

Los Angeles Times

<http://www.latimes.com/news/opinion/la-ow-green-thornberg25-2009feb25,0,5237258.story>

From the Los Angeles Times

Dust-Up

Untangling the mortgage-backed securities gridlock

Should Washington extend some liability protection to loan servicers who modify troubled mortgages? Christopher Thornberg and Richard K. Green debate.

February 25, 2009

Today's topic: Should the federal government protect loan-servicing companies that modify troubled loans against investor lawsuits, even if it means abrogating contracts between servicers and investors?

This week's complete Dust-Up: [Day 1](#) | [Day 2](#)

Set a clear national policy, and go from there

Point: Christopher Thornberg

Whatever your opinion on government money being spent on workouts for borrowers who made terrible financial choices, one question that consistently pops up is why such public action would be needed in the first place. When you sit down and consider the costs of writing down or in some way modifying a loan relative to the cost of foreclosing on the home and finding a new buyer, there is little issue that the former is significantly cheaper than the latter.

In both cases, money is being lost on the loan, but in the latter case, you also have to add in legal fees, the extended period of time that the loan is nonperforming and the costs, both financial and physical, of carrying the property in question on the books until a new buyer can be found in a market flooded by a stock of already-foreclosed units. Why don't investors recognize the potential savings and simply act on their own accord to keep people in their homes?

The answer is very complex. One problem is the relationship between the servicers of the loan portfolios and the many investors who bought the bonds backed by the mortgages. These bond pools have a waterfall-type distribution plan, in which certain investors receive payment before others. This was once touted as a wonderful way of segmenting the risk across different types of potential investors.

In practice, it has turned out to be a nightmare. Different forms of modifications impact the different tranches of investors in different ways. Interest rate modifications hit all investors, whereas reductions in principal balances hit the lower tranches first. As such, no matter what the servicers do, they are highly likely to be sued. Some, such as Countrywide, have already ended up in court.

Could the Obama administration have moved to limit the liability of servicers to allow more flexibility? Possibly, but the administration chose not to. I'm no lawyer, but it does strike me that such a move may have ended up being contested in federal court, perhaps all the way up to the Supreme Court, a process that would have nullified most of its usefulness as servicers would have waited on the sidelines for a decision before making any moves. More important, limiting the liability of servicers would permanently reduce the confidence investors have in third-party asset administrators, who suddenly could be made unaccountable for their actions by a stroke of the pen. This wouldn't be good for the long-run health of the U.S. financial system.

Of course, this invites the question of why banks that hold these mortgages directly, with no liability to mortgage securities investors, have not made substantial modifications to the problem loans they have on their books. Indeed, anecdotes from Realtors show that even short sales -- when the bank allows forgiveness of debt on a house sold for less than the outstanding principal of the mortgage -- are often rejected or simply sat on until the potential buyer has moved on.

One possible reason for this may be that the banks fear the potential impact on the rest of their mortgage pools. If delinquency leads to a better deal, what borrower out there would not immediately stop paying the mortgage? Would you trade a black mark on your credit record for a \$100,000 write-down on your mortgage? I might. I definitely would if my house was already substantially underwater, even if I could make my monthly payments.

But there is another potential reason. Perhaps the banks are hoping for a substantial bailout and are therefore unwilling to make adjustments when they may get some sort of handout from the federal government to offset some losses. From this point of view, the best thing for Washington to do is encourage banks to do the right thing by making it absolutely clear that there will be no massive bailout.

In short, this pattern of passing new plans every few months creates regulatory uncertainty that can make the overall situation worse. This would suggest that we need to stop with the ad hoc day-to-day policy changes and instead pick a course of action and stick with it.

Christopher Thornberg is a founding partner with Beacon Economics.

The cram-down conundrum

Counterpoint: Richard K. Green

This is a very tough issue. As you note, Christopher, part of the problem is that different classes of securities holders have different interests, so no matter what the servicers do, they risk being sued. Part of the problem is that the trusts holding the mortgages are supposed to be passive entities, so servicers were unprepared to deal with de facto management issues. And part of the problem is that volumes of difficult mortgages have far outstripped the servicing infrastructure.

I think this is why [cram-downs](#) have become attractive to some. They allow bankruptcy courts to deal with the issue of who gets what and take the problem out of the hands of servicers. A cram-down is a court-ordered reduction of the secured balance due on a home mortgage loan. Basically, it reduces lenders' collateral to the current value of the house, which is determined with an appraisal.

That said, I worry about the impact of cram-downs on the ability of borrowers to get mortgages going forward. [UC Berkeley economist John M. Quigley](#) wants the government to use "the FHA's mortgage authority to force lenders to recognize the actual values of homes and thus to restructure loans accordingly." This would again remove the servicer from the proceedings but would also abrogate contracts. As you note, Christopher, one of the reasons we can attract foreign capital is because we honor our contracts.

Long story short: I see no good answer here. I have very reluctantly come to the view that the threat of cram-downs might unstick things.

Richard Green is director of the Lusk Center for Real Estate at USC, where he is also a professor in the School of Policy, Planning and Development and the Marshall School of Business.

If you want other stories on this topic, search the Archives at latimes.com/archives.

TMSReprints

Article licensing and reprint options

Copyright 2009 Los Angeles Times | [Privacy Policy](#) | [Terms of Service](#)
[Home Delivery](#) | [Advertise](#) | [Archives](#) | [Contact](#) | [Site Map](#) | [Help](#)

partners:

