<u>**WHAT MORTGAGE CRISIS?**</u>

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With all of the press coverage about the "$700b Bailout", the basics have been ignored. This is supposed to be a crisis brought about by the collapse of the mortgage industry and of borrowers. It would be easier if it was. Unfortunately, it is not, at least not when you get to the fundamentals. Here's why:

It used to be that when a potential home-mortgage borrower wanted money, the borrower would go to a lender, meet face-to-face the banker (now called "loan originator"), and discuss the request, giving the banker a full financial history and detailing the borrower's plans. The banker would take the information, say "thank you", complete a credit analysis, ultimately saying "YES" or "NO"! That banker and the banker's institution was on-the-risk for the mortgage loan. If too many loans went bad, the bank lost money and the banker was fired.

It is no longer so simple. There are layers and layers between the loan originator and the end-owner/lender for that mortgage. In fact, the mortgage loan has probably been put together with thousands of others and sold as a package to investors, like mutual funds and even us, regular people. The packagers of the loans slice and dice them and sell pieces. Assume that there are 2,500 loans averaging $200,000 each (some $75,000, some $500,000) and that they are put together into a package, now called a "securitization"; the size here would be $500,000,000 or ½ billion dollars.

An average interest rate is calculated, the securitizer figures its costs and a profit, determines how much of the interest the pool can pay to investors, and then offers pieces of this big pool of loans for sale. The buyers? Mutual funds, retirement plans, state and local governments, and maybe you and I (but I got out a year ago). These financial instruments are BONDS, not unlike the bonds corporations and municipalities issue; these bonds have a special name - "Mortgage-Backed Securities". No lender, no entity in the creation of the securitization (pool), has any risk for the individual loan which was made by the loan originator. No one gets fired for loans that go bad. NO ONE IS "ON-THE-RISK"! There is only an incentive to create new loans - to sell new loans - regardless of quality or what the effects are on the borrower.

This is an over-simplification because there is a great deal of money at risk; money that is owned by the investors who bought these BONDS, called mortgage Backed Securities

<u>Was the Sky Really Falling? Is it down Yet?</u>

It might be that the sky is not falling, but the financial markets are, and home prices are, and CONFIDENCE IS PLUMMETING. The question is WHY!

Remember securitization and huge pools of mortgages? Each of those bonds, the mortgage-backed securities, has an agreement among the parties that put it together, the investors in it, and the company that actually administers it, known as the "Servicer". This document is called the “Pooling and Servicing Agreement” (PSA) and it specifies exactly what each of the parties can and

cannot do. Most importantly to individual borrowers/mortgagors, are the terms that may PROHIBIT a modification to specific types of loans or even all loans in the Pool.

As I contact lenders to modify loans, I am too often told, "This loan cannot be modified. We are bound by the pooling agreement". In the past, if a borrower got into trouble and either called the mortgage holder directly, or came to my office for help in negotiating an easing of mortgage rates, or to put the arrearages put into the end of the mortgage, we would contact the lender or its legal counsel. The issues discussed would be the borrowers reasons for default, the borrowers ability to make payments in the future, the past history of the loan, and similar matters. No one ever said "Well, everything is fine with us, but the Pooling agreement will not permit a modification". NOW IT HAPPENS.

Investors expect a certain ROI, translated to "Return on Investment", as well they should. But sometimes we cannot get what we expect - life and especially business is not always fair. And most of the time taking a little less is better than getting nothing.

It’s All In The Numbers

Getting a bit more concrete, let's assume the following which are based on real statistics and real experience: The loans supposedly causing the problems were originated between 2004+/- and a few months ago. This was the period that Option Adjustable Rate Mortgages ("Option ARM"s), pick-your-payment ARMs, Negative amortization mortgages, Simple Interest Mortgages etc., etc. became popularized.

(If you want to skip the numbers, just accept that the real losses to the investment pools, the mortgage backed securities/bonds, containing the so-called subprime or predatory loans, are about 4%-5%).

This is how we get there: Assume that 75% of these loans made during the 2004-2008 period will never have a default - therefore only 25% will. Assume that of the 25% of the loans that default, ½ of those self-cure, meaning that the borrower fixes the problem him/herself. Most defaults are traditionally the result of a temporary illness, or temporary layoff, or other such short-duration problems. Now, due to the Predatory Lending practices of many mortgage originators, we have this higher-than-normal default rate higher because of sub-prime borrowers getting sold a "bill of goods" along with their mortgage. Now, we are at ½ of the 25% (the defaulting loans), or 12.5% of the entire portfolio of loans) that are still problems.

Assume further that of the 12.5% of the total which do go into foreclosure, (not to an auction sale, but just a term to describe when a lender sends a "Notice of Intent to Foreclose" to the borrower), ½ of those will never go to sale. Borrowers somehow manage to get enough money together to reinstate the loan, or at the last minute get a reprieve from the lender due to a sale of the property. Taking in account some losses, say 20%, from sales by the homeowners of these “not going to auction sale” loans, for less than the amount which is owed (called a “short sale”), the entire portfolio so far has lost just 20% of 6.25% or 1.25% !

Now we have only 6.25% of the total portfolio remaining in foreclosure. These actually get

sold at foreclosure sales. As an estimate, the foreclosing lenders recover only 40% of the value of the loans made, thus losing 60%.This leaves the loss for this last part of the portfolio, the loans that have the houses go to foreclosure sale, at only 3.75% (60% of 6.25%). THE LOSS FOR THE ENTIRE POOL OF LOANS IS ONLY 5%

At any other time, with all accepted loss ratios, THIS IS NOT A CRISIS. In fact, not even close! Unfortunately these are not any other times. The ability to negotiate with lenders is greatly reduced due to the Securitization of Loans. Wall Street took away the risk so no one cared if borrowers could afford their loans, and then severely limited and in many cases took away the ability to try to fix a broken mortgage by making a deal with the lender.

What Is The Value Of The Securities Created By Pooling Loans?

Is a 5% loss a crisis? Are all of the loans made to subprime borrowers going to be worth $0.00? The answer is NO to both questions. If that is the case, then what is the problem? How much is an acceptable loss?

Imagine a small to medium sized "local" bank. Imagine every depositor showing up at all of the bank's offices on the same day demanding their money, in cash. Can the bank pay everyone? NO! The deposits have been invested in all kinds of normal loans and other earning assets, like overnight loans to other banks. What happens to the bank when all of its depositors demand immediate cash? THE BANK FAILS, and FDIC steps in to pay depositors what was in their accounts. That is essentially the Indy-Mac Bank scenario. There, FDIC rather than closing the bank and paying depositors their $100,000 per account (now $250,000) figured it would just take over, everything, and stop a "RUN ON THE BANK". That is the term to describe what depositors did.

Due to the failures and the uncertainty surrounding the subprime loans/predatory lending, banks do not know how to value assets that they hold. Further, if no one can determine the value of a mortgage-backed security ("MBS"), then the investors do not have anything that can be sold. Banks that are holding MBSs are stuck. The pools are static. Banks will not trust each other because no one knows which bank will fall next!

This lack of confidence, created somewhat artificially by hype about subprime loans etc, has left depositors shaking, not knowing what is safe, banks not lending to other banks which stops everything because there is no liquidity, and the stock and bond markets, here and abroad, extremely violatile because everyone is looking for assurance, and insurance, that everything is not worth nothing. Again, I will state over and over that even if the misnamed subprime loans are defaulting at a higher than average rate, higher than that which would be seen in a "normal" loan portfolio in "normal" times, these loans do not make up the entire world of mortgages.

Step back for a moment and think about billions and billions of dollars of residential mortgage loans where some, not all, mainly originated since 2004, will have a higher loss ratio than should be expected. The MBSs are not comprised of only these bad loans, making the MBSs “TOXIC ASSETS”. They are a subset of all of the loans put on the books during the same period. The MBSs

are made up of all types of loans - most are a more or less random assortment.

What Is the Problem and Can it Be Fixed?

The problem is the MBS structures. As dealt with earlier, the Pooling and Servicing agreements that bind these MBS packages and get SEC approval, restrict the ability to modify individual loans owned by the pool. There are legal issues involved in disturbing the pool beyond a certain point, and tax issues for the investors, servicer, and the MBS itself.

One possible solution is for Congress to pass legislation that mandates the MBSs be opened and the indiviual assets managed, not unlike something that happened during and after the Depression in the 1930s. Congress passed a law that stated that under certain circumstances, where a new federal home lender was going to buy or modify loans, that contracts could be broken without the federal lender being held liable to bond holders for losses.IRS could deal with the tax issues later.

Getting the ability to really determine the value of the particular security would restore confidence to the markets. THE TASK WOULD BE ENORMOUS, but so is dealing with the lingering loss of confidence, bank failures, tightening of credit due to liquidity problems, and handling the volitility of the market and having pensions wiped out due to another 300+ point plunge in the Dow Average.

I personally oversaw the workout of several S&Ls in the mid-80s. I know the work that lies ahead to address the core issues. But, there are those in and out of government who also dealt with the S&L crisis which could have been a $1 trillion mess. Perhaps, instead of just a bailout, our leaders should use it to stop the bleeding, and then immediately move towards the steps outlined above.