

U.S. Structured Finance Newsletter

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THE PRESSURE ON SERVICERS TO MODIFY LOANS INTENSIFIES

Recently, the U.S. Comptroller of the Currency and the Office of Thrift Supervision (OTS) jointly released their quarterly report on first-lien mortgage performance for the fourth quarter of 2008.¹ The report showed that credit quality continued to decline, with slightly less than 90% of mortgages performing, down from 93% at the end of September 2008. This decline in credit quality was evident in all loan risk categories, with subprime mortgages showing the highest level of serious delinquencies. However, the biggest percentage jump was in prime mortgages, the lowest loan risk category and one that accounts for nearly two-thirds of all mortgages serviced by the reporting institutions. At the end of the fourth quarter, 2.4% of prime mortgages were seriously delinquent, more than double the 1.1% reported at the end of March 2008.

Consistent with Q3 2008 findings, the report also showed that re-default rates on modified mortgages were both high and rising during the first three quarters of 2008, with loans modified in the third quarter showing the highest re-default rates. The percentage of modified loans that were seriously delinquent (60 or more days past due) after eight months was 41% for loans modified in the first quarter of 2008 and 46% for loans modified in the second quarter, with the third quarter results continuing to trend higher.

Overall for 2008, about 42% of modified loans resulted in reduced payments, 27% in unchanged payments and 32% in increased payments. The proportion that reduced payments increased significantly in the fourth quarter to more than 50% of all modifications. Servicers cited several reasons for mortgage modifications that did not result in reduced payments:

- A servicer could freeze an adjustable-rate mortgage's interest rate when the borrower faced the risk of imminent default rather than allowing it to reset to the higher rate stated in the loan contract.
- Modifications resulted in higher monthly payments because missed principal and interest payments were capitalized and added to the loan.
- The servicer's flexibility to reduce payments was in many cases constrained by servicing agreements that defined the type and amount of modifications permitted. (Recent laws regarding safe harbor for servicers modifying loans should allow for more flexibility in this regard.)

Re-default rates were consistently lower for modifications that resulted in lower monthly payments. When modifications decreased monthly payments by more than 10%, only about 23% of the loans became seriously delinquent six months later. By contrast, some 51% of the loans in which payments remained unchanged and 46% of modifications where payments increased were seriously delinquent after six months. The results of the report angered the two regulatory bodies, which issued the following statements. The Comptroller of the Currency John C. Dugan said, "This new data shows that, in the current stressful environment, modification strategies that result in unchanged or increased mortgage payments run the risk of unacceptably high re-default rates." OTS Acting Director John E. Bowman added, "The continuing decline in credit quality underscores the need for mortgage servicers to increase their efforts to modify home mortgages. Sustainable and affordable mortgages is a goal we all share for keeping more Americans in their homes."

As the U.S. government continues to pressure servicers to help distressed homeowners, modifications that reduce a homeowner's monthly payment or forgive mortgage debt will likely become the preferred loss mitigation strategy for many servicers. As a result, DBRS will continue to monitor the industry for its use of modifications as well as the ongoing performance of modified loans.

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

1. www.occ.treas.gov/ftp/release/2009-37.htm.