

The National Mortgage Meltdown and the Collapse of the Shadow Banking System
Written by
Richard I. Rydstrom, Esq., LL.M.
rrydstrom@gmail.com

National foreclosures jump 93 percent! Over 154 U.S. lenders have “imploded”! Recent figures for defaults and foreclosures are evidence of a serious threat to the American dream of home ownership for both subprime and now, prime borrowers. On August 21, 2007 RealtyTrac® (www.realtytrac.com), the leading online marketplace for foreclosure properties, released its July 2007 U.S. Foreclosure Market Report, which shows a total of 179,599 foreclosure filings for the month (including default notices, auction sale notices and bank repossessions). Those figures were up only nine percent from the previous month, but up a whopping 93 percent from July 2006. That amounts to a national foreclosure rate of one filing for every 693 households for the month of July. “While 43 states experienced year-over-year increases in foreclosure activity, just five states — California, Florida, Michigan, Ohio and Georgia — accounted for more than half of the nation’s total foreclosure filings,” said James J. Saccacio, chief executive officer of RealtyTrac.

From May to June, the National Association of Realtors reported the worst sales figures since November 2002. “Jumbos” (loans over \$417,000) are being overpriced or not available as the secondary market dries up. The lenders that have imploded include all types – prime, subprime and a mix of both; retail and wholesale; subsidiaries and entire companies. According to Implode-O-Meter (www.ml-implode.com), lender “implosion” means bankruptcy filing, temporary but open-ended halting of major operations or a “firesale” acquisition.

The States and Cities Behind the National Numbers

According to the RealtyTrac® July 2007 U.S. Foreclosure Market Report, Nevada came in with the nation's highest state foreclosure rate for the seventh consecutive month. That's one foreclosure filing for every 199 households or more than three times the national average. In second place, Georgia's foreclosure rate exploded from the eighth highest in June to second highest in July with a 75 percent increase in foreclosures over the prior month. That's one foreclosure filing for every 299 households or 2.3 times the national average. In third place, Michigan stepped up from the seventh position, at one foreclosure filing for every 320 households. That's a 39 percent jump, month-over-month, and a 130 percent year-over-year increase.

California (ranked #4) jumped 289 percent in July 2007 over July 2006. It reported the most in number of any state for the seventh month in a row, although up less than one percent from the previous month. That's one foreclosure filing for every 333 households, down from second place to fourth among all the states. Florida's foreclosure filings in July 2007 were up 78 percent from July 2006. That's a foreclosure rate of one foreclosure filing for every 431 households, the seventh highest and 1.6 times the national average. Ohio (ranked #6) incurred a 12 percent increase over the previous month and a 143 percent increase year over year.

Colorado, Arizona, Massachusetts and Indiana were also among the nation's 10 highest in July.

The top 10 cities included Detroit (MI), which has seven times over the national foreclosure average or one filing for every 97 households. Also highly ranked were Las Vegas at No. 6, Atlanta at No. 7, and Greeley, Colorado, at No. 10. The top 10 metropolitan areas are all located in California: Stockton at No. 2; Merced at No. 3; Modesto at No. 4; Vallejo-Fairfield at

No. 5; Riverside-San Bernardino at No. 8; and Sacramento at No. 9. (Refer to the chart National Breakdown of Foreclosure Changes July 2007 for national figures.)

Can the Markets Self-Adjust?

The markets are in the process of re-pricing risk, and Moody chief, Mark Zandi, predicts things will get worse before they get better. Defaults will rise to 2.5 million over the next two years and 10 percent of subprime homeowners will be in foreclosure by mid 2008, up four percent. On July 24, Countrywide confirmed that delinquencies have soared in the prime markets as well, from 1.8 percent to 4.6 percent ending June 2007. Bear Stearns has filed for bankruptcy protection on at least two high-risk, high-yield, mortgage-backed funds and will bail out another hedge fund with at least \$1.6 billion. This is “the biggest bailout since the dealer consortium-led rescue of Long-Term Capital Management in 1998.” (Risk Magazine, Jayne Jung, Vol. 20, No. 7, 2007)

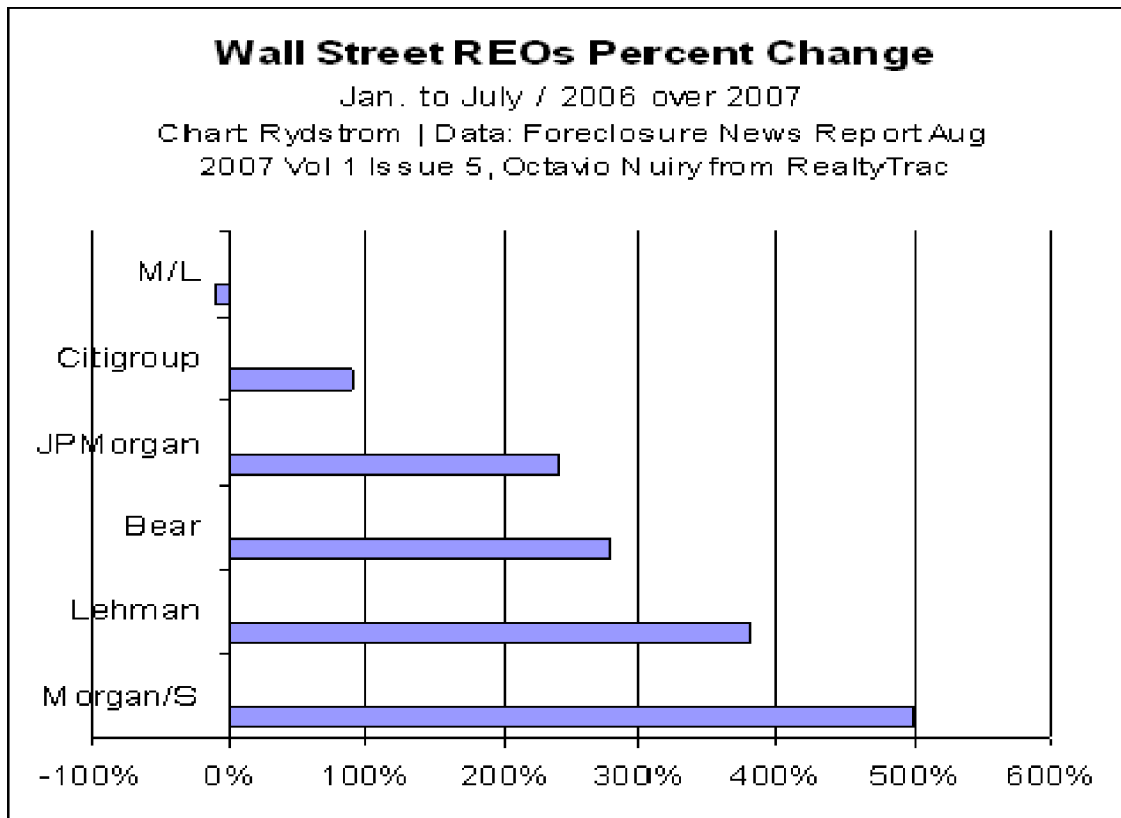
But the fallout from this lending debacle does not just affect individual borrowers. It is already taking a grave toll on the business, finance, real estate and lending industries nationally. On July 24, Wall Street investors failed to fund \$250 billion in high-risk corporate buy-out or growth securities causing junk bond yields to rise to a four-year high. On August 10, the Federal Reserve injected \$38 billion of liquidity (REPOS) into the markets, an amount not seen since September 14, 2001. Employment has declined for the first time in years, and over 45,000 individuals have been laid off from mortgage lending jobs alone.

The mortgage meltdown means that fewer subprime (and potentially prime) borrowers can buy a new home or refinance their current loan. There are three reasons: (1) extreme credit tightening under way with more restrictive eligibility requirements; (2) affordability is now tested at the fully indexed rate (not the lower teaser rate); and (3) property values have fallen to

the point where homeowners have insufficient equity to refinance or profitably sell. In other words, most borrowers are locked into their property and loan as adjustable rate mortgages (ARMs) are resetting to higher rates resulting in unaffordable monthly payments. \$1.1 trillion in loans are pending reset; in some cases, monthly payments will increase by 100 percent (Weiss Research, Mike Larson, July 19, 2007). The 2006 so-called 2/28 ARMS will reset in 2008. Senator Dodd reported on CNBC (September, 2007) that payment-shock monthly increases might reach 300 percent.

In July and August, the debate on Wall Street was whether a secondary mortgage market, a non-agency paper market, or a commercial paper market actually existed or not during times of “no bids”. This should be compelling evidence that the solutions, short and long term, must include private and public (government) safeguards that reduce market uncertainty.

In addition to recent bankrupt Bear Stearns funds, over 154 imploding lenders, a credit crunch and a liquidity crisis, REOs owned by Wall Street investment banks are rising at an alarming rate. Note the rate of change from 2006 to 2007 for REOs of Bear Stearns, Citigroup, JP Morgan Chase, Merrill Lynch, Morgan Stanley, and Lehman Brothers (See chart Wall Street REOs Percent Change). The rate of firms taking back ownership of property has jumped as high as 497 percent.



The Collapse of the Shadow Banking System

Since the dotcom bust of 2000, the flight to survival and profits went into real estate. As a result, the real estate market soared to all-time highs. In the process, the lending industry endured growing pains over the last seven years. The 80/20 “piggy back” went into high gear, followed by teaser adjustable rate mortgages (ARMs). In fact, the banking system underwent primal and systemic changes. The mortgage lenders’ model went from one of originating a mortgage with retained servicing, to one of using warehouse lines to fund a loan often pre-sold on forward contracts to Wall Street investment bankers waiting to deliver the “securitization” of a pool of loans to third-party investors.

From 2000 to 2007, the banks took in securitization products, including mortgages worth over \$1 trillion, and issued commercial paper. They created a great number of off-balance-sheet conduits and structures whose full liabilities they failed to report on their financial statements.

This is known as RahC (Randomly Activated Hidden Contingency) and RahD (Randomly Activated Hidden Debt). In short, the industry created a Shadow Banking System (SBS) to use a phrase coined by Paul McCulley, PIMCO.

Sound familiar? Remember Enron? Enron apparently, through a series of related entities, garnered a massive off-balance-sheet contingency that exposed the company to risks and liabilities in untold and unknown amounts. Now, with off-balance-sheet liability and exposure related to hedge funds, commercial paper and derivatives, the formal banking system is trying to absorb assets burdened with unknown quantities and qualities of RahC and RahD losses and liabilities recently exposed in the Shadow Banking System (For more information, click on Shadow Banking System at www.fbrom.org).

Literally untold exposure is etched in the fabric of off-balance-sheet contingencies. The economy must be safeguarded against this type of market destruction, but at the same time laws and industry practices must emerge that create a steady and voracious growth across the board in new homeownership for decades to come.

Minimally, private-public solutions include: (1) government bailouts or foreclosure moratoriums; (2) the Federal Reserve cutting interest rates (Bill Gross, PIMCO), 200 basis points over the next six months (Economist, Peter Yastrow); (3) Freddie Mac/Fannie Mae approvals for loan buyouts (acting as a loan “warehouse”) (Jim Cramer, MadMoney); and (4) new bailout “Private Equity Rescue Funds” (Ron Insana, CNBC).

With a \$10 trillion mortgage market, the subprime market is about 15 percent. Assuming a loss ratio of some 10 percent, a loss bailout would be in the area of \$150 billion (CNBC 8/2007). A \$100 to \$300 million “bailout” or “rescue” blanket will not be sufficient. \$1 billion is

a good start, but we will need to start planning for much more (see www.EquityBuildingRescueFunds.org).

Home Ownership and the Health of the Economy Are Dependent

It is obvious the rising threat of defaults and foreclosures facing America is harming the economy, causing extreme asset devaluation and potentially creating a serious social problem for the greatest example of a democracy in the world today (www.marketuncertainty.com). At this stage, society must decide a threshold question: *Do we want to expand the American dream of homeownership and grow the economy at the same time, or not?* Increasing home ownership is a necessary component of success for the economy. That's because housing creates jobs and tax revenues. It also helps balance the budget, pay for Medicare and stimulate growth. In fact, about 20 percent of GDP (Gross Domestic Product) and 20 percent of consumer spending are related to housing. Specifically, according to The State of the Nation's Housing (Harvard, Joint Center, 2002), every 1,000 homes built create 2,448 jobs, \$79.4 million in wages and \$42.5 million in federal, state and local tax revenues and fees.

Immediate loan workout solutions exist for homeowner defaults and foreclosures. Lenders and servicers are willing to work out solutions for troubled loans. The first step for homeowners in distress is to contact the lender's loss mitigation department to obtain an affordability interview. Because homeowners are often hesitant to approach their lenders, approved consultants are offering to act as a neutral representative between the parties. These include HUD (U.S. Department of Housing and Urban Development, <http://www.hud.gov>), Neighbor Works (<http://www.nw.org/network/home.asp>) and select attorneys (www.hotneutral.com). In addition, a free public outreach education service, Help4ThePeople(www.help4thepeople.org, 800 770-0797, extension 701, or

www.helphomeowners.org), provides information on viable solutions and avoiding foreclosure scams. It offers a free public outreach booklet for homeowners entitled “13 Homeowner Solutions to Defaults and Foreclosures.”

The many viable solutions for homeowners include the following:

- Pre-foreclosure loan refinance
- Pre-foreclosure sale
- Extension of adjustable loan reset dates
- Cash payment loan reinstatement
- Repayment installment plan
- Loan modification
- Loan forbearance
- FHA HUD partial claim
- Short sale for less than mortgage amount due
- Deed in lieu of foreclosure
- Short refinance
- Reverse mortgage (for seniors)
- Defenses to foreclosure and bankruptcy

Homeowners have rights just as lenders do. Consulting a third-party organization or an attorney who specializes in this area of law can provide the help consumers need to select the most favorable option for their situation.

When Free Market Purism Fails, Refinement Is Mandatory

There is nothing wrong with a more profitable shadow mortgage banking model per se. In fact, the economy can benefit from more shadow banking. This time, it needs to be supported

by industry and/or government minimum transparency, liquidity and credit safety belts.

Moreover, homeowners must have access to new “affordability” models that pay for higher risk with “non-cash burdened” insured investment Wall Street funds such as Foreclosure Mortgage Insurance Investment Funds (FMII) or Quarantined Built-In Origination Equity (QBIOE); see www.ccoom.org. When free markets allow 2.2 million families to become homeless and the broad economy is threatened with recession, capitalism falls to its knees begging for refinement.

The fact that the Shadow Banking System’s model is neither federally insured nor able to use the Federal Discount Window makes it vulnerable to market extremes as well as to levels not yet known or understood. Furthermore, since Japan and China have bought the majority share of the U.S. subprime high-risk, high-yield mortgages, international issues will now ensue that could result in weaker world markets or confidence. Refinements and safeguards should be in place to prevent extreme asset devaluations and to ensure that society is fairly treated, protected and participates in the success of the model. It’s no longer just about profits. Capitalism must grow up like the rest of us and become more responsible. The greatest capitalists in the world should and can do better than they did in this last round of historic homeownership growth!

National Breakdown of Foreclosure Changes July 2007
RealtyTrac® July 2007 U.S. Foreclosure Market Report

Rate Rank	State Name	NODs	NTSs	NFSs	LISs	REOs	Total	1 for every #HH	%Change from Jun 2007	%Change from Jul 2006
--	United States	36,741	57,327	23,136	35,553	26,842	179,599	693	9.08	93.44
38	Alabama	1	379	0	0	119	499	4,173	-21.54	62.54
36	Alaska	0	80	0	0	5	85	3,226	7.59	2.41
8	Arizona	10	5,138	0	0	725	5,873	433	2.84	189.31
17	Arkansas	20	861	0	0	163	1,044	1,196	-15.40	47.88
4	California	27,071	7,498	0	0	4,444	39,013	333	0.55	289.16
5	Colorado	59	5,261	0	0	600	5,920	347	3.77	55.38
11	Connecticut		0	129	1873	116	2118	672	-11.23	104.05*
39	Delaware	0	0	27	2	55	84	4,463	-15.15	21.74
	DC	0	6	0	0	1	7	39,682	-58.82	133.33*
7	Florida	9	87	3,449	14,828	806	19,179	431	-8.82	78.29
2	Georgia	19	11,122	0	0	1,461	12,602	299	75.25	167.73
45	Hawaii	1	81	0	0	3	85	5,777	-24.78	60.38*
19	Idaho	206	200	0	0	17	423	1,408	-23.92	82.33
15	Illinois	1	153	605	4,243	528	5,530	930	-3.91	10.20
10	Indiana	4	36	2,332	1,024	1,079	4,475	609	8.83	34.59
28	Iowa	21	394	0	0	206	621	2,105	35.89	283.33*
32	Kansas	0	9	284	137	0	430	2,782	18.46	5.39
33	Kentucky	3	18	345	102	176	644	2,897	-20.00	19.70
37	Louisiana	0	4	470	25	58	557	3,484	-21.22	90.10
43	Maine	32	92	0	0	1	125	5,470	-26.90	1462.50*
16	Maryland	0	4	1,432	637	141	2,214	1,027	1.00	575.00
9	Mass.	0	0	3076	1337	220	4633	580	48.64	386.66
3	Michigan	2,293	6,947	0	0	4,739	13,979	320	38.52	130.30
29	Minnesota	20	855	0	0	172	1,047	2,151	8.27	145.20*
46	Mississippi	3	134	0	0	31	168	7,354	-22.22	93.10
18	Missouri	354	987	0	0	692	2,033	1,275	5.01	54.02
42	Montana	6	74	0	0	4	84	5,099	12.00	25.37
35	Nebraska	0	6	200	6	37	249	3,080	60.65	99.20
1	Nevada	3,367	1,064	0	0	685	5,116	199	8.34	214.64

34	New Hampshire	2	87	0	0	109	198	2,946	-53.85	1137.50*
14	New Jersey	2	4	1,123	2,813	215	4,157	828	-12.81	52.55
44	New Mexico	0	0	6	112	29	147	5,705	-17.42	-26.87
25	New York	1	12	804	3,131	322	4,270	1,839	-3.24	22.56
27	North Carolina	1,221	165	0	0	513	1,899	2,075	-2.26	12.10
49	North Dakota	0	0	3	1	22	26	11,710	-38.10	136.36
6	Ohio	10	89	5,961	4,197	3,059	13,316	376	12.10	142.73
22	Oklahoma	177	515	0	0	207	899	1,767	17.67	-34.38
30	Oregon	404	246	0	0	19	669	2,329	-23.98	10.95
24	Pennsylvania	2	12	2,408	374	194	2,990	1,813	32.42	0.50
31	Rhode Island	1	167				168	2,666	-40.85	-18.84
40	South Carolina	0	26	109	50	227	412	4,679	4.04	-6.15
48	South Dakota	0	0	29	0	1	30	11,598	-11.76	42.86
13	Tennessee	687	2,293	0	0	546	3,526	748	5.29	48.59
12	Texas	261	8,670	0	0	3,510	12,441	726	45.94	-5.05
23	Utah	117	334	0	0	34	485	1,800	-22.28	-58.37
50	Vermont	6	3	0	0	0	9	34,149	12.50	350.00
21	Virginia	332	1,421	0	0	206	1,959	1,621	13.17	303.09
20	Washington	16	1,630	0	0	125	1,771	1,497	8.92	48.95
47	West Virginia	0	94	0	0	0	94	9,279	-38.16	-9.62
26	Wisconsin	0	36	344	661	206	1,247	2,004	34.52	116.87
41	Wyoming	2	33	0	0	14	49	4,811	68.97	16.67

About the Author:

Richard Ivar Rydstrom is an attorney with O'Connell & Rydstrom. He has developed solutions to the current lending crisis including www.Help4ThePeople.org, TID - Truly Intelligent Disclosures and SHILO - Safe Harbor Intelligent Loan Options and FMII (Foreclosure Mortgage Insurance Investment Funds) published by the 110th Congress (www.HotNeutral.com). He holds a B.S. in Professional Accounting from C.W. Post at Long Island University, a J.D. from Western State University, an LL.M. from Pacific West College of Law and an International Law Certificate from Cambridge Law, England. For further information, call (949) 798-6206 or email rydstrom@gmail.com, www.rirlegal.com.