Statement of

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Fannie Mae and Freddie Mac's Key Role in Subprime Lending

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Submitted testimony by Edward Pinto, real estate financial services consultant and former chief credit officer of Fannie Mae (1987-1989)

Chairman Waxman, thank you for the opportunity to testify today. I was Fannie Mae's chief credit officer from 1987 to 1989 and head of marketing and product management for 3 years before that. I left the company in 1989 and since then I have specialized in providing mortgage finance related consulting services. Since leaving Fannie Mae, I have followed the GSEs closely.

The data problem with home mortgages:

Many market observers are not aware that there is surprisingly little consistent information available about the size of the subprime market and the contribution of Fannie and Freddie to its growth. My testimony today will bring together all the available information that I could find in my research, and will contain information that has not to my knowledge been published anywhere else.

There are a total of approximately 25 million subprime and Alt-A loans outstanding, with an unpaid principal amount of over $4.5 trillion. The data and computations necessary to derive these numbers are included in Attachment 1. Because of customs developed years ago in the mortgage markets, subprime and Alt-A loans may show up in both subprime and prime databases.

The loans purchased or securitized by Fannie and Freddie, which were once solely prime loans, are still now included in databases of prime loans, even though 34 percent of Fannie and Freddie's loans should now properly be classified as subprime, Alt-A, or other non-prime loans. For this reason, using a common definition of subprime as those borrowers with weak credit histories as evidenced by a FICO score below 660[1], there are many more subprime borrowers reported as prime (10 million) than reported as subprime (5 million)[2]. In addition, the Alt-A or "liar" loan is generally not classified as subprime, because the FICO score of the borrower was generally above 660, but this loan was the favorite of the real estate speculator, and are currently defaulting at rates approaching those of subprime loans. For example, I estimate that one million of the GSEs' Alt-A loans had no down payment, using the high risk 80/20 piggy back loan financing vehicle.

For historical reasons, these loans are also carried in databases as prime loans when they were purchased by Fannie and Freddie, which conveniently allowed them to deny that they were active in the subprime market. This created tremendous disclosure problems for the industry, since a massive portion of subprime, Alt-A and other non-prime lending has long been hidden behind Fannie and Freddie's "prime" façade. Accordingly, there are many more subprime and Alt-A mortgages outstanding today than many people suppose, because half of all these loans are held or securitized by Fannie and Freddie and yet are carried in many databases as prime loans.

As I will discuss later, the purchase of large numbers of subprime loans and Alt-A loans was justified by the GSEs because they helped meet affordable housing goals.

As outlined in the attachments to this testimony, I estimate that there are 25 million subprime, Alt-A, and non-prime loans currently outstanding, about half of them held or guaranteed by Fannie and Freddie, and these loans are the source— although not the exclusive source---of the financial crisis we now confront. They are currently defaulting at unprecedented rates.

Fannie and Freddie's roles in the current crisis:

Fannie Mae and Freddie Mac played multiple roles in what has come to be known as the subprime lending crisis.

Fannie and Freddie went from being the watchdogs of credit standards and thoughtful innovators (see Attachment 2) to the leaders in default prone loans and poorly designed products[3]. They introduced mortgages which encouraged and extended the housing bubble, trapped millions of people in loans that they knew were unsustainable, and destroyed the equity savings of tens of millions of Americans. Freddie in 2004 acknowledged their flagship affordable housing program was "off to a poor start in terms of defaults"[4]. This "poor start" could not have been a surprise, since Freddie had published its estimated default rates by loan-to-value (LTV) in the late 1990s and found that its 95% LTV loans had about 6 times the default rate of 80% loans (see Attachment 3). They certainly had to know that this would not bode well for its "flagship" 97% and 100% programs.

While the American Dream of millions of homeowners hung in the balance, Freddie staffers then proceeded to discuss whether having more than 10 times the default level of their traditional loan programs was a problem. They decided to ignore the adverse impact on home buyers and just absorb the extra anticipated defaults and

noted that no one thought that "this was a showstopper"[5].

At the same time Freddie knew that its automated underwriting system was having subprime loans thrown against it by originators to see what would stick and that was a purpose for which it was never intended:

> **"The reasons against [using] LP [to source subprime loans] were LP [Loan Prospector, Freddie's automated underwriting system] weaknesses, if you throw nothing but subprime loans against LP, it will miss some, maybe even a lot." Internal Freddie Mac email from David Andrunkonis, dated April 12, 2004 FMAC0013766**

The same concern was expressed about using FICOs for unintended uses:

> **"[T]he reason FICO predicts as well as it does for mortgages might have something to do with all the other processes traditionally required in mortgages. Without these processes, the relationship between FICO and mortgage performance could change." Internal Freddie Mac email from Donald Bisenius, dated April 4, 2004 FMAC0013675**

This concern was well founded. In 1992, a mortgage borrower with a FICO of 620-659 was 7 times more likely to experience a serious delinquency over the next two years than a borrower with a 720-759 FICO. By about 2004 the 620-659 borrower was now 12 times more likely and the default propensity of the 720-759 borrower was unchanged.

Ignoring these concerns was a major change. Up until the late 1980s Fannie, for example, had a determined but low risk approach to affordable housing. Given the inherent risks and pitfalls, originating lenders who were closer to the marketplace were expected to design sustainable loan programs suited to the community and to put up capital to absorb first losses, while Fannie's main goal would be to provide liquidity for these types of loans. This would assure Fannie that loans were originated by lenders with both a stake in loan performance and involvement at the community level in program design. This was important because many of the affordable housing efforts undertaken by HUD had been directed from afar and had created more problems than they solved and had led to extraordinary levels of defaults and fraud.

This cautious approach was encouraged by some key community groups that had experienced the problems left in the wake of HUD's earlier misguided efforts. One such group was National People's Action (NPA) of Chicago. The founder and head

of NPA was Gail Cincotta, known as the "Mother of the Community Reinvestment Act". Ms. Cincotta had lived through the lending debacles caused by HUD's Washington bureaucrats. She begged Fannie to work through local banks already undertaking Community Reinvestment Act lending and to keep the banks on the hook for a substantial portion of the risk. This would keep the decision making local and reduce the risk of lending debacles. She also wanted Fannie to monitor and evaluate underwriting requirements and risk factors so that default rates could be kept at a low level (contrary to HUD's experience) and would support efforts to tighten underwriting where warranted.

In early 1989 Fannie abandoned this risk sharing approach because the requirement was slowing down the desired ramp up of Fannie's affordable housing initiatives.

In the late-1980s, Fannie hired a high powered political operative and consultant from Lehman Brothers to advise it on how to embrace and protect its charter from political attack - Jim Johnson. The means Fannie would use to embrace and protect Fannie's charter was to undertake a major expansion of its affordable housing initiatives. The goal would be to make Fannie indispensable to its supporters on Capital Hill. The ambitious nature of the plan would fully take shape once Johnson was tapped in early 1990 to become Fannie's next CEO. Johnson was initially named Vice Chairman (a new position) and by 1991 was named Chairman and CEO.

The new team at Fannie either forgot and/or ignored its recent brush with disaster in the early 1980s when foreclosures ballooned out of control. It embarked on a massive affordable housing effort (mandated and encouraged by its mission regulator - HUD) that eventually promoted subprime, ultra- high LTV, and Alt-A loans (many were NINJA loans – no income, no job or assets).

Johnson decided Fannie needed to undertake a massive effort to protect Fannie's remarkable charter advantages - at all costs and risks. This would be done by offering Congress ever larger promises of "reverse earmarks" done in the name of affordable housing. Reverse earmarks would take the form of affordable housing projects and funding commitments targeted geographically so as to garner and/or solidify support from its large group of Congressional supporters.

In 1993 HUD adopted its first set of affordable housing goals and Johnson reciprocated in 1994 when he announced a new goal of $1 trillion for its "Opening the Doors to Affordable Housing" initiative.

This was quickly followed by Fannie's opening of its first local partnership office. Eventually 51 of these local out reach offices would blanket the country. The main goal was to seal the charter deal with Congress. These offices were overtly political and performed a grass roots lobbying function. This network helped implement an aggressive "reverse earmark" program for members of Congress who supported Fannie.
While this effort was initiated by Fannie, it would eventually result in Freddie Mac needing to comply with and respond to the new congressional affordable housing mandates because these mandates applied equally to Freddie. Freddie would eventually launch its own affordable housing juggernaut. The periodic year-end bidding wars between the two over the limited supply of qualifying loans are an unusual side note to this scandal and caused an under pricing of the risk of these loans.

Likewise Fannie's massive expansion of its portfolio investments in the early 1990s would pressure Freddie to follow suit.

Eventually Fannie and Freddie would announce over $5 trillion in affordable housing initiatives.

This unprecedented abandonment of underwriting principles coupled with the fact that the GSEs were permitted to take on $5.6 trillion in credit risk and maintain portfolios of $1.5 trillion has put America's homeowners at risk (see Attachment 4 for an analysis of myriad risks faced by Fannie and Freddie). Their high risk activities were allowed to operate at a 75:1 leverage ratio[6], much higher than that of the recently bankrupted Lehman Brothers.

The cumulative impact of governmental policies over the last 70 years has caused the risk of real estate lending to increase radically. In the 1950s and 1960s the average homebuyer put at least 20% down to get an 80% LTV loan from an S&L that held about 10% capital against the loan. Simply put, there was 30% equity capital protecting an 80% LTV loan, yielding a low risk 2.7:1 leverage ratio.

Contrast that with 2007 when about 25% of Fannie and Freddie's loan purchases were zero down to 3% down payment loans and they had capital not of 10% but 0.45% on a mortgage backed security (MBS). Add 1% capital from the mortgage insurance company and 1.6% from the bank holding the MBS and total capital is about 3%. That's 3% equity capital protecting a 100% LTV loan resulting in a very risky 30:1 leverage ratio. Said another way, Fannie and Freddie decreased equity and capital by 91% on a loan that they knew was 10 times as risky as an 80%

loan. This leverage level was and continues to be nothing short of reckless for high LTV lending.

HUD's responsibility:

The key role played by HUD in this debacle cannot be ignored. In 1997, HUD commissioned the Urban Institute to study Fannie and Freddie's credit guidelines. It found:

> **"Almost all the informants said their opinion of the GSEs has changed for the better since both Fannie Mae and Freddie Mac made substantive alterations to their guidelines and developed new affordable loan products with more flexible underwriting guidelines. ...**
> **Informants did express concerns about some of the GSEs' practices. The GSEs' guidelines, designed to identify creditworthy applicants, are more likely to disqualify borrowers with low incomes, limited wealth, and poor credit histories; applicants with these characteristics are disproportionately minorities."**

With the encouragement of HUD, their mission regulator, a relentless assault was made upon the three underpinnings of underwriting: capacity, collateral and credit. Administrative fiat and wishful thinking made these "old fashioned" concepts fade away. Fannie and Freddie rolled out "innovative" program after innovative program that substituted new and untested rules on income or abandoned income qualification entirely, eliminated down payments, and catered to borrowers with damaged credit. The frequency of these innovations seems to coincide with the ever increasing affordable housing goals set by HUD. Fannie and Freddie's affordable housing goals reached 55% in 2007.

Fannie and Freddie's subprime and Alt-A assets:

While they may deny it, there can be no doubt that Fannie and Freddie now own or guarantee $1.6 trillion in subprime, Alt-A, and other default prone loans and securities (see Attachment 5). This comprises over 1/3 of their risk portfolios and amounts to 34% of all the subprime loans and 60% of all Alt-A loans outstanding (see Attachment 6). These 10.5 million unsustainable, non-prime loans are experiencing a default rate 8 times the level of the GSEs' 20 million traditional quality loans. This total includes 5.7 million subprime, 3.3 million Alt-A, and 1.5 million with other high risk characteristics (see Attachment 7).

I estimate that one million of the GSEs' Alt-A loans had no down payment, using the high risk 80/20 piggy back loan financing vehicle and untold more were NINA loans (no income no assets). The purchase of Alt-A loans was justified in 2004 by Freddie because they helped it meet affordable housing goals, notwithstanding that Freddie had called these loans dangerous in 1990 and stopped buying them.

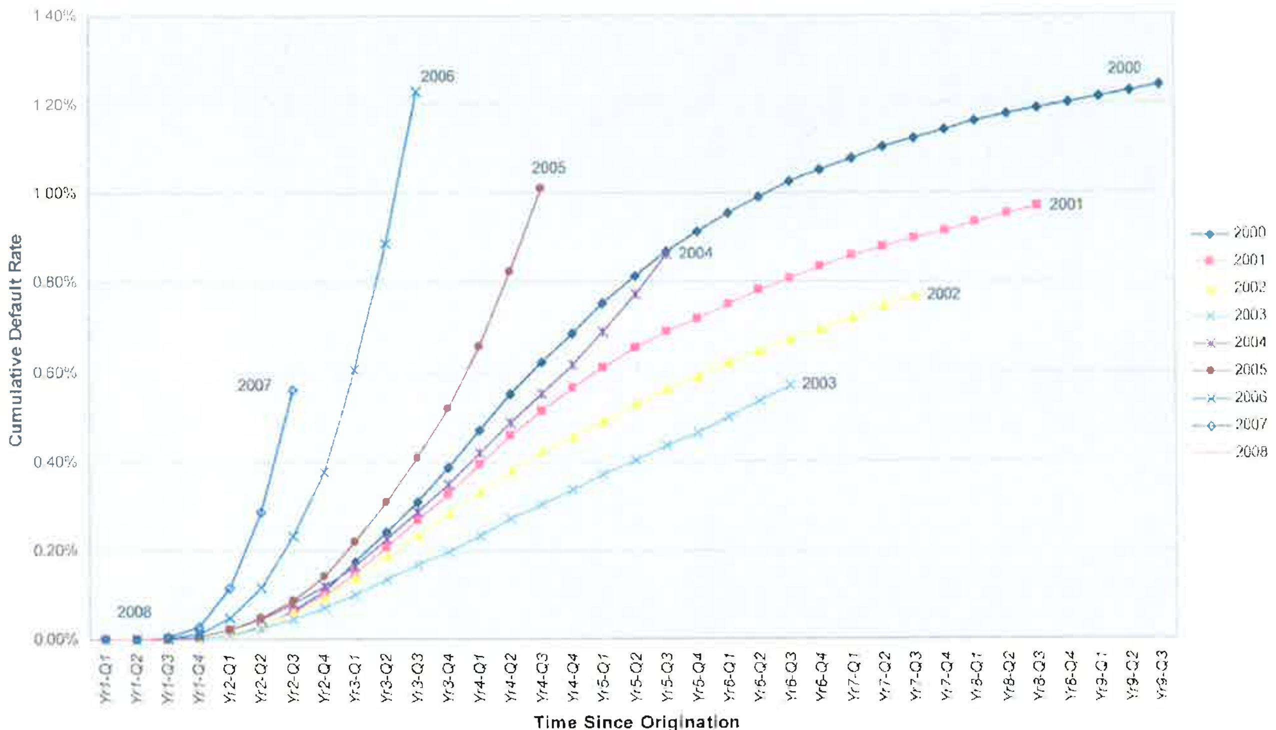
> **"The potential for the perception and reality of predatory lending with this product [NINA] is great." Internal Freddie Mac email from David Andrunkonis to Dick Syron, dated September 7, 2004 FMAC0013766 and**
>
> **"The Alt-A business makes a contribution to our HUD goals." Internal Freddie Mac email from Mike May to Dick Syron, dated October 6, 2004 FMAC0013694**

Their $1.6 trillion in unsustainable, default prone loans does not include FHA's obligations. Add in FHA's loans and the government is responsible for 54% or over 13.5 million of all 25 million subprime and other default-prone loans. These 25 million default prone loans constitute 44% of all the mortgage loans in the US, a result that is unprecedented in our history (see Attachment 6).

<u>Consequences of Fannie and Freddie's $1.6 trillion in unsustainable, default prone loans:</u>

The GSEs' default rates are skyrocketing (see Exhibit 1 below). Although they are too new to predict default rates with any certainty, I would expect those portions of Fannie and Freddie's 2005-2007 books consisting of subprime and other default prone loans to experience default rates ranging from 8% for the 2005 originations to 40% for 2007 originations. The GSEs will be responsible for a large percentage of an estimated 8.8 million foreclosures expected over the next 4 years, accounting for the failure of about 1 in 6 home mortgages. Fannie and Freddie have subprimed America.

Exhibit 1: Fannie's Overall Cumulative Default Rates By Origination Year:



Note: Cumulative default rates include loans that have been liquidated other than through voluntary pay-off or repurchase by lenders and include loan foreclosures, preforeclosure sales, sales to third parties and deeds in lieu of foreclosure.

Consistent with industry trends, 2006 and 2007 vintages performing poorly. Defaults for the 2008 vintage through 2008 Q2 have been negligible.

Data as of September 30, 2008 is not necessarily indicative of the ultimate performance and are likely to change, perhaps materially, in future periods. 7

The losses likely to be suffered by Fannie and Freddie will be a terrible burden to US taxpayers. If the default rates I predict actually occur, US taxpayers will have to stand behind hundreds of billions of dollars of Fannie and Freddie losses.

<u>This did not have to happen:</u>

This could have been averted. They could have exercised leadership, as they had done at least twice before, and stopped the mortgage madness that was enveloping the industry. In 1985 Fannie published new guidelines that tightened its underwriting standards[7]. In the early-1990s Fannie and Freddie publicly announced they were no longer buying low doc/no doc loans because they were too risky (see attachment 8). But in 2004, Fannie and Freddie announced initiatives

that opened the floodgates. In the years 2005 through 2007, they bought over $1 trillion of loans that they knew were default prone[8]. Their purchases were a major factor in the development of the housing bubble, and in the huge number of defaulted mortgages that are causing the massive decline in home prices. Without Fannie and Freddie's actions, we would not have this unprecedented housing crisis.

<u>Likely excuses offered by Fannie and Freddie:</u>

I am sure some will say that any company limited to only one line of business, namely housing finance, would of course suffer from a nationwide decline in home prices. However, this ignores several realities:

1. **Fannie and Freddie always justified their extraordinarily low capital requirements on the fact that they were restricted to one line of business;**
2. **A government protected duopoly could and did create a housing bubble; and**
3. **They ignored common sense and the advice of their own credit risk experts and dramatically loosened lending standards, thereby unleashing a flood of unsustainable, default prone loans.**

Or that mortgage backed securities were the root cause, but they ignore these realities:

1. **Fannie and Freddie were the world's largest MBS issuers and certainly among the most "creative";**
2. **They fought mightily to keep the capital requirement on MBS issuances low at 0.45%. That's $450 on a $100,000 mortgage. The capital undergirding their $4 trillion in the GSE's MBSs was a mere $18 billion, and half of that was so called preferred stock;**
3. **They traded on their implicit government guarantee and as a result about 50% of their debt ended up overseas (see Attachment 9), as did a substantial portion of their MBS issuances. This helped create a doubly urgent situation for the Fed and Treasury as the GSEs rocketed towards conservatorship in late August.**

Or that they were just following Congress' bidding, but they ignore these realities:

1. **While there is certainly plenty of blame to place at Congress' feet, it is nothing short of astounding to hear this excuse. Fannie and Freddie created and nurtured a relationship with Congress that lead many to question who controlled whom;**

2. Their lobbying tactics, foundations, cronyism and "reverse earmarks" were legendary

Or that they did not create the subprime or Alt-A market, but they ignore these realities:

1. **Fannie and Freddie jealously and forcefully protected their Congressionally granted turf;**
2. **In their usual "take-no-prisoners" style, they beat back every challenge by the likes of Salomon Brothers, GE Capital, and many of the largest banks and thrifts in the late-80's and early-90s;**
3. **Properly chastised, the private sector turned to what was left and developed subprime and Alt-A business lines;**
4. **By the early part of this decade, the GSEs realized that the private sector was beating them in terms of share and, default risk notwithstanding, these subprime and Alt-A loans were to affordable housing "goal rich" to ignore.**
5. **Internal Freddie emails express a worry that it is leading the market on no income/no asset loans. Internal Freddie Mac email from David Andrukonis, dated April 5, 2004 FMAC0013704-5**

These excuses remind me of the twins who killed their parents and then threw themselves on the mercy of the court because they were orphans.

<u>How else Fannie and Freddie turned the American dream of homeownership into the American nightmare of foreclosure:</u>

Compounding the problems caused by their minimal capital was the fact that they followed an origination model initially established by FHA that enabled thinly capitalized mortgage brokers and bankers to take over virtually the entire origination market. Mortgage brokers alone accounted for 63% of all originations over the period 2001-2006, almost double the rate in 1990. And Freddie knew in 1999 that brokers presented a danger:

> **"Freddie Mac has found that 65% of its fraud cases involve loans produced by third-party originators [For 1999 OHFEO reported that third-party originators, ie. brokers, had a 26% market share with the GSEs]. … Independent mortgage brokers account for 32% of the fraud cases, while banks are the remaining 3%. The majority of the fraud – 60% - comes from defective loans (see Attachment 10)."**

Adding to this bias in favor of mortgage broker and mortgage banker sourced business was the fact that Fannie and Freddie offered its best pricing to its largest (and riskiest) customers, (ie. Countrywide, Indy Mac) while offering much worse pricing to customers, ie. community banks, with proven track records of delivering high quality loans done the traditional way.

Armed with these unfair advantages bestowed by Fannie and Freddie, these mortgage brokers and bankers set about to compete with thousands of well capitalized community banks – banks that are conspicuously absent from the epidemic of default prone loan problems nationwide.

In 2004, Fannie and Freddie decided to plunge into the subprime market:

> **As reported in the Mortgage Banker: "The top executives of Freddie Mac and Fannie Mae made no bones about their interest in buying loans made to borrowers formerly considered the province of nonprime and other niche lenders. ...Richard Syron, chairman and [CEO] of Freddie Mac, said, 'Our success in the future depends on our ability to serve emerging markets; they will become the 'surging markets.'...**
>
> **Meanwhile, Fannie Mae Chairman and [CEO] Franklin Raines told mortgage bankers [at the October 2004 annual Mortgage Bankers' convention] in San Francisco that his company's lender-customers 'need to learn the best from the subprime market and bring the best from the prime market into [that market].' He offered praise for nonprime lenders that, he said, 'are some of the best marketers in financial services.'... We have to push products and opportunities to people who have lesser credit quality," he said." Mortgage Banking, December 2004, "Looking for new customers"**

These statements alerted the originator community that if they could make subprime and Alt-A loans, there was ready market for them, and this stimulated an orgy of junk mortgage development.

Fannie and Freddie used their automated underwriting systems to divert subprime and Alt-A loans from the private label securitizers, driving up the value of these loans and making mortgage brokers even more eager to find borrowers, no matter what their credit standing.

Why did Fannie and Freddie do this?

First, they were trying to meet HUD's affordable housing goals, which by 2005 required 55% of the loans they purchase to be affordable housing loans, including 28 percent to low income and very low income borrowers.

Second, after their accounting scandals in 2003 and 2004, they were afraid of new and stricter regulation. By ramping up their affordable housing lending, they showed their supporters in Congress that they could be major sources of affordable housing financing.

This was not a failure of the free market. It is a failure of Congress and the ill-conceived regulatory regime it implemented.

The Equity behind home mortgages:

As a result of Fannie and Freddie's misguided and destructive efforts, we now face the greatest economic crisis of the last 80 years.

In 2006 there was an estimated $22 trillion in home value. By October 31, 2008, it was down to $18.5 trillion. There's currently $12.1 trillion in mortgage debt, over 42% of which are default prone loans. Seventy percent of all mortgage debt is now held or guaranteed by the US government.

$6+ trillion in home equity sounds like a lot, but at 66% loan-to-value, it is at the lowest level in our history. 30% of all homes are owned free and clear – there's no mortgage. Thus only $13 trillion in home value backs $12.1 trillion in debt. House prices are conservatively predicted to drop about another 15% by the end of 2009 - so the value of homes with mortgages goes down to $11 trillion – well below the level of outstanding debt which will total 110% of value. At the depth of the Great Depression outstanding mortgages totaled 20% of all home values. The total price drop from peak to bottom during the Great Depression (1925-1933) was 30% - the same percentage drop projected for 2005-2009.

Lax and excessive lending by Fannie and Freddie have triggered a housing collapse that is generating foreclosure rates in excess of those experienced in the depths of the Great Depression. In 2008 there are expected to be over 25 foreclosures per 1000 loans, a rate about double the rate in 1932.

As this Committee continues with its oversight responsibilities, I'd like to remind you of the oft repeated warnings of the late-Gail Cincotta, whom I had mentioned earlier. Ms. Cincotta died in 2001. She spent 30 years:

> **"[f]ighting abuse, fraud, and neglect of the FHA program that has destroyed too many neighborhoods and too many families' dreams of home ownership…." Statement by Gail Cincotta before the Subcommittee on Housing and Community Opportunity, April 1, 1998**

I can speak with familiarity regarding Gail's views because she and I worked for 3 years from 1986-1989 to design and implement an affordable housing program at Fannie Mae that we both knew would finance needed affordable housing and keep foreclosures low. Unfortunately as noted earlier, the principles underlying that program were abandoned.

Gail repeatedly warned Congress that poor lending practices led the FHA program to have:

> **"a national default rate 3 to four times the conventional market, and in many urban neighborhoods it routinely exceeds 10 times." Id**

She attributed FHA's "American Nightmare of Foreclosure" to the fact that mortgage bankers and brokers:

> **"take advantage of the fact that they share no risk on these loans to cut corners." Id**

In 1998 Ms. Cincotta expressed a wish that FHA's default rate be on par with Fannie and Freddie's. Her wish was granted, but with a horrible twist. Fannie and Freddie's serious delinquency rate on their $1.6 trillion in default prone lending is now on par with FHA's still unacceptably high rate. And it's getting worse by the month!

Rather than Congress straightening FHA out, it proceeded to create a new problem. The American taxpayers now find themselves saddled with 10.5 million subprime, Alt-A, and other default prone loans originated by Fannie and Freddie.

Dealing with today's crisis:

The mortgage industry was heavily regulated in almost all areas except the one that mattered most – having participants with real money at risk! As Gail warned: "firms take advantage of the fact that they share no risk on these loans to cut corners."

It's time to end Fannie Mae and Freddie Mac's role as promoters of default prone and unsustainable loans that trap people in homes they cannot afford.

Towards this end I have two recommendations:

First the short term solution (adapted from an article by Peter Wallison and Edward Pinto originally published October 25, 2008 in the Wall Street Journal):

> **The current foreclosure problem can only be addressed with a standardized plan that must work both for whole mortgages held by banks, and mortgages that collateralize mortgage-backed securities (MBS). It must also address several obstacles and challenges: the refinancing agency must have the necessary legal authority now (there is no time to establish a new agency); funding for mortgage purchases must be immediately available; and the plan must be voluntary, so the rights of lenders and the holders of MBS are protected. The plan must also target the right group of homeowners--those already delinquent or in danger of default because of impending interest-rate resets or other factors, but who are otherwise willing and able to carry a fixed-rate, reasonably priced mortgage. This last point is critical. Fighting the current crisis of foreclosures is similar to fighting an out-of-control forest fire. You can't fight it at the fire – you must create a fire break away from the fire. The same applies to the current mortgage crisis – we must get ahead of and break the cycle of foreclosures enveloping the landscape.**
>
> **The legal authority and the funding for such a standardized plan are already in place. Fannie Mae and Freddie Mac, as government sponsored enterprises (GSEs), have the authority to renegotiate any mortgage they own now or purchase in the future from others. They also have the necessary funding, either from the sums they can themselves raise in the market or through borrowing by the Treasury, which is authorized under the Housing and Economic Recovery Act of 2008 to lend virtually unlimited amounts to both GSEs.**

The banks that own whole mortgages will want to keep those that they assess as performing now and likely to perform in the future. They also know that if they have to foreclose on a mortgage, they will incur substantial costs.

Accordingly, Fannie and Freddie should make a blanket offer to all banks or other mortgage lenders to buy any existing mortgage at a fixed discount--say, 20%--from the principal amount then due on the mortgage. This will induce the banks to sell their weaker mortgages (including those not now delinquent). This in itself will improve their financial condition. Fannie and Freddie would similarly identify the weaker loans in their own portfolios and be prepared to write them down 20%.

The GSEs should then offer to modify or refinance these weak and defaulted loans under the following terms: The unpaid principal amount of the mortgage will be reduced 20%. If the loan has a fixed rate, the rate will be reduced by 2% (but not below 5%), and if it is an adjustable, it will be recast at a 5% fixed rate, over 20 years. The purpose of a 20-year (rather than a 30-year) amortization is to build up equity in the home more quickly and help protect taxpayers against loss, and to help stabilize home values. Monthly payments will end up being reduced about 20%, ultra-high loan-to-value (LTV) ratios will be eliminated, and the downward slide in housing markets will be mitigated. This solution is crafted so as to increase the amount of equity present in the real estate market immediately and over time. It therefore has the potential to help all homeowners maintain the equity in their homes.

Loans that are in pools of mortgage-backed securities present a more complex, but manageable, problem. Fannie and Freddie are authorized to modify the terms of defaulted mortgage loans in MBS pools, and they could offer to refinance loans that servicers of MBS pools deemed likely to fail. Banks that hold these MBSs are likely to accept an offer for these securities by the GSEs for the same reasons that they will sell whole mortgages that are troubled or in default. For loans that are not in default, Fannie and Freddie could advise servicers that it is offering a targeted refinance program and borrowers who chose to participate would be offered the same terms.

There are two additional conditions that must be added to these new mortgages, to make them less of a windfall for borrowers. The house could not be further encumbered by a home-equity loan until the government mortgage is fully paid off; and the mortgage-holder would be fully liable for the loan, unlike almost all other mortgages, which are backed only by the house itself. Requiring the new mortgages to be "full recourse" loans will tend to screen

out of the plan those homeowners who can currently make their mortgage payments, and will attract those homeowners who are willing to assume personal liability in preference to foreclosure.

This plan requires banks that are holders of MBS to accept a 20% "haircut" on the weak mortgages they hold. It also requires greater responsibility and risk for the homeowners who choose a modified GSE mortgage. True, if many of these mortgages ultimately go into default, the taxpayers will suffer losses--but this is a risk that was always implicit in the TARP, and the risk will only be greater if we fail to act and losses further weaken the banks.

It is in our national interest to clean up the mortgage mess as promptly as possible, return the banks to financial health, and arrest the rise in mortgage defaults. This plan has a chance to accomplish these objectives.

Avoiding future financial crises:

It is imperative that you implement Gail Cincotta's vision whereby participants in the mortgage lending system have an adequate level of equity and capital at risk. Without adequate equity and capital our entire economy is put at risk.

The solution is a well designed risk absorption structure for both conventional and affordable housing:

First, borrowers must bring some equity to the transaction – the standard loan must return to one with a down payment of 20%. Some percentage of home buyers might use private mortgage insurance to qualify for a 10% down payment. FHA would be limited to perhaps 10% of homebuyers qualifying with minimum 5% down payment.

Second, require originating lenders be well-capitalized and retain a component of risk on any loan they hold, sell or securitize, thereby keeping them in a first loss position. The minimum capital requirement might be 6% on held loans and 1% on sold or securitized loans. This capital would be available to cover losses on any of the loans made by the lender. This places prudential lending responsibility squarely on the originating lender and will become the first line of defense (after adequate borrower equity) to absorb the inevitable mistakes and market price fluctuations. If a lender makes too many mistakes, it will fail its capital test and not be able to make any more loans.

Third, provide liquidity for originating lenders and another layer of capital by encouraging the formation of a number of well-capitalized private mortgage guaranty companies. They would be prohibited from holding a portfolio. They would need not 0.45% capital but perhaps 2% capital on 80% and below loans. These companies would have no Congressional or HUD involvement. A separate group of private mortgage insurers insuring loans with a 10%-19% down payment would be required to have not 1% capital, but perhaps 4%. This then becomes the third line of defense in the event of default by borrowers and extremely serious mistakes by originators.

Under this structure, third party investors in mortgage backed securities would benefit from multiple layers of real capital protecting them from the vicissitudes of the marketplace. Initial average down payment would be about 20%, the originator would add 1% capital, the private mortgage guaranty company adds another 2%, and the privately insured loans with 10%-19% down payments would add another 4% on its loans. This results in a minimum equity/capital percentage of 23% or a 4.25:1 debt to equity leverage ratio on 80% lending and a minimum equity/capital percentage of 17% or 6:1 debt to equity leverage ratio on 81-90% lending.

The above isn't a cure all. By reducing leverage to 4.25:1 you'll go a long way towards stopping default prone lending where it starts – the borrower, originating lender and mortgage guarantor.

Finally, I would be remiss if I did not tell you that Fannie Mae, Freddie Mac, and FHA are continuing some of the same unacceptable practices. They continue to make unsustainable loans to unsuspecting borrowers, loans that will fall at unacceptably high rates. Many are being originated by the same brokers that have caused so many past problems. Fannie and Freddie will still be subject to the same unrealistically high affordable housing goals set by HUD (temporarily suspended) and now the responsibility of their safety and soundness regulator.

Thank you for the opportunity to testify.

Respectively submitted,

Edward J. Pinto, epinto@lendersres.com

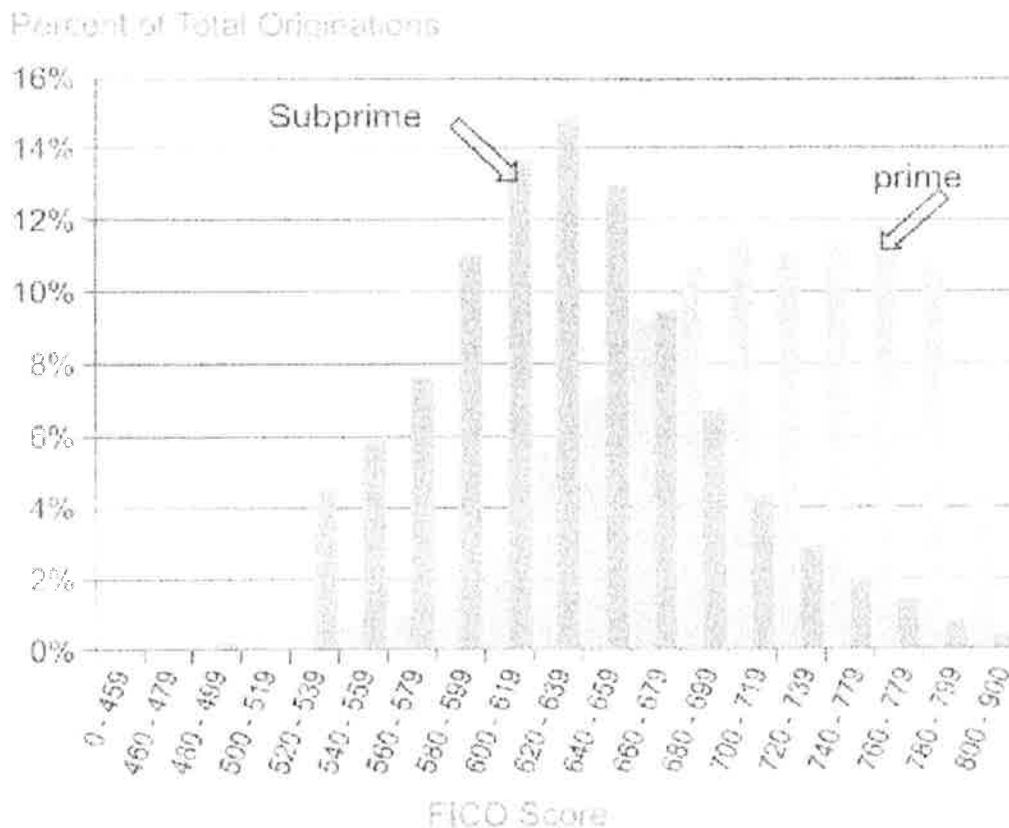
[1]Expanded Guidance for Subprime Lending Programs: (http://www.federalreserve.gov/Boarddocs/SRletters/2001/sr0104a1.pdf"):

"The term "subprime" refers to the credit characteristics of individual borrowers. Subprime borrowers typically have weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies. ... Subprime loans are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase. Such loans have a higher risk of default than loans to prime borrowers. Generally, subprime borrowers will display a range of credit risk characteristics that may include one or more of the following:

- **Two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months;**
- **Judgment, foreclosure, repossession, or charge-off in the prior 24 months;**
- **Bankruptcy in the last 5 years;**
- **<u>Relatively high default probability as evidenced by, for example, a credit bureau risk score (FICO) of 660 or below (depending on the product/collateral), or other bureau or proprietary scores with an equivalent default probability likelihood (emphasis added)</u>; and/or**
- **Debt service-to-income ratio of 50% or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income."**

This list is illustrative rather than exhaustive and is not meant to define specific parameters for all subprime borrowers. Additionally, this definition may not match all market or institution specific subprime definitions, but should be viewed as a starting point from which the Agencies will expand examination efforts (emphasis added)."

[2]Distribution of self-denominated subprime and prime loans by FICO score. ☐



"Surprise: Sub-Prime Mortgage Products are not the Problem!" James R. Barth, Tong Li, Triphon Phumiwasana, and Glenn Yago, Milken Institute

The above chart is based on Loan Performance Corporation data. Loan Performance reports that its LP Prime Database has "[L]oan-level data on over 75% of the nation's active first mortgages—more than 38 million—including all of the Fannie Mae and Freddie Mac portfolios." Fannie and Freddie's risk portfolios account for 29 million or 76% of these loans.

[3]Fannie & Freddie abandoned their credit underwriting principles – principles that Gail Cincotta (founder and president of National Peoples Action) and I had discussed at length in the late 1980s and knew were needed to protect homeowners from default prone loans.
In Fannie's 2007 report to HUD, it stated:

> **"In 2007, Flexible mortgages offered the potential for borrowers, based on down payment amount, to obtain up to 100 percent LTV funding while allowing flexible sources for closing costs. Flex products served many borrowers with incomes below area medians and many first-time homebuyers as well. Specifically, Fannie Mae purchased $37.5 billion in Flexible loans made to 207,819 households in 2007. Of that total, 96,738 Flexible mortgages were made to first-time homebuyers." Fannie Mae's 2007 Report to HUD**

Fannie also reported that:

> **"In mid-2007, due to changing market conditions, it ... implement[ed] pricing & eligibility changes that allow MCM to continue providing borrower funds while also remaining aligned with performance and underwriting criteria." Id**

Allow me to translate: these loans were default prone and necessitated higher delivery fees and tighter eligibility standards.

By September 30, 2008 these and other ultra-high LTV loans were experiencing a 4.68% serious delinquency rate, not withstanding that half of these loans were made last year or later. This does not bode well for many of the over 3 million homeowners with one of these loans from Fannie and Freddie.

I suggest you read the entire 2007 report in light of Ms. Cincotta's warnings. You will agree that Fannie and Freddie's self-described efforts to purchase loans that have:

> **"[r]elatively higher risks attributed to such factors as a blemished credit history, limited savings, or low down payments." Id**

was just another in a long line of doomed FHA-like programs that Ms. Cincotta pointed out:

> **"...destroyed too many neighborhoods and too many families' dreams of home ownership".**

[4] Internal Freddie Mac email to Dick Syron dated June 24, 2004 regarding "June Risk Committee Summary/No action required", FMAC0013799

[5] Internal Freddie Mac email dated July 12, 2004 regarding "Mission Committee Meeting", FMAC0013801-2

[6]They were required to hold capital of 0.45% on MBS and their portfolio holdings required 2.5%. Only about 50% of Fannie and Freddie's capital was comprised of equity raised from the sale of common stock and retained earnings. The other half was gotten through the sale of preferred stock at below market rates sold to banks. Banks were "encouraged" by their regulators to invest $36 billion of their core capital in these so called "ultra-safe" investments. This made raising new capital "easy" since Fannie and Freddie had ready buyers. The irony is that Fannie and Freddie used their high leverage to compete unfairly with better capitalized banks. Fannie and Freddie "invested" this capital in affordable housing tax credits created by Congress which were used as a tax shelter. In September 2008 all of Fannie and Freddie's preferred stock was written off by the banks and in November 2008 all of the tax credits owned by Fannie and Freddie were written off. These credits accounted for about 50% of their capital as recently as June 30, 2008. This situation was compounded by the minimal equity that Fannie and Freddie were permitted to operate with and the high amounts of leverage in the housing finance system generally. See also "Who's Letting Banks Invest in Fannie and Freddie Preferred Stock?" Thomas Kirchner, August 28, 2008 http://seekingalpha.com/article/93039-who-s-letting-banks-invest-in-fannie-and-freddie-preferred-stock

[7] A severe real estate recession occurred during the early 1980s. The default levels experienced in Texas, Alaska, and other energy dependent states became known as the "Texas depression scenario". I started working at Fannie Mae in September 1984. During the period September 1984 – August 1985 my staff and I were responsible for the development of underwriting guidelines that resulted in a major tightening of Fannie Mae's acceptable credit quality standards. Prior to this date, it had been accepting many categories of loans with unacceptable levels of risk. In August 1985, Fannie Mae issued Selling Guide Announcement 85-13 which publicly implemented wholesale changes which significantly tightened its acceptable underwriting guidelines so as to restrict characteristics leading to default prone loans. The changes eliminated or restricted specific loan products and also changed generally applicable loan guidelines and standards. The changes, based on a review of Fannie Mae's default experience and underwriting guidelines, were deemed necessary so as to eliminate or restrict underwriting criteria that had contributed to the high default levels experienced in the period 1980-1985. Various types of adjustable rate mortgages (ARMs) had proliferated during this period of high interest rates and had become one of the predominant forms of mortgage loans. ARMs had contributed disproportionately to Fannie Mae's defaults and were singled out for many of the changes. For example, wholesale changes were made that were designed to reduce payment shock and reduce the use of "teaser rates". The experience with graduated payment ARMs, which generally allowed for scheduled or potential negative amortization, was so poor that this category of loan was generally eliminated. Underwriting changes designed to reduce the default prone characteristics of high loan-to-value (90% and 95% LTV) lending were made. Likewise poor experience with investor loans, loans on 3 and 4-plexes, and cash out refinances led to substantially tightened requirements for these types of speculative loans. Valuation issues were addressed with new limitations on buy-downs/seller contributions for all types of loans, along with major revisions to appraisal requirements. Allowable debt-to-income ratios were reduced depending on the product and loan-to-value (LTV). The purchase of 1st mortgages with simultaneous seconds (piggy-back seconds) was restricted. Selling Guide Announcement 85-13 generally resulted in significant tightening of mortgage standards nationwide.

[8] The unacceptably high risk associated with ultra-high LTV loans has already been noted. The same was true for NINA (no income/no asset) loans.

> **"Freddie Mac should withdraw from the NINA market as soon as practical. [Performance Is poor as evidenced by] first year delinquency rates on these mortgages, which rangh from 8 to 13%, depending on the lender." Internal Freddie Mac email dated September 4, 2004 regarding NINA mortgages, FMAC0013739**

Attachment 1 to Submitted testimony of Edward Pinto before US House of Representatives Oversight Committee - December 9, 2008

US Mortgage Market: Sizing Total Subprime, Alt-A & Other Junk Loan Exposure

Research prepared by Edward Pinto, epinto@lenderres.com **Date: 12.1.08**

A. Subprime:

Allowing each individual originator to define on its own what constitutes a subprime loan was found by banking regulators to be an unsatisfactory situation. In 2001 Federal banking regulators gave "Expanded Guidance for Subprime Lending Programs": (http://www.federalreserve.gov/Boarddocs/SRletters/2001/sr0104a1.pdf"):

> "The term "**subprime**" refers to the credit characteristics of individual borrowers. Subprime borrowers typically have weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories. Subprime loans are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase. Such loans have a higher risk of default than loans to prime borrowers. Generally, subprime borrowers will display a range of credit risk characteristics that may include one or more of the following:
>
> - Two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months;
> - Judgment, foreclosure, repossession, or charge-off in the prior 24 months;
> - Bankruptcy in the last 5 years;
> - **Relatively high default probability as evidenced by, for example, a credit bureau risk score (FICO) of 660 or below (depending on the product/collateral), or other bureau or proprietary scores with an equivalent default probability likelihood** (emphasis added); and/or
> - Debt service-to-income ratio of 50% or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income."
>
> This list is illustrative rather than exhaustive and is not meant to define specific parameters for all subprime borrowers. Additionally, this definition may not match all market or institution specific subprime definitions, **but should be viewed as a starting point from which the Agencies will expand examination efforts** (emphasis added)."

The use of a FICO score below 660 as a significant point of demarcation between prime and subprime loans goes back to 1995. As noted in January 1997 by Standard & Poor's, "...a FICO score of 660 [is] the investment-grade score as defined in Freddie Mac's industry letter of August 1995." (S&P Structured Finance Ratings, January 1997, p. 14).

Based on these sources, defining subprime as a loan with a FICO of less than 660 should guide any effort to determine the other subprime loans beyond those described as such by originators.

1. **Subprime loans denominated by the originator as such:** The Fed Reserve of NY maintains a data base on subprime and Alt-A found at: http://www.newyorkfed.org/regional/techappendix_spreadsheets.html#sub_loans

   The Fed's database of subprime loans denominated as such by the originator is based on Loan Performance Corporation's subprime servicing/private securities databases which track loans that are self-denominated by originators as subprime (LP Subprime Database). While a FICO below 660 is a significant determinant (71% of such loans have such a FICO), there are other characteristics used in this self-determination. The NY Fed defines **Subprime** as:

   > "Compared with prime mortgages, subprime mortgages are typically made to borrowers with blemished credit history or who provide only limited documentation of their income or assets. Originations of subprime mortgages fell sharply in the second half of 2007 and have been extremely light so far in 2008. Of the 3.3 million active subprime loans in the data at the end of 2007, there were some 3 million loans for owner-occupied units with an average outstanding loan balance around $180,000."

   It further adds:

   > "The underlying data do not represent every subprime mortgage, whether in portfolio or in a security, or mortgage securitized in an alt-A pool. We estimate that as of **year-end 2007**, there were about a total of 7 million subprime loans. The underlying data contained 3.3 million active subprime loans, suggesting a coverage ratio of 47 percent."

   These 7 million loans almost certainly meet one of more of the Federal bank regulators' definition of subprime. Based on an average balance of $180K (see above), this translates into **$1.260 trillion**. This compares favorably to MBA delinquency data reporting 5.541 million subprime loans (excludes FHA) at 6.30.08, however the MBA believes its database captures 85% of all loans, resulting in an MBA estimate of 6.52 million subprime loans. Using the same $180k per loan, this suggests **$1.173 trillion.** Since the MBA is from 6.30.08 while the NY Fed data is from 12.31.07, the two sources appear to be very close.

2. **Subprime loans denominated as prime loans but with FICOs below 660:** Loan Performance Corporation also maintains a prime loan database (LP Prime Database) that predates the establishment of its LP Subprime Database. The LP Subprime Database and LP Prime Database are mutually exclusive (confirmed by Loan Performance). All Fannie and Freddie loans (regardless of FICO) are reported into the LP Prime Database only (confirmed by Loan Performance). The LP Prime Database was setup in 1989 before the use of FICOs, which were only developed in 1989 and did not come into general use in the mortgage industry until 1995. It was populated by prime loan servicers and investors (originally just Freddie, with Fannie added in 1991). The LP Prime Database is a mix of Fannie and Freddie loans, other conforming loans, prime jumbo loans, FHA and VA loans. As Fannie and Freddie started doing large

volumes of loans with FICOs below 660, these were reported into the LP Prime Database along with their traditional prime loans.

As noted earlier a FICO below 660 is the most clear cut determinant set out by the Federal banking regulators as a characteristic of a subprime borrower.

- About 71% or 5 million loans out of the NY Fed's 7 million subprime loan total have a FICO below 660.[1]
- About 20% or 10 million loans out of Loan Performance's grossed up prime loan total of 50 million loans have a FICO below 660. [1,2]

[1]"Surprise: Sub-Prime Mortgage Products are not the Problem!" Percentages obtained from Figure 1.
[2]Loan Performance reports that the LP Prime Database has "[L]oan-level data on over 75% of the nation's active first mortgages—more than 38-million—including all of the Fannie Mae and Freddie Mac portfolios."

To convert the 10 million subprime loans contained in the LP Prime Database to dollars, an average loan amount of $150,000 seems appropriate. Fannie and Freddie account for 49% or 4.9 million[3] of the 10 million loans and have an average loan amount of about $132,000, the other 51% are a mixture of many loan types including FHA (the original subprime "lender", whose loans have somewhat lower balances) and jumbo loans (much higher balances). $150,000 x 10 million = **$1.5 trillion**. Note: There are more subprime "prime" borrowers with a FICO below 660 (10 million) than all subprime borrowers denominated by the NY Fed (7 million).
[3]Fannie and Freddie are estimated to have $646 billion in loans with FICOs below 660. At an average loan amount of $130,200

Table #1: Total Subprime exposure:

Type:	#	% of subprime/ % of all loans	Serious delinquency rate
Loan Performance subprime grossed up	7 million	41%/12%	17.85%[4]
Loan Performance Prime grossed up	10 million	59%/17.5%	5%[5]
Total	**17million**	100%/29.5%	

[4]MBA National Delinquency Survey, Q2:08, Data as of 6.30.08
[5]Estimate based on Fannie's loans with FICOs <620 having a serious delinquency rate of 6.74% at 9.30.08. This estimate of 5% is likely low, as Fannie's subprime portfolio is relatively unseasoned and its delinquency level is increasing rapidly (for Q2:08 the comparable rate was 5.48%).

Table #2: Fannie/Freddie conventional subprime exposure:

		Fannie	Freddie	Total #/% of subprime
Conventional loans	Subprime Private Label Mortgage Backed Securities	0.24 million	0.56 million	0.8 million/5%
	"Prime" loans <660 FICO	3.05 million	1.85 million	4.9 million/29%
Total		3.29 million	2.41 million	5.7 million/34%

B. Alt-A:

The NY Fed defines **Alt-A** as:

> **"Alt-A Mortgages defined:** Loans marketed in alt-A securities are typically higher-balance loans made to borrowers who might have past credit problems—but not severe enough to drop them into subprime territory—or who, for some reason (such as a desire not to document income) chose not to obtain a prime mortgage. In addition, many loans with nontraditional amortization schedules such as interest only or option adjustable rate mortgages are sold into securities marked as alt-A."

It further adds:

> "Our best guess is that 2.4 million loans in this portion of the data cover more than 90 percent of the pools marketed as alt-A. The loan data are drawn from reports by the Board of Governors of the Federal Reserve System based on data from FirstAmerican CoreLogic, LoanPerformance Data. Data on the number of housing units are drawn from the U.S. Census 2000." and
>
> "Although the term "alt-A" applies technically only to securities, not mortgages, it has become common practice to refer to near-prime or non-traditional mortgages as "alt-A" loans. The 2.4 million alt-A loans in the data contained approximately 1.7 million loans for owner-occupied units with an average outstanding loan balance around $300,000 at the end of 2007."

The above translates into **2.67 million** Alt-A. Based on an average balance of $300K (see below), this translates into **$0.800 trillion** Alt-A held in securities. The MBA does not have a separate category for Alt-A. This definition does not include Fannie and Freddie's Alt-A loans.

Fannie and Freddie Alt-A loans total **$0.497 billion** comprising **2.9 million** loans not covered by the NY Fed and $77 billion in private MBS tranches (450,000 loans) already included in the NY Fed estimate.

This brings the total for Alt-A to **$1.3 trillion and 5.6 million loans**. Fannie and Freddie's share of **3.35 million** is **60%** based on loan count.

C. Total for all junk loans: 25.1 million loans out of 57 million 1st mortgages (44%) or $4.63 trillion:

Fannie/Freddie's portion of conventional junk loans: 10.1 million loans out of 25.1 million junk 1st mortgages (40%).

The Loan Performance and the MBA both estimate that there are about 57 million 1st mortgages.[6] The 25.1 million junk loans are distributed as follows:

- **Subprime: 17 million of which Fannie and Freddie are responsible for 5.7 million or 34% of all subprime loans.**

- **Alt-A: 5.6 million of which Fannie and Freddie are responsible for 3.35 million or 60% of all Alt-A loans.**

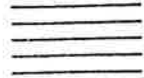
- **Other junk: 2.5 million loans consisting of many negatively amortizing ARMs (Option ARMs), Interest Only ARMs, Original LTV >90%, and piggy back seconds not included in the above. Fannie and Freddie responsible for 60% of all other junk.**
  - $262 billion (1.5 million loans) - $198 billion for Fannie and $64 billion for Freddie.
  - $350 billion estimate (1 million loans) Wachovia has $122 billion of pay-option/potential negatively amortizing ARMs (Wachovia calls them pick-a-pay). These are not subprime, not securitized, and not held by Fannie or Freddie. They are certainly junk loans. Other uncounted junk loans can be found at B of A (from their Countrywide purchase) and WaMu ($53 billion, these assets are now owned by Chase), and IndyMac (specialized in Alt-A, now owned by the FDIC). A rough guess is that this adds at least another $350 billion in junk loans.

[6]Fannie and Freddie have a total of 30.6 million loans, plus 1.25 million in PLMBS traunches; for a total of 31.85 million loans. 10.55 million or 33% are high risk.

ATTACHMENT 2

Industry Letter

July 11, 1995



SUBJECT: The Predictive Power of Selected Credit Scores

TO: CEOs and Credit Officers of all Freddie Mac Sellers and Servicers

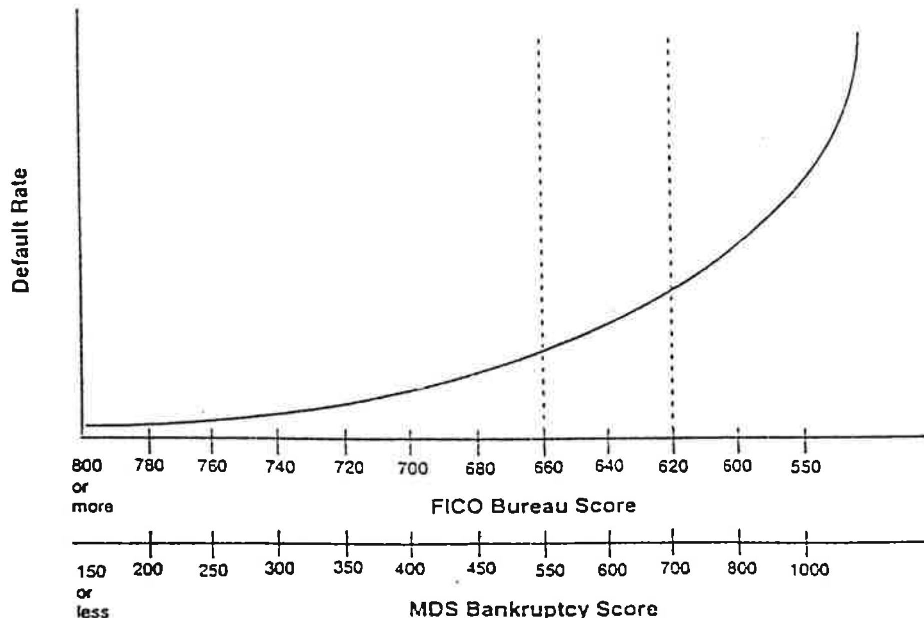
Having bought over 16 million loans during our 25-year history, Freddie Mac is in a unique position to conduct research and spot industry-wide trends. Sharing observations about industry trends and offering tools to help you manage the mortgage lending process are key ways we fulfill our mission of making decent, accessible housing a reality.

We recognize the challenges of today's market environment. To assist you in meeting these challenges, we want to provide you tools to underwrite credit risk and meet the needs of every creditworthy borrower. One such tool is the use of certain credit scores to help you focus your underwriting efforts.

Research Findings

Freddie Mac studied how hundreds of thousands of loans performed over several years to determine which attributes of the loan file were most predictive of default. We identified a strong correlation between mortgage performance and two types of credit scores, created by national credit scoring companies and frequently used in consumer lending. The types of credit scores we reviewed were "bureau scores," as prepared by Fair, Isaac and Co., Inc. ("FICO") and "bankruptcy scores," as prepared by CCN-MDS ("MDS"). The chart below illustrates the predictive power of these credit scores.

Predictive Power of Credit Scores



Although the chart illustrates the correlation between credit scores and default rates, we have documented the same correlation with delinquency rates.

Credit Scores and Freddie Mac's Quality Control

We are including credit scores as one of the selection factors in our quality control sampling procedures. You can expect a higher percentage of loans made to borrowers with scores indicating a higher probability of default to be selected for review by our underwriters. Once the file is selected, a Freddie Mac underwriter will review the entire file using the standards set forth in the Purchase Documents. It is important that the file thoroughly document, and that Form 1077A, *Uniform Underwriting and Transmittal Summary*, adequately summarize, both the positive and negative factors that your underwriter considered in making the investment-quality decision.

Credit Scores and Underwriting

After reviewing a number of alternatives, we determined that, within the manual underwriting process, one of the easiest and most readily available tools to assist you in managing the challenging credit-risk environment is the use of either FICO bureau or MDS bankruptcy scores. Using these scores can help you better assess and manage the quality of your loan originations, reduce servicing costs and sustain profitability.

For 1-unit single-family dwellings, we suggest that you apply the information in the following chart before underwriting borrower creditworthiness as required in Chapter 37 of the *Single-Family Seller/Servicer Guide* (the Guide).

If the FICO bureau score is	or the MDS bankruptcy score is	then the recommended approach to reviewing credit is
over 660	less than 550	BASIC: Underwrite the file as required to confirm the borrower's willingness to repay as agreed.
660 to 620	550 to 700	COMPREHENSIVE: Underwrite all aspects of the borrower's credit history to establish the borrower's willingness to repay as agreed.
less than 620	over 700	CAUTIOUS: Perform a particularly detailed review of all aspects of the borrower's credit history to ensure that you have satisfactorily established the borrower's willingness to repay as agreed. Unless there are extenuating circumstances, a credit score in this range should be viewed as a strong indication that the borrower does not show sufficient willingness to repay as agreed.

The attached Exhibit A provides examples and an additional description of each recommended approach.

Loans secured by 2- to 4-unit properties carry additional risk. Therefore, we recommend stronger guidelines for FICO bureau and MDS bankruptcy scores for these loan types. Please refer to the attached questions and answers (Exhibit B) for our 2- to 4-unit recommendations.

We want to emphasize that there is no single FICO bureau or MDS bankruptcy score that means an individual borrower will default. However, these scores can help you identify loans that may require a closer look by your underwriter. If your underwriter is able to establish the borrower's willingness to repay as agreed, then we encourage you to consider this in your investment-quality decision, regardless of what the credit score alone might suggest. Remember that you are still responsible for underwriting the credit reputation, as well as the file as a whole, to make your investment-quality decision.

Layering of Risk

Traditional underwriting has long relied upon the "three Cs"-- collateral, capacity and credit reputation. The underwriting guidelines in Freddie Mac's Guide are based on this fundamental approach to determining investment quality.

Collateral is measured by the loan-to-value ratio and confirmed by the appraisal. Capacity is measured by the overall income and expense profiles and confirmed, in part, by the debt-to-income ratios. Credit reputation, or the determination of the borrower's willingness to repay as agreed, is more difficult to assess. However, FICO bureau or MDS bankruptcy scores provide an indication of the relative likelihood of credit risk and can direct the underwriter to an appropriate level of credit review.

We urge you to maintain underwriting standards that guard against layering multiple risk factors within a single loan file, particularly when either a credit score indicates, or your underwriter identifies, that increased credit risk is present.

Conclusion

We encourage you to obtain FICO bureau or MDS bankruptcy scores for your mortgage applicants and use them as a tool to help you focus your underwriting and quality control processes. The attached exhibits provide practical information and examples to help you incorporate credit scores into your processes today.

We are committed to helping you expand your markets with confidence, reduce your costs and sustain your long-term profitability. We will continue to conduct research, identify solutions to industry challenges and share with you tools that will help improve mortgage finance practices.

If you have any questions about our suggestions regarding the use of credit scores or layering of risk factors, please call your account manager, quality control underwriter or (800) FREDDIE, option 2.

Sincerely,

Michael K. Stamper
Executive Vice President
Risk Management

Exhibit A

SUBJECT: Case Studies to Help You Apply Freddie Mac's Recommendations on Using Credit Scores

A credit score is a snapshot that objectively assesses a borrower's credit history at a given point in time. Each score is a reflection of the unique set of facts currently on file for a specific borrower at a particular credit repository. Although two borrowers with identical credit scores may have received that score for very different reasons, our research indicates that those two borrowers have the same probability of default based on credit. Therefore, both borrowers should be underwritten with the same recommended approach.

Freddie Mac has studied two types of credit scores and found that they are strong predictors of mortgage default for all borrowers. FICO bureau and MDS bankruptcy scores can help you focus your underwriting of the borrower's credit reputation. Using credit scores this way makes you more efficient when manually reviewing the borrower's credit report and any other information needed to establish the borrower's willingness to repay as agreed. You can then combine your findings on credit reputation with data on the borrower's capacity in order to determine creditworthiness.

We developed the following case studies to illustrate our suggested approaches to reviewing the borrower's credit reputation. These examples cover borrowers who fall into each of the three risk ranges developed through Freddie Mac's research. We hope they will help you incorporate credit scores into your underwriting process. Once you have used credit scores as a tool to focus your efforts, we believe you will clearly see the value that they add.

FICO BUREAU SCORE OVER 660 OR MDS BANKRUPTCY SCORE LESS THAN 550

BASIC REVIEW: Underwrite the file as required to confirm the borrower's willingness to repay as agreed.

When you conduct a basic review, you

- Focus on establishing whether the credit documentation indicates additional risks
- Evaluate all available and pertinent credit information to verify consistency with the loan application
- Identify any issues related to misrepresentation or data integrity

OUTCOME: When you have completely reviewed the credit documentation and not found any additional credit risks, the borrower's willingness to repay as agreed is confirmed. If you have noted additional risks, they must be documented and factored into your decision on the borrower's creditworthiness. Additional risks could include a debt

listed on the application that was not included in the credit report (such as a mortgage or a newly opened installment or revolving charge) that when verified indicates a significant derogatory payment history.

CASE STUDY: Kim's credit report shows a FICO bureau score of 730. The details of the report show that Kim has excellent credit and confirms her willingness to repay as agreed. She has six open tradelines that include four revolving accounts and an installment debt. Her previous mortgage has no late payments and her complete credit profile is reported on the credit report. Kim is applying for a 90 percent loan to purchase a new home. Her housing expense-to-income ratio will be 29 percent, her total debt-to-income ratio will be 41 percent, and she will have two months' reserve after closing.

In this case, Kim's demonstrated ability to maintain an excellent credit history (fully documented in the file) confirms a strong willingness to repay debt as agreed, which compensates for the higher than recommended debt-to-income ratios. Unless other factors in the loan file related to capacity and collateral value indicate otherwise, Kim's loan would be considered investment quality.

In contrast, if Kim's previous mortgage and auto loan, which she listed on her application, were not contained in her credit report but were reported on a verification from her credit union, then her credit report would not reflect her complete credit profile. You would then need to review the additional credit information. If the direct verification indicated two 60-day late payments on her mortgage and an auto repossession in the last 12 months, Kim's willingness to repay as agreed would not be confirmed even though her credit score was 730. Then, Kim's loan would not meet the definition of investment quality.

FICO BUREAU SCORE OF 660 TO 620, OR MDS BANKRUPTCY SCORE OF 550 TO 700

COMPREHENSIVE REVIEW: Underwrite all aspects of the borrower's credit history to establish the borrower's willingness to repay as agreed.

A comprehensive review focuses on all the features of the basic review, plus an in-depth review of the borrower's credit history. This review includes evaluating the number and use of credit lines, the number of derogatory accounts, and the age and disposition of such accounts.

OUTCOME: When your review of the credit documentation is complete, you will have considered the explanations for derogatory accounts and inquiries (if any), whether the explanations are consistent with other documentation in the file, and the effect of the derogatory information on the borrower's overall creditworthiness. You must document your rationale for finding sufficient willingness to repay as agreed and note any

compensating factors identified in your review that establish the borrower's willingness to repay as agreed.

CASE STUDY: Spencer's credit report shows a MDS bankruptcy score of 650. The report reveals six revolving accounts, four of which were 30 days late one to three times in the past. All accounts are current and have been for six months. The file includes documentation of credit not reported on the credit report in the form of direct verifications for his mortgage, auto and credit union loans. All verifications confirm excellent payment histories for 36 months. Spencer is applying for an 80 percent loan to purchase a new home. His housing expense-to-income ratio will be 21 percent, his total debt-to-income ratio will be 36 percent, and he will have two months' reserve after closing.

This case illustrates that information not included on the credit report may play an important role in establishing the borrower's willingness to repay as agreed. Though Spencer's credit score is in the middle default-risk range, the significant obligations that were not included on his credit report establish a willingness to repay as agreed. Unless other risk factors are present, Spencer's loan would be considered investment quality.

In contrast, if Spencer's verification of mortgage indicates a 1x30 one year ago and a 1x30 four months ago, the additional documentation would not support his willingness to repay as agreed. Then, Spencer's loan would not meet Freddie Mac's definition of investment quality.

FICO BUREAU SCORE LESS THAN 620 OR MDS BANKRUPTCY SCORE OVER 700

CAUTIOUS REVIEW: Perform a particularly detailed review of all aspects of the borrower's credit history to ensure that you have satisfactorily established the borrower's willingness to repay as agreed. Unless there are extenuating circumstances, a credit score in this range should be viewed as a strong indication that the borrower does not show sufficient willingness to repay as agreed.

A cautious review focuses on all the features of both the basic and comprehensive reviews, plus an intensive analysis of the borrower's credit reputation (willingness to repay as agreed) to determine whether extenuating circumstances can be used to determine sufficient willingness to repay as agreed.

OUTCOME: When your review of the credit documentation is complete, you will have considered the explanations and supporting documentation for derogatory accounts and inquiries (if any), whether the explanations are consistent with other file documentation, and what effect this information has on establishing the borrower's credit reputation. In addition, you will have considered the amount and use of credit, the age of the credit, the number of outstanding accounts, and the credit profile of the borrower. You must identify

and document extenuating circumstances to satisfactorily establish the borrower's willingness to repay as agreed.

CASE STUDY: Bob's credit report shows a FICO bureau score of 602. The details of his report reveal six open accounts (four revolving and two installment debts) that have no late payments reported in the past 18 months. His credit during the previous three-year period, however, reveals a significant pattern of 30- and 60-day late payments and one paid collection on a revolving account. Bob is applying for a 90 percent loan to purchase his first home. His housing expense-to-income ratio will be 28 percent, his total debt-to-income ratio will be 36 percent, and he will have two months' reserve after closing.

Bob explained that until 18 months ago he was employed as a commissioned salesman and his income was not stable. When his company closed, Bob was unemployed and looking for work for three months. He is now in a full-time salaried position, has paid the collection account and has maintained excellent credit for 18 months. The facts of this case clearly show that Bob has not only achieved income stability but has re-established his credit reputation. In this scenario, a thorough review of Bob's credit profile helped to ensure that he demonstrates sufficient willingness to repay as agreed. Unless other risk factors are present, Bob's loan would be considered investment quality.

In contrast, if Bob's explanation for his delinquent credit was that he incurred significant expenses due to unforeseen circumstances for which he had no documentation, or the documentation he provided was not consistent with his credit history, it would be impossible to establish that extenuating circumstances caused Bob's problems. His willingness to repay as agreed would not be satisfactorily established. Under these circumstances, Bob's loan would not meet Freddie Mac's definition of investment quality.

Exhibit B

SUBJECT: Questions and Answers on Using FICO Bureau and MDS Bankruptcy Credit Scores

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Credit scores are available for most borrowers. They are easy and inexpensive to obtain. The following Q&A provides background on FICO bureau and MDS bankruptcy credit scores, tells you how to obtain them and offers guidelines on using them. We have included this information to help you incorporate credit scores into your business processes and maximize the benefits of using them. Please note that Freddie Mac has no direct role in preparing credit scores. Also, the information in this Q&A about credit reporting companies, credit repositories and the scores they provide may change without our knowledge.

Q1 What are credit scores?

A1 Credit scores are objective assessments of a borrower's credit reputation, based on information documented in a credit report. Lenders have used them in various forms for many years to assess the credit reputation of an individual. The assessment results in a numeric calculation, or score, for each individual. Credit scores rank individuals by risk and are calculated from information that has proven to be indicative of loan performance.

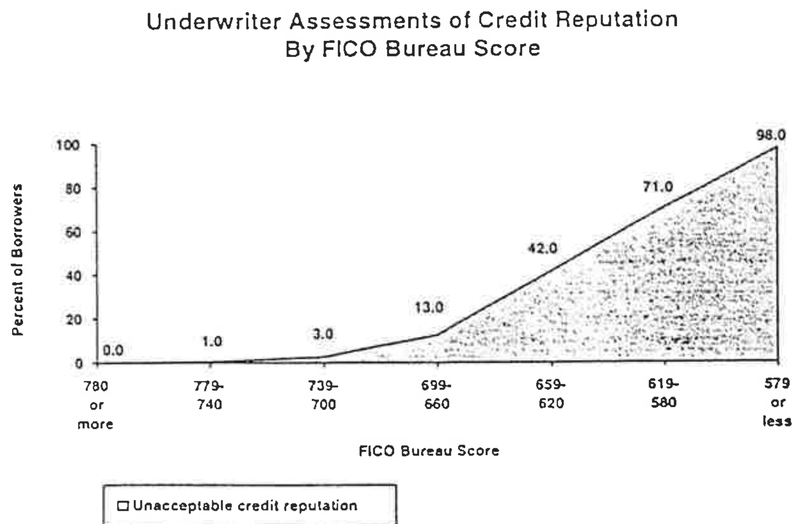
Q2 How did Freddie Mac determine that certain credit scores are predictive of mortgage performance?

A2 To determine the usefulness of credit scores as predictors of mortgage performance, we obtained FICO bureau and MDS bankruptcy scores available at or near the time of origination on hundreds of thousands of Freddie Mac loans. The loans were originated over several years and selected from a wide distribution of lenders, product and loan types, and geographic areas. We conducted extensive statistical analysis on the performance of these loans, which documented a strong correlation between credit scores and mortgage performance as illustrated by the chart in the industry letter. This analysis convinced us that credit scores are a valid, quantifiable and objective mortgage underwriting tool.

Q3 How does an underwriter's assessment of a borrower's credit reputation compare with the borrower's credit score?

A3 Freddie Mac's Quality Control underwriters reviewed thousands of loans to compare their assessments of the borrowers' credit reputations with the borrowers' FICO bureau scores. As the chart below illustrates, there was a strong correlation between the underwriters' judgments and the actual scores. It's important to note that the chart also confirms that some borrowers with scores indicating high risk were found to have acceptable credit reputations. More than one-half of the borrowers with FICO bureau scores in the 659-620 range were found acceptable. Other borrowers with scores indicating lower risk were found to not have acceptable credit reputations. Credit scores are indicators, not absolutes.

Underwriter Assessments of Credit Reputation
By FICO Bureau Score



Q4 Has Freddie Mac studied the effectiveness of FICO bureau and MDS bankruptcy scores as predictors of default for mortgages secured by 2- to 4-unit properties?

A4 Yes. There is also a strong correlation between scores and the performance of mortgages secured by 2- to 4-unit properties.

Q5 Does Freddie Mac recommend different score ranges for 2- to 4-unit properties?

A5 Yes. Because of the higher risk of this product type, we recommend the following ranges for 2-unit and 3- to 4-unit properties, respectively:

Property Type	If the FICO bureau score is	or the MDS bankruptcy score is	then the recommended approach to reviewing credit is
2-unit 3-4 unit	over 680 over 700	less than 450 less than 400	BASIC: Underwrite the file as required to confirm the borrower's willingness to repay as agreed.
2-unit 3-4 unit	680-640 700-660	450-600 400-550	COMPREHENSIVE: Underwrite all aspects of the borrower's credit history to establish the borrower's willingness to repay as agreed.
2-unit 3-4 unit	less than 640 less than 660	over 600 over 550	CAUTIOUS: Perform a particularly detailed review of all aspects of the borrower's credit history to ensure that you have satisfactorily established the borrower's willingness to repay as agreed. Unless there are extenuating circumstances, a credit score in this range should be viewed as a strong indication that the borrower does not show sufficient willingness to repay as agreed.

Q6 Does Loan Prospector[SM], Freddie Mac's automated underwriting service, use credit scores?

A6 Yes, but they are only one of many factors that are weighed in the Loan Prospector assessment of credit quality.

Q7 How does using Loan Prospector differ from using credit scores in manual underwriting?

A7 Loan Prospector refines the predictive value of credit scores by assessing other data specific to each mortgage. Loan Prospector incorporates credit scores and a

rules-based assessment into a comprehensive analysis that weighs a variety of factors, including layered risk, to provide a Freddie Mac purchase decision.

Also, Loan Prospector enables lenders to streamline many origination functions through automation because Freddie Mac is re-engineering credit policy to match credit risk. Loan Prospector provides a comprehensive and automated risk evaluation that includes information from the loan application, credit file and property data to determine the likelihood of mortgage repayment.

Finally, for loans receiving an accept purchase decision from Loan Prospector, the lender is relieved of responsibility for certain representations and warranties.

Q8 How can these credit scores enhance my manual underwriting process?

A8 Credit scores enhance, but do not replace or take away from, the flexible underwriting guidelines in Chapter 37 of the *Single-Family Seller/Servicer Guide* (the Guide). Your underwriter will continue to review each file on a case-by-case basis to evaluate the borrower's creditworthiness and apply all relevant underwriting criteria in a manner that considers the borrower's individual situation.

Using these credit scores as an additional tool will help you

- Identify loans with a higher likelihood of default
- Distribute underwriter workload effectively
- Improve overall loan quality
- Achieve consistency and objectivity in your underwriting decisions
- Focus quality control reviews
- Assess origination channels
- Manage servicing value and costs

Remember that you are still responsible for underwriting the credit reputation, as well as the file as a whole, to make your investment-quality decision.

Q9 How do credit scores relate to assessing the overall investment quality of the loan?

A9 Underwriters must assess the combined effect of all "three Cs" of mortgage underwriting—capacity, collateral value and credit reputation. Each of the "three C" components is a key element in establishing investment quality. FICO bureau and MDS bankruptcy scores help to quantify the credit reputation component.

Once the components are documented, the underwriter can review credit reputation, capacity and collateral value, and assess risks that may be present in one or more elements to determine the overall investment quality of the loan.

Q10 How should an underwriter respond to a score that may indicate a high likelihood of default?

A10 While Freddie Mac is convinced of the predictive power of these scores, we also believe that an experienced underwriter can recognize factors within a credit profile that may more accurately reflect the borrower's credit reputation. After assessing the entire credit history, the underwriter should make a decision about the borrower's credit reputation and then use that *in conjunction with other "three C" components* to make the overall investment-quality decision. If the underwriter determines that a borrower's credit reputation is marginally acceptable, a low loan-to-value (LTV) ratio would be a compensating factor. However, the borrower (or borrowers as a unit if there are multiple borrowers) must be found creditworthy by the underwriter.

Q11 Can I use scores that imply a very low credit risk as a compensating factor for higher debt-to-income ratios?

A11 Yes. For example, a FICO bureau score of 720 or higher (or an MDS bankruptcy score of 350 or less)* will generally imply a good-to-excellent credit reputation. If your underwriter confirms that the borrower's credit reputation is indeed excellent, then it could be used as a compensating factor for debt-to-income ratios that are somewhat higher than our traditional guidelines as defined in Guide section 37.6.

*For 2-unit properties: FICO bureau of 740 or higher (MDS bankruptcy 300 or lower)
*For 3- to 4-unit properties: FICO bureau of 760 or higher (MDS bankruptcy 250 or lower)

Q12 What is "layering of risk?"

A12 "Layering of risk" occurs when multiple high-risk factors are present in a single loan file. For example, minimally acceptable willingness to repay (credit reputation risk) in a file that also reflects less than the standard two months' reserve requirement (capacity risk) would be an example of risk layering. Underwriters should exercise extra care when multiple high-risk factors are present within a single loan application to ensure that investment quality has not been compromised.

Q13 How can using credit scores benefit borrowers?

A13 Borrowers benefit when credit decisions are based on consistent, objective criteria that accurately assess default risk. Tools that, in an unbiased manner, help separate loans that are likely to perform well from loans that are less likely to perform well ensure the continued availability of mortgage money to all creditworthy borrowers. Credit scores are an effective tool to help you promote this goal.

Q14 What types of credit scores do you recommend I obtain?

A14 Freddie Mac analyzed two types of credit scores and determined that they are predictive of mortgage performance. These two types, FICO bureau and MDS bankruptcy scores, are marketed under the following product names:

<u>FICO bureau scores:</u>	Equifax BEACON[SM] Trans Union EMPERICA® TRW/FICO
<u>MDS bankruptcy scores:</u>	Equifax Delinquency Alert System[SM] Trans Union DELPHI[SM] TRW/MDS

Q15 What is the difference between these two types of scores?

A15 The two scores are generated by two different companies in partnership with the three major credit repositories. FICO bureau scores are produced by San Rafael, CA-based Fair, Isaac and Co., Inc. (FICO) and MDS bankruptcy scores are produced by Atlanta-based CCN-MDS (MDS). Either type of score may be used.

FICO bureau and MDS bankruptcy scores have different scales. MDS bankruptcy scores range from 0 to 1300, but under some circumstances can occasionally go outside these bounds. FICO bureau scores range from about 400 to about 900. When interpreting scores, the *lower* the FICO bureau score or the *higher* the MDS bankruptcy score, the greater the risk of default.

Q16 Are there other types of credit scores?

A16 Yes, other types of scores (such as mortgage credit scores) are commercially available. Freddie Mac has not validated the predictive nature of scores other than FICO bureau and MDS bankruptcy.

Q17 How can I obtain FICO bureau or MDS bankruptcy credit scores?

A17 You can get both scores from most credit reporting companies or any of the three major credit repositories. You can obtain these credit scores using either of the following options, depending on your needs:

<u>Option 1</u>: **Obtaining Credit Scores Through Credit Reporting Companies**
You can contact your credit reporting company and ask to add the credit scores from the three main repositories to the credit reports you currently receive. Most credit reporting companies have the capability to do this at a minimal cost per score and are able to begin providing repository credit scores within days of changing your contract.

<u>Option 2</u>: **Obtaining Credit Scores Through Credit Repositories**
To obtain credit scores from a credit repository, contact a representative from the repository of your choice. If you are already receiving services from the repository, call your repository service representative directly. If you do not have a current agreement with the repository, you can call the toll-free numbers listed below for more information.

Equifax	(800) 685-5000
Trans Union	(800) 899-7132
TRW	(800) 831-5614

Q18 How much does it cost to obtain credit scores?

A18 Costs vary by credit reporting company or credit repository (and the options you choose), but in general credit scores are not expensive to obtain.

Q19 What information should I specifically request?

A19 You may find it most effective to request either FICO bureau or MDS bankruptcy scores for all borrowers, including nonoccupant coborrowers. It is not necessary to

order both types of scores. Whether you choose FICO bureau or MDS bankruptcy scores for a borrower, obtaining the borrower's scores from each of the three major repositories will provide more accurate information than one or two, because different repositories may maintain a somewhat different credit history for the same individual. For multiple borrowers, we suggest requesting these scores for each borrower, including a husband and wife individually.

Q20 Are FICO bureau and MDS bankruptcy scores based solely on a borrower's delinquency history?

A20 No. A borrower's delinquency history is only one of many factors considered in the calculation of a FICO bureau or MDS bankruptcy score. Numerous other items of credit information are also key factors.

Q21 If I get more than one score, which one should I use?

A21 Scores for a given borrower often differ among repositories, but as a general rule scores will be similar enough to provide guidance on your approach to underwriting the credit reputation of a borrower. If you obtain three scores for a borrower, we suggest using the middle score. If you obtain two scores, we suggest using the lower FICO bureau score or the higher MDS bankruptcy score.

Q22 What if no scores were generated for a specific borrower?

A22 First check the borrower's name, social security number and address for accuracy. Even if you requested a score correctly, one may not be available. However, another repository may successfully generate a score for your borrower. A loan file can be considered complete without any credit scores.

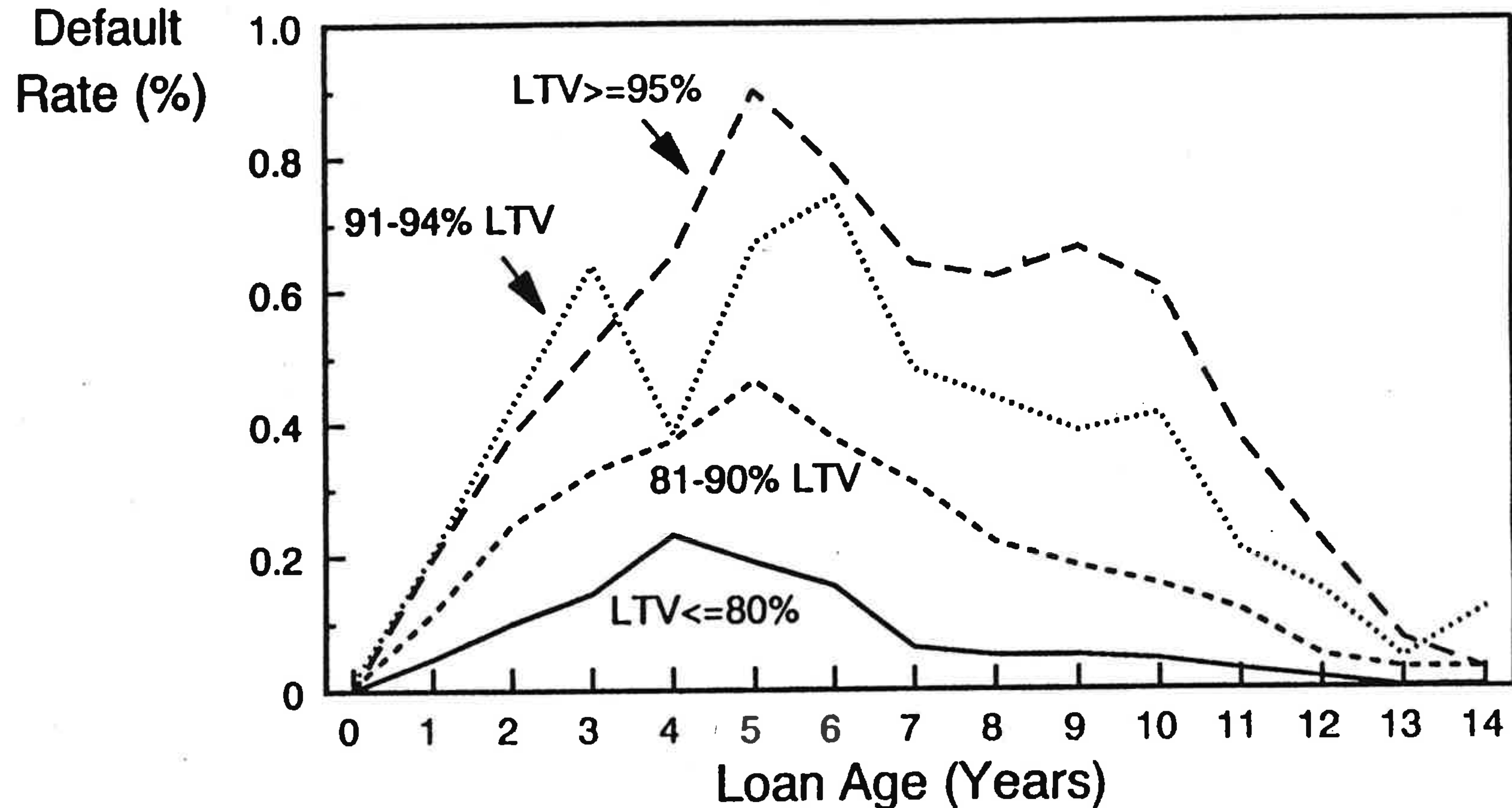
Q23 Where can I get more information about using credit scores?

A23 Your credit reporting company or credit repository can provide training and other materials.

ATTACHMENT 3

Goldman, Sachs & Co.

Estimated Default Rates by Loan-to-Value Ratio



Source: Robert Van Order, Freddie Mac

DATE: LATE 1990s

Attachment 4 to Submitted testimony of Edward Pinto before US House of Representatives Oversight Committee - December 9, 2008

Background paper on selected events leading up to the conservatorships of Fannie Mae and Freddie Mac

Unpublished research by EDWARD J. PINTO, epinto@lendersres.com

November 25, 2008

The problems with Fannie and Freddie are systemic:

a. **The inherent conflict of serving two masters: safety and soundness enforced by its HUD regulator vs. low and moderate income housing mandates imposed by Congress and enforced by its HUD regulator**
b. **The irresistible lure of outsized profits offered by portfolio mortgage investments made possible by the implied federal guarantee and low capital requirements.**

The delay to real and effective reform was due to the opposition of the GSEs themselves and their continued effectiveness in lobbying their allies and silencing their enemies in Congress. Key to this effort was their continued use of low and moderate income housing efforts as a "reverse earmark" targeted at Congress. This was crony capitalism at its worst. The mere fact that Congress continued to remain opposed to real reform after both Fannie and Freddie experienced massive accounting scandals in the early part of this decade is proof positive. Fannie and Freddie had gotten so powerful that they felt that they should be able to dictate the terms of their own reform to Congress or block the reforms if they did not like them.

Many unsuccessful efforts were undertaken to convince Congress to require the GSEs to have more capital, be subject to an independent and stronger regulator, and to reduce the exposure to the financial system created by the immense size and risks contained in the GSEs portfolios.

The Bush administration, in its FY2005 Budget released in February 2004,

> **"expresse[d] concern about the systemic risk posed by the GSEs. Noting that 'even a small mistake by a GSE could have consequences throughout the economy,' the budget proposal call[ed] for strong market discipline, effective supervision and adequate capital requirements. The budget also call[ed] for a new regulator for all three housing GSEs to be housed within Treasury and given responsibility for both safety and soundness and approval of new activities." Mortgage Banking, April 1, 2004.**

These two Government Sponsored Enterprises ("GSEs") each operate 2 related but inherently different businesses with very different risk profiles:

1. Mortgage guaranty business: each GSE creates mortgage backed securities ("MBS") backed by the full faith and credit of the GSE. This guaranty, along with extremely favorable risked based capital rules, makes MBS both liquid and profitable for investors (including US banks). Traditionally these MBS were sold to investors in the US and, starting in the 1980's, in large quantities to investors around the world. While the income stream and profit potential is relatively steady, it is small compared to the income stream and profit potential from placing the same mortgage in Fannie or Freddie's mortgage portfolio. The MBS guarantee fee plus float averages 15-18 basis points per year. The main risk from the mortgage guaranty business is credit risk.
2. Portfolio investment business: both GSEs now operate huge mortgage portfolios (a high of $1.58 trillion in 2003 and a combined $1.4 trillion at mid-2008). This was not always the case. In 1990 their combined portfolios were $136 billion, mostly in the hands of Fannie. While Fannie had historically relied heavily on its portfolio, Freddie Mac relied primarily on its MBS business until the 1990s. During the 1980s Freddie kept a relatively small mortgage portfolio as a perfect hedge against its MBS business. The lure of the portfolio is its opportunity for high revenues - the spread earned on a mortgage held in portfolio can average 120-130 basis points (excluding hedge gains). This is about 8 times the revenue available from the guaranty business. Given the GSEs' low capital requirements, the highly leveraged portfolios allowed for robust returns on equity in good times.

Having a huge portfolio business has other advantages:

1. Tax exempt bond safe harbor: IRS rules allow a firm to invest up to 2% of its assets in tax exempt bonds and deduct the interest used to finance them from federal income tax. This adds perhaps another 4 basis points to the spread earned on the entire mortgage portfolio. No portfolio – no 2% safe harbor.
2. Liquidity portfolio: back in the mid-1980s, pre-payments on Fannie's mortgage portfolio were coming in faster than the money could be redeployed into mortgage assets. Yet, Fannie wanted to keep selling its "AAA" rated debt so as to maintain the predictability of its debenture issuances in the marketplace. The liquidity portfolio was born. Cash raised in excess of immediate needs was invested in lower rated assets so as to create an arbitrage spread. Over time and even as the original need faded, the liquidity portfolio grew to a huge size. Early in 2008 it was again ballooning. The arbitrage profit it earns adds perhaps another 3 basis points to the spread earned on the entire mortgage portfolio. However soured investments such as Freddie's $1+ billion loan to Lehman Brothers create their own havoc and losses. No portfolio – no need for a liquidity portfolio.

This incremental extra 7 basis points earned from tax exempt bonds and the liquidity portfolio roughly equals the pre-tax profit opportunity on the MBS business.

3. Both Fannie and Freddie developed sophisticated hedging operations which ostensibly reduced the mismatch between 30 year fixed rate mortgage investments (and unpredictable pre-payment speeds) and the shorter debt used to fund the mortgages. Over time this added perhaps another 20-30 basis points in spread earned on the entire mortgage portfolio.

These three additional advantages made it harder and harder for other entities holding mortgage portfolios (mainly banks and thrifts) to compete with the two GSEs.

4. Given the attractiveness of mortgage portfolio returns, Fannie and Freddie's appetite for mortgage portfolio investments became insatiable. Fannie and Freddie started buying their own MBS for their portfolios. Then each started buying each other's MBS. Eventually, they started buying "AAA" rated traunches of private label sub-prime and Alt-A securities as investments. The GSEs' total purchases in 2006 and 2007 of these private label securities backed by risky loans are estimated at over $225 billion. At one point during this period their combined purchases were estimated to total 30% to 50% of mortgage-securities issued by Wall Street.
5. Portfolio investing had yet one more advantage: the opportunity for "managing" income. While accounting rules were such that this opportunity was much greater in the early to mid-1980s, it was still a factor in the late 1980s and early 1990s. If one had a choice as to whether to add $5 billion to its guaranty business or its portfolio business in July of a given year, part of the decision process would be the financial impact on the current year. Due to the relatively small revenue impact for the current year (perhaps 5-6 basis points) largely offset by reserving requirements, adding say $5 billion in guaranty business would have little or no impact on current year income. However, put the same $5 billion into the portfolio and the result is quite different. Revenue for the 5 months might total 60 basis points (somewhat offset by reserving requirements). The incremental impact on current year pre-tax income might be $20-$25 million.

As a result of all these advantages, the GSEs almost always out bid other financial institutions for the mortgages they wanted to buy. Further, their appetites were so huge their purchases had a distorting effect on the markets.

Current losses and past accounting scandals are just two manifestations of the problems caused by the GSEs maintaining portfolios.

Fannie and Freddie have had outsized losses from its share of subprime and alternative mortgages. In point of fact 50% of Fannie's and █% of Freddie's recent mortgage write offs are a result of portfolio investments in Alt-A loans. For example, as of June 30, 2008, Fannie had $307 billion in Alt-A mortgages on its books, comprising 11.5% of its mortgage exposure. These loans accounted for 50% of Fannie's credit costs booked during the 2nd quarter 2008. In fact both GSEs should have known better, as both had vast experience with the pitfalls of investing in Alt-A loans in the late 1980s and early 1990s (back then they were known simply

as no doc/low doc loans). The *Wall Street Journal* in 1991 had a Page 1 story entitled "*Haste Makes… Quick Home Loans Have Become Another Banking Mess"*. Mozilo was quoted as follows: "At one time, I was a prophet of low-doc. The problem is that it went much too far. Human beings are basically rotten. If you give them an opportunity to screw up, they will." The WSJ went on to report that Fannie stopped buying no-doc and low-doc loans in October 1990 and Freddie did the same in April 1991. Clearly Fannie and Freddie did not learn from this earlier brush with Alt-A/liar loans and the lending mess it created. Countrywide, still headed up by Mr. Mozilo, was Fannie's largest customer, accounting for an amazing 29% of its business in 2007. It was also one of Freddie's largest customers. Mr. Mazilo proved his own observation that if you give people an opportunity to screw up, they will.

But it gets worse. All told the GSEs invested about $1.6 trillion in subprime, Alt-A, other default prone loans and private mortgage backed securities backed by subprime and Alt-A loans. The GSEs even invested heavily in the "AAA" traunches of subprime mortgage securities. The GSEs hold about $122 billion in mostly "AAA" traunches of subprime mortgage securities (about 12% of all sub-prime securities). Add to this the GSE's investments of approximately $77 billion in "AAA" traunches of Alt-A mortgages. All told the GSEs are responsible for 34% of outstanding subprime and 59% of outstanding Alt-A loans. These loans and securities are causing outsized losses.

The lure of the portfolio's opportunity for outsized profits noted above come with even bigger opportunities for outsized risks:

1. **Credit risk – while generally the same as for the mortgage guaranty business, investments in affordable housing loans tended to be concentrated in the portfolio. In addition, all of the investments in "AAA" rated traunches of sub-prime and Alt-A securities were held on the balance sheet. These investments would prove toxic.**

The rest of the risks listed below are applicable to the mortgage portfolio and do not apply to the mortgage guaranty business.

2. **Interest rate risk: long-term fixed rate mortgages have the inherent risk of pre-payment depending on the interest environment over the course of the loan. The challenge for a portfolio investor is to initially fund for long enough, but not too long. Fannie was almost brought down by the interest mismatch in its portfolio in the early 1980s (see below for more on this brush with insolvency).**
3. **Hedging risk: given the inherent interest rate risk of fixed rate mortgages, the GSEs took to mounting ever larger and more sophisticated hedging operations. However, hedging profits and losses can be quite volatile on a quarterly and annual basis. Applying hedge accounting rules can easily double or triple a quarterly profit or wipe it out. The GSEs solution was to "manage" hedge profits and losses. In Fannie's case it "managed" losses of $11 billion and in Freddie's case it "managed' gains of $5 billion – as both attempted to manage earnings.**

4. **Control risk: as their hedging operations became ever larger, more sophisticated and more complex, fewer and fewer people understood the hedging operation and the operations complexities outstripped accounting systems and controls. This led to both GSEs being involved in accounting scandals and paying large fines (Freddie paid $125 million in 2003 and Fannie paid $400 million in 2006).**
5. **Basis risk: any portfolio investor in mortgages (both fixed rate and ARMs) must anticipate not only the impact of future interest rate changes on its sale of new debt to replace expiring debt, but it must factor in the potential for changes in its basis risk (the spread between a benchmark security such as a US treasury bond and the price paid by the portfolio investor). This risk was recently demonstrated on August 19, 2008 when Freddie sold 5 year notes at 113 basis points over a similar length US treasury bond. This was 44 basis points higher than Freddie paid as recently as May 2008.**
6. **Market access risk: if basis risk increases to an unmanageable level, a portfolio lender is then faced with market access risk. On a combined basis Fannie and Freddie have over $220 billion in bonds due by September 30, 2008. These refundings will be a major test of the GSEs continued market access.**
7. **Liquidity risk: if market access becomes closed off or limited to the GSEs, they then face liquidity risk as their immediate cash needs cannot be covered by illiquid or impaired assets.**
8. **Counter-party risk: the GSEs have a variety of counter-party risks relative to mortgage insurance companies, defaulting or defunct lenders, and hedge counter parties.**
9. **Risk from lack of investment diversity: unlike most financial guaranty companies which invest their excess capital in highly rated and diversified investments, the GSEs have invested most of their surplus capital in mortgages. They have, in effect, doubled down.**
10. **Profitability risk: both GSEs invested heavily in tax exempt bonds and tax credits. These assets are valuable to entities that have federal tax liabilities. Since the 3rd quarter of 2007, the GSEs have lost a combined $15+ billion. Their tax advantaged investments have now become another problem to be addressed.**

The shareholders of the GSEs benefited mightily for 20 years from the GSEs legendary take-no-prisoners lobbying efforts mounted to protect the GSEs' charters and their mixed public/private structure. For example Fannie's stock increased over 70 times between 1984 and December 2000, when Fannie reached its all-time high. The shareholders were attracted by the irresistible lure of outsized profits offered by portfolio mortgage investments made possible by the implied federal guarantee and low capital requirements. The GSEs core goal was to protect the immense financial benefits and leverage their shareholders derived from the implicit federal GSE guarantee by offering up ever greater low and moderate housing assistance to the powers on Capital Hill. Unfortunately the GSEs found that once they started down this road; Congress had an insatiable appetite for this "off balance sheet" housing aid. There was no turning back, the housing goals set by Congress and the GSEs' regulator had to be met, even if it meant taking on ever

greater levels of credit risk. Eventually the GSEs mission included buying subprime securities. Their charters had to be protected at all costs. The additional material credit risks this entailed are noteworthy given that the companies were always accused of being thinly capitalized and highly leveraged. The GSEs were faced, whether they recognized it or not, with an incredibly difficult (and most would say impossible) task of serving two masters: safety and soundness concerns as enforced by its HUD regulator vs. low and moderate income housing mandates imposed by Congress and enforced by its HUD regulator. Needless to say they failed the test. (Elaborate on losses related to mandates and prior HUD interference.)

One has to ask whether it was the flawed nature of Fannie and Freddie and their easy money lending practices that helped feed both the run-up in homes prices and the eventual decline that we are experiencing today. It is absolutely critical that the real reasons for the failure of the GSEs be analyzed. Otherwise we run the danger of crafting a solution that takes us down the same road that led us to where we are today. The bailout/rescue of the GSEs will be incredibly expensive. We need to get it right the first time.

It has long been the GSEs desire to protect their remarkable charter advantages at all costs and risks that led them to offer Congress ever larger promises of reverse earmarks. Fannie's history is representative. In the mid- to late -1980s Fannie's affordable housing efforts were substantial but low risk. Starting in the later part of the 1980s Fannie decided to protect its charter privileges at all costs. This lead to the following series of public pronouncements:

1. 1991 - CEO Jim Johnson announces Fannie's $10 billion "Opening the Doors to Affordable Housing" initiative.
2. 1992 – Congress decides it likes the "reverse earmark program", but seizes the initiative from the GSEs. The deceptively named "Federal Housing Enterprises Financial Safety and Soundness Act of 1992" is passed which, for the first time, mandates formal affordable housing goals and authorizes HUD to set, monitor and enforce them. Congress sets three goals: low- and moderate-income housing, special affordable housing, and underserved areas. Congress has a new piggy bank and best of all it was off budget (or so they thought). Act also establishes a weak Fannie/Freddie regulator which is housed in HUD.
3. 1993 – HUD sets its first set of affordable housing goals.
4. 1994 – CEO Jim Johnson announces a new goal of $1 trillion (yes trillion) for its "Opening the Doors to Affordable Housing" initiative. A pattern of one-ups man ship develops.
5. 1994 – Fannie opens the first local partnership offices. Eventually these local out reach offices will blanket the country. The main goal was to seal the charter deal with Congress. This becomes an aggressive "reverse earmark" program for members of Congress who support Fannie.
6. 1995 – HUD issues new regulations raising the GSEs' goals.
7. 1996 – Fannie opens a major new front in the "reverse earmarks" war when it contributes $350 million in stock to the Fannie Foundation.

8. 1997 and following - Fannie and Freddie have new competition as a number of the Federal Home Loan Banks (FHLBs) establish their own mortgage purchase programs. The FHLBs are themselves GSEs. Their new programs are designed to compete with Fannie and Freddie for the highest credit quality loan originations. Over the next 10 years, hundreds of billions in low risk loans are diverted from Fannie and Freddie.
9. 1998 – Fannie announces national roll out of its high risk, ultra low down payment 97% LTV loan.
10. 2000 - HUD issues new regulations raising the GSEs' goals for the second time. No matter how hard Fannie tries, HUD keeps raising the GSEs' affordable housing goals.
11. 2001 – CEO Frank Raines announces Fannie's "American Dream Commitment®, a ten-year, $2 trillion pledge.
12. 2004 - HUD once again issues new regulations raising the GSEs' goals for the third time. The new goals impose significantly higher percentages and increased goals kick in for 2005 and for the first time mandates further annual increases for each of the next 3 years (through 2008).
13. 2006-2007 – In what would prove to be a self-administered death blow, Fannie takes one more swing at meeting its affordable housing goals by making over $350 billion in high risk subprime and Alt-A investments.

The financial meltdown that led to the nationalization of Fannie and Freddie is directly attributable to the trillions of dollars in loans using loose lending standards promoted by Fannie and Freddie to protect their charters as aided and abetted by Fannie and Freddie's supporters in Congress and its erstwhile regulator – HUD. One can say that this is a case of Congress and HUD making a more than willing Fannie and Freddie drive the two companies into the ground – all in the name of affordable housing.

Mr. Pinto is the former Executive Vice President and Chief Credit Officer of Fannie Mae. He held this and other positions at Fannie Mae from 1984 – 1989. From 1974-1982 he worked on affordable housing efforts at the Michigan State Housing Development Authority

Attachmernt 5: to Submitted testimony of Edward Pinto before US House of Representatives Oversight Committee - December 9, 2008

Combined Fannie and Freddie Credit Books Showing Composition of Their $1.6 trillion Subprime, Alt-A, and Other Default Prone Loan Exposure — **Prepared by Edward Pinto, 11.26.08**

All data as of 6.30.08, and except as otherwise noted is from Fannie's August 8, 2008 10-Q Investor Summary or Freddie's Update dated August 2008 $ in billions	Risk relating to whole loans										Risk related to private-label mortgage backed securities				Grand total	% of total single-family mortage exposure
	Total single-family mortgage exposure (inc. Private Label MBS)	Subprime (as defined by Fannie/Freddie fn1)	Additional subprime (as generally defined by bank regulators fn2)		Other junk loans (deduped for multiple risk characteristics in black, undeduped amounts in red)											
			FICO <620	FICO >=620 & <660 fn3	Original LTV >90% (effectively means 95%+) fn4	CLTV >90% (when simul 2nd added) fn5, fn6	Alt-A (a high % have simultaneous seconds) fn7	Interest only fn8	Option Arm (minimal after deduping)	Subtotal		Subprime	Alt-A	Subtotal	Grand total	% of total single-family mortage exposure (inc. PLMBS)
Fannie (deduped)	$2,730.0	$8.0	$127.4	$270.0	$193.0	$87.3	$162.4	$44.4	$10.0	$894.5		$36.3	$29.4	$65.7	$960.2	35%
Fannie (not deduped)		$8.0	$127.0	$270.0	$277.4	$126.0	$307.0	$216.4	$19.1	$1,342.9		$36.3	$29.4			
Fannie (% from 2005-07)		79.3%	57.5%	57.5%	62.0%	70.0%	73.0%	83.8%	62.2%	67.9%		92.0%	67.0%			
Freddie (deduped)	$1,970.0	$0.0	$76.0	$165.0	$50.0	$76.8	$81.7	$38.0	$7.0	$494.5		$86.0	$48.0	$134.0	$628.5	32%
Freddie (not deduped)		$0.0	$76.0	$165.0	$145.0	$118.0	$190.0	$164.1	$13.0	$871.1		$86.0	$48.0			
Freddie (% from 2005-07)		0.0%	61.0%	61.0%	58.0%	75.0%	78.0%	90.0%	72.0%	71.7%		92.0%	67.0%			
Combined (deduped)	$4,700.0	$8.0	$203.4	$435.0	$243.0	$164.1	$244.1	$82.5	$36.7	$1,389.1		$122.3	$77.4	$199.7	$1,588.8	34%
Combined (not deduped)		$8.0	$203.0	$435.0	$422.4	$244.0	$497.0	$360.5	$32.1			$122.3	$77.4			
Combined % (from 2005-2007)										69.4%		92.0%	67.0%		71.0%	

1 Fannie definition -Subprime Loans: A subprime mortgage loan generally refers to a mortgage loan made to a borrower with a weaker credit profile than that of a prime borrower. As a result of the weaker credit profile, subprime borrowers have a higher likelihood of default than prime borrowers. Subprime mortgage loans are typically originated by lenders specializing in these loans or by subprime divisions of large lenders, using processes unique to subprime loans. In reporting our subprime exposure, we have classified mortgage loans as subprime if the mortgage loans are originated by one of these specialty lenders or a subprime division of a large lender. 2007 10-Q, p. 129

2 Federal regulators - 2001: Expanded Guidance for Subprime - http://www.federalreserve.gov/Boarddocs/SRletters/2001/sr0104a1.pdf
Lending ProgramsGenerally, subprime borrowers will display a range of credit risk characteristics that may include one or more of the following:
Two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months;
Judgment, foreclosure, repossession, or charge-off in the prior 24 months;
Bankruptcy in the last 5 years;
Relatively high default probability as evidenced by, for example, a credit bureau risk score (FICO) of 660 or below (depending on the product/collateral), or other bureau or proprietary scores with an equivalent default probability likelihood; and/or
Debt service-to-income ratio of 50% or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.

3 FICO >= 620 & <660: Fannie: 10% of entire book (P127 of 2007 10-K). Freddie had 9% of entire book (P59 of Q2:2008 10 Q).

4 OLTV >90% - Fannie: deleted 10.5% for <620 FICO overlap, deleted an estimated 20% for 620-659 FICO (used 2x incidence in overall portfolio, same incidence as found for <620 FICO), Freddie: deleted 10% for <620 FICO overlap, deleted an estimated 25% for 620-659 FICO (used 2.5x incidence in overall portfolio, same incidence as found for <620 FICO).

5 CLTV >90% - Fannie reports on p. 128 of its 2007 10-K that 15% of its entire book had an original combined LTV >90%. Its OLTV percentage >90% (without counting the simultaneous 2nd) is 10.4% This means another 4.6% ($126 billion before deduping) of its portfolio is over 90% CLTV at origination (where the 2nd was disclosed, they admit that this data is soft - on the low side). Freddie reports on p60 of its Q2:2008 10 Q that 14% of its portfolio had an original combined LTV >90% (1st + simultaneous 2nd). Its OLTV percentage >90% (without counting the simultaneous 2nd) is 8%. This means another 6% ($118 billion before deduping) of its portfolio is over 90% CLTV at origination (where the 2nd was disclosed, many are not). In both cases most of these are Alt-A loans and constitute a significant proportion of Alt-A loans. This very risky characteristic helps explain why the GSEs' Alt-A loans constitute 11% of risk and 60% of losses.

6 CLTV >90% - Fannie: deleted 10.5% for <620 FICO overlap (same % as OLTV >90%) and deleted an estimated 20% for 620-659 FICO (used 2x incidence in overall portfolio, same incidence as found for <620 FICO, Freddie: deleted 10% for <620 FICO overlap (same % as OLTV >90%) and deleted an estimated 25% for 620-659 FICO (used 2.5x incidence in overall portfolio, same incidence as found for <620 FICO).

7 Fannie: deleted 0.7% for <620 FICO overlap, deleted 1% for 620-659 FICO overlap (average FICO of Alt-A is 719), deleted 5.4% for >90% OLTV overlap, & deleted 40% (estimate) of Alt-A for overlap with CLTV 90%.

7 Freddie: deleted 4% for <620 FICO overlap, deleted 9% for 620-659 FICO overlap (used 1x incidence for overall portfolio, (average FICO of IO is 724), deleted 4% for >90% OLTV overlap, & deleted 40% (estimate) of Alt-A for overlap with CLTV 90%.

8 Fannie: deleted 1.3% for <620 FICO overlap, deleted 2% for 620-659 FICO overlap (average FICO of IO is 725), deleted 9.1% for >90% OLTV overlap, estimated overlap of CLTV >90 @40% of Alt-A total, deleted (60% x 42.5%) for Alt-A overlap

8 Freddie: deleted 3% for <620 FICO overlap, deleted 5% for 620-659 FICO overlap (average FICO of IO is 719), deleted 4% for >90% OLTV overlap, estimated overlap of CLTV >90 @40% of Alt-A total (used same as Fannie), deleted 60% X 42.5% for Alt-A overlap (used same as Fannie)

Attachment 6 to Submitted testimony of Edward Pinto before US House of Representatives Oversight Committee - December 9, 2008

US Mortgage Market: Sizing Total Subprime, Alt-A & Other Junk Loan Exposure

Research prepared by Edward Pinto, epinto@lenderres.com **Date: 12.1.08**

A. Subprime:

Allowing each individual originator to define on its own what constitutes a subprime loan was found by banking regulators to be an unsatisfactory situation. In 2001 Federal banking regulators gave "Expanded Guidance for Subprime Lending Programs": (http://www.federalreserve.gov/Boarddocs/SRletters/2001/sr0104a1.pdf"):

> "The term "**subprime**" refers to the credit characteristics of individual borrowers. Subprime borrowers typically have weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories. Subprime loans are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase. Such loans have a higher risk of default than loans to prime borrowers. Generally, subprime borrowers will display a range of credit risk characteristics that may include one or more of the following:
>
> - Two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months;
> - Judgment, foreclosure, repossession, or charge-off in the prior 24 months;
> - Bankruptcy in the last 5 years;
> - **Relatively high default probability as evidenced by, for example, a credit bureau risk score (FICO) of 660 or below (depending on the product/collateral), or other bureau or proprietary scores with an equivalent default probability likelihood** (emphasis added); and/or
> - Debt service-to-income ratio of 50% or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income."
>
> This list is illustrative rather than exhaustive and is not meant to define specific parameters for all subprime borrowers. Additionally, this definition may not match all market or institution specific subprime definitions, **but should be viewed as a starting point from which the Agencies will expand examination efforts** (emphasis added)."

The use of a FICO score below 660 as a significant point of demarcation between prime and subprime loans goes back to 1995. As noted in January 1997 by Standard & Poor's, "...a FICO

score of 660 [is] the investment-grade score as defined in Freddie Mac's industry letter of August 1995." (S&P Structured Finance Ratings, January 1997, p. 14).

Based on these sources, defining subprime as a loan with a FICO of less than 660 should guide any effort to determine the other subprime loans beyond those described as such by originators.

1. **Subprime loans denominated by the originator as such:** The Fed Reserve of NY maintains a data base on subprime and Alt-A found at: http://www.newyorkfed.org/regional/techappendix_spreadsheets.html#sub_loans

   The Fed's database of subprime loans denominated as such by the originator is based on Loan Performance Corporation's subprime servicing/private securities databases which track loans that are self-denominated by originators as subprime (LP Subprime Database). While a FICO below 660 is a significant determinant (71% of such loans have such a FICO), there are other characteristics used in this self-determination. The NY Fed defines **Subprime** as:

   > "Compared with prime mortgages, subprime mortgages are typically made to borrowers with blemished credit history or who provide only limited documentation of their income or assets. Originations of subprime mortgages fell sharply in the second half of 2007 and have been extremely light so far in 2008. Of the 3.3 million active subprime loans in the data at the end of 2007, there were some 3 million loans for owner-occupied units with an average outstanding loan balance around $180,000."

   It further adds:

   > "The underlying data do not represent every subprime mortgage, whether in portfolio or in a security, or mortgage securitized in an alt-A pool. We estimate that as of **year-end 2007**, there were about a total of 7 million subprime loans. The underlying data contained 3.3 million active subprime loans, suggesting a coverage ratio of 47 percent."

   These 7 million loans almost certainly meet one of more of the Federal bank regulators' definition of subprime. Based on an average balance of $180K (see above), this translates into **$1.260 trillion**. This compares favorably to MBA delinquency data reporting 5.541 million subprime loans (excludes FHA) at 6.30.08, however the MBA believes its database captures 85% of all loans, resulting in an MBA estimate of 6.52 million subprime loans. Using the same $180k per loan, this suggests **$1.173 trillion.** Since the MBA is from 6.30.08 while the NY Fed data is from 12.31.07, the two sources appear to be very close.

2. **Subprime loans denominated as prime loans but with FICOs below 660:** Loan Performance Corporation also maintains a prime loan database (LP Prime Database) that predates the establishment of its LP Subprime Database. The LP Subprime Database and LP Prime Database are mutually exclusive (confirmed by Loan Performance). All Fannie

and Freddie loans (regardless of FICO) are reported into the LP Prime Database only (confirmed by Loan Performance). The LP Prime Database was setup in 1989 before the use of FICOs, which were only developed in 1989 and did not come into general use in the mortgage industry until 1995. It was populated by prime loan servicers and investors (originally just Freddie, with Fannie added in 1991). The LP Prime Database is a mix of Fannie and Freddie loans, other conforming loans, prime jumbo loans, FHA and VA loans. As Fannie and Freddie started doing large volumes of loans with FICOs below 660, these were reported into the LP Prime Database along with their traditional prime loans.

As noted earlier a FICO below 660 is the most clear cut determinant set out by the Federal banking regulators as a characteristic of a subprime borrower.

- About 71% or 5 million loans out of the NY Fed's 7 million subprime loan total have a FICO below 660.[1]
- About 20% or 10 million loans out of Loan Performance's grossed up prime loan total of 50 million loans have a FICO below 660. [1,2]

[1]"Surprise: Sub-Prime Mortgage Products are not the Problem!" Percentages obtained from Figure 1.
[2]Loan Performance reports that the LP Prime Database has "[L]oan-level data on over 75% of the nation's active first mortgages—more than 38-million—including all of the Fannie Mae and Freddie Mac portfolios."

To convert the 10 million subprime loans contained in the LP Prime Database to dollars, an average loan amount of $150,000 seems appropriate. Fannie and Freddie account for 49% or 4.9 million[3] of the 10 million loans and have an average loan amount of about $132,000, the other 51% are a mixture of many loan types including FHA (the original subprime "lender", whose loans have somewhat lower balances) and jumbo loans (much higher balances). $150,000 x 10 million = **$1.5 trillion**. Note: There are more subprime "prime" borrowers with a FICO below 660 (10 million) than all subprime borrowers denominated by the NY Fed (7 million).
[3]Fannie and Freddie are estimated to have $646 billion in loans with FICOs below 660. At an average loan amount of $130,200

Table #1: Total Subprime exposure:

Type:	#	% of subprime/ % of all loans	Serious delinquency rate
Loan Performance subprime grossed up	7 million	41%/12%	17.85%[4]
Loan Performance Prime grossed up	10 million	59%/17.5%	5%[5]
Total	**17million**	100%/29.5%	

[4]MBA
[5]Estimate based on Fannie's loans with FICOs <620 having a serious delinquency rate of 6.74% at 9.30.08. This estimate of 5% is likely low, as Fannie's subprime portfolio is relatively

unseasoned and its delinquency level is increasing rapidly (for Q2:08 the comparable rate was 5.48%).

Table #2: Fannie/Freddie conventional subprime exposure:

		Fannie	Freddie	Total #/% of subprime
Conventional loans	Subprime Private Label Mortgage Backed Securities	0.24 million	0.56 million	0.8 million/5%
	"Prime" loans <660 FICO	3.05 million	1.85 million	4.9 million/29%
Total		3.29 million	2.41 million	5.7 million/34%

B. Alt-A:

The NY Fed defines **Alt-A** as:

> **"Alt-A Mortgages defined:** Loans marketed in alt-A securities are typically higher-balance loans made to borrowers who might have past credit problems—but not severe enough to drop them into subprime territory—or who, for some reason (such as a desire not to document income) chose not to obtain a prime mortgage. In addition, many loans with nontraditional amortization schedules such as interest only or option adjustable rate mortgages are sold into securities marked as alt-A."

It further adds:

> "Our best guess is that 2.4 million loans in this portion of the data cover more than 90 percent of the pools marketed as alt-A. The loan data are drawn from reports by the Board of Governors of the Federal Reserve System based on data from FirstAmerican CoreLogic, LoanPerformance Data. Data on the number of housing units are drawn from the U.S. Census 2000." and

> "Although the term "alt-A" applies technically only to securities, not mortgages, it has become common practice to refer to near-prime or non-traditional mortgages as "alt-A" loans. The 2.4 million alt-A loans in the data contained approximately 1.7 million loans for owner-occupied units with an average outstanding loan balance around $300,000 at the end of 2007."

The above translates into **2.67 million** Alt-A. Based on an average balance of $300K (see below), this translates into **$0.800 trillion** Alt-A held in securities. The MBA does not have a separate category for Alt-A. This definition does not include Fannie and Freddie's Alt-A loans.

Fannie and Freddie Alt-A loans total **$0.497 billion** comprising **2.9 million** loans not covered by the NY Fed and $77 billion in private MBS tranches (450,000 loans) already included in the NY Fed estimate.

This brings the total for Alt-A to **$1.3 trillion and 5.6 million loans**. Fannie and Freddie's share of **3.35 million** is **60%** based on loan count.

C. Total for all junk loans: 25.1 million loans out of 57 million 1st mortgages (44%) or $4.63 trillion:

Fannie/Freddie's portion of conventional junk loans: 10.1 million loans out of 25.1 million junk 1st mortgages (40%).

The Loan Performance and the MBA both estimate that there are about 57 million 1st mortgages.[6] The 25.1 million junk loans are distributed as follows:

- **Subprime: 17 million of which Fannie and Freddie are responsible for 5.7 million or 34% of all subprime loans.**

- **Alt-A: 5.6 million of which Fannie and Freddie are responsible for 3.35 million or 60% of all Alt-A loans.**

- **Other junk: 2.5 million loans consisting of many negatively amortizing ARMs (Option ARMs), Interest Only ARMs, Original LTV >90%, and piggy back seconds not included in the above. Fannie and Freddie responsible for 60% of all other junk.**
  - $262 billion (1.5 million loans) - $198 billion for Fannie and $64 billion for Freddie.
  - $350 billion estimate (1 million loans) Wachovia has $122 billion of pay-option/potential negatively amortizing ARMs (Wachovia calls them pick-a-pay). These are not subprime, not securitized, and not held by Fannie or Freddie. They are certainly junk loans. Other uncounted junk loans can be found at B of A (from their Countrywide purchase) and WaMu ($53 billion, these assets are now owned by Chase), and IndyMac (specialized in Alt-A, now owned by the FDIC). A rough guess is that this adds at least another $350 billion in junk loans.

[6]Fannie and Freddie have a total of 30.6 million loans, plus 1.25 million in PLMBS traunches; for a total of 31.85 million loans. 10.55 million or 33% are high risk.

Attachment 7 to Submitted testimony of Edward Pinto before US House of Representatives Oversight Committee - December 9, 2008

Fannie/Freddie conventional subprime. Alt-A, and other default prone loan exposure by loan count:
Prepared by Edward Pinto, December 1, 2008

Default prone conventional loans:		**Fannie**	**Freddie**	**Total # of loans**
A. Subprime:	**Subprime Private Label Mortgage Backed Securities:**	**0.24 million**	**0.56 million**	**0.8 million**
	"Prime" loans <660 FICO:	**3.05 million**	**1.85 million**	**4.9 million**
Total: Subprime		*3.29 million*	*2.41 million*	*5.7 million/34% of all subprime*
B. Alt-A:	**Alt-A Private Label Mortgage Backed Securities:**	**0.172 million**	**0.273 million**	**0.45 million**
	Alt-A loans	**1.79 million**	**1.08 million**	**2.87 million**
Total: Alt-A		*1. 96 million*	*1.35 million*	*3.32 million/59% of all Alt-A*
C. Other default prone loans:	**Option ARMs, original LTV>90%, piggy back seconds with combined LTV>90%**	**1.11 million**	**0.37 million**	**1.48 million**
Total: Other default prone loans		*1.11 million*	*0.37 million*	*1.48 million*
D. Total (all above deduped for overlaps)		*6.36 million*	*4.08 million*	*10.5 million loans/18% of all outstanding loans*

ATTACHMENT 8

WALL STREET JOURNAL JULY 5, 1991

VOL. CCXVIII NO. 4 ★★★

Haste Makes . . .

Quick Home Loans Have Quickly Become Another Banking Mess

Lenders That Didn't Require Usual Data on Borrowers Find Delinquencies Rising

Inflating the Income Figures

By MITCHELL PACELLE
Staff Reporter of THE WALL STREET JOURNAL

To would-be residents of Brightside Place, a complex of 46 duplex homes scattered across a treeless ledge in Derry, N.H., the Dime Savings Bank seemed a godsend. By the summer of 1988, New England home prices had soared into the stratosphere. But instead of tightening its scrutiny of potential borrowers, the New York thrift institution's officials seemed willing to approve a mortgage for just about anyone who walked in.

"They were so easy about everything," recalls one Brightside buyer. "I thought, I haven't looked at a house in years. Maybe times have changed."

Indeed they had. The Dime was spearheading a movement to slash the time and trouble needed to get a mortgage. Lending officers did little to verify borrower claims about income or savings; paper work once used to weed out potential defaulters was eliminated. Borrowers who at one time would have waited two months or more for a loan got informal commitments on the spot and typically had their money as soon as the property was appraised.

Can't Lose

The theory behind these no-documentation and low-documentation loans, called low-docs or no-docs for short, was simple: If lenders got a 20% or 25% down payment, the size of the borrowers' income didn't matter: No one would walk away from that much money. And even if banks did have to foreclose, ever-rising home prices would give them a profit.

But as buyers stretched to buy the largest houses they could, some also stretched the truth. A survey by United Guarantee Corp., a Greensboro, N.C., mortgage insurer, found that 30% of applicants misrepresented their income by more than 10%. Moreover, commission-hungry lending officers were falsifying loan applications and concealing second mortgages obtained by borrowers to cover the down payments

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Now, the widespread lying and cheating, coupled with collapsing home prices, have produced an underwriting debacle of staggering proportions. Aggressive no-doc lenders such as the Dime and Citicorp, also of New York, have seen delinquency rates soar to many times the industry norm. Such increases are stirring fears that many lenders may face worsening losses on residential real estate. In addition, the fiasco has sparked a broad retreat to tougher lending standards, and now people are finding it harder to buy homes.

Disillusioned 'Prophet'

"At one time, I was a prophet of low-doc," admits Angelo Mozilo, president of Countrywide Funding Corp., of Pasadena, Calif., the nation's largest independent mortgage banker. "The problem is that it went much too far. Human beings are basically rotten. If you give them an opportunity to screw up, they will."

The pioneers of no-doc lending never dreamed that streamlined underwriting would prove so risky.

The Dime, a basically conservative thrift that had avoided the commercial-real-estate and junk-bond deals which sank so many others, was seeking to exploit a maxim of mortgage lending: It is nearly impossible to lose money on home mortgages. By sidestepping the time-consuming process of soliciting written confirmations of income, salary histories and bank balances, lenders could offer middle-income borrowers the quick loan commitments previously available only to wealthy customers.

A Popular System

The loans were a big hit. In 1987, 75% of the Dime's $4.5 billion of new mortgage loans were low-docs. At Citicorp, about 25% of mortgage originations between 1986 and 1988 were low-docs. "Mortgage brokers from all over the country were calling us saying, 'Find us some more lenders like Dime and Citicorp,' " recalls Barry Havemann of HSH Associates, a Butler, N.J., publisher of mortgage information.

Such competitive pressures brought Prudential Home Mortgage Corp. into the market, says Robert Williams, managing director of the unit of Prudential Insurance Co. of America. In 1988, low-docs accounted for about 25% of its $2.9 billion in loan originations.

When the Federal Home Loan Mortgage Corp. (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae), the nation's largest secondary-market buyers of mortgages, began purchasing the loans, all lenders were under pressure to offer them. In 1988, such loans accounted for 20% to 30% of the annual mortgage market.

The product soon turned into a marketing tool to get borrowers "in the front door quickly," says Joel Pasternack, senior vice president of ComFed Savings Bank, a once-highflying no-doc lender based in Lowell, Mass. It was seized last December by the Office of Thrift Supervision.

Underwriting standards began to slip. Original down-payment requirements as high as 30% eroded, at some lenders eventually to as little as 10%. Lenders "really got carried away in 1987," says Stuart Feldstein, president of SMR Research, a Budd Lake, N.J., consulting firm. "They

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Haste Makes . . .: Quick Home Loans, Arranged Without Usual Diligence, Quickly Hurt Some Banks

Continued From First Page

were applying scarcely more than the breath test: If the guy breathes, give him the loan."

The sloppy underwriting soon caused trouble. Borrowers who had lied about their incomes began defaulting when their adjustable-rate mortgages racheted up.

And when the Resolution Trust Corp., the federal agency handling failed thrifts, moved in to run ComFed, it discovered another problem. Many of the low-doc mortgages recorded on bank documents as 75% or 80% loans were actually 95% and 100% loans, says Mr. Pasternack, who didn't come to ComFed until last July.

Buyers were getting second mortgages from the sellers or the sellers were discounting the properties, and the buyers weren't disclosing either ploy on loan documents. Though second mortgages are perfectly legal, falsification of loan documents is not. In many cases, lending officers were to blame.

Driven by Commissions

"The secret to the whole thing was putting these loan originators on commission," contends Michael Conley, a Wakefield, Mass., lawyer who represents some ComFed borrowers. "That turned out to be a disastrous marriage to the low-doc loans. Loan originators started to get greedy and stopped turning in accurate applications." ComFed loan officers were after commissions of $300 to $500 per loan.

Tony Kingsbury, a body-shop manager, and his wife, Jonella Parish, an insurance adjuster, couldn't afford even a 5% down payment on a $145,000 home they were eyeing in Manchester, N.H. In February 1989, they bought it for nothing down. ComFed lent them 80% and the builder the rest.

"They didn't do any checks at all," Ms. Parish recalls. "I brought a credit report, but they said they didn't need it." In addition, a former ComFed senior vice president, Patricia Hajjar, inflated their incomes and bank balances on the loan application, which the couple signed without reading at the closing, Ms. Parish says. The couple say they were unaware of the misrepresentations until the Federal Bureau of Investigation, which was investigating lending abuses at ComFed, got in touch with them.

Last December, Ms. Hajjar, a real-estate broker and a lawyer were convicted in federal court in Boston of bank fraud in connection with the submission of phony loan applications on other properties. She was sentenced to three years in prison, fined $6,000 and ordered to pay $8,000 in restitution. She recently pleaded guilty to fraud and conspiracy and testified for the government in the trial of eight others in connection with the concealment of second mortgages on 71 loans, including Ms. Parish's. No charges were brought against any ComFed borrowers.

Problems at the Dime

Stories of similar abuses are beginning to haunt the Dime.

For instance, a Dime borrower who works in the financial-services industry says she was flabbergasted by the loan officer who offered her a 90% no-doc loan to buy a $150,000 condo in suburban Boston. She says the officer told her to exaggerate her income and put down $10,000 in assets she didn't have, and advised her she could lie about her credit-card debts because there was a delay in checking. The buyer of a Brightside Place duplex in New Hampshire says that after he got his loan he found that the Dime's loan officer had inflated his income and his wife's job tenure on the loan application.

Asked about both of these loans, Frank Wright, a Dime senior vice president, responds that the thrift never condoned such practices and that the borrowers were also at fault for signing fraudulent applications. Roger Williams, another Dime senior vice president, says: "We don't know the extent of the fraud. The farther we got away from [New York], the more susceptible we were to abuses." He says the bank has referred some cases to federal prosecutors.

If homes in the Northeast had continued to appreciate, no-doc and low-doc lenders might have got away with such reckless underwriting. But when prices sank, some borrowers found themselves with loans far exceeding the home's value. Delinquencies at low-doc and no-doc lenders skyrocketed. Nationwide, according to SMR Research, 1.48% of the dollar amount of thrifts' loans on one- to four-family homes was more than 90 days delinquent at the end of last year, the latest period for which such figures are available. For bank holding companies, the rate was 1.36%.

High Delinquency Rate

At the Dime, 9.44% of its $6.7 billion of such mortgages was more than 90 days delinquent at March 31. In Massachusetts, its delinquencies hit an astonishing 24% of the dollar amount outstanding.

ComFed reports 13% of its home-mortgage portfolio more than 90 days delinquent. Its low-doc loans soured at four times the rate of conventional loans, Mr. Pasternack estimates.

At Citicorp, the delinquency rate was 4.4% at year end and rose to 4.8% at March 31. In comparison, Chase Manhattan Bank, which never offered no-doc or low-doc loans, had a 0.55% rate.

The Dime closed its out-of-state offices in early 1989, and early this year it eliminated all low-doc lending. Citicorp also began tightening its underwriting in 1989 and, in March, scrapped the low-doc program entirely. It says it now verifies the incomes and assets of all borrowers and does thorough credit checks.

"It comes right down to traditional credit practices: to ascertaining borrowers' willingness and ability to repay the loan," says Mr. Williams of Prudential, which also discontinued low-doc lending.

Last October, Fannie Mae stopped buying no-doc and low-doc loans. On April 1, so did Freddie Mac.

Another System

With the secondary market shut down, no-doc and low-doc loans are far scarcer. Many lenders have replaced them with "alternative documentation" loans, which rely on borrowers' tax returns, pay stubs, bank statements and similar documents to substantiate claims. But high delinquencies will probably dog former no-doc and low-doc lenders for some time. "You live for years with the underwriting that you did long ago. This is the scorecard we're seeing for what banks did in 1986 and 1987, the biggest years of mortgage origination in U.S. history," SMR's Mr. Feldstein says.

And many no-doc borrowers who would not have got traditional mortgages may be struggling for a long time, too.

Mr. Kingsbury and Ms. Parish have seen their monthly payments leap from $845 to $1,300. (They hold a negative-amortization loan, in which the outstanding principal grows for several years because initial payments are kept artificially low.) But although Mr. Kingsbury recently lost his job and now works only part-time as a bouncer at a bar, they are managing to stay current on their mortgage.

"It's putting all of our other bills behind," says Ms. Parish, who has taken a second job at a supermarket deli on weekends. "But we don't want to be foreclosed on. We have kids."

Sales of New Homes Fell in May, in Sign Of Industry Weakness

By a WALL STREET JOURNAL *Staff Reporter*

WASHINGTON – Sales of new single-family homes fell 3.3% in May to a seasonally adjusted annual rate of 474,000, the Commerce Department said, reflecting continued weakness in the housing industry.

Although monthly home-sales reports often are revised substantially in subsequent months, the news nonetheless was disappointing for the housing industry. In May 1990, sales of new homes were at a seasonally adjusted annual rate of 530,000. "No one was expecting it to be that high, but it's lower than what we expected," said Mark Obrinsky, senior economist at the Federal National Mortgage Association.

The government also revised downward its April home-sales report. The new figures show that sales of single-family homes declined 0.2% that month to 490,000, rather than growing 1.2% as reported earlier.

New-home sales have fallen steadily over most of the last year, but they rebounded slightly in February and March. Most economists believe that the housing sector of the economy hit bottom in January, and is slowly recovering. "These numbers just indicate how weak the housing recovery is likely to be," Mr. Obrinsky said.

Sales rose only in the Midwest, where they jumped to a seasonally adjusted 107,000 annual rate in May from 88,000 in April.

The U.S. now has a 7.8-month supply of new homes for sale, up from a 7.5-month supply in April.

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ATTACHMENT 9

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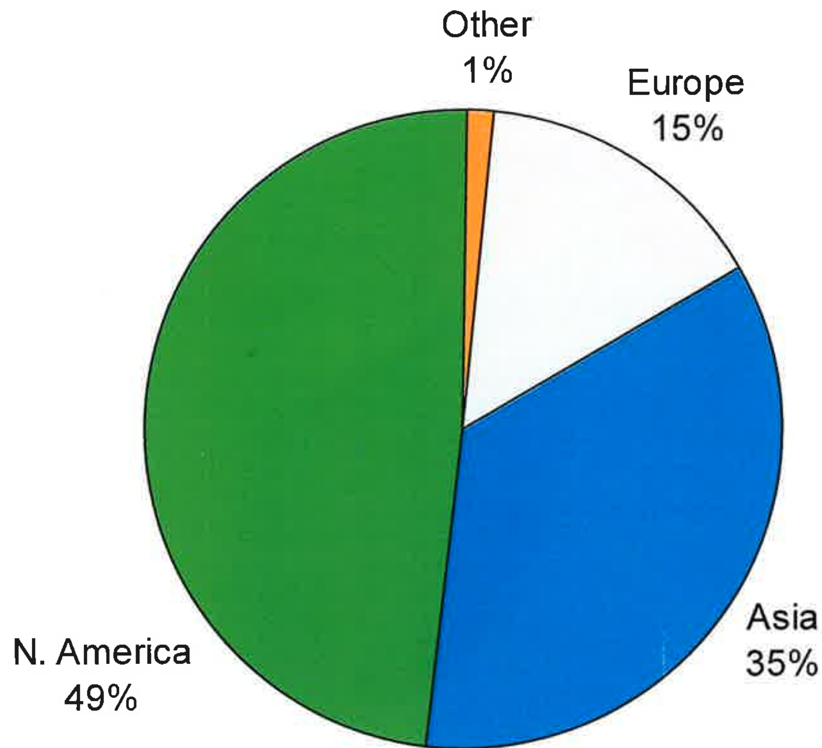

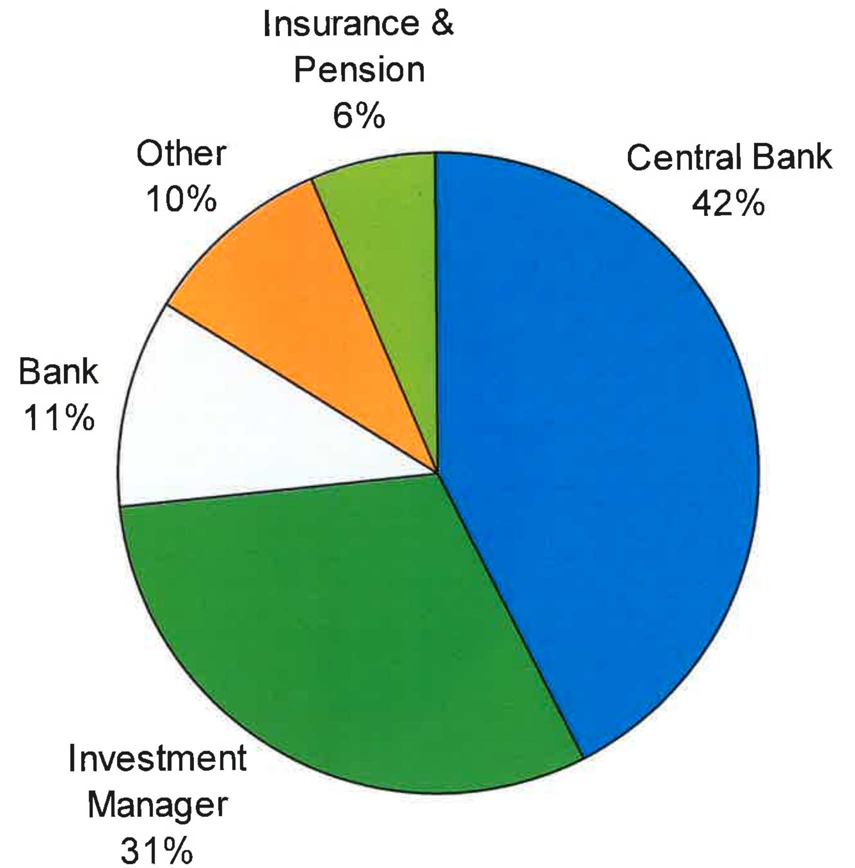

Note: Data reflects orders placed in our US$ Reference Notes® securities syndicated bond deals.

Source: Freddie Mac. Data for the 12 months ended September 30, 2008.

ATTACHMENT 10

Origination News

APRIL 1999

Freddie Mac: Fraud high through third parties

ATLANTIC CITY, NJ–Freddie Mac has found that 65% of its fraud cases involve loans produced by third-party originators.

This is no reflection on the industry at large, said Gerald Langbauer, vice president of institutional credit risk at Freddie Mac, but because so much of the business now comes from the wholesale channel, so does the fraud.

Independent mortgage bankers account for 32% of the fraud cases while banks are the remaining 3%.

The majority of the fraud – 60% – comes from defective loans. Theft of funds or "air loans" account for 23% of the fraud cases, while flips are 17%.

It is with "air loans" that you have significant losses, Mr. Langbauer told the Regional Conference of Mortgage Bankers Associations here. Defective loans usual are those misstatements that aim to put a borrower in a house, where air loans involve funds lost, which are tough to recover.

Among the areas where Freddie Mac is finding the most fraud cases are: Michigan, California, Nevada, the Washington, D.C., metro area and New Jersey.

But the ultimate hot spot right now, he said, is Florida, and in particular Dade and Broward counties.

In Florida, the default rate is five times higher than the national average, more than double the next highest in the region and mortgage brokers are predominantly involved.

However, Mr. Langbauer said, the brokered loans are not from third-party originators, but go as far back as fourth and fifth party originators, making them difficult to trace. These schemes are taking off in South Florida because the area has large groups of people who have limited knowledge of the English language. This makes them susceptible to unscrupulous individuals, he said.

In order to combat this fraud, Freddie Mac sent an industry letter out in June, which was a first for the agency. It advised all seller/servicers on the company's findings. It is also working with the Florida Quality Council, a group that takes a proactive stance on getting the bad people out of the mortgage business, Mr. Langbauer noted.

Freddie Mac is also doing more industry training in Florida and it is working with mortgage lenders to find the sources of the bad loans and get a resolution. When dealing with third party originators, wholesalers should know with whom they are doing business, Mr. Langbauer said.