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Not Done Yet:
Washington Takes Another Swing at Stimulating Housing

Many policymakers would now agree that a) the government's overeager involvement in housing was a large contributor to the boom and its inevitable bust, and b) in the long run, much smaller GSEs and much more private capital is needed. But for now, Washington is still experimenting with polices to ameliorate the housing crisis. Below we discuss some of the current thinking at the Federal Reserve on housing, and also the impact of the newly announced settlement between the largest mortgage servicers and the various states Attorneys General.

All in all, we continue to maintain that the government does not truly have the capacity to control home prices, nor should it, as many excesses need to be wrung from the system to restore equilibrium. That said, at this juncture in the crisis, actions taken on the margin could be helpful. By several measures, home prices in much of the country are close to fair value or below, while the employment picture is starting to get better, and confidence along with it. In such a context, policies such as those now discussed could help bring us to that tipping point more quickly, where there are fewer foreclosures ahead of us than behind us. And that will be the first step toward stable home prices.

Current Conditions – the View from the Fed

At the very start of the housing crisis, now 5 years ago, many claimed it was a "contained crisis". By contrast, the Fed now recognizes that the housing crisis prolongs the weak economy, and is also *prolonged by* the weak economy. This interconnectedness is apparently one of the reasons that the Fed now supports an entire array of pro-housing policies, some controversial.

The numbers cited in the Fed's recent white paper[1] were stark. Since 2006, the aggregate home equity wealth in the US has been halved, a loss of more than $7 trillion. That leaves the average homeowner with an equity stake that equals a little over half a year's disposable income; the lowest that figure has been in the 60-odd-year history of the dataset. And of course, many have no equity at all; the figure now stands at 12 million homeowners with negative equity, or 1 in 5 mortgage borrowers.

In an environment where income inequality has become a campaign issue, it is worth noting that the middle class has been disproportionately battered by the housing crisis. Lower income groups are often not homeowners, and higher income groups have a relatively small share of their net worth in housing. But for Middle America, in just the three short years between 2007 and 2009, two thirds of their home equity was lost.

[1] The white paper, entitled "The U.S. Housing Market: Current Conditions and Policy Considerations", was sent by the Federal Reserve Chairman to the Chairman and Ranking Member of the House Committee on Financial Services last month.

While the recession has clearly exacerbated the housing crisis, housing remains beset by its own unique challenges -- namely, the excess supply of vacant homes, externalities caused by foreclosures, and tight credit. The Fed white paper suggests policies to confront all three of these challenges.

A Call to Ease Credit

First, mortgage credit. The credit pendulum always swings too far. Credit is now too tight, at least in the Fed's view. Of course, at the current time, private mortgage credit remains uneconomic and the GSEs are virtually *the* mortgage market.

But, problematically, the GSEs' true role has never been resolved post government takeover. They are mandated to minimize losses, but it is not clear what that may mean. For example, would greater leniency in lending create the demand needed to sell REO at a higher price, and net, net, minimize losses? Moreover, is minimizing losses the appropriate mandate, or should we be crafting GSE policy that we believe will help lead to a quicker, more vigorous economic recovery? Which is truly in the best interest of the taxpayer? Would not, "steps that promote healthier housing and mortgage markets" be "good for safety and soundness, as well?"

While it is hard to conclude a priori if mortgage credit is now too tight, Fed Chairman Bernanke does, asserting point blank that "extraordinarily tight standards" are shutting out "creditworthy borrowers". One manifestation is the decline in first time home buyer activity, as seen in the age 29-34 cohort, where the share of first time mortgage borrowers has fallen to 9% versus 17% in 1999.

Even if the GSEs themselves loosen credit, that may not flow through to borrowers. An example given is the 90% LTV product for 620 FICO borrowers. While that meets GSE requirements, only 50% of banks surveyed offer the product today. The reasons for the relative unpopularity of these lower credit products with lenders is two fold; the banks are concerned about buyback obligations, and higher servicing costs. While not specifically addressing how to ease credit, the Fed paper makes it clear that tight credit after the fact is short-sighted.

Finding Ways to Absorb Supply: "REO to Rental"

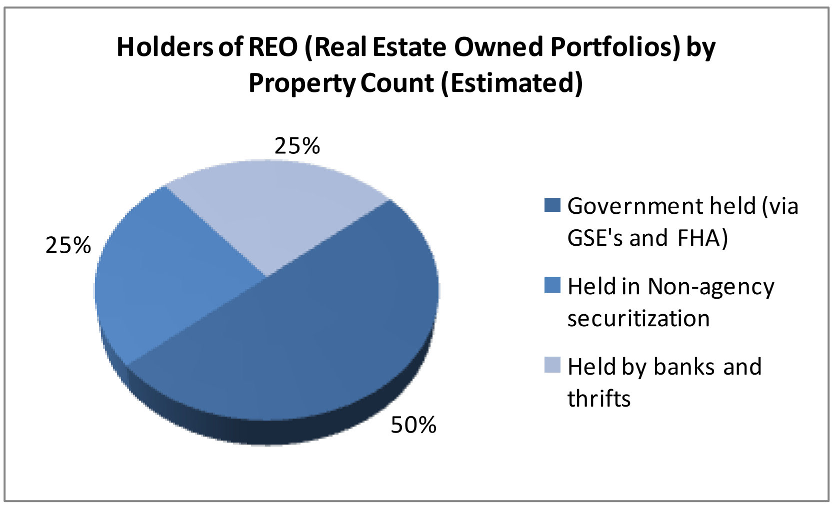
It's almost a tautology that if you can't return to the lofty homeownership rates we achieved during the height of subprime (easy credit, 0%-down) lending, then you are going to have to replace homeowners with investors and renters. Of course, bear in mind that demand for housing isn't just a matter of breaking out owners versus renters. Currently we have both less owners <u>and</u> less renters, due to combining of households and low new household creation, both of which have characterized this crisis.

Yet it is also true that many former homeowners have become renters. Unfortunately, the investors that buy such rentals buy properties at a lower price than an owner-occupier would, for a whole host of reasons. How can we make it more attractive for investors to buy properties for rent, even single-family detached properties (which are costly to maintain and manage), and hold them off market? How can we attract not just Mom-and-Pop money, but institutional investor money?

REO is a deep vein for potential investors. Of the 2 million vacant homes for sale, 35% are REO. While servicing controversies have slowed REO growth, by any measure we can expect at least 1 million more REOs per year for the next several years (the REO pipeline today is four times the current number of REOs). While investor activity has been increasing, particularly in areas like Phoenix, three things have stymied large-scale investing: 1. The need to buy geographically clustered properties in scale for efficiency (and the related cost of carry while assembling the portfolio), 2. Lack of financing, and 3. Bank regulations that discourage holding REO for any period of time (i.e. disallowing the bank REO holders the option of becoming investors themselves, by holding onto REO and renting it out).

The government is in a unique position to help address the first hurdle -- that of aggregating properties. Of the total REOs, most are held by the GSEs and the FHA (see exhibit below). If we assume that you need at least 250 properties in a given Metropolitan Statistical Area ("MSA") for efficient property management, there are many such "clusters" that can be created from existing REO portfolios. For example in the GSE and FHA portfolios, there are over 60 MSAs with 250 or more REOs. The single largest concentration of REO properties in those portfolios is in the Atlanta MSA, where the GSEs and FHA have over *5,000* properties: other MSAs with particularly large concentrations of REO (2,000-3,000 properties) include Chicago, Detroit, Riverside and Los Angeles. Non-agency MBS and banks are also estimated to have many REOs that can be assembled into "250+-per-MSA" packages.

Exhibit 1: Holders of REO (Real Estate Owned Portfolios) by Property Count (Estimated)



Interestingly, according to several recent studies, REO properties are not necessarily particularly undesirable. For example, most REOs in a given MSA are located in neighborhoods where the average home price and average income closely match the averages for the MSA as a whole. In addition, average commute times from these properties are not dissimilar from averages for the MSA. Of course, deferred maintenance and vandalism are real problems, but faster default resolution, outside of the foreclosure system (more on this later), could help ease those blights.

With respect to the second issue preventing large-scale investment in REOs -- lack of financing -- the Federal Reserve's white paper, while not giving specifics on financing terms for any REO to rental program, estimated that many REO properties would make viable rentals. Viable is given to mean that the REOs would provide pro forma capitalization rates in excess of 8%. Eight percent is in line with historical returns on single-family rental real estate, which Morgan Stanley Research estimates have averaged 8.1% since 1990. Certainly, while 8% is an attractive return, any new availability of financing would boost demand for REO. The Fed's return assumptions are below.

Exhibit 2: REO to Rental – a Viable Alternative

Assumptions Used:	
Leasing Costs:	1 month's rent
Management Fees:	8% of monthly rent
Maintenance:	2% of property value
Vacancy:	1 month per year
Rents by MSA from Zillow	
Property taxes by MSA from Census survey data	
Result:	**Capitalization rates of 8%**

The actual design of the REO to rental program is an interagency group effort, about which few details are yet known. The Fed freely admits that predicting the efficacy is difficult, but believes that the program could both help the housing market and improve recovery rates in REO. The open question is whether that can be achieved without subsidizing investor participation in REO to rental. Logically and in practice, investors demand a higher risk premium for investing in single-family homes then do owner-occupiers. While it seems to us that a subsidy of some sort (whether via financing terms or tax policy or both) is likely (and, we believe, necessary) for REO to rental to work, the Fed paper merely states, "whether such funding (for REO to rental) should be subsidized is an important question." Indeed.

There are three possible models being discussed for REO to rental: 1) The REO holder rents properties directly, or, 2) sells properties to a third party who rents them, or 3) joint ventures with an investor to rent them. Among features being considered is a private/public risk sharing mechanism, government financing guarantees, and rent-to-own provisions. Another wrinkle is a sort of "TBA" program, whereby REO holders (i.e., GSEs or banks) could auction the rights to investors to acquire a future stream of REO in a given area. Whatever the design of the program, presumably a minimum holding period will apply so that the program has the intended effect of keeping properties off market until, hopefully, demographics and demand catch up.

Moreover, the considerations will have to be not only economic but also societal. While there are numerous existing landlord-tenant laws to protect renters, the designers of "REO to rental" want to make sure that communities are not damaged by rental practices. As a result, they may restructure the programs so as to defer some compensation until the investor demonstrates "good landlord" practices. As a first step in a proposed pilot program for REO to rental, investors were invited last week to prequalify to bid on the initial transaction in a "near term" pilot. To prequalify, investors must demonstrate financial wherewithal and expertise, and agree to confidentiality.

Some properties will not be viable rental candidates. Chief among them are very low value properties (i.e. with current appraised values below $20,000). While such properties are only 5% of REO overall, there are concentrations. In Detroit and Chicago, for example, more than half of the REO inventory is in properties currently appraising below the $20,000 mark. The Fed paper suggests the best disposition for many such REO is non-profit community "land banks", who buy up properties to rehabilitate or demolish. Currently only a handful of states have such land banks and most can only handle a few properties a month. Both funding and technical assistance for growing land banks is advised.

Preventing Foreclosures for Homeowners at Risk

Refinancing

The government has rolled out several programs aimed at helping homeowners with their mortgage burdens, all of which have fallen short of their target. For example, the Home Affordable Refinance Program (HARP) originations have been disappointing, reaching less than a million homeowners. A few causes are identified. First, the put-back risk on these loans is high. As a result, lenders won't refinance a competitor's loan in HARP because they are taking on the "old" put-back risk. GSE fees (i.e. Loan Level Price Adjustments) have also been too high. Lastly, the process should be streamlined for those with LTV below 80%, to encourage more take-up. The Fed laments that monetary policy is being thwarted by refinancing hurdles (while also allowing that gains to homeowners are at least partially offset by reductions in the incomes of MBS investors).

More controversial, is the question of extending the HARP program into the private market, i.e. for non-GSE, non-FHA loans. The Fed estimates that between 1 and 2.5 million non-agency borrowers would meet HARP requirements. Street estimates suggest the number is far lower, and that less than 10% of non-agency borrowers would qualify. Because this is de facto outside of the GSE/FHA mandate, expanding HARP to non-agency requires legislation. It is also, of course, totally counter to the long-term stated goal of returning private capital to the mortgage market. The question posed by policymakers is do the expected benefits to the housing market and economy offset the added costs of extending the program. In any event, we think such a program would be tough to get through the political process.

Loan Modifications

Refinancing puts more money in consumers' pockets, and presumably makes them somewhat less likely to default. But many homeowners' finances cannot be remedied without a loan modification, which the Fed freely describes as "a mechanism to distribute some of the homeowner's loss to lenders, investors, guarantors … and taxpayers." Some claim that the foreclosure process is so very inefficient that modifying loans can in fact be a win-win proposition, whereby all parties are better off than they would be in a foreclosure. Like HARP, HAMP (Home Affordable Modification Program) has reached far fewer borrowers than hoped. The Fed suggests that the program could be expanded in several ways.

Currently, the loan coupon and then the principal amount are modified to solve for a 31% DTI ratio (for mortgage debt only and using the borrower's updated current income). The first issue is that, while 31% appears quite fair and has long been viewed as standard for prudent lending, it may be too high when also considering other debts, especially second liens (in fact, outside of HAMP, many servicers already consider these other debts when they look at modifications). The second issue relates to borrowers for whom HAMP's current parameters are unworkable, since they are unemployed. While unemployed they may not be able to make virtually any payment, not even a modified payment. For such borrowers some sort of payment deferral approach may be warranted.

Under HAMP, principal reductions are used (as a last resort) to achieve an affordable payment for borrowers who are having difficulty carrying their mortgage. Some policymakers believe we should also consider principal modifications for borrowers who are current but underwater (yet sixty percent of those with negative equity have nonetheless never missed a payment). Proponents suggest that modifying underwater borrowers reduces the likelihood of future defaults, by improving the homeowner's financial stability, while also reducing the incentives for strategic default, and improving labor mobility (though studies show the effect of negative equity on mobility is scant).

Addressing negative equity would be terribly costly; the aggregate dollar amount of mortgagor negative home equity is $700 billion, and $425 billion of that is borne by borrowers who are now current. Moreover, if the goal of the policy is to ameliorate negative equity so as to prevent future defaults, all agree that it is nearly impossible to determine, a priori, who will default without help. As a result, one needs to help far more homeowners than is actually necessary to prevent default, making any policy not only costly but also wasteful. Therefore, on top of the fairness issue (how many financially prudent readers' blood boils as they read this?), writing down loans to market value is simply bad policy.

Apart from the specifics of how best to modify borrowers, are philosophical issues. In mortgage securitizations, loans can only be modified if the servicer believes that modifying the loan will maximize the net present value. To date, all policy measures have preserved that concept, i.e. that modifications need to be done for sound business reasons. The white paper suggests that we may want to "abandon" this concept and do loan modifications because they are socially beneficial. To do so would not only entail additional taxpayer funding (for the GSEs, as well as perhaps to private lenders as incentive payments to modify loans) but possibly "overriding of private contractual rights". The suggestion is that the servicing contracts that specify the need to maximize NPV would be put aside. That would be quite dramatic and highly controversial, with possible ramifications far beyond housing finance.

As an interesting and timely aside, it was recently reported that, within the FHFA (which regulates the GSEs), there has been controversy over loan modifications. The head of the FHFA, Edward DeMarco, told lawmakers that "our analysis does not indicate a preservation of assets … substantial enough to offset the costs (of principal write downs)" and in fact that such write-downs could theoretically cost taxpayers "$100 billion". But a FNMA employee has since come forward claiming that, in fact, the company's analysis showed that principal write downs would "minimize losses", and that a pilot program to do so was pulled two weeks before launch, in 2010. According to the employee, executives "philosophically opposed to writing down balances" canceled the pilot.

By contrast to the approach of principal forgiveness, perhaps the least controversial approach to reducing foreclosures is procedural. Short sales and deeds-in-lieu (DIL) are more efficient alternatives to foreclosure, especially in judicial foreclosure states. Borrowers need to be educated about the short sale and DIL options, and we need to remove obstacles such as disposition of 2nd liens and mortgage insurance.

Mortgage Servicing Reform and the Attorneys General Settlement

Once an arcane, little known industry, mortgage servicers have become the bogeyman of the housing crisis. It is clear that they are the gatekeepers to modifying loans, and that they were wholly unprepared for the shift from a business that was largely paperwork and payment processing, to the business of workout and fraud specialists. They failed to meet investors' performance expectations, and in many cases failed to comply with the law.

The AG settlement, being finalized as we write, after nearly 15 months, has a $26 billion price tag[2]. That figure could possibly grow substantially depending on the total number of servicers who eventually opt in, and other factors. The five largest mortgage servicers have signed on (with nine more in the wings expected to participate) and the federal government and all the states but Oklahoma have also agreed. The focus of the settlement is on abusive servicing and foreclosure

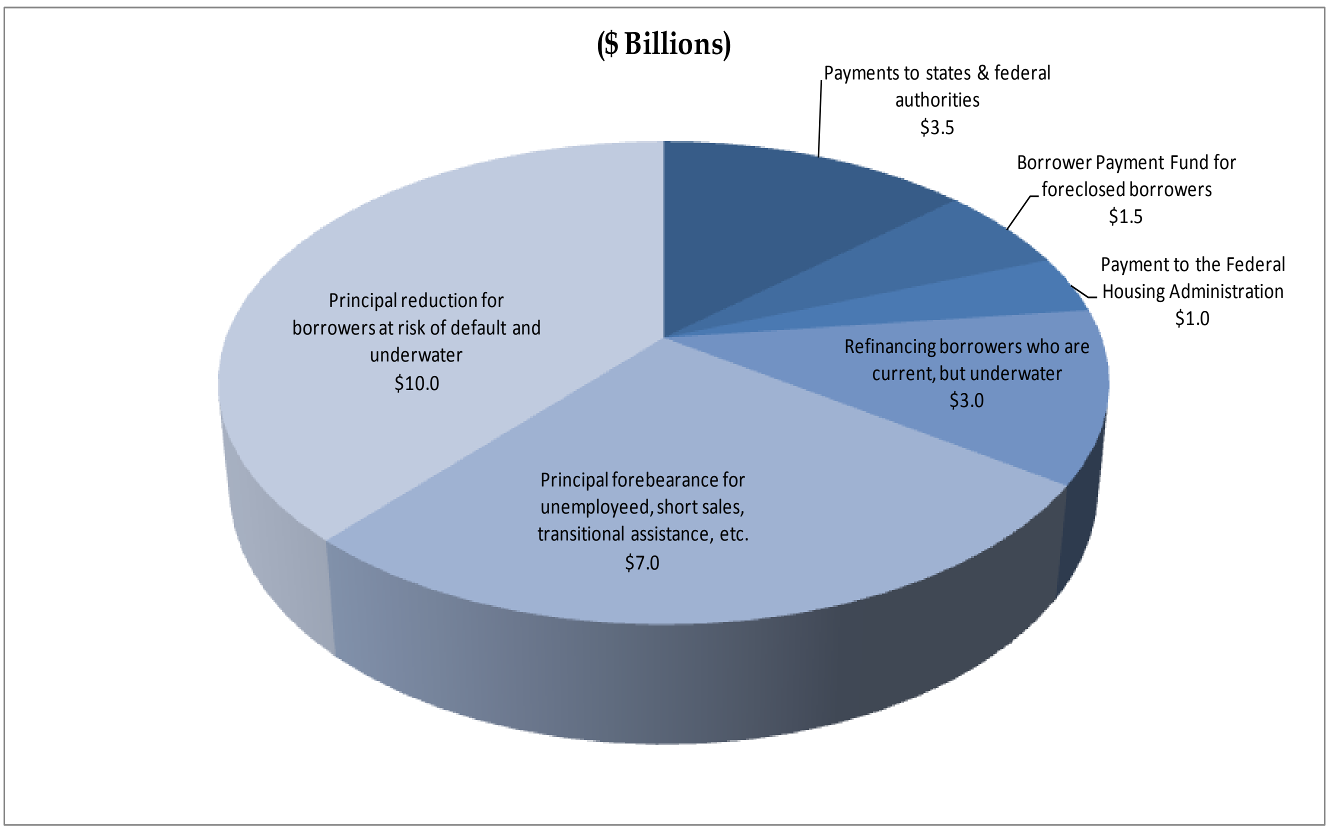
[2] Apart from the financial settlement, servicers are required to implement new loan servicing standards, including explicit agreement that foreclosures are to be done as a last resort, requiring servicers to evaluate other options first.

practices, and not origination or securitization practices, where the banks remain liable. So too are the banks still liable for any criminal wrongdoing and MERS-related wrongdoing. The five mortgage servicers are Bank of America, JPMorgan Chase, Wells Fargo, Citigroup and Ally Financial. The settlement is generally viewed positively for the banks, and is in line with amounts reserved.

The settlement amount breaks down as follows in the Exhibit 3 below. The settlement money applies only to non-agency mortgages, and is to be distributed under a complex rubric that is designed to encourage the servicers to reduce principal and or refinance borrowers with negative equity, in an attempt to prevent foreclosures. Settlement negotiators estimated the tally of those assisted in some way will reach 1,000,000 borrowers. The obligations are to be fulfilled over three years. This scope suggests only a modest (yet positive) impact on the housing market.

Lastly, those who lost their homes in foreclosure between 2008-2011 (~750,000 people) may be eligible to receive checks for $1,500-2,000, their share of a $3.5 billion "Borrower Payment Fund". This compensation for wrongdoing in the "robo-signing" controversy does not preclude individual lawsuits. The cash payments to the FHA and state and federal authorities are to repay public funds lost as a result of misconduct, and to fund public programs such as legal aid and housing counselors.

Exhibit 3: Breakdown of AG Settlement with Top 5 Mortgage Servicers



One rather unusual twist to the settlement is that a portion of the settlement is paid not just from the banks themselves, but, in essence, out of securitization trusts as well. In other words, servicers get credit toward their obligations under this settlement when they modify their own loans, but they also get a smaller, partial credit for modifying loans that they service but do not own. The protection for investors is that the modifications must meet the maximization of NPV test and comply with servicing documents. Presumably institutional investors as a group are positioned to advocate for themselves. Even so, the prospect of a bank satisfying a claim, by forgiving principal on loans they do not own, certainly bears scrutinizing.

With punishment now having been meted out, we turn to a discussion of how to reform mortgage servicing. The Fed delineates the four factors that need to be addressed. First, we need data to track servicers' performance (now being collected). Second, servicing must be easily transferrable (long a goal of securitization investors). Third, outdated and cumbersome systems for registering liens need to be standardized and centralized, online. The fourth issue is regarding the compensation structure for mortgage loan servicing, which should be better aligned with actual costs and with a policy preference to avoid foreclosure.

Mortgage servicing income takes three broad forms, float earned on property insurance and tax payments, ancillary fees such as late charges, and the annual servicing fee, typically 25 bp. Because servicing seriously delinquent loans is an order of magnitude more costly then processing payments on current loans, the servicing fee should vary with the delinquency status of the loans. Moreover, borrowing the "special servicer" model used in commercial mortgages, severely delinquent loans should be "special serviced", with fees tied to actual expenses incurred, and contractual incentives for successfully resolving the loan. In addition, servicer advances should stop at sixty days, so that servicers, eager to reduce their cash requirement for advancing, are no longer incented to resolve loans quickly, regardless of the maximum recovery value.

Conclusion

The Federal Reserve is clearly advocating for more support for the housing market, including some controversial and costly policies. In its report to the Committee on Financial Servicers, key themes include loosening credit at the GSEs, creation of a mortgage product to finance REO investors (likely subsidized at least initially), and more generous refinancing and loan modification efforts. The overarching theme seems to be that we might consider things that are unpalatable in and of themselves (growing the GSEs, rewarding bad behavior, even interfering in private contracts) if we believe they will serve the greater cause of getting the economy on track for true recovery.

We do not know if all of the Fed's housing "wish list" will be granted, and if so how much and how soon. In the recent State of the Union address, the President proposed many of the suggestions outlined in the Fed's white paper, including broader refinancing opportunities, REO to rental, expansion of HAMP, and forbearance for the unemployed.[3] It is clear that the government remains focused on supporting the housing market, which at this point in the multi-year downturn could be an important edge in finally stabilizing home prices --- sooner rather than later. For MBS investors, that benefit comes with a price, which is that timelines for resolving delinquent loans will remain extended as the government continues to try every tactic to keep homeowners in their homes.

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[3] The President also kept the pressure on the mortgage finance industry by establishing a task force under the Department of Justice to investigate misconduct in mortgage origination and securitization practices, and called for a Homeowner's Bill of Rights that would specify disclosure and foreclosure guidelines.