

Many investors have taken a negative view on US subprime mortgages over the past year through credit default swaps. But with the US Congress putting pressure on servicers to modify the terms of loans to help borrowers avoid default, those trades might not perform as well as initially hoped. This has infuriated some major investors and could have a knock-on effect on documentation.

By Jayne Jung

Tranche warfare

The US subprime housing market has taken a nosedive. Sixty-day delinquency rates for subprime interest-only and option adjustable rate mortgages jumped from 3.47% in December 2005 to 13.06% in February 2007, according to San Francisco-based research and analytics firm LoanPerformance. The deterioration in loan quality has also been reflected in the ABX.06-2 BBB-, an index that comprises credit default swaps (CDSs) referencing 20 US subprime home equity loans originated in 2006 and rated BBB-. On February 27, the index plummeted to 63.16 points, about 40 points lower than at the beginning of the year and its lowest level since its creation in January 2006.

For some, this upsurge in delinquencies was signposted early last year. Intense competition in the subprime space had led many lenders to relax underwriting standards and increase loan-to-value ratios. Convinced the long bull-run in US house prices would stall and, with interest rates on the up, that increasing numbers of subprime borrowers would struggle to repay loans, a number of investors – primarily hedge funds and proprietary trading desks – began to take short positions, either through the ABX index or CDSs of asset-backed securities (ABSs).

As delinquencies began to rise, these trades came into the money. Deutsche Bank, for instance, took short positions on the ABX index and on collateralised debt obligations (CDOs) referencing mortgage-backed

securities at the end of 2006, enabling it to profit from the slide in the index in February. The bank declined to comment on how much it made from that strategy, but reported revenues of €3.4 billion from fixed-income sales and trading in the first quarter of 2007, up 20% from the same period a year before. Paulson & Co, an \$11 billion New York-based hedge fund, is also believed to have put on a similar strategy, contributing to a sharp rise in the net asset value of its fund in February. Officials from Paulson were unavailable for comment.

However, despite recent mark-to-market gains, there are signs that these trades may not perform as well as had initially been hoped over the long term. Under pressure to help prevent subprime borrowers from defaulting, mortgage servicers are modifying the terms of loans to a much greater extent than they have in the past – some bankers estimate that modification rates have increased fivefold, to as much as 10% of servicers' portfolios. That could have significant consequences for short trades: despite being correct in their view that subprime borrowers would struggle to repay loans, actual delinquency rates may not be as high as investors thought – and that, in turn, could cause short strategies to under-perform.

“Loan modification, if it in fact materialises, may not be a good thing for investors who went short the market,” says Ron D’Vari, head of the structured finance CDO division at BlackRock, a New York-based investment management



firm with \$1.2 trillion in assets. “Some of the early short players in the market may not have had detailed loan-level credit models and shorted the ABX indexes and single-name CDSs on ABSs. They expected their successful shorts to pay for the ones that will not ultimately get written down. But the market has recently rallied, partly due to short covering and partly due to the expectation that loan modification may have a positive impact.” Since February, the ABX.06-2 BBB–index has risen from its 63.16 point low to 76.52 on May 17.

And loan modification rates could increase further. Last month, the Senate Committee on Banking, Housing and Urban Affairs issued a statement of principals for home-ownership preservation, encouraging the industry to contact borrowers early and modify contracts. It also sent a letter to the Federal Reserve requesting that it establish new laws regarding the subprime market. In March, Barney Frank, chairman of the US House of Representatives’ Financial Services Committee, said his group is drafting legislation that would “improve the [subprime] situation and ensure we do not end up here again”.

Some regulators have expressed similar views. Sheila Bair, chairman of Federal Deposit Insurance Corporation, has strongly encouraged early detection of borrowers who need a modified loan. “It appears that a number of loan servicers are proactively contacting borrowers several months before their loans are due to reset to determine the prospect of repayment and modifying loan terms if necessary to avoid default. This is a highly positive development that should be encouraged,” she said in testimony before the US House of Representatives on April 17.

There are several ways that servicers can modify mortgages. One of the most popular is to extend the maturity of the mortgage, typically by an extra 10 years. For instance, total monthly payments on a 30-year \$250,000 loan fixed at an interest rate of 9% would be \$2,111. Increasing the maturity to 40 years would mean payments drop to \$1,928 – a saving of \$183 a month.

A second method is to reduce the interest rate or extend low initial ‘teaser rates’ for more than the pre-agreed period. Servicers can also



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reduce the principal amount to make payments more affordable. Loan modifications differ from other loss mitigation strategies – such as issuing new, interest rate-only loans – as borrowers technically still have their original loans, meaning they are not classified as defaults.

If expansive loan modifications do occur, there will be significant repercussions, both for those investors that went short via the ABX and/or the CDS market, as well as for some of the more traditional mortgage-backed securities participants. Indeed, many investors have expressed strong concern about the effect of loan modifications on ABS performance right across the capital structure.

“Servicers are going to modify mortgages they find are profitable – those loans that have a high probability of being paid back. That’s what they say in their publicised speeches. But in reality, they might be forced to modify all of them. And in the end, it might hurt the performance of the lower junior tranches. If

investors are not worried about this, then they’re really ignorant,” says a senior vice-president at a hedge fund specialising in ABSs.

Joseph Astorina, a New York-based director in Barclays Capital’s US securitisation research team, agrees. “There’s a very good reason to be concerned, especially if Congress does something to impose these modifications. Investors bought these ABS bonds on a certain set of assumptions about what these cashflows are going to look like from the underlying mortgages and with the assumption that there’s only going to be a limited amount of modifications,” he says. “But then if, all of a sudden, there’s the ability to modify a significantly higher percentage of loans in these securitisations, that changes the underlying assumptions the investors bought the bonds on. It can introduce a lot of risk to ABS investors.”

Dealers estimate that \$800 billion–850 billion notional in ABSs on home equity loans was outstanding as of February. Generally

speaking, loan modifications are beneficial for investors of mortgage-backed securities (MBSs) – by altering the terms of the mortgages, fewer borrowers will default, protecting investors against losses.

But that depends on whether the modifications are successful. Greg Lippmann, global head of ABS trading and syndicate at Deutsche Bank in New York, says this isn't always the case. "We think modifying mortgages will delay when the losses occur and reduce losses somewhat. I do know that, historically speaking, modifying mortgages that were delinquent doesn't mean that none of them default," he says. Re-default (or recidivism) rates two years after a loan has been modified run between 30% and 50%.

However, future re-default rates may end up being higher than the historical data suggests, argues the hedge fund senior vice-president. "Servicers often say that a certain percentage of modified loans do not re-default after loan modification. But that cure rate is based on a portfolio where only 30% of the original balance remained on a mortgage-backed security. Change the remaining balance to 50–60%, and the cure rate may not apply. You're in uncharted territory where your re-default rate will increase even higher," he says.

If the loan modifications are ineffective at staving off default, then MBS noteholders may be worse off than before. That's a function of the way excess spread is built up as a cash reserve in these structures. To provide

additional protection for investors, there is often a differential between the average weighted interest rate on the underlying pool of mortgages and the interest rate paid to investors of the notes, providing an excess spread. This excess spread accumulates over time and provides a cushion to protect investors against defaults in the portfolio. If the underlying loans are modified and the rates of interest paid by borrowers are reduced, the excess spread – and therefore the protection for noteholders – also shrinks.

"If all the modified loans default one year later, from an excess spread point of view, the MBS investor is probably worse off," explains Rod Dubitsky, head of ABS research at Credit Suisse, and author of a report published in April called *The Day After Tomorrow: Payment Shock and Loan Modifications*. "Of course, there's extra income being generated from the excess spread in that year when the borrower is paying under the modified plan, but if you have losses you're using it. So, it's not crystal clear. Overall, however, investors probably will lose more than they gain if most of the modifications re-default."

As well as affecting the timing of losses, loan modifications can also have implications on which class of investors is worst hit. "If loan modification only delays defaults and the losses are back-ended, the risk shifts higher up the capital structure," argues an analyst at a major Wall Street firm.

That's because of the unique pay-down

structure in home equity ABSs, which allows transactions that have met performance triggers to de-lever, beginning with the most subordinate tranches. If modifications to the underlying loans mean a structure is able to hit its trigger level, the over-collateralisation credit support is released to the residual tranche holders – something that typically occurs three years into the life of the transaction. If defaults once again begin rising after this point, mezzanine investors risk downgrades and principal loss.

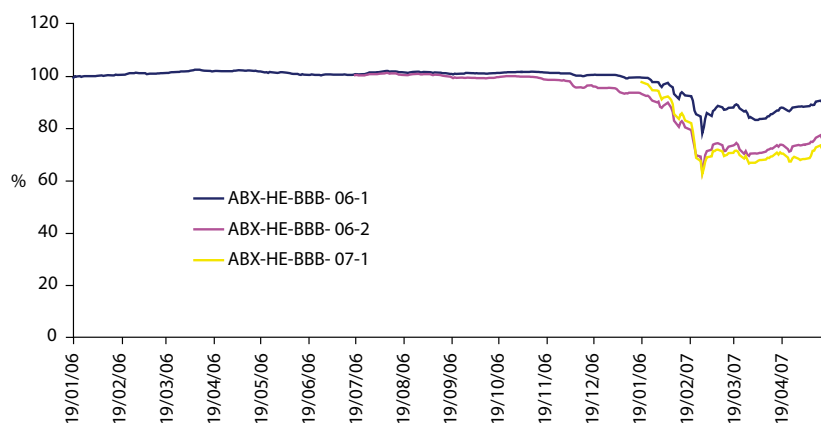
So what does this mean for investors? Most senior investors are likely to have an ambivalent attitude towards loan modification. Some may be against modification as it will probably extend the life of their bonds – and given the increased risks in the subprime market and falling house prices, senior investors may want their money back as early as possible. Others may feel modifications will reduce losses in the portfolio, and so would not be averse to a modest extension in expected maturity. Residual tranche holders, on the other hand, will be very much in favour of loan modification and for the underlying loans to be deemed current.

But it is the middle-tier investors who are likely to cry the loudest. "The guy that will care the most is the A or BBB bondholder, who is going to say 'I need the over-collateralisation to protect me. And if you give it all back to the residual holder, then I'll have to take the loss and the residual holder, who is supposed to be junior to me, will be money-good'," says Karen Weaver, global head of securitisation research at Deutsche Bank in New York. "There is inter-class warfare in terms of what people are going to want to be done here."

Meanwhile, loan modification is likely to be negative for those investors that have taken short positions on CDSs of ABSs and/or the ABX indexes. "If you're betting on this big explosion and this tsunami of subprime defaults in two years and betting on shorting the whole market, we don't believe it will happen. They are going to be dampened because of modifications and other assistance to borrowers," says Credit Suisse's Dubitsky.

For those investors who shorted the residual tranche, increased loan modification will mean fewer defaults than expected in the near term. Many also shorted the A and BBB tranches – a trade that will only be profitable

1 Closing prices of ABX sub-prime indexes, January 2006–May 2007



if loan modifications delay, rather than eliminate, defaults and if the investors took a long-term view.

Most ABX investors use models that assume defaults will occur at a certain rate. However, loans that are technically in default can be modified and shown as current. Servicing contracts do not require servicers to report to investors whether mortgages have been modified. Even if they do, there isn't a set standard about when and how they should report it. "So, all of a sudden, although the quality of the underlying collateral hasn't changed much, the default predictions have changed because that loan is not considered in default any longer. The ABX index could artificially be pumped up," explains an analyst at a major California-based mortgage originator.

This means less profit for hedge funds and proprietary trading desks that have taken short positions on the ABX indexes. It's meant some investors are taking a much closer look at MBS documentation.

Securitisations are set up as real estate mortgage investment conduits (Remic), which allow the securitisation trust to be taxed at the entity level, instead of taxing individual bondholders. The regulation stipulates that the mortgages cannot be modified unless they are either in default or the default is 'reasonably foreseeable'.

"Under Remic, they want to prevent active management of the pool. They want to prevent modifying the terms of the loans when it doesn't represent a significant credit problem," says George Miller, an executive director at the American Securitisation Forum (ASF), a New York-based trade association.

In fact, some contracts stipulate a limit on the number of loans that can be modified. However, in a study that has yet to be released, Moody's Investors Service reports these limitations only occur in a minority of cases. The rating agency estimates that about 5% of securitisation transactions issued in 2006 do not allow for modifications at all, while about a third have a 5% limit, either on the principal balance of the pool or on the number of underlying mortgages.

The lack of clarity in the loan documentation has caught some investors off guard. "Loan modification was a very small percentage of the

overall servicing portfolio, so no-one really paid attention to it. Delinquencies weren't that high, so no-one was concerned about it," says the hedge fund senior vice-president.

The big difference now is the popularity of adjustable rate mortgages (Arms), which has enabled subprime borrowers to take out loans with high loan-to-value ratios, at initial low teaser rates. Around \$220 billion of subprime Arms loans will reset in 2007, with another \$190 billion in 2008 – and with interest rates



Karen Weaver, Deutsche Bank

having steadily risen over the past few years, there are concerns about whether borrowers will be able to meet the higher repayments. In the past, the rising housing market meant that defaulting borrowers could sell their houses to repay the mortgage. That's all changed with the recent drop in house prices, meaning banks are more willing to consider modification rather than take a loss on the loan.

"The reason there is so much talk about loan modification now is that if borrowers have an inherently unaffordable loan on a depreciating asset, servicers are saying we don't want it back either," says Deutsche Bank's Weaver. "In past cycles, the fact that home prices were softer meant those people who lose their job may end up having to default instead of being able to sell. That's where the pain came from. Here,

we have this whole group of people who took out loans right at the peak of the market. The way the loans were structured and underwritten, and the way people invested in them, the implicit assumption is that home prices would be appreciating."

Around 1–2% of subprime originations were modified in the past – a figure that analysts expect will rise significantly. Shane Ross, senior vice-president at Texas-based Litton Loan Servicing, says his firm made 200–250 modifications a month last year. Given current market conditions, he estimates the firm will modify 1,500–2,000 loans a month by May 2008. "A lot of this is because a large percentage of the originations in 2005 and 2006 were adjustable-rate mortgages, and a lot of those are set to reset in the second half of 2007 and in the first half of 2008. It's during those times that we think modifications will become more needed," says Ross.

Even if documentation stipulates a cap on modification, servicers are confident this limit can be exceeded in certain circumstances. Litton Loan Servicing's contracts, for instance, state that it can work with the rating agencies to either increase or remove the limit.

These trends have led to the formulation of a working group, organised by the ASF. Both buy-side and sell-side firms are participating, and are requesting certain changes in loan documentation. "We are not asking that loan modifications be set in stone. This is a dynamic market and documentations need to allow for flexibility, so that servicers can evolve with it," says Mani Sabapathi, principal in the structured finance group at Prudential Financial, who is part of the working group. "But investors are asking servicers to provide more data on loan modification, such as what percentage of the servicer's portfolio has been modified and how many loans have been converted from fixed to floating rate."

But this is cold comfort to disgruntled CDS of ABS and ABX investors. If servicers exceed the number of modifications spelled out in the ABS documentation, investors have little recourse in the courts, say market participants. "They're not a bondholder so they don't have any legal rights. They might buy a bond so they can sue the servicer. But that's very costly, and you better know that you're going to succeed," says one New York-based analyst. ●