

November 18, 2008

Changing the Quality of Existing Loans

In early October, we circulated a proposal addressing the heart of the current residential mortgage crisis with a debt-for-equity swap based upon the principal of shared appreciation between the lender and the borrower. (The proposal can be found here: http://www.wrhambrecht.com/pdf/Residential_Mortgages_100808.pdf). The proposal, which is predicated upon the creation of a transparent and liquid market for residential equity securities, is based upon the work of Professor John O'Brien and his colleagues at UC Berkeley, as well as his co-founders of Home Equity Securities, LLC, a company that is creating this market.

Although the response to this proposal has been generally positive, some concerns have been raised that need to be addressed. Specifically, there is a fear of a moral hazard which would unfairly penalize mortgagees who are in compliance with their loans. Wouldn't our plan encourage every homeowner with negative equity to rush towards a renegotiated shared equity mortgage? No. The proposal creates no perverse incentive at all, and in actuality, significantly improves upon a number of initiatives that have been suggested or embarked upon over the past month.

Many large banks have recently announced plans to provide relief to certain distressed mortgage holders through a renegotiation of terms and interest rates. While appears to be good news for the homeowner, the forbearance of principal only postpones inevitable pain, and does not go far enough to fundamentally change the quality of the toxic loans themselves.

In contrast, our proposal does. By providing the mortgagee the option of exchanging some ownership in their own residence for a more affordable arrangement and by compensating the bank with equity for that concession, only homeowners who are unable to take any other route will be motivated to pursue this restructuring. The starting point is a government grant of \$250 per month as a subsidy to each participating homeowner. By accepting the subsidy and entering the debt for equity swap, the borrower would relinquish a percentage of their home ownership to the lender (which implies forsaking that percentage remuneration on any future upside sale of the house). Frankly, this is not a transaction that any homeowner with better alternatives would want to take (or at least be reluctant to take), as the surrender of equity in the house is a steep penalty to pay for a restructured loan.

At the same time and importantly, this plan creates a new, non-toxic loan that reflects current market conditions and fundamentally improves the health of the outstanding debt. The intractable issue now facing mortgage lenders is the vast number of unsound loans on their books, hence that should be the focus of any solution. The market value of the lowest-rated tranches of the mortgage market will not be improved by a reworking of loan amortizations and interest rates for troubled borrowers. But if the market value of the toxic loans are notably raised the financial health of the lending institution is immediately enhanced.

The chart below illustrates the dramatic repricing of the various tranches of mortgage-backed securities that has taken place over the past two years. Repricing the debt will only substantially be improved by changing the credit quality of the loans themselves.



The \$250 monthly governmental subsidy, an idea put forward by Thomas Peterffy, CEO of Interactive Brokers, LLC sensibly illustrates the power of incentivizing troubled borrowers to agree to begin the renegotiation of distressed mortgages which will ultimately make the loans more viable. A review of the data on mortgage delinquencies shows that the highest incidence of delinquency occurs on loans below \$75,000, a level where the subsidy will go furthest in addressing the toxicity of the loans themselves. As the chart above illustrates, current market value of the most toxic loan portfolios have cratered this year, leaving the mortgage holders with a severely distressed asset. We feel that the debt for equity swap that we propose will address the critical piece of the equation, the valuation of the loans themselves, and that the prospect of an increase in that value will be a powerful incentive for the mortgage holders to participate. (The expense of the government subsidy is estimated to be roughly \$9 billion annually, based on the assumption that 3 million troubled mortgages are involved).

Using a distressed \$75,000 mortgage as an example, we can see that loan abatement in return for equity has immediate and powerful benefits. If the value of the property has fallen 20% to \$60,000 and a new loan is offered to finance 80% of the property value, the borrower now has a \$48,000 note, and in exchange has swapped 45% of the equity in the property to the lending institution. Most importantly, the \$250 monthly subsidy from the government goes most of the way towards ensuring the creditworthiness of the new loan, addressing the critical task of improving the underlying collateral of the lender's portfolio. As the mortgage size increases, the \$250 subsidy has less of an impact, ensuring that the application of this program will apply directly to the most acute and widespread incidence of delinquency. Broadly applied, our program will begin to move the market value of the loans up along the vertical axis of the chart above. This illustrates the powerful incentives that exist to bring both the borrower and the lender together to begin the process of loan quality transformation. It must be noted that any intermediary in the process with a fiduciary responsibility for the loan portfolio would be likewise interested in seeing this beneficial outcome.

Our plan provides a path towards the creation of new healthier loan portfolios for the lenders, while at the same time providing a way out for the most critically distressed homeowners. No perverse incentives are created, no moral hazard exists. Rather, the essential issue facing the lenders is addressed at a steep but fair price for the mortgagee. Rather than postponement, we provide a path towards remedy, which we feel is a critical distinction in the crisis we face.

Sincerely,

A handwritten signature in black ink that reads "Bill Hambrecht". The signature is written in a cursive, flowing style.

William R. Hambrecht
Chairman and CEO