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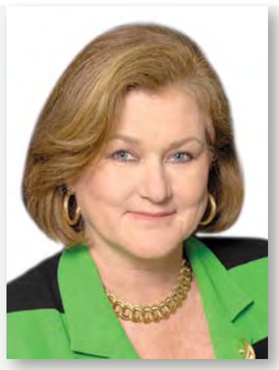
Distressed Mergers & Acquisitions

Another One Falls: Shades of Drexel Burnham?



BY CORINNE BALL

Starting in February 2006, ABFS was one of the early subprime mortgage companies to implode. Since then we have seen New Century, Northern Rock, American Home Mortgage, and the recent addition of Delta Financial and downgrading of ACH Financial. Each had a warehouse line of credit to originate mortgages and what was once a robust relationship with financial firms engaged in packaging and selling mortgage-backed securities.

Today's events reveal distress investors buying mortgage company assets out of Chapter 11 and reports of private equity firms diluting the public shareholders of leading monoline insurers. Critical to understanding these developments in distress investing is an understanding of the chain of investment events.

Mortgage companies, using highly structured vehicles, isolated ownership of a pool of mortgages they originated into separate and identifiable special purpose vehicles (SPVs), which, in turn, issued their own securities, and used the proceeds to buy the mortgages. Mortgage-backed securities had the appeal of being secured, dependent on a theoretically diversified consumer profile and isolated from operational risks.

The appetite for such investments seemed insatiable as the SPVs in the mortgage-backed area multiplied by the thousands, and the levels of risk and reward were further refined. SPVs issued securities with varying priorities, such as a senior debt certificate and a junior debt certificate, with varying yields, depending upon the quality and nature of the underlying mortgages. Higher risk securities, such as subordinated SPV certificates, generated higher yields. The equity, or the "residual," was the most junior SPV interest and was often retained by a mortgage company sponsoring the SPV and used as collateral for additional credit.

An SPV mortgage-backed security represented a claim against the SPV and its mortgage assets. The mortgage company originating the mortgages would often continue as the servicer of the mortgages it had sold to the SPV. As the servicer, the mortgage company would perform billing and collection on the mortgages as the agent of the SPV, pursuing defaults and foreclosures.

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Generally, the SPV uses the mortgage payments to meet its obligation to the servicer and thereafter pay the holders of its mortgage-backed securities. The priorities of payment, or "waterfall," are set forth in the SPV investment securities and often provide for a cessation of payments to junior SPV securities if the default rate or other cashflowing characteristics of the SPV's mortgage assets deteriorate.

Because the SPV is isolated from the credit risk of the mortgage company, it depends on the performance of its pool of mortgages with negative events driven by the default rate on its mortgages. SPV arrangements also provide protection against the two remaining mortgage company connections: the residual and the servicing, through the ability to stop distributions on the residual and terminate the servicing relationship upon a deterioration of its mortgage portfolio.

Most SPVs provide for a "back-up" servicer should the original mortgage company suffer some negative event. "Back–up" servicers are described in various ways from being "cold," meaning not ready to take over the job of servicing, to "hot," meaning having the data, systems, and related information which would enable the "back-up" servicer to commence servicing almost immediately. The logistical difficulty in switching servicers depends upon the magnitude of billing and other records, mortgages, values, foreclosures and related information.

The simple SPV mortgage-backed structure is further complicated when the purchaser of the SPV's mortgage-backed securities is another special purpose investment vehicle (SIV).

Most financial firms that had a mortgaged-backed business also participated in secondary, even tertiary, mortgage-backed securities markets, SIVs as direct purchasers of SPV's mortgage-backed securities or as purchasers of intervening SIV securities. Just as SPVs had the mortgage companies as sponsors and a relationship with a financial intermediary to sell their mortgage-backed securities, the SIVs had similar relationships with a sponsor and financial intermediary who sold or placed the SIV's securities.

The SIV's sponsor also retained a residual interest and various obligations to the SIV and its securities, in a manner analogous to the mortgage company sponsor, frequently acting as the servicer, owning the residuals and from time to time performing additional obligations for the SPV.

When a mortgage company files for bankruptcy, the SPVs that it sponsored are not debtors, and the SPVs' property is not subject to the automatic stay. The assets of a mortgage company usually include some "whole loans" or mortgage loans that have not yet been sold through an SPV, cash, residual interests, its servicing contracts, and what is often called the "platform" which is a network of mortgage brokers who originate mortgages.

Its primary liability is to its "warehouse" lender that provided funds for originating mortgage loans to be repaid, following selling mortgages into an SPV, from the sale proceeds of the SPVs mortgage-backed securities. Unlike the warehouse lender, the creditors of the SPV, usually the holders of its securities, are free to enforce their rights and exercise their remedies.

Income from servicing mortgages may be the primary source of the mortgage company's cashflow. If the mortgage company enters Chapter 11 as the servicer, the SPVs are stayed from terminating the servicing contract and moving to the back-up servicer without an order modifying the stay.

Such modification may be difficult to obtain if the servicing relationship has value to the mortgage company. The early stages of a mortgage company Chapter 11 case are marked by expeditious asset sales under §363 of the Bankruptcy Code, notably the servicing contracts and platform.

Monolines

Before looking to the complexities attendant upon the SIVs as purchasers of the SPV mortgage-backed securities, the impact of credit support of mortgage-backed securities merits further attention. The sale of SPV securities, especially for higher risk subprime SPVs, may be aided by arranging for credit support for the SPV securities, most often from the monoline insurance companies, that permit others to take advantage of their credit rating, usually the highest investment grade rating available.

Although the exact terms would vary, monolines like FSA, AMBAC, CFIG, FGIC or MBIA, among others, would enhance the credit of the SPV's mortgaged-backed securities through a guaranty of the security or other assurance of debt service payments over the life of the original mortgage-backed security.

The monolines review the underlying mortgage assets and the SPV debt terms to determine the scope and cost of their credit support.

Ironically, the search for yield compromised the quality of the mortgage backed-securities. Most subprime mortgages are adjustable rate mortgages extended to consumers with weak credit and low incomes.

Unfortunately, the similar credit profiles outweigh the other diversity factors such as employment, geography, etc. As the interest rate "adjusts" or resets, the subprime consumer cannot afford increased payments, and defaults occur. Rather than being "secured," many subprime mortgages are undersecured in a declining real estate market given prevailing loan to value ratios approaching 95 percent to 100 percent. Rising default rates cause defaults or at least deterioration in the various SPVs and promote the probability that the monolines' credit support will be called upon.

Valuation

Absent a ready market for direct and indirect mortgage-backed securities, valuation involves analyzing the rights of each security against the assets held by such security's issuer and tracing back to the underlying assets.

Today the market for SPV mortgage-backed securities and interlocking SIV securities is too thin to establish values. Since the credit crunch of last summer there is insufficient trading to establish an implied market value. Investors no longer want high risk mortgage-backed securities.

Although the securities have become illiquid, they still have value. The difficulty in determining that value, however, increases substantially as the distance between the underlying subprime mortgages and the investor grows.

Starting at the consumer level, as confirmed by the foreclosure numbers, the problem reaches the mortgage companies, as confirmed by the number of Chapter 11 filings, but actually consumer defaults hit the SPVs first.

The SPV, as the owner of defaulted mortgages, exercises remedies to terminate the servicer and stop residual distributions, placing the mortgage company in extremis. Similarly, subprime defaults impact the holders of SPV mortgage-backed securities, like the SIVs, the warehouse lenders holding the SPV residuals as collateral, and monolines provide credit enhancement for any shortfall in the SPV's waterfall.

More foreclosures affect, among other things, the collateral value supporting mortgage-backed securities, due to the downward price pressure from the expanding supply of homes in foreclosure. As more homes go into foreclosure the selling price of any individual home suffers from the surplus supply of other homes being sold in foreclosure.

The value of an SPV mortgage-backed security is dependent upon the SPV's asset values, its priority in right against those assets and its claims against any third party credit enhancer. Given the size of the mortgage pools owned by thousands of SPVs, the differing reset or interest rate adjustment dates for each of mortgages in any given pool, and the specific terms of mortgage-backed securities, the information and resources required to perform such valuation are enormous.

The level of detail necessary to evaluate the mortgage pool quality is not easily accessible to every investor, particularly as their servicers fall into Chapter 11. The magnitude of the task for any given SPV investment is daunting. Yet the SPV investor may be required to value its now illiquid mortgage-backed investment.

The monolines have insured or otherwise provided credit support for a multitude of mortgage-backed securities of varying tenor and priority issued by virtually legions of different SPVs sponsored by multiple mortgage companies from all over the country.

Valuation is critical to determining monoline liabilities on account of subprime mortgages. The monolines' business is built upon its credit rating, which is based upon various factors, but certainly the quality of its underwriting in subprime mortgages and the sizing of its insurance liabilities relative to its capital are critical.

With respect to a mortgage-backed security enjoying monoline credit, the monolines likely have asset reviews from their underwriting process that were specific to a identified mortgage pool, and the terms of that particular security. Nevertheless, the magnitude of the task takes time and resources.

The highest credit ratings cannot sustain uncertainty for the time that may be required to reliably assess the liability. Recent reports of investment by a major private equity firm in the equity of MBIA, one of the largest monoline insurance companies in the mortgage-backed business, as well as the rescue by the French regulators of CFIG, tend to confirm an exposure, perhaps an unmeasured exposure, to subprime mortgages as does the recent negative outlook assigned to four prominent monolines by S&P.

Valuation of indirect mortgage-backed securities, like the SIVs securities, presents a far greater challenge.

Although an SIV may own millions in SPV mortgage-backed securities issued by multitude of SPVs on specific terms, it likely did not have details of the underlying mortgages owned by the SPV's who issued the mortgage-backed securities. To the extent that the SPVs experience cash shortfalls that interrupt the payments on their securities, that deficit necessarily reaches the SIV purchaser of such securities, which, in turn, has obligations to the SIV investors.

For example, the sponsor of a SIV purchasing securities backed by subprime mortgages may have provided a credit enhancement for its affiliates and customers who have invested in its SIV. Given the uncertainty, the sponsor may fund deficits to protect the SIV investors and its interest in the SIV residual while it attempts a "bottom-up" valuation.

What Next?

The SPV is bankruptcy remote, as is the SIV. On the assumption that either would seek (or be eligible for) Chapter 11 relief, their benefit, if any, may be limited. Upon filing, payments to their debtholders would cease, and liquidation under adverse circumstances might follow. Value preservation demands an alternative.

Although the extent of subprime losses remains unknown, the monolines' stockholders and the SIV sponsors, if not their investors, are in the chain of distress.

Recently SIV sponsors, which are highly regulated financial institutions, are announcing losses, and the regulators are considering intervention aimed at consumers and mortgage-backed intermediaries. The confluence of factors impacting today's mortgage-backed market and the SIVs is reminiscent of circumstances leading to the savings bank crisis of the late 1980s.

Like today's SIVs' searching for a higher yield, then the savings bank invested heavily in the nascent "junk" bond market, later encountering rising default rates which stressed their liquidity, which was already stretched by consumer behavior, that drained cash from savings banks. Savings banks' were forced out of the high-yield market, and the secondary market for high yield securities collapsed. High-yield securities became illiquid and were connected to suits regarding the so-called "daisy chain" allegedly orchestrated by the lead sponsor of the high-yield market, Drexel Burnham and Lambert, and others.

The catalyst, however, was financial distress in a highly regulated financial sector that did not have the resources or time to invest in illiquid assets of uncertain value and could not sustain the lack of liquidity, which distress lead to FIRREA, multiple failures in the insurance and savings and loan sectors, and a wide variety of alleged securities and other law violations encompassing executives, arbitrage firms, securities firms and law firms.

No doubt some issuers of high-yield defaulted, but most issues had inherent value. There was uncertainty, and the savings banks were ill-equipped to value high yield issues. Astute distress investors saw value and bought S&L investment portfolios and opportunistically explored the S&L distress opportunities.

Are the similarities between the S&Ls search for yield by investing in what became illiquid high yield investments and today's search for yield by SIVs and their sponsors in investing what has become an illiquid market in subprime mortgages too attenuated?

The answer may well depend on the behavior of the regulated players in terms of contributing to the subprime crisis and the regulatory response as well as the time that it takes to restore liquidity. As then, there undoubtedly will be opportunities for the savvy distressed investor.