What Now?

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The Realities

- Unbundling isn’t going away
- Neither is securitization
- Nor are boom-bust cycles
- Deregulation and dual regulation failed

The Challenge

- Help future borrowers
- Help current borrowers
  - In refis
  - In workouts
- Restore liquidity to the secondary market

Objectives

- Eliminate insane underwriting
- Promote competitive pricing
- Improve price revelation
- Well-tailored regulation
- Same set of federal standards for all lenders
- Effective enforcement

Second Quarter Total U.S. Homeownership Rates (Census Bureau)

1994	63.8%
1995	64.7
1996	65.4
1997	65.7
1998	66.0
1999	66.6
2000	67.2
2001	67.6
2002	67.6
2003	68.0
2004	69.2
2005	68.6
2006	68.7
2007	68.2

What To Do?

A. *Address shoddy underwriting:*

- Will the market correct?
- What should any standards consist of?
  - * Federal banking regulators reached consensus on essential underwriting standards in the *Interagency Guidance on Nontraditional Mortgage Product Risks* (Sept. 2006) and the *Interagency Statement on Subprime Mortgage Lending* (June 2007)

Underwriting Standards, cont'd

- *The federal standards apply to:*

  (1) subprime loans;

  (2) low- and no-doc loans;

  (3) ARMs (including prime ARMs) presenting potentially severe payment shock (of 300 bps or more);

  (4) loans with PPPs beyond the initial reset date; and

  (5) negative amortization products

Underwriting Standards, cont'd

- *The federal standards provide*:

  (1) *Ability to repay and verification:* Lenders must perform a credible analysis of the borrower's ability to repay, taking DTI ratios into account

  (2) *For ARMs:* Lenders must underwrite to PITI at the fully indexed rate, based on full amortization

  (3) *Prepayment penalties on ARMs:* Must expire at least 60 days before the initial reset date

What To Do?

B. *Improve Competitive Pricing*

- By eliminating yield-spread premiums and similar compensation that increases the price of credit in all three channels (broker, wholesale, and retail)

What To Do?, cont'd

C. *Improve price revelation*

Two possibilities:

-- Through rate and product locks

-- Amend the Truth in Lending Act (TILA) and the Real Estate Settlement Procedures Act (RESPA) to require firm price and product quotes upfront, subject to verification

What To Do?, cont'd

D. *Ensure effective enforcement of laws*

Reality # 1: Today, borrowers lose all meaningful claims and defenses to foreclosure when their loans are securitized.

Reality #2: Today, borrowers are denied most claims and defenses to foreclosure when their loans are made by national banks, federal thrifts, and their mortgage lending subsidiaries

Legal Enforcement, cont'd

Reality # 3: Government enforcement doesn't work.
Exhibit A: The current mess.

Reality #4: The federal interagency guidances:

- are not binding on banks, thrifts, or their op subs
- do not apply at all to independent lenders
- provide no private relief to injured borrowers

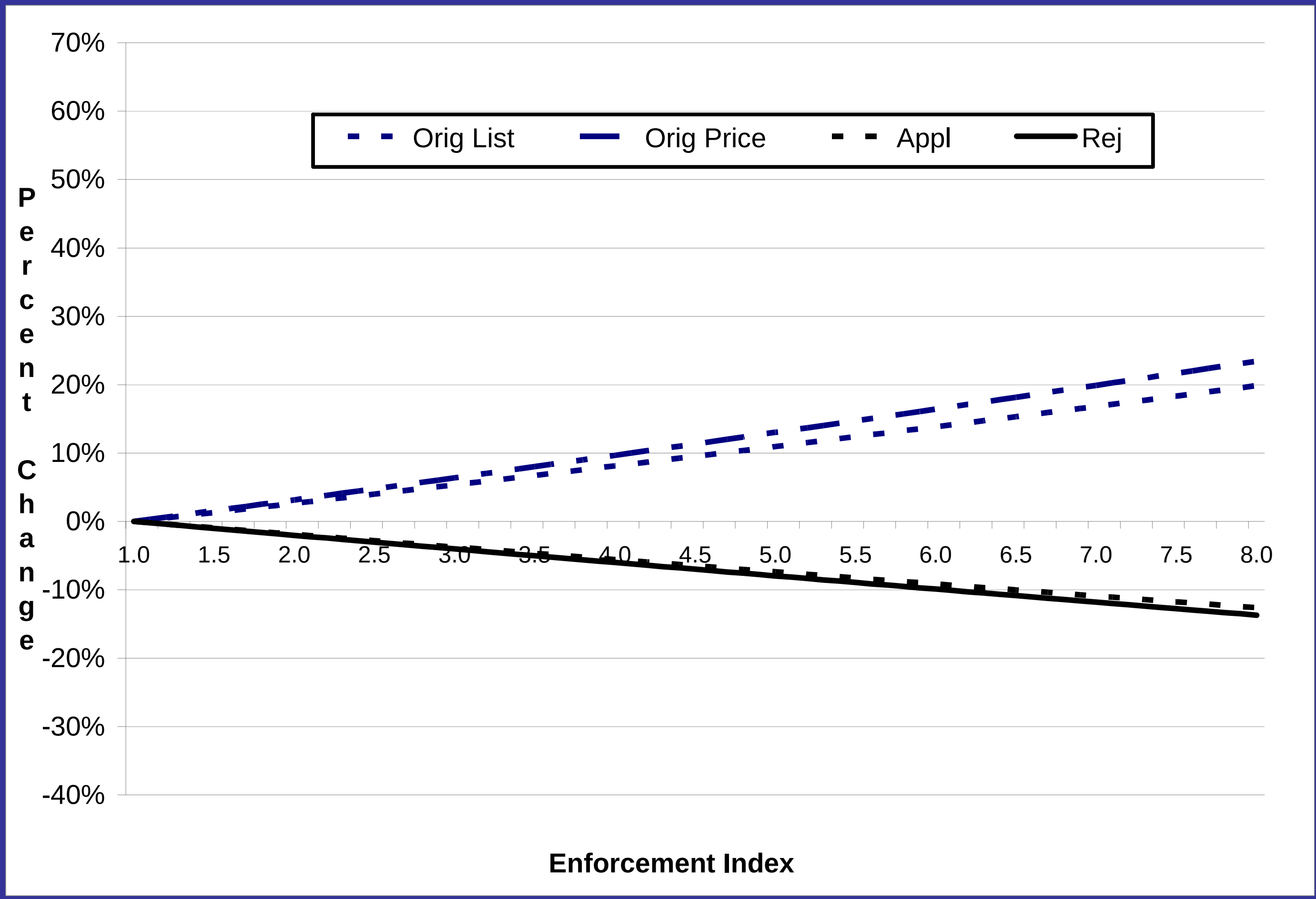
Legal Enforcement, cont'd

- *Congress should*:
  - Elevate the federal underwriting standards to statute and apply to all lenders
  - Make ability to pay and verification standards apply to all home loans
  - Make violations of those standards a defense to all foreclosures
  - Allow borrowers to sue for violations:
    - Brokers and lenders
    - Investment banks and/or trusts that did not conduct reasonable due diligence to screen out illegal loans

What Will Happen to Securitization?

- Some states have had assignee liability provisions in their laws with no secondary market exit.
  - *Quantifiable liability* is key for ratings.
- It appears the secondary market choked up due to inability to value RMBS, not assignee liability.
- Prediction based on the experience in 1998: As underwriting standards improve, lenders will slowly rebuild investor confidence and eventually Wall Street is likely to repurchase subprime loans in significant volumes.

Bostic et al. (2008): The Effect of Enforcement Mechanisms on Mortgage Outcome



Simulation of Effects of Assignee Liability Laws

Bostic et al. (2008): *C*ompared origination probabilities in 9 states with assignee liability laws to an unregulated state (Montana) for 2004-2005 and found:

- *HMDA price definition of subprime*: all 9 states had higher origination probabilities
- *HUD list definition of subprime*: 6 of the 9 states had higher origination probabilities, while 3 had lower origination probabilities

Parting Question

What type of society do we live in and
what level of defaults are we willing to accept?

- In particular states?
- In particular cities?
- In predominantly poor or minority neighborhoods?