Bringing out the Plumbers: Restarting Private Mortgage Financing

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Fixing the plumbing

1. **Return of Private Capital: Waiting for Godot**
   - Bank Portfolio bid is small, banks prefer to buy Agency MBS
   - Big banks continue to pull out of mortgage origination and ration scarce capacity with huge margins
   - Housing bubble has fully corrected
2. **"Green Shoots" are Sprouting from Non-Traditional places**
   - New TPO Channels being set up
   - REO rental ideas are proliferating, some capital arriving
3. **Reducing risk to the taxpayers: Originator First Loss**
   - Cutting loan limits is the wrong way to do it
   - Real first loss insurance beats bond tranching on all metrics
4. **Top Priority: Give existing, performing borrowers access to low rates as a first step in rebuilding housing finance**
   - Historically high delinquency and defaults continue
   - Voluntary prepayments limited by poorly understood frictions
     - LLPAs imposed by the GSEs
     - Lack of capacity and competition in a more concentrated industry
     - MSRs severely and unfairly punished by Basel III
   - Main monetary policy transmission mechanism has been broken

Non-agency MBS issuance has disappeared

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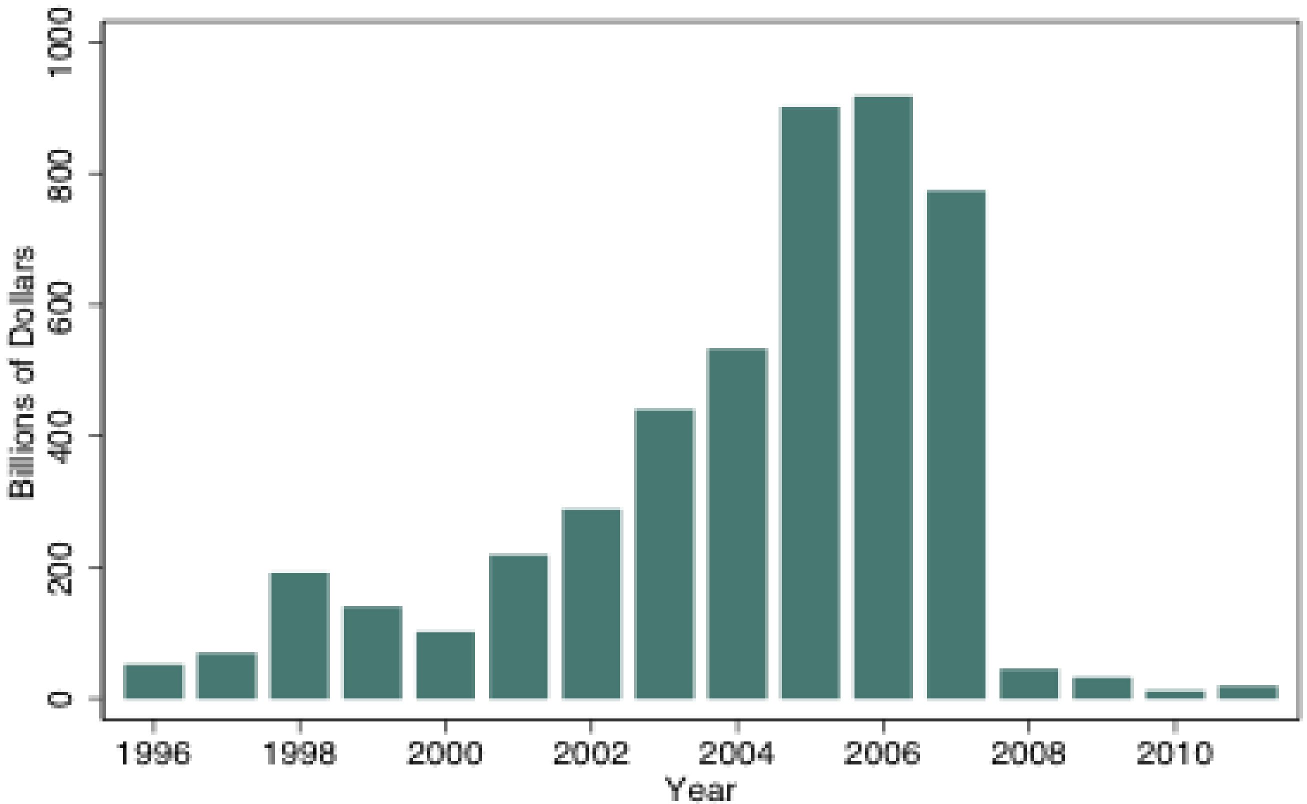
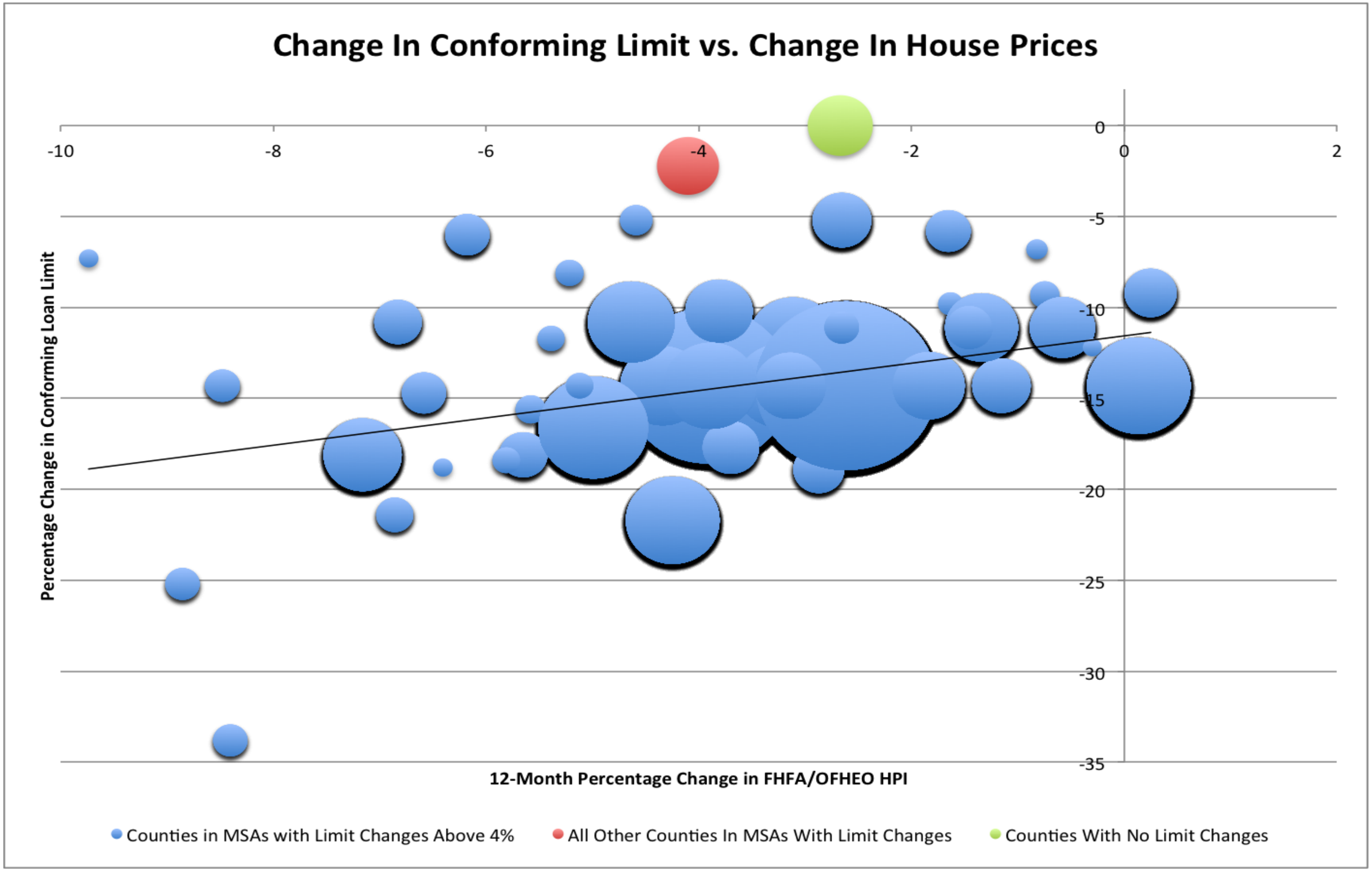


Gross Non–Agency MBS Issuance by Year (Includes CMBS)
Current as of August 2011 (2011 Figures Projected)
Source: SIFMA

Reducing GSE loans limits has had an effect



Housing is now Cheap

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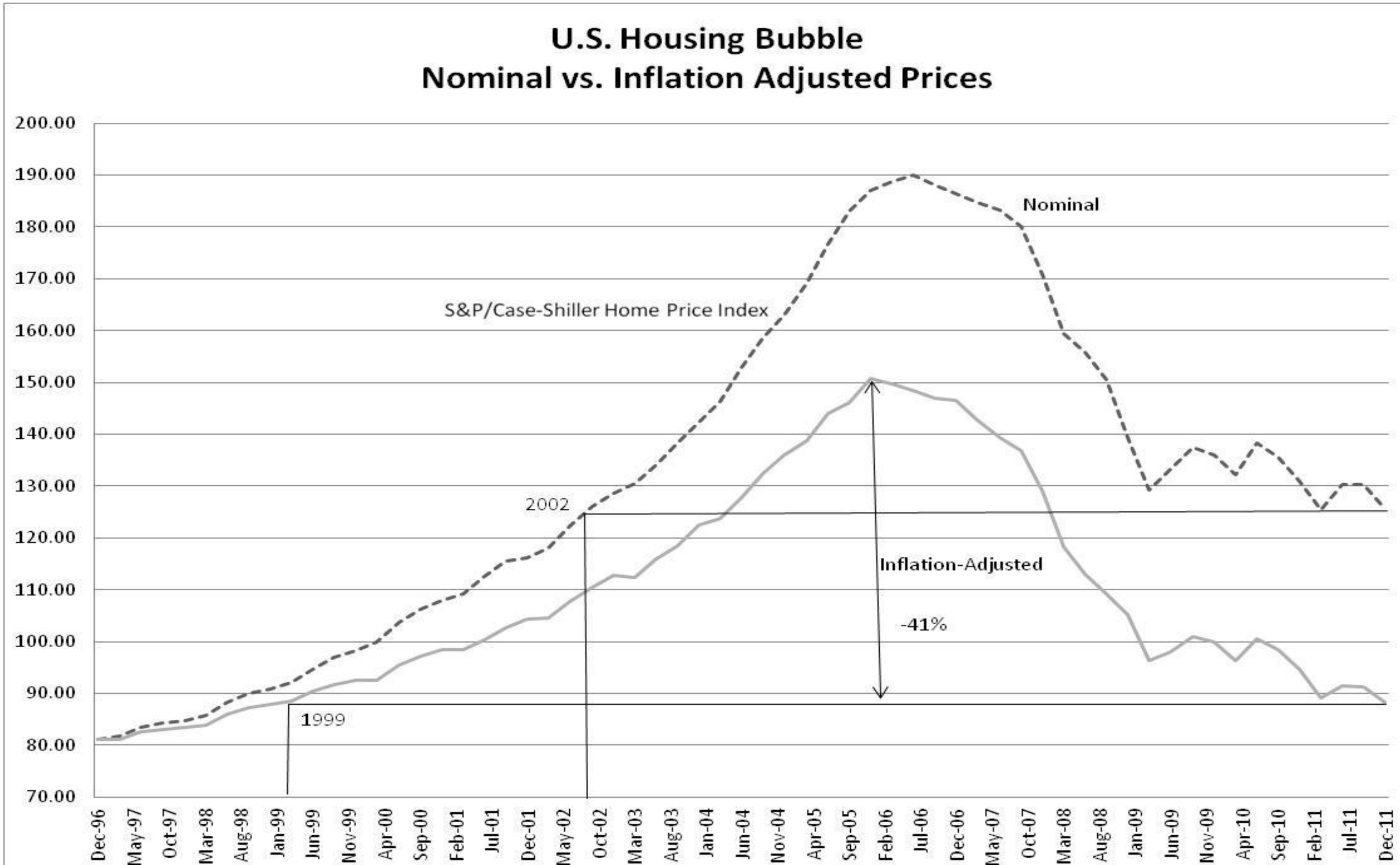

GSE’s are going to matter

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- *“More competition will make the mortgage market more efficient….will drive down economic rents and cause the value of the GSE charter to be passed on to the customers. In this context, there is a theoretical economic position that it would be best to have no GSEs at all. However, even if you find this correct in theory, in the U.S. context it has not practical significance. The fact is that the GSEs are the dominant forces in the mortgage market….and are fundamental to the structure of the mortgage market.”* **Alex J. Pollock, President, FHLB of Chicago, 1999**

- *“There’s simply no such thing as a nonguaranteed housing finance market, other than in ideological fantasies.”* **Adam Levitin, Georgetown University, Sept, 2011**

Alex J. Pollock's 7 Steps

1. **Fannie and Freddie should be put into receivership**
   - Common and non-government preferred stock wiped out
   - Boards removed
2. **Fannie and Freddie should be on the federal budget**
   - This would be honest accounting, we are not fooling anyone today
   - Creates incentive for Congress to proceed with further fundamental reform.
3. **Fannie and Freddie should be divided into three parts**
   - A liquidating trust for the existing government-guaranteed debt and related mortgage assets. As these run off, their imbedded losses will consume the Treasury's preferred stock.
   - The intellectual property, systems, customer networks, human capital, and goodwill formed into two private companies and sent out into the world to compete.
   - The guarantee business, subsidy and non-market loan programs, should be explicitly part of the government, merged into HUD and subject to Congressional oversight.
4. **Encourage credit risk retention by the originators of mortgages**
   - This both creates the best alignment of incentives and takes advantage of the maximum amount of knowledge about the loans.
5. **Formal goal of creating a private secondary market**
   - For prime, middle class mortgages
   - Creating a U.S. covered bond market would be part of this project
6. **Rediscover savings as an explicit goal of housing finance**
7. **Inject countercyclical factors into housing finance**
   - loan-to-value ratios which fall as house prices escalate rapidly over their trend
   - the establishment of much bigger loan loss reserves in good times

What happens with a “no GSE solution”

1. **Product Availability Lower**
   - 30 Year, fixed rate, callable mortgage will not exist
   - Homeowners will have to take more risk, will not be able to match duration of their largest asset
   - 3-5 year ARMS with prepayment penalties will be the norm, putting more risk upon households
   - Much larger TBTF banking system will be needed, with government support in another form
2. **Level of Rates Higher**
   - Level of mortgage rates will be 100 to 250bp higher
   - Spread history shows that private RMBS market had more volatile rates
3. **Costs to Society will be higher**
   - Taxpayer bailouts will be more expensive
   - Homeownership will be lower, fewer good borrowers will qualify
   - Labor mobility will be lower, NAIRU will be higher
   - Main monetary policy transmission mechanism will be diminished

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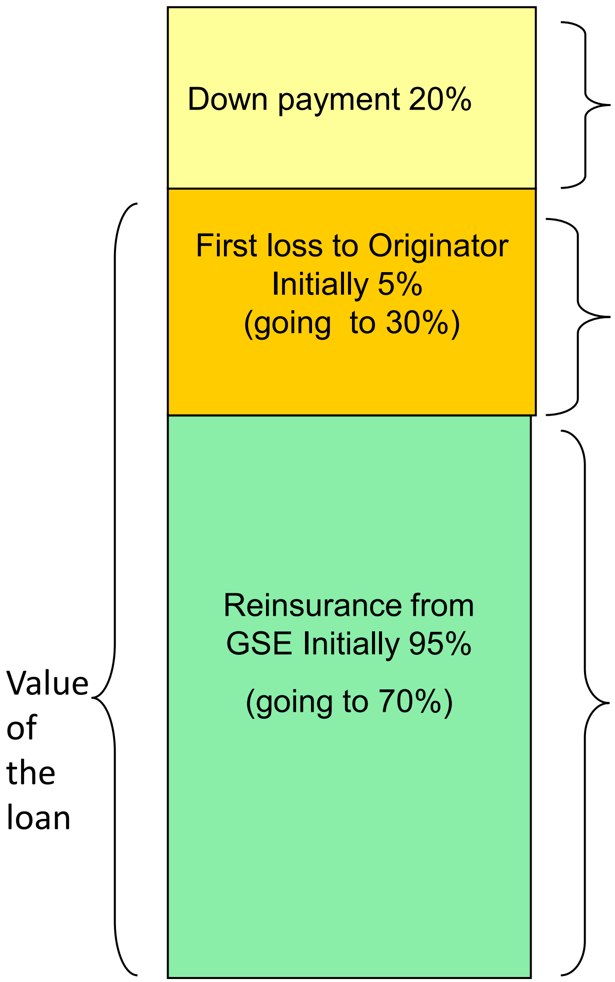
A new model for risk sharing



1. **Quality Mortgage Loans**
   - Minimum Down Payment, no second liens
   - Strict UW Standards and Appraisal Requirements
   - Full Recourse to borrower
2. **Separately Capitalized Originator Insurance**
   - Subordination based on extreme stress scenarios
   - Standardized structures capitalized by valuable assets
   - Non-rescindable insurance contract or subordinate bonds
   - Originator earns profits over time instead of booking it all upfront. Capital in SPV accrues in tax advantaged way.
   - Reps and Warranties hit this first , no debate, no delay
3. **GSE Wrap (could be Millstein's MIGC concept)**
   - Bond holder looks to GSE for full faith and credit guaranty
   - GSE looks to Originator to remove bad loans from the pool
     - Originator purchases pari passu amount of bonds from pool at lower of market or par
   - If originator fails to perform, GSE can seize servicing rights and margin and reassign to another servicer
   - AAA rating flows from GSE reinsurance guarantee

How to reduce taxpayer risk

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1. **GSEs have reduced maximum loan size**
    - Many MSAs are significantly impacted
    - This was done to "provide market opportunities" for the non-Agency RMBS market
    - This is crushing HPI and increasing taxpayer risk
    - Loan size maximum should remain the same or even increase!
2. **Better Structure: reduce risk over time by having lower <u>inception</u> levels**.
    - Private sector takes more of the first loss every year.
    - GSE starts with bottom 95% of risk
    - Maximum inception point drops by 2-3% every year until it reaches 70% of loan value
3. **Expected Capital reserves in separate insurance SPV**
    - 30% for first 5% loss / 1.5 points
    - 20% for first 10% loss / 2 points
    - 12% for first 30% loss / 3.6 points
4. **MSRs could be the collateral posted at the captive insurance SPV.**
    - Current tax accounting would fit nicely with this structure

Traditional GSE Guarantee vs. Reinsurance

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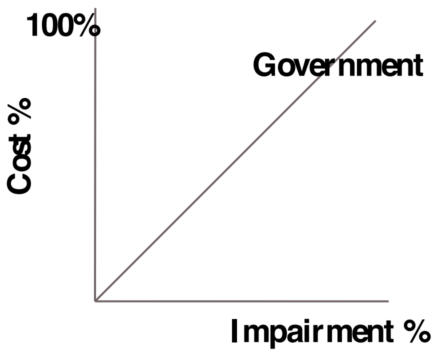
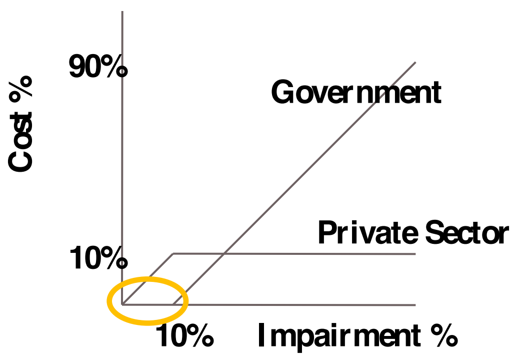
1. Current programs ensure government shoulders all impairment costs (for 100% guaranteed projects) – or pro rata for a partial guarantee (none issued to date)
2. Vast majority of impairments would be less than 10% - thus government needs minimal reserves to provide guarantee
3. **Proposed structure could support much more mortgage lending than existing GSE guarantee programs or support the same amount with significantly less taxpayer risk**

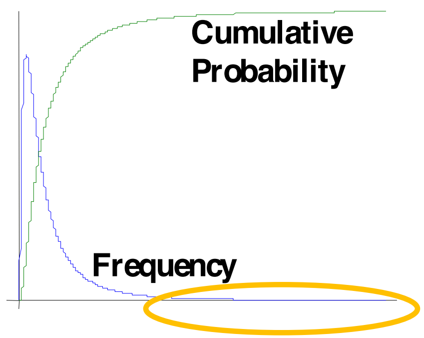
Current GSE Guarantee Program



Proposed Structure



Illustrative Outcome Distribution



Government only has cash outlay in low probability tail risk events

What about the fixes?

Why No Refinancing Wave Despite Historically Low Rates?

1. **Low rates have not resulted in a refinancing boom in the current downturn.**
   - In the fall of 2008, the Fed lowered rates to historic lows. The Fed Purchase Program was designed to make credit more affordable for homeowners.
   - A wave of refinancing applications ensued in early 2009
   - But few refinancings were actually closed, and applications have tailed off
   - At current mortgage rates, prepayment speeds (CPR) should be 60%.
   - Instead CPRs are 20% with FN 3.5s above 104.
2. **Why?**
   - Costs of refinancing above the bond market cost of funds have soared.
   - The rate that existing, performing borrowers actually receive is 50-200 bps higher than the headline 30-year rate. This is poorly understood.
   - Driven by upfront fees charged by the GSEs, uncompetitive mortgage banking industry and mis-categorization of MSRs in Basle III
3. **Impact?**
   - Monetary policy transmission is frustrated by transaction costs.
   - Lower rates do not result in refinancings that increase homeowners' discretionary income
   - This should have become permanent income without affecting the federal budget and creating Riccardian equivalency issues.
   - $67 billion in additional, annual permanent and discretionary income for 25mm systemically important households is lost.

The Dog That Didn't Bark: GSEs and lack of competition

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1. **GSE's are trying to recapitalize themselves while in "conservatorship"**
   - Existing programs attempt to extract premiums from existing current borrowers to offset nonperforming losses.
   - Most borrowers who are current on a GSE guaranteed loan face 2 points of LLPA fees upon a refinancing
   - Charging higher "G-fees" for guaranteeing MBS
   - Every loan is assessed a ¼ point Adverse Market Delivery Charge (AMDC)
   - Additional Loan Level Pricing Adjustments (LLPAs) are charged for low FICO, high LTV, property type, mortgage type, investor property
   - Part of the LLPAs are directed to the struggling mortgage insurance (MI) industry, as the GSEs depend upon MI solvency
2. **Mortgage banking is highly concentrated and uncompetitive**
   - 55% in top 3 originators control the TPO channels
   - Profit margins increased as the competitive mortgage banks have been assimilated into the large, uncompetitive banks
   - Remaining lenders are cautious response to aggressive loan put backs
   - No expansion of staff to deal with surge in demand for refinancing.
     - Staffing levels running less than half of mid-2007 levels
     - Lack of industry capacity led to extraordinary profit margins
3. **Basle III discourages the creation and holding of MSRs**
   - MSRs , once viewed as the only "skin-in-the-game" , have dropped by 70%
   - MSR and loan servicing are being driven out of regulated financial institutions
   - Impact on every new mortgage loan is over 25bp
   - This ruins the traditional mortgage banking model which results in disincentive to participate in mortgage originations market – banks will prefer to be nothing more than large mortgage brokers or focus only on portfolio objectives

Historical Benefits of Refinancing

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1. **Refinancings result in *permanent* annual cost savings to households, not just one-time savings.**
   - Refi wave in 1991/94: 202 bp rate drop, $2.3T mortgage outstanding
     - $47 billion in annual savings.
   - Refi wave in 2001/04: 134 bp rate drop, $5T mortgage outstanding
     - $67 billion in annual savings.
   - Refi wave in 2007/11 with traditional primary/secondary market spread, and with full monetary transmission: 112 bps, $10T mortgage outstanding
     - $112 billion in annual savings.
   - Refi wave in 2007/11 (actual): 45 bp rate drop, $10T mortgage outstanding
     - $45 billion in annual savings.

2. **Growth of primary/secondary market spread has cost US households $67 billion in annual savings. Savings would go to the 25mm households who are current on their existing loans but are unable to refinance due to LLPAs, restrictions on MSRs and less competitive pricing from the big banks.**

HARP 2.0 cannot be successful unless the following occur

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1. **Industry perception about refinance program must be significantly altered**
   - Minor tweaks will reinforce current behavior
   - Probability for success must be materially improved.
   - Need proactive solicitation, borrower response rates will improve with positive publicity
2. **Revised solution must be streamlined and simple to execute**
3. **Industry must have capacity to manage the volume**
   - Open Channels to non-servicer originators
   - Address title, and MI issues
   - Subordinate seconds despite who refinances the first
4. **This risk is already created and owned.**
   - Existing, performing borrowers should not be forced to subsidize deficiency of others
5. **All impediments to success must be removed**
   - LLPAs must be eliminated, compensated with increased Gfees

Economic impact is large!

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1. **11.6 million refinancings** from 22 million FNMA/FHLMC guaranteed loans, increase of more than 140% over baseline
2. **Reduced mortgage payments of over $30 billion/yr**
    1. **lower income borrowers** get over half of the savings
    2. **$16 billion/yr** to borrowers who otherwise would remain in above market-rate mortgages
3. **Improved labor mobility** will reduce unemployment
4. **Large servicers will benefit** from helping households
5. **Add 30-40 basis point guarantee fee on new mortgages** (up from 12.5-15 basis points) to pay for losses on GSE portfolios, loss of R&Ws on loans that prepay
6. **GSEs can be big winners:** fewer defaults and higher guarantee fee

Projected Refinancings

Coupon	Total Balance Outstanding	WAC	WAM	Number of Mortgages	Average Loan Size ($k)	Projected Total Balance Refinanced	Proj. Refis WAC	Proj. Refis WAM	Projected Number of Refinancings
Under 4.00	$ 451,039	3.83	248.94	2,243,729	$ 201	$ 65,639	3.83	248.19	338,884
4.00-4.49	$ 650,767	4.49	293.16	3,499,292	$ 186	$ 249,145	4.51	288.14	1,324,662
4.50-4.99	$ 779,414	4.94	296.05	4,739,704	$ 164	$ 522,660	4.94	296.18	2,941,317
5.00-5.49	$ 564,272	5.50	271.73	4,119,670	$ 137	$ 378,995	5.49	274.67	2,548,975
5.50-5.99	$ 450,882	6.01	264.46	3,492,401	$ 129	$ 289,867	6.01	266.41	2,146,089
6.00-6.49	$ 286,239	6.52	271.41	2,428,848	$ 118	$ 181,058	6.52	273.39	1,469,162
6.50-6.99	$ 92,150	7.00	261.55	1,001,863	$ 92	$ 55,077	7.00	266.12	566,209
7.00-7.49	$ 24,996	7.57	241.52	350,047	$ 71	$ 14,463	7.57	249.15	189,407
7.50-7.99	$ 5,475	8.08	197.22	102,721	$ 53	$ 2,867	8.08	204.24	50,672
8.00 and Above	$ 3,635	8.89	158.08	184,928	$ 20	$ 1,795	8.88	161.17	89,206
Total	$ 3,308,869	5.16	242.62	22,163,203	$ 149	$ 1,761,566	5.39	245.66	11,664,584

Winners and Losers

	Fed & Treasury	Banks & Mortgage Bankers	R&W Substitute Fund	GSEs	Other Investors	Homeowner PV of First 5 Years (After tax)	Homeowner PV of First 10 Years (After tax)	Total w/ 10 Year PV
Gains	$ -	$ 57,919	$ -	$ 13,434	$ -	$ 65,705	$ 124,421	$ 195,773
Opportunity Costs	$ (20,820)	$ (14,619)	$ -	$ -	$ -	$ -	$ -	$ (35,439)
Losses	$ -	$ (12,389)	$ -	$ (14,504)	$ (34,918)	$ -	$ -	$ (61,810)
Other	$ -	$ 4,340	$ 8,720	$ 25,146	$ 8,796	$ -	$ -	$ 38,281
Net Impact:	$ (20,820)	$ 35,251		$ 24,075	$ (26,122)	$ 65,705	$ 124,421	$ 136,805

The economy is the winner

1. CBO estimates large offset in terms of **lower defaults** (stabilize housing market)
2. **Helps reduce mortgage frictions** for new borrowers…this will bring new buyers into the housing market, increasing demand for housing
3. **Liquidity constrained borrowers likely to increase spending** (with a smaller offset in terms of reduced spending by bondholders)
4. **Equivalent of a permanent tax cut**—with higher marginal propensity to consume
5. **One of few options to stimulate growth and help housing without budget impact**
6. What will the housing market look like if we do nothing? **Without these steps, credit for housing will remain impaired**, impacting new purchases, not just refis
7. **Facilitates wind down or recasting GSEs** by removing retained portfolio