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THIS MONTH

IN CONSTRUCTION SUPPLY

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A handwritten signature in black ink, appearing to read "Greg Brooks".

Greg Brooks, editor | 303 845 4880 | Greg@cs24.us

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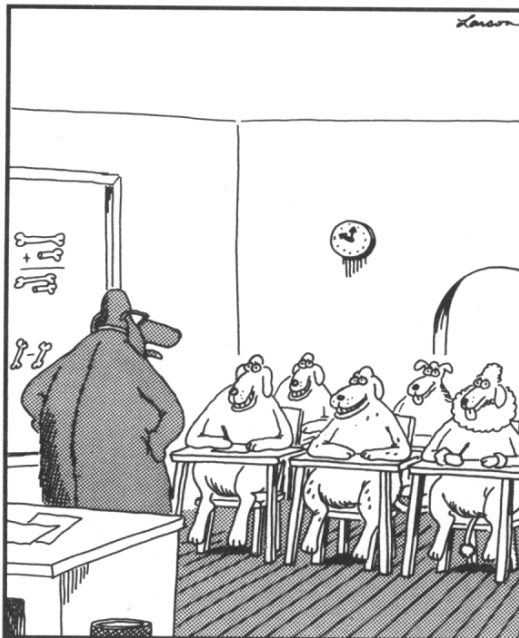
The logo for DMSI Software features the letters "DMSI" in a large, bold, black font with a yellow arrow pointing to the right. The word "Software" is written in a smaller, black, sans-serif font to the right of "DMSI".

THIS MONTH

IN CONSTRUCTION SUPPLY

SEP-OCT 2010

TOO SLICK TO FAIL



"Well, here we go again. ... Did anyone here *not* eat his or her homework on the way to school?"

By Greg Brooks. You may not be a fan of the too-big-to-fail (TBTf) banks, but whatever you call them, you can't call them slackers. In the drive to squeeze every conceivable dime out of this economic crisis, they outthrustled, outmaneuvered, and outsmarted everyone. Including, it appears, themselves.

No doubt you've heard about the latest flap in foreclosures. "Flawed paperwork" is the polite term; "fraud" is the more common headline.

In the past two weeks, Bank of America, Ally Financial (formerly GMAC), JP Morgan Chase, and a handful of others have [suspended all foreclosure sales](#) pending internal investigations. Attorneys general in 40 states are preparing to launch a joint [investigation into improper foreclosures](#).

Homeowners in Kentucky have filed a [civil-racketeering class action suit](#) against Citigroup, Ally, and the Mortgage Electronic Retrieval System (MERS) for conspiring "to falsely foreclose on loans." At least one major title insurer, Old Republic, announced that it will no longer provide title insurance for [homes foreclosed by Ally or Chase](#).

The details are still emerging, but here's the story so far. It's complicated and long, but it's also serious.

A mortgage consists of two parts: 1) the promissory note from the borrower and 2) the mortgage itself (called a deed of trust in some states), which is the lender's lien on the property.

Residential mortgage-based securities (RBMS) were introduced in the 1990s to dilute risk by creating bonds that contain pieces of thousands of promissory notes. The problem was that whenever a note (or a piece of it) changes hands,

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the assignment has to be documented to reflect the new ownership.

That's where MERS came in. The Mortgage Electronic Retrieval System Corp. was set up by loan servicers in 1997 to act as "the legal 'nominee' in public records for the lender and mortgage servicer," explains the [Financial Times](#). MERS "made slice and dice possible" by allowing "mortgage rights to be traded without having to go down to county courthouses and record additional assignments in public records."

So far so good; MERS gained wide acceptance early on. But when "creative" mortgages – subprime, Alt-A, option ARMS, etc. – became popular, the system began to break down.

Here's how the securitization process worked: Loan originators (e.g., mortgage brokers) sold notes to a sponsor (typically an investment bank, including TBTFs). The sponsor sent them to a depositor, a neutral third party whose job was to bundle notes in ways that ensured a balance of high and low risk. Those bundles were then transferred to trusts that in turn issued bonds (RBMS) to investors.

The trustees were responsible for making sure each note was properly documented. But as RBMS mania heated up in the 2000s, the process broke down. Key documents – including original promissory notes – were never delivered to the trusts, yet trustees continued to certify that they had received and verified them.

Some say it was a matter of fly-by-night mortgage brokers cutting corners. Others say it was part of a wider plot to make mortgage-backed bonds appear safer than they really were.

Those bonds are divided into segments called "tranches," that offer varying levels of risk. You earn more if you buy a high-risk tranche, but when some of the loans start to go bad, you incur losses before investors who bought low-risk tranches.

But if a bond consisted exclusively of subprime loans, they were all risky; no one knew which mortgages belonged in which tranche. [One analyst believes](#) paperwork was deliberately lost "to avoid an audit, which would have revealed to investors that they had been sold a bill of goods – a package of toxic subprime loans very prone to default."

MERS obscured the problem by enabling servicers to assign mortgages to high-risk tranches after they defaulted, and it worked for a while. But when mortgage mania morphed into foreclosure mania, servicers couldn't prove they had a claim to the properties they were foreclosing on. So they got creative: They used "robo-signers" to verify documents by the thousands without ever examining them, "re-created" lost documents from scratch, and apparently even forged signatures on documents.

That's the fraud part, but even that isn't the big problem. Lack of documentation establishing a clear chain of title [may undermine MERS's legal right](#) to foreclose on any property. Not surprisingly, [the mortgage industry](#) is apoplectic about the possibility. But the Kansas and Maine Supreme Courts have already ruled that MERS does not have the standing to foreclose, as have

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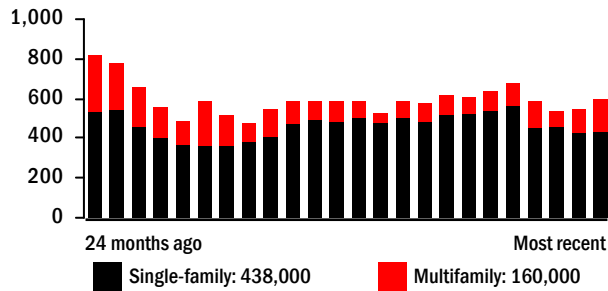
[Federal Housing Finance Agency Home Price Index](#), 2Q 2010. The latest home price trends for all 50 states plus 330 MSAs.

[State of the Nation's Housing 2010](#). The Harvard Joint Center for Housing Studies' annual report on the state and future of housing.

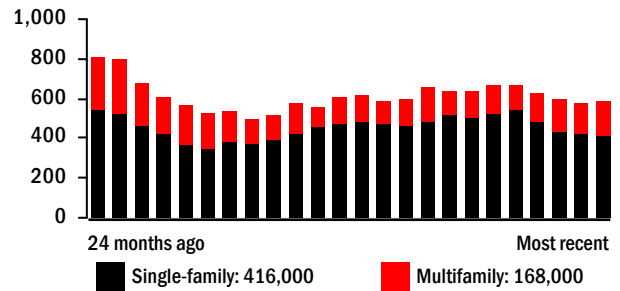
[Case-Shiller Index](#). Seasonally-adjusted home price trends for the 20 major metro markets tracked by Case-Shiller.

VITAL STATISTICS

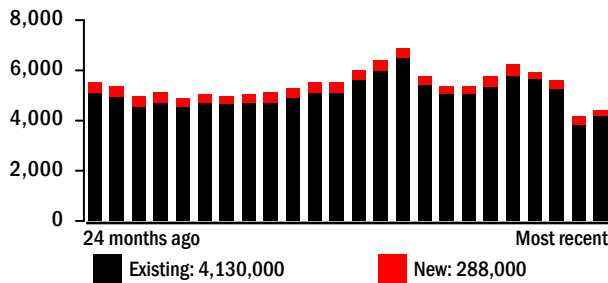
ANNUALIZED HOUSING STARTS (000)



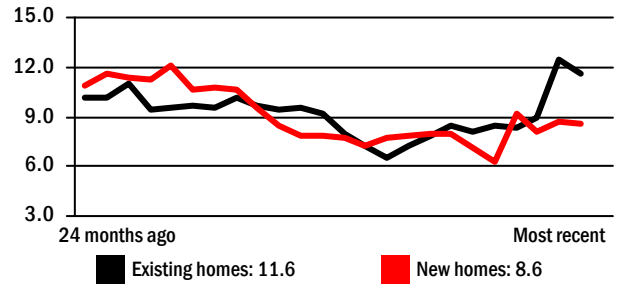
ANNUALIZED BUILDING PERMITS (000)



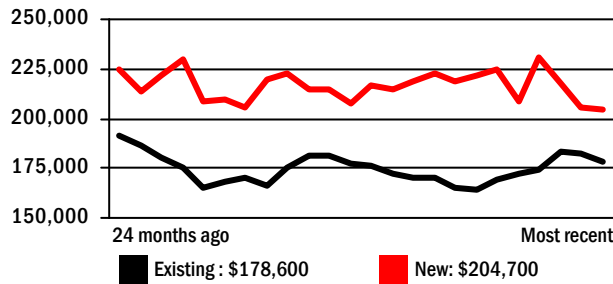
ANNUALIZED HOME SALES (000)



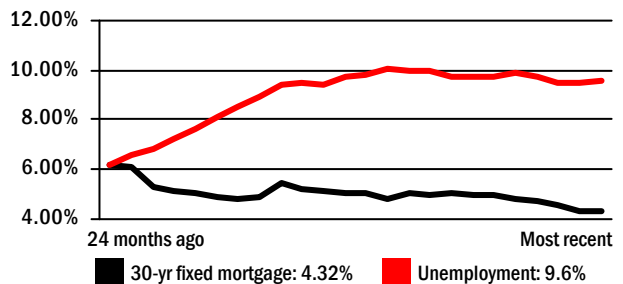
MONTHS' UNSOLD INVENTORY



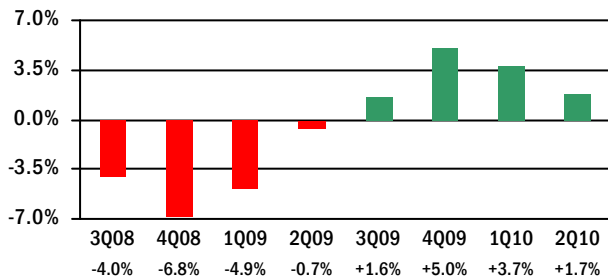
MEDIAN HOME PRICES



MORTGAGE & UNEMPLOYMENT RATES



GDP CHANGE VS. PREVIOUS QUARTER



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Sources: U.S. Census Bureau, National Association of Realtors, Freddie Mac, U.S. Bureau of Economic Analysis, U.S. Department of Labor. Data compiled by



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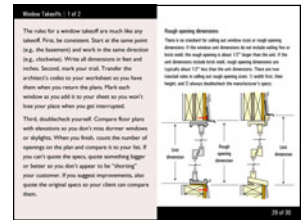
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judges in California, New York, and Florida in individual cases.

According to [one legal expert](#), the implications are nothing less than historic. “Earlier (legal challenges to MERS) focused on the inability of MERS to produce a promissory note or assignment establishing that it was entitled to relief, but most courts have considered this a mere procedural defect. The more recent cases, however, are looking at something more serious. If MERS is not the title holder of properties held in its name, the chain of title has been broken and *no one* may have standing to sue.”

In theory, every defaulter in the MERS system could wind up owning his or her home free and clear.

That’s probably not going to be the outcome, but the more likely outcomes are no less interesting.

When existing home sales plunged 27% in July, the consensus was that home prices would also start to fall again (which apparently is happening according to early returns). That raised the possibility that buyers might stop buying foreclosures in hopes of getting a better price later, which in turn would prolong the crisis.

Sixty days later, that’d be a wonderful problem to have. The issue now is why anyone in their right mind would buy an REO when it isn’t certain that the seller has a clear title to it.

And even that isn’t the biggest headache if you’re a TBTF bank. It might be that investors in mortgage-based bonds will shrug this whole thing off, but I wouldn’t bet on it. Chances are that the next few months will see an explosion of lawsuits that, win or lose,

will do serious damage to TBTFs’ balance sheets.

What happens then? No doubt you saw the announcement last week that the Troubled Asset Relief Fund (TARP), otherwise known as the bank bailout, has ended. Initiated in the final months of the Bush administration and continued under Obama, the \$700 billion program was sold on the premise that the global financial system would collapse without an injection of cash to jumpstart lending. But TBTFs didn’t lend the money; instead they used it for multimillion dollar bonuses and stock buy-backs.

You would think it’d be cause for celebration that most of the money has been paid back. TARP’s final cost to taxpayers will be [less than \\$50 billion](#) and it’s even possible that we’ll turn a profit. But the public perception is so strong that TBTFs lined their pockets at the expense of the recovery, their goodwill accounts aren’t merely depleted – they’re badly overdrawn.

[Pundits are already speculating](#) about the possibility of TARP II, and by the time “Foreclosuregate” shakes out, it’s entirely possible that TBTFs will need another government bailout to survive.

Try selling that one to the American people right now.

So does this mean housing is screwed, blued, and tattooed? Hardly. When you have a product everyone wants – and the market is growing at a rate of roughly 3,500 willing buyers per day – it’s a safe bet someone will find a way to deliver it. There are already rumblings about [alternatives to TBTF banks](#).

No doubt whatsoever it’s a huge problem and will be for months to come. On the other hand, how often do you get to witness the end of an era? ☺



Greg Brooks, editor of THISMONTH, is a 41-year veteran of the construction supply business with 20 years’ experience in the field. Brooks is a former editor of *ProSales*, a steering committee member at the Harvard Joint Center for Housing Studies, and author of *Scope of the LBM Industry*, published by the National Lumber & Building Material Dealers Association.

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