

**Commercial Real Estate Outlook**

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*Joseph A. Furlong, VP, Capital Markets Group*

*John Togneri, Associate, Capital Markets Group*

While the economy is expected to continue expanding, the overall pace of GDP growth is projected to be lackluster. With the recovery likely to remain slow in the near term, industrial demand, which depends heavily on rising consumer demand, will continue to improve, but at a measured pace.

**Commercial Servicing Rights Market Update**

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*Daniel Thomas, MD, Client Solutions Group*

Market values for Commercial MSRs should be relatively flat in 2012. Forecasts from multiple CMBS research reports are estimating between \$40B - \$45B of new CMBS issuance in 2012.

**Residential Real Estate Outlook**

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*Bassirou Sarr, Research Analyst, Capital Markets Group*

Looking ahead, construction in single family units will decrease while servicers clear the foreclosure inventory. The supply of newly constructed single unit houses will continue to slump while multifamily construction drives the housing starts index.

**Mortgage Servicing Rights Market Update**

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*Robert Lee, Director, Capital Markets Group*

*Mike Carnes, SVP, Capital Markets Group*

Prepayment volatility continues to be a factor as the market gathers new evidence of the regulatory landscape and its impact on markets. Continued debate on housing, delinquency performance and proactive measures to clean up the housing overstock will continue for some time.

**Inside Ginnie Mae<sup>®</sup> – Interview with Ted Tozer, President**

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*David McCraw, SVP, Client Solutions Group*

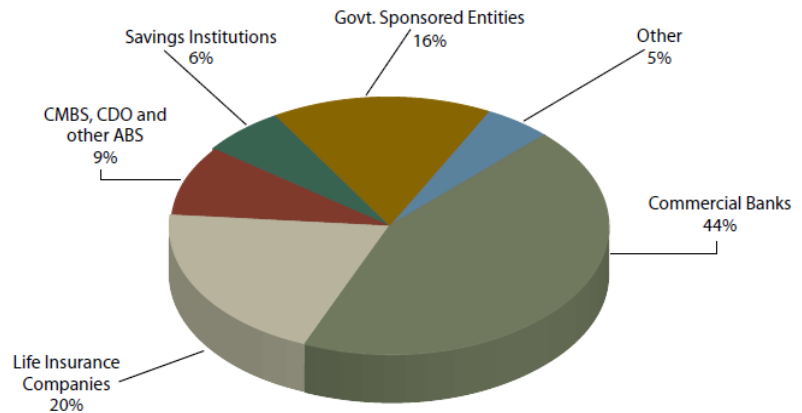
Ginnie Mae has grown to more than \$1 trillion in MBS, assuming a greater role in the secondary mortgage market as Fannie Mae and Freddie Mac regain their footing. Perspectives recently spent time with the Ted Tozer, the leader creating a new path for the agency and the residential market.

## Commercial Real Estate Outlook

The performance of the commercial real estate market in 2011 was divided into two segments. By most measures, during the first half of the year, it appeared the commercial real estate market was turning around. Many existing lenders as well as new participants reestablished their “originate to securitize” lending units. In the second half of the year, many of the same firms closed down these divisions or greatly reduced their outlook. The reason for this transition was multifold. The economic indicators, gross domestic product, unemployment and property values, generally did not rebound as originally expected. For example, unemployment, one of the main drivers in commercial real estate, languished and failed to realize any meaningful gains. These pressures caused lenders to focus their origination efforts on major markets, trophy or class A properties, high underwriting standards with loan-to-value (LTV) ratios of less than 55%, debt service coverage ratios (DSCR) more than 1.6 and strong sponsorship support. Additionally, continued pressure was realized on the net operating incomes (NOI) during 2011.

Looking forward into 2012, we believe the commercial real estate market will continue on the same path. In most property types, continued pressure is likely, as NOI continues to slide, or at best, remains consistent. At the same time, the market will demand high capitalization rates (cap rates) in order to compensate for an uncertain market outcome.

MIAC believes commercial real estate investors will begin to look at secondary and tertiary markets to find additional investment opportunities, but the focus will be on specific asset classes such as multi-



**Fixed Income Markets- \$3.15 Trillion Lender Composition**

Source: Federal Reserve, 4Q 2010

family, grocery-anchored real estate and industrial where demonstrated predictable leasing demand can be established.

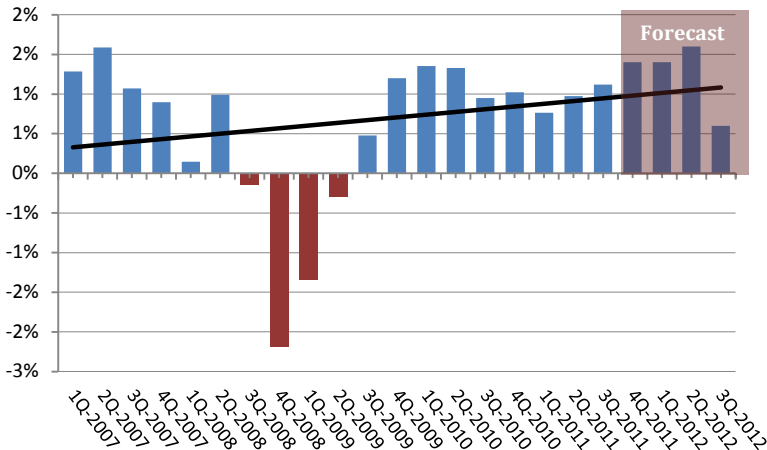
### Economic Factors

The U.S. economy continues to move along with sluggish and uncertain results. The consistent reoccurrence of “good news / bad news” in the U.S. and global economies weighs heavily upon any growth that may occur going forward.

Additional challenges, such as continual foreclosure activity, high unemployment and global economic risks will put a drain on the overall U.S. economic performance. The continued issues coming out of the euro-zone sovereign debt crisis weigh on the U.S. economy, causing severe stock market volatility, uneven commodity prices and reduced investor confidence. Banks as well as other lenders continue their conservative credit policies limiting available credit for businesses with expansion plans. In turn, businesses continue conserving cash by reducing employment, capital investment and inventory.

This approach will continue to dampen growth in 2012 and into 2013.

**Gross Domestic Product Growth Rate**



Source: U.S. Dept. of Commerce: Bureau of Economic Analysis & DGP Growth Rate Forecast from The Financial Forecast Center

Approximately 70 percent of GDP has been attributed to consumption, while the remaining 30 percent is attributed to governmental activities. With this likely to be the situation going forward, we could expect a slow near-term growth while inflation begins to erode increased personal income. On the positive side, corporate profits remain high. Additionally, and as a result of high unemployment, worker productivity is higher than pre-recession levels because employees are asked to do more than previously required. This productivity pressure will continue, even though employee performance will peak if it hasn't already.

Many challenges must be overcome over the next few years in order to regain sustainable and normalized growth. Among them:

- The US debt-ceiling issue along with a possible credit downgrade lowers global confidence. Uncertainty about increased federal taxes could damage the willingness of consumers and businesses to spend and invest.

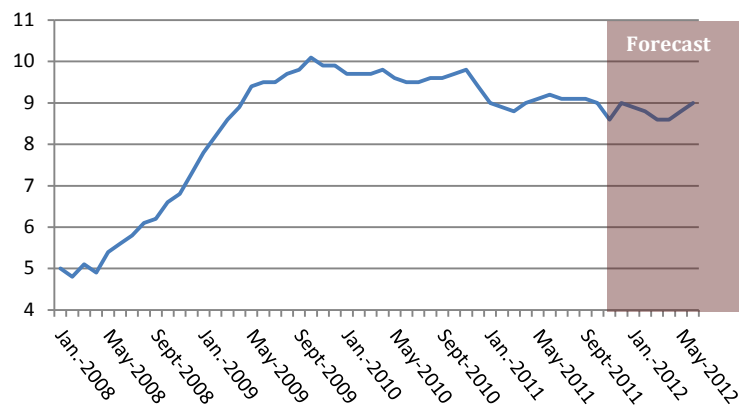
- An improved job outlook, wage growth and progress in crisis resolution will be required to prop up consumer attitudes.
- Foreclosures and short sales make up approximately 30 percent of sales transactions. Single-family home sales fell to 4.3 million units while the median sale price declined 3.9 percent to \$165,600 over 2011. This trend must reverse before the economy can regain its footing.

**Unemployment Rate**

The private sector added 2.04 million jobs in the last 12 months as of November 2011. Year-end hiring was concentrated, and was led by business and retail trade, leisure and hospitality, professional and business services as well as health care. The decline in unemployment in November 2011 to 8.6 percent was partly due to a reduction in overall labor force by approximately 315,000.

The economy is forecasted to add 1.7 million jobs by year-end, with the unemployment rate remaining stable near 9 percent. Sub-par employment growth is likely as GDP struggles to surpass its historical average of a quarterly 2.5 percent increase.

**Unemployment Rate**

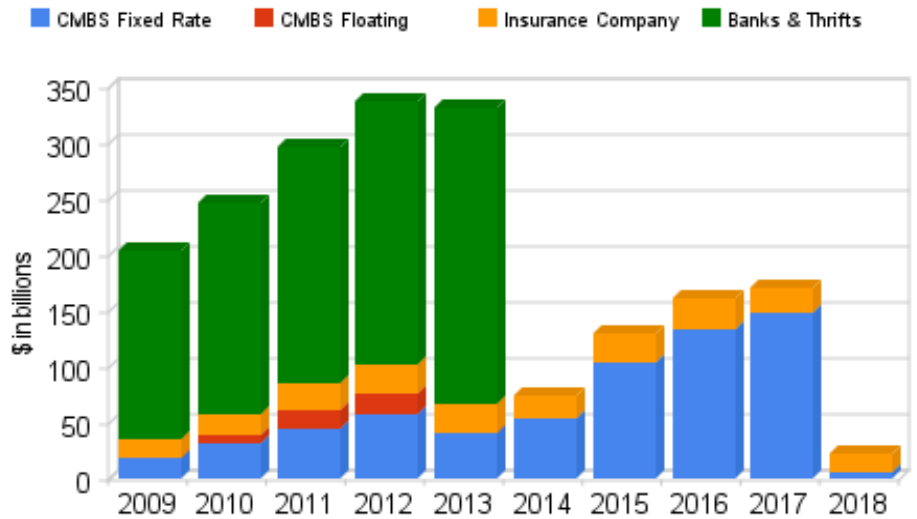


Source: U.S. Dept. of Commerce: Bureau of Economic Analysis & DGP Growth Rate Forecast from The Financial Forecast Center

## Maturing Loans

Many of the loans which were originated during the boom times of 2005 to 2007 are scheduled to mature in 2012 and 2013. Many of the properties are defaulting and owners and lenders are facing the realization that they are worth a lot less than once thought. Since these loans were originated during times of economic booms, the projected optimistic cash flow scenarios never materialized. This, in combination with tighter credit standards has made it difficult or impossible to refinance loans. Borrowers who are unable to pay off their loans at maturity have few choices. Lenders, realizing this situation, have begun to work with borrowers through special servicing in order to modify loans rather than foreclose. As reported by Cushman & Wakefield's Capital Market Update of 11-4-11, loan modifications account for approximately 60% of all CMBS loan resolutions as opposed to foreclosures or property sales. The "All Commercial Loan Maturities" graph illustrates that although the bulk of the maturing loan issue is behind us, 2012 and 2013 will still have challenges needing to be addressed.

### All Commercial Loan Maturities

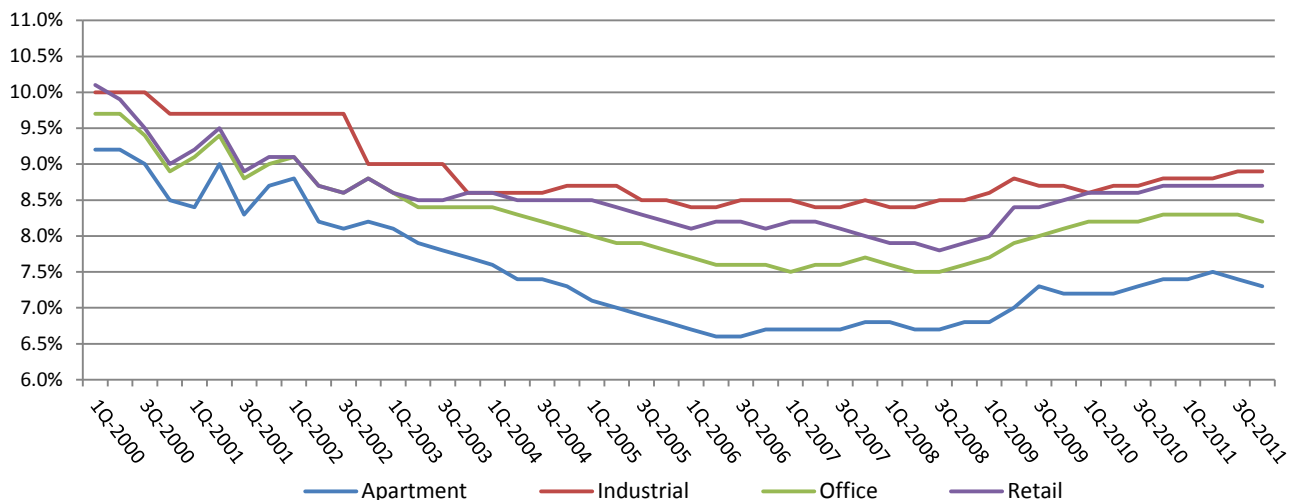


Source: Deutsche Bank, Intex, Trepp, Mortgage Bankers Assoc, Federal Reserve

## Capitalization Rate

Capitalization Rates (Cap Rates) have mostly remained steady during the third quarter in three of the four main commercial property types. However, rates for apartments have declined and remain at significantly lower levels than the other three property types. These are mixed signals, as declining cap rates generally mean favorable commercial valuations and that was not apparent in the most recent quarter.

### National Cap Rate by Property Type

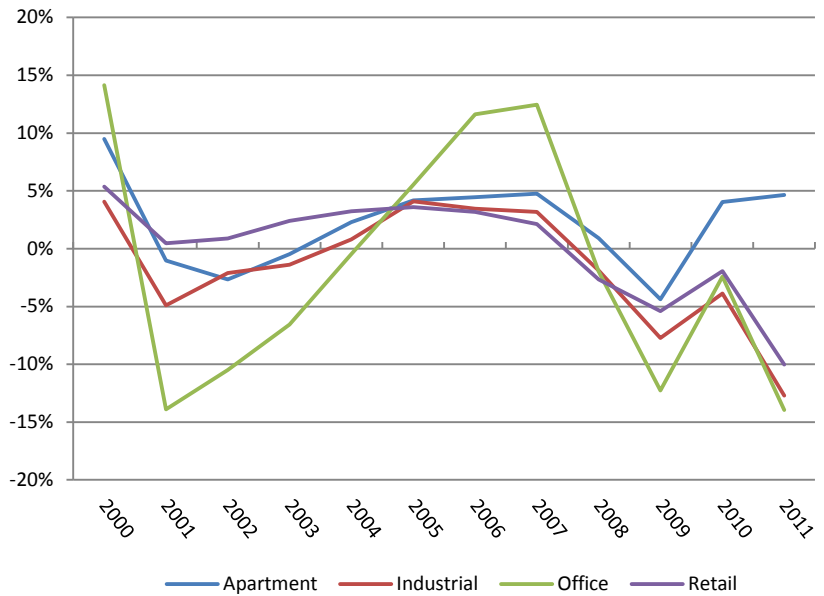


Source: REIS Custom Research and Advisory Services

## Net Operating Income

Continuing the recent trends, net operating income (NOI) declined in three of the four major property types during the third quarter. Industrial, Office and Retail properties saw another quarter with declining NOIs while the apartment sector continues to buck the trend. NOIs in the apartment sector have been, increasing since 2009 and continue to increase although at a less accelerated pace.

National Annual Net Operating Income Growth Rates by Property Type

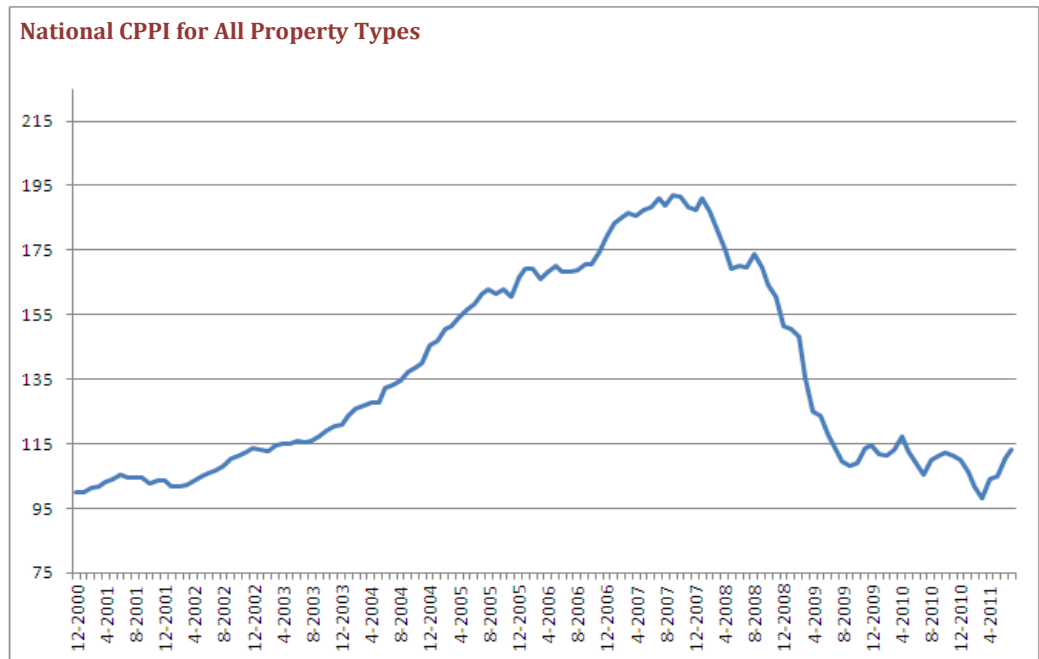


Source: REIS Custom Research and Advisory Services

## Commercial Property Price Index

The Commercial Property Price Index (CPPI) is down over 41% percent from the high in October 2007; however it has steadily increased since the end of last year. The most recent month - end data released in October shows a 2.4% increase in the national index.

National CPPI for All Property Types



Source: Moody's/REAL Commercial Property Price Index (CPPI)

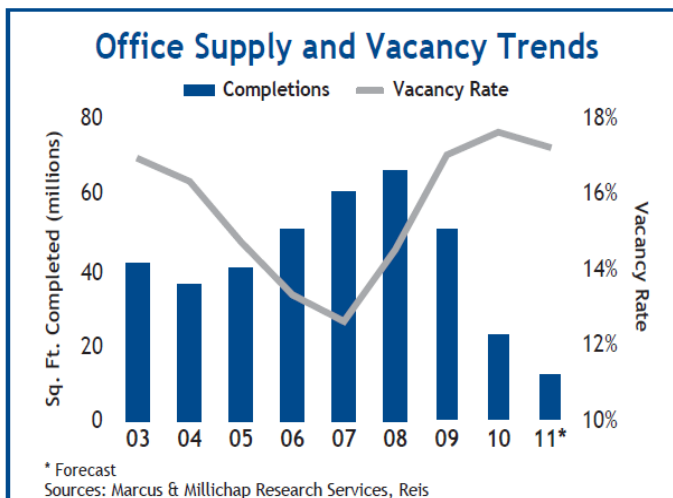
## CMBS Loans in Special Servicing

Last month, the amount of CMBS loans in special servicing declined 5.4%, which marks the largest single month decline in some time. The overall percentage of loans in special servicing fell to 12.8 percent. This decline in both volume and percentage is misleading, because as loans are removed, others are being added and therefore it doesn't necessarily indicate that market conditions are improving. More notably, it illustrates that special servicers are finding successful workout plans and moving loans back to master servicers. The performance of apartment loans has continually improved; their delinquency rate fell in the most recent month to 8.8 percent and

they make up 20.1 percent of all loans in special servicing. Office and retail saw a slight increase in special servicing loans during the most recent quarter.

## Office

Even though there was significant economic uncertainty, volatile financial markets and consumer and business pessimism, the commercial office market vacancy levels improved slightly through 2011. The net absorption of 6.6 million square feet was realized in the third quarter of 2011 alone. Although in the fourth quarter of 2011, the market seems to be pulling back from these levels, leaving uncertainty of future performance. Vacancy rates recorded a modest decline to 17.4 percent at the end of 2011, but mostly due to modest completions, which totaled approximately 3 million square feet. This vacancy rate declined on 20 basis points on a year-over-year basis. Asking rents as of third quarter remained 5.2 percent below the peak, while effective rent was 10.7 percent below the peak.



The national vacancy rate will likely remain elevated, even though current trends reflect positive changes. This is due mostly to lackluster employment growth. The office sector continues to raise red flags, illustrating few positive demand-side drivers. If the economy remains tepid, many companies may downsize as existing leases terminate. Additionally, companies that have already downsized may still carry enough shadow space to accommodate expansion at a later time.

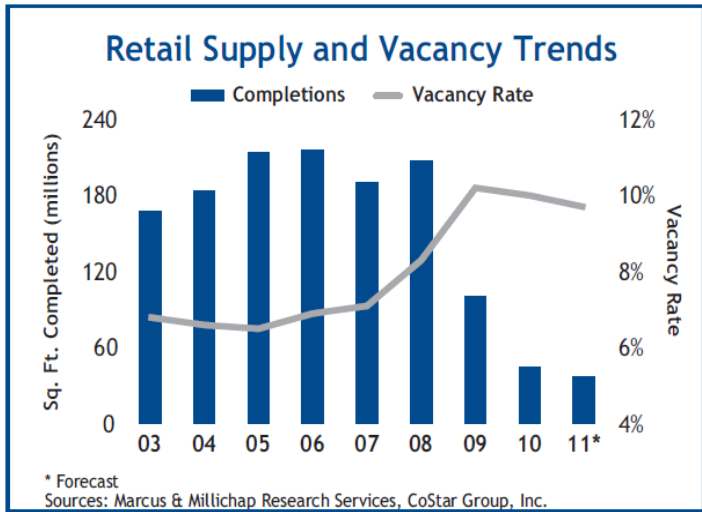
Wide variances have resulted within the office section; determining factors are: market and submarket characteristics, local economic performance and asset class. The strongest rates of recovery in vacancy and rents have been realized in the major markets located on either coast as well as in Texas. Some secondary markets have recently begun to exhibit improved results, but it is too earlier to call it a trend. There are significant differences when comparing absorption in property classes. There is a clear flight to quality by tenants. Class A space offered at depressed market rents may compel companies with leases terminating to upgrade while rents remain low. This pattern is expected to continue as lease renewals occur throughout 2012 and 2013. As the amount of available Class A space declines, we foresee upgrades beginning to be realized in the Class B space.

A surge in sales of central business district (CBD) properties in secondary markets and suburban properties in primary markets signals a move on the risk/return spectrum by investors. These two segments exhibited a decline in cap rates in the third quarter, down 60 and 40 basis points, respectively. Cap rates for CBD assets in primary markets, while still low, flattened to 6.2 percent, on par with CBD properties in secondary markets.

## Retail

Retail sales performance departed from negative expectations, posting gains led by clothing stores followed by restaurants. Retail property operations also showed positive momentum with third-quarter 2011 net absorption totaling 17.6 million square feet. Completions remained moderate, totaling nearly 9 million square feet and resulting in a vacancy decline of 10 basis points over third-quarter 2011 to 9.9 percent. Modest year-over-year decrease in asking and effective rents were realized, netting a 0.2 percent fall. This is a slower pace of decline for

the fourth consecutive quarter, indicating a possible bottoming of retail rents.



Despite higher levels of new supply by year-end, forecast net absorption should also trend higher, outpacing completions and subduing the national vacancy rate.

Consumers will remain under pressure until disposable income begins to trend positively. Additionally, uncertain confidence and price sensitivity will eventually cause a slower sales pace and challenge business confidence.

End of year 2011 retail sales recovered from summer's lows, with activity being realized in all major categories. Total retail sales have increased 5.7 percent on a year-to-date basis compared to 2010. In the low interest rate environment, a volatile stock market and higher core inflation may encourage more spending, particularly among wealthier consumers.

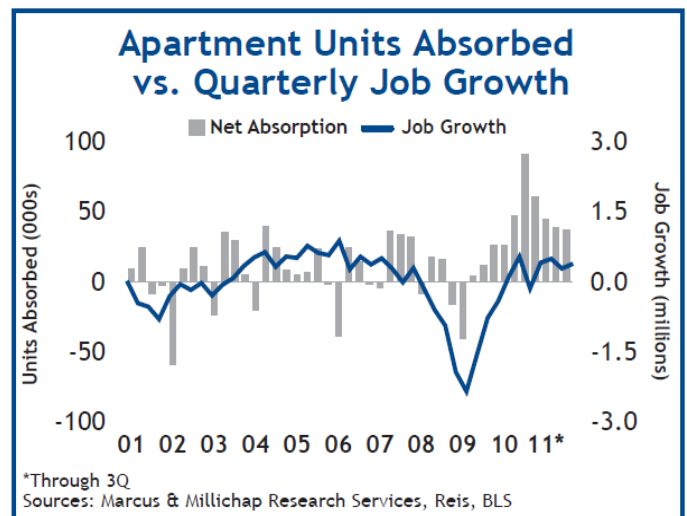
Throughout the recession, many retailers repositioned stores by optimizing locations, closing under-performing stores and opening new ones. Retail operators continue to improve overall efficiency through technology and by decreasing their footprint. National retailers target premier locations in primary markets rather than secondary

or tertiary markets. We believe this trend will continue until full absorption within the premier locations is realized. This is not expected to occur during 2012.

Class A properties located in secondary markets are likely to provide more attractive pricing going forward into 2012, although NOI growth will not meet the performance of similar properties in primary markets. However, with consumers under pressure and questions about the sustainability of retail sales in the face of eroding wage and income growth, investors may be reluctant to take on too much risk until payroll growth gains significant momentum.

### Multi-Family

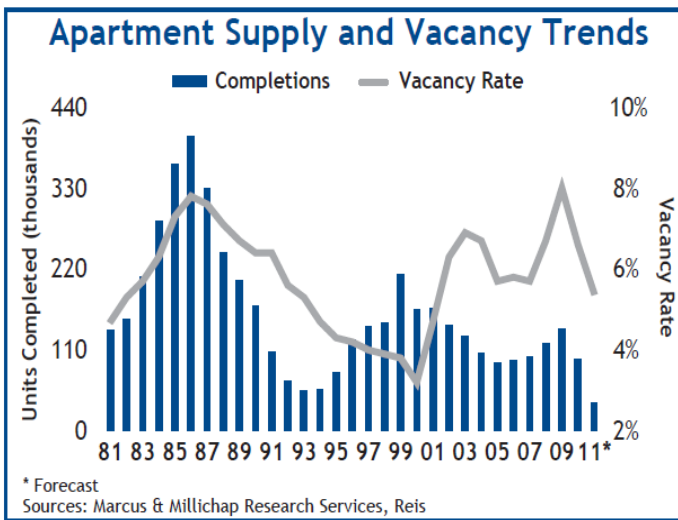
A major driver of the increasing success of multi-family properties is due to a variety of factors, including continued foreclosures, lackluster home sales, value declines and a sharp reduction in credit availability. By some estimates, lenders have foreclosed on more than three million homes since 2009.



The national homeownership rate was reported to be 66.3 percent in the third quarter 2011, which is a drop of 20 basis points from a year ago. This represents approximately 660,000 displaced owner-

occupied households within a three-month period. Despite record-low mortgage rates, single-family home sales volume and pricing remain 29 percent and 32 percent below the 2005 peak, respectively.

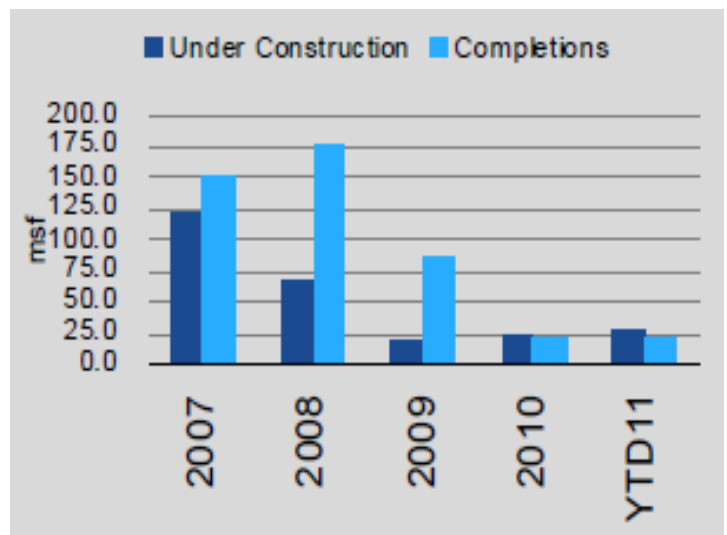
Apartments have overcome the slower economic environment by posting universal gains in net absorption. The sector secured significant reduction in vacancy and solid rent growth. Tight supply conditions will continue to bolster apartment performance, but apartments are thriving from profound shifts in demographic, economic and social patterns.



As payroll growth gains momentum, demand for apartments should progress at a consistent, yet slower pace. Looking forward, stronger employment growth will generate higher immigration levels, a critical component of rental demand, and growing ranks of Echo Boomers will continue to form new households.

### Industrial

The industrial real estate market began a slight rebound in the second half of 2010. Overall vacancy has steadily increased since that time, but a main driver is historically low construction levels. Approximately 21.9 million square feet was completed in 2010, of which 4.7 million square feet was speculative development.



This sector will move into the third year of positive momentum as sweeping improvements in apartment operations tighten vacancy across the country. Third-quarter 2011 apartment vacancy measured 5.6 percent, which is a 30-basis-point decline from the second quarter and measuring 150 basis points lower than one year ago. The apartment sector has moved into a moderate sustainable expansion.

Cap rates have declined as investors gravitated to higher risk/higher return strategies as evidenced in the pickup in transactions in secondary markets. The cap rate compression in primary markets has slowed as investors explore secondary and tertiary markets.

In addition to the reduction of available inventory, the industrial properties have now recorded four consecutive quarters of positive gains with 54 of the 67 industrial markets posting positive absorption. The constrained pipeline is a key difference in the current recovery. In the third quarter 2011, 9.3 million square feet of space was added to the market, bringing the year-to-year total for new construction to 21.8 msf.

## Conclusions

While the economy is expected to continue expanding, the overall pace of GDP growth is projected to be lackluster. Economic headwinds like historically high unemployment and uncertainty about the future fiscal, tax and regulatory environment must be resolved before a robust and sustained recovery can truly take hold.

With the recovery likely to remain slow in the near term, industrial demand, which depends heavily on rising consumer demand, will continue to improve, but at a measured pace.

*Joseph A. Furlong, Vice President &  
John Togneri, Associate  
Capital Markets Group*

# Commercial Servicing Rights Market Update

## Overview - Q4 2011

The commercial real estate market continues to struggle with significant amount of underperforming assets in most of the major property types. Delinquency rates rose during the second half of 2010, albeit at a more moderate pace than the first half of the year. CMBS delinquency rates (30+ days and REO) have slowly increased from 8.95% at the end of Q4 to 9.18% at the end of Q1 2011. In its most recent projections, Realpoint expects CMBS delinquencies continue to rise above 9% in 2011. CMBS loans in Special Servicing at the end of April 2011 amount to approximately \$88 billion, down from the trailing 12-month high of \$91.4 billion in September 2010. Delinquencies for the other investor groups have not been anywhere near as severe as the CMBS investor group. At March end, the 60+ days and REO delinquency rates were the following: Life Companies (0.14%), Fannie Mae (0.64%), Freddie Mac (0.36%), and Bank & Thrifts (4.18%). These modest levels are slightly less than reported at September-end 2010. As discussed in previous MIAC Perspectives, delinquencies have had little or no impact on the value of Agency MSRs. However, CMBS delinquency and default levels continue to have an impact on values through involuntary prepayments (defaults) and the resulting loss of servicing revenue.

## Commercial Servicing Supply

The overall volume of commercial servicing that was available for sale year-to-date has been extremely light, with the only real volume coming from new issuance CMBS. As previously reported, CMBS servicing supply was only \$37.5 billion as of November 2011, with the vast majority of the volume going exclusively to the large CMBS servicers. The forecasts from multiple CMBS research reports are estimating between \$40B –

\$45B of new CMBS issuance in 2012. This will mostly be absorbed by the top CMBS servicers.

## Market Demand

Market demand continues to remain strong among the top commercial servicers, especially for CMBS loans. This strength has been mostly driven by the lack of commercial servicing supply available to market participants and involuntary prepayments. However, demand continues to be weak among the middle-tier and small commercial servicers. This lack of demand has created a very thin secondary commercial MSR market, one that is highly dependent on the participation of the mega servicers for liquidity and ultimately market value.

## The Outlook for CMSRs in 2012

Market values for Commercial MSRs should be relatively flat in 2012. There are offsetting factors that will influence both the cost and revenue side of commercial servicing economics which include:

- Interest income on escrow and reserve balances have leveled off after a three- year period of declines due to a steep drop in the yield curve. Interest rates are not expected to increase dramatically from current levels in 2012 and should not impact market value.
- Low servicing replenishment rates at the mega-servicers will continue to be a driving factor in keeping the demand for CMSRs strong.
- Servicing costs have been rising over the past couple of years due to the increase of watch list loans, rising delinquencies and defaults, and slower workouts and liquidations.

- Prepayment rates are a bit of a wild card for 2012. In the CMBS sector, involuntary prepayments (defaults) will continue to decrease servicing income whereas the voluntary prepayments will likely be extremely slow due to the ongoing depressed market conditions in commercial securitizations. In the Agency sector, involuntary prepayments will again not be a noticeable factor in market values. However, voluntary prepayment rates for multifamily properties have been much faster than anticipated over the last 18 months due to the extremely low level of interest rates available for refinance. The question remains as to whether property dynamics and the overall economic climate remain flat or improve over the next year. Any improvement will allow more properties to enter the realm of potential refinance and that will hurt market values on existing commercial servicing portfolios.

There are some clouds on the horizon beyond 2012. Some volatility is to be expected as balloon maturity and default risk remains an issue for highly seasoned CMBS transactions as loans are unable to pay-off due to a combination of low DSCRs and/or high LTVs. The darkest cloud however is Basel III. Basel III capital limitations for MSRMs may put pressure on several of the large Bank owned mortgage servicers to reduce their overall mortgage servicing holdings. Since the CMSR market is largely driven by the strong demand by the mega-servicers any reduction in that demand could have a **dramatic** long term effect on CMSR values.

*Daniel Thomas*  
*Managing Director, Client Solutions Group*

## Residential Real Estate Outlook

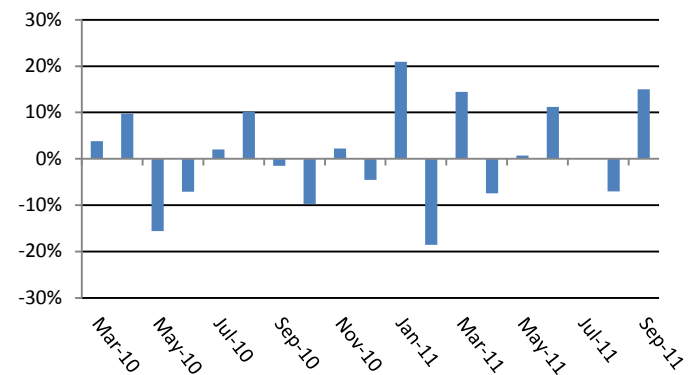
The recovery of real estate markets remains one of the principal goals of economic policy. In earlier downturns, housing recovered with the broader economy and has been an engine of growth because of the major role it plays in the monetary transmission mechanism. According to the National Income and Product Account Tables (NIPA) published by the Bureau of Economic Analysis, residential real estate has contributed, on average, twenty percent and ten percent of GDP growth in the first and second year of the last three economic recoveries. However, in this great recession, it has remained the major laggard, creating a negative feedback loop with unemployment to impede consumer spending and the overall growth of the United States. Lower home prices also impact the capital of financial institutions which take part in the real estate markets through direct lending or ownership of securities.

As a result, financial markets closely monitor the evolution of housing related indexes for improvement signals. In this context, positive data on September housing starts provided partial relief to some market participants. NAHB/Wells Fargo and Census Bureau/HUD figures showed a total gain of 15%. Nonetheless, to get an accurate assessment of the market's direction, it's worthwhile to understand three factors, namely: the forces underlying recent patterns in housing start figures, homeownership and rental demand. The resumption of foreclosure proceedings, which were mired down since October 2010, is also a major indicator shedding light on these trends. The aggregation of all these components reveals the importance of dissecting the gross housing starts figures. Such an analysis substantiates a momentous change of preferences from home ownership to renting. It will shape housing construction in the near term.

Housing starts measure the number of residential units where construction began for the said month.

The total number only includes new housing units. It is, therefore, a partial gauge of demand and supply dynamics within real estate markets. In principle, a sustained increase in new construction signals stronger demand which, in turn, pushes home prices higher. With this logic, September housing starts constituted positive news for the broader financial markets as they were surprisingly strong. As Figure 1 indicates, the month-over-month change was 15%, the highest growth since January of this year. Despite this surge, Figure 1 also illustrates the volatility of the month-to-month statistic. In comparison to pre-recession years, the absolute level of housing starts remains low. Hence, the positive month-over-month growth, which is an encouraging sign, needs to be analyzed in a new market environment.

**Figure 1: Month-over-Month Growth in Total Housing Starts**



Source: Bureau of the U.S. Census/HUD

The breakdown of the gross figures reveals dynamic favorable to multifamily properties. The units counted include detached and semi-detached properties, rowhouses and townhouses, apartments, a group of rooms or a single room intended for occupancy as separate living quarters. Therefore, it is natural to divide the aggregate figures between

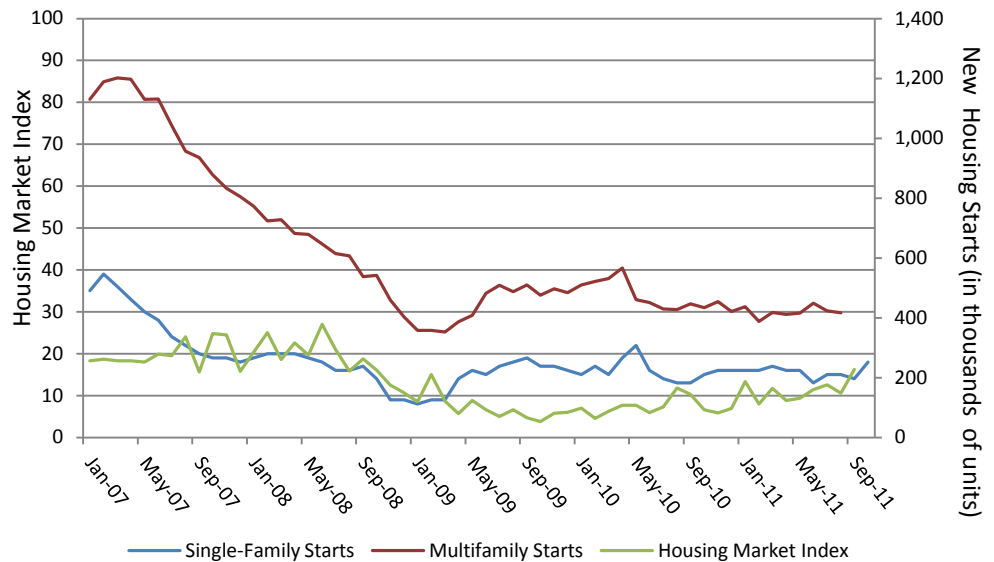
single and multifamily units. With this partition, the data reveals that single family starts have been flat for the last two years, leaving multifamily construction as the major driver of the index.

As illustrated in Figure 2, single unit construction reached a peak in early 2007 and has followed an overall declining trend since then, the first-time home buyer tax credit period providing a slight nod between Q2 2009 and Q2 2010. Figure 2 also reveals that single unit starts have stagnated since the summer of 2010. On the other hand, multifamily construction reached a minimum in October 2009 and has gained significant strength up to now.

Figure 3 illustrates an even more dramatic pattern. Year-over-year multifamily changes have been mostly positive since March 2007, while the same statistic for single unit construction was largely negative. This trend reflects a fundamental change from pre-recession times. Real estate market participants need to understand the economic and demographic forces behind these trends.

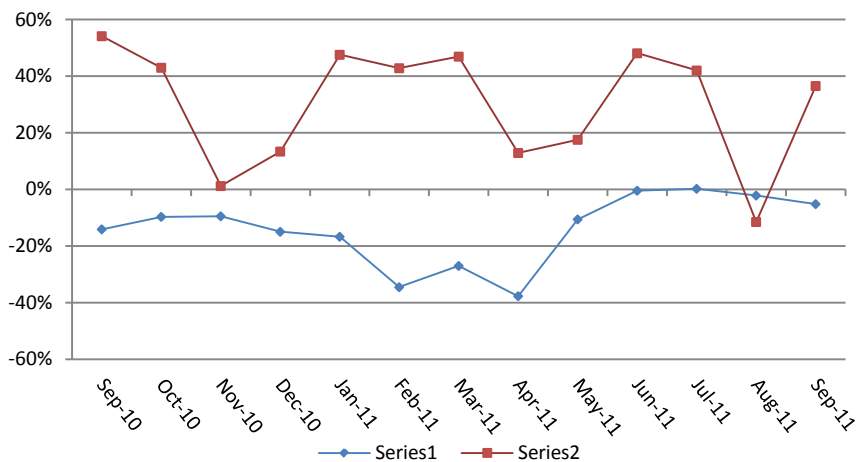
Whether the upward pattern in multifamily construction will positively affect housing prices depends on the attitude of buyers. Is the surge driven by rental demand or purchases for owner occupancy? The latter hypothesis is less probable as home purchase applications are still impaired and strict underwriting guidelines have restricted the opportunities to purchase new homes.

Figure 2: NAHB/Wells Fargo HMI and Family Starts



Source: Bureau of the U.S Census/HUD

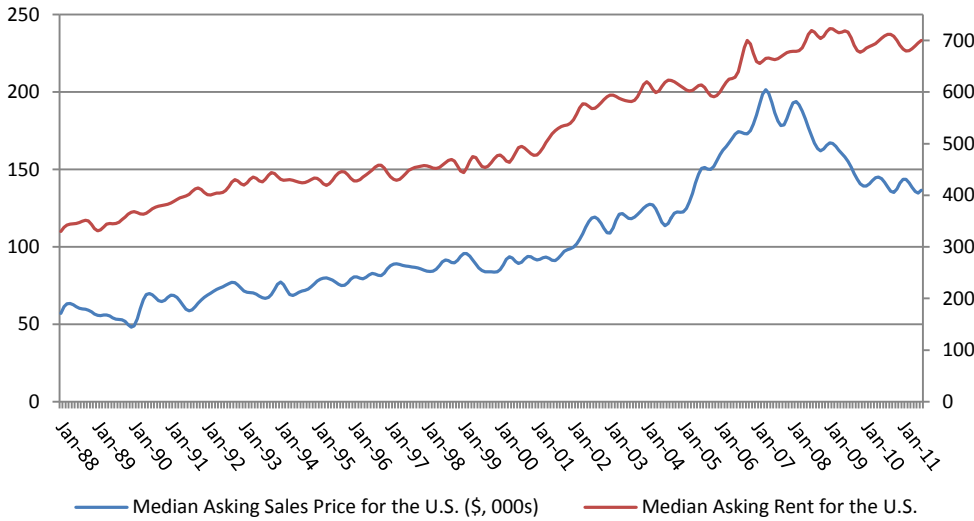
Figure 3: Year-to-Year Change in Housing Starts



Source: Bureau of the U.S Census/HUD

And even if, in theory, these new multifamily units are designed for purchases, data on rental prices suggest otherwise. The median asking sales price has been steadily dropping since 2008 while median asking rent has not Figure 4 (Next Page).

Figure 4: Median asking prices for home sales and rent



Source: Current Population Survey/Housing Vacancy Survey, Bureau of the U.S Census

In all likelihood, stronger demand for rental properties has increased rent prices which, in turn, incited an upswing in multifamily construction. The latest Current Price Index (CPI) figures published by the Bureau of Labor Statistics corroborate this hypothesis. Between August and September, the cost of primary residence rent has increased 0.2% and 2.1% year-to-year. The seasonally adjusted percent changes from the summer months were positive as well.

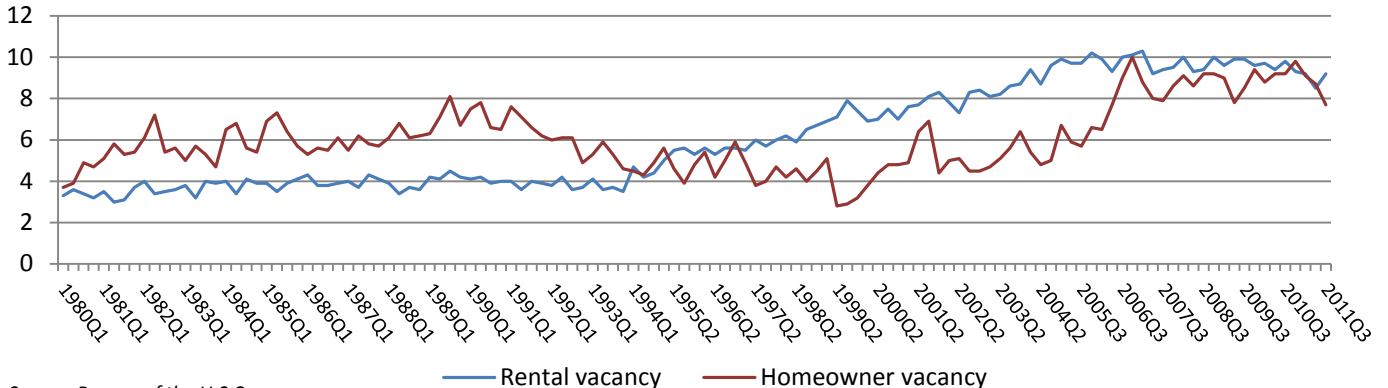
In addition, multifamily vacancy rates published by the US Census Bureau illustrate an interesting development. As illustrated in Figure 5, due to the foreclosure activity of recent years, homeowner vacancies increased to levels that surpassed the last

three recessions. Meanwhile, there was a pervasive increase in rental vacancy rates up to the fourth quarter of 2006, after which it stagnated below 10 percent.

The decline in rental vacancies could have two causes: a halt in multifamily construction and/or an increase in rental demand. The former is less plausible as we have previously shown that housing starts show a sustained growth in multifamily construction. Then the answer lies within rental demand. Data

on homeownership support this point. Absent significant declines in key demographic measures such as population and income growth, the level of homeownership has a negative correlation with rental demand. This scenario is concomitant to the current situation of the real estate market because the demographic picture of the United States has not changed since the crisis hit. The Census Bureau's monthly population estimates point to a population growth rate hovering between 0.79% and 0.91% for the 2006-2010 periods, hardly an indication of significant population growth. Likewise, U.S. Bureau of Economic Analysis data on personal income per capita indicate no material change in the last four years.

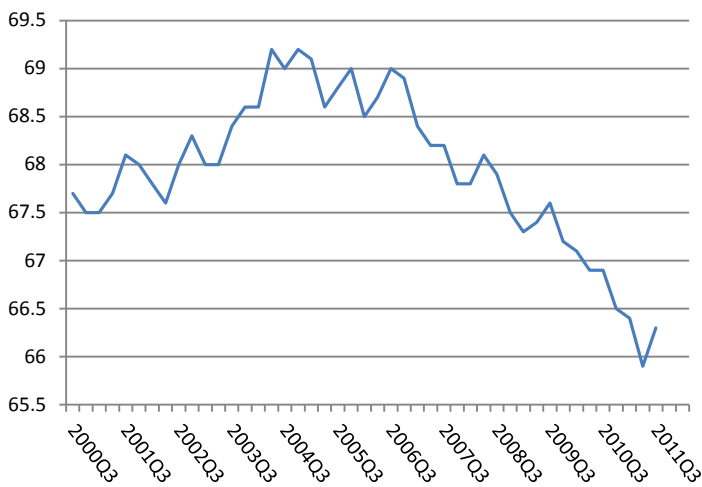
Figure 5: 5 Unit Vacancy Rates



Source: Bureau of the U.S Census

Figure 6 shows that homeownership rates reached a peak of 69.4% in the third quarter of 2009 and have declined by 310 basis points, to 66.3% in the same period of 2011. Recalling the aforementioned conditions on population and income growth, it is safe to conclude that higher rental demand is in fact the main force behind the decrease in rental vacancies and, by extension, on the pervasive hike in multifamily construction.

**Figure 6: US Homeownership rates**



Source: Current Population Survey, Bureau of the Census

Another confounding effect on housing starts in the medium term is the uptick in foreclosures. They have been mired down since the robo-signing controversy broke in October 2010. But, third quarter foreclosure activity has marginally increased, halting a trend of three consecutive decreases which date back to Q4 2010. In fact, the processing of the backlog of foreclosure properties will further reduce home prices and potentially reduce the profit margins in single family construction. This will reinforce the movement toward multifamily construction, for which demand depends on rent.

In summary, it is important to consider the demand and supply dynamics that underlie the overall figure of housing starts. Construction in single family units will decrease while servicers clear the foreclosure inventory. Hence, supply of newly constructed single unit houses will continue to slump while multifamily construction drives the housing starts index. An unprecedented upswing in rental demand will drive a momentous change in homeownership and housing starts. As the US economy emerges out of recession, for the foreseeable future, the fabric of residential housing will be tilted toward development in multifamily construction.

*Bassirou Sarr, Research Analyst  
Capital Markets Group*

## Mortgage Servicing Rights Market Update

Mortgage Rates since September have been relatively stable and range bound leading to Mortgage Servicing Rights (MSR) valuations that have also stayed in a fairly tight range of +/- 10 basis points over the past quarter. Most of our clients with lower coupon product have stayed within a +/- 5 basis point range. The 30-Year Fixed Rate Mortgage averaged 4.11% in September as per the Freddie Mac Primary Mortgage Rate (NMCMFUS), whereas it has averaged 3.99% in the latest November period.

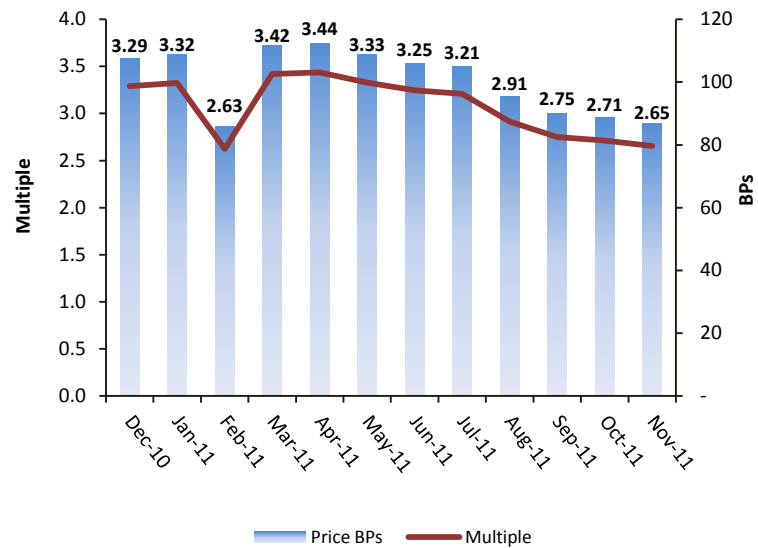
Prepayments in general have inched higher, with faster prepayments in general reducing MSR values slightly. Cusp coupon product with clean collateral attributes such as the 2009-2011 Agency cohorts are seeing more prepayment volatility than both the seasoned and the more credit impaired cohorts. The limited overall market breadth and strict underwriting standards remain, which is muting prepayments for the more credit impaired product.

Home prices remain fairly weak as stated in the latest Case Shiller reports that had the US Home Price Index down 3.90% year-over-year. On the other hand, the latest readings on Consumer Confidence were strong albeit the seasonal holiday period. The Conference Board Index on Consumer Confidence registered its highest monthly gain since 2003. This gauge was in addition to the higher confidence readings of the University of Michigan index of consumer sentiment.

Figure 1 displays results that were derived through MIAC® hypothetical auction process, which analyzes a select group of Generic Servicing Assets that collectively simulate the agency market cohorts as a whole. Participating firms, which mainly represent large to middle tier servicers, submit Mortgage Servicing Rights values to MIAC for each cohort, which reflects what they would pay for a similar asset if offered in the marketplace today. As a

participating member, firms receive beneficial market feedback that includes high, low, and median values and how member firms' values compare to each of these benchmarks.

Figure 1: 30-year Fixed GSA Pricing



Source: MIAC Analytics®

As the chart above depicts, from August to November, GSA portfolio values are down by approximately one quarter of a multiple or on average 6 to 9 basis points. MSR transactions have been concentrated in some large Agency and Non-Agency purchases. Some smaller MSR transactions have been in the market with most transactions occurring on low seasoned product. We continue to see a wider bid/ask spread on market executions than historical past. Continued discussions on funding costs tied to servicing advances, prepayment performance versus model derived prepayment projections, Basel III, and balance sheet issues are being factored into the MSR markets and have led to market execution pricing in general being lower than cash flow based values.

Mark-to-Market Loan-to-Values continue to be a good indication of portfolio performance.

Delinquent loans continue to drive values lower due to the increased costs to service associated with these loans, and the respective funding of the delinquent advances.

Lastly, the increased cost to refinance a loan, and the increased regulatory and compliance hurdles will continue to be monitored for its impact to the Mortgage Servicing Rights Asset.

The major drivers and commentary regarding mortgage delinquencies, prepayment projections, and earnings rates are listed below. Additionally we discuss some of the mortgage news concerning HARP and the proposals on Mortgage Service Fees in the MSR Modeling Corner.

### **Mortgage Delinquencies**

The delinquency rate for mortgage loans on one-to-four-unit residential properties dropped to a seasonally adjusted rate of 7.99% as of the end of the third quarter of 2011 according to the MBA. This represents a 5% improvement over the second quarter of 2011 level of 8.44%. The delinquency rate includes loans that are 30 or more days past due, but does not incorporate loans in foreclosure.

The percentage of loans in foreclosure at the end of the third quarter was 4.43 percent and stable with the previous second quarter results. While this number has labored and is not showing nearly the improvement that delinquencies are showing, for now, foreclosure percentages are at least displaying some stability at current levels according to the latest MBA survey results.

### **Mortgage Prepayment Speeds**

For the last 5 years, primary/secondary spreads averaged approximately 63 basis points with spreads at times reaching as high as 144 basis points. At a current spread of 90 basis points, the primary/secondary spread has widened significantly from the 5-year median of 64 basis points. In assessing a Mortgage Servicing Rights value, it is

critical that one incorporates the true refinance rate as opposed to a secondary rate plus a constant spread; otherwise, one runs the risk of over inflating pre-pay speeds.

Prepayments remain a credit driven event, as tight underwriting standards and lack of refinance ability remain driving factors for the majority of borrowers outside of the top tier borrowers. Continued weak housing and high unemployment continue to play a hand in muting prepayments for the majority of mortgage products.

Policy risk may impact the future outlook for prepayments. A continued push by Washington for lower mortgage rates, adjusted guidelines making access to refinancing slightly less stringent (HARP) and a continued trend for mortgage rates staying near or through historical mortgage rate lows are just a few examples that may impact prepayments.

Further performance variances among servicers based on their collateral attributes and internal policies provide additional volatility in terms of forecasting prepayments, so servicer specific prepayment risk is becoming more relevant.

### **Escrow Earnings Rates**

Escrow earnings rates have been range bound in the past few months and saw significant reduction in rates from the Second Quarter Period. Quarter-over-Quarter Escrow rates based on the Three Year and Five Year Swap Rates have in general been flat on the Five Year Swap. September Month-End Swap Rates were 74 basis points and 126 basis points respectively on the Three and Five Year Swap Rate. November Swap Rates were 89 basis points and 134 basis points.

The slight back-up in escrow earning rates resulted in a slight uptick in the Float income streams on MSR values.

## MIAC Modeling Corner

### HARP Loans and the FHFA Proposed Fee Structure

Discussions concerning the new HARP structure have been discussed at length. Outlined below are some of the major modeling points and their impact on MSR values for HARP eligible loans.

In general, we isolate base on the eligibility requirements on HARP as follows;

- 1) The mortgage must be owned or guaranteed by Freddie Mac or Fannie Mae.
- 2) The mortgage must have been sold to Fannie Mae or Freddie Mac on or before May 31, 2009.
- 3) The mortgage cannot have been refinanced under HARP previously, unless it is a Fannie Mae loan that was refinanced under HARP from March-May, 2009.
- 4) The current loan-to-value (LTV) ratio must be greater than 80%.
- 5) The borrower must be current on the mortgage at the time of the refinance, with no late payment in the past six months and no more than one late payment in the past 12 months

Much has been written about the changes relating to Representations & Warrants and HARP. Overall there has been a slight easing in Representations & Warrants.

Some of the key points include the following:

- 1) Rep and Warranty relief
- 2) Verbal verification of employment and source of income
- 3) Reduction/Elimination of Loan Level Pricing Adjusters (LLPA's)

MIAC's® WinOAS™ MSR valuation model can isolate HARP eligible loans based on the specific HARP criteria. Portfolio performance and overall collateral and borrower characteristics are adjusted to take into consideration HARP, namely faster baseline speeds over non HARP eligible product of similar collateral attributes.

### Servicing Compensation Proposals

Lastly, we provide highlights on the proposals on the revised servicer compensation structure. MIAC® would like to offer observations on the impact of a change to the servicing fee structure. The current servicing compensation options have room for improvement when it comes to delinquent mortgage servicing rights. Changing the servicing fee from its current form may have implications in terms of asset values, modeling risk, prepayment performance, hedging strategies, and capital and risk structures to name a few. We discussed many of the pros and cons of the various options in a white paper released in April of this year, and will now focus our attention on the major proposals that have been making rounds in the industry. Please see our previously released white paper on this subject at: <http://www.miacanalytics.com/aboutmiacnews/AlternativeServicingFeeProposal>

- 1) **Existing Service Fee Structure:** Leaving the current servicing fee (SFee) structure as is. Generic Minimum Service Fee (SFee) rate of 25 basis points;
- 2) **Lowering to a Minimum Service Fee:** This would still be a part of the balance sheet asset, but kept at a minimum of say 20.0 basis points and creating a reserve account to handle future delinquencies and losses;
- 3) **Creating a Fee for Service structure,** where the servicer is paid a set amount for servicing performing loans and a set amount for servicing delinquent loans.

### Proposal One: Keep the Service Fee Structure as is with no changes

In considering the existing service fee structure, there has been debate over whether the current service fee levels are too high in comparison to the services delivered. One argument is that due to 'economies' of scale, the servicers are generating too much service fee income premiums given the administrative work to service loans.

Another argument is that incentives are not properly aligned and should be redesigned to reflect the reduced cost on current loans and the increased cost on delinquent loans. However, in discussions with many servicers, servicing costs have increased as the financial landscape over the past few years has continued to evolve.

Increased regulatory compliance costs, delinquency advance costs, repurchase risk exposure, system modifications and increased time spent servicing the portfolio have all resulted in stress on the profit margins of many servicers. This point is outlined in more detail below.

Historically, Servicing Fee revenue steams steadily increased as average loan balances on newly originated loans were on the rise. The additional revenue helped to offset increasing costs, but as loan balances began to decline, so did the profit margins.

Many servicers' business models were built on automated, turnkey processes to create economies of scale. However, once servicing portfolio performance started to deteriorate, associated expenses increased, while the income side of the cash flow servicing rights equation stayed constant or even lessened.

In cases where delinquencies increased, servicing advances ballooned to advance the principal and interest on the delinquent loans. Performing Loan Servicing Fee Revenue decreased as more loans became highly delinquent. In general, on GSE loans, less late fee income was generated on the severely

delinquent loans, float income decreased as market rates declined, and servicing income, which represents approximately 70% to 85% of the revenue side of the cash flow, was reduced. Service fee revenue in general declines over time while expenses increase. Increasing delinquencies and lower quality credit product caused by better quality product leaving the portfolio are some of the reasons for this occurrence.

In terms of the GSE servicer, many of the cash flow revenues have diminishing returns, meaning higher initial cash flows (revenues) with low initial costs (expenses) in the beginning life of the mortgage servicing rights portfolio. As the portfolio ages and delinquencies increase, the servicer collects less service fee revenue while his cost structure (expenses) increases to handle delinquent loans. Often, the servicing fee revenue streams in addition to the revenue from late fee income, escrow float earnings and cross selling opportunities that added additional ancillary income may not be enough to offset the expenses at a certain delinquency threshold.

### Proposal Two: Lower the Service Fee and Create a Reserve Account for future delinquencies and Losses

Another proposal is to take the 25 basis point servicing fee strip and distribute it into two components. There would be a 20 Basis point strip and the remaining 5 Basis Points would be placed in a Cash Reserve Account to handle future delinquencies and losses. In this proposal, the 5 Basis points are anticipated to cover the compensation for delinquent loans. The servicer will have a few options: they could service these delinquent loans in-house, preferably in a separate loss mitigation division, or have them subserviced at a specialty servicing shop. Additionally, any unused reserve would be released to the owner of the servicing rights. In concept, the approach has merit. The difficulty is ascertaining the proper coverage so that a servicer is not putting too much aside in

reserves nor not putting aside enough in reserves to cover delinquency costs.

The accumulated risk based reserves will aid the investor, classified as the GSE's or the Private Label Originator, as they will accumulate more credit reserves to offset future collateral delinquencies or losses. First line losses should be covered by this increased insurance fund reserve. This reserve (insurance) fund will benefit from the originator having more skin in the game, thereby reducing investor losses. As borrower credit profiles decline, increased reserves may be set aside to allow for the increased projected losses.

### Proposal Three: Fee for Service

In the fee for service proposal, the guarantor would have a set dollar fee to service a loan for both performing and non performing loans. Because performing loans in general have a low cost structure, the amount set aside may be small such as \$10.00 per month. The performing servicing fees would be reassessed to account for changes in the servicing requirements.

Nonperforming loans would receive a separate compensation and most likely would be incentive and performance based.

### **Servicer Impacts from Proposal Two & Three**

Smaller servicers that did not have performance issues, namely delinquency and advance issues, will have a significant reduction in revenue income derived from the reduced service fee. Given their higher servicing cost structure, higher market yield requirements, and higher capital costs, the smaller servicer may find that reduced MSR's no longer cover the risk in owning mortgage servicing rights. Prepayment volatility will still be a factor, albeit it will have a smaller impact to overall values given the reduced service fee.

In Figure 2 (*Next Page*), MIAC® demonstrates the impact to the servicer with various cost structures,

default projections, and prepayment scenarios. In our servicing cost example, refer to the \$100 marginal cost projection for a small servicer.

Additionally, the smaller servicer often does not service the loan internally on their own servicing platform and may use a sub-servicer. This frequently results in revenue streams exclusive of service fee income (namely, late fee, ancillary income, and float income) being partially or fully passed through to the subservicer. Higher expenses (servicing costs, funding costs) with less revenue offset (late fee, float, and ancillary income) may result in fewer lenders being able to continue holding MSR's. The smaller servicer may hold a smaller portion of MSR's and/or may sell the MSR's servicing released (AOT).

The end result is likely to be fewer servicers. The risk is that all servicing is eventually congregated with a few, large investors that have robust enough cross selling operations that make servicing for reduced revenue possible to stay in the servicing business. A business line that has for years been driven by economies of scale will become even more so. Additionally, most lenders consider the home mortgage a central part of the customer relationship from which many other mutually profitable relationships are formed (e.g., checking, savings, money market, credit card accounts, etc.) Most lenders agree that not managing the mortgage servicing relationship frequently results in losing the customer altogether to larger servicing institutions over time. Small originators will have diminished customer relationships. Additionally, servicing congregated at only a handful of servicers puts taxpayers at further risk of investors becoming "Too Big to Fail". Whether the eight-hundred pound gorilla investor is public or private, their value and risk to the overall economy will be increased and undeniable.

Large servicers should experience more positives than negatives. On the assumption that large

servicers (namely banks) have cheap access to capital, lower servicing costs due to economies of scale, and in general lower yield requirements, these large servicers should still be able to make a profit on the performing MSR, (albeit at a reduced service fee revenue projection). However, late fee income, float income, and ancillary income resulting in fewer cross selling opportunities will again, disadvantage the smaller servicer.

In addition, the large servicers tend to have hedging programs in place to manage the interest rate prepayment exposure and earnings volatility. By having a smaller service fee and hence MSR financial exposure, the large servicer may not require as active a hedging strategy and profile, thereby resulting in decreased hedging costs and overall expenses. Some of the reduction in revenue from the reduced servicing fee may be offset by these lower expenses (hedging costs).

Additionally, with a lower value assigned to the MSR, the mortgage servicer's balance sheet related to MSR would be reduced, a positive for Tier1 regulatory capital requirements under Basel III.

In our servicing cost example, refer to Figure 2 under the \$50 marginal cost projection.

Overall impact to the servicing market of a reduced service fee and the use of a risk-based tiered reserve may promote higher quality originations. Higher risk collateral that would already incorporate higher mortgage market rates would incur a higher reserve structure resulting in higher note rates (premium coupon) product. From a servicing standpoint, this high premium coupon product would have lower servicing values for at market and below market rate mortgage servicing rights.

Modeling the correct reserve to correspond to the delinquency and credit loss projection will become very important so as not to overcharge or undercharge the borrower for the perceived risk exposure to delinquencies and losses. MSR values will be attributed to the projected performance and collateral attributes of the servicing asset.

Figure 2: Payment Projections

	Cost @ \$50 CPR @ 10	Cost @ \$50 CPR @ 15	Cost @ \$50 CPR @ 20	Cost @ \$50 CPR @ 30	Cost @ \$75 CPR @ 10	Cost @ \$75 CPR @ 15	Cost @ \$75 CPR @ 20	Cost @ \$75 CPR @ 30	Cost @ \$100 CPR @ 10	Cost @ \$100 CPR @ 15	Cost @ \$100 CPR @ 20	Cost @ \$100 CPR @ 30
	<b>BPs</b>				<b>BPs</b>				<b>BPs</b>			
0.000%	(2.0)	(1.3)	(0.8)	0.1	(8.6)	(6.4)	(4.8)	(2.8)	(15.2)	(11.5)	(8.9)	(5.7)
0.050%	20.4	16.7	14.1	10.8	13.8	11.6	10.0	8.0	7.3	6.6	6.0	5.1
0.125%	54.1	43.7	36.4	27.0	47.5	38.7	32.4	24.1	41.0	33.6	28.3	21.2
0.150%	65.3	52.7	43.9	32.3	58.7	47.7	39.8	29.5	52.2	42.6	35.7	26.6
0.250%	110.2	88.8	73.7	53.9	103.6	83.7	69.6	51.1	97.1	78.6	65.5	48.1
	<b>Multiple</b>				<b>Multiple</b>				<b>Multiple</b>			
0.000%	-	-	-	-	-	-	-	-	-	-	-	-
0.050%	4.08	3.34	2.82	2.16	2.76	2.32	2.00	1.60	1.46	1.32	1.20	1.02
0.125%	4.33	3.50	2.91	2.16	3.80	3.10	2.59	1.93	3.28	2.69	2.26	1.70
0.150%	4.35	3.51	2.93	2.15	3.91	3.18	2.65	1.97	3.48	2.84	2.38	1.77
0.250%	4.41	3.55	2.95	2.16	4.14	3.35	2.78	2.04	3.88	3.14	2.62	1.92

Source: MIAC Analytics®

## Conclusion

We discussed the overall market and the drivers that we will continue to monitor in 2012. Prepayment Volatility may continue to be a factor as the market

gathers new evidence of the regulatory landscape coming out of Washington and its impact on markets. Continued debate on housing, delinquency

performance and proactive measures to clean up the housing overstock will continue for some time. We see this as continued headwinds that may make 2012 quite similar to the performance that we have seen throughout 2011. The service fee compensation proposals have some positive aspects. At the same time, no one method in and of itself provides a key for making the current servicing method obsolete. Based on the recent vintage outperformance and strong collateral attributes, at times it seems the industry is recommending changes that still warrant further inspection. Some of these changes will result in a significant changing of the mortgage landscape in its current form.

We remain optimistic that models and modeling tools along with hard fought experience in these financial markets will continue to create possibilities and opportunity. We look forward to continued service in working with you.

*Robert Lee, Director &  
Michael Carnes, Vice President  
Capital Markets Group*

## Inside Ginnie Mae®

MIAC® recently interviewed Ted Tozer, President of Ginnie Mae, for its publication Perspectives. Under Ted's careful direction, Ginnie Mae has grown to more than \$1 trillion in MBS, assuming a greater role in the secondary mortgage market as Fannie Mae and Freddie Mac regain their footing. What stands out from the interview is not just Ginnie Mae's commitment to doing things differently than it has in the past, but also its commitment to moving forward. Following Ted's lead, customer service at Ginnie Mae is paramount in following this new direction forward. What follows is the heart of that conversation with one of the most influential people in today's housing market.

### Interview with Ted Tozer

**MIAC®:** Looking back over the last year and a half, what do you see as most memorable during your tenure to-date at Ginnie Mae? Also, what do you see in the coming year with regard to those things most critical to you and the agency?

**Tozer:** *The thing that I've been most proud of is our ability to deliver significant accomplishments toward becoming more customer-centric. For, example, we've been able to build up our account executive staff so that they can service our issuers better. This has been facilitated by an impressive amount of ongoing support from the Administration. This support has come not just from the HUD Secretary, but also from the Office of Management and Budget. OMB has been very helpful, so I really can't stress enough how the Administration has provided significant support in buying into this concept. We've pretty much been given a free hand, and have been trusted to do what's right. I think that speaks well of the Ginnie Mae organization.*

*Also, Congress has been supportive with passage of the 2012 HUD budget. Congress is allowing us greater autonomy by removing Ginnie Mae from the HUD*

*budget. And what's interesting about our budget is that when one looks at HUD, Congress is relatively specific about how the money should be spent. Congress allocates specific amounts money for the block grant program, so much money for designated items. With us, they said "Here's your money; you can spend it how you think best, for salaries and other necessary expenditures to do what you think is appropriate."*

*The biggest thing I've talked to folks about on Capitol Hill and at OMB is that Ginnie Mae is evolving. We're really trying to change the organization, and we need the flexibility to be able to hire contractors if we need to, hire the talent we need to, and introduce a more efficient and customer –centric style of management. Congress has been very supportive of this approach; it is an incredibly positive development. At first I was concerned that I would run into a lot of roadblocks. But once I laid out for people the vision of where I think Ginnie Mae needed to go, I think everybody's bought into it, and I've had very little resistance. Of course our financial results help a lot. When you're consistently earning money for taxpayers that gives you a bit more latitude. Congress, OMB, our HUD Secretary and others are letting us do what we think is best to get the job done.*

**MIAC®:** As you talk about hiring additional Account Executives and bringing in the private sector elements that you need, it sounds like you've accomplished a lot since you've been with Ginnie Mae. As you look toward the coming year, where will your focus be?

**Tozer:** *My focus will be on continuing to find ways to better meet the needs of our issuer base. Just like the concept of our recognition agreement, doing our single loan pooling and other progressive things we've done this year. Continuing to provide more outreach to our issuers, especially now with the transition the industry's going through is key. For example, Bank of*

America getting out of the third party the business has now changed the whole complexion of selling to aggregators, and many lenders are now deciding to service. I was talking to our person responsible for issuer application review and he said right now we've got 80 applications pending to become issuers. That's just incredible, considering that our whole issuer base, when I joined Ginnie Mae, was less than 300 issuers and we've got 80 applications just in the pipeline. And we approved 33 new applicants this past year. Bringing all those new people on board will create challenges for us as far as giving them service but I'm committed to making sure we have the staff to service them properly.

We also are reviewing our operational systems to make sure they're state of the art. We've got a multi-year project underway to completely replace our old systems that date back to the 1970s with up-to-date systems. We'll continue that into 2012. We're also reviewing our risk management structure again, now that we have a portfolio of \$1.2 trillion. The goal is to keep Ginnie Mae moving forward. We just have so many things going on right now. I think that's the reason we've been able to recruit a lot of high quality people. I think people are excited about the things we're trying to do, and I think that's part of the draw.

**MIAC®:** You've talked about what you've been doing since the beginning of your tenure and what you're going to do over the next year or so. It's clear you really want to bring Ginnie Mae more into the 21st Century in terms of systems and people and becoming more customer-centric. Are there strategic goals beyond these that you're focused on for the next five years?

**Tozer:** Beyond those key goals, our biggest concern is risk management, simply because we're the custodians of the U.S. Guaranty. As we get bigger and we take on more and more issuers, it's essential we have the risk management regimen we need to make sure we really know who's in the program, how they're doing and to be able to have an early warning

system in place when issuers are in trouble. We just need to keep evolving all those aspects of our business to make sure we're able to give great customer service, whether it's to the investment community that's buying the Ginnie Maes, the issuers, or to the tax-payer by protecting them or actually making as much money as we can for them by minimizing the losses we're going to have from the Guaranty being called upon.

**MIAC®:** Speaking of the Guaranty, as you know there was recently an audit and subsequent report on FHA's Mutual Money Insurance Fund (MMIF) and the results were positive. However, some of the reports in the industry press question whether the fund will be sufficient to cover losses from mortgages with a vintage prior to 2009. What are your thoughts on whether the MMIF reserves are sufficient to cover future potential losses?

**Tozer:** The actuaries have indicated that there is still a cushion. Even though that cushion is not what we'd like to see, it appears that there are adequate funds there, so I have no reason to question the actuarial analysis that was done. And keep in mind that whatever the findings, it in no way impacts Ginnie Mae's ability to protect the Guaranty.

Which brings to mind another five-year goal: One of the biggest challenges I have is getting people to understand that our business model is not tied to FHA. That truly our model is simply to leverage the government guaranty to create a homogenous security that can trade in a TBA environment so that investors can buy a billion dollars worth of securities and not worry about whether they're in Arizona or Utah. It also facilitates foreign investment in the U.S. housing market. That's basically our model and I don't think a lot of people really understand that.

**MIAC®:** Speaking of the Guaranty, you mentioned risk management earlier. Are there specific things you can share that you're doing with regard to improving your risk management infrastructure as you grow?

**Tozer:** *We're bringing people on staff that are modelers to be able to do things like run different economic scenarios against our issuers to find out, for example, if employment goes up by 'X' or the economy slows down by 'Y', what level of delinquencies we might anticipate, as well as what impact various other stresses may have on our portfolio. So, ultimately, the goal is to become stochastic in our modeling to improve our predictive capability. A lot of our models were built back when Ginnie Mae had \$400 or \$500 billion worth of bonds outstanding and now we're \$1.2 trillion. We really need to improve this process to be more sophisticated in how we're analyzing our issuers, especially as we bring on more and more issuers. Before, when we had this domination of four or five major issuers: Chase, Well Fargo— they're going to be around no matter what – but as we're starting to see deconsolidation, we need to have sophisticated models to really understand independent mortgage bankers, so we can try to get involved early in their business challenges. The goal is not to put them out of business, but to help them remediate. My goal is, if we spot someone in trouble because of our modeling, we work with them to try to figure how can we keep them solvent and so that the institution can remain a good partner with Ginnie Mae into the future.*

**MIAC®:** One of the things you talked about is that you're seeing an increase in the number of people interested in becoming Ginnie Mae approved and you've brought on more people to help with that process. Has the approval process itself changed?

**Tozer:** *The only new approval criteria is our requiring more capital and for the first time this past year we've required that part of the capital actually be liquid. Ginnie Mae issuers have got to be able to make those delinquent payments. For example, a servicer that has a lot of MSR on their books could have plenty of capital, but now we're requiring that a substantial percentage of the capital be liquid to ensure that they can make those P&I payments.*

**MIAC®:** Regarding upcoming changes to the servicing fee structure, Ginnie Mae has decided to keep their structure as it is. As you know, FHFA is considering changing that fee structure to either a pay for service fee model or another model where servicers still earn 25 BPs, but 5 basis points would be set aside for potential troubled loans. Can you comment on the role you believe servicers are providing and how they should be compensated for that?

**Tozer:** *As far as the servicer responsibility, going back to all my years in the business, a mortgage borrower was also a bank customer and was treated that way. But when we began to consolidate servicing, borrowers went from being a relationship to a transaction. Once they became a transaction, doing the right thing became less important, and it became about dollars and cents. So, I think some servicers need to take a step back and look at borrowers in the context of the relationship; they are a partner and a customer. It's just common sense. For example, I was looking through some drafts on the servicing standards that we kicked around here with some other agencies in Washington and one point listed was the timely application of P&I payments; to me, that seems pretty standard, but I guess some servicers must not have been doing that. Another was the idea of returning phone calls within two days. In my mind, that's your customer; you should be doing that anyway.*

*From the perspective of some servicers, it could all be about cost, because over the last ten, fifteen years, servicing costs have been driven down. Everyone has prided themselves on how low their servicing costs were, so they could have the biggest MSR they could, which could subsidize their front-end production as much as possible. I think that's the death spiral we're in. Hopefully we can turn that around so that servicing departments have as much money allocated to them as they need to provide the proper customer service and not to simply manage servicing cost in the least expensive manner possible. That's where I'm*

hoping that all this comes back to, of doing what's right for the customer.

As far as how servicers are compensated, whether it's done from an IO strip or dollar per loan, in theory, who knows which approach is best? I think each servicer needs to look at its own issues. I think perhaps what's most important is that the idea of front-loading all your income to try to not allocate that money for servicing is a mistake. I think we need to all realize that it does cost to provide good customer service and if it means the MSR gets smaller, then it gets smaller. Another question is what this new structure does to new entrants trying to hedge their MSR and the costs they're going to incur. I think this gets back to the question you raised about the 25 basis points with part of it held in reserve. Should the 25 basis points be 20? Again, who knows what the number should be? But maybe we should pull back a little bit just to minimize some of the MSR's that are being created, just to help with hedging.. Hopefully, that's input the industry gives to FHFA. We need servicers to explain how comfortably they're managing the MSR and how much capital they need to support the asset. It's a long term decision we're making here and that's why I'd encourage everyone to spend the appropriate amount of time explaining their organization's concerns, explaining what's unique about their organizations, and educating FHFA on what the appropriate thing to do is.

**MIAC®:** You did a press release at the MBA annual on the new parameters for the acknowledgment agreement. Basically, Ginnie Mae no longer requires creditors to name a stand-by Issuer when an Acknowledgment Agreement is executed. Instead, when a portfolio needs to be transferred, the creditor is given the opportunity to identify an approved Ginnie Mae Issuer to assume the portfolio. In exchange for limiting its ability to refuse a transfer of servicing, Ginnie Mae requires the creditor to accept the portfolio. What kind of reaction are you getting and what are you seeing so

far with regard to your issuers and the rest of the industry?

**Tozer:** The initial response we're getting is very positive, everybody is very happy about the concept of being able to leverage up their MSR asset because as I've said, for independent mortgage bankers, that's probably one of the largest assets on their balance sheet, so this helps them achieve the liquidity they need. We're getting a good response from major lenders. We've been tweaking it a little here and there, but we worked with the major lenders and we're very close to finalizing this with a number of them. I also think it's of interest to the GSE's, because I was talking to one lender and he stated that now Fannie Mae said they're willing to do what we're doing. But, Fannie Mae's approach is apparently a little bit different, because they have to enforce reps and warrants, they will need to reserve some portion of the MSR for their protection. For example, I understand they're stating that the first "X" percentage UPB goes to Fannie and the default, and the rest goes to the warehouse lender; they understand that the lender needs something to cover their rep and warrant obligations. So we may have actually opened up a door for the industry. GSE's historically have never wanted to give up their rights; possibly our doing this has now got the GSE's acknowledging that this does improve liquidity.

**MIAC®:** It sounds like you've been able to get the industry to think about the whole process differently.

**Tozer:** Well, you know, my issue is I just really feel that the independent mortgage bankers have got to be supported. We've got so many independent mortgage bankers that, because of the timelines for foreclosures, are just really having a hard time right now and I just hate to have a whole segment of the industry wiped out. That's why I think this issue of getting liquidity to them is so critical. I would just love for them to get through this rough patch, whatever it's going to take, to work through these borrower-related bankruptcies and foreclosures. Once we're

through that, at that point they can continue to be a good part in the industry. I think relying 100 percent on banks isn't all bad, but still the independent mortgage banker, over the years, have always been kind of a stabilizing force; it seemed like they always helped to keep the banks in check because of their entrepreneurial spirit. I'd love to have the independent mortgage bankers remain a vital piece of the industry. Having independent mortgage bankers in our local communities compete with banks helps to keep the industry very competitive, and of course borrowers benefit from that.

**MIAC®:** Thinking a little bit about the role of government in the mortgage industry and with an eye toward Fannie and Freddie, we know that what happens to Fannie and Freddie is anyone's guess at this point, but do you have an opinion on what you think might be a good compromise with regard to their role or, for that matter, the government's role in general, in the market?

**Tozer:** Well, I think I can say just from my time here at Ginnie Mae that it seems like the place the government really has positive impact is around the issue of liquidity, not so much from the standpoint of the borrower but for the market in general. I was shocked to see how quickly the U.S. housing market has grown. I think right around 2000 or 2001 there were \$3 trillion worth of mortgages outstanding, and now we're at over \$10 trillion. I think the idea of being able to raise capital internationally to finance the market requires government support. However, when it comes down to credit risk, borrower credit risk, I think that's where you've got to ask yourself the question: "How much of our housing market should carry credit enhancement provided by government? Traditionally we have focused on first time home buyers, and low and moderate income persons.

The average borrower should be able to obtain credit without a whole lot of support or risk to the government. However, you do need government support to provide borrowers with low interest rate

financing. So as we think about the future role of government, I think we need to consider delinking government support of credit risk and interest rate risk. The GSE model provided implicit government guaranty of both of kinds of risk. But it doesn't have to be that way. Government support of interest rate risk and credit risk can be separated. A guaranty can be used to provide credit enhancement to encourage lenders to make loans and a separate guaranty can be provided for the interest risk. The guaranty of interest rate risk assures bond holders that they will always receive payment and as a result encourages the flow of capital.

Until I came to Ginnie Mae, I never really appreciated how capital around the world moves so quickly between borders. The government guaranty on securities is what allows that money to be moved so quickly. Holders of big blocks of capital don't have to do a lot of analysis on the credit risk because they're relying on the government guaranty. However, I think the government guaranty should be of last resort and should support bond holders. The question is how does one draw the line so that the government is strictly there as a catastrophic backstop that protects the bond investor and the overall process has other industry players with skin in the game? It should be a limited guaranty for borrowers and for lenders. However, Fannie and Freddie being were on the line for dollar one, I think that's where our current system broke down.

**MIAC®:** What do you think it would take to get private investors back in the market today?

**Tozer:** First of all, I think the biggest thing is that investors need to feel that home prices are starting to stabilize to some degree. As a private investor, it's hard to determine whether your credit enhancement is adequate without knowing how much the collateral is going to deteriorate in value. Economic stability is critical as well. Borrowers may look great on paper, but as long as there is the possibility they could lose their job tomorrow, private investors will remain

hesitant. Additionally, based on conversations I've had with private investors, they feel there has to be more oversight of the issuer's originators. A lot of them feel that no one has been looking out for the private investor. In some cases, they feel that the trustees weren't enforcing the reps and warrants, so if somebody didn't play by the rules, the private investors ended up taking the hit.

Ideally, there would be some sort of intermediary looking out for both sides that would be willing to say to the seller "You need to repurchase this loan" or to the investor, "Yes, this lender's delinquencies are high, but they loaned appropriately, and an entire community was laid off when GM closed a plant." Someone needs to make those kinds of calls. Right now, private investors don't feel like they're getting their day in court. Servicers are scared to death because they're worried that every loan that goes delinquent now will get pushed back. Subsequently, both investors and servicers are fearful in today's environment, and that's why I think we need some sort of remediation process. I think that's part of the issue, but I also think that you've got to have adequate disclosures too from the standpoint of any kind of controlled relationship. For example, I've talked to a lot of private investors that were concerned that servicers had subsidiaries doing work for them that were charging too much. It's this whole breakdown between the investors and the servicers and the originators; trust has just become a real challenge right now. You've got to rebuild that relationship. Although these are important issues, really the most important thing is the economy's got to settle down.

**MIAC®:** What do you see as the future of HUD, FHA, and VA?

**Tozer:** I think that HUD, FHA, and VA, all these organizations, including Rural Housing, are all critical right now because of the fact that Fannie and Freddie are too large. The GSEs are just refinancing their portfolios, so really the purchase activity is being supported by these three government agencies. And I

think these agencies will be critical to the stability of the housing market for some period of time. I don't know if it's going to be a year, two years, or longer. But, until that point, I don't think you're going to see a lot of private money coming in to support the purchase money activity unless it has a lot of cushion as far as LTV and down payments, which most borrowers don't currently have. Most borrowers today have lost much or all of the equity in their homes. Historically, it use to be that once you bought your first home, your next home you'd have 20 to 30% to put down because you made so much money on your first home. Now, it's as though we have a whole nation of first time homebuyers, so for this reason alone, I think these government programs will probably be around for at least a couple more years. At that point, I think we've got to examine how the nation's housing system evolves into something more sustainable.

**MIAC®:** You've spoken about the responsibilities between servicers and investors and servicers to customers, but what about the responsibility of the customer? Given your background in the banking industry, were you at all surprised that so many people walked away from their homes and continue to do so?

**Tozer:** Yes, I'm really, to some degree, disappointed because having a mortgage is really a commitment. It's like anything else: you make a decision and you act accordingly. It's truly one thing if you've lost your job or don't have the income; I can appreciate somebody saying "I'm stuck". But, for somebody to make that call because their home is now underwater; that really bothers me. It's a moral comment on America, because in those situations, people are saying "I'm just going to take advantage of somebody else".

I think to a large degree, it may go back to this issue of being a transaction, because when you think about it, if you got your mortgage from your local bank, you know the people there. However, increasingly now, it's this faceless entity, so it's a lot easier to say I'm not going to make a payment. So, maybe this whole issue

*of losing customer contact and customer service has led us to this point where it's gotten so impersonal. But it's an interesting dilemma we're in because the whole concept of mortgages is that because people want to live in their home, they're going to make their payments. Whether their house is upside down or not doesn't make any difference. If your house was underwater by 20%, who cared; people tended to make their payment anyway. So for people to strategically walk away actually stop paying the mortgage simply because a house has declined in value that is a scary development and a huge change in how people have traditionally viewed "mortgage obligations".*

*Hopefully, we're moving away from that and people are willing to take responsibility for their agreements. But, again it's a two way street. The servicer's got to be willing and the lender's got to be willing to live up to their end of the bargain, too. I think we've got to bring civility back to all aspects of homeownership. Everybody needs to treat everybody else like a partner throughout the entire process.*

**David McCraw**  
**Senior Vice President, Client Solutions Group**