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MARKET Commentary

Mortgages Make Another Mess

November 2010

Risks to the financial industry of mortgage putbacks, foreclosure delays, and documentation errors have dominated recent headlines, quarterly earnings calls and analysts' reports. The result has been a renewed effort by market participants to pass around losses on mortgages and mortgage securities like hot potatoes: homeowners and investors are seeking indemnification from the originators and issuers of securities while banks are challenging these claims or passing them along to others where possible. While we believe putbacks present some financial risk to the banks, we do not feel the resulting losses will lead to a systemic crisis or the collapse of a major financial institution.

Mitigation of the losses will come as they are drawn out over the next few years rather than all realized immediately. Losses will also be minimized as many errors are corrected through revisions and the mortgages are returned to investment pools. Delinquent mortgages, after being put back to the originator, can return to performing status through loan modifications. Foreclosure delays will increase costs for servicers but they will be minimal and all of the other issues with documentation are more clerical in nature and will be corrected. A deeper dive into the mortgage market and the status of key players will help to clarify the issues.

The Players

A bank can wear many hats in the mortgage industry: originator of mortgages, issuer of mortgage securities, and servicer of mortgages. Each of the different roles could be fulfilled by separate institutions or one institution could be the sole party involved in the process from origination to securitization. The risk to an institution varies depending on the part or parts of the process in which it is involved.

The **originator** is usually defined as the institution that extends loans to purchasers of homes. A broader definition to help understand the current risk to financial institutions is that the originator is an entity that sells mortgages to the securitizing agent. This broader definition is appropriate since mortgages can be originated either in-house or by third-party institutions on behalf of the bank, or they can be purchased from third parties.

The **issuer** is the institution that pools the mortgages into a trust and sells securities in that trust to investors as a mortgage-backed security or other structured product (CMO, CDO, etc.). This could be the same institution that originated the mortgages or the institution that purchased the mortgages from a third party. The issuer will either act as the **underwriter** for this deal or use a third party underwriter.

The **servicer** is responsible for managing the payments received from the borrower, distributing the payments to the investors in the trust, and managing the escrow account. The servicer is also responsible for carrying out the foreclosure process. The servicing of mortgages is generally a specialization performed by a third party if the originator is not a large servicer of mortgages.

US Treasuries

As of 29-Oct

Benchmark	Yield
3 Month	0.12%
6 Month	0.17%
1 Year	0.21%
2 Year	0.34%
5 Year	1.17%
10 Year	2.60%
30 Year	3.98%

Merrill Lynch Indexes

30-Sep to 29-Oct

Index	Return
1-3 Yr Gov/Corp ≥ A	0.27%
1-3 Yr Municipals	-0.30%
1-3 Yr Agencies	0.29%
0-3 Month UST	0.01%
S&P 500	3.80%

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Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan

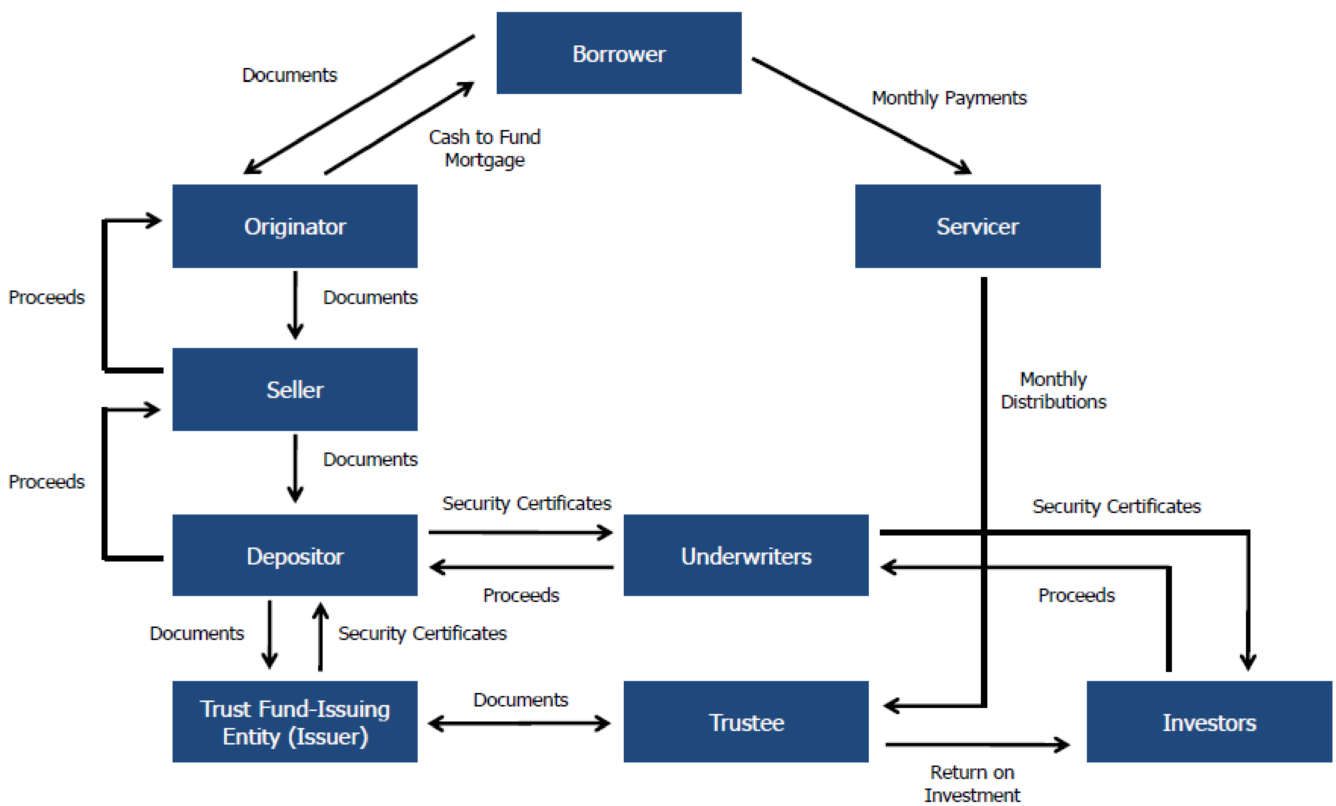
Figure 1: Top Ten Mortgage Servicers (in $ millions)

Bank	Total Loans	Market Share
Bank of America	$ 2,135.30	19.9%
Wells Fargo	$ 1,811.97	16.9%
JP Morgan	$ 1,353.60	12.6%
Citigroup	$ 677.81	6.3%
GMAC/Ally Financial	$ 349.08	3.2%
US Bank	$ 189.85	1.8%
SunTrust	$ 175.93	1.6%
PHH Mortgage	$ 155.97	1.4%
OneWest Bank	$ 155.00	1.4%
PNC Financial Services	$ 149.94	1.4%
Industry Total	$ 10,640.00	

Source: Inside Mortgage Finance

The role of **trustee** is not one performed by the originating, issuing, or servicing institution but is generally a third party that acts on behalf of the investors and acts as an intermediary between them and the trust. For example the trustee is responsible for supplying the documentation to investors in an attempt to validate a violation of Representations and Warranties.

Figure 2: The Mortgage Securitization Process



Source: Truth In Lending Audit & Recovery Services, LLC and Clearwater Advisors

Life of a Mortgage

After a mortgage is originated it is held on the originator's balance sheet, sold as an individual mortgage, or put into a securitization. The securitization process, outlined in the conveniently-house-shaped diagram above, transfers legal ownership and economic interest of a mortgage from the originator to the trust or issuing entity where it is packaged with other mortgages and then issued as a structured product to investors. If it is a conforming mortgage (one that meets strict criteria established by the agencies) it can be sold to one of the Government Sponsored Enterprises (GSEs) and then structured into a deal. The mortgage remains in the trust until it is paid off (through being paid down, refinanced, or liquidated in foreclosure) or less frequently it is returned to the originator through the putback process.

Putbacks Present the Largest Risk

A putback is a repurchase of a mortgage by the originator, forced by the current owner of the mortgage. A mortgage or a securitization qualifies to be put back to the originator for various reasons but essentially it occurs when there was a misrepresentation by the originator or the underwriter of the deal. This misrepresentation can be in the form of incorrect information about the borrower, improper types of mortgages being included in a securitization, improper documentation, or incorrect assignment or transfer of a loan in the securitization process. In any case the Representations and Warranties, or contractual agreement, has been violated, allowing the mortgages to be returned to the originator or securitizing agent.

Figure 3: Mortgages, Reserves, and Repurchase Requests as of Q3 2010 (in $ millions)

Ticker	Total GSE Loans Sold	Total Private Label Sold	Remaining Reserves	Outstanding Repurchase Claims
BAC	1,090,000	883,500	4,402	12,875
C	232,073	110,000	952	NA
FHN	60,000	40,500	175	469
JPM	311,149	285,324	3,332	3,100*
PNC	69,826	391	290	NA
STI	116,136	30,000	270	NA
WFC	555,634	159,339	1,300	3,800
Total	**2,434,818**	**1,509,054**	**10,721**	**20,244**

*JPM repurchase figure representes most recent data as of Q2 2010

Source: Deutsche Bank Research

The mortgages in question fall into two categories: agency and non-agency mortgages. Agency mortgages are guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae. Non-agency mortgages are mortgages that do not conform to the GSEs' standards and end up either being held by the originator, sold as individual loans, or sold as part of a securitized investment. The agency mortgages make up the majority of the market, and have thus dominated the claims for repurchase. Given the frequency of agency putbacks the banks have developed accurate forecasts to estimate losses on this pool of mortgages. The process for non-agency mortgage putbacks, on the other hand, is riddled with uncertainty, which complicates the forecasts of future losses.

Some of the sources of uncertainty are the relatively smaller size of the non-agency mortgage market, the diversity and disunity of the investors in these mortgages and more hurdles to overcome in the process of successfully returning a non-agency mortgage to the originator. For example, the burden of proof for investors in this market is greater as they have to not only prove fraud or discover a material error, but they must also prove that this caused the loss in value that they are attempting to recover. The GSEs merely need to show that the mortgage is nonconforming. Also, unlike the GSEs, these groups of investors do not have experienced, dedicated teams working at this on a regular basis. Furthermore, in many instances the investors must gather support from 25% of the owners before the trustee will provide access to the necessary documents. The agencies have met very little resistance when seeking documentation since July when the Federal Housing Finance Agency (FHFA), as Conservator of Fannie Mae and Freddie Mac, issued 64 subpoenas seeking documents related to MBS in which the GSEs invested.

Loss Estimates

The magnitude of the losses on repurchased mortgages is uncertain and many analysts' projections are wide-ranging. The estimated losses to the industry due to both agency and non-agency putbacks range from around $20 billion to $120 billion. There are risks that losses from non-agency putbacks could reach the upper end of estimated ranges if private investors successfully organize their efforts or if regulators and politicians insert themselves into the process on behalf of the taxpayer, but we consider the probability of such extreme losses to be very low.

Figure 4: Estimated Losses Due to Putbacks (in $ millions)

	GSE		Private Label		Impact on Net Income (2H10-2013)	
Ticker	*Low*	*High*	*Low*	*High*	*Low*	*High*
BAC	5,185	15,556	8,307	24,922	9%	47%
C	1,115	3,344	1,131	3,394	2%	8%
FHN	286	857	138	413	13%	104%
JPM	1,485	4,455	2,522	7,565	-3%	6%
PNC	259	776	1	2	0%	3%
STI	553	1,659	170	510	-4%	24%
WFC	2,661	7,984	967	2,902	2%	10%
Total	**11,544**	**34,631**	**13,236**	**39,708**	**-**	**-**

Source: Deutsche Bank Research

Other Concerns are Just Noise

Other concerns making headlines include increased costs to servicers due to delaying the foreclosure process, "robo-signers," documentation errors, incorrect transfers of the note and deed, and concerns over ownership of the title. While delays create additional costs for servicers, they will be minimal. The remaining are mostly clerical issues that will be resolved, having no real financial impact on the banks.

Conclusion

We recognize that there are risks of this round of the mortgage crisis affecting the U.S. banks through losses on mortgages that are successfully put back, though we view the reaction as extreme. The effect will be tempered by losses being drawn out over several years as the outstanding and future repurchase claims are addressed. Losses will also be reduced through loan modifications of delinquent mortgages that are repurchased, and many of the errors will be corrected and the mortgages returned to investors through other securitizations. However, we do expect an increase in volatility in the industry as the situation develops and as the actual results are released over the next quarters**. Aside from the mortgage issues, we remain cautious on the financial industry as the quality of earnings is low and pressure comes from regulators and higher capital standards.**

The delay in foreclosures, though not presenting a material risk for the banks, will affect the economic recovery. Any delay in clearing out the supply of foreclosures in the housing market will postpone a significant rise in consumer confidence and spending, thus inhibiting growth of small businesses and employment. **This confirms our view that we will remain in this low-rate environment for the foreseeable future. Investors in the short end should look to extend the duration of their portfolios where possible and prepare for continued volatility in U.S. banks.**

Please feel free to contact the desk with any questions.

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