



Comments on Development of a Guaranty Program for Troubled Assets as Authorized by Section 102 of the Emergency Economic Stabilization Act of 2008 (EESA)

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CMPS Institute¹ appreciates the opportunity to comment on Treasury's development of a guaranty program for troubled assets as authorized by Section 102 of the Emergency Economic Stabilization Act of 2008 (EESA).

Premise / Introduction:

It is impossible to insure the value or performance of any derivative product unless there is a way to accurately predict and measure the performance of the underlying asset. Troubled mortgage assets such as Residential Mortgage Backed Securities (RMBS), Collateralized Mortgage Obligations (CMOs), Collateralized Debt Obligations (CDOs) and other mortgage loan derivatives, cannot be effectively insured without first examining the value and likely performance of the underlying mortgage loans. Further, it is unwise for the government to assume liability for insuring whole loans unless there is a reasonable expectation that the loans will perform well. This proposal and our comments focus on:

- Why mortgage assets are "troubled" in the first place
- How to cure the valuation, performance and other "troubles" through a systematic restructuring of the underlying mortgage loans in a way that would restore a reasonable expectation that those underlying loans will perform well
- How to minimize government involvement and risk to the taxpayer through the effective creation and deployment of a Home Mortgage Guaranty (HMG) program for the restructured underlying mortgages
- How the HMG can effectively jumpstart a covered-bond market for US real estate loans and lay the foundation for the eventual break-up and complete privatization of Fannie Mae and Freddie Mac

¹ CMPS Institute is a training, certification, and ongoing membership program for financial professionals who provide mortgage and real estate equity advice. The CMPS Institute administers the Certified Mortgage Planning Specialist™ (CMPS®) designation through an extensive core curriculum that focuses on financial analysis and suitability of various mortgage options, a comprehensive examination process, an enforceable code of ethics and annual continuing education requirements. Since its inception in 2005, over 5,000 mortgage bankers, brokers and financial advisors have gone through the CMPS® live and self-study programs.

The Problem – Why Mortgage Assets Are Troubled

Uncertainty Regarding the Value and Performance of Underlying Mortgage Loans

Mortgage lenders and investors in mortgage-backed securities and derivatives have three ways to recover their investment:

1. Timely mortgage payments made by borrowers
2. Full or partial pre-payment of principal through refinancing, periodic lump sum principal payments made by borrowers, or sale of homes on the open market by borrowers
3. Full or partial recovery of principal on defaulted loans through the foreclosure process

The decline in real estate values and resulting negative homeowner equity, resetting interest rates on adjustable rate mortgages (ARMs), recasting payments on negatively amortized Option ARMs, loss of jobs due to economic conditions, and over-extended household debt burdens are among many factors contributing to uncertainty regarding how and when mortgage loans will be repaid. Default rates are approaching 7% of all mortgage loans outstanding and this number is likely to rise as property values continue to fall or stagnate and economic conditions worsen. This means continued uncertainty in all three areas of how mortgage lenders and investors expect to be repaid:

1. Many borrowers are not making timely mortgage payments and many more are expected to default
2. Borrowers are unable to pre-pay their loans by refinancing due to negative equity and tight lending guidelines
3. It is unclear how much lenders will recover through the foreclosure process due to unstable real estate values, high inventory levels, and (most recently) ad hoc and rapidly changing rules on foreclosures and loan modifications by various state governments, lending institutions and federal government agencies. For example, some states have recently enacted one-year moratoriums on all foreclosures, while loan modification efforts across the country have been inconsistent and poorly organized. These efforts are having the real effect of simply delaying into the future foreclosures and write downs that may be unavoidable. This contributes to uncertainty regarding the value and expected performance of the mortgage assets, and pushes into the future recognition of losses by financial institutions that hold the troubled assets.

Decline in Housing Values and Negative Homeowner Equity

The decline in housing values creates a “negative feedback loop” in which homeowners are thrust into a negative equity situation, walk away from their homes or otherwise default on their loans, and push their homes into the foreclosure process. Increased foreclosures further depress housing prices and drive even more homeowners into a negative equity situation, perpetuating the downward spiral. It is estimated that 20% - 40% of all US mortgage borrowers will owe more on their mortgages than the value of their homes by the time home values stabilize sometime in 2009 or 2010. The decline in housing values is most pronounced in states such as California, Arizona, Florida, and Nevada, which unsurprisingly also carry the highest mortgage default and foreclosure rates. In fact, California alone accounts for approximately one third of all securitized mortgages and over 25% of all US foreclosure activity.

Even so, many states (California for example) have anti-deficiency statutes that render mortgage loans non-recourse to the borrower. This means that the only recourse mortgage lenders have if a borrower defaults on a mortgage loan is to foreclose on the property. If the sale price of the home through foreclosure is insufficient to cover the entire mortgage balance owed, the lender cannot pursue a deficiency judgment against the borrower for the difference. Consider this example:

- \$350,000 - sale price of home through foreclosure
- \$21,000 - 6% fees and costs to sell the home
- \$400,000 - mortgage balance
- \$71,000 – loss incurred by mortgage lender

If this property was located in a state like California with anti-deficiency statutes, and the circumstances were such that the loan was considered non-recourse (borrower's primary residence, mortgage loan used to acquire the home), the lender would be unable to pursue a deficiency judgment against the borrower and recover the \$71,000 shortfall.

In other words, many homeowners who owe more on their non-recourse mortgages than the value of their homes have a very strong incentive to default and walk away from their negative equity situation. Even the borrowers who are not currently in default will have strong incentives to default on their non-recourse mortgage loans and walk away from their negative equity situation if home values continue to stagnate or decline. After all, these home owners with negative equity could very well wake up to the reality that they could simply walk away with very little adverse consequences, rent for a few years, re-establish their credit rating and jump back into the housing market when conditions improve.

Therefore, although approx. 93% of mortgage loans are not currently in default, that high number of performing loans could quickly deteriorate and go sour as home values continue to stagnate or decline. This reality contributes even further to the uncertainty and instability surrounding the value of all mortgage assets.

De-leveraging Among Financial Institutions and Mark-to-Market Accounting

Financial institutions, including both regulated banks and unregulated hedge funds, are currently engaged in a de-leveraging process under which their investments are being sold and their trading positions are being unwound in order to restore adequate capital ratios. More on this process can be found here: http://www.cmpsiinstitute.org/pdf/navigating_turbulence_series1.pdf

This "Great Unwind" and de-leveraging process includes selling assets (including mortgage-related securities and financial assets) at very depressed fire-sale prices into a rapidly declining marketplace. In many cases, the current market values of mortgage-related securities and financial assets assume that over 50% of sub-prime borrowers will default on their mortgages and US home values will decline to \$0, making the underlying value of defaulted mortgages absolutely worthless. Here is a link to an illustration of how mortgage assets are valued:

<http://www.cmpsiinstitute.org/pdf/WhatAreTroubledMortgageAssetsWorth.pdf>

Mark-to-market accounting rules require financial institutions to value their assets (such as complex mortgage securities) at the currently depressed market prices and then adjust their “capital levels” (the amount of cash they have in reserve) accordingly. If the market value of their mortgage holdings declines, financial institutions have to raise more cash to make up for the difference. Most of the losses being reported are simply paper losses based on currently depressed fire sale prices – but financial institutions have to raise real cash and beef up their reserves just in case those paper losses become real losses.

It is virtually impossible to attach a market value to something when there are no buyers able or willing to buy it. This doesn’t mean that the mortgage-related assets are in fact worthless. It simply means that no one wants to buy them right now because all the buyers have financial problems of their own.²

The accounting rules are unclear as to how financial assets (such as complex mortgage holdings and derivatives) should be valued if the market for those assets completely disappears due to lack of buyers. Many market participants have called for a temporary moratorium or suspension of mark-to-market accounting rules. In fact, EESA gives authority to the Securities and Exchange Commission (SEC) to investigate and even suspend mark-to-market accounting. Depending on exactly how the accounting rules are amended or modified, a suspension of mark-to-market accounting without replacing it with a credible alternative could have very adverse consequences and only serve to delay recognition of losses by financial institutions.

If financial institutions are allowed to hold assets on their books at values that are higher than actual market value, this could erode market confidence as to the actual solvency of financial institutions that use “fuzzy math” and don’t adhere to mark-to-market accounting standards. The lack of transparency around financial institution balance sheets and erosion of confidence in the solvency of financial institutions would prolong the financial crisis. Under this scenario, the interbank loan guaranty program and other programs created and announced by the FDIC, Fed and Treasury to restore market confidence would be put to the test and taxpayer funds would be put at even further risk.

² Also, many buyers are simply waiting on the sidelines waiting for the currently depressed prices to fall even further so that they can get an even better deal than what is currently available. An example of this was the bankruptcy of Lehman Brothers, where potential buyers were unwilling to pay the then depressed market prices to purchase Lehman, but preferred to push the company into bankruptcy and pick up the various pieces of Lehman at even lower prices. Another example of this was the battle over Wachovia, where Wells Fargo was in talks to purchase Wachovia at a premium price, and then backed out of the deal. Citigroup then signed an agreement to take over Wachovia at a much lower price with the FDIC agreeing to assume a substantial portion of the potential losses from Wachovia’s mortgage portfolio. Wells then jumped backed into the fray with a bid that was much higher than Citigroup’s, but still less than what Wells was willing to pay the prior week. Although Wells later obtained legal approval from Citigroup to proceed with buying out Wachovia, the matter is still in dispute with Citigroup seeking tens of billions of dollars in damages from Wells for interfering in Citigroup’s transaction with Wachovia.

The Solution – Home Mortgage Guaranty (HMG) Program

It is clear that any large scale rescue of the financial system must address the root causes of the current turmoil:

- Uncertainty Regarding the Value and Performance of Underlying Mortgage Loans
- Decline in Housing Values and Negative Homeowner Equity
- De-leveraging Among Financial Institutions and Mark-to-Market Accounting

The Home Mortgage Guaranty (HMG) program is a solution that can be deployed quickly while addressing all three of the major issues outlined above. The details of the HMG are as follows:

- Treasury, using the authority granted by EESA³, would mandate that all financial institutions and mortgage servicers embark on a 90-180 day moratorium on foreclosures during which time a large-scale systematic restructuring of mortgage loans will occur in adherence with the standards outlined below
- Treasury and/or the FDIC will issue a Home Mortgage Guaranty (HMG) certificate for each restructured mortgage
- Upon the expiration of the 90-180 day timeframe, the mortgage securities, collateralized obligations and derivatives will be retired, settled, restructured and/or revalued to reflect the new intrinsic values of the underlying mortgages in each securitization pool. The hold-to-maturity prices of the securities can then be established in cooperation with financial institutions and rating agencies with government oversight.
- Treasury and/or the FDIC would issue a Securitized Mortgage Guaranty (SMG) for each security that insures a certain portion of the security's hold-to-maturity value (which would be reliable due to restructuring and revaluation of the underlying mortgage loans).
- Treasury, along with private market participants, could bid for (through a reverse auction process or otherwise) and purchase the restructured mortgage-related securities that now carry an SMG certificate with a US Government guarantee that covers a certain portion of the security's hold-to-maturity value
- Financial Institutions will be allowed to hold the securities on their balance sheets at the hold-to-maturity prices reflected by each security's SMG certificate
- Mark-to-market accounting will only be suspended with regard to specific securities that will be revalued and held at hold-to-maturity prices as part of the HMG/SMG program

³ Sections 109 and 110 of EESA require the federal government to come up with a systematic plan (within 60 days of the passage of the legislation) to help homeowners stay in their homes and avoid preventable foreclosures.

Step #1 - 180 Day Foreclosure Moratorium, Mass Mortgage Modifications and Mandatory Balance Reductions

To quote from economist Nouriel Roubini⁴:

“Households in the US have too much debt (subprime, near prime, prime mortgages, home equity loans, credit cards, auto loans and student loans) while their assets (values of their homes and stocks) are plunging leading to a sharp fall in their net worth. And households are getting buried under this mountain of mounting debt and rising debt servicing burdens. Thus, a fraction of the household sector – as well as a fraction of the financial sector and a fraction of the corporate sector and of the local government sector – is insolvent and needs debt relief. When a country (say Russia, Ecuador or Argentina) has too much debt and is insolvent it defaults and gets debt reduction and is then able to resume fast growth; when a firm is distressed with excessive debt it goes into bankruptcy court and gets debt relief that allows it to resume investment, production and growth; when a household is financially distressed it also needs debt relief to be able to have more discretionary income to spend. So any unsustainable debt problem requires debt reduction. The lack of debt relief to the distressed households is the reason why this financial crisis is becoming more severe and the economic recession - with a sharp fall now in real consumption spending – now worsening. The fiscal actions taken so far (income relief to households via tax rebates) and bailouts of distressed financial institutions (Bear Stearns creditors’ bailout, Fannie and Freddie and AIG) do not resolve the fundamental debt problem for two reasons. First, you cannot grow yourself out of a debt problem: when debt to disposable income is too high increasing the denominator with tax rebates is ineffective and only temporary; i.e. you need to reduce the nominator (the debt). Second, rescuing distressed institutions without reducing the debt problem of the borrowers does not resolve the fundamental insolvency of the debtor that limits its ability to consume and spend and thus drags the economy into a more severe economic contraction.”

The first step in the HMG program would be for Treasury, using the authority granted by EESA, to mandate that all financial institutions and mortgage servicers embark on a 90-180 day moratorium on foreclosures during which time a large-scale systematic restructuring of mortgage loans will occur. Lenders will have the option of re-writing the loans entirely as part of their participation in the FHA Hope for Homeowners program, or they could participate in the government-mandated HMG program of mass-modifications that would include these elements:

⁴ Professor Nouriel Roubini is an internationally known expert in the field of international macroeconomics. He is a Professor of Economics at New York University's Stern School of Business and is also the co-founder and Chairman of RGE Monitor, an innovative economic and geo-strategic information service named one of the best economics websites by BusinessWeek, Forbes, the Wall Street Journal and The Economist. Professor Roubini served as a senior adviser to the White House Council of Economic Advisers and the U.S. Treasury Department; has published numerous policy papers and books on key international macroeconomic issues; and is regularly cited as an authority in the media. He received an undergraduate degree at Bocconi University in Milan, Italy and a Ph.D. in Economics at Harvard University, and was previously a faculty member at Yale University.

- A reduction in all home mortgage balances to not more than 90% of the home owner's current home value as established by one or more independent appraisers
- A Home Mortgage Guaranty (HMG) fee paid by the lender to the federal government equal to 3% of the new loan amount.
- Government insures against any further decline in mortgage value (below the 90% of current home value) over a 3 year timeframe
- Representations and warranties from the lender and the lender's agents that they have helped the borrower establish a household budget demonstrating long-term affordability of the new monthly mortgage payments
- In the case of situations involving second or third liens, the second or third lien positions would be entirely wiped out with no potential for equity sharing. This incentivizes lenders to participate in the FHA Home for Homeowners program that does allow for equity sharing on the part of second lien holders. Further, 2nd and 3rd liens typically carry higher interest rates than 1st liens in order to compensate for the risks inherent in their subordinate lien positions.

Example of how the HMG program would reverse the borrower's negative equity position in a situation with approximately 15% negative equity:

- \$345,000 mortgage balance
- \$300,000 Current Home Value

Step #1 – Lender writes down balance to 90% of current home value

- \$270,000 New Reduced Mortgage Balance

Step #2 – Lender pays a Home Mortgage Guaranty (HMG) fee to the federal government equal to 3% of the new loan amount:

- \$8,100 – HMG fee

Step #3 – Homeowner agrees to split the current equity and future equity appreciation 50/50 with the federal government

In this example, the lender wrote off \$75,000 in principal and paid an HMG fee of \$8,100; bringing the lender's total loss to \$83,100 or 24% of the original face value of the mortgage. This would value the mortgage loan at 76% of its original face value as compared to the recent fire sale prices of 22%, (in the case of Merrill Lynch subprime CDOs), 34% (in the case of Lehman's subprime portfolio), and 39% (in the case of Lehman's Alt-A portfolio).

Example of how the HMG program would reverse the borrower's negative equity position in a situation with approximately 30% negative equity:

- \$390,000 mortgage balance
- \$300,000 Current Home Value

Step #1 – Lender writes down balance to 90% of current home value

- \$270,000 New Reduced Mortgage Balance

Step #2 – Lender pays a Home Mortgage Guaranty (HMG) fee to the federal government equal to 3% of the new loan amount:

- \$8,100 – Home Mortgage Guaranty (HMG) fee

Step #3 – Homeowner agrees to split the current equity and future equity appreciation 50/50 with the federal government

In this example, the lender wrote off \$120,000 in principal and paid an HMG fee of \$8,100; bringing the lender's total loss to \$128,100 or 33% of the original face value of the mortgage. This would value the mortgage loan at 67% of its original face value as compared to the recent fire sale prices of 22%, (in the case of Merrill Lynch subprime CDOs), 34% (in the case of Lehman's subprime portfolio), and 39% (in the case of Lehman's Alt-A portfolio).

Example of How the Equity Sharing Works:

- \$390,000 mortgage balance
- \$300,000 Current Home Value

Step #1 – Lender writes down balance to 90% of current home value

- \$270,000 New Reduced Mortgage Balance
- Borrower receives a net benefit of \$120,000
 - Difference between old balance (\$390,000) and new balance (\$270,000)

Step #2 – Borrower signs an Equity Sharing Certificate and agrees to pay back to the federal government up to half of their net benefit (\$60,000) if they experience a corresponding rise in property value

- Scenario #1 - The borrower sells the home for \$350,000 with 6% costs of sale (\$21,000), leaving \$329,000, of which \$270,000 is used to pay off the mortgage, leaving net proceeds of \$59,000:
 - \$29,500 (50%) is retained by the borrower
 - \$29,500 (50%) is paid to the government
- Scenario #2 - The borrower sells the home for \$290,000 with 6% costs of sale (\$17,400), leaving \$272,600, of which \$270,000 is used to pay off the mortgage, leaving net proceeds of \$2,600:
 - \$1,300 (50%) is retained by the borrower
 - \$1,300 (50%) is paid to the government as equity sharing
- Scenario #3 – The borrower sells the home for \$250,000 with 6% costs of sale (\$15,000), leaving \$235,000, all of which is used to pay back the lender.
 - No equity sharing
 - If home is sold after the 3 year holding period, the government would pay an insurance claim to the lender covering the \$35,000 difference between the \$270,000 owed and the \$235,000 recovered

Step #3 – Borrower is prohibited from pulling cash out of the property through refinancing for a period of at least 3 years (this provision could even mirror the FHA H4H provision restricting equity extraction). Also, costs of sale allowed to be excluded from equity share should be limited to approximately 6%.

HMG Program Should be Mandatory for All New Home Purchases

Buyer purchases a new home for \$300,000 with a \$30,000 (10%) down payment:

- \$270,000 mortgage
- HMG fee of 3% of \$270,000 paid to government (\$8,100)
- Government insures against any decline in home value below \$270,000 over a 3 year timeframe
 - HMG program should be limited to only cover declines below 90% of the home purchase price
 - Only available for primary residences; fee can be paid by buyer, seller, lender, Realtor
 - Seller can afford to pay the HMG fee due to at least 10% positive equity (no more negative equity problem)

Benefits:

- Real estate market stimulus
- Raises enormous amounts of revenue for the federal government to help fund the myriad economic rescue initiatives without raising taxes
- Inspires confidence in the US real estate markets, mortgage backed securities and derivatives

How the HMG Program Affects Financial Institutions:

- Forced to write off mortgage balances and book massive losses
- Revalue their troubled mortgage securities at the new hold-to-maturity values that could very likely be much higher than the fire sale prices of the last several months
 - Avoids the need for massive mark-to-market write downs while preserving balance sheet integrity and transparency
 - Could even mean valuation “write-ups” if financial institutions have already “marked-to-market” and are holding assets on their books at values below the new hold-to-maturity values
- Recapitalized by federal injection of funds as already being implemented by Treasury’s Capital Purchase program – this process restores adequate capital levels as necessary due to massive mortgage balance reductions and write offs

Addressing moral hazard concerns:

- Preferred equity stakes in financial institutions already taken by federal government and further capital could be injected as necessary at terms that continue to protect the taxpayer
- Measures already taken to limit executive compensation
- Treasury should consider mandating a complete suspension of dividends until government’s preferred shares are redeemed. However, this step could harm efforts by financial institutions to raise private capital
- Treasury could require a private capital matching program for all future capital injected into financial institutions

How the HMG Program Affects Homeowners and Mortgage Borrowers:

- Nationwide temporary moratorium on foreclosures:
 - Gives lenders and their agents time to implement the program and re-underwrite mortgages based on borrowers' ability to afford payments at the reduced balances
 - Only borrowers who can afford the new loan terms on a long-term sustainable basis will be eligible to participate
 - Foreclosure process will resume for all borrowers who cannot afford the new loan terms on a long-term sustainable basis
- Massive household debt reduction and elimination of the negative equity problem:
 - Avoids harmful long-term implications associated with proposed amendments to the bankruptcy code that would allow mortgage "cram downs"
 - Removes homeowners' incentive to default on their mortgage loans
 - Equality and uniformity of the HMG program does not unjustly disadvantage "good borrowers" who can afford payments but are otherwise innocent victims of the real estate downturn and caught in a negative equity situation
 - Shores up consumer confidence and helps restore economic growth
 - Stimulates the housing market

Addressing moral hazard concerns:

- Steps have already been taken to move the mortgage industry toward more sound underwriting and lending procedures; more steps should be taken in this regard, namely training lenders to help borrowers establish a manageable household budget demonstrating long-term affordability of mortgage and debt payments⁵
- Government intervention in the markets has already occurred. The key is to implement a plan that solves the root causes of the problem and also limits taxpayer exposure. The HMG program carries enormous upside for the taxpayer in addition to significant economic stimulus without increasing government spending or raising taxes.

How the HMG Program Affects the Federal Government:

- Valuation process of troubled mortgage assets becomes simplified, predictable, transparent, and reliable
- Avoids the need for massive federal government purchases of mortgages and troubled mortgage assets that currently have no reliable method of valuation
- Equity stakes in financial institutions increase government revenue due to arbitrage of low government borrowing costs vs. higher dividends received on preferred shares
- Equity sharing with participating homeowners increases government revenues without raising taxes
- 3% HMG fee paid by financial institutions (modified loans) and 3% HMG fee paid by home sellers and buyers (all new home purchases) covers administrative costs of the program and increases government revenues (without raising taxes) beginning immediately

⁵ CMPS Institute is the foremost industry leader in this regard, having developed curriculum and systems to help lenders make suitable mortgage recommendations. Suggestions made by CMPS Institute have even been cited by the Federal Reserve Board of Governors in their final rules issued in July 2008 amending the implementation of Regulation Z.

Step #2 – The Securitized Mortgage Guaranty (SMG) Certificate and Re-Valuation of Troubled Mortgage Assets

Upon the completion of the 90-180 day foreclosure moratorium, mass mortgage modifications and mandatory balance reductions, the mortgage securities, collateralized obligations and derivatives will be retired, settled, restructured and/or revalued to reflect the new intrinsic and hold-to-maturity values of the underlying mortgages in each securitization pool. In some cases, the underlying mortgages will have been completely retired through the refinancing process (into FHA Hope for Homeowners or some other new mortgage product). In other cases, the underlying mortgages will simply have been modified to reflect different balances, interest rates, payment schedules or a combination of any of the above. In other cases, the underlying mortgages will be sent into the foreclosure process. The bottom line, however, is that Treasury and the marketplace will have the information required to re-value the troubled mortgage assets based on the new hold-to-maturity value of the securities. The hold-to-maturity prices of the securities can be established in cooperation with financial institutions and rating agencies with strict government oversight. Treasury, the FDIC, private insurance companies, or a combination of any of the above can then issue a Securitized Mortgage Guaranty (SMG) certificate with a guarantee that covers a certain portion of the security's hold-to-maturity value. This will insure potential investors as to the security's intrinsic value. Investors could bear the risk of loss up to a certain portion and the insurer (either the government or a private entity) could bear the remaining risk of loss.

Once the securities are re-valued, Treasury, along with private market participants, would bid for (through a reverse auction process or otherwise) and purchase the restructured mortgage-related securities that now carry an SMG certificate guaranteeing a certain portion of the security's hold-to-maturity value. The insurance claims would only need to be paid out upon maturity if the securities mature below their guaranteed value. In the meantime, the securities can be traded on the open market amongst investors and other market participants. Financial Institutions will be allowed to hold the securities on their balance sheets at the hold-to-maturity prices reflected by each security's SMG certificate. Mark-to-market accounting will only be suspended with regard to specific securities that will be revalued and held at hold-to-maturity prices as part of the HMG/SMG program.

The HMG/SMG program can be utilized to jumpstart the covered bond⁶ market in the United States while providing a mechanism to reduce federal involvement with Fannie Mae and Freddie Mac. The public policy goal of promoting home ownership can be realized by having private lenders issue mortgages and covered bonds, with the federal government insuring the value of the covered bonds for a time through the use of the HMG/SMG program. Once the financial markets stabilize and the US covered bond market is jump-started, changes can be made to reduce federal involvement in the mortgage markets.

⁶ A covered bond is where banks must keep the mortgages on their balance sheet and replace any loans that default, thus "covering" the bonds. This allows mortgage lenders to offload interest rate risks to bond investors, while retaining the default risk of the underlying mortgages. Covered bonds have recently been cited as one way to attract capital to the US mortgage markets and replace the CDOs and other complex investment vehicles of the past.

Concerns and Drawbacks of the HMG Program

Concern #1 - HMG program forces financial institutions to write off mortgage balances without adequate compensation or equity sharing with the homeowner.

Answer: Financial institutions can choose to participate in the FHA Home for Homeowners program as an alternative to the HMG program. Further, financial institutions benefit immensely by Treasury's Capital Purchase program, the FDIC guaranty of inter-bank loans, the Fed's liquidity measures, and other unprecedented government interventions to shore up financial institutions and their balance sheets. Also, financial institutions will benefit from cures to the valuation and performance of troubled mortgage assets, as well as confidence that the "troubles" will not spread to their performing loan portfolios. Finally, financial institutions will benefit from the enormous economic stimulus and boost to consumer confidence and spending that will occur as a result of reductions to overall home owner debt and debt service levels.

Concern #2 – How is the net present value (NPV) to taxpayers maximized (as required by EESA) in the case of mortgage balance reductions where borrowers are not currently delinquent or in imminent danger of default – especially with regard to performing loans owned by (the now nationalized) Fannie Mae and Freddie Mac?

Answer: The economic stimulus and boost to consumer confidence and spending that will occur as a result of reductions to overall home owner debt and debt service levels will offset the losses incurred by Fannie and Freddie in reducing home owner mortgage balances. Taxpayers will directly benefit from the economic stimulus in terms of enhancements to their own private wealth as well as increased government tax revenues that result from a well functioning economy. Additionally, the HMG fees on all restructured mortgages and new home purchases will result in enormous and immediate revenue streams to the federal government and taxpayers. Further, through equity sharing, the government will recover up to half of all US mortgage balance reductions under the HMG program – not just the reductions that occur in the Fannie/Freddie portfolios.

Concern #3 – Should the HMG program be available for second homes and investment properties? If so, what about the moral hazard of rewarding speculators for their behavior?

Answer: The HMG program for new home purchases should not be extended to real estate investors and those purchasing second homes. This would only encourage more speculation in the real estate markets as government would effectively be setting a floor on real estate values with very limited downside to investors and speculators.

However, the HMG program for existing homes (where existing balances are reduced to 90% of the current home value) could potentially be extended to cover investment properties and second homes. In many of the hardest hit markets (CA, NV, FL, AZ) retirement and second home purchases along with speculation among real estate investors was the primary driving factor of unsustainable home price appreciation, and the resulting downturn in home prices. Even so, extending the HMG program to cover second homes and investment properties could have several benefits to taxpayers.

The main benefit is the increased revenue to the government from all the HMG fees and equity sharing that will be collected on these properties. Also, this would do much to stabilize real estate values as up to 40% of all home sales over the past few years have been second homes and investment properties. This would obviously benefit all home owners, not just investors. Like primary residence homeowners, many investors and owners of second homes also have little or no incentive to keep up their mortgage payments under current market conditions. Limits could be imposed to discourage speculation while shoring up the market. Namely, the government equity share on second homes and investment properties could be higher than the 50/50 split and the repayment schedule of the forgiven mortgage balances could be based on 100% of the net benefit to the property owner instead of the 50% cap for primary residences. Other limitations could include limiting the number of homes that a single investor could include in the HMG program.

Concern #4 – What if the real estate markets continue to decline and the government has to actually pay up on the HMG claims?

Answer: House values been declining since 2006, and most economic experts agree that the bulk of the declines are already behind us. The worst case estimates are that values will decline another 10-15% below their current levels. Even if this occurs, HMG claims will only be paid on declines below 90% of the current home value. In other words, this 10% cushion will cover most, if not all of the future declines. Furthermore, claims will only be paid on losses incurred after 3 years, giving the housing market a fair amount of time to stabilize and recover.

Additionally, the 3% HMG fees on restructured loans and new home purchases will generate enormous amounts of capital, essentially self-funding the HMG program. Further, the economic stimulus that will occur as a result of this program will increase tax revenues and further cushion the expense of any claims that may need to be paid. All these render the HMG program a far better solution than any of the alternatives. The alternative proposals would require enormous amounts of government funding without addressing the core issues of negative homeowner equity, over-loaded household debt burdens, and uncertainty as to the intrinsic value of troubled mortgage assets.

Conclusion

The Home Mortgage Guaranty (HMG) program is a solution that can be deployed quickly while addressing all three of the root causes of the current financial turmoil:

- Uncertainty Regarding the Value and Performance of Underlying Mortgage Loans
- Decline in Housing Values and Negative Homeowner Equity
- De-leveraging Among Financial Institutions and Mark-to-Market Accounting

For further information, please contact:

CMPS Institute

Gibran Nicholas, Chairman

3017 Walnut Ridge Drive | Ann Arbor, MI 48103 | 888-608-9800 | Gibran@CMPSInstitute.org