those mortgages that should never have been made for excessive amounts with excessive carrying costs and fees? The resulting write-offs may be more or less than already incurred by lenders, banks and securities firms, but by converting distressed property sales into a new group of performing loans, we can begin to establish a floor for property values, and a basis for revaluing MBS and CDOs containing devalued MBS.

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A MORTGAGE REFORMATION PLAN

This concept has ample precedent in the commercial real estate world. That multi-trillion dollar market utilizes primarily non-recourse "permanent" (usually 10 years) mortgage loans with unamortized balloons to be repaid from the proceeds of sale or refinancing. Ironically, this market also financed most loans through large billion dollar CMBS pools, leaving the lender and subsequent investors with the risk that at the end of the typical 10 year loan term, the property will retain enough residual value to enable that mortgage to be refinanced. To cover market cycles and downturns, lenders usually require 10 percent to 25 percent equity, but this will vary by market and property type. Mezzanine and subordinated loans bridge the gap up to as much as 90 percent to 95 percent of fair market value if the value and borrower's track record are strong. By contrast to the securitized residential loans now going into default, the commercial CMBS market is supported by relative uniformity in underwriting standards and documentation and careful appraisals and due diligence.

In terms of lender's risk, the Subprime, Option ARMs, and many Alt. A loans offer a close analogy. By originating and reselling "no-doc" or "stated income" loans, brokers and lenders were, in effect, telling borrowers that their credit was irrelevant. They assumed, and told borrowers to assume, that property values would continue to rise to permit them to refinance before required payments exceeded the borrower's cash flows. Why not, then, treat primary residence mortgage loans to non-speculative borrowers as non-recourse loans? Instead of requiring short sales or foreclosures — which are guaranteed to produce net sale proceeds at least five percent to 10 percent below fair market value — why not allow those borrowers who can afford to make reasonable payments to retain ownership and pay a conventional market rate on a reduced mortgage amount based on current appraised value?

A REAL WORLD EXAMPLE

This proposal may be better understood by an example:

Bill and Lisa Armstrong, in their mid-40s, are a two-earner household

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in the Cleveland area. Their combined household income supporting a family of five was about $50,000. In 2006, their original 1,700 square foot three bedroom house worth about $225,000 on a .125-acre lot had become tight and rather than spend $50,000 to $75,000 to expand it, they decided to move up to a newer 2,500 square foot house on .25 acre at $350,000. They sold their house for $225,000, paid off their $150,000 seven percent mortgage and invested $35,000 of the $50,000 remaining proceeds after commissions and closing costs in the new house, borrowing $315,000. The mortgage broker said they wouldn't qualify for a conventional 30 year mortgage at 6.5 percent, and that loan would be limited to $280,000, but he could get them a $315,000 quick "no-doc" ARM at an initial rate of three percent for the first two years resulting in monthly payments about the same as in their old mortgage. Although the rate would reset to the stated 8.5 percent rate, the broker said the house should be worth 20 percent more so the loan could be easily refinanced on a conventional 80 percent LTV basis to keep the payments reasonable, or they could sell the house at a big profit.

By then, of course, their incomes would have risen, so no problem, or so they thought. There was no discussion of the facts that (1) the broker's firm would receive five percent of the loan amount (of which the broker/salesman would get half); (2) that the broker's firm was reselling the loan to a Wall Street packager at a rate of seven percent, producing extra profits; or (3) that the mortgage principal to cover "negative amortization" (between the 8.5 percent stated rate and the three percent pay rate) would actually increase by $34,650 (11 percent) over two years to $349,650. This would require the house to be appraised at more than $437,000 to support an 80 percent LTV refinancing in two years. Instead values have gone in the other direction.

When the loan rate resets to 8.5 percent in 2008 on their $349,650 loan, the Armstrongs' monthly payment will more than double. If they try to refinance or sell the house, they are faced with the reality that the neighborhood has 15 similar homes for sale for sale at $275,000 — more than 20 percent below the $350,000 they paid. A sale at that price would net them about $255,000, and leave them about $90,000 short. It seems that they will exhaust their kids' college funds and savings to repay the lender

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and be forced to file for bankruptcy.

The 2006 mortgage was resold to a major bank and then packaged into a $1 billion RMBS pool, which was sliced and diced into classes of CDO bonds. The loan is now being serviced by a major bank on behalf of the trust that manages the CDO. The lender's workout group has re-appraised the house and knows the house is only worth $275,000 and if it's auctioned or foreclosed, the lender will be lucky to keep about $250,000 after six months of carrying costs. Whether or not the current loan servicer was affiliated with the original mortgage broker or lender, or inherited any legal or ethical responsibility for the broker's misrepresentations, it may be unable or reluctant to write off any portion of the loan while it remains in a CDO pool.

If, however, an equity or bankruptcy court was authorized to reform the loan, it could reduce the loan to the current $275,000 appraised value. An 80 percent LTV conventional 30 year fixed rate loan — which could qualify for FHA insurance or for purchase by FNMA or FHMLC — at a current rate of 5.75 percent on $220,000 would leave the Armstrongs with an affordable monthly payment. As for the $55,000 or 20 percent "equity," the Armstrongs could pay half from their savings and the lender could extend a subordinated loan for the other half. The lender would either pay off the old loan and be done with it, and book a performing loan for about the same amount it would receive in a foreclosure of "short sale," and the house would not have to be sold. Alternatively, the lender could re-classify the loan on the new terms, but I suspect the CDO securitization documentation may require those loans to be discharged.

Of course, someone takes the hit equal to the write-down of the loan. Approximately $75,000 or 21.7 percent of the accreted loan amount would be charged off, but that is likely to be less than the average loan amounts already written off by the various participants in the subprime chain. Most of the bank hits taken to date have been based on reduced market values of CDOs on their books caused by ratings downgrades, and not directly correlated to anticipate loan default rates and estimated loan losses. If the volume of distressed sales can be reduced by 30 percent to 40 percent, the underlying real estate value of the collateral underlying these CDOs can be stabilized. At the same time, lower defaults can counter the over-reactive,

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Draconian default assumptions of the rating agencies.

Then, too, as loans previously stripped down to no value are retired at 70 percent to 80 percent of their face amount, some the super-senior portions of CDO securities should regain market value. Eventually, the trash heap of subprime loans expected to support AAA tranches of CDOs, and then discarded as worthless, will regain some value as the percentage of performing loans in CDO pools increases. This would permit re-rating some of the downgraded CDO classes and restore market value.

It should be noted that this mortgage reformation concept is very similar, not only to the non-recourse world of commercial mortgages, but also to the "short sales" now being practiced by some lenders and promoted by non-profit consumer groups. The major differences are that this reformation plan would keep motivated owners in their homes and keep them off the market at a cost of requiring the lender to extend a subordinated loan roughly equal to the costs of sale. In some cases, the struggling borrower may require more assistance, such as increasing the subordinated equity loan from 10 percent to as much as 20 percent, but at least in the case of borrowers with the ability to pay the reduced loans and interest on the subordinated portion, it is a vastly superior solution.

THE MECHANICS OF EQUITABLE REFORMATION

Although most states have equity or chancery courts, the mortgage crisis is a national problem and requires a national solution. New federal legislation would be necessary to implement this or any similar reformation plan. Although the simplest solution would be to amend the bankruptcy laws, a new set of laws without the taint of bankruptcy would be preferable. The main objective is to provide a court, referee, special master, administrative law judge, or another quasi-judicial entity with equitable powers to reform primary residence mortgages made on a "no-doc," "stated income," or other unverified basis. This law would supersede the terms of mortgage and assignment contracts and require mortgagees and their assignees to offer to reduce the amounts of the loan to current appraised values, or refinance those reduced loans at then current market rates.

Legislation or regulation establishing an equitable reformation

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process would be most effective if it also created a quicker and simpler administrative mechanism — like a prepackaged reorganization handled with standardized forms. Neither homeowners nor lenders benefit from months of uncertainty and court appearances. Although the mechanics work best in this administrative, quasi-bankruptcy setting, it should be supplemented through the bank regulatory framework of the FDIC, OCC, and OTS in order to reduce the costs and pain of administrative or bankruptcy proceedings.

This equitable approach and a bankruptcy law amendment have the benefit of being able to "legalize" the deviation from securitization documentation. Legal opinions confirming the validity and enforceability of the mortgage payment obligations usually contain standard bankruptcy and equity "hedge" provisions. Thus, trustees, mortgage servicers, custodians, and others in fiduciary capacities would be free to consider both practical economics and politically desirable solutions in dealing with distressed borrowers without fear of claims by CDO investors.

If a reformation eventually evolves into or requires a form of bankruptcy filing, the law should limit the adverse effect on credit access. Loan write-offs are, of course, reportable and remain on credit records, but the reformation of subprime loans can, in many cases, be regarded as a positive reflection on a borrower's credit. The loan was clearly not repaid in accordance with its original terms, but investing new equity and continuing to make payments on a new performing loan are not the acts of a deadbeat. Just as mortgage borrowers in the commercial world are not penalized forever for walking away from declining properties, or accepting a rewritten mortgage, residential borrowers should not carry the usual bankruptcy onus for 10 years. Thus, the new law should require a more benign characterization and disclosure of the charge-off, possibly describing the loan "paid as required."

Finally, this reformation proposal has the virtue of avoiding the need for time-consuming and unproductive investigation into the precise misrepresentations of mortgage brokers or borrowers. Litigation and arbitration may be appropriate in some case to resolve individual disputes, but reformation provides a quick remedy for a limited class of borrowers — subprime or otherwise.

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THE FUNDAMENTAL FAIRNESS OF EQUITABLE REFORMATION

Since these borrowers paid higher fees and rates to obtain "no-doc" or "stated income" loans for higher LTV amounts with no income verification, it seems eminently fair to leave the lender with the loss in value of its primary source of repayment. However, by limiting this remedy to borrowers who can meet the terms of performing loans reduced to current market levels and rates, the plan minimizes the risk of future defaults and offers the lender a performing loan to replace the non-performing loan. The primary residence requirement excludes speculators, while the equity and continuing payment requirements ensure that those borrowers who benefit will share some pain over an extended period in return for keeping their homes.

CONCLUSION

There is no single or easy solution to the Subprime Meltdown. The unimaginable fallout of a small percentage of poorly underwritten mortgages will haunt the housing and capital markets for many years. While lenders and investors are seeking to replace capital and allocate financial responsibility for defective mortgage-backed securities, a mortgage reformation program that helps some mortgage borrowers with limited culpability can help stabilize the value of the collateral underlying those securities.

It should be noted that as this article goes to press, prospective programs and solutions abound. Some are similar to what is proposed here. Other equally important programs seek to provide lower refinancing rates. These ideas include:

- A five year freeze on certain reset rates (proposed by the Bush Administration but so restrictive that it would help only about three percent of the resetting loans).
- Broader access to new and refinanced mortgages by raising the limits on FHA insured loans and FNMA and FHLMC-qualified loans to

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$417,000 to $729,750 in higher cost markets, at least through the end of 2008.

- A Bank of America-sponsored plan (somewhat similar to Senator Dodd's Senate Banking Committee plan) to create a new Federal Homeowner Preservation Corporation to buy delinquent mortgages at a steep discount, forgive debt above current market values, and ultimately replace them with lower-cost federally-guaranteed loans. (Note that Bank of America is in the process of acquiring Countrywide Financial, the country's biggest non-bank mortgage lender.)
- A similar House Financial Services Committee proposal, being considered by the Bush Administration, with limitations.
- A proposal by the National Community Reinvestment Coalition to have a federal agency buy $80-$100 billion of troubled loans at a deep discount and repackage and sell them in the securitization market at prices reflecting their realistic cash flows.
- Although it is more modest than the other bailout plans, another appealing plan — surprisingly similar to that presented here – has been offered in concept by the Office of Thrift Supervision. That plan would establish a voluntary system (which would be better if it became mandatory within limits) to have lenders reduce both total principal loan amounts and monthly payments to the current realistic value of the underlying property.

All of these reform proposals reflect the long overdue recognition that the economy cannot withstand the downward pressures of forced sales caused by unregulated subprime and Alt. A mortgage loans. While the liquidity and credit crunches and capital markets disruptions are far greater than were ever imagined, reforming those markets won't solve the root problem of a housing oversupply fueled by forced sales. As a side benefit, most of these plans share in requiring the writedown of the mortgages to reflect the current market value of the mortgages. This could even help the banks' capital by enabling them to recoup some of their prior markdowns, if a new market price is available in a broader, government supported secondary market.

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