

October 14, 2010

## **Foreclosure Moratorium: Another Fly in the Housing Ointment**

Following GMAC's (Ally Financial) announcement that it was suspending foreclosures in states that follow a judicial foreclosure process, JPMorgan Chase, PNC Financial and Bank of America have followed suit (with Bank of America suspending foreclosures in all 50 states). At issue is whether the banks which are servicers of these loans (both for mortgages held on-balance sheet and mortgages included in securitizations, the latter being a much larger universe) failed to properly verify that they possessed original mortgage and note documents prior to initiating the foreclosure process.

There are several implications:

- In judicial foreclosure states, the banks/servicers represent to the court, via notarized affidavit, that they have verified possession of the original mortgage and note documentation. It has become apparent that such verifications were not actually done on a case-by-case basis in many instances, but were batch processed (at rates of up to 10,000 cases per month in some instances). Regardless of the validity of such a foreclosure proceeding, failure to verify possession of original documents potentially makes the banks guilty of perjury for each instance of foreclosure proceeding where such verification did not occur. The exact number of batch processed affidavits remains to be determined, but investigations are already under way by state Attorneys General, and there is the potential for a monetary penalty for each instance of proven perjury (the highest per-instance penalty we have heard is \$40,000, though each state is different). In addition to facing suit from state Attorneys General, in states with a judicial foreclosure process, an additional risk factor is the individual judges, who can find the bank/servicer in contempt and could throw the entire proceeding out (although this seems less of a risk than just having to restart the entire process). The focus on judicial foreclosure states arises from the affidavit process, which is not present in administrative foreclosure states (thus no perjury issue, as the foreclosure process runs through the state's administrative bureaucracy rather than the courts).
- In addition to documentation verification/perjury issues, there is a question about instances where foreclosures proceeded without the required or correct documents, which could amount to fraud, and would leave past foreclosures and current legal title to previously foreclosed properties in doubt. This highlights a bigger issue with the documentation chain from original sale and mortgage, through a multiple-step securitization process, which generally requires original paperwork at each step, and where there is evidence that record keeping has been

uneven in past years. The biggest implication is for MBS security holders who are left with questions about perfected claim on collateral, but which could result in suits against MBS underwriters and servicers. However, we view this as a secondary issue at the moment.

- Finally, beyond the nuts-and-bolts of the foreclosure process, the impact on the residential real estate market is likely to be a dramatic slowdown in resales of foreclosed/previously owned property. This is both because foreclosures account for 1-in-4 sales currently, and because buyers may hesitate to purchase ANY previously owned property if serious questions are raised about the validity of title to the property. The impact on resale transactions is likely to manifest itself starting with October sales transaction data. While the interim impact may be a boost to housing prices as non-foreclosure sales tend to be at a higher price vs. bank foreclosure sales (thus boosting home price indexes like Case-Schiller), the slowdown in foreclosure sales would likely lead to a much larger shadow inventory that will ultimately hit the market once the documentation issue is resolved. As a result, the time until the residential real estate market clears is probably pushed out.

#### Key Risks to Banks:

- Penalties associated with potential perjury
- Litigation risk from MBS investors that are harmed by a slowdown/reversal in the foreclosure process
- Increased cost arising from protracted servicing of defaulted mortgages which weighs on mortgage banking profitability
- Renewed political and regulatory risk given the headlines and the election season

While the obvious risks are relatively easy to identify, they are at this point, very difficult to quantify. As the dimensions/cost/timing of this issue become more apparent, we will follow-up with additional details. Despite a range of opinions about the materiality of the foreclosure issue, we currently believe that it results in an incremental monetary cost to fix, rather than a material credit impact that would change our view on the sector as a whole. However, we acknowledge that we are early in the discovery process, and that the combination of the absolute amount of distressed residential mortgages, as well as increased political and regulatory scrutiny, could ultimately evolve into a considerably more material credit issue for the bank sector. At that point, it could become a systemic issue for the economy and therefore, the Corporate market.

#### **Impact on Structured Credit**

The foreclosure moratorium will immediately halt the liquidation of properties backing the delinquent loans serviced by the four banks as outlined above. Without an actual sale of the property through the foreclosure process, no losses will be realized on these delinquent loans and hence no losses will be charged against the subordinate bonds in a non-agency mortgage securitization. The end result will be an ever increasing backlog of delinquent loans, which, in the absence of offsetting liquidations, will cause 60+ day

delinquencies to rise. Depending on the length of the moratorium, subordinate bonds will marginally benefit from the interruption at the expense of senior notes as it delays loss recognition and allows more trust cash flow in the form of larger interest payments to flow to the junior bonds. Additionally, the senior notes lose access to principal recovered from property sales, causing average lives to extend.

Non-Agency note holders lose when the foreclosure timeline extends due to the increased costs associated with servicing delinquent loans for longer periods of time. Servicers are required to advance scheduled principal and interest, as long as those advances are deemed to be recoverable, as well as any and all tax and insurance payments due on the property. Once the homes are sold, the servicers are first in line to be repaid any monies advanced on the loans as well as any other reasonable cost incurred during the foreclosure process. Any remaining sales proceeds are then released to pay senior note holders. If the foreclosure process was to be terminated for an extended period of time, perhaps 12 months or longer, these costs could increase materially, leading to much higher loss severities at the time the properties are ultimately liquidated and greater losses being passed on to note holders.

As also noted above, much of the problem resides in the paperwork associated with the foreclosure process in the judicial states. If it turns out that the servicers are able to address the shortcomings with increased staffing to properly verify the contents of the affidavit and to sign the affidavit in the presence of a proper notary, the moratorium could be concluded in a matter of months. In this case, increased foreclosure costs should be manageable and realized loss severities should not increase appreciably. If, however, the moratorium spreads to include other servicers and non-judicial states, these delays could become much longer and the costs will increase accordingly. While litigation and fines can't be ruled out if the servicers are found to have committed perjury, any costs associated with the ensuing litigation and any and all penalties arising from that litigation are the responsibility of the servicers and should not be charged to the mortgage securitizations.

One unfortunate outcome of an extended foreclosure moratorium is the moral hazard it presents homeowners to stop paying their mortgages without fear of eviction from their homes. In the absence of a timely foreclosure process, delinquent homeowners could remain in their homes for a year or more, effectively living rent free. It might be an attractive option for homeowners with properties that are substantially underwater.

While a meaningful extension of the foreclosure moratorium beyond 6 to 12 months would certainly not be a positive development for the non-agency market, there are some securities that would benefit from the delay in loss recognition aside from the subordinate bonds mentioned above. Most notable would be short dated sequential and scheduled sinking fund bonds in non-agency CMOs backed by prime borrowers. These bonds have first claim on principal receipts at the expense of other, longer dated classes and therefore pay down rather quickly. There is a provision in most prime, non-agency securitizations where these bonds lose their priority claim on principal cash flow if the credit enhancement of the transaction is exhausted and losses begin to be allocated to the senior bonds. In this instance, the sequential and scheduled sinking fund bonds share losses and principal receipts pro-rata with other senior classes of the securitization dramatically lengthening their expected average lives and exposing them to greater losses.

If, however, there is a material delay in loss realization, these bonds will maintain their priority position longer, paying down more rapidly and will represent a much smaller portion of the transaction once the moratorium is lifted. In the future as losses begin to flow through to the senior notes, these bonds will be allocated a lesser share of those losses than they originally would have received and might avoid taking losses altogether.

So far we haven't seen any realignment of security pricing to factor in more than a modest interruption of the foreclosure process. However, if recent headlines are any indication, there is the very real risk that this becomes a very sensitive political situation which could cause the market to begin to factor in a much longer moratorium, potentially covering more servicers and more non-judicial states.

Scott A. Edwards, CFA  
Director of Structured Products

N. Sebastian Bacchus, CFA  
Vice President, Corporate Credit - Financials

*Disclaimer: Asset Allocation & Management Company, LLC (AAM) is an investment adviser registered with the Securities and Exchange Commission, specializing in fixed-income asset management services for insurance companies. This information was developed using publicly available information, internally developed data and outside sources believed to be reliable. While all reasonable care has been taken to ensure that the facts stated and the opinions given are accurate, complete and reasonable, liability is expressly disclaimed by AAM and any affiliates (collectively known as "AAM"), and their representative officers and employees. This report has been prepared for informational purposes only and does not purport to represent a complete analysis of any security, company or industry discussed. Any opinions and/or recommendations expressed are subject to change without notice and should be considered only as part of a diversified portfolio. Past performance is not an indication of future returns.*

*This information is distributed to recipients including AAM, any of which may have acted on the basis of the information, or may have an ownership interest in securities to which the information relates. It may also be distributed to clients of AAM, as well as to other recipients with whom no such client relationship exists. Providing this information does not, in and of itself, constitute a recommendation by AAM, nor does it imply that the purchase or sale of any security is suitable for the recipient. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, inflation, liquidity, valuation, volatility, prepayment and extension. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission.*