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The Fix Is Not a Cap on Losses; It Is a Floor on Values – *Uncle Sam needs to have faith in America*

Banks and Wall Street have invested heavily in the mortgage business over the last five to seven years, seeking above average returns. They bought mortgage processors, lenders, and brokers. They build their syndication and securitization teams to enhance the flow of funds. I deeply believe that much of this has been good for the American homeowner and the global financial system. However, some of this has been driven by the lure of excessive gains and fungible risks. The lessons here are that in the long run, there are no excessive gains and that the sale and transfer of risk does not eliminate risk. It just moves it around.

The crisis facing the financial system and the residential real estate market in the United States is due to mistakes made by both banks and homeowners. The problem is that the banks are large enough for the government to fix their problem with taxpayer money; the homeowners are too small and too many for the government to fix their problem with money.

At the corporate level, the losses have been booked and the senior management of the firms has been focused on the liquidity of their balance sheets, as they should be. At that level, money and mergers solve a lot of systemic problems. These executives are not involved deep down the food chain with the issues facing the homeowners. They cannot deal with a multibillion-dollar problem on their balance sheet one mortgage at a time. That is delegated to those closer to the individual mortgages. This is where the problem resides. It is also where the long-term systemic fix needs to be made.

In dealing with this crisis, the government needs to remember the social contract all Americans made with our government and renew at every election. The government of the United States and each individual State of the Union need to appreciate that when a lender forecloses on a house, you break a family; you wound a neighborhood, and hurt a community. Do that enough times and you rip the fabric of our society. America is about to do that to a huge number of homeowners, neighborhoods and communities all across the country. The long-term consequences will be deeply damaging. The time has come for government to play a role.

When people buy a house they do not stop investing in that home. They remodel the kitchen, buy new appliances, paint and wallpaper, improve electrical and plumbing, replace the roof or put in a swimming pool. They continue to make investments over the life of their ownership. They do this with the firm understanding, supported by real estate brokers, bankers and appraisers, that their investments increase the value of their homes. For many Americans, this is their nest egg, the

~ 1 ~

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money they will retire on when they stop working. So after all that investment, it can be shocking to learn that the current market value is less than the amount due on the mortgage.

When a family cannot pay its mortgage, or finds that the market value of their home is less than the face value of their mortgage, reality sets in very fast. David Streitfeld, a writer for the New York Times, wrote an excellent article in the September 19, 2008 issue called “Coming Up Short.” The article is one of the best examples of what is going on, down the food chain at the banks, mortgage companies, loan service companies, and financial institutions. There are many such articles on the Internet and the enormous pain and frustration they all express is deeply disturbing.

In the Streitfeld article, a family gets a new job and wants to move. When they went to sell their home, they discovered that the market had imploded and the best offer they could get was for less than the value of their mortgage. They acted in good faith and tried to execute a “short sale” and sought lender approval. In the end, it was lender intransigence and bad faith that led to failure. This is a sad, regrettable and avoidable story.

Part of the problem facing the financial system today is denial. It is not denial on the part of regulators or on the senior executives of banks or financial service firms, or of traders or homeowners. It is denial on the part of mortgage lenders, loan service companies and syndicated mortgage portfolios trustees. They seem unwilling to accept the fact that property values have fallen sharply, or the word of any borrower who claims distress. But that does not relieve the lender of responsibility to act honestly and fairly to mitigate loss. Furthermore, it does not mean that all borrowers in distress are dishonest. This is part of the problem that needs to be addressed.

Lenders may be advised to take no action that could waive their rights to full recovery. Lenders seem stuck on the idea that there is a future value to be recaptured and that the homeowner is hiding like a thief. Distrust breeds distrust, which leads to failure. So to bridge this gap and break the structural and legal logjam, government should impose a solution.

Based on conversations with real estate lenders and lawyers, few participants in the real estate market, at the level of the individual home or mortgage, bring a capital markets perspective to the problem. Furthermore, there is a deeply imbedded faith in the face value of an existing mortgage, independent of current market forces. As the Streitfeld article makes clear, lenders view a residential short sale as a lender approved sale where the property is sold for less than the face value of the mortgage, and that difference must be reclaimed from the original homeowner. This does not work. Failing that, there is foreclosure and sale. Foreclosure is a court ordered auction of the property for substantially less than the face value of the mortgage; that lost value can never be recaptured by the homeowner, nor for that matter can homeowners ever recapture their additional investment in the improvement to their homes.

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Conceptually, it seems to me that everyone is missing an important point. If I buy a stock for \$50, its price falls. I sell it for \$30, I do not care that the buyer is the same person who sold it to me. What I care about is preservation of remaining capital. I made a mistake, I was wrong. I acknowledge the mistake, exit the position and move on. Applying this perspective to the current residential real estate market and mortgage market could put a floor on the value of residential real estate.

Here is how the government can help. Before a house, that is the primary residence of a homeowner, can be put into foreclosure, Federal law should require that the lender and the borrower each provide the other with a current and independent appraisal of the property and engineering report, each paying their own expenses. This lays out for both parties what the current estimated value of the house is and the physical condition of the property. It also tells both parties the reasonable band of value for the home, taking into consideration the physical condition and marketability of the home. It provides both with transparency about the other party's view of the current market value. Future value of the property, either up or down, is not part of this assessment; the reasonable estimate of current market value is all that matters.

Once the lender and the homeowner have a reasonable view of value, the homeowner should be given 90 days to buy out the mortgage, from the current mortgage holder, at the difference between the two valuations. If qualified and professional appraisers and engineers make the appraisals, the spread should be reasonably small. So, for example, if the lenders appraisal says the property is worth \$350,000 and the borrower's appraisal says it is worth \$300,000 the buyout of the mortgage is \$325,000. Taking transaction costs and legal fees into consideration, both parties would be better off.

The borrower should then have 90 days to reach out to family and friends, another bank, or find a way to raise the \$325,000 to buy the mortgage from the lender. If the borrower cannot raise the money, then the house can be sold at the \$325,000 price. Please note that I am referring to the mortgage note, not the house. The house remains with the homeowner. What changes is the holder of the note. In arranging the funds to buy the note, the homeowner has the opportunity to make it clear that the future payments will be based on the purchase value of the note, not the original amount. Other terms and conditions can be pre-negotiated with the new holder(s) of the note. If the alternative is a sale, the buyer putting up the \$325,000, acquiring the note and accepting a deed in lieu of foreclosure from the homeowner accomplishes this.

On the lender's side, once the loan is in default, it has been included in the corporate reserve calculations on the lender's books. The lender has taken the charge to income, so whatever they subsequently recover is taken back into income upon sale of the note. After the 90-day period, if the borrower cannot raise the new funds, or get a sale made, then the foreclosure process takes place. The lender executes with the buyer a deed in lieu of foreclosure, releases the homeowner from any and all future claims and auctions off the property. The lender must be required by law

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to liquidate the property at whatever price is offered at auction from any and all bidders. The lender cannot be allowed to put a reserve price on the property. The objective here is to get the property into stable hands and help the market clear. And since a time restriction of 90 days is placed on the homeowner, so one must be placed on the lender. The faster the real estate is sold, the faster the market clears. Nothing above limits a lender and borrower from negotiating a modification agreement to achieve the same end or to reasonably extend the time period to permit the loan to trade.

Let's think about what this does. First and foremost it forces everyone involved to deal openly and transparently with reality and each other, and slows the initial foreclosure process. Second, it gives a family, facing foreclosure, time to save its home by reaching out to family and friends or find a proper buyer. Third, by moving the mortgage into the hands of family and friends, the homeowner has stepped up to the character test of good credit and will be reluctant to fail on the new note. This creates opportunities for mortgage lenders as well. They may qualify for a mortgage of \$325,000 from another institution. A homeowner might be able to raise only \$150,000 from family or friends. A bank might write a mortgage of \$325,000 representing \$175,000 from the bank and \$150,000, from family and friends. Lastly, and importantly, the solution is local and does not require government funds, GSE financing or taxpayer dollars.

When the government breaks the structural and legal logjam, it forces mortgage service companies and portfolio trustees, to recognize and promptly deal with the real values in their portfolios. Converting troubled mortgages to cash will accelerate the development of liquidity in these companies. Consequently AAA, AA, and A tranches of mortgage backed securities, become liquid and tradable, bringing improved stability to vital money markets.

This also puts a floor under more important values. When families help members of their family, they strengthen the family. When neighbors and friends help a neighbor or friend they strengthen their community. Strong communities strengthen America. The government of the United States needs to unblock the systemic obstacles to our ability to help each other and ourselves. Only the government can do this. If Uncle Sam expects us to trust him, then he needs to have faith in us.

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~ 5 ~

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