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Trillion Dollar Federal Bailout – How Bad Is It?

Ann Arbor, MI September 19, 2008 – “The number one issue that needs to be addressed as the government considers its rescue plan is the actual realistic value of troubled mortgage assets,” said Gibran Nicholas, Chairman of the CMPS Institute, an organization that certifies mortgage bankers and brokers. “The current market value of many of these mortgage assets assumes that more than 50% of subprime borrowers will default on their loans and US home values will decline to \$0 making the underlying defaulted mortgages absolutely worthless. This is a totally unrealistic worst-case scenario and reflects extreme panic in the marketplace.”

Here is a link to an illustration of how troubled mortgage assets are valued:

<http://www.cmpsinstitute.org/pdf/WhatAreTroubledMortgageAssetsWorth.pdf>

Accounting rules require financial institutions to value their assets (such as mortgage holdings) at current market prices and then adjust their “capital levels” (the amount of cash they have in reserve) accordingly. If the market value of their mortgage holdings declines, financial institutions have to raise more cash to make up for the difference. “Most of the losses being reported are simply paper losses – but financial institutions have to raise real cash and beef up their reserves just in case those paper losses become real losses,” Nicholas said.

However, the accounting rules are unclear as to how financial assets (such as mortgage holdings and complex derivatives) should be valued if the market for those assets completely disappears due to lack of buyers. “The real issue here is that it is virtually impossible to attach a market value to something when there are no buyers able or willing to buy it,” Nicholas said. “This doesn’t mean that the mortgage asset is really worthless, it simply means that no one can afford to buy it right now because all the buyers have financial problems of their own.”

To illustrate this concept, picture yourself as part of a group of 100 homeowners in a given neighborhood. Next, consider that all 100 of you lose your jobs and are having trouble making your mortgage payments. Not a single one of you can afford to buy your neighbor’s home - in fact, you might even lose your own home. Does this mean that all of the homes in that neighborhood are completely worthless? Of course not, it simply means that you yourselves cannot afford to buy the homes in that neighborhood at this particular time. The buyers have simply disappeared, and there is no longer a market for those homes.

Next, consider what it would be like if your rich Uncle Sam came along and offered you a “bailout.” He will help you make your mortgage payments or even buy some of

your homes from you at a steep discount. Of course, you'll have to pay him back with a huge interest rate once you find another job or possibly even give him 80% ownership of your home (and 80% of the proceeds when you are finally able to sell it at a later time). Is this "bailout" a good deal or bad deal for Uncle Sam?

Depending on how exactly the government intervention takes place, there is a huge potential upside for taxpayers. "The government could basically take over all these troubled mortgage assets at bargain basement prices and then sell them at a profit over time once the buyers return and the financial markets stabilize," Nicholas said. "After all, how likely is it that 50% of all subprime home owners will default on their loans and home values all across the United States of America will go all the way down to \$0? Are troubled mortgage assets really worthless?"

That is the trillion dollar question!

About CMPS Institute: CMPS is a training, examination, certification and ongoing membership program for financial professionals who provide mortgage and real estate equity advice. Recognized for its preeminence within the industry, the CMPS curriculum represents the core knowledge expected of residential mortgage advisors regardless of the diversity of specializations within the industry. Over 5,500 financial professionals have gone through the program since its launch in 2005. For more information or to find a certified professional near you, please visit www.CMPSInstitute.org or call 888.608.9800.

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