

U.S. Structured Finance Newsletter

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Claire Mezzanotte
Managing Director, ABS/RMBS
U.S. Structured Finance,
+1 212 806 3272
cmezzanotte@dbrs.com

Jan Buckler
Senior Vice President,
Research and Modeling
U.S. Structured Finance
+1 212 806 3925
jbuckler@dbrs.com

David Hartung
Senior Vice President, ABS
U.S. Structured Finance
+1 212 806 3269
dhartung@dbrs.com

Quincy Tang
Senior Vice President, RMBS
U.S. Structured Finance
+1 212 806 3256
qtang@dbrs.com

Kathleen Tillwitz
Senior Vice President,
Operational Risk
U.S. Structured Finance
+1 212 806 3265
ktillwitz@dbrs.com

Toronto
DBRS Tower
181 University Avenue
Suite 700
Toronto, ON M5H 3M7
+1 416 593 5577

New York
140 Broadway, 35th Floor
New York, NY 10005
+1 212 806 3277

Chicago
101 North Wacker Drive
Suite 100
Chicago, IL 60606
+1 312 332 3429

BANKRUPTCY CRAM-DOWNS UPDATE

As the *Helping Families Save Their Homes in Bankruptcy Act of 2009*¹ (the Act) works its way through the U.S. Senate and the House of Representatives, many believe that mortgage cram-downs will become a reality in the near future. The proposed legislation amends the federal bankruptcy law governing a Chapter 13 debtor and would change the existing bankruptcy code to allow judges to alter the terms of mortgages on primary residences. Historically, bankruptcy judges could only modify the terms of mortgages on investment properties and vacation homes but not on primary residences.

The proposal will allow a bankruptcy judge to do the following:

- Reduce the principal amount of the loan to the fair market value of the property.
- Reduce the interest rate of the loan.
- Prohibit, reduce or delay the adjustment of an adjustable-rate mortgage (ARM).
- Extend the term of the mortgage to a period that is no longer than 40 years (reduced by the period for which the loan has been outstanding).
- Waive prepayment penalties.

While supporters of the bill argue that giving bankruptcy judges the authority to modify mortgages would help stem the foreclosure crisis, its unintended consequences have the residential mortgage-backed securities (RMBS) market worrying about an increase in AAA downgrades and bankruptcy filings. Many transactions have a bankruptcy carveout that places a limit on the maximum amount of losses that will be absorbed by the subordinate tranches from bankruptcy filings (typically two to three basis points). Any bankruptcy losses exceeding this limit are allocated on a pro rata basis, which can lead to losses on the senior most tranches. Furthermore, as consumers struggle with imminent foreclosure due to job losses, home price depreciation and ARM resets, a Chapter 13 bankruptcy² would give them the opportunity to restructure their debts (usually over a three- to five-year period) and keep their homes.

Since this legislation would allow bankruptcy judges to reduce the principal amount of the loan to the fair market value of the property, the amount of the write-down will become an unsecured debt that will be paid pro rata along with any other unsecured claims that the borrower has, such as credit cards. As a result, the unsecured portion of the mortgage debt (or the cram-down amount) will likely result in immediate losses to RMBS pools, which may cause subordinate classes to be written down faster.

DBRS agrees that recent voluntary efforts to modify mortgages by servicers have been unsuccessful, yielding more than a 50% re-default rate, and that extending the time frame borrowers are allowed for repayment and reducing the amount owed can help make the mortgage more affordable. As a result, DBRS expects to see an increase in personal bankruptcies if this bill is passed. DBRS believes that, in an effort to help prevent borrowers from declaring bankruptcy, servicers will be more aggressive in using principal forgiveness modifications, particularly if the servicer is notified prior to a borrower filing for bankruptcy. Therefore, DBRS will continue to monitor the industry for its use of debt forgiveness as a loss mitigation tool as well as the passage of this Act.

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

1. <http://www.govtrack.us/congress/billtext.xpd?bill=h111-200>.
2. <http://www.uscourts.gov/bankruptcycourts/bankruptcybasics/chapter13.html>.