

**Modified Reverse Auction Plan for Troubled Assets**  
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The current crises facing our financial institutions are almost completely derived from what has been referred to as “toxic” mortgages that have spread throughout the credit system. What is unknown is exactly how pervasive are these mortgages and other loans. As a result, few debt portfolios can be accurately valued, resulting in both the likely undervaluation of assets which are reported on the holder’s books due to mark-to-market valuation requirements, and the disappearance of a viable secondary market for these loans and debt instruments. The first attempt with the TARP funds as implemented by Secretary Paulson utilized a cash infusion program for financial institutions rather than the purchase of troubled assets from those institutions. The result was that the program provided no method by which a participating lender could clean up its financial accounts and increase the value of their capital.

It now appears that this plan was doomed to failure for several reasons. One, the infusion of cash did not displace the troubled assets, leaving the banks in the same poor financial position they were in before the capital infusion. Second, the cash was provided in a manner which effectively prohibited the receiving bank from using these funds to make loans. Since the loan of these funds were represented by warrants, which are essentially claims to the bank’s capital disguised as a loan, the bank is effectively prevented in using these funds to make new loans due to the repayment requirement. Failure to repay would trigger a call on the

warrants and the likely failure of the bank if the funds were not readily available to repay the loan.

It is not only banks which are troubled by these assets, but insurance companies as well. All insurers (as well as banks) must maintain certain levels of cash or liquid reserves to support their obligations, be they insurance policies or deposits. As the mark-to-market value of a financial institution's assets was lowered, the strain on its reserves increased, resulting in failure, regulatory intervention or reduction of credit ratings. We all have seen how this has rippled through the economy with disastrous side effects and unintended consequences.

The TARP program was originally created as a means to erase these toxic assets from the financial system in order to neutralize the resulting restrictions on available credit. Since the Treasury officials charged with implementing the TARP program decided that such a program would be too complicated and hard to operate, they chose an easier plan to simply shore up banks and insurance companies with cash. But is an asset purchase program really an unworkable plan? Is it necessary to return to the Resolution Trust Corporation model as the only viable path forward? Although the federal government eventually came out on top through the RTC and actually made money with the asset purchase program, the process was long and fraught with many administrative problems. Is this the only way forward?

The purpose of this paper is to offer an alternative program that uses market forces to cleanse the economy of its toxic assets. Can all of these assets be cleansed? The simple answer is no. Those debt instruments that were originated based on fraudulent action or

representations cannot be fixed. The perpetrators can and should be prosecuted in an effort to help stem this conduct in the future. For those home purchasers making \$35,000 a year who borrowed close to 100% financing to buy a \$500,000 home, there are few options. These buyers simply do not have the financial resources to repay such a mortgage using any conventional loan amortization method, regardless of the interest rate on the mortgage. Even with 0% interest, the mortgage payment would equal over 47% of gross income, before taking into account property insurance premiums and real estate taxes, not to mention such necessities as food and utilities. A fair, market based plan likely cannot be created to address this type of situation, and something similar to the RTC model may be the only hope for people. The end result is that many of these people will not be able to keep their homes. However, these loans do not represent the vast majority of “toxic” loans in the market place.

Indeed, I suspect that no one knows exactly how pervasive these loans really are. The mere possibility of the existence of fraudulent or toxic loans in any debt pool creates the market assumption that all pools of debt obligations are comprised of a sizable number of these loans, which makes the pool’s market value virtually zero. The government does not, and likely should not, have the power to forcibly restructure debt obligations without the consent of the creditors. Of course, if the creditors agreed to such restructuring, there would be no need for governmental intervention.

To reinvigorate the credit markets through a cleansing of a significant portion of these toxic debt obligations, you cannot look solely at the mortgage portfolios in collateralized debt

obligations, nor can you look solely at individual homebuyers and debtors under a restructuring plan. It is necessary to approach this problem from both ends of the creditor/debtor spectrum. For the creditors who are holders of these mortgage pools, they must be given fair value for their investments. Since it is impossible to determine the current fair value of the debt pool until it can be dismantled into its constituent debt parts, a process needs to be created to return a fair value to the investor so that the government will be free to dismantle the debt pools.

Likewise, it is in the government's and the economy's interest to maintain as many debtors in possession of their property as possible. This will serve to help stabilize neighborhoods as well as home prices. Without the government obtaining the ownership of the debt instruments themselves, the government will be limited in how the debt can be restructured. Only through ownership of the debt obligations will the government be in the position to affect the restructuring of the debt instruments to the extent necessary. Once restructured, the government can elect to either hold the debt until it is paid off or refinanced outside the government program, or repackage the loan into a "clean" collateralized debt obligation and sell it into the secondary market.

#### Creation of Mortgage Pool Purchasing Entity

The initial step involves the creation of a distinct separate legal entity whose role is to acquire the mortgage pools through purchase of all of the ownership interest in the collateralized debt obligations. In order to avoid potential issues associated with existing

governmental regulations and laws regulating the disposition of federal assets, a separate entity is created. Perhaps the simplest, most straightforward method is to establish a trust or non-profit organization formed under state law. Although the legal framework for this entity can be simple, it is envisioned that a fairly complex operating agreement would be prepared to regulate the conduct of business activities of the new entity and how TARP funds are used to acquire the mortgage assets. The operating agreement would also provide the framework for oversight by the Treasury. At a future date, once a separate governmental agency is created through legislation to operate this program (whether modeled after the Resolution Trust Corporation or FDIC) or an operating division inside Treasury is established and fully staffed, the activities of the entity can be dissolved into the new agency. The use of a state law created entity has the benefit of virtually instant creation and operations, without the necessity of additional legislative authorization.

#### Modified Reverse Auction Program

A modified reverse auction process on the creditor side of this equation would seem to provide a viable road map to follow. Under this program, investors would participate in an auction process where the winning bidder is the one that offers to sell the portfolio investment for the lowest price. Depending on the ultimate price to be paid, the bidder could retain rights to receive additional sale proceeds once the portfolio is scoured clean of the toxic loans. For example, assume a \$100,000,000 principal amount in a debt pool that is offered for sale in the auction for \$60,000,000, or 60% of the principal amount of the debt pool. Classic market forces

can be used through the auction process to set both the purchase price of the portfolio as well as the residual amount a seller may receive. It is possible to provide a “guesstimate” of the market value of a pool of mortgages based on location of the mortgaged property and its payment history. At least initially, such analysis could only lead to educated guesses at value. Although the first few sales may be off-market, normal market forces should respond fairly quickly to adjust the auction prices to reasonable and realistic initial sale prices.

The use of a classic reverse auction process would likely result in a purchase price being too high or too low, leaving many potential sellers with no interest in participating (although an exception to the mark-to-market rules allow an institution to not mark-to-market an asset if the market value of the asset can not be determined). A single step reverse auction process could potentially create an artificial market value leading to further unintended consequences. With the modified reverse auction, two step participation is introduced into the program. Since 5% to 10% of all mortgages are 60 days or more delinquent, we can assume a base line value of 90% of principal amount. A market scale will develop in which the amount of participation by the seller is adjusted to market values. For example, if the sale is at 90%, the buyer (government through the trust) may retain the right to charge back to the seller bad mortgages in excess of 10%, up to a pre-set limit of 5% to 10%. Where the initial purchase price is less than 90%, the seller participates in the resale of the “cleansed” mortgages as well as the resale of any restructured “toxic” mortgages. The cleansing process, as discussed later, involves at least two stages where the seller could share in any gains. This process prevents an immediate

recognition of loss, restores some capital, potentially releases capital reserves and prevents a cascading loss in market value to non-participating sellers. It should be kept in mind that the vast majority of the holders of interests in these collateralized debt obligations purchased them with clean hands, and should not be required to pay too much of a price for the bad faith actions of others.

### Stage I Cleansing

Once the pool is purchased by the government (or the designated agency), the pool is unwound into its constituent debt parts. Each loan is then analyzed and reverified to determine whether the loan is a healthy loan or toxic loan. The healthy loans are then securitized into a new collateralized debt pool, perhaps with a federal guaranty similar to a Fannie Mae, Freddie Mac or GNMA pool, or by a governmental certification that this pool does not contain any toxic assets and meets certain basic, market accepted underwriting standards. Let's assume that out of the \$100,000,000 original principal amount of debt in the pool, \$85,000,000 are healthy loans and are sold back into the market at a price close to 100% of their principal amount. The government just made \$25,000,000 on this purchase, which will be shared with the original sellers, resulting in a second stage adjusted sale price greater than 60% but not in excess of 85%.

### Potential Benefits to Seller

What do the sellers receive? They receive cash to be invested elsewhere with no strings attached, and immediately improve their balance sheets by converting an asset that was carried on a mark-to-market basis at close to zero into new value. Any required reserves to cover the

reduced value of the sold assets are also released, providing additional cash infusions into the lending institution. Do the sellers potentially take a haircut? It is hard to tell whether in all circumstances all investors will take a loss on the transaction. One should consider the effects of the conversion of ultra low valued assets into cash at close to par value, the immediate cleansing of their balance sheets and financial statements, the release of reserves and potential tax deductions (with multiple year carryback of the NOL), will have on the seller's resulting financial position. This can be a tool for these financial to make a fresh start.

### Stage II Cleansing

With respect to those homeowners and other debtors whose debt falls into the "toxic" asset category, there will need to be a case by case approach taken. Since all of these loans are not toxic for the same reason, no one-size fits all approach can be taken. There will be certain policy decisions that must be addressed. For example, should a homebuyer who was led into a subprime loan without understanding the ramifications of the loan but who otherwise was fully creditworthy be treated in the same manner as a homebuyer who participated in a home purchase under less than honorable circumstances? Likely the answer will be no.

As the loans are reviewed and the information is reverified, there will be instances where potential criminal actions occurred. The most likely instances would involve criminal fraud perpetrated by one or more of the participants in the mortgage and home buying process. This could be the appraiser, mortgage broker, lending agent, real estate agent, lending agent or the actual homebuyer. As these cases are discovered and documented, it will be incumbent on

the program operators to refer these files to the appropriate Justice Department or state Attorney General for investigation and prosecution. It is likely that where there was fraud and other criminal activity, both federal and state laws would have been violated.

For those homebuyers who qualify for relief, a participating mortgage structure can be utilized. Under this program, the mortgage is written down or restated to a principal amount based on an 80% loan-to-value ratio, using current market values rather than the values at the time the loan was executed. The new loan will be a 30 year loan based on low market rates. The difference between the current principal amount of the original loan and the new loan is reflected in a differed equity sharing that will be due on sale or refinance, and in which both the homeowner and the government will share in any increase in value. The percentage sharing arrangement can be tied to the interest rate on the new loan, where the lower the new rate, the greater share the government receives in the appreciation.

An example would be as follows. Homeowner originally purchases a home for \$250,000 using a mortgage of \$237,500, or 95% financing. The mortgage used an “innovative” loan structure which has resulted in homeowner no longer being able to afford the mortgage payments and facing default. In addition, similar defaults have led to foreclosures in the neighborhood and falling housing prices. At present, the home is valued at \$200,000. Under the refinancing program, the loan would be restated as a \$160,000 principal amount 30 year fixed rate mortgage bearing interest at 4.50%. The difference between the current principal amount of \$237,500 and the new amount of \$160,000 is reflected in an equity participation note

with a superior lien position to the mortgage. There are no payments due on this \$77,500 equity participation interest. However, should the homeowner stay in the house until market values have returned, when the home is sold, the government is able to recapture some or all of the deferred equity amount.

In exchange for a low interest rate mortgage, the homeowner would give the government the greater share of the gain over the original restated mortgage amount (in this case \$160,000) up to the full amount of the deferred equity sharing amount. If all of the gain is given to the government, then the homeowner receives the return of the principal paid on the mortgage loan (the amount by which the mortgage loan at sale is less than the original amount of \$160,000), together with the gain over \$237,500. If the home's value is restored to the same level it was when the purchase occurred, the homeowner would (1) achieve a full return on equity, (2) enjoy any federal tax benefits derived from homeownership, (3) maintain credit ratings and (4) have been in the position to have lived in a home they owned. If a different equity split is used, then it will require a greater increase in home values to fully repay the government. Since this is an investment in our economy and our neighborhoods, the percentage equity split can be adjusted over time, such that the longer the period the homeowner stays in the home, the greater the share of future increased value the homeowner will receive rather than the government. An alternative would be for the equity participation loan to remain in place until satisfied through successive sales, refinancing or simply a new owner paying the government off to obtain full ownership.

These restructured mortgages can now be securitized and sold into the capital markets. To the extent the government receives a profit on these sales, that profit would be shared with the seller to establish the final, adjusted sales price for the mortgage loan pool sold in the modified reverse auction.

### Interaction with Community Organizations

In those instances where the mortgage loan can not be restructured in a manner that will enable the homeowner to retain ownership, other actions are necessary. As homes become vacant as a result of abandonment or foreclosure, additional deterioration of the neighborhoods and communities occur. Although some relief was provided in the Housing and Economic Recovery Act of 2008 enacted July 30, 2008, the mechanisms have proved to be unworkable. The assistance of local community organizations, including cities, counties, housing authorities and exempt organizations can be harnessed to provide local services necessary to rebuild these neighborhoods. Local public/non-profit/for profit partnerships and initiatives can be made on a local basis by those who have a vested interest in making this program work. At least the initial funds for the local community involvement were provided by the 2008 Housing Act.

### What is needed to get started?

The institutions needed to implement this program already exist or can be quickly created. For example, there are several operating master servicers providing mortgage servicing for collateralized debt securities in conjunction with tax exempt single family revenue bond programs. These servicers are experienced in verifying mortgage information data and

have operations able to reach into virtually every community. These servicers can assist the servicers presently serving the mortgages in these collateralized debt obligations. All mortgage and other loan pools do not need to be taken on at the same time. A few collateralized debt obligations can be subjected to the modified reverse auction process initially on a demonstration basis.