THE FORECLOSURE PROBLEM

by Steve Brown

The successful rescue of the Chilean miners is fantastic news and serves as an interesting allegory for the rescue that now needs to take place for the American mortgage market. Like a mine, this story goes deep, is complicated and will take along time to architect a successful rescue. Last week, the market exploded with talk about a "foreclosure" problem. In the press, it seems as though only the millions of ex- homeowners already foreclosed upon or the major banks have this problem. What seems to be missing is this is a potential crisis of title that could impact all mortgages, including commercial, because it could dramatically alter liquidity. Any mortgage that was subject to securitization is most likely affected.

As you have no doubt read, after heavy political pressure from FNMA and FHLMC, Bank of America went from freezing foreclosures in 23 states to all 50. At issue is the question over preservation of title. When you get a home loan, the perfection of title is meticulously preserved in order to insure the bank and the new owner their respective claims on the property. In a foreclosure, the same process happens in reverse. However, since foreclosure is an involuntary process, it requires an extra set of steps (such as attestation by a bank that they in fact own the note and the borrower is delinquent, a filing with the county clerk of the foreclosure, another attestation by the bank that they intend to foreclose and the proper notice must be given to the homeowner). While this process varies by state, it is essentially the same. It is within these highlighted issues that it is unclear if Bank of America followed the proper process. Further complicating the issue is that Bank of America, like most major banks, utilized a company called MERS (which is a beneficial title holder that allowed for the efficient exchange of title). MERS allowed the securitization market to explode, because instead of waiting for the clerk of the county to accept a filing, it could transfer ownership in a privatized and electronic manner. While the intent was good, the problem that has surfaced that was never contemplated occurs when a beneficial owner brings into question whether the letter of property law was upheld.

Once again, community banks will be tainted by the actions of large banks, as they will undoubtedly continue to be vilified. While the courts may in fact find that the transference of title was flawed, the press is much too quick, in our opinion, to claim fraud. Further, while most of the press has pointed a finger at the banks, it is important to remember that these borrowers were delinquent and needed to be foreclosed upon (many lived 18 months mortgage and rent free). We are sure the foreclosure process in some areas is lacking and sloppy, however, like most issues surrounding the financial crisis, many parties are at fault.

The immediate impact is a slow down in the foreclosure process by at least 60 days until this gets sorted out. It also calls into question all those that have purchased a foreclosed home. Legal and mortgage expenses will also go through the roof at many of these large banks. We fear a potential class-action movement, were recently foreclosed households attempt to win back their homes on technicalities. The long term impact could be a complete reorganization of how banks and servicing companies process and service foreclosures. This could include the restructuring of beneficial title holding; less securitization and the possible destruction of current title companies that guaranteed the above process was followed. Mortgage rates are likely to increase and home sales prices will be quick to firm (since 30% of the inventory will be taken off the market), only to prolong the housing inventory overhang. As the days go by, expect many more facts to be pulled out of this dark hole and a slow rescue process to take place that will most likely result in another shock to both the equity and bond markets.

BANK NEWS

M&A

The parent company of Berkshire Bank ($2.7B, MA) will acquire the parent company of Rome Savings Bank ($330mm, NY) for about $74mm (70% stock and 30% cash).

Foreclosures

According to SNL Financial, JP Morgan Chase, BofA and Wells Fargo hold the most foreclosed mortgages($) in the US, totaling $55.7B and accounting for 7.5%, 4.39% and 4.74% of their respective portfolios. On another front, FBR Capital Markets estimates foreclosures errors will cost banks $2B/ month, potentially topping $6B.

Consumers Cut Back

The Fed is reporting consumers cut credit card use for the 24th consecutive month last month, as unemployment and economic concerns drove ongoing conservative financial behavior.

Small Biz Retirement

A Gallup poll finds 47% of small-business owners will not retire until forced to do so for health reasons. That is up from only 40% in 2007 and points to how the weak economy has impacted this group. In addition, only 67% say they have enough money to live comfortably when they retire (down from close to 80% in 2007) and more than 60% say they have made "major" or "minor" changes to their retirement strategy as a result of the downturn.

Significant Costs

Hewitt Associates projects companies will pay 9% more for health care costs for employees in 2011, the highest level in 5Ys. That is despite the fact that employees will pay 22.5% of the total premium (up 12.4% from 2010).