Fixing the Sub-Prime Market

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Sub-Prime Balance Sheet

- Assets
  - Expand home ownership in US
- Liabilities
  - Overcharges
    - Prime borrowers caught in net
    - Opportunistic pricing
    - Fee-packing to payment-myopic borrowers
  - Lax underwriting
  - High foreclosure rate
  - Default spikes are contagious
    - An enormous negative externality
- Net Worth to Society - Negative

Objectives of Reform

- Eliminate Contagious Credit Shocks to Investors
- Eliminate Sloppy Underwriting
- Make the Market Work For Borrowers
  - Eliminate ability to catch prime borrowers
  - Reduce opportunistic pricing and fee-packing
  - Make it easier for borrowers to shop

Definition of Sub-Prime Mortgage-Backed Security (SPMBS)

- Sub-Prime Mortgage-Backed Security
  - A security collateralized by a mortgage pool having any <u>one</u> of these features:
    - More than 1/3 of loans have FICO scores <640
    - More than 1/4 of loans are cash-out refinances
    - More than 1/3 have debt-to-income ratios >40%
    - More than 1/2 of ARMs have gross margins >5%
- Sub-Prime Mortgage
  - A mortgage in a sub-prime collateral pool

Qualifying and Non-Qualifying SPMBS

- Qualifying SPMBS Requires That:
  - Borrowers are certified as “sub-prime”
  - All loans carry cash flow insurance (CFI)
  - Lenders follow transparent pricing rules
- Qualifying SPMBS Receive GNMA Insurance
- All Other SPMBS Are Non-Qualifying
  - These SPMBS must be sold privately

Requirement of Borrower Certification

- Borrower Doesn’t Meet Conforming, FHA, VA or Alt-A Underwriting Requirements
  - Evidenced by certification from authorized mortgage counselor
  - Authorized mortgage counselor has been trained in, and passed a competency test in using automated underwriting systems
  - Eliminates prime borrowers caught in sub-prime net

Requirement For Cash Flow Insurance on Each Loan

- Each Loan Must Carry Cash Flow Insurance (CFI) From AA or AAA-Rated PMI
  - Guarantees that payment on loan will be received within (25) days of the due date.
    - Guarantee effective at securitization
  - CFI is first line of defense protecting GNMA
  - Removes credit risk from mortgage pricing

Requirements For PMIs

- Must Offer CFI Directly to Borrowers
  - Can also offer it thru lenders and others
- Must Provide On-Line Facility For Showing Transaction-Specific Premiums
- Objective Is a Competitive Market For CFI

Transparent Pricing Requirements For Lenders

- Lenders Must Absorb All Third-Party Costs
- Lenders Can Charge Borrowers Only Rate and Points
- Single Premium Mortgage Insurance and Points Can Be Added to the Balance
- Prepayment Penalties Allowed
  - To earlier of first rate adjustment or 5 years
  - Limited in amount to financed points

GNMA Guarantee

- A Guaranty of Payments to Investors
  - Similar to its guaranty on existing GNMA MBS
    - Guarantee kicks in only upon failure of primary insurer
  - Available only on qualifying SPMBS
    - 5-10% of the market
  - A small guaranty fee would be paid by PMIs

Meeting the Objectives

- Objective: Eliminate Contagious Credit Shocks to Investors
  - Accomplished thru CFI backstopped by GNMA guaranty
  - Ineligible sub-prime loans sold privately to hedge funds and others would pose no significant threat
    - Purchasers do their own due diligence, and don't assume the securities are liquid.

Meeting the Objectives (Continued)

- Objective: Eliminate Sloppy Underwriting
  - PMIs will do a better job of underwriting
    - They can’t pass on the risk to the next entity in the chain, as happens now
    - They have a relatively long time horizon

Meeting the Objectives (Continued)

- Objective: Make the Market Work For Borrowers
  - End misclassification by soliciting prime borrowers
    - Eliminated by the certification requirement
  - Reduce fee-packing to payment-myopic borrowers
    - Met by requirement that lenders absorb third party costs and charge no fees except points
  - Make it easier for borrowers to shop
    - Removal of credit risk from mortgage price results in flatter pricing structure
    - Pricing is simpler, only rate and points

Will It Work? Will PMIs Be Aboard?

- Opens New Market For PMIs Where Old Markets Are Shrinking
- CFI With GNMA Backing Will Be Profitable
  - Price of sub-prime loans will drop by 2-3%
  - Cost of CFI is only marginally higher than the cost of traditional mortgage insurance
  - Allows PMIs to be very conservative in pricing

Will It Work? Will Lenders Be Aboard?

- Profits Reduced
  - Requirement of borrower certification
  - Reduction in fee-packing, opportunistic pricing
  - The “fast-buck” guys may all leave
- But Mainstream Lenders Will Enter
  - It will be legitimate and respectable
  - Can do it under their own names rather than thru affiliates