To	Date
Dick Syron and Gene McQuade	October 6, 2004
From	Subject
Mike May	No Income/No Asset (NINA) Mortgages

ACTION REQUESTED

The purpose of this memo is to request a decision about Freddie Mac's purchase of NINA mortgages and investment in securities backed by NINA mortgages. Due to the increased reputation, fraud, predatory lending and credit risks posed by our current programs, time is of the essence. Freddie Mac must choose to either modify our business practices to mitigate risks and continue purchasing NINA mortgages or exit the NINA market completely. I plan to bring this issue to the October BEC meeting where we can discuss it in more detail.

EXECUTIVE SUMMARY

Freddie Mac has come to a critical crossroads on a controversial mortgage product – NINA mortgages. NINA mortgages create dynamic tension between key corporate goals and objectives: meeting customer needs, market share, expanding homeownership, managing credit risk, and corporate reputation. NINAs pose higher risks and can be vulnerable to predatory and/or fraudulent practices. During the past several weeks, there has been vigorous debate within the Corporation regarding whether or not Freddie Mac should continue purchasing NINA mortgages and investing in securities backed by NINA mortgages. After much discussion and debate, I recommend that Freddie Mac continue to purchase NINA mortgages and securities backed by NINA mortgages if we complete the following: require borrower disclosure; establish maximum LTV limit of 90%; require new appraisal requirements; promote Freddie Mac's leadership of a task force -- comprised of key industry representatives, including the MBA, and adopt their recommendations.

BACKGROUND

The NINA mortgage was created as an additional documentation option for consumers who cannot, for whatever reason, provide personal financial information. Typically, this product serves borrowers with inconsistent income patterns (self employed, etc.) but with strong credit profiles and substantial down payments. Under this mortgage offering, borrowers do not disclose income or assets to the lender – the borrower's ability to repay the loan is not analyzed or considered.

Understanding the legitimate marketplace need that NINA mortgages provide is difficult to ascertain, without knowing what the borrower and originator motivations were during the origination of the mortgage. Some lenders have stated that NINA mortgages provide access to mortgage financing for borrowers who may have difficulty legitimately documenting their income and/or assets and, for whatever reason, do not want to report their income. For example:

- Borrowers with non-traditional or cash income
- Borrowers with multiple self-employed income sources
- Retirees with substantial assets
- Borrowers relying on rental income, particularly those who rent a portion of their home
- Borrowers who, for cultural reasons, do not trust financial institutions

However, the opposing view questions the need for this product in today's marketplace that offers various alternative documentation mortgages, particularly stated income/stated assets (SISA) mortgages. SISA mortgages serve the same needs outlined above -- as an option for borrowers who chose not to, or cannot legitimately, fully document their income and/or assets. SISA differs from NINA in that the borrowers capacity to repay the debt, along with their financial ability to contribute the required equity down payment, can be analyzed as part of the loan origination process.

BACKGROUND (continued)
Recently, we embarked on an effort to expand our flow offerings for SISA with the intent of streamlining deliveries of this product to us by more lenders. In addition, other mortgage products and underwriting practices have evolved, making the market niche that NINA mortgages traditionally served less unique.

DISCUSSION
During the past several months, new information emerged about NINA mortgages in the following venues, which heightened concerns with Freddie Mac's fraud, predatory lending, reputation and credit risks:

- Mortgage Insurers have stated publicly that the performance of NINAs is poor.
- Consumer media – Ken Harney featured the risks associated with NINAs.
- Anecdotal information provided by a large customer indicates that NINAs are sometimes used to keep rejection rates constant. In addition, they noted NINAs are by far and away the worst performing of alternative documentation mortgages.
- Several issues surfaced with NINA mortgages sold to us by GreenPoint.

In response, we conducted a research effort to examine this product. Given the limits of our analysis, due to sample size, it is difficult to reach solid conclusions. However, the following additional concerns were brought to light:

- Some lenders have expanded the market for NINA mortgages by raising the maximum loan-to-value ratio and lowering credit score requirements.
- Quality control reviews highlighted origination practices that raise concerns; lack of consistent borrower disclosure; instances where borrowers are "coached" to lose their income information after it is known that they did not qualify for their mortgage using standard documentation; nearly two-thirds of married borrowers in our sample had a spouse dropped from the note -- which means that the spouse with the weaker credit score may not have been evaluated during the underwriting process.
- NINA borrower profile has changed from largely self-employed to salaried or fixed income.
- It appears NINAs may be targeted to Hispanics. This increases the risk that this product may be associated with predatory lending.

To avoid facing increased predatory lending and reputation risks, Enterprise Risk Oversight (ERO) is recommending that Freddie Mac cease purchasing NINA mortgages. However, there are a number of concerns associated with this approach:

- Freddie Mac's Alt-A purchases, via the bulk transaction path, were $3.5 BB between January and July of 2004. The retained portfolio purchased an estimated $1BB in NINA mortgages. NINAs are an integral part of our Alt-A transactions (bulk and retained) – if we cease to purchase them, the entire Alt-A business is at risk due to the fact that NINA mortgages are bundled into the Alt-A transactions.
- PVA impact of the Alt-A bulk and retained portfolio transactions for the entire year is estimated between $25 MM and $75 MM – best estimate of $50 MM.
- In addition to the possible loss of the Alt-A bulk business, leaving the NINA market will have negative impacts on key customer relationships and business volumes; standard and alternative documentation volume goals are placed in jeopardy.
- Eliminating or substantially reducing our purchases of NINA mortgages will increase the competitive gap between Freddie Mac and Fannie Mae – they purchase NINA mortgages as well.
- The Alt-A bulk business makes a contribution to our HUD goals. This year, the Alt-A bulk transactions contribute 2 basis points toward achieving our Low/Mod goals, 5 basis points to our Special/Affordable goals, and 40 basis points to our Underserved GSE goals. During 2003, the Alt-A bulk business contributed 10 basis points to our Low/Mod and Special/Affordable goals. However, NINA loans by themselves have a negative impact to goals due to the fact that borrower income is not disclosed.

DECISION OPTIONS

Freddie Mac has three options:

1. Continue purchasing NINA mortgages without changing business practices
   - Risks: this option will not protect Freddie Mac from reputation, fraud, predatory lending and credit risks. Continuing business "as usual" is not wise given the concerns raised with this product and given our tradition of anti-predatory leadership.
2. Cease purchasing NINA mortgages entirely
   - Risks: this option presents risks to market share, customer relationships, HUD goals, and negative impact to PVA. In addition, leaving the NINA market provides Freddie Mac very little leverage to lead changes in the alternative documentation market.
3. Continue purchasing NINA mortgages with required changes to business practices.
   - Risks: credit, fraud, predatory lending and reputation risks remain. However, the implementation of appropriate modifications to business practices will mitigate them.

RECOMMENDATION

I recommend that Freddie Mac continue to purchase NINA mortgages (option three). This option positions Freddie Mac as a flexible business partner, maintains present value add, provides HUD goal benefits, mitigates marketplace perceptions that Freddie Mac is ceding the non-traditional marketplace to Fannie Mae, and serves as a venue for the firm to promote responsible market leadership. My recommendation is conditional upon the following:

- We will implement a policy, for NINA mortgages and securities backed by NINA mortgages purchased by Freddie Mac, that requires the consistent use of borrower disclosure. This disclosure, the language of which must be approved by legal, will be signed by the borrower and retained in the mortgage file, will include statements that acknowledge that the borrowers have selected a No Income/No Asset mortgage and that they have not been coached or otherwise coerced into this product. The borrower disclosure will include an acknowledgement that had they provided their income and asset information to their mortgage lender, they may have been eligible for a lower mortgage rate. In addition, the disclosure must make it clear that because the borrower has not provided either income or asset information, the lender cannot determine their capacity to repay the loan and that the borrower must be sure that they have the capacity to repay. We will provide our customers sufficient time (60-90 days) to implement this change.

- The disclosure requirement will substantially mitigate Freddie Mac's reputation risks associated with these mortgages. The disclosure requirement, which we have already implemented with some of our customers who sell NINA mortgages to us, provides assurances to Freddie Mac (and the originating lender) that the borrower understood the mortgage they entered into and the additional costs.

- Implement, for NINA mortgages purchased, a maximum LTV of 90% and require full appraisals. These requirements will limit layering of additional risks of mortgages purchased. In addition, we need to create a detailed loan offer product code for this product, so that we can more easily identify these mortgages after purchase. We will provide our customers sufficient time (60-90 days) to implement this change.

- Freddie Mac will lead a task force comprised of key industry representatives, including the MBA, to discuss, recommend, and document best practices associated with the origination, secondary marketing, and servicing of NINA mortgages. This task force, chaired by Bob Tsien of the Mission Division, will evaluate the lending and servicing practices associated with NINA mortgages in order to identify the best practices and additional underwriting guidelines (for example; borrower coaching and leaving the spouse off the note) that can be deployed broadly to mitigate any additional risk. This task force should also seek to understand the borrower and lender/originator demographic associated with this product. An additional focus of this effort is for Freddie Mac to gain industry alignment to condition the market to switch to SISAs, thereby reducing the market demand for NINA. Task force membership may include originators, servicers, mortgage insurers, industry trade groups and consumer advocacy groups.

RECOMMENDATION (continued)

- Pursuit of an external strategy to promote our NINA requirements and industry task force. Freddie Mac's leadership of this task force will strengthen our position in the marketplace. Our public positioning regarding this task force will reaffirm Freddie Mac's commitment to improving lending practices, feature our expanded SISA flow offering, and reinforce our position that the mortgage industry has a responsibility to ensure that borrowers understand the long-term financial impact of decisions made during mortgage origination.

If any of the components listed above cannot be carried out, then my recommendation is to leave the NINA market (option two). Appropriate changes to business practices and promotion of Freddie Mac's leadership outlined above provide adequate mitigation to known risks associated with the purchase of NINA mortgages.

REVIEW PROCESS

This memorandum was reviewed by the executives listed below. I've grouped them based on their response to my recommendation:

Supportive

Bob Ryan, VP Integrated Bid
Dave Stevens, SVP Mortgage Sourcing

Neutral

Dave Andrukonis, SVP Enterprise Risk Oversight
Clarke Camper, SVP Government Relations
Susan Gates, VP Public Policy

Concerned

Don Bisenius, SVP Mortgage Credit Policy
[redacted]
Bob Tsien, SVP Mission

APPENDIX

OPPOSING VIEWS/ADDITIONAL CONSIDERATIONS

Person/Department	Comment/Issue
Don Bisenius: Mortgage Credit Policy (ICM)	I disagree with your characterization that NINA mortgages fulfill a marketplace need. The only group of the 5 groups you list as being examples of the niche for this product that couldn't be otherwise served with stated income products are the "borrowers who for cultural reasons do not trust financial instititutions" and I find it ironic that borrowers who don't trust financial institutions are coming to financial institututions for money. They trust them enough to take their money, just not provide any information.
	Throughout this document we note issues associated with the credit risk. While these loans have higher credit risks, I don't believe this is the issue being discussed and I am concerned that it detracts from the reputation risk associated with the origination practices. I am reasonably comfortable that we can cost these risks and can credit enhance those aspects of the credit risk I am concerned about. I would encourage you to drop the credit risk references and stay focused on the predatory risk.
[redacted]	

Person/Department	Comment/Issue
Bob Tsien: Mission	The disclosure proposal seems more like a legal fig leaf than a real effort to inform borrowers. A more meaningful screen might be to require either a FICO score of 680, or better. Lacking that, we should require counseling as a prerequisite to a NINA.
	When we discussed the potential predatory characterization of very high LTV affordable loans, we agreed to live with the risk (at least provisionally). I supported that decision for three factors that I do not believe are present with NINAs: ▪ First, the external world will view expanded affordable mortgages as clearly an attempt to better serve underserved populations. As a tool to reach underserved borrowers, however, no one in Mission HCL believes NINAs are an important and unique tool because SISAs could do the same for underserved borrowers, with less predatory risk. ▪ Second, with affordable loans, we are making a measured bet on extending credit to underserved borrowers, whereas NINA s are more of a blind bet. As a defense against predatory charges, some affirmative effort to measure risk and weed households who are probably bad risks is sensible. The sample data, although limited, clearly suggests NINAs are capturing many borrowers who probably are not qualified and a mix of borrower and broker complicity. As an alternative, SISAs are better because we are only exposed to borrower misrepresentation and it is more difficult for a borrower to press a predatory claim. ▪ Third, I think there is better Seller-Freddie alignment with affordable mortgages because of some degree of repurchase risk, where very little or none exists with NINAs. ▪ *I could live with a graduated approach to change market behaviors. We need to push forward with more than just pursuit of borrower disclosure.*
Ray Romano: Credit Risk Oversight (Dave Andrukonis)	The overall recommendation outlines three requirements, one of which relates to LTV standards. From my perspective, if the proposal were adopted, I think we would want to have a broader discussion on minimum credit standards for NINA loans (i.e.; minimum credit scores, LTV, product types, occupancy, etc).
	The core question of the NINA program continues to relate to just one fundamental issue: *what legitimate business need is the NINA program serving that cannot be filled through other more traditional methods including those that are available under SISA programs*? The list of borrower types for which NINA's help expand homeownership opportunities does not address this question and in fact may confuse the issue by introducing borrower motivations that may relate to SISA programs. Moreover, this list is inconsistent with market practices that we have observed. I would strongly recommend that you revise this section to address the core question with facts that we know. If we cannot answer to the central question then we should state upfront that we are unaware of the true motivations of consumers in selecting mortgage options that do not require, at minimum, that they state their income and asset positions.
	The overall recommendation makes the assumption that we could not separate out NINA from other Alt A loan programs. While this may ultimately be true, it is not a proven assumption. As market leaders we would at least want to test the theory as we have done in the past with: ▪ CMBS cash flows only coming in from multi-family properties ▪ Mandatory arbitration ▪ Pre-payment penalties ▪ Financed ancillary insurance products

	Other things to consider as part of recommendation: ▪ Limits on Volume ▪ Program Identification ▪ Pricing ▪ Fraud prevention ▪ QC approach ▪ Timing for implementation of consumer disclosure ▪ Articulation of minimum expectations of Industry task force ▪ Rep and warrant language

<u>**APPENDIX**</u>

ADDITIONAL INFORMATION

Benefits to Freddie Mac
Freddie Mac purchases NINA mortgages primarily through bulk transactions, combined with other Alt-A mortgage types (e.g. Stated Income/Stated Asset). Customers prefer combining several Alt-A types into the same transaction and are unwilling to change this practice. A decision to leave the NINA market places the Alt-A business at great risk. Therefore, the NINA market must be viewed in the context of the impact on Freddie Mac's ability to compete for its share of the Alt-A business.

The following highlights key facts regarding the Alt-A business:

- Alt-A market for the first half of 2004 exceeds $90 billion; accounting for just over 6.5% of total industry originations
  - This volume represents a 136.8% increase from the same period in 2003
  - The second quarter of 2004 exceeded $54 billion
- With one of the lowest GSE flow penetrations of the SF market, the Alt-A segment provides unique market growth opportunities for Freddie Mac
- Freddie Mac's Alt-A purchases, via the bulk transaction path, were $3.5 BB between January and July of 2004. It is estimated that NINA mortgages represent 30% of that total ($1 BB). The retained portfolio has purchased nearly $1BB in NINA mortgages this year.
- The transaction price we receive, as well as the credit enhancements required, adequately cover the credit risk of the mortgages we purchase.

Earnings
Bulk Alt-A mortgages purchased between January and July of 2004 ($3.5 BB) contributed $10.3 MM ex-ante PVA. During the same time period, Alt-A represent 38% of mortgages purchased via bulk path, however contribute 68% bulk PVA.

PVA impact of the Alt-A bulk and retained portfolio transactions for the entire year are estimated to be between $25 MM and $75 MM – best estimate is $50 MM and is trending upward. The impact to security spreads [for all securities issued] could cost roughly $4 million per $100 billion of total production, contributing between $10-$15 million of PVA loss. The overall PVA impact number does not include potential impacts on our ability to secure flow contracts from key customers – with the largest example being Countrywide.

Mission/HUD Goals
The Alt-A bulk business makes a minor contribution to our HUD goals. This year, the Alt-A bulk transactions contribute 2 basis points toward achieving our Low/Mod goals, 5 basis points to our Special/Affordable goals, and 40 basis points to our Underserved GSE goals. During 2003, the Alt-A bulk business contributed 10 basis points to our Low/Mod and Special/Affordable goals. The sample analyzed by Housing Economics showed that 38% of NINA type loans qualified for the Underserved goal compared to 27% of single-family purchases.

However, NINA loans may have a negative impact on the low/moderate and special affordable goals because, without income information, they cannot count in the numerator when calculating the percentage of goal-qualifying loans purchased by Freddie Mac. In addition, with respect to the underserved goal-qualifying NINA loans, HUD could refuse to count the loans if they are determined to be mortgages with unacceptable terms and conditions as described in HUD's current affordable housing goals Rule. In addition, it is conceivable that regulators or NINA borrowers may allege that either Freddie Mac and/or its sellers/servicers have engaged in practices that would violate anti-predatory lending laws, fair lending laws or unfair and deceptive acts and practices laws.

Performance Analysis

Housing Analysis, Research and Policy conducted an analysis of NINA mortgages purchased by Freddie Mac, via the bulk transaction path, that were originated during the second and third quarter of 2003. These mortgages were compared to similar full documentation mortgages originated during the same time period. The sample included a total of 7,297 NINA and No Doc mortgages. A decision was made to include both documentation types in this analysis since they are similar – in both cases the borrower is not required to disclose income or assets to the mortgage lender. Please note: the sample size is relatively small and covers a limited period of time.

Highlights from Housing Analysis, Research and Policy included the following:

- NINA (and No Doc) mortgages perform somewhere between 2 and 7 times worse (*more likely to go into delinquency*) than their non-NINA counterparts.
- *Time frame*: About 1% of these were originated before 2003, 94.5% in 2003, and 4.5% in 2004.
- Among the NINAs analyzed, about 10% were ever 30 days delinquent, 2.7% were ever 60 days delinquent, 1% were ever 90 days delinquent, 0.52% were ever in foreclosure, .03% went to REO, .03% had a foreclosure alternative executed (the latter two correspond to a total of 2 loans each).
- The delinquency reason for "excessive obligation" was noted for 92% of the mortgages reflected in the ever-foreclosed category. Excessive obligation is typically found in less than 20% of foreclosures reported to Freddie Mac.
- Eliminating GreenPoint reduces the performance variance -- Greenpoint's delinquencies were nearly twice as high as the remaining sample. In addition, almost all mortgages in the ever-foreclosed category (36/38) were from GreenPoint; the delinquency reason of "excessive obligation" was reported for 92% of the mortgages in this category

Borrower Race Information

Financial Research completed analysis of borrower race among non-NINA loans and compared that with the race distribution for NINAs. Their analysis[1] used a 10% sample of 2003 fundings and compared that to the sample of NINA mortgages used in the early default analysis mentioned previously.

The proportion of Hispanic borrowers among the NINA loans is over 3 times as high as the proportion among non-NINA loans. Also, the proportion of African-American borrowers among the NINA loans is over twice as high as it is among non-NINA loans.

- *NINA* loans: 40% were missing race information altogether. Of the loans that were not missing race, 66% were white, 18% were Hispanic, and 7% were African-American.
- *Non-NINA* loans: 16% were missing race information. Of the loans that were not missing race, 86% were white, only 5% were Hispanic, and 3% were African-American.

NINA Loans		
Borrower Race	Num. Loans	Percent
White non-Hispanic	2,921	65.5%
Hispanic	**816**	**18.3%**
African-American	321	7.2%
Asian or Pacific Islander	244	5.5%
Other	139	3.1%
Native American	18	0.4%

Random Sample of 2003 Fundings		
Borrower Race	Num. Loans	Percent
White non-Hispanic	342,040	85.5%
Hispanic	**19,219**	**4.8%**
African-American	10,968	2.7%
Asian or Pacific Islander	17,070	4.3%
Other	9,630	2.4%
Native American	1,322	0.3%

Mortgage File Review
Operational Risk Management reviewed 100 mortgage files on NINA mortgages purchased from Chase and Countrywide. They selected a random sample of 50 NINA mortgages from each organization.

Several observations from their review and analysis are consistent with information received from the Mortgage Insurers interviewed. Noted in their findings are several concerns that indicate that NINA mortgages may be more susceptible to questionable lending practices:

- Dropping borrowers to qualify is prevalent – co-borrowers were dropped on 62% of loans with married borrowers.
- 22% of borrowers were Hispanic.
- 23% of borrowers increased their mortgage payment by more than 50% from the previous mortgage payment.
- NINA borrower profile has changed from largely self-employed to salaried or fixed income.
- 33 of the 100 loans appeared to have stretched appraisal values.

GreenPoint MI Rescissions
We received information showing that mortgage insurer rescinded coverage on 46 NINA mortgages originated by GreenPoint so far this year. Nearly half of these mortgages had the MI coverage rescinded because it was found that the borrower's income was disclosed to the originator/broker. In addition, there are several mortgages where the borrower was unemployed at origination and there was evidence of occupancy mis-representation. It is important to note that this is an adverse sample – all of the mortgages included have gone into foreclosure.

Mortgage Insurer Interviews
Part of the product analysis included interviews with five Mortgage Insurers (MIs). Each MI interviewed was asked a standard set of questions and their answers were documented. The information gained from the MIs correlated to the information we found in our mortgage file review and other anecdotal information.