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A Lawyer's Perspective

Bailout drilldown

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It has been difficult to find anything about the current financial crisis that explains it in terms that we real estate people understand. So when I received an analysis last week that drilled down to details, I wanted to share it with you.

The author of the analysis is Talcott J. Franklin, an intellectual property attorney with Patton and Boggs, one of the most prominent and influential law firms in the country. West Publishing recently released his book on Mortgage and Asset Backed Securities Litigation along with his fascinating eight-page white paper. Google him for more info and a copy of the paper.

Before I try to summarize Franklin's analysis and add my own perspective, I must first point out that his paper takes no sides in the "bailout" debate. Comments on the technical points discussed in this column are my own.

Let's start by saying that you gave a mortgage to a lender to finance your purchase of a property. It doesn't matter if the mortgage is on a single family home or an office building, since both can be funded by Mortgage Backed Securities (MBSs).

The Lender sells your loan to a purchaser, who sells it to a depositor, who deposits your loan into a Trust, which is administered by a servicer and a trustee. The trustee sells MBSs to fund the trust and the servicer receives your loan payments. The servicer pays the real estate taxes and insurance from your total payment and sends the mortgage payment portion to the trustee. The trustee pays out that portion to the trust investors, called certificate holders.

The loan includes assurances that the underwriting analysis was sound, that you have had a good payment history and that loan information is correct. Certificate holders are paid in order of priority level. Profits first go to AAA certificates, then down the line. Losses first go to the lowest ranked, then work their way back up the food chain. Given these basics, let's illustrate the current financial crisis with some hypotheticals.

Hypo #1 was the focus of Secretary Paulson's congressional testimony on the bailout. Your loan is past the basics and it is now in a trust originated by Oh-Oh Bank, which acted as Purchaser and depositor into their newly-created O-No Trust, for which Oh-Oh acts as Servicer. O-No Trust is primarily sub-prime loans like those popular "NINJA" (No Job, No Income or Assets) loans, loans from Cracker Jack Mortgage Brokers, with an approval promised in every application, and internet loan applications by "Fixum & Run Investors, LLC."

After the market tanked, Oh-Oh is left holding the remaining O-No certificates, with the monetary value of tidal wetlands. After foreclosure rates jumped on O-No Trust loans, Oh-Oh suffered big-time losses and can't fund new loans. Yesterday, your Realtor sent your buyer's mortgage loan rejection letter from Oh-Oh along with a notice that the contract of sale mortgage contingency clause allows them to back out of the deal.

Hypo #2 has the same facts as above except that LB Investment Bank bought into O-No Trust as a Certificateholder. When the water level of foreclosure losses reached nor'easter proportions, LB drowned in red ink, with no flood insurance.

In Hypo #3, your loan was originated by Do-Diligent Bank and transferred to their DD Trust. DD Trust loans are performing like the Borgata on a Saturday night in July. The rest of the market is performing like the AC Tropicana before the NJ Casino Control Commission rejected its relicensing. Even though DD Trust loans are performing well and DD plans a hold to maturity, certificates values can plummet based on a relatively new accounting rule: "Mark-to-Market."

If there is a "non-temporary impairment" in the asset, that rule requires DD Trust to value its assets, including your loan, as if everything were going to be sold now, based on sales of other MBSs. It gets marked down to fire-sale prices even if the impairment doesn't justify such a liquidation value. Alternately, if DD categorizes the certificate on the book with intent to sell at some future date, the certificate is marked down to today's market value.

Thus, when foreclosures skyrocketed, Mark-to-Market values tanked, and certificates in these categories caused loan-to-asset ratios to spike over the regulatory limit. This results in a halt in lending and the current crisis.

The U.S. Treasury proposes to buy both the O-No Trust and DD Trust MBS certificates at values essentially assuming no foreclosure crisis and no Mark-to-Market rule. The theory is that Oh-Oh Bank and Do-Diligent Bank would make new loans and regain financial stability. Once Wall Street sees this, the theory goes, all other MBSs will increase in value and private capital will come back into the market.

Will Treasury consider the intrinsic value of O-No and DD underlying collateral? If so, how will that collateral be valued? What about trusts with mixed Oh-Oh and Do-Diligent-type loan originations? As Mr. Franklin points out, it will be years before we know if the American taxpayers win or lose on the Bailout. More on all this and the bailout legislation next week.

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