

U.S. Structured Finance Newsletter

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IS MORE DEBT FORGIVENESS ON THE HORIZON?

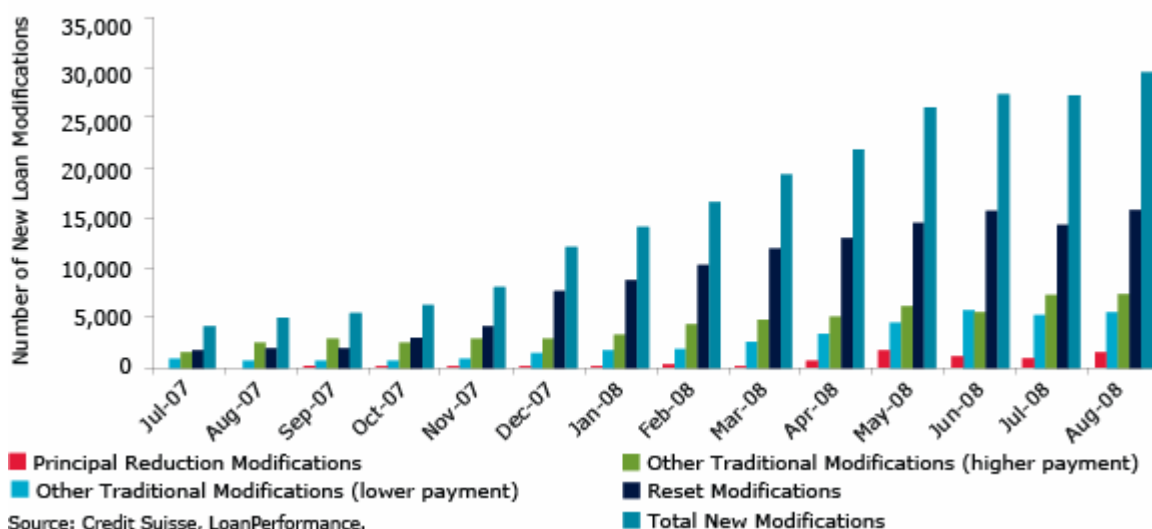
On December 8, 2008, John C. Dugan, the U.S. Comptroller of the Currency, announced that new data showed that after three months, nearly 36% of the borrowers who had had their loans modified had re-defaulted by being more than 30 days past due. After six months, the rate was nearly 53%, and after eight months, a staggering 58%. He also reported that there were an increasing number of delinquencies and foreclosures in process for all first-lien mortgages held by the largest national banks and federally regulated thrifts; however, new foreclosures had decreased 2.6% from the second quarter.

The re-default rate on modifications is believed to have been the result of servicers not reducing the monthly payments enough to make the mortgages truly affordable to the borrowers. With delinquency trends continuing to rise as a result of growing negative home equity, depressed home price forecasts, increased unemployment and borrowers finding it difficult to refinance because of the tightened underwriting standards, many expect to see an increase in personal bankruptcies for 2009. As a result, the subject of bankruptcy reform is expected to resurface, particularly because it was part of President-elect Barack Obama's rescue plan, which calls for removing legal impediments that discourage broader mortgage restructuring and for legislation to close the loophole in the bankruptcy code that allows bankruptcy judges to modify the terms of mortgages on investment properties and vacation homes but not on primary residences. Currently, bankruptcy courts are unable to modify existing loan contracts for primary residences without the express approval of the lender.

While many feel the bankruptcy reform issue has already been debated and defeated by Congress, we cannot ignore the fact that in a few weeks, a new Congress and president will be in place. Since the mortgage industry strongly opposes a provision that would allow bankruptcy judges to unilaterally change the terms of mortgage loans, DBRS believes servicers may begin to be more aggressive in using principal-forgiveness modifications in an effort to prevent borrowers from declaring bankruptcy and improve recidivism rates.

Even though there are many different types of modification programs currently being offered to borrowers, very few servicers used a principal-reduction feature over the last year (see the chart below). As the U.S. government continues to pressure servicers to help distressed homeowners, drastic measures will need to be taken in order to improve the re-default rates for modified loans. As a result, DBRS will continue to monitor the industry for its use of debt forgiveness as a loss mitigation tool and the ongoing performance of modified loans.

Subprime Loan Modifications by Type



Source: Credit Suisse, LoanPerformance.

For questions or comments, please contact Kathleen Tillwitz at ktillwitz@dbrs.com.