

Unlocking the Housing Market Recovery

A Housing Expert's View

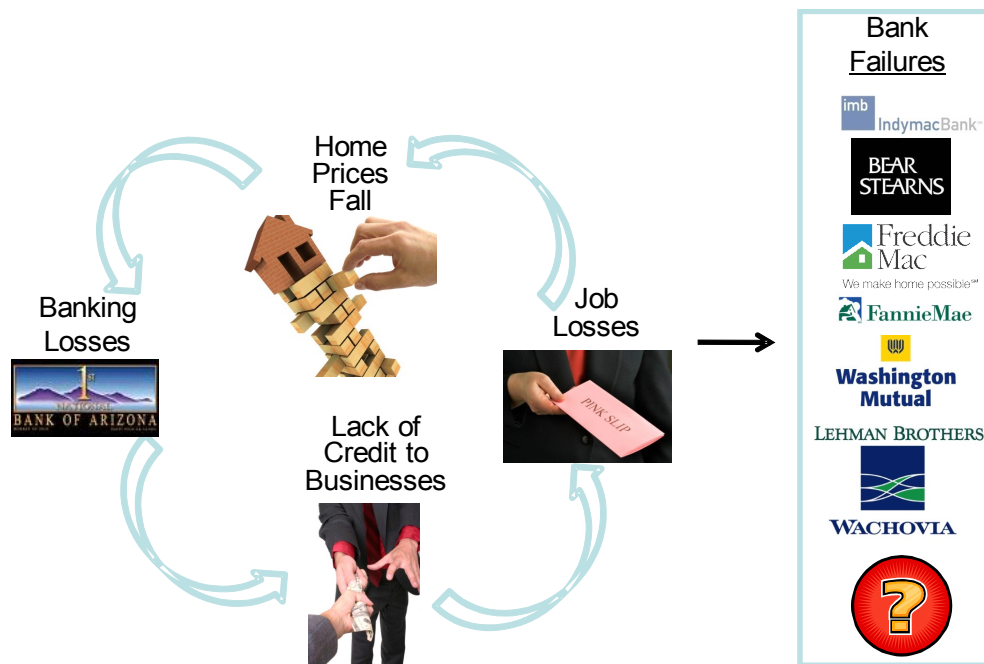
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February 3, 2009

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Executive Summary

The U.S. is undoubtedly in the worst financial and economic crisis since the 1930s. Home prices are falling rapidly across the nation, which has resulted in more than \$2 trillion in losses in the last two years. The declining stock market has wiped out trillions more. These tremendous losses have created a vicious downward spiral that requires government intervention to avoid a 1930s-style economic collapse. This problem is affecting both Wall Street and Main Street.



There has been a lot of rhetoric and not a lot of facts about the current economic and financial crisis. In this report, we use facts to assess the current situation and provide our recommendations to save the U.S. economy from collapse.

To stabilize home prices, we believe Congress needs to do four things in conjunction with the Federal Reserve and US Treasury Department. Some of



our recommendations have already been accomplished, but many of them have not.

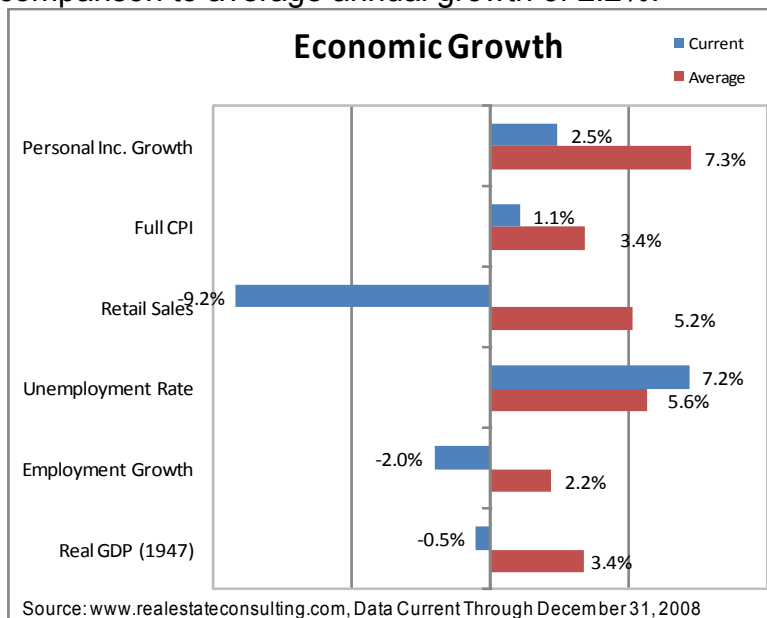
1. **Stabilize The Banking System** - Save local businesses by saving the local employers' bank.
 - Continuing insuring deposits up to \$250,000 and unlimited amounts in payroll accounts
 - Close all poorly managed and undercapitalized banks ASAP
 - Keep lending money to stabilize the best and largest banks
 - Properly dispose of bad loans, RTC-style, instead of the way it is currently being done
 - Finance new banks to create competition for good loans
 - Continue supporting commercial paper liquidity
 - Continue liquidity guarantees on new bank debt
2. **Stimulate Job Growth** - Bring more jobs to the economy with short-term stimulus and smart government spending.
 - Fund infrastructure projects to create jobs
 - Stimulate short-term spending while recognizing that long-term saving is also needed
 - Allow companies to utilize their current losses to recapture taxes paid over the last 4 years so they can keep enough cash in the bank to meet payroll
 - Create government-backed initiatives to help banks lend
3. **Stimulate Responsible Home Buying** – Stop home price declines by stimulating home buying by responsible individuals, to bring demand and supply back into balance.
 - Keep mortgage rates low
 - Keep Fannie and Freddie lending and FHA insuring
 - Temporarily provide a down payment match to all home buyers
 - Temporarily double the mortgage interest rate deductions for all homeowners
4. **Support responsible loan modifications** – Stop home price declines by helping keep responsible people in their homes.
 - Provide financial incentives for loan servicing firms to modify loans
 - Create a vehicle to buy loans that have been responsibly modified



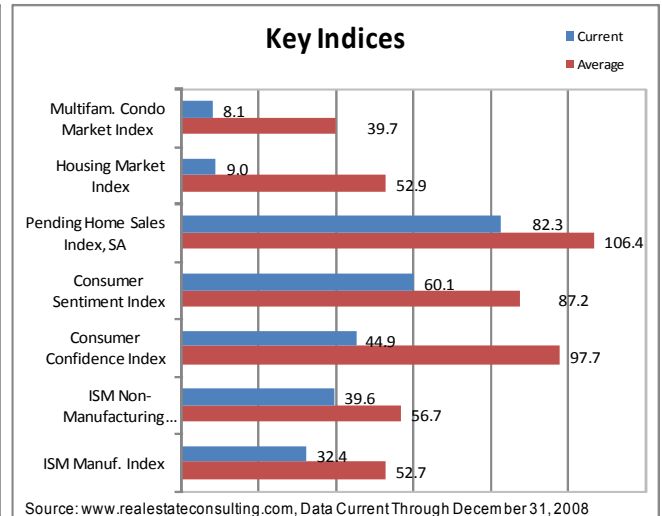
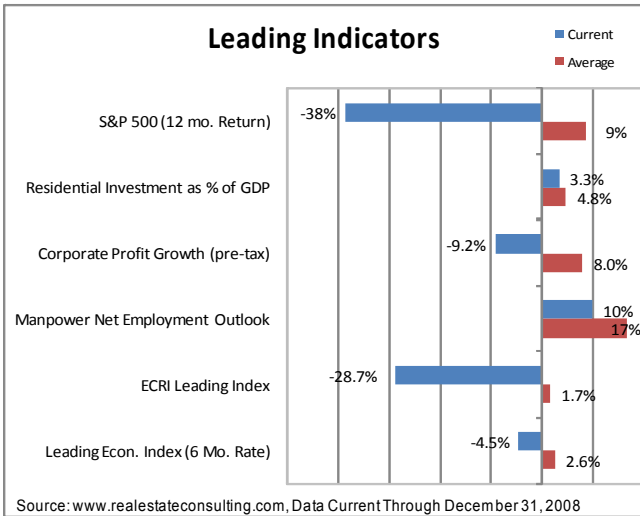
Why We Need to Act Quickly

Key Indicators

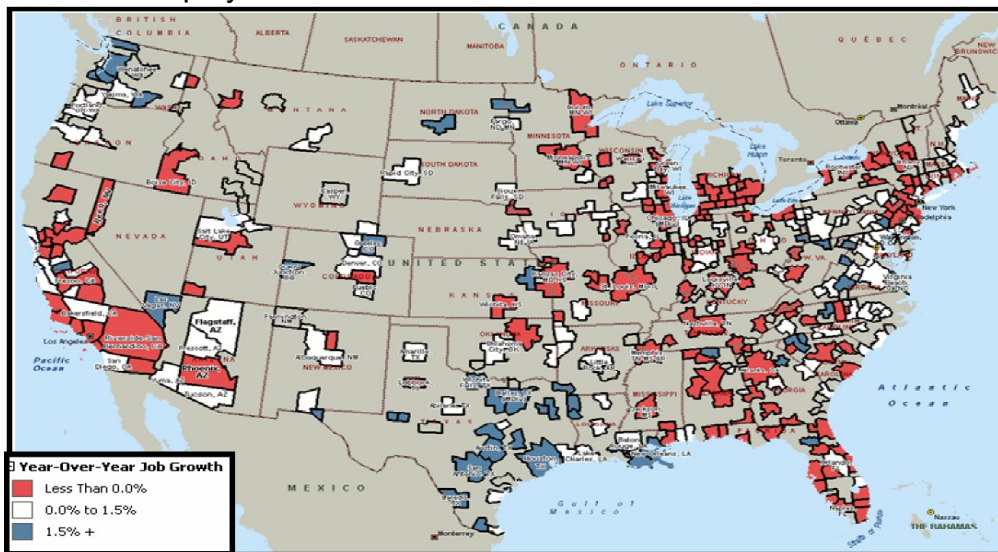
The current US recession is turning into a depression. In the following chart, we compare the current economic indicators with the long-term average of each indicator. Many of these indicators are significantly below the long term average and many are at an all-time low. For example, retail sales are falling at a 9.2% rate in comparison to its usual 5.2% growth. Similarly, employment is falling at a 2.0% rate in comparison to average annual growth of 2.2%.



Applying the same methodology, every key index in the US is well-below average, and the leading indicators are all miserable.



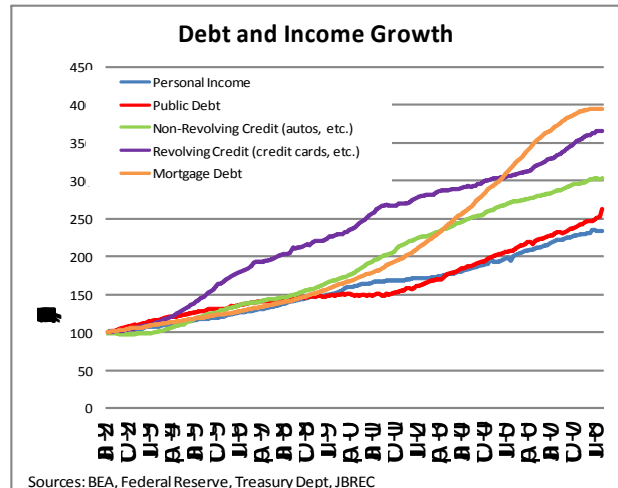
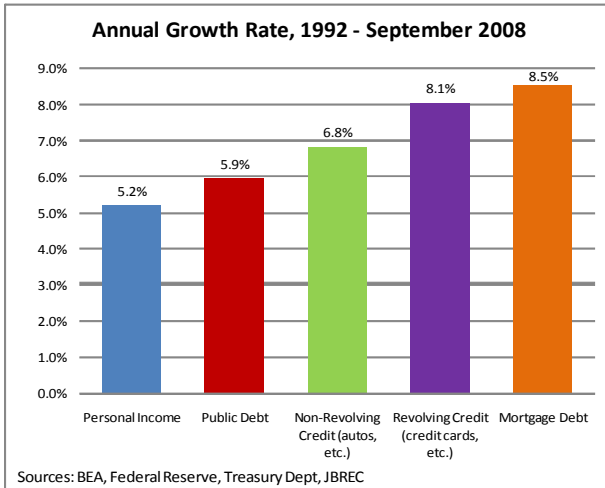
Employment losses are mounting across the country. This is no longer a problem of one state versus another; the effects of this recession are spread across every state. As seen in the following map, the red sections show areas of job losses. Most of the major metropolitan areas along the coast and the Midwest are experiencing employment losses today. The areas that are experiencing positive job gains are approaching job losses as well. As oil and gas prices decline, we expect Texas employment to decline.



The Borrowing Problem

The primary issue in the economy, which has been occurring for many years, is that we have borrowed more than we can repay. Since 1992, all categories of debt have grown much faster than incomes, when over time, debt and income

have to grow at the same pace. From 1992 to September 2008, personal income (including population growth) has grown at an average annual rate of 5.2% in the US. This compares to the growth of non-revolving credit (such as auto loans) of 6.8%, revolving credit (such as credit cards) of 8.1%, and mortgage debt of 8.5%. This 16-year period where the growth of debt outpaced income has finally reached a breaking point.

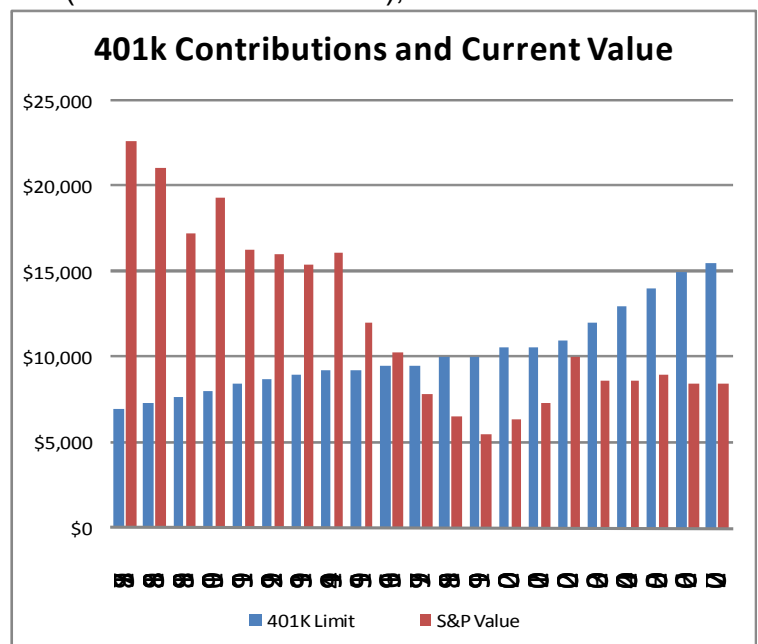


As a result of the high levels of debt, businesses and consumers are now saving more than they ever have before. They are hoarding cash to pay down debt because it is the smart thing for them to do. However, this saving, which is called deleveraging, is very difficult to stop and has devastating effects when done quickly and worldwide, which is what is happening today. The collective effect of reduced spending will cause a Depression (a sustained recession), which is highly likely at this point. Looking ahead, it will be policy responses that determine the extent and length of this long recession or even depression.

The Spending Problem

The conundrum is that consumers and businesses need to save, yet we cannot have economic growth without spending. There are two huge obstacles to spending:

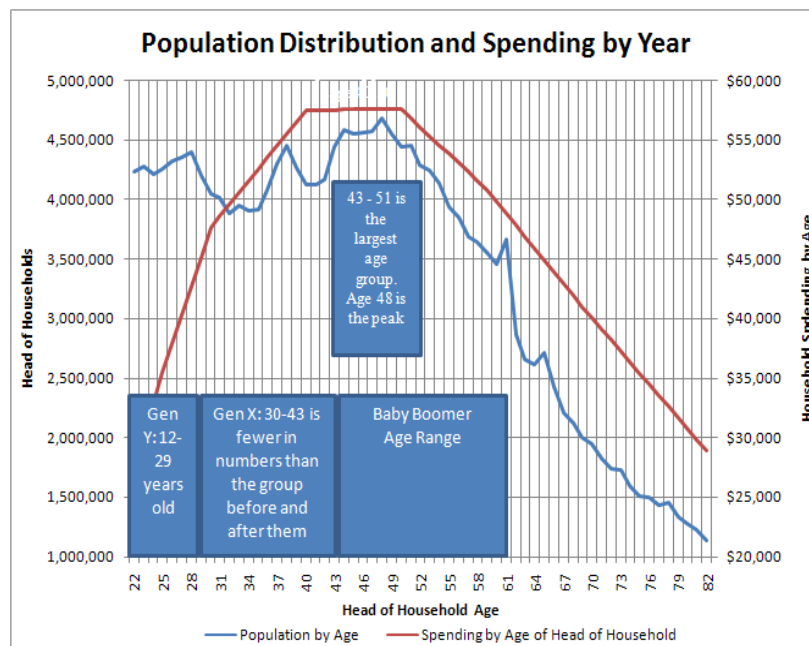
- recent wealth destruction and
- demographic trends.





Baby boomer wealth destruction has been enormous. All 401K contributions since 1996 have declined in value if invested in S&P 500 stocks. To further this point, consider the profile of a responsible saver who put the maximum 401K contribution of \$231,000 in S&P 500 stock funds since 1987 (shown in blue). The value of those investments was \$465,000 in December, 2007. The value on November 21, 2008 (S&P at 800), was only \$265,000.

Long-term demographic trends are more favorable to saving than spending. The peak birth year of the U.S. population occurred near the end of the baby boom in 1960. These people are currently 48 years old. The peak spending years for an average adult is in their 40's when their children are in college. After these years, many people become net savers. As a result, we are heading into a decade long period when spending due to our aging population is going to be trending down. This is purely a demographic shift and does not take into consideration how many people will have to be saving more now that their retirement savings have declined substantially. The demographic shift is similar to what occurred in Japan over the last 15 years, but not nearly as significant.

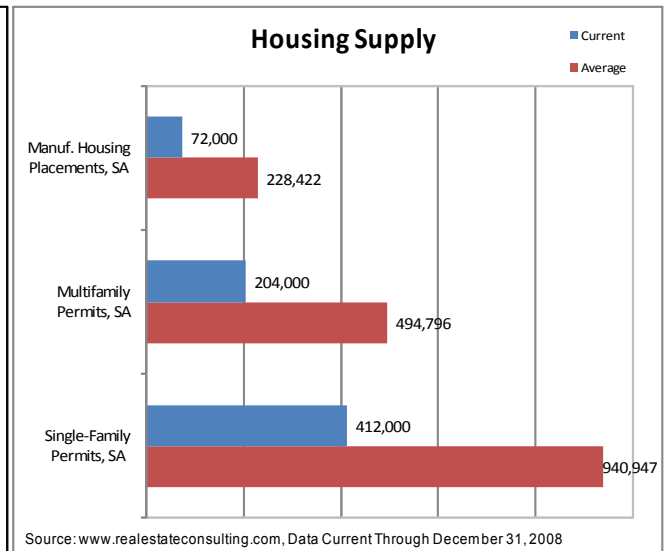
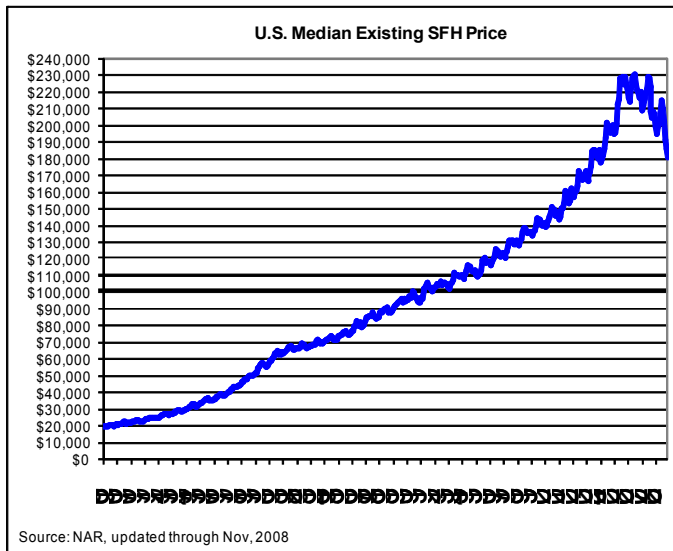


The Housing Problem

The US housing market decline began in late 2005 and has continued to weaken, with falling prices and declining home sales across the US. National home prices are falling for the first time since the 1930s. This is a much more severe national price decline than anything we have seen before. The current



median home price of \$181,300 is 22% below the peak level of \$230,900 in July 2006. Housing production currently stands at less than 50% of the 50-year average. This includes single-family, multi-family and manufactured housing permits.



The Banking Problem

As a result of weak economic and housing conditions across the US and the precarious situation of many local and national banks, banks do not want to lend. In our opinion, they have good reason. Not only is lending very risky in a recession, but bank capital needs to be conserved for future losses. These future losses include additional mortgage defaults, commercial real estate loans, credit card loans, auto loans and business loans.

Even with the TARP funds, banks must hoard their cash at the current time. We conducted a simple balance sheet analysis of Wells Fargo as of December 2007. We chose Wells Fargo because of its reputation of being a solid bank in the current crisis. Wells Fargo is a \$521 billion bank, with approximately \$267 billion of deposits and \$22 billion in cash. If 10% of those deposits want their money bank, there are not sufficient funds in the bank today to accommodate that request. That is the reason a run on banks needs to be avoided, and we believe the US Treasury is doing all it can to avoid that situation. Additionally, if 11% of the loans on the bank's balance sheet are not recovered, Shareholder's Equity is wiped out, which basically means the bank is insolvent. This is why the banks are incented to keep the TARP money in cash – it is in the best interest of their shareholders.



WELLS FARGO
12/31/07 BALANCE SHEET AS SUMMARIZED BY JBREC

<u>Assets</u>	<u>\$ (bil)</u>		<u>Liabilities and Equity</u>	<u>\$ (bil)</u>	
Short-term securities	\$9	2%	Checking & Savings Accts	\$202	39%
Treasuries/other securities	\$13	2%	Foreign Deposits	\$37	7%
MBS/CMOs Held for Sale	\$45	9%	Net Non Int Earning Deposits	\$28	5%
Mortgages Held for Sale	\$33	6%	ST Borrowings	\$26	5%
Commercial R.E. loans	\$78	15%	LT Debt	\$93	18%
Other RE Mortgages	\$33	6%	Non Int Bearing Funding Sources	\$88	17%
RE Constr Loans	\$17	3%	Shareholders Equity	\$47	9%
Consumer R.E. 1-4 1st Loans	\$62	12%		<u>\$521</u>	<u>100%</u>
Consumer R.E. 1-4 2nd Loans	\$72	14%			
Credit Cards	\$16	3%			
Other Consumer Revolvers	\$54	10%			
Foreign Loans/Leases/Other	\$15	3%			
Non Int-earning Assets	\$75	14%			
	<u>\$521</u>	<u>100%</u>			

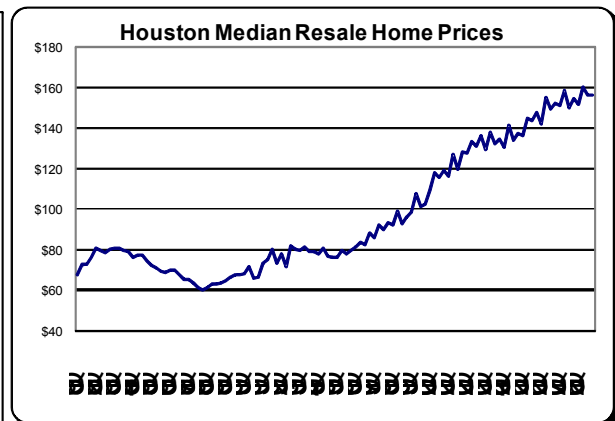
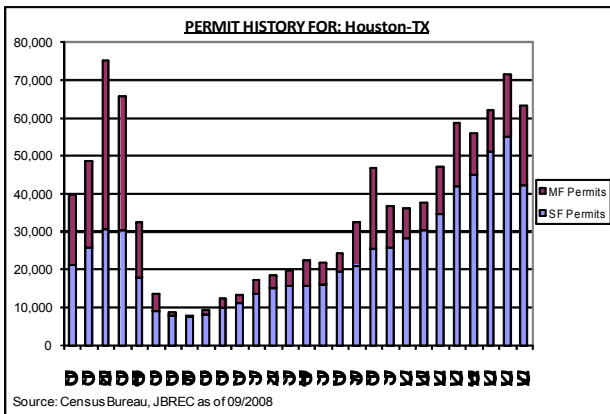
Source: Yahoo.com. Note: This is a non-GAAP summary compiled by JBREC.

The Government Problem

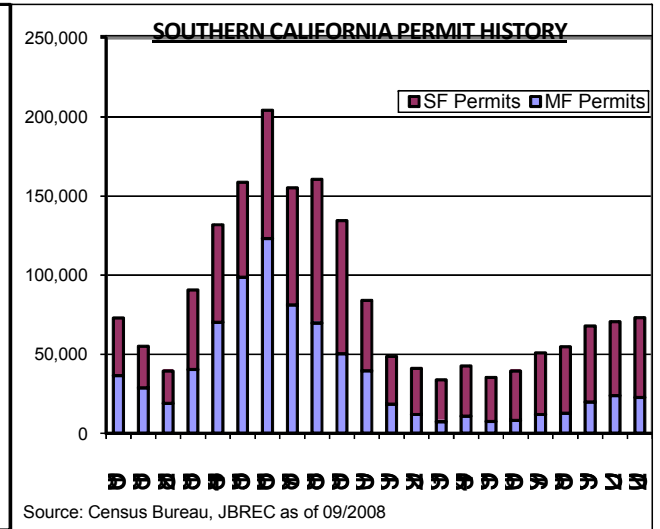
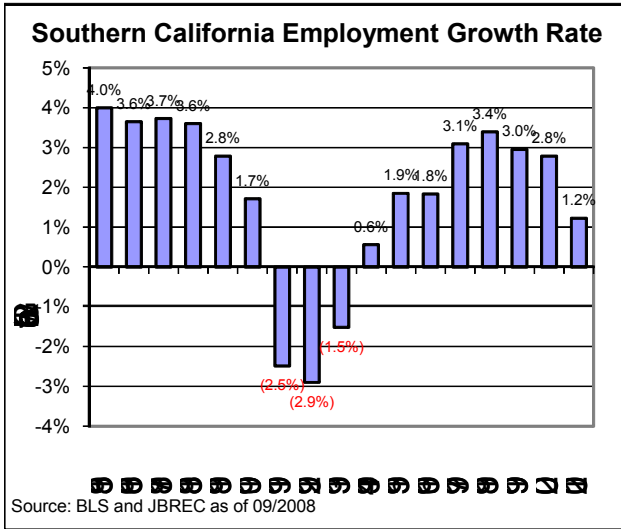
All of these conditions are leading to tremendous declines in government revenue, including income taxes, sales taxes, property taxes, hotel occupancy taxes and the cost of failed federally insured institutions. The costs of fixing the problem will be partially or fully offset by saving the government tax base.

Housing Downturns Last Many Years

Housing recessions can often last more than 8 years. We find it relevant to compare this national downturn with the regional recessions that occurred in Houston during the mid-1980s and Southern California in the early 1990s. In Houston, the 1983 oil-industry based downturn lasted 13 years. Residential construction in the metropolitan area fell 88% from 1983 to 1987 and stayed low through 1996. Home prices fell 25% from 1983 to 1987 and did not recover full values until 1992.



In Southern California, the defense-industry related downturn resulted in the region losing 7% of its employment base from 1991 to 1994. The region did not recover all of the jobs until 1997. Home prices fell 22% from 1991-1994 and did not recover until 1999. Construction stayed low throughout the 1990s.





Our Recommendations

It is essential to stabilize home prices in order to stabilize the US economy. Stabilizing home prices will stabilize banks, which will stabilize the economy. In order to stabilize home prices, we provide four recommendations, listed in order of priority.

- Stabilize the banking system
- Stimulate job growth
- Stimulate responsible home-buying
- Support responsible loan modifications

1. Stabilize the Banking System

Home prices will continue to fall until the banking system stabilizes. We recommend that the banking system be stabilized with loans that will be repaid over time. The Federal Reserve and US Treasury Department are currently doing this and will likely remain on this path. Our best-case scenario is that banking stability occurs in 2010.

We recommend the following actions to stabilize the banking system.

Continue insuring large deposit balances

Effective October 3, 2008 through December 2009, the FDIC raised the deposit insurance amount to \$250,000 from \$100,000, and insured larger accounts that are typically used for payroll. This gave a large number of individuals and small businesses confidence that their money is safe in the banks.

Close all of the poorly managed and undercapitalized banks

Currently, the FDIC is closing a few banks every Friday, liquidating assets and moving deposits to more sound banking institutions. This slow process damages consumer confidence in the banking system. We believe the Government should announce support for banks believed to be solvent and well-managed and close all of the poorly managed and undercapitalized banks as soon as possible.

Keep lending money to stabilize the best and largest banks

Once the poorly managed and undercapitalized banks are closed, we recommend the Federal Government continue lending money to stabilize the best and largest banks. The notion that banks don't need TARP funding is



primarily a P.R. move designed to instill confidence. The government should require that distressed banks eliminate dividends until the money is repaid and/or minimum capital ratios are obtained. The Federal Government should also lend money to the FDIC as needed.

Properly dispose of bad loans, RTC-style

The significant decline in real estate markets across the country has resulted in a considerable number of bad loans and REO properties currently sitting on bank books. We recommend selling the loans of insolvent banks quickly and to the highest bidder. However, we believe it is extremely important to spend the money needed to collect and provide excellent property, market and other information to the bidders to increase bidder knowledge and confidence and maximize taxpayer recovery. This has not been the case in the current cycle. Also, seller-financing must be provided to encourage more bidding.

Finance new banks to create competition for good loans

The recent OCC approval of the first “shelf charter” bank is a great move. With the large number of US banks expected to fail, the FDIC is compiling an approved “bidder list” that will include the contacts of potential buyers of bank assets when a bank is expected to fail. Ultimately, new healthy banks will result.

Continue supporting commercial paper liquidity

There is serious concern for the ability of financial institutions to fund the short-term cash needs of good businesses given the lack of available cash in the market. Typically, investors such as money-market funds would purchase commercial paper of financial institutions as it was considered a safe investment. The Federal Reserve has allocated \$1.8 trillion to the Commercial Paper Funding Facility, which will allow great companies to continue making payroll.

Continue liquidity guarantees of new bank debt

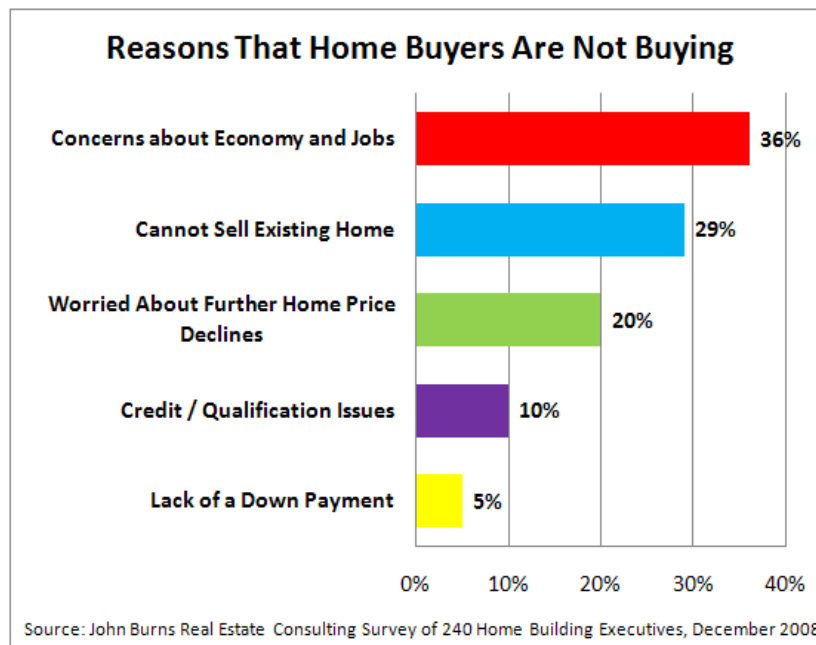
Programs that allow the banks to raise capital should be backed by the government. The FDIC has designed a program to provide liquidity guarantees of new bank debt, in exchange for a fee. This program has attracted a number of participants, including Citigroup, General Electric, JPMorgan Chase, and Wells Fargo, who have issued approximately \$40 billion in bonds, and the Government has allocated approximately \$1.4 trillion dollars to support this program.



2. Stimulate Job Growth

When job losses are mounting, more foreclosures occur and fewer home buyers emerge. We need both a short-term and long-term program for job growth that provides enough stimulus to create new jobs as soon as possible, and restores the feeling of job security. Our best-case scenario is for job growth to return to the US in 2010.

Our survey of 240 home building industry executives concluded that the #1 impediment to home buying in the current environment is concerns about the economy and jobs. An inability to sell their existing home and worries about further home price declines are the next most prominent reasons that potential home buyers are sitting on the sidelines. Qualification issues and down payment assistance ranked last. The survey results are displayed in the following chart.



Home prices will fall until job growth returns. Therefore, in order to stimulate job growth we recommend the following actions be taken:

Fund infrastructure projects to create jobs

New infrastructure is a major policy of the new administration, and we believe this program is essential to create jobs over the long term. The Government should fund projects that are 'ready to go' that can create jobs and benefit society in the long term. These projects should be in urban areas where people live, and need to benefit the majority of Congressional districts to receive approval. The



American Contractors Association estimates \$215 billion in infrastructure spending can create 2.5 million new jobs (one job for every \$86,000 in spending).

Stimulate short-term spending

Stimulating short term spending which will allow existing jobs to be maintained. We recommend another stimulus plan to support spending and job growth while the long-term infrastructure spending plans are beginning.

Allow companies to use current losses to recapture taxes

We recommend allowing companies to use current losses to recapture cash taxes paid over the last four years to maintain existing jobs. Companies can currently look back two years, but we propose an extension to four. The long term cost of the program is primarily the time value of money as these tax losses could eventually be used to offset future income. The goal of this program would be to create healthier corporations which would lead to greater employment.

Create government-backed initiatives to help banks lend

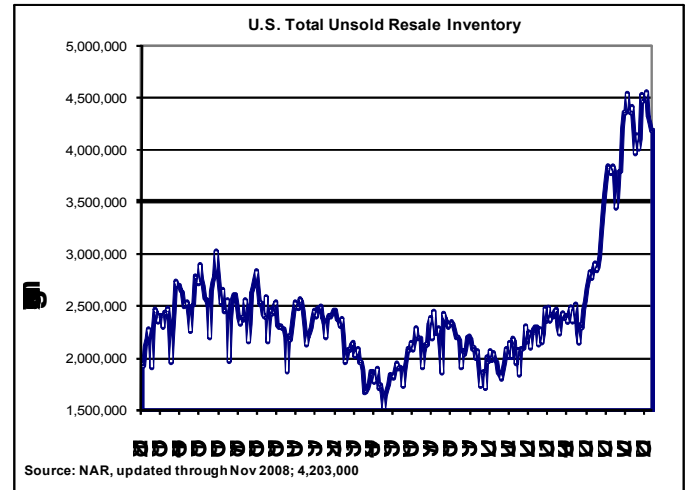
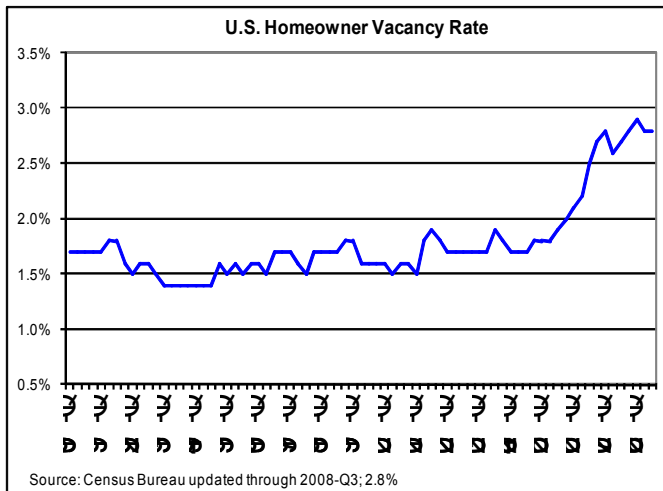
Well-managed companies and responsible individuals are the economic engine that drive growth and will create jobs for everyone as long as they can access capital. We believe the government needs to create more initiatives to help banks lend to qualified companies and people so they can employ people. The Federal Government can accomplish this by expanding the Small Business Administration and other loan programs.

There is a precedent for this type of program. The Reconstruction Finance Corporation was created in 1932 "to provide emergency financing facilities for financial institutions; to aid in financing agriculture, commerce, and industry; to purchase preferred stock, capital notes, or debentures of banks and trust companies; and to make loans and allocations of its funds as prescribed by law" and lent \$2 billion to businesses, which helped support employment and stave off bankruptcies. Most of the loans were repaid.

3. Stimulate Responsible Home Buying

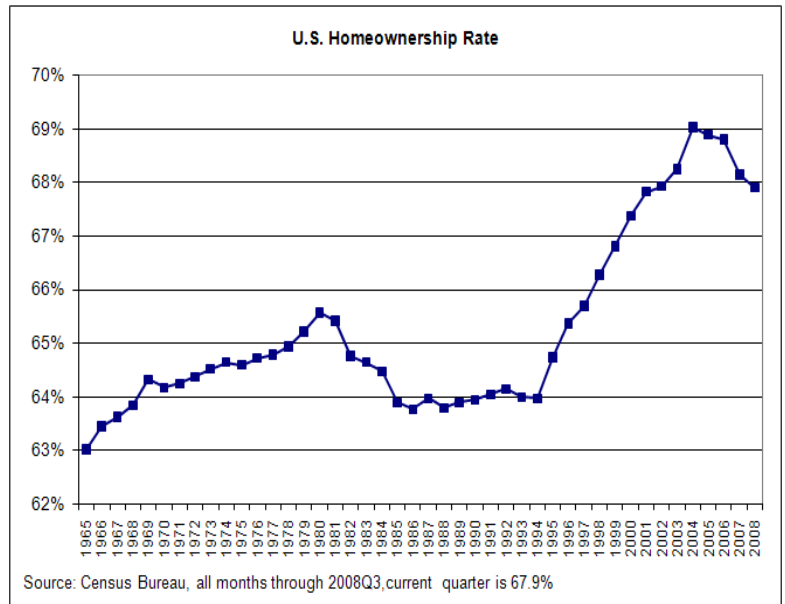
We need to stimulate responsible home buying to reduce the excess supply of homes and to fill unoccupied homes. Our estimated cost of this program is \$416 billion through 2010. Our best-case scenario for price stability is 2010. If stability is achieved earlier, the cost would be less.

The housing market is oversupplied, and more home buying is needed to fill the excess vacant homes in the US. The homeowner vacancy rate is currently at an all-time high of 2.8%. Additionally, there are over 4 million homes available for sale today, versus a historical average of 2.5 million. We need to fill these homes with buyers or renters in order to stabilize home prices.

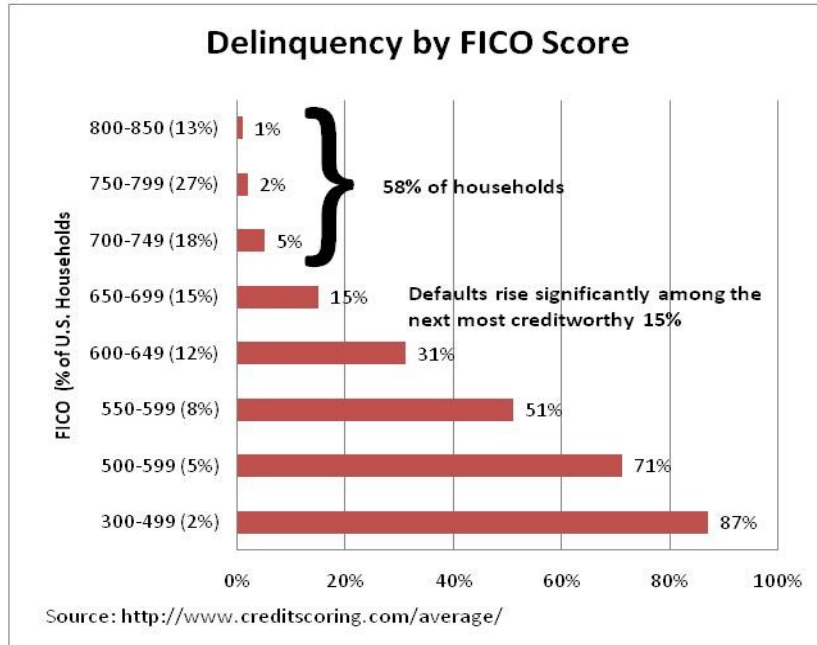


Help “Responsible” People

US homeownership grew from 64% to 69% during this cycle. Historically, 64% to 65% of households achieve homeownership. With the recent growth, the Federal government (through Fannie, Freddie and FDIC) took on the risk of lending to less qualified households. If there are 6 million total foreclosures, which is our forecast for the next three years, the homeownership rate will fall back to its normal levels.

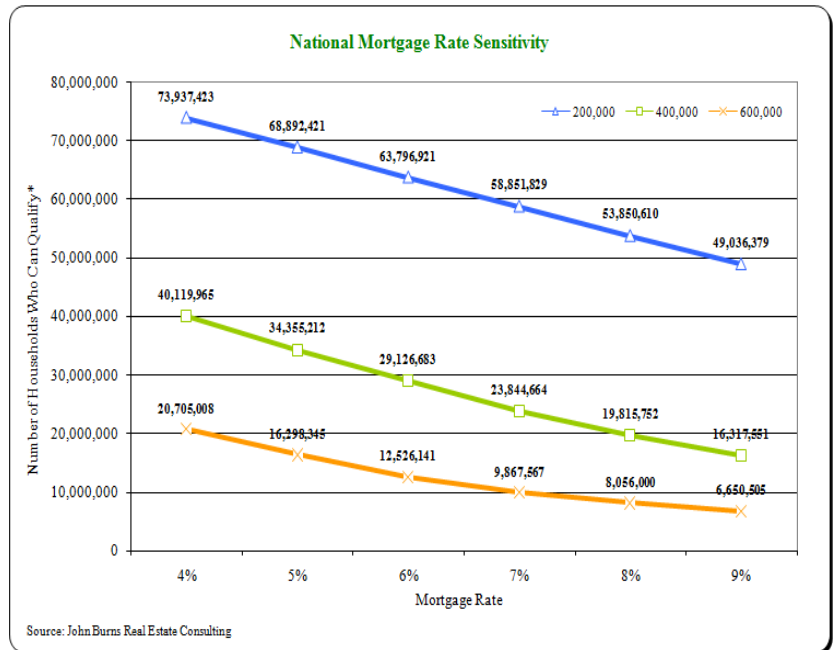


Only 58% of households have good credit (700+ FICO score or higher). The default rate among these buyers is extremely low (5% or less). Defaults rise significantly among the next most creditworthy (15% of households who have a 15% default rate). Subprime loans were made to the lower-credit groups, and a high percentage of those groups have demonstrated that their lenders are taking significant risks.



Keep mortgage rates low

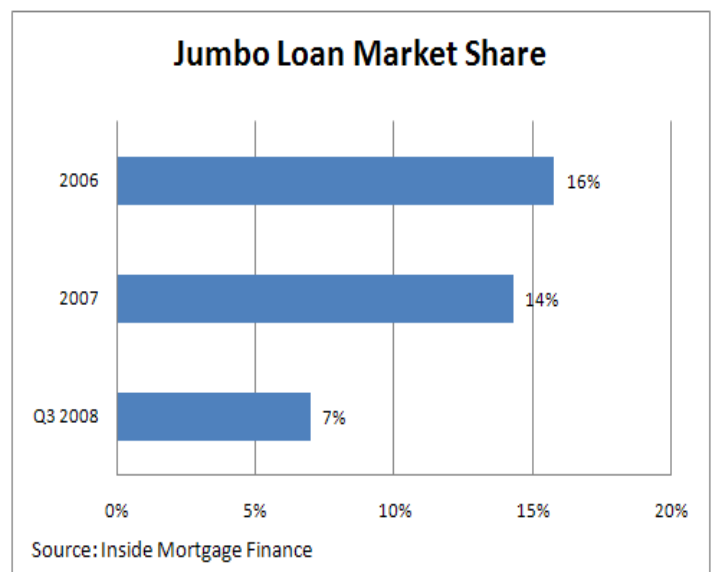
The government should continue its current policy of using the Federal Funds rate to keep interest rates, including mortgage rates, low. The recent announcement by the Federal Reserve to keep the Fed Funds rate in the 0% to 0.25% range will allow mortgage rates to remain low. Buying assets from Fannie and Freddie also helps keep mortgage rates low. Each point of interest allows 5 million more houses to qualify for a home.



Keep Fannie and Freddie lending and FHA insuring

To keep responsible people buying homes, they will need loans. Fannie Mae and Freddie Mac (the GSEs) are crucial to the lending process, in addition to the FHA. We believe these groups will continue to experience huge losses, so we are concerned that there may be some people calling for these groups to lend more conservatively in 2009. Although the GSEs are likely to continue reporting huge problems, it is essential to keep them lending in the current environment, as they are the main entities willing to lend at reasonable rates.

The GSE's do not make jumbo loans and this segment of the market has declined significantly. The jumbo loan market represented approximately 15% market share in 2006 and 2007, and represented only 7% of all loans originated in the third quarter of 2008. Since jumbos are financed by private financial institutions, jumbo loans currently require 20% or more down payments and have 7% or higher interest rates. We believe home buying activity would plummet if all loans had those terms, which would be the case if





the GSEs were not continuing their programs, and this would result in further price declines.

Provide temporary down payment match

Although many argue that the presence of down payment assistance has resulted in a higher rate of foreclosures across the country, we believe some form of down payment assistance is necessary to help reasonable buyers with their down payments. Down payment is a huge financial obstacle for responsible renters. We understand that offering full down payment assistance creates a risky loan as the borrower made no investment and there are opportunities for appraisal fraud. Therefore, true to our theme of responsible home buying, we strongly advocate that the buyer have some 'skin in the game' when purchasing a new home.

To this end, we propose down payment assistance in the form of an immediately available tax credit to borrowers who are contributing \$1 of down payment for every \$1 in government assistance. The minimum personal contribution (including gifts from relatives) should be 5% of the home price, and the maximum government assistance should be \$25,000. Additionally, the buyer should have personal recourse in the form of a tax lien if he or she defaults within 5 years. Finally, we recommend creating an urgency to act by promising to stop the program once housing stability has been achieved.

Private capital should be allowed to participate in our proposed down payment assistance program by buying investment homes with a minimum of 20% down payment. These buyers have currently been shunned by the mortgage market and in many cases represent a responsible segment of the home buying population. They would also be subject to personal recourse if there was a default within 5 years.

The cost of our proposed down payment match would be approximately \$40 billion, assuming 4 million transactions and average government assistance of \$10,000 (equivalent to 5% of a \$200,000 home). For example, on a \$200,000 home, the buyer would need to invest at least \$10,000 and could invest as much as \$25,000, with a government match of their investment.

Double mortgage deductions for all homeowners

We propose doubling the mortgage deduction through 2010 for the first \$15,000 in annual interest on all fully amortizing, fixed rate, 40 year or less, owner-occupied mortgages. This policy will encourage more people to stay in their homes and increase disposable income for homeowners, which they will use to save and spend. Additionally, the policy will encourage responsible people to



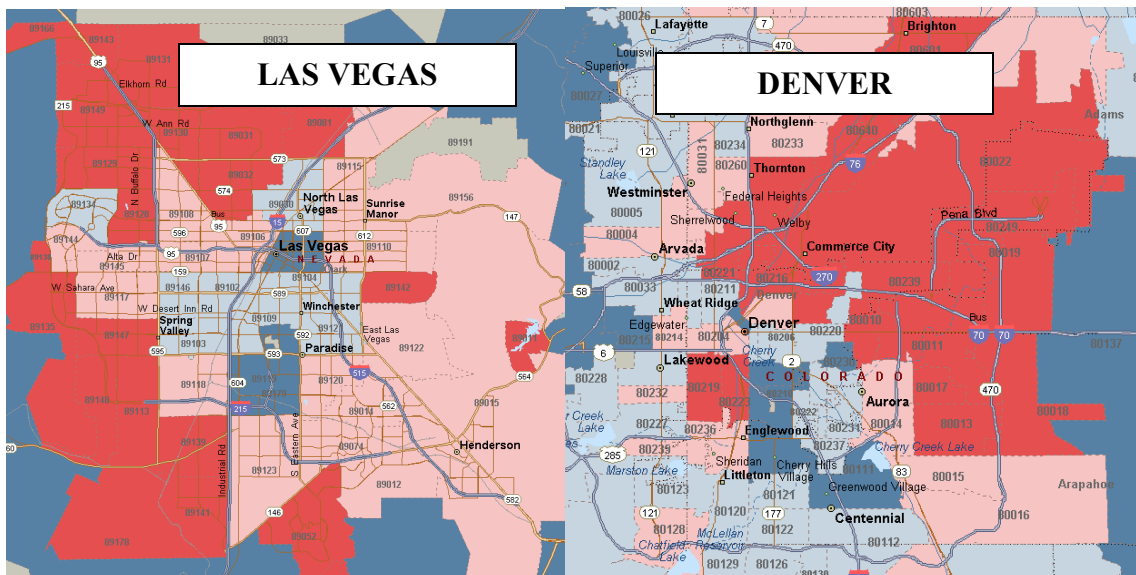
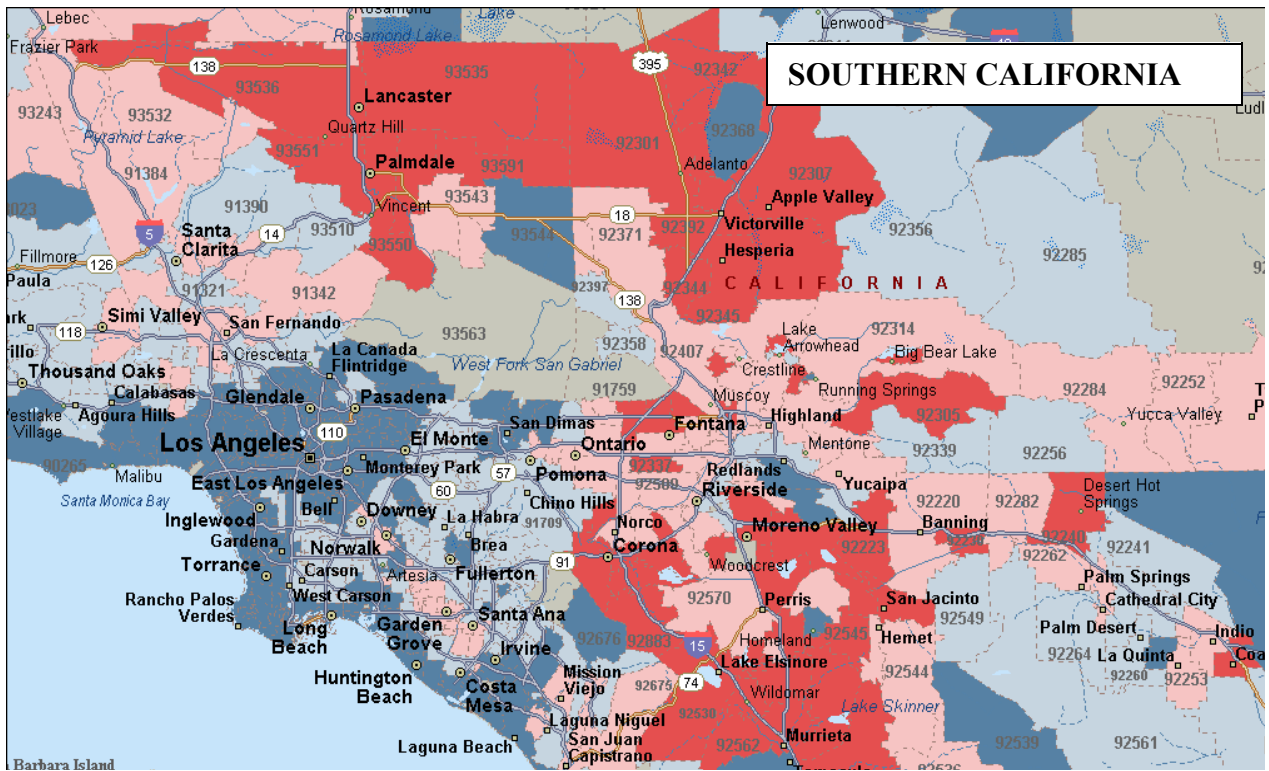
own homes rather than rent and help qualified renters become homeowners. We believe this expensive policy should be extended one year at a time until no longer needed, therefore creating an urgency to buy a home.

We estimate the cost of this policy at about \$188 billion per year. We calculate this cost by assuming 50 million Borrowers times \$15,000 deduction times the typical top Federal tax rate of 25%. Therefore, a two year program would cost \$376 billion.

4. Support Responsible Loan Modifications

Congress is under tremendous pressure from their constituents to encourage loan modification programs that will help stem foreclosures. We believe loan modifications are ideal for responsible owners, but irresponsible buyers should return to the rental market. There are currently about 500,000 foreclosures started every quarter, and we believe that will rise to 600,000 foreclosures in 2009.

Loan modifications will generally help the lowest income areas the most, as that is primarily where the foreclosures are concentrated. The greatest distress has been in the outlying areas and in inner-city areas. The maps below provide a good visual on the concentration of foreclosures – the heaviest concentration (red) are in the outlying suburbs where most of the new homes were built over the last few years, with high concentrations also occurring in the inner-city areas.



Failure of past programs

Loan modification programs historically have a high failure rate. In a recent study by American Banker, 44% of borrowers who obtained traditional loan



modifications in the fourth quarter of 2007 re-defaulted within 8 months. The reasons behind loan modification failures include: 1) the owner does not occupy the house (18%), 2) the borrower does not respond to requests (23%), and 3) the loan modification was not sufficient (future monthly payments set to increase, the borrower is left with no equity or negative equity, or the borrower has a track record of not paying bills on time) to solve the problem (29%).

Recommended Loan Modification Plan

Our recommendation is for the Government to create liquidity for loan modifications. In other words, create a government vehicle to buy good loans that have been modified responsibly. The loans should be good assets that can be sold in the future, and therefore will have minimal taxpayer risk. Smart mortgage owners and/or servicers will opt for this program if it recovers more of the principal than if there were a foreclosure.

In order for this program to be successful, the loan modifications must provide payments to the borrowers that are affordable and sustainable. This is achieved by providing for payments that have 35% or less total debt to income including all monthly debt obligations, and a 30-year or less fixed rate payment using prevailing market interest rates and terms. Additionally, a 100% or less LTV must be achieved.

Complex ownership of pooled mortgages can possibly be resolved by creating a vehicle for service providers to put the mortgage or group of mortgages in bankruptcy. We also realize that government incentives may be needed to finance the servicer to do the loan modification.

Finally, in order for this loan modification program to work, it must be fair to the taxpayers. It must be only available to borrowers who have, at some point in the past or present, invested their own money. Additionally, the borrower must have recourse in the form of an IRS tax lien if there is future default.

The Home Owners Loan Corporation (HOLC) is a successful precedent to our proposed program for loan modifications. The HOLC bought mortgages from banks and issued new loans. In two years, it bought more than 1 million loans (1.9 million applied), or 20% of outstanding mortgages at a 20% discount from the banks. The HOLC was established in 1933 to refinance homes to avoid foreclosure, with the goals of protecting homeowners from foreclosure and relieving homeowners of the higher interest and principal payments incurred during periods of higher property values and higher earning power. Additionally, the HOLC declared that it was a national policy to protect home ownership and tried to do so by imposing the least possible cost on the Federal Treasury and avoid injustice to the investor. The HOLC was abolished in 1951 after reportedly



turning a profit over its lifetime, although some argue that not all of the costs were counted, and it was able to borrow at below market rates.

Summary

This downturn is unlike others experienced in the nation's past. The problem does not lie solely with consumer confidence; rather the lack of confidence is built upon real fears that cannot be alleviated with rhetoric.

We recommend four courses of action in order to stabilize the economy and housing market.

1. **Banks:** Stabilize the banking system. Major institutions have failed, and we need to end the failures.
2. **Jobs:** Stabilize the job market. People know their employers are struggling, so they are worried about their job. They are saving to build up cash reserves in the event of a problem, and they need to regain confidence.
3. **Stimulate responsible home buying.** People know their college savings and accounts just fell by 30% or more, the equity in their home has declined, and that their pensions (both Social Security and now their employer) are in serious jeopardy. To compensate, they are saving. Give them a reason to buy a home, which will occupy empty homes and end price declines.
4. **Support responsible loan modifications.** Let the private sector deal with their bad investments, but provide liquidity opportunities for the private sector to be rewarded for dealing with the borrower fairly.

All of us have learned some important lessons from the excesses of the 1990s and early 2000s. Let's fix the problem and then make sure this never happens again.

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