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Essay: Sticky Seconds -- The Problems Second Liens Pose to the Resolution of Distressed Mortgages

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Abstract:

Almost five years into the foreclosure crisis, policymakers, the mortgage industry, consumers and taxpayers all express disappointment over the slow pace of modifications, refinancings, and other resolutions of borrowers' distress short of foreclosure auctions. Many analysts point to the prevalence of second liens on the properties as a significant impediment to efficient resolutions of borrowers' distress and therefore to the stabilization of the housing market. In addition, many observers argue that a significant number of second liens are at serious risk of default, and therefore may imperil the financial solvency of the financial institutions holding the liens.

To better understand whether and how second liens might prevent efficient resolutions of borrower distress and to assess how second lien holders could be encouraged to cooperate with efficient resolutions without undermining the financial interests of the banks, we reviewed existing data and research, as well as debates among both academics and industry experts about the role second liens might be playing in slowing the recovery of the housing market. We then convened a small group of experts from across the country on April 10th, 2012, gathering around one table servicers, investors, title insurers, consultants, bank regulators, government officials, mortgage counselors, economists, lawyers, accountants and academics to explore the full range of issues that second liens pose to efforts to stabilize the housing market.

This article reports the results of our research and the roundtable discussion. It first explores what we know about the prevalence and delinquency rates of different types of second liens, the extent to which banks are exposed to losses on the liens, and the extent to which the banks already have accounted for those expected losses. It then reviews the various reasons that second liens have interfered with the efficient resolution of distressed mortgages, and documents advances that recently have been made in addressing those problems. Finally, the article examines the most promising proposals for reducing the transaction costs and frictions that are behind many of the current problems second liens are posing, as well as proposals to prevent similar problems from arising in the future. We focus our analysis of solutions on programs to remove barriers to greater coordination between first and second lien holders, rather than on the incentive approaches that have already been attempted.

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Introduction

As foreclosures of residential mortgages continue at an extraordinarily high rate, and millions of homeowners with outstanding mortgages are estimated to be underwater (owing more on their mortgages than the value of the house), the prevalence of second liens on the properties often is cited as a significant impediment to efficient resolutions of borrowers' distress and therefore to the stabilization of the housing market. While there is still debate about exactly what constitutes the most efficient resolution, there is widespread concern that servicers are having an even harder time reaching such resolutions for distressed borrowers with second liens than they are for borrowers with only one outstanding lien. In addition, many observers argue that a significant number of second liens are at serious risk of default, and therefore may imperil the financial solvency of the financial institutions holding the liens.

Second liens encumber roughly 25 percent of outstanding mortgages.[1] But they are disproportionately represented in the most troubled of mortgages. Of the 11.1 million borrowers who were estimated to be underwater at the end of 2011, for example, 4.4 million, or almost 40 percent, had both first and second liens. Those borrowers had negative equity averaging $84,000, with a combined loan to value (LTV) ratio of 138 percent.[2] That is of concern not only because the families struggling with those mortgages are at risk, but because outstanding second liens still account for more than 70 percent of bank tier one capital.[3] Resolving borrowers' distress while maintaining bank solvency poses a catch-22: If banks try to enforce borrowers' obligations on a second lien by holding on to their claims to the collateral (even when decreases in house prices mean that the lien holder could not recover the debt by seizing collateral) or seek to prolong the flow of regular payments rather than addressing borrowers' distress, the second liens may make default on first mortgages more likely, and make refinancing, short sale, modification and other efforts to prevent foreclosure less likely. Thus, self-interested behavior on the part of second-lien holders may exacerbate foreclosures and thereby impede the recovery of the housing market. On the other hand, if banks write off their second mortgages too aggressively, their capital positions may be imperiled, and that too may impede the recovery of the housing market and the economy by constraining credit and reducing public confidence in the economy.

The federal government has tried to balance these concerns through a variety of programs to help borrowers who are unable to sustain their mortgage payments, while limiting the scope of financial institutions' losses on the mortgages.[4] Options that may

[1] *See* sources cited *infra*, text accompanying notes 11~~14~~ - 14~~17~~.
[2] Press Release, CoreLogic, Corelogic Reports Negative Equity Increase in Q4 2011 (March 1, 2012), available at http://www.corelogic.com/about-us/researchtrends/asset_upload_file866_14435.pdf.
[3] *See infra*, note 60~~63~~.
[4] *See generally* Federal Reserve Board of Governors, *The U.S. Housing Market: Current Conditions and Policy Considerations* 21 (Jan. 4, 2012), *available at*

help distressed borrowers retain their homes include refinancing at a lower rate, directly lowering the rate by modifying the terms of the mortgage, extending the period for amortizing the principal, reducing the principal due, and deferring payment of some of the principal due.[5] Options that may assist borrowers who want to sell homes that are underwater so that they can move to pursue a new job, or who simply cannot afford mortgage payments even under a modification, include permission to sell the property for less than the outstanding balances on existing mortgages (a "short sale") and voluntarily turning over the deed in exchange for complete release of the debt (a "deed in lieu of foreclosure" or "DIL").[6] All of these alternatives avoid the legal and administrative costs of foreclosure, reduce the risk of deterioration and vandalism when a property is left vacant because of a foreclosure, and reduce the harms that foreclosures may cause to the borrower, the borrower's renters, the borrower's or tenants' children, neighbors, and local governments.[7]

To better understand whether and how second liens might prevent efficient resolutions of borrower distress and assess how second lien holders could be encouraged to cooperate with efficient resolutions without undermining the financial interests of the banks, we reviewed existing data and research, as well as debates among both academics and industry experts about the role second liens might be playing in slowing the recovery of the housing market. We then convened a small group of experts from across the country on April 10th, 2012, gathering around one table servicers, investors, title insurers, consultants, bank regulators, government officials, mortgage counselors, economists, lawyers, accountants and academics to explore the full range of issues that second liens pose to efforts to stabilize the housing market.[8] We provided the participants with an outline of the issues identified in our literature search in advance of the meeting, but used the roundtable to draw upon the on-the-ground experience and up-to-the-minute knowledge and research of those directly involved in the mortgage industry. The convening was lively, with all participants actively involved in the effort to clarify the

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http://www.federalreserve.gov/publications/other-reports/files/housing-white-paper-20120104.pdf.

[5] For a description of the various alternatives, and a snapshot of how prevalent they are, see Sewin Chan, Claudia Sharygin, Vicki Been and Andrew Haughwout, *Pathways After Default: What Happens to Distressed Mortgage Borrowers and Their Homes?* (April 2012) (manuscript under review), *available at* http://furmancenter.org/files/publications/Pathways_II_Working_Paper.pdf.

[6] *Id*.

[7] For evidence of such harms, see, e.g., Ingrid Gould Ellen, Johanna Lacoe, and Claudia Sharygin, Do Foreclosures Cause Crime? (2011) (unpublished manuscript) *available at* http://furmancenter.org/files/publications/Ellen_Lacoe_Sharygin_ForeclosuresCrime_June27_1.pdf; Daniel A. Hartley, The Effect of Foreclosures on Nearby Housing Prices: Supply or Disamenity? (FRB of Cleveland Working Paper No. 10-11, 2010); *available at* http://ssrn.com/abstract=1670820 or http://dx.doi.org/10.2139/ssrn.1670820; Jenny Schuetz, Vicki Been, and Ingrid Gould Ellen, Neighborhood Effects of Concentrated Mortgage Foreclosures, 17 *Journal of Housing Economics* 306 (2008).

[8] A list of the participants is included in Appendix A.

issues, understand the wide range of perspectives stakeholders in the debate hold, and narrow the range of potential solutions to the most promising ideas.

This article accordingly reflects both our research on what academic and industry experts have said over the past few years about the problems second liens pose and the discussion at the roundtable. The article does not, however, necessarily represent the views of any particular participant in the roundtable.

I. Background

A. How prevalent are second liens?

Drawing on a variety of data sources and analyses, we were able to piece together a reasonable estimate of the prevalence of second liens. Second liens accounted for a total indebtedness outstanding of $873 billion as of the fourth quarter of 2011, which is down from $1,132 billion in 2007.[9] Second liens therefore made up about 8.5 percent of a total of some $10.3 trillion of home mortgage debt outstanding at the end of 2011.[10] As for the number of mortgages with second liens, Robert Avery and his colleagues recently estimated that some 13.2 million of the mortgages originated between 2004 and 2009 had a second mortgage.[11] Given that there are nearly 52 million homes with mortgages, the share with second liens amounts to roughly 25 percent.[12] Second liens encumbered about 18 percent of the loans held or guaranteed by Fannie Mae and Freddie Mac ("agency" mortgages).[13] Laurie Goodman and her colleagues estimated that more than 50 percent of non-agency mortgages were accompanied by a second lien.[14] Taken together these two estimates are not inconsistent with the conclusion that 25 percent of all mortgages are accompanied by a second lien, because agency loans significantly outnumber non-agency mortgages.

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[9] Statistical Release, Board of Governors of the Federal Reserve System, Flow of Funds Accounts of the United States (Mar. 8, 2012) at 98 tbl. L.218 (available at http://www.federalreserve.gov/releases/z1/Current/z1.pdf).

[10] *Id*.

[11] Robert Avery, Ken Brevoort, Carla Inclan, Jessica Lee, Lexian Liu, Cindy Waldron, Xun Wang and Peter Zorn, *Second Liens: Their Impact on Mortgage Default*, Presentation at National Bureau of Economic Research Conference on Housing and the Financial Crisis (Nov. 16, 2011).

[12] This estimate covers only owner-occupied units. The 52 million estimate for all owner occupied units comes from U.S. Census Bureau, Mortgage Status: 1 Year Estimates, American Community Survey (2007). Avery et al., *supra* note 11~~14~~, estimated the number of homes with mortgages outstanding at 56 million, which produces a slightly lower estimate that 24 percent of all first liens are accompanied by second liens.

[13] *See* Jon Prior, *Less than One-in-Five GSE Loans hold a Second Lien*, HousingWire.com, Apr. 5, 2012, http://www.housingwire.com/news/less-one-five-gse-loans-hold-second-lien. The estimate was attributed to industry sources, and the attendees at our recent convening did not think it was an unreasonable estimate.

[14] Laurie S. Goodman, Roger Ashworth, Brian Landy and Ke Yin, *Second Liens: How Important?*, J. Fixed Income, Fall 2010, at 19, 21.

B. Who holds/owns the second liens?

Second liens are rarely securitized and are mainly held in the portfolios of banks and credit unions, presumably the same institutions that originated them. Of the $873 billion in second liens outstanding as of the end of 2011, only 2.1 percent are securitized, down from a still relatively minor 6.2 percent of the total in 2007.[15] Of the remainder, $723.1 billion, or 82.8 percent, are held in the portfolios of commercial and savings banks (with the four largest banks holding about 42 percent of the total).[16] Credit unions account for another 9.5 percent, and finance companies and foreign banks hold 5.7 percent.[17]

C. Some important distinctions between types of second liens:

While all second liens are defined as having a subordinate claim on the collateral of the home, there are important differences between second liens as to how the funds are to be used, the timing of the loans, and their terms. Some borrowers take out second mortgages to supplement their own funds in order to provide a downpayment on the first mortgage. Larger downpayments can allow borrowers to obtain more favorable pricing for a first mortgage by lowering the size of the first mortgage to bring it within the guidelines for an agency mortgage. Larger downpayments also enable borrowers to avoid mortgage insurance, which the two agencies require for first mortgages when the amount of the mortgage exceeds 80 percent of the value of the property.[18] When the second lien is used for the downpayment, it is called a piggyback loan.[19] Second liens also can be taken out for other purposes, such as funding college tuition or home improvements.

Second liens also can be categorized by whether the loan is closed-end or open-end. Closed-end second lien loans (CESs) generally are fixed rate, self-amortizing loans.[20] Because the borrower receives the proceeds of such a loan in one lump sum, this type of loan works well for financing a one-time expenditure, such as the downpayment needed to purchase a house. Open-end loans, usually referred to as HELOCs (home equity lines of credit), by contrast, can be drawn down over time. Open-end loans generally have an adjustable interest rate that varies with short-term market interest rates. Repayment of the principal borrowed under an open-end loan generally is not required to begin until years 5 or 10, at which time, the line converts to a fixed rate, self-amortizing

[15] Statistical Release, Board of Governors of the Federal Reserve System, *supra* note 9~~12~~.
[16] See *infra*, text accompanying note 58~~61~~.
[17] *Id*.
[18] *Id*.
[19] "Piggyback" is sometimes used interchangeably with "simultaneous," even though the latter includes all second liens made at the same time as the closing of the first mortgage, even if they are not used to make the downpayment.
[20] CESs also are referred to as home equity loans (HELs).

loan. HELOCs offer borrowers the flexibility to drawn down the line only as needed to smooth over periods of low or no income, or to cover special purchases.[21]

Both HELOCs and closed-end loans can be made either simultaneously with, or subsequent to, the purchase of the home and, regardless of the timing, may be made either for the purpose of buying the house or for other purposes. Second liens taken out subsequent to the purchase of the home are presumably used for other purposes.[22]

Originations of HELOCs have outnumbered those of CESs and their periods of popularity differed somewhat. Lee, Mayer and Tracy recently found that CESs accounted for between 30 and 40 percent of the total second lien balance over the period between 1999 and 2011.[23] Originations of HELOCs peaked at approximately $140 billion in the fourth quarter of 2005, just as housing prices peaked in most regions of the country, which is consistent with the view that HELOCs were primarily used during the run-up in house prices to take advantage of increases in the newly available equity imbedded in the home.[24] New originations of HELOCS then fell 30 percent over the next two years.[25] CES originations peaked at approximately $55 billion almost a year later, but remained at a high level for another year, consistent with the belief that they were used by borrowers stretching to be able to make the purchase.[26] CESs also are associated with higher CLTV loans and lower downpayments, which again is consistent with CESs being used to finance the purchase.[27] Once the housing bubble burst, the originations of both HELOCs and CES fell rapidly in 2008, to levels that were only 15 to 20 percent of the boom years.[28]

D. The legal rights of second lien holders:

Second liens provide two claims for repayment: the security interest in the home that serves as collateral; and a note that may be enforceable even if home has insufficient

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[21] *See* Sumit Agarwal, Brent W. Ambrose and Chunlin Liu, *Credit Lines and Credit Utilization*, 38 J. Money, Credit and Banking 1, 3 (2006).

[22] CES loans taken out after the purchase of the home appear to be relatively rare, accounting for less than 10 percent of second liens. Email from Xun Wang, Senior Housing Economist, Federal Home Loan Mortgage Corporation, to Peter Zorn, VP-Housing Analysis and Research, Federal Home Loan Mortgage Corporation (Feb. 23, 2012, 13:41 EST) (on file with authors).

[23] Donghoon Lee, Christopher Mayer and Joseph Tracy, *A New Look at Second Liens* 5 (Feb. 23, 2012) (unpublished manuscript), *available at* http://www.nber.org/chapters/c12623.pdf. The authors note that CES accounted for $158 billion in August 2011 approximately 25 percent of the total second lien balance, which is less than the 30 to 40 percent of the total noted elsewhere in the paper. *Id*. at 2 n.5. That may reflect the difference between the balance as of August 2011 and the average of the period between 1999 and 2011.

[24] *Id*. at 10 and app. 4 fig.7.

[25] *Id*. at 10.

[26] *Id*. at 10 and app. 4 fig.6.

[27] *Id*. at 6.

[28] *Id*. at 10.

value as collateral to cover the outstanding principal balance.[29] When a borrower goes into default and the first lien holder enforces its lien, the second lien holder has no right to recovery from proceeds of a sale of the property until the first lien holder's claim has been satisfied.[30] But the second lien holder also holds a note, and is entitled to payments on that note even if the borrower is not paying on the first mortgage, and even if the underlying property is inadequate to protect to the first lien holder. Further, at least in some states, the second lien holder may have recourse against the borrower on the note even if the house that serves as collateral has been liquidated, if the debt to the second lien-holder remains unpaid.[31]

These legal rights govern the relationship between the holders of the first and second liens when the borrower on the first lien is in default or in imminent danger of default. As detailed below, while the second lien holder's rights should not impede most types of loan modifications, they will effectively block a refinancing, short sale, or DIL of the first lien if those outcomes would jeopardize the second lien holder's rights, or if the refinance lender, short sale purchaser, or first lien holder accepting a DIL insists upon a resubordination of the second lien.[32]

In general, the second lien holder would not gain priority over a first lienholder after modification of the first lien unless the modification somehow prejudices its rights, in which case the second lien gains priority only as to the amount involved in the prejudicial modification.[33] Lowering the interest rate, extending the maturity of the loan,

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[29] Second liens, which generally are recourse loans, may have some recovery value because in many states, lenders have the option of pursuing borrowers for the debt not covered by the foreclosure sale proceeds. "The recovery on such debts is generally minimal, though." Alex Ulam, *Why Second-Lien Loans Remain a Worry*, American Banker, May 2, 2011, http://www.americanbanker.com/specialreports/176_5/second-lien-loans-remain-worry-1036731-1.html. Recovery is limited unless a borrower has income that can be garnished (or unless the borrower can be pressured into paying off the loan). Lenders sometimes sell the debt to collection agencies, which may be able to persuade, or harass, the borrower into paying some or all of the debt. Recovery is not available, however, in some states if the proceeds of the loan were used to buy the house. *See, e.g.*, Cal. Civ. Proc. Code § 580 (West 2008). This article does not address the issues raised by aggressive attempts to recover on the second lien.

[30] Restatement (Third) of Prop.: Mortgages § 7.4 (1997) (in the event of foreclosure, junior lien holder's claims may only be satisfied after the senior lien holder's claim has been fully satisfied by the proceeds of the sale). When a borrower is in default on the first and second liens, but the first lien holder takes no action to take possession of the collateral, the second lien holder may enforce its lien by foreclosing, but it must pay off the first lien holder in full before it could recover from the collateral.

[31] *See generally* 2 Real Estate Law Digest § 21:60 (4th ed. 2012).

[32] *See, e.g.*, Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang and Eileen Mauskopf, *The Incentives of Mortgage Servicers: Myths and Realities*, 41 UCC L.J. 4 Art. 2 (2009).

[33] *See, e.g.* Shultis v. Woodstock Land Dev. Associates, 188 A.D.2d 234 (N.Y. App. Div. 1993). *See also* Restatement (Third) of Prop.: Mortgages § 7.3. For an overview of the law, see Patrick A. Randolph, Jr. Mortgage Modification and Alteration of Priorities Between Junior and Senior Lienholders, Practising Law Institute, Real Estate Law and Practice Course Handbook Series, 501 PLI/Real 41 (2004).

and reducing principal on the first lien improves, rather than impedes, the ability of the second lien holder to collect on its loan. Moreover, even capitalizing arrearages should not prejudice the second lien holder because those amounts were already due and payable to the first lien holder.[34]

Nevertheless, many first lien holders have insisted that the second lien holder resubordinate its lien to remove any risk that the modification will jeopardize the first lien holder's priority. Such additional protection seems unnecessary, unless there is an explicit requirement for resubordination in the Pooling and Servicing Agreement (PSA) that governs the servicer of the first mortgage.[35] Further, if the first lien holder wants additional assurance, title companies offer lien priority insurance.[36]

On the other hand, the second lien holder does have the legal right to restrict the ability of the first lien holder to refinance the first lien or to agree to a short sale or DIL. Because the new, refinanced mortgage necessarily is recorded after the "second" mortgage, it would normally be subordinate, absent consent of the second lien holder. Although courts will apply the doctrine of equitable subrogation in some circumstances to protect the holder of the refinanced mortgage,[37] the safest course for a provider of

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[34] Although the issues does not appear to have been litigated, capitalizing the arrears as a non-interest bearing element of the principal should not constitute a materially prejudicial modification. Modifications are prejudicial when they are not contemplated in the original mortgage and the junior lienholder has no notice of the possibility of such a modification. *See* Restatement (Third) of Prop.: Mortgages § 7.3. If the arrears are capitalized, but the senior lienholder agrees to forbear interest on the capitalized arrears, the amount "added" to the principal is merely the amount of the arrears, which is already due to the senior lienholder and was fully contemplated by the original mortgage. However, capitalization of arrears technically may be regarded as an increase in principal, which is generally considered prejudicial to the junior lienholder. *See* 2 Law of Real Estate Financing § 12:30 (suggesting that delinquent payments should be held as a separate debt on the account, rather than capitalized, during a workout agreement to avoid subordination). Importantly, even if the capitalization of the arrears were found to materially prejudice the junior lienholder's rights, the first lien would maintain priority except as to the amount of the prejudicial modification. *See, e.g.*, Shultis v. Woodstock Land Dev. Associates, 188 A.D.2d 234 (N.Y. App. Div. 1993). Thus, at worst, only the capitalized arrears would be subordinate to the second lien.

[35] Discussants at the convening speculated that some PSAs may be ambiguous on this point, and Agarwal, et al. assert that PSAs sometimes require resubordination. Sumit Agarwal, Gene Amromin, Itzhak Ben-David, Souphala Chomsisengphet, and Yan Zhang, *Second Liens and the Holdup Problem in First Mortgage Renegotiation* 3 n.3 (December 14, 2011) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2022501). But it would be hard for an investor to argue that a servicer had granted a modification that caused a loss in priority because there is little reason to believe that courts would hold modifications to be new mortgages. *See* Cordell, et al., *supra* note 32~~35~~.

[36] For example, First American Title Insurance offers Lien Priority Insurance for approximately $125. *See* http://www.firstam.com/title/products/loss-mitigation-title-services/lien-priority-insurance.html.

[37] *See, e.g.,* Washington Mut. Bank v. Chiappetta, 584 F. Supp. 2d 961, 972 (N.D. Ohio 2008) (holding refinanced mortgages are entitled to equitable subrogation under Ohio law). *But see*

refinancing to ensure priority is to have the second lien holder agree to resubordinate.[38] The second lien holder also has the power to hold up short sales and deeds in lieu, because prospective purchasers will be unable to get a mortgage given that the existing second lien would take priority over that later mortgage. Short sales and DIL are attractive options only if they come with clean title, and only the second lien holder can agree to extinguish the lien (unless the borrower is in bankruptcy).[39]

Holders of first liens sometimes have the mistaken impression or hope that the second lien is subordinate not only in terms of the collateral but also in terms of payment.[40] That is not the case: whether or not the first lien holder chooses to provide relief to the borrower, the second lien holder is under no obligation to either pass payments received from the borrower on to the first lien holder or to modify the terms of its mortgage.[41] While it might be possible in the future to specify such obligations in an intercreditor agreement (see the discussion in Section VII below), the home mortgage industry apparently did not anticipate the problems that second liens could cause in the

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Deutsche Bank Nat. Trust Co. v. Citibank, N.A., 775 F. Supp. 2d 1334, 1339-40 (M.D. Ala. 2011) (holding equitable subrogation of refinanced mortgages invalid, under Alabama law, when the refinancing company had knowledge of the intervening lien).

[38] Kevin M. Baum, *Apparently, "No Good Deed Goes Unpunished": The Earmarking Doctrine, Equitable Subrogation, and Inquiry Notice Are Necessary Protections When Refinancing Consumer Mortgages in an Uncertain Credit Market*, 83 St. John's L. Rev. 1361, 1374-81 (2009).

[39] Katie Porter, *Redemption (of the 722 Variety) for Struggling Homeowners*, Credit Slips (Mar. 30, 2010, 8:22 AM), http://www.creditslips.org/creditslips/2010/03/redemption-for-homeowners-722-as-a-savior.html. If the borrower is in bankruptcy, the bankruptcy court can strip off junior liens that are without any underlying collateral value. *See* Tara Twomey, *Frequently Asked Questions On "Stripping Off" Home Mortgages (Part 1 Of 2),* Practising Law Institute, Corporate Law and Practice Course Handbook Series, 1946 PLI/Corp 709, 711 (2012).

[40] *See* Porter, *supra* note 39~~42~~ ("The investors in the first loan somewhat sensibly resist modifications, particularly those with principal write-downs, pointing out that it doesn't seem right that they should take a haircut, while junior lien holders refuse to modify their loans."). *See also*, Felix Salmon, *Why the AGs are Right to Leave Second Liens Alone*, Reuters (Mar. 17, 2011), http://blogs.reuters.com/felix-salmon/2011/03/17/why-the-ags-are-right-to-leave-second-liens-alone/ ("[T]he owner of the first lien has always had the freedom to leave the second lien entirely untouched if they want . . . [but if] you're taking a hit on a secured loan, you don't want to be bailing out someone whose debt junior [sic] to your own.").

[41] "It is important to distinguish between payment priority and lien priority. In almost all scenarios, second lien holders have rights equal to a first lien holder with respect to a borrower's cash flow. The same is true with respect to other secured or unsecured debt, such as credit cards or car loans. Generally, consumers can decide how they want to manage their monthly payments. It is only at liquidation or property disposition that the first lien investors have priority." *Second Liens and Other Barriers to Principal Reduction as an Effective Foreclosure Mitigation Program: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 57 (2010) [hereinafter Lowman] (prepared statement of David Lowman, CEO, JPMorgan Chase Home Lending).

event of a major housing price decline, and the parties generally have no such provisions in place.[42]

II. How are Second Liens Performing?

Borrowers with second liens are more likely to be underwater than those with only one mortgage.[43] Being underwater is not the same as being delinquent, of course, and the Federal Reserve Board of Governors recently estimated that approximately 72 percent of borrowers with underwater mortgages are current on their payments.[44] However, an estimated 40 percent of borrowers with underwater mortgages have both a first and second lien,[45] and those borrowers are further underwater[46] and more likely to default than borrowers with just a first mortgage.[47]

A recent study found that HELOCs had a serious delinquency rate (90 or more days late) of 5 percent at the end of the third quarter of 2011, while CESs had a serious delinquency rate of 12 percent, although performance has been deteriorating further recently.[48] CES loans perform worse than HELOCS at least in part because they "were often originated to borrowers with low credit scores and were more likely to be originated simultaneously with a first lien…or with a non-prime first mortgage."[49] Simultaneous second liens, whether HELOCs or CESs, performed worse than those originated

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[42] *See, e.g.*, *Report of the Model First Lien / Second Lien Intercreditor Agreement Task Force*, 65 Bus. Law. 809, 810 (2010); James P. Nehf, *Second Lien Financing* 2–19 (2008) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1924328.

[43] Lee, Mayer & Tracy, *supra* note 23~~26~~, at 13 ("Borrowers with a second lien had an average LTV during the boom of at least 95 percent").

[44] Federal Reserve Board of Governors, *supra* note 4~~7~~, at 21. The FHFA found that 80 percent of its underwater borrowers were current as of June 30, 2011 and even 74 percent of those with CLTV above 115 percent were current. Letter from Edward J. DeMarco, Acting Director, Federal Housing Finance Agency, to Elijah E. Cummings, Ranking Member, H. Comm. on Oversight and Gov't Relations 2 (Jan. 20, 2012) (available at http://www.fhfa.gov/webfiles/23056/PrincipalForgivenessltr12312.pdf). Further, about 50 percent of Chase's second lien portfolio is underwater, and 95 percent of this portfolio is performing (less than 60 days past due). Thirty percent of second lien mortgages have CLTVs over 125 percent, but 94 percent of this portfolio is performing. Lowman, *supra* note 41~~44~~, at 56.

[45] Press Release, Corelogic, *supra* note 2~~5~~.

[46] CoreLogic found that first mortgages without second liens were on average underwater by $51,000. The comparable figure for those with second liens was $84,000. *Id*.

[47] Sumit Agarwal, Gene Amromin, Itzhak Ben-David, Souphala Chomsisengphet, and Douglas D. Evanoff, *Market-Based Loss Mitigation Practices for Troubled Mortgages Following the Financial Crisis* 13, 16 (Charles A. Dice Center Working Paper No. 2010-19, October 11, 2010), *available at* http://dx.doi.org/10.2139/ssrn.1690627. *See also* Vicki Been, Mary Weselcouch, Ioan Voicu and Scott Murff, *Determinants of the Incidence of Loan Modifications* 21 (Oct. 2011) (manuscript under review), *available at* http://furmancenter.org/files/publications/Determinants_of_Mods_October_2011_Final_1.pdf.

[48] Lee, Mayer & Tracy, *supra* note 23~~26~~, at 14 and app. at 10 fig.19.

[49] *Id*. at 6.

subsequent to the purchase, consistent with the view that simultaneous second liens were most commonly used by borrowers who were otherwise unable to meet downpayment requirements.[50] Laurie Goodman and her colleagues looked at 30-89 day delinquency rates for all second liens in the first quarter of 2010, and found delinquency rates of 1.2 percent for second liens in bank portfolios (versus 3.1 percent for first liens); 10.0 percent in all securitizations (versus 8.1 percent for first liens), and 5.5 percent in securitizations with FICO greater than 720 (versus 4.0 percent for first liens).[51]

Robert Avery and his colleagues found that, over a seven year period, 69 percent of the mortgages held by borrowers with both a first and second lien were never delinquent.[52] While 31 percent of borrowers experienced a delinquency on one or both liens at some point during that time period, only 15.1 percent of borrowers had a period of serious delinquency on both liens. In all the other cases, at least one of the liens had only been delinquent for 60 days or less. Further, it is not uncommon for delinquent loans to re-perform. For example, Lee, Mayer and Tracy found that 40 percent of borrowers seriously delinquent on first liens but performing on second liens became current on the first lien again.[53]

As those numbers show, borrowers do sometimes remain current on their second lien while being delinquent on the first.[54] An early study found that about one third of borrowers who defaulted on their first lien mortgage kept their second lien mortgages current, and surprisingly, about 20 percent of borrowers in foreclosure because of

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[50] *Id*. at 15. Further, first liens with simultaneous seconds perform worse than those with subsequent seconds. Goodman et al., *supra* note 14~~17~~, at 22; Michael LaCour-Little, Charles A. Calhoun & Wei Yu, *What Role Did Piggyback Lending Play in the Housing Bubble and Mortgage Collapse?*, 20 J. Housing Econ. 81, 89-92 (2011). HELOCs used to fund the home purchase also are associated with worse performance of the first lien. Michael LaCour-Little, Wei Yu and Libo Sun, *The Role of Home Equity Lending in the Recent Mortgage Crisis* 14-16 (Jan. 28, 2012) (unpublished manuscript, on file with authors).

[51] Goodman et al., *supra* note 14~~17~~, at 28 Exhibit 10.

[52] The Avery et al. study uses a unique database that combines information from a credit bureau and the Home Mortgage Disclosure Act. Avery et al., *supra* note 11~~14~~.

[53] Lee, Mayer & Tracy, *supra* note 23~~26~~, at 16–18.

[54] There are a number of reasons why a borrower rationally may continue paying on the second lien months after stopping on the first: to preserve access to an available line of credit; to prevent the second lien holder from pursuing recourse; to minimize impact on their credit ratings; and to qualify for a modification of the first lien. Alternatively, servicers of the second lien may simply be more aggressive or more skilled, having been more familiar with collection practices used with other consumer debts., including encouraging borrowers to make some sort of payment on seconds before the loan becomes delinquent for reporting or accounting purposes Of course, borrowers also may act irrationally, paying on the second lien when is it inefficient to do so, either out of ignorance or confusion, or simply because the monthly payments on seconds tend to be lower and therefore more manageable than payments on first liens,. *See* Lee, Mayer & Tracy, *supra* note 23~~26~~, at 18; Laurie Goodman, Roger Ashworth, Brian Landy, & Lidan Yang, *Strategic Default and 1st/2nd Lien Payment Priority*, Amherst Mortgage Insight 6, 7 (Feb. 17, 2011); Ulam, *supra* note 29~~32~~.

defaults on the first mortgage kept their second lien mortgage current.[55] Lee, Mayer and Tracy recently found, however, that when a first mortgage reaches the 90 to 120 days delinquent stage, only about 21 percent of CES remain current four quarters after the first mortgage delinquency (31 percent for HELOCs).[56] Zorn and his colleagues found that in 12.9 percent of the cases, firsts and seconds performed differently, but with seconds performing better only 8 percent of the time and worse 5 percent of the time.[57]

III. What Risk Do Second Liens Pose to the Banking System?

A. Bounding the potential losses on second liens in bank portfolios

Some observers have worried that because the portfolios of the four largest banks contain about 42 percent of the second liens,[58] defaults on those loans could jeopardize the economy. For at least three of the four,[59] the total value of the second liens held in their portfolios in 2008 exceeded their tier one capital, so potential defaults posed a threat to their solvency. Since that time, however, banks have been able to improve their equity positions through earnings and capital raises, although second liens still exceed 70

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[55] Julapa Jagtiani & William W. Lang, *Strategic Default on First and Second Lien Mortgages During the Financial Crisis* 11 (Research Dept., Fed. Reserve Bank of Philadelphia, Working Paper No. 11-3, 2010), *available at* http://ssrn.com/abstract=1724947. Other estimates of borrowers who are delinquent on their first liens but nevertheless stay current on their second liens range from 6 percent to as high as 64 percent. Ulam, *supra* note 29~~32~~, cites an Amherst Securities Group study that found, for mortgages in non-agency securitizations, "59 percent of borrowers with a home equity line of credit turned delinquent when the first was in delinquency, compared with 78 percent of borrowers with closed-end seconds." The OCC found that 6 percent of all borrowers with both first and second liens were current on their second while delinquent on their first. Letter from John Walsh, Acting Comptroller of the Currency, to Representative Brad Miller 2 (Dec. 14, 2010), *available at* http://blogs.reuters.com/felix-salmon/files/2011/03/OCC-Response-FSOC-Letter-p.pdf. At a Congressional hearing, David Lowman, CEO for Home Lending at JPMorgan Chase, stated that "[A]lmost 64 percent of borrowers who are 30-59 days delinquent on a first lien serviced by Chase are current on their second lien." Lowman, *supra* note 41~~44~~, at 57.

[56] Lee, Mayer & Tracy, *supra* note 23~~26~~, at 17 and app. 13 tbl.2.

[57] Avery et al., *supra* note 11~~14~~. Tracy found that 26 percent of CESs and 38 percent of HELOCS were current when the first lien was 60 or more days delinquent. Lee, Mayer & Tracy, *supra* note 23~~26~~, at app. 13 tbl.2.

[58] Bank of America, JPMorgan Chase, Wells Fargo, and Citi together held 42 percent of the 2nd liens at the end of 2009 ($436 billion, of a total outstanding of $1032 billion, with $78 billion of the four banks' total in CES and $358 billion in HELOCs). Goodman, et al., *supra* note 14~~17~~, at 27 Exhibit 9.

[59] Citi did not specify the size of its home equity/junior lien portfolio in its 2008 10K. Citigroup, Annual Report on Form 10-K, (2008), *available at* http://www.citigroup.com/citi/investor/data/k08c.pdf?ieNocache=262.

percent of the tier one capital of all banks.[60] The combination of this lower ratio and a better understanding of the likely scale of losses has reduced the concern that second liens could topple the banking system. Most recently, FitchRatings reported that the threat to solvency appears to have passed, although further losses on second liens could still have a significant impact on annual earnings over the next three years.[61]

To get a better sense of how the four largest banks have addressed the risks posed by the second liens, we began with a look at their 10K's. While the data in the 10K's are not exactly comparable from bank to bank or year to year,[62] a back of the envelope calculation suggests that these banks have been able to increase their tier one regulatory capital by one-fifth over the past few years – from $462 billion in 2008 to $555 billion in 2011. At the same time, they have reduced the dollar amount of second liens in their portfolio by 25 percent ($400 billion to $298 billion).[63] Some loans have presumably paid off (and only relatively few have been added), but the reduction also is a result of having to charge off the underwater portion of those loans that are more than 180 days delinquent.[64] Taken together the increase in capital and the decrease in reported liens outstanding have lowered the relative importance of second liens, so that, for the four banks, they ranged from 75 percent to 33 percent of tier one capital at the end of 2011.

The banks' exposure to second liens that are underwater has been of particular concern, both because underwater mortgages are more likely to default,[65] and because the shortfall in collateral value decreases the potential for any recovery if the loan should default.[66] If, for example, the second lien is completely underwater (the current value of

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[60] Total Tier one capital in the last quarter of 2011 was $1.2 trillion. The data is compiled by BankRegData.com from the quarterly Call Reports filed by banks. *See* Tier 1 Capital Ratio, BankRegData.com (last visited May 31, 2012).

[61] Fitch Ratings, U.S. Housing and Bank Balance Sheets: Special Report 7-8 (2012) at 7-8.

[62] Some banks, for example, make it impossible to determine the exact level of their exposure to second liens by grouping under the category of home equity loans both those that are subordinate and those that are in a first position. Also, for Wells and Chase, second lien portfolios acquired from Wachovia and Washington Mutual respectively, are accounted for separately as "purchased credit impaired" and are valued based on an assessment of their worth at the time of acquisition so no comparison can be made between the origination value of the loan and its current value on the books. *See, e.g.*, Wells Fargo and Co., Form 10-K (2010), *available at* https://www.wellsfargo.com/invest_relations/filings_2010.

[63] JP Morgan Chase has recognized losses of more than $16 billion since 2007 (somewhat higher than seems apparent from 2011 10K). Letter from Jamie Dimon, CEO and Chairman, JP Morgan Chase and Co. to Shareholders, in JP Morgan Chase and Co. Annual Report 30 (2011), *available at* http://files.shareholder.com/downloads/ONE/1801363047x0x556139/75b4bd59-02e7-4495-a84c-06e0b19d6990/JPMC_2011_annual_report_complete.pdf.

[64] Uniform Retail Credit Classification and Account Management Policy, 65 Fed. Reg. 36,903, 36,903 (June 12, 2000).

[65] Approximately half of those homes with mortgages that are delinquent are underwater. In comparison, underwater mortgages only account for about 25 percent of all mortgages. Corelogic, *supra* note 2~~5~~.

[66] Chase, for example, also services a first lien mortgage for $40 billion of its owned second lien mortgages: 92 percent of these first lien mortgages are performing and 28 percent of these first

the house is less than the amount of indebtedness on the first lien, so that there is no value in the collateral for the second lien), then the loss (called the loss severity) could be 100 percent of the unpaid principal balance unless the borrower has other resources to pay back part, or all, of the loan.[67]

A conservative estimate of the upper bound on possible losses from second liens would start with the assumption that the loss severity on those second liens that are underwater (the current value of the house is less than the value of the first and second liens combined) and in default will be 100 percent. A recent Federal Reserve Board of Governors white paper reported that, of 12 million underwater mortgages, 8.6 were current; 0.6 million were 30 days past due; 0.31 million were 60 to 89 days delinquent; 1 million were 90 days or more delinquent; and 1.4 million were in foreclosure.[68] The banks already have written down most of the mortgages that are delinquent or in foreclosure to their underlying collateral value, as bank regulatory accounting rules require for all real estate loans that are delinquent 180 days or more.[69] That leaves us to focus on the 9.5 million underwater liens that the banks may not have written down (the 8.6 million that are current plus the 0.91 million that are 30 to 89 days past due). If a quarter of the underwater mortgages that are now current are likely to default, as some in the industry have projected,[70] an additional 2.4 million of the underwater mortgages will default. Using an estimate from FHFA that as many as half the mortgages that are seriously delinquent and underwater have a second lien, we can project that another 1.2 million mortgages with second liens will default. Assuming 100 percent loss severity, expected losses going forward accordingly would be on roughly 1.2 million second liens. That constitutes 9 percent of all the estimated second liens outstanding. To put that number in perspective, recall that all second liens constituted between 75 percent and 33 percent of the major banks' tier one capital at the end of 2011.[71]

While this is at best a rough estimate of a possible upper bound for future losses just on underwater mortgages, it probably covers the bulk of potential future losses. Additional losses from second liens that are not underwater should not be that large given that the borrower still has equity in the home and so will likely work hard to keep the home or be able to sell it for enough to cover the mortgages.[72] These findings give more

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lien mortgages are by themselves underwater (loan-to-value ratio of over 100 percent). Lowman, *supra* note 41~~44~~, at 56.

[67] While we cannot ascertain how underwater these 2nd liens are, we know that on average, mortgages with 2nd liens have a negative equity of $84,000 compared to only $51,000 for mortgages without a second lien. Press Release, CoreLogic, *supra* note 2~~5~~.

[68] Federal Reserve Board of Governors, *supra* note 44~~47~~, at 21 and 21 n.30.

[69] Uniform Retail Credit Classification and Account Management Policy, 65 Fed. Reg. at 36,904.

[70] *See, e.g.*, Letter from Jamie Dimon, *supra* note 63~~66~~, at 28.

[71] *See*, *supra* text accompanying notes 62~~65~~ - 65~~68~~.

[72] For example, Bank of America reports the following: "Ninety percent of Bank of America's home equity portfolio is made up of standalone originations used to finance a specific customer need, such as education expenses or home improvements. The remainder consists of piggyback loans originated with the home purchase. Most of our second loans continue to have collateral value, and of those where the second loan is underwater, a significant number are still

credence to the Fitch Ratings' conclusion that future losses on second liens may have an impact on annual earning over the next three years but their impact on capital should be manageable for most banks.[73]

B. Have banks appropriately accounted for likely losses on second liens?

Banks account for likely losses by setting aside an allowance for loan losses and by writing the value of the lien down to the value of the underlying collateral for loans delinquent for 180 days or more.[74] Some commenters question whether, even assuming that the banks are in compliance with those regulatory standards, the banks are sufficiently accounting for troubled loans. They claim that troubled loans may be hidden by the ability to keep them "current" at little cost to the borrower through small payments on day 89.[75] As noted earlier, Laurie Goodman and her colleagues looked at 30-89 day delinquency rates for all second liens in the first quarter of 2010, and found delinquency rates of 1.2 percent for second liens in bank portfolios versus 10.0 percent in all securitizations,[76] which could mean either that the portfolio delinquencies are artificially low, or that the second liens held in portfolio are significantly different from those that are securitized. To get a better sense of whether the banks are adequately providing for future losses, we need to assess how adequate the allowances for loan losses are for those loans still on the books.

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performing. Indeed, out of 2.2 million second liens in Bank of America's held for investment portfolio – only 91,000 seconds – about four percent – are (i) delinquent, (ii) behind a delinquent first mortgage and (iii) not supported by any equity." *Second Liens and Other Barriers to Principal Reduction as an Effective Foreclosure Mitigation Program: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 44 (2010) [hereinafter Desoer] (prepared statement of Barbara Desoer, President, Bank of America Home Loans). Testimony

[73] Fitch Ratings, *supra* note 61~~64~~, at 7-8.

[74] Uniform Retail Credit Classification and Account Management Policy, 65 Fed. Reg. at 36,904.

[75] *See* Yves Smith, *Clearing Up Some Misperceptions on the Mortgage Modification/Second Lien Debate*, Naked Capitalism, Mar. 21, 2011, http://www.nakedcapitalism.com/2011/03/clearing-up-some-misperceptions-on-the-mortgage-modificationsecond-lien-debate.html ("So what does a bank do? On day 89, before the HELOC is about to go delinquent, it tells the borrower to pay anything on it. A trivial payment is treated as keeping the HELOC current."); *see also* James Kwak, *Underwater Second Liens*, The Baseline Scenario, Mar. 13, 2010, http://baselinescenario.com/2010/03/13/underwater-second-liens/; Mike Konczal, *Those Pesky Second Liens, and an Update on HAMP*, Rortybomb, Mar. 25, 2010, http://rortybomb.wordpress.com/2010/03/25/those-pesky-second-liens-and-an-update-on-hamp ("The second/juniors will continue to 'perform' because much of it is HELOC debt, which like a credit card you'll never pay off, can have interest added to principal, without ever a real exit strategy to the debt."). Note, however, that such statements seem at odds with the general terms of HELOCs, which typically require that they convert after a 5-10 year period to self-amortizing loans. *See What is a HELOC?*, The Mortgage Professor, http://www.mtgprofessor.com/a%20-%20second%20mortgages/what_is_a_heloc.htm (last visited June 7, 2012).

[76] Goodman, et al., *supra* note 14~~17~~.

Recently, the regulators stepped up pressure on the banks to make sure their loan loss allowances reflected the risk in their portfolios.[77] As a result, the four largest banks all reported a significant increase in their non-performing second lien loans in the first quarter of 2012.[78] The impact on the bottom line of these banks appears to have been limited, however, as the banks indicated they had already set aside sufficient reserves against these loans. Banks do not necessarily have to disclose the allowances they set aside for loan losses specific to their portfolios of second liens, and most banks group together the allowances for a number of consumer loans.[79] The only firm numbers we were able to find for allowances specifically for second liens were from Bank of America, which reported that as of March 31, 2011, it was carrying its portfolio at a net value of 93 cents on the dollar, excluding the already written down loans included in the Countrywide purchase.[80] While many commenters have argued that the banks were significantly under-accounting for prospective losses, this 7 percent set aside for future loan losses is in line with the estimate described above that approximately 9% of the current but underwater second liens may be expected to default over the next few years, assuming that housing prices do not fall much more.

IV. Are Second Liens Getting in the Way of Efficient Resolutions for Distressed Mortgages?

Studies have shown that mortgages with second liens are more likely than first liens alone to result in foreclosure or to be in a nebulous state with no action taken by the lender despite serious delinquency, and are less likely to be modified.[81] Foreclosure counselors also report that distressed mortgages with second liens are particularly difficult to resolve in ways that allow the borrower to stay in the home. This section

[77] FDIC, *Allowance for Loan and Lease Losses; Estimation Practices for Junior Liens on Residential Properties*, Financial Institution Letter, FIL-4-2012 (Jan. 31, 2012).

[78] Peters, Andy Peters & Victoria Finkle, *Wells, JPM Reclassify Billions in Mortgages in Response to Regulators*, American Banker (Apr. 13, 2012), *available at* http://www.americanbanker.com/issues/177_72/jpmorgan-chase-reclassifies-nonperforming-loans-treasury-1048370-1.html.). See also, for example, the first quarter 2012 earnings reports of Bank of America. Financial Release, Bank of America, Bank of America Reports First-Quarter 2012 Financial Results (Apr. 19, 2012) (available at http://investor.bankofamerica.com/phoenix.zhtml?c=71595&p=irol-newsArticle&ID=1684843&highlight). http://investor.bankofamerica.com/phoenix.zhtml?c=71595&p=irol-newsArticle&ID=1684843&highlight=

[79] Lee, Mayer and Tracy found that linked first and second liens perform more similarly to each other than they do with credit cards and auto loans. Credit card and auto loans are more likely than second liens to remain current one year after default on the first lien. *See* Lee, Mayer & Tracy, *supra* note 23~~26~~, at 16.

[80] *See* Ulam, *supra* note 29~~32~~. *See also* Wells Fargo, *2012 Investor Day*, available at https://www.wellsfargo.com/invest_relations/presentations/2012/terms

[81] Indeed, loans with second liens are the least likely to be modified. *See* Agarwal et al., *supra* note 47~~50~~, at 16; Been et al., *supra* note 47~~50~~ at 21.

explores how second liens can make it more difficult for borrowers to refinance, to modify their first liens, or to get permission for a short sale or deed in lieu of foreclosure.

A. Transaction costs:

Second liens increase the complexity and transaction costs of resolving a delinquency or imminent default because they require consent from an additional party for a refinancing, short sale, or deed in lieu (and because servicers and others may believe – perhaps erroneously, as discussed above – that consent is required for a modification). The resulting increase in costs likely has caused inefficient foreclosures, that is foreclosures in cases where all parties – the borrower and both lenders – could have been made better off by another course of action. The problem has been compounded by the slow rate at which servicers staffed up to meet the growing number of delinquencies resulting from the subprime crisis and the recession. It also has been compounded by the compensation system for servicers, which receive an annual fee based on a fixed percentage of the unpaid principal balance, regardless of the amount of work done by the servicer and thereby made mortgages that required more work by the servicer particularly difficult to resolve by means other than foreclosure.[82]

B. Ambiguity about servicers' authority and liability:

Ambiguity about how much authority servicers have to negotiate with (or to ignore) the second lien holders may have prevented efficient resolutions of distressed mortgages. Vague pooling and servicing agreements (PSAs) and uncertain legal standards left many first lien servicers reluctant to engage in modifications or other resolutions that they feared could trigger legal liability to investors by jeopardizing the first lien's priority. Servicers' concerns about staying within the bounds of their legal authority were compounded by the lack of standardized language in PSAs and by seemingly (or actually) contradictory provisions within the same PSA. The resulting timidity may have led servicers to require second lien holders to resubordinate their liens when resubordination was unnecessary, and the resulting transaction costs undoubtedly prevented many efficient modifications.[83]

C. Externalities:

The second lien holder may be more likely to block (or more likely to underinvest in cooperative approaches to) a modification or other efficient resolution of a distressed mortgage because some of the costs of doing so – such as the consequences of

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[82] *See, e.g.*, Federal Housing Finance Agency, *Alternative Mortgage Servicing Compensation Discussion Paper* (Sept. 27, 2011), *available at* http://www.fhfa.gov/webfiles/22663/ServicingCompDiscussionPaperFinal092711.pdf.

[83] Resubordination is required only if the action taken by the servicer results in a loss of lien priority. As discussed earlier, text accompanying notes 30~~33~~ - 40~~43~~, the typical types of modifications being done today do not compromise the interests of the second lien holder and so should not jeopardize lien priority. *See supra* text accompanying notes 30~~33~~-40~~43~~.

foreclosure – are born by the first lien holder or by others who are not involved in the transaction, such as the neighbors of the property. Moreover, the benefits of modifying a delinquent mortgage accrue to the borrower, neighbors, and the economy as a whole, and not necessarily the holder of a second lien.

The ability to externalize some of the costs of a second lien holder's failure to cooperate in loan modifications is likely to affect a second lien holders' willingness to modify its lien. For example, consider situations in which the first lien holder or its servicer is willing to modify the first lien by reducing the borrower's payments to 31 percent of the borrower's income, a level that, but for the second lien, is assumed to be sustainable. If the second lien holder refuses to modify its lien, the burdens of the second lien debt (and any unsecured debt, such as credit card debts or auto or student loans) could leave the borrower unable to pay both the modified mortgage and the second lien. But the holder of the second mortgage will not have to bear the full costs of its refusal to cooperate with the first lien holder – those costs will be spread over the first lien holder, the borrower, and neighbors and others who suffer from the resulting foreclosure.[84] Consequently, the second lien holder is less likely to cooperate, and either the first lien holder will then not modify the first lien, or even if the first lien is modified, the borrower may still be unable to carry the mortgage over time. The ability to externalize some of the costs of the refusal to cooperate accordingly likely results in inefficient foreclosures.

D. Irrational expectations as to future increases in home prices:

The holder of a second lien in effect holds an option on the property.[85] Even after property values have fallen, there is the possibility that the value will rebound and that the collateral underlying the second lien may again cover at least some of the debt. To the extent that second lien holders are slow to recognize the fall in the value of the property or overestimate the potential for the value of the property to rebound, they will be more reluctant to accept a resolution that limits their option.

E. Moral hazard:

Similarly, second lien holders that hope the government will introduce programs that will require taxpayers to bear some of the costs of any workout will be reluctant to cooperate in any actions that would prevent the lien holder from taking advantage of that subsidy if and when it becomes available.[86]

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[84] *The Need for National Mortgage Servicing Standards: Hearing Before the Subcomm. on Housing, Transportation, and Community Development of the S. Comm. on Banking, Housing, & Urban Affairs*, 112th Cong. (May 11, 2011) (prepared statement of Laurie S. Goodman, Senior Managing Director, Amherst Securities), at 2-3.

[85] Kwak, *supra* note 75~~78~~.

[86] *See* Kwak *supra* note 75~~78~~ ("In practice, the second liens do have some small value, based on three things: (1) the hope that some borrowers will continue to make payments on second liens, even though would do better (financially) to walk away; (2) option value, since housing prices

F. Strategic bargaining:

The second lien holder may block an efficient resolution by engaging in strategic behavior to exploit its potential to hold up a resolution of the distressed mortgage. As Professor Christopher Mayer and his colleagues have argued: "[B]y delaying, the second-lien lender might convince the first-mortgage servicer to 'buy out' the second lien at a price above its true value. This is often called a 'hold-up' problem."[87] The second lien holder can make it untenable for the first lien holder to refinance its loan or to approve a short sale or deed in lieu, but if the second lien holder's refusal to cooperate triggers the first lien holder to foreclose, then the potential for the second lien holder to collect any further revenue generally is lost. The challenge for the second lien holder, then, is to extract as much as it can from the first lien holder without triggering a foreclosure.

G. Principal/agent costs:

Servicers deciding whether to grant a modification (or other resolution) may have different interests than either the first lien holder or the second lien holder. Under the typical servicer compensation scheme (described above), the servicer of the first lien may prefer to foreclose upon a delinquent mortgage rather than to modify the mortgage, because foreclosure allows the servicer to minimize its out of pocket servicing costs and to recover quickly any advances it has to make to the cover the shortfall to investors when a borrower is delinquent. To the extent that second liens add to the costs a servicer must bear to modify a loan, second liens exacerbate the gap between a servicer's own interests and the interests of the principal for whom the servicer is acting as an agent – the investors themselves. As Professor Levitan and Tara Twomey have noted, "[s]ervicers have no stake in the performance of mortgage loans, so they do not share investors' interest in maximizing the net present value of the loan. Instead, a servicer's decision whether to foreclose or modify a loan is based on its own cost and income structure, which is skewed toward foreclosure."[88] That is particularly true when second liens would add to the costs the servicer would incur in trying to resolve the distressed mortgage through a modification or other resolution.

A different principal/agent problem arises when the servicer of the first lien is affiliated with the entity that holds the second lien. More than half of all second liens are

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could rise enough to make the second liens worth something; and (3) the possibility that the government will start paying off second lien holders to stop blocking short sales.").

[87] Christopher J. Mayer, Edward R. Morrison, and Tomasz Piskorski, *Essay: A New Proposal for Loan Modifications*, 26 Yale J. on Reg., 417, 419 (2009).

[88] Adam J. Levitin and Tara Twomey, *Mortgage Servicing*, 28 Yale J. on Reg. 1, 1 (2011). *See also* Federal Reserve Board of Governors, *supra* note 4~~7~~, at 23; Diane E. Thompson, *Foreclosing Modifications: How Servicer Incentives Discourage Loan Modifications*, 86 Wash. L. Rev. 755, 771-72 (2011).

held by the servicer of the first lien.[89] In such cases, the servicer may have a disincentive to foreclose on the first lien, because of the effect foreclosure would have on the value of the second lien.[90] A recent paper by Agarwal and his colleagues, using data through March 2011, finds that first liens serviced by the same financial institution that owns the second lien are much less likely to be liquidated or modified, and more likely to have no action taken, than other first liens.[91] Their findings suggest that financial institutions have been able to bolster the accounting valuation of their second liens by delaying action on the underlying first, perhaps at the expense of third-party investors in the first liens.[92] On the other hand, affiliated servicers may be biased in favor of modifications to the associated first because such modifications would benefit second liens on the balance sheet of the affiliate by increasing the borrower's debt capacity.[93]

H. Lien holders' sense of fairness:

Some experts report that first lien holders refuse, on fairness grounds, to consider modifications that do not require second lien holders to take an equal or greater write-down.[94] On the other hand, some second lien holders are said to refuse write-downs because they think it is unfair to ask them to forgive debt unless other unsecured creditors, such as credit card lenders, also are asked to do so.[95] The friction may be caused in part by the belief among first lien holders that second lien holders should be junior not only in their claim to the collateral, but also when it comes to payment. As

[89] Agarwal, et al., *supra* note 35~~38~~, at 2; *but see* Lowman, *supra* note 41~~44~~, at 56 ("About 10 percent of Chase's total serviced portfolio of first lien mortgage loans has a Chase-owned second lien. Our best estimate is that about 20 percent of Chase serviced first lien mortgages may have a second lien from another lender and about 70 percent do not have a second lien.").

[90] *See* Ulam, *supra* note 29~~32~~.

[91] Agarwal, et al., *supra* note 35~~38~~, at 16.

[92] Agarwal and his colleagues suggest that the first lien holder will be reluctant to grant a modification without the second lien also doing so, because that would violate the priority of the mortgages. Id. at 3. But as noted previously, the second lien holder has a lower priority on the collateral, but not on payment.

[93] Many participants in the roundtable asserted that the internal policies of the servicers do not allow them to treat loans on which seconds are held by affiliated institutions differently from other loans. Moreover, they claimed that it was often easier for services to coordinate with affiliated seconds and to make arrangements for joint modifications.

[94] See, e.g., Annie Lowrey. New Stance on Forgiving Mortgages, New York Times, Apr. 10, 2012 (noting concerns of FHA Acting Director Edward DeMarco that liberalization of GSE loan modification policies could inappropriately benefit banks as second lien holders).

[95] *See* Felix Salmon, *When Mortgage Companies Give Up Money*, Reuters (Mar. 16, 2010), http://blogs.reuters.com/felix-salmon/2010/03/16/when-mortgage-companies-give-up-money/ ("[P]eople aren't profit maximizers if they think that the profit-maximizing outcome is fundamentally unfair. And it turns out that the same is true of mortgage companies."); Felix Salmon, *The Second-Mortgage Underwriting Failure*, Reuters (Feb. 8, 2010), http://blogs.reuters.com/felix-salmon/2010/02/08/the-second-mortgage-underwriting-failure/8, 2010), http://blogs.reuters.com/felix-salmon/2010/02/08/the-second-mortgage-underwriting-failure/ ("[F]irst-lien mortgage holders are going to hate to give the second-lien holders anything at all . . . .").

discussed earlier, this is not the law. A second lien, particularly when it is totally underwater, is more like other unsecured debt than it is like the first lien. While the unwillingness of second lien holders to modify may prevent the first lien holder from being able to come up with a solution that is sustainable for the borrower and has a positive net present value for the first lien holder, any general refusal by servicers to modify the first lien if the second lien holder does not also modify probably precludes efficient modifications. A further factor that may complicate negotiations between first and second lien holders is the phenomenon, noted above, that borrowers sometimes remain current on second mortgages while defaulting on the first. In such instances, second lien holders are likely to be even less amenable to modifications, notwithstanding equitable claims on the part of first lien holders.

I. Accounting and disclosure rules

Another reason second liens may interfere with efficient resolutions of distressed mortgages stems from the regulatory accounting and disclosure rules. Banks resist actions that would prompt a decrease in their bottom line profits, or that would require disclosure of an increase in expected losses. So, for example, a restructuring of a first lien mortgage may have implications on the reserving requirements for second mortgages on the same property, and those implications may affect the decisions of a servicer on the first mortgage that is affiliated with the second lien-holder, as discussed earlier. Further, while the rules require a bank to charge off that portion of a closed end or open end lien that is 180 days or more delinquent that is above the underlying collateral value,[96] the regulatory guidance at the beginning of the crisis may have been vague enough, and the loss experience sufficiently limited, to enable the banks to over-estimate the underlying collateral value in the home. Financial institutions had wide scope on when and how to assess the potential losses on their second liens, especially those that were continuing to perform. Moreover, restructuring second liens with below-market terms triggers additional disclosures and further examinations, so banks may have shied away from undertaking troubled debt restructurings, especially when, as discussed earlier, the borrower was still paying on the loan. As long as the liens remained on the books of the banks in an unimpaired status, the banks likely were reluctant to modify a lien or agree to a payment less than the book value of the loan.

At our roundtable, discussion, participants had mixed views as to whether financial firms were systematically resisting appropriate reserves for, and write-downs of, second mortgages, and thereby holding these assets on the balance sheet at inflated prices. Industry representatives and their advisers maintained that valuations were in line with current prices, while academic participants were skeptical that current accounting rules, which are dependent on an incurred loss model of valuation for loans, are sufficiently attentive to downward adjustments for expected losses on loan portfolios.[97] Several

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[96] Uniform Retail Credit Classification and Account Management Policy, 65 Fed. Reg. at 36,903..
[97] *See e.g.*, Mary E. Barth & Wayne R. Landsman, *How did Financial Reporting Contribute to the Financial Crisis?*, 19 Eur. Acct. Rev. 399, 415-16 (2010) (arguing that current loan-loss provisioning methods lead to delayed and asymmetric recognition of losses, depriving the

participants with regulatory experience noted that regulated financial institutions were sometimes reluctant to acknowledge problems with their portfolios, and reserving decisions for mortgages were often the subject of supervisory discussions. There was no consensus on the adequacy of the reserves and write-downs, but there was a general recognition that reserving and write-down practices around second mortgages are the subject of keen attention from both outside auditors and supervisors and are being enforced more strenuously today than in the recent past.[98]

V. The Present Situation

Of the problems or potential problems just discussed, the most serious at this time is simply the difficulty and cost imposed by having more players whose cooperation is needed, or is thought to be needed, to achieve a modification, short sale, or deed in lieu. The sense of those experts who participated in our roundtable discussion was that the understanding of, and practice on, many of the issues identified above have evolved over time. This evolution may account for some of the variance between the conclusions of the research based on historical data and the descriptions of current practice those working in the mortgage industry today provide. It is also possible, of course, that despite our best efforts, participants in the roundtable were not representative of the industry, or were expressing an optimistic, rather than a sober, assessment of the current situation. Regardless, the regulators, the industry, and foreclosure counselors seem to have learned from bitter experience over the last few years, and have made and are continuing to make improvements to their systems and policies that appear to be mitigating some of the problems posed by second liens. That is not to say that there are no problems;[99] our claim instead is that many efforts are underway to resolve the difficulties second liens pose, and that those efforts seem to be paying off.

The following sections briefly describe some of the improvements.

A. Increased staffing levels

There is widespread agreement that servicers were unprepared for the huge volume of delinquencies that followed the subprime crisis and the decline of the economy. Servicers were inadequately staffed to meet the challenge, the staff was inadequately trained for the task, and systems were not in place to deal with the vast

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markets of timely information regarding the value of bank assets). Some industry representatives countered that current loan reserving and write-down practices now do take account of expected losses especially in the area of troubled debt restructuring.

[98] One participant noted that supervisors have in some instances required banks to resubmit quarterly financial reports when loans reserves were deemed to be inadequate, and noted that banks tried to avoid troubled debt restructurings – seen by some institutions as a "scarlet letter," but viewed by supervisory officials as evidence of good management.

[99] See, e.g., Prashant Gopal and John Gittelsohn, Home Sales in U.S. Hostage to Holders of Junior Liens: Mortgages, Bloomberg News, July 23, 2012.

quantities of paperwork required. For borrowers with second liens, the problems caused by inadequate staffing of first lien servicers were compounded when a resolution required the involvement of a third-party – the servicer of the second lien – whose resources also were overstretched. Since the worst of the crisis, servicers have ramped up their staffs: Chase increased its staff from 6800 people servicing delinquent loans or dealing with foreclosures to 23,000 in 2011[100] and Bank of America took on an additional 10,000 people to service distressed borrowers.[101] Whether the current staffing will be sufficient to handle the coordination required when a borrower has both first and second liens remains to be seen, but staffing levels certainly have improved significantly.

B. Second lien servicers are more responsive to requests from borrowers and first lien holders/servicers

Spurred in part by the requirements of a range of government programs to encourage modifications and other resolutions, the banks report that they have improved their procedures in order to shorten turnaround times for approving re-subordination in the case of refinances, for example. The HAMP/2MP program[102] and HAFA[103] have pushed banks to respond more quickly to borrowers' questions about whether they qualify for modifications of first liens or for 2MP modifications, and to borrowers' requests to extinguish their liens under HAFA.[104] The settlement between the state attorneys general and the five largest mortgage servicers also has stepped up pressure on these servicers to review borrower eligibility under both government and proprietary programs more quickly.[105]

[100] Dimon, *supra* note 63~~66~~, at 27.

[101] Tom Braithwaite, *BofA Struggles to Close Door on Mortgage Woes*, Fin. Times, Apr. 20, 2012, at 17.

[102] HAMP (Home Affordable Modifications Program) is part of the Obama Administration's Making Home Affordable Program that was announced in March of 2009. 2MP (Second Lien Modification Program) is a companion program to HAMP for the modification of second liens when the associated first lien is modified under HAMP. 2MP prescribes for participating servicers the form that that modification needs to take. 2MP also provides subsidies to servicers, borrowers, and investors to offset some of the costs of making the modifications. For more details, see *Home Affordable Modification Program: Overview*, https://www.hmpadmin.com/portal/programs/hamp.jsp.

[103] The HAFA (Home Affordable Foreclosure Alternatives) Program is designed to help borrowers transition to more affordable housing. HAFA facilitates short sales and deeds in lieu of foreclosure through subsidies to servicers of the first lien, owners of the second lien, and borrowers. For more details, see *Home Affordable Foreclosure Alternatives Program: Overview*, https://www.hmpadmin.com/portal/programs/foreclosure_alternatives.jsp.

[104] While our analysis highlights those features of HAMP, 2MP, and HAFA that should reduce the frictions caused by second liens, we have not assessed the overall effectiveness of these programs.

[105] The state attorneys general servicing settlement with the five largest mortgage servicers requires new standards for loan servicing and foreclosure practices, and has a particular focus on principal write-downs for both first and second liens. *See* Press Release, Dep't of Justice, Federal Government and State Attorneys General Reach $25 Billion Agreement with Five Largest Mortgage Servicers to Address Mortgage Loan Servicing and Foreclosure Abuses (Feb. 9, 2012),

C. The government's HAMP/2MP program has created a database to link first and second liens

First and second lien holders, servicers, and borrowers were seriously disadvantaged by the lack of data on who owns and who services first and second liens on the same property. The industry has begun to address the problem under the 2MP program: participating servicers have agreed to provide Lender Processing Services (LPS), a mortgage loan data vendor, with information regarding all eligible second liens they service,[106] and LPS, in turn, is providing participating 2MP servicers with data on corresponding first-lien mortgages modified under the HAMP program.[107] Differences in the spelling of addresses (such as different abbreviations or spacing) have prevented complete and accurate matches between first and second liens. Similarly, it has often been difficult to follow changes in loan ownership and servicing because there are, for example, dozens of ways to attribute a loan to a particular bank or servicer.

Bank servicers are reporting, however, an improved ability to match first and second liens that has resulted in more second liens being modified under 2MP.[108] Moreover, title insurers are developing tools to match credit reporting information with public data in order to identify the owner of a second lien.

D. The HAMP/2MP program has provided incentives to modify second liens

The HAMP/2MP program also provides a set of incentives to encourage second lien holders/servicers to modify their liens. These incentives include a one-time compensation payment to the servicer of $500, along with $250 per year as a "pay for success fee" for up to three years as long as the loan continues to perform and the second lien payment is reduced by at least 6 percent. The owner of the lien receives an amount

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available at http://www.justice.gov/opa/pr/2012/February/12-ag-186.html. *See also, e.g.*, Consent Judgment at D1-1–D1-3, United States et al. v. Bank of Am. Corp., No. 12-cv-00361 (D.D.C. Apr. 4, 2012).

[106] Fannie Mae engaged,LPS to create a database tracking modifications to first liens under HAMP, providing notice of modifications to the holders of related second liens. *See* Government Accountability Office, *Troubled Asset Relief Program: Treasury Continues to Face Implementation Challenges and Data Weaknesses in Its Making Home Affordable Program*, GAO-11-288 at 13, *available at* http://www.gao.gov/assets/320/316715.pdf; Making Home Affordable Program, Handbook for Servicers of Non-GSE Mortgages 139 (Version 3.4 Dec. 15, 2011), *available at* https://www.hmpadmin.com/portal/programs/docs/hamp_servicer/mhahandbook_34.pdf.

[107] The Government Accountability Office has expressed concerns about the completeness and accuracy of the data being compiled. Foreclosure Mitigation Program, *supra* note 106~~108~~ at 13

[108] Credit bureaus are now able to match first liens with second liens, allowing holders of the second lien to better assess the likelihood of losses on the second lien based on the performance of the first lien. Equifax, for example is now able to match 2nd liens with 1st liens with an over 90 percent success rate by combining publicly available property records with their trade line information. Interview with Christopher Kennedy, [title], July XX, 2012.

equal to 1.6 percent of the balance due for up to five years, while the interest rate paid by the borrower is held to 1 or 2 percent, depending on whether the loan is amortizing. Borrowers also get a principal balance reduction of $250 per year for up to five years.[109] The program encourages second lien holders to extinguish part or all of their liens by reimbursing them for a portion of the write-off.[110]

E. HAFA has created a payment standard and incentives to extinguish second liens

The lack of accepted standards about how much a second lien holder should receive for cooperating with the borrower and first lien holder prolongs the time needed to negotiate each request to extinguish the lien when a short sale or DIL is contemplated. Individual negotiations are especially counterproductive because the same parties often find themselves on alternating sides of the negotiations depending on whether they are servicing or owning the first or second lien. HAFA, the Obama Administration's program to encourage short sales and deeds in lieu of foreclosure, sets a maximum of $8500 (recently increased from $6000 to conform to the amount allowed in the state attorneys general servicing settlement.)[111] HAFA also prohibits the first lien holder from requiring additional payments from the borrower for releasing the lien or for releasing the borrower from personal liability.[112]

F. The state attorneys general settlement with the servicers has created incentives to spur principal reduction

A primary goal of the state attorneys general settlement with the major servicers was to encourage more principal reductions on both liens. The settlement requires that when the first lien holder modifies the loan to reduce principal, the second lien holder must follow suit either by reducing the second lien to a CLTV of 115 percent, or by reducing the unpaid balance by 30 percent. Those reductions are in addition to the interest rate reductions and lengthening of maturity specified in the HAMP/2MP program. In the case of short sales and DIL, the servicer of an underwater second lien must extinguish the lien and waive the balance on the note. The settlement in return allows servicers to apply some of these costs to offset the payment totals they individually agreed to in the settlement. For reductions in principal, the credit ranges from 90 to 10 cents on the dollar, depending on the delinquency status of the second lien. Moreover, with short sales and DILs, the first lien holder receives full credit for the

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109 *See* Home Affordable Mortgage Program: Compensation Matrix, *available at* https://www.hmpadmin.com/portal/programs/docs/hamp_servicer/mhacompensationmatrix.pdf.

110 *Id*. If the second lien is partly or wholly extinguished permanently, the investor is compensated based on the CLTV, ranging from 21 cents on a dollar (for CLTV less than 115) down to 10 cents (for CLTV greater than 140 percent) (amounts doubled for modifications effective as of June 1, 2012). If the second lien is more than six months past due, the investor will be paid only $0.06 per dollar of the pre-modified UPB (amount doubled as of June 1, 2012).

111 Making Home Affordable, Supplemental Directive 12-02 at 18, *available at* https://www.hmpadmin.com/portal/programs/docs/hamp_servicer/sd1202.pdf

112 Making Home Affordable Program, Handbook for Servicers of Non-GSE Mortgages, *supra* note 106~~108~~, at 148.

payments to unrelated second lien holders, but is limited to payments to second lien holders of between $2000 and $8500.[113]

G. Estimation of expected losses appears to have improved

As discussed earlier, the large banks moved significant numbers of performing second liens into the non-performing category in the first quarter of 2012 in response to the January 2012 regulatory guidance issued jointly by the federal bank regulators.[114] That guidance emphasized the importance of properly accounting for future losses and required extensive segmentation of the portfolio to sort out higher risk segments such as second liens associated with delinquent first liens. The guidance also mandates loan loss reserves appropriate for each of the subgroups, and specifies factors to consider, including the type of second lien, the current combined loan to value of the two liens, characteristics of the borrower such as credit score ranges, year originated, type of first lien, performance on the first lien, and housing price movements in the geography.[115] In accordance with this guidance, the banks re-categorized many loans as non-performing. These changes did not result in a significant reduction in the banks' expected profits, apparently because the banks had already set aside loan loss reserves for these loans even though the borrowers were continuing to pay.[116]

H. Borrowers are more aware of options

It appears that borrowers, and certainly mortgage foreclosure counselors, are becoming more aware of the advantages and disadvantages of paying on one lien but not on the other. Perhaps as a result, Lee, Mayer and Tracy recently found that borrowers are more likely to be in default on their second liens than on their credit cards or auto loans one year after the first lien entered default.[117]

VI. Additional steps that could be taken to address the current situation

Our literature review and discussions with academic and industry experts identified a number of areas of continuing friction and suggested a number of steps that could be taken to further reduce the problems second liens pose. We focus first on those steps that could be taken immediately to address the current situation. Our proposals do not focus on additional incentives to encourage modifications, short sales or other assistance to distressed borrowers, but instead focus on the need to reduce a variety of transaction costs and information asymmetries that are getting in the way of those resolutions.

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[113] *See, e.g.*, Bank of America Consent Judgment, *supra* note 105~~107~~, at D-7.
[114] *See* FDIC, *supra* note 77~~80~~.
[115] *Id*.
[116] *See, e.g.*, Press Release, Wells Fargo, Wells Fargo Reports Record Quarterly Net Income 6 (Apr. 13, 2012) (available at https://www.wellsfargo.com/downloads/pdf/press/1q12pr.pdf).
[117] Lee, Mayer & Tracy, *supra* note 23~~26~~, at 7.

A. Further efforts to reduce the transaction costs of modifications, short sales and deed-in-lieu transfers of mortgages accompanied by second liens.

Under HAMP/2MP, first lien servicers need to identify who is servicing the second lien. The second lien holder also needs to know the status of the first lien in order to assess the likelihood of default. Deed records may not tell who currently owns the lien, let alone who is servicing it, so a comprehensive database with that information is essential. HAMP/2MP has already spurred the creation of a database to match first and second liens,[118] but more work needs to done to improve the accuracy and completeness of the data. Further pressure by regulators for banks to share updated information on their ownership and servicing of second liens might improve the coverage and reliability of the data.

B. Educate the industry that modifications do not necessarily require securing a re-subordination by the second lien holder.

As noted earlier, it does not appear that the types of modifications being done today (those that capitalize existing arrearages, lower the monthly payments by reducing the interest rate and extending the maturity, or reduce or defer principal) require that the second lien holder resubordinate in order for the modified loan to maintain lien priority. But some PSAs may require servicers to seek resubordination, and servicers trying to deal with ambiguous and conflicting sections of PSAs appear to be seeking resubordination as an extra measure of caution. Further research about the prevalence of resubordination requirements in PSAs, and further legal research about how judges are treating modifications, followed by a campaign to educate servicers about the rights of the first lien holders to modify without resubordination also would help address the concern.

C. Increase the acceptance of 2MP protocols for all modifications of first liens that lower the debt-to-income ratio to 31% or lower.

While the appropriate distribution among the lien holders of the burden of modifying first and second liens is controversial, the government has developed a standard for sharing the burden under HAMP and its associated 2MP program.[119] For

[118] Making Home Affordable Program, *supra* note 102~~104~~.
[119] As noted earlier, *supra* notes 102~~104~~ and 109~~110~~, key provisions of 2MP include offering servicers a one-time compensation of $500 for each second lien modification that becomes effective under 2MP plus an annual “pay for success” fee of $250 for up to three years as long as the second lien payment is reduced through 2MP by at least 6% and, all open-end second liens converted to closed-end. The borrower gets an annual “pay for performance” principal balance reduction payment of up to $250 for up to five years following the effective date of the second lien modification if the borrower’s monthly second lien payment is reduced through 2MP by at least 6%. The investors receive cost share compensation equal to 1.6% of the UPB annually for up to 5 years. If the second lien is partly or wholly extinguished permanently, the investor is compensated based on the CLTV, ranging from 21 cents on a dollar (for CLTV less than 115)

those modifications that occur outside HAMP, it would be advisable for the industry to adopt similar standards, at least for those modifications that reduce the debt to income ratio on the first lien to 31% or below.

D. Use the timetables and protocols of the state attorneys general settlement with the major servicers for all servicers.

The settlement between the state attorneys general and the major servicers established additional timetables and standardized protocols for writing down the principal of second lien when the first lien has been written down, and for lowering the interest rate and extending the maturity of both liens.[120] Second lien holders are also required to "send loan modification documents to the borrower no later than 45 days after the Servicer receives official notification of the successful completion of the related first lien loan modifications and the essential terms."[121] In the case of requests for a short sale or DIL, the settlement also imposes a fixed timetable for the second lien holder to make a decision and requires more transparency as to the criteria for evaluating the request. These rules are in addition to the incentives provided under HAFA.

While many servicers are not party to the settlement, they could voluntary adopt the same timetables and protocols in order to reduce the transactions costs second liens impose.

E. More generally, establish additional protocols/standard industry practices.

Standardizing the payment schedules and timetables will help servicers find their way through the thicket of often contradictory requirements in the wide variety of PSAs used by the industry. Similarly, trade groups or perhaps a task force of the American Bar Association could bring stakeholders together to propose basic default rules – essentially a schedule of modification requirements and payoff amounts for second mortgages, reflecting a limited number of key factors such as LTV ratios, debt to income ratios, and perhaps other indicia of borrower creditworthiness like FICO scores or employment status. The default modification terms would then serve as a focal point for discussions, and while parties could negotiate deviations from the terms, having a standard default rule could reduce the transaction costs of negotiations over modifications. As noted above, HAFA has set some parameters on payments to second lien holders, and the use of those amounts as benchmarks, even when HAFA doesn't apply, could again help to

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down to 10 cents (for CLTV greater than 140%) (amounts are doubled for modifications effective as of June 1, 2012). If the second lien is more than six months past due, the investor will be paid only $0.06 per dollar of the pre-modified UPB (amount doubled as of June 1, 2012).

[120] The servicer also gets credit for payments it makes to unrelated 2nd lien holder for release of the second lien. The 2nd lien holder gets credit for release of the lien with the amount of the credit dependent on the delinquency status of that lien, the more delinquent, the less the credit for a given amount of write-down. See Bank of America Consent Judgment, *supra* note 105~~107~~, at D1-2, D1-3.

[121] *Id*.

smooth negotiations for short sales and DIL.

F. Continue to take steps to ensure second liens are valued properly.

The efforts by regulators and accountants to make sure that the banks take into account expected losses on the second liens (and not just register losses as they occur) are important, both because financial markets depend on accurate information to value securities and also because inflated values of second may inhibit economically sensible modifications of both first and second loans. Fortunately, as described above, potential losses on second mortgages no longer appear to threaten bank solvency and concerns about solvency need not inhibit appropriate accounting treatment of second mortgage. Accordingly, holders of second mortgages should be encouraged to incorporate into their reserving policies all publicly available information about the financial capacity and collateral quality of underlying properties, including information about first mortgages on the same properties. Regulators and accountants should also continue to encourage the banks to gather more information about their loan portfolios on a segmented basis in order to identify more precisely the various factors that affect the probability of loss. One area of potentially helpful further investigation would be comparison of the NPV calculations that banks use to make modification decisions under HAMP and other modification programs with the accounting values used for second mortgages and other loans on bank balance sheets.

VII. Proposals to prevent this situation from arising in the future

There are considerably more options that the government or industry groups could employ to prevent the problems associated with second mortgages in the future.[122] Indeed, sensible responses to the problems of multiple mortgages may be a prerequisite to the restoration of a robust home lending market, because the difficulties of coordinating loan modifications over the past several years has cast a pall over future residential home financing.

Perhaps the most obvious response to coordination problems would be an outright ban on second mortgages, whether used for a down payment on the first mortgage or taken out subsequently. While such a ban would eliminate the problems

[122] Some have proposed to use eminent domain to purchase the second liens standing in the way of efficient modifications of the first liens. While such an approach would obviate the need to enlist the cooperation of second lien holders, the likelihood of extensive litigation over such a use of eminent domain power (to say nothing of the likely political controversy) probably means that, at best, federal use of eminent domain could only be considered as an option for avoiding similar difficulties with second liens in the future. Some local governments, however, are reportedly exploring eminent domain options to be implemented through public-private partnerships in the relatively near term. For discussion of using eminent domain for first liens, see Howell E. Jackson, *Building a Better Bailout*, Christian Science Monitor, Sept. 25, 2008; Lauren E. Willis, *Stabilize Home Mortgage Borrowers, and the Financial System* (working paper, No. 2008-28), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1273268.

second liens pose, it would also make it more difficult for homeowners to tap the equity in their home to smooth out their cash flow or to fund major expenditures such as a child's education. Moreover, any approach that depends on the ability of the first lien holder to prevent the borrower from entering into second liens unless those liens meet certain conditions (such as a commitment to modify if the first lien is modified) would presumably require legislation to modify the prohibitions in the Garn-St Germain Depository Institutions Regulation Act of 1982 that make "due on encumbrance" clauses unenforceable against the recording of a junior lien.[123] Because legislative action is so difficult in the current political climate, we focus primarily on steps that the industry itself can take to address the challenges second liens can pose when a borrower is in distress, as well as legislative steps that are less extreme than outright bans.

The following are options that the industry and regulators should explore to restrict the circumstances under which a second lien can be placed on a property or to explicitly restrict the ability of the second lien holder to interfere unreasonably in the efforts by the first lien holder to modify or refinance a first lien or to approve a short sale or accept a deed in lieu of foreclosure.

A. Require that, under certain circumstances, all second liens would be automatically stripped-down, allowing the first lien holder/servicer to act on its own to refinance a loan or permit a short sale or deed in lieu.

A strip-down could be tied to the loan to value (LTV) of the first lien, and to specific requirements for the modification by the first lien servicer, such as principal reduction.[124] Such a trigger would, presumably, require legislative action (although further research should explore whether there is any way first liens or intercreditor agreements could include such a trigger that would be consistent with the Garn-St Germain Act). The criteria might set the threshold at an LTV for the first lien of 100% or lower, for example. To prevent abuse based on inaccurate appraisals or for cases where the value is fluctuating and could be expected to recover within some reasonable period of time, it may be necessary to set the LTV test lower and/or require that the property value be below that limit for some period of time.

To soften the harm to the second lien holder, it may be possible to allow the second lien holder to share any appreciation in value above what is due to the first lien

[123] Robert Bruss, *Cases When Due-on-sale Clauses Don't Work*, Chi. Tribune, Oct. 6, 1991, at 2I.
[124] *See, e.g.*, Christopher Mayer, Edward Morrison & Tomasz Piskorski, *Analysis of Second Liens and a New Proposal* 5 (unpublished manuscript, 2012) (on file with authors) ("Federal (or state) law should require that every second mortgage include a provision that automatically eliminates the second lien, thereby converting the second mortgage into unsecured debt, upon the occurrence of two conditions: (i) the first mortgage lender (or servicer acting on behalf of investors) agrees to reduce the principal balance of the first lien and (ii) the appraised value of the home indicates that it is worth less than the first lien (i.e., LTV<100)."). While doing this retroactively may raise constitutional issues under the Fifth Amendment's Taking Clause, setting out the rules in advance may be both more palatable and less likely to spur litigation.

holder. This approach would not work for short sales, because purchasers would be unlikely to buy subject to some sharing of proceeds from a future sale, but may be possible when the property is refinanced or the deed is taken in lieu of foreclosure.

Stripping off the lien would allow the first lien holder to make decisions without needing the consent of the second lien holder and accordingly should allow for more efficient resolution for mortgage distress. This approach, however, would still leave the second lien holder free to pursue collection on the note (just as other unsecured loans such as credit cards and auto and student loans, could pursue repayment). The ability of the second lien holder to pursue recourse may make modification of the first lien unsustainable, however, so some additional requirement that the second lien holder lower the payments due by modifying the second lien may be necessary.

B. Prohibit simultaneous second mortgages and prohibit any subsequent second liens that have a CLTV that exceeds the initial loan's LTV.

A more extreme approach (though still short of an outright ban on second liens) would be to prohibit the most troublesome second liens, such as simultaneous seconds used to finance the downpayment, or second liens that cause the borrower to have a CLTV higher than some standard.[125] While this approach, which most likely would require legislation, might better protect the first lien holder and eliminate the difficulties of coordination with the second lien holder, it likely would also limit the ability of low wealth individuals to buy a home (although FHA, which only requires a 3.5% down payment for borrowers with FICO scores above 580, would remain an option for some borrowers). In any case, such a restriction on simultaneous seconds should not preclude the ability of the government to offer with so-called community seconds to make homeownership more affordable for lower income households.

C. Encourage intercreditor agreements.

Creditors can enter into agreements that specify clearly what the rights of the first and second lien holders will be in the event of borrower distress (or try to accomplish the equivalent through language in the first mortgage which clearly lays out the rights of the first lien holder). The agreements should precisely delineate when the first lien holder is able to proceed without the consent of the second lien holder and when the second lien holder must modify its loan.[126] Such an agreement can set out the terms for payment priority and specify when and how the second lien needs to be modified. The more

[125] *See, e.g.*, David A. Dana, *The Foreclosure Crisis and the Antifragmentation Principle in State Property Law*, 77 U. Chi. L. Rev. 97 (2010) which allows for a second lien but vests the servicing of the first and second lien in a single, economically disinterested, third party; Goodman, *supra* note 84~~87~~, at 5.

[126] *See, e.g.*, *Report of the Model First Lien / Second Lien Intercreditor Agreement Task Force,* 65 Bus. Law. 809, 836 (2010); Robert L. Cunningham, Jr., *ABA First Lien / Second Lien Intercreditor Issues Analysis*, Com. Lending Today, Jan. 28–29, 2010; Goodman, *supra* note 84~~87~~, at 5.

restrictive the requirements, the riskier the second lien holder's investment will be, and presumably, the higher the price borrowers will have to pay for second liens. The challenge in drafting such an intercreditor agreement, accordingly, will be striking the right balance between strengthening the interests (and lowering the risks) of the first lien lender/investor and allowing home owners to be able to tap into their home equity at reasonable cost and without having to go through the process of refinancing their home. While the terms of the intercreditor agreements should be the subject of experimentation within the industry, industry groups and regulatory authorities can monitor the experience to see which terms stand the test of time, and provide information to the industry about the outcomes of the various experiments. If efficient levels of agreement are not voluntarily undertaken by the industry, regulatory officials could impose some sort of supervisory penalty, perhaps higher capital requirements, for first or second mortgages that did not incorporate qualifying intercreditor agreements, or could adopt the terms that have best performed over time as default rules.

D. Preclude owners of second liens from servicing the corresponding first lien.

While the degree to which banks that own second liens fail to do what is best for the investors in the first liens is unclear, the appearance of conflict is real. To ensure that no conflict exists, the servicers could be precluded from both servicing the first lien and owning the second lien. Alternatively, as suggested by at least one participant at our Roundtable, second mortgages could be required to come from a lender associated with the servicer of the first mortgages so as to facilitate coordination in times of distress. Because it is unclear which of those approaches will be most efficient in the widest variety of circumstances, this again is an area in which industry groups and regulators should monitor experiments with different approaches. Once the industry has tried different approaches, regulators can then evaluate whether regulation or legislation is needed to require the industry to adopt a particular approach.

Conclusion

Second liens have created considerable frictions that have slowed or prevented efficient resolutions of distressed mortgages. Recently, however, regulators and the industry have begun to address many of the market failures that allowed those frictions to get in the way of efficient resolutions of borrowers' distress. The additional steps outlined above would further ensure that second liens do not impede efforts to keep distressed borrowers in their homes when a sustainable modification or other resolution would be best both for the borrower and for the investors. The difficult lessons of this housing crisis should spur additional discussion, however, about the appropriate balance between consumer needs for second liens and the dangers second liens pose.

Appendix A: Participants in Roundtable on Second Liens
NYU Furman Center for Real Estate and Urban Policy
Harvard Law School

Note: institutional affiliation is provided for identification purposes only; participants did not necessarily represent the views of their employer. Also, the views expressed in the text do not necessarily represent the views of any individual participating in the Roundtable, and do not necessarily represent a consensus of those present.

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