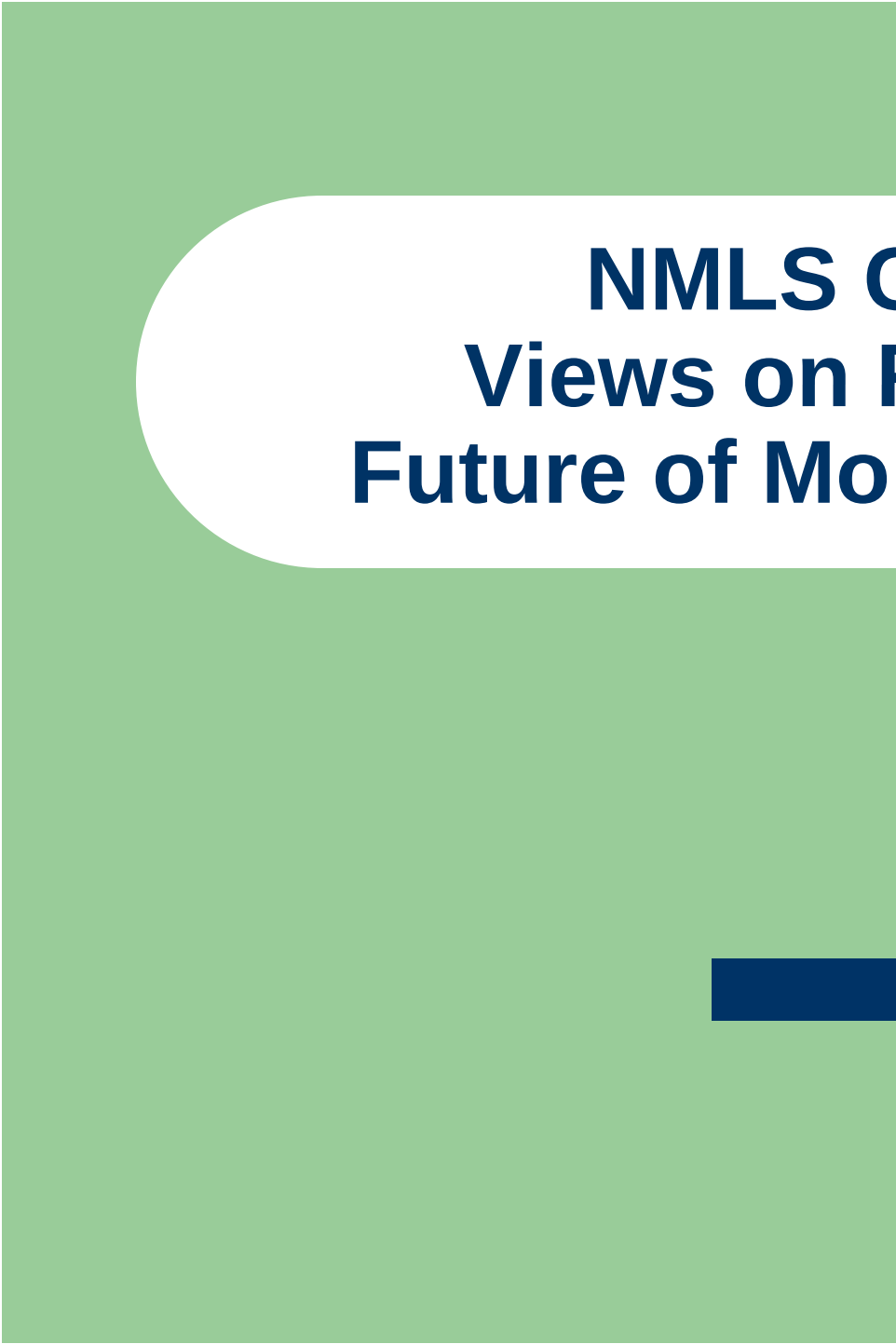


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NMLS Conference Views on Regulation & Future of Mortgage Industry

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Brian Chappelle
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Overview

- Mortgage Market Today
 - Enforcement & Overlays
- Views on Regulations
 - What are the concerns of mortgage lenders?
 - What has been the impact of changes that have been made so far?
 - What changes are on the horizon?
- Future of the mortgage industry
 - Role of government in housing
 - Significant industry changes are likely

Mortgage Market Today

- Current dilemma: Two conflicting “facts”
 - **90+% government financing & credit is tight**
 - Why is credit tight when gov’t taking risk?
 - Federal Reserve understands the problem:
 - “Lenders are applying tougher restrictions ... in order to limit the risk that they will have to take back such loans when they become delinquent.”
 - “Aggressively putting back delinquent loans helps the GSEs ...at same time discourages lenders from originating new mortgages.”
 - Lender response: Overlays (e.g. credit score floors)

What is the impact?

Fed Chairman Bernanke's view

"Unfortunately, there are problems, including the fact that credit standards for mortgages have tightened quite considerably so that roughly a bottom—the bottom third of people who might have qualified for a prime mortgage in terms of, say, FICO scores a few years ago cannot qualify today. So that's—that's certainly an important problem."

- Poll question:
 - How many either agree, think it is better or worse (for homebuyers) than the Fed Chairman believes?

“Good News”/“Bad News”

- Recent mortgages: best credit quality in history
 - GSE average homebuyer credit score: over 750
 - FHA average homebuyer credit score: about 700
 - Impact: Recent loan performance is excellent
 - Both FHA & GSEs have historic low EPD rates
 - “Bad news”:
 - Not doing enough loans for credit worthy borrowers
 - HMDA data – 4.7m purchase loans in 2000; now 2.4m
 - Why is the Fed concerned about overlays?
- “Declining house prices are a drag on household wealth and thus on consumer spending”

Views on Regulations: Introductory Questions

- Why have lenders put overlays on loans with government backing?
- What are the concerns of mortgage lenders with the regulatory process?
- What are the problems that the regulations need to address going forward?

Why have lenders put overlays on loans w/ government backing?

- Lenders have “skin in the game”
 - Enforcement risk takes two basic forms
 - Repurchases & audits/litigation
- GSEs: Repurchases - \$20 billion est. – 2011
 - Jamie Dimon: “Mortgages are killing us in case you haven’t noticed.”
- FHA: Few indemnifications so far
 - Yet, lenders put overlays in place starting in 2008
 - 50% had credit scores below 620 in 2007
 - By end of 2008, only 25% had credit scores below 620
 - Now, 4% have credit scores below 620

Why did lenders start putting overlays on FHA loans in 2008?

- Built-in protections in FHA program
 - Economic value is in servicing of FHA loan
 - Servicers pay originators - \$5 billion – (SRPs)
 - Long-term performance matters
 - Reputation risk – Neighborhood Watch system
 - In addition to FHA, “others” are watching
 - Enforcement actions reverberate through industry
 - HUD suspended Taylor, Bean Whitaker in 2009
 - DOJ sued Deutsche Bank in May 2011

Why is Deutsche Bank lawsuit important?

- Background:
 - DOJ alleges violations of FHA quality control rules
 - For systemic mistake, DB responsible for all claims
- Lenders worry about procedural errors (human)
 - Example of systemic error
 - Administrative error: Use of same underwriter ID
 - False underwriter certification
 - Enables government to propose significant penalties without reviewing individual loan files
- Fast forward: Rumored servicing settlement
 - Will penalty fit the “crime”?

Impact of Enforcement Initiatives

- Access to credit has been reduced
 - Lenders are using overlays to protect themselves
- Lenders (particularly some large ones) are pulling back/leaving the mortgage market
 - Repurchase/indemnification risk is significant
 - “Filing” of lawsuits affects lender/industry behavior
 - Issuing subpoenas does also
 - Impact of servicing settlement?
 - Reputation risk

What are the mortgage lenders' concerns w/ new regulations?

- Background: More rules enable responsible lenders to differentiate themselves
 - Knowledge and service will be more important
 - Creates opportunities for those who can follow rules & adjust to new environment
 - Gov't lenders must know how to follow rules
- Mortgage lender regulatory “hot buttons”
 - Level-playing field
 - More details on rule specifics (Q&As)
 - Penalties that do not fit the “crimes”

What regulatory changes have been made so far?

- NMLS: State registration & licensing
 - Improved professionalism
- Appraiser Independence
 - Separation of appraiser assignment from production
- Loan officer compensation
 - Eliminates loan officer benefit from loan terms or conditions (or proxy for terms or conditions)
- Tougher enforcement

What changes are on the horizon?

- Qualified Residential Mortgage
 - Higher downpayments?
- Ability to Repay Standard
 - Lender must make “reasonable” determination” that “consumer has a reasonable ability to repay”
 - Will it discourage lenders from participating?
- More enforcement
 - “Serious & material” vs, technical violation (“gotcha”)
 - Marketplace (other lenders) will evaluate validity of actions
 - Must take actions to protect themselves

View on Regulations: Summary

- What problems still need to be fixed?
 - The problem today is not the same as in 2008
 - Types of loans made pre-post bubble
 - Documentation: No doc vs. documentation
 - Products: Teaser rate/Neg Am vs. fixed rate & basic ARM
 - Loans made since 2009 do not have risky characteristics
 - Best performing loans in history
- Industry view: Target loans & behavior that caused problem or will cause problems
 - Enforcement is a necessary part of that process
 - Lender concern: Does penalty fit the crime?

Federal Reserve's view

- New York Fed President Dudley

“Today’s tough underwriting standards and high risk-based premiums should also be reviewed. I do not want to see a return to the lax standards and underpricing of credit risk in boom period. But the guarantee fees for new purchase mortgages should be based on the expected losses ... not realized losses on loans of earlier vintages.”

- Will further changes---

- Reduce access to credit to creditworthy homebuyers
- Increase costs to homebuyers
- Discourage lenders from participating

Future of Mortgage Industry

- Role of government in housing
- Significant changes in mortgage industry likely

Role of Government in Housing

- What to do w/ Fannie/Freddie
 - Widespread agreement that private/public structure did not work
 - Could private sector meet demand?
- We are getting a glimpse of a private sector market today
 - Creditworthy borrowers are unable to obtain loans
- Administration “white paper” last February
 - Page 1: “plan dramatically transforms role of gov’t”
 - Broadens debate far beyond reforming GSEs
 - Curtails FHA and other government programs

FHA: How are its finances?

- FY 2011 actuarial review
 - Stayed positive (barely) - \$2 billion
 - Snapshot of portfolio as of September 30th
 - How will portfolio perform in run-off scenario?
 - Rely on economic projections (house prices)
 - “Tug of war” between performance & projections
 - CY 2009 -2011 books have “saved” FHA
 - Performance & credit quality = \$18 billion net revenue
- Will FHA remain positive in 2012?
 - Quality of new loans vs. problems w/ old loans
 - 75% of portfolio = new loans
- Where would we be w/o FHA?

Significant changes in the mortgage industry likely

- Enforcement & other regulatory changes (e.g. BASEL III capital standards) are causing large financial institutions to rethink role
 - Impact on smaller originators?
- Private capital is entering the market
- Higher entry requirements companies & individuals
- Plays to strength of lenders that know how to follow rules
 - Knowledge & service matter

Summary

- Mortgage industry has already imposed significant tightening because of liability (actual & potential)
- Mortgage industry is concerned about:
 - Level-playing field
 - Explanations of the rules
 - Enforcement – does penalty fit crime?
- Challenge going forward:
 - Addressing problems w/o jeopardizing homeownership opportunities of creditworthy borrowers