

MARKETS & MORE



MORTGAGE MESS

Fraud-closure and the Housing Market

Is this another train wreck?

Websites, blogs and the nightly news have all been reporting on the latest problem in the housing market, that of potentially fraudulent foreclosures. Unfortunately, many of these reports leave out the more subtle and important points concerning the mortgage mess. Many servicers signed documents that they didn't fully read, doesn't that sound familiar? This is leading to a host of possible problems with past sales and may impact the rate and price of future sales. Understanding what has and is happening is important due to the far-reaching effects that it may have on the economy.

The first step in getting to the bottom of the problem is understanding the process by which a house sale takes place. Anyone who owns a house has been through this process at least once. Broadly speaking the steps from the buyers perspective are:

1. Sign the mortgage note
2. Make the payments
3. Forget about it

On the other side of the transaction, the process is a little more complex. There are a variety of players who all have an interest in the mortgage, all for different reasons. In general terms they are: 1) the bank that issues your mortgage, 2) the bank that buys your mortgage and bundles it with other mortgages, and 3) the investor who buys a piece of the MBS. There are more entities on this list, but we are only going to concern ourselves with them for now.

The Originator

The first player in the process is the bank that writes the mortgage. Let's lump the banks and mortgage companies together and call them originators. They are taking the other side of the transaction when you sign the note. Then they hold the mortgage for several months to make sure that the homeowner stays current, a process known as seasoning. After they are confident that the note will continue to be paid down, they sell the mortgage to a servicer. Originators are tasked with checking the creditworthiness of the borrower, ensuring that the assets and income are legitimate, and determining that the buyer is capable of making the monthly payments. As 2008 showed, this part of the process was largely suspect during the housing boom.

The Secondary Market

The secondary market is big but we can reduce it to a manageable size. After the mortgage has been adequately seasoned, the originator sells the mortgage to another bank, takes the money and writes another mortgage. The bank that buys the mortgage packages it together with other mortgages into a mortgage backed security (MBS). It is important to know that since the beginning of the subprime crisis, nearly all of the mortgages that have been written are subsequently sold to Fannie Mae and to a much lesser extent, Freddie Mac. Once the mortgage has been sold and packaged, it is issued in a number of tranches to investors. The tranches represent various levels of risk and each investor class gets a commensurate level of return.

That's Great, How Does it Relate to Foreclosures?

Let's assume that all doesn't go according to plan and a homeowner stops paying his or her payments. Normally, the bank that packaged the loan would foreclose on the property and sell it at auction. Since a certain level of foreclosures are assumed when the MBS is created, this isn't a problem for the investors. There are several current problems that are evolving.

- **The assumed number of foreclosures may be too low.** Much too low. Banks arrive at an assumed level of foreclosures in each MBS by sampling. This means that they take a certain number of mortgages from the entire

pool, check the borrowers' credit quality, income, etc... and see what percent of the sample is likely to default. They then use this as the likely percent of defaults in the whole package. According to an anonymous whistleblower, the sampling may have been defective. In the whistleblower's example, an MBS sample may have been listed as 10%, meaning that 10% of the mortgages are likely to default. However, several samples actually show much higher percentages, This would mean that the MBS has been misrepresented and might have credit and legal problems in the future. a bad situation, but one that could be overcome.

- **The documents in the foreclosure process are wrong or missing.** This is a bigger problem. When a bank starts the foreclosure process, they have a signatory that, in essence, makes a legal claim that the mortgage has defaulted. the news has reported cases of signers that did not read what they were signing. Regardless of why, this means that a foreclosure started without anyone being certain that it should have. There's more and it's worse. Many of the docs that were signed without being read have missing or wrong information. This means that the bank starting the foreclosure process doesn't have the legal grounds to do so. Assuming that the property then sells at auction, the buyer now owns a property that doesn't have clear title. OUCH.

So, with more than 30% of recent sales being foreclosed properties AND an unknown number of foreclosures have taken place under false pretense, you can understand how this might cause some friction.

The Wrap

We don't dare get into the legal aspects of how this gets unwound. We will, however, speculate on what it could do to the property market. The current wisdom holds that any slow-down or stoppage in the foreclosure process is actually good for the market because it will limit supply. We do not subscribe to that logic for a few reasons.

1. There may be a growing backlog of homeowners that would *like* to sell their houses but have been slow to put up the "for sale" sign because of the inventory on the market. This cohort, if they exist, might view the shutdown in the mortgage market as an opportunity to enter the market. Should that happen, supply would increase and the net effect on prices could be \$0. Moreover, at some point the foreclosure halt. With 11 months of inventory currently in the market, it is possible that prices could be negatively impacted.
2. There are serious questions about the title situation on every sale, not just foreclosures. If buyers are concerned over the chance of an impaired title, they will adjust the offer down, to compensate for the added risk. This will further impair the market, whether or not foreclosure sales take place.
3. Lenders could further tighten the requirements in order to lessen the risk that they will lend against an asset that is impaired in some way.

These are some of the potential outcomes. Of course, it's possible, that this will pass with a modest amount of pain and not much else. Time will tell.

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