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To: Our clients and friends
From: Jim Callahan, Executive Director
Subject: Bullet point observations regarding the FDIC's July 8, 2008 forum on low to moderate income housing.
Date: July 11, 2008

Earlier this week, I attended the FDIC's forum on mortgage lending.
-8 hours of discussion with roughly 200 in the audience.

I have never seen such an all-star roster of housing and lending leaders in one session. The FDIC did an impressive job in setting it up and hosting. Here are my summary thoughts.

The roster included (speaking order):

- FDIC Chairman
- Federal Reserve Chairman
- Chairman of JP Morgan
- US Treasury Secretary
- Various industry CEO's from the rating agency, private equity, community lending, advocacy and related housing industries.

The tone was somber (except Secretary Paulson but then again, that is his job). Jamie Dimon commented that even he needed to inject a positive comment in his speech every once in a while.

(Note to self..... Negative tone. Still negative. Very negative.)

Personally, I have a tendency to "bucket" my observations into movie analogies but I am confused on this one. I have two choices for yesterday's movie: "You ain't seen nothin' yet" or "Welcome to the Titanic. Would you like a refreshing drink while I rearrange your deck chair?"

The speakers were broken into two categories; private sector leaders and government leaders. The private sector leaders expressed frustration in attending non-stop forums that don't result in sufficient action items. Some emphatically called for government intervention on certain key matters, effectively saying, "we are done talking and analyzing; let's make some hard decisions and get this thing fixed!"

Sadly, the government speakers trumped them. Officials said they were not in a position to provide that "silver bullet". They argued that some initiatives are underway to chip away at the issue (large praise for the FDIC Chairman Bair) and they were improving the "system" to deal with the pending "storm". In other words, "we all see the levy is about to break and we can't fix it fast enough so let's minimize the post-event clean up." There was clearly a difference of opinion on this. Some called it an "inevitable bubble correction" (government) while others called it financial ruin for millions (lenders and advocates).

Frustrating but reality. No clear action plan to avert the storm was presented. (Note: we should really identify two storms, one is a housing storm, the other is a financial system storm.)



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As part of the housing storm discussion, lots of statistics were cited about the number of houses that need to be sold in the next two to three years. (Millions) To compound that, credit is limited and consumer confidence in the home ownership dream is being beat-up daily by the popular press. While no one said it, two overriding questions seemed to hover in the room: “who is going to buy all of those houses? (lender’s perspective) and “where will these people live?” (advocates’ perspective). In either case, it seems like U-Haul is a stock to consider. (I’m trying to be positive.)

Overall, I think the government showed impressive focus. Paulson looked exhausted and Sheila Bair seems to have been dubbed the “Mortgage Czar” that was called for last year in the public press. Even though she has a day-job running an insurance company, she showed great energy in “stirring the pot”, getting the players to openly discuss the issues. Also, she has developed a reputation for proposing insightful actionable items. She and her team are trying. Trying hard.

There were a few interesting sound bites from the movie list.

Movie name, “Securitization is dead”. A dead securitization market will cause price discovery on existing financial instruments to diminish materially which will create a circular downward spiral with recent accounting guidance to mark virtually everything to market. Ironically, we just converted to market based pricing but there are no new deals to act as a market benchmark. A dead securitization market equals more capital needs for remaining institutions because of falling asset values. Say good bye to the private sector providing material cash for an extended period.

Movie name, “Back to the 80’s”. Mortgage finance is currently DOMINATED by federally supported or guaranteed entities. (Didn’t we try to reverse that in the 90’s which created the securitization market?) It is clear that the federal entities are the lifeblood to the housing finance cure. This GSE dominance will continue until AAA bond spreads rally 500 basis points to result in a securitization financing cost that is lower than where a homeowner wants to borrow. 500 basis points! Currently, there is a significant negative arbitrage. Significant. So when will securitization return? When CREDIT bond prices rally a ton (probably not next week).

Movie name, “Free Willy”. After this week’s rout in GSE stock prices, Bernanke and Paulson were more than open about their support for the GSEs to play a big role in the housing cure. They realize that moral suasion on the private sector is not sufficient to fix the problem. They appear to have concluded that the GSEs are their implementation partners.

Movie name, “Help me. Help me!” The FHA official was great. He basically said he was tired of making calls to congress for sufficient tools (money) to do his job effectively. Given that this is an election year, he seemed to be resigned to his fate as a lame duck. He actually showed great compassion to fix the mess but realized that he will be leaving with the administration. “Write your congressman to help FHA” was a recurring theme to his comments.

Movie name, “Power play” Chairman Bernanke laid out his vision for the Fed overseeing virtually all of the US financial system. (Note that I didn't say housing which was the goal of the forum.) The Chairman is really focused, and his carefully worded speech laid out the rationale with great eloquence. While there is material merit in such a move, it was a bit odd to see him dub the fed (himself) as the potential ruler of the US financial system.



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In side conversations, I engaged a few “friends” whose day-job is to analyze and predict the future performance of mortgage loans. I commented that the mortgage market is implying that default frequency will be roughly two times higher than credit card default frequency in some LIMITED geographic areas. How weird. It isn’t supposed to happen that way. Is unsecured debt truly a lower credit risk than secured debt? Again, if we think about the movies, we’ve seen this sort of counter-intuitive behavior in periods of intense pressure. In the movie *Titanic*, some “proper gentlemen” abandoned the women-and-children-first rule to save their own lives. Today, we’re starting to observe that there is a higher probability that consumers will choose to stop paying for their house (18-month eviction period) instead of annoying their credit card company (18 minute window before credit is shut off.)

Note of caution. There was a lot of discussion about the sub prime and Alt A markets and their very real challenges. In reality, these markets are proportionately small and effectively dead right now. We are simply cleaning up the mess by pushing the bad loans through the loss mitigation / foreclosure process. During the forum, it was this “process” that got all the attention. What WASN’T discussed was the prime market which is continuing to show decent resilience so far. Sure the delinquency statistics are higher but they are not crazy at this point. I wish someone had stood up and clarified this point because everyone left the room thinking the sky is falling in over the entire nation. (It isn’t. We just have localized storms. Granted some are tornados.)

In closing, I don’t think anyone expected a new direction to come out of the session. It was more like a Presidential State of the Union summary of where we are in the housing market and a forum to highlight developing strategies. It was a good use of time. Hats off to the FDIC for taking leadership.

A storm is coming. The key players have been identified. They need our support. Jump in. Help them. This is a team effort!

If you have any questions about the forum, please feel free to give me a call. Separately, we have recently posted some of our position papers on our web site to address the rating agency conflict issue as well as ways to improve securitization governance -- items that we are passionate about fixing. They can be found at www.PentAlphaGlobal.com