The Foreclosure Mess

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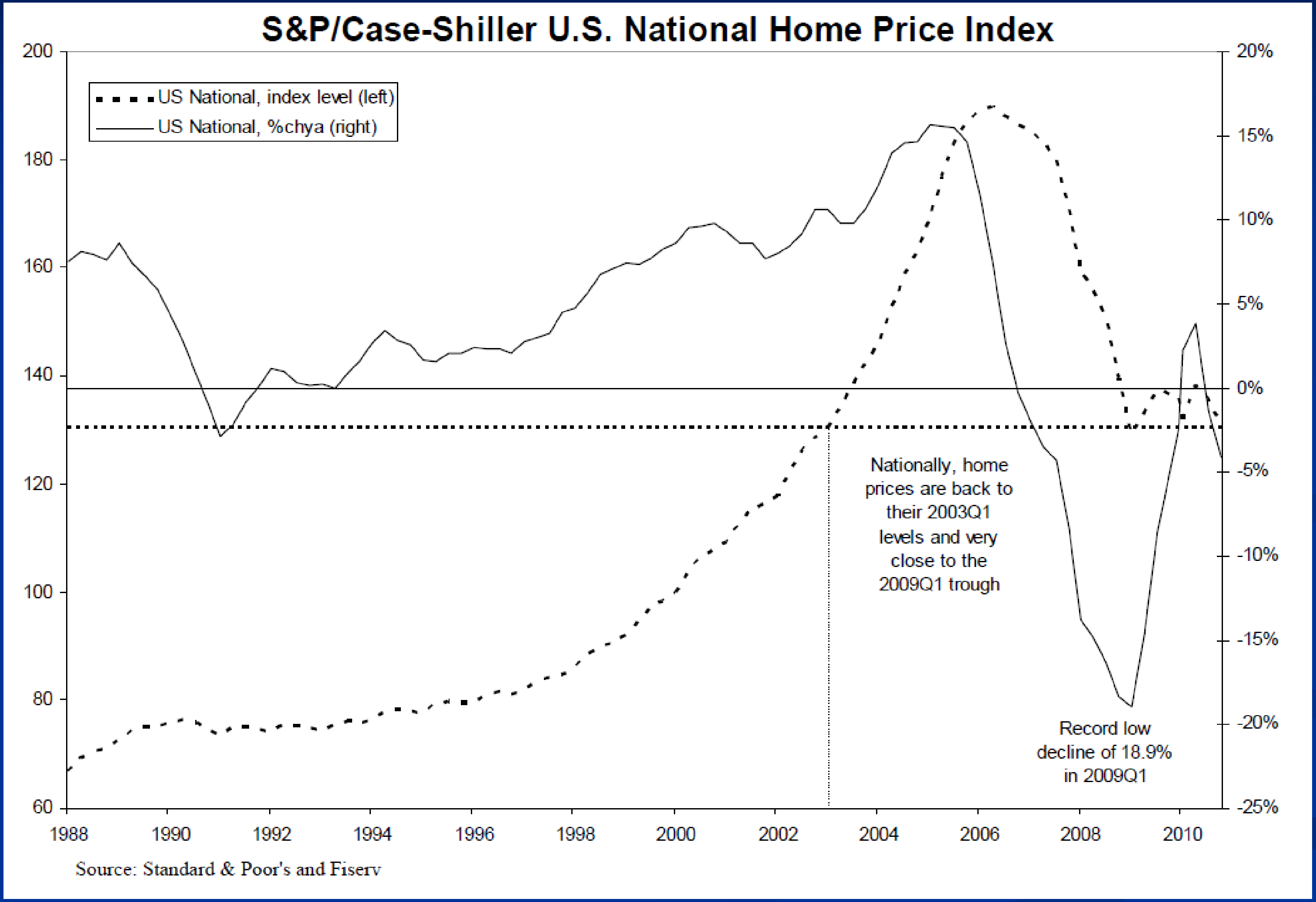
Residential Foreclosure Overview

- According to LPS Applied Analytics, as of Dec. 2010, there were 2.2 million mortgages in the process of foreclosure, and 2.1 additional mortgages seriously delinquent (90+ days past due) out of a total of 52.9 million mortgages.
- According to RealtyTrac, 832,000 residential properties in the foreclosure process sold during 2010.
- If not a single additional mortgage went into foreclosure, this translates into an inventory of *five years*.

Residential Foreclosure Overview

- Moreover, RealtyTrac reports that foreclosure sales accounted for 26% of all sales during 2010, and sold at a discount of 28% relative to houses not in foreclosure.
- Together, these statistics imply that the foreclosure mess will continue to put downward pressure on U.S. housing prices for years to come.
- Last week, the S&P/Case-Shiller Home Price Index confirmed a double dip in housing prices.

Case-Shiller Home Price Index



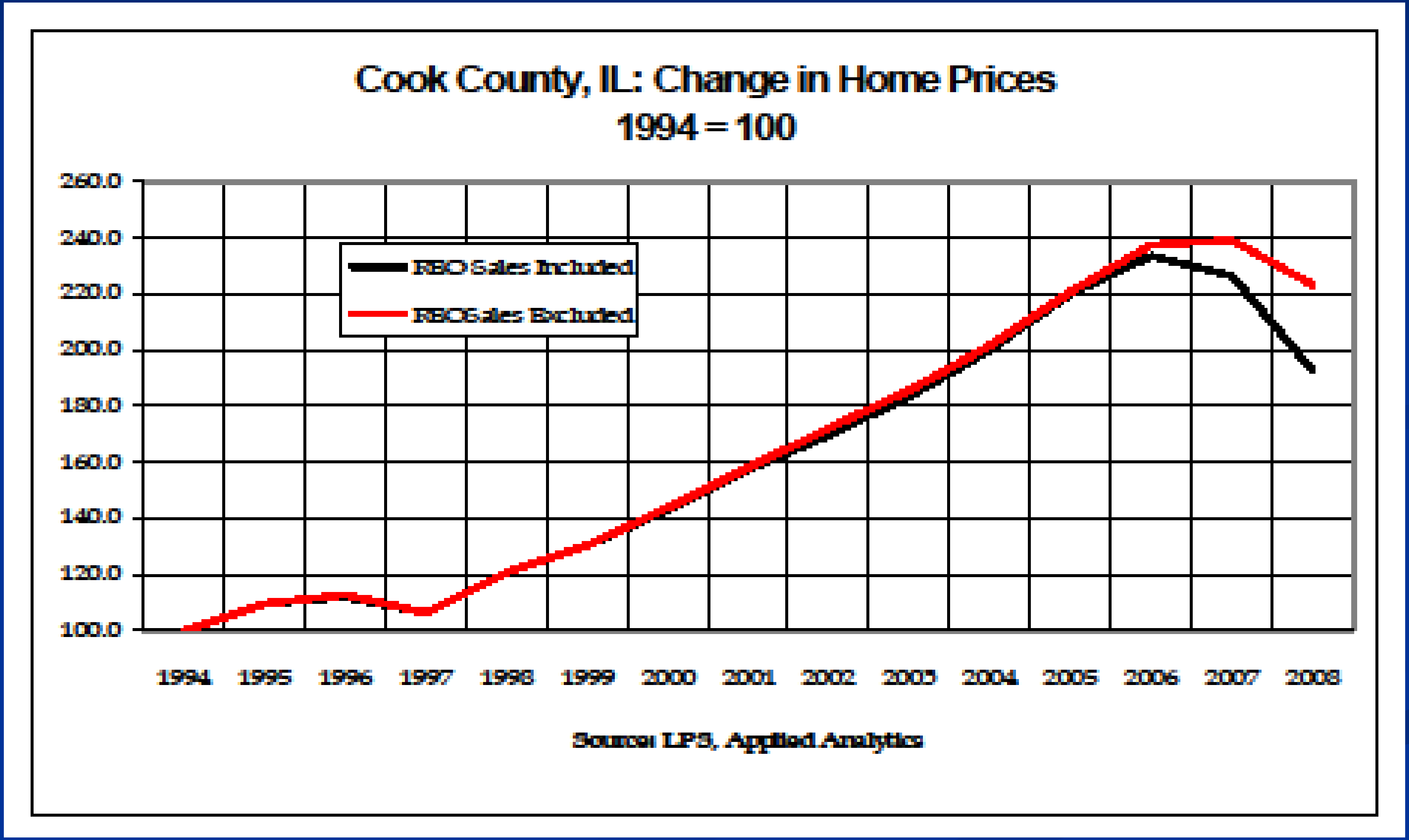
2000 = 100. Prices peaked in 2006 at 180. Since then, have dropped to 130.

Effect of Foreclosures on Home Prices:

- Finally, let us consider how foreclosures affect home prices.
- A foreclosure sale is not a traditional “arm’s length transactions between a buyer and seller, neither of whom is under duress.”
- As such, foreclosure sales should not serve as market comparables, but they often do.
- In many markets, they are a majority of all recent sales.
- How does this impact home prices?

Effect of Foreclosures on Home Prices:

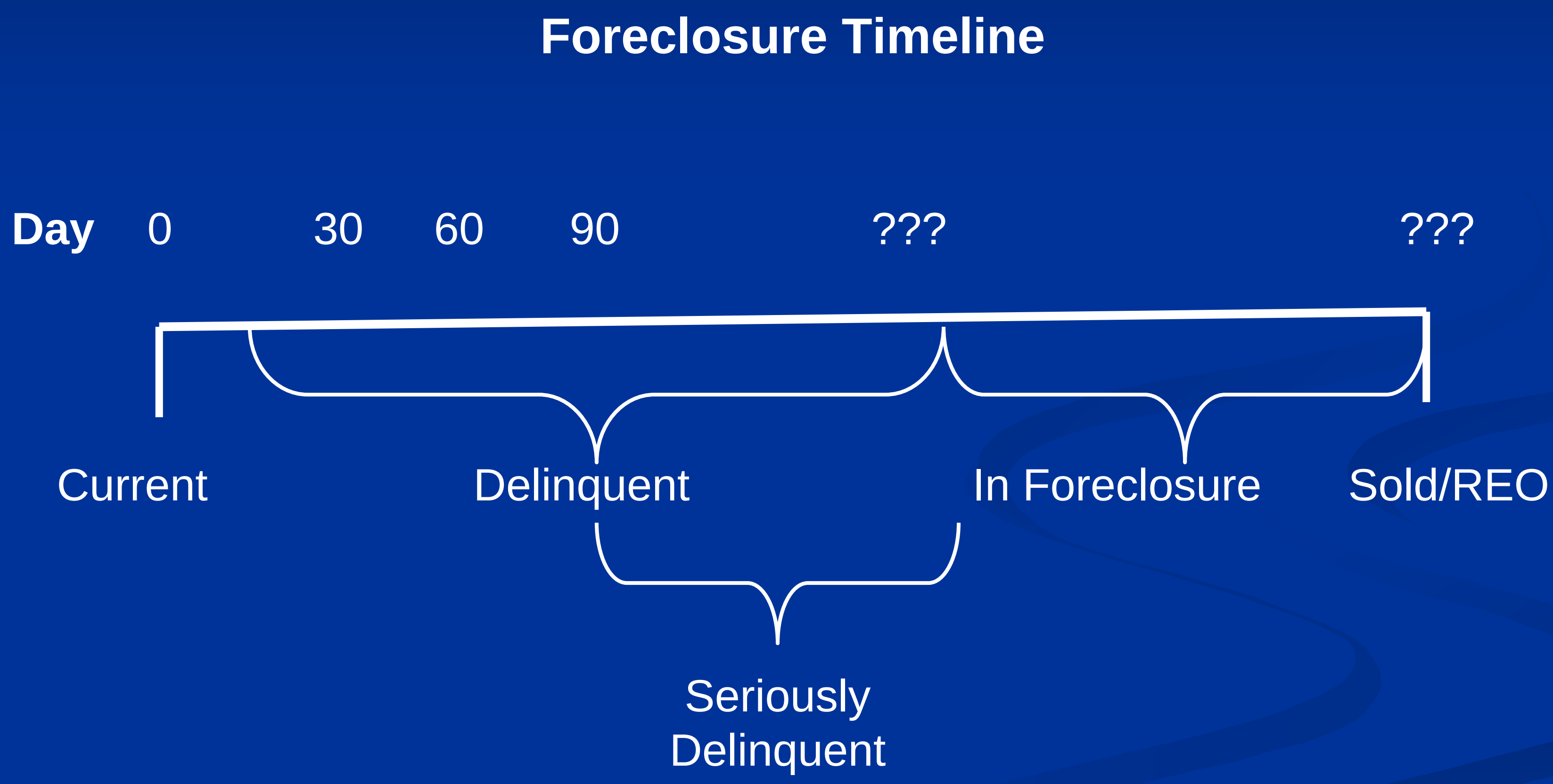
Source: Lender Processing Services



Residential Foreclosure Overview: Terminology

- Foreclosure means many things to many people, so let's define some terminology:
  - **Current**: borrower is current on mortgage payments.
  - **Past Due**: borrower has missed at least one payment and is at least 30 days past due.
  - **Seriously Delinquent**: borrower is more than 90 days past due.
  - **In-Foreclosure**: borrower has missed several payments and lender has begun foreclosure legal proceedings, which can take weeks in some states, years in others.
  - **Sold/Real-Estate-Owned**: Foreclosed property has exited the foreclosure process by sale to the lender or to a third party.

Residential Foreclosure Timeline



Have We Hit Bottom . . . ?

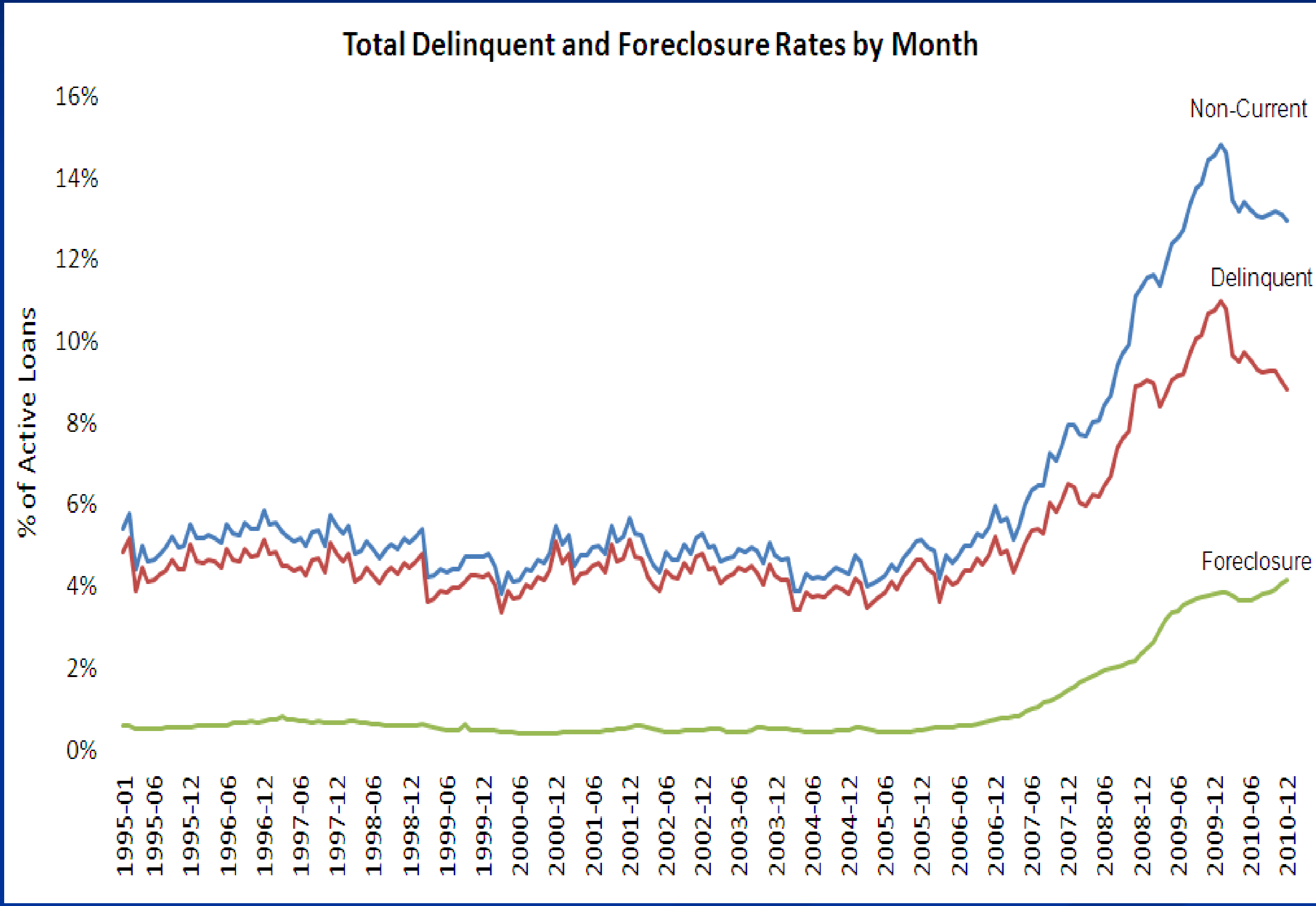
- Obviously, mortgage underwriting standard have tightened considerably since 2007, so new delinquencies are not being driven by NINJA loans.
- Instead, new delinquencies are increasingly a function of adverse changes to borrowers' financial condition, especially due to job loss.

Have We Hit Bottom . . . ?

- According to data from LPS, we hit bottom 12 months ago, at 8.1 million non-current mortgages, of which 2.1 were in process of foreclosure and another 3.1 were seriously delinquent.
- Last month, the number of noncurrent mortgages had fallen to 6.9 million, of which 2.2 million were in the process of foreclosure and another 2.1 were seriously delinquent.

Have we hit bottom . . . ?

Non-Current U.S. Mortgages 1995 - 2010



Source: LPS Mortgage Monitor for December 2010

Have we hit bottom . . . ?

- So, the situation is improving, but the foreclosure outlook is deteriorating.

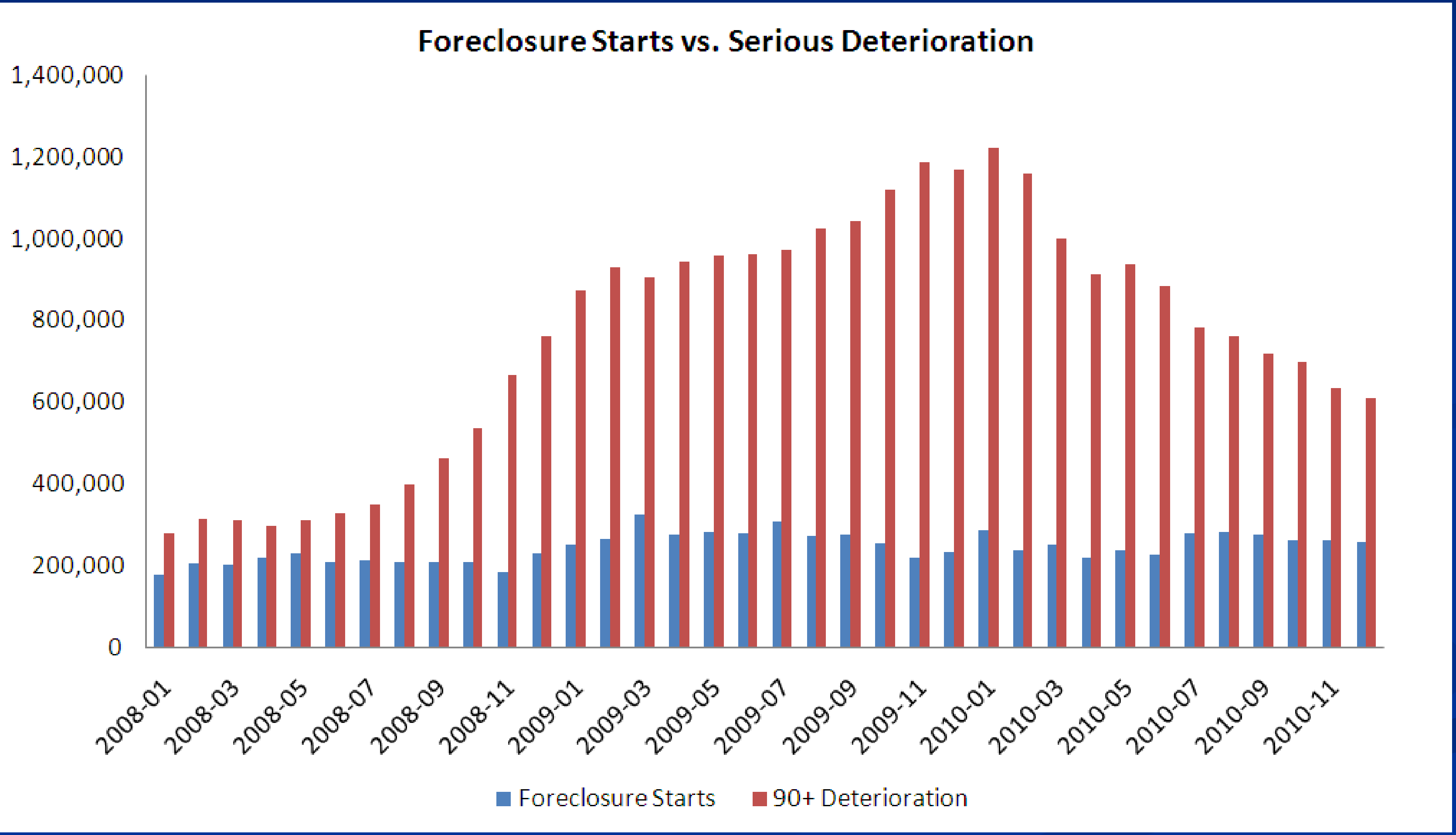
- Remember that 830,000 properties in foreclosure were sold to third parties in 2010, yet the number of properties in foreclosure at the end of 2010 increased by about 120,000 year-over-year to a new peak of 2.2 million.

Have we hit bottom . . . ?

- In other words, the influx of seriously delinquent properties into the foreclosure process exceeds the outflow of in-foreclosure properties sold to third parties.
- In addition, the number of properties rolling from 30 – 90 days past due to 90+ days past due is more than twice the number o f properties rolling from 90+ days past due to in foreclosure, but this is much improved from a year ago, when the ratio was 6 to 1.

Have we hit bottom yet . . . ?

Mortgages rolling to 90+PD and from 90+PD to FC



Have we hit bottom yet . . . ?

- Another troubling statistic is the average number of days that a property has been delinquent, which measures the speed of the process.
- For seriously delinquent properties, this number has risen from 196 in Dec. 2008 to 249 in Dec. 2009 and 334 in Dec. 2010
- For in-foreclosure properties, this number has risen each and every month from 319 in Dec. 2008 to 406 in Dec. 2009 and to a new peak of 507 in Dec. 2010.
- WHY???

Have we hit bottom yet . . . ?

- Backlogs and mitigation efforts have prevented many lenders from moving assets from “delinquent” status to “in foreclosure” status.
- Recent “moratoria” on foreclosure sales have mucked up the “in foreclosure” statistics, preventing final sales of these assets.

Foreclosure Mitigation Efforts

- The previous and current administrations have launched a number of programs that attempt to reduce the number of foreclosures, most notably:
  - Hope for Homeowners: Jul. 2008
  - Making Home Affordable: Feb. 2009
  - Home Affordable Modification Program (HAMP): Mar. 2009

Home Affordable Modification Program

- The goal of the HAMP was to “help 3 to 4 million homeowners by 2012.”
- $75 Billion (with a “B”) was allocated from TARP to cover costs of the program.
- Through year-end 2010, $1 billion (yes, ONE) have been spent.
- Primary mods: lengthen maturity, reduce interest rate, add balloon payment.
- Very little principal reduction. WHY???

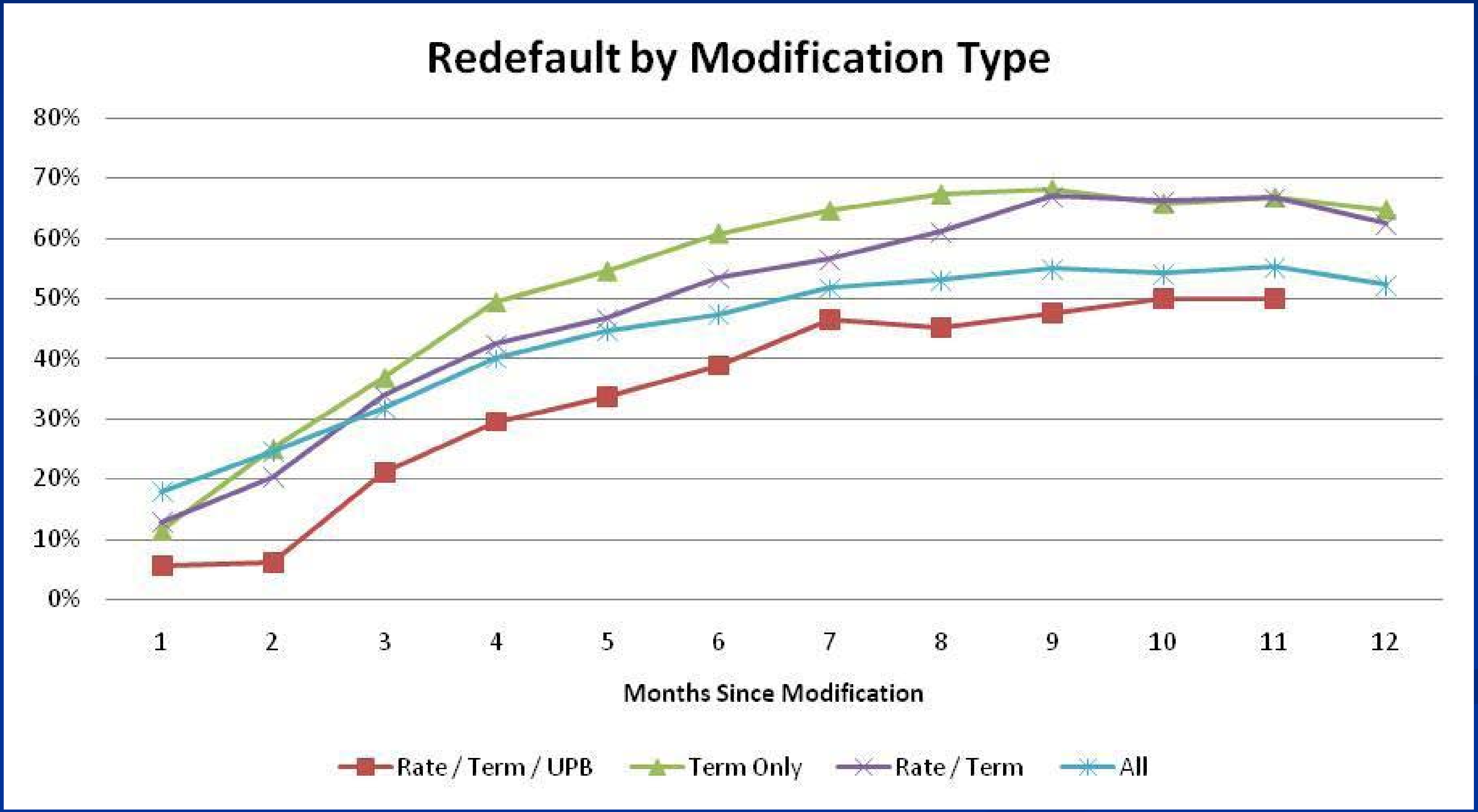
Home Affordable Modification Program

- Fear of “moral hazard” and “strategic defaults.”
  - CoreLogic estimates that more than one in four mortgages are “underwater,” where outstanding balance exceeds the value of the property.
  - But without principal reduction, 12-month redefault rates have historically exceeded 50%.
  - Hence, only $1 billion spent thus far.

Home Affordable Modification Program

- The goal of the HAMP was to "help 3 to 4 million homeowners by 2012."
- As of Dec. 2010, HAMP has led to:
  - 1.47 million "trial modifications"
  - 580 thousand "permanent modifications"
  - 735 thousand "trial mods cancelled"
- 12-month "redefault rate" for permanent mods is now 21%, but for all mods,

Redefault Rates:
Source: Lender Processing Services



The Role of Second Liens

- Another key problem is the existence of second liens on the majority of delinquent mortgages.
- For some odd reason, borrowers who default on their first mortgage usually remain current on their second mortgage, so banks, which own the vast majority of second mortgages, don’t have to “mark-to-market” these mortgage assets.

The Role of Second Liens

- Look who owns most of these second liens:
  - BofA: $155 billion
  - Citi: $60 billion
  - JPM Chase: $128 billion
  - Wells: $102 billion
- These banks typically refuse to take any write-downs when a borrower seeks a principal reduction on his first mortgage, leading the owner of the first to balk at the modification.

The Role of Second Liens

- Regulators have the power to *force* these banks to mark to market, but choose not to do so.
- Why? At 50 cents on the dollar, such write-downs would force another explicit bank bailout, as these banks would face serious capital shortfalls
- Wells would be rendered insolvent.

The Role of Servicers

- Guess who are the four largest servicers?
  - BofA, Citi, JPM Chase and Wells
  - Same as the four largest holders of 2nd liens.
- Servicing is a low-margin, high-volume business that doesn't easily accommodate labor-intensive modifications.
- Hence, the failure of servicers to reach permanent modifications with HAMP trial-mod participants.
- Most common complaint: lost paperwork.

The Role of Servicers

- “Paperwork problems” have become the trademark of the entire financial crisis.
- It began with “low-doc” and “no-doc” mortgages where underwriters did not collect “paperwork” on borrowers’ income and assets.
- It continued with investment banks failing to file the “paperwork” with the REMIC trusts, as required by Pooling and Servicing Agreements, the contracts that govern REMICS.
- Now, we learn that the servicers don’t have the “paperwork” needed to foreclose on a property.

Robo-Signing

- Hence, the emergence of the “robo-signer.”
- If I don’t have the requisite “original note” with “wet signatures” assigning ownership, I can simply swear before the court that I have personal knowledge of such documents and have the right to foreclose.
- Most of the time, I’ll get away with it.
- That all changed when a few foreclosure attorneys deposed foreclosure-mill employees who admitted to perjury in thousands of cases.

Affidavits of Lost Note

- Similarly, the emergence of the “affidavits of lost note.”
- I can file an affadavit before the court, stating that I had the original note, complete with wet signatures, but lost it.
- Sort of like “the dog ate my homework.”
- Tens of thousands filed in FL. Then FL Bankers Association admitted that they had BURNED the original notes. Why?

MERS: What is it?

- MERS: Mortgage Electronic Registration System
- Brainchild of Angelo Mozillo, and executives at Fannie, Freddie and the Wall Street Banks.
- In essence, a system of tax evasion to avoid paying recording fees with county registrars for transfers of real properties.
- Separates the “note” from the “lien,” i.e., the mortgage or deed of trust.

MERS: What is it?

- Mortgage is recorded in MERS name; note goes unrecorded, and is typically “assigned in blank.”
- In other words, I assign my interest in this note to “________.” To be filled in later.
- Note is then sold several times, as required to establish a “true sale” to distance the mortgage from the originator and RMBS sponsor.
- Because MERS is the owner of record of the mortgage, no fees need to be paid.

MERS: What is it?

- Problems: Wall Street has sidestepped 400 years of real-property law without asking permission.
  - Separating the lien from the note: No note, no delinquency, no right to foreclose.
  - Principal or Agent: MERS claims to be both, in violation of many state laws.
  - Assignment in Blank: in violation of many state laws.
  - Etc., etc.

MERS: What is it?

- Four State Supreme Courts have ruled that MERS does not have the right to foreclose; others are likely to follow.
- MA State Supreme Court: Ruled against "assignments in blank" as a "legal nullity."
- Federal Bankruptcy Court: Ruled against MERS right to foreclose.
- Bottom line: real property law is a creature of the states.
- MERS has clouded title to 60 million mortgages.

Mortgage Putbacks

- Warranties and representations were made by investment banks regarding the quality of the mortgages sold to REMIC trusts.
- Testimony emerging from numerous lawsuits has clearly established that the quality of these mortgages was materially misrepresented, in violation of the PSAs.
- PSAs give the REMIC trusts the right to force the investment banks to “buy back” the bad mortgages.

Mortgage Putbacks

- Monoline insurers such as Ambac also are suing, alleging fraud.
- Bear Stern emails bragged of selling “sacks of s#*t” to investors like Ambac.
- It then would sell the same bad loans back to originators.
- And it would short the stock of the companies to which it sold the toxic securities.
- These companies are now seeking damages.

Is RMBS just BS?

- Perhaps the biggest threat to the financial system is the legal status of residential mortgage backed securities.
- PSAs required all REMIC trust assets to be “in place” within 90 days of the formation of the trust.
- Also require original paperwork (notes and liens) with wet signatures to be in the physical possession of the REMIC trustee, in a vault, typically in NY.

Is RMBS just BS?

- We are now learning through testimony emerging from lawsuits that the paperwork was never transferred from the originators, such as Countrywide, to the REMIC trustees.
- If so, then some legal scholars argue that the RMBS are simply BS: unsecured debt.
- If true, the $11 trillion in RMBS are facing massive downgrades similar to what hit CDOs.
- Virtually every commercial bank will be insolvent. Game over.

What Next?

- Ultimately, the real-property legal issues will have to be resolved by the Supreme Court in each of the 50 states and DC.
- Congress cannot solve this problem with a “magic bullet.”
- This will take a decade to work its way through the courts, just as did the S&L debacle.
- However, this one will be much more costly.