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Banks Face Another Mortgage Crisis

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The government may have bailed out the nation's biggest banks, but now the courts will sort out who gets stuck with mortgage losses. Banks could lose more than $100 billion.

JUST WHEN AMERICA'S MAJOR BANKS seem to be back on their feet, having paid back federal bailout money and cranked up their employee bonus programs, a new threat has emerged that could seriously affect their earnings power over the next few years.

The potential liability facing bankers arises from the $2 trillion in subprime, alt-A and option-adjustable rate mortgages that they underwrote and sold to investors, mostly as mortgage-backed securities during the home-lending boom of 2005 to 2007. The losses on the mortgages will be horrendous before the dust settles—over $700 billion on these and other so-called nonagency mortgage securities, according to New York mortgage-research specialist and broker Amherst Securities Group.

And now investors—from the federal housing giants **Fannie Mae** (ticker: FNMA) and **Freddie Mac** (FMCC) to major bond managers like closely held Pacific Investment Management and **BlackRock** (BLK)—are fighting back. They are seeking to put back the mortgages to the banks from whence the investment flotsam came and force the banks to eat much of the mortgage losses.

The argument hinges on the arcane contract principle of representations and warranties, known as reps and warranties in legal jargon. Namely, did the mortgages go bad because of the unanticipated nationwide collapse in home prices (a so-called exogenous factor) or are the banks responsible for the mess because they "misrepresented" to the mortgage purchasers the shoddy quality of the mortgages they put in securities and pools?

Already some of the buyers have enjoyed a modicum of success in their putback efforts. Fannie Mae and Freddie Mac have managed to return over $13 billion in defective mortgages and are gearing up to do even

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more. Before it's all over, the banks may have to swallow more than $30 billion in losses from Freddie and Fannie putbacks alone, according to an estimate by the Washington, D.C., mortgage-research boutique Compass Point Research & Trading. That's because no bank in the mortgage business can afford to play hardball with secondary market behemoths like Fannie and Freddie, the government-sponsored enterprises (GSEs) that own or guarantee about half of all home mortgages in the U.S.

The monoline bond insurers such as **MBIA** (MBI), **Assured Guaranty** (AGO) and now bankrupt Ambac have likewise notched a few victories on the mortgage putback front. These insurers provided credit enhancement for the mortgage-bond offerings. Their wins bode well for garnering a substantial portion of the nearly $6 billion in anticipated recoveries of insurance-claim losses they've booked on their respective balance sheets. MBIA, for example, has been able to fight off several attempts to dismiss its reps and warranties-based case against Countrywide and its parent, **Bank of America** (BAC), in New York Superior Court and is now progressing toward trial. The suit, originally filed in 2008, is being closely watched.

Assured Guaranty, meantime, has gone granular, negotiating directly on a loan-by-loan basis with the banks whose mortgage-backed pools it insured. On a recent conference call, Assured execs said that the insurer had already won over $400 million in recoveries and found serious rep and warranty breaches on some $4.7 billion out of the $5.3 billion in insured mortgages it had reviewed. It plans to examine some $20 billion in insured mortgages before it winds up the effort. So, given its claimed 80% success rate on the mortgages it has already put back and settled, one can assume that its recoveries will dramatically exceed the $1.4 billion in future rep and warranty benefits it now expects.

BUT THE BIGGEST PUTBACK battles with the banks figure to come from the investors themselves in the subprime, alt-A and option ARM nonagency or "private label" securitizations who have suffered such grievous losses. Subprime, alt-A and option ARM nonagency mortgages are generally regarded as the riskiest. Private-label securitizations were issued by banks under their own names and often included these sorts of mortgages. Even Fannie and Freddie couldn't resist taking investment fliers in this $2 trillion market and paid a heavy price as a result.

A Potentially Big Hit

Big banks could lose $134 billion if mortgage securities are put back to them, according to Compass Point Research & Trading.

Company/Ticker	Estimated Loss (bil)	Per Share*	% Tangible Book Value
Bank of America /BAC	$35.2	$2.11	17%
JPMorgan Chase /JPM	23.9	3.59	13
Deutsche Bank /DB	14.1	12.56	21
Goldman Sachs /GS	11.2	12.43	11
RBS Greenwich /RBS	9.4	0.10	12

Credit Suisse /CS	8.9	4.50	22
UBS /UBS	8.4	1.32	15
Morgan Stanley /MS	7.9	3.37	14
Citigroup /C	7.8	0.16	4
Barclays /BCS	3.6	0.18	3
HSBC /HBC	3.5	0.22	2
Total	133.8		

* After-tax. *Sources: Compass Point Research & Trading LLC; Bloomberg; Inside MBS & ABS Asset Backed Alert*

It figures to be tougher for investors to sue the banks and recover a goodly proportion of their losses than it has been for Fannie and Freddie and the monolines. These three have stronger contractual language in their mortgage deals and thereby superior leverage in demanding documentation of all the mortgage loans underlying the securities. Also the reps and warranties made in the prospectuses of many of the mortgage securitizations sold to investors are, at best, vague.

Yet some progress has been made on this front. Various Federal Home Loan Banks around the country have filed suits against a number of bank underwriters, seeking rescissions, or putbacks, on around $25 billion worth of mortgage-backed securities based on defects in their mortgages and misleading prospectuses. Likewise, over 100 major mortgage-bond investors, reportedly including the aforementioned Pimco, BlackRock and Fannie Mae, are banding together by joining a clearing house of private-label securities holders established by Dallas litigator Talcott Franklin. If the group decides to sue the banks, they would have ample legal standing since they represent considerably more than 25% of the holders on more than $500 billion of damaged private-label mortgage bonds. The 25% minimum holding level is sometimes regarded as a necessary threshold for legal standing.

Finally the banks were shocked last month when such clout-heavy investors as the Federal Reserve Bank of New York, BlackRock, Pimco, Freddie Mac, Metropolitan Life Insurance and Western Asset Management signed a letter written by the Houston law firm Gibbs & Bruns that signaled their intent to ultimately try and force Bank of America to buy back some $47 billion in alleged defectively underwritten mortgage bonds. Many of the bonds ended up on the balance sheet of the Federal Reserve as a result of the 2008 bailouts of both Bear Stearns and American International Group.

How much of a loss the big banks will suffer as a result of investors' putbacks is anyone's guess. The law in this area is largely untested. The banks figure to put up an epic battle because the stakes are so large and no federal bailout of big banks seems likely in this political climate. They are on their own.

The guesses on the bank private-label securities losses range from as low as $23 billion to worst-case scenario estimates of $180 billion. Compass Point's base-case estimate of $134 billion seems as good as any since the firm was the first to ferret out the growing size of the Fannie and Freddie putbacks. They also based their number on a conservative estimate of how many suits would be able to survive the bank defense gauntlet and the size of the loss banks would suffer on the putback loans.

Bank of America faces the biggest potential loss, $35 billion, according to Compass Point. That's because BofA is the largest originator, packager and servicer of the bad mortgage paper as a result of its acquisitions of Countrywide and Merrill Lynch during the depths of the financial bust. The bank holding company is a veritable trifecta of liability for the plaintiff's bar as a result. Though any putback losses it may suffer will likely be spread over, say, three years or so, these losses would still constitute a serious headwind. Moreover, the bank can ill afford to take a hit to its net worth with higher capital requirements being mandated for large banks under the new global bank accord, Basel III. Compass Point estimates putback losses could reduce BofA's net worth by 17%.

Since the putbacks hit the headlines a few weeks ago, BofA's stock has fallen 22.6% this year and recent headlines about possible mortgage problems have kept it under pressure.

Bank of America spokesman Jerry Dubrowski was skeptical of Compass Point's loss estimates from putbacks. "We have all the data, which they don't, and we don't know what the final number will be other than it will be manageable. So how can they come up with a number like that? To reiterate, we will act responsibly on honoring all valid claims and contest vigorously all invalid claims."

Certainly, some of the major banks amply deserve to suffer additional putback losses. By almost any measure, they were either negligent or willfully culpable in issuing securities with such glaring defects on the global investment markets. They had little incentive to worry much about investment quality, since the securitized loans passed off their balance sheets, ladling all the credit risks onto the credulous buyers.

The banks had created such a fee-rich securities sausage factory during the middle of the current decade that the ingredients going into their products were of little concern. It was merely important to keep production levels elevated even after the pool of creditworthy mortgage borrowers had run dry, only to be replaced by dead-beat subprime borrowers and alt-A mortgage-financed home speculators ready to mail their home keys to their lenders at the first whiff of home-price weakness.

Bankers argue that economic woes rather than shoddy loan underwriting are to blame for most of the lamentable financial performance of the mortgage market. Therefore, the pugnacious CEO of Bank of America, Brian Moynihan, has promised that the bank will engage in "hand-to-hand" combat to fight putback claims. "People who come back and say, 'I bought a Chevy Vega, but I wanted it to be a Mercedes with a 12-cylinder [engine].' We're not putting up with that," he insisted during a recent conference call.

Yet there's plenty of evidence that the banks during that key three-year period in the middle of the decade passed off some Yugos as sleek sedans. One has to look no further than the claims in the lawsuit filed by the Federal Home Loan Bank of San Francisco, one of 12 regional lenders to banks designed to promote home-mortgage and community loans, seeking to putback some $19 billion of mortgage securities the bank had invested in.

The prospectuses covering some 116 securitizations the bank was involved in seemed wildly misleading. In one portfolio, a model employed by the FHLB showed that the appraisals on the mortgage properties were greatly inflated, with 16% of the mortgages in the pool having loan-to-value ratios of over 100%. In other words, the loan amounts exceeded the value of the home. The remainder of the L-T-V-s far in excess of promised levels. Likewise, a check of the same pool, which was only supposed to include mortgages on owner-occupied homes, revealed that a significant percentage of the borrowers had property tax bills sent to other addresses or never bothered filing for homestead exemptions. In fact, these folks turned out to be overleveraged home flippers with multiple mortgages.

The models used by the FHLB were seemingly robust. The data came from mortgage-analytics firm CoreLogic and were based on contemporaneous home-sale data sorted by different geographical areas to establish obvious evidence of appraisal kiting. Their sample size covered 58% of the entire pool—all the properties on which they could find comparable home-value data.

Similarly damning was testimony taken in September by the Financial Crisis Inquiry Commission, a bipartisan body established by Congress to get at the root causes of the U.S. financial bust. Here the former president of Clayton Holdings, D. Keith Johnson and current Clayton Senior Vice President Vicki Beal stated that only 54% of some 911,000 mortgage loans Clayton sampled for several dozen of Wall Street's blue-chip firms ranging from **Goldman Sachs** (GS) and **Morgan Stanley** (MS) to **Citigroup** (C) and **Deutsche Bank** (DB) to be packaged into different mortgage pools for sale met the underwriting standards stipulated in the offerings.

Nonetheless, many of the 46% that didn't make the first cut were "waived in" to the portfolios on the basis of mitigating circumstances claimed by the various underwriters.

Yet despite Clayton's concerns about the manufacturing quality of the portfolios, its sample data never made it into any of the investor prospectuses.

Apparently the Clayton data were merely employed by the securitizers to negotiate lower prices on the mortgages from the originators without passing any price discount or higher yield on to the investors.

Yet it's likely to be a long, hard slog for the investors in the private-label mortgage securitizations to succeed in making large putbacks and recover some of their losses. Bank of America has put together a crack legal team led by Wachtell, Lipton, Rosen & Katz. Likewise, the process for private-investor pools to even obtain loan documentation on the thousands of mortgages underlying the securitizations is cumbersome. They must first sue the trustee of each securitization trust to order the trust's mortgage servicer to proffer the documents and assert the pools' putback rights. The servicers are frequently units of the same bank-holding companies under fire for packaging the bum securities. The same holds for the banks that are dominant players in the bond-fund trustee field. They have no incentive to be aggressive on behalf of the investors whether out of professional courtesy to their fellow bankers or because of their own potential liability.

Nor can one be sure that the major bond-fund managers will risk alienating the major banks by vigorously pursuing putbacks. Once the litigation stage is reached, the managers will lose their anonymity. Moreover they will have to start paying major litigation costs even though many of the investors in the damaged pools will enjoy the fruits of any putback recoveries whether they pay up or not. That's known in the business as the free-rider problem.

But in the end, the bond-fund managers and other major players will have to exercise their fiduciary responsibilities and go to the mat with the banks. The participation of government and quasigovernment entities like Fannie, the Fed and the Federal Home Loan Banks in the effort ought to insure some constancy of purpose.

So a battle, epic in proportion, impends over the next couple of years. And more than likely, the banks will have to eat yet another helping of their own cooking. Though this time, it will be without the benefit of any government bailout to ease their indigestion.

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