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The REAL Foreclosuregate Mess And What Could Happen

Dear Readers, this text came to me in an email from sources that are in the financial services business and with whom I have a personal relationship. The original text was laced with expletives and I would not use it in the form I received it. Therefore the text below has had some substantial editing in order to remove that language. The intentions of the writer are undisturbed. The writer shall remain anonymous. This text echoes some of the news items we have seen and heard today; however, it can serve as a plain language description of the present foreclosure-suspension mess. There is a lot here. It takes about ten minutes to read it. - David Kotok (www.cumber.com)

"Homeowners can only be foreclosed and evicted from their homes by the person or institution who actually has the loan paper...only the note-holder has legal standing to ask a court to foreclose and evict. Not the mortgage, the note, which is the actual IOU that people sign, promising to pay back the mortgage loan

"Before mortgage-backed securities, most mortgage loans were issued by the local savings & loan. So the note usually didn't go anywhere: it stayed in the offices of the S&L down the street.

"But once mortgage loan securitization happened, things got sloppy...they got sloppy by the very nature of mortgage-backed securities.

"The whole purpose of MBSs was for different investors to have their different risk appetites satiated with different bonds. Some bond customers wanted super-safe bonds with low returns, some others wanted riskier bonds with correspondingly higher rates of return.

"Therefore, as everyone knows, the loans were 'bundled' into REMICs (Real-Estate Mortgage Investment Conduits, a special vehicle designed to hold the loans for tax purposes), and then "sliced & diced"...split up and put into tranches, according to their likelihood of default, their interest rates, and other characteristics.

"This slicing and dicing created 'senior tranches,' where the loans would likely be paid in full, if the past history of mortgage loan statistics was to be believed. And it also created 'junior tranches,' where the loans might well default, again according to past history and statistics. (A whole range of tranches was created, of course, but for the purposes of this discussion we can ignore all those countless other variations.)

"These various tranches were sold to different investors, according to their risk appetite. That's why some of the MBS bonds were rated as safe as Treasury bonds, and others were rated by the ratings agencies as risky as junk bonds.

"But here's the key issue: When an MBS was first created, all the mortgages were pristine...none had defaulted yet, because they were all brand-new loans. Statistically, some would default and some others would be paid back in full...but which ones specifically would default? No one knew, of course. If I toss a coin 1,000 times, statistically, 500 tosses the coin will land heads...but what will the result be of, say, the 723rd toss? No one knows.

"Same with mortgages.

"So in fact, it wasn't that the riskier loans were in junior tranches and the safer ones were in senior tranches: rather, all the loans were in the REMIC, and if and when a mortgage in a given bundle of mortgages defaulted, the junior tranche holders would take the losses first, and the senior tranche holder last.

"But who were the owners of the junior-tranche bond and the senior-tranche bonds? Two different

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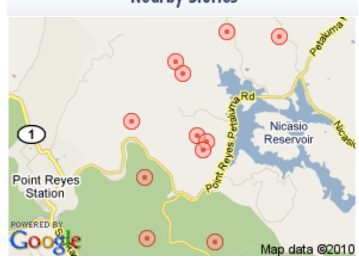

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