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Securitization and the Great Mortgage Meltdown

*Gil Sandler**

The author argues that securitization and structured finance have been libeled by association with the Great Recession of 2008, which was caused by the Great Mortgage Meltdown of 2007.

Once upon a time, the capital markets sold stocks and bonds. Publicly traded stocks were quoted by market-makers on exchanges or over-the-counter. Bonds were all OTC, and had published or private credit ratings assigned after professional analysis. Institutional research firms also published reports that were supposed to be analytic and objective. Issuers of publicly offered stocks and bonds filed, and periodically updated, disclosure documents that could be understood by most knowledgeable investors or advisers. The SEC actually enforced reporting and anti-fraud violations.

Market-makers were agents for buyers and sellers, not interested proprietary traders looking to skim a toll on each transaction by paying buyers less than the securities were worth, and selling them for more. The transaction cost was similar to current staffed and online brokerage operations—flat or percentage commissions for executing transactions, no undisclosed, discretionary mark-ups. Sales desks existed to distribute IPOs, new bond issues and to help investors resell so they could be comfortable buying securities

and make room for the next new issue. Trading desks were created to anticipate market needs and cover the cost of providing this liquidity, not to generate huge bonuses for swaggering, gun-slinging traders.

So, the problem was not, historically, that the public were being sold evil securities, or that the markets were corrupt. Of course, some IPOs were rigged by insiders, but the SEC wrote and enforced “hot issue” and “front-running” restrictions. Anti-fraud rules were crafted to minimize underwriters’ conflicts of interest. Insider trading occurred, but at the peril of those who were caught.

What we saw in 2007-08 was the natural progression of the Wall Street vs. Main Street game. Big banks—often emulated by smaller banks as well—ceased to care about retail and commercial banking customers and came to focus on extra ‘000s in projected transactional profits. Market volatility was invited, not controlled, in order to raise the tolls extracted by bankers on each trade. Hedge funds and private equity grew like weeds to collect and redirect institutional capital and needed major bank proprietary

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trading desks as their liquidity source and partners in profits. Not surprisingly, prop trading desks became dominant profit centers for major banks and evolved further, like a self-perpetuating virus, when in 1999, the Clinton Administration bought into the self-regulating markets mythology to repeal Glass-Steagall.¹ This single event—even without securitization or the over-leverage of derivative products like pooled collateralized debt obligations (“CDOs”) and credit default swaps (“CDS”) — was destined to bring down the House.

Much has been written and discussed the “Great Mortgage Meltdown” of 2008.² The repeal of Glass-Steagall,³ motivated by Citigroup’s need to build a global financial empire, ignored the inherent conflict of interest between commercial banks supported by governmental programs, and proprietary trading and investment banking businesses. Arguably, proprietary trading profits were the biggest motivator behind the creation of unmanageable and unmeasurable risks through financial engineered products like CDOs and CDS.

Some form of Glass-Steagall and of the so-called “Volcker Rule” were the principal consumer and taxpayer protections sought by Rep. Frank in the Obama-supported Dodd-Frank, bill but were effectively blunted by Wall Street lobbying. Even a simpler form of the Volcker Rule in Dodd-Frank was deferred to regulations, which, in turn, were paralyzed by pro-Wall Street Congressmen anxious to preserve campaign funding sources. Perhaps the most damaging legislative act was the late insertion by Sen. Gramm into a 2000 farm bill of a provision to exempt financial derivatives from CFTC or Treasury regulation or margin requirements. This enable credit default swaps (“CDS”) to magnify

and spread the adverse effects of mortgage defaults

Aside from economists and financiers, few have considered the role of securitization⁴ in the expansion of the market for traded real estate mortgage securities, and even fewer can recall the original purpose of securitization.

In the now distant 1980s, the slicing and dicing of residential mortgages was popularized by Lewis Ranieri’s trading desk at Salomon Brothers, and later by Morgan Stanley, Bear Stearns and other major Wall Street firms after RTC re-established governmental support in the early 1990s. Then, securitization was limited to the pooling of residential mortgages, underwritten to uniform standards, whose payments were guaranteed by FHLMC and FNMA. Since those pools had uniformly strong federal, AAA/Aaa-rated credit, the pooling and tranching (creation of different bond series) was not to spread credit risk, but for such other reasons as:

1. Re-ordering of cash flows from mortgage payments to enable shorter-term investors to be repaid sooner in time than medium and longer-term investors. This enabled bonds to be tailored and sold to investors with differing maturity and duration preferences at interest rates corresponding to the maturities and durations of other governmental and corporate securities. Rates typically moved with maturities in an ascending order and longer term tranches reflected the rate and reinvestment risks, but not credit risk.
2. Reallocating pre-payment risk so that certain tranches could be sold to different types of investors whose risk pro-

files required precise predictions of repayments to manage reinvestment and rate risks. Thus, cash flows from early prepayments of mortgages—usually due to statistically predictable owner/mortgagee moves and refinancings—would be allocated to amortize certain tranches sooner than others. Again, because all mortgages were federally guaranteed, the shorter term investor did not have a senior credit position and rates could be lower, reflecting an earlier repayment requirement or lesser tolerance for reinvestment risk. By contrast, the longer-term investor need not be concerned with the pool running out of cash to pay off the earlier-maturing tranches, and could happily take the higher yield for taking only interest rate risk.

The scope of securitization changed dramatically when Wall St's financial engineers decided to expand the mission to include:

- A. The reallocation of credit risk to permit mortgage-backed securities—residential, as well as commercial—to be sold as limited-recourse financial assets to classes of investors without financial guarantees from governmental or private institutions.
- B. The extension of MBS pooling to enable credit strength to be determined, and confirmed, by the major rating agencies primarily on the basis of over-collateralization and diversity of assets within mortgage pools.

This new approach to credit analysis⁵ broadened the spectrum of securitizable financial assets to meet the growing demand from international and domestic institutional investors for seemingly-safe, investment-

grade bonds and to enable Wall Street to generate more trading volume.

Commercial Mortgage-Backed Securities

Securitization had already been applied to commercial mortgages and loans through private placements of pooled leases (government and corporate) and major bank syndications of loans to investment grade corporations. Whole mortgage loans were also sold to multiple investors, and in some cases, the cash flows were divided. However, these pools and the resulting securitized bonds were sold (with and without credit ratings) on the basis of their uniformly strong, underlying credits, rather than on the timing of receipt of cash flows from an uncertain revenue stream. It was not until over-collateralization replaced obligor/guarantor credits as a primary ratio tool that the tranching became credit-sensitive. As an example, if all payments are not equally likely or guaranteed, earlier payments become more secure, and later payments less secure. This issue was managed by the redirection of mortgage payments to more senior tranches, but required statistically reliable estimates of repayment of all mortgages. Once pools began to include varieties of mortgages from weaker and stronger mortgagors and mixed 30-year conventional with three, five and seven year ARMs, the predictability of repayments became much less certain.

In the CMBS world of the post-RTC of the mid 1990s, Wall Street created a new statistical orientation of credit analysis to allow streamlined, carefully underwritten non-recourse financing for income-producing commercial residential real estate. This was immensely popular to major real estate developer, equity investors (including equity REITs) and bond investors (including mort-

gage REITs), since it provided lower rates than conventional commercial mortgages, but higher returns than other highly-rated corporate bonds. Credit analysis, assuming well-documented valuations by professional appraisers, now focused on the strength of developers, geographic and demographic diversity of a pool, historical trends in the construction costs and resale prices of classes of real estate and rental rates in various markets over a typical 10-year holding and financing period. If properly underwritten, sufficient reserves could be set aside for non-performing mortgage loans to cover periods of vacancy or reduced rental income and a certain number of defaults, all of which would be absorbed by the junior tranche.

By creating senior, mezzanine (senior, subordinated) and junior tranches, the application of cash flows from payments and prepayments to repay senior and mid-level investors enabled the junior investor (often the originator or distributor of the pooled bonds) to earn a higher return for taking a higher risk. Usually, that tranche was retained by the originator or sponsor of the pool, but even if resold to higher-risk investors, the yield could be sufficient to generate a profit after defaults. These CMBS were actively traded by Morgan Stanley, Goldman, Lehman, Bear and major international banks, and as a result of the underwriting analysis, the size and the diversity of the pools, defaults were rare.

Residential Mortgage-Backed Securities

This expanding demand for MBS led Wall Street to create vast pools of residential mortgages that were no longer guaranteed by RTC, FHLMC or FNMA. If billion-dollar pools of CMBS could be created, why not mix and match RMBS? Securitization had

been successfully extended to car loans, leases, credit card receivables—any steady or predictable pool of cash inflows.—based on statistical evidence of performance. In the case of consumer, as well as mortgage, loans, underwriters could use historical default rates and double or triple reserves for junior tranches without losing their ability to obtain AAA/Aaa ratings for 75% to 90% of the loans in the pool. The globalization of sales and trading by a fraternity of major international banks facilitated the influx of new money into the US mortgage market and reduced rates sufficiently to trigger refinancing of staid, older 30-year fixed rate, federally guaranteed mortgages.

But, volume still was not enough. Hungry Wall Street traders and pool sponsors, and huge non-bank mortgage originators (e.g., Countrywide Financial, Household Financial, etc.) realized that they could multiply their fee and underwriting income by shortening terms of mortgages and promoting frequent refinancing—“early and often.” Unlike CMBS, which relied on customary five to 10 year holding periods and refinancings based on improvements in rent rolls, lower interest rates, or recycling amortization schedules to minimize amortization⁶ RMBS required only a perception, through re-appraisal, of higher underlying real estate valuations. Thus, owners who had a 30-year fixed rate at say, 5% to 6%, could refinance at an adjustable medium-term rate three percent to four percent for a five to 10 year term. In addition to saving from recycling the amortization schedule, the mortgagor could retrieve cash because his property had supposedly increased in value over five years by as much as 25% to 50%. The transition from long-term fixed-rate mortgages to ARMs, in combination with securitization based on overcollateralization, fueled a refinancing boom and

the broad, inflationary optimism that led to massive over-building. Aided further by the Federal Reserve's easy-money policy, and the FHLMC and FNMA policies of expanding home ownership, mortgage originators found readily available credit lines from Wall Street and expanded aggressively. Soon, mortgage brokers were being routinely acquired by larger non-originators, and they were being bought by banks and Wall Street firms seeking a steady supply of new mortgages and servicing income.

The Boom That Became a Bust

After the Bust producing the Great Recession of 2008, some would argue that the tragic flaw in securitization was using over-collateralization as a rating methodology. There is ample evidence that the major rating agencies, in their lust for huge fees, profits, and bonuses, had all sold out to Wall Street in a feeding frenzy to manufacture more AAA/Aaa paper to sell to yield-hungry global investors. This required discarding traditional underwriting analysis, but the rating agency chiefs were happy to fatten their paychecks by helping underwriting firms to create and bless new computerized models. Just as traders wrote self-serving pricing models to show profits on risky, losing trades, raters and underwriters predicted few defaults in newer, riskier piles of ARMs, Subprimes, Option ARMs, and even "piggy-back" first and second mortgage loans, based on paper then home-equity. In many cases, underwriters and raters did only scatter-shot or random sampling of loan documentation or consistency with published credit, underwriting and appraisal standards.

This led to reduced over-collateralization and lower reserve requirements to obtain top ratings, and a streamlining of the rating pro-

cess to abandon individual loan review. Clearly, if a uniform credit (such as a guarantee by originators or sponsors or federal insurance), were required for top ratings, the markets would have been unaffected by defaults and fluctuated based solely on interest rates. The credit strength of pools was further diluted by the addition of "liar loans" and "no-doc" loans, there was a predisposition to initiate, process and package any and all loans in nearly all over-built real estate markets.

Over-Collateralization as Rating Tool

Over-collateralization did, in fact, set the stage for uncontrolled expansion, which invited sloppy underwriting and loan fraud. However, the biggest cause of the Bust was neither over-collateralization nor securitization. It was the popularization of "subprime" mortgages, so-called "Option ARMs," and "no-doc" loans. These supposed innovations disregarded entirely the predictability of repayment based on borrower capacity and motivation, in favor of a single unproven—in fact, a historically disproven⁷—assumption:

That property values would always rise at a rate sufficient to enable any borrower to sell or refinance the property and repay the loan with the proceeds.

Overcollateralization, in itself, was neither a poor tool, nor was it irrelevant to credit analysis. Mortgage lenders routinely reserve against losses, even unpredictable losses, through equity requirements and loan-to-value limits. Business routinely reserve against uncollectible accounts. Credit lenders, bond investors, financial guarantors and rating agencies have long used reserve factors, translated into overcollateralization, to

estimate potential loss, and thereby, correlate loss with yields and returns on investment. What went terribly wrong this time around is setting unrealistically minimal overcollateralization standards for high investment-grade ratings that could not be correlated with statistically reliable projections of future mortgage and pool payments. Unfortunately, in their rush to create volume, underwriters chose to ignore normal underwriting standards and document review, and rating agencies chose to ignore realistic reserve requirements.

If future cash flows—*i.e.*, mortgage repayments—could be reliably predicted based on past performance of comparable and a clear understanding of causal relationships between past value and rate movements and future events, models could be devised to provide sufficient reserves. For example, a cursory review of past real estate and economic declines and recessions would suggest that a 50% to 70% decline in collateral value of residential real estate, because that was what was experienced in many inflated markets during the early-to-mid 1970s, late 1980s. Most recently, over-developed areas suffered even greater losses in the past few years. If anyone had seriously considered realistic reserves, they would have taken at least a 100% reserve on valuation, and dismissed refinancing entirely as a source of repayment. That would have focused directly on the mortgagor's credit as a source of repayment in all but the highest equity, lowest LTV loans. This methodology would have precluded the next two contributors to the Bust: Subprime mortgages and Option ARMs.

Subprime Mortgages

Subprime mortgages supported the government's desire to expand home-ownership

by lending to weaker credit borrowers, but even this invention was not inherently evil. Many lower-income borrowers could pay less in mortgage payments than rent if they had sufficient down-payments and income (including government subsidies or payments) because their mortgage amount was limited to homes that were affordable. Instead, the otherwise laudable objective of expanding home ownership created such demand for mortgage borrowers that subprime borrowers of limited means were offered unaffordable "golden apples" with the false assurance that they could continue to trade up in a forever-rising market. This was coupled with the threat that they would be missing the golden opportunity to buy before the rise.

Subprime mortgages were gobbled up by Wall Street, in part due to their expected short duration and frequency of refinancing with an insufficient level of overcollateralization, and were destined for default under any reasonable estimate of home price escalation. Not surprisingly, these loans generated higher origination fees, so even good-credit borrowers were often sold subprime mortgages which would reset at much higher rates than more conventional loans available at the same time. Wall Street and rating agency underwriters ignored this risk because they wanted to believe repayment capability was irrelevant to an ever-rising market that permitted resale or refinancing.

In effect, the golden apple to seize the golden opportunity was a golden pyramid scheme,⁸ created by Wall Street,⁹ supported by the Fed, and not understood by either Main Street investors, like U.S. pension funds, or foreign institutional investors.¹⁰ The classic definition of a "security" in the Securities Act of 1933, as amended, includes an "invest-

ment contract” in which repayment and/or a return on investment relies primarily on the efforts of others. Considering that even Subprime and Option ARMS required borrower down-payment and upfront fees, those mortgage loans could have been treated as “securities,” which would have required a full disclosure of the risk of higher future reset rates and property declines.

Option ARMs

The second type of radioactive mortgage which fed this pyramid game was the heavily promoted Option Adjustable-Rate Mortgage or ARM. An Option ARM offered eager new borrowers of first and second homes a below-market teaser rate with lower monthly payments for one to three years, subject to a rate reset at a “normal” higher rate. The sub-market rate subsidy, or negative amortization, would be added to the back end of the loan amount, and the new payment would be at the higher rate on the higher amount. Often, this reset would double the monthly payment and raise it from perhaps, 30% to 40% of monthly income to 60% to 80%. It was designed to enable a low or middle-income borrower to qualify for a bigger loan to buy a bigger more expensive home. Combined with “no-doc” loans, it was a financial bomb waiting to explode. All objections to the reset risk were overcome by the assurance that the home would appreciate and the loan could be refinanced at a lower rate.

No-Doc/Low-Doc Loans

A major volume contributor was the “No-Doc” loan, and its sibling, the “Low Doc” loan. Initially conceived as a streamlined application process for newer borrowers, this became a standard method of qualifying poor-credit borrowers for a much bigger loan, often with less equity, motivation and ability

to repay. Tax returns, W-2, 1099 and routine income verification documents were no longer required. Even credit checks were skipped. Aided by unscrupulous originators and their commissioned mortgage brokers, borrowers were invited to estimate or report their own incomes, and sometimes encouraged to lie, on unchecked loan applications. Again, Wall Street, and rating agency underwriters all ignored documentation deficiencies and prospective inability to make regular—or normalized—mortgage payments because they chose to believe in the myth that resale or refinancing would always bail out weak borrowers and sloppy lenders. The probability that the home would have to be sold sooner was a net positive for mortgage pool sponsors, who paid brokers more for shorter-term, weaker-credit, loans, because it would expedite turnover, increased origination fees, and generate volume for new MBS pools.¹¹

Other Risky Loans

In addition to No-Doc and “Low-Doc” loans, the credit strength of new mortgage pools was further weakened by the introduction of “Alt A” Loans and “Piggy Back” mortgages. “Alt A” loans were higher LTV loans to stronger borrowers whose credit scores were high enough for conventional loans, but could be steered into higher-fee loans by increasing the amounts borrowed from 75% or 80% LTV to 90%. This reduced equity requirement, often on second homes or investment properties, was fueled by speculative optimism that new developments or later phases in booming areas would drive up values in older phases or developments. Even previously responsible borrowers were swept up by the craze to snag easy profits by flipping units in big-builder subdivisions of open space in Florida, Arizona and Nevada, among others.

Banks of all sizes then saw the opportunity to build loan profits by piggy-backing a second mortgage loan onto the first mortgage. Home-equity loans, or HELOCs, were added to new mortgage loans, even before any equity had been accumulated. A borrower could open an account at the local bank, take a normal 80% LTV loan on a new condo unit built by another bank friend or client, and qualify for various types of mortgages from that bank or a friendly mortgage broker. However, the 20% equity requirement was not being invested by the borrower; an extra 10% to 15%¹² was coming from the bank as an interest-only second mortgage loan, which would be repaid when the property was sold or refinanced. Ultimately, HELOCs became another asset for securitization, and generated extra profits for aggressive banks. While HELOC borrowers did have to meet basic income requirements to pay interest, the assumption remained that they would not need outside income to pay down the loan. Again, so long as the music continued to play, and new buyers could be enticed into the bubbling market by 20% to 40% profits in one and two year flips, loans could be repaid.

Mixed MBS Pools Meet Securitization Squared and CDS Derivatives

This sounds like Frankenstein meets Dracula, and the analogy is not that far off. Poorly and fraudulently originated and underwritten mortgages were poorly documented and poorly analyzed, so they could be hastily, and even fraudulently, sold by hungry traders and bankers. In the normal course, the really bad loans would default when ultra-low teaser rates on Option ARMs reset at three or four times, the borrowers couldn't pay, and the property couldn't be refinanced. And "liar loans" would default after six

months or a year if the property couldn't be rented or flipped. Greenspan's decision to start raising interest rates in 2006 pushed many borderline borrowers over the edge and triggered HELOC defaults. Still, many of the senior tranches in RMBS pools might have survived, and the fallout contained, had Wall Street not engineered two more risk-spreading innovations—exponential securitization and credit default swaps ("CDS").

Despite cheap money and the incendiary over-heating of the residential market, Wall Street was sure to run out of new mortgage loans to process and repackage. For a time, sales inventory was maintained by creating Collateralized Debt Obligation ("CDOs") by bundling pieces of other RMBS pools, often junior pieces, with other commercial or retail loan receivables. Using over-collateralization, the rating agencies were ready to rate the senior tranche AAA/Aaa, regardless of the lower credit quality of some of the pieces, and their inability to analyze the underlying credit quality of other pieces.

A fairly logical next step was creation of "CDO-Squared" (aka "CDO") pools, sold at higher yields to sophisticated, institutional investors, like pension funds and hedge funds. This securitization product blended pieces of other CDOs, including their most junior tranches, and created a new senior AAA/Aaa tranche. Thus, pieces of RMBS could be repackaged into CDOs, sometimes with the same, sometimes a different, level of risk, and pieces of CDOs could be similarly repackaged into CDO-Squared pools. Each billion-dollar pool produced a new AAA/Aaa security to sell to a new, or the same, investor. Each new sale generated a commission or spread to the banker, and this fed the traders, who could buy and resell some of these investors' other CDO holdings.

As early as 2004-05, some of the bank trading desks realized they could get caught holding MBS and CDOs when the market began to reflect potential underlying loan defaults, and looked for ways to hedge their positions. At the same time, some big investors began to worry about segment risk and resist new purchases. The big banks had begun to write and sell “Credit Default Swaps” as a form of inter-bank and inter-investor insurance on corporate bonds and syndicated loans.¹³ CDS reduced investor risk on the underlying bond or loan by wrapping the credit of the bank writing the swap. This was a wildly successful tool to persuade investors to buy riskier investments, including the underwriters’ unsold inventory, by giving up a few bps of yield for insurance premiums. Like a “covered put” in equity circles, CDS enhanced the originating banks’ bond or loan profits on positions they intended to hold, so long as they were able to take the credit risk behind what it sold. Soon, CDS trading desks emerged as separate profit centers to clip a toll on each sale and resale of a CDS. CDS also created a new risk for banks and financial institutions that were nominally regulated by the Federal Reserve and other bank regulators, by adding the undercapitalized, unreserved, unsecured risk of the CDS to the underlying obligation.

The big expansion of the CDS market was its natural extension to MBS and CDO pools. As indicated, CDS spreads the underlying risk to the writer of the CDS. In a trading market, however, buyers of pieces of a CDS are buying a yield of steady premiums from MBS and CDO investors in return for their willingness to repurchase that portion of a defaulted security. Like an unwanted time share demanding maintenance payments, when defaults began to seem more likely, fewer buyers could be found to accept even higher

premiums for the much higher risk. What is notable, here, is that the writers and buyers of CDS insurance were not required to maintain any collateral or capital to support their risk, leaving the bank as intermediary to pick up the cost of defaults.

Many of the earlier AAA/Aaa tranches of MBS and CDOs had been insured by the traditional AAA/Aaa bond insurers, MBIA, AMBAC, FGIC and FSA. For them, the staid, albeit reliable, municipal bond business offered narrow, competitive profit margins that could not pay their executives or stockholders exciting bonuses or returns. The security of governmental obligation, tax-backed¹⁴ repayments left capital to play in new markets at much higher premiums. However, once these insurers reached their minimalist capital limits, they began to back away from the primary market, and bankers needed another form of insurance: CDS. Wall Street searched for other prospective insurers and reinsurers for CDS, and found AIG Financial Products, seeking profit centers. By buying or writing billions of dollars of CDS, AIG brought billions of dollars of exposure to Wall Street banks. Although AIG stopped buying and writing CDS well before the mortgage market meltdown in 2007, CDS on RMBS and CDOs is believed to be the primary source of the \$182 billion of liability owed by AIG to US banks (and US-regulated foreign branches), and the real reason for the Fed’s decision to bail out AIG.

Betting Against the House

A relative handful of market-watchers saw the real estate market over-heating and the mortgages being over-written, instead of underwritten. Some investors and hedge funds saw an opportunity to profit by betting against the viability and repayment of mort-

gage pools, RMBS and CDOs.¹⁵ Some, like hedge fund king John Paulson, began to short subprime pools as far back as 2006, and went so far as to induce Goldman to create a CDO¹⁶ with hand-picked CDS positions on RMBS tranches deemed more likely to default so that he could take the opposite side of the CDS trade.

The Future of Securitization

Securitization has been used and abused by the tragically flawed and fraudulent mortgage securitization process. An under-regulated inflow of cheap easy money, supported by federal policy as much as capitalistic greed, encouraged mortgage brokers to originate bad loans, bad borrowers to lie on loan applications, builders to build in bad locations, buyers to overspend on overpriced properties, bankers to spread undisclosed and unknown risk to unwary investors, and left financial institutions with liabilities exceeding even the outsized profits paid to their bankers and traders.

Proper regulation of investment products requires a full disclosure of underlying and derivative risks, identification of the factors and obligors that could cause investment loss. Ratings need to be based on a thorough analysis of loan underwriting criteria and documentation, as well as historical trends. Derivative products like CDS should require the same disclosure, capital and reserves as insurance products—perhaps even more if they are allowed to be publicly traded as investments.

Securitization and structured finance have been libeled by association with the Great Recession of 2008, which was caused by the Great Mortgage Meltdown of 2007. The Financial engineering that created securitization can be productive and beneficial in

providing greater liquidity, lower financial costs, risk diversification and suitability for different investors and for different portfolios. Like financial guarantees, properly regulated and disclosed guarantors or debt instrument insurers can provide market access for unrated borrowers or loans. Credit default swaps, like other derivative products sold by banks, need to be secured by marketable collateral, or regulated like insurance. In any event, they should be segregated from bank liabilities to depositors which are supported by federal guarantees.

The Mortgage Meltdown occurred principally in the RMBS market, but its ripple effect slowed the CMBS market, which has never fully recovered. Although the author has only anecdotal information on the state of the CMBS market, a more conservatively underwritten mortgage pool with lower LTV ratios, loss reserves, stronger retained equity or junior positions, should be attractive to investors as an alternative to low-yielding government and corporate bonds. There is definitely a need for distribution of the credit and timing risk in the real estate world, but real estate loans involve different credit criteria than other conventional securities, and should not be subjected to the limited disclosure and analysis of conventional publicly traded debt securities. Securitized real estate investments should be structured as private placements requiring careful analysis of financial, demographic and other real estate factors.

NOTES:

¹See, J. Rickards, Repeal of Glass-Steagall Caused the Financial Crisis, USNews.com/opinion, August 27, 2012. The repeal of Glass-Steagall by the Gramm-Leach-Bliley Act, though pressed by Republicans, received support from the Clinton Administration, led by Treasury Secretary, Robert Rubin (formerly, co-

head of Goldman Sachs and soon-to-be-Citigroup Vice-Chairman). In their defense against what should have been obvious even then, Clinton supporters meekly claim that the Republicans had a veto-proof majority.

²See, E.L. Andrews, *Busted: The Great Mortgage Meltdown* (W.W. Norton 2009), for an interesting analysis of the mortgage crisis. See, also, Muolo and M. Padilla, *Chain of Blame: How Wall Street Caused the Mortgage and Credit Crisis* (J. Wiley & Sons 2010); S. Bhagat, *Causes of Subprime credit Crisis*, Leeds-Faculty, Colorado.edu (June 2008); J. Dunbar, *Who's Behind the Financial Meltdown*, <http://www.publicintegrity.org> (Aug. 26, 2009); Klein & Goldfarb, *Anatomy of a Meltdown: The Credit Crisis*, *The Washington Post* (June 17, 2008) and <http://www.washingtonpost.com>; J. Eisinger, *New Target in Finger Pointing Over Housing Bubble*, <http://www.dealbook.nytimes.com> (Jan. 9, 2013); B. Barlett, *Who Saw the Housing Bubble Coming*, <http://www.forbes.com> (Jan. 2, 2009).

³See, B. Ritholz, *Repeal of Glass-Steagall: Not a Cause but a Multiplier*, *The Washington Post* (Aug. 4, 2012). Citigroup's former CEO, John Reed, and longtime director, Richard Parsons, belatedly recognized the damage caused by allowing banks to grow into financial behemoths. See, Chipman & Harper, *Parsons Blames Repeal of Glass-Steagall for Crisis*, <http://www.bloomberg.com> (April 19, 2012).

⁴"Securitization," in the context of financial assets, can be defined as:

"The process through which an issuer creates a financial instrument by combining other financial assets and then marketing different tiers of the repackaged instruments to investors. The process can encompass any type of financial asset and promotes liquidity in the marketplace." (Investopedia.com) "A structured finance process, which involves pooling and repackaging of cash flow producing financial assets into securities that are then sold to investors." (*Webster's Online Dictionary*.)

⁵The author can recall meeting with the major rating agencies in the late 1980s and early 1990s to devise a rating structure for commercial mortgage pools based on over-collateralization. The response was uniformly negative: ratings could only be based on severable ratings for each mortgagor (although most mortgagors of multi-tenant properties were unrated) or the weakest credit in the pool. Raters, and even traders of whole mortgage loans, preferred the "garbage-in, garbage-out" approach, which, in hindsight, was better-suited to investment-grade investors.

⁶The interest component is tax-deductible to owners of real estate, while the principal component is not. Restructuring amortization defers principal repayments, thus maximizing tax benefits.

⁷In the late 1980s, dozens of savings banks and savings and loan associations in California, Arizona and other over-developed areas failed when their high LTV residential and commercial mortgage loans could not be refinanced based on higher values. Expansive, cheap credit and fraudulent loans to bank-related developers and investors led to over-building and a bubble waiting to burst. Sound familiar? Twenty years

before the Great Mortgage Meltdown, lenders abandoned a "true equity" requirement in a wishful belief in ever-rising property values, and it was disproven.

⁸A pyramid or Ponzi scheme relies on payments from future investors, borrowers or buyers to avoid defaults and generate excessive returns.

⁹See, Muolo and M. Padilla, *Chain of Blame: How Wall Street Caused the Mortgage and Credit Crisis* (J. Wiley & Sons 2010).

¹⁰Fabrice Tourre, the manager of ABACUS 2007-AC1, Goldman Sachs' innovative, but deadly, synthetic CDO was cited in the SEC's fraud complaint as having bragged that only he understood the risks inherent in this admixture of CDS written on selected pieces of risky RMBS and sold to unwary institutional investors. See, Andrew Ross Sorkin's summary in <http://www.Dealbook.NYTimes.com>, July 15, 2010.

¹¹This is analogous to securities brokers recommending volatile stocks and frequent portfolio turnover to generate commissions.

¹²The HELOC could be based on a higher bank-commissioned appraised value by adding the value of buyer improvements and free builder incentives, such as upgraded carpeting, appliances, built-ins, etc., shown as closing credits.

¹³CDS became a useful tool in distributing sub-investment-grade corporate bonds and loans to smaller banks and non-bank investors. Essentially, the writer of the CDS would agree to repurchase the bond or loan in the event of default for an ongoing premium or insurance payment. The Federal Reserve cooperated with the big banks and ruled that CDS was not insurance subject to state insurance regulation.

¹⁴GO and tax-backed governmental bonds had historically produced very few defaults. Ironically, Orange County, California, and Jefferson County, Alabama defaults were caused by Walls T. selling municipal officials investment products that were not understood or fully disclosed. The insurers also sold insurance on revenue bonds at higher premiums for investment-grade healthcare education and utility systems.

¹⁵See, M. Lewis, *The Big Short* (W.W. Norton 2010), for an entertaining and informative chronology of Wall Street insider's views of the RMBS market.

¹⁶Paulson is reported to have made \$3.7 billion in 2007 by betting against mortgage securities pools involving subprime mortgages. See, G. Zuckerman, *The Greatest Trade Ever* (2010). In July 2010, Goldman Sachs paid the SEC \$550 MM (\$300 to Treasury and \$250 for investors) to settle its claim that its CDO, called ABACUS-2007-AC1, fraudulently sold synthetic CDO mortgage investments deemed by insiders like Paulson as likely to fail. Allegedly, Paulson—who was not charged—recommended the securities to be purchased by the pool, which his firm had researched, unlike the rating agencies which routinely accorded them high ratings. See, Andrew Ross Sorkin's summary in <http://www.Dealbook.NYTimes.com>, July 15, 2010. Essentially, ABACUS was a synthetic CDO, or

Credit-Linked Note Structure, in which equity investors, like Germany's farm bank, IKB, would win if the underlying tranches of RMBS continued to pay, but pay out their entire investment—\$150 MM for IKB—to Paulson's fund if they defaulted. Other losing participants were ABN AMRO, which insured \$849 MM of the portfolio for repayment to Paulson. ABN's position was

taken over by Royal Bank of Scotland, since nationalized by the Bank of England. These notes were sold without disclosure to investors or ACA, the Portfolio Selection Agent, of Paulson's role and true intent, and apparently, with the misleading inference that Paulson was taking a positive, equity position in the pool, instead of the contrary position.