ADVISOR PERSPECTIVES

What to Do With Those Impaired MBS Holdings?

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By now, institutional investors worldwide are painfully aware that those "conservative" investments in private label mortgage securities ("PLS") are very distinct from other fixed income holdings in terms of the factors that drive value, liquidity, and the dynamics for recovering lost value. Despite the highest of investment grade ratings, the poor performance of the underlying collateral exceeded the worst case cash flow models of Wall Street's rocket scientists, leaving many fund managers scratching their heads wondering how things could have gone so awry.

There has been so much press dedicated to assigning blame and the political debate regarding consumer and institutional bailouts, the plight of pension fund and investment managers with fiduciary responsibilities has been largely overlooked. It almost seems that investors in these securities are being tarred and feathered with the same brush as hedge fund gurus and other high risk participants in the securitization process, virtually ignoring the reality that working class retirement funds and support for vital municipal services like school budgets are also at stake.

The meltdown in PLS has also exposed flaws in the securitization structures, leaving unclear or unanswered many questions that remain to be tested in today's unprecedented market conditions. Despite the sheer magnitude of the loss experienced at every rating level, it seems that investor response to date represents a state of paralysis, with investors looking to gauge what, if any, action should be taken to recover or mitigate losses.

Several explanations for the delayed reaction are:

- The exposed structural flaws further complicate already complex investments to the point that investment managers and their advisors cannot get a handle on their relative rights and appropriate recovery strategies;

- A considerable population of the investor base is comprised of highly leveraged hedge funds with outstanding borrowings to the very same institutions that distributed the PLS. Their priority is the deleveraging of their funds, at which point strategies to recover lost value may take a front seat;

- Unrealistic hopes that legislative action will restore market confidence, with imminent and significant improvements to value: and

- The time lag to acquire needed expertise due to conflicts of interest. Experts in this area are firms or individuals that played key roles in the rating, underwriting, or distribution of the securities, greatly limiting their ability to perform services for investors that suffered related losses.

So what are the alternatives? No doubt, the pace of lawsuits will gather momentum, as the legal community will come to the rescue of the victims of the crisis, as long as deep pockets are involved. Lawsuits will be based upon the alleged misrepresentations or inadequate disclosure of risks in connection with the sale of PLS. These cases (often referred to as 10(b)5 actions based upon the rule promulgated under the 1933 Securities and Exchange Act dealing with disclosure requirements) promise to be long drawn out affairs, taking many years and considerable expense to reach resolution. Moreover, this adversarial approach pits parties against each other that will sour future business dealings to the detriment of all involved.

Another, less adversarial approach, relies on the enforcement of recourse obligations embedded in many of the securitization structures to materially improve cash flows and values. The validity of this approach depends upon a number of factors, including the structure of the securitization and the nature and financial capacity of the counterparties. For purposes of this commentary, this approach is referred to as “Recourse Recovery.”

The Recourse Recovery Process

Most securitizations include contractual representations and warranties regarding the underlying collateral. To the extent that breaches of these reps and warrants can be documented, the Issuer or Depositor of the underlying mortgage collateral in the special purpose trust comprising the securitization is obligated to repurchase the “defective” loan. The repurchase price includes not only the full principal balance but all accrued and unpaid interest along with any expenses incurred, including legal fees.

The repurchase of a loan as described above is equivalent to a prepayment in full. For a PLS of mid 2005 – 2007 vintage, representative samples would suggest that more than 50% of the cumulative default rates pertain to loans that breach at least one representation and warranty. Recall that a high percentage of the loans supporting these securities were high risk in nature (no down payment, no documentation of income or assets) and encouraged widespread abuse.

With many of these securitizations experiencing cumulative default rates in the low 20% - 35% range and loss severities of 40%-50%, the conversion of at least half of the losses (historical and anticipated) to full prepayments over an abridged period of time will considerably improve current and anticipated cash flow and translate to correlating lift to the value of the related securitization. This opportunity for vastly improved performance has lured savvy investors and billions of investment dollars into the distressed PLS market.

For fund managers, one major benefit of the recourse recovery approach is that, instead of pitting investor against issuer, the “independent” Trustee is charged with the obligation to enforce loan repurchase obligations on behalf of the securitization, creating a buffer between parties for the benefit of future business dealings. Other advantages include:

- Lower profile and less publicity for all parties;
- The ability for PLS investors to engage in limited forensic reviews depending on established objectives in pursuit of tailored settlements; and
- Greater expediency and cost effectiveness

The Recourse Recovery approach is not without its challenges. One of the flaws exposed by the credit crisis directly relates to the role and obligations of the Trustee, the sole representative of the interests of investors in the securitization process. Leaving aside the vast body of law that covers the fiduciary obligations of Trustees, the Trust Contract itself essentially limits the trustee’s role to a passive one – primarily serving as a conduit of reports and cash flow based upon information provided by the loan servicer. The major servicers for most loan securitizations are typically owned by the Issuers of the PLS or have significant economic relationships, creating conflicts of interest in the recourse recovery process.

Trust agreements never contemplated the need for the more aggressive role dictated by the current unprecedented market conditions. While Trustees are willing to enforce repurchase obligations where they are aware of a breach of representation or warranty, they simply lack the resources, infrastructure and economic incentive to directly engage in a broad forensic review of the underlying mortgage loans and are not willing to let investors engage in a “fishing expedition” for this purpose. Without specific knowledge of a documented defect, Trustees may feel handicapped in their ability to demand repurchases, notwithstanding the unusually high level of defaults and implications of a high percentage of defective collateral.

In the past, to minimize legal exposure, Trustees have generally been advised by counsel to reject investor led forensic inquiries. Trustees have also raised

concerns regarding rights to financial privacy and their obligation to avoid favoring any class of security holder over other classes.

The challenges described above are not insurmountable, and experienced advisors can certainly overcome, to the Trustees' satisfaction, concerns related to financial privacy and disparate treatment of classes of investors. In addition, recent case law supports obligations of the Trustee beyond the four corners of the document. A Federal Court in Massachusetts recently sanctioned a leading institutional trustee for having turned a "blind eye" to the mistakes of a servicer in connection with bankruptcy filings. This "blind eye" ruling may require Trustees to take, or at least allow, affirmative steps to assess the extraordinary default rates associated with 2005 – 2007 vintage securities.

In addition to persuasive legal support for forensic reviews of securitized mortgage loans, the interests of investors have evolved to become more closely aligned. As a result, we should see collaboration by investors, either informally or through the exercise of governance powers set forth in the Trust Agreement, to require affirmative activity on the part of the Trustee.

Given the changing climate, Trustees and PLS investors will move to a more accommodating posture to avoid economic exposure that far exceeds the sliver of fees earned in connection with each securitization. Based upon these positive trends, we are on the cusp of greater investor access to loan files that will drive a considerable increase in Issuer/Depositor loan repurchases from securitizations.

Next Steps for PLS Investors

In keeping with their fiduciary obligations, pension and investment managers should take the following steps to be in a position to identify the best approach to recover value:

- Engage in a detailed analysis of MBS holdings to reassess and validate the impairment levels. This serves multiple objectives, and will most importantly allow the allocation of resources to the subset that presents the greatest opportunity for recovery;

- Review each deal to identify the economic capacity of the parties and the trail of warranties and representations. Deals should fall into one of three groups:

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

repurchase obligations. It is this group of investments where the Recourse Recovery approach presents a viable alternative;

- 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.

(10(b)5 claims may be an appropriate strategy with respect to the latter two categories depending on the circumstances).

- Develop expectations and objectives with respect to acceptable recovery levels. The more modest the objectives, the greater the likelihood of an expedited resolution. For example, an attractive result may be a settlement that improves value from 75 to 87. A settlement by the Trust and the Issuer on this basis may serve mutual objectives and show fund investors earlier positive returns.

The steps described above can be performed with internal staff where there is adequate resources and expertise, or with the assistance of a qualified advisory firm. There is value in starting the process early before Trustees and counterparties become overwhelmed with claims.

One thing that is certain is that pension and investment managers need take steps to demonstrate that all options have been considered for the benefit of their respective client base.

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