

Structured Finance Newsletter

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MORTGAGE DEBT FORGIVENESS AND ITS IMPLICATIONS ON RMBS

At the end of last month, an announcement from the Administration's Home Affordable Modification Program (HAMP) reignited discussions on mortgage debt forgiveness. As a modification technique, debt forgiveness has long been regarded as controversial in the mortgage industry due to its moral hazard risk and the potential impact to security performance in various parts of the capital structure. As such, this particular form of modification has been utilized on a very limited basis so far by mortgage servicers.

Among other things, HAMP announced its plans to do more debt forgiveness on loans and intends to reduce the moral hazard risk by encouraging borrowers to be more responsible over time. As a result, HAMP servicers are required to consider debt forgiveness as an alternative modification approach by reducing the principal balance of the loan to 115% of the current value of the home (i.e. a loan-to-value or LTV ratio of 115%). Servicers will initially treat the write-down amount as forbearance and will forgive the forbore amount in three equal steps over three years, as long as the borrower remains current on payments.

Investor reactions to the government push for an increase in debt forgiveness has been mixed at best. First, senior and subordinate bondholders often have split views on this issue. In a traditional debt forgiveness scenario, the principal forgiven will be treated as security losses and be absorbed first by subordinate holders. Many investors who in recent years bought subordinate bonds based on their "interest-only" values will see these bonds deplete faster than initially anticipated. Senior investors, while losing some immediate credit enhancement, may benefit from such modifications as overall cumulative losses should hopefully lessen in the long run. Second, even within the senior bondholders' class, super senior and senior mezzanine investors may also disagree on debt forgiveness. Although both are senior bonds, certain senior mezzanine tranches may likely benefit more when principal is forgiven. This would occur if the subordinate write-downs cause the "cross over" from sequential to pro-rata pay among all senior bonds to occur sooner, thus allowing the senior mezzanine bonds to start receiving principals sooner than expected.

If done properly, DBRS believes that transactions should, in the long run, benefit from principal forgiveness. Although securities average lives may be extended, some borrowers could prepay and cumulative losses could be reduced if the housing market recovers in the next few years. Implementing debt forgiveness may also moderate the ever increasing delinquency pipeline by curtailing the roll rates from 90+ days delinquent to foreclosure or from foreclosure to real estate owned (REO), and as such, help shrink the housing supply and trim down distressed sales in some regions.

For questions or comments, please contact Quincy Tang at qtang@dbrs.com.

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