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Legacy Countrywide mortgage investors rally against potential settlement with Bank of America

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A growing faction of mortgage bond investors are rallying to fight a potential "sweetheart" deal between Bank of America and a handful of friendly funds related to Countrywide Financial's mortgage buyback saga, Debtwire reports.

The investors fear talks led by some of the nation's largest fund managers, including PIMCO and BlackRock, along with Freddie Mac and the New York Federal Reserve, could bind them to pennies-on-the-dollar payouts even though contractually Countrywide's owner is required to repurchase all flawed mortgages at par, said two sources involved in the negotiations. A deal could materialise in as little as 30 days, they said.

Investors looking to be refunded for loans that don't meet the criteria they were promised accuse the bank of selling them Pintos instead of Ferraris. In Countrywide deals, the number of mortgages that differ substantially from their descriptions is estimated between 40%-45% to as high as 70% of the balance, according to one of the sources involved and a source familiar with the lender's collateral.

Attempts to reach a side-deal with BofA reflect underlying fears the US retail and investment bank could be forced to re-absorb billions of the non-conforming loans at par to settle a mounting chorus of buyback challenges, the sources said.

The US government extended the bank a multi-billion dollar lifeline in 2008 as it tee-tolled from heavy losses at Merrill Lynch. Countrywide was taken over in a USD 4.1bn stock deal in 2008, making BofA the largest US mortgage lender. Shortly after, BofA infused Countrywide with billions as it struggled against mortgage losses, securities investor lawsuits and the largest predatory lending settlement in the nation's history.

An agreement struck between the big boys could bind all non-agency mortgage backed securities issued by Countrywide, BofA and potentially Merrill Lynch, should trustees for the deals participate, said David Grais, a partner in New York law firm Grais & Ellsworth, which represented Greenwich Financial in a buyback case against Countrywide in 2007. Such a deal would likely prevent mortgage bond investors from pursuing a higher payout in the future, Grais said. Between 2004 and 2007 Merrill Lynch and Countrywide issued at least 491 deals totaling USD 414bn.

The agreement would mirror the USD 3bn deal BofA arranged with Freddie and Fannie Mae in January. Opponents say it would allow poor servicing practices to continue and hamper investor confidence in the mortgage bond market at a time when government lending is beginning to contract.

'Double agents'

All of the mortgage bond investors, including PIMCO and BlackRock, initially banded together to pursue full reimbursements for bad mortgages sold into the Countrywide mortgage deals they bought, the second source involved said. The investors compiled evidence that Countrywide was granting first lien mortgage modifications to consumers, but denying them a second lien modification when BofA stood to take a loss from the work-out, the source said. The first mortgages Countrywide services were already sold to RMBS investors, but BofA holds more than USD 100bn in second lien mortgages on its balance sheet and it would be forced to write them down following a modification, the sources said. The investors found evidence of the so-called servicer self-dealing in 200 RMBS deals holding USD 200bn in mortgages, the sources said.

The evidence would have armed bond investors with the arsenal to declare BofA in default of its Countrywide servicing contracts, stripping it of its servicing rights, while revealing information that would have resulted in untold amounts of repurchase requests, the source said. BlackRock and PIMCO, however, switched course.

The BlackRock and PIMCO-led faction turned to Kathy Patrick, a partner in Houston, Texas-based law firm Gibbs and Bruns, and employed several tactics to recover their losses – but balked at using the evidence, according to the source.

The funds eventually sent Countrywide a non-compliance notice on 18 October, demanding it cure a number of

servicing breaches, but did not provide specific evidence, according to a copy of the letter obtained by Debtwire. The funds agreed to extend the 60-day cure window twice, most recently on 2 February, according to Patrick.

In order to prove a servicer has breached its contractual duties, specific evidence is required at the onset because it becomes challenging to obtain it during litigation. Once a servicer defaults, the trustee is obligated to pursue a replacement servicer and/or potential representation and warranty breaches under the "prudent person" clause of the US Trustee Act.

Because it declined to use the allegedly damning evidence, the PIMCO group's attempts to negotiate with BofA has been labeled as "unleashing a dog with no teeth" - partly to fulfill their fiduciary duties to their own investors while also ensuring BofA's financial strength, the two sources, a third with knowledge of the situation and a lawyer following the dispute said.

The letter dispatched by Patrick was signed by BlackRock, Freddie, Kore Advisors, the New York Fed (on behalf of the Maiden Lane funds), Metropolitan Life Insurance Company, Neuberger Berman Europe, PIMCO and Western Asset Management Company.

BlackRock holds an estimated USD 3.4bn of BofA equity, and BlackRock, PIMCO and fellow signatory Western Asset Management Co. maintain significant government ties through the Public-Private Investment Program (PPIP) funds they run.

Patrick denies allegations that the firms' pursuit was for show. "I don't know how anybody could look at the list of institutions that has previously been published ... and conclude that they were pursuing discussions in anything other than a good faith effort," she said.

Bank of America spokesperson Jerry Dubrowski said the bank is still in talks with the investor group. Representatives from Bank of New York and BlackRock declined to comment. A PIMCO representative did not return a request for comment.

Majority rule

The original bond investor group, organized through the Dallas, Texas-based RMBS Investors Clearing House, now encompasses a number of anonymous investors with holdings amounting to one-third of the USD 1.5 trillion RMBS market - including foreign banks representing USD 100bn in RMBS, said Greenwich Financial CEO Bill Frey, who belongs to the Clearing House and opposes the settlement.

Winning the conflict depends on which group can accumulate like-minded investors fast enough. When it comes to exercising contractual rights to oppose servicing practices or put back a bad mortgage to the originator, at least 25% of investors of a given mortgage pool must approve.

The faction led by PIMCO and BlackRock purport to have at least that much standing in USD 47bn of Countrywide mortgage bonds. The opposition, meanwhile, is gaining momentum by soliciting more foreign banks to join the movement, Frey said.

The settlement could be used as a roadmap for resolving similar buyback and servicing challenges pending against the nation's largest banks, the sources said.

Georgetown University professor Adam Levitin suggested US banks should come to a global settlement on mortgage issues in November testimony to Congress. This would involve restructuring bank balance sheets, special servicing and perfecting titles on securitized properties.

Last week, BofA announced it would separate its legacy asset servicing from the rest of its operations. Similarly, JPMorgan Chase, embroiled in buyback law suits involving its EMC and WaMu portfolios, recently told employees that its Chief Administrative Officer Frank Bisignano would be overseeing its servicing unit, according to an internal memo. "If they have a separate unit, they can put some money in it and hopefully get a court to say 'this is all fair and good,'" the first source said.

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