ESSAY: STICKY SECONDS—THE PROBLEMS SECOND LIENS POSE TO THE RESOLUTION OF DISTRESSED MORTGAGES

Vicki Been*, Howell Jackson** and Mark Willis***

Almost five years into the foreclosure crisis, policymakers, the mortgage industry, consumers and taxpayers still express enormous 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 how second liens might prevent efficient resolutions of borrower distress and to assess how second lien holders could be encouraged to cooperate to bring about efficient resolutions without undermining the financial interests of banks, we reviewed existing data, research and 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 difficulties 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 those liens, and the degree to which banks already have accounted for expected losses. It then reviews the various ways in which

* Boxer Family Professor of Law, New York University School of Law; Director, NYU Furman Center for Real Estate and Urban Policy. The authors would like to thank Ben Jackson, Harvard Law '13; Graham Lake, NYU Law '12; Armen Nercessian, NYU Law '12; and Gregory Springsted, NYU Law '14, for the excellent research assistance, and Dani Rosen, Sharon Carney, and Bethany O'Neill of the NYU Furman Center for Real Estate and Urban Policy for their help in organizing the roundtable from which much of this article is drawn. The Pew Charitable Trusts provided funding for the roundtable and to support this research, but the views expressed are those of the authors and do not necessarily reflect the views of The Pew Charitable Trusts. Professor Been also is grateful to the Filomen D'Agostino and Max Greenberg Research Fund for support of her research.
** James S. Reid, Jr. Professor of Law, Harvard Law School.
*** Resident Research Fellow, NYU Furman Center for Real Estate and Urban Policy.

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second liens have interfered with the efficient resolution of distressed mortgages and documents advances that have been made recently in addressing those issues. Finally, the article examines the most promising proposals for reducing the transaction costs and frictions that are behind many of the current problems that second liens pose as well as proposals to prevent similar problems from arising in the future. We focus our analysis of solutions on efforts designed 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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I. 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 properties often is cited as a significant impediment to efficient resolutions of borrowers’ distress (that is, resolutions that would have made all parties—the borrower and both lenders—better off) and therefore to the stabilization of the housing market. 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 20 percent of outstanding mortgages.1 They are disproportionately represented, however, in the most troubled mortgages. Of the 11.1 million borrowers who were estimated to be underwater at the end of 2011, 4.4 million (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 This is disconcerting not only because the families struggling with those mortgages are at risk, but also because outstanding second liens still account for more than 50 per-

1. See infra notes 11-13 and accompanying text.

2. Press Release, CoreLogic, Corelogic Reports Negative Equity Increase in Q4 2011 (Mar. 1, 2012), http://www.corelogic.com/about-us/researctrends/asset_upload_file886_14435.pdf. “Negative equity” refers to the shortfall between the amount the house would sell for and the amount the homeowner owes on the mortgage. If the ratio between the amount of the loan and the value of the house (referred to as “loan to value” or LTV) exceeds 100%, the borrower is in negative equity.
cent 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, or if banks refuse to modify in an attempt to prolong the flow of regular payments, the second liens may make defaults 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.

The federal government has tried to balance these concerns by implementing a variety of programs designed 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 help distressed borrowers retain their homes include refinancing at a lower rate or modifying the terms of the mortgage by lowering the rate, extending the period for amortizing the principal, reducing the principal due, or deferring payment of some of the principal due.\(^5\) Options that may assist borrowers who are underwater and need to sell their homes 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

3. See infra notes 70–76 and accompanying text.
6. Id. at 3, fig.1.
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 how second liens might prevent efficient resolutions of borrower distress and assess how second lien holders could be encouraged to cooperate with first lien holders in order to bring about efficient resolutions without undermining the financial interests of the banks, we reviewed existing data, research and 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 10, 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 research in advance of the meeting but used the roundtable to draw upon the on-the-ground experience and up-to-the-minute knowledge of those directly involved in the mortgage industry. The convening was lively, with all participants actively involved in the effort to clarify the 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


8. See infra App. A for a list of the participants.
represent the views of any particular participant in the round-
table.

II.
BACKGROUND

A. *How Prevalent Are Second Liens?*

Second liens accounted for outstanding indebtedness of $853 billion as of the fourth quarter of 2011, which is down from $1,132 billion in 2007.9 Second liens therefore made up about 8.4 percent of a total of some $10.2 trillion of home mortgage debt outstanding at the end of 2011.10 Direct mea-
ures of the percentage of homes that currently have both a first and second lien outstanding are not available, to our
knowledge. Robert Avery and his colleagues recently estimated that 13.2 million mortgages originated between 2004 and 2009 had a second mortgage.11 Given that there were almost 66 million home purchase and refinance loans originated over the same period, that estimate would suggest that some 20 per-
cent of them had second liens.12 That is likely an upper limit, because second liens as a share of new originations peaked in 2006,13 and second lien balances as a percent of outstanding home mortgages have fallen since 2009 from 9.5 percent to 8.4

reserve.gov/releases/z1/current/z1.pdf.

10. Id. (row 23 divided by row 1). Both total mortgage debt and second lien indebtedness declined in 2012, so that by the end of the third quarter 2012, second liens accounted for $790 billion of the $9.9 trillion of home
mortgage debt outstanding. Id.

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

12. See Robert B. Avery, Neil Bhutta, Kenneth P. Brevoort & Glenn B.
Canner, The Mortgage Market in 2011: Highlights from the Data Reported under
HMDA.pdf.

www.newyorkfed.org/research/staff_reports/sr569.pdf.
percent by the end of 2011.14 Other estimates suggest a simi-
lar or slightly higher percentage. Industry sources have re-
ported, for example, that second liens encumbered less than
18 percent of the loans held or guaranteed by Fannie Mae and
Freddie Mac ("agency mortgages").15 Laurie Goodman and
her colleagues estimated that more than 50 percent of the
mortgages in non-agency securities were accompanied by a
second lien.16 Because the dollar volume of non-agency mort-
gage-backed securities outstanding in 2011 amounted to less
than a fifth of that of agency mortgages,17 the weighted aver-
age of the 18 percent estimate for agency loans and the 50
percent estimate for non-agency mortgage backed securities
yields an average in the low 20's.18

B. Who Holds/Owls the Second Liens?

Second liens are rarely securitized and are mainly held in
the portfolios of banks and credit unions, typically the same
institutions that originated them. Of the $853 billion in sec-
ond liens outstanding as of the end of 2011, only 2 percent
were securitized, down from a still relatively minor 6.3 percent
of the total in 2007.19 Of the remainder of second liens out-
standing in the last quarter of 2011, $723.1 billion, or 85 per-
cent, were held in the portfolios of commercial and savings

14. Statistical Release, supra note 9, at 105 tbl.L218 (row 23 divided by
row 1).
15. Jon Prior, Less than One-in-Five GSE Loans Hold a Second Lien, Hous-
ingWire (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 convening did not think it was an unreasonable
estimate.
16. Laurie S. Goodman, Roger Ashworth, Brian Landy & Ke Yin, Second
17. Statistical Release, supra note 9, at 105 tbl.L218 (total home mort-
gages held by the GSEs—row 18—plus total agency and GSE-backed mort-
gage pools—row 19, divided by total held by ABS issuers—row 20).
18. Those estimates are cautious because they don’t take into account
the additional third of the outstanding loans that are held mainly by banks
and savings institutions and are more likely to resemble the higher quality
agency business than the non-agency liens.
19. Statistical Release, supra note 9, at 105 tbl.L218 (home equity mort-
gages held by ABS issuers—row 27—divided by total home equity mort-
gages—row 23).
banks (with the four largest banks holding about 48 percent of the total held by banks in the first quarter of 2012). Credit unions accounted for another 9.6 percent, and finance companies and foreign banks held the remaining 3.5 percent.

C. 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 among 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 their 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 both Fannie Mae and Freddie Mac require for a first mortgage when the amount of that mortgage exceeds 80 percent of the value of the property. When the second lien is used for the downpayment, it is called a piggyback loan. 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

20. Id. (home equity mortgages held by U.S chartered depository institutions—row 24—divided by total home equity mortgages—row 23).


22. STATISTICAL RELEASE, supra note 9, at 105 tbl.L.218 (rows 25, 26 and 28).


24. “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 down payment.
(CESs) generally are fixed-rate, self-amortizing loans. 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. HELOCs 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 loan converts to a fixed-rate, self-amortizing loan. HELOCs offer borrowers the flexibility to draw down the line as needed to smooth over periods of low or no income, or to cover special purchases.

Both HELOCs and CESs can be made either simultaneously with, or subsequent to, the purchase of a home. Regardless of the timing, both may be made either to finance the purchase of the house or for other purposes. Second liens taken out subsequent to the purchase of the home are presumably used for other purposes.

Originations of HELOCs have outnumbered those of CESs and their periods of popularity differ somewhat. Donghoon Lee, Christopher Mayer and Joseph 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. Originations of HELOCs reached a high of approximately $140 billion in the fourth quarter of 2005, just

25. CESs are a type of home equity loan ("HEL").
28. See Lee, Mayer & Tracy, supra note 13, at 5. Lee, Mayer & Tracey note that in August 2011, the CES's share of the total second lien balance fell to approximately 25 percent, with roughly $158 billion of CESs outstanding. See id. at 2 n.5.
29. See id. at 11, 29 fig.2, 31 fig.5.
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 home prices to take advantage of increases in the newly available equity imbedded in the home. New originations of HELOCs then fell 30 percent over the next two years. 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 home purchases. CESs are also associated with higher cumulative loan to value ratios ("CLTV") and lower downpayments, which again is consistent with CESs being used to finance home purchases. Once the housing bubble burst, the originations of both HELOCs and CES fell rapidly in 2008 and have since remained at only 15 to 20 percent of the rates during the boom years.

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 the home has insufficient value as collateral to cover the outstanding principal balance. When

31. Lee, Mayer & Tracy, supra note 13 at 11.
32. See id. at 11, 30 fig.4.
33. See id. at 7.
34. Id. at 11, 29 fig.2.
35. 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. Alex Ulam, Why Second-Lien Loans Remain a Worry, AM. BANKER (May 2, 2011, 3:16 PM), available at 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). Id. ("The recovery on such debts is generally minimal . . . "). In some states, however, recovery is not available if the proceeds of the loan were used to buy a house. See, e.g., Ariz. Rev. Stat. Ann. § 33-814(G) (2012) (exempting "property of two and one-half acres or less which is limited to and utilized for either a single one-family or a single two-family dwelling"). 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. Gopal & Gittelsohn, supra note 21. This article does
a borrower goes into default and the first lien holder enforces its lien, the second lien holder has no right to recovery from the proceeds of a sale of the property until the first lien holder's claim has been satisfied. 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 the first lien holder. In most states, if the debt to the second lien holder remains unpaid, the second lien holder may have recourse against the borrower on the note even if the house that serves as collateral has been liquidated.

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 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.

In general, the second lien holder will not gain priority over a first lien holder 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. Lowering the interest not address the issues raised by aggressive attempts to recover on the second lien.

36. Restatement (Third) of Prop.: Mortgages § 7.4 (1997) ("When the foreclosure sale price exceeds the amount of the mortgage obligation, the surplus is applied to liens and other interests terminated by the foreclosure in order of their priority . . . .") When a borrower is in default on the first and second liens, but the first lien holder takes no action to take possession "will be subject to all mortgages and other interests that are senior to the mortgage being foreclosed." Id.


38. See, e.g., Larry Cordell, Karen Dynan, Andreas Lehner, Nellie Liang & Eileen Mauskopf, The Incentives of Mortgage Servicers: Myths and Realities, 41 UCC L.J. 4, art. 2, at 8-9 (2009).

39. See, e.g., Shultis v. Woodstock Land Dev. Assocs., 188 A.D.2d 234 (N.Y. App. Div. 1993); see also Restatement (Third) of Prop.: Mortgages § 7.3 ("[T]he mortgage as modified retains priority . . . except to the extent that the modification is materially prejudicial to the holders of such interests and
rate, extending the maturity of the loan, and reducing the 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.

Nevertheless, many first lien holders have insisted that the second lien holder resubordinate its lien to remove any risk that 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. Furthermore, if the first lien


40. See Restatement (Third) of Prop.: Mortgages § 7.3.

41. Although the issues do 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 lien holder has no notice of the possibility of such a modification. See id. If the arrears are capitalized, but the senior lien holder 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 lien holder 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 lien holder. See 2 Michael T. Madison, Jeffry R. Dwyer & Steven W. Bender, Law of Real Estate Financing § 12:30 (2012) (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 lien holder's rights, the first lien would maintain priority except as to the amount of the prejudicial modification. See, e.g., Shultis, 188 A.D.2d at 237. Thus, at worst, only the capitalized arrears would be subordinate to the second lien.


43. Discussants at the convening speculated that some PSAs may be ambiguous on this point, and Agarwal, et al. assert that PSAs sometimes require
holder wants additional assurance, title companies offer lien priority insurance.\textsuperscript{44}

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,\textsuperscript{45} the safest course for a provider of refinancing to ensure priority is to have the second lien holder agree to resubordinate.\textsuperscript{46} The second lien holder also has the power to hold up short sales and deeds in lieu ("DIL") because prospective purchasers will be unable to get a mortgage given that the existing second lien would take priority over that later mortgage.\textsuperscript{47} 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).\textsuperscript{48}
Holders of first liens sometimes seem to operate under the mistaken impression that the second lien is subordinate not only in terms of the collateral but also in terms of payment. 49 That is not the case, however: 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. 50 While it might be possible in the future to specify such obligations in an intercreditor agreement, 51 the home mortgage industry apparently did not anticipate the problems that second liens could cause in the event of a major housing price decline, and the parties generally have no such provisions in place. 52

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49. As discussed below, this behavior may be the product of equitable considerations, rather than misperceptions of law. See Porter, supra note 48 ("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 lienholders 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 [is] junior to your own.").

50. "It is important to distinguish between payment priority and lien priority. In almost all scenarios, second lienholders have rights equal to a first lienholder 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] (statement of David Lowman, CEO, JPMorgan Chase Home Lending).

51. See infra Part VII.A (encouraging increased use of intercreditor agreements to prevent similar problems in the future).

III. How Are Second Liens Performing?

Borrowers with second liens are more likely to be underwater than those with only one mortgage.\(^5\) 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.\(^4\) However, an estimated 40 percent of borrowers with underwater mortgages have both a first and second lien,\(^5\) and those borrowers are further underwater\(^5\) and more likely to default than borrowers with just one mortgage.\(^7\)

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 during the same period.\(^8\) 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

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53. Lee, Mayer & Tracy, supra note 13, at 3, 15 ("[S]econd liens are much more likely to be underwater than first liens . . . . Borrowers with a second lien had an average CLTV during the boom of at least 95 percent.").

54. Fed. Reserve Bd. of Governors, supra note 4, 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 Dir., Fed. Hous. Fin. Agency, to Rep. Elijah E. Cummings, Ranking Member, H. Comm. on Oversight & 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 that portfolio is performing (less than 60 days past due). Lowman, supra note 50, at 56. Thirty percent of second lien mortgages have CLTVs over 125 percent, but 94 percent of that portfolio is performing. Id.

55. Press Release, Corelogic, supra note 2.

56. 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.


58. Lee, Mayer & Tracy, supra note 13, at 17, 37 fig.18.
first lien . . . or with a non-prime first mortgage.” Simultaneous second liens, whether HELOCs or CESs, performed worse than those originated subsequent to the purchase. This fact is consistent with the view that simultaneous second liens were most commonly used by borrowers who were otherwise unable to meet downpayment requirements. Goodman and her colleagues looked at 30 to 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 percent in all securitizations (versus 8.1 percent for first liens), and 5.5 percent in securitizations with FICO scores greater than 720 (versus 4 percent for first liens).

Robert Avery and his colleagues found that, from 2004 to 2009, 69 percent of the mortgages held by borrowers with both a first and second lien were never delinquent. 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 of 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 borrowers to remedy nonperformance. For example, Lee, Mayer and Tracy found that 40 per-

59. Id. at 7.
61. Goodman et al., supra note 16, at 28, ex.10. As discussed in more detail below, the fact that second liens in bank portfolios are performing better than first mortgages is potentially important. See infra text accompanying notes 66-69. The difference could reflect either the quality of seconds retained in bank portfolios or the manner in which banks are dealing with write-downs of seconds that remain on their balance sheets.
62. The Avery et al. study uses a unique database that combines information from a credit bureau and the Home Mortgage Disclosure Act. See Avery et al., supra note 12, at 1-2, 19.
63. Avery et al., supra note 11, at 10.
64. Id.
cent of borrowers seriously delinquent on first liens but performing on second liens became current on the first lien again.  

As these numbers show, borrowers do sometimes remain current on their second lien while being delinquent on the first. A study of delinquency status from 2004 to 2009 found that "about one third of borrowers who defaulted on their first lien mortgage kept their second lien mortgages current [and s]urprisingly, about 20 percent of borrowers in the process of foreclosure due to defaults on the first mortgage . . . kept their second lien mortgage current." Lee, Mayer and Tracy re-


66. 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. See Lee, Mayer & Tracy, supra note 13, at 18; Laurie Goodman, Roger Ashworth, Brian Landy & Lidan Yang, Strategic Default and 1st/2nd Lien Payment Priority, AMHERST MORTG. INSIGHT 6, 7 (Feb. 17, 2011); Ulam, supra note 35. 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.

67. Julapa Jagtiani & William W. Lang, Strategic Default on First and Second Lien Mortgages During the Financial Crisis 11 (Research Dept., Fed. Reserve Bank of Phila., Working Paper No. 11-3, 2010), available at http://ssrn.com/abstract=1724947. Other estimates of borrowers who are delinquent on their first lien but nevertheless stay current on their second liens range from 6 percent to as high as 64 percent. See Ulam, supra note 35 (citing an Amherst Securities Group study that found, for mortgages in non-agency securitizations, "59% of borrowers with a home equity line of credit turned delinquent when the first was in delinquency, compared with 78% of borrowers with closed-end seconds") (internal citation omitted). 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 "almost 64% of borrowers who are 30-59 days delinquent on a first lien serviced by Chase are current on their second lien." Lowman, supra note 50, at 57.
cently found, however, that when a first mortgage reaches the 90 to 120 days delinquent stage, only about 21 percent of CESs remain current four quarters after the first mortgage delinquency (31 percent for HELOCs). Avery and his colleagues found that in 12.9 percent of the cases, first liens and second liens performed differently, but with second liens performing better only 8 percent of the time and worse 5 percent of the time.

IV. 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 in the United States contain about 42 percent of the second liens, defaults on those loans could jeopardize the economy. In fact, at the end of 2007, the total value of the second liens held in the portfolios of those banks exceeded their tier one capital, and potential defaults therefore posed a threat to their solvency. Since then, however, the four banks have been able to increase their combined tier one capital by over 25 percent while reducing their exposure to second liens by almost 30 percent, thereby reducing the ra-

68. Lee, Mayer & Tracy, supra note 13, at 17 tbl.2.
69. Avery et al., supra note 11 at 10. Lee, Mayer & 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 13, at 17 tbl.2.
70. 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 CESs and $358 billion in HELOCs). Goodman et al., supra note 16, at 27, ex.9.
71. We computed the ratio of the value of the second liens in the banks' portfolios to the banks' tier one capital using data in the "call reports" the banks file quarterly with their regulatory agencies. That data is available at BankRegData.com (last visited December 26, 2012). To compute the ratio, we added together the "Home Equity Loans" and "1-4 Family Junior Liens" reported for Wells Fargo and Company, Bank of America Corporation, JPMorgan Chase & Co., and Citigroup (and for all banks), then divided those sums by the respective amounts of "Tier 1 Capital" reported for each (and for all banks). Since the Home Equity category can include first liens as well, the ratios provide an upper bound of the potential impact on a bank's solvency if the second liens were to be worthless.
ratio of second liens to tier one capital to just under 70 percent by the end of the third quarter of 2012. Some loans have presumably been 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. JPMorgan Chase, for example, has recognized losses of more than $16 billion since 2007.

Similarly, the ratio of second liens to tier one capital for the banking industry as a whole has fallen substantially over the same period of time from just under 90 percent to just over 50 percent. 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, Fitch Ratings 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.

The banks' exposure to second liens that are underwater has been of particular concern, both because underwater

72. Id.

73. See Lee, Mayer & Tracy, supra note 13, at 11, 29, figs.1-2.

74. Uniform Retail Credit Classification and Account Management Policy, 65 Fed. Reg. 36,903, 36,903-04 (June 12, 2000) ("For open- and closed-end loans secured by residential real estate, a current assessment of value should be made no later than 180 days past due. Any outstanding loan balance in excess of the value of the property, less cost to sell, should be classified Loss and charged off.")


76. See supra note 71. For all banks, total tier one capital has grown by over $272 billion—from $995 billion in the fourth quarter of 2008 to over $1.267 trillion in the third quarter of 2012. See Tier 1 Capital Ratio, BankReg Data.com (last visited Dec. 26, 2012) (compiling data from quarterly call reports filed by banks). For all banks, the total second lien indebtedness fell to $670 billion in the third quarter of 2012, down from $894 billion in the fourth quarter of 2008. See Loan Review – 1 to 4 Family Junior Liens and Loan Review – Home Equity Loans, BankRegData.com (last visiting Dec. 26, 2012). The ratio of second liens to tier one capital therefore was 90 percent in the fourth quarter of 2008 and 53 percent in the third quarter of 2012.

mortgages are more likely to default and because the shortfall in collateral value decreases the potential for any recovery if the loan should default. If, for example, the second lien is completely underwater, leaving no value in the collateral to satisfy 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 all of or part of the loan.

We were unable to find careful estimates of the potential losses second liens might entail for the banks holding those liens. To provide an estimate of the upper bound on possible losses, we began with the assumption that the loss severity on those second liens that are underwater and in default will be 100 percent. A recent Federal Reserve Board of Governors white paper reported that 12 million homeowners are underwater, and, of those, 8.6 million were current, 0.6 million were 30 days past due, 0.31 million were 60 to 89 days delinquent, 1 million were 90 or more days delinquent, and 1.4 million were in foreclosure. We assume that the banks have already written down most of the mortgages that were seriously delinquent


79. Chase, for example, also services a first lien mortgage for $40 billion-worth of its owned second lien mortgages: 92 percent of these first lien mortgages are performing and 28 percent of these first lien mortgages are by themselves underwater (loan-to-value ratio of over 100 percent). Lowman, supra note 50, at 56.

80. While we cannot ascertain how underwater these second liens are, we know that, on average, mortgages with second 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.

81. This estimate seems to be as of the third quarter of 2011 and, according to the study, may be a slight under-estimate. See U.S. Housing Market, supra note 4, at 21 n.39 ("The share of underwater borrowers would likely be a bit higher if we had complete coverage of these liens.").
or in foreclosure to their underlying collateral value because those loans should have triggered the regulatory requirement that calls for such a write-down once a real estate loan is delinquent 180 days or more. 82 That leaves 9.5 million underwater liens that the banks may not have written down. 83 If a quarter of the underwater mortgages that are now current were to default, as some in the industry have projected, 84 that would mean that an additional 2.4 million of the underwater mortgages would default. Using an estimate from the Federal Housing Finance Agency ("FHFA") that as many as half of the mortgages that are seriously delinquent and underwater have a second lien, we would then project that another 1.2 million mortgages with second liens would default. If we assume that 20 percent of the outstanding first mortgages have second liens and that there are approximately 52 million first liens outstanding, 85 then the universe of first mortgages with second liens totals 10.4 million. The 1.2 million of those we assume would be the most that would default therefore constitutes about 11.5 percent of the total. To put that number in perspective, recall that all second liens constituted less than 70 percent of the major banks’ tier one capital at the end of the third quarter of 2012, so 11.5 percent puts at risk a relatively small fraction of the banks’ tier one capital. 86

This is, at best, a rough estimate of a possible upper bound for future losses on underwater mortgages with second liens. Additional losses from second liens that are not under-

82. Uniform Retail Credit Classification and Account Management Policy, 65 Fed. Reg. 36,903, 36,904 (June 12, 2000).

83. The 9.5 million includes the 8.6 million that are current plus the 0.91 million that are 30 to 89 days past due. See U.S. HOUSING MARKET, supra note 4, at 21 and n.39.


85. The Census Bureau reports that there were 52 million owner-occupied units encumbered by a mortgage in 2007. U.S. CENSUS BUREAU, AMERICAN COMMUNITY SURVEY: MORTGAGE STATUS: 1 YEAR ESTIMATES (2007). That number may be smaller today given the number of real estate owned properties resulting from the foreclosure crisis, and given the drop in the homeownership rate since the crisis.

86. Of course, if losses on second liens correlate with other risks to which the banks are exposed, the added losses from second liens could be critical to bank solvency, particularly for banks with a relatively high exposure to second mortgages. See supra notes 70-76 and accompanying text.
water should not be very significant given that the borrower still has equity in the home and therefore will likely work hard to keep the home or be able to sell it for enough to cover the mortgages.\textsuperscript{87} Our estimate is consistent with Fitch Ratings’ conclusion that future losses on second liens may have an impact on annual earnings over the next three years but that their impact on capital should be manageable for most banks.\textsuperscript{88}

B. \textit{Have Banks Appropriately Accounted for Likely Losses on Second Liens?}

Banks account for likely losses on second liens by setting aside an allowance for such losses and by writing the value of the liens down to the value of the underlying collateral for loans delinquent for 180 days or more.\textsuperscript{89} Some commenters question whether the banks, even assuming that they are in compliance with those regulatory standards, are accounting sufficiently 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.\textsuperscript{90} As

\textsuperscript{87} For example, Bank of America reports, “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 performing. Indeed, out of 2.2 million second liens Bank of America is holding in its 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).

\textsuperscript{88} Fitch Ratings, \textit{supra} note 77, at 7-8.

\textsuperscript{89} Uniform Retail Credit Classification and Account Management Policy, 65 Fed. Reg. 36,903, 36,904 (June 12, 2000).

\textsuperscript{90} Yves Smith, \textit{Clearing Up Some Misperceptions on the Mortgage Modification/Second Lien Debate}, \textit{Naked Capitalism} (Mar. 21, 2011, 5:30 AM), http://www.nakedcapitalism.com/2011/05/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 Mike Konczal, \textit{Those Pesky Second Lien, and an
noted earlier, Goodman and her colleagues looked at 30 to 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 percent in all securitizations,91 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 providing sufficiently for future losses, we need to assess how adequate the allowances for loan losses are for those loans that haven’t been written down.

Recently, regulators stepped up pressure on the banks to make sure their loan loss allowances reflected the risk in their portfolios.92 As a result, the four largest banks all reported a significant increase in their non-performing second lien loans in the first quarter of 2012.93 The impact on the bottom line of these banks appears to have been limited, however, as the banks indicated that they already had set aside sufficient reserves against these loans.94 Banks do not necessarily have to disclose the allowances they set aside for loan losses specific

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92. See FDIC, FIL-4-2012, ALLOWANCE FOR LOAN AND LEASE LOSSES; ESTIMATION PRACTICES FOR JUNIOR LIENS ON RESIDENTIAL PROPERTIES (2012).
94. See Ulam, supra note 35.
to their portfolios of second liens, and most banks group together the allowances for a number of consumer loans. 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 involved in its purchase of Countrywide.

Even if banks are reserving only 7 percent, that may be sufficient, contrary to the arguments of many commenters that the banks are significantly under-accounting for prospective losses. While the 7 percent is less than the 11.5 percent upper bound for losses from second liens estimated in the previous section, that estimate is an upper bound, and 7 percent may well be adequate to cover expected losses over the next few years unless house prices resume their decline.

V. ARE SECOND LIENS GETTING IN THE WAY OF EFFICIENT RESOLUTIONS FOR DISTRESSED MORTGAGES?

Studies have shown that mortgages with second liens are less likely to be modified and are more likely than first liens alone to result in foreclosure (or to be seriously delinquent but with no foreclosure action yet taken by the lender). 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

95. 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. See Lee, Mayer & Tracy, supra note 13, at 7, 17, 28 tbl.2, 37 fig.18. Credit card and auto loans are more likely than second liens to remain current one year after default on the first lien. See id.


98. Indeed, loans with second liens are the least likely to be modified. See, e.g., Agarwal et al., supra note 42, at 16; Been et al., supra note 57 at 21.

explores how second liens can make it more difficult for borrowers to refinance, modify their first liens, or get permission for a short sale or deed in lieu of foreclosure. Of course, a refinance, modification, or a short sale/DIL would not necessarily have a higher value than foreclosure for every distressed borrower with a second lien, so any added difficulty second liens may cause is not necessarily inefficient.

A. Increased Transaction Costs

Second liens increase the transaction costs of resolving a delinquency or imminent default because they require consent from an additional party for a refinancing, short sale, or DIL (and because servicers and others erroneously may believe that consent always is required for a modification). The problem has been compounded by the slow rate at which servicers increased their staffs to meet the growing number of delinquencies resulting from the subprime crisis and the recession.\textsuperscript{100} It also likely was compounded by the compensation system for servicers: the annual fee servicers receive is based on a fixed percentage of the unpaid principal balance, regardless of the amount of work done by the servicer, and that makes mortgages that require more work by the servicer particularly difficult to resolve by means other than foreclosure.\textsuperscript{101}

B. Ambiguity About Servicers’ Authority and Liability

Ambiguity about how much authority servicers have to negotiate with (or ignore) second lien holders may have prevented efficient resolutions of distressed mortgages. Vague 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 jeopard-

\textsuperscript{100} See, e.g., Paul Kiel, Banks’ Disorganization Pushed 800,000 Homeowners into Unnecessary Foreclosure, HUFFINGTON POST (Sept. 11, 2012, 2:42 PM), http://www.huffingtonpost.com/2012/09/11/banks-unnecessary-foreclosure_n_1874737.html (discussing the impact of inadequate staffing levels at servicers on foreclosure rates).

izing 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, increasing the costs of resolving distressed mortgages.

C. Externalities

The second lien holder may be more likely to underinvest in or block cooperative approaches to a modification or other efficient resolution of a distressed mortgage. Some of the costs of doing so—such as the consequences of 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. On the other hand, the benefits of modifying a delinquent mortgage accrue to the borrower, neighbors, and the economy as a whole, not necessarily to 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 likely affects 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.


104. Resubordination is required only if the action taken by the servicer results in a loss of lien priority. See supra text accompanying notes 38-44. As discussed earlier, 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 Randolph, supra note 39, at 189 ("Generally speaking, alterations in the payment schedule of the senior lien, even dramatic changes in the term and payment amounts, have not been viewed as prejudicial to the junior lienholder.").
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. The holder of the second mortgage, however, 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, neighbors and others who suffer from the resulting foreclosure. Consequently, the second lien holder has less incentive to cooperate.

If the second lien holder refuses to modify the second lien, the first lien holder may not modify the first lien. Further, even if the first lien is modified, the second lien holder’s refusal to modify the second lien may leave the borrower unable to carry both mortgages 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. Even if property values have fallen, there is still 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 may hope the government will introduce programs that will require other parties (such as taxpayers) to bear some of the costs of any workout. That expectation may lead to moral hazard: a second lien holder will be more likely to take the risk that its delay in working with the


106. See Kwak, supra note 90.
first lien holder to reduce the borrower’s distress will render the second lien worthless if it believes that delay may allow it to take advantage of subsidies that might become available.\textsuperscript{107} Just as a second lien holder will take into account in considering the risk of delay the possibility that housing prices will rebound, it will take into account the possibility that the government may bear part of its losses by subsidizing modifications or other workouts in the future.

Further, some commenters have complained that the programs the government has introduced to encourage modifications have removed or decreased the threat of foreclosure that was the only leverage that first lien holders had over second lien holders. By imposing obligations upon first lien holders to modify first liens that meet certain criteria, for example, those programs have reduced the risk to the second lien holder that its refusal to cooperate will result in foreclosure that will extinguish the second lien.

F. Strategic Bargaining

The second lien holder may derail an efficient resolution by engaging in strategic behavior. As Professor Christopher Mayer and his colleagues have argued, “by 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.”\textsuperscript{108} The second lien holder’s demands can make the first lien holder less likely to modify or refinance its loan or to approve a short sale or DIL, because the demands make the workout too costly for the first lien holder. If the second lien holder’s refusal to cooperate causes 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 trig-

\textsuperscript{107} See \textit{id}. (“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 could rise enough to make the second liens worth something; and (3) the possibility that the government will start paying off second lienholders to stop blocking short sales.”); Cordell et al., \textit{supra} note 103, at 13.

\textsuperscript{108} Christopher Mayer, Edward Morrison & Tomasz Piskorski, \textit{A New Proposal for Loan Modifications}, 26 \textit{Yale J. on Reg.} 417, 419 (2009).
gerng a foreclosure. But if the second lien holder doesn’t get that strategy just right, its tactics likely will lead to fewer efficient resolutions of distressed mortgages.

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. As Professor Adam 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.”109 Under the typical servicer compensation scheme,110 the servicer of the first lien may prefer to foreclose upon a delinquent mortgage rather than modify the mortgage, because foreclosure allows the servicer to minimize its out of pocket costs and to recover quickly any advances that it has to make to the cover the shortfall to investors when a borrower is delinquent.111 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.

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 held by the servicer of the first lien.112 In such cases, the servicer may have a disincentive to foreclose on the first lien because of the ef-


110. See McCoy, supra note 102, at 15-16 (describing typical structure for servicer compensation).

111. See id. at 18 (noting that the costs of loss mitigation and the fixed-fee compensation structure for servicers makes foreclosure generally more attractive than loan modification).

112. Agarwal et al., supra note 42, at 2. But see Lowman, supra note 50, 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.”).
fect foreclosure would have on the value of the second lien.\textsuperscript{113} A recent paper by Sumit Agarwal and his colleagues finds that first liens serviced by the same financial institution that owns the second lien are less likely to be liquidated or modified, and more likely to have no action taken, than other first liens.\textsuperscript{114} Their findings suggest that financial institutions may 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.\textsuperscript{115} On the other hand, affiliated servicers may be biased in favor of modifications to the associated first lien because such modifications would benefit second liens on the balance sheet of the affiliate by increasing the borrower's debt capacity.\textsuperscript{116}

H. \textit{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.\textsuperscript{117} 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

\begin{itemize}
\item \textsuperscript{113} See Ulam, \textit{supra} note 35.
\item \textsuperscript{114} Agarwal et al., \textit{supra} note 42, at 16.
\item \textsuperscript{115} 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. \textit{Id.} at 3. But as noted previously, the second lien holder has a lower priority on the collateral, but not on payment. See \textit{supra} text accompanying notes 35-52.
\item \textsuperscript{116} 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. See also Agarwal, et al., \textit{supra} note 42, at 24 (finding that servicers who service both the first and the second lien are more likely to delay any action on delinquent first-lien mortgages, lowering the likelihood of foreclosures; such servicing arrangements increase the likelihood of modifications for GSE-backed loans, but lower it somewhat for private label securitized loans).
\item \textsuperscript{117} See, e.g., Annie Lowrey, \textit{New Stance on Forgiving Mortgages}, \textit{N.Y. Times}, Apr. 10, 2012, at B1 (noting concerns of Federal Housing Finance Agency Acting Director Edward DeMarco that liberalization of GSE loan modification policies could inappropriately benefit banks as second lien holders).
\end{itemize}
card lenders, also are asked to do so.118 The friction may be caused in part by the erroneous belief among first lien holders that second lien holders are junior not only in their claim to the collateral, but also when it comes to payment.119 A second lien, particularly when it is totally underwater, is more like other unsecured debt than it is like a 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.

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 are likely to resist actions that might prompt a decrease in their bottom line profits or require disclosure of an increase in expected losses. 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.120 Furthermore, while the rules require a bank to charge off the portion of a closed-end or

118. 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/ ("[F]irst-lien mortgage holders are going to hate to give the second-lien holders anything at all . . . ."). Borrowers sometimes remain current on second mortgages while defaulting on the first, and that further complicates negotiations between first and second lien holders. See Agarwal et al., supra note 42, at 14.

119. See supra text accompanying notes 49-50.

open-end lien that is above the underlying collateral value if
the note is 180 or more days delinquent,\textsuperscript{121} the regulatory gui-
dance at the beginning of the crisis may have been vague
enough, and the loss experience sufficiently limited, to enable
the banks to overestimate the underlying collateral value in
the home. Financial institutions had wide discretion regard-
ing when and how to assess the potential losses on their sec-
ond liens, especially those that were continuing to perform.\textsuperscript{122}
Moreover, restructuring second liens with below-market terms
triggers additional disclosures and further examinations,
which may have led banks to avoid troubled debt restruc-
turings, especially when the borrower was still current 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 mort-
gages 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 ac-
counting rules, which are dependent on an incurred loss
model of valuation for loans, are sufficiently attentive to down-
ward adjustments for expected losses on loan portfolios.\textsuperscript{123}
Several participants with regulatory experience noted that reg-
ulated financial institutions were sometimes reluctant to ac-
knowledge problems with their portfolios and that reserving
decisions for mortgages were often the subject of supervisory
discussions. There was no consensus on the adequacy of the

\textsuperscript{121} Uniform Retail Credit Classification and Account Management
\textsuperscript{122} See Ulam, supra note 35.
\textsuperscript{123} See, e.g., Mary E. Barth & Wayne R. Landsman, How Did Financial Re-
porting 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 markets of timely infor-
mation 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 restruc-
turing.
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 reviewed more strenuously today than in the recent past.\textsuperscript{124}

\textbf{VI. THE PRESENT SITUATION}

Of the problems or potential problems just discussed, the most serious at this time is 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 than would be the case if the borrower had only one lien. Most of the experts who participated in our roundtable discussion agreed that our understanding of the impediments posed by many of the issues identified above, as well as government and industry attempts to address those impediments, 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 practices that 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 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 continue to make improvements to their systems and policies that appear to be mitigating some of the problems posed by second liens. This is not to say that we believe there are no problems—second liens continue to be associated with lower rates of short sales, for example.\textsuperscript{125} Rather, our claim is that many efforts are underway to resolve the difficulties second liens pose, and that those efforts seem to be paying off.

\textsuperscript{124} 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.

\textsuperscript{125} \textit{See}, \textit{e.g.}, Gopal & Gittelsohn, \textit{supra} note 21.
The following sections briefly describe some of the improvements.

A. **Servicers Have 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 too leanly staffed to meet the challenge, the staff was not well trained for the task, and systems were not in place to deal with the vast quantities of paperwork required.\textsuperscript{126} 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 6,800 people servicing delinquent loans or dealing with foreclosures to 23,000 in 2011\textsuperscript{127} and Bank of America took on an additional 10,000 people to service distressed borrowers.\textsuperscript{128} Whether 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 government programs aimed at encouraging modifications and other resolutions, the banks report that they have improved their procedures in order to shorten turnaround times for approving resubordination in the case of refinances. The Second Lien Modification Program ("2MP") of the Home Affordable Modifications Program ("HAMP")\textsuperscript{129} and the Home Affordable Foreclosure Alterna-
tives ("HAFA") program 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. 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.

C. The Government's HAMP/2MP Program Has Created a Database to Link First and Second Liens

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 of second liens when the associated first lien is modified under HAMP. See generally Second Lien Modification Program (2MP): Overview, Making Home Affordable, https://www.hmpadmin.com/portal/programs/second_lien.jsp (last visited Nov. 19, 2012). 2MP prescribes for participating servicers the form that that modification needs to take. Id. 2MP also provides subsidies to servicers, borrowers, and investors to offset some of the costs of making the modifications. Id.

HAFA is designed to help borrowers transition to more affordable housing. See generally Home Affordable Foreclosure Alternatives Program: Overview, Making Home Affordable, https://www.hmpadmin.com/portal/programs/foreclosure_alternatives.jsp (last visited Nov. 19, 2012). 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. Id.

While our analysis highlights those features of HAMP, 2MP, and HAFA that should reduce the frictions caused by second liens, it is beyond the scope of this paper to assess the overall effectiveness of these programs.


has begun to address this 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.\footnote{134} In turn, LPS is providing participating 2MP servicers with data on corresponding first-lien mortgages modified under the HAMP program.\footnote{135} Simple discrepancies, such as the spelling of addresses and the use of different abbreviations or spacing, however, 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 dozens of ways to attribute a loan to a particular bank or servicer. Nonetheless, bank servicers are reporting an improved ability to match first and second liens, which has resulted in more second liens being modified under 2MP.\footnote{136} Additionally, title insurers are developing tools to match credit-reporting information with public data in order to identify the owners of second liens.

D. The HAMP/2MP Program Has Provided Incentives to Modify Second Liens

The HAMP/2MP program also provides incentives to encourage second lien holders and their servicers to modify liens. These incentives include a one-time compensation pay-

\footnote{134. 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. \textit{Id.} at 13; \textit{TREASURY DEP'T, MAKING HOME AFFORDABLE PROGRAM, HANDBOOK FOR SERVICERS OF NON-GSE MORTGAGES} 139 (2011), \textit{available at} https://www.hmpadmin.com/portal/programs/docs/hamp_servicer/mhahandbook_34.pdf [hereinafter \textit{NON-GSE MORTGAGE SERVICER HANDBOOK}].}

\footnote{135. The Government Accountability Office has expressed concerns about the completeness and accuracy of the data being compiled. \textit{Home Affordable Foreclosure Alternatives Program, supra note 130, at 13.}

\footnote{136. 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. Telephone Interview with Christopher Kennedy, Director, Capital Markets Division, Equifax (July 18, 2012). Researchers have successfully matched first and second liens using the OCC's Mortgage Metrics, Home Equity and Crosswalk databases. Agarwal et al., \textit{supra} note 42, at 11-12.}
ment to the servicer of $500, along with $250 per year for up to three years as a "pay for success fee" if 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 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. The program encourages second lien holders to extinguish part or all of their liens by reimbursing them for a portion of the write-off.

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 a lien when a short sale or DIL is contemplated. Individual negotiations are especially counter-productive because the same parties often find themselves on alternating sides of the negotiations depending on whether they are servicing or holding the first or second lien. HAFA, the Obama Administration’s program to encourage short sales and DIL, sets a maximum of $8500 (recently increased from $6000 to conform to the amount allowed in the state attorneys general servicing settlement). HAFA also prohibits the first lien holder from requiring additional payments from the bor-

138. Id.
139. Id.
140. 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). Id. at 4-5. 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). Id. at 4.
rower for releasing the lien or for releasing the borrower from personal liability.\textsuperscript{142}

F. The State Attorneys General Settlement with the Servicers Has Created Incentives to Spur Principal Reduction

In February 2012, 49 states' attorneys general and the U.S. Department of Justice reached a $25 billion agreement with Bank of America Corporation, JPMorgan Chase & Co., Wells Fargo & Company, Citigroup Inc. and Ally Financial Inc., the five largest mortgage servicers.\textsuperscript{143} A primary goal of the state attorneys general settlement with the major servicers was to encourage more principal reductions on both first and second liens. The settlement requires that when a 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 (whichever yields lesser of a write down). 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 10 to 90 cents on the dollar, depending on the delinquency status of the second lien.\textsuperscript{144} Moreover, with short sales and DILs, the first lien holder receives full credit for the payments to unrelated second lien holders, but for payments to related second lien holders is limited to credits of $2000 to $8500, depending on the size of the unpaid principal balance.\textsuperscript{145}

G. Estimation of Expected Losses Appears to Have Improved

The four largest 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

\textsuperscript{142} Non-GSE Mortgage Servicer Handbook, supra note 134, at 148.
\textsuperscript{143} See Press Release, Dep't of Justice, supra note 132.
\textsuperscript{144} See, e.g., Consent Judgment, supra note 132, at Ex. D-7.
\textsuperscript{145} See, e.g., id.
guidance issued by federal bank regulators. That guidance emphasized the importance of properly accounting for future losses and required extensive segmentation of the banks’ portfolios to identify higher risk segments such as second liens associated with delinquent first liens. The guidance also mandates loan loss reserves appropriate for each of the segments 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 relevant market. In accordance with this guidance, the banks recategorized many loans as non-performing. These changes did not result in a significant reduction in the banks’ bottom line, however, apparently because the banks had already set aside loan loss reserves for these loans even though the borrowers were continuing to pay.

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


147. See FDIC, supra note 92, at 3-4.

148. Id.


second liens than on their credit cards or auto loans one year after the first lien entered default.\textsuperscript{151}

VII. 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 contemplate additional incentives to encourage modifications, short sales or other assistance to distressed borrowers, but instead hone in on the need to reduce a variety of transaction costs and information asymmetries that are getting in the way of those resolutions.

A. Further Efforts to Reduce the Transaction Costs of Modifications, Short Sales and DIL 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 the debt. A comprehensive database with that information is therefore essential. HAMP/2MP already has spurred the creation of a database to match first and second liens,\textsuperscript{152} but more work needs to be done to improve the accuracy and completeness of the data. Further pressure by regulators on 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 Resubordination by the Second Lien Holder.

It does not appear that the types of modifications being done today (those that capitalize existing arrearages, lower the

\textsuperscript{151} Lee, Mayer & Tracy, supra note 13, at 7.

\textsuperscript{152} NON-GSE MORTGAGE SERVICER HANDBOOK, supra note 134, at 161-63.
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. 153 However, 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 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 Percent 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. 154 For those modifications that occur outside HAMP, the industry could benefit by coming together to adopt similar stan-

153. See supra text accompanying notes 36-50.
154. As noted earlier, 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 are converted to closed-end. MHA Compensation Matrix supra 137, at 4, 6; Making Home Affordable Program, Supp. Directive 09-05, Update to the Second Lien Modification Program (2MP) at 8 (Mar. 26, 2010), https://www.hmpadmin.com/portal/programs/docs/second_lien/sd0905r.pdf. 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%. MHA Compensation Matrix supra 137, at 6. The investors receive cost share compensation equal to 1.6% of the UPB annually for up to 5 years. 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%) (amounts are doubled for modifications effective as of June 1, 2012). Id. at 4-5. 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). Id. at 5.
dards, at least for those modifications that reduce the debt to income ratio on the first lien to 31 percent 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. Second lien holders are 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." 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 parties to the settlement, they could voluntarily adopt the same timetables and protocols in order to reduce the transactions costs second liens impose.

E. **Establish Additional Protocols and Standards for Industry Practices**

Standardizing 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

155. The servicer also gets credit for payments it makes to unrelated second lien holder for release of the second lien. See Consent Judgment, supra note 132, at D1-2, D1-3. The second 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 id.

156. Id. at A-26.

157. See id. at A-30.
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. HAFA has set some parameters on payments to second lien holders,\textsuperscript{158} and the use of those amounts as benchmarks, even when HAFA doesn’t apply, could again help to smooth negotiations for short sales and DIL.

F. Continue Taking 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 liens may inhibit economically sensible modifications of both first and second loans. Fortunately, as described above,\textsuperscript{159} potential losses on second mortgages no longer appear to threaten bank solvency (at least as long as house values do not decline further), and concerns about systemic risks need not inhibit appropriate accounting treatment of second mortgages. Still, capital is costly, and banks may resist write-downs in order to preserve capital balances. 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

\textsuperscript{158} See supra text accompanying notes 141-143.  
\textsuperscript{159} See supra text accompanying notes 70-88.
valuations used for second mortgages and other loans on bank balance sheets.

VIII.

PROPOSALS TO PREVENT THIS SITUATION FROM ARISING IN THE FUTURE

There are many more options that the government or industry groups could employ to prevent the problems associated with second mortgages from arising in the future. Indeed, sensible responses to the problems of multiple mortgages may be a prerequisite to the restoration of a robust home lending market, because the difficulty 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 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 change the prohibitions in the Garn-St Germain Depository Institutions Regulation Act of 1982162 that make “due on encumbrance” clauses unenforceable against the recording of a junior lien.163 Because legislative action is difficult in the current political climate, we initially focus on steps that can be taken without legislative intervention, and then to turn 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 DIL.

A. **Encourage Intercreditor Agreements.**

Without any legislative changes, creditors could 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). These agreements could 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.164 Such an agreement could set out the terms

for payment priority and specify when and how the second lien needs to be modified. The more 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 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. Alternatively, regulators could adopt the terms that have best performed over time as default rules, which would control absent an agreement to the contrary.

B. Experiment with Restrictions on Affiliations Between First and Second Lien Holders

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, borrowers could be required to take out second mortgages only from a lender associated with the servicer of the first mortgage 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.

C. **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 LTV of the first lien and to specific requirements for the modification by the first lien servicer such as principal reduction.\(^\text{165}\) Such a trigger would presumably require legislative action, although further research should explore whether there is any way that first liens or intercreditor agreements could include a trigger that would be consistent with the Garn-St Germain Act.\(^\text{166}\) The criteria might set the threshold at an LTV for the first lien of 100 percent or higher, for example. To prevent abuse based on inaccurate appraisals or in 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 higher and/or require that the property value be below the outstanding loan balance 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 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 possi-
ble when the property is refinanced or the deed is taken in lieu of foreclosure.

Stripping down the second 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 resolutions 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.

D. 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 down payment, or second liens that cause the borrower to have a CLTV higher than some to-be-established standard. 167 While this approach, which would most likely 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 percent down payment for borrowers with FICO scores above 580, 168 would remain an option for some borrowers).

167. See, e.g., David A. Dana, The Foreclosure Crisis and the Antifragmentation Principle in State Property Law, 77 U. Chi. L. Rev. 97 (2010) (arguing for a modification process in which an economically disinterested third party is vested with the servicing of both the first and second liens); Hearing, supra note 105, at 5.


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IX. CONCLUSION

Second liens have created considerable frictions that have slowed or prevented efficient resolutions of distressed mortgages. Recently, however, regulators and the industry itself have begun addressing 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 consumers' needs for second liens and the dangers second liens pose.

APPENDIX A: PARTICIPANTS IN ROUND TABLE 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.

Rebecca Alderfer
The Pew Center on the States

William Apgar
Harvard University Joint Center for Housing Studies

Roger Ashworth
Amherst Securities Group

Vicki Been
New York University Furman Center for Real Estate and Urban Policy
New York University School of Law

Ryan Bubb
New York University School of Law

Matthew Cooleen
Deloitte & Touche LLP

Larry Cordell
Federal Reserve Bank of Philadelphia

Ryan Crowley
JPMorgan Chase Mortgage Banking

Ingrid Gould Ellen
New York University Furman Center for Real Estate and Urban Policy
New York University Wagner School

Suzy Gardner
FDIC

David Gibbons
Promontory Financial Group

Mitch Hochberg
Consumer Financial Protection Bureau
Federal Reserve Board
Marietta Rodriguez
NeighborWorks America
Joseph Tracy
Federal Reserve Bank of New York
William Treacy
Federal Reserve Board
John Valdivielso
Freddie Mac
Susan Wachter
The Wharton School, University of Pennsylvania
Max Weselcouch
NYU Furman Center for Real Estate and Urban Policy
Mark Willis
NYU Furman Center for Real Estate and Urban Policy
Mark Winer
Fannie Mac
Daniel Wu
Citigroup Mortgage
Peter Zorn
Freddie Mac