



What's New?

Feddern Financial Consulting Group Newsletter

November 13, 2009

KEYS TO THE BEGINNING OF A RECOVERY:

- 1. The Real Estate market must stabilize. If not reversing, at least not continuing to fall. *NEW HOUSING STARTS UP this past Spring and Summer because of seasonal factors but inventory still huge! The Nationwide COMMERCIAL COLLAPSE IS JUST BEGINNING!***
- 2. Unemployment must stabilize. If not reversing, at least not continuing to rise. Last report was lower! *IT'S ACTUALLY WORSE as a "%," Back to near 10% - BUT IT CONTINUES TO MOUNT @ OVER 250,000+ weekly.***
- 3. Corporate Earnings (profits) must stabilize. If not reversing, at least not continuing to fall. *SOME POSITIVE SIGNS but mainly in TECHNOLOGY.***
- 4. Banks must begin to make loans again (especially to small businesses and potential home owners...albeit under ancient premises of buyers being qualified and of all things, a down-payment! Lots of "hoopla" from the mega banks, but it appears that there's no real progress. They're "hoarding" any cash they can get their hands on. And now here comes the Regional problems compounded by PRIME loan and Alt-A resets!**
- 5. The DOLLAR has to decline. *It's started for REAL!***
- 6. Auto sales must stabilize at some NEW level. *Maybe started!***
- 7. The consumer must get "back in the game of consumin'" *NO WAY!***

ANALYSIS OF THE ABOVE: No Real Hope YET! -11/13/2009

Securitization Screwed It All Up

Surprise, surprise!...Securitization – the product of the finest brains of Wall Street for more than two decades – doesn't work as advertised.

Historically, mortgage loans were made by small local institutions, which knew the borrowers personally and took the credit risk themselves. It's the main driving force for us to have recommended smaller, regional banks. They should be in your region...and headquartered within driving distance of your house!

You can see how it worked in the 1946 classic movie “It’s a Wonderful Life.” Main character George Bailey (Jimmy Stewart), as heir to a local building-and-loan company, battles the evil capitalist Henry F. Potter (Lionel Barrymore) to change the character of his local town by offering affordable housing loans to the poor but upwardly mobile.

It is an appealing model, but has one real flaw: If a local savings and loan is in financial difficulty (as was Stewart’s “Bailey Bros. Building & Loan” in 1932), it will not be able to attract deposits, and no mortgage loans will be made in that locality. With the rise of interstate banking, that problem would have been soluble – mortgage loans would be more expensive in an area if a large national bank was their only potential source, but they would still be available.

Jimmy Stewart and his building-and-loan peers were forced out of business by the inflationary surge that we saw from 1974 to 1982. That surge caused short-term interest rates to rise sharply, while long-term returns on the lender’s mortgage loans remained fixed. By 1982, the great majority of U.S. mortgage lenders had lost their capital and were insolvent. It was almost another full decade for them finally to go out of business, but the damage had been done.

The initial securitizations were done by Ginnie Mae (the Government National Mortgage Association) in 1970; the government agency had guaranteed home mortgages, and wanted a way to finance the result. Thus, when the U.S. savings-and-loan crisis began, and S&Ls actually began to fail, the securitization markets were available to pick up the slack.

It didn’t hurt that two government sponsored entities – Fannie Mae (NYSE: FNM) and Freddie Mac (NYSE: FRE) – were ready to guarantee everything in sight, and to prevent investors from worrying too hard about the underlying credit risk.

Under securitization, instead of making mortgage loans directly, mortgage bankers only “originated” them, doing whatever paperwork was thought necessary, then sold them on to a Wall Street broker, which packaged them into a shell company with other mortgages. The resultant mortgage-backed security and sold the resulting package to bond investors.

There are two major problems with securitization.

First, in modern securitization markets, nobody is really responsible for the credit risk. Instead of taking loans onto their own balance sheet, and losing money if they default, mortgage companies merely sell the loans they originate to Wall Street, pocketing a fee for doing so. Wall Street, in turn, retains very little of the resultant mortgage packages: It sells them on to investors, who can hardly expect Wall Street to be responsible for each individual mortgage.

Thus, all the parties involved in originating the transaction became salesmen. Since it was no longer necessary to have a balance sheet to originate mortgages, mortgage brokers became pure sales operations. The sales business being what it is, the more unscrupulous and aggressive the sales operation, the more business it did.

That's how we ended up with so-called "Liar Loans."

In newly unveiled draft legislation, the U.S. Treasury Department has proposed to reduce this problem by making securitization originators keep 5% of the resultant credit risk. This seems a sensible move, and should help matters considerably, even if it does reduce the attraction of the more-exotic securitizations.

A second problem with securitization, highlighted by the Massachusetts court decision, is that of documentation. As I can testify from experience, securitizations are by far the most tiresome of all Street transactions to document, with a non-standard securitization creating incalculable costs while taking 18-24 months to complete.

You can see why the more complex transactions were complicated: Hundreds – or even thousands – of mortgages were being bundled and sold as a bundle to maybe tens of thousands of investors.

From the comments of Judge Long, corners were cut here as everywhere else during the housing bubble that subsequently precipitated the global financial crisis. If you take the documentation seriously, foreclosures are made very difficult by securitization, because each of those 10,000 investors owns a tiny piece of, say, a \$300,000 foreclosed loan – while at the same time also owning pieces of loans not in foreclosure.

If you get to the point where loans that had already been packaged are repackaged and resold, the paper trail may become completely inscrutable, in the sense that it is no longer possible to figure out who owns what.

At that point, the owners can't foreclose, because nobody can identify them. That's true even if the documentation was done correctly. And we now know that during the bubble, it wasn't – the lawyers had inexperienced interns working on this stuff. You can then either ignore the fine print, allowing securitizing banks to sweep the problems under the rug, or – as Judge Long has done – insist that the precise ownership position be known.

This may be a huge blow to the entire securitization industry. If given normal human fallibility, you can't track down the true owners of a mortgage, then the ownership of thousands of houses in default, all over the country, comes into question. Whatever solution is found will inevitably involve increased costs.

And that means that the risks of securitization just got much greater.

Is this a pity? No. You see, the move to securitization actually cost home mortgage borrowers money. The average differential between Treasury bond yields and 30-year mortgage yields in 1971-76 (before securitization really got going) was slightly more than 1%. In 2000-06, before the housing finance crash made mortgages still more expensive, it was more than 1.5%.

In other words, securitization has added 0.5% to mortgage costs since moving away from the Jimmy Stewart mortgage-market model – something free-market theory says shouldn't happen.

As you might expect, securitization was just a way for Wall Street bankers and lawyers (don't forget the lawyers, who made out like bandits from all the documentation) to extract additional "rents" from the rest of us. In the long run, in a free market, this should not be able to happen.

In the ongoing battle between Wall Street, the Obama administration and the public interest, it will be interesting to discover whether the United States has a true free market.

If it does, securitization should die

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www.fedderngroup.com

We continue to receive more and more inquiries about our Down-side Risk Management disciplines along with our group of recommended money managers. We appreciate your "referrals." It's the main way we continue to build our business.

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