

**Tough Choices
A Return to American
Greatness and World Stability**

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Overview

The primary objectives of the plan need to be. . .

- To stabilize the economy at minimal, or no, cost to the taxpayer
- To focus on the root problem, not the symptoms
- To avoid politicizing the issue
- To let free markets work, avoid socialism
- To hold everyone accountable for their action or inaction
- To be executable immediately, not over a prolonged period of time

Credit flow is essential to the economy . . .

- Remember, to fuel the economy, banks need to lend. Lending is the lubricant of economic growth in the U.S.
- Leverage and capital are the issues, liquidity is the symptom.
 - For every decline in bank equity of \$1, bank assets need to contract by \$12.50 (assuming an 8% capital ratio).
 - So every solution talked about should be thought of in that vein.

As suggested in part seven of *FinPro's Solutions to Fix the Economic Doldrums*, the real estate market must be fixed . . .

- Falling values in the real estate market is the root problem.
- The plan must immediately substantially reduce the devaluation of real estate. As such, it is critical to understand what is causing the devaluation to occur.
 - There is an excess supply of homes on the market
 - Weak demand does not meet the excess supply
 - Increased foreclosures are resulting in neighborhood blight, driving down values throughout the neighborhood as properties are not being maintained

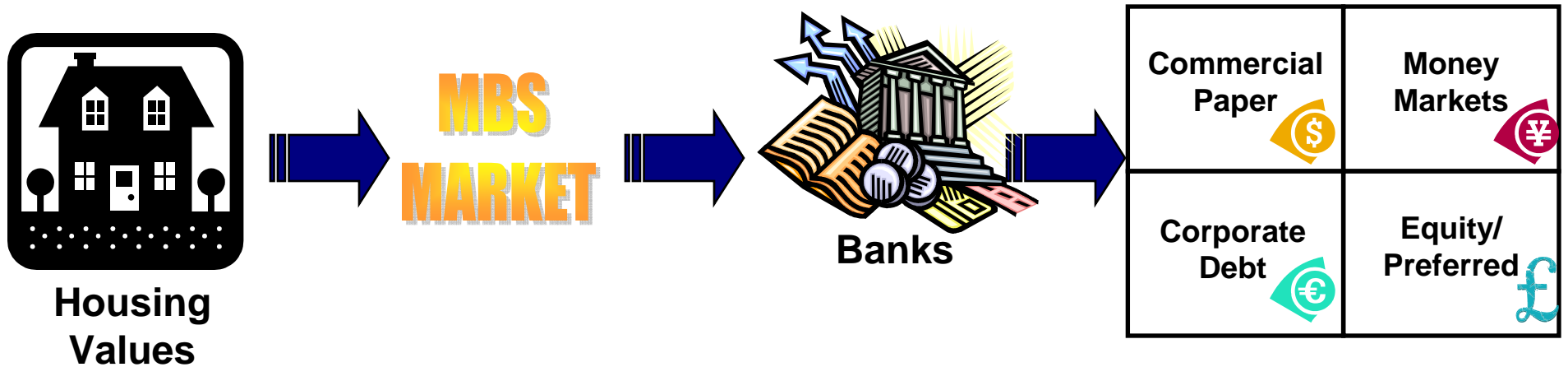
Overview of the plan . . .

- Step 1: Banks review their mortgage loan portfolios and conduct a “triage”, modifying loans for certain borrowers.
- Step 2: Isolate the problem loans into a separate division of the bank and modify terms to interest only payments for five years.
- Step 3: Government lends money to the bank to fund the problem loans for up to a maximum five year term. Interest cost on the government funding is paid for by the yield on the problem loans. Spread between government funding cost and loan yield goes in to a default reserve.



The Fundamental Problem – Real Estate Affordability Analysis

The housing market is the beginning and root of the problem which lead to issues throughout other markets, including the banking industry . . .



This analysis uses 2007 estimates for median income and median owner occupied value to assess the affordability of real estate at the state level across the United States . . .

- This analysis is based on the following assumptions:
 - Median Income estimate for 2007 (Claritas)
 - Median Owner-Occupied Housing Unit Value for 2007 (Claritas)
 - Assumed Median LTV Ratio of 80% (FinPro)
 - Assumed Mortgage Terms of 30 years and 6.0% interest (FinPro)
 - Assumed Average Property Tax Rate (2005 American Community Survey from the U.S. Census Bureau)
 - Assumed Modification of Mortgage to Interest Term of 3.50% for five years (FinPro)
 - Assumed Underwriting Qualifying Ratio of 28% (FinPro and normal agency guidelines)

- NOTE: the analysis of an individual borrower would be the same as illustrated below for regions.

The table below illustrates the methodology used at the national level . . .



PAYMENT ANALYSIS	The United States
2007 Estimated Median Owner-Occupied Housing Unit Value	\$172,914
<i>Assumed Median LTV</i>	80.00%
Estimated Median Mortgage	\$138,331
<i>Assumed Term</i>	360
<i>Assumed Rate</i>	6.00%
Req'd Monthly Payment on Median Mortgage	\$829
Assumed Annual Avg Property Tax Rate on Housing Unit Value	0.93%
Monthly Property Tax Payment	\$134
Total Monthly Principal, Interest and Taxes (PIT)	\$964
2007 Estimated Median Household Income	\$49,314
<i>Assumed Underwriting Qualifying Level</i>	28.00%
Median Qualifying Monthly Payment	\$1,151
Difference: Ability to Pay vs. Market req'd Pmt	\$187

- The median U.S. mortgage is \$138,331 assuming an 80% LTV on the median home value.
- That would require a monthly mortgage payment of \$829 based on a 30 year 6% mortgage.
- Utilizing an average property tax rate of 0.93%, this requires monthly taxes of \$134.
- That results in a monthly mortgage and tax payment of \$964.
- The median household can afford a payment of \$1,151 based on the median income level and a 28% of median household income underwriting standard.
- That means that the monthly payment the median household qualifies for is \$187 more than the required payment.

The table below illustrates the difference between the 2007 estimated required payment as illustrated on the prior page versus the payment supported by the median income for the top five least affordable states . . .

PAYMENT ANALYSIS	The United States	California	Hawaii	District of Columbia	New Jersey	Mass.
2007 Estimated Median Owner-Occupied Housing Unit Value	\$172,914	\$466,668	\$466,595	\$377,048	\$329,990	\$346,842
<i>Assumed Median LTV</i>	80.00%					
Estimated Median Mortgage	\$138,331	\$373,334	\$373,276	\$301,638	\$263,992	\$277,474
<i>Assumed Term</i>	360					
<i>Assumed Rate</i>	6.00%					
Req'd Monthly Payment on Median Mortgage	\$829	\$2,238	\$2,238	\$1,808	\$1,583	\$1,664
Assumed Annual Avg Property Tax Rate on Housing Unit Value	0.93%	0.48%	0.20%	0.38%	1.60%	0.82%
Monthly Property Tax Payment	\$134	\$187	\$78	\$119	\$440	\$237
Total Monthly Principal, Interest and Taxes (PIT)	\$964	\$2,425	\$2,316	\$1,928	\$2,023	\$1,901
2007 Estimated Median Household Income	\$49,314	\$56,379	\$59,106	\$49,549	\$65,216	\$60,331
<i>Assumed Underwriting Qualifying Level</i>	28.00%					
Median Qualifying Monthly Payment	\$1,151	\$1,316	\$1,379	\$1,156	\$1,522	\$1,408
Difference: Ability to Pay vs. Market req'd Pmt	\$187	(\$1,109)	(\$937)	(\$772)	(\$501)	(\$493)

- In CA, HI, DC, NJ, and MA the current median home value well exceeds the median qualifying monthly affordable payment.
- In order from least affordable downward; California, Hawaii, Washington D.C., New Jersey, Massachusetts, Rhode Island, New York, Nevada, Connecticut, Washington, New Hampshire, Oregon, and Maryland have a median monthly mortgage and tax payment that exceeds the qualifying monthly affordable mortgage.

The table below illustrates the 2007 estimated median home value depreciation required to make the median home value affordable in those states shown on the prior page. Values would need to fall from 2.44% in Maryland (not shown) to a high of 49.57% in California . . .

PAYMENT ANALYSIS	The United States	California	Hawaii	District of Columbia	New Jersey	Mass.
2007 Estimated Median Owner-Occupied Housing Unit Value	\$172,914	\$466,668	\$466,595	\$377,048	\$329,990	\$346,842
<i>Assumed Median LTV</i>	80.00%					
Estimated Median Mortgage	\$138,331	\$373,334	\$373,276	\$301,638	\$263,992	\$277,474
Less: Req'd Dollar Value Write-down	\$0	\$185,053	\$156,218	\$128,718	\$83,570	\$82,208
Resulting Mortgage Value After Value Write-down	\$138,331	\$188,282	\$217,058	\$172,920	\$180,422	\$195,265
Total Monthly Principal, Interest and Taxes (PIT) on Affordability Equilibrium	\$964	\$1,316	\$1,379	\$1,156	\$1,522	\$1,408
Median Qualifying Monthly Payment	\$1,151	\$1,316	\$1,379	\$1,156	\$1,522	\$1,408
Difference: Ability to Pay vs. Market req'd Pmt	\$187	\$0	\$0	\$0	\$0	\$0
<i>Required Loan Write-down to Meet Affordability</i>		49.57%	41.85%	42.67%	31.66%	29.63%
<i>Dollar Value Write-down</i>		\$652	\$577	\$493	\$482	\$417

- Varying levels of depreciation would be required to bring home values, and thereby mortgage values, in line with income levels.
- The five states shown above would require significant declines in value. Allowing values to drop this dramatically would exacerbate the economic downturn. We cannot afford to solve the problem through value adjustment. In fact, just the opposite needs to occur.
- We must hold values and make the payments affordable, similar to auto leasing versus a purchase!

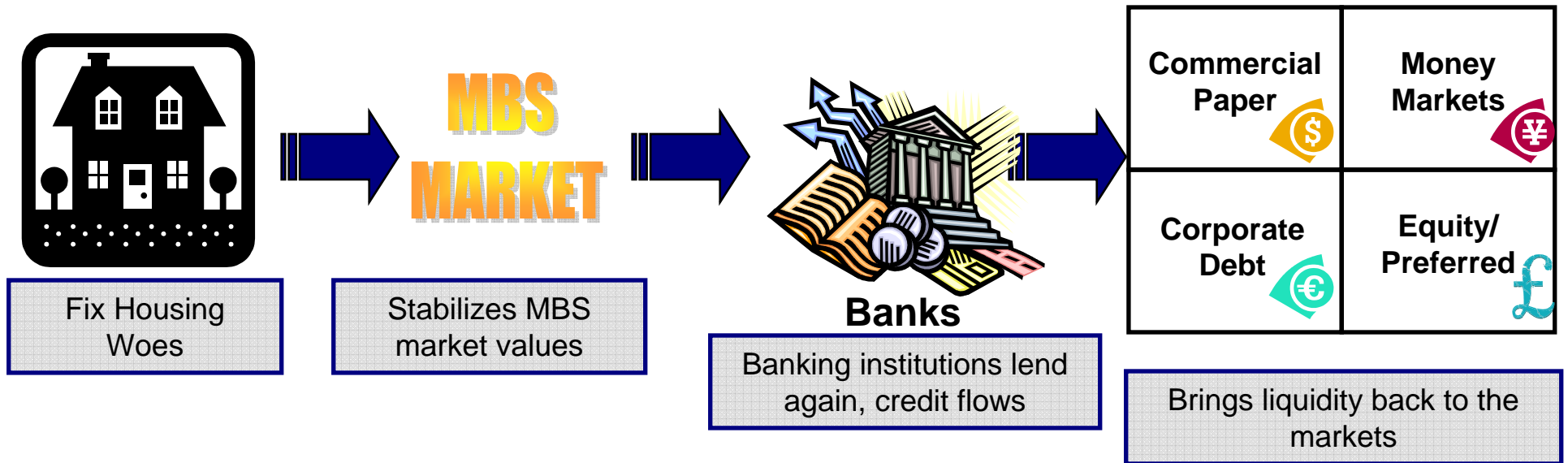
In all states that were previously unaffordable, modifying loans to be an interest only (IO) loan at 3.50% would make housing affordable for every state that was previously unaffordable . . .



PAYMENT ANALYSIS	The United States	California	Hawaii	District of Columbia	New Jersey	Mass.
Estimated Median Mortgage	\$138,331	\$373,334	\$373,276	\$301,638	\$263,992	\$277,474
<i>Assumed Interest Only Modified Rate</i>	3.50%					
Interest Only Monthly Payment and Taxes on Median Mortgage	\$538	\$1,276	\$1,166	\$999	\$1,210	\$1,046
Median Qualifying Monthly Payment	\$1,151	\$1,316	\$1,379	\$1,156	\$1,522	\$1,408
Difference: Ability to Pay vs. Modified IO Payment	\$613	\$40	\$213	\$157	\$312	\$361

- In all states, modifying a loan to an interest only payment at 3.50% will make housing affordable as the ability to pay is greater than the modified IO payment including taxes.
- An interest only payment can help to make payments affordable for those homeowners that can not currently afford their payments. We can solve the problem by attacking the monthly payment of those homeowners.

Fixing the primary problem of falling real estate values will have a cascading effect on the overall economy and will help fix the liquidity issues as well . . .



All of this restores confidence!

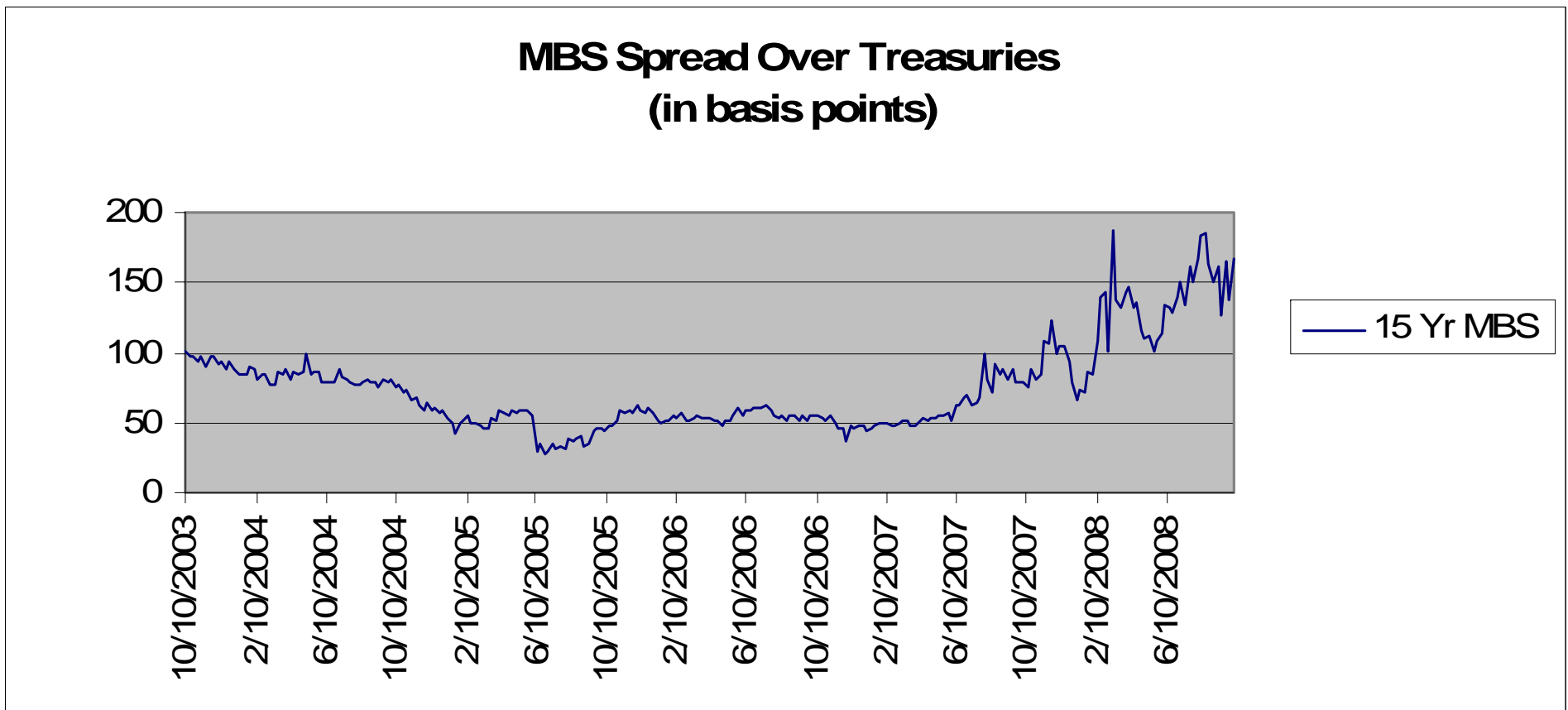
Comparing TARP to Defeasance, modifying loans and removing them from MBS and CMO investments is much better than buying the whole security . . .

- As we understand the TARP component of the \$700 billion rescue plan:
 - The federal government would acquire subprime and illiquid investments via either an auction or a negotiated purchase from financial institutions at a price to be determined.
 - There is great uncertainty regarding how the price will be determined. If it is too low, there is no benefit to the financial institution. If it is too high, the price to the government and taxpayers is great and the banks receive a windfall.
- All this price uncertainty is reflected in (and depressing) the market price for other than “plain vanilla” agency mortgage backed securities and CMOs.
- Modifying loans within a security are problematic:
 - Modifying the loan without the consent of the investor in many instances opens the servicer to liability.
 - Many securities have multiple classes of investors that may either benefit or be penalized by the modification because it affects the underlying cash flows that are shared by their particular tranche.

By removing the defeased loan from the security . . .

- Only the defeased loan needs to be funded with government proceeds versus purchasing the entire security
- The market price of the security should improve because:
 - The remaining collateral in the security is of higher overall quality
 - There is less uncertainty regarding the potential effect of modifying loans within the security, because that will not happen
 - Overall market conditions will improve because of improved liquidity and greater investor confidence
- Thus the liquidity problem is solved by fixing the real estate problem and the TARP program should have to outlay far fewer taxpayer dollars than \$700 billion.

Concerns about asset quality still exist, even in government guaranteed securities. Spreads on FNMA and FHLMC MBS have started to close when compared to Treasuries, due to recent government actions, but are still well above historical levels. A return to normal levels could reduce mortgage rates 50 basis points or more . . .





The Solution – Defeating the Problem

Step 1: Banks review their mortgage loan portfolios and conduct a “triage” . . .

- Performing borrowers – leave “as is”
- Non-performing borrowers who have abandoned the property or are unable or unwilling to work out a loan modification program should be taken through to foreclosure. Congress must speed the foreclosure process in cases where that is necessary. Examples of loans that can not be modified:
 - Abandoned properties
 - Investment properties
 - Borrowers that can’t afford payments even with a loan modification
- Non-performing borrowers who can meet some level of acceptable debt service (as determined by underwriting) become eligible for a restructured loan (to be discussed in the following pages) with funding provided to the bank by the government. Those restructured loans are then moved to a separate division of the bank’s balance sheet for management and monitoring.

Step 2: Isolating the problem loans and modifying terms to interest only payments for five years . . .

- Presume that the borrower is delinquent on a \$263,992 loan (median house price in NJ at an 80% LTV) at a fixed rate of 6% and a 30 year amortization period. The current monthly payment of principal and interest is:
 - \$1,583
- Modify the interest rate down to 3.50%, making the borrower's payments interest-only for a period of five years (the term and rationale will be discussed further). The new payment becomes:
 - \$770
- With the new payment less than half of the original payment there is a powerful incentive for the borrower to stay current on the loan, stay in the property, continue to pay property taxes and preserve some chance for equity appreciation down the road.
- The banks recast fixable problem loans into interest only loans and isolate them on the balance sheet.
- It adds up the five year cash flow and obtains a loan from the government for the precise cash flow also at a rate of 3.50%. Any principal reduction from the customer to the bank is paid in full to the government to reduce the loan balance correspondingly. The cash flows are always in balance.

Payments for the IO mortgages must approximate rental payments for properties of comparable value in order to provide incentive to owners . . .

- Using the New Jersey example of a \$263,992 loan (80% loan to value on \$329,990 median house):

– Monthly IO mortgage payments:	\$	770
– Monthly taxes (2% of property value):		550
– Monthly insurance:		<u>100</u>
– Monthly Total	\$	1,420

- Depending upon type of property and geographic location in New Jersey, rental values on a similarly priced property would approximate \$1,500.
- The monthly total costs of the IO mortgage are within the range of rentals for a similarly priced property.

Step 3: Government funding . . .

- The government has the ability to raise funds and re-lend those funds to the banks at rates that:
 - Cause minimal, if any, cost to the taxpayer
 - Can match fund a reduced rate to the borrower
 - And incorporate the ability to build a reserve fund, via a spread difference, to cover losses on loans that subsequently go non-performing
- So the government sells treasuries at auction at current rates for a period not to exceed 5 years. Today, that equates to funding at a cost ranging from .40% (1 month) to 2.50% (5 year). Using the highest cost of 2.50%, the government then lends the money to banks at 3.50%. As such, the banks pay the government for its debt rate as well as an extra 1.00% which would go into a default allowance fund.
- The amount of money lent to the banks would be equivalent to a cash flow required to be met from moving loans into a separate division.

Using the same single \$263,992 non-performing loan, the government would place a deposit in the bank which would fund that loan, separated in a division of the bank. The bank's spread would be zero but the government would build a 1% default reserve on its 2.5% market cost versus 3.5% deposit rate. Within the five year period the loan must be refinanced or paid down and the government deposit returned . . .

Financial Institution	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Nonperforming Loans Balance	\$ 263,992	\$ 263,992	\$ 263,992	\$ 263,992	\$ 263,992	\$ -
Modified Nonperforming Loan Rate	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%
Interest Income	9,240	9,240	9,240	9,240	9,240	-
Deposit Balance from Gov't	\$ 263,992	\$ 263,992	\$ 263,992	\$ 263,992	\$ 263,992	\$ -
Deposit Rate	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%
Interest Expense	9,240	9,240	9,240	9,240	9,240	-
Spread at the Bank	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Net Interest Income at Bank	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Government	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Deposit Balance	\$ 263,992	\$ 263,992	\$ 263,992	\$ 263,992	\$ 263,992	\$ -
Rate	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%
Interest Expense	9,240	9,240	9,240	9,240	9,240	-
Funding Balance	\$ 263,992	\$ 263,992	\$ 263,992	\$ 263,992	\$ 263,992	\$ -
Market Cost on 5 Year Treasury	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
Interest Expense	6,600	6,600	6,600	6,600	6,600	-
Spread for Default Reserve	1.00%	1.00%	1.00%	1.00%	1.00%	1.00%
Default Reserve - Government	\$ 2,640	\$ 2,640	\$ 2,640	\$ 2,640	\$ 2,640	\$ -



Benefits

Benefits to the borrower . . .

- The borrower stays in the property at an affordable cost.
- There is no principal reduction of the mortgage loan.
- At some point within, or at the end of, the five year term:
 - The loan would be recast at the prevailing rate at that time and amortization would resume
 - Or the property would be put up for sale
- The borrower has five years to enhance their income stream, reduce other debt obligations and be in a position to:
 - Either sell the property (at a price that has hopefully appreciated or stabilized)
 - Or resume higher debt service payments and build equity (or reduce their indebtedness)
- Borrower's mortgage payment remain tax deductible whereas alternative rental payments are not tax deductible.

Benefits for financial institutions . . .

- The primary benefit is the elimination of future write-downs and further reduction of capital.
- Mitigates vicious cycles of write-downs at financial institutions
- A non-earning asset becomes earning again.
- We propose that the loans (and the funding) are designated as a separate division of the bank and excluded from:
 - The bank's leverage ratio
 - The bank's risk based capital ratio
- The bank does not need to deleverage its balance sheet, and has freed up funding (and capital) to lend and generate net interest income.
- The bank does not need to expend capital and management resources acquiring, maintaining and marketing REO.
- Only borrowers that can afford a modified loan will get the modification.

Benefits for the economy . . .

- By reducing the potential number of properties being foreclosed and placed for sale:
 - The influx of unsold homes will be curtailed giving local real estate markets a chance to reach equilibrium
 - Owner occupancy is maintained which is an important component of value and neighborhood stability.
- It puts a floor under the real estate market by reducing the increase in supply of homes that would result due to foreclosures and/or forced sales in the market
- Minimizing taxpayer exposure by matching cash flows from modified loans with matched cash flow of government funding and creating a default reserve
- Keeps the government from becoming directly involved in the purchase of homes and/or mortgages
- The stabilization of housing values will allow the market to more efficiently price securities collateralized by mortgages.

Benefits of “Defeasance” versus government purchasing assets . . .

- Since this involves funding the banks instead of acquiring troubled assets, the government:
 - Has not directly purchased property or loans
 - Avoids managing troubled assets
 - Receives its interest payments directly from the bank to pay bondholders
 - The restructured loan is defeased at a rate that is above the funding cost of the government funding so that the interest payments from the borrower matches the interest cash flows from the bank to the government. This builds a loss reserve in case of future loan losses.



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