Dear Reader,

I've been in the mortgage industry for 30 years in Texas, and I'm hoping to gain your support for the effort to responsibly restructure and transition the national mortgage market. The attached proposal is an extension of a concept I've been attempting to persuade the state of Texas to implement, but because the proposed changes at the federal level affect its viability we need to attempt to affect change on the national level. It's a practical solution with powerful positive benefits for all Americans. I sincerely hope you seriously consider supporting this proposal and you ask others to do the same.

Rick Baron – 512-422-1949 – rick@rickbaron.com – NMLS #220934

Brief Summary of the Plan to Restructure and Transition the U.S. Mortgage Market

The plan for restructure calls for the creation of at least 12 regional, extremely well capitalized, single purpose nonprofit mortgage securitization firms. They are to be initially funded with $3 billion from Fannie Mae's and Freddie Mac's earnings, or $250 million for each entity, to avoid using taxpayer funds. Once they are operational they will be permanently self-sufficient and self-reinforcing. Their purpose is to purchase conforming, Agency quality mortgages from lenders throughout their regions, pool them into mortgage-backed securities (MBS), and sell them to MBS investors worldwide. Since nonprofits are not required to pay corporate taxes or distribute their profits to investors, they will use their net operating profits to build enormous Guaranty Reserve Funds to guarantee MBS investors they will always be repaid. They will effectively replace a government guarantee with a cash guarantee. The overall goal is to use the funds generated from securitization activities to protect MBS investors and to provide affordable housing finance to the majority of Americans.

The plan also calls for a permanent exemption of traditional, conforming Agency quality MBS from the QRM/QM/ATR rules since Agency MBS already have a 75 year history of properly documenting and assessing borrowers' *ability and willingness* to repay mortgage loans. Loans that meet these traditional standards have a historical default rate of less than 1%, and these loans are currently exempt from any risk retention requirements. The plan also calls for the QRM/QM/ATR rules to be applied only to mortgage loans intended for Private Label Securities (PLS), and prohibits the combining (tranching) of Agency MBS and PLS to give investors a clear choice between the two categories.

The plan for transition calls for these institutions to gradually take over the 1-4 family residential securitization market from Fannie and Freddie over the next 5 to 7 years with minimal or no market disruption. It is assumed they will be able to utilize the new common securitization platform being developed by the FHFA. It is recommended the Agencies remain in some form to assist with these entities and to ensure uniformity of underwriting guidelines.

The goal of this plan is to preserve traditional, affordable mortgage lending and to create a mechanism that transitions the residential mortgage market away from the federal government, minimizes taxpayer risk, interest rate risk, political risk, risk for profit, and ensures mortgage market liquidity. Please read the White Paper on this subject for in depth explanation and details. Your support for this concept is greatly appreciated.

A Specific Plan to Restructure and Transition the U.S. Secondary Mortgage Market and to Preserve Traditional Mortgage Lending

White Paper

August 2013

By

Rick Baron

NMLS #220934

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Executive Summary

The solutions to the current state of mortgage lending appear to be very elusive and complex. The reason is because there are multiple aspects of the mortgage finance system that must be addressed. These aspects can be best understood if they are viewed as different aspects of financial risk: taxpayer risk, systemic risk (and illiquidity risk), interest rate risk, credit risk (risk of default and risk of loss), political risk, and risk for profit.

The following proposal is a relatively simple solution designed to simultaneously address these multiple aspects of financial risk and return us to a more normalized lending environment.

The proposal is to create a nationwide network of smaller, extremely well capitalized Fannie Mae/Freddie Mac clones which will restructure the national secondary mortgage market utilizing a business model that is neither a government agency nor a private corporation. Once created, they will purchase loans that meet and conform to current Fannie Mae/Freddie Mac (Agency) quality standards from lenders of all types, then securitize and sell them as mortgage-backed securities (MBS) to long-term investors around the world. They will not need or risk taxpayer funds to get started or to function, and they will effectively replace a government guarantee for MBS investors with a cash guarantee. They are designed to grow stronger every year. They will also serve as a mechanism to smoothly transition the residential mortgage securitization business away from Fannie Mae and Freddie Mac within a few short years.

Because these entities are intended to continue the loan quality standards set by the Agencies, this proposal also calls for a permanent exemption of this category of home loans from the requirements and rules being imposed by the Consumer Financial Protection Bureau (CFPB) known as the Qualified Residential Mortgage (QRM), the Qualified Mortgage (QM), and the Ability-to-Repay (ATR) Rules. The QRM/QM/ATR rules assume that Fannie Mae and Freddie Mac will eventually cease to exist and are intended for a purely private mortgage market. Unfortunately, the CFPB's approach will likely prove to be highly restrictive and discriminatory toward millions of potential homebuyers if fully implemented and applied to all home lending. Considerable explanation and detail regarding traditional underwriting methodology, where and how we lost our way, and the potential unintended consequences of our current direction is offered within this document.

Adopting this proposal will keep housing finance much more affordable for the vast majority of Americans than a purely private market. It will also enable the creation of a powerful low income and first-time home buyer housing finance program.

This proposal is intended to serve as a roadmap to find our way out of the woods and to place us on a permanently sustainable path for home finance.

A Practical, Responsible Plan to Restructure and Transition the U.S. Mortgage Finance System

This is a proposal to restructure the U.S. Secondary Mortgage Market in a manner that, if implemented as described herein, will permanently stabilize and strengthen our nation's housing finance system.

The Federal Government currently securitizes over 90% of all of the mortgages made in the U.S. through Fannie Mae, Freddie Mac and Ginnie Mae. By any definition, it has a monopoly on mortgage securitization. The current plan appears to be for the government monopoly to gradually exit the business and hand it over to the private markets (Wall Street, for short). Apparently, we think Wall Street did such a fine job in mortgage securitization over the last decade we're just going to let them take over the entire business.

The proposed structure outlined here is designed to prevent what happened to the industry in the past from ever happening again. It's intended to address, balance, and minimize several aspects of financial risk: taxpayer risk, systemic risk (and illiquidity risk), interest rate risk, credit risk (risk of default and risk of loss), political risk, and risk for profit. It's also designed to preserve traditional, affordable home financing for generations of Americans and to strengthen the securitization aspect of the mortgage industry. Once created, it will accomplish the following objectives:

1) Dramatically reduce and likely eliminate taxpayer risk from mainstream mortgage finance and securitization by using an alternative business model.
2) Rapidly reduce and eventually remove the need for government support in the mortgage market by replacing a government guarantee with a cash guarantee.
3) Avoid the concept of "too big to fail" in mortgage securitization as well as avoid the moral hazard of private profits and social losses.
4) Provide a permanent "Safe Harbor" for all lenders originating home loans that meet specified standards and help normalize credit standards.
5) Preserve traditional, prime quality mortgage lending standards, the 30 year fixed rate mortgage and shorter fixed rate terms, and responsibly termed adjustable rate mortgages.
6) Be permanently self-sustaining, not require any taxpayer funds to establish, and grow stronger every year.
7) Provide for a smooth transition for the mortgage industry away from the federal government with virtually no disruption to the secondary market and mortgage-backed security (MBS) investors.
8) Help minimize the spread between the yield earned by MBS investors and the interest rate paid by borrowers, keeping home finance affordable relative to a purely private mortgage market.
9) Establish and enhance a true and proper affordable housing system for low income families and first-time homebuyers.
10) Level the playing field for small and large lenders, ensure deep, stable and broad liquidity for mortgage finance, and provide certainty, transparency, uniformity of standards and competitive pricing for borrowers, lenders and investors.

11) Establish financial education initiatives to teach Americans of all income levels how to responsibly manage money, credit and debt, and encourage participation in the American Dream of homeownership and financial independence.
12) Restore integrity, accountability, trust and confidence in our nation's mortgage finance system.

The Plan for Restructuring

The plan is to create a minimum of 12 regional 501(c)(3) Nonprofit Mortgage Securitization Firms that span the entire United States and its territories. Their creation will be sponsored by each of the states within their respective regions. They could be located in each of the 12 Federal Reserve Districts or there could be as many as one in each state. Although the legality has not yet been investigated, it may be possible and more expedient to have each of the Federal Reserve Districts co-sponsor their creation with the states within their respective districts. The number, locations, and sponsorship can be determined later. For now, the primary focus is on the concept and the business model.

The benefits of a nonprofit business model for mortgage securitization are straightforward:

- A nonprofit corporation that meets its mission is exempt from state and federal corporate income taxes, and it's not required to distribute its profits to investors, allowing it to retain *all* of the net operating revenues it generates. These funds will be deposited into an ever-growing Guaranty Reserve Fund (GRF) to guarantee mortgage-backed securities (MBS) investors who invest in its MBS that they will always be repaid in a timely manner.
- A nonprofit corporation business model *removes the incentive to take on more risk for the sake of higher profits.*
- A nonprofit corporation is much more transparent and easier to regulate than a private, for-profit corporation.
- Unlike a government agency, a nonprofit corporation can pay its executives and personnel market salaries to attract the most qualified talent to staff the organization. Raises, bonuses and other incentives can be tied to reaching benchmarks in the GRF as well as quality of performance.
- Perhaps best of all, it's neither a government agency nor a private, for-profit corporation. A nonprofit corporation will have a much greater ability to build reserves more quickly and hold them for their specified purpose than either of the above.
- Similar to the Federal Reserve, a network of nonprofit securitization firms will have a public/private benefit but will not be under the direct control of either. Their dual mandate will be to protect the integrity of traditional, prime quality mortgage securitization and to pursue affordable housing finance goals.

If these entities are created, two very important legislative firewalls will need to be established to insulate them from political risks:

1) No governmental entity, state or federal, shall ever be allowed to require these firms to lower their lending or credit standards in any way, shape, or form, no matter what the rationale or intent.
2) No governmental entity, state or federal, shall ever be allowed to touch or dictate the use of these entities' Guaranty Reserve Funds. These funds are to be used solely and specifically to guarantee timely repayment of principal and interest to its MBS investors in the event of large numbers of defaults or unforeseen catastrophes.

The primary mission of these nonprofit mortgage securitization firms will be to purchase mortgage loans of all categories that meet current Fannie Mae, Freddie Mac, and possibly Ginnie Mae standards from mortgage lenders of all types and sizes, pool them into mortgage-backed securities, sell them as Agency MBS to MBS investors around the world, and use the fees generated from this activity to build ever-growing Guaranty Reserve Funds used solely to protect investors against the risk of loss. At some point (as determined by actuaries) the funds will begin having excess reserves, and those funds will be used specifically to fulfill their secondary mission of offering affordable financing to low income borrowers as well as financial education for everyone, discussed in more detail later in this document.

Initial Funding and How the Numbers Work

Because of the economies of scale being addressed, it's estimated that these firms will need initial funding of at least $250,000,000 each. Fifty million dollars should more than cover the initial cost of startup, $100 million will be used for operating capital (collateral for borrowing), and the remaining $100 million will be used to kick start the Guaranty Reserve Fund. Each entity will be given a 10:1 line of credit with the Federal Reserve, allowing each to borrow up to $1 billion to be used to purchase Agency quality home loans from mortgage lenders, package them into mortgage-backed securities, and sell them to investors as Agency MBS utilizing the new securitization platform currently being developed by the FHFA. Assuming they are able to securitize at least $1 billion per month and earn at least 1% from a combination of delivery fees and guaranty fees, each one would be able to funnel at least $100 million per year into their GRFs. With higher margins (fees) or larger volumes, within a few short years each entity will have multiple hundreds of millions and eventually billions of dollars in reserve to protect MBS investors, effectively replacing a government guarantee with a cash guarantee on Agency MBS that are currently exempt from any risk retention requirements. Assuming we create at least 12 of these securitization firms, they can be up and running for the bargain basement price of $3 billion.

As evidenced by Fannie Mae's and Freddie Mac's recent record profits, there are enormous sums of money that can be generated by mortgage securitization. Very soon, Fannie and Freddie will have given back to the U.S. Government all of the money given to them by taxpayers in the bailout. However, because the government payments are classified as dividends, and because all of their profits are being "swept" by the Treasury Department, it's virtually guaranteed Fannie and Freddie will never again become viable, standalone entities. Therefore, it makes very good sense that the $3 billion needed for startup of these entities come from the profits currently being spun off by Fannie and Freddie. It's a relatively small amount in the scheme of things and will not likely be missed by Uncle Sam. This will enable their creation without using taxpayer funds. Also, because contributions to a 501(c)(3) are tax

deductible and can come from any source, additional funds can be raised from any and all interested Americans. Anyone working in the housing industry or housing related fields, and everyone who currently rents a home, owns a home, or hopes to someday buy a home using borrowed funds will have a vested interest in making a tax deductible contribution to aid in the success of these entities. Federal and State governments will also be able to contribute, but that would involve taxpayer funds which this proposal is attempting to avoid.

It is strongly recommended that, once these entities are up and running, they invest a fixed amount of $1 million per month in gold bullion which should be held by the Federal Reserve Bank. Investing a fixed amount each month applies the principle of dollar cost averaging which helps to ensure these entities pay an average price for gold and reduces the risk they will overpay. Having this in place will effectively apply a gold standard to the securities, further reassuring investors they will be repaid regardless of what happens to the value of the dollar.

It's also highly probable that, over the longer term, these entities will be able to amass enough capital to become self-financing. Having this ability will enable them to minimize the need for hedging and the use of derivatives to offset interest rate risk. It will also turn their financing costs into an additional income stream and further ensure their viability and sustainability.

Understanding the Role and Importance of Mortgage Securitization

A valuable lesson we supposedly learned from the Savings & Loan debacle of the 1980's was understanding the vulnerability of our banking system to interest rate risk and how to better mitigate that risk. When banks and financial institutions lend long-term fixed rate mortgage loans to long-term borrowers (home buyers), they use short-term funds (either funds on deposit or funds borrowed on a short-term basis) to make those long-term loans. If short-term interest rates rise, and especially if they rise rapidly, their cost of funds can exceed the interest income they're receiving on their long-term home loans and they lose money. In that scenario, the lending institutions' profitability, viability and ability to even exist are threatened. This is known as *interest rate risk*, but it can also be a *systemic risk* because it can potentially threaten the solvency of the entire banking system.

Fannie Mae was created by Uncle Sam in 1938 during the Great Depression to help banks offset this interest rate risk. It used taxpayer funds to purchase federally insured loans that met specified credit standards from the lenders, which replenished the lenders' funds and enabled them to make new long-term loans at market interest rates. In 1968, Uncle Sam privatized (sort of) Fannie Mae in order to get its debt off of the federal books. In 1970, Uncle Sam created Freddie Mac for the purpose of purchasing non-federally insured loans from lenders to accomplish the same goals for private mortgage lenders. Freddie Mac began pooling loans they purchased and selling them as "pass-through" securities and named them *participation certificates*, and Fannie Mae started doing the same in the early 1980's and called them *mortgage-backed securities* (MBS). They sold these large pools of mortgages to those who had billions of dollars to invest, such as life insurance companies, pension funds, endowment funds, sovereign wealth funds, wealthy individuals and other wealthy long-term investors. This process passed

on interest rate risk to the long-term investors and also broadly deepened the liquidity, availability and affordability of long-term mortgage finance.

Ultimately, mortgage securitization became the *conduit* that connected long-term borrowers to long-term investors. As a result, everyone in between – the loan officers, mortgage brokers, mortgage bankers, big banks, and mortgage securitization firms – became *middle-men*. Each middle party that performed its part used borrowed money to do so, and charged a fee for their service (historically between 1% and 3% of the loan amount). Also, once mortgages were securitized, they transformed from an account receivable for the lender to an interest bearing asset for the investor, much like a Certificate of Deposit one would purchase from a bank. Since the loans in the securities (that met quality standards set by the Agencies) came with a guarantee of repayment, investors purchased them with confidence and the flow of mortgage money became consistent and reliable. The consistent flow of mortgage money from investors is why Fannie Mae, Freddie Mac and Ginnie Mae are critical to the industry.

Understanding Mortgage Rates, Pricing, and How Money is Made by the Middle-men

(a simplified explanation)

Interest rates fluctuate daily (just like stock prices) and are set by the markets in which MBS are traded. On any given weekday, the market publishes a range of rates from high to low on Fannie, Freddie and Ginnie securities for 30 and 15 year fixed rate mortgages. The rate in the middle is called the “par” rate, which is the actual cost of mortgage money for that day. If, for example, the par rate is at 4.00% and the loan officer needs to make a 1% commission, he or she would say “Right now I can get you 4.00% with one point origination fee”. One point is equal to one percent of the loan amount. If the borrower wants a lower rate, he or she can buy down the rate by paying additional points, and as a general rule, one additional point will buy down the interest rate by .25%. So to get the borrower’s rate to 3.75% it would cost two points – one for the commission and one to buy down the rate. Buy down points are traditionally called discount points, and are the same as paying interest up front in order to permanently buy down the long term interest rate. In this case, the extra point paid to get to 3.75% still equals a 4.00% yield to the market and investor.

On the other side of this scenario, if the borrower doesn’t want to pay any points, the loan officer would quote the borrower 4.25% with no points, and because the market says the cost of money is 4.00%, the market will pay a form of rebate to the loan officer of 1% in order to keep the yield to the investor at 4.00%. The rebates are known in the industry as above-par premiums or yield spread premiums.

This is an over simplified explanation, but the purpose is to illustrate that the market sets the par interest rate, and a lower rate comes with a cost and a higher rate generates a rebate and the numbers fluctuate daily as MBS investors buy and sell the securities. This aspect has been the subject of much

debate, confusion, and industry abuse over the last several years and is an important aspect to keep in mind.

The Evolution of Mortgage Lending (traditional vs. non-traditional) and the Role of Technology

From 1938 until 1997, underwriting standards and guidelines were developed based on analyzing and documenting a potential borrower's ***ability and willingness to repay*** the loan, as well as analyzing the property to ensure the collateral is safe, sound and valued correctly. The goal was to assess and balance both the risk of default by the borrower and the risk of loss to the lender/investor. Loans were made with the understanding that mortgage lenders had a dual fiduciary responsibility – first to the borrowers to ensure they received the best loan for their situation, and to the lender/investor to ensure they received a well-performing loan. Loans underwritten to these standards have a historical default rate of less than 1%.

Mortgage underwriting was considered both an art and a science. The science aspect was to determine if the numbers fell within reasonable parameters and was an analysis of a borrower's ability to repay the loan. A borrower's income, liquid assets, debt-to-income (DTI) ratios, and cash reserves left over after closing were carefully documented and analyzed. The philosophy toward the borrower was "trust but verify". The willingness to repay aspect was a careful analysis of a borrower's credit history, with special emphasis on the most recent 24 months. If the borrower is current on other monthly debt payments (car payment, credit cards, student loans, etc.), with no or minimal late payments or defaults, especially within the last two years, they generally met the willingness to repay criteria and could be considered to have an "A" credit rating, or *prime* credit. If the borrower's recent credit history reflected an unwillingness or inability to repay other debts on time, the borrower was considered to have a "B" or "C" credit rating, or *subprime* credit, and was generally considered too risky to be granted an approval unless there were substantial compensating factors present that would reduce the lender's risk of loss (e.g. large down payment).

The art aspect was applied by using human judgment as to whether the terms of the loan minimized the risk of default by the borrower as well as to whether the investor risked a loss in the event the borrower did default. Home loans underwritten in this manner were traditional loans and had a historical default rate of less than 1% and the standards were set by Fannie Mae and related Agencies. Industry participants called them "A Paper" loans because of their good credit quality.

Until the late 1990's, what are now known as Alt-A and subprime loans were available to those who could not meet the standards of Fannie, Freddie, FHA, VA or FmHA/USDA loans. Both categories required a minimum 20% down payment (or more), because in the event the borrower defaulted the lender could foreclose on the home and re-sell it quickly at a discounted price (usually at 85-90% of its market value) to quickly recoup its losses and the costs to foreclose and possibly earn a little profit. This is why the *80% Loan-to-Value Ratio* is so significant - it minimized the risk of loss to the lender when at or below this level. This enabled many people to have a shot at home ownership that could not

otherwise prove sufficient income, or had no established credit history, or whose credit history reflected an inability or unwillingness to repay their debts in a timely fashion.

Loans where the borrower either had a good credit history or a lack of credit history and/or an inability to document their ability to repay were typically lent out by local thrifts or community banks and credit unions that made independent decisions regarding their risk of loss. If those loans eventually showed at least 24 months of on-time payments they were considered performing (or seasoned) loans, and they could be considered for sale and securitization. These loans were later named Alt-A loans, with the "Alt" referring to alternate documentation of the ability to repay, and the "A" referring to the credit grade of the borrower. The very first mainstream Alt-A loans were stated income loans designed specifically for self-employed borrowers (with 20% down and good credit) because they rarely showed enough taxable income to qualify for a loan. These loans actually made sense and opened the door for millions of small business owners to buy homes with affordable financing terms.

The loans that reflected a borrower's recent negative credit history (bad credit) or were not paid on time were normally not eligible for sale to other than private or "hard money" lenders and investors. Industry participants called these loans "B Paper" or "C Paper" loans because of their less than good credit quality. Their interest rates started out much higher, ranging from 2% to 5% more than traditional Agency loans because of their much higher risk of default. They were usually only fixed for two or three years then nearly doubled in rate and payment, and most had costly pre-payment penalties. The loan terms shifted the risk of loss to the borrower and heavily favored the lender in the event of default. These loans became known as subprime loans, referencing the borrower's credit as being something less than "prime". By their very nature, subprime loans were predatory.

Fannie and Freddie first introduced adjustable rate mortgages, or ARMs, in the early 1980's. The idea was to offer the borrower a reduced or discounted interest rate in the beginning of the loan term in exchange for assuming some of the risk for rising or higher interest rates in the future. They were tied to short-term interest rate indexes (e.g. 1 year U.S. Treasury Notes, the LIBOR rate, etc.) and added a "margin" as in a profit margin, and would typically adjust monthly, semi-annually, or annually. The original ARMs had payment adjustment caps, but no interest rate adjustment caps and no lifetime interest rate ceilings. They allowed for negative amortization, which is the difference in the lower allowable payment made and the payment needed to be made to cover the actual interest charged – and the difference was added to the loan balance each month. Many also included pre-payment penalties. In a fairly short time, many borrowers simply mailed in their keys when they discovered their balance had grown to more than their home's value and they were "upside down" or "under water" on their loan versus the home's value. Some loan officers nicknamed them "Neutron Mortgages" because they eliminated the occupants but left the building standing (a Carter era reference). By the mid-1980's, however, Fannie and Freddie had modified their ARM terms to reflect interest rate adjustment caps on an annual basis only, lifetime rate ceilings, no negative amortization possibilities, no pre-payment penalties, and reasonably low margins. They also created Intermediate ARMs, where the rate was fixed for the first 3, 5, 7, or 10 years before adjusting annually thereafter. These ARMs ended up benefitting millions of borrowers as interest rates fell through the 1990's and 2000's by lowering their payments without having to go through the cost of refinancing. These ARMs became known as traditional ARMs.

However, in 1997 everything changed. That's when both Fannie Mae and Freddie Mac introduced their fancy new mortgage loan underwriting software programs. Fannie Mae's was named Desktop Underwriter, or DU, and Freddie Mac's was named Loan Prospector, or LP. Collectively, they were known as automated underwriting systems, or AUS. This was also the first year we began using credit scores from the three major credit bureaus, and DU and LP incorporated them into their analysis. Initially, DU and LP appeared to be very helpful because they analyzed loan data at light speed and often picked up on information human underwriters would otherwise miss. From 1997 to 1999 Fannie and Freddie told underwriters to use DU and LP as underwriting aides only. But by 2000, they had become so confident in their AUS software's ability to analyze risk and approve loans, they told the industry that from that point on it should only rely on the software results and underwriters should only ask for information the software findings required. The reason this point is so significant is because it *removed accountability from human beings* for risk assessment in the loan approval process. Human underwriters became, for lack of a better term, spell-checkers.

The benefits of utilizing technology to process mortgage loans, though, were immediately obvious. Before 1997 it took anywhere from six to eight weeks to originate, process, underwrite and close a home loan because most everything was done manually. After 1997, with technology and good teamwork, the process could now be completed in as little as six to eight *days*. The loan process became incredibly *Fast and Easy* (to borrow Countrywide's old slogan).

It's important to understand that underwriting software uses mathematical formulas called algorithms to assess risk and predict outcomes, not human judgment and not artificial intelligence. Algorithms must use certain assumptions in order to predict outcomes (e.g. if this is X, then that must be Y). Underwriting software, therefore, analyzes numerical values regarding a borrower's situation to predict the risk of default by the borrower and the risk of loss to the lender/investor. The software also uses credit scores in the analysis. Credit scores are developed and issued by the credit bureaus, and credit scores are also derived by using algorithms based on a person's use of, misuse of, or lack of use of credit. Both sets of algorithms work fairly well, unless their programmers fail to factor in a potential variable or variables, or make incorrect assumptions, or until something unanticipated happens. When any of those occur, the "models" tend to fall apart.

In the early years they made two very critical incorrect assumptions: 1) That real estate values would always go up rapidly, and 2) That people inputting the data would always tell the truth. Obviously, neither one are always true. Because of the shift to AUS's, loan officers went from making a good case for loan approval from human underwriters to figuring out how to configure the numbers in the software to gain an approval. The software also allowed for, as a convenience to the borrower, reduced documentation (proof) of income and assets if it perceived the borrower's credit and financial profile to be especially strong. Within a nanosecond, less scrupulous loan officers across the country figured out how to "tweak" the software by inflating the numbers to obtain loan approvals and be allowed to ask for little to no documentation from their borrowers who had good credit. Low and no documentation loans made to borrowers with good credit and AUS approvals moved the category of non-traditional mortgages now called "Alt-A Loans" into the mainstream of mortgage lending. The interest rates on these loans were typically .25% higher than traditional, fully documented loans.

Simultaneously, largely due to the government's encouragement to broaden homeownership, private markets began creating and using their own AUS software with even more optimistic assumptions and lower credit requirements than Agency standards. These subprime and Alt-A loans were also packaged into mortgage-backed securities by Wall Street firms and others and sold to investors. These securities were called Private Label MBS, or simply PLS. They didn't have a government guarantee, but they were supposedly "priced appropriately for risk" since subprime loan rates averaged from 2% to 4% higher than Agency loans. However, the higher pricing went into the middle-mens' pockets and very little was passed on to the investors, which is why Wall Street loved them so much. Because their software was so "smart" and subprime loans were so lucrative, Wall Street demanded more of them. The only way they could get more of these loans was to reduce the down payment requirements, so they did. They went from requiring 20% down payments in the 1990's, to 10% down, then to 5% down, then to zero down and in a few cases would even loan more than the property was worth by the mid-2000's (subprime loans requiring less than 20% down were also non-traditional loans). Between 2004 and 2007, to increase the business they also began allowing for reduced or no documentation of a borrower's ability to repay. (Note to all – never loan several hundred thousand dollars for a home loan to someone who is currently unable or unwilling to make their car payment or other debt payments on time (or at all) without requiring 20% down. The odds are extremely high they will default, especially if their payment is doubled, and foreclosure with quick re-sale is the only way to recoup losses.)

By 2002, as the internet was coming of age, thousands of unemployed dot-commers suddenly realized they could be on the receiving end of a link that said "click here to refinance" while sitting at home in their boxer shorts, and we were off to the races. By 2004, anyone with a computer and an internet connection could instantly "be in the mortgage business". They would capture an internet lead, receive an online loan application, pull a credit report, shop it around to several Alt-A and subprime lenders to get an AUS approval, and make two, three, four or more points per loan by steering the borrowers with good or bad credit into loans that paid the highest rebates. There was almost no oversight, licensing, training, or sense of fiduciary responsibility to the borrowers or investors among these people. The abuses were mind boggling.

Through most of the 1980's and 1990's the total outstanding mortgage debt in the U.S. had averaged between $4 and $5 trillion. At the peak in 2007, the total outstanding mortgage debt had reached nearly $12 trillion. In less than a decade, we had nearly tripled the mortgage debt in the United States with loans that would have never been made under traditional standards. ***Software underwriting*** was the ***Great Enabler*** and the ***internet*** was the ***Great Facilitator*** of the credit bubble, and the world marveled at the miraculous explosion of home ownership. The non-traditional subprime and Alt-A business had hi-jacked the industry with the help of technology and nearly destroyed our financial system, and virtually no one was held accountable because every single loan had been approved by an AUS. Can you say "Revenge of the Nerds"?

During this time-frame, Fannie and Freddie were not sitting idly by. At the behest of Congress and under the guise of "affordable housing" and "competing for market share" they were also purchasing, securitizing, and guaranteeing subprime loans beginning in the late 1990's. According to The Mortgage Reform and Anti-Predatory Lending Act (HR 1728 RFS, Title VII, section 701, paragraph (6)) Congress

clearly states that under their authorization "*In 2004 alone, Fannie Mae and Freddie Mac purchased $175,000,000,000 in subprime mortgage securities, which accounted for 44 percent of the market that year, and from 2005 through 2007, Fannie Mae and Freddie Mac purchased approximately $1,000,000,000,000 in subprime and Alt-A loans, while Fannie Mae's acquisitions of mortgages with less than 10 percent down payments almost tripled*."

The functions Fannie Mae and Freddie Mac perform have been extremely important to our mortgage and financial system. What was done to them by politicians and politically appointed executives was nothing short of criminal incompetence.

Now We're Fixing It

When the first wave of the Dodd-Frank Act (DFA) reform regulations hit in 2010, it was clear that those who were writing the reforms had learned almost everything they know about the mortgage industry from the non-traditional subprime and Alt-A sectors. The first thing the DFA did was ban subprime and Alt-A loans, which quickly flushed out the majority of the bad actors from the industry (they went back to building web pages and selling cars; most of those that remain are either long-time veterans or rookies). The DFA regulations could have stopped there, but they didn't. They assume everyone in the mortgage business is either crooked or incompetent or both. The regulations are punitive, cumbersome and costly, and many of them are contradictory or vague and subject to interpretation. The DFA created and tasked the Consumer Financial Protection Bureau (CFPB) to sort things out and re-write the rules for mortgage lending going forward.

Interestingly, the CFPB made it very clear in their revised Mortgage Market Note regarding Qualified Residential Mortgages (QRM) dated April 11, 2011 that they are re-writing the new rules for underwriting mortgages based on *analyzing the data on loans acquired by Fannie Mae and Freddie Mac between 1997 and 2009*. What that means is that, with all due respect, the future of the mortgage industry is in the hands of a group of very bright young minds who are attempting to *reverse-engineer underwriting guidelines by analyzing loans approved by software programs based on flawed assumptions*, two-thirds of which would have never been made under traditional underwriting guidelines, and apparently with no knowledge of (or total disregard for) how home loans were successfully underwritten for the previous six decades.

(Expletive deleted)

Additionally, when the CFPB issued its Qualified Mortgage (QM) rules announcing the Ability-to-Repay requirement (so far they've gotten it half right), the only reference to credit in several hundred pages is that a credit report is required to be in the file. With no reference to *Willingness-to-Repay*, this makes it appear as though they're attempting to resurrect, or at least allow for…*subprime loans*. In their summary of the QM/ATR Rule they state "The line the Bureau is drawing is one that has long been recognized as a rule of thumb to separate prime loans from subprime loans." With all due respect to the DFA and CFPB, if we're drawing a line between prime and subprime loans, that line should be at a FICO

credit score of 620. The line they're actually drawing is between traditional, fully documented loans and alternatively documented loans (Alt-A, Alt-B, Alt-C).

The good news is that they've created a "temporary" subcategory of QM loans for all Agency quality loans that are, for now, exempt from the new QM and QRM requirements. Since the meltdown, Fannie and Freddie have restored more traditional underwriting standards to DU and LP (e.g., reintroduced debt-to-income ratios with reasonable flexibility and requiring documentation of data) and they both actually do a pretty good job now of balancing the risk of default by the borrower and the risk of loss to the investor.

Since this category, through which over 90% of all loans in the U.S. are made today, is temporary, and the political rhetoric is sounding more serious about eliminating Fannie and Freddie entirely, we are, in effect, throwing the baby out with the bath water and trying to re-invent the wheel.

The Current State of Mortgage Lending

Right now, the industry is operating in an extremely heightened state of fear – fear of being out of compliance with all of the new regulations applied since the passage of DFA, fear of the additional waves of new rules on the way, fear of the seemingly unlimited power of the CFPB to punish lenders for non-compliance, and especially the fear of being required to buy back loans for even the smallest of reasons. One too many repurchase demands can bankrupt most lenders.

The powers that be are attempting to limit and/or eliminate financial risk from the system rather than balance it (note – when dealing with humans and money, risk cannot be eliminated – only managed and balanced). They apparently think they can limit or eliminate risk by having very strict rules on what constitutes a loan application, the time-frame in which a borrower *must* be given (disclosed) certain information, the number of days allowed before certain things *can* happen, the number of days allowed before certain things *must* happen, and if the numbers change even slightly, the time-frame that certain things *must* be done and *can* be done.

They also think risk can be eliminated by gathering all possible data on the borrower in the file to verify ATR and to use algorithms to predict human nature. Of course it includes the basic information needed to determine if a borrower is able to repay the loan. But it also includes, and is certainly not limited to, things like the paper trail for every single deposit into their bank account, including the copy of the $200 cancelled check their grandmother gave them for Christmas because it was clearly not part of their regular paycheck, or a written explanation for every single credit inquiry on the borrower's credit report within the last several months, even from places like AT&T and Geico, to make sure there are no new debts that are not able to be detected otherwise.

Underwriters are no longer spell-checkers; they're spell-checkers on steroids. Their job is to thoroughly investigate every single piece of information and require double and triple verification of everything in writing, and compliance with the rules and regulations are strictly adhered to, with no exceptions, in order to protect the lender from buy-back demands or penalties from the CFPB. All loan officers are assumed to be crooks, and all borrowers are assumed to be liars, unless otherwise documented. The

industry mantra is now "perfection of compliance" and "perfection of documentation". Considerable amounts of time are being spent by loan officers and processors chasing paper and trying to explain to borrowers why they need things that have little to do with whether or not they qualify for the loan. The home loans being made today are more thoroughly documented and fully investigated than ever before in the history of humankind, and lenders are being held accountable by a fear-induced obsession with compliance and documentation to ensure they perform their activities properly.

Common sense has left the business, and the unintended consequence of the current environment is that the consumer is harmed. Today, lenders are much more likely to delay or decline a loan because it may possibly be interpreted as being out of compliance or can't be perfectly documented than whether the borrower appears to be able and willing to repay the loan.

The DFA and the CFPB have imposed rules designed to control and punish a segment of the market that *no longer exists* onto the traditional lending industry. The magnitude of the unintended consequences of the path we're on is simply horrifying.

What a Purely Private QM/QRM Mortgage Market Will Look Like

For starters, if we eliminate Fannie Mae and Freddie Mac, what underwriting software will we use? Currently, DU and LP are used to underwrite just about every loan type available today, including FHA, VA, and even Jumbo loans (i.e., loans that exceed Agency loan limits). Will there be one, or dozens? Will we go back to using human underwriters alone? This aspect has been conspicuously missing from the reform debate.

The current QRM definition requires 20% down, over 690 credit scores, and debt-to-income (DTI) ratios of not more than 36%. This definition locks out the majority of potential borrowers. Only a small segment of people can meet these criteria and they are mostly the more affluent.

The current QM definition is supposed to be for everyone else, but it has no apparent credit requirements, caps the DTI ratio at 43%, and requires proof of ability to repay. Right now, DU and LP allow for a 45% DTI ratio and up to a 50% DTI ratio when the loan is well below 80% of the value on conventional loans, and up to 55% DTI on FHA and VA loans in many cases. Borrowers who qualify with higher ratios today will also be locked out under the new rules. The QM and Ability-to-Repay rules will not only reduce the number of eligible borrowers, it will dramatically reduce most lenders Ability-to-Earn-Money.

Right now, investors who invest in 30 year fixed rate mortgages from Fannie Mae are getting a yield (interest rate) of around 3.50%. Until a few years ago, that meant the interest rate a borrower would pay was around 4.00%, because the loan servicer received .25% and Fannie Mae's guaranty fee was .25% and both were added to the rate. Now, however, the borrower must pay around 4.25% because Fannie and Freddie have gradually raised the guaranty fee to .50% over the past few years. They also charge a form of points called delivery fees, and the best guess is that they average around 1% to 1.50% total income per loan (they keep that information pretty close to the vest) between guaranty fees and delivery fees.

Remember the part about how middle-men get paid? Wall Street is going to want to make double, triple, or even quadruple the profits Fannie and Freddie used to make in the old days, and the guaranty fee will just be a fee with no guarantee. Using the 1 point per .25% in rate general rule and the above example, this means the investor will earn a 3.50% yield and the borrower will pay closer to 5.00% or even 5.50% rate when factoring in all of the middle-men. As interest rates rise in general, mortgage rates in the future will be substantially higher relative to historical benchmarks. *All* borrowers will be paying subprime rates in a purely private market. The notion of affordable housing finance will be a thing of the past.

Reform of the Reforms

At the very least, loans that meet current Agency standards should be made permanently exempt from the QRM/QM/ATR rules and allowed to be securitized only by Fannie Mae, Freddie Mac, and the entities proposed here. Loans that conform to Fannie/Freddie/Ginnie criteria *already have* tried and true standards for determining a borrower's ability and willingness to repay.

Additionally, if we insist on a "one size fits all" approach, the following is suggested:

In order to restore balance, accountability, clarity and certainty to the home lending industry, it's strongly recommended the Dodd-Frank Act be amended to reflect something along the lines of the following:

> A mortgage loan that falls outside of the definitions of current Agency guidelines is only eligible for Agency quality securitization if it meets the following criteria:
>
> 1) The loan is at or below 80% of the property's appraised market value.
> 2) The loan has been retained in the lender's portfolio for a minimum of 24 months and on time payments can be documented and verified, establishing "seasoning".
> 3) The loan terms do not feature characteristics that increase the potential for default.
>
> A mortgage loan intended for securitization that does not meet the above criteria must adhere to the QRM/QM/ATR requirements set forth by the CFPB and must be classified only as Private Label mortgage-backed securities. Any loan that does not conform to either Agency standards or QRM/QM/ATR requirements must be retained by the lender and is ineligible for securitization.
>
> Additionally, ALL mortgage loans must be reviewed by human underwriters and be signed by those underwriters with certification verbiage as follows:
>
> > I, (underwriter's name), have personally reviewed and analyzed this application for a home mortgage loan. It Has/Has Not been analyzed by an automated underwriting system, and the AUS result is Approved/Denied/Not Applicable. In my professional opinion, it Does/Does not meet traditional Agency standards and should be classified as Prime/Alt-A/Subprime. In my professional opinion, I feel the risk of default by the borrower is Low/High and the risk of loss to

the lender/investor is Low/High. Therefore, I have Approved/Denied this application for a home mortgage loan.

(Underwriter's Signature& Date)

The current rules and regulations regarding compliance and disclosures to borrowers shall remain in place. However, home mortgage lenders in all categories who exhibit actions and behaviors that clearly show good faith efforts to comply with the regulations and/or provide benefit to the consumer will not be penalized. Those who blatantly violate current regulations, show intent to harm or cause actual harm or financial detriment to the consumer or exhibit incompetence shall be prosecuted and penalized to the fullest extent of the law and the authority of the CFPB.

Additionally, the CFPB's mission shall be modified slightly and be renamed the Consumer Financial Protection and Education Bureau, or CFPEB. The CFPEB shall assist in the development and coordination of national financial literacy and financial education initiatives, both with existing and future programs, so that all consumers will be aware and informed of "best practices" when engaging with our financial system.

Making the above changes will have a dramatic positive impact on the MBS industry, the home mortgage lending industry, and consumers and their financial behavior.

For instance, keeping the riskier Private Label MBS category of loans separate from Agency MBS quality loans will enable investors to compare the subprime/Alt-A category to corporate junk bonds as a potential investment with full knowledge and understanding of risk vs. yield. Mixing the two categories together with traditional prime loans in the past (called tranches or tranching) is what caused many unsuspecting MBS investors to invest in subprime securities without fully understanding their actual risk. Agency quality MBS, on the other hand, will be seen as an alternative to and compete with U.S. Treasury Securities as investments. To this point, an MBS investor will not have as difficult of a choice when deciding whether to invest in quality Agency MBS backed by a verifiable mountain of cash and gold, collateralized by nice homes, and repaid by hard working Americans with decent credit and reasonable DTI ratios versus a Treasury Bond backed by an IOU from Uncle Sam who has a 180% DTI ratio, almost no collateral, an enormously over extended credit line, and an unlimited ability to print paper money.

Allowing human underwriters to make independent loan decisions will give lenders (specifically state banks, community banks, and credit unions) the continued flexibility to make home loans based on a common sense assessment of the risk of loss, with the confidence that their performing loans can be sold and securitized after two years if the risk they took proves successful. This will allow those that are "outside the box" to have a shot at homeownership that would otherwise be shut out by the proposed QRM and QM.

As any experienced lender can attest, financial profiles are as unique as fingerprints – no two individuals' financial profiles are exactly the same. Imposing a "one size fits all" approach on all mortgage lenders across the board by requiring the QM/QRM rules will prove to be highly discriminatory toward a broad variety of Americans, especially for the millions of self-employed small business owners who file their income taxes under either Schedule C or Sub-Chapter S IRS regulations. It's the American Way for them to show as many expenses as possible in order to reduce their tax liability. Wage and salaried workers incur many of these same expenses but are not allowed to deduct them from their taxable income. Therefore, self-employed borrowers typically show substantially less income (or even no income) than their salaried peers and will therefore be disqualified under the Ability-to-Repay requirement. But if they can make a 20% or more down payment, the risk of loss to the lender is minimal if the collateral is sound and it should be up to the lender whether to take the chance.

Requiring human underwriters to undersign and attest to the above suggested language will restore accountability for risk assessment to the system. The technology exists today that is capable of tracking every participant in the loan process for the life of the loan. If fraud or incompetence resulting in loan default or loss is detected, the responsible parties can be efficiently identified and addressed and/or removed from the system. It's recommended such systems be in place once these proposed institutions are created.

Implementing the proposed QRM/QM/ATR rules across the board will cause severe damage to our nation's housing and lending industries. It's strongly recommended the implementation of the QM/QRM rules be postponed indefinitely or withdrawn, or applied only to loans intended for Private Label securitization. Traditional, Agency quality mortgage lending methodology is alive and well and will be continued indefinitely with these proposed institutions. Traditional lending is not broken and does not need to be fixed.

Financial Education

Clearly, attempting to expand home ownership through encouraging subprime lending was the wrong approach. A much more responsible and sustainable solution is through comprehensive financial education. It's in the mortgage industry's best interest to help educate all Americans about best practices regarding successful personal financial and credit management to ensure a steady and growing supply of well qualified borrowers. This is a vastly more responsible approach to growing the business than trying to figure out ways to make home loans to those who cannot currently manage money and credit responsibly. The mortgage industry knows better than anyone what constitutes proper, sustainable, and responsible financial management. Every American should know what their debt-to-income ratio is and where it should be, as well as what their credit rating is and how to enhance it. If we teach people how to take the necessary steps, we can help them buy a home by the time they are 30 years old and own it free and clear by the time they turn 60. If we show them how to spend less than they earn and use the difference to build a nest egg over time, once they reach retirement age they will stand a good chance of being financially independent regardless of their income level. (Note – the Big Banks/TBTF's won't like this aspect – they make billions per year in overdraft fees alone). With some of the excess profits generated from their securitization activities, and with the help of the CFPEB and

other financial education groups, these institutions will endeavor to help Americans accomplish these goals with a broad array of financial education programs and methods of delivery (e.g., books, online videos, TV and radio PSA's, etc.).

Affordable Housing Finance

Because these entities are designed to amass an enormous amount of capital with ongoing operations, over time they will have *substantial* excess reserves. These funds are to be dedicated toward achieving affordable housing finance goals targeted at low income borrowers and first-time homebuyers up to a certain income limit to be determined later.

The cost of residential real estate is determined by market forces and cannot be controlled and should not be attempted to be controlled by any other means. The cost of real estate finance, however, can make a substantial difference in the affordability of home ownership.

For example, a married couple with both spouses working 40 hours per week making minimum wage earn approximately $30,000 per year, or $2,500 per month. Assuming their monthly debts are no more than $450/mo. and they pay them and their current rent on time, in a higher property tax state such as Texas they would just barely qualify for a $100,000 home under current FHA guidelines. Their PITI payment (principle, interest, taxes, insurance, and mortgage insurance) would be approximately $845 per month on a 30 year fixed rate loan at 4.50%, and they would need to put a minimum down payment of $3,500. Their total DTI ratio would be just under 52% (current FHA guides allow up to 55% DTI). If rates rise to 6.50%, their maximum sales price would be reduced to just under $88,000, and as rates go higher their purchasing power will decline even further.

However, the funds set aside for affordable housing finance can essentially ignore market interest rates and offer loans with very little or no interest and possibly no mortgage insurance. For example, using the same scenario above, the same couple could qualify to buy a home that costs *$140,000* with a 30 year fixed rate loan at 2.00% (to cover the cost of administration) with no mortgage insurance and a 1% ($1,400) down payment. Their PITI payment would be approximately $848 per month. At a 0.00% interest rate and with zero down payment, no mortgage insurance, and a 2% administration fee added to their loan, they could qualify to buy a home at a price of *$162,000*.

All of the above scenarios are with a monthly PITI of between $845 and $849 per month and a DTI ratio of less than 52%. Mortgage insurance will not be required because there will be no investor to protect.

With proper education and information, every low income person will know that if they can show they have a two year history of paying their rent and other debt payments on time, and if the combination of their rent and other monthly debts is less than half of their income, they will have a good shot at becoming a homeowner.

As you can see, having institutions with hundreds of millions and possibly billions of dollars available to offer this kind of affordable home financing will be an incredibly powerful tool to keep home financing affordable and open the door to the possibility of home ownership to millions of low income Americans.

Also, with this mechanism in place, it will likely be cheaper to buy a home than to rent. Because of that fact, it will apply downward pressure on the cost of renting a home or apartment due to competition for tenants, which will have the net effect of keeping housing affordable for everyone.

To incentivize lenders to make these types of loans and in the spirit of its intent, it's recommended (since Realtor's fees typically average 6% and are normally paid from seller proceeds) that listing and selling agents reduce their fees to a combined 4% and allow the lender to be paid 2% (to be split between the loan officer and the lender) from the seller's proceeds. Compensating lenders this way will keep costs minimized for both the borrower and the nonprofits.

It's also recommended, once these entities are to this point, that we seriously consider creating nonprofit servicing companies to collect monthly payments from these borrowers on behalf of the institutions. They can either be subsidiaries of these institutions or separate, standalone companies. In either case, they should be configured as helpful partners to the borrowers to assist with financial education and offer payment deferrals in the case of difficult life events such as death, divorce, illness, etc.

This category of mortgage loans will be the only loans allowed to be kept on these entities' balance sheets for any length of time. All others will always be sold as soon as possible unless market disruptions required emergency exceptions on a temporary basis. This will ensure they avoid interest rate risk or potential insolvency or illiquidity issues in the event of major market upheavals.

The Plan for Transition

This is the recommended process for gradually reducing Fannie and Freddie's footprint over the next few years. Importantly, it's strongly recommended that Fannie and Freddie *not* be eliminated entirely. They have a 75 year history of doing a very fine job of setting loan quality standards that balance the risks in mortgage lending and only lost their way for 10 years. They have been, are now, and hopefully always will be, a valuable resource for the U.S. housing industry and financial system. Consider Fannie and Freddie the mom and dad with 12 or more children, and we need them to be around for a while to teach the little Frannies how to run the family business.

Fannie Mae, Freddie Mac and FHA have historically done a very fine job in the multifamily lending arena. It's highly recommended, at least for the next 10 or more years, that they continue in this endeavor. The dozen or more securitization firms proposed here are intended to take over only the 1-4 family residential sector from Fannie and Freddie, at least for now. It is recommended Fannie and Freddie be eventually converted into nonprofit corporations as well and possibly be combined into a single entity.

Assuming we gain consensus and agreement on this proposal relatively soon and secure initial funding as suggested, these 12 or more institutions can be up and running within twelve to eighteen months. Once operational, they can begin purchasing 1 to 4 family residential loans that meet current Fannie Mae and Freddie Mac standards and securitize and sell them through the new FHFA exchange or by other means if necessary. The goal is to focus exclusively on 1 to 4 family home loans and begin diligently building the guaranty reserve funds. Any and all lenders currently approved by and are in good

standing with Fannie Mae and/or Freddie Mac will automatically eligible to sell mortgage loans to these institutions. All others will need to follow existing Fannie/Freddie approval procedures with perhaps some slight modifications to better accommodate smaller lenders.

It's not yet known how competitively priced the loans offered by these entities will be with current Fannie and Freddie offerings, both on the interest rates for borrowers and yields to investors. If, initially, yields available to investors are lower and/or rates available to buyers are higher than Fannie and Freddie's, then it may be wise for Fannie and Freddie to begin increasing down payment requirements and/or begin reducing their maximum loan limits on loans sold directly to them to incentivize lenders to divert their business to the new entities. On the other hand, if yields are better for investors and/or rates are better for borrowers, market forces will take care of the transition. The TBTF banks will likely be the last to leave Fannie and Freddie because of "swaps", wherein they sell large amounts of loans to Fannie and Freddie at a time and buy them right back as securities. It will likely take a while for these entities to be able to handle these types of transactions, and the big banks will be inconvenienced if they have to bundle and sell loans in smaller batches and by region. They'll figure it out eventually, though.

It's also likely unwise to start up these institutions with much more initial funding than described here. We should start them relatively small and let them grow into the business. At the most, they should initially be configured to take over about one third of the market share for their designated regions. We will want to make sure we have the right personnel in place to manage them properly, and we will want to avoid any colossal blunders in case we don't. We will also want to make absolutely sure the business model proves successful before dumping too much money into them. Few things are more undesirable than multi-billion dollar blunders.

Hopefully, the new securitization platform the FHFA is building will be able to address and accommodate a concern for MBS investors called "geographic concentration of risk". MBS investors don't like to hold securities tied to loans in a small geographic region. In the event of a natural or manmade disaster, like a Category 5 hurricane, a large earthquake, or a good sized nuclear detonation, large numbers of homes could be destroyed and large amounts of mortgage defaults could occur, creating heavy losses for the MBS investor. The proposed entities may be vulnerable to these risks during the first 10 or so years while they're building their reserves. If the FHFA's platform cannot blend securities from different regions, either a temporary federal backstop will be required (which this business model is trying to avoid) or we may need to reconsider putting one in each of the 12 Federal Reserve Districts for this reason. Some of the Districts are geographically small, especially along the east coast. In any event and no matter the configuration, over time these entities will be able to absorb any losses or will be able to help each other absorb any potential losses while continuing to protect MBS investors.

Alternative configurations may be to group states that have similar mortgage laws and practices, like judicial foreclosure states versus non-judicial foreclosure states, or escrow states versus table-funded states. Again, the number and locations of these institutions is debatable, but these are aspects that should be considered.

Once these institutions are up and running they will be able to gradually take market share away from Fannie and Freddie. Once they prove to be well capitalized with substantial and growing reserves to strengthen the liquidity of the mortgage finance system and have excess reserves to apply toward affordable housing finance, Fannie Mae and Freddie Mac will be in a position to exit the business of securitizing 1-4 family residential home loans but remain in a much smaller form to provide guidance and ensure uniformity of underwriting guidelines among the proposed entities. Since the standards of the new Agency MBS will be identical to current Agency MBS, the transition will be smooth and seamless, especially from the MBS Investors' perspective.

If these entities prove to be even more successful than presented here, it's very possible they could assist in absorbing and removing the remainder of Fannie Mae and Freddie Mac's legacy assets (bad loans and REO's), as well as purchasing a fair portion of performing underwater private label securities and allowing for principle reductions and loan rehabilitations. This would help make the Agencies and the entire housing market whole again and possibly help stave off the eminent domain issue being contemplated by some municipalities. It's also possible they can phase in Ginnie Mae securitizations over time or create their own comparable loan programs insured or guaranteed with separate funds. When the U.S. housing market is healthy, it can account for up to 25% of our GDP.

Political Viability and Anticipated Opposition

The only things that are new in this proposal are a change in the securitization business model to better address the risks in the system and a different approach to affordable housing. It's a relatively simple solution to an otherwise complex combination of problems. This is primarily an effort to restore and preserve traditional mortgage lending that has proven to work well for the past 75 years and is based on experience, wisdom, and a fair amount of common sense.

The proposals contained in this document have something for almost everyone. They meet most, if not all, of the goals set forth by the Federal Agencies, the Mortgage Bankers Association, the National Association of Realtors, the American Enterprise Institute, the Center for American Progress, the Association of Mortgage Investors, the National Community Reinvestment Coalition, and many others. Both the political left and right should appreciate the benefits of, and support the creation of, a nationwide network of extremely well capitalized nonprofit mortgage securitization firms whose mission is to guarantee the liquidity of our nation's mortgage and financial systems by attracting and protecting MBS investors which will also get the federal government out of the residential mortgage lending business. The political left should especially appreciate the nonprofit and affordable housing finance aspects. The political right should appreciate the aspects that remove taxpayer risk and balance and minimize several other types of financial risks. Both sides should be able to support keeping housing finance affordable and available for all Americans by using the vast majority of the profits generated from securitization to accomplish the objectives. Everyone in the housing and related industries should find multiple reasons to support the effort as well. It separates the mainstream mortgage industry from both Washington and Wall Street and avoids the concepts of "Too Big to Fail" and "private profits with social losses".

The reality is, though, that this does not fit the current Washington-to-Wall Street agenda. It will be opposed for the following reasons:

1) It makes too much sense and is too practical, affordable, and actionable
2) It denies Wall Street and the TBTF's the opportunity to take over Fannie & Freddie's $1 trillion+ per year business
3) It weakens the Federal Government's control over the home lending industry
4) It won't make any individual or group of individuals richer, but it benefits us all
5) The Federal Government wants to keep Fannie and Freddie as a profit center, now that they're making money, to offset deficit spending

The only way this proposal stands a snowball's chance of being implemented is if ***WE The PEOPLE*** become united behind it and stand up and demand it. It's up to us, and it starts with you. If you support the concept and this proposal, then please share this with others, especially with those you know in the home lending industry and your state and federal elected officials.

Thank you for your time and consideration.

Rick Baron

NMLS #220934

About the Author:

Rick Baron is a 30 year veteran of the mortgage industry, primarily as a retail loan officer. Over 99% of the loans he's originated in his career have been high quality Agency and Jumbo loans. He began this effort in late 2010 attempting to persuade his home state of Texas to create its own small Fannie Mae clone to preserve traditional lending for his state and be able to finish out his career helping people obtain home loans the old fashioned way. However, because of the political climate and regulatory uncertainty generated at the federal level, the primary response from the majority of people has been "That's a great idea…good luck with it." Also, since the CFPB's rules appear to be applied to all home mortgage lenders across the board, he felt he had no choice other than to attempt to influence the direction of home lending on the national level to restore and preserve traditional mortgage lending. He's hopeful you will join in the effort. He can be reached by email at rick@rickbaron.com .