Seer Capital Management LP
489 Fifth Avenue, 17th Floor
New York, NY 10017
212-850-9000
www.seercap.com

Foreclosuregate – What to Worry About, and What Not to Worry About

Mortgages are once again garnering headlines. A number of disparate issues surrounding bad mortgage loans have now coalesced into what some are calling "Foreclosuregate". Fifty states' Attorneys General are investigating foreclosure processes at the nations' largest servicers. The entire complex legal and accounting process of securitizing mortgages, the machinery and minutiae that transform John Doe's $250,000 mortgage in Iowa into a security generating cash flows for Mortgage-Backed Securities (MBS) investors across the world, is being called into question. It should not be surprising that MBS, the arcane and complex market already fingered as the epicenter of a global financial crisis, is spawning alarmists. But we believe that much of the fuss is overblown, and will blow over. The one big exception: banks (more on this later).

This latest chapter in the mortgage crisis brings to mind three key questions:

- **Are these issues likely to have a meaningful economic impact?** We believe that many have exaggerated the problems, as they relate to the ability to foreclose on delinquent borrowers and the legitimacy of existing securitizations. As a result we find "Foreclosuregate" unlikely to significantly impact the housing market or broader economy.

- **What do these controversies mean for banks?** Of all of the issues being discussed, we believe that the obligation by banks to buy back improperly originated mortgages loans is the most significant. But sizing the problem is extraordinarily difficult and, whatever the outcome, it is likely to play out over several years. Our extreme downside scenario suggests that such obligations could end up costing banks as much as $40 billion a year for the next few years, which is about half of the annual earnings of the industry's major players. We do not put a high probability on this outcome, as there are many hurdles, but such a large worst-case size warrants further discussion.

- **What do these controversies mean for MBS investors?** We do not believe that MBS investors are terribly vulnerable to Foreclosuregate. Some of the issues may result in moderate delays in the foreclosure process, but our scenario analysis already assumes that foreclosure timelines would be extending. The potential for forced buybacks of improperly originated loans could be a bonus for MBS, but we would not ascribe a high value to that possibility. Net net, these events are not likely to significantly impact valuations of MBS securities. For example, on a representative MBS bond, even extending foreclosure timelines by 6 months would reduce expected yield by 50b.p. or less.

The Elements of Foreclosuregate

MERS, the Mortgage Electronic Registration System

MERS was founded by a consortium of the country's largest mortgage lenders, including FNMA and FHLMC. The process of recording and assigning mortgages is a rather complex and cumbersome one, with different rules and procedures in 50 states and even in some municipalities. MERS was created to help make mortgages more liquid by creating a parallel electronic mortgage recording system, much like DTC for securities. This facilitates pooling into securitizations and subsequently trading the securities issued. The benefits of MERS are unambiguous. If the market wishes to have a modern, liquid mortgage market (as the current administration clearly does, to wit TALF, PPIP, etc…) and hopes to attract global investors (as the prior administration clearly illustrated that it did in bailing out the GSEs two years ago), then MERS is mandatory.

Of course, at the local level, administrators take their procedures very seriously and are not necessarily persuaded that a system like MERS is for the greater good. Some legal minds have poked holes in MERS and suggested that the whole concept is invalid and calls into question which holder actually has the right to foreclose on a borrower. This is an extreme and iconoclastic view. Even more dire, some have claimed that using MERS does not fulfill the legal requirements necessary to transfer mortgages into securitizations, and therefore the securitizations are invalid and have to be unwound.

In response, several leading law firms have spoken out and totally debunked the idea that using MERS in any way jeopardizes the effective transfer of mortgages. Whether or not there are clever legal arguments that undermine MERS, the public policy issues in support of MERS are compelling and will win out. We think this issue will fade.

"Robo-signing"

In some jurisdictions, where foreclosures are a judicial matter, before a foreclosure proceeding can begin, the lender must submit certain specified paperwork to the court. That paperwork must include an affidavit from the servicer to the effect that the file has been reviewed and is in order. The nuance: does the affidavit mean that the signer *personally* performed those functions or does the affidavit mean that the signer is merely attesting that the servicer followed procedures involving several people employed by the servicer? This is a distinction only a lawyer could love.

The term "robo signing" has been coined because some of employees who were signing such affidavits have indicated they signed hundreds or even thousands per week. Some media reports have suggested that the robo-signing phenomenon indicates that borrowers may not have gotten due process, and hence some borrowers shouldn't have been foreclosed upon. This is the Holy Grail of the complaining crowd - a foreclosed mortgage borrower who actually could have made payments and stayed in the home. We dismiss this idea, that robo-signing is likely to have resulted in many instances of viable borrowers losing their homes. By the time robo-signers are involved, the loan has usually been delinquent for an extended period of time and alternatives have been exhausted. Notably, a recent court decision held that robo signing per se is not violative of borrowers' rights, as long as the files are accurate and required procedures were followed.

Foreclosure Moratoriums

Foreclosure moratoriums are bad public policy. They have an appealing ring to the uninitiated, but communities have found that the worst thing for a neighborhood is leaving properties in limbo. Properties deteriorate, and borrowers rarely experience a reversal of fortune. And so the best results occur when properties are rehabilitated back into the economy, with new (solvent) owners buying at a new (market) price while taking out a new (appropriate) mortgage.

Moreover, moratoriums are unlikely to save borrowers. Based on figures from some of the largest servicers, the average foreclosed borrower has not paid their mortgage for over 1.5 years; and, in about 20% of the cases, the borrower has already abandoned the home. Allowing more time is not the answer to these defaults or the resulting losses.

Several large mortgage loan servicers (most notably Bank of America, JPMorgan, and Ally, aka GMAC) suspended foreclosures in response to allegations of process issues like robosigning, using the period of these suspensions to review their procedures. In most cases these were only "foreclosure halts", meaning the process continued moving forward except for final sale, rather than stopping as would happen in a full moratorium. Already the largest servicer, Bank of America, has resumed their full foreclosure process. We expect these voluntary foreclosure suspensions will be brief. We do not expect policy makers to require additional moratoriums, with the White House, FHFA and FDIC on the record in opposition.

Bank Repurchase (Buyback) Obligations

Among the various issues surrounding Foreclosuregate, we believe this to be the most significant. The implications for MBS investors, however, will either be de minimis or positive. If, in fact, investors are able to induce the loan originators (or their successors) to buy back faulty loans at par, returns on discount-priced MBS would increase significantly.

It is useful to bifurcate the bank repurchase obligations into two types, those related to paperwork improprieties, and those related to faulty underwriting and or servicing. With regard to the former, some alarmists have suggested that paperwork problems might preclude foreclosure or even invalidate entire securitizations. We give no credence to this suggestion. We believe these suggestions may be the result of misunderstanding of the actual process required under the Uniform Commercial Code to transfer interests in mortgage loans.

The more interesting buyback controversy, indeed to our mind the most significant part of the whole raft of foreclosuregate stories, is bank obligations to buy back loans that did not meet their stated underwriting guidelines. When mortgage loans are transferred into a securitization, the issuers "represent and warrant" in their documents that the loans met certain underwriting criteria (loose as those criteria may be). MBS investors can sue originators for putting loans into the pool that did not actually meet the given underwriting criteria (over and above what was sometimes a generous bucket for underwriting exceptions).

While only a file-by-file review can prove it, we do suspect that there may be many instances of such errors. With everything we know about the 2003-2006 mortgage market (rapid growth, small companies, weak controls, poorly trained personnel, misaligned incentives, etc…), it stands to reason that some loans that did not meet even the liberal criteria of the day still wound up in securitizations. Recent testimony by a specialized firm that was used to audit loan files for securitization certainly suggests underwriting violations are not an isolated problem.

Sizing the problem is unusually difficult because there are so many decision nodes which require estimates in order to calculate a dollar figure for the banks' potential liability. Nonetheless, it is helpful to bracket the problem between two points, even if those two points are as far apart as $25 billion and $200 billion, over several years. (Note that this figure does not include other fallouts from this crisis, i.e. somewhat longer timelines to resolves problem loans and perhaps additional operational costs to improve procedures.)

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Our estimates start with aggregate default estimates. If a mortgage loan is performing, then the MBS investor has not been harmed by any breach and therefore has no basis to sue. Next, we assume that not all loan files are reviewed, as access to loan files can be limited by servicers, depending upon the guidelines established at the time of securitization. Of those loans that default and are reviewed, we assume some have an error, and further that only some percentage of *those* have an error that is material. We then use our loan level loss model to estimate the losses that buying back the necessary loans at par will generate. This loss equals the potential projected buyback liability of the banking system.

The exercise suggests two conclusions. One, many subjective assumptions are required. Two, the problem does have the potential to be very large indeed. The combination of great uncertainty, a potentially large magnitude, and the litigation process needed to arrive at a conclusion will keep this controversy hanging over banks for a long time.

Seer Capital Estimate of Potential Mortgage Buyback Liabilities System-wide on $5.2 Trillion of Mortgages

Parameter*	Percentage of Total Base case – Worst case	Dollar amount (bln) Base case – Worst case
Cumulative mortgage defaults	24-30%	$1,233- $1,566
Percentage of loans reviewed	36-58%	$448- $832
Percentage of reviewed loans with an error or omission	64-75%	$336- $578
Percentage of errors/omissions that are material	36-43%	$128-251
Expected severity of loss	51-60%	$65- $193
Potential liability - 5 year horizon	Approximately $15 to $40 billion per year	

* Each parameter is a weighted average of estimates for agency mortgages, non-agency mortgages, second mortgages and HELOC's.

Keep in mind also that it is by no means assured that investors will be successful in forcing these repurchases. Below are some of the issues that will complicate investors' attempts to force buybacks.

1. While there are many poor quality loans and many defaulted loans, these flawed loans do not necessarily trigger a buyback liability. Because underwriting criteria was often quite loose, and because we have seen an dramatic decline in home prices and spike in unemployment, many bad loans simply have to be borne by investors and cannot be put back. Banks are only liable if they securitized loans that were not as they were represented and warranted.
2. Forcing buybacks of loans in MBS requires concerted action by a specified percentage of bondholders, who are a) very difficult to identify and organize, and b) often in different positions and want different outcomes;
3. Forcing buybacks of loans in MBS requires indirect action, i.e. via a trustee, who may require indemnification and who is often underpaid and understaffed;
4. Buybacks are a loan-by-loan process, which is costly and includes privacy hurdles;
5. Proving a breach on a loan written several years ago requires some forensics. One example – how easily can one prove that the loan represented as an owner-occupied property in 2005 was actually an investor property at the time?;
6. Proving fraud by the loan originators requires proving that the investors were intentionally misled; proving intent is difficult;
7. Must be settled via litigation, which draws out the process;
8. Is not viable with defunct entities (of which there are several), in some cases even if they've been acquired.

One soft argument to keep in mind when sizing the bank buyback obligations is what we'll call "negotiation asymmetry". The particular wording of repurchase obligations was never a focus for investors or rating agencies. The nature of the obligation can vary quite a bit from deal to deal, but those differences were never considered meaningful (the wording of the obligations or creditworthiness of the entity making reps and warranties, for example, never effected trading levels). It is fair to say that representations and warranties were a detail not usually focused on by investors. However, issuers themselves did focus on their potential liabilities under representations and warranties, and as a result tried to make them as loose as possible. As a result we find that the actual provisions in the documents are heavily skewed in favor of issuers and against investors.

It is further instructive to consider that, if investors were likely to be broadly successful in putting back loans, it should have already happened. The repurchase obligation may be news to people outside of the MBS sector, but it is not news to investors. If we "carbon date" the mortgage crisis to the first big decline in ABX, we are nearly four years into the mortgage crisis. If this is such a potent weapon, why is it only surfacing now? Data from one large bank showed that, in the case of mortgage insurers, who, operationally, can far more easily force a repurchase, such repurchases have been less than 10% of defaults.

Conclusion

The media has taken Foreclosuregate and run with it. And who can blame them? On one side, we have the iconic American homeowner, a sympathetic character only trying to live out the new American Dream of owning a home. One the other side, we have Wall Street and the securitization machine, assumedly rapacious, arrogant and regularly accused of behavior that spans the continuum from honest mistakes and sloppiness to being clever and skirting the rules to actionable fraud. Enter the politicians, who desperately want to believe that there is some choice between another 5-7 million Americans being foreclosed on, and "candy store" loan modifications -- where consumers just get large swathes of debt forgiven. Such political intervention is exacerbated by the fact that we are in election season and that it's not very popular to be perceived as pro-bank. And so, the stage is set for controversy.

We believe that a lot of the controversy is form over substance. However, we do not intend that to sound dismissive. "Form" does matter, especially in matters of the law. But if the form matters, and sloppy paperwork and record keeping matters, the next question is "what should the remedy be"? Do we think that delinquent borrowers whose loans were not properly processed should have their mortgage expunged? The law includes the concept of "unjust enrichment", i.e. that in settling a contract dispute, the remedy should not unfairly reward one party. So while we are hardly shocked that there are paperwork deficiencies in the mortgage lending business, we think most of those problems will be cured and draconian scenarios are not credible. In the meantime, the various state Attorneys General do have the industry in their cross hairs, and it will likely be expedient for both sides to come to a midpoint with banks willing to allow some process concessions while paying a fine that is not disruptive to the system during this still fragile point in the economy.

The real issue to watch will be the success of investors in forcing banks to buy back improperly underwritten loans. While the hurdles are not small, the potential liability is very large. But even in the "worst case", the buybacks will be a drag on banks' earnings over several years and not a cataclysmic event. Of course, the "worst case" for the banks would actually be an unexpected boon to many MBS investors, who would receive par for mortgages bought at a discount.

Karen Weaver, CFA

Head of Market Strategy and Research

212 850 9010

October 25, 2010