

**PURCHASING MORTGAGE-BACKED SECURITIES DOES NOT GIVE THE GOVERNMENT THE  
ABILITY TO MODIFY MORTGAGES BACKING THE SECURITIES**

**Adam J. Levitin  
Associate Professor of Law  
Georgetown University Law Center**

The residential mortgage-related assets that the government is proposing to purchase in the bailout plan are for the most part not mortgages themselves. Rather, the assets are mortgage-backed securities (MBS). An MBS is a security issued by a trust (SPV) that has been specially created for a securitization transaction. The SPV will purchase large pool of mortgages from a financial institution. The SPV pays for the mortgages by issuing securities. These securities are collateralized by the mortgages owned by the SPV, hence they are “mortgage-backed” securities. These MBS are typically referred to as “certificates,” and most are debt securities that entitle the holder to a series of regularly scheduled payments, as with a corporate bond.

By purchasing MBS, the government will not become the direct owner of the mortgages. Instead, it will simply hold securities of an entity that owns mortgages. This is insufficient to give the government the ability to modify the mortgages. Just as corporate bond holders have no right to control the bond issuer’s management decisions, so too do MBS holders have no right to control how the SPV’s management of the mortgages.

The decision to modify mortgages held by an SPV rests with the SPV’s agent, call the servicer. The servicer to performs the day-to-day tasks related to the mortgages owned by the SPV, such as collecting payments, handling paperwork, foreclosing, and selling foreclosed properties. These servicers, including many "mortgage companies" like Countrywide and Wells Fargo owned by bank holding companies, are the entities that actually consider loan modification requests. Confusingly, the servicer is often, but not always, the originator.

Servicers carry out their duties according to what is specified in their contract with the SPV. This contract is known as a “pooling and servicing agreement” or PSA. PSAs frequently place restrictions on servicers’ ability to modify mortgages. Sometimes the modification is forbidden outright, sometimes only certain types of modifications are permitted, and sometimes the total number of loans that can be modified is capped (typically at 5% of the pool). Additionally, servicers are frequently required to purchase any loans they modify at par (100 cents on the dollar). This functions as an anti-modification provision. Moreover, all PSAs prohibit the servicer from undertaking any action, including many modifications, that would threaten the MBS’s pass-thru tax status.

In order to direct servicers to engage in large scale loan modification, it is necessary to amend the PSA; a servicer that does not comply with a PSA risks being sued by the SPV and by the MBS holders. PSAs, however, cannot easily be modified. This is to preserve pass-thru tax status for the trust in order to avoid double taxation; to preserve the bankruptcy remoteness of the trust, so that the trust’s assets cannot be seized by creditors of the mortgages’ originators; and to protect the MBS holders from liability for the trust’s actions.

To date, servicers have granted few significant modifications for several reasons: contractual limitations (discussed above); understaffing for the volume of modification demand; lack of properly trained personnel; fear of suit by MBS holders who believe that modifications hurt their investments; and misaligned incentives. Foreclosure is frequently more profitable to

servicers than loan modification. Therefore servicers are incentivized to foreclose rather than modify loans, even if modification is in the best interest of the MBS holders and the homeowners.

Six major problems prevent the government from modifying mortgages simply by purchasing hundreds of billions of dollars of MBS. Some of these problems prevent modification outright; others would result in a significant loss to taxpayers due to the modifications.

### **Problem 1. Treasury Will Typically Need to Hold At Least Two-Thirds of All MBS in a Pool to Modify the Underlying Mortgages**

The typical PSA provides that it may only be modified with the consent of two-thirds of all of the MBS holders, as well as the insurer for the Net Interest Margin Securities—the resecuritization of the residual claims on the SPV.<sup>1</sup> Further, PSAs prohibit any modification of the underlying mortgages that would change the scheduled cashflow to a MBS holder, absent the holder’s consent. PSAs contain this provision to comply with the Trust Indenture Act of 1939.<sup>2</sup> Thus, Treasury would have to incur all of the losses itself if it wished to engage in modifications. In so doing, the Treasury would be bailing out not just the financial institutions that chose to sell their MBS holdings to Treasury, but also the ones that did not sell, as their positions would be protected by the losses absorbed by Treasury.

Even if Treasury were willing to absorb all the modification losses itself, there is still the question of whether the government will be able to purchase the necessary two-thirds of MBS issued by any particular pool in order to have the authority to alter the PSA. This alone will be a tall order, as there might be thousands of MBS from a single pool and these MBS might be dispersed world-wide. Some may be held by entities from which the Treasury Department will not be authorized to make purchases. And others will be held by entities that choose not to sell to the Treasury Department. The Treasury would need to put a Humpty-Dumpty of MBS back

---

<sup>1</sup> See, e.g., Pooling and Servicing Agreement, Park Place Securities, Inc., Series 2005-WHQ4:

This Agreement or any Custodial Agreement may also be amended from time to time by the Depositor, the Master Servicer, the NIMS Insurer, the Trustee and, if applicable, the Custodian, with the consent of the NIMS Insurer and the Holders of Certificates entitled to at least 66% of the Voting Rights for the purpose of adding any provisions to or changing in any manner or eliminating any of the provisions of this Agreement or any Custodial Agreement or of modifying in any manner the rights of the Swap Provider or Holders of Certificates; provided, however, that no such amendment shall (i) reduce in any manner the amount of, or delay the timing of, payments received on Mortgage Loans which are required to be distributed on any Certificate without the consent of the Holder of such Certificate, (ii) adversely affect in any material respect the interests of the Swap Provider or Holders of any Class of Certificates (as evidenced by either (i) an Opinion of Counsel delivered to the Trustee or (ii) written notice to the Depositor, the Master Servicer and the Trustee from the Rating Agencies that such action shall not result in the reduction or withdrawal of the rating of any outstanding Class of Certificates with respect to which it is a Rating Agency) in a manner other than as described in (i), or (iii) modify the consents required by the immediately preceding clauses (i) and (ii) without the consent of the Holders of all Certificates then outstanding.

<sup>2</sup> 15 U.S.C. § 77ppp(b). (“Notwithstanding any other provision of the indenture...the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder...”).

together again in order to modify the PSA to direct the servicer to engage in large-scale loan modification.

**Problem 2. Collateralized Mortgage Obligations Make It Exceedingly Difficult for Treasury to Purchase a Sufficient Number of MBS to Modify Mortgages**

The Treasury's Humpty-Dumpty problem is exacerbated by collateralized mortgage obligations, second mortgages, and mortgage insurance. Collateralized mortgage obligations or securitization seriously impedes the government's ability to purchase a sufficient number of MBS for any particular pool in order to ultimately engage in modification of the underlying mortgages. MBS issued by an SPV are typically tranchéd—divided into different payment priority tiers, each of which will have a different dividend rate and a different credit rating. Because the riskier tranches are not investment grade, they cannot be sold to entities like pension plans and mutual funds. Therefore, they are often resecuritized into what are known as collateralized mortgage obligations (CMOs). A CMO is a securitization in which the assets backing the securities are themselves mortgage-backed securities rather than the underlying mortgages. CMOs are themselves then tranchéd, and the senior tranches can receive investment grade ratings, making it possible to sell them to major institutional investors. The non-investment grade components of CMOs can themselves be resecuritized once again into what are known as CMO<sup>2</sup>s. This process can be repeated, of course, an endless number of times.

The upshot of this financial alchemy is that to control a sufficient share of MBS to alter a PSA, the government will frequently also have to own a sufficient share of CMOs to alter the CMOs' PSA and of CMO<sup>2</sup>s to alter the CMOs PSA in order to alter the MBS PSA. As a result it will be incredibly difficult for the government to purchase a sufficient amount of MBS to ultimately be able to modify the underlying mortgages.

**Problem 3. Junior Mortgages Are Securitized Separately and Must Also Be Modified for Any Modification of Senior Mortgages to Be Effective**

The impossibility of modifying PSAs to permit modification on a wide scale is further complicated because many homeowners have more than one mortgage. Even if the mortgages are from the same lender, they are often securitized separately. If a homeowner is in default on two or three mortgages it is not enough to reassemble the MBS pieces to permit a modification of one of the mortgages. Modification of the senior mortgage alone only helps the junior mortgage holders, not the homeowner. For homeowners with multiple mortgages, the obstacle to providing effective mortgage modification through government purchase of loans is even higher.

**Problem 4. Net Interest Margin Securities Insurers Must Agree to Modifications of PSAs and Mortgages**

An SPV's income can exceed the dividends it must pay certificate holders. The residual value of the SPV after the certificate holders are paid is called the Net Interest Margin (NIM). The NIM is typically resecuritized separately into an NIMS, and the NIMS is insured by a financial institution. This NIMS insurer holds a position similar to an equity holder for the SPV. The NIMS insurer's consent is thus typically required both for modifications to PSAs and modifications to the underlying mortgages beyond limited thresholds. NIMS insurers financial

positions are very similar to out of the money junior mortgagees—they are unlikely to cooperate absent a payout because they have nothing to lose. This will complicate mortgage modification by the Treasury and add to its expense.

**Problem 5. Loss of Private Mortgage Insurance Coverage Upon Modification Would Destroy MBS Resale Value and Cost Taxpayers Money**

On top of all this, many mortgages are insured by private mortgage insurance. This can be purchased either by the borrower or by the lender. Private mortgage insurance protects MBS investors from losses and greatly enhances the value of MBS. Private mortgage insurance policies typically provide for the termination of the insurance upon a loan modification.<sup>3</sup> The termination of private mortgage insurance would greatly reduce the resale value of loans for the government.

**Problem 6. REMIC Tax Problems from Modification Would Destroy MBS Resale Value and Cost Taxpayers Money**

Even if the government could somehow modify the underlying mortgages by purchasing MBS in spite of all the obstacles mentioned thus far, modification would result in serious negative tax consequences for the MBS that would make them hard for the government to resell and would penalize MBS holders who could not or did not participate in the bailout.

The value of MBS depends heavily on their tax treatment. MBS are structured to enjoy REMIC (Real Estate Mortgage Investment Conduit) status under the Internal Revenue Code, which enables the MBS to avoid double taxation of income. Absent REMIC status, federal income tax would apply to the SPV as well as to the dividends paid to the MBS holders. REMIC status gives an SPV pass-thru status, so federal income tax only applies to the MBS holders on the dividends received from the trust. In order to qualify for tax-advantaged REMIC status, the pool of loans securitized in a REMIC must generally be treated as a static pool.<sup>4</sup> This usually precludes large scale modification of loans in the pool.<sup>5</sup> Thus, significant mortgage modification

---

<sup>3</sup> Radian Guaranty Master Policy, Condition 4.C, at [http://www.radian.biz/pdf/Master\\_Policy\\_2008.pdf](http://www.radian.biz/pdf/Master_Policy_2008.pdf):

Notwithstanding any other provision of this Policy, the coverage extended to any Loan by a Certificate of Insurance may be terminated at the Company's sole discretion, immediately and without notice, if, with respect to such Loan, the Insured shall permit or agree to any of the following without prior written consent of the Company: (1) Any material change or modification of the terms of the Loan including, but not limited to, the borrowed amount, interest rate, term or amortization schedule, excepting such modifications as may be specifically provided for in the Loan documents, and permitted without further approval or consent of the Insured.

<sup>4</sup> Treasury Reg. Subchapter F, § 301.7701-4, provides in part:

Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

<sup>5</sup> Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation on Possible Responses to Rising Mortgage Foreclosures before the Committee on Financial Services, U.S. House of Representatives; 2128 Rayburn House Office Building, April 17, 2007, at

by servicers could cost an SPV its REMIC status and result in double taxation of the MBS. Because of this concern, many PSA place significant constraints on modification of mortgage loans as well as modification of the PSA itself.<sup>6</sup> Once REMIC status is lost, it cannot be regained, so any government action that would cost an MBS its REMIC status would seriously impair its resale value.

**The Government Will Be Unable to Modify Mortgages Simply By Purchasing Billions of Dollars of Mortgage-Backed Securities. Bankruptcy Modification Provides the Only Guaranteed Method of Widescale Mortgage Modification for Distressed Homeowners**

Only bankruptcy law changes can require the trust to go along with a loan modification and deal with the junior lien problem. Already Chapter 11 bankruptcy is used for the same effect. Because of the Trust Indenture Act, it is very difficult to engage in a consensual modification of corporate bonds. As a result businesses that need to restructure their bonds often find it necessary to do in bankruptcy. Amending the Bankruptcy Code to permit modification of all mortgages would also make voluntary modifications more likely, because a trust could defend any lawsuit by asserting that the borrower could have gotten the same deal (or one less favorable to the trust) in bankruptcy. Thus, permitting bankruptcy relief may well cause it to be unnecessary in many cases.

---

<http://www.fdic.gov/news/news/speeches/archives/2007/chairman/spapr1707.html>.

<sup>6</sup> Pooling and Servicing Agreement, ABFC 2005-OPT1 Trust, *at* <http://www.sec.gov/Archives/edgar/data/1343316/000091412105002222/as871211-ex4.txt>:

Notwithstanding any provision of this Agreement to the contrary, neither the Trustee nor the NIMS Insurer shall consent to any amendment to this Agreement unless it shall have first received an Opinion of Counsel, delivered by (and at the expense of) the Person seeking such Amendment, to the effect that such amendment will not result in the imposition of a tax on any REMIC constituting part of the Trust Fund pursuant to the REMIC Provisions or cause any REMIC constituting part of the Trust Fund to fail to qualify as a REMIC at any time that any Certificates (other than the Class P Certificates) are outstanding and that the amendment is being made in accordance with the terms hereof.