FARPM
FLORIDA ASSOCIATION OF RESIDENTIAL PROPERTY MANAGERS

A Quarterly Publication of FARPM, Inc.,
The Florida Association of Residential Property Managers

SUMMER 2009

rentalhomesplus
Powered by Apartments.com
Official 2008-2009 FARPM, Inc. Annual Partner

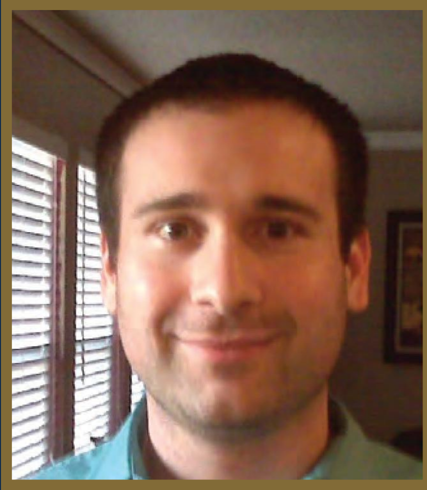
FLORIDA RESIDENTIAL PROPERTY MANAGER™

Florida in the Summer

In This Issue:

FARPM 2009 Convention Overview, p. 9
The Calm Before the Storm, p. 10
Move-in Inspection Procedures, p. 16
How Do You Change in Property Management Sanely, p. 20

www.FARPM.com
Setting "THE STANDARD" for Residential Property Management



Steven Palmieri
President

CMA Financial Corporation
Millennium Centre
15455 Dallas Parkway
Sixth Floor
Addison, TX 75001

Phone: (800) 539-5242
Fax: (800) 948-8077
Email: spalmieri@cmafinancialcorp.com

www.CMAFinCorp.com

The Lifecycle of a Collateralized Financial Instrument

by Steven Palmieri

As the government continues to bail out lenders in today's illiquid financial markets, it is often overlooked that the United States underwent a similar financial shift after the Great Depression. The Roosevelt Administration helped unfreeze financial markets by creating the Federal Housing Administration (FHA) and the Federal National Mortgage Association (Fannie Mae) in the 1930s.

Throughout the following decades mortgages evolved to 30 year terms that allowed people to work towards home ownership by retirement. Fannie Mae and Freddie Mac evolved as government sponsored enterprises which helped create the framework under which today's financial mortgage loan markets have flourished.

In order to set the foundation for this article, it is important to clarify what money really is. There are four types of money, or monetary aggregates, as recognized by the US Federal Reserve Bank. The accepted terms of recognition are "M0" through "M3."

Here are the four monetary aggregates in very simple terms:

M0: is actual currency such as cash that is directly controlled by the Federal Reserve Bank. We will refer to M0 as "Cash" in this article. Cash is the most liquid form of money and the easiest to control by the Federal Reserve System.

M1: includes money that is held in bank reserve vaults plus demand accounts such as checking accounts.

M2: includes savings accounts, money market accounts, and CDs. We will call M1 and M2 "Bank Money" in this article.

M3: includes financial instruments which provide evidence of an ownership interest backed by a debt, such as a home mortgage or car loan. We will call M3 "Financial Instrument" in this article. A Financial Instrument is the least liquid form of money and the hardest to control by the Federal Reserve System.

The understanding of monetary aggregates is important in order to fully understand how lenders can gain a level of economic influence that the Federal Reserve System cannot directly control. A lender can create a Financial Instrument that, in large enough quantities and under the right conditions, can create a chain reaction large enough to slow the economy to its current recession.

Few people actually differentiate between Cash, Bank Money, and Financial Instruments. But this is a very important fundamental concept. Cash is created and controlled by the Federal Reserve Bank, while Bank Money and Financial Instruments are created and controlled by for-profit companies

such as banks and lenders. As long as these Financial Instruments meet legal requirements including those of the Truth-In-Lending Act, then it is up to the guidelines of the lender underwriting the Financial Instrument to determine the risk vs. reward when qualifying customers. When Cash becomes cheaper for banks to get and turn into Bank Money, as was the case a few years ago when the Prime Rate was low, Bank Money then becomes cheaper for lenders to borrow and turn into a Financial Instrument. And if a bank or lender can increase the profit spread between the cost of the Cash or the Bank Money relative to the market value of the Financial Instrument that they create, they then benefit from a larger profit margin. The Adjustable Rate Mortgage Financial Instrument (ARM), which has many different variations, is what this article focuses on as we travel the subprime customer's journey from pre-home ownership to post-foreclosure.

It is important to note that ARMs are often sold by the original lender. The collateral manager (also known as asset manager) who works on Wall Street moves these ARMs into other investment vehicles. The collateral manager goes to an investor on Wall Street to borrow, say, $500 million in order to make an investment vehicle known as a Collateralized Debt Obligation (CDO). The CDO will use the investor's money to buy and hold the ARMs which are then used to create Asset Backed Securities (ABS) through a process known as Securitization. Because the CDO is composed of ARMs, the collateral used to create the ABS are the homes themselves. The collateral backing this particular CDO are the homes for which the ARMs are written. The ARMs that these homes are attached to are securitized by the asset manager in $500 million blocks on Wall Street.

Any cash flow producing asset can be securitized by repackaging the cash flow as securities and offering the securities for sale to investors. The securitization creates $500 million worth of ABS which are then used to create and sell bonds (debt) to investors. The payments from these bonds are fueled by the monthly principal and interest payments the subprime customer makes on the original ARM. This securitization process is very similar to how auto subprime lenders operate.

These bonds are valued on Wall Street by the anticipated future value of the assets (homes) and the anticipated future cash flow of the monthly payments of the ARM attached to the asset. Many of these bonds were erroneously rated "Senior" and "Super Senior" triple A status by Wall Street credit rating agencies because the true risk was underestimated. John Dugan, the Comptroller of the Office of Comptroller of Currency of the United States, in a speech on 27 February 2008 recognized that "these better-than-triple A tranches [of bonds] were supposed to be the least risky parts of the subprime securities pyramid. Instead they have generated the clear majority of reported subprime writedowns in capital markets."

The Office of the Comptroller of Currency charters, regulates, and supervises all national banks. According to John Dugan non-bank lenders originated 90% of all subprime mortgages in 2006. National banks and their subsidiaries originated only 10 percent.

When the securitization criteria tightened in 2007 and Wall Street's demand for these Financial Instruments decreased, small lenders found themselves unable to create the cash flow necessary to sustain their business models. This has resulted in a domino effect of lenders, home builders and realtors having to find other ways to maintain their business models.

The collateral manager's circumstances are different. He is responsible for maintaining profitability on Wall Street which he does partly by managing CDOs. ABS are needed to create the CDO, so lenders push the ARMs to subprime customers that then fill the CDO that the collateral manager is creating. The lender is essentially only a middle-man (or a loan originator) with no intention of keeping the mortgage because the collateral manager on Wall Street can buy these Financial Instruments to create profitable CDOs.

continued on page 30

continued from page 25

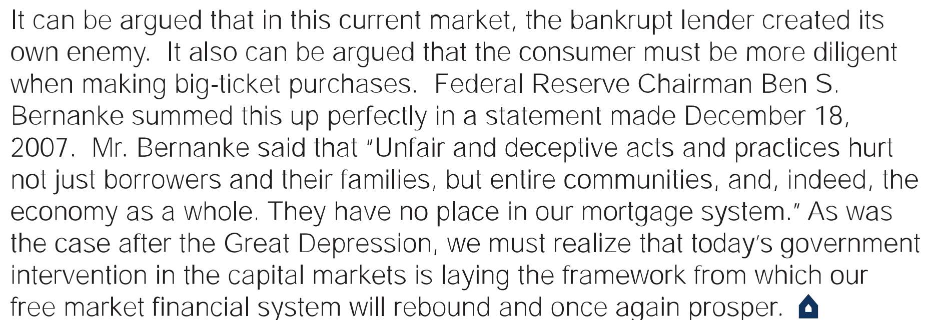
ARMs written at 9-10% were common.

These ARMs are fundamentally sound options for customers who do not plan to keep a home past a few years and who can budget to pay their taxes annually. The amortization structure gives the customer a lower payment, while giving the collateral manager a higher APR loan to securitize, package, and sell. Significantly more customers are able to afford the monthly payments on a dream home because the lender guidelines do not require taxes and insurance to be included monthly.

The problem starts when the customer is unable to budget the true cost of home ownership including utilities, insurance and property taxes. When a lender force-places escrow on a mortgage for back taxes and future taxes, a customer can easily see a significant increase in the monthly mortgage payment.

In today's market, mortgage companies are more willing to postpone foreclosure and keep a house as an occupied Non-Performing Asset (NPA) while the homeowner tries to sell the home as a short-sale.

Traditionally, a lender would quickly foreclose on a home and put it for sale on the open market at the auction. When a home would not sell at the foreclosure auction and the open market, the lender would pull the home from the market. The home now becomes a class of property owned by the lender known as Real Estate Owned (REO) property. Mortgage default is nothing new. It is the risk a lender takes as a part of doing business.



It can be argued that in this current market, the bankrupt lender created its own enemy. It also can be argued that the consumer must be more diligent when making big-ticket purchases. Federal Reserve Chairman Ben S. Bernanke summed this up perfectly in a statement made December 18, 2007. Mr. Bernanke said that "Unfair and deceptive acts and practices hurt not just borrowers and their families, but entire communities, and, indeed, the economy as a whole. They have no place in our mortgage system." As was the case after the Great Depression, we must realize that today's government intervention in the capital markets is laying the framework from which our free market financial system will rebound and once again prosper.