

The Perfect Storm

An Assessment Emergency

Ingredients for Disaster

The Game

- Make money in the real estate market
- Make more money in the real estate market
- Leverage existing projects to finance future projects
- Emotional need to WIN!
- The only way to make money is to spend money, so spend more money!

The Players

- Real Estate Developers
- Mortgage Brokers
- Banks
- Appraisers
- Investment Institutions
- Government
- Consumers

The Setup

- 1992 Boston Federal Reserve Study
 - Purported to show minorities were treated less well than whites
 - Increased political pressure on banks to modify lending standards
- Community Reinvestment Act
- HUD Regulations requiring parity of outcomes in lending process

The Subprime Primer

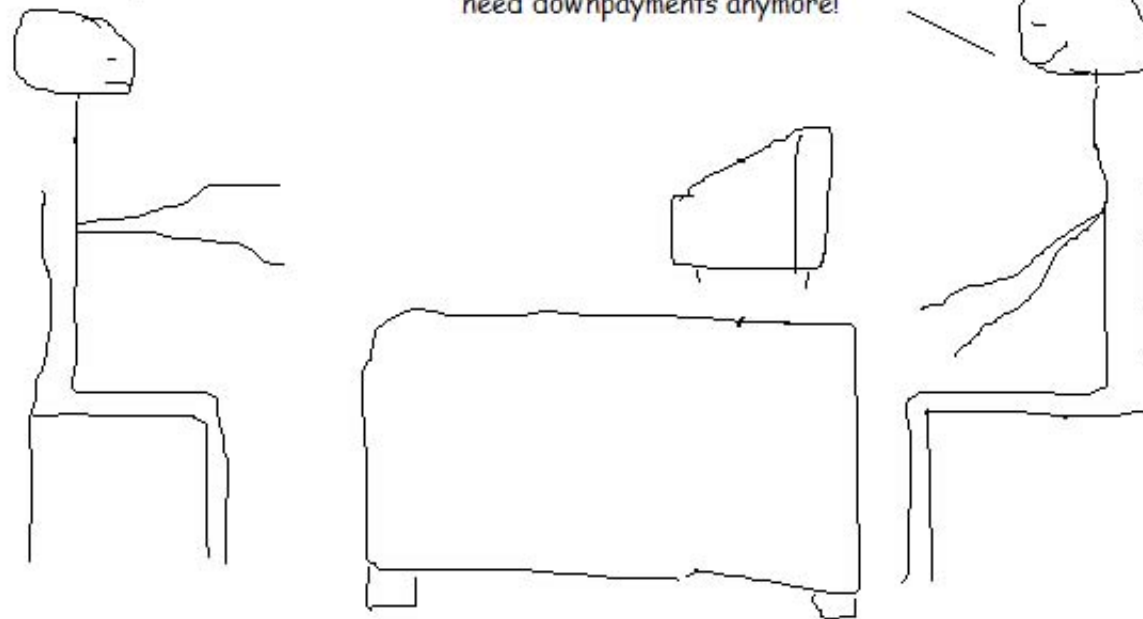
At the Mortgage Broker's

Ace Mortgage Brokers

"We Make Your Dreams Come True"

Gee, I'd like to buy a house but I haven't saved any money for a downpayment and I don't think I can afford the monthly payments. Can you help me?

Sure! Since the value of your house will always go up, we don't need downpayments anymore!



Consumers

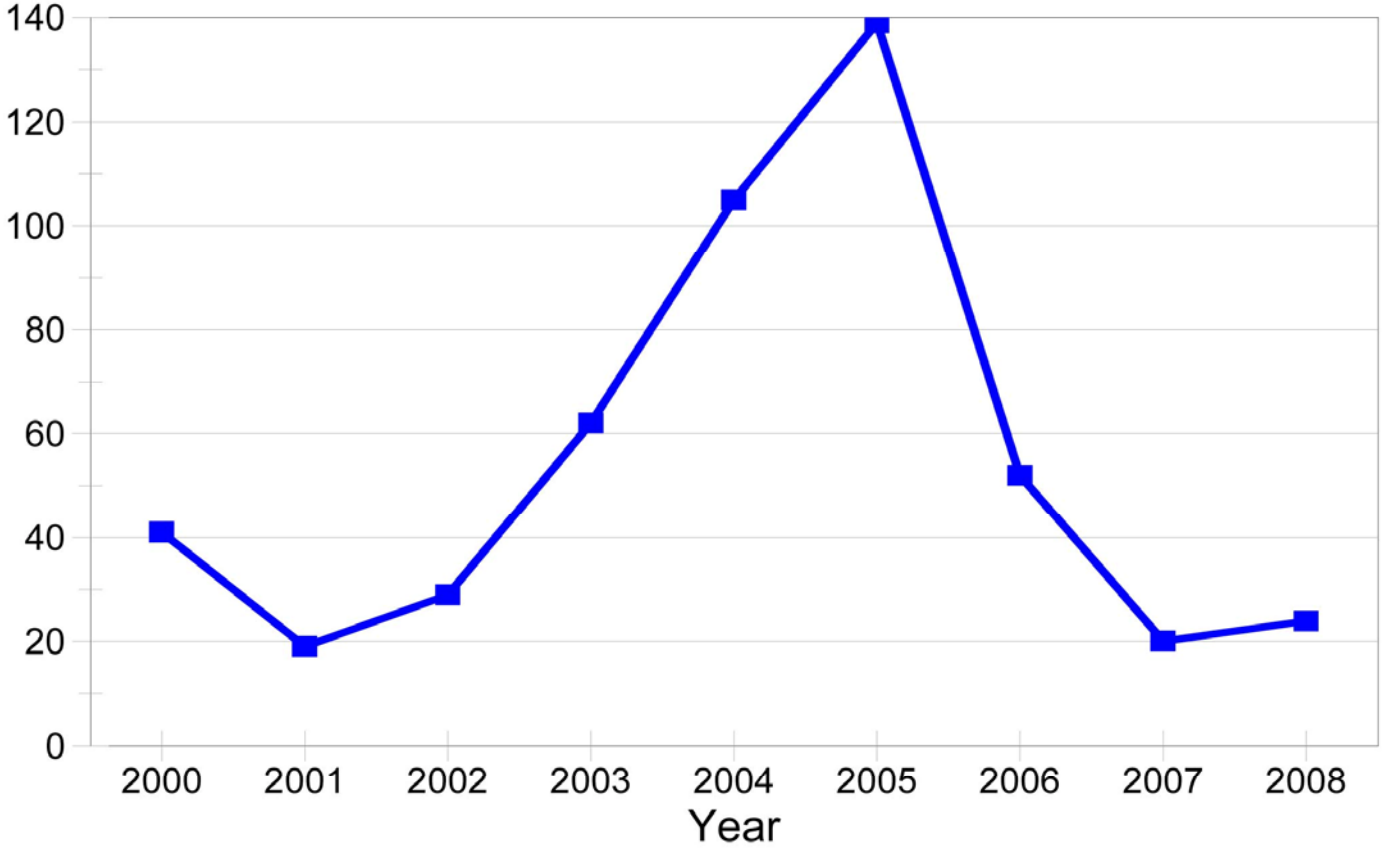
- Sub-Prime Lending and Adjustable Rate Mortgages allow almost everyone to be a homeowner.
- Jumbo loans allow normally responsible consumers to purchase homes they couldn't otherwise afford.
- Quest for the American Dream helps fuel rising real estate prices.
 - Good old Supply and Demand

Real Estate Developers

- Easy consumer financing created demand
- Real Estate Developers stepped up to create supply
 - Loose lending extends to developers
 - Build rental properties to sell as investments
 - Caught up in “profit frenzy”
 - Profit margin = 10% of sale price
 - Build bigger, more expensive houses to make more net profit

Washington County

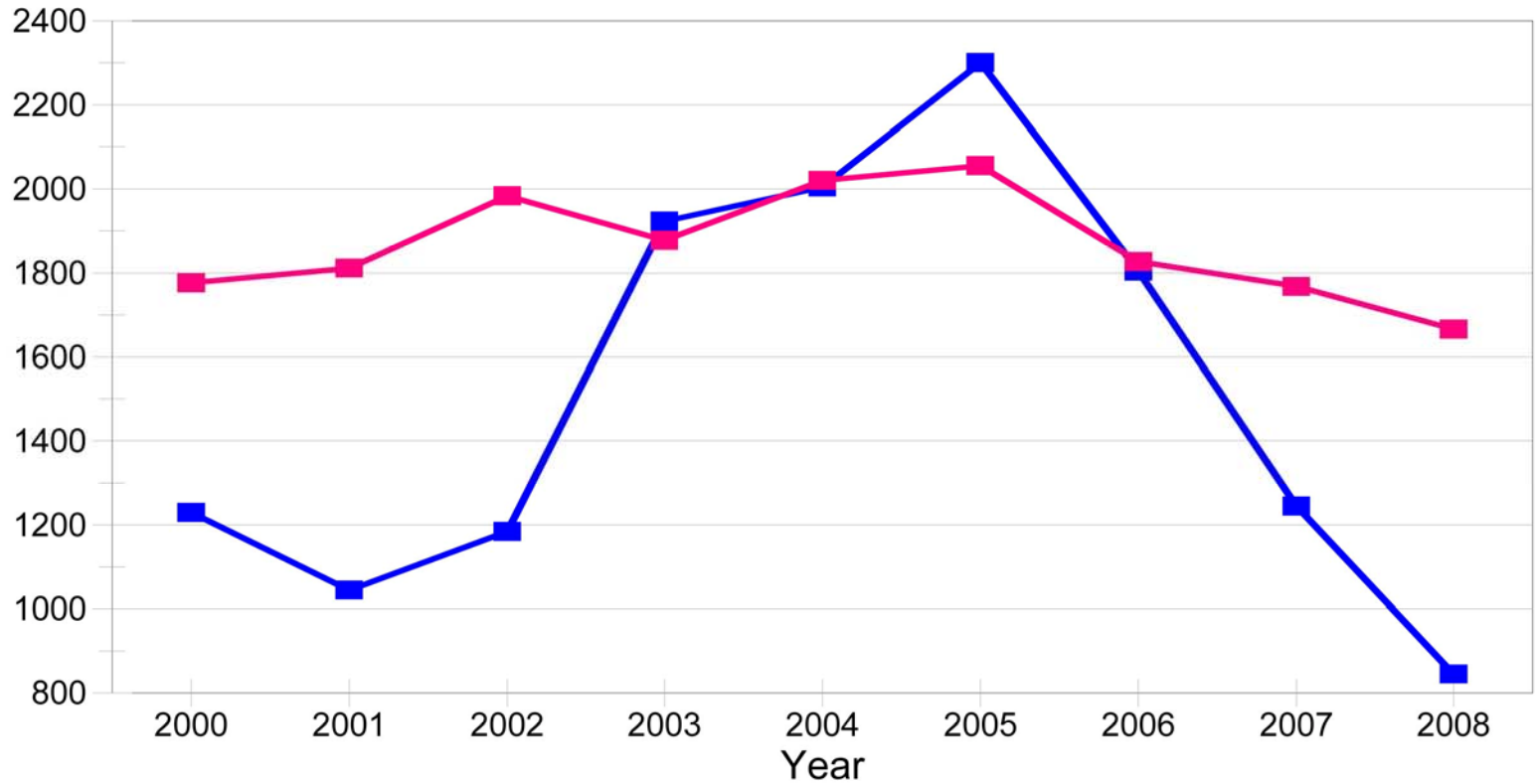
Duplex New Construction



■ New Duplexes

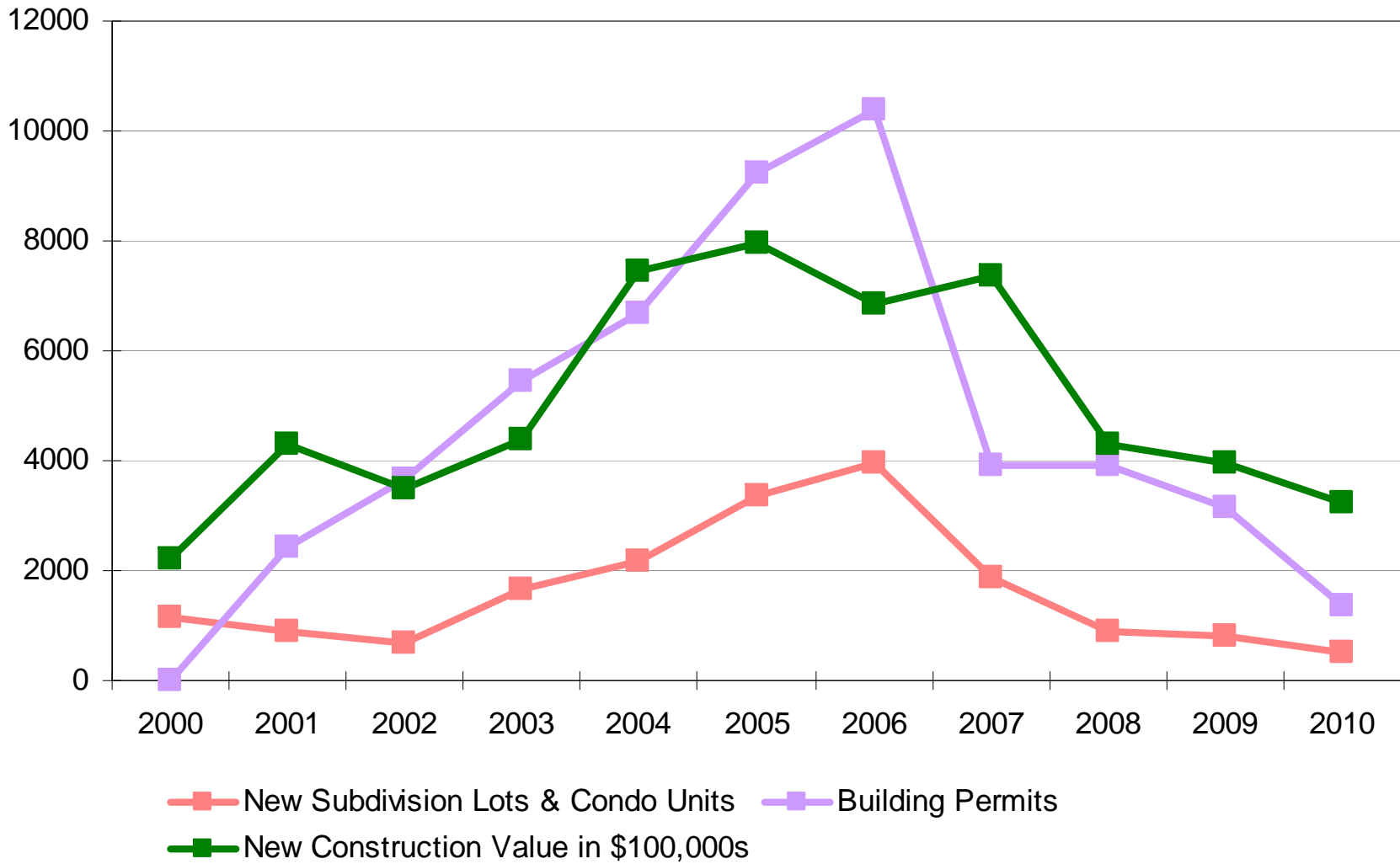
Washington County

Single Family New Construction



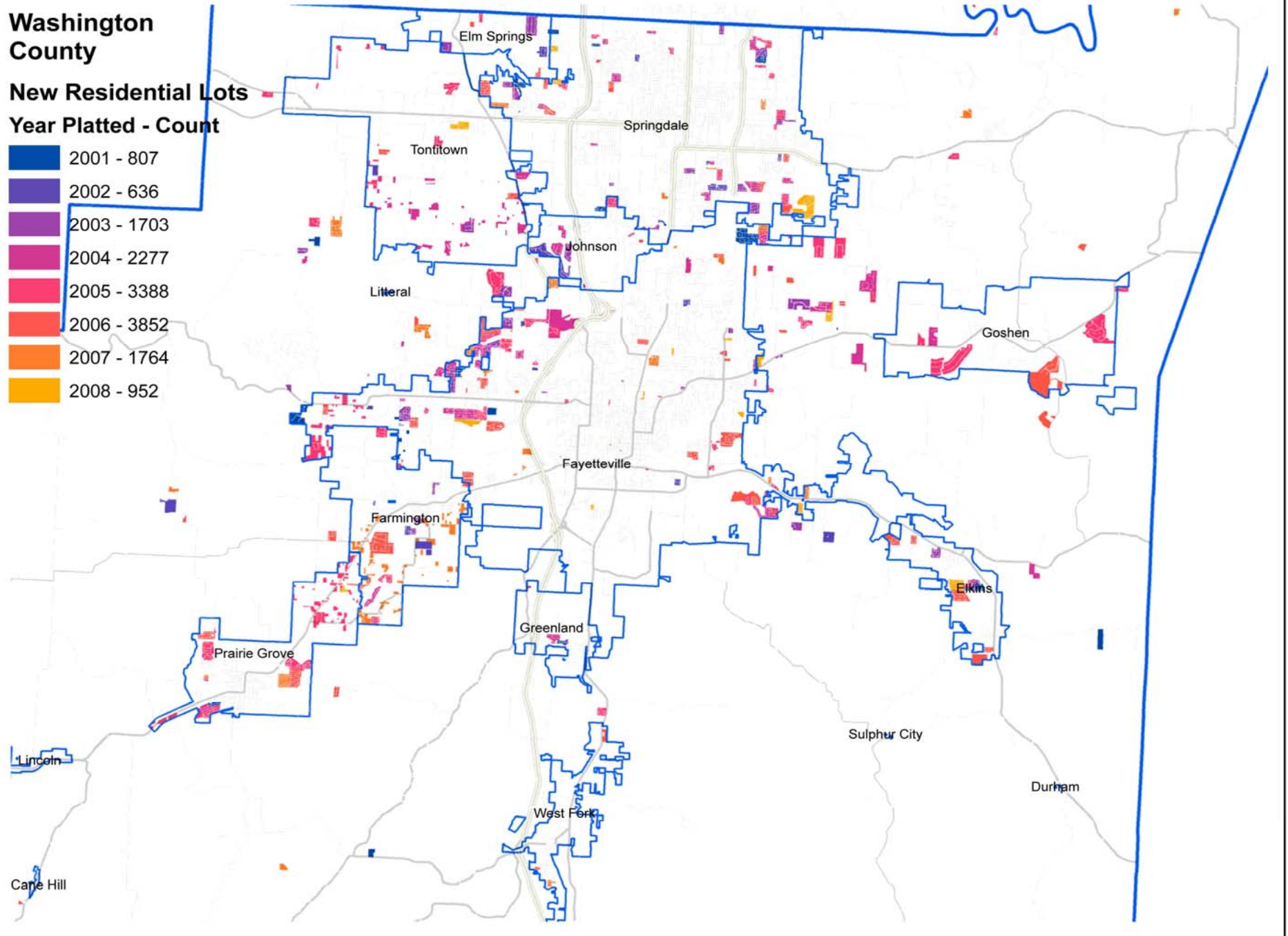
—■— New Single Family Dwellings —■— Median Size

Washington County New Construction Activity



Washington County

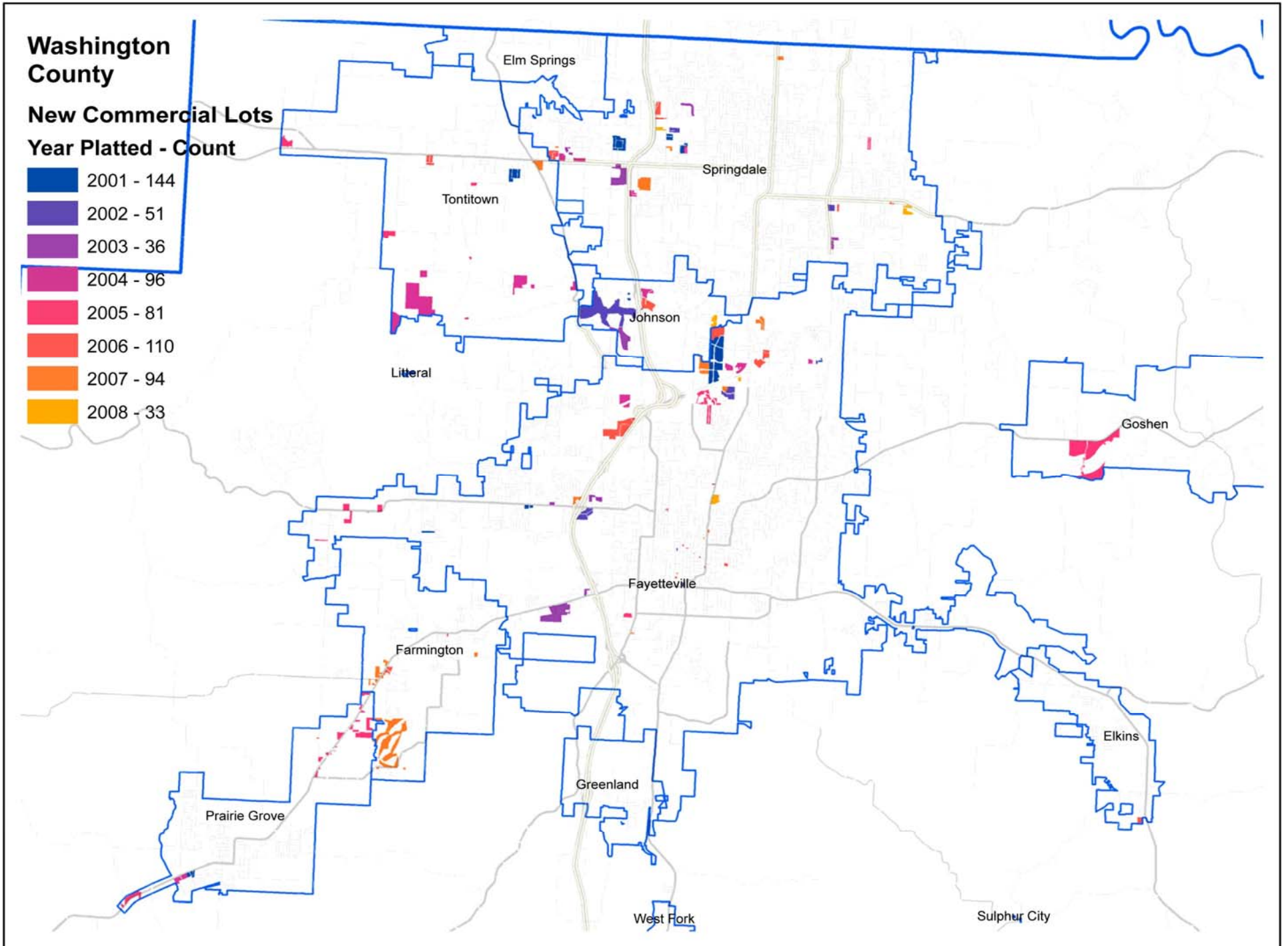
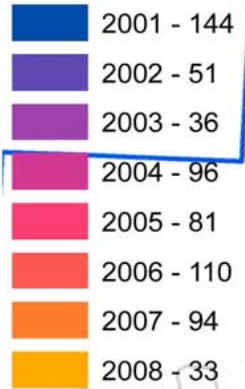
New Residential Lots Year Platted - Count



Washington County

New Commercial Lots

Year Platted - Count



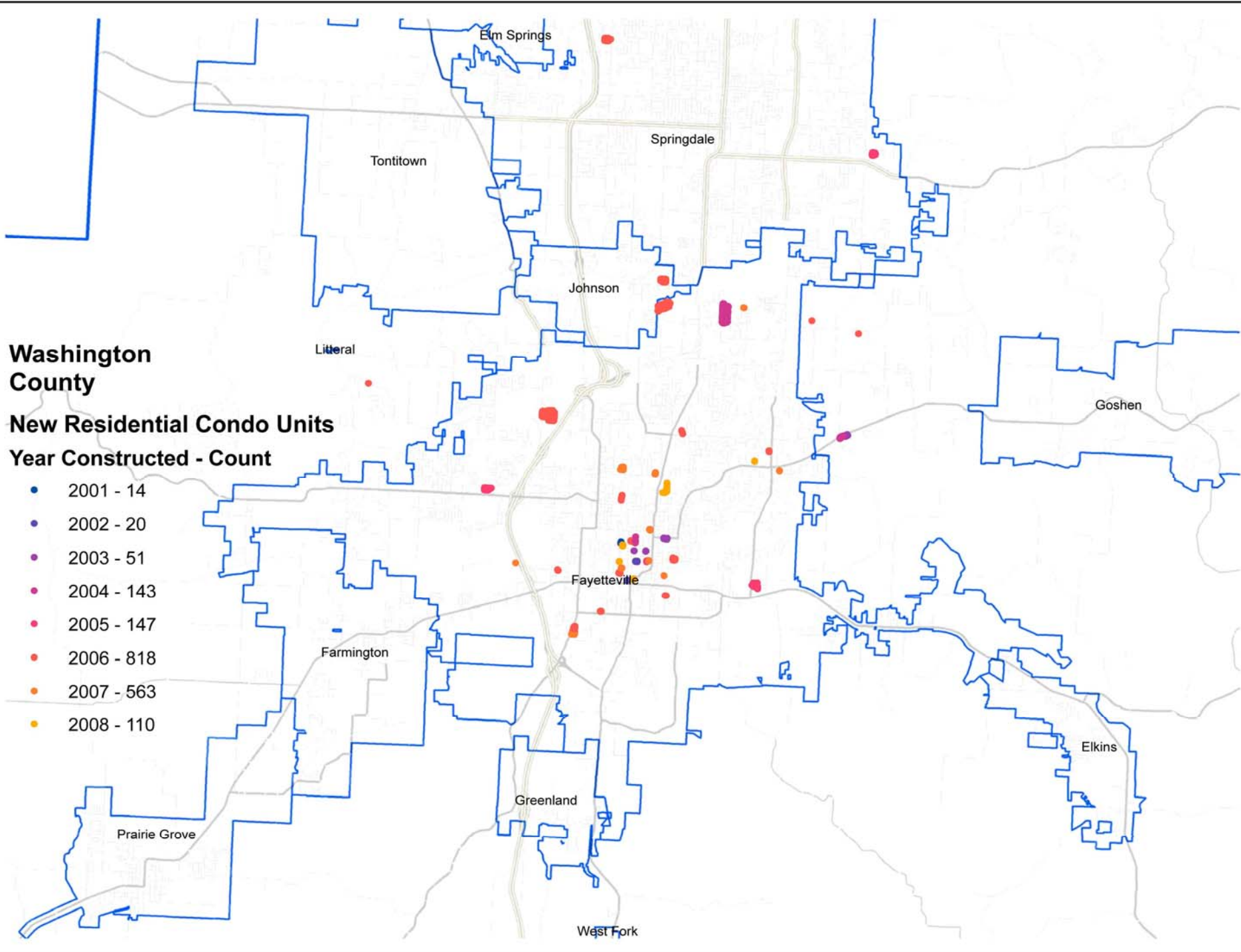
The Condo Craze

- Demand drives up land prices
- No large tracts available in downtown areas
- Developers come up with way to sell housing units without much land
- Let's build CONDOS!

Washington County

New Residential Condo Units Year Constructed - Count

- 2001 - 14
- 2002 - 20
- 2003 - 51
- 2004 - 143
- 2005 - 147
- 2006 - 818
- 2007 - 563
- 2008 - 110





Underwood Plaza

10 Commercial
Units

0 Sold

51 Residential
Units

8 Sold



Legacy Building

4 Commercial
Units

0 Sold

37 Residential
Units

10 Sold

Unsold units
foreclosed
Nov.2008.

Now owned by
three banks.



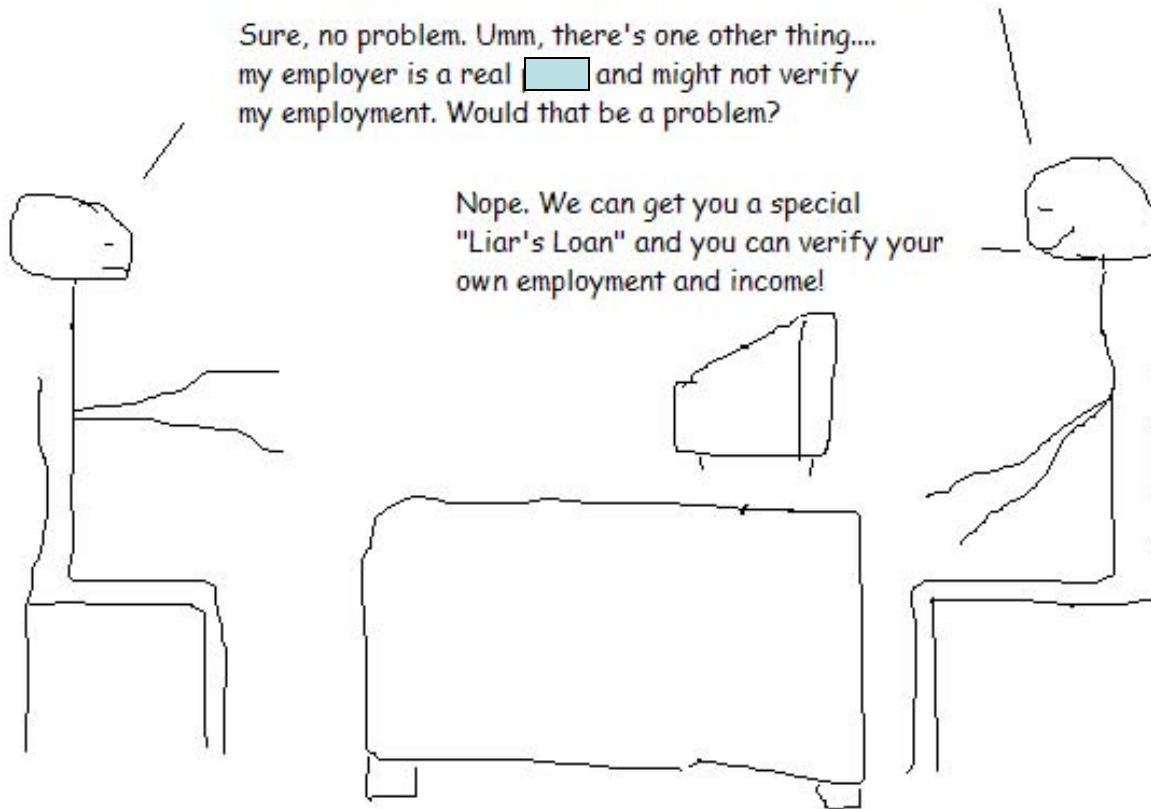
Ace Mortgage Brokers

"We Make Your Dreams Come True"

And we can give you a really really low interest rate for a few years. We'll raise it later, okay?

Sure, no problem. Umm, there's one other thing... my employer is a real and might not verify my employment. Would that be a problem?

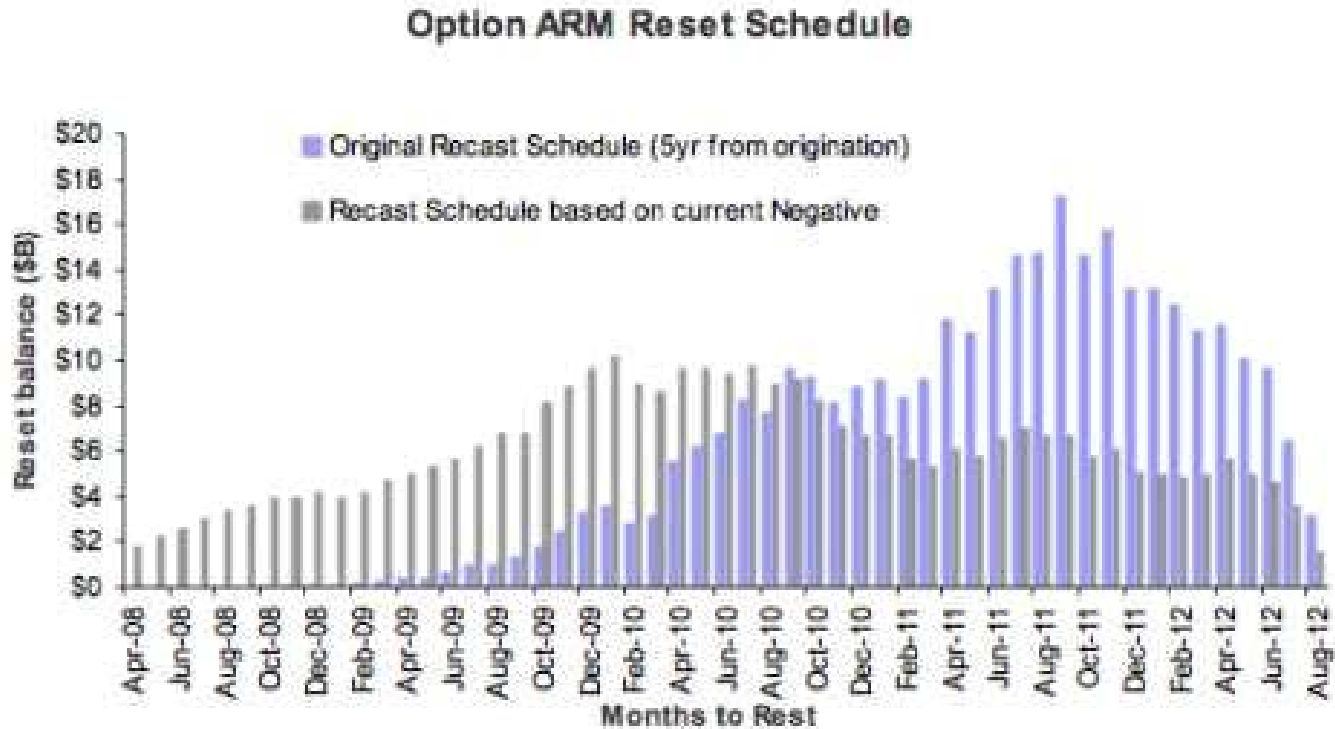
Nope. We can get you a special "Liar's Loan" and you can verify your own employment and income!



Adjustable Rate Mortgages

- Sold to consumer as
 - “Creative Financing”
 - “\$300,000 mortgage with payments less than \$900 per month”
 - “120% Loan to Value”
- Truth was
 - Term only good if “normal” payments made
 - If advertised payment made
 - Negative amortization
 - Rate adjusts more quickly

Option Arm Resets



http://images.businessweek.com/story/08/190/060_4_arm_reset.jpg

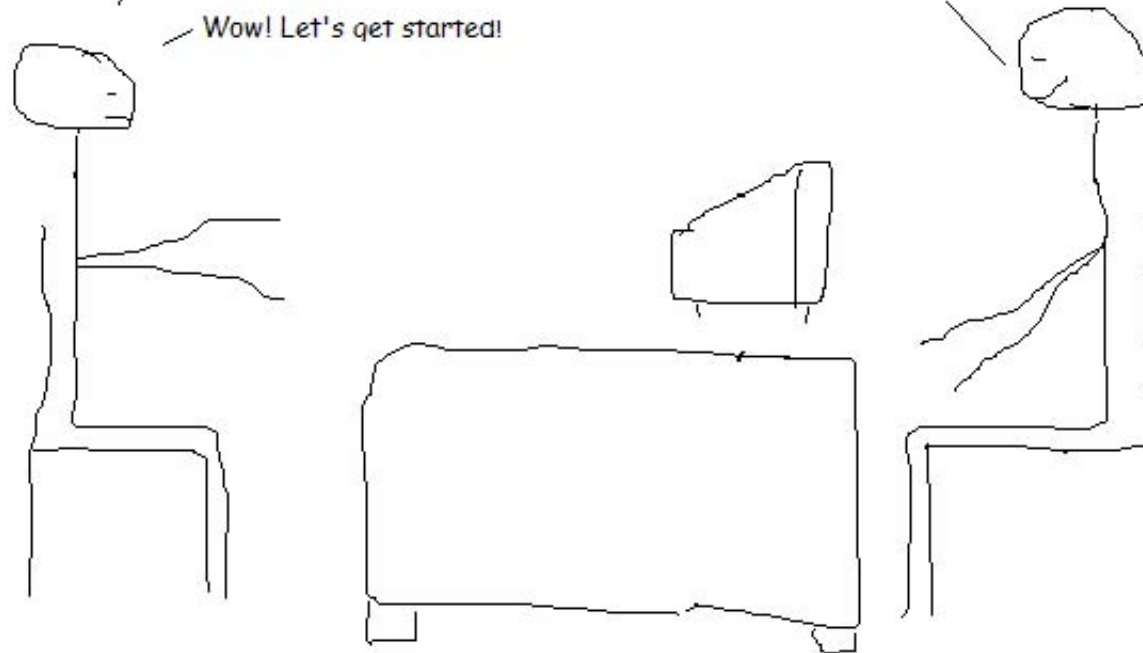
Ace Mortgage Brokers

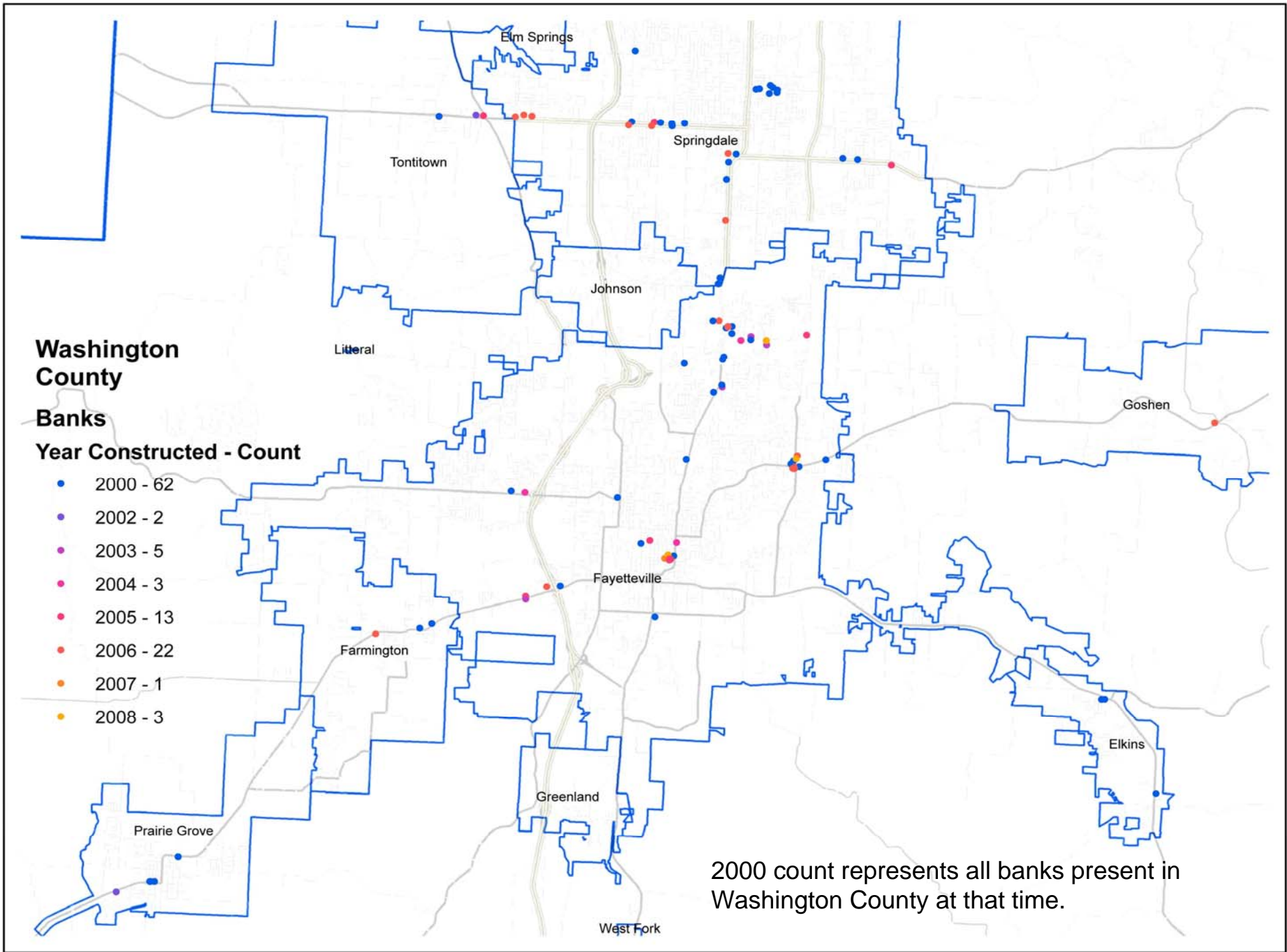
"We Make Your Dreams Come True"

You guys are awesome! You are really willing to work with guys like me.

Well, we don't actually lend you the money -- a bank will do that -- so we don't really care if you repay the loan. We still get our commission.

Wow! Let's get started!





Loose Lending Standards

- Banks only make money when they lend money
- Government pressure to increase home ownership
- Need to “create” more buyers
 - All the qualified buyers already have mortgages
 - Need to fuel more lucrative (more risky) development financing
- More mortgages needed to back new security instruments



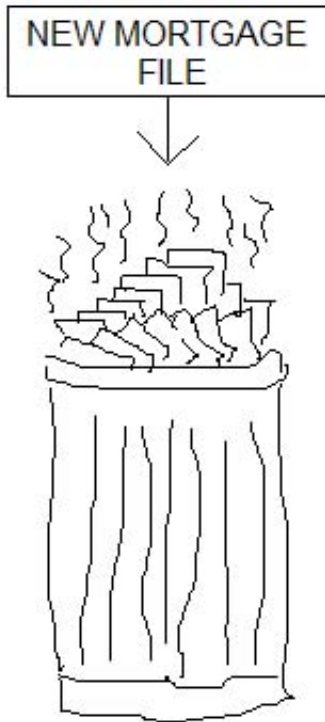
A Few Weeks Later, at the Bank

First Bank of Bankland, Inc

"Open Your Christmas Club Account Today"




I'd better get rid of these crappy mortgage loans. They are starting to stink up my office. Thankfully the really smart guys in New York will buy them and perform their financial magic! I'll call them right away!

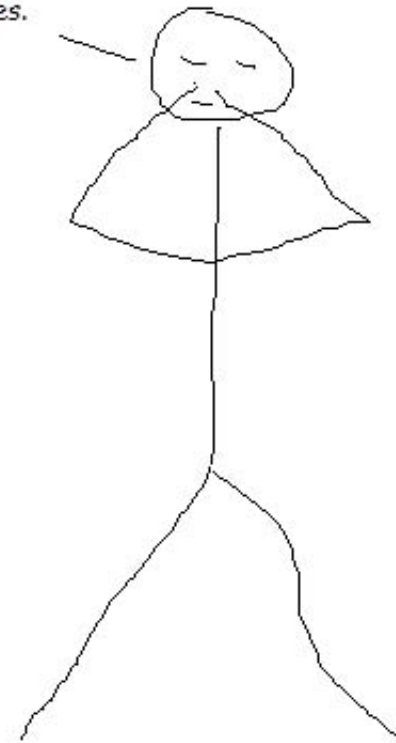
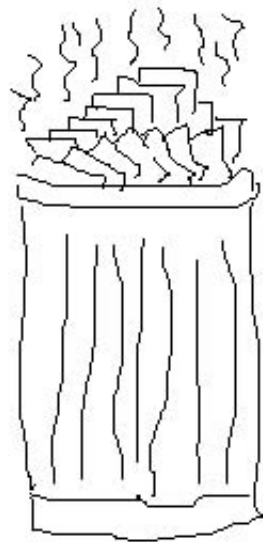
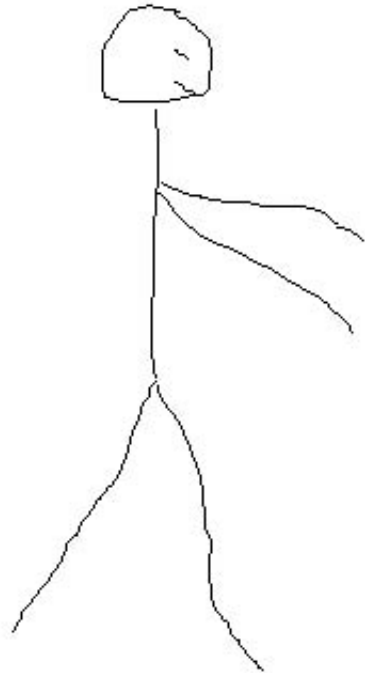


Let's See What the Smart Guys Are Doing...

RSG Investment Bank of Wall Street

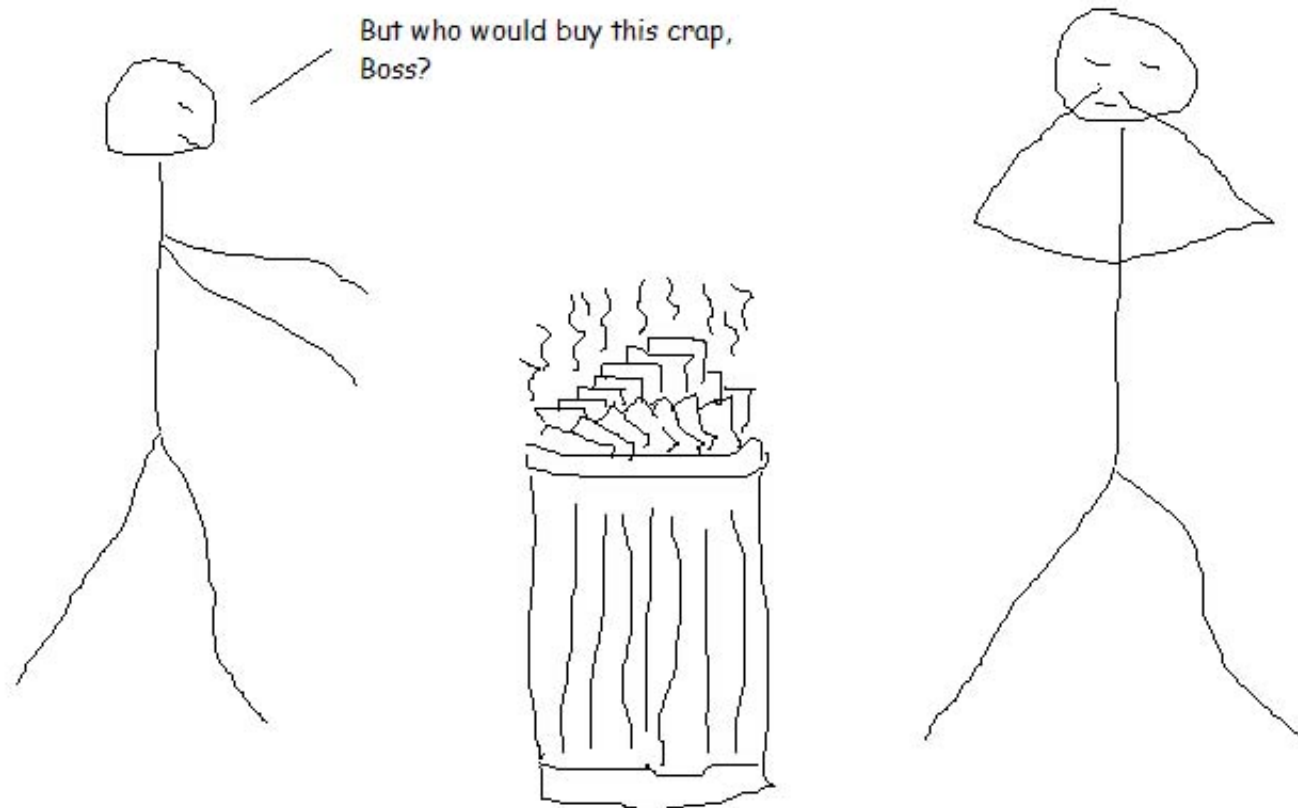
"Trust the 'Really Smart Guys' for All Your Investment Needs"

Phew!!! We'd better get rid of these  mortgages before they start attracting flies.



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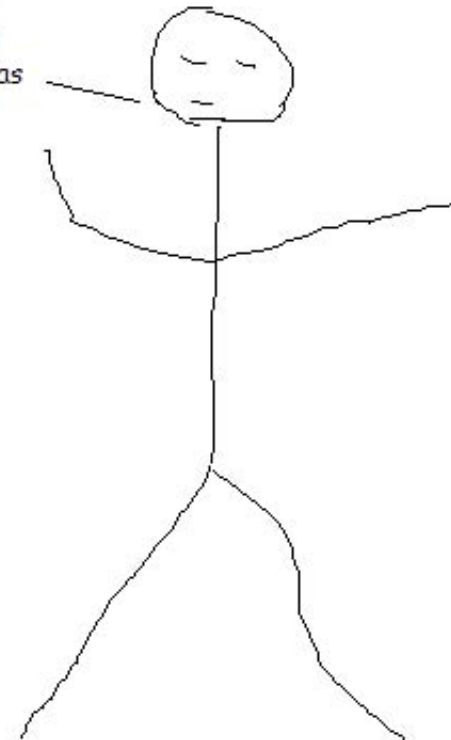
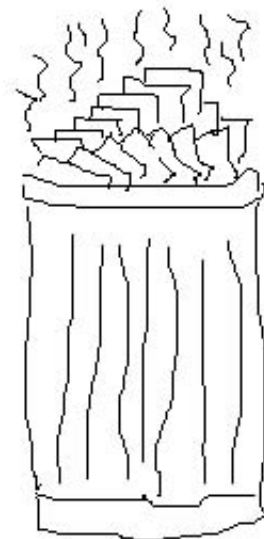
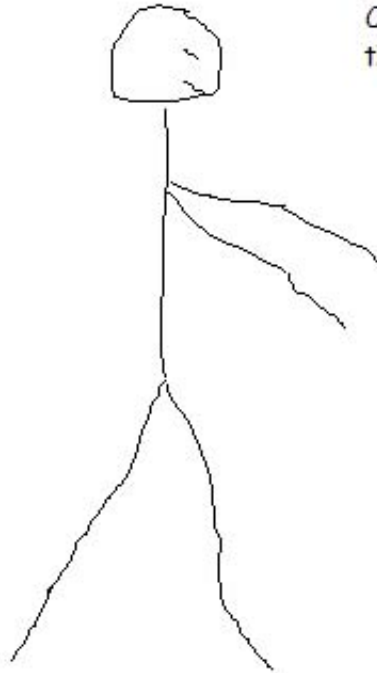
"Trust the 'Really Smart Guys' for All Your Investment Needs"



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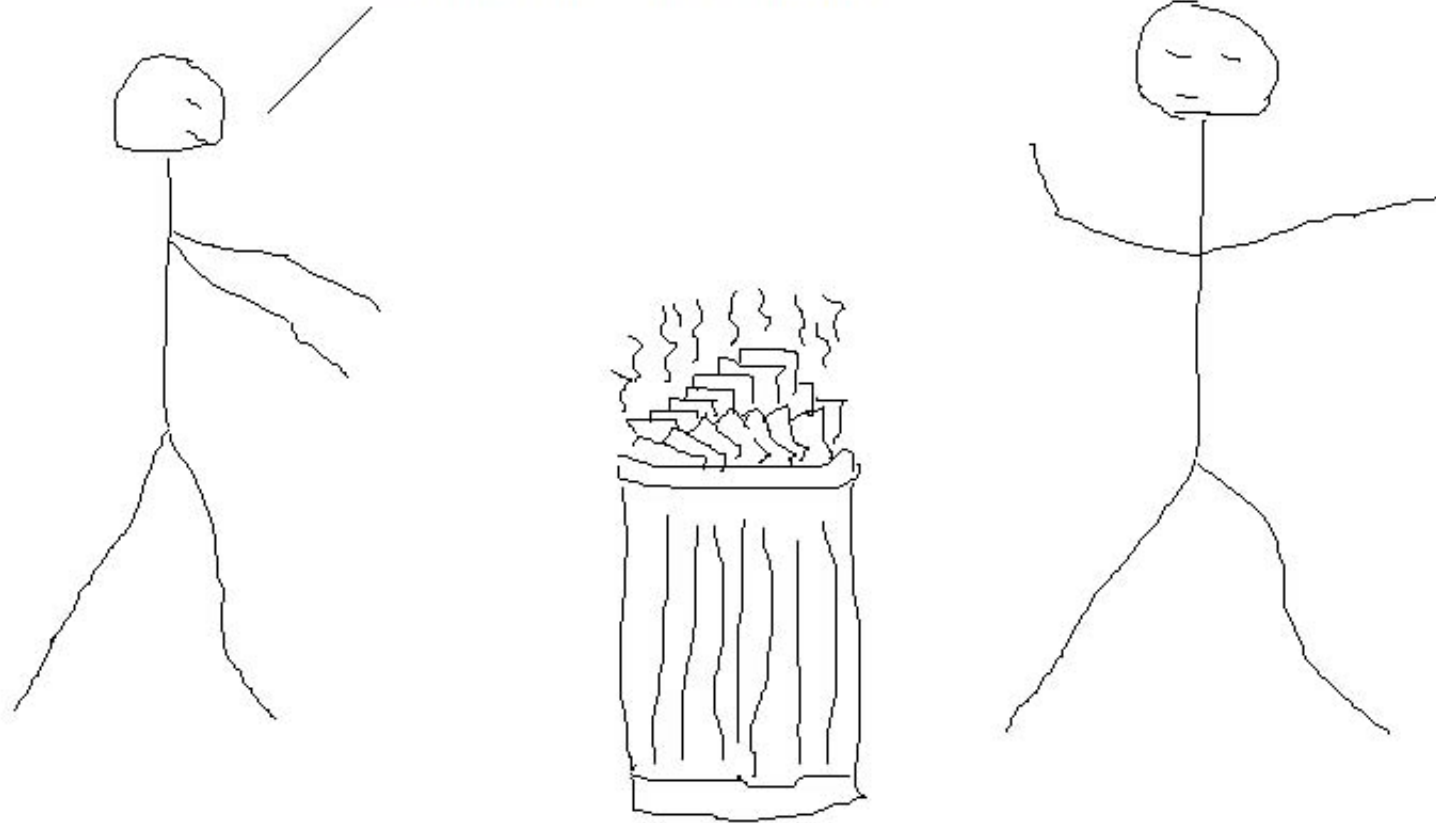
I've got it! First We'll create a new security and use these crappy mortgages as collateral. We'll call it a CDO (or maybe CMO). We can sell that CDO to investors and promise to pay them back as the mortgages are paid off.



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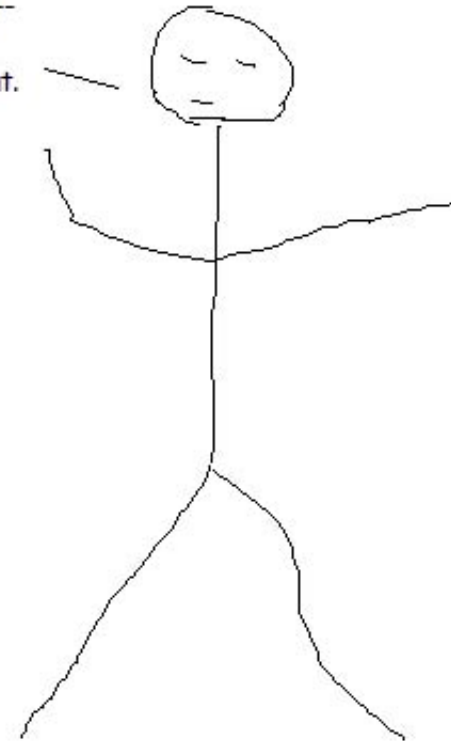
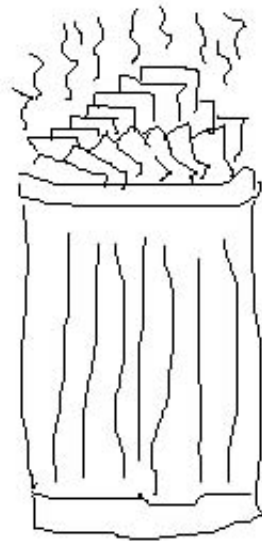
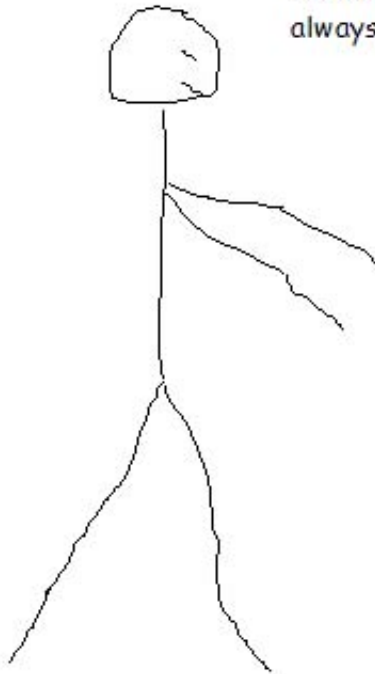
But crap is crap, isn't it? I don't get it.



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Sure, individually these are pretty crappy loans, but if we pool them together only some of them will go bad -- certainly not all of them. And since housing prices always go up, we really have very little to worry about.



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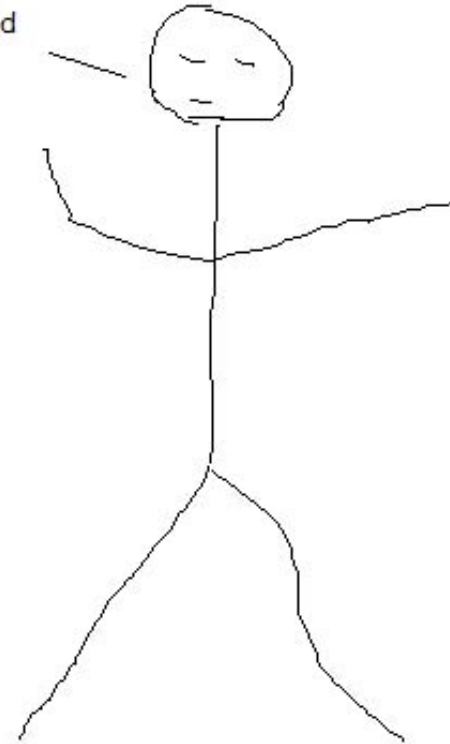
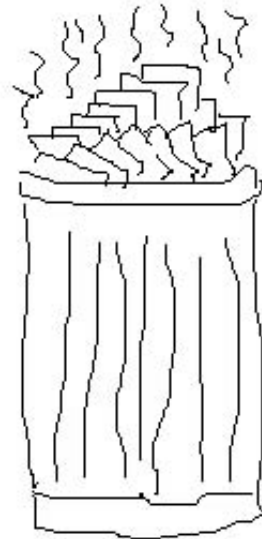
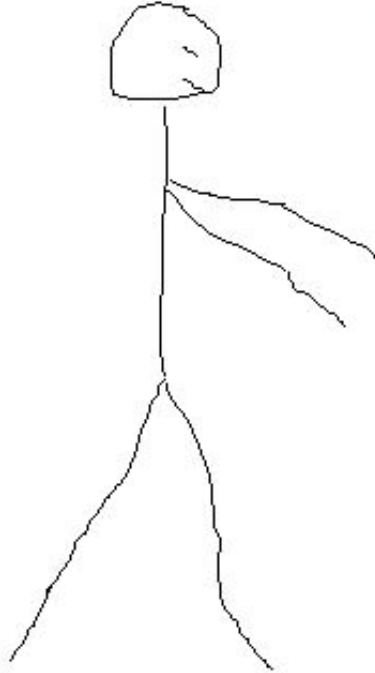
"Trust the 'Really Smart Guys' for All Your Investment Needs"



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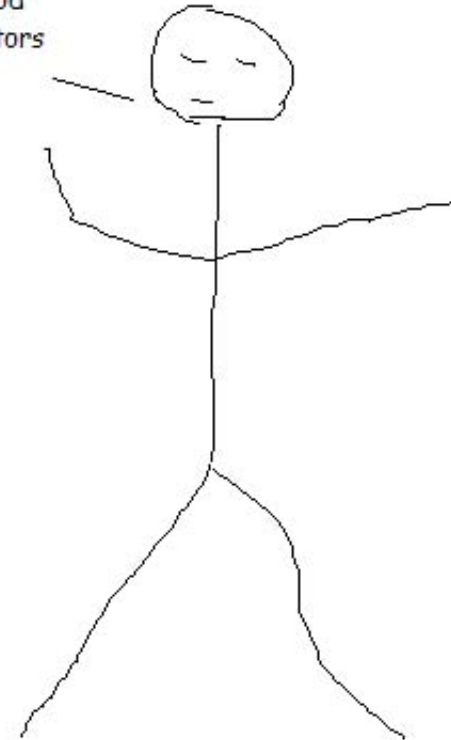
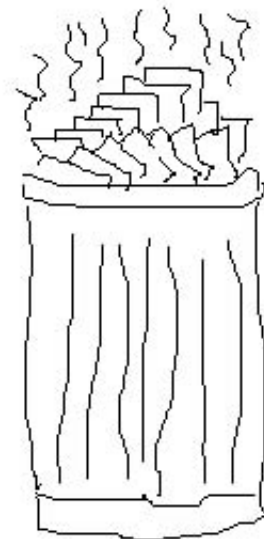
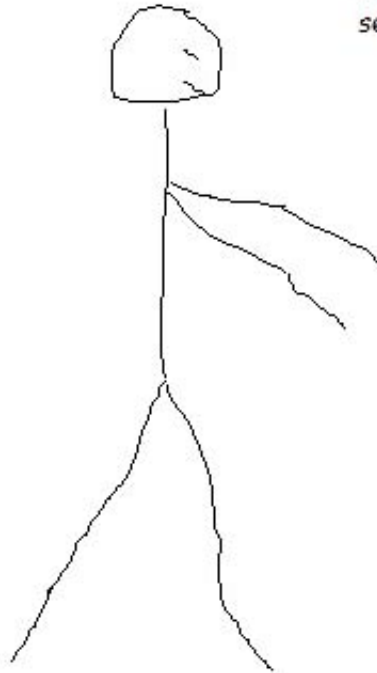
The new CDO will work like this: It will be made up of three pieces (or "tranches") and we'll call them "The Good", "The Not-So-Good" and "The Ugly".



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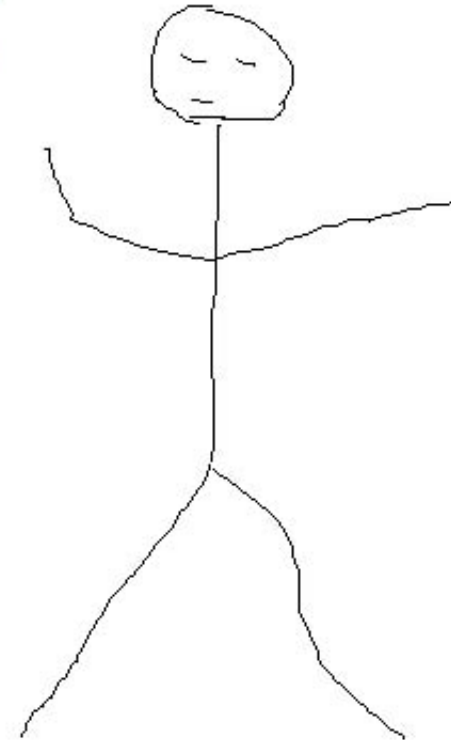
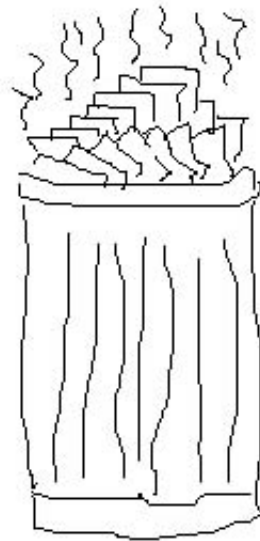
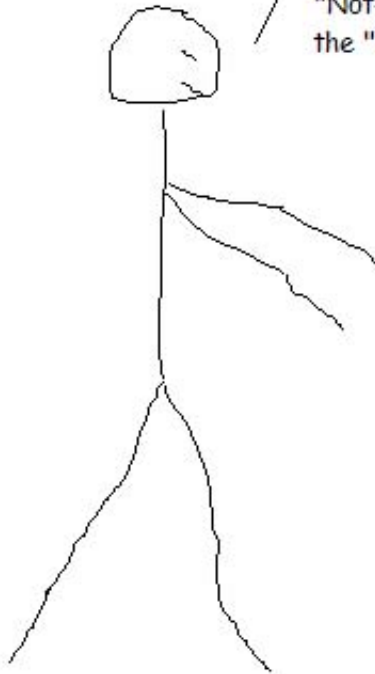
If some of the mortgages fail, as surely some might, we will promise to pay investors holding the "Good" tranch first. We'll pay the "Not-So-Good" investors second, and the "Ugly" investors last.



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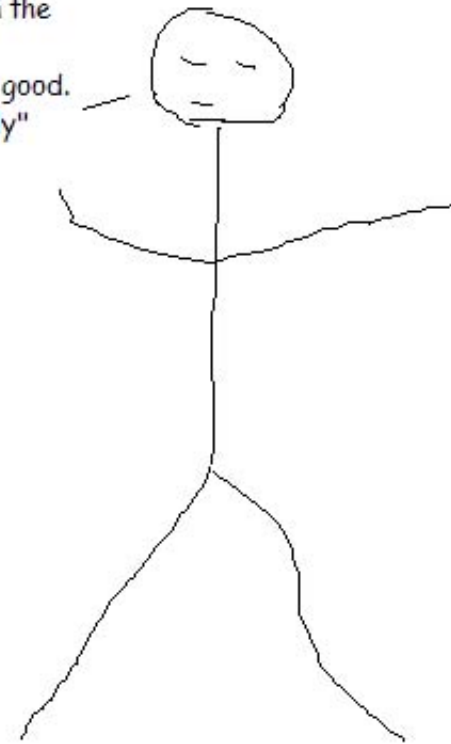
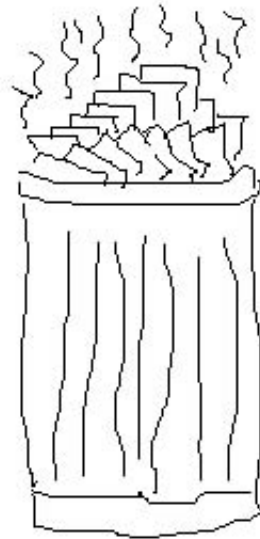
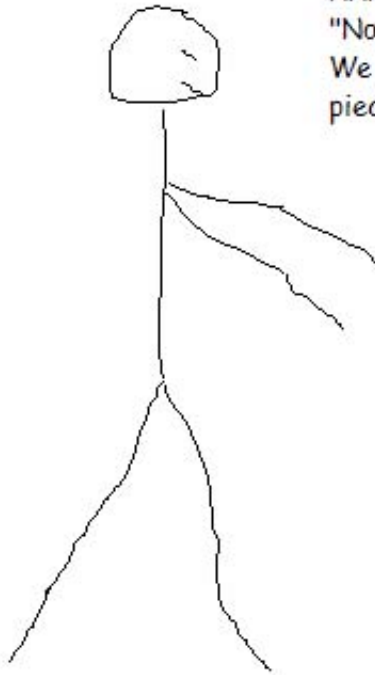
I'm starting to get it. And because the "Good" investors have the least risk, we'll pay them a lower interest rate than the other guys, right? The "Not-So-Goods" will get a better interest rate and the "Ugly" guys will get a nice fat interest rate.



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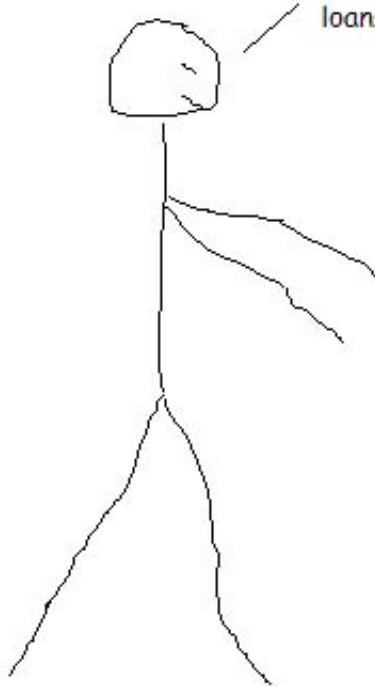
Exactly. But wait, it gets better. We will buy bond insurance for the "Good" piece. If we do that, the Rating agencies will give it a really great rating, in the AAA to A range. They will likely give the "Not-So-Good" piece a BBB to B rating, still pretty good. We won't even bother asking them to rate the "Ugly" piece.



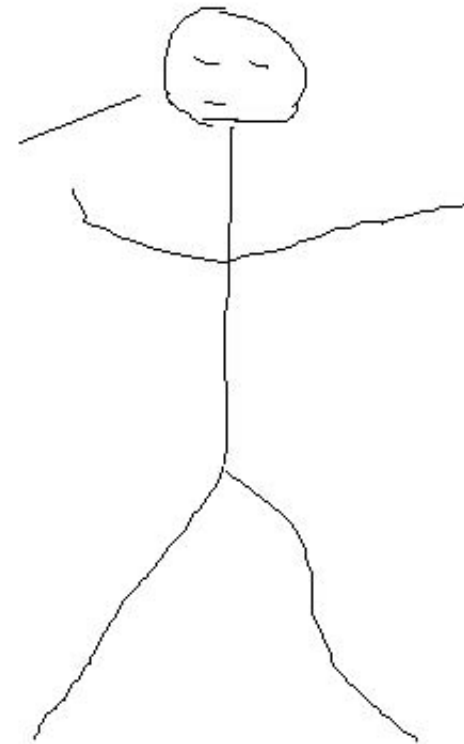
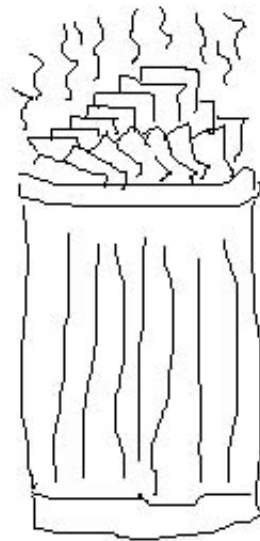
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So you have managed to create AAA and BBB securities out of a pile of stinky, risky mortgage loans. Boss, you are a genius.



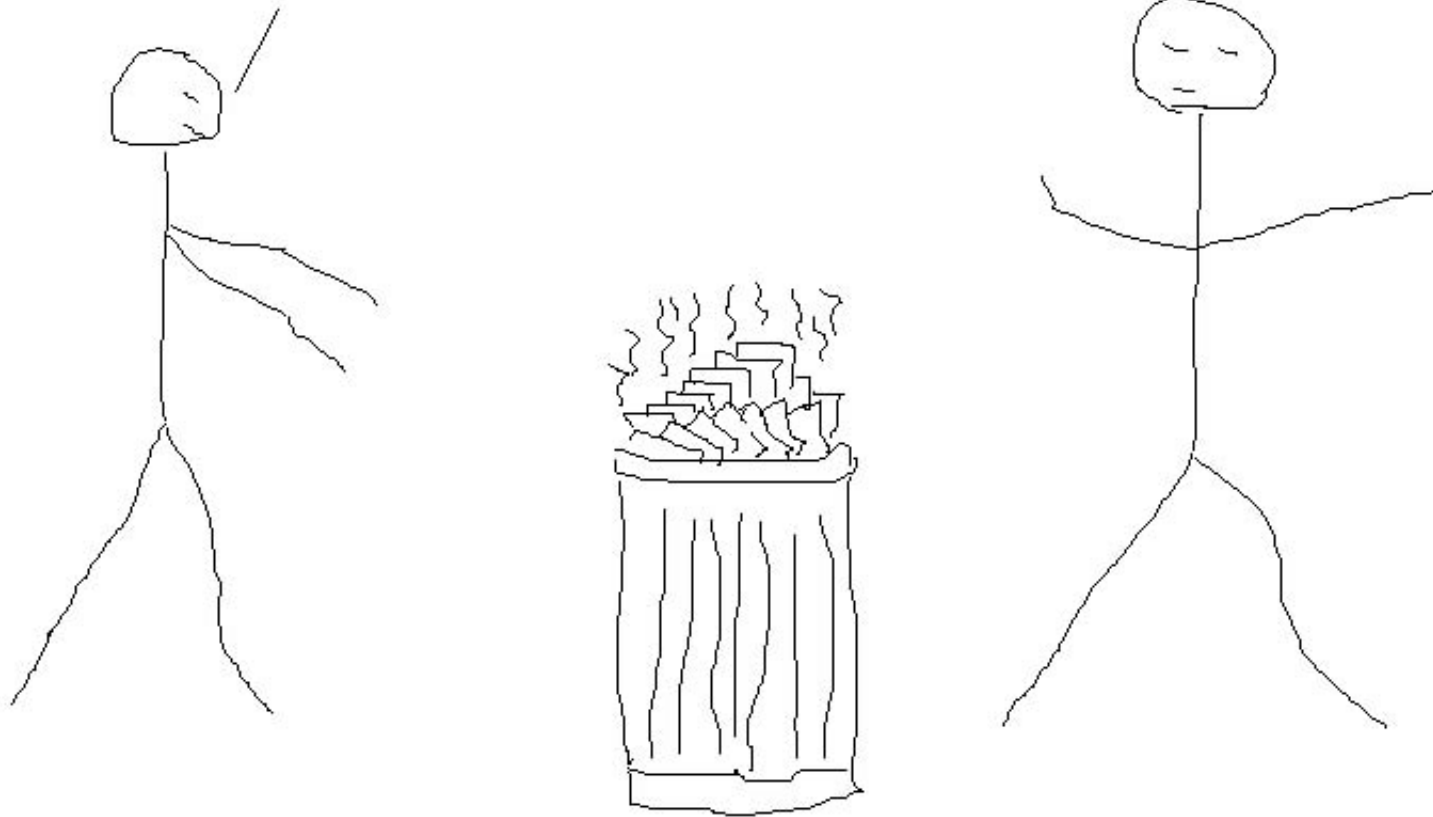
Yes, I know.



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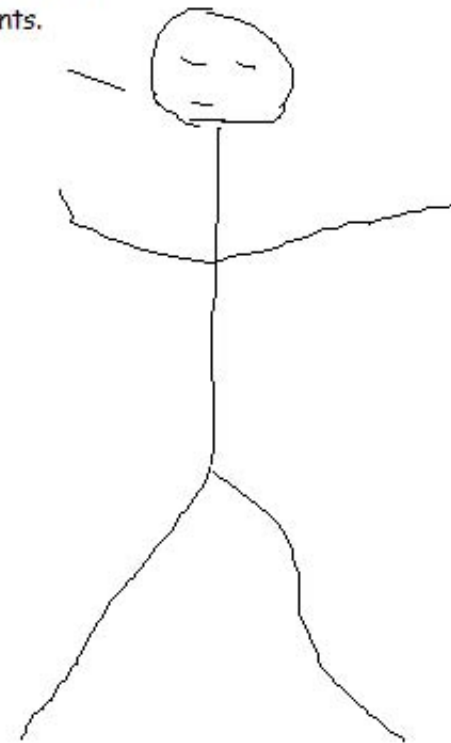
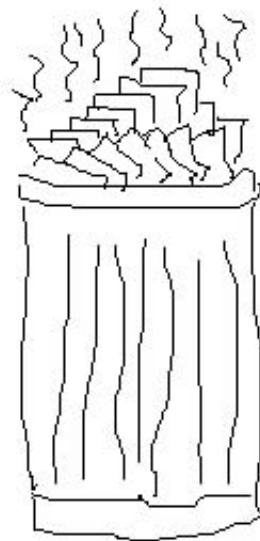
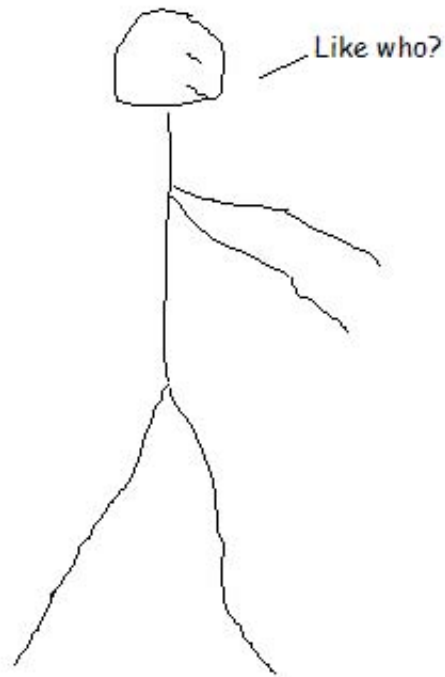
Okay, now who are we going to sell
the three pieces to?



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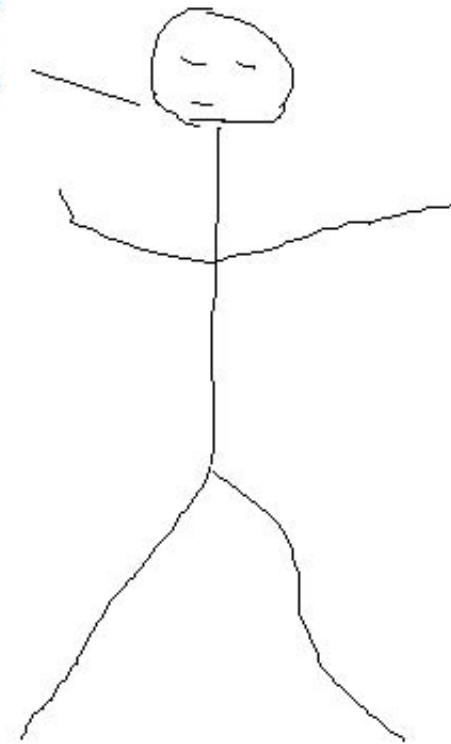
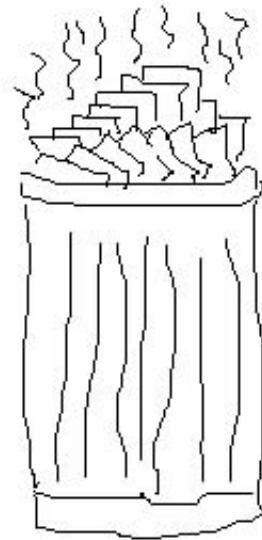
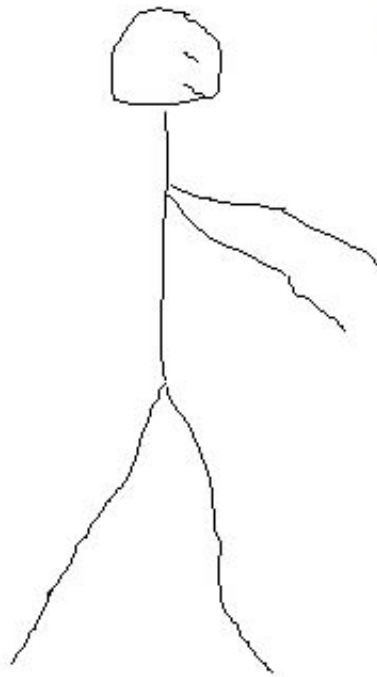
The at the SEC won't let us sell this stuff to widows and orphans, so we'll sell it to our sophisticated institutional clients.



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"Trust the 'Really Smart Guys' for All Your Investment Needs"

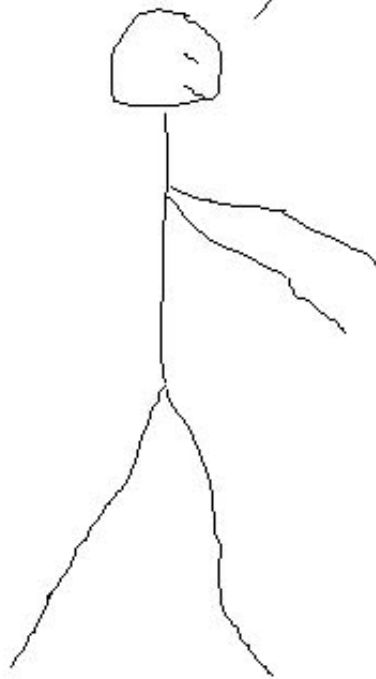
Like insurance companies, banks, small towns in Norway, school boards in Kansas -- to anyone who is looking for a high-quality safe investment.



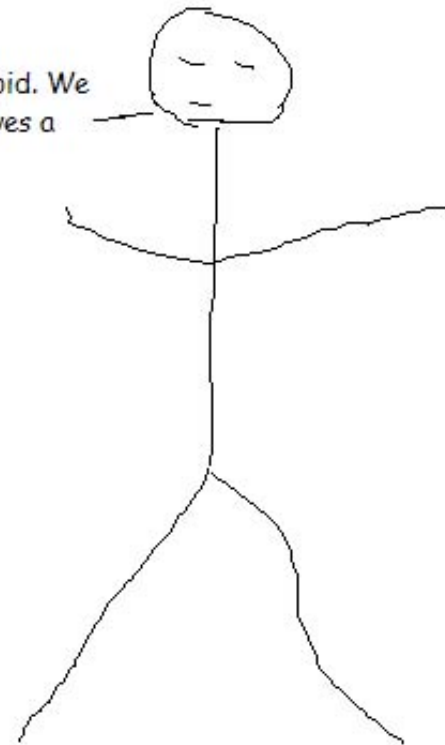
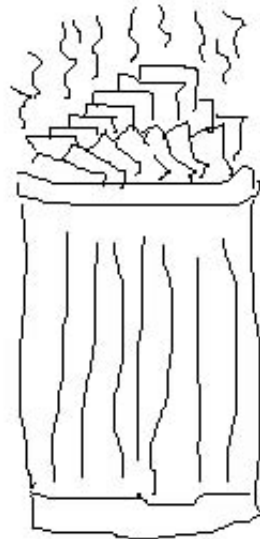
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But surely nobody would buy the "Ugly" piece, would they?



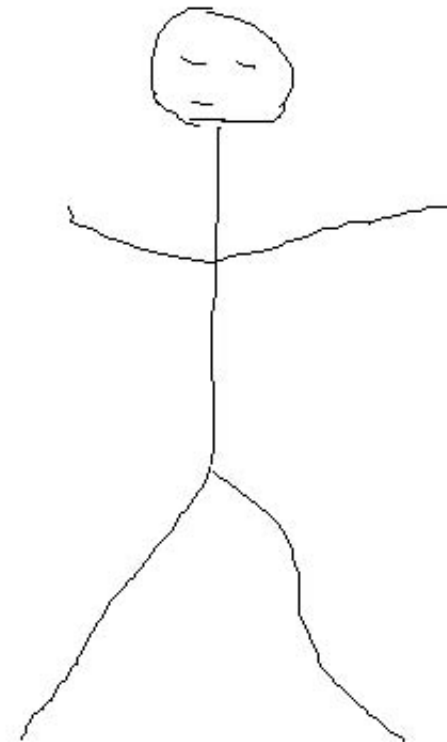
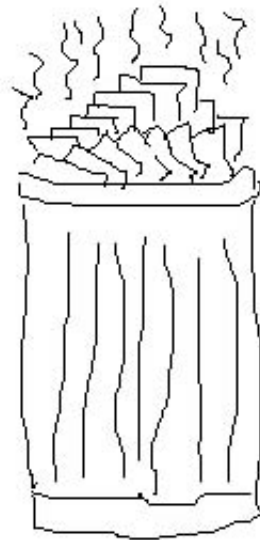
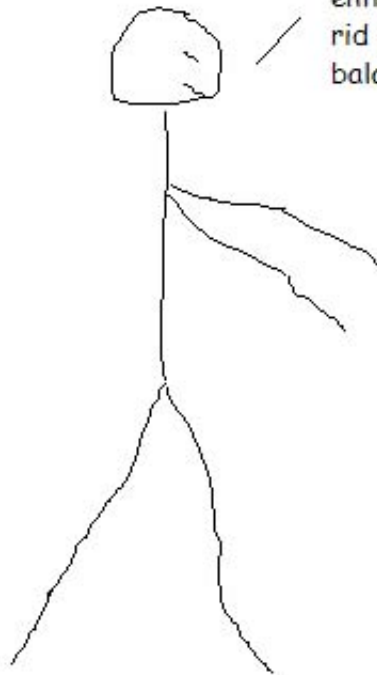
Of course not -- nobody is that stupid. We will keep that piece and pay ourselves a handsome interest rate.



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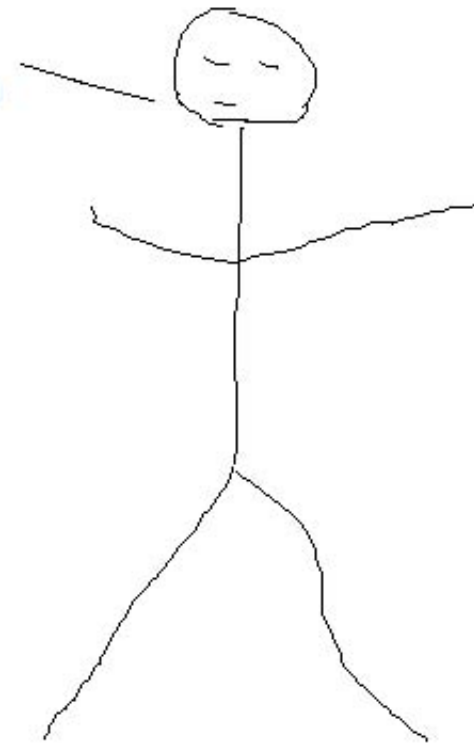
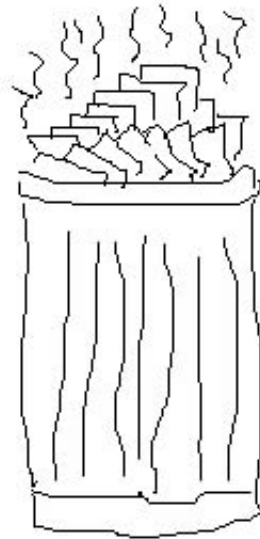
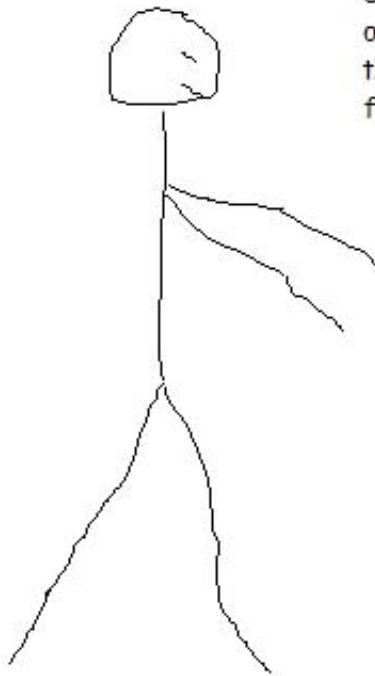
This is all great, but since we are only using the smelly mortgages as collateral on an entirely new security, we haven't really gotten rid of them. Don't we have to show them on our balance sheet?



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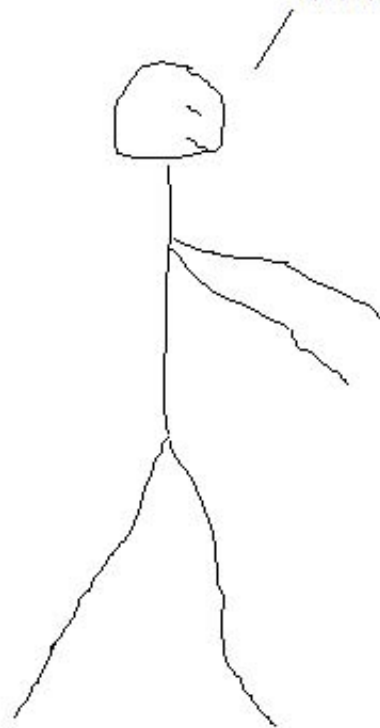
No, of course not. The guys who write the accounting rules allow us to set up a shell company in the Caymen Islands to take ownership of the mortgages. The crap goes on their balance sheet, not ours. The fancy name for it is "Special Purpose Vehicle" or SPV.



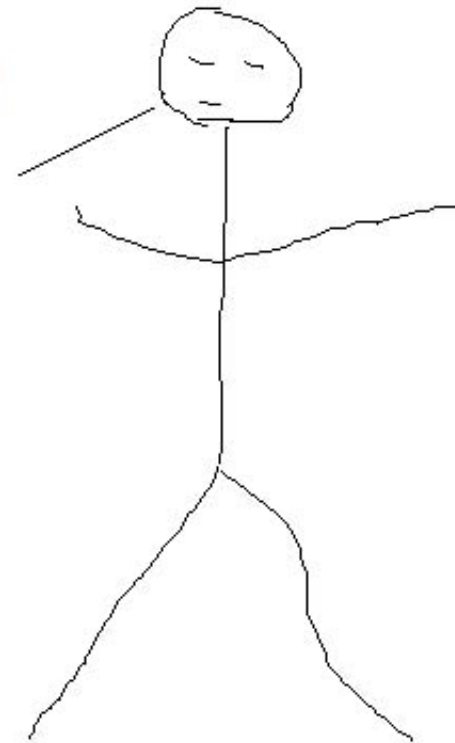
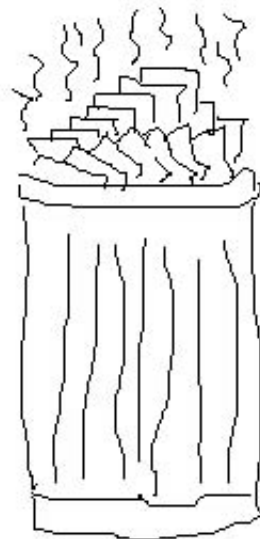
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That's great, but why would they let us do that,
aren't we just moving our own crap around?



Sure, but we have convinced them that it
is vitally important to the health of the
U.S. financial system that investors not
know about these complex transactions
and what is behind them.

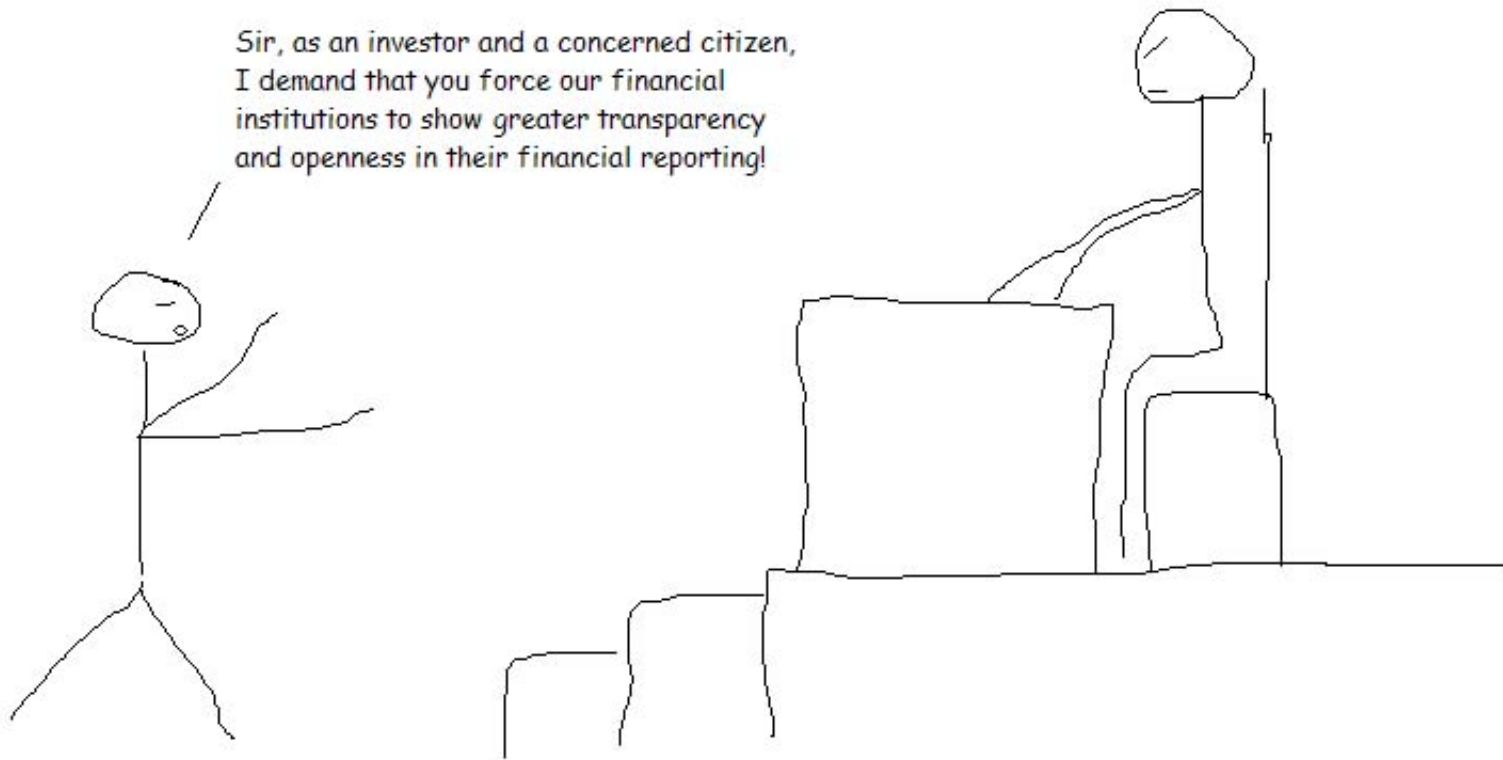


Let's drop in to see the Accountants.....

Office of the Czar of Accounting

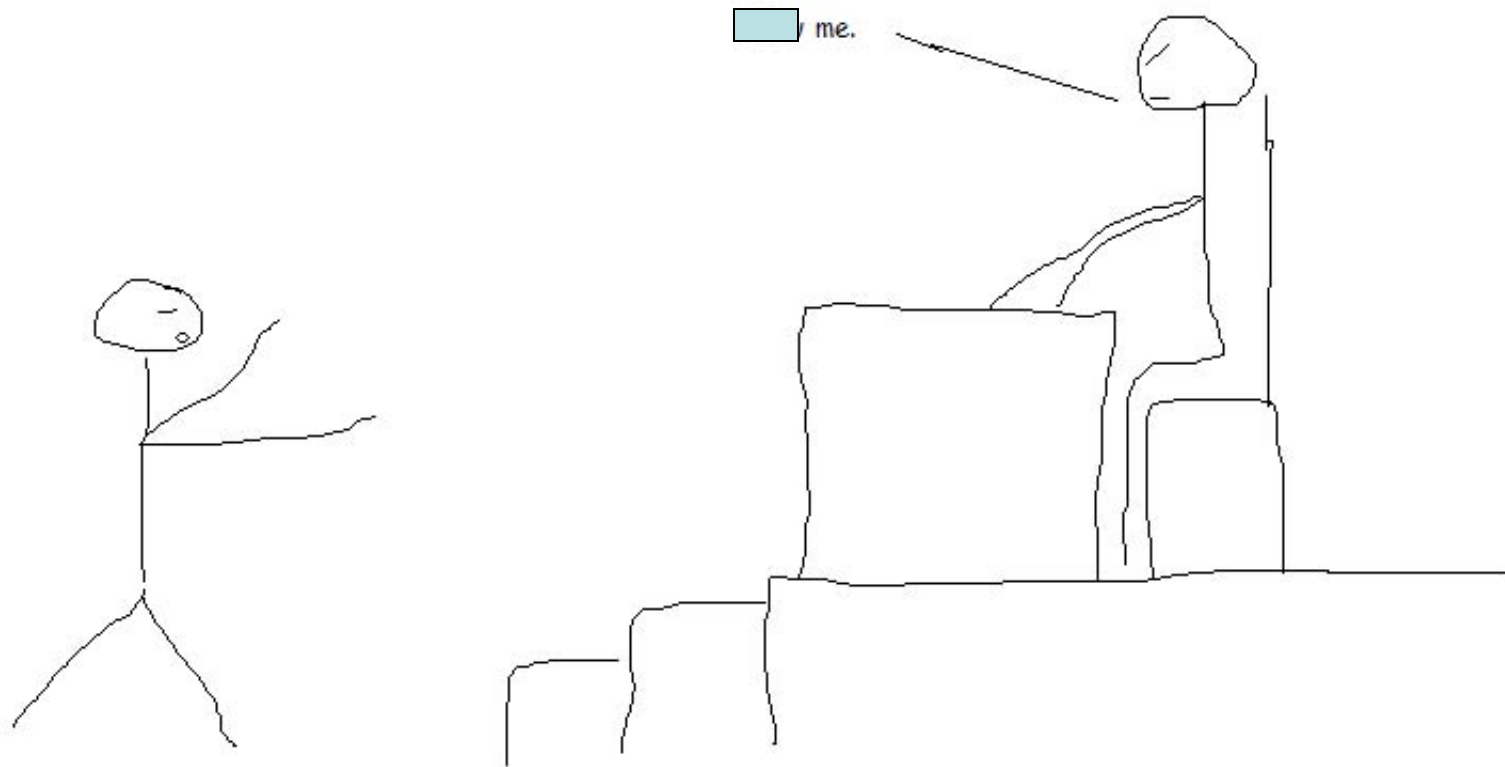
"No Nit Too Small to Pick"

Sir, as an investor and a concerned citizen,
I demand that you force our financial
institutions to show greater transparency
and openness in their financial reporting!



Office of the Czar of Accounting

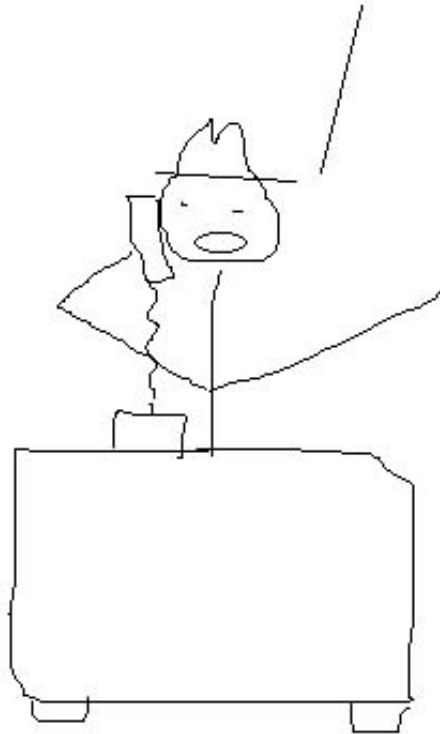
"No Nit Too Small to Pick"



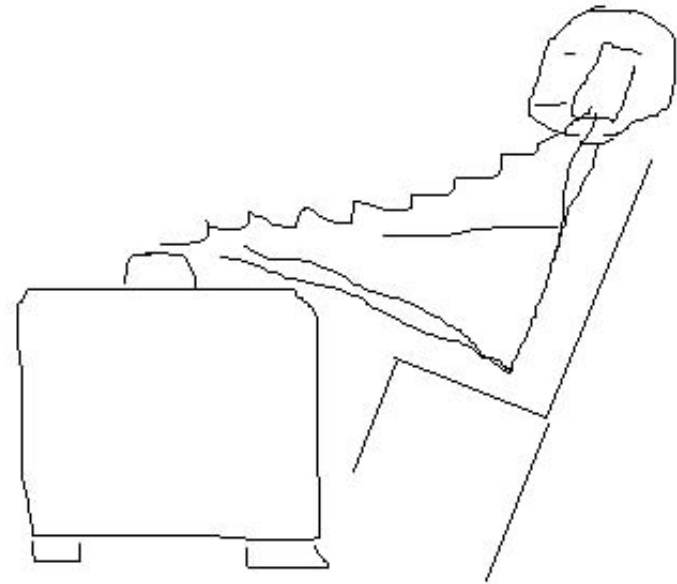
Gee, We Never Saw it Coming.....

Norwegian Village Pension Fund

Hey man, what the hell is up?
We're not receiving our
monthly payments!



RSG Investment Bank



Exotic Financing

- Easy money led to exotic financing for very large projects
- Tax Increment Financing tapped to redevelop “blighted” areas
 - Bonds issued based on flawed assumptions
 - Continued rapid growth (> 10% per year)
 - Large project completion by local developers
 - No “tax increment” revenue to repay bonds



2/14/2005



3/7/2008

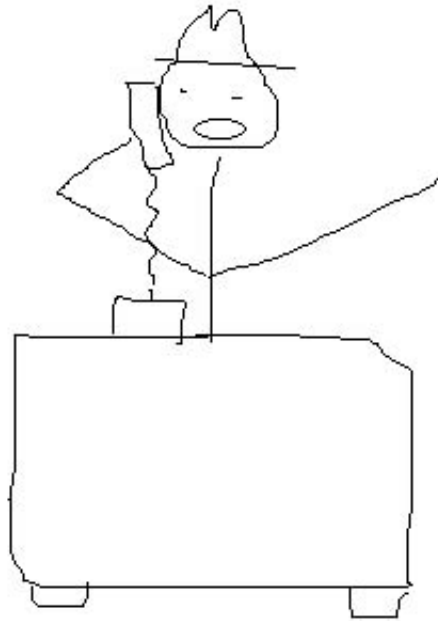


9/6/2009



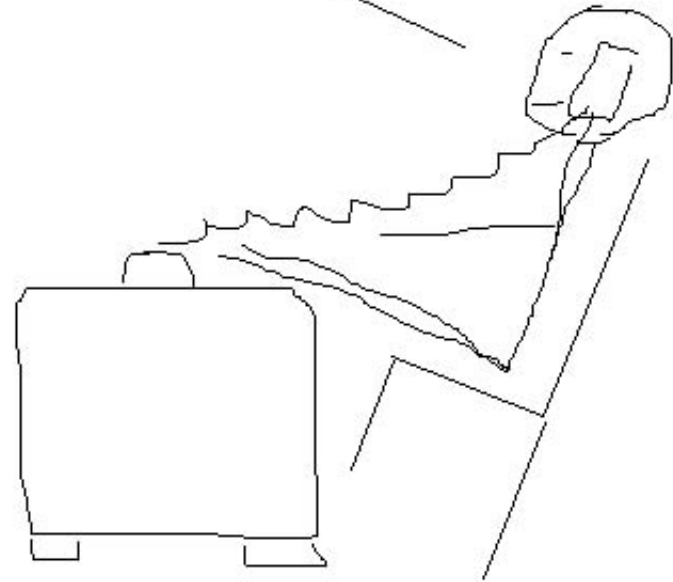
Old movie theater converted to office/retail sitting vacant.

Norwegian Village Pension Fund



RSG Investment Bank

Yeah, I meant to call you but it's been really crazy around here. It seems that the who took out the mortgages backing your CDO aren't able to pay them off.



FOR SALE by

THE BANK OF
FAYETTEVILLE

MEMBER FDIC

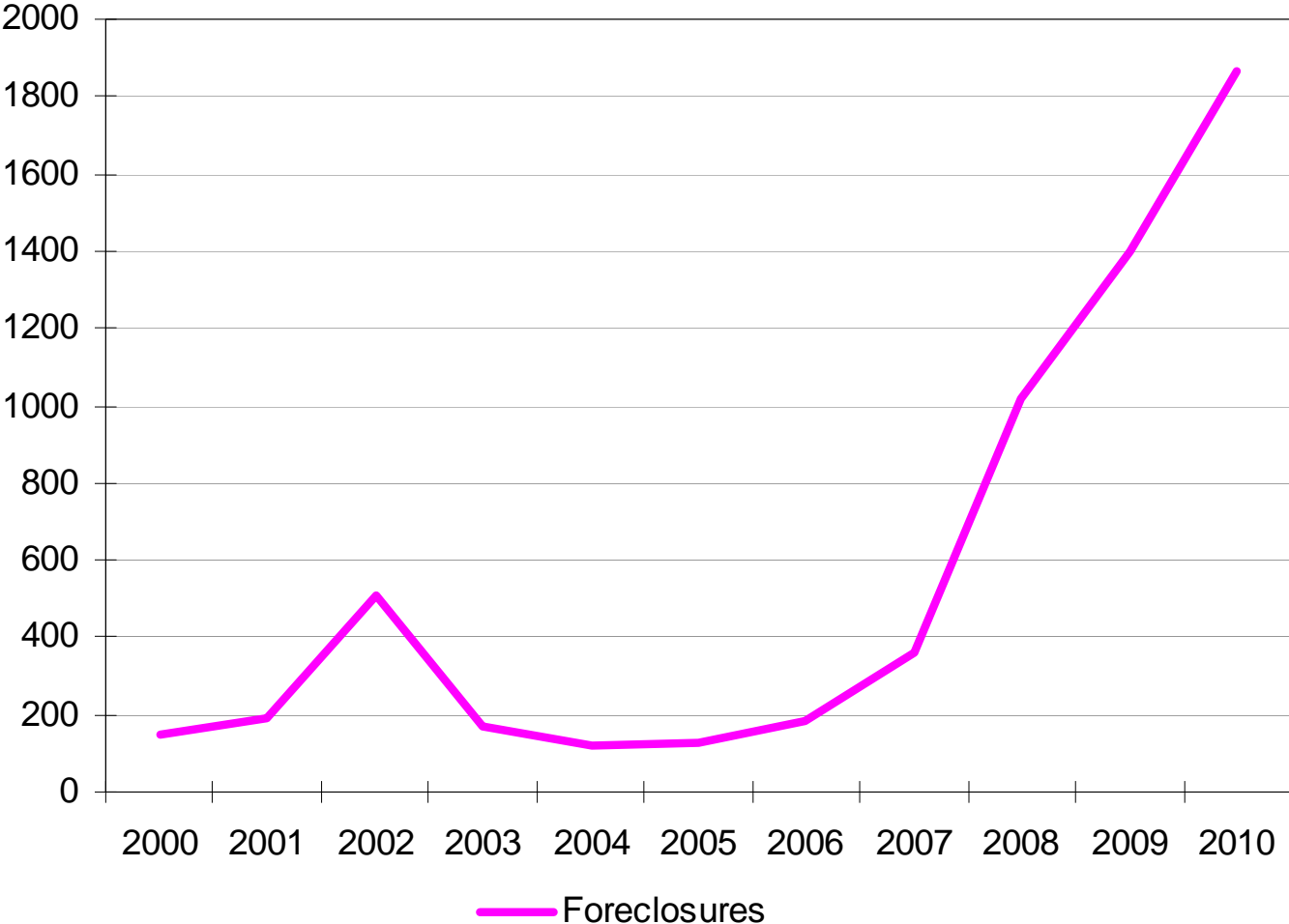


Helping Our Community Grow

444.4444

TRIAL HOURS
LENDING

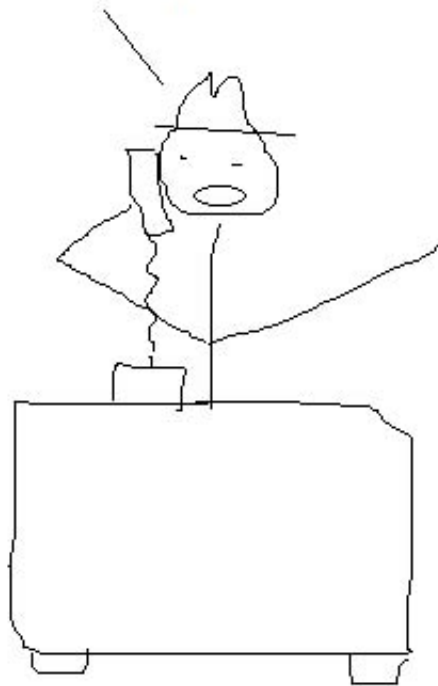
Washington County Foreclosures



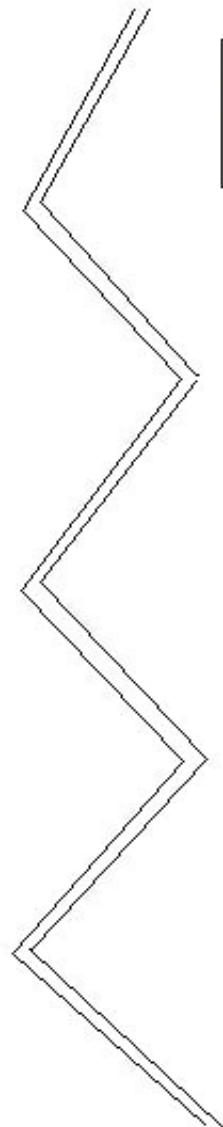
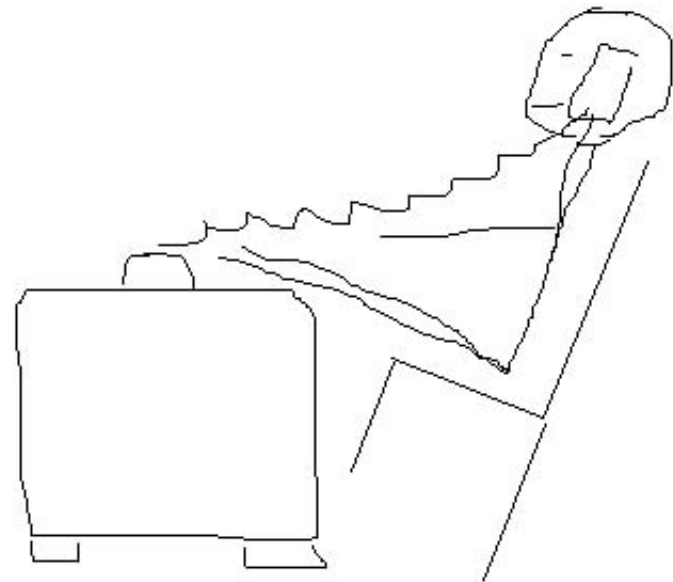
2010 values are extrapolated from 6 months of data.

Norwegian Village Pension Fund

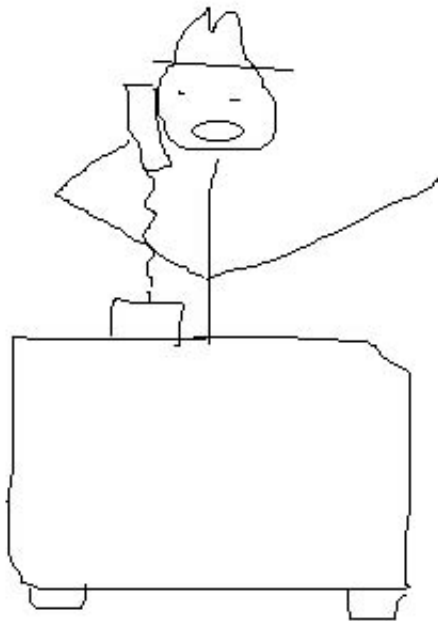
Wait a minute! We bought the AAA "Good" piece of the CDO. You know? The safe one. We're supposed to be getting paid first.



RSG Investment Bank

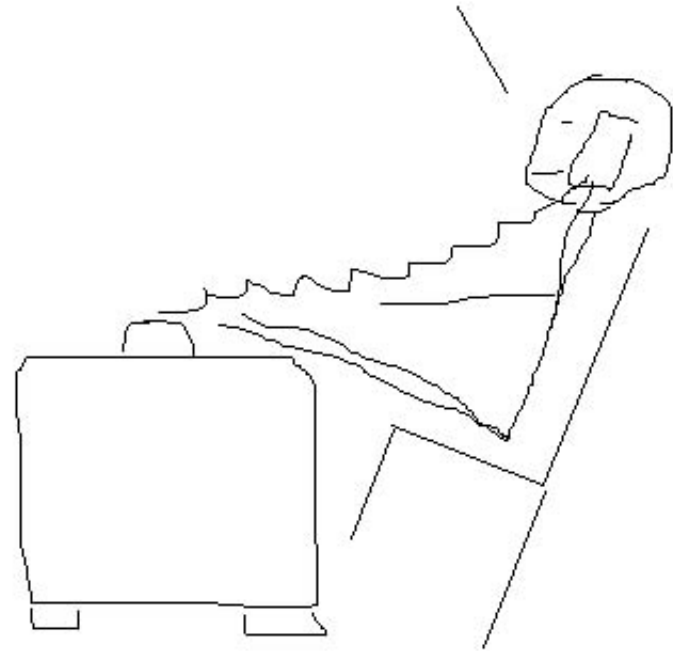


Norwegian Village Pension Fund



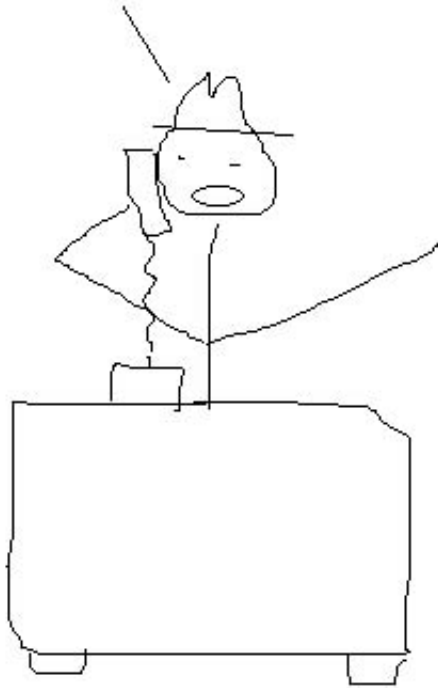
RSG Investment Bank

Well unfortunately the loans were quite a bit crappier than we originally thought and there is very little cash coming in. Frankly, I assure you that we are as disappointed as you are.

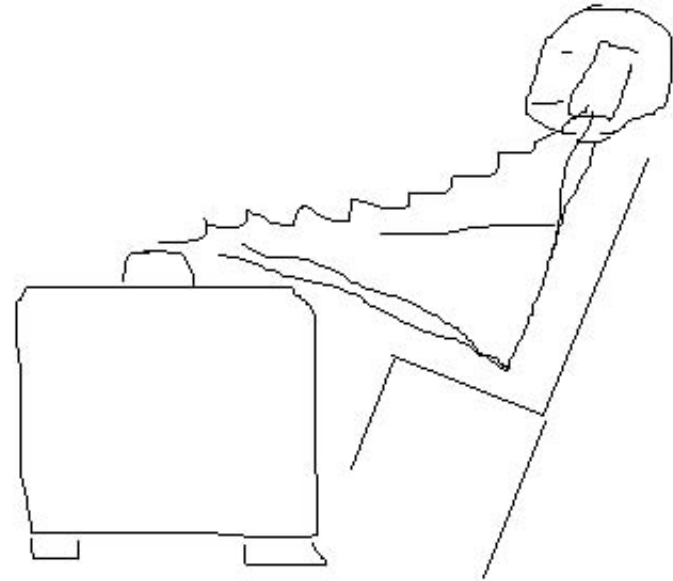
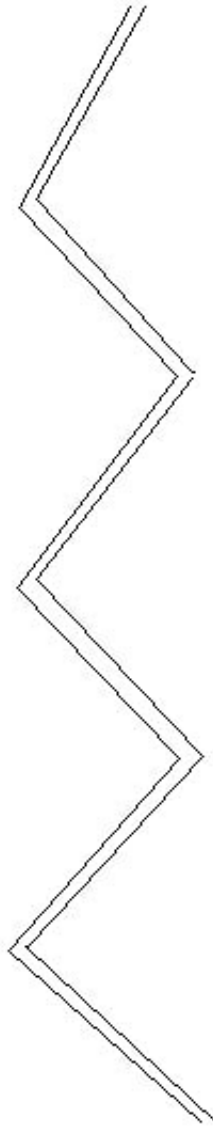


Norwegian Village Pension Fund

But you told me that housing prices always go up and that your borrowers could always refinance their mortgages!



RSG Investment Bank

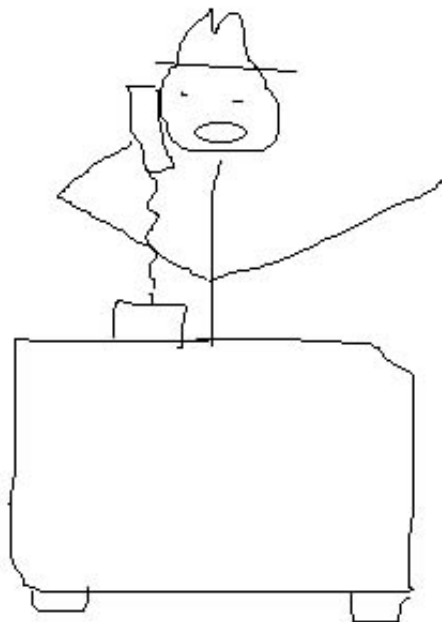


The Equity Problem

Homeowner's Equity = Home Value – Mortgage Debt Owed

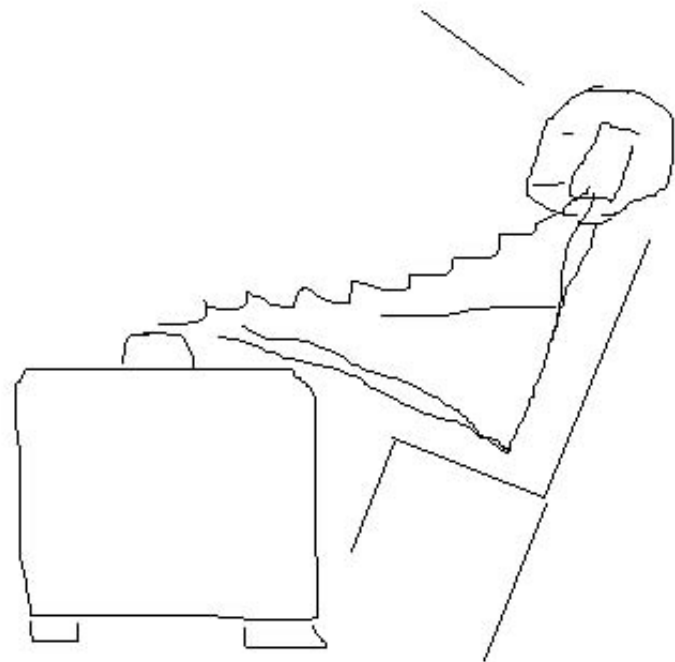
- As home value increases, so does equity.
- Homeowners borrow against increased equity.
- As home values drop, equity drops.
- If homeowner borrowed 100% of home value, equity goes negative if home value drops *any*.
- Negative equity = “underwater” mortgage

**Norwegian Village
Pension Fund**

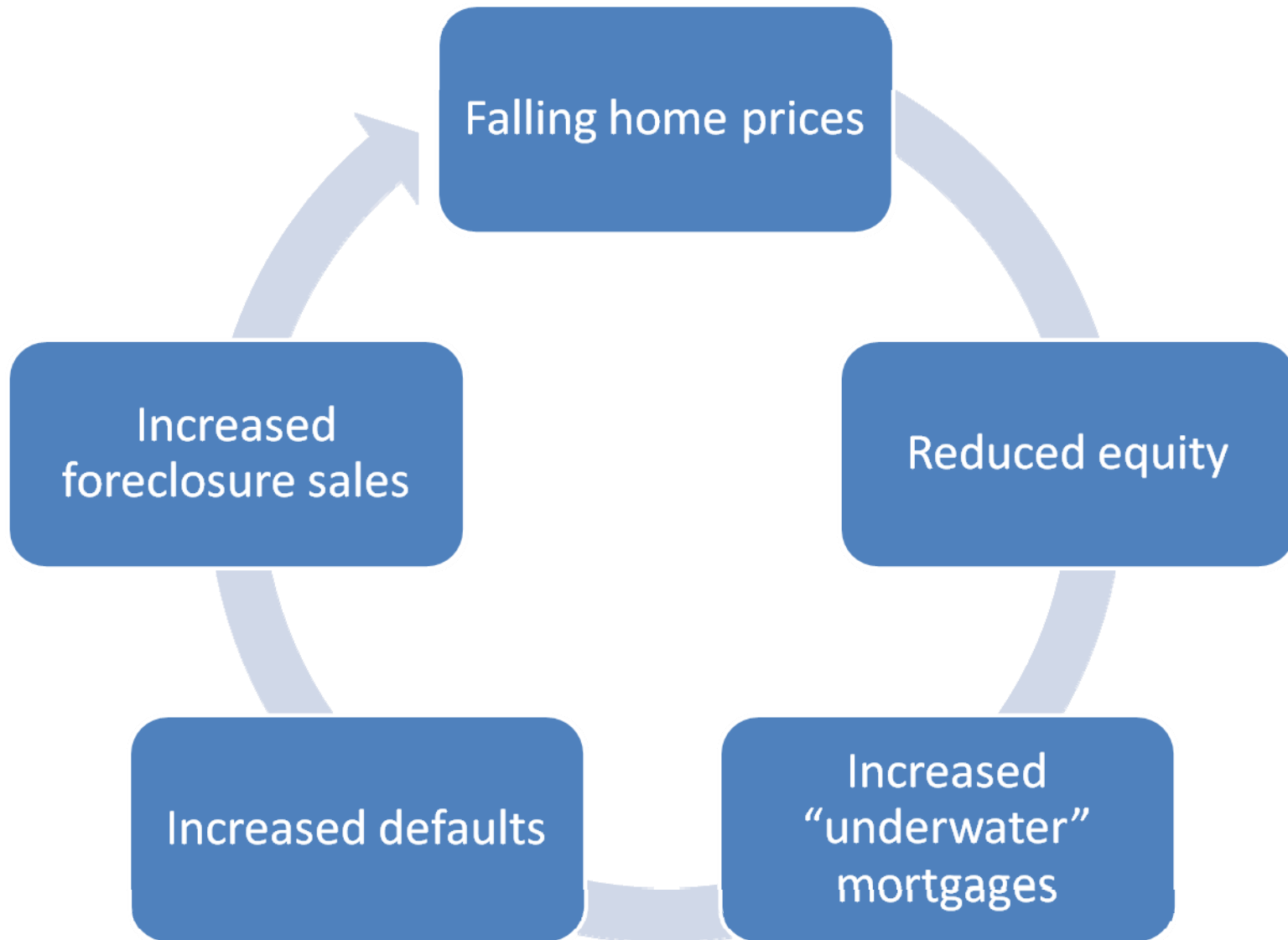


RSG Investment Bank

Yeah, that was a bad assumption.
We up. Sorry.



The “Cycle of Doom”



The mortgage mess: Have we seen the worst of it?

Unfortunately, **NO**.

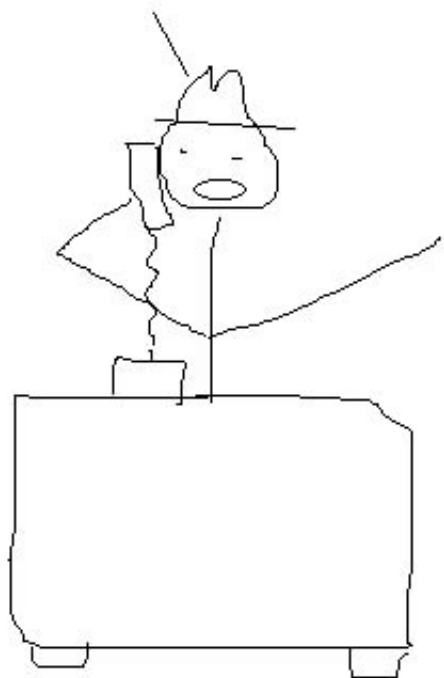
- First wave: subprime mortgage defaults
- Second wave of mortgage defaults on its way.
- Prime Jumbo Loans (6.9% 90 days delinquent in Dec. 2008, up from 2.6% in Dec. 2007)
- Option ARMs to reset in 2009, 2010.
- Option ARMs reset early if only minimum payment made (negative amortization).
- Rising unemployment will result in further defaults.

Closed businesses contribute to rising unemployment in the area.

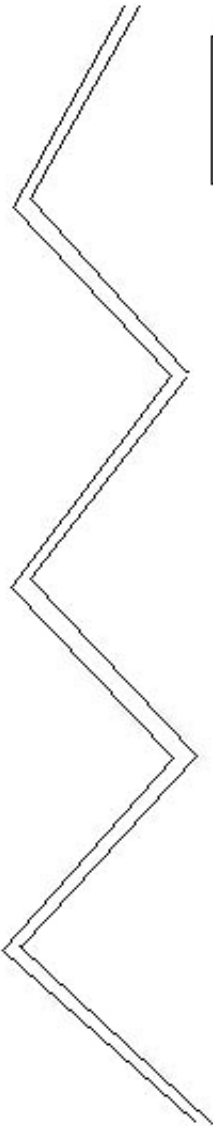
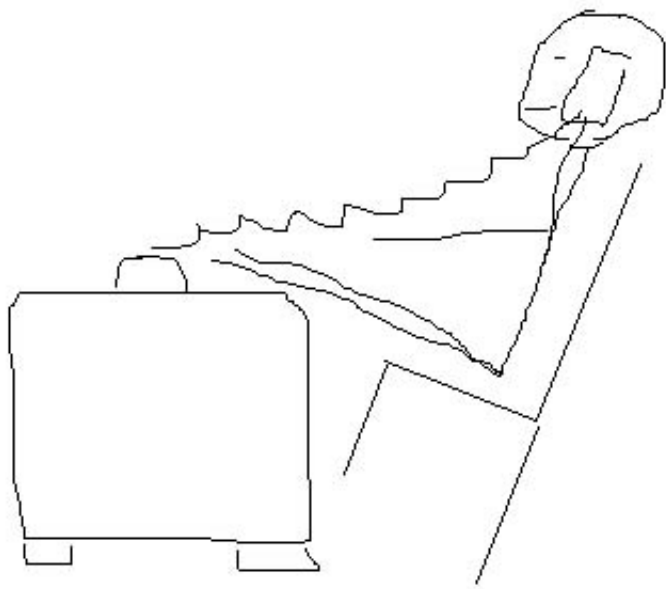


Norwegian Village Pension Fund

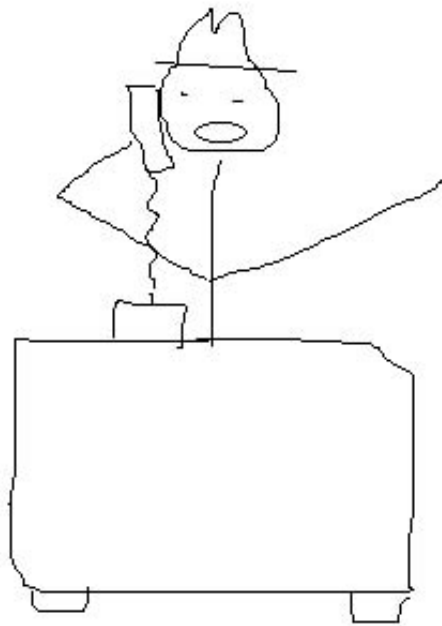
Bad assumption my frigid Norwegian [redacted]! What about the AAA rating from the agencies?



RSG Investment Bank

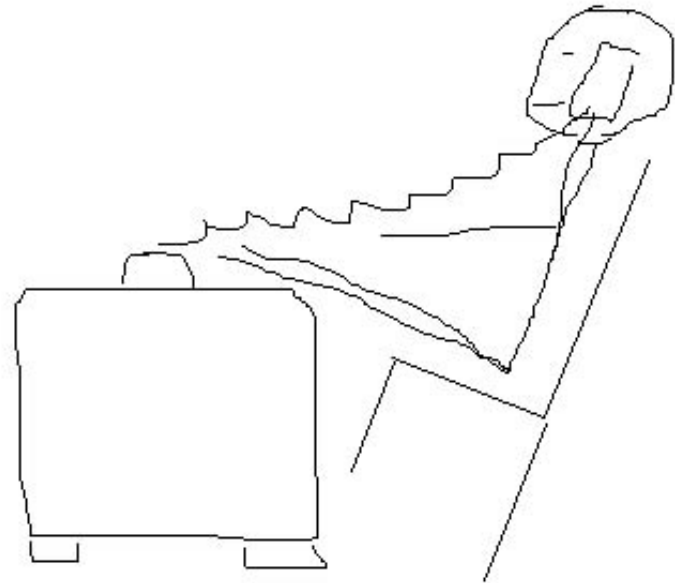


**Norwegian Village
Pension Fund**



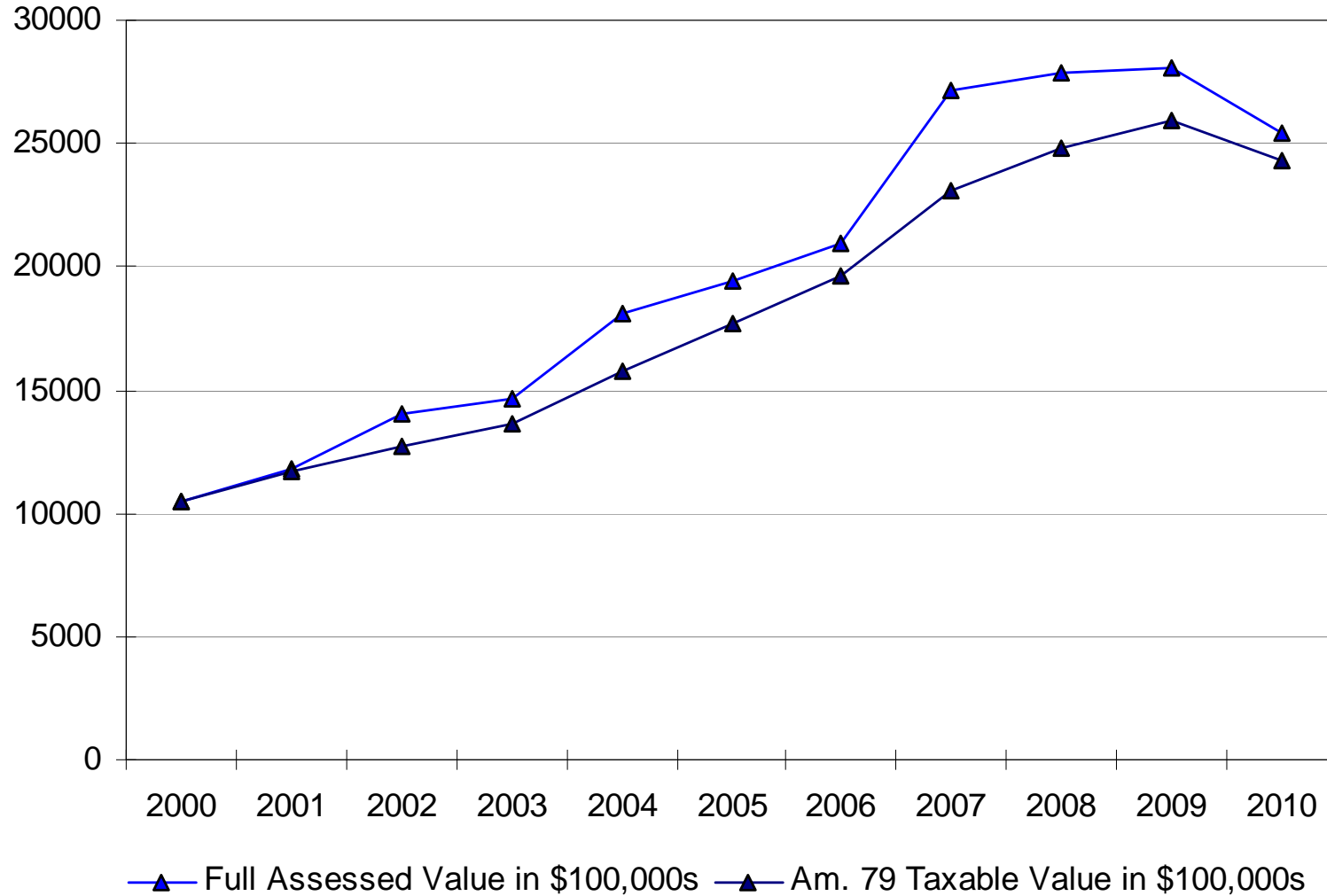
RSG Investment Bank

They up too.



**Market Conditions
Create
Unique Assessment Climate**

Washington County Ad Valorem Valuations

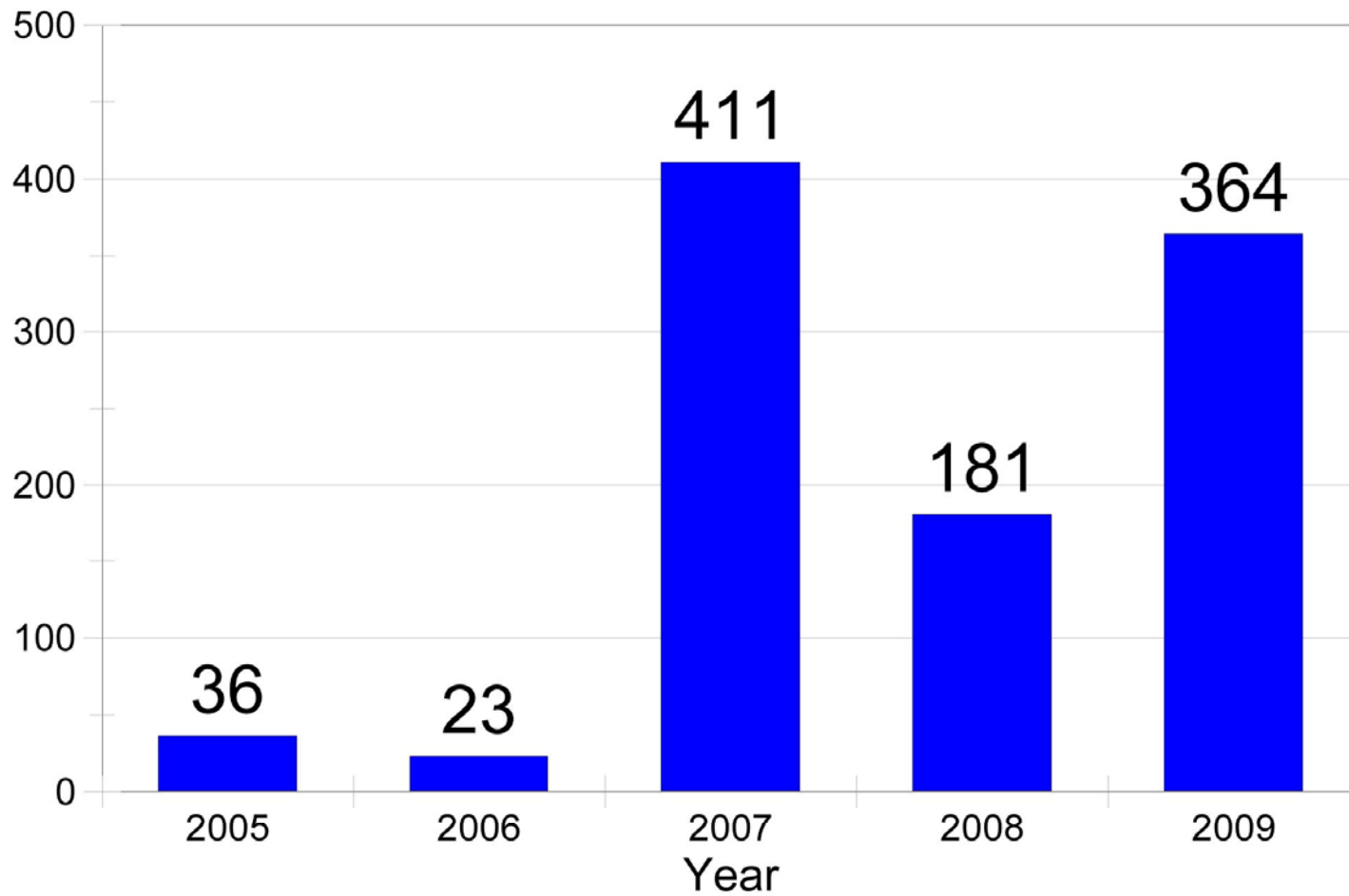



A Rock and a Hard Place

- 2007 Reappraisal increased values over 30% based on 2006 sales.
- In Arkansas, assessors may only revalue once every 3 years.
- 2007 taxpayer appeals were overwhelming
- Something had to be done.

Washington County

Board of Equalization



 Number of Hearings

Assessor asked Board of Equalization to equalize values in a countywide project which turned into a mini-reappraisal.

2008 Project Results

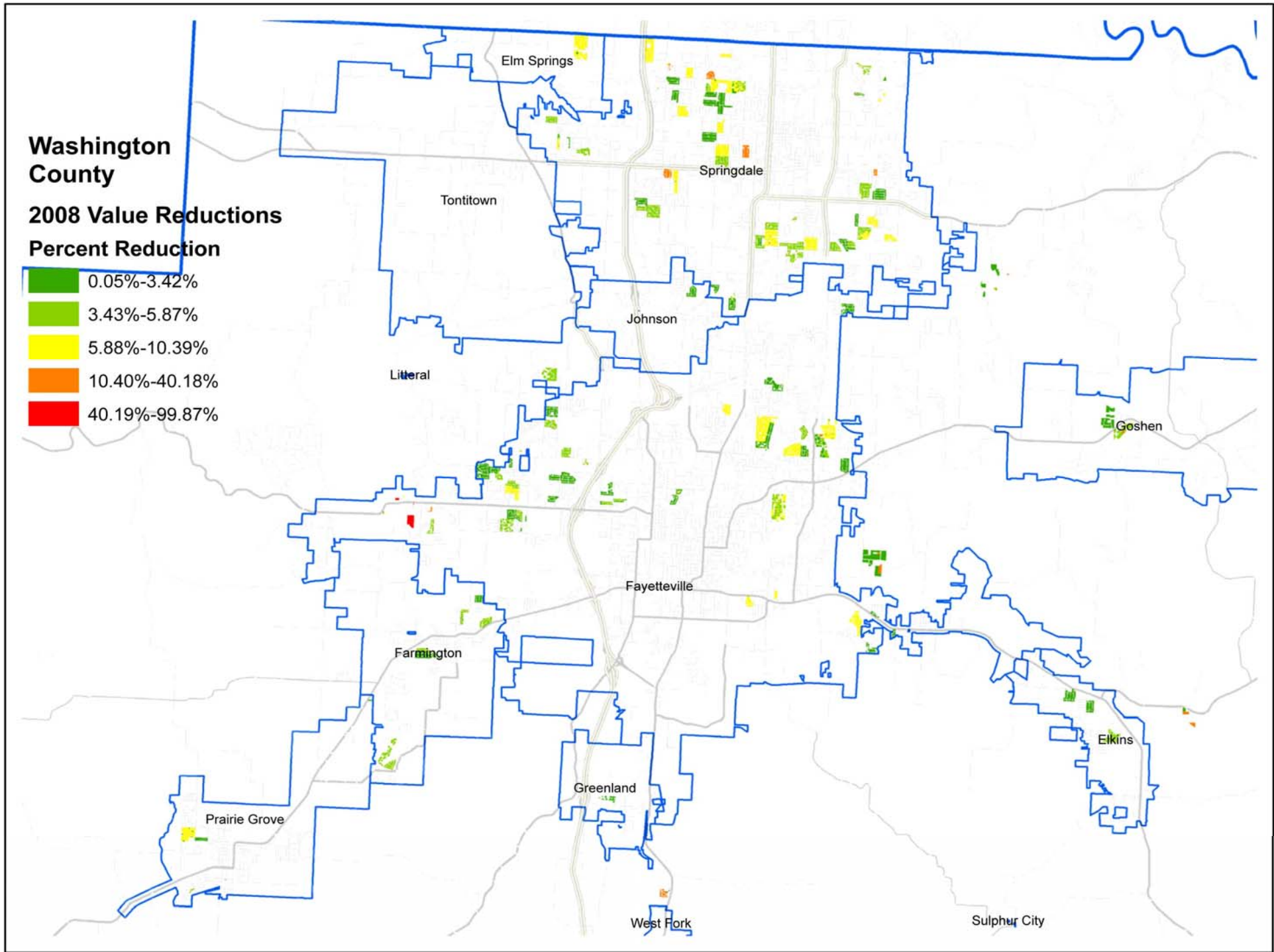
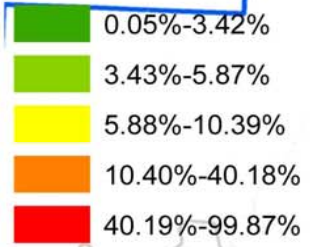
- Reduced value on 7104 parcels
- Median reduction of \$7,250
- Median percentage difference of 3.97%

- Strictly houses and duplexes
- Neighborhoods with 3+ sales
- Adjusted each neighborhood to 100% ratio

Washington County

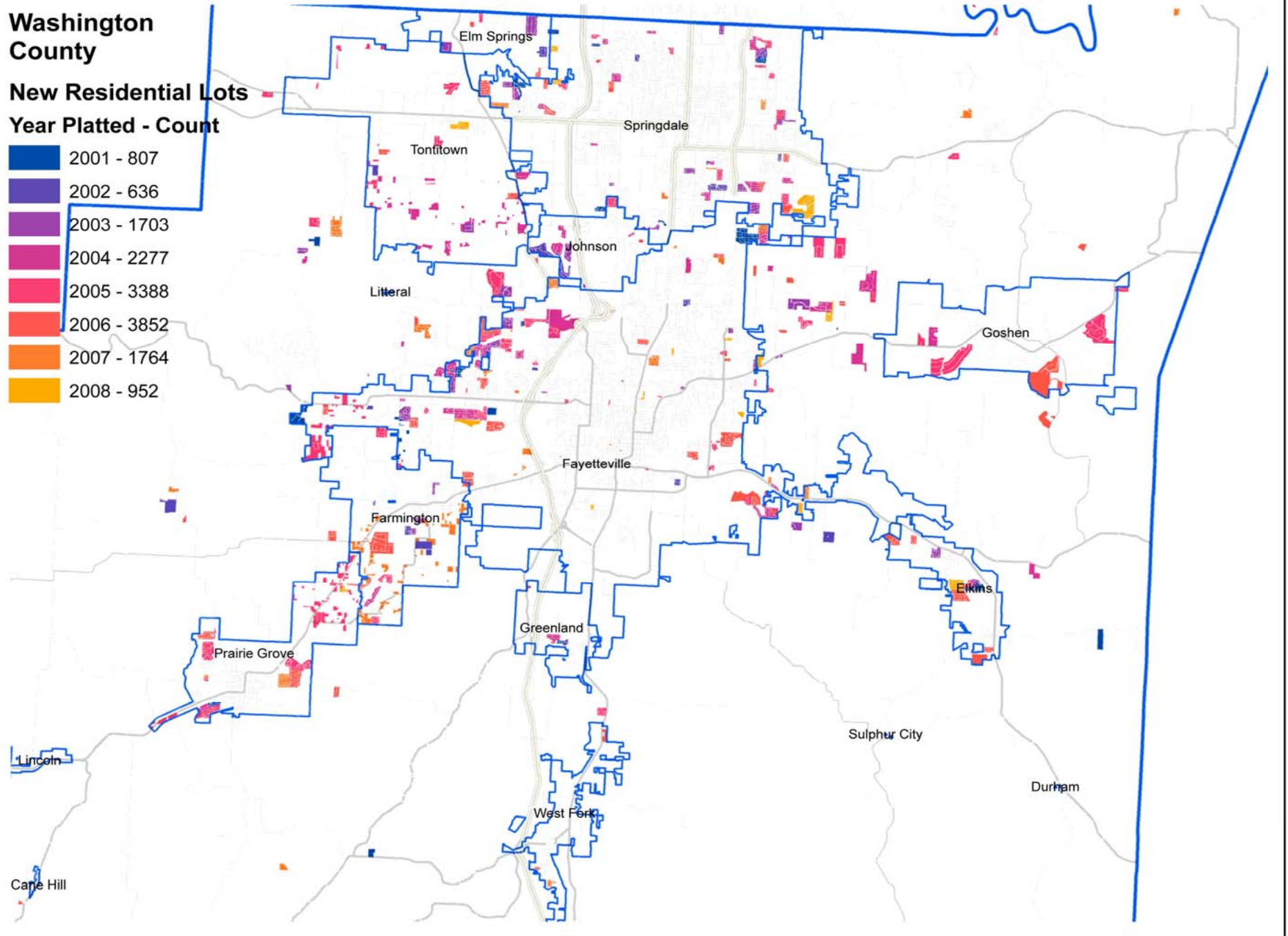
2008 Value Reductions

Percent Reduction



Washington County

New Residential Lots Year Platted - Count



2009 Project Results

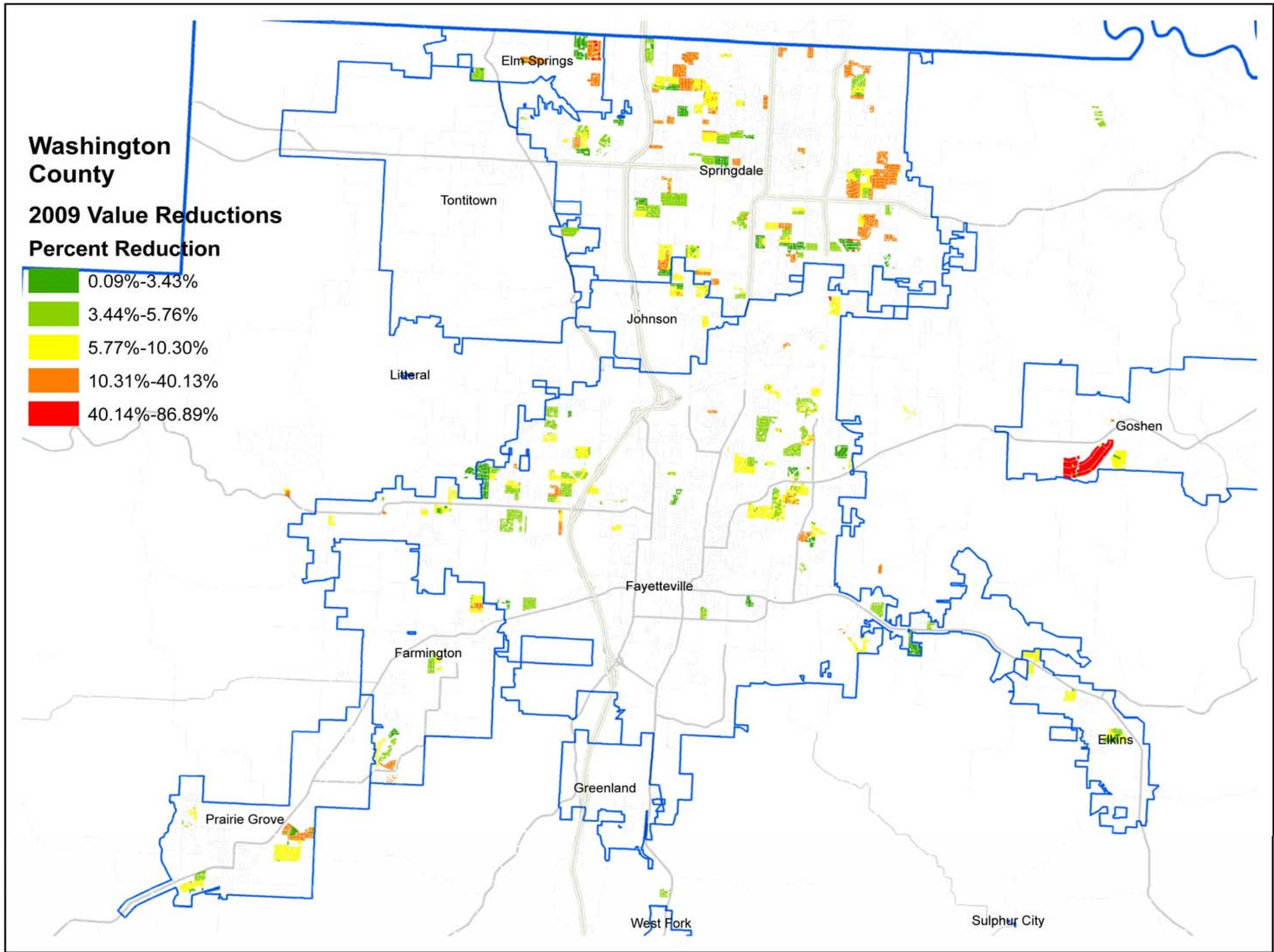
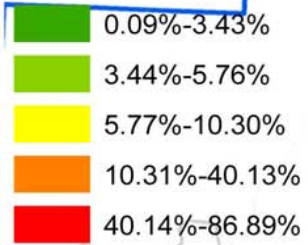
- Reduced value on 13,619 parcels
- Median reduction of \$10,400
- Median percentage difference of 6.67%

- Houses, duplexes, vacant lots
- Neighborhoods with 3+ sales plus any related neighborhood
- Entire duplex market
- Adjusted each neighborhood to 100% ratio

Washington County

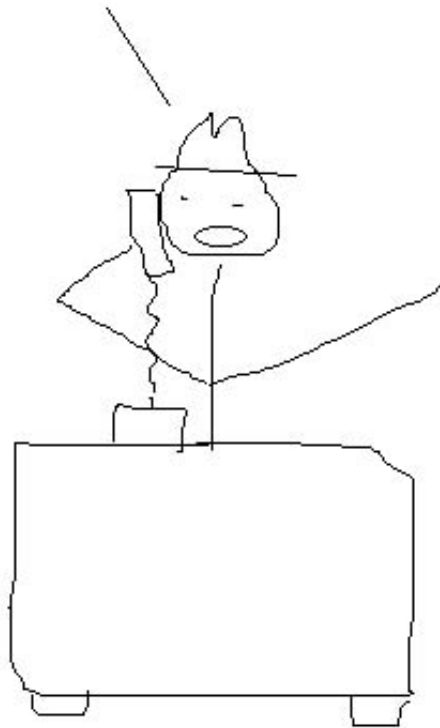
2009 Value Reductions

Percent Reduction

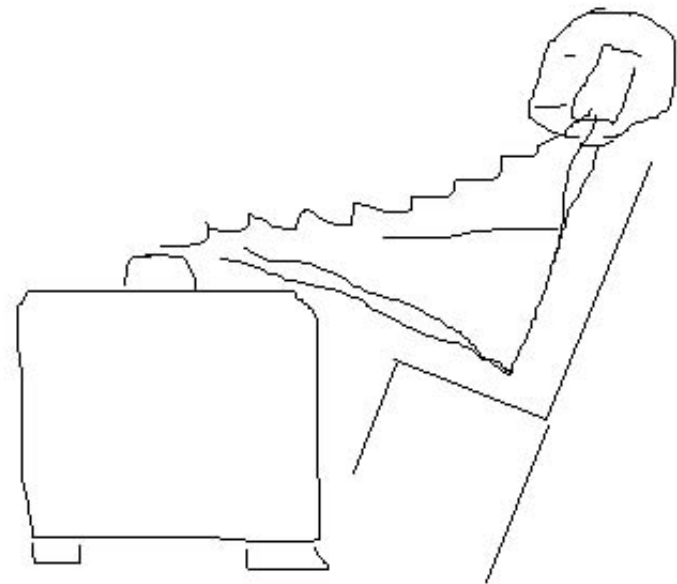
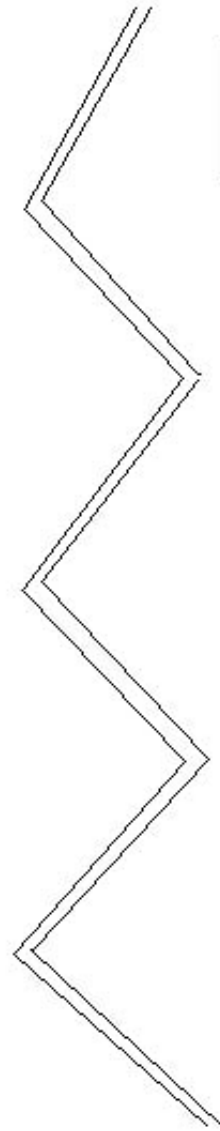


Norwegian Village Pension Fund

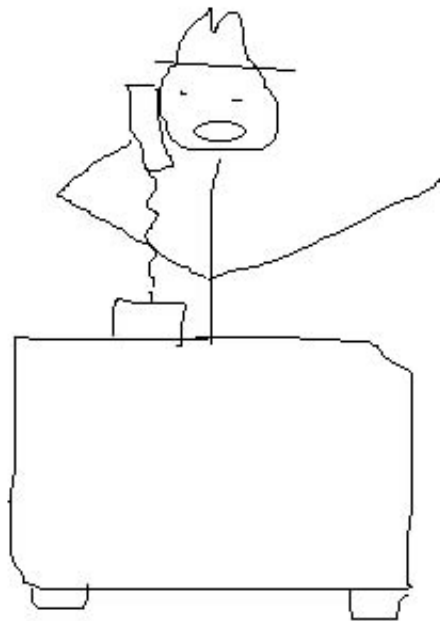
But this security was insured! What about the insurers?



RSG Investment Bank

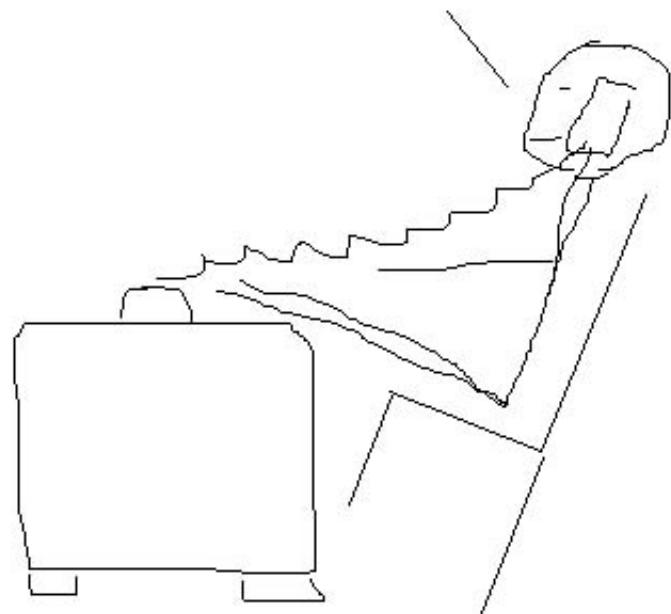


Norwegian Village Pension Fund



RSG Investment Bank

Are you kidding? There's no way they have enough money set aside to cover this mess. They up.

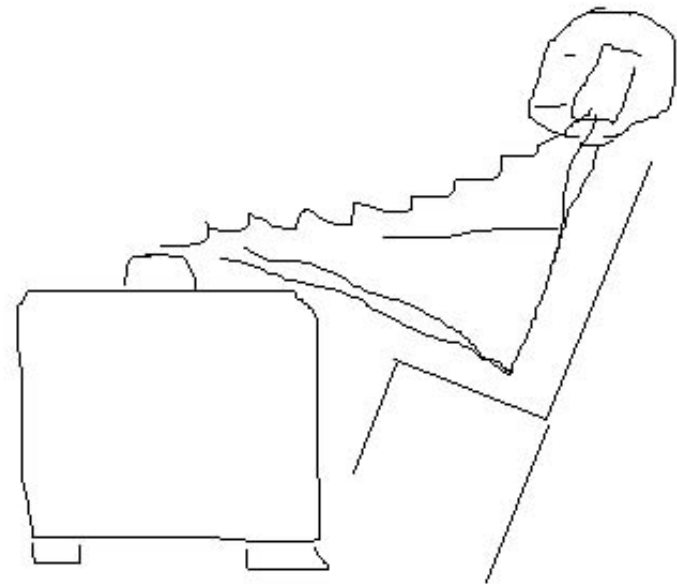
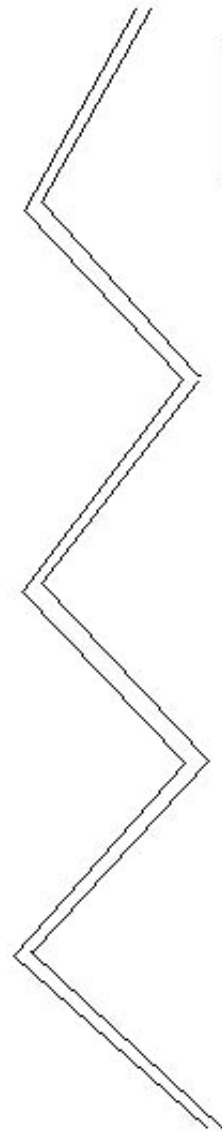


Norwegian Village Pension Fund

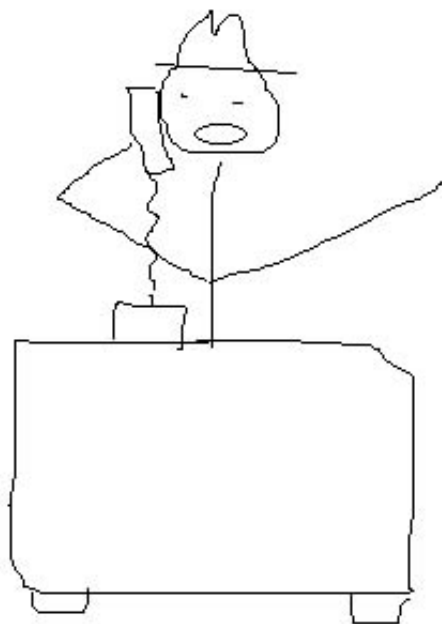
Well that's just great,
What am I supposed to tell my villagers?



RSG Investment Bank

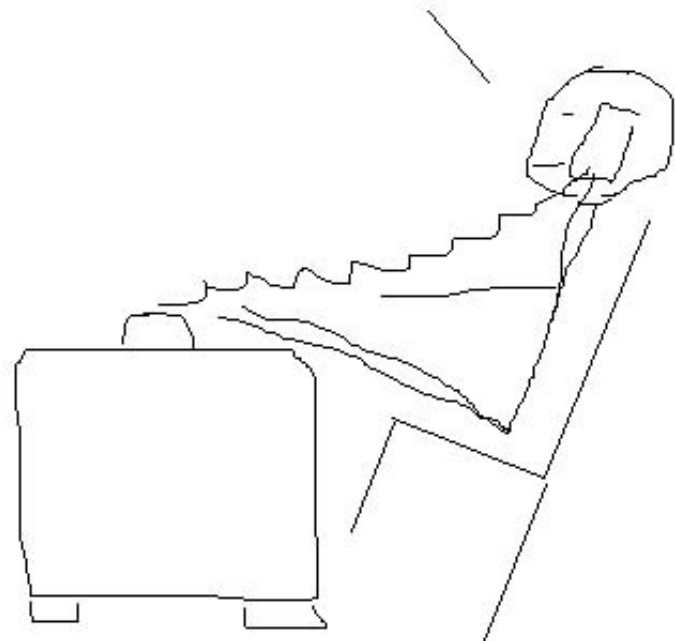


Norwegian Village Pension Fund

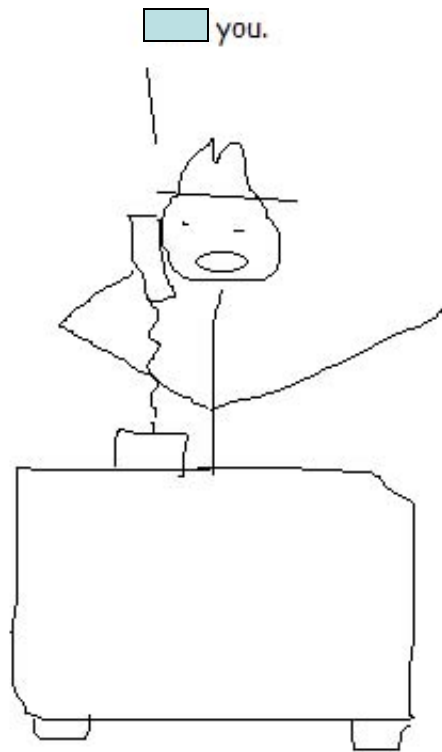


RSG Investment Bank

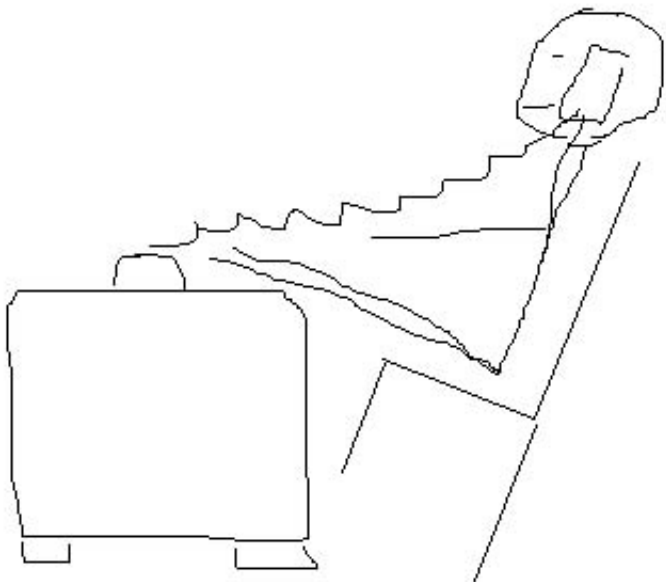
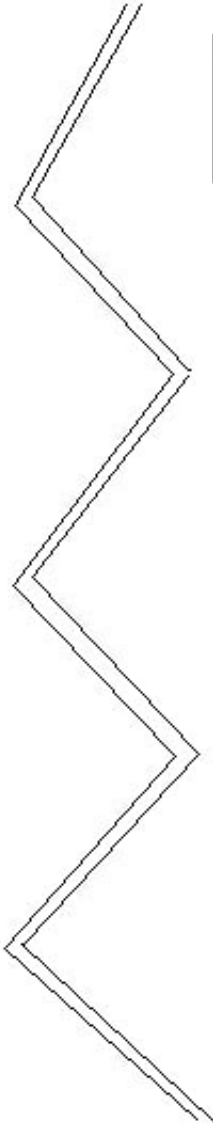
Tell them you up.



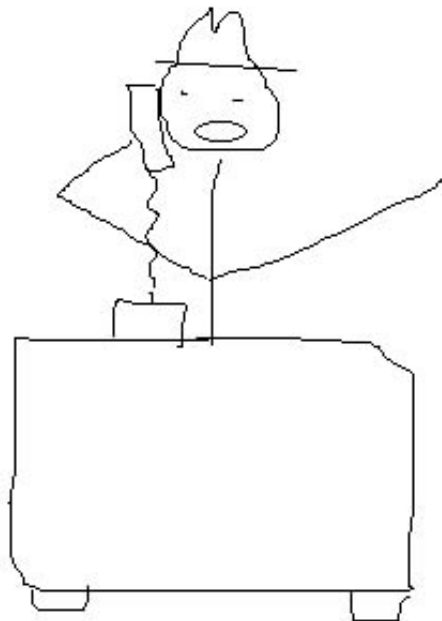
Norwegian Village Pension Fund



RSG Investment Bank

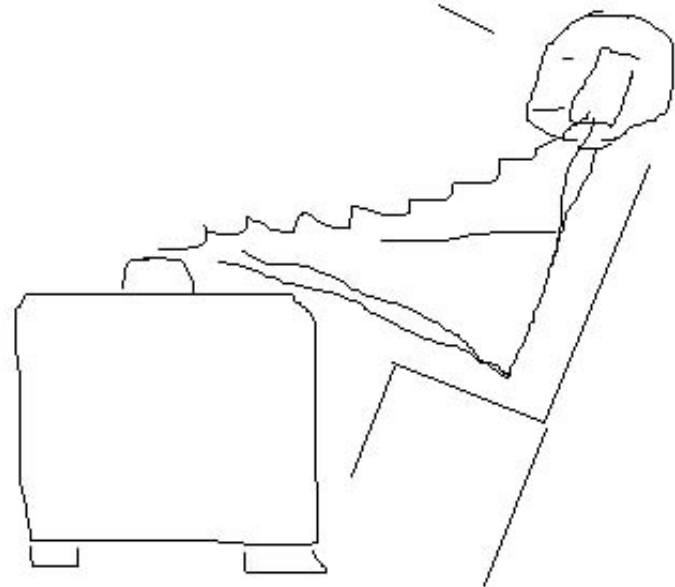


**Norwegian Village
Pension Fund**



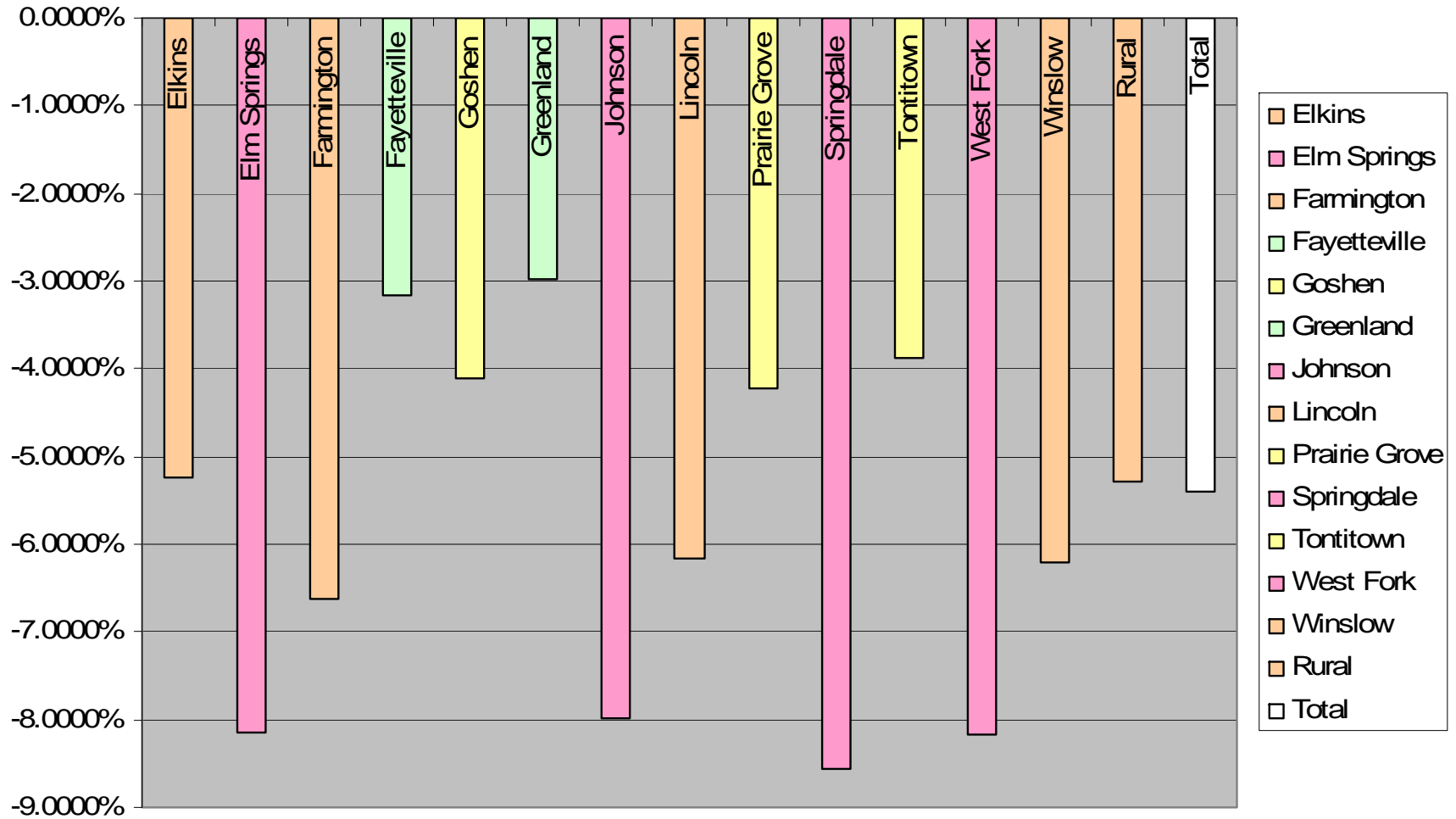
RSG Investment Bank

 you.



Effects of 2010 Reappraisal

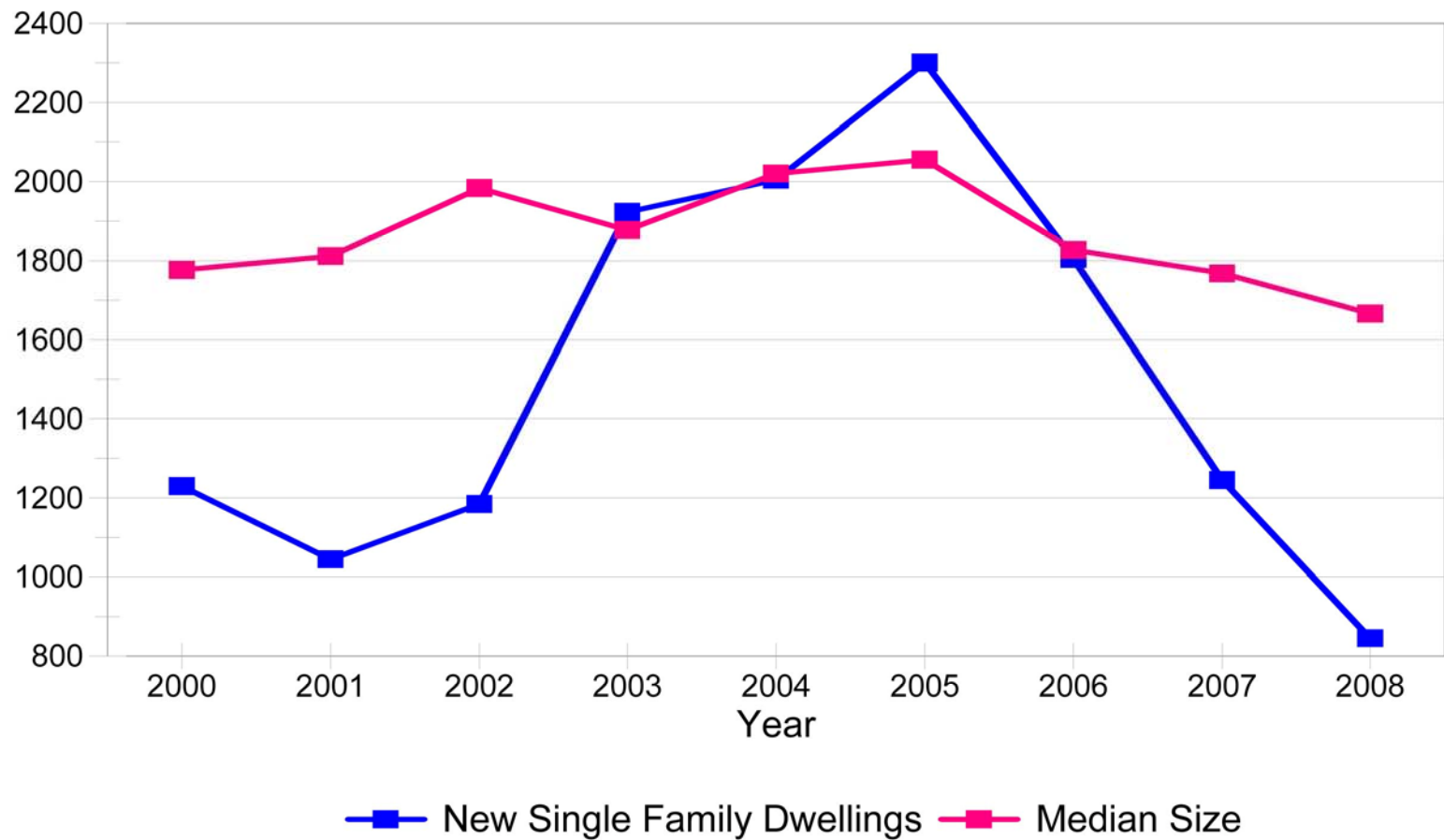
Washington County 2011 Revenue Loss



Signs of Recovery

Builders building smaller speculative houses.
They are selling.

Washington County Single Family New Construction



Adaptive re-use of older downtown structures.



Regional mall 100% leased.







Summary

- Is it over? NO
- Is it hopeless? NO
- Assessors must recognize the abnormal market conditions.
- Flexibility is required to avoid a revolution.
- Assessors must maintain equity and accuracy.
- Very good data is necessary to properly adjust values in a timely manner.

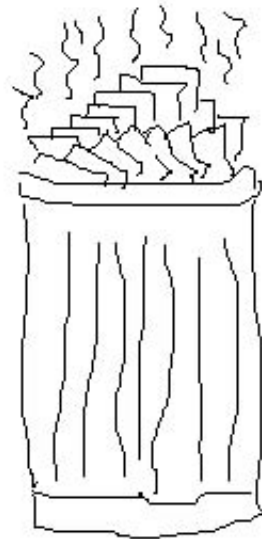
Signs of Trouble

- Banks popping up on every corner
- Condo developments turning up on the Planning Board agenda
- All your friends are building spec houses

- A lot of people d up.
 - When you can't blame **SOMEONE**, blame **EVERYONE.** Dr. Haggard
- Assessors need to be part of the solution, not part of the problem.

The End

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