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Safety in Separation: *How Unbundling Emerging Mortgage Markets Benefits Borrowers, Lenders, and MBS Investors*

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The residential mortgage markets in several developing countries have been fairly straightforward and easy to understand, especially when compared to the complex, mature residential mortgage market seen in the United States just before the market meltdown in 2007. And while the developing markets have matured significantly in the past two decades, they have reached neither the sophistication nor the size of the U.S. market.

That is true, mainly, because the residential mortgage markets in most developing countries largely continue to be bundled markets in which one institution still performs the origination, servicing, and funding, and also takes the credit risk of mortgage loans, similar to the manner in which savings-and-loans originated, serviced, funded, and absorbed credit risks on residential mortgages in the United States prior to the mid-1980s. (Notably, this “single institution” model is now being seen again in the U.S. with respect to loans not eligible for sale to Fannie Mae, Freddie Mac, and Ginnie Mae.)

However, as noted, the residential mortgage markets in certain developing countries have evolved and matured to the point where, similar to what is seen in the U.S., residential mortgage participants in some developing countries have decided to unbundle their mortgage lending in order to be able to promote the secondary mortgage market.

This process has also benefited lenders and home borrowers, too—a win-win for all participants.

Indeed, some nations learned that a bundled market isn’t necessarily a safer market. When the crisis hit, those emerging nations that had their mortgages originated at adjustable or inflation-linked rates, or even denominated in hard currency, saw their interest rates, inflation, and, in some cases, foreign-exchange skyrocket. This created a huge payment shock to borrowers, since their wages did not keep up with the resulting payment increases, and several institutions suffered large losses on loans.

Mexico is a good example of the potential perils of a bundled market. The currency devaluation that Mexico suffered at the end of 1994 set off a recession and banking crisis that hit housing, too. Because Mexican mortgage loan contracts were designed in a way that ignored the current economic scenario, the mortgage default rate soared. Mortgage loan contracts permitted excessive negative amortization that, when coupled with a decline in property values, left many borrowers with negative equity in their homes.

Banks verged on collapse, and the government took several measures to provide liquidity to the system and prop up borrowers. The Debtors Support Agreement (Acuerdo de Apoyo a los Deudores de la Banca [ADE]) was initiated to allow

borrowers to restructure loans into inflation-adjusted accounting units (Unidades de Inversion [UDIs]) at a low (subsidized) fixed real interest rate. The idea was to avoid the acceleration of negative amortization in a high-inflation environment. The government supported restructuring of the UDIs by creating a swap with the commercial banks that aimed to eliminate the asset-liability mismatch between UDI-denominated mortgages and peso-denominated deposits. Unfortunately, despite the benefits offered for restructuring mortgages, borrower participation was low, and delinquency continued to rise.

Another fairly recent example is Argentina, where the government broke the exchange mechanism that maintained a one-to-one exchange policy for its peso relative to the U.S. dollar. The government allowed the mortgage loans to be paid in pesos—the so-called “re-pesofication”—which led to the immediate default of residential mortgage bonds denominated in U.S. dollars.

Unbundling in those and other markets allows institutions to pass certain risks, such as interest-rate and credit risk, to the end holders of the mortgages. That, in turn, allows those entities to promote growth of their products by creating economies of scale and efficient division of labor. The challenge is that national markets must have strong regulatory frameworks in place to facilitate such unbundling.

To meet this opportunity, several emerging countries have adopted different strategies for creating trust laws and securitization companies as well as promoting the creation of efficient investment funds and other similar structures designed to foster the development of the secondary residential mortgage market.

In the late 1990s, for example, Brazil established Law 9514, a comprehensive legal framework for changing the face of the nation’s mortgage industry, principally through the introduction of a new securitization vehicle that would improve liquidity in the mortgage market. In addition, by defining how mortgages may be legally isolated from the risk of their originator, the new law allowed assets to be removed from the originator’s balance sheet, thereby freeing up additional capital that could then be used to provide additional loans. Finally, Law 9514 streamlined the foreclosure process by significantly reducing the time needed to seize and liquidate the property of defaulting borrowers in Brazil. This was an important contribution to the growth of that nation’s

mortgage market because it substantially reduced the costs associated with foreclosure.

With these examples of the perils of a bundled mortgage marketplace in mind, let’s seek to understand the main legal and regulatory considerations at issue in creating an unbundled market that is viable for mortgage-backed securities (MBS) as well as other structured financings by looking at the key questions any investors in these securities would need to ask and answer.

In general, the main concern in this marketplace is related to the potential insolvency of the originator and transferor of the mortgage loans, the servicer of the mortgage loans, and/or other participants in the transaction as well as the foreclosure process. In other words, could the ownership of the assets be re-characterized by the courts or regulatory authorities, and how much would such legal and regulatory actions delay payment to investors?

The Exhibit shows a typical mortgage securitization structure along with frequently asked legal questions about that structure.

MBS CREDIT PERFORMANCE DEPENDS ON MYRIAD LEGAL RISKS

Typically, investors should ask the questions listed above, and legal opinions provided in MBS transactions should address the risks raised by the following four questions.

What Is the Nature of the Investors’ Claims on the Collateral?

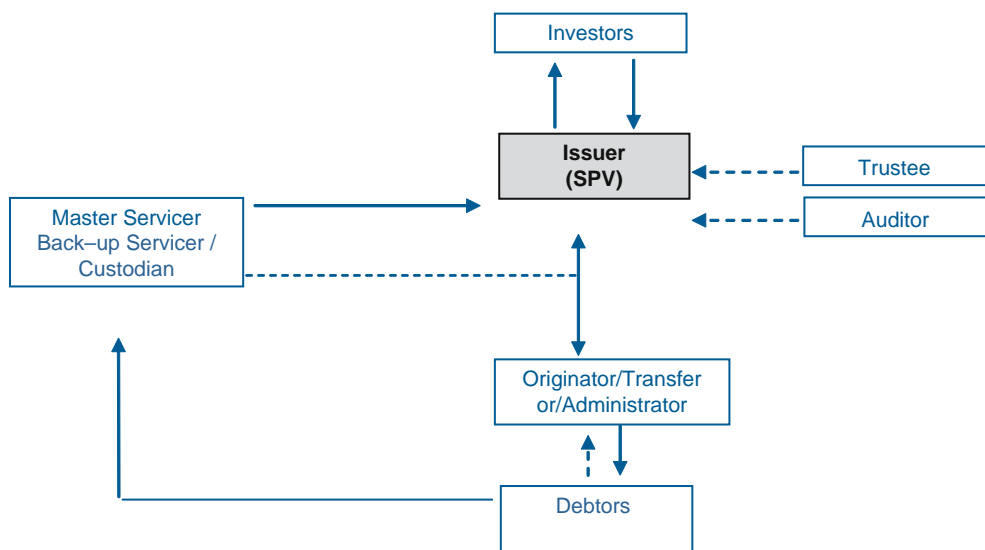
It depends on the way in which the rights in the assets were transferred to the bankruptcy-remote entity. In some countries the assignment has to be registered or recorded in a local or national public registry, while in others the issuer must notify borrowers of the transfer. If notification of borrowers does not happen when and where required, then investors are exposed to credit risk of the originator, since the borrower does not have the obligation to make payment to the assignee.

Therefore, investors want to make sure they have a first priority security interest on the collateral. In other words, investors need to have a priority over the collateral and be certain their claim on the assets has been correctly registered.

Nevertheless, other countries might not have this concept of first priority security interest, and the

EXHIBIT

Typical Mortgage Securitization Structure



Frequently Asked Legal Questions Related to the Structure

- What if the issuer enters into bankruptcy?
 - Is the issuer bankruptcy remote?
- What if the assignor enters into bankruptcy?
 - Could there be an automatic stay?
 - Is there any relevant fraudulent conveyance law?
- How are the rights over the assets transferred to the issuer?
 - How easy is it to register the assets?
 - What are the costs?
- Is notification or approval required from the debtor to have a legal transfer?
 - Do the loans comply with existing consumer-protection laws?
 - Was there a true sale of the underlying assets?
 - How can a first priority perfect security interest be established?

ownership of the collateral may be actually transferred to the bankruptcy-remote entity. In such a case, it is important that such a transfer remains effective in a bankruptcy or insolvency of the originator, with the related mortgage loans not treated as part of the originator's bankruptcy estate. In addition, it is important to insure that the bankruptcy-remote entity does not assume any liabilities due to the ownership of the mortgage loans, as this could jeopardize the remote status of the entity.

In the case of Mexico, since the peso crisis, changes in the nation's legal system have helped to develop a mortgage-backed securities market. These include the creation of new entities able to act as originator and/or as special-purpose entities, as well as the reduction of formalities for the transfer of loans backed by mortgages or guaranty

trusts. The goal of the Mexican government has been to raise funds in order to finance the construction of houses and lower the big deficit in the housing sector.

Is the Issuer (Special-Purpose Entity) Bankruptcy-Remote?

If the issuer is not a bankruptcy-remote entity, investors run the risk of not receiving timely payments, regardless of whether they have a claim on the collateral, because the mortgage loans and collections may be subject to a stay imposed on the bankruptcy estate of the originator. As defined by Standard & Poor's, an SPE is "unlikely to become insolvent as a result of its own activities" and is "adequately insulated from the consequences of any

related party's insolvency." It is important that the borrowers' counsel is able to provide a clean legal opinion on whether the SPE:

- Maintains its assets in a way that segregates and identifies such assets separate and apart from the assets of any other person or entity.
- Holds itself out to the public as a separate legal entity distinct from any other person or entity.
- Conducts business solely in its own name, and has no indebtedness other than a loan being made that is secured by a particular parcel property and indebtedness for trade payables incurred in the ordinary course of business.

The foregoing is an abbreviated version of an extensive list of "limited purpose and separateness covenants" made by a borrower in its loan documents and/or its organizational documents (e.g., bylaws of corporation, partnership agreement of limited partnership, or operating agreement of limited liability company).

The borrower's counsel should provide its opinion that the transferee of mortgage loans will not be part of the bankruptcy estate of the originator. Put in legal terms, such an opinion letter generally states that a transferee's assets shall not be consolidated with the assets of any party controlling it ("controlling party") in the event of a bankruptcy or insolvency of any controlling party, and the assets and liabilities of each controlling party shall not be consolidated with the transferee. (A controlling party is deemed any person or entity that has the ability to control the transferor's activities.)

It is important to remember that, as previously noted, each country has its own peculiarities, and there are several differences between common law and civil law in each.

Was There a True Sale of the Assets?

Even if the above questions are addressed, investors still need to make sure that there was a true sale of the assets.

In order to know a true sale of the mortgage loans has occurred or if the assets were merely pledged by the originator, we need to understand the extent of recourse to the seller the securitization has. In other words, what is the degree of control the seller has, how much responsibility does the seller have to substitute good loans for

defaulted loans, how is that responsibility defined, and what is the sellers' compensation for servicing the assets? This is important because, in the event of a bankruptcy filing by or against the seller of the assets, the regulator may rule the assets were never sold.

The goal of the securitization process is to isolate the loans, or assets, and ensure that payments on the ABS/MBS come exclusively from the pool of assets rather than from the lender that originated the assets. To accomplish this, the sale of the assets to the SPE must be a "true sale" in legal terms. When a true sale occurs, the lender can move the assets off balance sheet, and investors in the MBS have the right to the cash flows on the pool of assets even if the lender becomes bankrupt.

Bottom line: A true sale opinion is needed to provide investor comfort that the transaction will be characterized as a transfer of assets and not a secured financing.

Was There Fraudulent Conveyance?

A fraudulent conveyance is the transfer of property with the intent of delaying or defrauding a known creditor. If such a fraudulent intent can be proven, the creditor may bring a lawsuit to void the transfer. Such a situation would normally arise if the seller of the mortgage loans were insolvent when the mortgage loans were transferred or subsequently became the party of a bankruptcy or insolvency petition shortly after transferring the mortgage loans.

There are number of ways to mitigate this risk, and the counsel involved in the MBS transaction should provide an opinion by stating that the transfers would not be successfully challenged.

There are still more legal risks that investors need to address, such as consumer protection laws and risks related to the collection, foreclosure, and eviction process. But the risks raised in the above questions are the ones of primary concern.

CONCLUSION

By breaking up the monoline nature of their residential loan industries and thus opening the door to creating mortgage-backed security markets, emerging nations are deepening their overall credit markets, giving banks and other lending institutions room for further growth and creating opportunities for domestic and international bond

investors. But the legal and regulatory groundwork needed to help ensure that these markets efficiently and safely allocate capital without creating undue risks is formidable. The experiences of the U.S. MBS market are instructive, although a system-wide credit crisis like that seen when U.S. “subprime” loans began defaulting would stress even the most well-regulated secondary MBS market.

In the end, lenders sell a put option when they originate a mortgage that explicitly allows the borrower to relinquish the home at the price of the mortgage. When the value of the outstanding loan exceeds the value of the house, the put is in the money, and a rational, wealth-maximizing borrower will default. Even before the mid-1990s, numerous emerging market mortgageholders responded by exercising such puts.

Regardless of the national market in which they are operating, investors must question and understand what claims, if any, they have on the collateral—i.e., the mortgage loans—backing the financial vehicles that issue MBS. Also, they must be satisfied that the issuing vehicle is itself protected from bankruptcy. And the loans bundled into the vehicle must meet local legal standards for being truly sold and transferred.

The bottom line: Any marketplace created by securitizing the assets must be founded on a solid legal infrastructure if it is to be viable. Governments, regulators, and institutions should learn from the experiences and best practices of other national markets and also engage qualified experts to design and maintain vibrant markets.

All investments contain risk and may lose value. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Mortgage and asset-backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and while generally supported by a government, government-agency or private guarantor there is no assurance that the guarantor will meet its obligations.

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