Aspen Publishers

Real Estate Finance

Volume 24, Number 4
December 2007

Wolters Kluwer
Law & Business

Real Estate Finance

VOLUME 24, NUMBER 4 DECEMBER 2007

Mortgages, And More

We have a wide range of articles in this issue, beginning with "Aggressive Mortgage Lending And The Housing Market: The Economic Impact Of Minor Miscalculations," by Gil Sandler, Managing Director of Realvest Capital Corporation, a financial consulting firm specializing in capital markets financing for real estate.

Mr. Sandler continues his analysis of the "Subprime Meltdown," explains who he believes will suffer the consequences, explains what steps officials are taking to deal with the problem—and proposes a solution of his own.

TENANT-IN-COMMON

Stephen I. Burr, a partner with Foley & Lardner LLP, is the author of our next article, "The Tenant-In-Common Industry: What to Expect in 2008."

In this article, Mr. Burr reviews the challenges the TIC industry faced during this past year, from a declining base of anxious sellers of appreciated real estate looking for exchange opportunities to confusion and concern in the real estate debt capital markets, and offers some thoughts on what the TIC industry will have to deal with in 2008.

A TOP 10 LIST

The contemporary syndicated line of credit or loan agreement can surprise the unwary lender that seeks to purchase a portion of a loan as a member of a syndicate of lenders. A lender entering into one of these arrangements will find that legal counsel with experience in these types of transactions can help explain the risks. Nevertheless, there are some aspects of these transactions that may be surprising.

Our next article, "The Top 10 Surprising Things about Syndicated Loans," is by Charles A. Guerin, a partner in the Dallas office of Bracewell & Giuliani LLP. In this article, Mr. Guerin discusses the 10 most surprising things about syndicated loans for lenders.

AND MORE…

We have an interview with Pillsbury Winthrop Shaw Pittman LLP insolvency partner Rick B. Antonoff and white collar litigation partner Maria T. Galeno discussing developments in the subprime mortgage industry

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and possible changes to come, as well as more, including a Real Estate Tax Update by Philip C. Sutton and Dawn M. Timan of Pricewaterhouse Coopers.

Best wishes to you all for a Happy, Healthy, and Peaceful New Year!

Steven A. Meyerowitz
Editor

Aggressive Mortgage Lending and the Housing Market: The Economic Impact of Minor Miscalculations

By Gil Sandler

Gil Sandler is Managing Director of Realvest Capital Corporation, a financial consulting firm specializing in capital markets financing for real estate. He can be reached at gsandler@realvestcapital.com.

The "Subprime Meltdown" and its evolving aftermath are moving targets more suited to financial market "blogs" and market-watch columns than this writer's observations and analysis, which foretold negative trends in the mortgage and housing markets and have approached self-fulfilling prophecies. Unfortunately, even keen observers—like our Fed Governors and Fed-watchers—did not anticipate the broad, global effects of what might have begun as "frothy exuberance" in the housing market, but graduated into a full-fledged liquidity crunch and, possibly, an economic crisis.

INTRODUCTION

As market-wary traders are short-selling and buying puts on mortgage lenders, homebuilders and housing-related stocks, the consensus among "trend-followers" seems to be that a market bottom is nowhere in sight. To control the damage, politicians, bankers, economists, lawyers and legislative staffers are devising programs to prevent record foreclosures.

Each day's headlines herald a new case of mortgage market fallout. Banks and investment banks (Merrill, Citigroup, Morgan Stanley, Bear, UBS, Deutschebank, HSBC, Bank of America, Washington Mutual) continue to report greater-than-expected write-down of devalued balance sheet investments in collateralized debt obligations or "CDOs," consisting mainly of residential mortgage backed securities (MBS). Financial service companies are struggling to put past miscalculations behind them, and create new profit opportunities. Banking and fixed-income management executives are pushed out (Merrill, Bear, and Citi) for encouraging or tolerating misunderstood mortgage market risk. Realizing that forward-looking reforms cannot prevent a liquidity crunch and seeking to avert the political pains of a direct bailout, the Fed has offered bipartisan support for a private bank-sponsored Super-SIV to buy rated, but unmarketable, CDO tranches.

Like an MRS staph infection spread by transient hospital "staphers," a deadly alchemy of economic inventions and factors was permitted to overheat our economy. Fed Governors and staff may have intended to inject this admixture of cheap and easy money to prop up a sagging economy while the dollar was losing nearly 50 percent of its value against the Euro. Indeed, the context of the Fed's push to lower rates from 2001-2004 was a stagnant stock market needing a push, an Iraqi war creating record foreign payments deficits and waning consumer power and confidence. The unfortunate miscalculations were the inability to foresee the effects of unregulated, de-personalized lending funded by global investors, newly crafted mortgages offering cheap and easy money to first-time homeowners and speculators alike, enhanced by old-fashioned greed disguised as healthy capitalism.

THE MORTGAGE INDUSTRY'S NEW TOYS

The most important economic toys of the industry's remarkable boost to an otherwise lackluster economy were:

- Option ARMs to finance as much as 100 percent of a home's cost. These no-doc or low-doc loans enticed move-up homebuyers with ridiculously low starter rates that were destined to double (or worse) in a year or two.

Postscript: Mortgage originators did not underwrite against likely reset rates with realistic borrower incomes. Nor did they disclose to borrowers the compound risks of much higher payments at predictably higher interest rates and the need to amortize higher accreting principal balances in a declining housing market held down by rising mortgage rates.

- "Subprime" loans to borrowers with no or poor credit history and inadequate income. First rationalized as a means for first-time and move-up buyers in poor neighborhoods, these higher-cost, higher fee loans soon cut a wide path across socio-economic lines, infecting middle and upper income home-buyers striving to buy new homes and condos that they would eventually be able to afford. The American dream was being pitched by uninformed and uninhibited high-pressure mortgage brokers with no concern for the details of rate resets, prepayment penalties, and fee disclosures.

Postcript: Qualifying for a no-doc loan despite low or unstable income money is cheap and easy and housing prices are inflated, does not prevent defaults when monthly payments double and supposedly easy refinancing is unavailable due to income requirements and declining housing valuations. This risk was not properly analyzed by mortgage originators nor disclosed to borrowers.

- Rapid securitization of mortgages originated without rational underwriting standards. Rating agencies, investment banks and bulk buyers were all so motivated by quick profits that they ignored or minimized fundamental assumptions about high default probabilities in a rising-rate environment and refinancing problems for borrowers with poor credit in a declining real estate market.

Postscript: Banks, investment banks and hedge funds offered low government-like rates for overrated tranches of mortgage-back securities sliced and diced into CDOs based on false assurances. Their senior claim on pooled cash flows was protected by the allocation of defaults to lower-rated tranches. However, once those junior classes incurred more defaults than were optimistically projected, the cushion disappeared and reduced the protection and rating assumptions applicable to senior classes.

PROSPERITY TO PANIC IN RECORD TIME

Some market observers, including this commentator, saw potential problems beginning to emerge back in 2005, when we encountered amateurs speculating on flipping unbuilt condominiums. We also saw highly leveraged, under-qualified borrowers receiving below-market loans leveraged up to 100 percent of cost. We then saw developer prices being artificially inflated by 20 percent or more over a year or two of phasing, further fueling "buyer's panic." Add to it a Fed determined to hike historically low rates to prevent even the hint of inflation, and we have an emerging problem.

In the views of some observers, it was not necessary to reduce the Fed Funds rate to one percent and keep it there for so long to avert the risks of deflation. Perhaps a two percent to three percent Fed Funds rate for an extended period would have sufficed and obviated the need to push that rate 4.25 percent to 5.25 percent over 18 months. If the prime lending rate affecting consumer loans had fluctuated between say, five and a half percent and seven percent, the volatility of mortgage rates and housing sales would arguably have been less. But, if the Fed's goal was really to inflate the housing market, and create spending power in an otherwise flaccid economy, its success came at a heavy cost.

By failing to impose realistic underwriting criteria on regulated lenders, while continuing to reduce rates, US regulators allowed legions of untrained, often unethical, commission-hungry mortgage brokers to exploit middle and lower-income consumers in the guise of helping them move up the ownership ladder. One plausible theory is that monetary and regulatory policy sought to raise the asset values of lower and middle-class homeowners while the economic boom was aiding upper-income Americans with top-tier tax cuts and soaring stock market gains. Real estate appreciation may have become a partial substitute for the absence of real wage income gains.

What eventuated was a bit different. Thanks to capitalism and Wall Street securitization, any mortgage broker could obtain inexpensive funding, and pass it down to increasingly unqualified borrowers stretching to buy overpriced homes. After all, why should anyone worry about what he or she can really afford when bombarded with glossy color brochures of new homes, feature-packed with "dramatic" two-story entry foyers, bonus rooms, and chef's kitchens, and can literally pick their payment? This extension of the American Dream stoked the demand for creative, albeit unsuitable, mortgages, but it was the funding system and regulatory and monetary policy that made it happen.

The Fed and most bankers publicly applauded and took credit for the economy's jobless growth without acknowledging that the economy's replacements for lost manufacturing jobs and spending power were really caused by the inflated residential mortgage market. Two years after record construction starts, sales and mortgage volume, investors in all markets are beginning to see the results of the Fed's promiscuity. Economists estimate that as much as 15 percent to 25 percent of the job growth experienced from 2001-2005 is derived from the housing industry, despite a net loss in manufacturing and industrial jobs. However, long term job growth and productivity must consider the longevity of job gains in newly minted real estate and mortgage brokers, construction and development workers, and related consumer services.

A PREVENTABLE CRISIS

This highly toxic—but largely preventable—reaction to over-stimulation of the housing market is only now beginning to emerge like a multi-headed hydra. Independent mortgage lenders and brokers have closed and/or filed for bankruptcy, while homebuilders, public and private, have auctioned assets and terminated new projects. Flooded with cancellations of once highly-sought purchase contracts, and terminations of financing commitments, builders have been forced to shut down projects and leave communities without utilities or amenities. Wall Street lending and servicing units have issued thousands of pink slips and recycled underwriters into servicing and workouts. Rating agencies will lay off as volume slows to a trickle. Department heads and other identifiable decision-makers have been wrapped into their golden parachutes or forced to live on the fruits of their previous stock options or severance.

Some industry executives and regulators and economists have tried to shift or sluff off responsibility by conceding only these same "minor miscalculations." Others have claimed ignorance of the complex workings of mortgage securitization. After all, it seemed like a win-win for all if global investors were willing to share the risks and rewards of high CDO yields while spreading affordable homeownership into marginal and blighted neighborhoods. While this approach appeared laudable as a political objective, it doesn't take economic clairvoyance for knowledgeable market professionals and regulators to ask another round of questions. Aside from the rhetorical tone, it is hard to understand how ignoring these obvious issues can be dismissed as "minor miscalculations."

- Is there any alternative to raising interest rates in a free market environment after the Fed ripped down to unsustainable record lows? Can any financial markets analyst be surprised that the Fed returned to its traditional inflation-fighting stance and systematically raised the Fed Funds rate 4.25 percent when the first sign of labor or supply shortages appeared?
- Why should it surprise rating agencies or investors that defaults would far exceed the projected four to seven percent of "subprime" borrowers, and would actually reach closer to 25 percent in the face of higher reset rates and declining property values? Remember, subprime borrowers were so classified because they could not verify income and invested little or no equity.
- Why should it shock markets when these mortgages and their underlying collateral—housing units—are devalued by the doubling or tripling of unsold housing inventory? Did anyone model the impact on housing prices—and related collateral values—of even small increases in unsold inventory or forced sales?
- Why did neither the Fed nor the major banks foresee that the devaluation of junior classes of billions of CDOs, stocked mainly with subprime and junior lien loans, would cause the so-called "super-senior," AAA-rated tranches to be similarly devalued or questioned. Why did they fail to anticipate the inevitable market effect of ratings and market perception downgrades? Since forced investment sales into illiquid markets require write-offs and impair capital levels, investors and lenders alike become unable or reluctant to lend, further impeding mortgage refinancing.
- Did Fed Governors and staffers realize that using cheap and easy mortgage money to ignite a limp economy would have an ultimately worse impact on housing values and the broader economy?

WHO WILL SUFFER THE EFFECTS?

The Subprime Meltdown can be seen as a form of Weapon of Mass Destruction visited upon the American economy, but the fallout is still largely unknown. These are some of the likely effects:

Banks & Investment Banks: As bank write-offs proliferate, fixed-income heads and even CEOs of major banks are being held accountable, though not quite impoverished, thanks to stock grants and severance payments. In most cases, the write-offs reflect a fraction of the banks' underwriting and trading profits over the past five years of record volume. They also include a chunk of paper losses in the form of extra reserves that can produce higher future earnings when future asset sales of better-performing loans result in higher sale proceeds. However, the sheer magnitude of these multi-billion dollar write-offs at even mega-banks can lead to an unduly restrictive lending policy, if only to rebuild impaired capital levels. Coincidentally, this dynamic could also lead to more consolidation in banking.

In the future, loan underwriting criteria will be much tighter and loan volume much lower, resulting in lower loan origination, securitization, and trading profits. Some loan losses at smaller banks and at bank-affiliated SIVs or investment pools could adversely affect the bank's reputation and asset management businesses. However, in much the same manner that insurance companies cover losses with premium hikes, banks will regenerate profits on all but the most competitive loans through higher commitment fees and lending spreads. As banks close mortgage-related units, many thousands of jobs will be permanently lost, along with the creation of surplus commercial office space. These cutbacks will put pressure on the commercial rental market and slow the economy.

Structured Investment Vehicles (SIVs): Another bank casualty appears to be bank-sponsored structured investment vehicles, a new breed of post-Enron, off-balance-sheet conduit. About $350 billion of mostly borrowed money was invested by SIVs in CDOs and various forms of mortgage-backed securities (MBS). SIVs obtain high investment grade ratings based on over-collateralization through their holdings of highly rated senior tranches of CDOs and MBS and borrowed at ultra-low rates in the high-grade commercial paper market. Unfortunately, however, when the market values of their collateral dropped or became speculative, some SIVs were unable to roll over their commercial paper and had to reach out to their big bank affiliates who managed or helped organize them. Although not fully responsible through liquidity or repurchase agreements, affiliated banks derived most of the profit through management fees, and were reluctant to let them fail.

As a result, Citibank—the largest SIV sponsor with about $80 billion in sponsored SIVs—obtained Fed backing to organize an $80-100 billion "Super-SIV," called a "Master Liquidity Enhancement Trust." Teaming with the two other largest US banks, JPMorgan Chase and Bank of America, a group of banks and investment banks and major fund groups would provide direct liquidity support (and top short-term ratings) for newly issued CP. This conduit would then buy higher-rated "super-senior" tranches of mortgage-related securities—reportedly AA or better—from SIVs and others at a discount under certain conditions, such as a limited first-loss guarantee from SIV sellers. The intention was to establish an orderly market—and a tolerable market discounted value for mortgage securities and prevent a wholesale sell-off at liquidation prices, which would, in turn, devalue remaining holdings.

Though falling short of a Fed bailout of bank affiliates, the Fed involvement is intended to provide incentives for other banks with little or no SIV exposure to participate. At this date, the success of this private initiative is uncertain.

CDO/Mortgage Investors: As hedge funds and smaller banks close, million-dollar managers and so-called analysts move on to the next fund or market. Their bonuses and profit-shares over the past five years far exceed any bankruptcy give-backs, penalties, or possible litigation costs.

Pension fund and foreign investors, however, have long memories and short appetites for risk. Like Orange County's investment fund invested in the highly leveraged junior tranches of MBS a decade ago, and investors blown away in Long-Term Capital's implosion in 1998, these institutional investors will suffer real losses that cannot be easily recouped. Although hedge funds usually comprise a small piece of large multi-billion portfolios, they have been increased over the past five years, and incur major losses. Some funds may react by firing their money managers and shifting remaining alternative investments in more conservative vehicles.

Mortgage Brokers: Many mortgage brokers will suffer a fate similar to that of migrant agricultural workers when a crop is destroyed before the harvest. They will return to a less lavish lifestyle and try to reclaim their "day jobs." Some will be retained in workout and restructuring positions or to handle refinancings, which will create substantial volume as ARM rates reset and the Fed pushes them downward. Many of the better trained brokers will qualify for licensing under new state regulations, and will find jobs with bank lenders.

Independent, non-bank mortgage lenders who funded their operations through securitization will either disappear or obtain permanent capitalization and/or bank affiliations. Larger mortgage originators, like Countrywide, will face class action litigation and regulatory pressures to restructure predatory loans. Despite its status as the largest lender in the country, substantial outside investment or Chapter 11 are beginning to appear as real possibilities.

Hedge Funds/Private Equity Groups: Paradoxically, some of the same hedge funds and private equity groups that invested in high-risk, lower rated CDOs could find new investment capital to take over larger mortgage servicers or buy distressed loans. Merger and acquisition teams at the same investment banks that securitized pools of poorly underwritten loans for failed mortgage lenders are probably working overtime to form new hedge funds or raise new capital pools of private scavenger equity. As the savings and loan failures of 1987 spawned a Fed bailout through the creation of the Resolution Trust Company, crises create opportunity, even as victims suffer.

An unexpected consequence of the Subprime Meltdown is the liquidity crisis that has spooked the global corporate bond market for both low-rated "junk" bonds of highly leveraged companies and senior bank loans. The prevailing "covenant-lite" bank loans that supported an active LBO market over the past several years has been replaced by a "covenant-right" market and collateralized loans. This credit tightening caught private equity sponsors and lead banks—who routinely gave firm underwriting commitments—off-guard, sending them into heated renegotiations to terminate or modify committed takeovers and LBOs. Some banks will hold unsold pieces and swallow some losses to keep the relationships with private equity sponsors.

As a result, even private equity investors who scrupulously avoided investing in CDOs and MBS are being scalded. As previously noted, investment bank M&A groups can be expected to share in the pain of failed deals and lower deal flow.

Homebuilders: Most of the large publicly held building companies have seen their stock prices drop by 40 percent or more. High cancellation rates and unsold inventory have depressed prices in over-built markets like Florida, Las Vegas, and Arizona. Second-home areas were especially hard-hit by mortgage-related problems, as much of the sales volume was supported by speculators using subprime and highly leveraged loans.

Continuing declines in sales of both new and existing homes—both in units sold and prices—suggest that the market has more room to drop. In fact, it has been suggested that the total loss in market value of real estate will move into the trillions and exceed the 30 percent drops of the late 1980s during the savings bank crisis.

The larger national homebuilders—such as D.R. Horton, Toll Brothers, Beazer, Pulte, Centex, and US Homes—are likely to survive in a slimmed-down form. With more than three years of inventory piling up after record buyer cancellations, even major companies will become takeover targets for consolidators and LBO sponsors. To the extent practicable, builders will retrench to focus on primary home areas, while slowing multi-phase projects. While much of their stockpiled land has been optioned over recent years, rather than owned and financed directly, a sizable portion of land has been stockpiled, and the reduction in value could erode profits and cut off dividends. Those builders who are well-capitalized should be able to complete projects and sell inventory by offering access to mortgage financing.

Regional and local builders, particularly in overbuilt markets, will be forced into discounted sales and possibly worse. Their distress will further depress local prices as new units become cheaper alternatives to older resales.

Mortgagors: Many borrowers will continue to suffer the pressures of loan workouts, short sales below mortgage balances and foreclosures. After mounting adverse publicity about its strong-arm tactics and unyielding workout policies, Countrywide Mortgage, the nation's largest mortgage lender, finally agreed to work with non-profit consumer groups to establish "fair" workout policies to avoid foreclosures. The primary focus is to avoid rate and payment increases in subprime and Option ARMs that are unsustainable and moderate or waive prepayment penalties and administrative fees that prevented borrowers from ever curing defaults. Some of the same lower and middle-income neighborhoods that were targeted by the mortgage peddlers have experienced record foreclosures and abandoned properties, further depressing property values and the refinancing capabilities of the remaining borrowers.

While Congress and several states draft and debate new legislation to protect homeowners, regulators and bankers must recognize both their culpability and future risk if they don't act to minimize the disruptions of foreclosures and forced sales. The Countrywide plan follows voluntary modification policies at other banks and mortgage lenders, but it must also be supported by the servicers and investment banks whose documents prevent rational modifications and fee waivers. Distraught investors relying on unrealistic bond ratings can legitimately complain about their losses, but instead of objecting to workouts, modifications and fee waivers, they should hold their securitizing investment banks responsible for lost income and values. In turn, investment banks can seek some recourse from the surviving mortgage originators and servicers.

Real Estate Investors: Owners of "for sale" housing units, like homebuilders and developers, have already been hit by the market glut and no rainbow has yet to emerge. Apartment owners, like REITs and developers, have benefited from substantial rent increases over the past two years as condominium units became too pricey. However, the overbuilding of condominiums will force more developers into conversions to rental units, creating some competition for new renters. In addition, the emerging economic downturn will probably limit rent increases in all but the most expensive markets—like New York, San Francisco Boston, and Washington.

Commercial property values trends tend to lag the housing market. Commercial developers target high-growth residential areas in selecting sites for new retail and commercial projects, but often don't complete and lease them for several years. Projects begun in 2003-2004 when interest rates were very low and housing prices were growing at 10 percent or higher, annual rates will be coming onstream during a period of economic stress, and slower or no growth. With housing-related industries and banks shrinking the demand for office space, commercial rents and values are likely to remain flat or decline slightly until a few years after the housing market hits bottom. Risk-tolerant investors will be watching REITS for trading and buying opportunities.

Homeowners: This group has and will continue to suffer the most from the Subprime Meltdown. It is now widely acknowledged that what began as overly-aggressive—and frankly—poor underwriting in this 10 percent +/– segment of the multi-trillion dollar market has spread into Alt. A (good credit, high leverage) mortgages and even traditional mortgage markets. Subprime delinquency rates moved from eight percent—even then above rating agency assumptions—to an estimated 18 percent in the past year alone, and are feared to hit 25 percent as rates reset in 2008. This predictable result of higher rates, drooping property values, and default losses being recouped through bigger lending spreads can be credited to the ingenious folks who brought us Option ARMs and no-doc subprime mortgages.

Now, even homeowners who had no connection to questionable mortgages and good-credit borrowers seeking new loans or refinancings are suffering from severe market declines and painful underwriting constraints. Trade groups like the National Association of Realtors report increasing distress in most markets due to swollen inventories. Independent economic surveys like the S & P/ Case/Schiller Report are confirming that same-unit sales slid as much as 10.1 percent in Tampa, and an average of 4.4 percent over 20 major national markets, in the 12 months ending in August 2007. This includes a .8 percent drop from July to August alone—a period of high sales volume and usual growth—and reflects the eighth consecutive monthly decline. Tampa, San Diego, Phoenix, Miami, Las Vegas and Washington—mostly due to over-building of new housing—and Detroit in the "rust belt" all showed year-to year losses of more than seven percent, while Portland (plus two percent), Seattle (plus 5.7 percent) and Charlotte (plus 5.6 percent) registered gains.

HELP IS ON THE WAY

As the Liquidity Crunch following the Subprime Meltdown rivals the Iraqi War in consumer concerns, politicians at all levels issue self-serving assurances that their plan will solve the problem. While pointing fingers at Wall Street and Federal banking regulators, they feign ignorance of the inner workings of the mortgage financing structure. As politicians, policy makers, and former Fed officials look backward for scapegoats, reform legislation and regulation is vital, if only to lessen the symptoms of the economic downturn triggered by housing declines.

Several popular plans involve new legislation that should provide some relief to current mortgage victims, but most of these systemic reforms will be "too little, too late." For example, increasing loan limits for government guaranteed loans from FHA and sponsored agencies like FNMA and FHLMC could offer an important benefit in the more expensive markets for refinancings and new loans. Qualifications will also have to be adjusted to make these funds available to squeezed mortgagors facing defaults. Since property values will have already declined by 10 percent to 20 percent in many markets, a vital addition to these proposals would be to restore credit and loan-to-value appraisal guidelines to "normal" levels before the recent market shake-up. Also needed is a clear policy of enabling lenders to forgive or waive delinquencies due to misunderstood and predatory loans without triggering regulatory capital breaches, or wholesale puts by investors.

State legislation requiring licensing of, and training for, mortgage brokers provides no retroactive benefit to the victims of predatory or mis-disclosed loans. Federal proposals for mortgage suitability standards—previously suggested by this commentator as analogous to standards for the sale of securities—are also constructive, though opposed by mortgage lending trade groups as unduly burdensome. Of course, those groups would object to any standard of conduct that would reduce loan volume or increase legal exposure.

Perhaps most useful among current proposals are plans to require lenders and servicers to offer realistic modifications and workouts to avoid foreclosure, including gradual rate increases justified by market rates and conditions, rather than preset rate hikes, and waivers of prepayment penalties and modification fees. Though not permitted by most securitization structures, lenders, servicers, and banks can negotiate a fare sharing of the cost of such modifications, and with legislative and regulatory support, implement modifications to minimize foreclosures and market disruptions.

Other new proposals to provide direct legal recourse to the brokers and investment banks that profited from the proliferation of bad loans could unleash the armies of class-action lawyers to relieve the last group of profiteers of some of their unearned treasures. The prospect of huge damage awards could create important incentives to improve underwriting and sales practices, but the lengthy litigation and low percentage of likely net recoveries (after costs and legal fees) offer little comfort to borrowers facing foreclosure or unaffordable payments. Unless these proposals include limitations on legal fees—which will be vigorously opposed by legal lobbies—and pay substantial proceeds into a fund to refinance or reimburse victims, they will have a limited effect on the housing market and easing credit problems. The creation of publicly administered recovery funds—generated by class-action or state regulatory enforcement awards—could enhance a broad national effort to refinance or modify predatory loans.

A NEW REFORM PROPOSAL: MAKE LENDERS AND SERVICERS REFINANCE PREDATORY LOANS

The current proposals before Congress tend to provide long term benefits to the industry and consumers, but they offer limited benefits to those currently in crisis. A more useful plan might require originators, servicers or financiers, whichever surviving entity had the most direct contact with borrowers of badly underwritten or marketed and/or mis-disclosed mortgage loans, including subprime Alt. A or "exploding" Option ARMs, to modify or refinance those loans on conventional market rates and terms, without additional equity paydowns. Since 10 percent to 30 percent of those loans in the present declining market would not meet traditional 80 percent LTV underwriting standards, most of these loans would not qualify for FHA, FNMA, or FHLMC without more equity.

This type of legislation should also require lenders to:

- Discount or forgive delinquencies or defaults attributable to unforeseen or poorly disclosed rate resets.
- Waive prepayment and modification fees.
- Subject to some percentage of each loan or loan pool—perhaps 10 percent to 15 percent—offer deferred-payment or interest-only second-lien loans at market rates in order to qualify the first mortgages at a traditional 80 percent LTV level. This would presumably enable the lenders to securitize those mortgages in a revitalized MBS market, although some governmental support may also be required for these new pools.
- Defer repayment of accreted portions of Option ARMs and payments missed after unforeseen or mis-disclosed rate resets.

To limit the burden on lenders, this remedy would be available only to mortgage borrowers on primary residences below certain income levels who are not otherwise shown to be sophisticated borrowers or speculators.

This program is suggested as a new approach to re-focus legislators, regulators and lenders on the urgency of limiting foreclosures and market turbulence in the sale of housing units. This can be done by a regulatory policy that "no homeowner will be left behind"—or foreclosed upon, by fee-happy mortgage servicers. Wall Street can and will ultimately deal with market turbulence in mortgage-related securities, but the best medicine for mortgage investors and the economy as a whole is a stabilized housing market.

Policy makers must strike a delicate balance between providing relief to borrowers who can afford to repay fairly priced mortgages and providing windfall benefits to knowing risk-takers with little or no equity. Though billions of dollars will be spent on this and other reform programs, the ultimate cost of a well-orchestrated program directed at saving homeowners will be much less than the alternative of accelerated foreclosures, continuing declines in property values, credit capacity, spending power and the broader economy. Whether the continuing slowdown approaches or ever reaches a classic "recession," the pain of seemingly minor miscalculations could be equally severe.