

## **2<sup>nd</sup> Chance Program**

The 2<sup>nd</sup> Chance program is designed to repair bank balance sheets to facilitate consumer lending, offer troubled borrowers a program to retain their homes, and jump start a securitization program for consumer products. 2<sup>nd</sup> Chance provides to banks and borrowers a subsidy based on the willingness of the Federal Reserve to lower interest rates to 0%. This presentation is in outline form having the following three sections and associated missions:

### **2<sup>nd</sup> Chance Bank Equity Contributions – New Lending**

*Mission: Provide the capital and financing to facilitate consumer lending with underwriting and controls such that receiving banks deploy funds in a prudent manor in terms of capital safety, risk-adjusted returns, and ultimate return of the tax payers money via internal earnings and/or external private capital.*

### **2<sup>nd</sup> Chance Existing Housing Inventory and Borrower Assistance**

*Mission: Give borrower access to the same funding as provided to the financial services industry for purposes of repairing their credit standing. The program must provide incentives to stabilize the equity position of borrowers and reduce the supply of distressed housing. In order to justify the incentive given by taxpayers the borrower will earn an equity position by adhering to a disciplined payment program.*

### **2<sup>nd</sup> Chance Securitization**

*Mission: Restart a struggling securitization market for consumer loans providing a need source of financing to facilitate market purchases.*

The challenge with any restructuring is balancing a needed helping hand with the complexities of the financial markets. The size of the market, capability to regulate, potential cause and effect, economics to the tax payer, legal and accounting complications, and entitlement must all be considered in design. Of course, some parties will not be benefited by the program and implementation so our goal is to best evaluate the trade-offs to reduce residual effect. At the end of each section we discuss the implications to the government and taxpayer, borrower, and existing investors in the residential mortgage backed market, as applicable.

## **2<sup>nd</sup> Chance Bank Equity Contributions – New Lending**

In order to promote new consumer lending the government should infuse capital into eligible banks. It is very important that this subsidy is monitored closely and underwriting guidelines are put in place to assure the tax payer that its investment is used appropriately. The following outline describes the basics for equity infusion to banks and associated checks and balances, capital and underwriting requirements:

- Equity only contributed into a consumer bank subsidiary having its own regulatory reporting. This assures transparency related to new consumers loans originated by the bank.
- Equity contribution in the form of Preferred Stock paying 3% or Funds + 300 bps (\$375 Billion)
- Fed provides up 2 to 1 leverage via financing facility at Fed Funds + 1%; remaining leverage to come from retail deposits and 2<sup>nd</sup> chance securitization program. Fed insures 2<sup>nd</sup> chance securitization program (see below).
- Minimum Capital Preferred + Bank Equity contributed to subsidiary = 8%.
- Retained Securitization Interest (2<sup>nd</sup> Chance Program) = 15% Risk Based Capital (see Securitization program)
- Only assets in subsidiary are new loans or bank's decision to contribute "good" loans (with requisite capital) from their current portfolio.
- Traditional Lending guidelines for new loans, no exceptions
  - Residential Owner
    - 20% Down – Two Outside Full Appraisals
    - Full Documentation
    - No Second Liens
    - 30 Year Term, Fully Amortizing, LIBOR + 5% max rate
  - Residential Second/Investor
    - 40% Down – Two Outside Full Appraisals
    - Full Documentation
    - No Second Liens
    - 30 Year Term, Fully Amortizing, LIBOR + 6% max rate
  - Consumer Loans (Secured)
    - 30% Down
    - Full Documentation/Scoring Combination
    - 5 Year Term, Fully Amortizing, LIBOR + 5% max rate
  - Initiative Loans
    - Insured by GNMA, Full Documentation
    - CRA Loans (GSE), Streamlined Documentation
    - 5% Down minimum, LIBOR + 4% max rate
- Unwound in Seven Years
  - Fed Facilities unwound; refinanced.
  - Securitization program reduced by loan payoffs.
  - Consumer Subsidiary Merged with parent bank
  - 6% Tier 1 Capital Required; 8% Risk Based Capital (for combined entity); under-capitalized banks under supervisory
- Same Fed Governance; separate subsidiary regulatory reporting.
  - New regulation developed for existing bank portfolio

The taxpayer/government has an earning asset in preferred equity and has transparency in the form of separate consumer subsidiary reporting. This program must be quickly

followed by a reform in regulatory guidance but in the interim traditional underwriting guidelines requiring full documentation, sufficient down payment, and conservative property values. Borrowers will benefit from increased consumer lending helping to ease the downward housing market spiral.

## **2<sup>nd</sup> Chance - Borrower Assistance Program**

Mounting foreclosures must be addressed to help declining housing values and provide borrowers the same subsidy opportunity that is being provided to the bank. In this program the borrower receives 0% financing consistent with the Feds statements with regard to potential stimulus. The key points related to providing troubled borrowers a chance to retain their homes are listed below:

- Qualifying Borrowers
  - Borrowers in Foreclosure or in Foreclosure Proceedings; also second chance for bank owned properties not yet sold. Must enter program within 90 days of foreclosure initiation.
  
- Program – Key Facts
  - Government (TARP) partners on property
  - Government is Owner; with purchase option to borrower
  - Financing 50% TARP (\$375 Billion); 50% Fed at Fed Funds (Facility) (\$375 Billion)
  - Fed Funds Interest Rate (0%) + 50 bps (1/2 of 1%)
  - Accelerated Principal Repayment (7 Years at 20% of 80% of Original Purchase Price) in 84 installments; at year seven borrower refinance to standard fully amortizing loan.
  - Option to Buy Back Loan at 80% of Original Purchase Price at any time.
  - If you default (3 missed payments) – Property goes to Sale and you lose the principal repayment, no exceptions
  - If you continue payment full credit given to borrower for equity contribution and should now qualify for a new loan. This assumes prices are at 80% of original value; if not CRA and Govt programs will take borrower. Six payment holidays after 1 year consecutive timely payments. Late fees 5%.
  - On a \$200,000 loan payment would be \$240 principal plus \$80 interest or \$320 per month. (about 2.0% overall cost of the loan balance per year)
  - Requires proof of employment and income; income must be 50% DTI
  - Investor/Issuer takes the equity loss on the property sale to the government partnership plus and interest advance costs to date. The government covers excess losses if the borrower cannot meet the payment demands of the program.
  - FNMA/FHMLC master servicer for issuer/servicers.
  - Same GSE Governance.

There is no reason why borrowers should not have the benefit of the Fed's low (or zero) interest rate stimulus program. The program allows all borrower payments to be credited up to 20% of the outstanding loan balance as long as the terms of the program are met. After seven years the borrower is no longer eligible for a bank or GSE loan. Investors in residential mortgage securities take a property sale loss when the government purchases the loan. This loss is considerably lower than losses the investor would ultimately take if the loan goes through the foreclosure process as 30-50% of the losses are associated with administering the sale. The other 80% of the loan will effectively be a prepayment to the investor. The taxpayer/government is making an investment directly in the impaired borrower as opposed to giving equity to a bank and allowing them to solve their loss problem. The taxpayer/economics is a tradeoff between the cost of picking up the cost of administering property sales or the cost of servicing the loan versus the interest and forfeited principal received. The true ancillary benefit to all parties should be the relief the housing market should gain from lower inventory for sale and the recuperation period that is afforded the borrower.

## **2<sup>nd</sup> Chance Securitization**

Securities holders are supported by a combination of significant bank and government credit enhancement to incent investment. The program requires the lowering of Risk Based Capital standards for retained subordination by banks and mortgage insurance to be provided by the government. The following outline addresses reviving the consumer loan securitization market:

- 1<sup>st</sup> Lien Residential Mortgage Program (Agency Eligible Balance)
  - 30% subordination held by issuer (15% Risk Based Capital)
  - 20 bps annual insurance premium to GSE
  - GSE insures loans down to 60% equity; 50% sharing below threshold
  - Financing – No Gain on Sale treatment
  - FNMA/FHMLC trustee/master servicer
  
- 1<sup>st</sup> Lien Residential Mortgage Program (Non-Agency Balances)
  - 40% subordination held by issuer (15% Risk Based Capital)
  - 40 bps annual insurance premium to Insurer
  - Third Party (Surety, MI, GSE) insures loans down to 60% equity; 50% sharing below threshold
  - Financing – No Gain on Sale treatment
  - trustee/master servicer TBD
  
- Asset Backed Secured Program
  - 50% subordination held by issuer (15% Risk Based Capital)
  - 100 bps annual insurance premium to Insurer

- Third Party (Surety, MI, GSE) insures loans down to 60% equity; 50% sharing below threshold
- Financing – No Gain on Sale treatment
- trustee/master servicer TBD

With 2<sup>nd</sup> Chance securities the government/taxpayer has another tool to stimulate investment in residential mortgage backed securities and receives fees for providing mortgage insurance. It is essential that the subordination interest held by the bank be given lower risk based capital treatment. Normally retained interest required 100% risk based capital (1 for 1). In this instance the loss expectancy is small versus the subordination retained which justifies a lower capital allocation. Investors should return to the non-agency market at prices near par which should be sufficient to profitably originate consumer loans. The program will provide financing to banks that otherwise would need to fund 100% of the consumer loan on their balance sheets.