Banking by Stephen Pepper

Maryland crisis shakes Wall Street

The impending fall of EPIC threatens to bring down the $300 billion mortgage securities business.

What seemed at first to be just another chapter in the continuing saga of the Maryland Savings and Loan industry has turned out to be much bigger, for it threatens to bring down the $300 billion mortgage securities industry. For this reason a summit of representatives of major financial institutions has been convened with Maryland state officials in the face of the near-certain collapse of the mortgage securities company, EPIC. Present at the meeting were representatives of the major mortgage insurers threatened with a $400 million loss, Salomon Brothers, the New York investment bankers, and federal and state officials. So far no solution is in sight, and the major subject of the meeting appears to be who will take the bath.

What happened is that a small Bethesda thrift, Community Savings and Loan Association, underwent a run on its seven offices when it was learned that a subsidiary, Equity Programs Investment Corp. or EPIC, was in default on several million dollars in interest payments due during the month of August. Community, an institution of $400 million in assets, was in fact sustaining EPIC, a company with book value of $1.4 billion, by injecting $18 million a month. Because of the previous Maryland crisis, all savings institutions in Maryland with more than $40 million in assets have to qualify for federal insurance by Jan. 1 or go out of business.

Federal officials refused to permit Community to qualify unless it severed its connection with EPIC. Without the monthly payment EPIC could not meet its interest payments, and so defaulted on approximately $4 million due to National Bank of Washington, and will do the same to money owed to First National Bank of Maryland. Also the government's own mortgage marketing agency, the Federal National Mortgage Association (Fannie Mae) is out the money on $115 million on mortgages it had placed through EPIC.

The reason why everyone involved is walking on eggshells, and essentially lying about the dimensions of the problem, is that the huge and wildly over-valued mortgage securities market is directly threatened by the collapse of EPIC. The *New York Times* in its latest coverage wrote, "That failure [of EPIC] . . . has caused concern on Wall Street that the real estate company's problems, if not solved quickly, could mar the reputation of the mortgage-securities business, including the market for tax-exempt housing bonds issued in huge quantities by states."

The way the business works is that an underwriter, such as EPIC, assembles a pool of mortgages based on private homes, in this case 20,000 such units. Backed by the value of the mortgages, EPIC markets them as securities to investors, some private individuals, but primarily other S&Ls, and to Fannie Mae. Private insurers, for a fee, guarantee the mortgages and the securities, and banks against such guarantees lend the money for EPIC to finance its mortgages. As long as the value of the real estate is going up, the units are being sold or leased, and the buyers are meeting their payments, all goes well. As soon as any or all of these conditions are no longer met, all of the financial institutions involved come under risk.

If EPIC is declared in default, the private insurers have to meet their obligations. To do so, the insurers will try to take over EPIC's properties and try to sell them for whatever they can get. Since "firesales" of this kind can bring as little as 25% of the list value of the property, it could easily mean that up to $400 million of real estate values will be lost. But even this is not the extent of the potential damage. As the *Washington Post* reported, "If any of the insurance companies can't pay off on their coverage or the EPIC properties can't be sold for enough to cover their mortgages, then the lenders will face losses." The principal banks involved are trustees for more than $1 billion in EPIC securities.

But what worries Wall Street the most is that if the insurers fail to meet their obligations, the entire mortgage market will be endangered, and this latter consists of $1.6 trillion. In reporting on the situation, the *Times* wrote, "The market for housing bonds depends on the availability of private mortgage insurance. It is this industry that could get hurt the most if Equity Programs collapses." The problem of any bailout to avert the collapse is that everyone—the investors, the insurers, the banks, the mortgage holders—are all scrambling to cut their losses, and someone is going to take a fall. Since all the assets upon which the house of cards has been constructed are highly overvalued, the crack could go to the very top of the paper mountain. That is what has been set in motion by this little default.