Are ALL Mortgage Backed Securities a Scam?

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Pensions and other large investors may sue the banks which sold them mortgage backed securities (mbs) based upon fraudulent misrepresentation.

Indeed, as William D. Cohen and Felix Salmon point out in must-read stories, the big banks hired a company called Clayton Holdings to sample the quality of mortgages being purchased.

Clayton found very high percentages of mortgages which did not meet minimal underwriting standards.

However, instead of disclosing to the investors purchasing mbs that many of the mortgages were bad – or even that there were samples and statistical analyzes performed by Clayton and the banks – the banks simply kept it to themselves, and used that inside information about poor mortgage quality to negotiate a discount of the price that the banks paid when purchasing the loan portfolios from the folks who originated the loans.

This is like buying a used car, but having a mechanic look it over first. Once the mechanic discovered a cracked engine block, the buyer negotiates the purchase price way down, but then turns around and sells the car for a higher price without ever disclosing that there was a cracked engine block or even that a mechanic had looked it over.

Indeed, its worse … at least with the car, there is something physical to inspect. But because many of the underlying mortgage documents have gone missing, there is nothing for the mbs buyer to investigate even if he wanted to. For example, as I've previously noted, MERS – the holder of 60% of all U.S. residential mortgages (and many commercial mortgages) – is a shell company, and many mortgage documents were forged.

But a financial insider claims (via David Kotok – chief investment officer of Cumberland Advisors – and investment adviser John Mauldin) that the entire mbs sausage-making process is a scam:

> "The whole purpose of MBSs was for different investors to have their different risk appetites satiated with different bonds. Some bond customers wanted super-safe bonds with low returns, some others wanted riskier bonds with correspondingly higher rates of return.
>
> "Therefore, as everyone knows, the loans were 'bundled' into REMICs (Real-Estate Mortgage Investment Conduits, a special vehicle designed to hold the loans for tax purposes), and then "sliced & diced"…split up and put into tranches, according to their likelihood of default, their interest rates, and other characteristics.

“This slicing and dicing created ‘senior tranches,’ where the loans would likely be paid in full, if the past history of mortgage loan statistics was to be believed. And it also created ‘junior tranches,’ where the loans might well default, again according to past history and statistics. (A whole range of tranches was created, of course, but for the purposes of this discussion we can ignore all those countless other variations.)

“These various tranches were sold to different investors, according to their risk appetite. That’s why some of the MBS bonds were rated as safe as Treasury bonds, and others were rated by the ratings agencies as risky as junk bonds.

“But here’s the key issue: When an MBS was first created, all the mortgages were pristine…none had defaulted yet, because they were all brand-new loans. Statistically, some would default and some others would be paid back in full…but which ones specifically would default? No one knew, of course. If I toss a coin 1,000 times, statistically, 500 tosses the coin will land heads…but what will the result be of, say, the 723rd toss? No one knows.

“Same with mortgages.

“So in fact, it wasn’t that the riskier loans were in junior tranches and the safer ones were in senior tranches: rather, all the loans were in the REMIC, and if and when a mortgage in a given bundle of mortgages defaulted, the junior tranche holders would take the losses first, and the senior tranche holder last.

“But who were the owners of the junior-tranche bond and the senior-tranche bonds? Two different people. Therefore, the mortgage note was not actually signed over to the bond holder. In fact, it couldn’t be signed over. Because, again, since no one knew which mortgage would default first, it was impossible to assign a specific mortgage to a specific bond.

“Therefore, how to make sure the safe mortgage loan stayed with the safe MBS tranche, and the risky and/or defaulting mortgage went to the riskier tranche?

“Enter stage right the famed MERS…the Mortgage Electronic Registration System.

“MERS was the repository of these digitized mortgage notes that the banks originated from the actual mortgage loans signed by homebuyers. MERS was jointly owned by Fannie Mae and Freddie Mac (yes, those two again …I know, I know: like the chlamydia and the gonorrhea of the financial world…you cure ’em, but they just keep coming back).

“The purpose of MERS was to help in the securitization process. Basically, MERS directed defaulting mortgages to the appropriate tranches of mortgage bonds. MERS was essentially where the digitized mortgage notes were sliced and diced and rearranged so as to create the mortgage-backed securities. Think of MERS as Dr. Frankenstein’s operating table, where the beast got put together.

“However, legally…and this is the important part…MERS didn’t hold any mortgage notes: the true owner of the mortgage notes should have been the REMICs.

“But the REMICs didn’t own the notes either, because of a fluke of the ratings agencies: the REMICs had to be “bankruptcy remote,” in order to get the precious ratings needed to peddle mortgage-backed Securities to institutional investors.

In other words, the author is saying that mbs buyers thought that they were buying specific tranches tied to real mortgages, but they were just getting a statistical cut of wispy, non-corporeal representations of information related to the entire universe of mortgages floating around in the digitized MERS ether.

So are all mortgage backed securities a scam?

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