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Plan B: A Comprehensive Approach to Moving Housing, Households and the Economy Forward

April 4, 2011

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Executive Summary

The mortgage crisis can and must be stopped now before it further damages the housing market and the overall economy. We propose the following five-point plan to address the problems created in the 2003-2008 bubble period and to restore the housing finance system to the health enjoyed in the previous 40 years:

1. Restore the flow of mortgage credit to all worthy borrowers for a sustained economic and housing recovery;
2. Maintain the critical role of FNMA and FHLMC or a successor entity to promote the future health of the housing and mortgage market at a balanced and appropriate level. The moral hazard inherent in the profit motivation currently a part of the government-sponsored agency structure must be eliminated;
3. Help improve servicers' performance and provide safe harbor for servicers and investors to allow for securitization of well-underwritten loans to funnel capital to housing finance;
4. Enable debt reduction for qualified borrowers to set them on the path to sustainable homeownership. This will require recognition of the loss to second lien mortgages and home equity lines of credit;
5. Implement strategies to reduce REO and absorb excess inventory.

Regulators are now considering risk retention rules and determining what qualifies as a Qualified Residential Mortgage, taking into consideration underwriting and product features that result in a lower risk of default. This report was written in anticipation of and in advance of the publication of the QRM which incorporates many valuable reforms, but creates a series of significant issues which we will comment on in separate publications.

Nearly $20 trillion in mortgages were originated between 2003 and 2008 when credit was the easiest in 50 years. The private sector drove the expansion of weakly underwritten instruments and resulting private-label securitizations pulled market share from the government agencies. The industry expanded products offered: subprime, Alt-A and option ARMs. It also expanded loan processing options including qualifying borrowers on minimum payment options or initial rates, no or limited documentation and short-form appraisals. As the pressure for creating earnings increased, the agencies lowered their credit and other standards to compete and purchased risky RMBS securities.

Restore the Flow of Mortgage Credit

We need to restore the flow of mortgage credit on reasonable terms to the mass housing market so the households who are prepared to buy a house can qualify for a loan. The bottom of the cycle is historically the best time to lend. In the current bottom, private players have failed to return to active lending. More problematic, government lending is excessively tight.

Maintain the Critical Role of FNMA and FHLMC or a Successor Entity

Some form of federal government intervention is necessary for the intermediation of mortgage credit for the public good. Without government intervention, we would return to a world where households cannot reliably access housing finance. The private sector cannot deliver equal access since the mortgage finance business is not equally profitable across the country. It requires a public effort to make mortgages equally accessible. A fully priced government insurance scheme to assist in the securitization of middle income, conservatively underwritten, fixed rate mortgages is desirable. The government as a lender of last resort in a credit crisis is also desirable.

Help Improve Servicers' Performance and Provide Safe Harbor

Servicers are structurally ill-equipped to deal with the current crisis and need to be relieved of the situation. The servicing building model is based on repeat, low-touch transactions. The current crisis requires customized, high-touch handling of each individual problem. Neither the staffing nor compensation structure of servicers is designed to meet this need; therefore, the bifurcation of servicing into regular servicing and customized special servicing is necessary. Special servicers should be required to invest in hiring and training staff to assign a single point of contact for struggling homeowners and move forward with loan modifications. We urge that a safe harbor is required to protect servicers and investors and to encourage their participation in mortgage finance going forward.

Enable Debt Reduction for Qualified Borrowers

A complete loan modification program must be implemented. Doing nothing, at this point, is more costly to taxpayers, banks, agencies and households, than taking action. We need a plan that addresses total household debt. Loan modifications should be done where:

- There is true financial need;
- The borrower behaved responsibly;
- The borrower has a history of financial responsibility and hard work.

If private financial institutions are not able to gain traction in executing the above necessary strategies, the solution may be simply to look to the past and create an updated version of the Home Owner's Loan Corporation used in the Great Depression.

As a fundamental principal of mortgage finance, if the first mortgage is underwater, the second mortgage has minimal value. Due to the high level of potential write-downs, this is not how banks are handling delinquent second mortgages. Going forward, everything accomplished to date in Dodd-Frank or Basel II would be undone by second mortgages levering up new loans even under QRM guidelines.

Implement Strategies to Reduce REO and Absorb Excess Inventory

To date in the mortgage crisis, an estimated 3 million homes have been foreclosed and a like amount is seriously delinquent. An estimated 10 million residential mortgages have negative equity. The crisis has left an unprecedented number of vacant homes, vulnerable to vandalism and neglect, putting downward pressure on values in the surrounding neighborhood. These homes create a tremendous opportunity to provide housing to needy households. We recommend two programs to facilitate the re-use of vacant homes: 1. Rent-to-Own; and 2. Investor Finance.

The Problem

Excessively easy mortgage credit caused the mortgage crisis. Between 2003 and 2008, a plethora of subprime, Alt-A and negative amortization mortgages were originated. Nearly $20 trillion in mortgages were originated in this period when credit was the easiest in 50 years. It wasn't just the proliferation of new loan products, but the addition of new approaches to loan processing that resulted in the creation of mortgages destined to fail. Subprime loans, for example, were offered with short-term ARMs to increase the number of borrowers who qualified at the initial rate. At origination, it was obvious that the borrower would not have qualified at the anticipated reset rate. In addition, underwriting either ignored the need to escrow taxes and insurance or disregarded such expenses. As with subprime, underwriting for Option ARMs relied on qualifying borrowers for the minimum payment option only. Low- and no-documentation (liar loans) was prevalent in underwriting Alt-A loans and loans with loan-to-value ratios above agency limits. Across all loan products, short-form appraisals were used, including drive-bys in lieu of interior evaluations and, in some cases, automated valuation models.

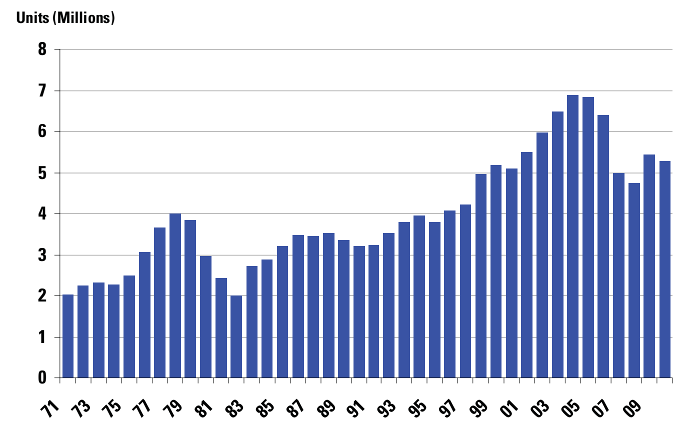
In most cases given the financial wherewithal of the borrower, the deceptive as well as onerous credit terms, and the layering of risk, these mortgages were destined to fail (Figure 1). After decades of solid performance by 30-year, fixed-rate mortgages and mortgage-backed securities, the weakening of underwriting and expansion of loan terms set the stage for the subsequent, predictable crisis.

Figure 1: Incremental Foreclosure Risk by Loan Attribute

Negatively Amortizing ARM	3-4 times
Reduced Documentation	3 times
Subprime Credit	2-3 times
Non-owner Occupied	2-3 times
Amortizing ARM	1.5-2 times
Over 45% total debt-to-income	1.5 times
Cash-out refinance	1.5 times

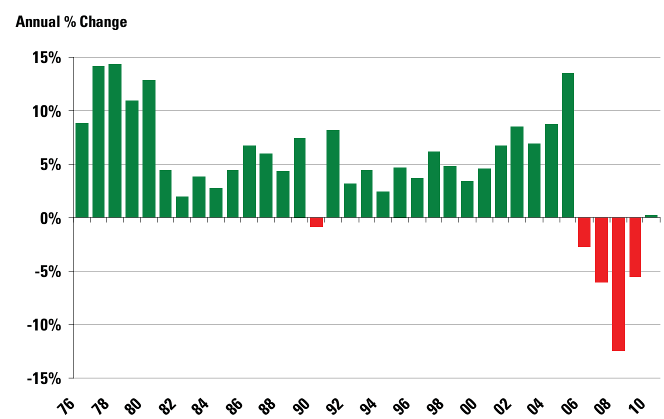
Source: MGIC

Figure 2: U.S. Existing Single Family Home Sales



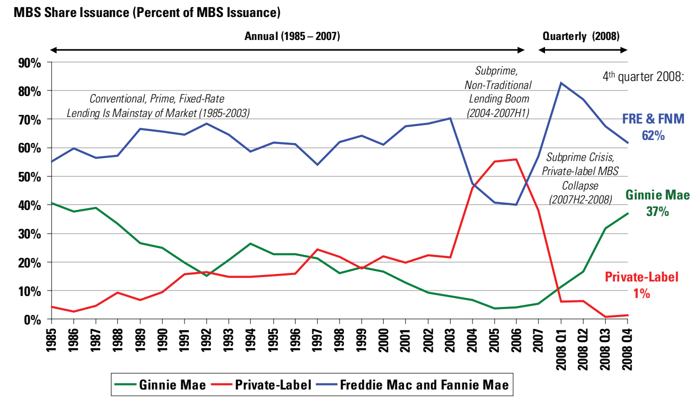
Latest data as of December 2010; Seasonally adjusted annualized rate; 2011 data are forecasted
Sources: NAR, RCG

Figure 3: U.S. Existing Median Home Price Appreciation



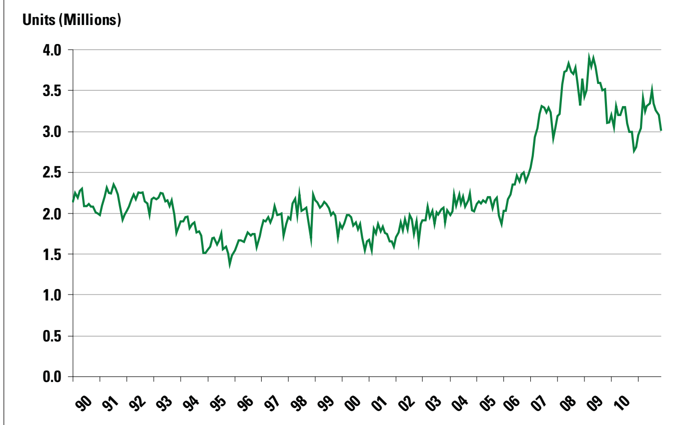
Note: Annual figures are 4Q vs. 4Q
Sources: NAR, RCG

Figure 4: GSE & GNMA Market Share



Source: Inside MBS & ABS (The 2008 Mortgage Market Statistical Annual - Volume II), Inside MBS & ABS (April 25, 2005, July 11, 2008 issues, and January 9, 2009).

Figure 6: U.S. Existing Single Family Housing Inventory



Latest data as of December 2010
Source: NAR

The easy credit led to a rise in both owner-occupied and speculative purchases that fed unprecedented house price appreciation (Figures 2 and 3). Homeowners reached for larger homes in more prestigious neighborhoods. Investors took advantage of low-risk terms to acquire multiple homes relying on anticipated re-sale to meet payments. According to 1010data, at least 20% of mortgages in 2004-2008 securitized non-agency mortgage pools were either to investors or to borrowers who vacated without paying off the loan. Both owner occupants and speculators were hurt by the subsequent 24% drop in house prices[1]. Also associated with this boom period was the expanded use of second mortgages as substitute for more traditional forms of low down payment loans such as FHA and mortgage insurance, as well as a mechanism to cash-out equity.

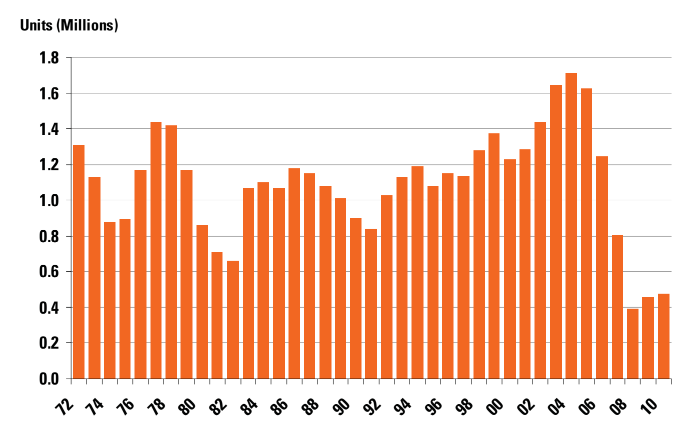
The private sector drove the expansion of the weakly underwritten instruments and resulting private-label securitizations (Figure 4). Regulators allowed for this growth with little comment. As the non-agency business grew, it pulled market share from the government agencies. As the pressure for creating earnings increased, the agencies lowered their standards to compete. The moral hazard that had been inherent in the structure of these privately-held, government-sponsored agencies was fully revealed. While the agencies have a clear public function to intermediate private mortgage originations, the revenue generated by this activity benefits the shareholders. This created a moral hazard for the management and board of directors of these entities. For the first 35 years, the moral hazard did not impair either the public or private purpose of these agencies. At the turn of the 21st century, this hazard became apparent. During the bubble period, profits were privatized while risk was socialized.

In the aftermath, the housing and mortgage markets face multiple interconnected problems:

- High foreclosure and delinquency rates on poorly structured mortgages given to high credit-risk borrowers;
- Underwater mortgages resulting from homes purchased at peak prices prior to the 24% drop in house prices;
- House prices declines of more than 30% in many markets;
- Sharply lower housing starts, flagging existing home sales

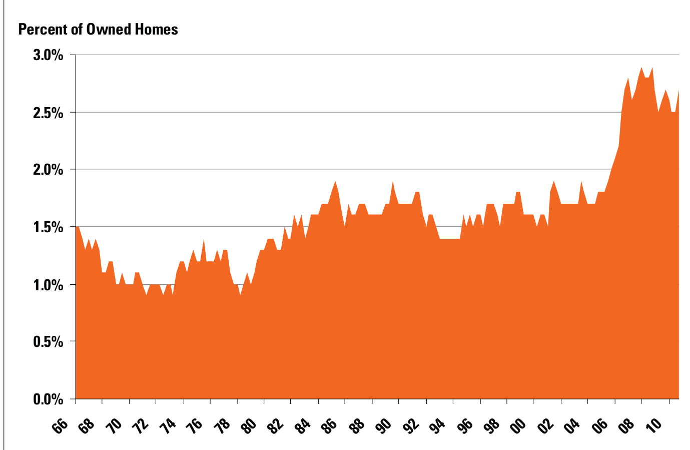
1 *As measured by the National Association of Realtors. S&P Case Shiller Home Price Indices reported a 30% peak to trough decline in house prices and the Federal Housing Finance Agency house price index reported an 11% peak to trough decline as of 2010.*

Figure 5: U.S. Single Family Housing Starts



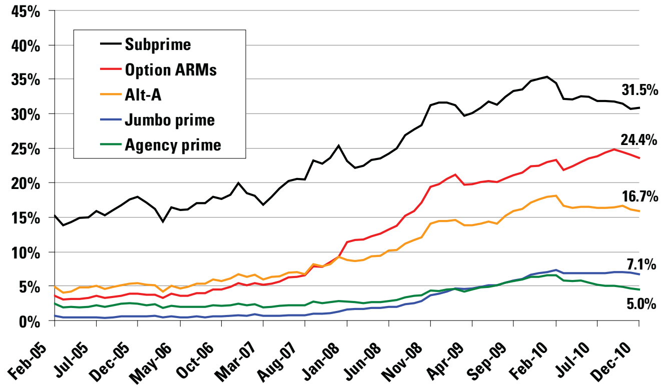
Sources: Census, RCG

Figure 7: Percentage of Housing Stock Vacant



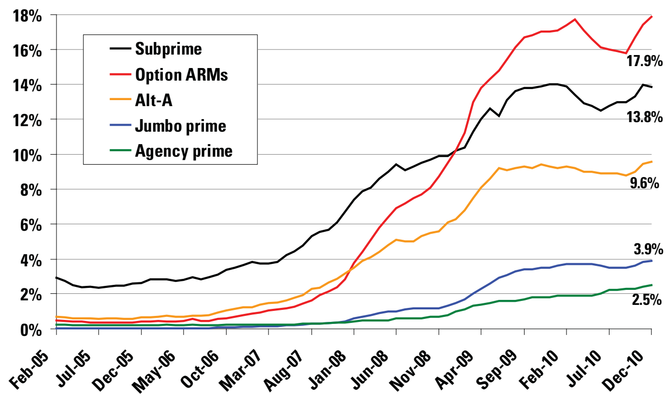
Source: Census

Figure 8: Total Loans Past Due 30+ Days



Note: Does not include foreclosures
Latest data as of December 2010
Sources: LPS Applied Analytics, RCG

Figure 9: Mortgage Foreclosures in Process by Loan Type



Latest data as of December 2010
Sources: LPS Applied Analytics, RCG

Figure 10: Delinquent Loans by Type

Loan Type	Delinquent	Seriously Delinquent
Prime	396,214	781,237
Alt-A	231,098	384,300
Subprime	252,136	481,784
Other	181,798	272,869
Total	**1,061,246**	**1,920,190**

Source: Comptroller of the Currency, U.S. Treasury Department

(post-tax credit), and a large inventory of unsold homes (Figures 5, 6, and 7);

- Excessively tight mortgage credit, particularly for lower income and minority households;
- Much tighter underwriting standards and high down-payment requirements reducing the potential homebuyer pool dramatically.

Delinquency and foreclosure rates have soared since 2008 (Figures 8 and 9). Delinquent non-prime loans are characterized by weak underwriting, loose loan terms and mortgage balances reflective of boom-era pricing. In some instances, low documentation policies allowed borrowers to lie about their income. Frequently, however, even under their stated income, these borrowers would not have been able to make the mortgage payments after the teaser rate expired and the balloon payment came due. Underwriting weakness was compounded by a layering of multiple risk factors. Despite obvious credit weakness, the following loan types were made for the fees generated by origination and securitization, with too little regard to the inherent risk in such lending (Figure 10).

- Subprime
- Alt-A
- Option ARMs
- Negative Amortization

Delinquent prime loans are largely characterized by income impairment from loss of employment and by house prices falling below mortgage balances (i.e. strategic default). In this sector too however, in the boom period, low-document and alternative risky structures were also originated.

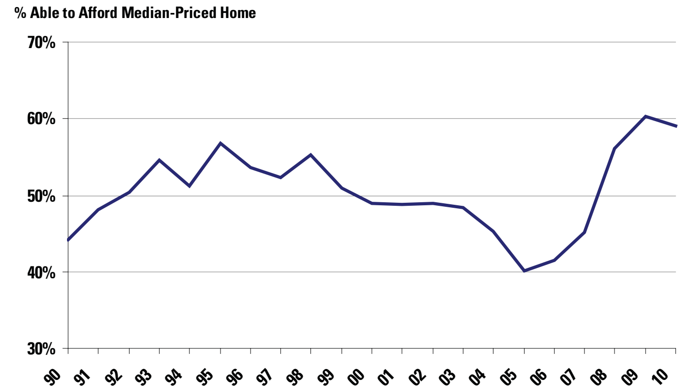
Second Loans and home equity lines of credit, both prime and non-prime, are characterized by a combination of the above problems. The vast majority of these loans are sitting behind delinquent first mortgages with 100% or greater loan-to-value ratios, rendering the second mortgages nearly worthless.

Figure 11: Mortgage Loan Portfolio as of September 30, 2010

Number of Mortgages in the Portfolio	Total		GSE		Rest of Market	
Current and Performing Loans	29,143,015	87.4%	18,877,065	92.3%	10,265,950	79.8%
Delinquent Loans	1,061,246	3.2%	444,871	2.2%	616,375	4.8%
Seriously Delinquent Loans	1,920,190	5.8%	636,193	3.1%	1,283,997	10.0%
Foreclosures in Process	1,201,622	3.6%	502,019	2.5%	699,603	5.4%
Total	**33,326,073**		**20,460,148**		**12,865,925**	

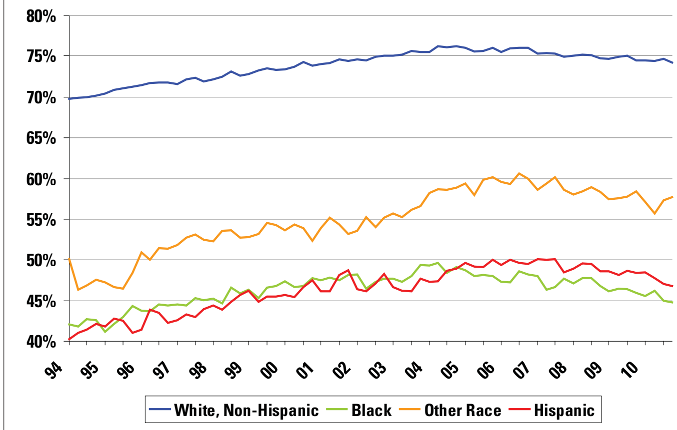
Source: Comptroller of the Currency, U.S. Treasury Department

Figure 12: Housing Affordability – United States



Note: RCG Universe of MSAs; Affordability is defined as the share of households that are able to afford the median-priced home in a given metropolitan area assuming a 20% down payment and a 30-year fixed rate mortgage at current mortgage rates.
Latest data as of 4Q10
Sources: RCG, CAR, NAR, FAR, Census

Figure 13: Homeownership Rate by Race and Ethnicity



Source: Census

The problem is sizeable and split between the public and private sectors. According to the Federal Reserve, the home mortgage market totaled $10.5 trillion, as of the fourth quarter of 2010:

- Government agencies hold $5.7 trillion;
- Banks, savings institutions and credit unions hold nearly $3.0 trillion in first and second liens including near $1 trillion in home equity loans;
- Private asset-backed securities issuers hold $1.3 trillion.

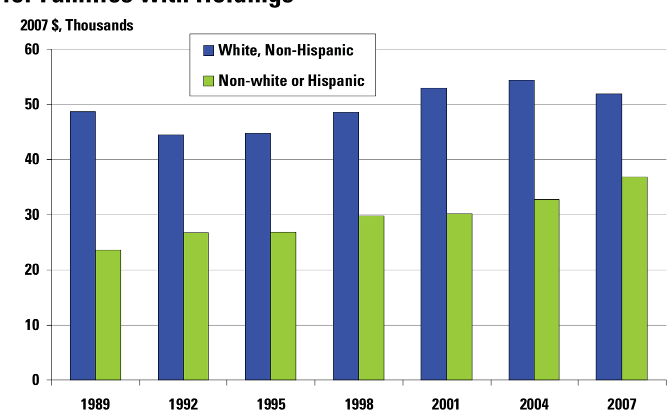
According to Amherst Securities and Core Logic, private-label MBS includes.

- $354 billion subprime;
- $389 billion Alt-A;
- $173 billion Option ARMs;
- $293 billion Prime.

The Office of the Comptroller of the Currency reports 4.2 million loans are currently delinquent or in process of foreclosure (Figure 11). While a portion of these are included in First American Core Logic's count of underwater mortgages, the total underwater now measures 11.1 million mortgages or 23.1% of all mortgages. An additional 2.4 million mortgages were nearly underwater or 5% of all mortgages as of the fourth quarter of 2010. Delinquencies are pervasive in both the GSE and overall market portfolios. According to the Office of the Comptroller of the Currency, the GSEs outperform the rest of the market due to a higher volume of prime loans. Severely delinquent loans are not isolated in the weaker credit categories. Problems are pervasive due to the combined negative impact of job losses and falling prices.

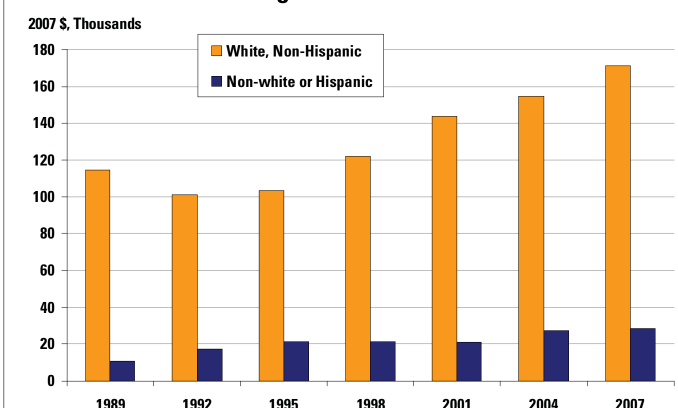
There are a number of short and long run solutions critical to the resolution of these problems. Time alone will not cure, but magnify the damage to hard-working American households struggling under the weight of outsized debt. The weight of foreclosed and foreclosing homes on the market is eating away at the equity of people who are paying their mortgages and those having trouble alike. Neighborhoods and communities are being decimated by vacant and deteriorating houses. The problem is not isolated in low-income communities, but has been documented in communities at all income levels across the country. Action is needed to put a floor under house prices and to re-awaken the housing and mortgage market. Inaction will impair the recovery of the housing market and the growth of the national economy.

Figure 14: Median Value of Before-Tax Family Income for Families with Holdings



Note: Holdings represent assets or debts; Debt includes secured residential properties, installment loans, credit card balances, lines of credit not secured by residential property and other debts.
Source: Federal Reserve Board, Survey of Consumer Finance

Figure 15: Median Value of Net Worth for Families with Holdings



Note: Holdings represent assets or debts; Debt includes secured residential properties, installment loans, credit card balances, lines of credit not secured by residential property and other debts.
Source: Federal Reserve Board, Survey of Consumer Finance

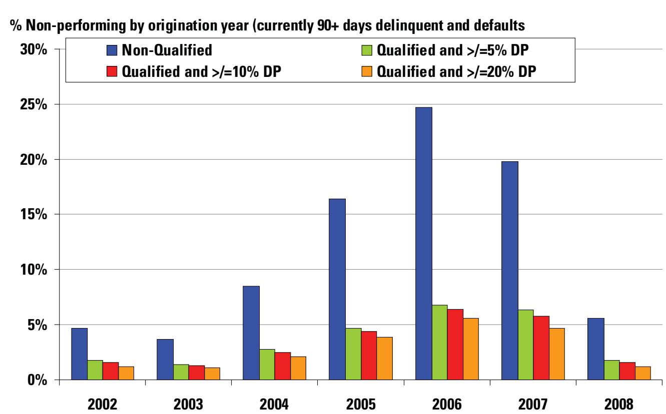
What Must Be Done

Restore the Flow of Mortgage Credit

We need to restore the flow of mortgage credit on reasonable terms to the mass housing market so the qualified households who are prepared to buy a house can qualify for a loan. We have moved from having the easiest mortgage credit environment in the 2003-2008 period to having the tightest mortgage credit environment in decades. Affordability is currently at the highest level in decades (Figure 12). Mortgage credit, however, is unduly restricted. The bottom of the cycle is historically the best time to lend. In the current bottom, private players have failed to return to active lending.

Banks and the GSEs in concert with the FHA must be encouraged to return to active lending for all worthy borrowers. Banks are wrong to lobby for high FICO limits for FHA and higher loan-to-value ratios. We are concerned that this will eliminate otherwise qualified borrowers with lower incomes and, in particular, African-American and Hispanic borrowers. As it is, there is a wide spread between homeownership rates for Whites and minorities. While 74% of White households own a home, only 45% of Black and 47% of Hispanic households own homes (Figure 13). This rate, in fact has slipped from a high of 49% for Black households and 50% for Hispanic households during the easy credit era. Delinquencies are highly concentrated in low-income minority neighborhoods where high-cost lending had dominated. Homeownership among households in the bottom income quartile, according to the Joint Center for Housing Studies of Harvard University, fell almost twice as much as for higher-income households between 2005 and 2009. The lower-income quartile had gained 6 percentage points between 1995 and 2005, but quickly lost that gain as the bubble burst. Figures 14 and 15 illustrate the disparity in income and net worth between White and Non-white families.

Figure 16: Downpayment Impact on Qualified Loans



Qualified criteria: Fully documented income and assets, maximum 30-year term, total DTI </=41%, fixed or 7+ year ARMs; Loans with CLTV >80% must carry mortgage insurance; qualified criteria also includes no balloons, no interest only and no negative amortization.
Source: Genworth Financial

The 30-year, fixed-rate mortgage worked for more than 40 years. A range of down-payment options also worked to facilitate homeownership for families with the income to support monthly principal and interest payments. For families with savings, a 20% down payment was routine and they benefited from lower fees in exchange for the reduced risk. For families with fewer saving, but an equal ability to make monthly payments, mortgage insurance counteracted lower 5% or 10% down payments to reduce risk. Finally, the FHA provided 3% down payment loans for qualified borrowers. Figure 16 illustrates for qualified loans, lower down payments do not markedly impact performance. Current discussions of what constitutes a Qualified Residential Mortgage (QRM) are looking at the range of underwriting and product features that result in a lower risk of default. Based on the experience of the crisis, the important elements of a QRM include:

- Documented and verified financial resources;
- Standards for residual income after meeting all obligations; ratio of housing payment to income; and the ratio of all installment payments to income;
- Standards and features that mitigate the payment shock of ARMs;
- Mortgage guaranty insurance (or other insurance or credit enhancement) obtained at the time of origination for loans with higher than 80% loan-to-value;
- Prohibitions/restrictions on balloon payments, negative amortization, pre-pay penalties, interest only and other similar high-risk features.

The present undersupply of credit is not good for the agencies, the banks, the housing market or the economy. In addition, there is a role for low down payment loans to qualified working borrowers facilitated either through FHA or private mortgage insurance. It is time to move forward:

- Banks must expand their present mortgage business beyond adjustable-rate loans to wealthy customers to the full array of qualified borrowers.
- The GSEs must move past their current overly-conservative posture and restore lending within its mission to serve borrowers not well-served by the private sector.
- All associated costs of origination including points or fees as well as terms and conditions must be included when determining affordability, not simply requiring higher FICO scores.
- We must move past un-marked-to-market problem assets currently cluttering the books of banks. A key component of this plan, as outlined below, is to allow banks to amortize their losses.

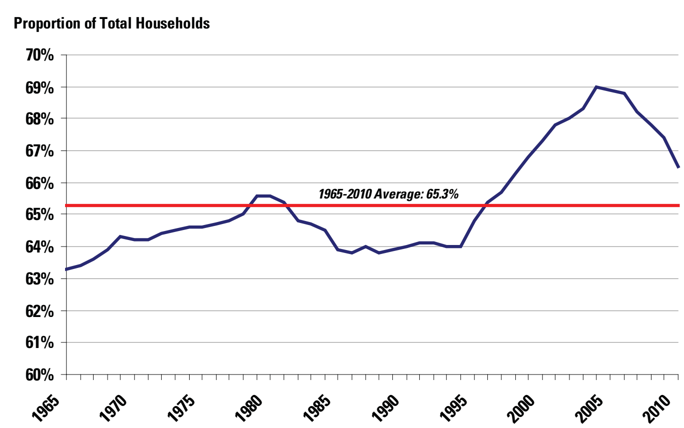
Maintain the Critical Role of FNMA and FHLMC or a Successor Entity

The GSEs are in a critical position to provide leadership and demonstrate the path to successful loan modifications and new originations. Just as they have for the bulk of their 40-year history, they play an important role in making mortgage finance available to the broadest number of American households. There is no historical proof that the private sector unaided could provide the magnitude of dollars necessary at an affordable level. We are not talking about subprime; we expect the subprime portion of the industry to return to its long-run share of 5% of the total mortgage market. We are talking about homogenous and predictable 30-year and other traditional mortgages including fixed-rate, adjustable-rate and 15-year terms. We believe the agencies are critical to achieving 65% homeownership, which is the long-run average (Figure 17). If the private sector were left to operate independently, homeownership could fall to unacceptably low levels, particularly for lower-income and non-white borrowers. The agencies are needed to provide the three requirements for making credit available to households:

- Liquidity
- Standardization
- Transparency

As a reminder, prior to the creation of the agencies, home buyers faced regional pricing differences and much variation in the availability of home mortgages. The agencies turned home mortgages into standard commodities, creating a large, efficient market that provided favorable mortgage credit to borrowers and investment vehicles for investors. For the bulk of their history, the agencies collectively defined acceptable risk and set underwriting standards that were met by agency underwriters and private lenders for non-agency loans. Through securitization, a new source of investment-grade securities was made available to investors worldwide.

Figure 17: Homeownership Rate



Latest data as of 4Q10
Source: Census

The government function is necessary for the intermediation of mortgage credit for the public good. Without government intervention, we would return to a world where too many households would not be able to reliably access housing finance. The private sector cannot deliver equal access as the mortgage finance business is not equally profitable across the country. It requires a public effort to make mortgages equally accessible. In fact, problems arose when the agencies acted like private players to compete for market share in the 2003-2008 boom period. The solution is not to eliminate the agencies, but to eliminate the profit motivation and the moral hazard involved.

- We recommend merging FNMA and FHMLC and making the resulting agency government-owned, providing an explicit guarantee of timely payment of principal and interest. This guarantee should be priced on an actuarially-sound basis.
- This agency must return to the mission of setting standards for mortgage underwriting and terms. Each mortgage must have a reasonable down payment and be in the first loss position.
- Full documentation and verification of borrower's income and finances must always be required.
- The agency should set a loan-size limit that fits its mission to serve borrowers not well-served by the private sector. We applaud the return to prior limit levels.
- It should retain the function of guaranteeing mortgages, but should minimize the holding of single family mortgages or mortgage-backed securities other than necessary for the securitization process and a narrowly crafted exception in times of crisis. It should be permitted to hold multifamily mortgages and mortgage-backed securities to provide capital for the development and ownership of rental housing.
- It should accumulate pools of homogenized mortgages and should issue securities.
- Rather than holding shares in the agencies, investors can purchase the resulting mortgage-backed securities.
- If these standards are followed, the new government agency will be able to operate profitably.

Help Improve Servicers' Performance and Provide Safe Harbor

The servicers are structurally ill-equipped to deal with the current crisis and need to be relieved of the situation. The servicing building model is based on repeat, low-touch transactions. The current crisis requires customized, high-touch handling of each individual problem. Neither the staffing nor compensation structure of servicers is designed to meet this need; therefore, the bifurcation of servicing into regular servicing and customized special servicing is necessary. Special servicers should be required to:

- Assign a single point of contact for troubled homeowners.
- Engage in loan modification to reduce principal and interest payments at the earliest stages of delinquency with the goal of making the mortgage affordable over the long term. In exchange for this effort, special servicers must have a safe harbor that provides assurance that their claims will be recognized.
- Invest in hiring and training staff and in information services to manage and support the extra workload associated with loan modification.
- Strengthen quality control and legal compliance. Where special servicers are deficient, servicers should be required to have independent third-party monitors.
- Resolve second-lien conflicts through a meaningful write-down of any second lien if a first mortgage is modified or approved for short sale.

Dodd-Frank applies a 5% risk-retention requirement on all but the most conservatively underwritten loans upon securitization. The FDIC and FOSC are working on developing risk-retention standards across all asset classes. The goal is to better align the incentives of servicers with those of mortgage-backed securities investors. Going forward, we believe regulators should:

- Require all servicers to disclose any ownership interest in other whole loans secured by the same real property;
- Require all servicers to have in place processes to deal with potential conflicts including "tranche warfare," when different tranches benefit differently from modifications or foreclosure actions.
- Require issuers, particularly those who are also servicers, to retain an interest in the mortgage pool that is proportional to the value of the whole pool or a "horizontal slice."

We recommend the following steps to create safe harbor for investors:

- Compensation should be appropriate to adequately incentivize both functions, thereby stopping the cycle of booms and busts. It is critical, however, for a safe harbor that is easily dismissible on summary judgment. In other words, a safe harbor that results in specious lawsuits being easily dismissible.
- Safe harbor must be expanded to be effective. For example, legal bills must be reimbursed.
- Action must maximize the net present value of the mortgages to the benefit of all investors rather than a particular tranche.
- Establish a pre-defined process to address any subordinate lien owned by the servicer or any affiliate.

Bottom line, the true role of the servicer and special servicer is to generate the highest net present value to the entire mortgage pool.

Enable Debt Reduction for Qualified Borrowers

First Mortgages

A complete loan modification program must be implemented. Doing nothing, at this point, is more costly to taxpayers, banks, agencies and households, than taking action. According to Selene Finance, carrying cost on a foreclosed home including taxes, insurance, utilities, maintenance and other expenses is 17%-20% of the purchase price, annually. We need a plan that addresses total household debt. One of the most common reasons Home Affordable Modification Program (HAMP) has failed is that loan modifications have not dealt with the entire household debt. As a consequence, borrowers used the modification to pay credit card bills and make second mortgage interest and principal payments. The net result was that households were not given the framework for a sustainable repayment schedule. A complete plan should be immediately put into effect by the mortgage servicer, whether a federal agency or private firm, for all households where:

- There is true financial need. This would eliminate some situations where the borrower has the ability to pay, but the mortgage is underwater.
- The borrower behaved responsibly. This would exclude borrowers, for example, who repeatedly withdrew equity through refinancing and second mortgages, and spent the balance. It would also eliminate borrowers who egregiously lied on their loan application.
- The borrower has a history of financial responsibility and hard work. Whether or not the borrower is currently working, they are actively looking for work.
- The borrower has the ability to make payments on a reasonably structured mortgage. This would exclude borrowers who overreached and are not able to afford their home even with a modified loan.
- Note, if the borrower is not working at the time of restructuring, the program will hold the deed for six-months to allow him/her additional time to seek employment. If still not employed at the end of the six-month periods, other options may need to be considered including deed for lease discussed below.

Bottom line, it is critical that the borrower is able to sustain payments at the modified level. We would proceed by:

- Reduction of the first mortgage debt to 110% of house value and 31% of front-end mortgage debt-to-income.
- Elimination of the balance on any second mortgage where there is significant forgiveness of debt on the first mortgage. We will address the impact on the banks in a separate section.
- Restructure revolving charges in order to attain 41%, back-end debt-to-income for the household.

- Debt reduction could be combined with a shared appreciation second mortgage to cover the debt reduction and allow for a partial recovery for the lender when the market recovers[2].
- Dual tracking of loan modification and foreclosure should be stopped where:
  - o The owner is the occupant;
  - o The borrower delivers current financials;
  - o The borrower can afford the house at the current reasonable ratio;
  - o If any of these conditions are not met, we would advise allowing servicers to dual track as a quicker resolution will be more beneficial to the borrower, servicer, investor, and, ultimately, the housing market and economy.

Debt-for-Equity Swap

In lieu of foreclosure, for borrowers who cannot afford the house even at current reduced market value, but can afford market rent for a comparable unit, we recommend a debt for equity swap. The homeowner would surrender the title to the house in return for a fixed rate long-term lease of five years or more at market rent. This will enable the former homeowner to continue to live in the house, reestablish credit and, potentially, earn his/her way back into homeownership. The suggested framework of the program would be:

- The owner (mortgagee) could not sell the property for the duration of the lease, unless they sell it to the former homeowner.
- The former homeowner makes market-rent payments to the mortgagee for the duration of the lease.
- The former homeowner maintains the house as if it were their own including mowing the lawn and taking care of repairs up to a certain maximum annual expense, for example $200, beyond which the owner pays.
- At the expiration of the lease term, the former homeowner has the first right-of-refusal to buy the house.
- If the former homeowner wishes to purchase, they must have access to reasonable mortgage finance.
- Whether or not the former homeowner is the purchaser, the former homeowner benefits from a 20% share of any upside in value of the property at point of sale (the former homeowner benefits from the increase in value, whether or not he/she is the purchaser of the property at the end of the lease term).

The benefits of a debt-for-equity program in the current housing environment are most evident for the struggling homeowner -- they get to keep their home. They are afforded the time to regain financial stability as renters. They are provided a clear path to final resolution of their financial troubles and through time, they can repair their credit.

Alternatively, if private financial institutions are not capable of executing the above necessary strategies, the solution may be simply to look to the past and create an updated version of the Home Owner's Loan Corporation used in the Great Depression.

- As in HOLC I, the government should instruct FNMA, FHLMC and FHA to purchase all qualified loans defined as above 90-day plus delinquent loans and those with more than 110% of value underwater at current market prices. This assumes the purchase of all such loans not currently in the agencies' portfolios.
- For the seriously delinquent loan, the government would modify the loan and overall household debt as above. In return, the government would share subsequent house price appreciation over a set period of time with the borrower: 20% of the appreciation would go to the borrower and 80% would go to the government.
- For underwater loans, the government could offer to exchange the troubled loans and carry out the modifications to the credit card debts and second mortgages as above in return for 80% of the house price appreciation for a set period of time. We believe this bargain will readily be acceptable to the homeowner even if he/she may still be current in his/her payments.
- As an alternative to shared appreciation, the forgiven debt can be rewritten as a second lien payable at the time of the sale.

Second Mortgages

As a fundamental principal of mortgage finance, if the first mortgage is underwater, the second mortgage has no value. Possibly due to the high level of potential write-downs, this is not how banks are handling delinquent second mortgages. The reality is that if the second mortgage is treated as untouchable, than the first is intractable. In addition, everything accomplished to date in Dodd-Frank or Basel II can be undone by second mortgages levering up new loans even under QRM guidelines.

It is important to draw the distinction among three types of high-balance lending: 1. Loans made through FHA; 2. high-balance loans made in the private sector or by agencies with mortgage insurance; and 3. a high-balance loan created by a low-balance first and simultaneously disclosed second mortgage. The FHA and mortgage-insured loans are underwritten at ratios that consider the realities of the higher loan-to-balance ratio, both in the mortgage debt to income and total debt to income. The second mortgage, on the other hand, even when disclosed, is in the first instance, not one note, but two; and there is no assurance that the ratios under which the first is written are the same as for the second. It is not the same loan. This distinction becomes intolerable when second mortgages and home equity loans are used subsequent to the granting of the first mort-

2 *The Home Owner's Loan Corporation used this approach with success in the aftermath of the Great Depression.*

gage to change the nature and/or cash flows of the first mortgage by either levering up the property or simply taking out equity. For second mortgages and home equity lines of credit, we propose:

- Treating seconds as second. The risk that was inherent when the second lien was made must stay on the holder of that lien.
- In keeping with the relative status of the liens, make the degree of debt forgiveness on the second proportionate to the first, as is done in commercial in-substance foreclosure.
    - If 10% of the first is forgiven, 80% of the second should be forgiven.
    - If 25% of the first is forgiven, 100% of the second should be forgiven.
- In order to accomplish this, banks must be allowed leniency on accounting so the volume does not cause financial harm. Banks should be allowed to amortize the loss over the expected life of the instrument (5-15 years).
- Bank regulators have rules on required capital that need to be enforced. Although a second may be performing, it is now an unsecured loan given the loan-to-value ratio of the first mortgage. It is disingenuous not to require the second mortgage to be written down to reflect the risk of an unsecured loan to the borrower in question.

Implement Strategies to Reduce REO and Absorb Excess Inventory

The mortgage crisis has left an unprecedented number of vacant homes, vulnerable to vandalism and neglect, putting downward pressure on values in the surrounding neighborhood. Rather than languishing, these homes create a tremendous opportunity to provide housing to needy households, stabilize neighborhoods and absorb for-sale inventory. We recommend two programs to facilitate the re-use of vacant homes:

- Rent-to-Own
- Investor Finance

Figure 18: Rent-to-Own Example

Original Purchase Price	$226,000
Original Principal Balance	$158,200
Mortgage Payment	$1,353
Current Price	$207,000
Monthly Carrying Cost, excluding Utilities	$250
Market Rent for House	$1,100
RCG House Price Forecast	3.2% Annual Growth
Forecast Price in 5 Years	$242,537

Option 1: Renter buys house for $242,537

Option 2: Renter receives $7,107

Sources: Selene Finance, RCG

Rent-to-Own

A rent-to-own program would be extremely beneficial to both troubled homeowners who cannot afford their current mortgages, *and*, future home buyers who find it difficult to come up with a down payment (Figure 18). Seldom do we have an opportunity to solve a couple of policy problems with one solution, and we believe a viable rent-to-own program is such an alternative. It is a once-in-a-lifetime opportunity to enfranchise a large number of Americans. Under a rent-to-own program:

- A troubled homeowner could stay in his or her home, and convert the loan obligation to a lease of three to five years; or
- A qualified working family could move into a vacant home under a rent-to-own agreement.

The suggested framework for a rent-to-own program is the same as for the proposed debt for equity above:

- The owner (mortgagee) could not sell the property for the duration of the lease, unless they sell it to the renter.
- The renter makes market-rent payments to the mortgagee for the duration of the lease.
- The renter maintains the house as if it were their own including mowing the lawn and taking care of repairs up to a certain maximum annual expense, for example $200, beyond which the owner pays.
- At the expiration of the lease term, the renter has the first right-of-refusal to buy the house.
- If the renter wishes to purchase, they must have access to reasonable mortgage finance.
- Whether or not the renter is the purchaser, the renter benefits from a 20% share of any upside in value of the property at point of sale (the renter benefits from the increase in value, whether or not he/she is the purchaser of the property at the end of the lease term).

The benefits are evident for working families wishing to become homeowners. Occupancy by the renter avoids the cycle caused by foreclosure and vacant properties decreasing the value of homes in a neighborhood. The program will bring stability to neighborhoods and communities through allowing potentially good borrowers an entry into homeownership.

Less apparent, the rent-to-own solution provides value to the lenders as well: immediate cash flow; reduced pressure from overcapacity at the servicer level; avoids headline risk of putting families out on the street; and, provides rental income to cover carrying costs. Rather than expensive foreclosure actions, rent-to-own defers sale of a home to a time when real estate prices stabilize and keeps the home tenant motivated to continue upkeep and maintenance. Lenders will similarly benefit from stabilization of the neighborhoods where they lend.

Investor Finance

Local people know their neighborhoods and should be equipped to tackle the local housing problem. We are not talking about large bulk sales. Builders/handymen/realtors have the knowledge and skills. Local doctors, dentists and other professionals have the means and interest in investing locally. Together, they can buy houses, fix them up and sell or rent them. The missing element is a finance program to set this process in motion. FHA has done this type of program as have the agencies in the past. We recommend both FHA and the agencies take the lead in offering investor finance and encouraging private participation. Such a program will be highly effective in stabilizing communities where there are the builders, local investors and potential new buyers or renters. Investor finance will absorb real-estate owned and other excess vacant inventory quickly.

- A high down payment can be required to cover the added risk of lending to a non-occupant. A starting place might be 30% down on the current sales price.
- Banks and agencies could also make the choice to offer low down-payment finance to encourage investor activity in distressed areas.
- At either down-payment level, the program is investor driven. If the government wants to target specific problem neighborhoods, additional incentives will be required.
- A Federal Reserve study proposed a national "first-look" property program that would give municipalities and local community groups the right of first refusal on repossessed properties. The hope is that this would facilitate neighborhood stabilization, encourage new methods of municipal code enforcement and innovative land-banking strategies.

Conclusion

The mortgage crisis can and must be stopped now before more damage is caused to the housing market and the overall economy. Our five-point plan is a comprehensive approach to solving the problem before the country is set back by a second leg down. Our plan addresses:

1. Restore the flow of mortgage credit to all worthy borrowers for a sustained economic and housing recovery;
2. Maintain the critical role of FNMA and FHLMC or a successor entity to promote the future health of the housing and mortgage market at a balanced and appropriate level. The moral hazard inherent in the profit motivation currently a part of the government-sponsored agency structure must be eliminated;
3. Help improve servicers' performance and provide safe harbor for servicers and investors to allow for securitization of well-underwritten loans to funnel capital to housing finance;
4. Enable debt reduction for qualified borrowers to set them on the path to sustainable homeownership. This will require recognition of the loss to second lien mortgages and home equity lines of credit;
5. Implement strategies to reduce REO and absorb excess inventory.

Biographies

Lewis S. Ranieri

Lewis S. Ranieri is the prime originator and founder of the Hyperion private equity funds ("Hyperion") and is a principal partner and founder of Selene Residential Mortgage Opportunity Fund. Prior to forming Hyperion in 1988, Mr. Ranieri had been Vice Chairman of Salomon Brothers, Inc. ("Salomon"). He is generally considered to be the "father" of the securitized mortgage market. Mr. Ranieri helped develop the capital markets as a source of funds for housing and commercial real estate, established Salomon's leadership position in the mortgage-backed securities area, and also led the effort to obtain federal legislation to support and build the market.

Kenneth T. Rosen

Ken Rosen is Chairman of Rosen Consulting Group, a real estate market research firm, and Chairman of the Fisher Center for Real Estate and Urban Economics and Professor Emeritus at the Haas School of Business at the University of California, Berkeley. Mr. Rosen is also the special real estate advisor to The Davos World Economic Forum. He was Chairman of Rosen Real Estate Securities. Mr. Rosen received his Ph.D. in Economics from the Massachusetts Institute of Technology in 1974 and a B.A. with highest honors from the University of Connecticut in 1970.

Andrea Lepcio

Andrea Lepcio, Principal, joined Rosen Consulting Group in 1997. She is based in New York and is responsible for business development and Eastern region client relations. Prior to joining RCG, Ms. Lepcio was Vice President and Head of Market & Investor Research at Chase Manhattan Bank. Before that, she was a founding member of the Real Estate Research group at Salomon Brothers. Ms. Lepcio earned a B.A. from the College of the Atlantic and an M.B.A. from the University of California, Berkeley.

Buck Collins

Buck Collins is the Senior Associate to Lewis S. Ranieri. Prior to joining Mr. Ranieri, Mr. Collins held a position as a consultant at Morgan Stanley in the Private Wealth Management division. A former member of the American Ballet Theater, Mr. Collins retired from his long standing career in 2006.