Exhibit 1 to Mem. of *Amici Curiae* In Supp. of Defs.' Opp. to Pls.' Mot. for Prelim. Injunction

Declaration of Glenn Schlactus

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UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

SAN FRANCISCO DIVISION

WELLS FARGO BANK, NATIONAL ASSOCIATION, as Trustee, *et al.*, Plaintiffs, v. CITY OF RICHMOND, CALIFORNIA, a municipality, and MORTGAGE RESOLUTION PARTNERS LLC, Defendants.	Case No. CV-13-3663-CRB **DECLARATION OF GLENN SCHLACTUS** Date: September 12, 2013 Time: 10:00 a.m. Judge: Honorable Charles R. Breyer Courtroom 6, 17th Floor

I, Glenn Schlactus, hereby declare as follows:

1. I am Counsel at the law firm Relman, Dane & Colfax, PLLC. I represent *Amici Curiae* National Housing Law Project, Housing and Economic Rights Advocates, Bay Area Legal Aid, California Reinvestment Coalition, and Law Foundation of Silicon Valley. I submit this declaration in support of these organizations' proposed Memorandum In Support of Defendants' Opposition to Plaintiffs' Motion for Preliminary Injunction.

2. Attached hereto as Exhibit A is a true and correct copy of a document titled "SIFMA Statement on Eminent Domain and TBA Trading," dated July 19, 2012, available at the web address https://www.sifma.org/news/news.aspx?id=8589939537 (accessed on Sept. 8, 2013).

3. Attached hereto as Exhibit B is a true and correct copy of a document titled "TBA Market Fact Sheet," dated 2013, available at the web address http://www.sifma.org/issues/item.aspx?id=23775 (accessed on Sept. 8, 2013).

4. Attached hereto as Exhibit C is a true and correct copy of an e-mail sent on July 11, 2012, by Richard Dorfman, Managing Director and Head of Securitization of the Securities Industry and Financial Markets Association. The e-mail was obtained from the federal government pursuant to a Freedom of Information Act request. It was produced by the government with the redactions identified on the document.

5. Attached hereto as Exhibit D is a true and correct copy of written testimony submitted on May 22, 2008, to the House Committee on Financial Services by Thomas Hamilton, Vice Chairman, MBS and Securitized Products Division, Executive Committee of the Securities Industry and Financial Markets Association, available at the web address https://www.sifma.org/workarea/downloadasset.aspx?id=1528 (accessed on Sept. 8, 2013).

6. Attached hereto as Exhibit E is a true and correct copy of a report prepared by Amherst Securities Group LP titled "Creative Uses of Eminent Domain—Implications for PLS Trusts," dated June 28, 2012.

7. Attached hereto as Exhibit F is a true and correct copy of a letter sent on July 15, 2013, by a coalition of advocacy organizations and unions to Congress.

I hereby declare under penalty of perjury that the foregoing is true and correct to the best of my knowledge and belief.

EXECUTED WITHIN THE UNITED STATES ON: September 9, 2013

BY: 

Glenn Schlactus

EXHIBIT

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Newsroom

SIFMA Statement on Eminent Domain and TBA Trading

Release Date: July 19, 2012

Contact: Katrina Cavalli,212.313.1181, kcavalli@sifma.org

SIFMA Statement on Eminent Domain and TBA Trading

New York, NY, July 19, 2012—SIFMA today issued the following statement on eminent domain and TBA trading:

Recent press reports have discussed SIFMA's consideration of the potential impact of a seizure of mortgage loans through an eminent domain process on the To-Be-Announced (TBA) markets for Mortgage-Backed Securities (MBS). The reports correctly note SIFMA and its members' strong concerns with and objections to such proposed policies that involve the use of involuntary seizures under eminent domain powers. SIFMA's existing TBA trading practice guidelines do not currently contemplate such actions and their impact on the homogeneity of loans eligible for TBA delivery needs to be assessed. Therefore, SIFMA necessarily discussed this issue with its members.

The TBA markets are the most liquid, and most important secondary market for mortgage loans. The hundreds of billions of dollars of daily trading in these markets, involving investors around the world, has for 30 years provided significant and tangible benefits to mortgage borrowers and mortgage lenders, and to the U.S. economy. Aside from being a conduit to draw massive amounts of global investment capital to the U.S. mortgage markets, the TBA markets also allow borrowers to obtain affordable rate locks as they shop for a home, and provide a critical risk management tool for mortgage lenders and servicers. The TBA markets are the benchmark for all mortgage markets in the country.

The fundamental concept that underlies TBA markets is homogeneity. In the TBA markets, buyers and sellers trade in a forward manner – that is, a trade executed on a given day may not settle for one, two, or even three months. Importantly, at the time of the trade, the identity of the mortgage-backed securities that will be delivered is not known. Rather, the counterparties agree on certain general characteristics of the pool, such as the issuer, coupon, term (15 or 30 years), and settlement month of the trade. This means that the collateral that falls into the various categories must be considered fungible. Investors must have confidence that, as a general matter, one MBS is interchangeable with another. Performance should be comparable, and risk factors should be similar.

SIFMA believes that protection of the integrity of this market is of utmost importance, and market participants share a similar feeling of responsibility to ensure the market works as efficiently as possible so as to provide maximum benefits to consumers, lenders, and other market participants. This is especially important given the general withdrawal of private mortgage funding that has been experienced over the last few years. During the crisis, if there were no TBA markets, mortgage credit would have been significantly more constrained for borrowers.

The introduction of eminent domain creates a material and unquantifiable new risk factor. To the extent that a municipality exercised such power on mortgage loans, loans within that jurisdiction would present a new, unique, and unquantifiable risk factor that would destroy the homogeneity of those loans with loans in areas where such eminent domain powers were not exercised. These loans would exhibit unpredictable prepayment behavior, and stand apart from other loans. The ability of municipalities to exercise a call option on loans in mortgage-backed securities would meaningfully decrease the value of those assets. Therefore, SIFMA, based on discussions with its members, does not believe that such loans should be eligible for inclusion in TBA trading. SIFMA is issuing this statement today to introduce a policy regarding the interaction of eminent domain with TBA trading. Loans to borrowers residing in areas that municipalities have initiated condemnation proceedings to involuntarily seize mortgage loans through their powers of eminent domain will not be deliverable into TBA-eligible securities on a going-forward basis. In the event such seizures occur and this policy is activated, SIFMA would review the facts and circumstances of the situation periodically; should those facts and circumstances

change, SIFMA would review its policy in light of those changes.

The exclusion from TBA trading would not exclude such loans from secondary markets, from securitization, or from global funding markets. Such loans could be securitized and funded by investors at levels that appropriately reflect the risk profile of the mortgage loan collateral, through the specified pool market and through other, non-government forms of securitization. This exclusion would protect the integrity of the TBA markets that serves all residents of this country though its promotion of affordable and accessible housing finance.

For more information on the TBA market, please review SIFMA's TBA Fact Sheet.

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The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

EXHIBIT

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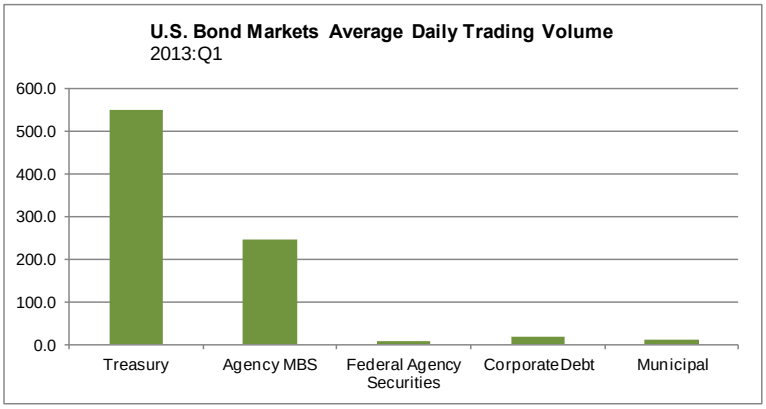
THE TBA MARKET

What is the TBA market and why is it important?

Established in the 1970s with the creation of pass-through securities at Ginnie Mae, the To-Be-Announced (TBA) market facilitates the forward trading of mortgage-backed securities (MBS) issued by the GSEs (Fannie Mae and Freddie Mac) and Ginnie Mae. The TBA market creates parameters under which mortgage pools can be considered fungible and thus do not need to be explicitly known at the time a trade is initiated. This is where the name for the product "To Be Announced" comes from. The TBA market is based on one fundamental assumption – homogeneity; at a high level, one MBS pool can be considered to be interchangeable with another pool. The TBA market is the most liquid, and consequently the most important secondary market for mortgage loans. The TBA market is responsible for significant capital flow from a wide range of investors. As shown below, an average of $246 billion of agency MBS was traded each day in March 2013 by the primary dealers and this volume is second only to the U.S. Treasury market.



As TBA trade settlements are often scheduled significantly into the future, the TBA market serves a critical market function by allowing mortgage lenders to hedge and/or fund their origination pipelines. By hedging the risk that market interest rates may change, lenders can lock in a price for the mortgages they are in the process of originating. The liquidity of the TBA market also creates efficiencies and cost savings for lenders that are passed on to borrowers in the form of lower rates.

How does a TBA trade function?

The process flow of a TBA trade is found below:

The key dates for a TBA trade are the trade date, the notification date (48-hour day) and the settlement date. On the trade date, 6 criteria are agreed upon for the security or securities that are to be delivered: issuer, maturity, coupon, face value, price, and the settlement date. For example: Customer A agrees to buy, at an agreed price, from Bank B $100 million of Fannie Mae 30-year securities with a six percent coupon for delivery in two months. TBA trades normally settle according to a monthly schedule set by SIFMA.[1] According to

[1] A full calendar of the settlement dates can be found at: http://www.sifma.org/Issues/Capital-Markets/Securitization/Housing-Finance-and-Securitization/Resources/.

industry practice,[2] two business days before the contractual settlement date of the trade, the seller will communicate to the buyer the exact details of the MBS pools that will be delivered (the 48-hour rule). Due to the required two days notice, the notification date is often called the 48-hour day. On the settlement date, the securities that were specified two days earlier are delivered and the buyer pays the seller for the securities.

How is the TBA market structured?

Participants in the TBA market generally adhere to market-practice standards commonly referred to as the "Good-Delivery Guidelines." These guidelines cover a number of areas surrounding the TBA trading of agency MBS, and are promulgated by and maintained by SIFMA, through consultation with its members. The purpose of the guidelines is to standardize various trading and settlement related issues to enhance and maintain the liquidity of the TBA market. Many of the guidelines are operational in nature, dealing with issues such as the number of bonds that may be delivered per one million dollars of a trade, the allowable variance of the delivery amount from the notional amount of the trade, and other similar details. However, other guidelines deal with qualitative aspects of the loans that underlie the securities, as well as the structure of the securities themselves. A concept that underlies the TBA guidelines is that of a "standard loan." Standard loans are loans which are eligible collateral for bonds which are traded in the TBA market. While each standard loan may not be exactly the same, they share many general characteristics, and perform in a more consistent manner.

Mortgage pools, which are not eligible for TBA delivery, may be traded in what is called the "Specified Pool" Market. In the specified pool market, unlike the TBA market, the actual identities of the bonds that are to be bought and sold are known at the time of a trade. This is similar to how most other bonds, such as corporate bonds, are traded. Many products which do not fit into the TBA guidelines are traded as specified pools. For instance these pools could be pools backed by interest-only loans, which in 2006-2007 became part of Agency issuance; pools backed by 40-year mortgages; pools backed by loans with prepayment penalties; and pools of various types of adjustable rate mortgages. Pools with specific desirable characteristics, such as low average loan balances, which are eligible for TBA trading may also be traded in specified pool markets if they can be sold at a premium to the prevailing TBA market prices.

[2] SIFMA's "Uniform Practices Manual" can be found at http://www.sifma.org/research/bookstore.aspx.

Chris Killian
Managing Director, SSG

CAPITAL MARKETS

Joseph Cox –Senior Associate, SSG
Marianne Brunet – Summer Intern, Capital Markets

EXHIBIT

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From: Dorfman, Richard [mailto:(b)(6) @sifma.org]
Sent: Wednesday, July 11, 2012 4:24 PM
To: Pollard, Alfred; DeMarco, Edward; DeLeo, Wanda; Ugoletti, Mario; 'Robert C. Ryan (b)(6) @hud.gov)'; 'Tozer, Theodore W'; 'Carol.J.Galante@hud.gov'; 'Benson, David C'; (b)(6) @treasury.gov; 'Michael.Stegman@treasury.gov'; 'Mark D Hanson'
Subject: San Bernadino Matter

Ladies and Gentlemen:

Here is an update as to the above:

The formative meeting of the San Bernadino Joint Resolution Authority, possibly to be empowered to pursue mortgage loan condemnation and taking by
force of eminent domain will take place in San Bernadino this Friday at 9:00 AM.

Please note:

- SIFMA has been informed by three top-tier law firms that the constitutionality of the potential action is seriously doubtful,;
- SIFMA will be represented in California by O'Melvany & Myers;
- SIFMA will be represented at Federal agencies and instrumentalities by Cleary Gottlieb;
- A group of top-tier institutional investors will be represented by Ropes & Gray;
- SIFMA has distributed to members draft language amending our TBA rules, that would serve to ban Enterprises' dealing in conforming mortgage loans
  sourced from jurisdictions that have authorized such use of eminent domain, whether that power has been used or not;
- SIFMA is planning to approach Federal banking, housing and mortgage regulators to argue for, *inter alia*, denying the enterprises the ability to acquire, guaranty or securitize
  such loans (we would expect that with the intended closure of TBA to such loans they would be shunned in the markets).

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EXHIBIT

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SIFMA
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Written Testimony of

Thomas Hamilton

Vice Chairman

MBS and Securitized Products Division

Executive Committee

The Securities Industry and Financial Markets Association

Before the House Committee on Financial Services

May 22, 2008

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Good morning Chairman Frank, Ranking Member Bachus, and Members of the Committee. I am Thomas Hamilton, Managing Director, Barclays Capital, Inc, where I am responsible for the MBS, ABS, and CMBS businesses. I am pleased to testify today on behalf of the Securities Industry and Financial Markets Association (SIFMA)[1], where I serve as Vice Chairman of the Mortgage Backed Securities and Securitized Products Division Executive Committee. We commend Chairman Frank and Ranking Member Bachus for their leadership and efforts to address the problems we see today in the mortgage markets.

We appreciate the opportunity to discuss the mortgage backed securities (MBS) market, and one of the most liquid secondary markets for mortgage loans in the world – the "To-Be-Announced" (TBA) Trading of Agency Passthrough Securities. More specifically, we would like to discuss action taken by SIFMA with respect to which loans are acceptable for inclusion in TBA-eligible MBS pools.

SIFMA is pleased to contribute to the understanding of a situation that is complex, with many moving parts and few simple answers, but incredible importance. By way of background, we will discuss the market for mortgage backed securities known as the Agency MBS market, the

[1] SIFMA brings together the shared interests of more than 650 securities firms, banks, and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington, D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. More information may be found on our website: http://www.sifma.org.

trading market known as the TBA market, an essential cog in the mortgage finance system, as well as SIFMA's role in these markets.

Rates for jumbo mortgages have risen since last August to previously unseen spreads to those for conventional mortgages. As shown in the chart below, jumbo mortgage rates tend to hover in a range between 25-40 basis points above those for "conforming" mortgages. Since last summer, however, jumbo rates have ballooned to exceed conventional mortgage rates by more than one percent. This is attributed to the so-called "credit crunch" and related general lack of liquidity in securitized product markets. The chart below shows that the spread between jumbo and conforming rates has two clear peaks that correlate with periods of stress in the credit markets (August 2007 – BNP Paribas hedge fund troubles, first wave of liquidity crunch & March 2008 – Bear Stearns and hedge fund liquidity problems). This makes painfully clear the interconnection between the capital markets and the primary mortgage markets.

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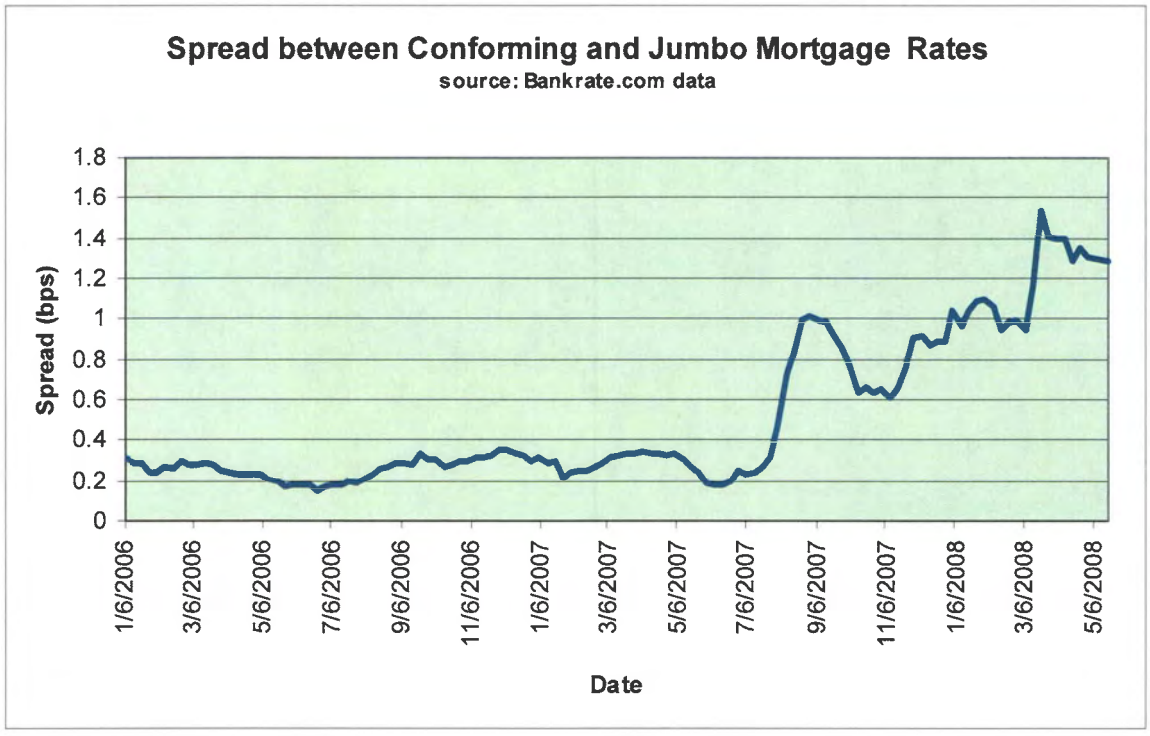

One bright light throughout the difficulties in the credit markets has been the performance of the markets for mortgage backed securities issued by Ginnie Mae, Fannie Mae, and Freddie Mac (referred to hereafter as "Agencies"). These markets have remained stable, given the guaranteed nature of these products and the generally more conservative underwriting standards employed, in comparison to the weak underwriting standards that permeated the subprime mortgage market. As Congress deliberated on an economic stimulus package several months ago, the issue of providing liquidity to the jumbo loan market by increasing the agencies' loan size limits became a matter of discussion.

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Current Jumbo Mortgage Rates

While rates of jumbo loans have not returned to ranges approaching historical norms, the seeming answer does not relate to TBAs or the lack of inclusion of jumbo loans as TBA eligible. Rather, lenders and the Agencies faced operational challenges to implement the programs – and the programs are not running at full speed at this point. This is not to say that the programs will not have the intended effect – we believe they will. Many analysts expect jumbo rates to drop to somewhere around 50 basis points over conforming loans, which would be quite an improvement. It is important to separate out the issues of pricing of loans in the secondary market and the timing of the implementation of the programs.

We see no reasonable means or mechanism for these programs to have been implemented more quickly than has happened given the requirements of the legislation. However, in the last month we have seen the first issuances of jumbo loan-backed MBS by Ginnie Mae[2], and the continued build-out by Fannie Mae and Freddie Mac of their loan purchase programs. Freddie Mac recently announced an agreement with a number of large lenders[3], and Fannie Mae has announced various changes to their pricing policies[4]. There are reports that a few small GSE pools are circulating in the trading markets. We believe that the market is on the verge of relief from higher rates – rates have dropped a quarter point in the last month, and we expect that to continue as the GSE and Ginnie Mae programs grow.

[2] http://ginniemae.gov/issuers/poolnum2008.asp?Section=Issuers
[3] http://www.freddiemac.com/news/archives/singlefamily/2008/20080417_jumbo.html
[4] http://www.bloomberg.com/apps/news?pid=20601087&sid=a9oy299Yq6K8&refer=home

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The Importance of Ginnie Mae, Fannie Mae, and Freddie Mac

The Agencies have long played a crucial role in the U.S. mortgage finance market. As the current mortgage and credit market difficulties evolved from the summer of 2007 until today, their role became even more essential. It is not an exaggeration to say that the Agencies currently provide virtually the only functioning means of accessing the secondary mortgage market which provides funding for about three-quarters of mortgage originations[5].

Mortgage backed securities (MBS) issuance statistics bear this out: as the issuance of mortgage backed securities in the private (a.k.a. "non-agency") market, which includes bonds backed by prime, Alt-A, and subprime loans, fell from about $270 billion in the first quarter of 2007 to around $20 billion in the first quarter of 2008[6], issuance of MBS by the Agencies grew to the point that the market share of Agency issued MBS now exceeds 80%. Over the last few years, the Agencies' market share fell into a range below 50%[7]. From 2006 to 2007 Ginnie Mae MBS issuance essentially doubled, driven by growth in FHA refinancing and origination programs[8]. As another example, the average daily trading volume of agency MBS reported to the New York Fed by the primary dealers[9] in 2007 was $320.1 billion, which dwarfs the $13.6 billion average for corporate debt, and approaches the levels for Treasury debt, which is regarded as the most liquid fixed-income product in the world. Difficulties in the non-agency mortgage markets

[5] Sources of funding for origination: http://www.imfpubs.com/issues/imfpubs_imf/25_13/news/1000008851-1.html
[6] Non-Agency MBS Issuance: http://www.imfpubs.com/issues/imfpubs_ima/2008_15/news/1000008955-1.html
[7] Agency share of new originations: http://www.imfpubs.com/issues/imfpubs_imf/25_17/news/1000009069-1.html
[8] Ginnie Mae MBS Issuance: http://www.imfpubs.com/issues/imfpubs_imf/25_15/news/1000008952-1.html
[9] More information about primary dealers: http://www.newyorkfed.org/markets/pridealers_current.html

contributed to a 25% year-over-year increase in this number from 2006 to 2007[10]. The outstanding volume of Agency MBS pools was $4.5 trillion at the end of 2007, and $1.3 trillion for Agency CMOs[11]. This total of nearly $6 trillion dollars exceeded the outstanding supply of Treasury debt in 2007[12].

While this is not a complete picture of the market, it provides a clear indication of the size, and thus the importance of the Agencies in providing financing to the primary mortgage market. Clearly, these are extraordinary times, and the Agencies are of extraordinary importance.

General Description of Mortgage-Backed Securities Issued by Ginnie Mae and the GSEs

Passthrough Securities

As the name suggests, the issuer or servicer of mortgage passthrough securities collects monthly payments from the mortgagees whose loans are in a given pool and "passes through" the cash flow to investors in monthly payments that represent both interest and repayment of principal. The payments of principal and interest on agency passthroughs are considered secure because of the guarantee they receive from their securitizing agency and the collateral (homes) that ultimately backs the mortgages.

[10] SIFMA's compilation of trading volumes: http://www.sifma.org/research/pdf/Overall_Trading_Volume.pdf
[11] Outstanding agency MBS: http://www.sifma.org/research/pdf/MortgageRelatedOutstanding.pdf.
[12] Outstanding Treasury debt: http://www.sifma.org/research/pdf/Treasury_Securities_Outstanding.pdf.

Normally, the mortgages backing a passthrough security are of the same loan type and are sufficiently similar with respect to maturity and interest rate to permit cash flows to be projected. At issuance, the stated maturity of most fixed-rate residential passthrough securities is generally 30 years, although some may have 20- or 15-year maturities. While most passthroughs are collateralized by fixed-rate mortgage loans, adjustable-rate mortgage loans (ARMs) may also be pooled to create securities. Most ARMs have caps and floors limiting the extent of interest-rate changes, and these option-like characteristics require that passthroughs collateralized by ARMS have higher yields than pure floating-rate debt securities.

Collateralized Mortgage Obligations / REMICs

The Agencies also issue Collateralized Mortgage Obligations (CMOs) in addition to the passthroughs discussed above. CMOs are multiclass structures that give investors a choice of short, intermediate and long-term maturities, while allowing issuers to reach a wider range of investors than normally possible with a standard passthrough. CMOs may be collateralized by FHA insured or VA-guaranteed mortgages, conventional mortgages, whole loans, Ginnie Mae, Fannie Mae or Freddie Mac passthrough mortgage-backed securities, AA passthroughs, other CMOs, callable MBS or combinations of these instruments. Unlike standard passthroughs, which typically pay monthly, CMO bonds may pay monthly, quarterly, semi-annually or as specified in the related offering materials. A related term often associated with CMOs is Real Estate Mortgage Investment Conduit (REMIC). In practice, the terms CMOs and REMICs have almost become interchangeable.

Guarantee of Payment on Agency MBS

Ginnie Mae securitizes Federal Housing Administration-insured (FHA), Veterans Administration-guaranteed (VA) mortgages and Rural Housing Service-guaranteed (RHS) mortgages. As a government entity within the Department of Housing and Urban Development (HUD), timely payment of principal and interest on Ginnie Mae securities is guaranteed by the full faith and credit of the U.S. Government.

Fannie Mae and Freddie Mac are private companies chartered by the federal government and are often referred to as Government-Sponsored Enterprises (GSEs). Fannie Mae and Freddie Mac securitize conventional mortgages that conform to certain size and underwriting criteria, and each agency provides its individual guarantee relating to timely payment of interest and principal for the securities it issues.

The Importance of Prepayment Projections and Expectations

Cash flows on mortgage-related investments may vary from month to month depending on the actual prepayment rate of the underlying mortgage loans. A critical feature of the mortgage passthrough security is that the principal on individual mortgages in the pool can usually be prepaid without penalty in whole or in part at any time before the stated maturity of the security. This is often referred to as an "embedded call option" in the security. Because of this, estimations and expectations of prepayment performance are critical to an investor's analysis of passthroughs. We will discuss this further later in the testimony.

"To-Be-Announced" Trading of Agency Passthrough Securities

Much of the volume in the agency MBS market today is in the form of "To-Be-Announced" (TBA) trading. A TBA is a contract for the purchase or sale of agency mortgage-backed securities to be delivered at a future agreed-upon date; however, the actual pool identities or the number of pools that will be delivered to fulfill the trade obligation or terms of the contract are unknown at the time of the trade. Actual mortgage pools guaranteed by one of the Agencies are subsequently "allocated" to the TBA transactions to be delivered upon settlement. Settlement dates are standardized by product type (e.g. 30 year FNMA/Freddie Mac pools, 30 year Ginnie Mae pools, 15-year pools). Monthly settlement date calendars for the TBA market are published one year in advance by a SIFMA committee on a rolling 12-month basis[13]. This is done to increase the efficiency of the settlement infrastructure. Pools may, however, be settled on days other than the established settlement date if the parties to the trade so desire.

For example, in a typical trade, a buyer may ask to purchase $100 million of 30 year Fannie Mae MBS with a 6% coupon for delivery next month. The buyer does not know the exact bonds that will be delivered. According to industry practice, two days before the contractual settlement date of the trade, the seller will communicate to the buyer the exact details of the MBS pools that will be delivered.

[13] Agency MBS Settlement Dates: http://www.sifma.org/services/stdforms/settlement-dates.shtml

The TBA market is the most liquid, and consequently most important, secondary market for mortgage loans in the world. In this current time of distress, the importance of the TBA market is only heightened, and it is difficult to exaggerate the terrible consequences of a loss of confidence in, withdrawal from, or general upward repricing of risk in this market. The effects would be directly and immediately felt by the average mortgage borrower.

TBA trading enables mortgage lenders to sell product forward through primary originations, by securitizing the mortgages for purchase in the secondary market. To allow mortgage lenders to hedge or fund their origination pipelines, TBA settlements are often scheduled significantly ahead of the date on which the transaction is negotiated. This permits the lenders to lock in a price for the mortgages they are in the process of originating.

Pools delivered to settle a TBA obligation may be either newly issued or "seasoned." There are circumstances in trading TBAs where counterparties agree that the pools to be delivered must meet certain stipulations or "stips", such as issuance year and/or month; or minimum or maximum percent in a particular geographic state or region, or others.

Homogeneity is the Key to the TBA Market

The TBA market is based on one fundamental assumption – homogeneity. TBA trading is based on the assumption that the specific mortgage pools which will be delivered are fungible, and thus do not need to be explicitly known at the time a trade is initiated. At a high level, one pool is considered to be interchangeable with another pool.

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SIFMA's Role in the TBA Market

SIFMA and its predecessor organizations have long played a central role in the TBA market. The genesis of this role began in the 1970s, when members of the Government Securities Dealers Association began to discuss standards for the trading and settlement of bonds issued by Ginnie Mae. In 1981, the Public Securities Association published the *"Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities"*, which is a manual that contains numerous of market practices, standards, and generally accepted calculation methodologies developed through consensus discussions of market participants, that are widely accepted and used in the MBS and asset-backed security markets.

Participants in the TBA market generally adhere to market-practice standards commonly referred to as the "Good-Delivery Guidelines", which comprise chapter eight of this manual[14]. These guidelines cover a number of areas surrounding the TBA trading of agency MBS, and are promulgated by and maintained by SIFMA, through consultation with its members. The purpose of the guidelines is to standardize various settlement related issues to enhance and maintain the liquidity of the TBA market. Many of the guidelines are operational in nature, dealing with issues such as the number of bonds that may be delivered per one million dollars of a trade, the allowable variance of the delivery amount from the notional amount of the trade, and other similar details.

[14] The Good Delivery Guidelines are a part of SIFMA's *Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities*, which is available here: http://www.sifma.org/services/publications/uniform-practices.shtml

A concept that underlies the TBA guidelines is that of a "standard loan." Standard loans are loans which are eligible collateral for bonds which are traded in the TBA market. While each standard loan may not be exactly the same, they share many general characteristics, and perform in a more consistent manner. This concept is the key to the homogeneity of the collateral.

While it is Critical, the TBA Market is Not the Only Agency MBS Market

Above we have outlined the critical nature of this TBA trading market. Pools that do not share this homogeneity of underlying collateral are not eligible for TBA trading – so where do they go? Mortgage pools which are not eligible for TBA delivery are traded in what is called the "Specified Pool" market.

In the specified pool market, unlike the TBA market, the actual identities of the bonds that are bought and sold are known at the time of a trade, similar to how most other bonds are traded. Many products which do not fit into the TBA guidelines are traded as specified pools: pools backed by interest-only loans, which in 2006-2007 became an important part of Agency issuance, pools backed by 40-year mortgages, pools backed by loans with prepayment penalties, and various types of adjustable rate mortgages. Furthermore, non-TBA eligible pools are actively bought by those who wish to create Agency CMOs. We have found in recent months that there exists a widely held misperception that there is no market outside of the TBA market; this is simply not correct.

Temporary Increases to Agency Loan Limits

On February 13th of this year, the President signed in to law the Economic Stimulus Act of 2008. Among other things, this Act temporarily increased the dollar size limits of loans which the Agencies may purchase to the lower of 125% of the area median price of a home or $729,750 (with higher amounts allowed in Alaska, Hawaii, Guam, and the U.S. Virgin Islands).

There are two significant facets of this legislation that will be considered below: (1) that the loan limit increases will sunset on December 31, 2008 and (2) that the Secretary of Housing and Urban Development was charged determination of "area median home price(s)." Both of these decisions impacted the implementation of the programs.

SIFMA's Actions Regarding Increased Loan Limits

In January and February, SIFMA called together its buy- and sell-side members on multiple occasions as the stimulus legislation progressed through Congress. SIFMA also met with representatives of Fannie Mae, Freddie Mac, FHA and Ginnie Mae. The legislation was viewed as extremely important, both in the context of the Agency MBS market, as well as in the larger context of something that could counteract the contraction of the availability of credit to deserving borrowers more generally. SIFMA believed that this legislation could be a useful tool to help strengthen the mortgage markets. SIFMA also realized that it must act as promptly as possible to minimize any uncertainty in the markets, and to ensure that the GSEs and Ginnie Mae could implement their new programs as quickly as possible.

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On February 15th, SIFMA announced its intention to publish an update to the Good Delivery Guidelines. The revised guidelines more explicitly define the characteristics of the "standard" loans which are acceptable for inclusion in TBA-eligible MBS pools. Concurrently, the revision implements modifications to the "non-standard" loans section to codify existing market practice and further delineate which non-standard loan product are eligible for de minimis inclusion in TBA-eligible pools. We have included in the appendix to this testimony the relevant sections of the guidelines.

The updates to the guidelines reflect the decision by SIFMA members to keep the maximum TBA eligible original loan balance at $417,000, as well as clarify several long standing market practices for good delivery. The previous maximum original balance allowable for a single family loan in a TBA eligible Fannie Mae or Freddie Mac pool was $417,000 (with the exception of Alaska, Hawaii, Guam and the U.S. Virgin Islands where the limit is $625,500). Loan size limits for Ginnie Mae pools also remained at 2007 levels. Higher balance loans which are now temporarily eligible for FHA and GSE guarantee programs under the Stimulus Package are not eligible for inclusion in TBA-eligible pools. They are instead expected to be securitized under unique pool codes for trading on a pool specified basis or included in REMIC transactions.

SIFMA views this arrangement as the most expeditious and least disruptive methodology currently available to facilitate securitization and secondary market activity for the higher balance loans, bringing added liquidity and rate relief to higher balance loan borrowers while not

imposing additional costs or impairing the liquidity for loans falling within the pre-existing loan limits.

The importance of the continued liquidity and smooth functioning of the current conforming loan market must be underscored in this time of broad disruption to financial markets. As discussed earlier in this testimony, this importance is reflected in data from the fourth quarter of 2007 that shows Agency MBS issuance represented over 80% of total MBS issuance, representing a vital source of financing for mortgage borrowers. The Agency MBS market is effectively the lone functioning secondary market providing liquidity to originators and borrowers.

There were two main drivers of SIFMA's decision:

***First*, paramount in all discussions of the conforming-jumbo program is the temporary nature of the legislation.** Given that market participants expected the program to take some time to implement, the December 31, 2008 cutoff only provides for a very small window for the purchase of these loans by the GSEs. While the program effectively only has a nine month life, preliminary estimates as to when this program would become fully operational were in the two to three month range. These estimates have turned out to be accurate, as we see the Agencies, led by Ginnie Mae, just getting their programs in gear in the last month. Market participants are hesitant to disrupt a functioning market, especially when the market is so essential to the mortgage finance system, to accommodate a program that effectively ends in less than 9 months.

***Second*, the issue of the importance of homogeneity of the TBA market was significant.** Experience has shown that higher balance mortgage perform differently than lower balance mortgages. As discussed earlier, prepayments are a key element in MBS investing. Higher balance loans respond differently than lower balance loans to changes in interest rates – this is the concept of convexity – in that for a given decrease in interest rates, higher balance loans are more likely to refinance (i.e. prepay). Logically, this makes sense, as a .5 % change in rates is much more meaningful in dollar terms on a $600,000 loan than a $150,000 loan.

Given that the TBA market depends on homogeneity, the introduction of jumbo loans which have different convexity characteristics into TBA-eligible pools would have reduced the homogeneity of the market – and would have begun a process of bifurcation of the TBA market into pools which contained jumbo loans and those that did not. This bifurcation would have reduced liquidity; liquidity that has been essential in the last year. Given that the TBA market is so essential in this time of stress, market participants are very hesitant to change the rules in a manner that may have negative consequences.

The market would have bifurcated because investors would have valued the securities which contained jumbo loans at lower levels than those which contained only conforming loans. The TBA market is a "cheapest to deliver" market – since the collateral is considered fungible it makes sense for a seller to deliver the collateral that it can obtain for the lowest price. Thus, collateral containing jumbo loans would generally be cheapest to deliver. Because of this, pricing would have been driven down across the market, causing borrowers of conventional

loans to pay higher rates. Another possible outcome would have been to drive trading into the specified pool market, which is less liquid than the TBA market, which also would have had negative implications for conventional loan borrowers.

In the time that SIFMA members were discussing how to proceed with respect to jumbo loans, there were proposals that jumbo loans be included in de minimis amounts – that is, up to 10% of the balance of a pool, as some other types of non-standard product are included (relocation, co-op, and certain buydown loans). SIFMA members, however, generally believed that any inclusion of jumbo loans in TBA eligible pools would incur a reaction from the market that would negatively impact the liquidity of the product, and thus negatively impact the rates that previously conforming borrowers would pay. Even if the actual impact of such inclusion would turn out to be insignificant, simply the *perception* that it could turn out as such would negatively impact the market and the rates paid by mortgage borrowers. This impact would have been immediate – prices for TBA trades would have changed instantly upon an announcement by SIFMA that jumbo loans would have been included. Regardless of SIFMA's decision, benefits of this still would not have accrued to jumbo borrowers for a period of months – but lower-balance borrowers would have seen increased rates immediately. Above all else, SIFMA members did not want to increase the rates of conforming borrowers to benefit jumbo borrowers.

While it is true that jumbo rates would see maximum impact if they were included in TBA-eligible pools, it is even more important that the rates of <u>all</u> conforming borrowers would have

been impacted negatively. Jumbo rates would *not* have simply come down to what was at that time the conventional mortgage rate – rather, the rates on jumbo and conventional mortgages would have converged somewhere in the middle – i.e. *conforming rates would have to increase.* While it is impossible to quantify the exact meeting point, it is clear that conventional borrowers would be impacted. SIFMA was also mindful of the "Sense of Congress" outlined in section 201 (e) of the bill, which instructs that the implementation of the conforming-jumbo programs *"not impose additional costs for mortgages originated, purchased, or securitized under the existing limits or interfere with the goal of adding liquidity to the market."*[15]. Including jumbo loans in TBA-eligible pools would have done just that. As mentioned earlier, perceptions that jumbo loans would weaken the quality of the TBA product would cause changes to pricing, and affect the rates paid by mortgage borrowers – and it is unlikely that these perceptions would be able to be discredited in the very short window that has been granted for the Agencies to purchase or insure jumbo loans.

Thus market participants had to weigh the potential for the disruption of the last functioning mortgage market against the short term benefit of a subset of mortgage borrowers. In 2006, jumbo origination had a 15% market share, versus a 52% share for FHA and conventional loans[16]. The liquidity of the market (and therefore borrowing rates) for loans representing more than half of the mortgage market would be impacted negatively for a program that was slated to expire in less than a year, and that benefitted a significantly smaller population.

[15] P.L. 110-185
[16] Mortgage originations by product: http://www.imfpubs.com/issues/imfpubs_imf/25_6/news/1000008524-1.html

It is for these reasons that SIFMA elected to recommend the separate pooling of jumbo loans. SIFMA and its members believe that this regime will best preserve the incredible liquidity the TBA market has provided over the last 30 years, keeping mortgage rates for lower balance borrowers unchanged, while still clearing a path to the secondary market for jumbo loan originations which are currently stuck in a purgatory of no liquidity. SIFMA fully expects jumbo rates to decrease – it is a matter of originators and the Agencies gearing up their programs to implement the higher loan limits.

Implementation of Jumbo Loan Purchase Programs

SIFMA believes the main factors in the delay in implementation of jumbo loan purchase programs are the operational requirements for these programs to be enacted. The main hurdle that was faced by the market was the issue of the calculation of loan limits for a given area.

As mentioned earlier, the legislation directed the Housing Secretary to delineate the "areas" and "area median home prices" for the various areas of the country. For Ginnie Mae, which is a part of HUD and accustomed to operating under the HUD/FHA methodologies for the calculation of loan limits, this was less of a challenge.

For Fannie Mae and Freddie Mac, as well as many lenders, however, this method of calculating loan limits was a change from their current methodology, and was known in advance by market participants to be an issue that would take some time to work out. For example, changes were required to various systems used by lenders and Fannie Mae and Freddie Mac to accommodate

this new methodology of determining whether or not a loan was within size guidelines. SIFMA believes that all parties moved, and are still moving, as expeditiously as possible to implement these changes.

It may be useful to present a timeline of events:

February 13	Stimulus bill signed into law[17]
February 15	SIFMA announces decision regarding TBA eligibility[18]
March 6	FHA publishes loan limits in Mortgagee Letter 08-06[19]
March 6	Ginnie Mae publishes information about their program, effective 3/24/08[20]
March 6	Fannie Mae publishes details of program, effective 4/1/08 for 15/30yr fixed rate products[21]
March 12	Freddie Mac publishes details of program, effective June 1 for flow program, reviewing bulk sales immediately[22]
March 24	Freddie Mac announces jumbo prefix information[23]
April 4	Fannie Mae expands/updates previous announcement[24]
April 17	Ginnie Mae issues 3 pools of jumbo loan backed pools (issuance date 4/1, delivery date 4/17)[25]
April 17	Freddie Mac announces $10-15 billion purchase agreement with a number of lenders[26]
April 17	Fannie Mae announces jumbo loans will be priced 39 basis points above conforming[27]
May 7	Fannie Mae announces jumbo loans will receive TBA pricing[28]

As shown by the table above, the process of implementing the new loan limits, buying loans from lenders, and issuing securities backed by these loans takes a significant amount of time. Even for Ginnie Mae, who was best positioned to implement the changes, it took until mid-April for pools to reach the secondary markets. It is important to keep in mind that increased liquidity and lower rates will only come to the jumbo market when an active secondary market is operational. This is happening now, and can be seen in the chart we provided earlier in this

[17] P.L. 110-185
[18] http://www.sifma.org/news/news.aspx?id=1930
[19] http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/
[20] http://ginniemae.gov/apm/apm_pdf/08-05.pdf
[21] https://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2008/0805.pdf
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[27] http://www.fanniemae.com/media/statements/2008/041708.jhtml?p=Media&s=Statements
[28] http://www.bloomberg.com/apps/news?pid=20601087&sid=a9oy299Yq6K8&refer=home

testimony. Regardless of the decision as to whether or not jumbo loans could be securitized in TBA eligible pools, the market would have faced the same operational hurdles to implement the provisions of the legislation.

Another issue is underwriting guidelines. The Agencies have recently gone through a process of changing and tightening their underwriting guidelines to better position themselves for current market conditions. SIFMA understands that many loans which have been sent to the Agencies for review were rejected because they did not meet underwriting standards. This is not to say that the Agencies' guidelines are too restrictive, but rather that Agency guidelines have tended to differ from guidelines for loans not originally meant to be sold to the Agencies. Jumbo loans have not been eligible for GSE purchase until this year, so it is natural to assume that there would be some fall out when previously originated jumbo loans are sent to the Agencies.

Expectations Were Unrealistic

We understand that some primary mortgage market participants expected jumbo rates to be nearly equivalent to those found on conforming loans shortly after the bill was passed, before there was a realistic chance for the Agencies to provide any liquidity. We discussed above some of the factors that contributed to the length of the implementation period for conforming jumbo programs. Clearly there exists a lack of clarity as to how secondary market forces impact primary market mortgage rates. The recent article in the *New York Times*[29] is further illustration of this. Expectations on one side of the coin were for immediate relief – while those on the flip

[29] http://www.nytimes.com/2008/04/30/business/30jumbo.html

side, involved in the secondary markets, always thought in terms of months. Hopefully this testimony, and this hearing, will help to correct these misunderstandings, and allow all concerned to have a better understanding of the issues at hand.

Conclusion

SIFMA supported the stimulus package provisions which increased the conforming loan limits and continues to do so. SIFMA believes that the housing agencies can, do, and will continue play a central role in the recovery of the mortgage markets.

SIFMA believes that the correct decision was reached regarding the TBA eligibility of pools containing jumbo mortgages. The decision strikes the correct balance between providing increased liquidity and rate relief to jumbo borrowers, while preserving the liquidity of the TBA market that provides lower rates to conforming borrowers.

We thank the Committee and its Chair for the opportunity to provide this testimony, and hope that we have helped to shed some light on what is a complex issue.

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Appendix

Sections 10 and 11 of SIFMA's "Good Delivery Guidelines"

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The Securities Industry and Financial Markets Association's

Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities

Selections from Chapter 8 – Standard Requirements for Delivery on Settlements of Fannie Mae, Freddie Mac, and Ginnie Mae Securities

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11. General Characteristics of Standard Loans for 15 and 30yr Fixed-Rate Single-Family TBA-eligible Pools

The following list represents important characteristics of loans eligible for unlimited inclusion in TBA-deliverable pools ("standard loans"). For complete details of characteristics of loans in various pools, please refer to the appropriate offering documentation available from the issuer.

- For 30 year pools: Term greater than 15 but less than or equal to 30 years
- For 15 year pools: Term less than or equal to 15 years
- Fixed rate
- First Lien
- Level payments
- Fully amortizing
- Servicing fee greater than or equal to 25bp per loan
- Maximum Original Balance for FNMA and FHLMC pools:
    - $417,000 for mortgages on one-unit properties;
    - $533,850 for mortgages on two-unit properties;
    - $645,300 for mortgages on three-unit properties; and,
    - $801,950 for mortgages on four-unit properties.
    - Limits for each of the above categories are increased by 50% for properties in Alaska, Hawaii, Guam, and the U.S. Virgin Islands.
- Maximum Original Balance for Ginnie Mae pools:
    - Note: FHA permits first year's mortgage insurance premium (up to 2.25% of original balance) to be financed in loan;
    - $362,790 ($370,953 if MIP is financed) for one-unit properties;
    - $464,449 ($474,900 if MIP is financed) for two-unit properties;
    - $561,411 ($574,043 if MIP is financed) for three-unit properties;
    - $697,696 ($713,395 if MIP is financed) for four-unit properties;
    - Limits for each of the above categories are increased by 50% for properties in Alaska, Hawaii, Guam, and the U.S. Virgin Islands;
    - VA loans are pooled with no limitation on balance.
- Loan does not include a prepayment penalty at time of pooling

- No extended buydown provisions (greater than 2% buydown of rate, or buydown period longer than 2 years)
- Not a cooperative share loan
- May be a participation interest in a loan
- Not a relocation loan
- Not a bi-weekly loan

12. Non-Standard Loans

Effective with trade date April 1, 2008, and for pools with issue dates of April 1, 2008 and later, pools containing more than 10% of any single type of nonstandard loan or more than 15% of the total nonstandard loans—as disclosed by the agencies—will not be acceptable as good delivery for TBA transactions.

The following, exclusive list details the types of nonstandard loan product which may be delivered in pools, subject to the de minimis limits described above:

1. Relocation loans
2. Co-op loans
3. Buydown loans, defined as follows: For purposes of SIFMA's good-delivery guidelines, a buydown loan shall be considered nonstandard if the difference between the actual and the "bought down" interest rate is more than 2% or if the buydown period is more than two years.

For pools with issue dates prior to December 1, 1991, existing good-delivery standards for nonstandard loans will apply.

EXHIBIT

E

Amherst Mortgage Insight

Amherst® Securities Group LP

June 28, 2012

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Creative Uses of Eminent Domain—Implications For PLS Trusts

Summary

On June 19, 2012, San Bernardino County and 2 cities in that county (Ontario and Fontana) approved a resolution which paves the way for the municipalities to acquire underwater residential mortgages using the right of eminent domain. Under one proposed plan the targeted loans are performing underwater loans in PLS. While the program as approved would be quite small, we believe this use of eminent domain sets a potentially troublesome precedent. In this article, we discuss the pro-forma economics of the program, highlight (once again) why legacy PLS structures provide investors with little ability to protect themselves, discuss possible courses of investor action, and the consequences if no actions are taken.

On June 19, 2012, California's San Bernardino County Board of Supervisors approved an amended resolution, which established a Joint Exercise of Powers Agreement between the County of San Bernardino, the City of Ontario, and the City of Fontana. This agreement allows for the establishment of a joint powers authority that will "*take actions and make decisions to assist in preserving home ownership and occupancy for homeowners with negative equity within the Parties' jurisdictions, avoid the negative impacts of underwater loans and further foreclosures and enhance the economic vitality and health of their respective communities*." It's dubbed the "Homeownership Protection Program," and is structured to allow additional cities to join.

This Homeownership Protection Program "*may include the Authority's acquisition of underwater residential mortgage loans by voluntary purchase or eminent domain*." After these loans are purchased at fair market value, the intent is to restructure these loans to allow the homeowner to continue to occupy the property. The "*joint parties authority is permitted to modify, restructure, hypothecate, assign, pledge, securitize, convey or re-convey these loans and deeds or trust.*" The program clearly applies only to the loans; it expressly excludes the power to acquire the homes by eminent domain.

A Concern To PLS Investors

This ordinance allows the "taking" of mortgages at fair market value. One plan, sponsored by Mortgage Resolution Partners (MRP), being considered by the Joint Powers Authority is currently seeking capital to support this program. The loans targeted will be performing underwater loans in private label securitizations (PLS).

Map of San Bernardino County, Fontana, and Ontario, CA

Source: Google

We understand the intent is to refinance these borrowers to just under the home's fair market value (97.75 LTV), using the FHA Short Refinance Program. The Homeownership Protection Program (HPP) structure would require that the local government entity take title to the loans, and pay the PLS Trusts with money provided by Mortgage Resolution Partners. When the loans are refinanced, the proceeds are used to repay investors who financed the HPP.

It is interesting that the targeted borrowers are expected to be those in private label securitizations, but not loans in GSE pools. [*NOTE:* FHA loans are ineligible for the short refinance program.] We believe this reflects the fact that private label securitizations (PLS) were poorly designed—the private label structure does not provide for a responsible party whose duty it would be to ensure that such a taking was legal and the "fair market" price was actually fair. If this program were to target GSE loans, the case would be certain to end up in court, challenged both on the legality of the program and the fair market determination.

We have long been concerned about the lack of flexibility, lack of transparency, and the passive nature of the servicer/trustee responsibilities in the PLS agreements. We are sympathetic to the basic premise that it is very difficult to get loans out of the private label trusts to allow them to be restructured and more actively managed. In particular, there is no mechanism for restructuring a performing loan within a PLS trust, and we have no doubt that many performing underwater loans will eventually proceed through foreclosure without some form of restructuring. Based on a very careful analysis of the total credit profile of the borrowers, it can be determined which of these loans are most likely to default, and taking select loans out of a trust could conceivably result in a higher realized value for PLS investors. Using eminent domain is a novel (albeit aggressive) idea to reach this goal. However, we suspect this program is being done without a careful analysis of which borrowers need the write down, and we also suspect that the parties are incented to purchase the loans below fair market price. Moreover, it is the lack of a "protector" for the PLS loans, potentially allowing for a purchase at less than fair value, which makes these loans an attractive target. The inability to write down performing underwater borrowers applies to GSE loans as well as PLS loans. (Principal reduction is an often used tool for non-performing loans in private label securitizations, an activity that we support; GSEs do not permit the use of principal write-downs under any circumstances.)

In this article, we focus on the Mortgage Resolution Partners version of the HPP program. We first detail the characteristics of the loans that we believe are targeted by this version of the program. We then describe our take on the pro-forma

economics of the HPP program, to the HPP investor, to the borrower, and to the PLS investor. In the third section we detail why private label investors have little protection. Finally, we cover why this use of eminent domain sets a very dangerous precedent that will add to the challenges of bringing back private label securitization.

BOTTOM LINE—While the HPP program is very small, the clear intent is to grow it. We believe this use of eminent domain sets a troubling precedent by targeting performing loans in private label securities; do not have a built-in mechanism that would protect them against a less than fair price. Programs like this highlight the need for securitization reform and, absent of such reform, show how it would be more difficult and expensive to bring private capital back into the market.

I. Targeted Borrowers

The borrowers targeted for this program are performing underwater loans in private label securitizations. We do understand that municipalities in which homes have lost close to 50% of their market value since housing's peak would want to "do something." We also understand that borrowers who are deeply underwater have a reasonable chance of defaulting going forward, adding to foreclosure inventory. A restructuring of the debt will lower the probability of default. However, if the targeted loans are performing and underwater loans—then the logic escapes us as how a municipality can make the case that the target should be only loans in private label securitizations, but not Fannie or Freddie loans, nor loans in bank portfolios.

While San Bernardino County is the first area to adopt this type of resolution, we do know that other municipalities have been approached by Mortgage Resolution Partners. And it is a very tempting proposition for communities that have suffered significant home price depreciation. Not only is it politically popular, but if the San Bernardino experience sets a precedent, the municipalities are getting paid for their participation in this program (as least under the MRP version of the HPP); these monies can be applied to reduce budget deficits or forestall property tax increases.

We decided to test how many loans could be affected if this resolution becomes widespread. Thus we grouped owner-occupied loans that were performing for 6 months, and had a mark-to-market LTV (loan-to-value) of ≥110. The results of our analysis, shown in Exhibit 1 (next page), indicate an aggregate of 4.2 million loans in private label securitizations. Of these, 1.4 million are at least 60 days past due (non-performing), 2.7 million are performing (current or 30 days past due), and 2.4 million of those 2.7 million have been current for the past 6 months. Approximately 0.5 million of the performing loans with a good pay history are non-owner occupied. Of the 1.9 million owner-occupied units, just over 0.5 million of them are sufficiently underwater to qualify for this type of program (173,000 have a 110–125 LTV and 359,000 have a >125 LTV). *That amounts to 12.7% of private label loans by count (or 15.4% by balances).*

Exhibit 2 (next page) shows the 532,000 loans for the potential program that are owner-occupied, current for the past 6 months, with a mark-to-market LTV ≥110,

Exhibit 1: PLS Loans Targeted for Eminent Domain—Loan Count and Balance

Performing Status	Pay History	Occupancy	MTM LTV	Loan Count	Balance ($Bil)
Non-Performing				1,426,016	358
Performing	Current < 6 Months			342,598	69
	Current ≥6 Months	Non-Owner Occupied		451,598	85
		Owner Occupied	≤100	1,268,897	305
			100-110	161,053	51
			110-125	172,534	56
			>125	359,325	102
		Owner Occ Subtotal		1,961,809	514
	Current ≥ 6 Months Subtotal			2,413,407	599
Performing Subtotal				2,756,005	668
Grand Total				4,182,021	1,026

Source: CoreLogic, 1010Data, Amherst Securities as of May 2012

Exhibit 2: PLS Loans Targeted for Eminent Domain—Characteristics

Region	Balance ($)	Count	Average Loan Size	WALA	FICO	% IO	Owner Occ (%)	Full Doc (%)	Multilien (%)	HPA CS (%)	LTV Orig	LTV MTM	CLTV Orig	CLTV MTM
US (ex. CA)	69,457,492,529	314,339	220,964	73	682	40	100	50	42	-43	81	146	86	159
CA (ex. Fontana and Ontario)	87,339,073,120	214,355	407,451	72	709	54	100	33	52	-44	78	141	83	155
Fontana and Ontario, CA	1,072,462,902	3,165	338,851	71	683	43	100	34	43	-50	78	154	82	167

Region	APL (%)	RPL (%)	Orig GWAC (%)	Curr APL/RPL GWAC Overall (%)	Curr GWAC APL (%)	Curr GWAC RPL (%)	Model Recovery Rate (% of Fair Value)	Model Recovery Rate (% of Curr Loan Balance)	% Default	Model Loss Severity (% of Curr Loan Balance)	Model Net Recovery (% of Curr Loan Balance, 100-Loss Severity)	Present Value of Loan (% of Curr Loan Balance)	Present Value of Loan (% of Fair Value)
US (ex. CA)	62	38	6.4	4.9	5.5	3.8	79%	54%	36%	64	36	65	95
CA (ex. Fontana and Ontario)	62	38	5.4	4.3	4.9	3.2	88%	62%	32%	50	50	71	100
Fontana and Ontario, CA	39	61	5.6	3.7	4.9	3.0	86%	56%	40%	57	43	66	101

Source: CoreLogic, 1010Data, Amherst Securities as of May 2012

broken down by loan characteristics. Our 3 groups are the 2 cities in San Bernardino County (Ontario and Fontana) that already approved the agreement, the balance of California, and the rest of the United States. Note that underwater, performing, owner-occupied loans are disproportionately located in California. While California has 21.2% of the private label universe by loan count and 34.8% by balance, it constitutes 41% of the loans that could be targeted by an HPP program by count and 56% by balance. Note also that the 2 cities in San Bernardino County that approved the resolution have only 3,165 loans meeting the necessary criteria. These 3,165 loans are distributed

across 1,533 deals, with 12 loans being the maximum in a single trust. *What concerns us is the precedent, not so much the impact of this one particular effort.*

The characteristics of the targeted loans are no surprise—680–710 FICO, 33–50% full documentation, 42–50% with second liens (multi lien %), and 40–54% were Interest Only (IO) loans at origination. The original LTVs were 78–81; current LTV is 154 for the 2 cities in San Bernardino County, with 141 and 146 for the balance of California and the rest of the nation, respectively. CLTV (combined loan to value) on the targeted loans are higher—167 for the 2 cities in San Bernardino County, with 155 and 159 for the balance of California and the rest of the nation, respectively.

Not surprisingly, this deeply underwater cohort contains many loans that have already been modified. Note that for the 2 affected cities, 39% of the loans are "always performing" (APL; never 2 payments or more behind), while 61% are "re-performing" (RPL; they have been two payments or more behind); most have become current via a modification (usually via an interest rate reduction). The gross WAC (weighted average coupon) on the APLs is 4.9%; the gross WAC on the RPLs is 3.0%, resulting in a blended gross WAC of 3.74%. For the balance of California and the rest of the nation, 62% of the loans are "always performing"; 38% are re-performing, with a gross WAC on the RPL loans of 3.8 and 3.2, respectively.

II. Economics of the Transaction—HPP Investors / Homeowners / PLS Investors

We believe that the intent (confirmed by investors who have heard the Mortgage Resolution Partners HPP pitch) is to buy the targeted loans out of the trusts at 75-80% of AVM (automated valuation model) on the property. It is unclear what type of AVM will be used—one including only distressed sales, only non-distressed sales, or a combination. AVMs are usually based on a mix of distressed and non-distressed homes. In an area that has many distressed sales, the AVM will reflect the mix (even though homes targeted for this program are neither distressed nor for sale).

The targeted homes will receive an FHA short refinance. This program (outlined in the HUD Mortgagee Letter 2010-23[1] and amended by HUD Mortgagee Letter 2012-5[2]) requires that:

- The homeowner must be in a negative equity position.
- The homeowner must be current on the existing mortgage to be refinanced. (If the Mortgagor successfully makes 3 consecutive on-time payments during the trial plan, the Mortgagor is eligible for a permanent loan through the FHA Short Refinance Program.)
- The homeowner must occupy the 1-4 unit property as their primary residence
- The homeowner must qualify for a new loan under standard FHA underwriting requirements and possess a FICO score ≥500. Standard FHA underwriting requires ≤31% housing DTI (DTI = [1st mortgage payment + 2nd mortgage payment + taxes + mortgage insurance premium + hazard insurance + homeowner's association dues + ground rent + any special assessments]) and a ≤43% back-end (total debt) DTI. Under the energy-efficient home policy, those limits can be stretched to 33% and 45%,

[1] The link is as follows: http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/10-23ml.pdf

[2] The link is as follows: http://portal.hud.gov/hudportal/documents/huddoc?id=12-05ml.pdf

respectively. In some circumstances compensating factors can permit the limits to be exceeded. Note that FHA Short Refinance Program will need a new appraisal; an automated valuation model (AVM) or broker price opinion (BPO) is insufficient to establish value.

- For loans that receive a "refer" risk classification from TOTAL Mortgage Scorecard, the housing DTI should be ≤31% and the back-end DTI ≤50%; the housing DTI can be ≤35% if the back-end DTI is ≤48%.
- The existing loan to be refinanced must not be an FHA-insured loan.
- The existing first lien holder must write off ≥10% of the unpaid principal balance.
- The refinanced FHA-insured first lien must have an LTV of ≤97.75%.
- Non-extinguished existing subordinate mortgages must be re-subordinated, and combined LTV on the new loan must be ≤115%.
- All loans made under this program must close on or before December 31, 2014.

Let's assume the first lien is written down to 97.75 LTV. *What happens to the second liens in these transactions*? It is unclear to us how this would be handled. The most logical alternative is that since the first lien is being taken by eminent domain, they also take the second lien. However, the banks would most certainly protest whatever "fair market value" is selected. It is conceivable to us that the second lien would not be taken by eminent domain, and thus would be left intact in some instances or re-negotiated in others (And there may be situations in which the presence of a large second makes it economically unattractive to take the first lien). The FHA Short Refi Program allows the second lien to be re-subordinated in its entirety if it is <17.75% of the current market value (115–97.75%). Thus, many second liens would require no write down. If the amount of the second lien is greater than that, then Mortgage Resolution Partners, as program sponsor, can ask the second lien holder to take a write down, in exchange for a second that is more likely to pay plus some cash.

This is possible because of the flexibility afforded second liens in the FHA Short Refinance Program. FHA short refinance rules allow that: *(1)* the first mortgage can be taken out for <97.75% and the second can comprise the difference (up to 115 LTV); or *(2)* a first lien of up to 97.75% LTV can be taken out, with cash from this used to pay down some of the second lien debt, as long as all of the criteria above are met. Thus, if the first lien were 110 LTV and the second lien was 25 LTV—the program would permit a 90 LTV first mortgage and a 25 LTV second mortgage (keeping the second intact). Alternatively, the FHA short refinance program would permit a new FHA mortgage to be taken out for 97.75 LTV, with the first lien written down to 90, and the 7.75 difference used to pay down the second lien. So the second lien holder remains intact, with a 17.25 mortgage and cash of 7.75%.

For first lien investors, the economics of this transaction depend critically on the level at which the loans are being purchased out of the Trust. For the purposes of the analysis below, we will assume the intent (confirmed by several investors who heard the the HPP pitch) is to purchase the loans at 80% of the market value of the property based on the AVMs. If the loans are purchased at 100% of the market value of the property, the economics become much less appealing to the HPP investor, and closer to fair value for the PLS investor.

Now let's look at the economics of the transaction to the HPP investors. Assume: (1) the loans are purchased out of the trust at 80% of the market value of the property based on AVMs, and refinanced into a 97.75% LTV FHA mortgage, and (2) the rate offered on the new mortgages were 4.0%. These mortgages could be sold into a

GNMA 3.5 pool at 106 (August settlement). Thus, the sponsor essentially obtains the mortgages at 80% of the property value and sells the FHA loans at 103.61% of the property value (97.75 x 1.06). We understand that the Joint Powers Authority must get paid something for their efforts. Discussions with market participants who were pitched on the program indicate that the Joint Powers Authority is slated to receive about 5 points per 100. In addition, not all the loans will qualify for the FHA short refinance program. This program requires the loans to be current. To the extent the borrower goes delinquent during the process, he is not eligible for the short refinance program (hence we assume that the loans that will be targeted will have 6 months of clean history). To the extent the borrower is unwilling to submit the documentation, or does not qualify for the short refi program (because of either DTI ratios or FICO scores), the loans will fall out and will be sold in loan form. However, if the AVM is low (and we argue it is likely to be below the fair market value of the property or the loans), then even the loans that "fall out" are unlikely to be sold at a loss. Mortgage Resolution Partners are receiving a per loan fee for structuring the transaction. There are also some costs of FHA origination that must be paid for out of the differential between the acquisition price of 80% of fair property value and the disposition of 103.61% of fair property value***. In summary, if the imposition of eminent domain occurs at a price of 80% of property value, investors in the HPP program will realize significant returns.***

Now we'll consider the borrower. Assume a current loan for $300,000 on a home worth $200,000, so the mark-to-market LTV is 150. The borrower is currently paying a gross WAC of 3.75% (the average rate on these loans), and assuming the loan must amortize over a remaining maturity of 288 months (weighted average loan age of 72 months) suggests a current monthly payment of $1,584.72/month. Assume the borrower is refinanced into a new 30-year first mortgage for $195,500 ($200,000 x 0.9775) at a 4.0% interest rate. The mortgage insurance premium is an upfront cost of 1.75% (which can be rolled into the loan amount) + 1.25% per annum. Thus, the new loan amount (rolling in the upfront premium) is $198,921; the new monthly interest rate is 5.25% (the 4.0% gross WAC + the 1.25% annual mortgage insurance premium), for a payment of $1,098.45. Thus—*the borrower is certainly better off. He has a lower monthly payment, and has been re-equified.*

Finally, consider a private label investor whose loans were sold out of the trust at 80% of market value. It is difficult to price these assets from comparables, as there is no real market for 150 LTV, 170 CLTV first liens that have not been delinquent in the past 6 months. We can estimate the fair value of the performing loans by assuming the investor is paid back in full on the loans that do not default; loans that default are liquidated at the severity appropriate to their loan characteristics. In the case of the loans above, assume the probability of default at 40% (this number is taken from the bottom section Exhibit 2). Thus, he has a 60% chance of eventually collecting $300,000 (but we must calculate a discount for the low coupon of 3.75%). Using a 6% discount rate (and the numbers are very sensitive to this discount rate), for value of the non-defaulted $300,000 claim is $243,582). The value of the defaulted claim is 43% of the original loan amount or $129,000. [*NOTE*: Recoveries are estimated to be 86% of the fair value of the property, or 56% of current loan balance, as shown in the bottom right section of Exhibit 2 for Ontario and Fontana. We must subtract the costs of foreclosure plus the value of taxes, insurance and excess depreciation during the foreclosure process, while the borrower is in the home but not paying. Thus, we calculate a severity of 57%, and a recovery of 43% of the current loan amount.] In our

example, the investor has a 60% chance of collecting $243,582 and a 40% chance of collecting $129,000, for an expected value of 197,749, or 98.9% of the fair market value of $200,000 (which is 66% of the current loan amount). Note that across the universe of loans, the "fair value" of the loans is very close to 100% of the value of the property.

Thus, if the private label loans are taken out of the trust at 80% of the value of the property, the private label investor would fare very poorly. Performing loans would be taken out of the trust without representation, with insufficient compensation (80% of current property value versus our estimated value of 100%). The PLS investor is also losing the option that the situation will improve; default rates will continue to decline, and home prices will at some point rise. If the PLS investor were compensated at the fair value, it would significantly reduce any profit for the HPP investors. And, as we show in the next section, compensation at fair value is unlikely, as the PLS investor is relatively defenseless.

III. Who's Looking Out For The Trust? (Neither Servicer nor Trustee Have That Obligation)

We argue that servicers and trustees (and trust administrators, if applicable) of non-agency trusts have no obligation to challenge a fair value estimate arising from the execution of eminent domain. We spent significant time with the governing documents, and we see no specific provisions where the servicer or trustee would be required to act on behalf of the PLS investor to ensure the application of eminent domain was at a "fair" price. We are not lawyers, but the documents appear to provide plenty of opportunity for servicers and trustees to take a passive role in this circumstance. To illustrate this point, we will use the Pooling and Servicing Agreement[3] (PSA) for OOMLT 2007-1, a subprime Option One transaction (selected because we see the PSA as a relatively generic RMBS agreement and broadly indicative).

a) Servicer's Responsibility to (*Not*) Act

If a loan were purchased out of a trust at fair market value through the eminent domain strategy, this fair market value would most likely be at some discount to the par value of the mortgage, which would create a loss on the loan. So, while liquidations are generally considered to originate from defaulted loans, it can be easily argued that an eminent domain purchase is a liquidation event as per the PSA. The PSA defines Liquidation Event and Proceeds as follows:

> ***"Liquidation Event"****: With respect to any Mortgage Loan, any of the following events: (i) such Mortgage Loan is paid in full, (ii) a* ***Final Recovery Determination is made as to such Mortgage Loan*** *or (iii) such Mortgage Loan is removed from the Trust Fund by reason of its being purchased, sold or replaced pursuant to or as contemplated by Section 2.03 or Section 10.01. With respect to any REO Property, either of the following events:* ***(i) a Final Recovery Determination is made as to such REO Property*** *or (ii) such REO Property is removed from the Trust Fund by reason of its being sold or purchased pursuant to Section 3.23 or Section 10.01.*

[3] The link as follows: http://www.sec.gov/Archives/edgar/data/1385902/000088237707000327/d616712_ex4-1.htm

> ***"Liquidation Proceeds"****: The amount (other than amounts received in respect of the rental of any REO Property prior to REO Disposition) received by the Servicer in connection with (i)* ***the taking of all or a part of a Mortgaged Property by exercise of the power of eminent domain or condemnation****, (ii) the liquidation of a defaulted Mortgage Loan by means of a trustee's sale, foreclosure sale or otherwise or (iii) the repurchase, substitution or sale of a Mortgage Loan or an REO Property pursuant to or as contemplated by Section 2.03, Section 3.23 or Section 10.01.*

As you can see above, eminent domain is referenced specifically in the definition of Liquidation Proceeds. In fact, the term is only referenced in one other place in the PSA (where the originator reps and warrants there were no outstanding eminent domain claims on properties). (Although clause (i) of the definition of Liquidation Proceeds refers to a Mortgaged Property instead of the mortgage loan itself, given the lack of other provisions relating to the taking of a mortgage loan itself, this clause could likely be interpreted to be relevant.)

What is the servicer obligated to do in the case of a taking of all or part of the property by eminent domain? As outlined in the section on Final Recovery Determination, the servicer is obligated to make sure they received the recoverable proceeds on a property. Here is the definition of Final Recovery Determination:

> ***"Final Recovery Determination"****: With respect to any defaulted Mortgage Loan or any REO Property (other than a Mortgage Loan or REO Property purchased by the Originator or the Servicer pursuant to or as contemplated by Section 2.03 or 10.01), a determination made by the Servicer that all Insurance Proceeds, Liquidation Proceeds and* ***other payments or recoveries which the Servicer, in its reasonable good faith judgment, expects to be finally recoverable in respect thereof have been so recovered****. The Servicer shall maintain records, prepared by a Servicing Officer, of each Final Recovery Determination made thereby.*

So the servicer is really just required to make sure they deposited in the trust the full amount of proceeds from the eminent domain taking.

b) Trustee's Responsibility to (*Not*) Act

Article VIII of the PSA contains trustee relevant provisions. Section 8.01 of the PSA discusses the "Duties of the Trustee." The first two sentences of this section highlight the basic responsibilities of the Trustee (i) prior to an event of default (defined in that PSA as a Servicer Event of Termination) and after such event of default is cured and (ii) when an event of default is occurring and continuing (which we will refer to as "in effect" herein):

While an event of default is not in effect, the Trustee "undertakes to perform such duties and only such duties as are specifically set forth in [the PSA]".

If there is an uncured event of default that a responsible officer of the Trustee has knowledge of (*i.e.*, the event of default is in effect), then the Trustee must "exercise such of the rights and powers vested in it by [the PSA], and use the same degree of care and skill in their exercise, as a prudent man would exercise or use under the circumstances in the conduct of his own affairs."

Much of Section 8.01 limits the Trustee's duties and obligations further. For instance:

> *The Trustee, **upon receipt of all resolutions, certificates, statements, opinions, reports, documents, orders** or other instruments furnished to the Trustee which are specifically required to be furnished pursuant to any provision of this Agreement, **shall examine them to determine whether they conform to the requirements of this Agreement**; provided, however, that the Trustee **will not be responsible for the accuracy or content** of any such resolutions, certificates, statements, opinions, reports, documents or other instruments. If any such instrument is found not to conform to the requirements of this Agreement in a material manner the **Trustee shall take such action as it deems appropriate to have the instrument corrected, and if the instrument is not corrected to the Trustee's satisfaction, the Trustee will provide notice thereof to the Certificate holders** and the NIMS Insurer.*

So if the Trustee is required to look at the documentation provided by the Servicer (if any) it must only make sure that it looks acceptable on its face. Moreover, since there are not likely to be any specific obligations of the Trustee relating to eminent domain takings of mortgage loans, the Trustee is not likely to take any further actions.

Sections 8.01, 8.02 and 8.03 further discuss how the Trustee has no real obligation to pursue/fight an eminent domain sale. Absent the Trustee's negligence, Section 8.01(v) provides that:

> *prior to the occurrence of a Servicer Event of Termination and after the curing of all Servicer Events of Termination which may have occurred, the Trustee **shall not be bound to make any investigation into the facts or matters stated in any resolution, certificate, statement, instrument, opinion, report, notice, request, consent, order, approval, bond or other paper or documents, unless requested in writing to do so by the NIMS Insurer or the Majority Certificate holder**;*

Section 8.02(a)(vi) further provides that—other than as provided in Section 8.01 (*e.g.*, negligence or perhaps the post event of default prudent person standard) – the Trustee:

> *shall not be accountable, shall have no liability and makes no representation as to any acts or omissions hereunder of the Servicer until such time as the Trustee may be required to act as Servicer pursuant to Section 7.02 and thereupon only for the acts or omissions of the Trustee as successor Servicer;*

Moreover, Section 8.03 provides:

> *… The Trustee makes no representations as to the validity or sufficiency of this Agreement or of the Certificates (other than the signature and authentication of the Trustee on the Certificates) or of any Mortgage Loan or related document. **The Trustee shall not be accountable for the use or application by the Servicer, or for the use or application of any funds paid to the Servicer in respect of the Mortgage Loans or deposited in or withdrawn from the Collection Account by the Servicer…** The Trustee shall at no time have any responsibility or liability*

> *for or with respect to the legality, validity and enforceability of any Mortgage or any Mortgage Loan, or the perfection and priority of any Mortgage or the maintenance of any such perfection and priority, or for or with respect to the sufficiency of the Trust or its ability to generate the payments to be distributed to Certificate holders under this Agreement…*

BOTTOM LINE—*We believe the Trustee will take the position that it has little or no obligation to ensure fair value is received in the event of an eminent domain sale*. Since it appears that neither Servicer nor Trustee have the fiduciary obligation to fight for fair value in eminent domain "takings," investors have very little representation. And the fact that each trust will have relatively few loans affected from each additional municipality that signs on to this program, makes it even more unlikely the eminent domain calculation of fair value will be contested. Moreover, it is not clear that the trustee (or other reporting party, as applicable) even has the responsibility to report which loan liquidations were the result of eminent domain activity, although we hope that they interpret their reporting obligations to require such disclosure as aggregating any eminent domain proceeds with liquidation proceeds would fail to give a complete picture to investors.

Eminent Domain—A Potentially Troublesome Precedent

We are very concerned that this use of eminent domain sets a potentially troublesome precedent. It gives the government a call on the loans, allowing for a re-strike of the loans, for what could be political motives. And it is likely to impact the willingness of investors going forward to purchase loans from this municipal area. This cost is irreversible.

As mentioned earlier, we are sympathetic to the fact that there is no way to restructure loans in a PLS, unless they are in imminent danger of default. And, even then, there is insufficient transparency to the investor on the restructurings (modifications). Thus, eminent domain could conceivably be used to do what the PSAs do not allow for—restructuring of performing loans under tightly guarded parameters. While we are sympathetic to this, we believe the troublesome precedent and impact on future borrowing outweighs this cost.

Even if we believed that there were a strong case to use eminent domain for this purpose, we would argue there is a better way to structure this program which more effectively preserves the rights of investors, but achieves the same result for performing underwater borrowers—the opportunity to refinance in an FHA short refinance loan. One possibility—the County of San Bernardino could work with a community-based housing organization to aid the borrower in filing out the FHA application, and work with the second lien holder to re-subordinate and possibly take a writedown. A warehouse line could be established by the Joint Authority in which, just prior to approval by FHA, it is taken by eminent domain, and funded until it can be placed in an FHA pool (FHA would have to give the county a heads up). The private label investors (or GSEs or bank lenders) receive about 103% of market value, not 80%. The Joint Authority does not receive its cut; the investors providing capital to this scheme do not benefit disproportionately, but the economics to the homeowner are the same.

What Has Experience Taught Us?

It is not unusual to find public policy goals in conflict. On one hand you want to further a public policy goal (in this case, preventing additional foreclosures), on the other hand there is a cost to mortgage holders. We can think of two precedents—the experience with PACE loans (loans to promote energy efficiency) in 2010 and the Georgia High Cost Lending Law in 2002. In both situations, the GSEs stood up to assert their rights. The difference in this situation is that the investors are less likely to do so.

In fact, this situation is very reminiscent of the PACE (Property Assessed Clean Energy) experience[4]. In areas with PACE legislation, the municipal government loans money to consumers and businesses for an energy retrofit; this is funded through a bond issue. These loans are repaid over 15–20 years, through a special assessment added to property tax bills. As initially conceived, the debt would be senior to existing mortgage debt, so if a homeowner defaults or goes into foreclosure, the PACE obligation would be repaid before the mortgage lender gets his money. While property tax assessments are usually senior to existing property debt, allowing property taxes to be used by homeowners that elect to make upgrades to their own homes create a dangerous precedent. Fannie Mae announced in August 2010 that they would not purchase mortgage loans secured by properties with an outstanding PACE obligation unless the terms of the PACE program do not permit priority over first mortgage liens. And for borrowers with loans securitized by Fannie Mae, who obtained a PACE loan prior to the July 2010 cut-off and want to refinance, the lender must first attempt to arrange a cash-out or limited cash-out refinance option, with the PACE loan paid off as part of the refinance. If the borrower is unable to qualify for this, the PACE loan payment must be included in the monthly housing expense calculation.

Fannie's press release addressed the dangerous precedent head on. Their language is as follows:

> *Fannie Mae supports the need for programs to help homeowners fund energy efficiency improvements, and believes it may be accomplished without altering the lien status of first mortgages. In the event that PACE or similar programs with automatic lien priority proliferate, Fannie Mae will consider further limitations as necessary to address safety and soundness concerns passed by PACE programs, in line with the July 6, FHFA statement. These restrictions may include tightening borrower debt-to-income ratios or loan-to-value ratios in jurisdictions offering such programs.*

We wish the author of that press release was available to help write this article!! But real world—where are we now with PACE loans? A minority of the 16 states that allowed localities to establish PACE programs have required that the PACE loans be subordinate to the first mortgage. However, the bulk of the PACE activity was effectively stopped by FHFA and OCC guidance. (On June 15, 2012, FHFA took more formal action, by issuing a Notice of Proposed Rulemaking (NPR), as required by a preliminary injunction issued by the Northern District Court of California.)

Georgia enacted a very tough Fair Lending Act in April 2002, effective October 2002. A loan of $20,000 or more is classified as High Cost if the total [point + fees] exceeds 5% of the loan amount (higher limits apply to smaller loans). This law provided a very

[4] For further information on the PACE experience, see FHFA Statement on Certain Retrofit Loan Programs, July 6, 2010, and Fannie Mae announcement SEL-2010-12 "Options for Borrowers with a PACE Loan."

stringent set of limitations for these loans, with strict penalties for non-compliance. While the rule was intended to protect borrowers, it left lenders very exposed, and making "high-cost loans" in Georgia was a poor business decision. The result—both Fannie and Freddie left the "high-cost loan" market in Georgia (Freddie Mac in November 2002; Fannie Mae in January 2003).

The likely result of this eminent domain activity for borrowers is that it will make future mortgage borrowing more costly, as investors will demand ever higher premiums to buy a new private label securitization. And as for the GSEs and bank portfolios—they are not included in this round, but could be included in the next. Thus, they too might build in a risk premium in these areas.

What Actions Can be Taken at this Point?

There has been widespread market concern that the price paid under the HPP will be low (although we don't know the price), and investors have little real protection. Thus, there has been a good deal of discussion among investors as to what actions can be taken. Much of the discussion has centered on trying, through non-legal channels, to stop municipalities from using eminent domain in this context. Let's enumerate the specific actions that investors have contemplated, with our spin on the implementation difficulty and likely success of each:

- Investors can bring a lawsuit questioning the legality of this use of eminent domain, but several large market participants would end up funding the lawsuit, as there is no mechanism for cost sharing.
- Investors can seek to apply business pressure to stop the HPP program—they will not work with any of the servicers, originators, investment banks involved in the program. If this were followed up on, it would be successful in many cases; however, some of these entities are not reliant on business from PLS investors.
- Investors and dealers, through SIFMA (Securities Industry and Financial Markets Association, the trade organizations for the securities industry), can conceivably determine that loans from affected areas would not be good delivery for TBA agency pools going forward[5]. This would require Fannie and Freddie to build screens in their systems to filter out certain zip codes. The loss of TBA eligibility would raise the cost of all future borrowings from affected areas. A less effective possibility would be to make FHA short refi loans ineligible for GNMA TBA delivery. However, this possibility cannot change the economics enough to thwart the program.
- The final possibility is that the GSEs step in on the side of PLS investors. It is important to realize that Fannie and Freddie together hold $112.9 billion of PLS, more than 10% of all PLS outstanding, and these portfolio holdings are clearly affected. If FHFA and the GSEs announced that the GSEs will be unwilling to insure loans in municipalities which are using eminent domain in this manner, it would stop the program immediately.

[5] It would be infeasible to exclude loans that have already been pooled.

Investors Need Representation with Fiduciary Responsibilities

We just showed that the private label securitization structure is inherently flawed; no one has a fiduciary responsibility to look out for investors. The results of this oversight are apparent on all fronts. Who is charged with looking at the fair value determinations that arise from the use of eminent domain and making sure they are fair to the investor? Who enforces the representations and warrantees in the PSAs on behalf of the investors? Who looks at the expenses relating to liquidations from an investors' perspective (long timelines, liquidation proceeds that bear no relationship to the value of the loan and the property, and, what many regard as excessive fees)?

In future securitizations, there is an acute need for an investor representative—with a fiduciary responsibility to represent investor interests. Investors need representation and a voice; a fiduciary achieves that goal.

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EXHIBIT

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July 15, 2013

Dear Members of Congress,

We write out of deep concern over the financial industry's effort to promote legislation or administrative action that would undercut the ability of communities to find local solutions to the continuing housing crisis. **We urge you to watch for and reject measures that would mandate discrimination by federal agencies against mortgage loans made in communities that implement local principal reduction programs.**

Predatory and irresponsible lending practices by the nation's largest banks were at the root of the financial crisis that drove the country into the great recession and continues to hurt millions of families. The crisis has affected everybody and disproportionally hurt communities of color: underwater rates are approximately 50 percent higher among African American and Latino homeowners and in neighborhoods of color foreclosure rates are almost three times those in predominantly white areas.

A number of municipalities are now exploring ways to restore community wealth and inject money back into local economies by purchasing mortgages, through traditional eminent domain authority if necessary, and resetting the mortgages to fair market value so that homeowners can avoid foreclosure and begin rebuilding equity. These cities – including El Monte, La Puente and Richmond, California – have large African American and/or Latino populations that were hit incredibly hard by the mortgage crisis.

In response to these local proposals, the Securities Industry and Financial Markets Association (SIFMA) has formally announced its intention redline any communities that make use of this authority.[i] After decades of redlining and years of predatory and discriminatory lending (*i.e.*, reverse redlining), the Wall Street banks that are members of SIFMA are proposing steps that could once again deny credit to – or make credit more expensive for - communities of color.

Three of SIFMA's allies in Congress have recently asked the Federal Housing Authority to alter its rules so as to deny qualified homeowners access to FHA loans if the homeowners' cities have purchased their previous mortgage through eminent domain.[ii] SIFMA has also asked the Federal Housing Finance Agency to alter the regulations governing Fannie Mae and Freddie Mac so that those entities will not purchase new mortgages on such homes.[iii] In late June, SIFMA attempted to insert language into the appropriations bill for the Department of Housing and Urban Development that would mandate these discriminatory changes to FHA policies.

We urge you to reject any proposals mandating that HUD or the FHFA discriminate against homeowners in cities that make use of their eminent domain authority to achieve principal reduction. Introducing new policies to redline qualified buyers would undercut fair lending and housing laws and policies and have a disparate impact on communities of color. Such action Congress or federal agencies would be a slap in the face to the cities and towns that were hardest hit by the housing crisis and are now working with local citizens and tax payers to find democratic, local solutions to the problem.

Sincerely,

Action Now
Action NC
AFL-CIO
AFSCME
Alliance for a Just Society
Alliance of Californians for Community Empowerment
American Federation of Teachers
Americans for Financial Reform
Arkansas Community Organizations
California Reinvestment Coalition
Center for Popular Democracy
City Life/Vida Urbana
Civil Justice
Common Good Ohio
Communication Workers of America
Courage Campaign
Delaware Alliance for Community Advancement
Home Defenders League

Idaho Community Action Network
ISAIAH
Jewish Community Action
Leadership Center for the Common Good
Living United for Change in Arizona
Los Angeles Alliance for A New Economy
Maryland Communities United
Minnesota Neighborhoods Organizing for Change
Minnesotans for a Fair Economy
Missourians Organizing for Reform and Empowerment
National Association of Consumer Advocates
National Consumer Law Center
National Fair Housing Alliance
National People's Action
New Bottom Line
New Jersey Communities United
New York Communities for Change
PICO National Network
Public Justice Center
Rebuild the Dream
Right to the City Alliance
SEIU 32BJ
SEIU 775NW
SEIU 925
SEIU1021
SEIU Healthcare Minnesota
SEIU International
SEIU Local 26
SEIU Local 284
SEIU Local 503
SEIU Local 1199
Southsiders Organized for Unity and Liberation
UAW 4123
Washington Community Action Network
Working Families Party

Cc: Secretary of Housing and Urban Development Sean Donovan
Federal Housing Finance Agency Acting Director Edward DeMarco

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[i] See 7/19/12 SIFMA Press Release, at www.tinyurl.com/SIFMAdocuments, stating that "SIFMA is issuing this statement today to introduce a policy regarding the interaction of eminent domain with TBA trading. Loans to borrowers residing in areas that municipalities have initiated condemnation proceedings to involuntarily seize mortgage loans through their powers of eminent domain will not be deliverable into TBA-eligible securities on a going-forward basis." Prohibiting the securitization of loans from these cities will raise interest rates and monthly payments on mortgages.

[ii] See 6/11/13 Letter from Representatives Ed Royce, Gary Miller, and John Campbell to Secretary of the Department of Housing and Urban Development Shaun Donovan, at www.tinyurl.com/SIFMAdocuments.

[iii] See 7/12/12 Email from SIFMA Managing Director Richard Dorfman to Acting Director of the Federal Housing Finance Agency Edward DeMarco, at www.tinyurl.com/SIFMAdocuments.