Agincourt Capital Management, LLC

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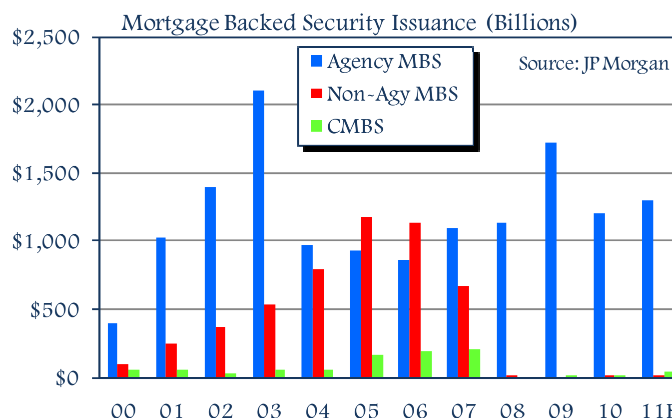
Investment Update

For this month's Investment Update, we're going to take on two different but related topics—the US mortgage market, and the reforms coming to a financial system near you.

First, the mortgage market. Let's first distinguish between the US housing market, and the loans/securities that are tied to that market. As for the US housing market, it's a mixed bag, which is an improvement over where it was a few months ago, when there was little positive news to report. After taking a dip in the second half of 2010 due to the expiration of the home buyers' credit program, home prices finally appear to be bottoming out, and in some areas of the country have actually moved up a bit in recent months. Foreclosures have not yet peaked, although this is likely due to suspension of the foreclosure process in the wake of state and federal governments' investigations into mortgage servicers' sloppy administration of delinquent mortgage loans. But these delays are temporary and we expect a big wave of foreclosures in the next few months. But delinquencies do appear to have peaked out, which reflects both the "burn out" of impaired borrowers as their homes enter foreclosure, and a slight improvement in the US labor market and household income.



The securities markets tend to be forward-looking, and the mortgage-backed securities (MBS) market is no different. The two largest US mortgage agencies (FNMA and FHLMC), as you may recall, became wards of the state in August 2008, with explicit government backing; prices of bonds issued by these agencies (and GNMA, too) have held up very well over the past couple of years. Non-agency residential MBS, on the other hand, have had a much bumpier ride; after suffering massive price declines early in the financial crisis, most non-government MBS showed dramatic improvement in their marketability as prices rose in 2009 and 2010. To be sure, not all "private label" MBS have recovered equally; those collateralized with subprime mortgages and other poor quality loans still trade for a mere fraction of their original selling prices, and those buried down the seniority structure (i.e., those that supported higher quality bonds by taking all the losses first) have either been wiped out completely or trade for pennies on the dollar. But for the most part, bondholders of so-called "prime" home loans, especially well-protected bonds issued with ample credit enhancement, have seen the prices of their bonds recover most of the damage suffered during the dark days of 2008. Bonds that had been marked down to 50 to 60 cents on the dollar are now trading at 80 to 90 percent of par value, and many may see little, if any, ultimate loss of principal over the life of the security. That's a heck of a turnaround for a market that had been declared dead and buried not too long ago.

Meanwhile the commercial mortgage-backed securities (CMBS) market has rebounded even more strongly. Like the residential market, commercial real estate prices are down significantly from their highs of two or three years ago. Unlike the residential market, however, it is possible, even preferable, to modify loans when the borrower gets in trouble (e.g., due to a shortfall in rental income), even after the loan has been packaged into a security. Currently, delinquencies are quite high for many commercial MBS, but actual foreclosures are not; most borrowers have sufficient cash flow to remain "current" on the interest payments, but those in trouble are renegotiating or extending the term of the loan. As a result, many CMBS have seen their average lives extend a year or two, but for the most part their credit ratings have not been downgraded, and many are trading at or near pre-crisis levels.

Now, let's be clear: the MBS markets are not back to normal. Not even close. As the chart shows, since 2008, there have been essentially no new CMBS or non-agency mortgage securities issued in the public bond market. A new issue market that was measured in the trillions of dollars has evaporated. Investors may have warmed up a bit towards older, better structured non-government mortgage bonds, but not nearly enough to prod Wall Street to ramp back up and create significant new issuance. Banks making new mortgage loans are much pickier about whom they're lending to; with the new issue market dead, if the loan doesn't conform to government agency standards, it most likely will have to be held on the bank's balance sheet. In this sense, the clock has turned back 20+ years, to a time before the widespread securitization of "private label" mortgage bonds, when banks who didn't participate in the Freddie/Fannie/Ginnie programs had no choice but to hold mortgages they underwrote in their loan portfolio.

Which leads to the second topic of the month: Regulation.

We welcome the sensible and effective regulation of financial institutions (and their markets) whenever taxpayers are on the hook to bail out firms that have the capacity to cripple our economy. Regulation and close scrutiny is the price these firms must pay for a government-funded safety net

The Dodd-Frank Act that was passed last year was a massive undertaking, and once implemented, will bring sweeping reforms to consumer lending, mortgage lending, broker/dealer operations, the regulatory regime of banks, the oversight of derivatives, and a host of other changes. Commissions have been formed and agencies have been assigned the job of "fleshing out" all the hundreds of details stipulated by the Act. These groups have been reporting back with recommendations, with all provisions of the Act due to be transferred to the respective agencies by July 21 of this year; however, there is an 18-month deadline after the "transfer date" for everything to be implemented. The amount of work that is yet to be done is staggering.

Obviously, a complete run-down of this Act is impossible in a short discussion, but some examples of the complexity involved with its implementation might be illuminating. For instance, the Act handed the Commodity Futures Trading Commission (CTFC) the job of being the chief regulator for the $500+ trillion derivatives market. But the CFTC is a relatively small organization, and simply drawing up the details of their new responsibilities is already straining their resources. Nevertheless, the CFTC has announced some guidelines on who will be regulated, including "swap dealers" and "major swap participants" as well as firms with a "substantial position" in commodity, interest rate, credit, equity or currency swaps. The pushback, as one might expect, has been swift and forceful. Royal Dutch Shell and Archer Daniels Midland, to name just two large firms, both objected (and rightfully, in our opinion) to the definitions, with both firms claiming that their use of commodity swaps to hedge their massive oil and farm commodities business posed no real danger to the economy, and asked to be exempted from the Act. A trade/lobbying organization, the International Swaps and Derivative Association, has released comment letters, press releases, and policy papers in response to both the SEC and the CFTC's plans for regulatory oversight. To their credit, ISDA seems committed to significant and meaningful oversight, including new registration, disclosure and transparency rules, but favors "self-regulation" by an industry trade group, overseen by the CFTC. The trade group that ISDA recommends for the self-regulation of the swaps markets is, not surprisingly, ISDA itself. They are sure to be disappointed.

The regulation of the derivatives markets, while seemingly obscure, is arguably where the greatest need for oversight exists. After all, the mostly-unregulated and highly opaque derivatives market is where the big boys played with impunity. It is where highly-levered hedge funds placed huge bets against Lehman and Bear Stearns, and where unscrupulous broker-dealers dumped their cheerfully-packaged toxic waste. It is where AIG wrote contracts it would never be able to repay. And because of its lack of openness, the derivatives market is where market participants, regulators and policymakers made their grossest miscalculations regarding the size and depth of the world's global financial risk.

But let's get back to the mortgage market; in general, regulations in the Dodd-Frank Act concerning mortgages seek to achieve two main goals: first, to protect consumers from deceptive or unfair mortgage lending practices, and second, to protect the financial markets from unscrupulous mortgage backed securities dealing. The first assigns many responsibilities to the newly-created Consumer Financial Protection Bureau (CFPB), charging them with broad oversight and enforcement of both new and existing regulations. Some of the new regulations include the requirement that all originators of mortgage loans be licensed and registered, the establishment of restrictions on fees and commissions paid to originators (to prevent them from pushing high cost/high-profit mortgages on unwary borrowers), and mandates that the lender make a good faith determination that the borrower has the ability to repay the mortgage loan, based on verified documents. There are other consumer-friendly provisions, including rules on appraisals and escrows, and restrictions on prepayment penalties. Once again, the details on many of these rules are still being ironed out.

The new mortgage rules that we, as bond investors, are most interested in are those which apply to the mortgage-backed securities market. Here, there are important new rules for ratings agencies, including the disclosure of ratings methodology, requirements that ratings agencies put up "firewalls" between the marketing of ratings services and those doing the credit work for customers, and a mandate that the GAO and SEC look into a "public utility" model for bond ratings. As with the rules forcing greater disclosure in the derivatives market, we view these as important steps towards greater transparency for investors.

Finally, there are important guidelines concerning classification of mortgage loans and mortgage securities, and new rules for securitizers. For those who securitize mortgage loans, they will have to retain at least a 5% credit risk exposure to any bond they create. This is a critically important rule, as it means that any broker/dealer or bank who pools together loans to create an MBS will have "skin in the game," and will take losses consistent with those who buy the bonds.
There will be a new class of loans, called "qualified residential mortgages" (QRMs) which will be exempt from the 5% rule. Details on QRMs are still being ironed out, but the general idea is that they will be mortgages that meet fairly strict underwriting standards for credit quality.

Whether these reforms bring back investors to the non-agency MBS markets is yet to be seen. As always, the devil's in the details.

200 South 10th Street Suite 800 Richmond, VA 23219 Tel: 804.648.1111 Fax: 804.864.2611