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The Mortgage Liquidity Crisis; Secondary Market Issues Affecting Mortgage Bankers

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MORTGAGE BANKERS ASSOCIATION®

Investing in communities

The good ‘ole days

- 2003-2005:
  - Frothy Market with Strong Volume and Execution
  - MLPA’s Continually Updated and Strengthened by Investors; Subject to Little or No Legal Review by Originators
  - Strong Originator Volume and Revenue, Combined with Rising Property Values, Masks Most Issues

Approaching Storms

- Late 2005: The Storm Approaches
  - Fed Slams on Brakes and Raises Short Term Rates (17x in two years): Mortgage Volume Drops and Housing Prices Weaken
  - FAS 140: FASB's attempt to provide more guidance on appropriate accounting treatment for securitizations and other off balance sheet arrangements
  - Reg AB: SEC introduces more uniform disclosure rules into the asset backed market
    - Limitations on Percentage of Pool that can be delinquent
    - Expanded disclosures for 20%+ originators
  - Uncertainty Created by Foregoing Combined with Traditional End of Year Decrease in Whole Loan Demand Further Depresses Pricing

2005 Year End Situation

- 2005: Year End (particularly November and December) sees spike in repurchase demands from Wall Street
  - Source of Claims is Largely EPD Claims
  - MLPA's Provide Broad Rights to Investors with Little Contractual Obligation to Timely Notify Originators or Mitigate Losses
  - Originators Cash Flows Heavily Squeezed: Infrastructure Scaled for 2005 Volume Combined with increasing repurchase demands, declining volumes and revenue

2006 Conditions

- Tightening liquidity due to rising EPD claims
- Investors netting cash on loan sales to pay claims
- Many investors also provide warehousing through affiliates, giving additional sources of offset on EPD claims
- Warehouse interest income decreases with increasing ARM volume (typically a source of 25%-40% of income)
- Borrowers cannot refinance based upon increased home equity
- Rapid change in guidelines leaves lenders with unsaleable inventory

2007 Forecasts

- About 15% of all outstanding mortgage loans in US are subprime and about 18% are alt-A (about $950 trillion in outstanding US mortgages according to Bear Stearns)
- Over 60 day delinquencies (Feb '07 vs Feb '06)
  - Subprime: 12.44% vs 7.84%
  - Alt –A: 2.6% vs 1.22%
- Lower end of housing market very soft
  - Housing prices falling in low end of market as high LTV/new home buyer products pulled from market
  - High end remains stronger with more liquid/higher FICO borrowers

2007 Forecasts

- Continued tightened liquidity:
  - Investors rejecting locked, pre-approved inventory due to quickly changing guidelines.
  - Executions down: (subprime loans selling at 2-10% under par (90-98), alt –A at par or less, and prime at par to 101).
  - 2nd mortgage market non-existent (pricing on seconds well below 80%)
    - Traditional home purchase/piggyback combo loan now a loss leader
- Increased governmental focus and litigation
- Increased risk in subprime ARM market:
  - 32 percent of subprime ARMS due to reset in next 12 months
  - Payment adjustments will range between 1%-3% of UPB
    - *Source: RBS/Greenwich Capital*

EPDs; Principal Issues

- Underwriting/Credit Quality: Originators not adapting policies to changing market and products
- Hand Off; Borrower Communication: Servicing transfer handled poorly resulting in lack of timely borrower communication; significant issue in subprime (note that only about 8% of EPD's involve borrowers having past foreclosure or foreclosure actions according to FATCO study)
- Payment Shock (Q2 '07 will see largest reset of interest rates on subprime loans in past several years)
- Servicer Expertise: lack of expertise by new servicer with product type
- Information Systems: failure to provide accurate information to new servicer (e.g., filling S/S number in borrower telephone fields)

EPDs; Investor/WH Lender Response

- Warehouse Lender Response
  - WH Lenders are secured
  - Tend to be willing to work with borrowers as long as some liquidity is available
  - Will seek blanket liens

- Investor Response:
  - Originally willing to work with lenders
  - Now seek a buy it all back approach – aggressive pursuit of repurchase claims with failing of many mortgage companies
  - Immediate cut off of previously approved product (even if locked)
  - Some have sought some or all equity of seller; now have backed off on that approach

EPDs; Originator Response

- Traditional Response
  - Reprice Loans and pay balance due (i.e., spread between original price and reprice amount)
  - Repricing driven by lack of capacity to warehouse non-performing loans and lack of servicing expertise
  - Little senior management or outside counsel review
- New Response
  - Get real
  - Heavy push back on repurchase claims: servicing logs to outside counsel
  - Senior management and outside counsel now involved – some litigation has arisen in more extreme cases
  - Immediate need to seek additional liquidity
  - *Review BK options including ABC*

EPD Fall Out; Originators

- Many originators (particularly subprime) have closed doors or declared BK including ResMae, MLN, Acoustic, Ownit, New Century, People's Choice
- Others Face Troubles: Option One, HSBC, Accredited
- Originators revisiting and negotiating MLPA's
  - Requiring investors to provide early notification of EPD Loans and to timely make repurchase claims
    - Equivalent information needed for Reg AB
  - Active participation in selection of servicers
  - More focus on investor (what is their reputation for handling repurchases?) and servicing transfer mechanics
- Originators slashing costs; revising L/O compensation plans to track profitability and performance
- Founders reinvesting '04-05 distributions

Fall Out; Accounting Issues

- Increase in loan loss and loan repurchase reserves
  - Reserves constantly being adjusted as market continues to soften
    - Re-pricing on seconds non-existent
- Sale or Financing: scale of repurchases has led at least one big 4 accounting firm to question whether FAS 140 permits sale treatment
  - Repurchase based upon performance introduces recourse
  - True sale opinions from outside counsel being required in some cases
  - Impact of treatment as a financing
- Going concern qualifications
- Delay in audit completion
  - Impact on regulators, investors and warehouse lenders
  - Other debt covenants; opportunities for hedge funds

Fall Out; M&A

- EPD Claims uncertainty slowing deals
- Buyers generally seeking to clean up all risk; known and unknown
- Claims settlements; range of UPBs
- Investors generally cooperating depending upon buyer and future relationships

Going Forward

- Combined warehouse and forward financing arrangements can no longer be relied upon as source of liquidity
- Flight to credit on loan products
- MLPA's matter
  - Understand loan level and entity level representations and remedies
- Know Your investor: history and reputation for repurchase claims; who is their servicer
- Accountant: consider need for national vs regional firm
- Continued audit delays
  - You are not alone
  - Keep constituents notified
- Don't be bashful – investigate and dispute (where appropriate) repurchase claims
- Review all investor reconciliation reports closely
- Seek global settlements for all EPD issues; also consider insurance

THANK YOU.

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