MANDATORY ELEMENTS

For the Return of Private Capital to the Residential Marketplace

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By the NAR Conventional Finance & Lending Private Capital Subgroup

INTRODUCTION

The recent financial crisis demonstrated the crucial role played by the housing industry in the overall health of the US economy. Full scale economic recovery will rely heavily upon the return of stability and confidence in the residential real estate market. Liquidity of capital and credit availability to fund housing is paramount and the return of the private sector to the housing finance equation is the key to restoring that stability and confidence.

Historically, there have been three sources of residential mortgage capital: (1) Bank balance sheets (referred to as portfolio loans) (2) FHA and the Government Sponsored Enterprises (GSE's) Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, and (3) Private Capital and the securitization process of Mortgage Backed Securities (MBS). Prior to the housing melt-down the GSE agency mortgaged-backed securities and FHA constituted 50% of the total outstanding loans. Today that percentage has climbed to nearly 90%. Since 2008, the role of Private Capital in housing finance, with the exception of a few offerings by Redwood Trust, has virtually disappeared. The return of that resource is critical to the future of the housing industry and the goal to provide liquidity of capital.

There is strong, general consensus that reform is necessary, and that government must have a role in that reform. Private capital will return to the marketplace only when comprehensive reform results in the restoration of confidence and trust in the system, and when investors and GSE's compete on a level playing field. Numerous pending legislative and regulatory proposals offer some level of partial reform; however, solutions must be comprehensive. The following represent what the Conventional Finance & Lending Private Capital Subgroup believes to be the MANDATORY ELEMENTS necessary for any reform model:

GUARANTEE

ISSUE: The "implicit" government guarantee that has been assumed since the inception of Fannie Mae and Freddie Mac became an "explicit" guarantee when they were put into conservatorship and thereby giving taxpayers the burden of billions of dollars. The private profit and public loss syndrome available only to the Government Sponsored Entities (GSE's) is unacceptable. Though willing to accept some kind of clearly defined, assessable risk, the private investor wants assurance or a guarantee that should the loan package fail there is a mechanism to recoup their investment (or portion of) based upon the type of coverage they purchased.

SOLUTION: Provide a self-sufficient mechanism whereby safe, sound, transparent, and insured Mortgage Backed Securities (MBS) may be packaged and sold.

1. There must be an option for explicit government guarantee or insurance for all offered MBS within the secondary mortgage market.
2. Taxpayer exposure must be minimized.
3. A mandatory not-for-profit “utility” company is needed to receive, package, sell and guarantee MBS. This entity would operate with similar insurance and enforcement components as FDIC.

POOLING SERVICE AGREEMENTS (PSA’s)

ISSUE: The Pooling Service Agreement is the contract that governs the rights between the Originator, the Trustee and the Servicer. The PSA outlines the rules of engagement. Investors rely on the Representation and Warranties (Reps and Warranties) disclosed in the PSA. Private investors see the wide variety of documentation, differences in terminology and government programs that often negate the warranties, as a deterrent to their return to the market. There exists today little consistency, much confusion, litigation, and a general lack of confidence in the underlying PSA’s of today’s MBS instruments.

SOLUTION: In order to bring private capital back into the marketplace Investors’ confidence and trust in the Reps and Warranties must be restored. Standardization in these contracts is imperative. The Pooling and Service Agreements must contain:

1. A simple, inexpensive way to transfer and record ownership.
2. Standardized terms with clear definitions. (Today there are countless definitions of “default”).
3. Documents, systems and flows generated through cooperative efforts with states with a goal of achieving parity throughout the country.
4. Clear disclosure of any deviations from “Federal Best Practice Standards” established for private capital. Said standards must be designed through joint cooperative efforts of Congress and the private sector who contribute both the expertise and funding in the capital markets.
5. Servicer operational policies consistent with their fiduciary duties to the Investor to minimally include:
    a. Standardized processing, procedures and enforcement
    b. Standardized protocol for handling non-performing loans with aggressive and timely procedures
    c. Standardized notice requirements for Investor to be made aware of deficiencies early on
    d. Thorough disclosure of a Servicer’s conflicting fiduciary interests
6. Clearly defined buy back rules.

LOAN LEVEL DATA

ISSUE: Investors measure and price credit risk of all products based on the data provided. Incorrect data, missing or hidden information and countless methods of data delivery contribute to the Investor’s risk creating the need for total reliance on rating agencies. Past performance of such agencies results in a lack of confidence and the desire for direct access to loan level data.

SOLUTION: There is strong consensus among multiple market participants that solid loan level data is the essential foundation from which to rebuild the private mortgage security industry. Investors want to be empowered and enabled to conduct their own risk analysis. With properly structured loan level data the mortgage collateral supporting a regulated, securitized instrument will lead to a verifiable, current, predictable instrument of cash flow and thus will attract private capital in to the secondary mortgage market.

1. Standardized Data is extremely important to the investor. The data must be real time, accurate and transparent.
2. Data areas of concentration: Loan Underwriting Attributes, Loan Performance Attributes, Collateral Attributes and Underwriter/Originator Attributes
3. Risk ratings on securities must be continuous and based on real time performance.
4. Loan level data must have availability in electronic, manageable industry standards so that immediate and continuous risk analysis is provided.
5. Listen to the investors in design efforts.
6. Integration will keep the system current. Examples such as US Census data, AVM modeling, actual MLS data, and credit score data can all have value.
7. The appraisal process must be done in a manner acceptable to the private sector.
8. Cyclical economic downturns are addressed in the housing data on a regional, as-needed basis, as opposed to a one size fits all federal level.

STANDARDIZED UNDERWRITING

ISSUE: Since the housing melt-down occurred, countless underwriting and compliance deficiencies have been identified. High yields and poorly modeled underwriting standards led to high risk, non-conforming products and marginal borrowers being accepted. The avalanche of foreclosures that followed profoundly impacted housing values and the economy in general.

SOLUTION: Sound underwriting principles and products must provide the foundation for responsible, credit worthy borrowers to be able to achieve homeownership goals. Standardization of policies and procedures is crucial.

1. Standards should be supportive of all markets and provide for the free flow of capital into mortgage pools.
2. Loan approvals must be based on a good faith determination that the borrower has a reasonable ability-to-repay the loan and related obligations based on verified and standardized documented information.
3. All loans must be safe and sound products that meet the “ability-to-repay” definition of a Qualified Mortgage (QM)
4. A Qualified Residential Mortgage (QRM) must meet the ability-to-repay requirement.
5. A credible independent process for the valuation of real property must be used in order to restore confidence of the private sector in the mortgage products and mortgage backed securities.

RESOURCES

"The Mortgage Finance Act of 2011" S1963; Sponsored by Senator Johnny Isakson
"Secondary Market Facility for Residential Mortgages Act of 2011" HR2413; Sponsored by Gary Miller
"Private Mortgage Market Investment Act" HR3644; Sponsored by Scott Garrett
"Housing Finance Reform Act of 2011" HR1859; Sponsored by John Campbell

"A Comprehensive Framework for Housing Finance System Reform"; National Association Home Builder Association White Paper released 2/9/12
"A Strategic Plan for Enterprise Conservatorships" FHFA White Paper 2/21/12
"A Guide to Restoring Private-Sector Residential Mortgage Securitization"; Redwood Trust 11/10
Written statement regarding HR3644; AMI (Association of Mortgage Investors) 12/7/11
"Reforming the Asset-Backed Securities Market"; AMI White Paper, March, 2010
"GSE Secondary Market Reform"; ICBA (Independent Community Bankers of America) 2012Policy Resolutions
"Servicer Performance Scoring"; Morningstar Credit Ratings LLC May 1, 2012
"Building a NEW Infrastructure for the Secondary Mortgage Market"; FHFA 10/4/12
"Ability-to-Repay Proposed Rule"; NAR letter to Bernanke 7/22/11
Numerous articles from "Housing Wire" 2012

Presentations/Interviews:

- Ron Haynie, President and CEO ICBA; April 9, 2012
- Chris Katopis, CEO AMI and Michael Waldorf, SR VP Paulson and Co; April 11, 2012
- Jim Millstein, Chairman Millstein & Co; July 13, 2012
- Arizona Representative David Schweikert, Vice Chair Capital Markets & GSE's; July 20, 2012

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