

Equities

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Foreclosures Gone Wild

Key Takeaways from Our Conference Call

- **What's New** — Yesterday we hosted a conference call on the topic of “Foreclosures Gone Wild: Understanding the Legal Issues Surrounding the Recent Foreclosure Freezes and Investigations.” Our speaker was Adam Levitin who is an Associate Professor of Law at Georgetown University. Levitin emphasized that all parties involved are still trying to get their arms around the legal issues in question. Relative to other opinions which we have heard on these issues, Levitin painted what we believe to be one of the bleaker portraits of these matters and their ultimate resolution.
- **Overview of the Key Legal Issues** — The underlying issues which have recently erupted involve the proper transfer of paperwork in the mortgage securitization process. Real estate law is “arcane” and requires that paperwork be physically transferred when mortgage ownership is transferred (“assigned”) from one party to another party. It appears that in many instances during the mortgage securitization process over the past few years, the paperwork was not properly transferred. If the paperwork was not transferred in the legally required manner, it raises questions not only about who owns the mortgages in question but also about the validity and tax exempt status of the trusts in which the mortgages reside. All of these issues also bear directly on the role played by the title insurance industry.
- **Why Attempted Remedies Raise New Questions** — Banks have attempted to remedy the aforementioned problems by having employees sign affidavits that they have personal knowledge that the trust was once in possession of the necessary documents. Two problems have emerged with regards to these affidavits. First, several news stories have reported that the people signing these affidavits had no knowledge of the matters in question despite the fact that there were legally swearing that they did. Second, the affidavits may be irrelevant because the issue is not that the documents were lost but they were never properly transferred at each step of the aforementioned securitization process.
- **Three Potential Outcomes** — Levitin articulated three possible outcomes to the aforementioned issues and assigned an equal likelihood to each. In his best case scenario, these issues are deemed merely technical in nature and are successfully resolved but it takes at least year to do so and all foreclosures are delayed by at least a year. Levitin disputed the claim by banks that these issues can be resolved in a month or so and attributed the banks’ claims to “legal posturing.” In the medium case scenario, litigation ensues and it takes years to sort out these matters. In the worst case scenario, the aforementioned issues become a “systemic problem” which causes the mortgage market to grind to a halt as title insurers refuse to insure mortgages involving existing homes.

[See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.](#)

■ Industry Overview

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Foreclosures Gone Wild

Over the past two weeks there have been several developments which have raised questions surrounding the integrity of the residential mortgage foreclosure process. As a result, several banks have announced temporary suspensions of their foreclosure proceedings in various states. Numerous states' attorney generals have launched investigations and key federal officials have weighed in as well. Importantly, these issues involve only mortgages which have been securitized and placed in a pool.

To help us better understand these issues and handicap the likely outcomes, we hosted a conference with Adam Levitin. Levitin is an Associate Professor of Law at Georgetown and has served as Special Counsel to the Congressional Oversight Panel for the Troubled Asset Relief Program (TARP) and spearheaded the Panel's reporting on the mortgage market and foreclosures. Levitin's research focuses on consumer and housing finance, payment systems, and bankruptcy reorganization.

Below we summarize the conference call's key takeaways.

Overarching Thesis

Our speaker argued that what appears on the surface to be a series of technical glitches in the mortgage securitization and foreclosure process may well cause a "systemic problem." He stated that what we have recently seen and heard in the news is "just the tip of the iceberg."

Overview of Foreclosure Law

The foreclosure process is governed by state law. Some states have what is known as a "judicial" foreclosure process whereas other states have a "non-judicial" foreclosure process. In a judicial foreclosure process, foreclosures must work their way through the state court system. In a non-judicial foreclosure process, the court system does not typically intervene. The federal government does not have jurisdiction over the foreclosure process.

The Underlying Key Issue: The Physical Transfer

The underlying problems center around the proper transfer of paperwork. It is important to appreciate that real estate law is arcane and requires the physical transfer of documents when ownership changes hands. In industry parlance this transfer is known as "assignment."

When a mortgage is securitized and placed in a mortgage pool, there are typically four parties involved. The mortgage bank or lender originates a mortgage and then sells it to a "sponsor" who in turn sells it to a "depositor" who then sells it to the "trust" which governs the pool. Importantly, as noted above, the original paperwork must be transferred at each step of the process.

It now appears that in many cases (1) the paperwork was not properly transferred and (2) it is unclear in many cases where the actual paperwork actually rests today.

Issues Concerning Affidavits

When the aforementioned paperwork is lost, an agent of the mortgage servicer can sign an affidavit swearing that he or she has personal knowledge that, although now lost, the trustee was once in possession of the necessary documents. The affidavit is considered to have the same weight as sworn testimony in a court of law.

Two problems have emerged with regards to affidavits. First, several news stories have reported that the people signing these affidavits had no knowledge of the matters in question despite the fact that there were legally testifying that they did. Many of these people have since been labeled “robo-signers” given the tremendous volumes of affidavits which they signed in relatively short periods of time. Second, the affidavits may be irrelevant because the issue is not that the mortgage documents were lost but they were never properly transferred at each step of the aforementioned securitization process.

Issues Concerning Tax and Trust Laws

Beyond the affidavit issues, our speaker highlighted potential problems concerning the trusts which hold the securitized mortgages.

Most mortgage trusts were set up as REMICs (Real Estate Mortgage Investment Conduits) which are special purpose vehicles used to pool mortgages. Under the IRS code, REMIC confers a special tax status in which the cash flows to the trust are not taxed. Investors in the trust pay taxes. The tax exempt nature is important. If the trusts were in fact to be taxed, the taxes would distort the yields required by investors.

To qualify as a REMIC under the IRS code and enjoy the beneficial tax treatment, the trust (1) must be passive and (2) cannot acquire any new assets 90 days following the trust’s creation.

If, as described above, mortgage documents were never correctly passed through to the trust when it was established, then the trust may not actually own the underlying mortgages it purports to own. Although it is possible that this issue could be remedied by some legal maneuvering, doing so could violate the REMIC status since the trust would be acquiring assets long after the aforementioned 90 day period has expired. Such a violation in turn could trigger a sizeable tax burden for investors. Our speaker indicated that there are a handful of open questions on this front and that this is a legal gray area.

Issues Concerning Title Insurers

Levitin noted that all of the above issues may impact how title insurance companies act. If a scenario emerges in which title companies are unwilling to issue title insurance, in those scenarios lenders may cease lending.

When a home with a mortgage on it is sold, the mortgage must be released at closing by the current mortgage owner before a new mortgage with title insurance is issued. If it is not known with certainty who owns the mortgage in question, it cannot be released. If the title company is not satisfied that there is a good release on the old mortgage, it will refuse to insure the new mortgage.

None of these issues affect mortgages for newly constructed homes. Our speaker expects the mortgage market for new homes to continue to function without any material hindrances.

Issues Concerning MERS

MERS (Mortgage Electronic Registration Systems) functions as a centralized electronic registry of mortgages and tracks ownership of mortgages. MERS allows mortgage ownership to change hands efficiently and relatively quickly since it is electronic and allows all parties to forgo making a filing in local land records. Indeed, MERS was designed to function as a substitute for local land records.

Although MERS was designed to enhance efficiency in the mortgage assignment process, Levitin argued it may not conform with the law. “Slowly but surely” courts are issuing decisions which “cast validity on the MERS process.” Although ~60% of mortgages list MERS as the “nominee” which owns the mortgage, a handful of recent court cases have ruled that MERS has no standing in foreclosure actions either because (1) physical paperwork must be transferred when a mortgage is assigned by one party to another or (2) MERS has no true economic interest in the mortgage in question since it collects no payments from the borrowers.

What Happens Next?

Our speaker predicted that more and more lenders are likely to stop their foreclosure processes in both judicial and non-judicial states. He also expects more states’ attorney generals to get involved. At the federal level, it is possible that banking regulators might step in as there is legal and reputational risk for the banks involved.

Ultimately, if these issues do in fact escalate, the Administration may try to broker some sort of settlement. If such deal brokering does take place, Levitin believes that “some payment” will be exacted from the lenders and servicers. The Administration could bargain for more mortgage principal write downs.

Appendix A-1

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