The Mortgage Crisis Act II – Is the Bleeding Over?

By Robert Pardes
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Is the bleeding over for the Mortgage Crisis?

With the inventory of foreclosed properties and resulting loss severities continuing to increase, it hardly seems so… Looking at only our major financial institutions, most of the press would have us believe these losses have been largely accounted for and investors should shift attention to visible cracks in other areas of consumer finance (prime home equity lines, auto loans and leases, marine and RV financing, etc.).

But, on a macro basis, the bleeding is not over. An important issue, largely overlooked and not fully appreciated, will continue to adversely impact the performance of financial institutions.

Investors are beginning to exert pressure to enforce the contractual rights embedded in most mortgage securities. These rights represent Act II of the Mortgage Crisis and will continue to create financial stress for many players in the housing finance arena as the related exposure is unlikely to be adequately reflected in existing loss reserves.

These institutions may well be reminded of the iconic Al Pacino line from the Godfather, Part III, "Just when I thought I was out, they pull me back in."

Generally, the referenced contractual rights relate to the obligation to require the issuer (often referred to as the "Depositor" in the securitization structure) or some other party to repurchase loans that support the securitization to the extent that the loan can be documented as "defective.." Typically a defective loan is one that does not meet the contractual representations and warranties that accompanied the transfer of the pool of loans to the securitization, which is generally sliced into tranches that are beneficial interests in a Trust. The Trust, in turn is managed pursuant to the trust agreement by a Trustee. The obligation to

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buy back defective collateral is referred to as a "repurchase" and, for purposes of this discussion, the overall contingent liability to repurchase loans is "recourse exposure".

To date, major financial institutions have reported aggregate losses in the range of $350 billion associated with holdings in private label MBS and related transactions. These reported losses overwhelmingly relate to write downs or cash losses for items reflected on the balance sheet. Recourse exposure, however, is the potential losses relating to loans previously securitized and therefore not reflected on the balance sheet. The realization of these losses is not a mere transfer of already recognized losses between investors and counterparties, despite what many believe to the contrary. In light of total private label securitizations for the years 2005-2007 in the range of two trillion, losses relating to non recourse exposure could total hundreds of billions. These losses will increase over time as delays in identifying and reporting the exposure has only increased the severity of loss associated with each potential repurchase, as interest and default related expenses continue to accrue.

In light of the above, the seminal issues that should be of concern to the financial community, including investors and analysts are:

- The scale of exposure by institution and in the sector;
- The timing for recognizing the related exposures

Potential Losses: As noted above, the potential losses to be recognized may be quite substantial relative to the losses already realized. Factors that will weigh in on the scale of recourse exposure include (i) the aggregate balance of 2005-2007 private label securitizations; (ii) the cumulative default rate and its correlation to "defective" collateral; (iii) the expected loss severity; (iv) the securitization structure; and (v) the nature of the counterparties in terms of economic capacity (i.e. deep pockets).

Many of these securities are loaded with products susceptible to widespread abuse and intentional fraud (no down payment and no verification of income or assets). Mortgage professionals close to the issue have reported that more than 50% of the loans that have defaulted based on representative contain material breaches of the related representations and warranties (See," Speculators may have accelerated Housing Downturn", Wall Street Journal, February 6, 2008). With reported cumulative default rates ranging from the low 20s to 35% and loss severities of 40% - 50%, it is not difficult to arrive at an estimate that the total loss exposure to loan repurchases well exceeds $100 billion, before accrued interest and expenses. Major issuers and depositors with historical securitization activity

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in the range of several hundred billion dollars are likely to face an operating revenue and capital impact in the billions.

Timing of Losses: There is little clarity or consistency in the accounting rules and practices for recognizing the potential exposure to loan repurchases. Where there is a documented claim, a basis for establishing a reserve exists. The amount of the reserve, though, can be arrived at by a highly subjective determination of the probability of success in having the claim rescinded on substantive grounds and the expected loss or market value of the loan if repurchased.

Where there is no documented claim, however, the accounting treatment becomes murkier, often relying on historical experience rather than the extraordinary circumstances that exemplify the current environment. The relevance of historical experience as a basis for estimating future exposure should be a cause of concern, due to the perceived paucity of documented claims generated by outstanding private label securitizations in the context of elevated default rates that are multiples of historical defaults. To a large degree, the lack of documented claims is a function of flaws and impediments in the securitization structures, presenting novel legal and business issues for the secondary mortgage market.

Figure 1 depicts the basic structure of the securitization process. Warranties and representations flow to the Trust and the potential for repurchase claims flows from the Trust back to the loan originator or issuer. From a loss exposure point of view, mortgage related securities fall into one of three classes:

- Standard representations and warranties are provided by the originator or securities firm having the economic capacity to honor repurchase obligations;

- Representations and warranties flow from a party with the requisite balance sheet to support recovery, but the representation and warranties are diluted, resulting in considerable debate as to the merits of a demand by the Trustee to repurchase the related collateral

- Representations and warranties flow from a party lacking economic capacity to honor repurchase demands and the potential for recovery for the Trust and investors based upon the structural obligations is remote.

Securitizations falling into the first category make up a considerable amount of the total population of the relevant vintage and the parties subject to recourse exposure are, for the most part, high profile investment banks and money center

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banks – the same institutions that reported the vast majority of the aggregate losses to date.

So, why haven't these losses been recognized to date, and when should investors expect the exposure to be reflected in financial performance? Increasing investor pressure to identify defective collateral has exposed mechanical flaws in the securitization structure and has provided clarity with respect to the role and obligations of the Trustee in this unprecedented environment. Since the Trustee is the sole representative of the interests of investors in the securitization structure, the inability to identify defective collateral has crippled a fluent process for investor recoveries and is the primary culprit in delaying the full recognition of off balance sheet exposure.

To be fair, the Trustee's contractual obligations are limited to an essentially passive role and the Trust Agreement to which they are subject fails to provide the resources or specific obligations to engage in a forensic examination of the transferred loans. Without specific knowledge as to a defect, the Trustee's may believe they are handicapped in their ability to demand repurchases, notwithstanding the unusually high level of defaults and the implication that the rate of defective collateral far exceeds the frequency of repurchase demands from the Trustee. Finally, Trustee fees are a tiny sliver of the cash flow generated by a securitization (as little as $10 - $20 thousand per $100 million). Trustees will argue that their level of compensation couldn't possibly cover anything but a passive role as a conduit of performance reporting and cash flow administration for the various tranches.

Several recent trends are likely to accelerate the pace of recourse demands and the realization by financial institutions of sizable related losses. A Federal Court in Massachusetts recently sanctioned a leading institutional trustee for having turned a "blind eye" to the mistakes of the servicer for a securitization in connection with bankruptcy filings. Institutional investors will latch on to the "blind eye" theory with increasing frequency to compel forensic reviews.

Secondly, as virtually all tranches of securities from AAA through unrated have suffered material losses and write downs, there is increasing collaboration among investors to seek redress in the governance provisions of Trust Agreements, which allows investors to exercise certain rights based upon pre-established voting percentages.

The above factors portend significant increases in losses transferred from the securitization to major financial institutions. The Federal Reserve may have understood that these losses would ultimately bleed through when it aggressively cut rates, allowing the gift of increased net interest margins to mask the impact to capital and earnings. From the Fed's perspective, an ongoing process may be

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preferable to immediate recognition to avoid the obvious depletion of capital, which would result in further disruption to the markets. Real growth in revenues for many financial institutions is likely to be retarded by recourse exposure for many quarters to come – continuing the pressure on earnings and performance and limiting any short term recovery in shareholder value.

As the investment community gains greater appreciation for the recourse/repurchase issue, the risk of even greater polarization between investors and issuers increases, further undermining the trust essential to functional markets. The flip side is the opportunity for value investors to strategically invest in securities that are likely to benefit from improved cash flows as more loans are paid off in full, as issuers settle claims related to recourse exposure.

The exposure to losses is real. As they say in Latin, "res ipsa loquitor" – the thing speaks for itself. The record level of defaults for the 2005-2007 vintage non-prime securities needs no further explanation. Nevertheless, investors and issuers are best served by expediting resolution through reasonable compromise. The adversarial route of protracted litigation over claims of fraud and disclosure will extend the pain and delay the restoration of confidence in the mortgage capital markets critical to a housing recovery. There is no perfection, just the opportunity to move on as quickly as possible.

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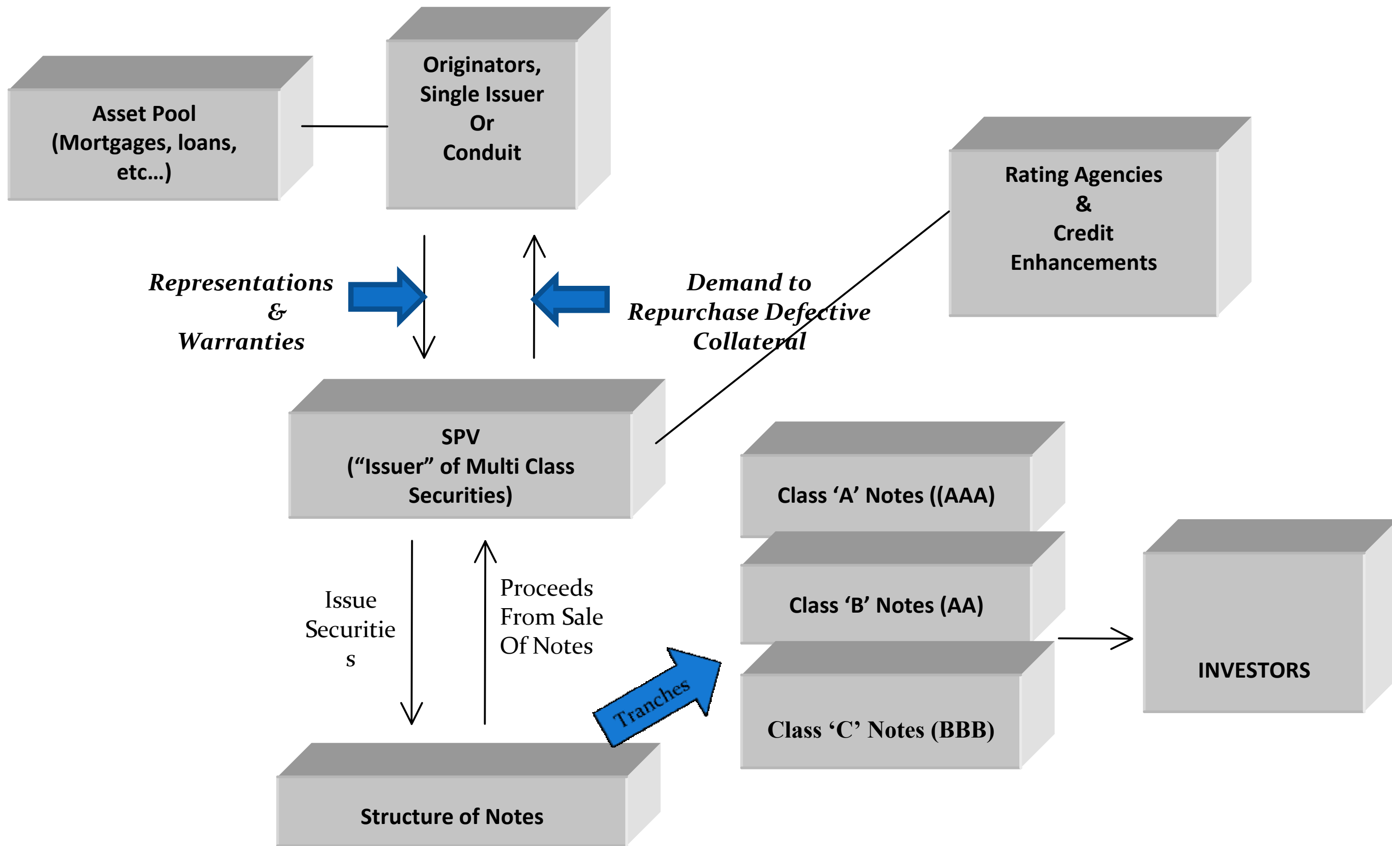
FIGURE I: BASIC SECURITIZATION FLOWCHART



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