Brookings Event - Restructuring the U.S. Residential Mortgage Market February 2011

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MBA Research & Economics

Discussion of Pozen's Paper: Summary

- The mortgage market from an institutional investor's perspective
  - Need tighter credit standards
  - Simpler security structures
  - More disclosure
  - Liquidity
  - Prepayment protection for investors
- Alternative view: the market from an originator's perspective

Conservative Rating Agencies Criteria

Generating Rating Stressed Losses

A core objective of the model framework is to more clearly associate rating stress levels with economic conditions and home price correction scenarios to aid investors in understanding the type of stress and the associated loss expectations each rating category represents.

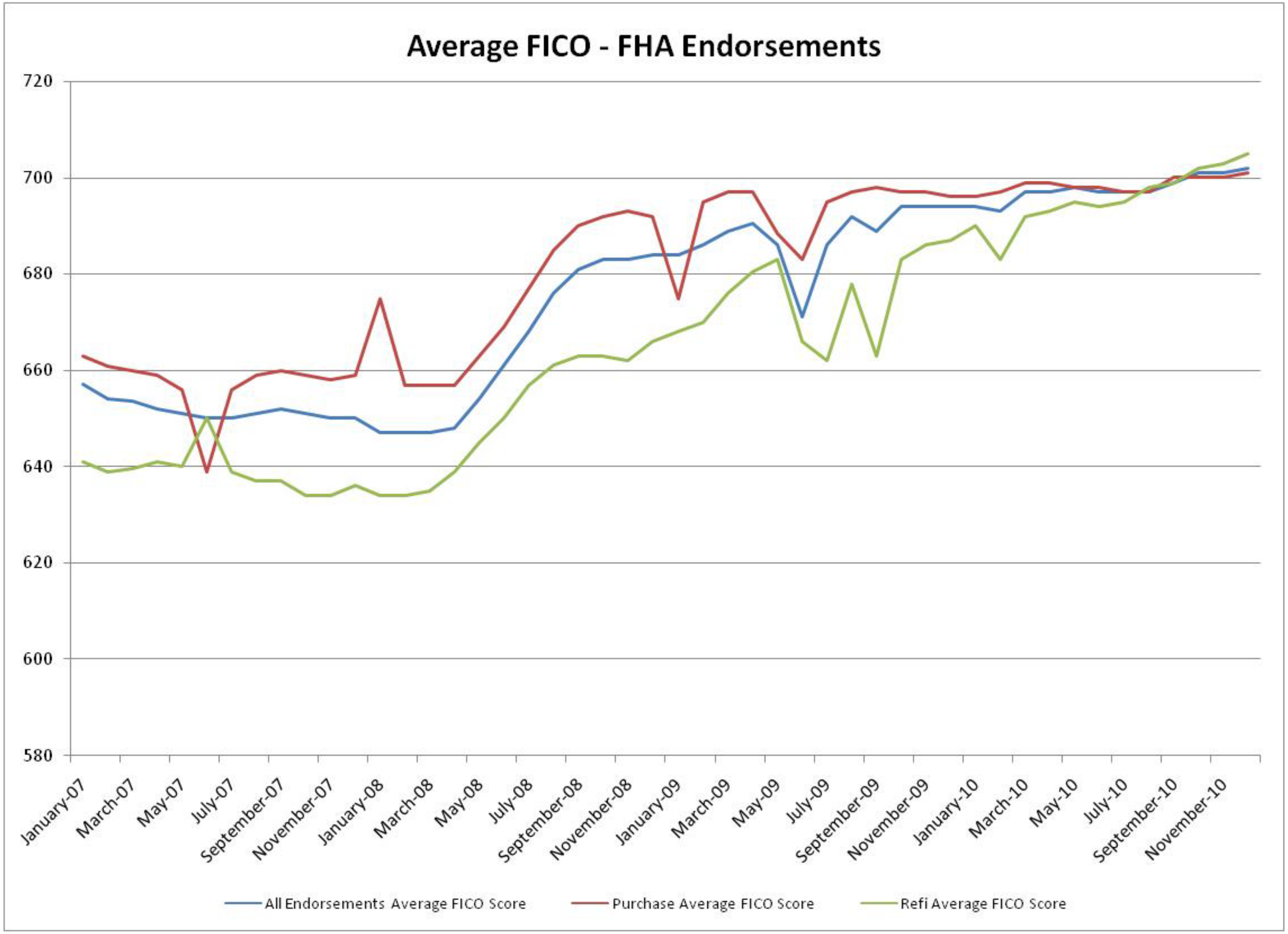
When deriving a loan's FOF and LS at each rating category, the primary variable used to determine the stressed scenarios is the sMVD. Fitch calibrated the sMVD stress scenarios using the recent downturn's 35% peak-to-expected trough national home price decline to represent a 'A' stress. Therefore, when assigning new ratings, bonds rated 'A' or higher must have, at a minimum, sufficient loss protection for each loan to experience a 35% market value decline.

Rating Category Stresses: sMVD Floors

	sMVD Stress is the Higher of:	
	sMVD Floor (%)	OR the Multiple Times (*) Base Case sMVD
AAA	45	1.30
AA	40	1.25
A	35	1.15
BBB	30	1.10
BB	25	1.05
B	20	1.00

Source: Fitch Ratings, US Prime RMBS Loan Loss Model Criteria: Exposure Draft, February 2011.

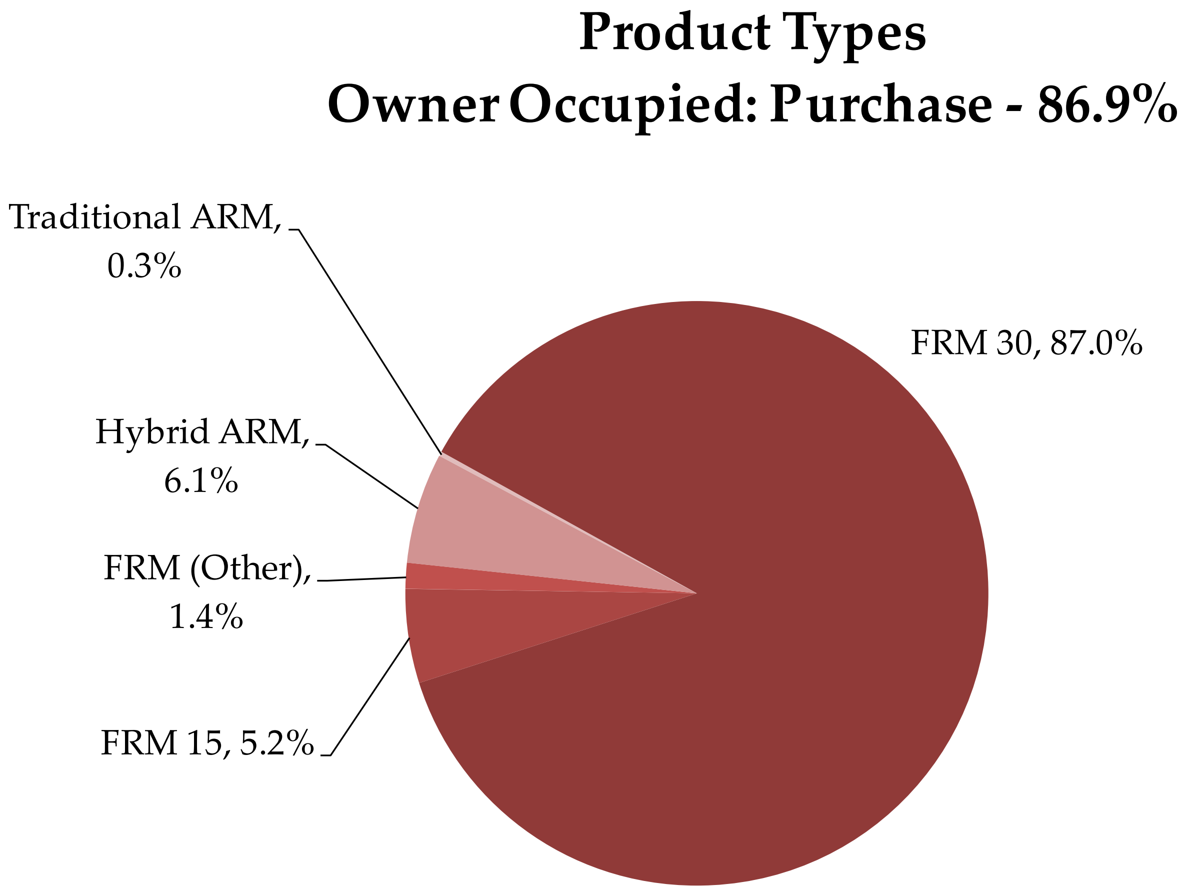
FHA Standards Tightening



Source: FHA

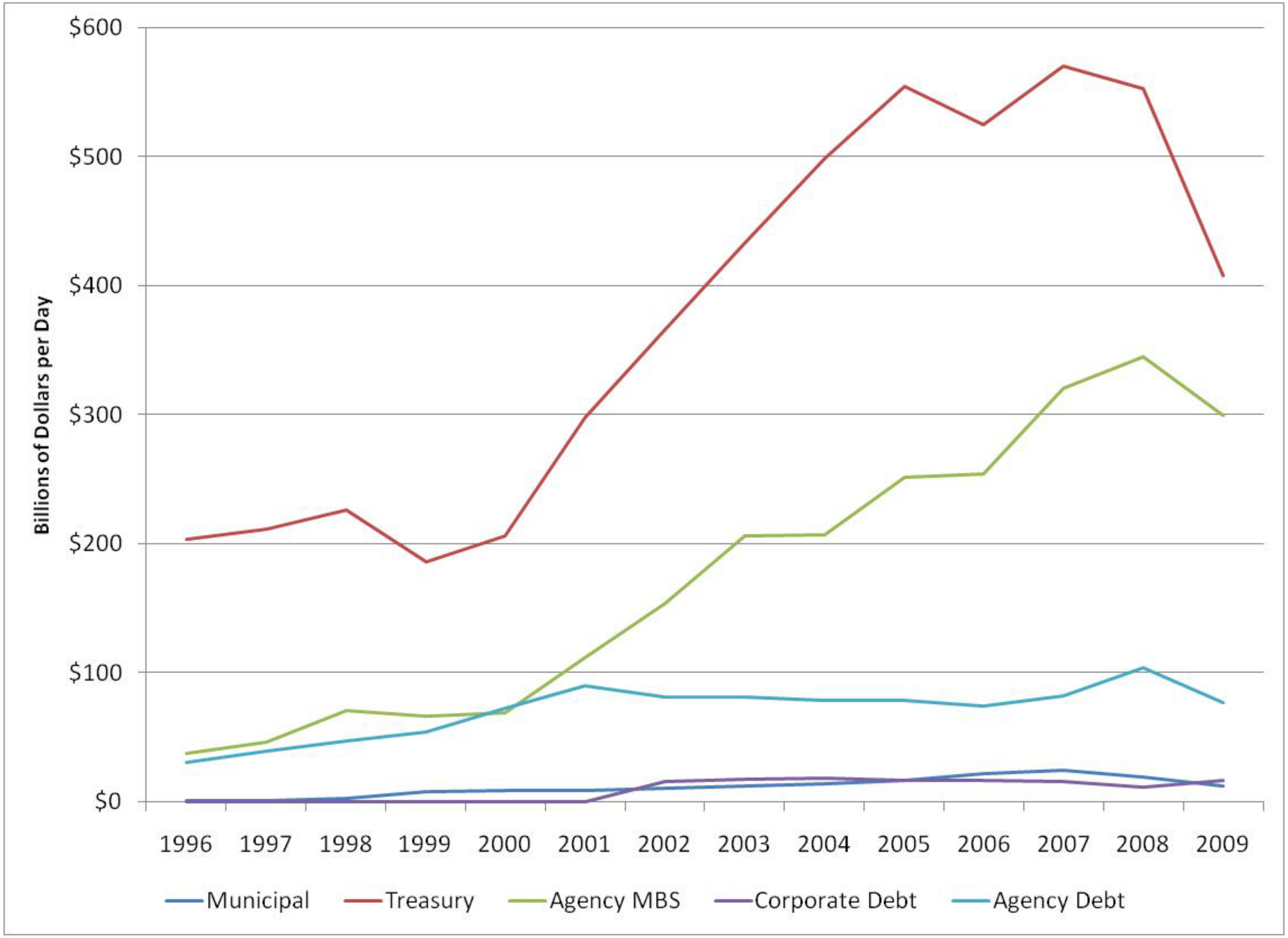
Weekly Apps – Product Mix

Purchase Apps For Owner-Occupied



Source: Mortgage Bankers Association, Weekly Loan Applications Survey- for the month of December 2010.

Liquidity is Abundant in Today's Market: MBS Trading Volume

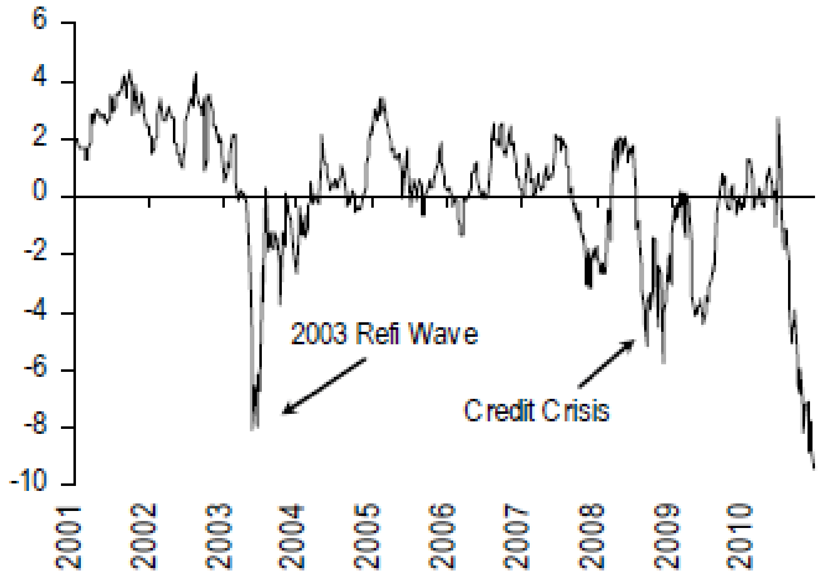


Source: SIFMA

…But Liquidity is Fragile

Exhibit 5: Gold/Fannie swaps at decade low

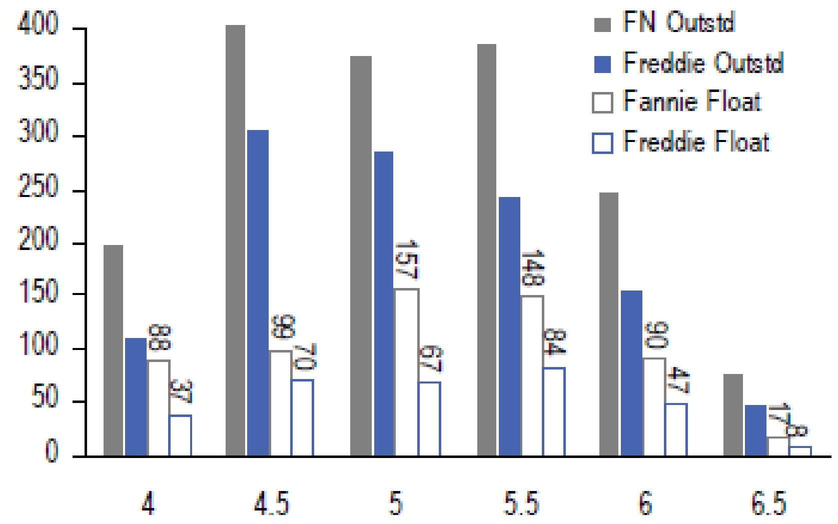
Balance weighted average Freddie 30-year TBA prices relative to Fannies 30-years, in ticks since 2001



Source: J.P. Morgan

Exhibit 8: Substantially smaller float in Gold 30-year collateral

Outstanding and float (net of REMIC, spec pools and Fed holdings) in Fannie and Freddie 30-year fixed rates, in billions



Source: J.P. Morgan, Fannie Mae, Freddie Mac

Originator's Perspective: Addressing Competing Demands

What Investors Need

1. Clearly defined federal credit support
2. Liquidity
3. Simplicity and/or information
4. Quality regulation of guarantors and systems

What Borrowers Need

1. Certainty of execution
2. Consistent offering of core products
3. Competitive pricing
4. Efficient means of locking in mortgage rate

Discussion of Pozen's Paper: Agreement

- Positive and negative externalities in this market
- The importance of recourse provisions (but questions about impact)
- Government subsidies should be transparent and on-budget
- "30-year, fixed-rate mortgages without any prepayment penalties…are not financially viable absent a governmental subsidy."
- Equity capital to support mortgage credit risk is scarce -- implications for covered bonds

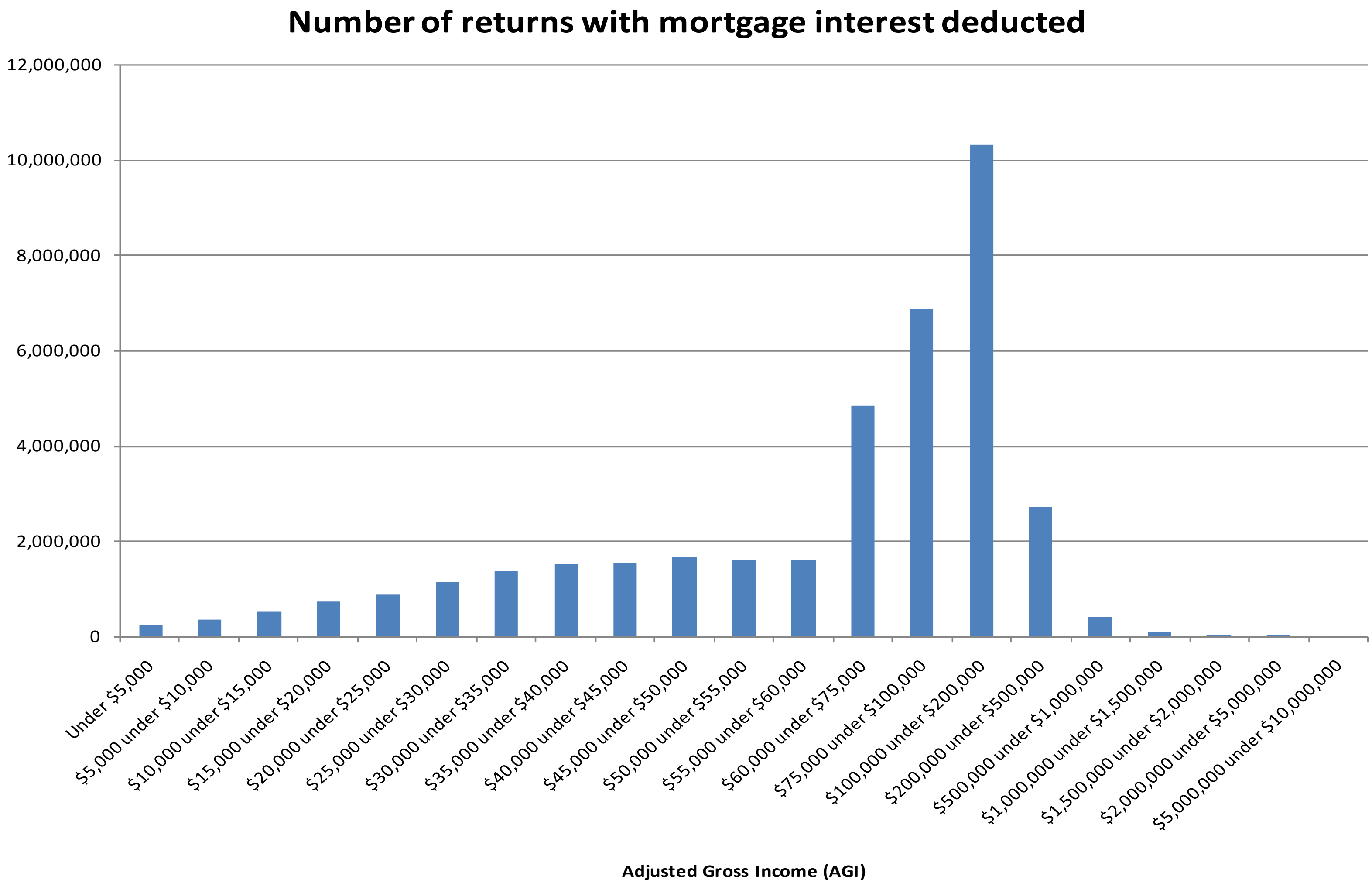
Discussion of Pozen's Paper: Disagreements

- 5-year prepay penalties are an option??

- Nature of QRMs/Connection to FHA

- Market impact of change in MID

MID Facts



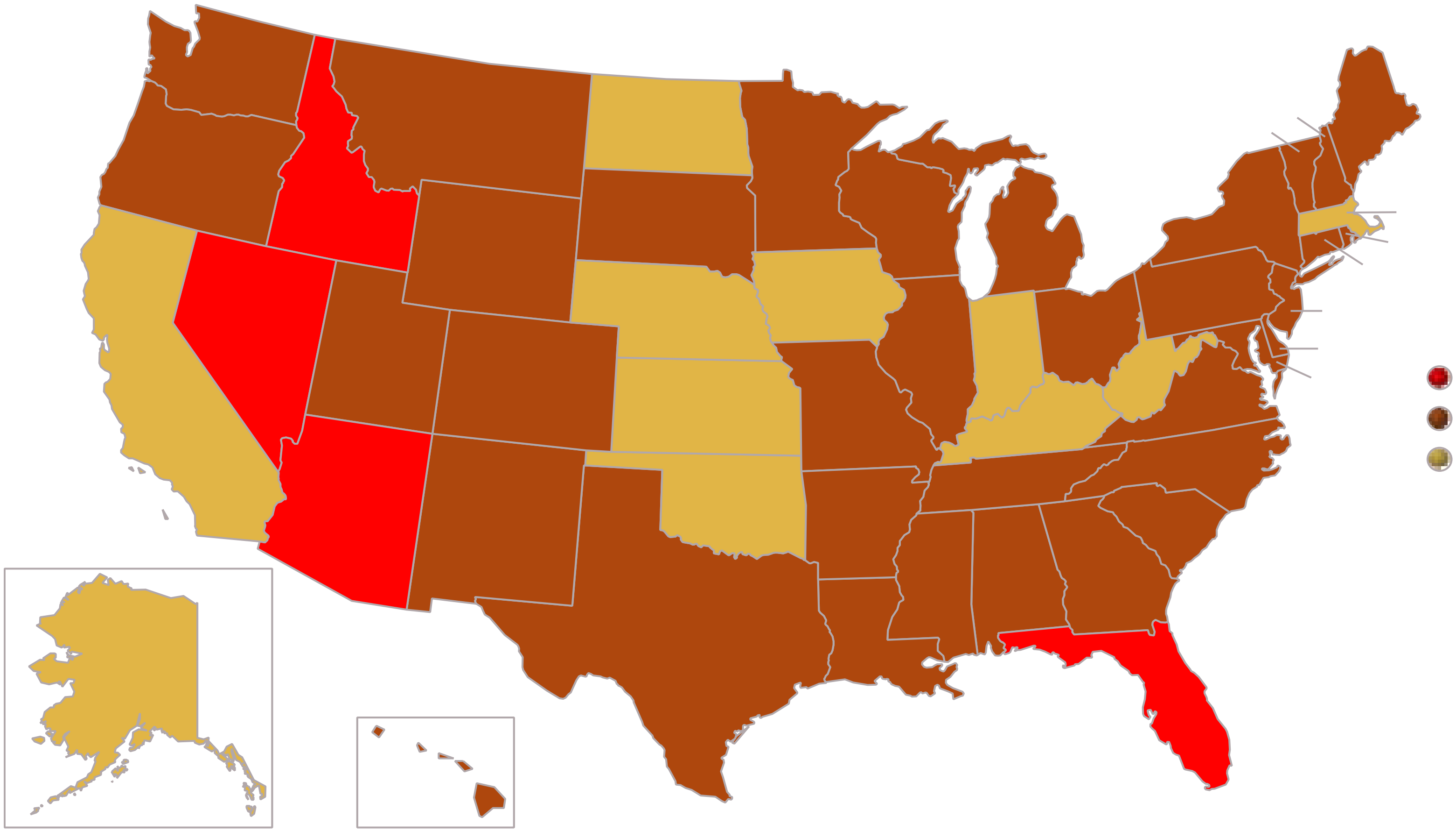
As shown above, the largest category of taxpayers who deduct mortgage interest have incomes in the $100,000-$200,000 range. Above this level, the cap on mortgage interest of $1.1 million becomes binding.

Of filers with itemized deductions, 64.7 percent have incomes below $100,000, and 91.4 percent have income below $200,000.

Source: This analysis was based on data compiled by the Brookings-Urban Institute Tax Policy Center from IRS historical records.

State-level Home Price Growth: 2010 Q3

Year/Year Change



Source: FHFA All Transactions Index

Seeking the Right Balance of Federal Support: MBA’s Plan for the GSEs

1) Make sure that private capital is the first line of defense against losses, with no institution too big to fail.

2) Establish an insurance fund as the second line of defense.

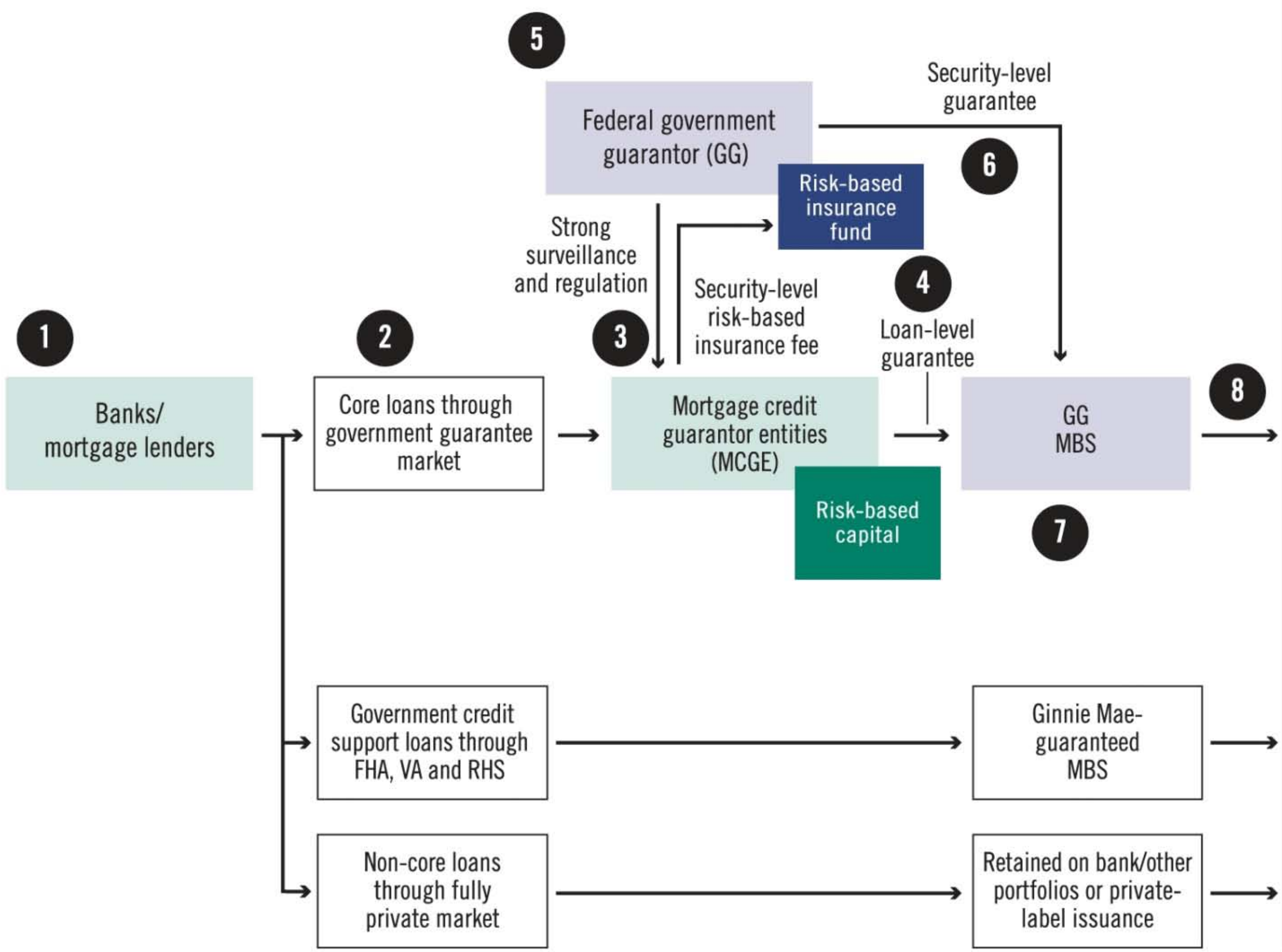
3) Make explicit what is and is not supported. Move from enterprise-level implicit guarantee to explicit security-level guarantee.

4) Establish explicit fees for compensating the government for the guarantee.

Core Secondary Mortgage Market: MBA Recommendation

HIGH-LEVEL VIEW

TARGET STATE: POTENTIAL ROLE OF THE FEDERAL GOVERNMENT IN THE CORE SECONDARY MORTGAGE MARKET



1. Mortgages are originated.
2. Mortgages are submitted to MCGE for credit underwriting and pooling.
3. MCGE prices and holds capital for the credit risk of the loans.
4. MCGE guarantees timely payment of principal and interest of the loans.
5. Federal agencies provide oversight, regulation and security-level guarantee in exchange for risk-based fee.
6. GG guarantees timely payment of principal and interest of the security.
7. MCGE or mortgage lender issues GG security to the market.
8. Based on the GG guarantee, security trades in equivalence to full faith and credit of the U.S. government; security buyer takes all the interest rate risk.

But can the government price a guarantee correctly?

- **The government could misprice the wrap premium:** Of course, they could over- or under-charge for the wrap, with costs for each.

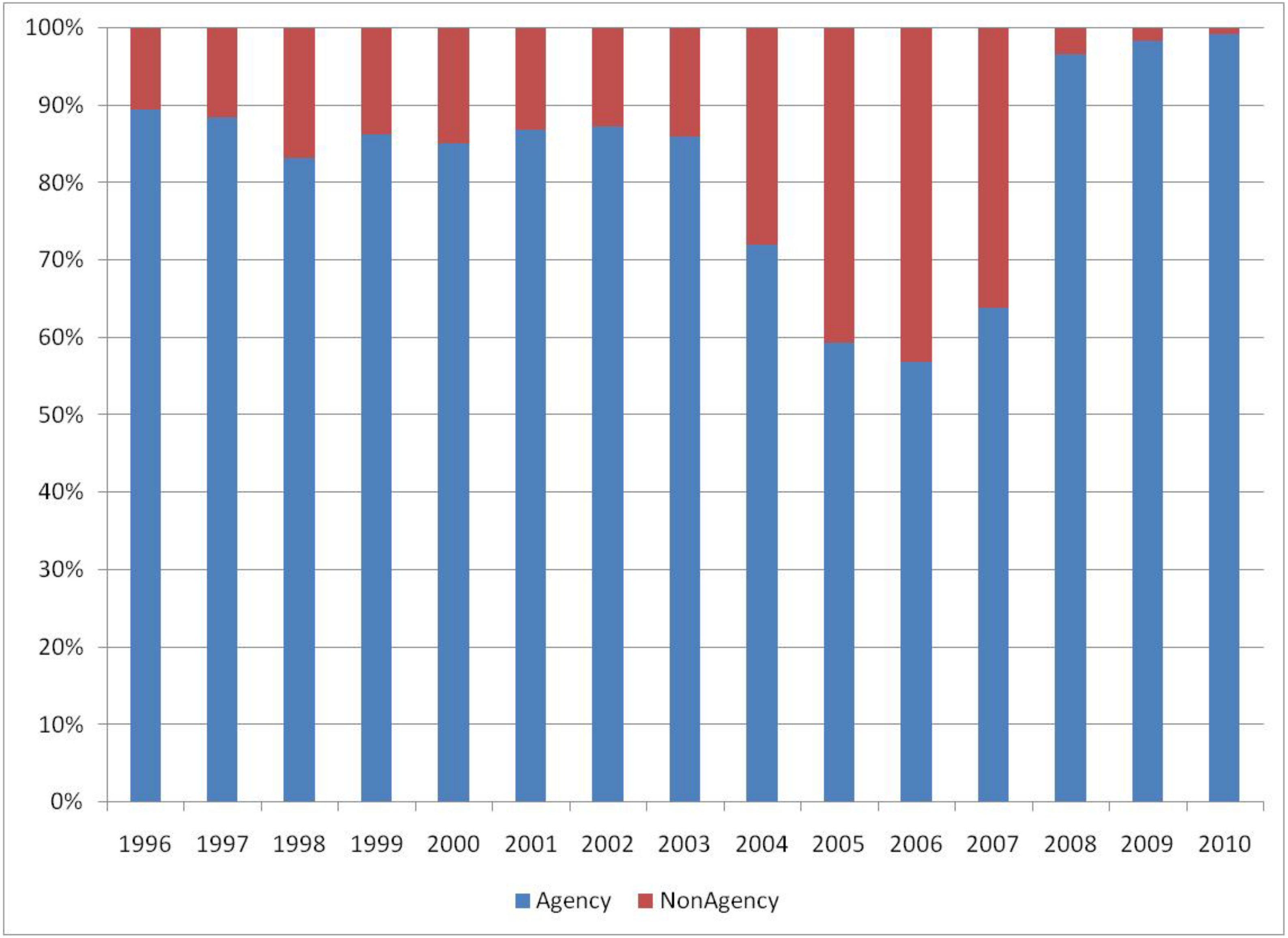
- **We know zero is the wrong price:** The GSEs paid nothing for the implicit guarantee, and yet taxpayers owe $150 billion and counting. In our model, the government will collect a stream of insurance premia.

- **In our model, the government guarantee protects against the risk of an institution failing, similar to deposit insurance.** Not a loan-level guarantee.

- **Pricing tail risk is difficult for both the private sector and the government. However, it is less difficult now than it was 5 years ago.** At that time rating agencies and investors looked to "stress events" for which there were incomplete data and different market practices. We just lived through the worst real estate downturn since the Depression. And we have excellent data capturing just how bad it was.

- **Governments intervene to protect depositors and prevent housing market collapses:** Better to recognize that upfront, collect revenue, and properly define the boundaries of intervention.

MBS Issuance by Type



Source: SIFMA

The Challenge of Housing Market Reform

“There is nothing more dangerous than to leap a chasm in two jumps.”

David Lloyd George

Source: As quoted in *Design for Power : The Struggle for the World* (1941) by Frederick Lewis Schuman, p. 200; This is the earliest citation yet found for this or similar statements which have been attributed to David Lloyd George, as well as to Benjamin Disraeli, Winston Churchill, Vaclav Havel, Jeffrey Sachs, Rashi Fein, Walter Bagehot and Philip Noel-Baker. Wikiquote

Contact Information & MBA Resources

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Appendix

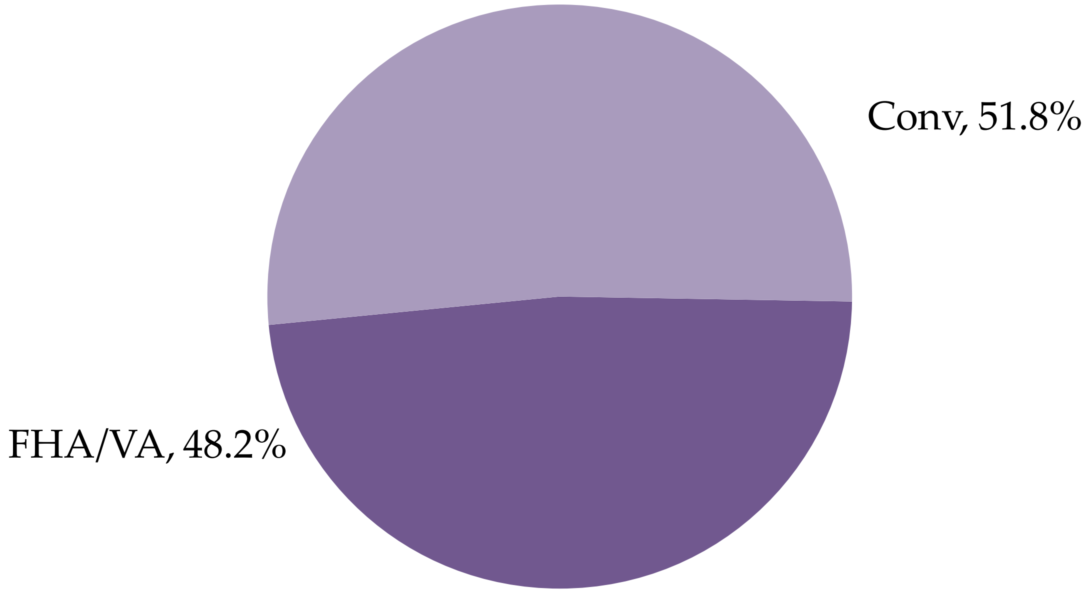
Mortgage Originations Forecast

	2009	2010	2011	2012
Mortgage Originations				
Total 1- to 4-Family (Bil $)	1,995	1,505	966	976
Purchase	700	473	614	740
Refinance	1,295	1,032	352	236
Refinance Share (%)	65	69	36	26

Weekly Apps – Loan Type Mix

Purchase Apps for Owner Occupied

Conventional vs. Government
Owner Occupied: Purchase - 86.9%



Source: Mortgage Bankers Association, Weekly Loan Applications Survey- for the month of December 2010.

Key Problems with the Fannie/Freddie Structure that the MBA Proposal Addresses

- **GSEs were allowed to set essentially any credit standards they wanted, including moving into subprime loans, low documentation loans and pay-option ARMs, all now guaranteed by the taxpayers.**

- ***MBA's proposal will limit the credit box, limiting the loans that can receive federal support to a narrowly defined set of criteria and risks, essentially just the loans that are crucial to the continued operation of the market.***

Key Problems with the Fannie/Freddie Structure that the MBA Proposal Addresses

- **The GSEs paid nothing for the implicit guarantee of all of their activities.**

- ***The MBA plan makes explicit what is guaranteed and establishes an explicit, risk-based payment for that guarantee.***

Key Problems with the Fannie/Freddie Structure that the MBA Proposal Addresses

- **The large, highly leveraged investment portfolios of the GSEs had tremendous amounts of interest rate and liquidity risk, risk that in turn weakened the ability to make good on the credit guarantees.**

- ***MBA's plan prohibits the new firms from holding portfolios except for what is needed for securitization and managing defaulted loans. Since the debt of the entities is explicitly not guaranteed, it is unlikely the entities could profitably hold portfolios or hit market ROEs on required capital.***

Key Problems with the Fannie/Freddie Structure that the MBA Proposal Addresses

- **Similar to the problems with the dual mission assigned to Fannie and Freddie, their regulator has had a dual mission of promoting housing and regulating safety and soundness.**

- ***MBA's plan removes HUD-type housing goals from the new entities so the new regulator can focus on safety and soundness.***

Commission Chairs Proposals

Option 1: The Zero Plan

	Bottom Rate		Middle Rate		Top Rate		Corp. Rate
Current Rates for 2010	10%	15%	25%	28%	33%	35%	35%
Scheduled Rates for 2011	15%		28%	31%	36%	39.6%	35%
Eliminate all Tax Expenditures*	8%		14%		23%		26%
Keep Child Tax Credit + EITC*	9%		15%		24%		26%
Keep Child Tax Credit + EITC; Reform Mortgage, Health, and Retirement Benefits at 80% of Current Level and Switch to Territorial System*	12%		20%		27%		27%
Keep Child Tax Credit, EITC, and Current Mortgage, Health and Retirement Benefits and Switch to Territorial System*	13%		21%		28%		28%

Rates based on *very rough* static estimates. No behavioral effects are assumed. Magnitude of tax expenditures estimated broadly.

*Note: All options set aside $80 billion for deficit reduction and treat capital gains and dividends as ordinary income

Option 2: Wyden-Gregg Style Reform

- **Individual Tax Reform**
  - Repeal AMT, PEP, and Pease
  - Establish 3 rates – 15%, 25% and 35%
  - Triple standard deduction to $30,000 ($15,000 for individuals)
  - Repeal state & local tax deduction, cafeteria plans, and miscellaneous itemized deductions
  - Limit mortgage deduction to exclude 2nd residences, home equity loans, and mortgages over $500,000
  - Limit charitable deduction with floor at 2% of AGI
  - Cap income tax exclusion for employer-provided healthcare at the amount of the actuarial value of FEHBP standard option
  - Modify and repeal several other tax expenditures
  - Dedicate portion of savings to deficit reduction

Option 3: Tax Reform Trigger

- Call on Finance and Ways & Means Committees and Treasury to develop and enact comprehensive tax reform by end of 2012
- Put in place across-the-board "haircut" for itemized deductions, employer health exclusion, and general business credits that would take effect in 2013 if reform is not yet enacted
- Haircut would limit proportion of deductions and exclusions individuals could take to around 85%* in 2015. Similarly, corporations would only take some proportion of their general business credits
- Set haircut to increase over time until tax reform is enacted

*This is a very rough estimate of the haircut necessary to reduce the deficit by $80 billion in 2015

Distributional Impact of Bowles-Simpson Plan

Below is a preliminary distributional analysis of a plan similar to the Illustrative Individual Tax Plan put together by the Tax Policy Center. This estimate assumes rates of 12.7%, 21%, and 28% (instead of 12% 22%, and 28%). They also include the effects of the gas tax and other tax provisions elsewhere in our proposal. Rates of 12%, 22%, and 28%, as described in the illustrative plan, would result in a slightly more progressive outcome.

Figure 8: Illustrative Distributional Analysis

Cash Income Percentile	Percent Change in After-Tax Income	Share of Total Federal Tax Change	Average Federal Tax Change	
			Dollars	Percent
Bottom Quintile	-0.2	0.4	24	4.1
2nd Quintile	-1.6	5.9	464	13.5
Middle Quintile	-1.5	8.4	722	7.2
4th Quintile	-1.5	11.5	1,193	5.8
Top Quintile	-3.7	73.5	8,686	10.4
All	-2.6	100.0	1,746	9.3
Addendum				
80-90	-2.0	10.0	2,354	6.5
90-95	-1.9	6.7	3,203	6.0
95-99	-1.7	8.6	5,114	5.0
Top 1 Percent	-7.8	48.2	112,533	18.0
Top 0.1 Percent	-11.8	32.1	735,172	24.0

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0509-4).