The New American-Dream Team: FHA/Ginnie Mae;
The $1 Trillion Ballooning of FHA/Ginnie Mae;
2010's Special Default Servicer's Outsource Dream;
Someone Else Please Enter Stage Left:
Private Label Securitization, Covered Bonds, Funds, China, Anyone?

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The new American-Dream Team is FHA/Ginnie Mae.

The Federal Housing Administration/Government National Mortgage Association ("FHA/Ginnie Mae") tag-team is ballooning into the next Fannie Mae/Freddie Mac monster. While Fannie and Freddie are on conservatorship life-support, and the other GSE (the 12 community purposed Federal Home Loan Banks) is on pit-row, something had to pick up the slack. Enter center stage: FHA/Ginnie Mae.

Although "subprime" blew-up, its demand has grown ever-stronger. The subprime demand has now expanded its reach to include recent prime and Alt-A borrowers now suffering from the negative affects of the economic crisis. Like a wounded animal, limping off to safety, the anemic securitization and shadow banking systems have not been able to get back on its feet and offer any substantial solution to meet the demand. Although Secretary Paulson authorized "Covered Bonds" over a year ago (on July 28, 2008), uncertainty feeds investor indecision. New covered bond legislation has only recently been offered in an effort to ensure: that insolvency priorities would not be changed by ever-changing 'regulatory' schemes, and that upon an issuer's insolvency, investors would be made whole through a new measure of damages, not the current less favorable investor formula. Moreover, the private sector has yet to stake its claim and capture the vast void in the private label securitization pie. The GSEs and its growing cousin, Ginnie, cannot meet the demand in the marketplace. If FHA/Ginnie continue its efforts at the pace seen in 2009 ($577 billion, about to reach an estimated $680 billion for COB 2009), Ginnie will have guaranteed nearly $1 trillion by year end, 2010.

The FHA/Ginnie Mission vs. New Market Demands:

The problem is the stated FHA/Ginnie mission is not aligned with the demand being thrust upon it, and its systems and staffing are not sufficient to handle the predictive volume and claims. Recent congressional authorizations will supply the tag-team with necessary resources to continue its growth and mission. However, the FHA/Ginnie mission is the backbone of the proverbial American Dream. The historic mortgage meltdown and current recession is creating long lines at the new sole-functioning-savior's doorstep. The official mission of the FHA includes providing a home financing system through insurance of housing mortgages and credit for low-and-moderate income borrowers, first time buyers, minority buyers and senior homeowners. The FHA was created on June 27, 1934 but incorporated into the HUD when it was formed in 1965. The

FHA provides mortgage insurance and Ginnie Mae (GNMA) provides its guarantee; then packages and sells FHA insured mortgages.

The Securitization Pie:

The FHA/Ginnie tag-team is carrying the load and ballooning into a giant. The securitization pie is missing the (private sector) cherries. The private sector must step-up, plant the seeds (of rejuvenated securitization and or new product solutions) and harvest the majority of the fruit or we will not fully recover. The MBA reports that Fannie, Freddie and the FHA "generate roughly 80 percent of secondary market transactions because of the reluctance of other organizations to issue their own private label securities" [MBA 1/26/09 Covered Bond report: Congress Should Improve Regulatory Clarity for Covered Bonds].

Covered bonds are mortgage debt that remains on the balance sheet of the issuer (bank or special purpose entity). Covered bonds should attract (safe) investment monies as they provide the investor dual recourse from the "cover pool" and the "issuer." Also, interest (money flow) is paid from an identifiable projected cash flow, not just out of financing operations. Since, non-performing or prepaid loans must be replaced, the pool is always performing. Unlike the securitization method which is designed to transfer and shield credit risk, prepayment risks, great contractual, regulatory and governmental restrictions (Pooling & Servicing Agreement, IRC 860, Rev. Proc. 2008-28, Financial Accounting Standards Board Statement 140 (FAS 140), Financial Accounting Standards Board Statement 114 (FAS 114 v. FAS 5, etc.), are placed on the ability of the "securitization vehicle" (Trust/Conduit/REMIC, etc.) to replace or effectively modify mortgage loans.

The new law, H.R. 3221: Housing and Economic Recovery Act of 2008, imposes a duty on servicers to maximize net present value for the securitization vehicle (investors' interests). Moreover, although the new U.S. covered bond device is a critical part of the overall solution, private label securitization and/or new credit enhancement products must return or be introduced into the market for the real estate market to recover. The U.S. Treasury reports that during the 2005 to 2007HI private label securitization exceeded or was equal to funding by GSE (MBS). During such periods FHA remained fairly constant but insignificant. Balance Sheet Lending was about the same as the GSE (MBS) and private label securitization until 2007H2 and 2008Q1, where it decreased significantly. But private label securitization fell significantly in 2007H2 and almost ceased to exist by 2008Q1. This is the problem. Private label securitization or the liquidity that it supplied the mortgage finance industry has all but dried up. Investors are not willing to put money into the securitization vehicles as it exists today for fear that they will lose their money with little or no recourse. During 2005, 2006 and 2007H1, private label securitization exceeded $1 Trillion ($1.2T). Now it is anemic. Additionally H.R. 3221: Housing and Economic Recovery Act of 2008, addresses this problem and supports as 'public policy' increased securitization as follows:

> (1) securitization of mortgages by the enterprises (GSEs) plays an important role in providing liquidity to the U.S. housing markets; and (2) Congress encourages

> them to securitize mortgages acquired under the increased conforming loan limits established by this Act.

Covered Bonds will help add some important portion of needed liquidity (funds to loan borrowers), but the market desperately needs the return of securitization, both for agency (government sponsored entities (GSEs), non-agency paper (or private-label securitization loan funding), and new sources of mortgage funding and external and internal credit enhancements, including but not limited to Covered Bonds (www.uscoveredbondcouncil.com).

Defaults: Economic Conditions & Home Prices as Key Factors:

The FHA default rate is 7%, 13% of these loans are 30 days or more delinquent, the reserve fund has been cut in half to 3% (from 6.4% in 2007), leaving it with a 33 to 1 leverage ratio (WSJ; August 2009).

"Some studies suggest as many as 5.4 million mortgages are currently delinquent" [Marrying the Right Vendor, L. Rennell, Mortgage Banking August 2009]. Matt Walker reports that the MBA's National Delinquency Survey (NDS) reported a seasonally adjusted delinquency rate of 9.12 percent as the highest in MBA's records since 1972 [Managing the True Costs of REO, Mortgage Banking August 2009]. When predicting defaults, loose underwriting conditions and complex loan products will not alone support the blame. Continuing home price declines and unfavorable economic conditions highlighted by rising and significant unemployment are critical factors that distinguish predictive modeling. As unemployment climbs (9.4% July 2009 Labor Dept.) and the economic conditions, home prices, FICO scores and other mortgage data continues to degrade, the potential performance of the FHA/Ginnie loans becomes a greater concern – even when written under stricter underwriting standards. "…[W]hile actual default rates rose 25 percent from 1990 to 2004, if economic conditions had not been so favorable, foreclosures started would have risen by 100 percent instead of 25 percent. The spectacular increase in foreclosures after 2005 is unprecedented in the data. Economic conditions and underwriting quality typically moved in opposite directions in the 19902. This negative correlation is consistent with lenders becoming more conservative when economic conditions are weak. However, after 2002-2005, economic conditions and underwriting quality both deteriorated at the same time, instead of balancing each other out as they had tended to do in the past. Indeed, it can be argued that the single biggest mistake that decision-makers made in the current crisis was their failure to incorporate the rapidly changing economic environment into their decisions" [Dissecting Defaults, D. Capozza and R. Van Order, Mortgage Banking August 2009].

"More than 800,000 consumer bankruptcies have been filed so far this year. Monthly filings reached the highest level in nearly four years. Consumers filed 126,434 bankruptcies during July, the American Bankruptcy Institute reported yesterday. Filings increased by nearly 10,000 from June's 116,365 consumer bankruptcies and were more than one-third higher than the 94,124 filings reported for July2008" [August 5, 2009 By *MortgageDaily.com* staff]. One in five homeowners is underwater [with negative equity]

(Zillo May, 2009). The Mortgage Bankers Association reports that about 12.07 percent of mortgage loans were delinquent or in foreclosure in the first quarter -- the highest level ever recorded since the survey was launched in 1972 and an increase of about 8 percent from last year's first quarter. Also, for the first time, most mortgages in foreclosure were prime loans -- at 49.8 percent, compared to 43.2 percent for subprime loans. MBA chief economist Jay Brinkmann says mortgage defaults are unlikely to improve until the job market rebounds. Lenders who held off while the Obama administration unveiled its foreclosure prevention program earlier this year are now working their way through a backlog of troubled loans, economists said. (The Washington Post, May 29, 2009). According to Rebel Cole, Professor of Real Estate and Finance: “Currently, there are about five million delinquent mortgages with average outstanding balances of less than $200,000.” (April, 2009.) Rick Sharga, RealtyTrac's senior vice president for marketing says: “Help might be on the way. The Obama administration announced a plan in March to provide $75 billion in incentive payments for the mortgage industry to modify loans to help up to 9 million borrowers avoid foreclosure.” And it may be months before the impact of the Obama administration foreclosure prevention plan, Making Home Affordable, becomes clear, said John Taylor, president of the National Community Reinvestment Coalition. Early intervention in the housing crisis could have forestalled some of the current problems, he said. But "the problem has deepened so badly since then and become compounded by rising unemployment.” The majority of the foreclosure problems remain centered in four states: California, Nevada, Arizona and Florida, where home prices spiked the highest and are now in freefall. They account for 56 percent of the increase in foreclosure starts. (The Washington Post, May 29, 2009).

Senate bill (S. 896) revamped the previously passed $300 billion FHA Hope for Homeowners (H4H) program…” Both bills include a “safe harbor” provision that gives servicers a green light to modify loans, if they “believe in good faith” the recovery from a modification will exceed that of a foreclosure.” “The Obama administration estimates that legislation will make the program more effective and lenders will originate $5.5 billion in H4H loans in fiscal 2010. (National Mortgage News, May 11, 2009 by Brian Collins, page 2). Overture also reports that the “60+ days delinquencies continue to rise from 600,000 in October to more than double that number through January.” Negative equity remains a big problem. "By our calculations, this could translate into as many as 20 million homes that could seep into the market as prices stabilize; maintaining a constant stream of supply that far outpaces demand, thus keeping prices flat. I'm doubtful that we'll see the bottom until 2010, and thereafter it's increasingly clear that we're likely to have a long bottom before we see meaningful recovery in home values," Dr. Stan Humphries, Zillow VP Data and Analytics. The second wave of delinquencies, defaults, and foreclosures is now upon us. Foreclosure News Report (RealtyTrac®, April 2009, Vol.3 Issue 4) reports “We’ve got a second wave of foreclosures coming – both here in D.C. and nationwide, “predicted Lance Young, who says about $1.5 trillion worth of Alt-A and option ARMs will begin defaulting soon.” “I think it’s going to be a little worse than a spike. The foreclosure pipeline is full right now. The default rate on these loans is north of 50 percent…”Susan Jacobs, owner of Assist-2-Sell (who sells REOs for IndyMac and other lenders) suspects that a “second wave of foreclosure activity is coming this spring or summer due to the large number of vacant properties she sees.” The delay to implement (en masse) sensible mortgage loan (or principal) modifications, and consumer credit card modifications that maintain FICO scores, may have caused another buildup of potential defaults, delinquencies, foreclosures, or repossessions.

Market Demand, Mission Conflicts & Solutions:

Currently, since the FHA/Ginnie Mae tag-team is the only (functioning) new game in town, there will be risk mitigation calls to alter its open-door (eligibility) policies to limit the very borrower eligibility provided for in its mandate. On a business level this makes sense because FHA/Ginnie as functioning today, will produce a great volume of mortgages that will experience dangerously high defaults and delinquencies tomorrow (while also attempting to process the workouts and claims of yesteryear).

The FHA/Ginnie performance metrics are likely to continue to degrade under the current backdrop of this economic crisis. However, FHA/Ginnie was intended to serve the very borrower that it serves. We must keep the FHA/Ginnie tag team fulfilling its mandates, but modernize its processes and workflow to gain the highest level of efficiencies, and launch additional vehicles to securitize, underwrite, insure, and guarantee the various and diverse financial needs of the consumer in this huge marketplace. We must fill-in the missing pieces of the securitization pie. We must stop asking FHA/Ginnie to handle pieces of that pie that it was not intended to handle; and as such we should not restrict its eligibility policies and turn off the spicket for the borrowers that meet its program goals. We must activate Covered Bonds. Private label must re-enter and take back the majority of the securitization pie. Otherwise, FHA/Ginnie will balloon into the next special default servicers outsource dream; so severe that Fannie and Freddie will become its footnote. It appears that the need for special default servicing will grow ever-larger in the near and intermediate future. It appears that the value gap will continue to grow and negative equity will continue to add to the default rates. If the FHA default rate grows to 10%, another $50 to $60 billion will be added to mortgage losses (WSJ; August 2009).

There is a great need for the restructuring and expansion of the capacity of the FHA and Ginnie Mae in these distressed times of anemic securitization, credit, and liquidity. Enhanced certainty and liquidity is necessary to return to a healthy level of securitization and secondary market activity. The FHA is a catalyst for liquidity. At the height of the securitization and secondary market meltdown, the void was (partially) filled by the GSEs (Fannie Mae and Freddie Mac), The Federal Home Loan Bank System and Ginnie Mae. As a result, the roles of these entities have enhanced greatly, and each has become even more critical moving forward. The pie of securitization and secondary market activity must consist of, and be secured by, government and private label interests including FHA/ Ginnie Mae, as well as Covered Bonds. The FHA and Ginnie Mae can and will play a vital role. There is an historic opportunity (or duty) that the FHA/ Ginnie Mae must grasp. FHA can step up now and fill the need and at the same time develop the latest efficiencies needed to refine the workflow, and perhaps move to a paperless model. The safety and soundness of the Mutual Mortgage Insurance Fund (MMIF) must be reviewed to maintain its successful loss prevention history, and to enhance the growth of the Fund necessary to absorb the predicted future volume (and claims). Reporting only will not enhance safety and soundness (H.R. 2467), it will require new external and internal credit and product enhancements approved by the newly envisioned Consumer Financial Protection Agency (CFPA), as well as the credit rating agencies (e.g. Standard & Poor's).

Over the last 3 years, the FHA's market originations went from 3% to 30%. This trend is expected to continue exponentially as the demand and need for FHA products becomes the only avenue for many borrowers; in times of growing negative-equity, weakening FICO scores, growing under-employment, exhausted savings, rising debt, etc.

In addition to higher loan limits in high-cost areas, (and Congressional certainty to make same permanent), new products and flexible eligibility programs remain critical for the revitalization of the marketplace and the enhancement of the American Dream of Homeownership – wealth building model. This includes no or low down payment programs (as historically a characteristic of FHA programs), but with new contractual loss mitigation/default pre-sets in the loan documents (SHILO™ - Safe Harbor Intelligent Loan Options™), new credit and security enhancements, and new tradable insured secondary market pieces with new insured futures event funds (DMII™ - Default Mortgage Insured Investment Funds™), and new shared appreciation modifications and mortgages like QBieSam™ - Quarantined Built in Equity Shared Appreciation Modifications™ for achieving affordable monthly cash payments without the necessity to forgive or realize loss write-offs, or covenant or capital ratio origination impairments for principal reductions on first and junior liens; all helping to lower the default and re-default rates and supply liquidity for default events. New products that create guarantees or fund reserves would allow risk mitigation with affordable cash monthly payments. Although risk must be paid for - it doesn't necessarily have to be in (borrower) monthly cash terms. New products and new credit and risk enhancement devices are key to the new mortgage banking framework.

In addition to enhanced funding, additional staffing, new technologies, national licensing, registration, new appraisal codes (and amendments), fraud detections, higher loan limits, and net worth requirements, the government should also fashion better incentivized refinance (and modification) solutions. For example, the H4H (short payoff) refinance program and its progeny have not resolved the key issues that would allow en masse refinances (or modifications). Negative equity is a critical issue that must be addressed further, or solved with new products. Also the 100% LTV requirements of HAMP will cause great ineligibility or require great principal reduction or forgiveness. As the private secondary market has yet to return, FHA has and will become the only hope for many borrowers looking to refinance their ARMs, especially with negative equity. As with the Making Home Affordable modification and refinance programs, lender/servicer/investors do not want to realize the loss of principal reductions or forgiveness as it also impairs the lenders capital ratios and lending capacity.

The game now is new products, new credit enhancements, new risk mitigation devices, and more efficient technologies and workflow systems. For example, a new and efficient FHA e-mortgage system must become the standard as explained by Brian Boike, 1st VP, Flagstar Bank. Additionally, new products that would allow for principal reduction or forgiveness without current realization of write-downs or losses and actually lower the re-default rates below 20% (far from the national average of 55%) would supply the missing piece of the incentive puzzle. Such a product would allow full or substantial principal claw-back while the borrower is motivated to Stay & Pay - as the borrower would receive a much lower monthly payment. The refinance may also be a short payoff refinance to achieve that goal if new product enhancements are brought to bear. The administration's budget requests are for $400b for FHA for FY 2010 and $500b for Ginnie Mae. If new FHA (H4H) short payoff refinancing would allow principal reductions of some 30% (with reimbursements from partial claims), then the stage is set for the en masse solution. The author is working on solutions for the industry on these matters and further information can be found at www.qbiesam.com (Quarantined Built-In-Equity Shared Appreciation Modification™) or www.NationalWorkoutAlliance.Com.

As enhanced authority and funding is needed for the recent and predictive FHA-insured loan volume increases, so too must Ginnie Mae receive same. Ginnie Mae's market share increased by 159% from 2007 to 2008 (from $85b in 2007 to $221b in 2008). The 2009 increase is expected to be greater. FHA-insured loans and Ginnie Mae servicing rights are in great demand. Immediate and substantial authority and funding are needed for both FHA and Ginnie Mae.

Related Regulatory Overhaul:

As we debate the safety and soundness, and general usefulness of FHA/Ginnie Mae in terms of technology upgrades, staffing authority and enhanced funding, a parallel debate is underway on fundamental financial regulatory reform. Part of debate of the latter includes the task of determining the "Future Role of the Government Sponsored Enterprises (GSEs)", as reported by the Treasury in its report: A New Foundation: Rebuilding Financial Supervision and Regulation. That recommendation is due Congress when the President's delivers his 2011 Budget. Treasury Secretary Geithner testified before the Senate Banking Committee (June 18, 2009) indicating in part that there would be a new and independent financial consumer protection agency with authority over "the interests of consumers of credit, savings, payment and other financial products." He also indicated that the Federal Reserve would be given enhanced powers.

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