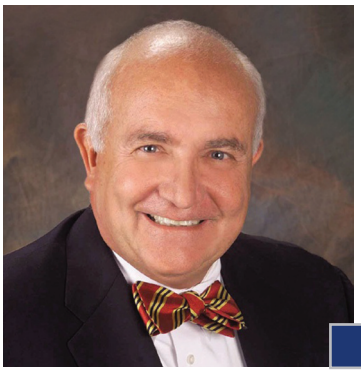

THE WIZARD OF OZ AND THE ECONOMIC CRISIS

BRUCE BEESLEY, PRESIDENT, STATE BAR OF NEVADA

"I'm melllllllting!"

As most of us know, the net worth of Americans as a whole has significantly, frighteningly, declined in the last 18 to 24 months. By November 2008 Americans had lost almost 20 percent of their net worth through a combination of declines in asset values including housing values down 20 percent; the S&P 500 down 45 percent; and total home equity down $5 trillion. These and other indicators of the economy continue to fall.

Most pundits blame the declining economy on the failure of the subprime mortgage market. I think it is because we didn't follow the yellow brick road.

When I bought my home, and for decades preceding that, the traditional mortgage lending model consisted of a bank or mortgage company originating and servicing a home loan. The lender reviewed the borrower's income and assets, appraised the property to be purchased, priced the loan to account for the risk and retained and serviced the loan until it was paid off. If the bank or mortgage company didn't do the appropriate diligence, they paid the price. (See chart A.)

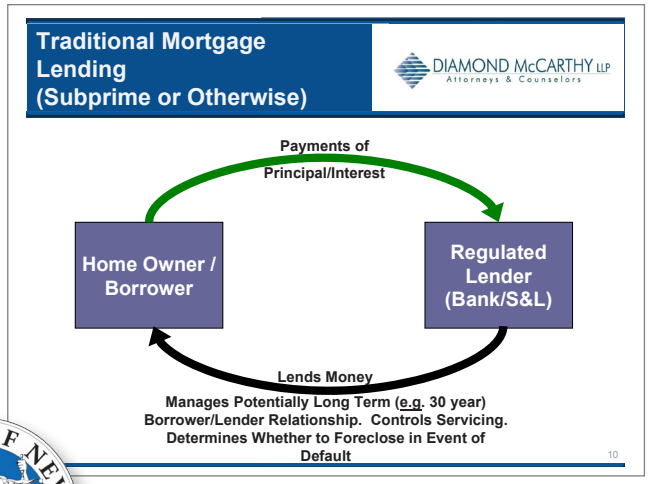

CHART A

Ten to 15 years ago, this model began to change. Loan originators no longer retained the loan or serviced the loan. In fact, the servicing was often sold to a party that did nothing but service the loan for a monthly fee, while ownership of the loan – the right to receive payments – was sold to a third party which did not, itself, retain ownership. The third party was generally a Special Purpose Entity (SPE) which purchased thousands of loans and then packaged them into equity known as Mortgage Backed Securities (MBS), and sold them as securities.

Initially, at least, people were not as foolish as they later became. Investors wisely concluded that a bundle of a thousand bad loans did not constitute a diversified loan portfolio; it was still just bad loans. Thus, "clever people" who may in fact have had straw for brains created "credit enhancers" to make the securities appear more attractive. These credit enhancers included such things as high ratings of the shares by rating agencies and, my personal favorite, the "Mortgage Default Credit Swap." This latter "enhancer," in my opinion, just slapped a new name on what was essentially insurance. But, with the new name, this vehicle was able to avoid the traditional regulation of insurance. (Pay no attention to the man behind the curtain!) Many companies now receiving government bailout money were sellers of Mortgage Default Credit Swaps. (See chart B.)

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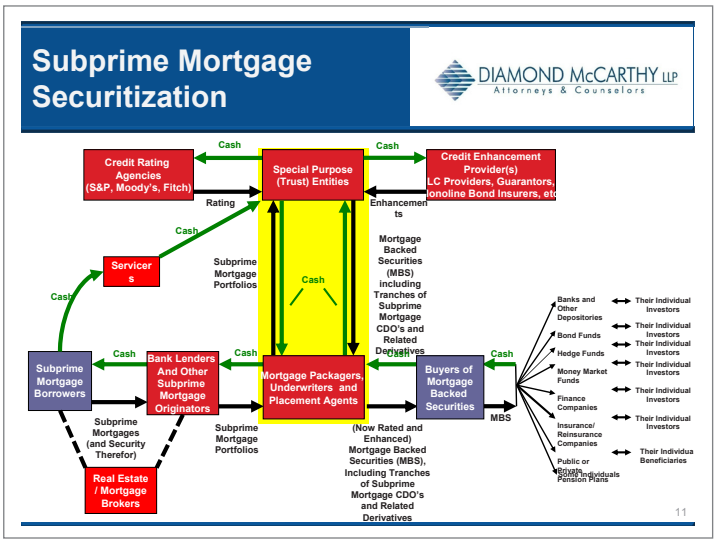

CHART B

With the originator of the loan no longer at risk if the borrower defaulted, the cowardly lion didn't need courage. The money to be made was no longer on the repayment of the loan but on the fees for originating the loan. In some cases, the riskier the loan, the greater the fee to the loan originator. Volume equaled profit. In order to speed up the traditionally slow lending process and thereby increase the receipt of income, some originators and lenders did away with the bothersome work of collecting and verifying information about the borrowers' income, assets and ability to pay. The high point of this lending model was the "no income, no job, no asset" or NINJA loan. No one worried about the possible failure of these loans because everyone was certain that housing prices would continue to rise forever. Dorothy's mantra "There's no place like home" became "There's no place like ***a*** home."

As we know, housing prices, like Dorothy's house, began to fall precipitously. When they crashed, we discovered not the ruby red slippers, but just how large a percentage of our credit market was invested in home loans that could not perform.

I do not venture to guess when this will end but I, like the Tin Man, am heartened by the government's efforts to restore confidence to the markets and by the knowledge that all previous economic downturns have eventually ended. The charts accompanying this column are, I believe, a great illustration of what went wrong. Perhaps the recovery will establish some sense that simpler is better when it comes to financial transactions. Follow the yellow brick road.

This column is not intended to be a complete review nor an academic analysis of a serious problem. NL

Charts provided by Jim McCarthy, a partner of Diamond McCarthy, LLP. Used with permission.