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Securitization Trustee Issues

By Kevin J. Buckley

In the wake of the recent turmoil in the residential mortgage-backed securities (RMBS) marketplace, securitization trustees have been confronted with an array of issues that the governing securitization transaction documentation either did not anticipate or did not address adequately. Among the issues with which RMBS trustees have struggled are the proper treatment of loan modifications, enforcement of remedies in connection with alleged breaches of representation and warranties, the bankruptcy or insolvency of deal parties, and various requests for information and access to underlying loan data or documentation. The purpose of this article is to explore some of these issues and to suggest certain possible resolutions.

Loan Modifications

In reaction to the decline in housing prices and increased delinquency and default rates, lenders and various governmental regulators have devised and implemented a variety of loan modification initiatives. Mortgage loan servicers, in particular, have been under significant pressure to modify the terms of residential mortgage loans as an alternative to foreclosure. Increased loan modification activity has presented trustees with various interpretive issues related to the proper treatment of modified mortgage loan payments in calculating required distributions to RMBS securityholders.

Pooling and servicing agreements (PSAs),[1] indentures, and other agreements that govern outstanding RMBS generally require the securitization trustee[2] to calculate the required monthly principal and interest distributions to RMBS securityholders. Those distributions rely on the related servicers' reports of borrower mortgage loan payments and recoveries and losses on properties acquired through foreclosure (REO). Transaction documents generally have anticipated that problem loans would be handled through foreclosure or a similar process, and PSAs typically limit servicers' ability to modify the terms of mortgage loans. For example, RMBS structured for treatment as real estate mortgage investment conduits, or REMICs, allow for loan modifications only if a loan is in default or default is reasonably foreseeable. Also, many PSAs require the servicer to commence foreclosure proceedings at certain benchmarks (*e.g.*, when a loan is 90 days or more delinquent). So, although PSAs for outstanding RMBS typically acknowledge the possibility of modifications (albeit in limited circumstances), they generally lack specific direction for the treatment of modified mortgage loan payments for purposes of calculating distributions to securityholders.

While PSAs lack guidance on the treatment of modified loan payments, they do provide direction for treatment of loan loss amounts. Losses generally are defined to occur only upon final liquidation of a loan or related REO, though some PSAs also provide for the allocation of "partial" loss amounts in connection with certain events, such as a bankruptcy court's reduction of a loan's principal balance

1 Governing documents for RMBS transactions take varying forms, including pooling and servicing agreements, sale and servicing agreements, trust agreements and indentures. The term "PSA," as used in this article, encompasses all of those forms of RMBS transaction documents.

2 In many RMBS transactions, a securities administrator or trust administrator is engaged to perform certain functions, including the calculation of required monthly principal and interest distributions to securityholders, rather than the trustee. The term "trustee," as used in this article, encompasses a securities administrator or trust administrator.

or a borrower's monthly payment. In most RMBS structures, losses are allocated first to reduce any overcollateralization amount and then to reduce the principal balance of outstanding classes of securities in reverse order of seniority. For example, a senior-subordinated securities structure may include one or more classes of AAA-rated senior securities and multiple classes of subordinated securities with varying credit ratings from AA to unrated. Losses incurred on loans in the related pool are allocated first to any unrated class, and then to each rated subordinated class, sequentially, from the class with the lowest to the highest credit rating. Therefore, PSAs typically specify the allocation of loss amounts upon final liquidation of loans and related REO but do not detail the required treatment of principal and interest modification amounts for loans included in RMBS pools.

A loan modification resulting in principal forgiveness has an effect similar to a partial principal loss. Although PSAs generally contemplate the calculation and allocation of loss amounts only upon final liquidation of a loan or related REO property, most trustees seem to be comfortable treating principal forgiveness in a manner similar to the treatment of principal losses. This treatment seems reasonable and justified, because the forgiven principal amount no longer is owed by the borrower, and the securitization trust has no continuing claims or rights to collect forgiven amounts.

Loan modifications structured as principal forbearance present greater interpretive difficulties. While there is general agreement that principal forgiveness amounts should be allocated in a manner similar to the treatment of principal loss amounts, there is no such unanimity of views regarding the treatment of principal forbearance amounts. The distinction between principal forgiveness (*i.e.*, a permanent reduction of the borrower's payment obligation) and forbearance (*i.e.*, an adjustment of timing of the payment obligation) is significant and could justify disparate treatment of principal forgiveness and forbearance amounts. Under most modification programs, however, a principal forbearance amount does not accrue interest and, therefore, represents a permanent loss of entitlement to interest accrued on the forborne amount, which may suggest that forbearance should be treated in a manner similar to a loss.

Recent directives of governmental and supervisory authorities have established loan modification protocols that provide for principal forbearance in certain circumstances. Principal forbearance is part of the modification protocol for the FDIC's Loan Modification Program, developed as receiver for IndyMac Federal Bank, and the U.S. Treasury's Home Affordable Modification Program (HAMP). Both programs provide that a portion of a loan's principal balance may be converted to a balloon payment amount, payable at final maturity, and that interest does not accrue on such deferred, or forborne, principal amount. HAMP's use of forbearance, in particular, has highlighted the interpretive difficulties faced by trustees in allocating forborne principal amounts.

Recognizing the interpretative difficulties that forbearance presents for RMBS trustees, the FDIC, Treasury and other market participants have expressed their views regarding the treatment of forborne principal amounts. The FDIC program specifies that "postponed" principal is due when the loan is paid in full, but directs that "for loans within securitizations, this principal forbearance should be passed as a write-off of principal to the trust, with any future collections at time of pay-off submitted to the trust as a recovery."[3] Initially, the HAMP program guidelines did not specify how principal forbearances were to be treated in securitizations. However, on July 22, 2009, in response to pressure from certain industry participants, Treasury adopted the FDIC position by adding the following to its "Frequently Asked Questions" on the HAMP program: "for loans within securitizations, principal forbearance should be passed through as a write-off of principal to the securitization trust, unless directed otherwise by the applicable pooling and servicing agreement or trust agreement, with any future collections at the time of the pay-off submitted to the trust as a principal recovery." On October 28, 2009, Treasury revised its response to a HAMP Frequently Asked Question (at that time, Question

3 FDIC Loan Modification Program, at p. 9 (*www.fdic.gov/consumers/loans/loanmod/FDICLoanMod.pdf)*.

No. 26) to amplify Treasury's view that HAMP principal forbearance amounts should be treated as losses and to assert that trustees should treat any forborne principal amount as a loss unless the PSA expressly provides otherwise.[4] Most recently, the Department of Treasury issued a HAMP Supplemental Directive in which, consistent with its Frequently Asked Question response, Treasury directs servicers to report HAMP forbearance amounts as losses and trustees to allocate forborne principal as realized losses.[5]

Other industry participants also have weighed in. In July 2009, Standard & Poor's published "refined" criteria for new RMBS transactions to "clarify" its view that "principal forbearance should be treated similarly to principal forgiveness" in its ratings analysis.[6] Likewise, in June 2009, the American Securitization Forum (ASF) published a "Discussion Paper on the Impact of Forborne Principal on RMBS Transactions" detailing the issue and summarizing the divergent positions of various market participants, including senior and subordinated securityholders, financial guarantors, trustees, master servicers, and servicers, on the proper allocation of principal forbearance amounts.[7] Senior securityholders favor treatment of forborne principal amounts as losses, because it results in a faster write-down of subordinated security balances, assuring greater relative distributions to senior holders. Of course, subordinated holders take the opposite view. According to the ASF Discussion Paper, financial guarantors generally side with subordinate holders in favoring an interpretation that forborne principal not be treated as a loss.

Trustees have no significant economic interest in the outcome of this interpretive dispute, but are interested primarily in fulfilling their duties and responsibilities under the related PSAs. Servicers generally are responsible for determining and reporting the occurrence and amount of losses, while trustees are responsible for the proper calculation and allocation of distribution, loss, and shortfall amounts in reliance on servicer reports. However, due to the acknowledged tensions between classes of securityholders and the ambiguity of PSA provisions, servicers and trustees may disagree on which party has the primary responsibility for determining the proper allocation of forbearance amounts. Despite the obligation of servicers to determine and report loss amounts to the trustee, servicer reports often do not clearly specify whether reported HAMP forbearance amounts are to be treated as losses. A trustee, therefore, may find itself obligated to make certain distribution calculations based on its considered judgment of the proper allocation of HAMP principal forbearance amounts under the terms of the related PSA. In general, the trustee is faced with a decision as to whether HAMP forbearance amounts are to be treated in a manner similar to realized losses (with immediate allocation of the forbearance amount to reduce overcollateralization and/or the principal balance of subordinated securities classes) or as monthly interest and principal shortfall amounts (allocated through application of the monthly PSA cashflow waterfall provisions).

4 Although the HAMP FAQs have been revised and reorganized since the October 28, 2009 edition, the response to former Question No. 26 remains unchanged as follows (now HAMP FAQ Question No. 1501, in the April 2, 2010 edition):

Q1501. Does the earlier FDIC guidance on accounting treatment of principal forbearance apply under HAMP?

Yes. For loans within securitizations, servicers, securities administrators and other transaction parties should treat HAMP principal forbearance amounts as realized losses as of the applicable loan modification dates under any applicable securitization pooling or trust agreement. The only exception to that principle is that servicers and securities administrators are permitted not to treat HAMP principal forbearance amounts as realized losses if, and only if, (i) the applicable securitization pooling or trust agreement specifically addresses principal forbearance in the HAMP context (i.e., it includes the permanent forgiveness of interest and postponement of principal repayment for a long period, as described below) and (ii) such agreement explicitly and affirmatively directs that such forborne principal not be treated as a realized loss.

For the avoidance of doubt, "principal forbearance" in the context of HAMP is non-interest bearing and non-amortizing. Securitization pooling or trust agreements often use the term "principal forbearance" in a context which only requires delaying of the date on which certain payments of principal are due for short periods; interest typically continues to accrue and is required to be capitalized. For HAMP, not only must principal forbearance delay the date in which such forborne principal is due to maturity sale or payoff, but no interest may accrue on such forborne amounts.

5 Supplemental Directive 10-05, Home Affordable Modification Program — Modification of Loans with Principal Reduction Alternative, June 3, 2010 (*https://www.hmpadmin.com/portal/docs/hamp_servicer/sd1005.pdf*).

6 RMBS: Methodology For Loan Modifications That Include Forbearance Plans For U.S. RMBS (Standard & Poor's Ratings Criteria for Structured Finance, July 23, 2009).

7 Discussion Paper on the Impact of Forborne Principal on RMBS Transactions (American Securitization Forum, June 18, 2009).

While trustees generally will give effect to a servicer's determination that a HAMP forbearance amount be treated as a loss, no consensus has developed among trustees on the proper treatment of HAMP forbearance amounts in the absence of clear servicer reporting. In those instances, a trustee's treatment of principal forbearance amounts as either shortfalls or losses would seem justifiable without subjecting the trustee to substantial risk of a claim that it has failed to meet its standard of care under the related PSA. A trustee, however, may wish to seek additional written advice of counsel on whichever approach it adopts, because most PSAs provide that the trustee is entitled to rely on such advice to support compliance with its standard of care.

Greater detail and instruction regarding the expected treatment of modification amounts should be included in future PSAs and other RMBS governing documents. In particular, future RMBS transactions should provide express guidance on the expected treatment of any principal or interest shortfalls, forgiveness, or forbearance amounts resulting from loan modifications.

Enforcement of Remedies

During the course of the past two years, many RMBS have sustained significant losses resulting from high levels of delinquency and default on underlying residential mortgage loans. PSAs generally include representations and warranties by the originator or seller of mortgage loans with regard to the origination and underwriting standards for the loans and certain other loan attributes. Upon breach of any representation or warranty regarding a mortgage loan, PSAs generally require the seller to repurchase the affected loan from the securitization trust. This repurchase obligation is often the sole remedy for breach of a mortgage loan representation or warranty.

In an effort to recover some portion of losses incurred on RMBS, securityholders increasingly have asserted that mortgage loan losses are the result of breaches of related seller representations and warranties and have demanded that trustees enforce sellers' repurchase obligations in respect of the related loans. Trustees have had a difficult time evaluating the merits of repurchase demands, because it often is difficult to determine whether a loss on a particular mortgage loan is the direct result of the breach of a specific seller representation or warranty. PSAs provide little guidance to determine whether a loss is occasioned by a breach of a representation or warranty, and the evaluation of breach claims often requires the review of loan files and the exercise of significant judgment. Therefore, trustees have found themselves in the difficult situation of evaluating the merits of a securityholder repurchase demand in light of uncertain evidence of breach of any particular seller representation or warranty.

Securityholders increasingly have sought to obtain access to mortgage loan files or other loan-level data to evaluate and substantiate claims of breaches of seller representations and warranties. Though PSAs generally provide the trustee with some access to servicer records, individual securityholders do not typically have the same access. Trustees subjected to securityholder demands for access to loan files or servicer records often need to distinguish between legitimate requests for data to evaluate potential repurchase claims and more generalized "fishing expeditions" by securityholders seeking to recoup unexpected losses. In addition, a trustee responding to a particular securityholder's requests for access to loan files and data must consider privacy law limitations on the sharing of certain borrower information and issues related to the selective disclosure of material information to securityholders.

In some situations, trustees and securityholders have worked together to enlist the aid of a third party to evaluate breach claims and have made the results of such reviews available to all holders. Future PSAs should detail a means for evaluation of asserted breaches of seller representations and warranties and should provide more specific authorization and direction for access to loan files and loan-level data. For example, some have suggested that future RMBS documentation should include procedures for arbitration of disputes over repurchase claims. Greater detail and specificity regarding the means for evaluation and resolution of breach claims and access to underlying loan files and loan-level data would assist trustees in navigating future securityholder demands for repurchase.

Administrative and Operational Issues

During the past several years, RMBS trustees have encountered a number

of other administrative challenges and issues that highlight the need for additional operational guidance in RMBS transaction documents. For example, struggles in the residential mortgage markets have resulted in a number of bankruptcies and insolvencies of mortgage lenders, servicers, and other RMBS participants, and other defaults by RMBS transaction parties. Insolvent or bankrupt parties often have obligations under outstanding RMBS agreements, including obligations to repurchase mortgage loans subject to claims of breaches of related representations or warranties or to perform certain administrative duties and functions on behalf of the trust, such as the preparation and filing of tax returns and UCC continuation statements or the provision of various consents and certifications. The bankruptcy or insolvency of transaction parties also has complicated other trust maintenance and administration matters, such as the ability to secure parties' consents to required amendments. In addition to managing issues related to bankrupt or insolvent parties, trustees increasingly have been required to declare defaults and exercise remedies against transaction parties, including the termination and replacement of nonperforming servicers.

RMBS trustees have been actively engaged in the exercise of remedies against defaulting transaction parties, including the preparation and filing of appropriate proofs of claim on behalf of trusts in connection with bankruptcy and insolvency proceedings and the termination of defaulting servicers and transfer of related servicing rights. Trustees also have assumed various administrative duties of insolvent or nonperforming parties, as necessary to protect and preserve the trust estate. These activities have involved substantial costs for trustees, not all of which were contemplated or adequately compensated in the related PSAs.

Some parties have attempted to amend the terms of outstanding RMBS transaction agreements to address certain interpretive issues or unforeseen circumstances. While PSAs generally provide for the possibility of amendment with consent of affected securityholders, obtaining that consent has proven difficult when the securities are held in book-entry form. PSAs typically provide that trustees may recognize the registered holder of a security as the holder for all purposes, including consent rights. However, the clearinghouse that is the registered holder of book-entry securities (e.g., The Depository Trust Company) generally is unwilling to provide consent absent direction from the beneficial owners. Communications with beneficial owners, in turn, often requires coordination through the facilities of several financial intermediaries. Therefore, amending outstanding PSAs has proven quite difficult due to the operational challenges to obtaining necessary securityholder consents.

Dealing with significant levels of insolvency and default of transaction parties has resulted in increased costs and expenses for RMBS trustees, often without adequate provisions for recovery of associated costs and expenses in the related PSAs. RMBS transaction documents should contemplate the possibility of insolvency or dissolution of transaction parties and allow exceptions to notice and consent requirements for bankrupt, insolvent or dissolved parties. Future PSAs also should provide adequate assurances of trustee cost and expense recovery for exercise of default remedies, including those associated with servicing transfers, the additional administrative duties resulting from the bankruptcy, insolvency or dissolution of transaction parties and the solicitation of holder consents.

The recent RMBS offering by Redwood Trust Company, Sequoia Trust 2010-H1, represents the first publicly-offered, private-label RMBS offering backed by newly-originated loans since 2008. Provisions of the Sequoia PSA suggest that RMBS transaction parties acknowledge some of the shortcomings of prior RMBS documentation and are willing to accommodate certain changes to address those shortcomings. For example, the Sequoia PSA provides that any rights of consent of a party are deemed waived if the party is bankrupt, insolvent, or has been dissolved. The Sequoia PSA further provides that the trustee is entitled to seek and follow the direction of a majority of securityholders in regards to the exercise of rights and remedies upon the bankruptcy, insolvency, or dissolution of any transaction party. Additional specific rights of

reimbursement for trustee costs and expenses also are included in the Sequoia PSA.

The experiences of the past few years have raised a number of issues for RMBS securitization trustees. As the party principally responsible for preserving and maintaining the securitization trust for the benefit of securityholders, the trustee should be entitled to adequate direction in the governing documents and sufficient compensation for its services. Recognizing that RMBS trustees undertake significant duties related to the protection of the trust and the interests of the investors, future PSAs should provide trustees with clear directives and adequate rights of reimbursement for costs and expenses. In particular, RMBS transaction documents should specify the expected treatment of loan modification amounts in calculating distribution amounts, provide a clear protocol for determination of breaches of loan representations and warranties, accommodate the administrative difficulties related to insolvent or dissolved parties, and provide assurances of adequate compensation and cost recovery for trustees.

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