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Changes to Loan Limits, the Return of Private Capital and the Future of the Secondary Mortgage Market

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Absalon Project

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Outline

1. **Changes to Loan Limits**
   - Implemented as of September 30th….most large originators changed pricing on July 2nd
   - Average impact is low, but significant impact in certain geographic areas
   - Continuation of trend to punish households for past sins committed by the GSEs, originators, ratings agencies, regulators and bond investors
2. **Return of Private Capital**
   - Bank Portfolio bid is way through secondary market execution levels
   - SEMT 2011-2 deal: more marketing than market
   - Purely private outcomes lack scale and are strongly pro-cyclical
   - Some "noise" about the quality of Jumbo Prime mortgages (Fitch and Markit)
3. **Future of Secondary Market**
   - Historically high delinquency and defaults continue into their 5th year
   - Voluntary prepayments limited by poorly understood frictions
     - LLPAs imposed by the GSEs
     - Lack of capacity and competition in a more concentrated origination industry
     - MSRs severely and unfairly punished by Basel III
   - Main monetary policy transmission mechanism has been broken
   - Talk of "streamlined refi" has put some uncertainty into the market

Outcomes for Loans Current in January 2007

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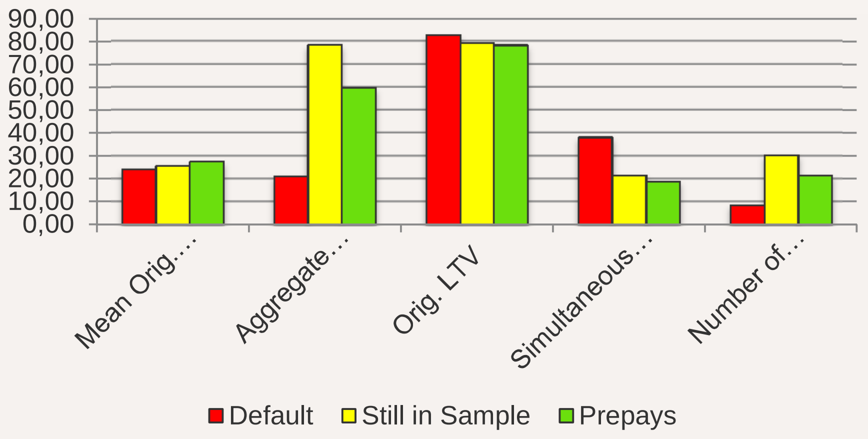
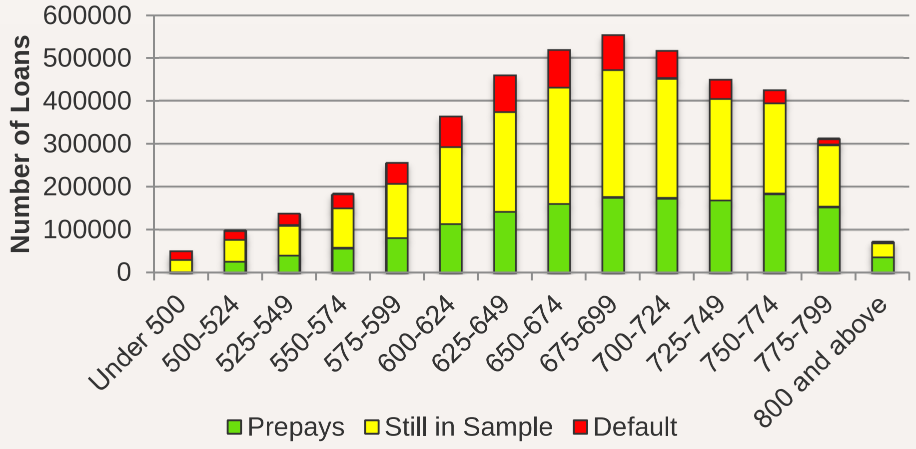
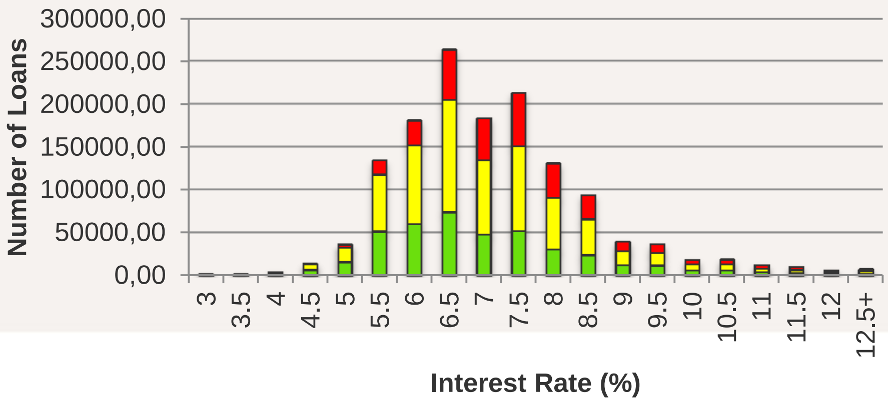
Summary Statistics



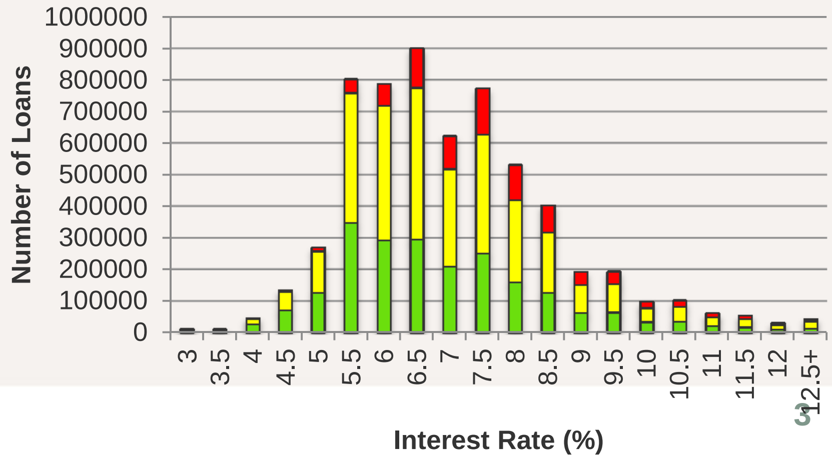
By FICO Score



By Int. Rate - Loans with Seconds

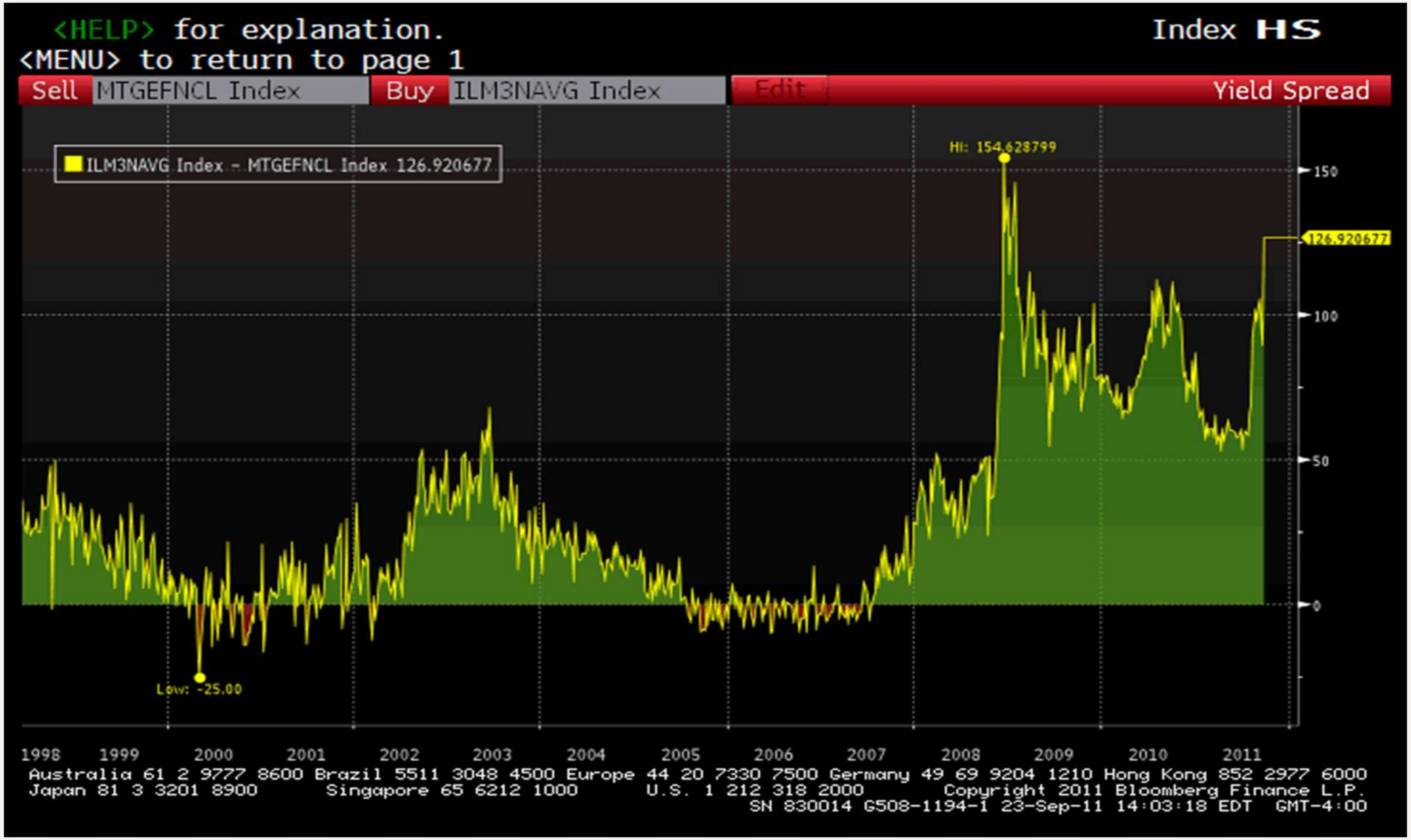


By Int. Rate – All Loans

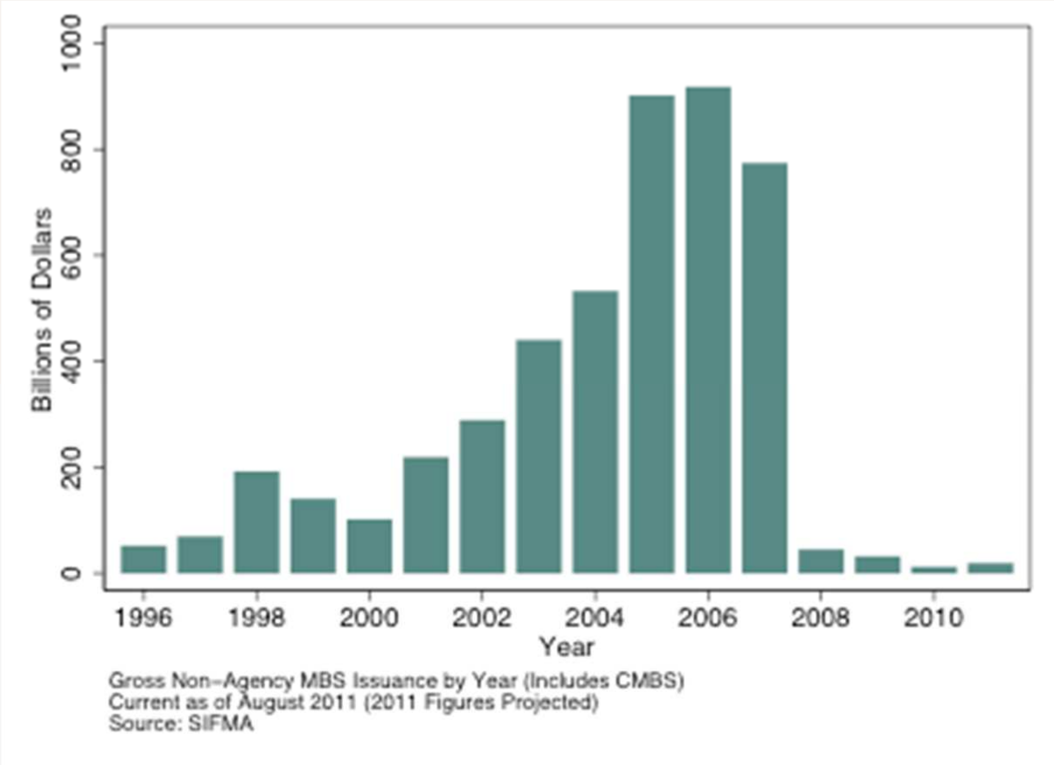


Source: BlackBox Logic

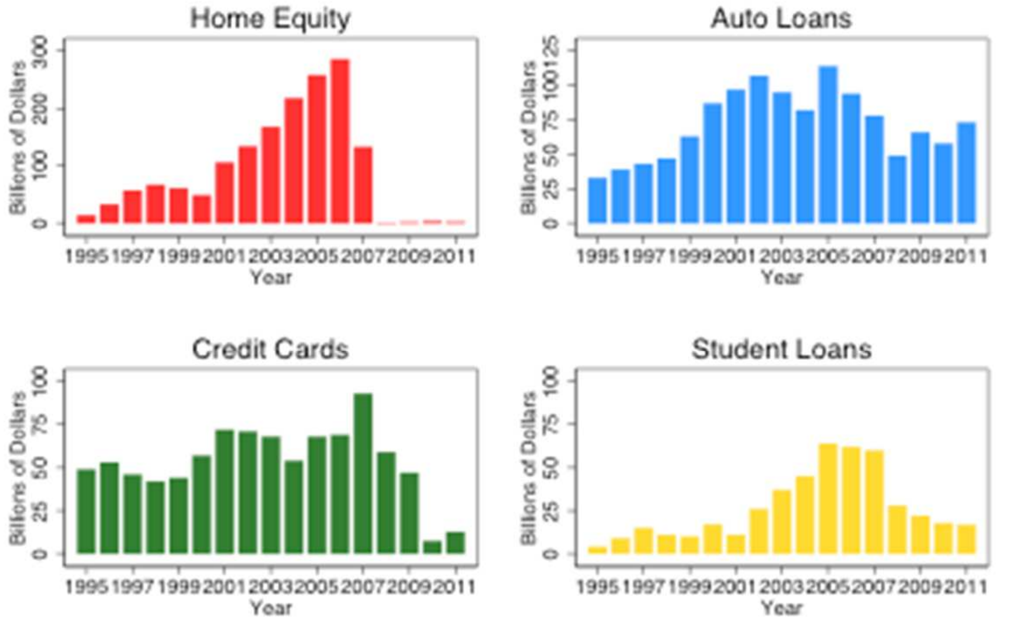
Primary/Secondary Spread



Non-agency MBS issuance has disappeared

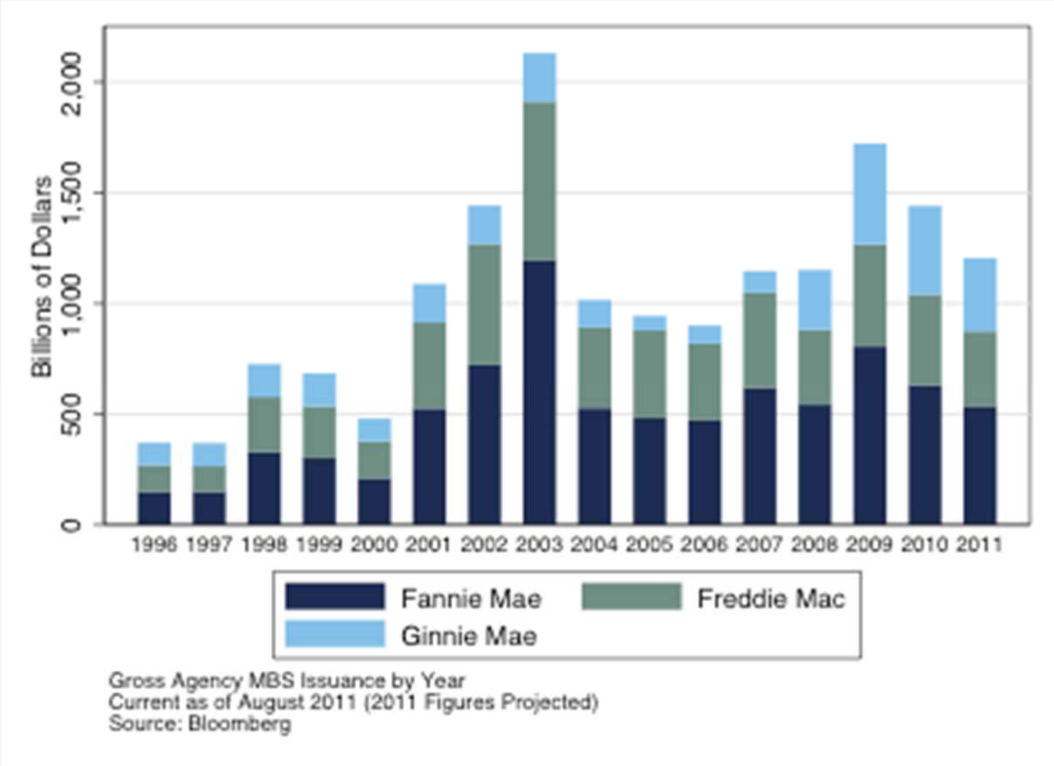


Other ABS Issuance has also Dropped



Gross Issuance of Home Equity, Auto, Credit Card and Student Loan ABS by Year
Current as of August 2011
Source: Bloomberg

Agency MBS issuance is 95% of Originations



Impact of drop in Agency loan limits

- **GROUP 1 (drop of $110,000 or larger)**: See next slide for details
  - $320 billion balances /1.2 million loans outstanding.
  - 11.3% already ineligible, another 9.7% of balances become ineligible.
- **GROUP 2 - WEST (drop of $100,000-$109,999 - CA, CO, ID)**:
  - $897 billion / 3 million loans outstanding.
  - 13.8% were ineligible already, another 8% becomes ineligible.
- **GROUP 2 - NORTHEAST (drop of $100,000-$109,999 - MA, NY, NJ):**
  - $488 billion / 2 million loans outstanding.
  - 8.5% were ineligible already, and 4% become ineligible.
- **GROUP 2 - MID ATLANTIC (drop of $100,000-$109,999 – DC, MD, VA, NC):**
  - $261 billion / 1 million loans outstanding.
  - 5.1% were ineligible already, and 4.7% become ineligible.
- **GROUP 3 (drop of $50,000-$99,999)**:
  - $569 billion / 2.7 million loans outstanding.
  - 8.3% were ineligible already, and 4.8% become ineligible.

Impact of Drop by Worst 12 Counties

County Name	State	One-Unit Limit	Percent Change	Change One-Unit Limit	County Population
MONTEREY	CA	$483,000	-33.8%	-$246,750	415,057
MONROE	FL	$529,000	-27.5%	-$200,750	73,090
SAN JUAN	PR	$417,000	-31.2%	-$189,250	3,966,000
MAUI	HI	$626,750	-20.7%	-$163,250	154,834
SAN DIEGO	CA	$546,250	-21.7%	-$151,250	3,095,313
SONOMA	CA	$520,950	-21.4%	-$141,550	483,878
SOLANO	CA	$417,000	-25.2%	-$140,500	413,344
NAPA	CA	$592,250	-18.8%	-$137,500	136,484
FAIRFIELD	CT	$575,000	-18.9%	-$133,750	916,829
VENTURA	CA	$598,000	-18.1%	-$131,750	823,318
SALT LAKE	UT	$600,300	-17.7%	-$129,450	1,029,655
SAN LUIS OBISPO	CA	$561,200	-18.4%	-$126,300	269,637

Impact of the Redwood Trust REMIC

- Redwood Trust has done its third RMBS transaction: REMT 2011-2
- Geographic concentration leads to fears of earthquake risk
- Super high quality loans justify subordination of only 7.5%
  - 773 FICO/64.2% CLTV/$952k average loan size
- Moody's was NOT asked to rate this deal
- Market based pricing?
  - Senior bonds priced +100 to Agency passthrus, widened since
  - Subs all went to the REIT, not subject to market pricing
  - Overall execution 1-2 points better than secondary market for similar RMBS
  - Still behind bank portfolio execution for the lucky few
- PrimeX is moving in the opposite direction (see next two slides)

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PrimeX ARMs at LIBOR + 450

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PrimeX Fixed has Underperformed by 10 pts

What happens with a “no GSE solution”

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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

Cost of Mortgages (ADCO)

	Full Gov't	Equity Only	Mezz and Equity	Private
Gov't Guarantee (5.00%)	100%	95%	95%	0%
Private Senior (5.50%)	0%	0%	0%	95%
Private Mezz (8.0%)	0%	0%	3%	3%
Equity (25%)	0%	5%	2%	2%
All in Cost	5.00%	6.00%	5.49%	5.97%
Stress Scenario	4.00%	6.33%	5.16%	7.51%

- This assumes perfect borrower (60 LTV/760 FICO, owner occupied)
- Imperfect borrower will be subject to private markets rate adds similar to existing agency market
- Purely private model will be very pro-cyclical in stress scenario
  - Gov't cash flows -100
  - Cost of equity doubles
  - Cost of Mezz increases 50%
  - Cost of PLS AAA rises 150bp
- The Stress Scenario is what has happened since March
  - Agency rates down
  - Non-agency rates up

A Different Model for Risk Sharing

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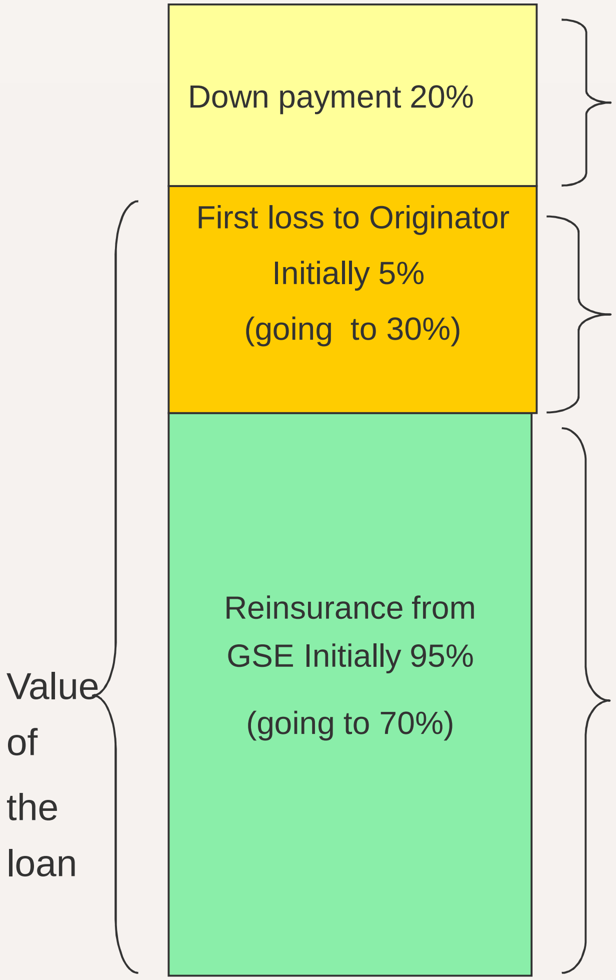


- Level 1: Quality Mortgage Loans
  - Minimum Down Payment, no second liens
  - Strict UW Standards and Appraisal Requirements
  - Full Recourse to borrower
- Level 2: Separately Capitalized Originator Insurance
  - Subordination based on extreme stress scenarios
  - Standardized structures capitalized 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
- Level 3: GSE Wrap
  - 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

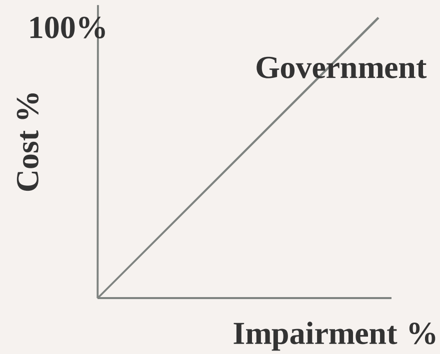
How to reduce taxpayer risk

- The private RMBS market continues to fail to materialize
- GSEs have reduced maximum loan size, significantly effecting many MSAs
  - This was done to “provide market opportunities” for the non-Agency RMBS
  - This will crush HPI and increase taxpayer risk
  - Loan size maximum should remain the same or even increase!
- Better Structure: reduce risk over time by having lower <u>inception</u> levels for taxpayers.
  - Private sector takes more of the first loss every year.
  - GSE starts with bottom 95% of risk
  - Maximum inception point drops by 2-5% every year until it reaches 70% of loan value
- 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
- MSRs could be the collateral posted at the captive insurance SPV
  - Current tax accounting would fit nicely with this structure

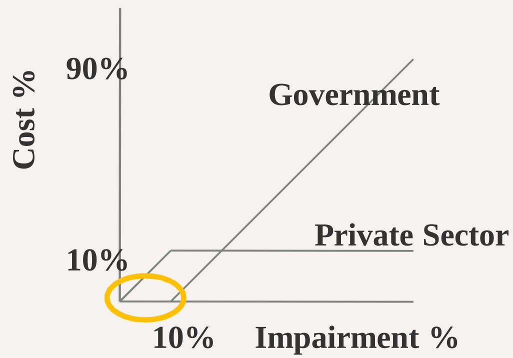
Traditional GSE Guarantee vs. Reinsurance

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

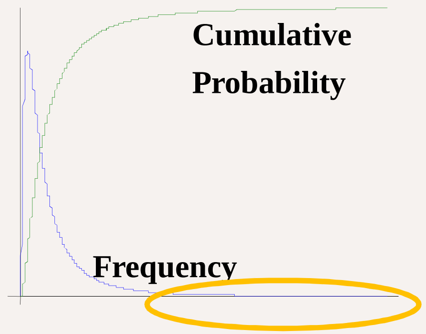
Current GSE Guarantee Program



Proposed Structure

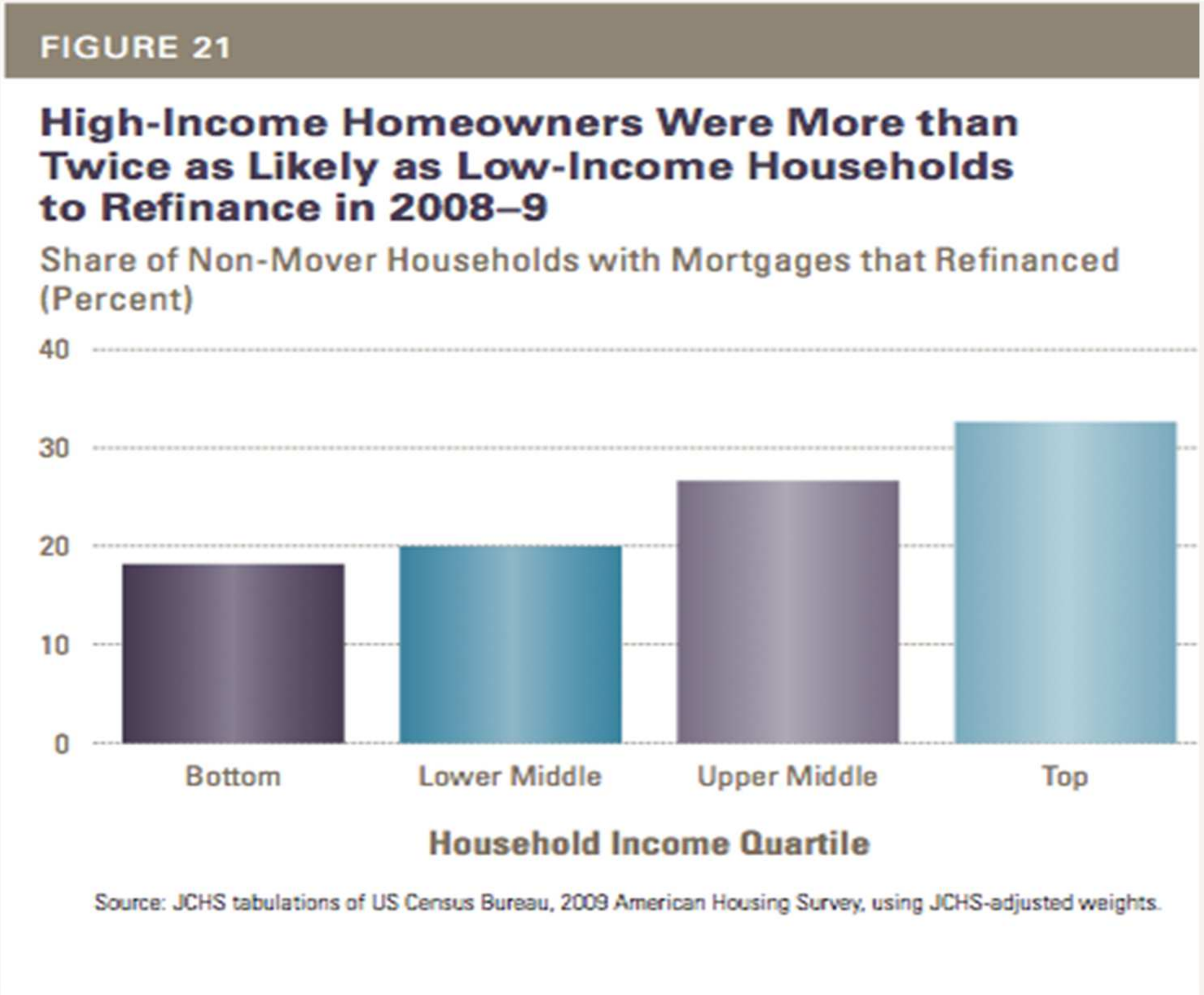


Illustrative Outcome Distribution



Government only has cash outlay in low probability tail risk events

Refis went to the people who did not need help



September Prepayments (30yr Fannies)

Coupon	Issue Year	Balance ($mm)	August CPR	Sept CPR	Percent Change	WAC	WAM	Age	Number of Loans	Loan Size ($k)
4	2010	$ 112,268	7	18	157%	4.50	346	11	478,932	$ 234
4	2009	$ 102,559	10	23	130%	4.58	326	27	441,000	$ 233
4.5	2010	$ 124,074	10	20	100%	4.94	341	15	575,112	$ 216
4.5	2009	$ 227,494	15	27	80%	4.95	327	27	1,054,103	$ 216
5	2009	$ 68,970	17	22	29%	5.46	317	35	408,555	$ 169
5	2005	$ 51,126	22	23	5%	5.62	278	74	301,666	$ 169
5.5	2008	$ 64,670	26	24	-8%	6.03	312	42	350,597	$ 184
5.5	2005	$ 45,412	20	20	0%	5.97	278	74	321,435	$ 141
6	2007	$ 62,204	24	23	-4%	6.57	305	49	387,696	$ 160
6	2006	$ 43,234	24	22	-8%	6.55	291	62	281,420	$ 154
6.5	2007	$ 16,477	23	20	-13%	7.06	305	49	128,681	$ 128
6.5	2006	$ 16,562	22	20	-9%	7.00	292	62	133,653	$ 124

What should we do?

- **Market mortgage rates; today likely below 4%**
- **Require FHFA to direct GSEs to use all tools available to stimulate refinancings**
  - Eliminate LLPAs for the refinance of ALL loans currently guaranteed by the GSEs
  - Eliminate the 25bp "Adverse Market Fee"
  - Eliminate appraisals and paperwork as part of a new "Super-Streamlined" refinance program
  - Requirement: being current on existing mortgage that is guaranteed by the taxpayers

What should we do?

- **Create independent trustee** to manage wind down of GSE portfolio of MBS so portfolio considerations do not drive lending decisions

- **Create fund** managed by independent trustee to adjudicate claims of reps and warranties violations by GSEs and MIs (funded by refi proceeds and banks)

- **Require MIs to make policies portable** for new refis to allow competition between originators

- **Give existing lenders a short period to offer to their customers**, then open for competition

Economic impact is large!

- **25 million new refinancings** from 32 million tax payer backed loans
- **Reduced mortgage payments of about $51 billion**
  - **lower income borrowers** get over half of the savings
  - **underwater borrowers** at greatest risk of default
- **Improved labor mobility** will reduce unemployment
- **Large servicers will benefit** from helping households
- **Add 40 basis point guarantee fee on new mortgages** (up from 15-25 basis points) to pay for losses on GSE portfolios, loss of R&Ws on loans that prepay
- **GSEs can be big winners** under any new deal, with fewer defaults and foreclosures and higher guarantee fee

The economy is the winner

- CBO estimates large offset in terms of **lower defaults** (stabilize housing market)
- **Helps reduce mortgage frictions** for new borrowers…this will bring new buyers into the housing market, increasing demand for housing
- **Liquidity constrained borrowers likely to increase spending** (with a smaller offset in terms of reduced spending by bondholders)
- **Equivalent of a permanent tax cut**—with higher marginal propensity to consume
- **One of few options to stimulate growth and help housing without budget impact**
- 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
- **Facilitates wind down or recasting GSEs** by removing retained portfolio