

Mortgage Backed Investments Threaten Nonprofits

By Tom Pope

APRIL 1, 2008

Mortgage Backed Investments Threaten Nonprofits

When the Indianapolis-based Children's Wish Fund (CWF) received an undisclosed settlement last December from the Morgan Keegan brokerage firm in Memphis, the issue centered on investments that decreased in value because of links to the subprime mortgage market.

"This is a going to be a problem with many nonprofits' investments and pension plans," said Thomas Hargett, a partner with Maddox Hargett & Caruso P.C., a securities and investment law firm in Indianapolis, which represented the CWF. "Most organizations will have some exposure, but officers haven't admitted the closeness of the danger."

The CWF, filed an arbitration claim against Regions Morgan Keegan Intermediate Bond Fund with the Financial Industry Regulatory Authority (FINRA) in Washington, D.C., because the bond fund, "was a completely inappropriate investment for the working capital surplus of the wish fund," according to the complaint filed by Hargett.

The ICWF invested around \$220,000 in the RMK Fund on June 26, and according to the complaint, believed the investment was "a relatively safe investment." The nonprofit lost nearly \$50,000 when the investment dropped 32.21 percent from the start of the year to Oct. 29.

While Hargett could not answer whether he was satisfied about the settlement because of a confidential agreement, he stated in the complaint that the Intermediate Bond Fund was, "an incredibly speculative and highly volatile bet on the housing market and mortgages."

According to Hargett, a number of nonprofits, such as churches and colleges, are being affected despite an unwillingness to speak to the press. "Brokers of nonprofits have a fiduciary duty to watch out for the investments by using a conservative approach," he said. "Investments from the subprime mortgage market are exposing nonprofits to a speculative high-risk approach that is completely inappropriate of those duties."

Generally the best way to recover losses like this comes through arbitration with the FINRA agency, according to Hargett. Yet nonprofit managers need to discover where those losses might hit within the investment portfolio.

There are three ways to assess the end-of-the-month holdings by investment banks, mutual funds, and money managers. Most people assume that the benchmark is the price of the last trade, such as with the S&P 500 or the Dow. That evaluation of the last trade is a level 1 approach.

However, collateralized mortgages obligations (CMOs) and collateralized debt

obligations (CDOs) don't trade every day. "These are mathematical equations that grant you portions of cash flows from an underlying mortgage that is very complicated," Hargett said. "The model generates cash flow based on a contract, but to inform investors about the value, opinions are added that make estimates of the real value."

A CDO is nothing more than a redistribution of credit risk, much in the same way a CMO is a redistribution of prepayment risk. "These CMOs and CDOs are evaluated at a level 3 approach," he said. "As you go from level 1 to level 3 there's a lot of wiggle room."

Bond managers are held back from showing the real extent of the risk because they are fearful of losing accounts and are protected by the Financial Accounting Standards Board (FASB), which allows them to use level 3. "They're using level 3 and that information is not an accurate portrayal of what's happening in the market," Hargett said.

How does a nonprofit manager get his hands around the investment portfolio to see just how much risk he bears? "He needs a lawyer to write a letter to each fund manager, whether it is a stock broker, manager of a mutual fund or private debt manager," Hargett said.

The letter must clearly require that the broker list every investment that has a CMO, CDO or subprime exposure, according to Hargett. Find the value reported in the last statement and the methodology used whether it was level 1, 2 or 3.

"The financial professional has to produce this," he said. "If they don't, they have to hide the answer and they have a liability. If they misrepresent it, they have a liability."

Armed with that information, the nonprofit needs people who can help determine if those values to make sure the organization is in a position of risk. Then the manager has to question whether the financial professional presented this as a high risk or not.

"If the instrument was sold as a standard of a good investment at low to no risk for an intermediate time frame," he said, "then the person who presented this has an exposure to your recourse."

The subprime aspect hides in many forms, according to Hargett. Investments in hedge, money market or bond funds along with private asset debt manager funds could be involved with the subprime area. "My guess is that nonprofits like all investors are going to be hurt," he said. "We could see a bunch of cities around the country affected because a number of money markets could fail."

The New York law firm of Stuart D. Meissner LLC, currently has several cases where people want to preserve capital and limit their risks. "I have seen charitable investments in the market that could have investments in CDOs and CMOs, so I'm assuming some could be involved," he said. "This is yet to be seen whether we have the tip of an iceberg because it's hard to tell until the cases start to roll in." Meissner was formerly with the New York State Attorney General's office.

To win an arbitration with FINRA the nonprofit would have to show that the broker did something wrong, according to Meissner. It must show that a contractual obligation was violated, resulting in the losses.

To establish that, you must:

- Show that the broker breached duties to the nonprofit;
- Show a violation of federal, state, or common law;
- Establish the real risk of the investment; and,
- Show that the investment wasn't suitable for the nonprofit.

"Like a lawsuit, you have to prove you've been the victim of incompetence or negligence," he said.

Look at the opening document to see in what position the assets were placed. Look at the description of the investment objectives. Find the projection on the idea of protecting the capital. "Those papers impose obligations on the broker," he said.

Statements should show what you've invested in and when confirmation of the purchase occurred. Check to see if the account is a discretionary or non-discretionary one. Most accounts are non-discretionary so that the broker has to explain to the investor about the trade. The broker has to obtain the consent prior to the transaction.

Test the value of the statement. Sell a small portion and see if you obtain what you expect. "If not or if you have trouble selling, then you have an indication of a trouble spot," Meissner said. Many times, a disclosure might not be an intentional act. "This could occur because of ignorance and the broker wanted to give an appearance that they were aware of the products," he said. "The full risks of these instruments often are not disclosed and they are complicated."

Nonprofits can't recover from arbitration just because securities have lost value, according to FINRA. "Two common types of wrong doing are the type that the investment was not suitable for the investor's net worth or overall portfolio," said John Gannon, senior vice president of investor education for FINRA. "The second type would be a misrepresentation."

FINRA is the regulatory authority with jurisdiction over brokers. FINRA becomes involved when an investor files a complaint and should the broker be found in violation, action could warrant a censure, fine, suspension, or barring from the industry.

"I'm not sure that the CDOs and CMOs lead to misrepresentation," Gannon said. "They can be complex and investors need to understand whether underlying mortgages are subprime or not -- investors should have asked about that."

Gannon did state that many people have taken another look at the merits of CMOs and CDOs and realized those instruments contain more risk than anticipated. Gannon pointed to the FINRA learning module called, Smart Bond Investing, that aids investors with details of how to look at risks within bonds. "Investors can avoid arbitration by going there and doing their homework."

Not everyone thinks the investor is the total victim. Kent Seton is CEO of the law firm Seton & Associates and co-founder and CEO of the Center for Nonprofit Creation (CNPC) in Beverly Hills, Calif. The CNPC provides nonprofits with help in establishing boards.

Seton questioned the way the ICWF stayed on top of the investments. "This seemed

like a naive reaction by the board," he said. "In this situation, they believed they could get a better return and the broker wasn't aware of Bear Stearns having trouble with mortgage-backed securities."

Seton explained that the Bear Stearns trouble was in the newspaper about money being placed into hedge funds. But the people in charge of the nonprofit might have thought the information was too general.

Boards without financial expertise are a common problem, he said. "Most organizations need at least one member on the board to stay on top of financial issues," said Seton. Boards need oversight to make sure the finance person is doing the job. "A move to have best practices on this issue would help nonprofit boards," he said.

Looking at risks through the CDOs and CMOs isn't the problem, according to Matthew Will, Ph.D., a finance instructor at the University of Indianapolis. "Risks can be measured," he said. "The measurement uses a standard deviation of annualized return to calculate the CDO and CMOs."

While Will admits the insurance companies and retirement plans concentrate on mortgages and could have a "huge ramification on the economy," he claims the mortgage crisis is overblown. "The crisis is based on the market speculation and not a true look at asset value," he said. "Now could be a good time to buy."

He explained that the worst case scenario of the crisis means you should not sell the mortgage-backed security. "If you invest in a bond and the interest rates go up, the value of the bond goes down and people worry," he said. "But you haven't lost money. Wait and hold off on selling even though the rate dropped in value."

New regulations might intensify the discovery by nonprofits that investments have been affected. Hargett points to the FASB guidelines that require investment managers since November 2007 to disclose which mechanisms of risk are used on all securities. "I think there will be a closing of doors by some brokers because of the crisis," Meissner said. "Some large firms like Bear Stearns and Merrill Lynch have obtained cash infusions and these are major firms, but the smaller ones might have more trouble."

Wall Street underwriters should have been aware of the risks as they put together the packages, according to Hargett. Rating agencies should have been aware of the risks. "For the past three to four years, the Wall Street underwriters got fat and dumb, telling investors these products were safe and secure," he said.