RCG

RANIERI PARTNERS
MANAGEMENT LLC

The Future Of Home Finance: Who Will Qualify?

October 2013

by:

Lewis S. Ranieri
Kenneth T. Rosen
Mark Goldhaber
Andrea Lepcio

Rosen Consulting Group
1995 University Avenue
Suite 550
Berkeley, CA 94704
510 549-4510
510 849-1209 fax

www.rosenconsulting.com

Introduction

Early in the bubble era, almost seven years ago in December of 2006, the Office of Thrift Supervision held a housing forum in which Lewis Ranieri participated, along with then Secretary of Treasury Henry Paulson, Michael G. Oxley and Barney Frank, among others. At the time Lew was deeply troubled by what he saw happening in the mortgage market. He noted the following in that 2006 presentation:

- The mortgage and capital markets were unfettered in their exuberance, and unchecked by ineffective regulation.
- The standard-setters and gatekeepers of old - the Inter-Agency Banking Group, and Fannie and Freddie - had, to a degree, moved aside, and the rating agencies had become toll collectors fueling the explosion of "affordability" products into the secondary market.
- Before the bubble, Fannie and Freddie had served as gatekeepers by setting standards on what they would purchase. Whether loans were prime, Alt-A, or subprime, conforming or non-conforming, everything was always written on agency-standard documentation. To the detriment of the mortgage market, that changed in the bubble era.
- In the past, investors could understand and had faith in the underlying value of mortgage-backed securities, which were predominately comprised of fixed-rate, 30-year mortgages -- or what we used to call "vanilla products." Investors could count on each loan being a first lien with no secondary or other competing lien.
- In 2006, the transparency of the past has been obscured by a massive proliferation of new products: IOs, Option ARMs, 80-10-10s, stated income, low doc, no doc, ABMs, automated evaluation models, 40-50-year loans, etc. As a consequence, it became very difficult for investors, institutional and otherwise, to accurately quantify the value and the risk of the opportunities available to them.

Additional details of the bubble period were offered at the time by David Berson at the OTS conference in December 2006:

- Subprime mortgage originations climbed to $626 billion at the end of 2005 from under $100 billion in originations in the late 1990s.
- The ARM share picked up substantially, particularly for the subprime market: more than 92% of subprime loans were adjustable rate in 2006. Interest-only ARMs in 2005 were almost 37% subprime and more than 50% of Alt-A loans were interest-only. Almost a third of Alt-A loans used negative amortization in 2006.
- The share of full documentation dropped to less than 50% in the subprime and prime market in 2006. These are the risk layers. The share with simultaneous seconds in the subprime market was more than 50% and in the Alt-A and jumbo market it was more than a third.

In retrospect, while many of the things Lew and David spoke about were correct, they could not have imagined the meltdown in the mortgage, housing and capital markets that brought not just the U.S. economy, but the world economy to the brink. This was a high-risk period characterized by rising house prices that created the expectation that appreciation would hide any underwriting mistakes and sins. Price expectations drove the quest for fees and the transfer of risk over good underwriting. When house prices reversed nationally for the first time since the Depression, the era screeched to a halt. The mortgage meltdown left us with dueling legacies. The first legacy is the loss of trillions, reflecting devastating losses to individuals and investors; the Federal Reserve estimates that losses peaked at $16 trillion in 2009. Ironically, though most of those losses have been recovered, too little accrued to the original owners who were unable to hold on. Within these losses are 4.5 million foreclosures and damaged credit across large parts of the nation, but particularly concentrated in low income and minority neighborhoods. The second legacy is the curtailment of credit availability that began during the years when house prices were falling, but persists as house prices correct and new regulations roll out. If this irrational restriction and contraction of credit legacy persists, it will take the opportunity for homeownership and wealth-building away from millions of Americans. Fear and not fact is making credit tighter than it should be. It is important to not confuse credit availability with bad loan structures and low documentation. Credit can be made widely available with strong underwriting and good performance as it was in the decades prior to the mortgage debacle. If we eliminate the structures that created the problem, we can restore broad credit to working families and individuals across the country.

It is critical, therefore, to recognize how different today's market is from the market that Lew and David described. The policy challenge we now face is to be clear about whom we seek to assist and build a mortgage finance system that provides access to credit while assuring the likelihood of long-term homeownership success. Programs that generate double-digit foreclosures are unacceptable for individuals, neighborhoods and taxpayers alike. The bad loan structures that contributed to that result have been outlawed. In today's market there are virtually no subprime, no Alt-A loans, no short-term hybrid ARMS and no low documentation loans. Interest-only loans are only available in the prime jumbo market. The implementation of the Qualified Mortgage early next year and the practices that were legislated out of existence by Dodd-Frank mean that the bubble market would not, cannot and should not return. Far from being the norm, the 2004-2007 bubble years were an aberration in five decades of successful lending. As we develop a new mortgage finance framework, it is critical to recognize that the worst of the practices that created the problem have been banned and we now have the opportunity to design a new system based on best practices. Getting it right will require experience, insight and vision.

The Problem

The housing boom/bust and resulting financial crisis understandably shook world governments and regulators. In its aftermath, stakeholders have worked to retool laws and regulations to try to prevent any such crisis in the future. This retooling process has proceeded slowly for five years and is not slated to be completed until 2014. The new rules as currently written will mitigate many problems, but, unfortunately, will create others. The combination of current circumstances and anticipated rulings has resulted in a post-crisis, mortgage-market status quo that is unsustainable and unacceptable for five reasons:

- New regulations are directionally correct in purging the system of poorly structured loans and in requiring underwriting standards, but a consequence of the new Qualified Mortgage and other new rulings are that they limit lender discretion and will result in fewer loan approvals and more loan denials. As long-time mortgage professionals, we recognize that it is possible to write a fair and understandable loan, but not possible to write a risk-free loan. The combination of new rulings, however, appears to be leaving lenders with no choice but to attempt to create a risk-free loan. We agree that standards need to be tighter than in the free-for-all subprime era, but the manner of implementing standards must take into consideration reasonable business practices. While the lender has the obligation to determine the ability to repay, the consumer who accepts credit must accept responsibility and intend repayment of that credit. Without this responsibility and intent of the consumer, investors will be reluctant to provide the required credit and capital. In addition, the significant costs of complying will ultimately be passed onto borrowers in the form of higher rates and fees.

- The Federal government currently owns the mortgage market, with little private capital participation. This is both unwise and unsustainable.

- There is ongoing litigation and regulatory exposure for past sins, real or perceived, which previously active lenders (and many still-active lenders) are grappling with. Further complicating – and retarding normal credit conditions – are the uncertainties about agency repurchase demands by Fannie Mae and Freddie Mac and indemnifications requested by FHA, and how agencies will interpret loan acceptability in the future. This is causing lenders to limit access to credit to households at the pinnacle of the credit pyramid. We are concerned this will eliminate homeownership opportunities for working families and individuals across the country.

- Securitization is needed to fully fund demand for mortgage credit. Neither the Federal government nor the private sector alone can fund the $10 trillion mortgage market. As we have seen and will provide evidence for below, securitization is a critical tool facilitating the capital formation necessary to fund a healthy U.S. housing finance system. Equally important, securitization provided prudent risk/return opportunities for investors. With an aging population more dependent on self-directed retirement plans, it is important to expand, not reduce, investment options. Restricting securitization would be a negative for seniors and other investors.

- The net result is that currently and, if policies are not improved, for the foreseeable future credit will be limited. This leaves us with two simple questions: Who will qualify in the housing finance system of the future and who will be excluded? We ask this recognizing that homeownership is not a right and is not for everyone. There are, however, millions of aspiring and capable potential home buyers who must not be denied access to credit.

Regulation Now Shaping the Market

The Consumer Finance Protection Board (CFPB) has worked diligently on its regulatory mandate (within difficult statutory language) and continues to seek out and listen to comments and refine its rules. The proposed regulations increase the cost of making a loan and decrease lender discretion. If the vast majority of lenders, as we expect, choose to originate only QM loans that fall clearly inside the prescribed safe harbor and avoid making the QM loans that carry a rebuttable presumption, the QM rule will prove to have the unintended consequence of denying lower and moderate income potential borrowers access. If any lenders decide to venture outside the QM box, it is most likely they will do so only for pristine borrowers. The regulatory framework – and all that goes into it – requires much greater coordination.

In the current and prospective market, government guaranteed loans are advantaged over non-agency executions. For a first-lien transaction, the threshold annual percentage rate ("APR") is 1.5% over the average prime offer rate ("APOR"). This threshold is adequate for GSE and government guaranteed loans. For non-agency loans that have a higher cost of capital, 1.5% is too low. This results in a non-agency jumbo loan that in many circumstances gets pushed out of the QM safe harbor and into a QM rebuttable presumption status merely because of a higher cost of capital.

The second problem is that the current three-point cap on fees if a loan is to be deemed a Qualified Mortgage is too limiting. Additionally, the rule as written disadvantages those mortgage bankers who utilize affiliated title relationships in their business model, which particularly hurts small loans, again pushing more loans outside of the Qualified Mortgage safe harbor.

The net impact on lenders is to limit their own discretion in making credit decisions to ensure a conservative outcome. Traditionally, before the dominance of credit scores, a lender would look at employment, income and other compensating underwriting factors to approve a loan. Under the proposed rulings, lenders will be looking for each borrower to achieve certain parameters for QM safe harbor and deem other borrowers ineligible, since the secondary market appears likely to only accommodate very few non-QM loans. Historical practice is evidence that many working families and individuals can qualify on the basis of income and assets that otherwise do not meet today's excessive FICO and debt-to-income (DTI) terms. The simple truth is that this over-reliance on credit scores and credit overlays by lenders and investors is severely truncating any meaningful examination by those actually doing the underwriting, adversely impacting a very large segment of the population.

Regulators and legislators are currently "full steam ahead" in building a housing finance system that will retain many of the housing subsidies, but will fail to serve traditional low- and moderate-income communities. It will be public policy at its worst if subsidies remain in place, but with new regulations added that limit the access to homeownership for low- and moderate-income people. We are concerned that many will be forced to remain renters not by their own choice, but as a result of the cumulative impact of regulatory rules seeking to create a limited-risk environment. We will propose solutions that include a new system design to retain pooling, renting with an option to own and an effective ownership and credit-improvement program that enables households with 620 to 680 FICO scores to be successful long-term homeowners. If these steps are not taken, we are in danger of allowing the recent aberrant crisis to completely redefine our mortgage finance system and, by extension, change our core values. The result will be the creation of a bigger economic divide in America.

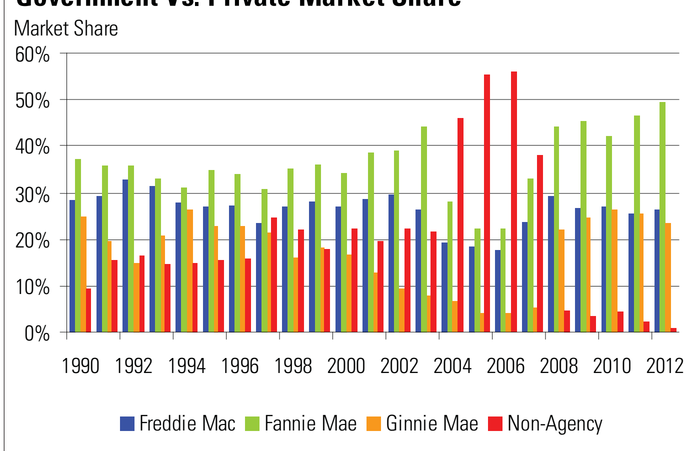
We also want to note that there are important items missing from the new regulations. It is startling that despite thousands upon thousands of pages of legislation and regulations already written, access to second mortgages remains largely unaddressed. Currently, there is no regulatory restriction on the simultaneous or subsequent creation of a second lien on the same property. Lenders may have their own loan-to-value guidelines, but there are no laws or regulations against seconds. It is important to return to a culture that allows equity in a family's home to grow and build wealth, as well as giving borrowers a cushion to fall back in the event of illness, disability or unemployment. During the housing boom, too many people turned their homes into ATMs. We caution, as the bubble era showed, that equity in homes is meant to be held on to, not cashed out to be spent on consumer goods or excesses.

In addition to the new mortgage rules, regulators are responding to perceived risks throughout the financial system. In the United States and globally, regulators are seeking to protect future markets from disruption and abuse. Therefore, new mortgage regulations must be understood in combination with a wide-ranging complex that includes other overlapping regulations, the collective of which will impact bank capital requirements and influence which activities – such as servicing – become too costly and are likely to be passed on to non-banks. America, the American economy - and indeed the global financial system - is being redefined without a vote. Historically, this would foster an enormous debate. In today's political and economic environment, we're doing it sub rosa. Although each individual regulation is done with the best of intentions, we are concerned that no entity or individual has been charged with reviewing the cumulative impact on financial activity and cost. The mosaic of QM and QRM rules alone, in addition to the risk-weighting of assets and current loan-to-value limitations, creates a large penalty box that captures many qualified low- to moderate-income borrowers and results in constrained credit. The end result will be government dominance in the market and an ongoing lack of private capital.

Government Dominance

The dominant source of credit today is the Federal government, which now provides or guarantees nine out of every ten mortgages. This government role was critical in the aftermath of the crisis that put many originators out of business, kept the survivors focused on servicing problem loans and saw investors leave the market. Today, housing is in recovery. Given the crisis-driven drop in home prices,

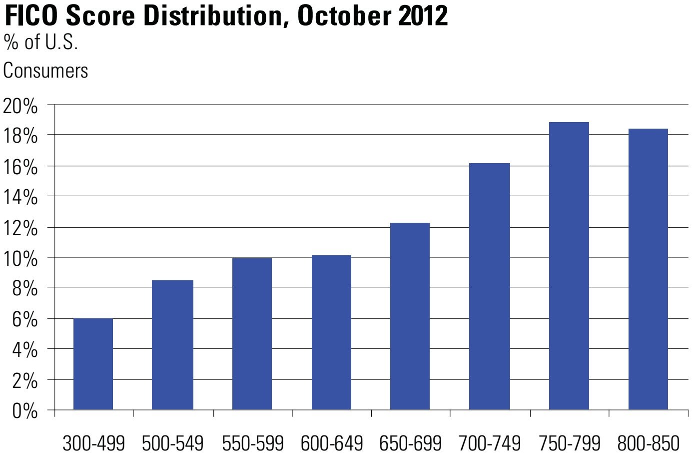
Government Vs. Private Market Share



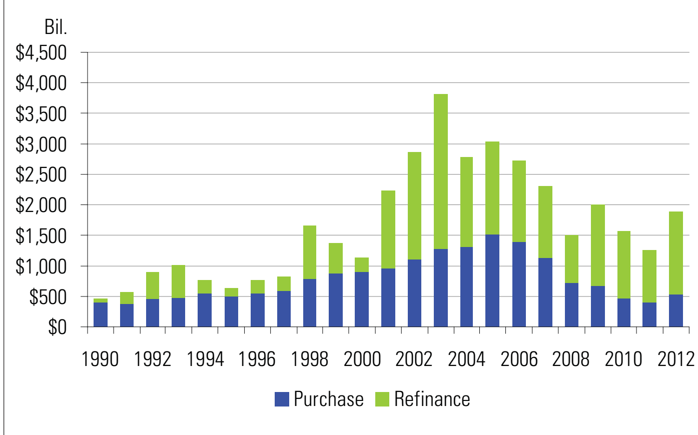
Source: Inside Mortgage Finance, 2013 Mortgage Market Statistical Annual relatively low mortgage interest rates and high affordability, it is one of the best times to lend or to borrow in more than 50 years. Even with the recent price and rate increases, we are still at the point in the cycle where it is a terrific opportunity to buy ahead of further price and rate increases. In times of old, such terms would encourage lenders to qualify and underwrite loans as quickly as they could, knowing how good those loans would be. Today, however, outside of a small jumbo market, FHA/Ginnie Mae and the GSEs are the market. Other than originating for the GSEs and creating some jumbo loans, private lenders are waiting for regulators to finish drafting critical regulations. Ongoing questions about the future role of the GSEs – even as they return to profitability and add billions to the U.S. Treasury till – are leading to new proposed legislation with many conflicting plans under discussion. The great risk is that the government never returns to pre-crisis loan limits and simply crowds out private capital. It is critical to remember that the Federal government, using government guarantees, can always finance cheaper than the private sector. The net effect is that the private market is under "house arrest," and that is a bad policy that will lead to a bad outcome for the taxpayer.

Numbers are Driving Mortgage Originations

Government dominance has come with a more surprising twist: higher FICO scores. FHA-borrower FICO scores have increased to 698 in 2013 from an average of 658 in 2009. GSE borrower FICO scores elevated to more than 750 from an average 723 in 2003. Loan limits remain high. Prior to the financial meltdown, the FHA loan limit was $362,795 and the GSE loan limit was $417,000. Starting in 2008, these limits were increased substantially to $729,750 for FHA and, currently, $625,500 for GSEs in high-cost areas, and these levels remain in force. The net result is that the GSEs and FHA are providing credit to better-off borrowers buying larger homes. Private lenders who are originating new loans both for GSE purchase and for their portfolio or securitization are also favoring those with high FICO scores. It is clear to see which part of the consumer credit spectrum is in favor – and driving the size of - the tiny $12-$15 billion private RMBS market that is emerging from the wreckage of the crisis.



Source: FICO



Source: MBA

The Threat of Put-Backs

At the same time, State Attorney Generals, the Justice Department and regulators are still seeking retribution for yesterday's problems. If there is a belief in boardrooms across the country that reputation and litigation risk is too high, banks will focus on other lines of business. The people who lose are the ones who will have no access to mortgage credit as a result. As we stated earlier, a consumer who accepts credit must accept responsibility and intend repayment of that credit. Without the responsibility and intent of the consumer, there won't be the issuers or investors to provide the credit and capital. The mutually beneficial relationship between borrowers and lenders has stood the test of time.

Historically, representations and warranties allowed for problems to be handled and solved most often without loans being put back to the originator. Today, the economics of lending is being impacted by aggressive enforcement by Fannie Mae, Freddie Mac and the FHA, resulting in many more repurchases and greater indemnification on FHA loans. The impact on constraining credit availability is so impactful that put-back practices are now being discussed among lenders, regulators, members of Congress and the White House. As part of a recent fact sheet on housing, the White House wrote: "We need to establish more certain, brighter-line rules for when government will rescind its guarantees, to give lenders greater clarity and encourage more lending to creditworthy borrowers." Without question, investors must have a set of representations and warranties that they can rely upon, just as a manufacturer has quality standards for a product that it manufactures at a plant.

Federal agencies are working to institute a common framework for government guarantees across the market. Lenders are concerned that there will not be predictability on how Federal agencies handle repurchases and indemnifications, and are constraining credit availability as a result. A lender should be able to write a fair and

Yields on Conventional Single-Family Mortgages for Selected Standard Metropolitan Statistical Areas on Each June 30, 1965 - 1972

MSA	1965	1966	1967	1968	1969	1970	1971	1972
Atlanta	5.96%	6.78%	6.94%	7.47%	8.25%	9.11%	7.86%	7.87%
Boston	5.18%	5.65%	6.02%	6.82%	7.53%	9.37%	7.07%	7.11%
Chicago	5.57%	6.03%	6.03%	6.74%	7.22%	8.13%	7.25%	7.16%
Dallas	5.92%	6.45%	6.49%	7.58%	8.37%	8.99%	7.68%	7.64%
Denver	6.09%	6.57%	6.47%	7.29%	8.01%	9.22%	7.53%	7.79%
Los Angeles	6.21%	6.51%	6.45%	7.27%	7.90%	8.86%	7.60%	7.51%
New York	5.77%	6.00%	6.07%	6.25%	7.50%	7.49%	7.47%	7.39%
U.S. Average	5.80%	6.20%	6.35%	7.03%	7.76%	8.48%	7.50%	7.55%
Variance from U.S. Average	0.104	0.143	0.097	0.194	0.143	0.352	0.061	0.077

Source: Federal Home Loan Bank Board

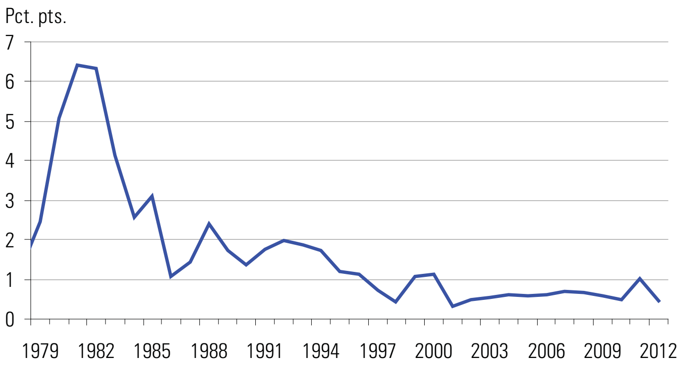
understandable loan that both the consumer and investor can accept. Representations and warranties should clearly state under what circumstances a loan might be put back. If credit markets are to function, these reasons must be egregious errors and not minor discrepancies.

The Necessity of Pooling and Securitization

Securitization has a big black eye coming out of the aberrant bubble period. There is sufficient blame to go around: from the originator to the issuer, the government to the rating agencies, the borrower to the bondholder, the appraiser to the servicer, and every other industry participant. Although every loan and every loss may reflect an individual error, each participant in the mortgage finance system as it evolved during the bubble that led to the crisis is culpable to some collective degree. While progress has been made in addressing many of the underlying causes of the bubble and the losses, we are far from finished in the effort to resolve all of the issues and much more work needs to be done. In particular, of the many mistakes made and deficiencies uncovered, securitization as a tool was not fundamentally flawed; rather, the problem lay in how securitization was executed day-in and day-out during the bubble period, as well as what was put into the securities.

It is important to remember that prior to the emergence of the broad mortgage-backed securities market, credit was unequally available geographically, with some parts of the country well-served and other parts under-served. Securitization also equalized and lowered the cost of mortgage credit across the county through diversification and cross-collateralization. In 1968, for example, yields on a conventional mortgage ranged from a low of 6.25% in New York and a high of 7.58% in Dallas. Another accompanying chart shows the difference between the highest and lowest mortgage rates by state since 1978. The difference was sharpest during the high interest-rate period in the early 1980s. The expansion of agency securitization and growth of private securitization from this period on led to a reduction in the variability of mortgage rates by geography. Critically, it also made 30- and 15-year loans available across the country. Previously, there were regions where only 5-year balloon loans were available, which did not serve the needs, budgets and risk tolerances of most working families.

Spread Between the High and Low Mortgage Rate by State

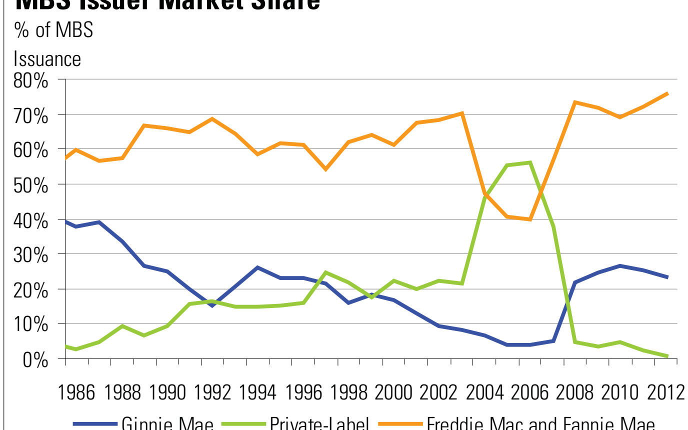


Source: FHFB

The growth of Federal programs, including the FHA and VA, and the expansion of government-sponsored agencies' charters lifted the public share of mortgages outstanding from under 20% in the early 80s, to 30% in 1985, 40% in 1989 and 50% in 1993 through 2003 after which it declined. A dramatic shift in public and private activity started with a burst of private (much of it subprime) activity during the boom, resulting in a corresponding compression of the agency share. Agencies increased participation in boom-era deals to regain market share starting in 2006. Private lending essentially stopped in mid-2007 and, upon restarting, has remained vastly diminished from historical levels. Public lending grew through mid-2011 and has also since shrunk. As we know, this shrinkage is a direct result of the damages caused by and constriction of credit as a result of the housing crisis. Even as we continue to recover from the effects of the crisis, private issuers collectively are not big enough to hold the $10 trillion plus volume of mortgages needed to finance national demand; in fact, the highest-ever volume of private mortgages outstanding was $6.5 trillion in 2007.

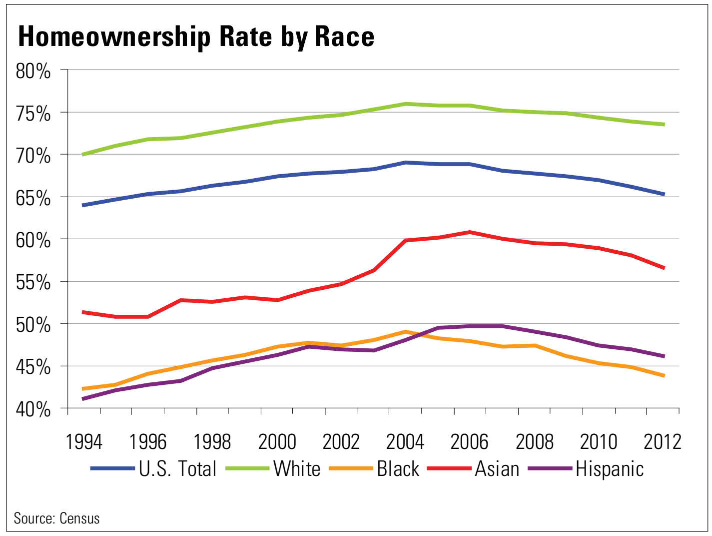
A core concept of the old system was pooling of a large group of loans with a range of credit strengths. There was a notion that

MBS Issuer Market Share



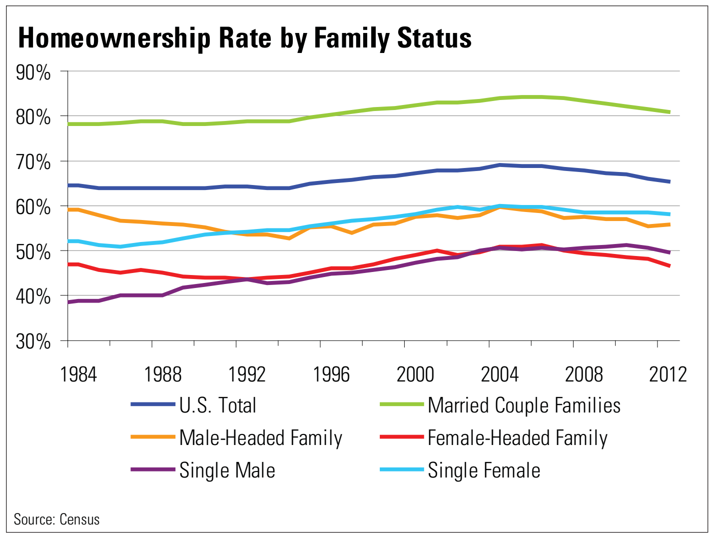
Source: Inside Mortgage Finance

stronger credits compensated within a large pool of mortgages for somewhat-weaker credits. When these loans were originated and pooled together, it resulted in a mortgage-backed security that offered both good profitability and an acceptable and predictable and low delinquency/foreclosure rate. We will develop this idea further in the paper, but today, ever-refined credit- and risk-based pricing attempts to create only the highest quality and lowest risk loans, moving away from the concept of pooling of risk to achieve acceptable returns and critical policy objectives. This reduces the number of people who can qualify under credit standards, creating a central policy issue which should be addressed. It is our belief that the combination of pooling and securitization will create good performing loans, a profitable business for the lender, attractive risk/return options for investors and access to credit to the widest number of potential borrowers.

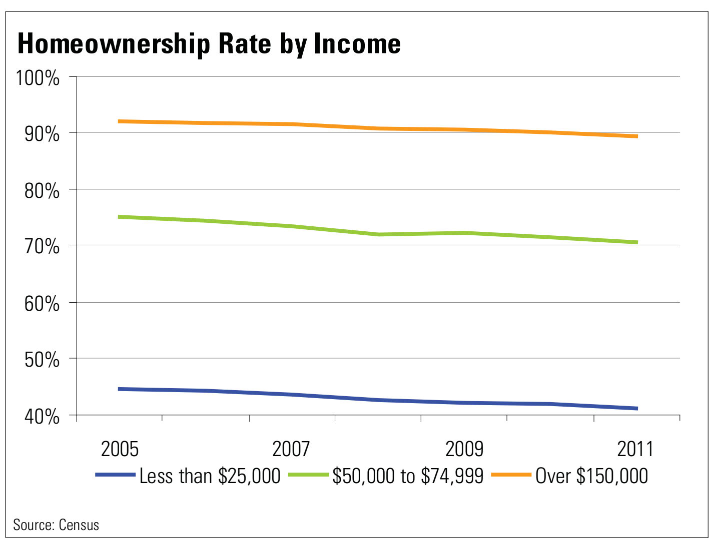


Who will Qualify in the Housing Finance System of the Future and Who will be Excluded?

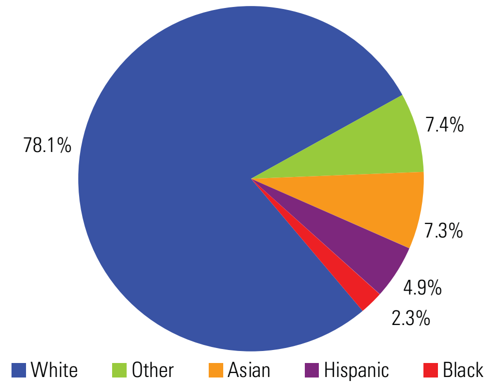
Over the past 50 years, loans were readily made to a broad cross-section of borrowers. Since the introduction of credit scores in the 1990s, those with 700, 650 and even 620 FICO scores who had the income required to make monthly principal and interest payments received loans. FICO score alone has never been the judge of a borrower's ability to pay. As an analogy for the credit box, we ask you to picture different size picture frames: 11 x 14, or 8 x 10, 5 x 7 or 3 x 5. Think of lender overlays like mats put in a picture frame to make it much smaller. In fact, today's FHA overlays are fundamentally shifting the program; FHA guidelines permit 580 FICO scores with as little as 3.5% down; but in practice, lender overlays are based at 640 or 660 minimums. Mortgage insurers would do a 97% loan-to-value, but under Fannie Mae's recent announcement, such loans have no outlet unless they are delivered to a state housing-finance agency.



Prior to the economic downturn, a 620 FICO with 5% down was an insurable prime loan. It used to be that below 620 was considered a non-prime loan; in today's conventional market, 680 has become the new 620. That line of demarcation is simply too high and squeezes too many families into higher-cost loans or out of the housing market completely. If the goal becomes to substantially avoid all risk and stunt a conventional low down-payment market by failing to recognize acceptable credit enhancement, the mortgage finance system will eliminate large numbers of families from homeownership. This impact will ripple beyond the individual and beyond neighborhoods, and will impact the overall economy, as housing and its multiplier effect will be inhibited. An effective mortgage finance system that provides adequate access to credit will help prevent this bifurcation. As has been proven for decades, homeownership is good for families, neighborhoods, communities and the nation. Upward mobility comes from taking rational risks.



Conventional Mortgage Originations by Race, 2012



Source: FFIEC Home Mortgage Disclosure Act

Mortgage Payment on Median-Priced Home as a Percent of Gross Income, 2012

	Median Income	Payment vs. Gross Income
White	$27,999	27.1%
Black	$21,644	35.0%
Asian	$30,893	24.5%
Hispanic	$20,856	36.3%
Male	$33,904	22.4%
Female	$21,520	35.2%

Sources: NAR, FHLMC, Census, RCG

Income and Earnings Summary Measures by Selected Characteristics, 2012

Type of Houshold	Number (Thous.)	Median Income
Family households	76,509	$62,527
Married-couple	55,775	$76,035
Female householder, no husband pres.	15,149	$30,486
Nonfamily households	39,460	$31,231
Female householder	21,111	$26,959
Male householder	18,349	$36,643
Race and Hispanic Origin of Householder		
White	90,224	$54,729
White, not Hispanic	80,947	$56,565
Black	14,032	$33,764
Asian	4,871	$70,644
Hispanic (any race)	14,032	$40,417

Source: Census

Even under the previous more open credit environment, homeownership was more accessible to white, higher-income, traditional family households than minority households. The rate of homeownership is highest for Whites, next highest for Asians, significantly lower for Hispanics, and lowest for African-Americans. The ownership rates for African-Americans increased during the 1990s and peaked in 2004, and then began to decline as a result of rising subprime-driven foreclosures. For Hispanics, the ownership rate rose during the 1990s and through the subprime era (2005-2007), but fell in the aftermath. The Home Mortgage Disclosure Act shows the problem both in far fewer applications by African-Americans and Hispanics, and still-fewer originations (a reflection of stringent credit policies.) In 2012, 75.6% of applications and 78.1% of originations were from White borrowers; note how the percentage grew through the approval process. In contrast, African-Americans represented only 3.8% of applications and 2.3% of originations in 2012. Hispanics represented 5.9% of applications and only 4.9% of originations. These numbers look more like the America of the 1950s, not the America of 2013. All one need do is look at the diverse and multicultural nature of our nation; the Joint Center for Housing Studies of Harvard University projects communities of color will account for more than 70% of net household growth between 2013 and 2023.

There is still an income gap in our society in which women earn less than men. For female headed-households, this can make the difference between qualifying and not qualifying for a loan. Median weekly earnings for women lag men by a ratio of 82.2%. The income gap between Whites and Minorities has widened, particularly for younger households. Unemployment is higher for the young and for those with less education. As a consequence, women, African-Americans and Hispanics must pay a higher percentage of their income for housing, whether purchased or rented. The United States welcomes more than a million new legal immigrants per year and is considering reforming immigration laws. At the same time we are making it likely that new immigrants will never qualify for mortgage credit.

According to the Joint Centers for Housing, the number of households paying more than half of their pre-tax income for housing climbed to 20.6 million in 2011, from near 13 million in 2001, a 58% increase. About half are renters and the rest are owners. Rents are currently rising. While the pace of multi-family construction has increased, demand still outweighs supply. In many communities, the cost of renting has exceeded the cost of buying, but households have no access to credit for a purchase. A historically small subset of individuals and families can choose if they want to rent or to own; for those who fall outside the current, smaller credit box, the choice is made for them, effectively denying them a full toolkit with which to manage and plan their finances and their futures. Indeed, with the cost of rent increasing and access to credit so limited, their options are continually diminishing. A comparison of a 43% DTI and rent alternatives may reveal little difference. Where will people go if they are denied mortgage credit and can't afford to pay rent? The only alternative is to "double up" with family or friends – which is evidenced by the slow growth in household formations during the Great Recession. Too many have already fallen out of the system with little opportunity to rehabilitate and now more are threatened. We remind readers that first-time home buyers with weaker and alternative credit histories, including many self-employed borrowers, have been brought into homeownership for decades. What qualifies a person for a loan is being dramatically narrowed at the same time the cost of renting is skyrocketing. Now more than ever, having a national housing strategy is essential to address both rental and home-buying concerns.

What is the New National Intent?

Beginning in the 1930s, Federal programs were put in place to encourage homeownership through providing credit to hard-working, less well-off families to facilitate their economic health and to strengthen the economy. The economic growth generated by home sales, mortgage creation, home repair and renovation, furniture purchases, lawn care, swing sets and other spending associated with homeownership creates jobs and contributes to GDP growth. Today, loan-to-value limits, fees and credit-score requirements – whether embedded in GSE or government loan guidelines or in the overlays that private lenders place on these guidelines – eliminate many of the families once served. New regulations will even more severely limit access to credit from the Federal government and from private sources. Individuals and families will make their own choices or may be forced to rent. As to choice, surveys indicate that the American consumer has the same desire to pursue the "American Dream" of homeownership that has existed as a cultural cornerstone for decades, if not centuries. In the most recent Fannie Mae National Housing Survey, 71% of respondents said it was a good time to buy and 65% said they would buy if they were going to move. Nevertheless, given the state of homeownership in the current economy, a sound multi-family strategy with new units available at affordable rents is essential. Equally essential, especially so when considering the long-term health of the American economy, is a mortgage finance system that opens the door to homeownership for those across all income classes that are willing and able to take that step.

In response to the excesses of the bubble period, we are step-by-step creating a reformed system with near zero tolerance for risk. The danger in not recognizing this is that we may end up creating a system that is far too restrictive and "throws out the baby with the bathwater." While it is relatively simple in theory, and should be demanded in practice, to avoid knowingly or negligently making a bad loan, no home loan is risk-free when you consider what can happen to a person's job, health and circumstances. The point of Dodd-Frank was to encourage the making of good loans; the goal was never to make the perfect (risk-free) loan (one that would never, under any circumstance, default – which is an impossible assignment). In examining the legislative history of Dodd-Frank, it is clear that Congress wanted to preserve access to affordable credit. Congress expressed throughout the legislative process that the QM test should not impair the availability of reasonable and affordable mortgages, and Congress provided authority to provide solutions. "The [Bureau] may prescribe regulations that revise, add to, or subtract from the criteria that define a Qualified Mortgage upon a finding that such regulations are necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers" (Dodd-Frank Act §1412).

In keeping with this intent, the agencies responsible for the newly re-proposed Credit Risk Retention Rule chose to link QRM and QM. They specify that QRM will be equal to QM by removing any down payment requirement. Included in the re-proposal is an alternative termed "QM plus" that does include a substantial down payment of 30%. These proposals are currently in the comment period. We appreciate this late-breaking simplicity and are not going to address the major restrictive effect of a 30% down payment requirement in connection with Credit Risk Retention; but in keeping the focus on the current rule, the non-agency market will need more than a 43% DTI risk marker to attract investors to new issues. There is also a plan to automatically make QM loans accepted for agency execution. This so-called patch to assure credit availability, however, is temporary with a scheduled expiration date. There has also been discussion that the GSEs may use 43% DTI as their standard which would vitiate the purpose of the patch. The importance of the "patch," or some accommodation cannot be overstated; 33% of African-Americans had back-end DTIs exceeding 43% while 20% of Whites are above.

In the final analysis, the mortgage meltdown left a series of issues that we as an industry are working hard to resolve. The challenge is to balance the need for financial safety with the economic and social need for access to credit. We had a problem. Now in trying to solve the problem, we paralyzed the private market even as we increased the uncertainty about the public market (i.e. GSE/FHA/VA). These new rules might prevent another financial crisis, but they are likely to slow the economic recovery and accelerate the wealth divide!

The Solutions

Developing solutions requires a holistic approach with an initial focus on whom our nation seeks to serve and what our nation seeks to achieve. Critical decisions include the level of government involvement, selection of inputs that create good mortgages, and the design of effective bridges to achieve successful homeownership.

Our four decades in housing finance have taught us that we can rebuild an effective mortgage and housing finance system to achieve these four core principles:

- Homeownership is an important avenue of wealth accumulation for the young and for the working class in our nation, and is therefore an element of a vibrant economy.

- Lending to individuals with low- to moderate-income can, and must be done successfully, and with a low rate of foreclosures.

- Low down-payment lending is critical in the conventional and governmental market if access to credit is truly to be made available to individuals other than those who already have significant resources.

- Government programs should be targeted and not crowd out the private sector and private capital. In addition, the regulatory framework should not disadvantage the private sector and the return of private capital.

Given these principals, to build a sensible mortgage finance policy that is sustainable over the long haul, we make the following recommendations:

Like any good manufacturing process, it is important to start with appropriate standards for the inputs to the product - in this case, the mortgage. The quality of the inputs matter for the consumer, the lender, the investor and every other market participant, and form a critical foundation for a properly functioning secondary market that supports the homeownership goals we are hoping to achieve.

The inputs include an analysis of the reasonableness of the loan and a borrower's ability to repay it. Key factors include:

- Fully amortized loan products that do not permit any negative amortization, so that we don't confuse liquidity with affordability as we did in the lead-up to the housing crisis;

- Documentation and verification of the borrower's income and financial resources, to ensure that the borrower has the means to repay the loan;

- Loan underwriting based on payments reflecting full amortization and that takes into consideration all mortgage-related obligations such as taxes, property insurance and all assessments, in order to paint a clear picture of the financial obligation under the loan;

- Reasonable debt-to-income ratio, to ensure that borrowers can afford not only to "live in their homes," but also to "live" in their homes – as in not being house poor.

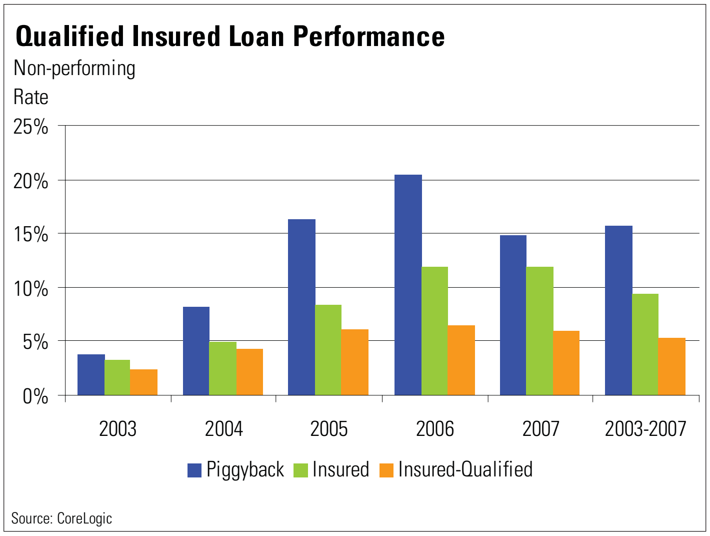
The inputs that make up the individual mortgage are the foundation upon which the rest of the system, including a secondary market buffered by investor confidence, is built. Prior to the first decade of this century, American mortgages were seen as a platinum asset. It is critical to return the mortgage product to this pristine status not just for consumer and investor confidence, but because doing so will allow us to pursue and implement policies that further the achievement of critical national goals.

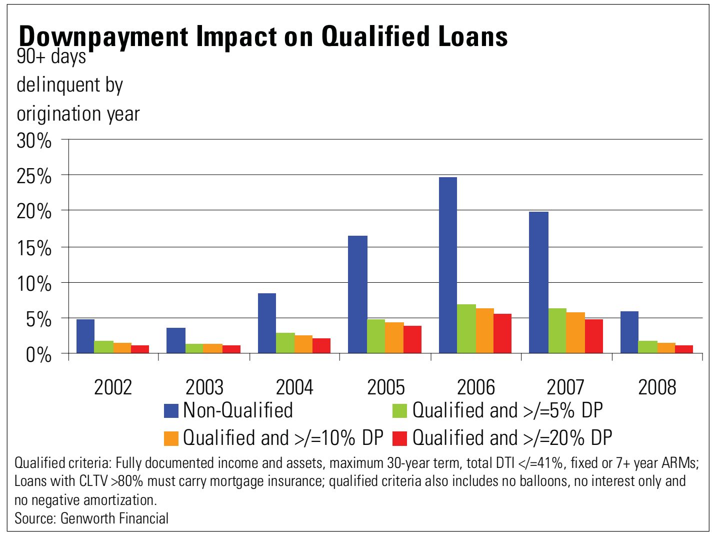
Designing and Targeting Government's Response

Whatever secondary market design policymakers determine, whether a replacement for or alteration to Fannie Mae and Freddie Mac, there will need to be a government guarantee. After the financial meltdown, investors are going to depend on that guarantee for the foreseeable future. The critical factors are that private capital is placed in front of the guarantee and that the government is adequately compensated for providing the guarantee. The guarantee will also be critical in preserving the TBA (To Be Announced) market that facilitates forward rate commitments and rate locks for consumers.

Specifically the capital, which is stacked in front of the government guarantee, should utilize structures that facilitate the pooling of mortgages and capturing the advantages that come with it. Pooling is a core concept of insurance, whether that insurance is covering homeowners, health, life or mortgages. It allows for the inclusion of well thought-out terms of borrowers who are strong and not as strong, leading to stronger performance and profitability. This type of pooling was a part of GSE and non-agency securitization issuance successfully for decades and was a key part of providing access to credit to first-time home buyers and lower income borrowers. The layer of private capital as credit enhancement to stand in front of a government guarantee exists in several GSE reform proposals, and could take the form of bond or mortgage insurance or a credit-default swap CDS contract or some type of credit-linked note. The new government insurance entity would guarantee the securities (meaning investors would be taking no credit risk) and then re-insure the subordinated security or buy protection via a CDS on that security. In either instance, because traditional bond or mortgage insurance or the CDS would be entered into with private parties, it would be private capital at risk on the subordinated security.

One of the critical structuring and policy questions is, who creates the pool? One of the risks of having the private sector able to select the risk it takes is that they will naturally select households at the pinnacle of the credit pyramid. If the government entity sets the parameters for the pool, then there is a greater likelihood that it will be broader in scope than a comparable pool created by the private sector using risk-based pricing and guided by profit goals. This is one of the reasons that the market moved away from smaller pools to mega pools during the last decade; this move had nothing to do with the boom/bust crisis. Broader pools set up by the government entity can take full advantage of pooling options that are generally not be available in more segmented private-sector structures.





The CFPB has been charged with defining the Qualified Mortgage as the new standard for presumptively reasonable mortgage products. This means that this system will have locked in a credit standard that creates a very predictable risk box. If there is predictability on the inputs, it allows for greater cross-subsidization to achieve policy objectives. This would translate into an ability to reduce today's mortgage government and GSE overlays and not have average FICOs for FHA loans of almost 700 and Fannie Mae and Freddie Mac loans of over 750. The GSEs could reduce their loan level pricing adjustments in order to open up additional credit availability.

The agency acceptance should allow for higher DTIs and retain a large credit box that will result in more originations for low- and moderate-income people. With this much disparity in the system, we have to consider extending the so-called patch to non-agency originations that are agency eligible except for loan amount. Regardless of loan amount, it should still be a QM. It will only limit credit to so restrict the non-agency market for loan amount alone. This is particularly critical as the government begins to reduce the loan limits.

The mission of the FHA should be targeted to focus primarily on first-time and low- to moderate-income borrowers. Serious consideration should be given to utilizing income rather than loan limits as the sole determinant. Income targeting is used today in mortgage revenue bond programs and in the rural housing program.

Once the Qualified Mortgage rule and the new CFPB mortgage-servicing rules go into effect next year, we suggest that the CFPB and U.S. bank regulators - or perhaps even Congress - create a regulatory "time out" or assessment period of 24 months to assess the cumulative impact and economic cost of all new rules to date. In particular, lenders need time to adjust to the new rules to make underwriting decisions. We hope that as loan performance stabilizes, regulators will adjust guidance to put more of the decisions in the hands of the underwriters. Lenders need time to ensure compliance where there are bright lines and to implement sound underwriting practices where there are no bright lines, and then to see how the landscape plays out. During the 24-month assessment period it would be constructive if regulators worked with lenders on identifying and strengthening bright lines.

Developing Bridges to Homeownership

Regardless of how well the Qualified Mortgage is implemented into the overall mortgage market, the limited size of the QM safe harbor market will reinforce the standing walls that created the very tight credit environment. Coupled with ongoing regulatory and litigation exposure, both for past actions and with respect to businesses yet to be formed, low- to moderate-income borrowers with credit scores between 620 and 680 are, in the short- to mid-term, going to find access to credit challenging, and those with scores below 620 will likely find themselves effectively shut out.

Lenders and those investors who accept risk within the new secondary market structure must develop a high-touch process to bring potential borrowers who are willing to work and improve their credit into a system that results in access to mortgages. Developing robust solutions that bridge individuals into successful homeownership is an important aspect of the new housing and mortgage finance reality.

It has been a long-term Federal policy to help get individuals and families on the ladder of homeownership. Is this still our policy? These policies paid dividends in improving homes, neighborhoods, communities and the economy as a whole, let alone the lives of the people who can call their four walls and a roof their own. The reality is that to support this policy, risk must be managed and tolerated and innovation is required. In economics, a virtuous circle is a self-propagating set of circumstances in which a successful result leads to another successful result in a circle or chain. In housing, this chain starts with the first-time home buyer and progresses to the trade-up buyer and on to the down-sizing buyer. Underwriting, in particular for first-time and low- to moderate-income home buyers, needs to depend on more than just a credit score and DTI ratio. Good underwriting is both an art and a science based on years of experience, but it requires a full and accurate income and credit profile of the borrower. There were many good loans written prior to the mid-1990s before FICO usage became dominant. Now that we are putting structural protections back in place, we need to recognize that trained, knowledgeable underwriters, working within lending laws and guidelines that make sense, should be able to make decisions that support the development of a stable, affordable borrowing base.

First-time and low- and moderate-income borrowers likely have saved some amount of money, but nowhere near the 20% that traditionally triggered mortgage insurance. They likely have employment with enough income to meet principal, interest and other mortgage-related payments monthly. In fact, their overall housing costs – principal, interest, taxes, insurance and association dues (PITIA) – may well be less than the rent they pay for equivalent housing in many parts of the country. If they are a young family, however, they and the lender will have to pay attention to what might happen down the road. Do they have adequate income if they decide that one of them will stop working, or cut back hours so they can have and raise a child? Does anyone want to be in the business of telling a family when they cannot have a child? This is why a strong lender partner with solid underwriting knowledge is so critical in the successful homeownership equation.

The tougher challenge is to outline and structure deliberate steps to help a family with a FICO score between 620 and 680 improve their credit score and home purchase readiness. It will take a multi-faceted, deliberate effort.

- Rent with an option to own is an approach that provides time for the home buyer to accumulate a down payment or work to rebuild a damaged credit score, obtain credit counseling and learn budgeting. An effective conventional rent with an option to own would benefit from an FHA execution targeted at very low-income individuals and a standardized execution by Fannie Mae or Freddie Mac.

Building a Path to Homeownership

- In addition to rent with an option to own, there should be an effective program built that leads a borrower to single-family homeownership. This program should utilize elements of first time homeownership programs that were successful previously. An approach that utilizes State Housing Finance Agencies, lenders, private mortgage insurance companies, and credit counseling agencies that are committed to savings and credit improvement can be successful.

- A full-cycle education program with debt and budget counseling should be mandatory for someone with a 620 or lower FICO score who is trying to improve to 680, but it should be available to anyone. A person can be higher income and still not understand what it takes to buy and own a home. Credit counseling helps prevent or resolve financial issues, and improve the borrower's credit so they may be eligible for a prime loan. A full-cycle approach is continuous with significant focus on the initial 24 months after closing a loan, so that individuals stay on track with budgeting and bill paying and maintain their credit improvement efforts. Counseling should include ensuring borrowers understand that owning a home is not like paying rent. The borrower needs to be prepared to meet the costs of expected and unexpected repairs, lawn care, homeowner insurance, property taxes and the other unique costs and responsibilities of homeownership.

    - Take the case of a responsible married couple in their late-30s with two children whose credit has been hurt by 18 months of the husband's unemployment. It illustrates the value of full cycle. Prior to his losing his job, they had savings, but they had also just purchased a car. The car is needed in the job hunt process, but with his unemployment check significantly lower than his paycheck, their savings dwindle to nothing. They fear homeownership is now out of reach. Finally, the husband gets a job, but at a 50% pay cut from his previous position. They are now about 24 months away from improving their credit and saving the 3 and ½% needed for an FHA down payment. They receive credit counseling and are extremely disciplined. They call each credit or other company to whom they owe money and negotiate a payment schedule they will be able to meet and do so. Over the next two years they gradually pay off their debts and increase their savings to meet the goal of the $7,875 down-payment needed to purchase a $225,000 home. They find a home of their dreams and apply for an FHA mortgage. Mortgage insurance is used to support their low down payment. And they are able to achieve homeownership.

- It is important to remember that successful homeownership over the decades has been about building equity. Potential home buyers should be educated on how buying a slightly smaller home with commensurate lower monthly payments can allow them to succeed as homeowners and to build equity more quickly. Home buyers might also consider shorter amortizing 25- or 20-year mortgages, or contribute additional principal every month to speed up the amortization of a 30-year mortgage.

- As an additional point of focus, second mortgages should have two common sense requirements:

- The entities that have the risk on the first lien should have the ability to approve a subsequent lien.

- The ability to take a second mortgage, other than a traditional home-improvement loan should be limited to using the funds to cover a health event or a college or similar professional education, not simply to facilitate additional consumer spending. Simply put: education YES, a 50-inch flat screen TV NO!

- Maintaining a conventional and government market with low down payment, where the borrower contributes a 3% to 5% down payment utilizing either FHA or private mortgage insurance, is also an important feature of a properly functioning mortgage market. The FHA program should be targeted to help borrowers that are first-time or low- to moderate- income buyers.

- The mortgage meltdown demonstrated the critical role of the special servicer in handling the unique servicing needs of distressed loans as the population of these loans increased to historic levels, as well as the critical need for special servicers (and, in fact, any servicer) to be responsive to the borrowers under these loans. Every borrower does not need the same level of attention, but certain borrowers need – and deserve – extraordinary, and extraordinarily careful, attention. It is clear that a special servicing function needs to be built into the new mortgage finance system as it is in commercial mortgage-backed securities. This will require a slightly higher servicing fee to cover the costs, but it will be available immediately when needed, which was not the case for an extended period during the recent crisis.

- So how do we – all of us, as an industry, including borrowers – pay for such a high-touch, robust program? There are many who would argue that it should be paid for by the lenders, the government or charitable/foundation contributions. But if we are serious about building a robust, properly functioning infrastructure, then the cost should be built into the individual transaction and the broader mortgage finance system. That includes a portion of these costs being charged directly to the borrower, who will ultimately benefit from the program through increased access to affordable credit on safer, sounder terms, and a portion of the costs being shouldered by other participants in the mortgage finance ecosystem. In addition, in order to make this program sustainable and broad-based to the benefit of the housing market, additional basis points should be added to the servicing of all newly originated loans. There is a justification for adding a few basis points on to the servicing fee to fund a high-touch system, targeted on welcoming a pipeline of home-ready buyers into the single-family mortgage finance system. Mortgage credit, unlike other forms of credit, has the potential of having an impact beyond those directly involved in a specific mortgage. If that wasn't understood before the recent meltdown, it certainly is understood today, so it is not unreasonable to spread a few basis points across all mortgages to cover the cost of a higher-touch system that provides expanded access to credit with lower future foreclosure frequency, and supports a virtuous housing circle as a policy goal. This additional cost will not push an individual loan outside of the mortgage universe, and the benefits to individual households, to neighborhoods, to cities, to the economy and ultimately to our country will certainly outweigh the cost in the long run.

Conclusion

As lenders and policymakers continue to build out the mortgage and secondary market of the future, it is critical that all participants remain focused on who the system is intended to serve. In the end, the segments of the population who qualify and who do not qualify should not be by accident or happenstance, but by policy design. While homeownership is not for everyone, and affordable rentals will be a larger element of the housing equation then in the past, for those Americans who are willing to work to be successful as homeowners, the mortgage finance system should provide them a clear path to achieving the "American Dream."

Our vision of the future is:

- To create a credit framework that is not based on fear of the past reoccurring, but creates a Qualified Mortgage that provides appropriate access;

- A Qualified Mortgage that is equally appropriate whether the loan is a government or a non-agency mortgage;

- A mortgage finance system and structure that utilizes pooling to expand opportunity as opposed to a structure that segments and limits access;

- A system that builds and pays for a pipeline of future home buyers that are willing to save and improve their credit to qualify for homeownership;

- And a system that always achieves access to homeownership with low foreclosures.