The State Law Impacts Project - Part I

Posted on **May 21, 2010** by Peter K. McKee, Jr.

Over the next few blog posts, *The Line* will roll out a study evaluating differences in state laws related to enforcing commercial mortgage remedies. We call this our State Law Impacts Project (or "SLIP").

An Overview

As part of this exercise, we'll include links to our research, which include:

- a narrative state-by-state summary of laws relating to foreclosure
- a comparison (in spreadsheet format) of state law elements related to judicial and non-judicial foreclosure requirements, notice requirements, deficiency claims, borrower post-default cure rights, borrower post-foreclosure redsemption rights, and applicable transfer/conveyance taxes
- charts showing the differences between state law approaches as they impact time to recovery
- our state "SLIP" ratings; that is, on a scale from 1 (maximum difficulty in exercising remedies) to 100 (maximum ease in exercising remdies), where each state law falls comparatively

Our hope is that looking at state law differences in this way will prompt further inquiry into the consequences of state law differences on loss experience.

With help from our readers, we'd also like to update our summary with "best practice" information, and revisit our SLIP ratings periodically based on feedback that is available.

Background

Multi-state lenders and other industry participants have long realized that state-by-state variations in the exercise of mortgage lending remedies can have a meaningful effect on loss severities and loan servicing decisions and resources. For the originating lender, though, these state law differences have rarely been an underwriting consideration. Loan origination programs have rather dealt with state law variations by systematizing loan documentation so that whatever remedies are available can legally be realized. In other words, they have largely focused on enforceability rather than substantive remedies differences.[1]

For the loan servicer, state law variations are certainly a recurring part of dealing with distressed loans, but they are less likely to be a source of systemic analysis or oversight. There is an anecdotal familiarity with remedies differences, but not a comprehensive or measurable way of understanding them that could be given allocative effect (i.e., for originations: aligning loan pricing, sizing or structure with specific state remedies and/or loss severity experience; and for servicing: calibrating distressed loan severities on the basis of remedies variations, achieving “best practice” decision-making across a multi-state servicing platform or even assigning or predicting staff resources).

When default rates were as minimal as they’ve been for CMBS loan originations (less than 0.5% for much of the period of irrational exuberance, for example), there were at least two reasons why studying mortgage lending remedies variations would not have seemed compelling: (i) the infrequency of the problem consigns the topic to “rounding error” status; and (ii) there’s not much data on how big the differences actually are. With increased default rates and the wave of distressed loans, there is perhaps no better time than now to measure and comprehend these differences. Default data is quantitatively significant now, and it is increasing, and there is an opportunity for market participants to use the information to both practical and strategic advantage.

Best Practice/Loss Minimization

Better understanding and measuring state law impacts on loss severities could benefit both loan origination and servicing. There is an incremental risk premium at play if remedies are protracted and costly. The loss experience of this cycle should certainly factor into loan documentation (we will see GGP-related work-arounds, for example). Beyond that, though, there are potential underwriting implications if state remedies drive higher loss severities, and those risks can, on the basis of SLIP ratings, be priced or mitigated with greater ease and precision. As program counsel for several national lending platforms, we are used to coordinating best practices with state variations in mind. This is an outgrowth of that role. Likewise on the servicing side, marrying loss severity information with state law typologies could make best practices more apparent, and there are similar possibilities when looking at other types of data (property types, market values, employment, demographics etc).

Transparency

Loan performance data has never been more critical to understand. Beyond establishing *baseline* methods of comparing mortgage loan enforcement practices, *ongoing* data can be used to adjust or corroborate those data patterns, or to identify new ones. SLIP ratings provide another evaluative tool to measure trends as they occur in real time. Policymakers and market participants alike are clamoring for transparency, and this is a tool that can both illuminate and measure an impact that has been sensed but not been examined in depth or discussed with these types of techniques. Despite the inherent complexity and nuance of multi-state remedies issues, there are common attributes, and patterns should emerge that tie those differences to loss severity data.

Policy Debate

Many parties are interested in how the lending industry handles the distressed loan crisis, and it has a huge bearing on our economic recovery generally. Using richer data and better analytical constructs can inform policy discussion and decision-making for the better.

In the next post, we'll move to our research regarding state-by-state foreclosure practices.

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1. At least for fixed rate, permanent loans in the current interest rate environment. Loan programs using variable interest rate, contingent interest, shared appreciation or participation products, for example, would have to be cognizant of state law differences pertaining to usury, which could drive structuring decisions to take advantage of choice of law elections.