

\$100 billion of sloppy paperwork?

Questions and answers about “foreclosure-gate.”

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As the housing market moves through the late stages of a long and painful correction, widespread errors in foreclosures have come to light. Each day brings new and troubling disclosures, calling the foreclosure process into question. In this paper we broadly define the issues around foreclosures, look at potential for repurchases by the loan originators, and explore the potential impact on mortgage related securities.

What’s the problem’s source?

Mortgage servicers have been overwhelmed by the sheer volume of delinquent loans. The Mortgage Bankers Association reports that 13.97 percent of loans are in foreclosure or delinquent by at least one payment. In more typical times, mortgage servicers efficiently process mortgage payments, and service the occasional delinquent borrower. For those services they annually receive less than one percent of the loan’s principal balance.

This business model worked well in ordinary times and very well in the housing boom. But with so many borrowers now delinquent on their mortgages, servicers now appear to be struggling. They are either offering borrowers loan modification or pursuing foreclosure. In our opinion, the combination of a large volume of delinquent loans and under-staffed mortgage servicers has resulted in spotty foreclosure documentation. And spotty documentation is at the heart of the foreclosure challenges.

Are these issues nationwide?

Foreclosure headlines are centered on the states with judicial foreclosure proceedings. In these states, the lender/plaintiff must file a complaint against the borrower. A judge must examine the complaint and all relevant documents. Many times the judge relies on the plaintiff’s (the servicer’s) representations during this process.

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- The sloppy handling of foreclosures has called into question whether the quality of loans sold to investors were accurately described by originators. With the stakes involved, it will take years of litigation before investors see any money.
- While large scale loan repurchases from securitizations are unlikely, this would be a major positive development in the non-agency mortgage sector.
- While delays in processing foreclosures will delay the housing market’s recovery, fewer distressed sales mean home price indices may show some strength.

In one widely publicized case a servicer’s employee stated that documents submitted to the court under affidavit had not been fully reviewed. The employee admitted to signing thousands of documents a day without having fully reviewed them, a practice called “robo-signing.” While efficient, this process doesn’t always hold up to judicial review. That’s why several large servicers suspended foreclosures in judicial states while they reviewed their foreclosure processes.

While this will slow down and increase the cost of foreclosures, document defects can and need to be corrected. Borrowers who are delinquent on their mortgages are unlikely to avoid foreclosure just because a servicer’s paperwork was sloppy. Shaun Donovan, HUD secretary, noted the absence of systemic problems, but did say that “throughout our reviews, as we uncover bad practices, cutting corners or sloppy processes that disregard or ignore the rights and protections of any homeowner, we’re committed to forcing institutions to change the way that they conduct business.” While there have been calls for a national foreclosure moratorium, that idea gets virtually no support from Administration officials such as Treasury Secretary Tim Geithner and FDIC Chairperson Shelia Bair.

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Judicial Foreclosure States

Okalahoma	Kansas	New Mexico
Pennsylvania	Florida	Kentucky
New York	South Carolina	Hawaii
Louisiana	Delaware	South Dakota
Illinois	Maine	Vermont
North Dakota	Indiana	Nebraska
Ohio	Wisconsin	Iowa
New Jersey		

Source: Barclay's Capital

Were investors misled?

The sloppy handling of foreclosures has called into question whether the quality of loans sold to investors were accurately described by originators. If the quality was lower than represented, then the originator may be contractually obligated to buy back the loans. Government-sponsored enterprises such as Fannie Mae and Freddie Mac, and private investors would have potential claims against the loan originator for breaching its representations about loan quality.

Fannie Mae and Freddie Mac have had some success at getting originators to buy back loans for breaches of representation and warranties. Their regulator, the Federal Housing Finance Agency (FHFA), has retained legal counsel to further explore additional claims against originators.

Private investors, however, face higher loan repurchase hurdles than federal agencies. One key first step is obtaining the loan files to establish evidence that representations and warranties regarding the loans were not accurate. These files are not easily obtained. Under the legal documents governing these transactions, investors are generally required to act in a collective manner to pursue such claims and it is often difficult to find the number of investors needed to succeed. Several large investors who have the resources necessary to be taken very seriously, however, now appear to be pursuing claims with regard to the securities they hold.

Analysts estimate that buy-back amounts could easily reach into the tens of billions of dollars, and could potentially climb as high as \$100 billion. We think of

this as a redistribution of losses from the investor back to the originator. Given the stakes involved we would expect a lengthy battle, and believe it will take years of litigation before investors see any money.

Will securitization trust structures hold up to legal scrutiny?

Some question whether mortgages sold into trusts as part of the securitization process were properly titled. The American Securitization Forum addressed this issue in a statement released October 15:

"In the last few days, concerns have been raised as to whether the standard industry methods of transferring ownership of residential mortgage loans to securitization trusts are sufficient and appropriate. These concerns are without merit and our membership is confident that these methods of transfer are sound and based on a well-established body of law governing a multi-trillion dollar secondary mortgage market.

We have consulted with a number of ASF's member law firms who are among the largest and most well-respected firms in the world, including Bingham McCutchen LLP, Cadwalader, Wickersham & Taft LLP, Dewey & LeBoeuf LLP, Hunton & Williams LLP, Orrick, Herrington & Sutcliffe LLP, Sidley Austin LLP and SNR Denton US LLP. Each of these firms believes that the conventional process for loan transfers embodied in standard legal documentation for mortgage securitizations is adequate and appropriate to transfer ownership of mortgage loans to the securitization trusts in accordance with applicable law. This process is sufficient to establish ownership by the securitization trusts. Over the course of the next two weeks, ASF will be releasing a white paper providing additional legal and market practice background regarding this process."

In short, we are currently unaware of any evidence to support the concern that the process does not meet legal standards.

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How will it affect mortgage related securities?

Here's how we believe these events will affect mortgage related securities:

Broad Impacts: Delays in processing foreclosures will delay the housing market's recovery. Excess inventory must be cleared before housing prices can begin a sustained recovery, and existing home sales are poised to slow as foreclosure sales drop. Conversely, fewer distressed sales mean home price indices may show some strength. The increased scrutiny on foreclosures may also lead servicers to more aggressively pursue alternatives, such as short sales or loan modification. If that occurs, it would somewhat offset the delays we identified above.

Agency Pass-throughs: There should be limited impact on the agency mortgage market. The Agencies repurchase delinquent loans, at par, after 120 days. The ultimate foreclosure resolution doesn't impact security credit worthiness or prepayment pattern.

Non-Agency Mortgages: The impact depends on position in the capital structure. Broadly speaking, this is a slight positive for subordinate bonds, since losses will occur more slowly than market expectations. Senior bonds are likely to receive less cash flow due to longer liquidation timelines, which is a slight negative. A major potential positive for the sector would be large scale loan repurchases from securitizations.

Every day there are new revelations regarding "foreclosure-gate." We will continue to monitor these developments and their investment implications. Overall, the questions and issues that have emerged about the foreclosure process represent another negative chapter in the saga of the housing bust. Overextended borrowers, understaffed servicers and inadequate oversight created conditions that attorneys, judges and lenders will be sorting out for some time.

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