MORTGAGE BANKERS ASSOCIATION
How to Evaluate Private Capital—Alternatives to Securitization

August 2, 2012
Agenda

• Overview
• Opportunities for private capital to enter the mortgage market
• Mortgage REITs
• Mortgage servicing assets
• Mortgage related opportunities involving non-banks
• The covered bond market
• Conclusions
Private Capital & the Mortgage Market
Challenges facing the mortgage market

• The fate of the GSEs is still unknown
• Continuing litigation and regulatory uncertainty
• Financing mortgage originations is challenging given market conditions
The mortgage market landscape

• Certain developments affect nonbank mortgage market participants and bank mortgage market participants equally
• However, there are important differences in terms of how banks are affected and differences also become significant as between the largest banks that are SIFIs and smaller banking institutions
• Impact of changes will continue to be felt for some time as the mortgage market adjusts
Non-banks and banks

• Both non-banks and banks are affected by
  • Accounting changes
  • Changes involving ratings and use of ratings
  • Changes that impact the securitization process, such as Reg ABII, risk retention
  • Changes involving mortgage originations and compensation for origination (to the extent entities originate) and changes involving servicing (again, to the extent entities service)

• However, by contrast, banks (and especially banks that are SIFIs) also are affected by:
  • Changes in relation to systemic oversight and enhanced supervision
  • The Volcker Rule
  • Limitations on affiliate transactions
  • The capital rules (implementation of Basel III)
  • Derivatives regulatory changes
Core D-F Reforms

• Risk Retention – D-F § 941
  • Joint regulatory proposal
  • 5% of credit risk must be retained
  • Applies to both public and private ABS transactions
  • Permissible forms: horizontal, vertical, L-shaped
  • Cash premium over par value must be placed in a “premium capture cash reserve account” (PCCRA)
  • No hedging or transfer of risk
  • Exception for “qualified residential mortgage” (QRM) –hotly debated
  • Comment period ended 8/1/11; still no final rule
Core D-F Reforms (cont’d)

• D-F § 942 – Disclosure
  • To be implemented via SEC’s “Regulation AB II”
    • Asset level disclosure
    • Compensation of broker and originator
    • Amount of risk retention by originator and securitizer
  • NPR published in 5/10; re-proposed post-D-F with comment period ended 10/4/11; final rule due by 7/21/11, but not yet issued

• D-F § 943 – Fulfilled and requested repurchases across all securitization trusts aggregated by originator; CRA rep & warranty disclosure
  • Rule 15Ga-1 (sponsor disclosure of repurchase history)
    • Adopted in Jan. 2011; filing of initial Form 15Ga-1 with repurchase history was due on 2/14/12
  • Rule 17g-7 (CRA analysis and disclosure of rep & warranties and enforcement mechanism)
    • Adopted in Jan. 2011; CRA compliance required commencing 9/26/11
Core D-F Reforms (cont’d)

• D-F § 945 – Issuer due diligence
  • Diligence on assets must be performed and disclosed by or on behalf of issuer
  • Rule 193 became effective on 3/28/11 for issuances after 12/31/11
  • Compare: Section 932 NPR (proposed Rule 15Ga-2) requiring issuers and underwriters to disclose third party due diligence reports published on 6/8/11 but no final rule yet

• D-F § 621 – Conflicts of interest
  • For one year after the closing of an ABS issuance (including synthetic ABS), no underwriter, placement agent, initial purchaser or sponsor, or any affiliate, may engage in any transaction that will result in a material conflict of interest with any investor in the ABS transaction
  • Industry concerned that proposed rule prohibits traditional structuring and hedging activities that should not raise conflict of interest concerns
    • Eliminates CDS vehicles
    • Eliminates credit linked note vehicles that protected bank’s assets if bank is also the u/w
    • Can u/w do simple interest rate swaps?
    • Can u/w retain subordinated notes? Senior notes?
  • Final rule was due under D-F by 4/15/11
  • NPR was issued in 9/11 (after final D-F deadline) with comments due on 2/13/12; no final rule yet
Other D-F Reforms (cont’d)

• D-F Title II – Orderly Liquidation Authority (OLA)
  • FDIC Final Rule re transfers effective on 8/15/11
  • FDIC repudiation powers not addressed in final rule; FDIC General Counsel’s letter provides relief until 90 days after addressed by FDIC Board
  • GC letter suffices for now, but FDIC and FSOC are expected to revisit later this year

• D-F § 619 – Volcker Rule
  • Joint NPR in 10/11, with comments due by 2/13/12
  • No proprietary trading by banking entities
  • No banking entity may acquire any ownership interest in any hedge fund or private equity fund (“covered fund”)
  • Industry concerns include:
    • “Covered funds” include many securitization structures, including ABCP and synthetic ABS
    • Exemption for securitizations only covers “loans” and not other asset classes like ABS, municipals, royalties, whole business
    • Under D-F, Volcker Rule required to take effect on 7/21/12 (but no rule yet)
Other D-F Reforms (cont’d)

• D-F Title VII – Derivatives
  • Securitization industry concern with mandatory centralized clearing and availability of “end user” exemption for securitization participants
  • Industry-seeking broad “structured finance” exemption
  • Final rule on swap participant definitions became effective on 7/23/12, but “end user” definition not clear
  • Industry relying on temporary relief provided by SEC on 6/15/11
Other D-F Reforms (cont’d)

- D-F § 939A – References to Credit Rating Agencies
  - Market Risk Capital Rule (Final rule adopted in 6/12)
  - SEC’s ANPR on ICA Rule 3a-7
  - SEC’s ANPR on ICA §3(c)(5)(C)
  - SEC ICA ANPRs published on 9/7/11 with comment deadline of 11/7/11; no further action to date
- D-F § 939F – Franken Amendment (Assigned Credit Ratings)
  - SEC report to Congress required in 7/12; deadline just missed
  - Must implement Franken’s assigned ratings system unless an alternative in place – Rule 17g-5?
Other D-F Reforms (cont’d)

• D-F § 939G – Rating agency “expert” liability
  • Sec. 939G repealed Rule 436(g), which previously eliminated exemption of rating agencies from status as “experts” in prospectuses
  • Market reaction caused SEC to issue a no-action letter overriding Reg AB requirement to disclose ratings in a prospectus
    • Ford Motor Credit Company LLC available July 22, 2010
    • Extended indefinitely on November 23, 2010
Other D-F Reforms (cont’d)

• D-F § § 1411 and 1412 – “Qualified Mortgage” Definition
  • Creditors must determine borrower ability to repay
  • Rebuttable presumption of ability to repay with “qualified mortgage” (QM) – controversial issue parallel to “QRM” under Section 941
    • Industry seeks safe harbor instead of rebuttable presumption
  • Rulemaking authority now with CFPB
    • FRB issued original NPR in 5/11; responsibility shifted to CFPB in 7/11
    • In May 2012, CFPB requested additional comments on limited questions under NPR, with comment deadline of 7/9/12
  • Proposal outstanding; no final rule yet
  • CFPB’s deadline under D-F is 1/21/2013
Accounting – FAS 166/167

• Much harder to obtain “sale” treatment of a securitization and to recognize “gain on sale”
  • Assets must be legally isolated from the transferor and its consolidated affiliates
  • Ignore “bankruptcy remote” subsidiaries
  • Transferor must surrender control
  • Transferees must have the right to pledge or exchange the assets

• A variable interest holder must consolidate a variable interest entity if it has a “controlling financial interest”

• FAS 166 and 167 became effective for most purposes in Jan. 2010
**FDIC Sale Rule  12 CFR 360.6**

- Applies to FDIC-insured banks
- Promulgated because of adoption of FAS 166/167
- Provides
  - A safe harbor for sale treatment of transfers of assets that qualify as a sale under FAS 166/167 for all but legal isolation requirement, or
  - Relief from the 90-day automatic stay for securitizations that fail to qualify as sales under FAS 166/167
- To qualify:
  - 5% risk retention; no hedging
  - Loan level disclosure and periodic reports
  - No synthetic or unfunded securitizations
  - If RMBS, no more than 6 tranches
  - If RMBS, 5% cash reserve for one year to repurchase loans in breach of reps
  - If RMBS, no external credit support or guarantees (other than GSEs)
- Final rule adopted by FDIC in Sept. 2010
Reg AB II

• Initially proposed prior to D-F, but would constitute SEC’s compliance with D-F § 942
• Extensive loan level data disclosure
• Reg AB extended to cover 144A and Reg D offerings
  • Same disclosure as S-1 offering
  • Departure from “sophisticated purchaser” paradigm for private placements
• Shelf offerings require:
  • A preliminary prospectus be available 5 days prior to pricing
  • CEO certification of assets being “sufficient to pay” offered securities
  • Quarterly 3rd party opinion that assets not repurchased for breach of reps in fact were not in breach
  • 5% risk retention; allocated among originator and sponsor
• Proposed rule issued in 5/10; most recent comment period ended 10/4/11
Rule 17g-5

• Adopted in 11/09 pursuant to Credit Rating Agency Reform Act of 2006

• Issuer, sponsor or underwriter must post all rating agency material on a password protected internet website
  • Material is available to any CRA that can make required certifications
  • Competing CRAs can issue their own ratings

• Advanced as an alternative to “assigned ratings” system under Franken Amendment
Basel III

• On June 12, 2012, the Federal banking agencies (the OCC, Federal Reserve Board and FDIC) (the “Agencies”) formally proposed three sets of significant changes to the U.S. regulatory capital framework:
  • The Basel III Proposal, which applies the Basel III capital framework to almost all U.S. banking organizations
  • The Standardized Approach Proposal, which applies certain elements of the Basel II standardized approach for credit risk weightings to almost all U.S. banking organizations
  • The Advanced Approaches Proposal, which applies changes made to Basel II and Basel III in the past few years to large U.S. banking organizations subject to the advanced Basel II capital framework

• Deadline for comments on all three proposals is Sept. 7, 2012. This deadline may be extended, but the regulators intend to finish the rules by year-end.
Basel III (cont’d)

• Applicability
  • All FDIC-insured depository institutions
  • U.S. bank holding companies and savings and loan holding companies
  • Basel II “advanced approaches” institutions—by virtue of the Collins Amendment
  • Small bank holding companies (consolidated assets of $500 million or less) are not covered
  • Foreign banking organizations are not covered, but any subsidiaries that are U.S. bank holding companies are covered
Impacted Aspects of Mortgage Business

• The proposals address regulatory capital treatment of:
  • Single-family (1-4 unit) mortgage loans
  • Multi-family mortgage loans
  • Residential construction loans
  • Residential mortgage-backed securities (RMBS)
  • Mortgage servicing rights (MSRs)
  • Gain on sale of mortgage loans and RMBS

• The proposals principally affect mortgage-related assets held in bank portfolios – not mere origination
Summary of Likely Impacts

• The proposals encourage conservatively underwritten, traditional mortgage loans
  • The proposals provide incentives for banks to hold conservatively underwritten, plain vanilla product – and penalize banks for holding mortgage loans deemed by the regulators to be more risky
  • The proposals do not address origination, so banks desiring to offer a broader range of products to borrowers who need more flexible payment options or lower downpayments, for example, can still make such loans, but are pushed to sell them in the secondary market shortly following origination
  • Even so, banks constitute a substantial portion of the secondary market, so non-traditional products will have fewer purchasers – likely affecting price and liquidity of non-traditional products
Summary of Likely Impacts (cont’d)

• The few large, multinational banks subject to the Advanced Approaches will have more flexibility than the vast majority of banks subject to the Standardized Approach with regard to holding non-traditional loan products
  • Advanced Approaches banks may well determine using their internal analyses that non-traditional products do not require the draconian capital haircuts that Standardized Approach banks must apply
  • The large, multinational banks may thus provide a market for smaller banks unable to hold non-traditional loans
  • At a minimum, the large multinational banks will likely have a competitive advantage in the loan products they can offer, if they choose to do so

• The restrictive treatment of MSRs will discourage banks from selling loans with servicing retained, and will lead many banks to try to sell MSRs
  • The new rules will encourage whole loan sales with servicing released
  • To the extent there is not a robust secondary market for both loans and servicing, banks will have no incentive to lend beyond the level of loans they can comfortably hold in portfolio
Summary of Likely Impacts (cont’d)

• The proposals do nothing to encourage securitization as a take-out for loans originated by banks
  • While the changes from the current rules for securitizations are not as substantial as the changes for whole loans, at the margin they are more restrictive than current rules
  • Regulatory and accounting changes implemented since the financial crisis – together with the continued weak housing market – have virtually shut down the new issue RMBS market

• All things being equal, the proposals suggest additional opportunities for non-bank lenders, securitizers and servicers to assume a larger role in the residential mortgage markets
  • Redwood Trust and Pennymac (mortgage REITs)
  • Nationstar and Ocwen (servicers)
How regulatory changes affect the playing field?

• Dodd-Frank removed or reduces certain advantages previously enjoyed by banks:
  • The Act subjects banks and nonbanks to the same consumer and mortgage lending rules
  • The Act reduces the availability and benefits of federal preemption, and provides state regulators with greater ability to regulate and enforce state requirements against banks

• The Act intensifies certain disadvantages of conducting a mortgage lending business through a bank
  • Regulatory capital requirements
  • Fewer capital raising alternatives
  • Securitization exposures will be subject to higher risk weights
  • Derivatives (that often accompany securitizations) will be more “expensive”
  • Section 23A/23B restrictions

• Generally, the changes in costs may motivate banks to reduce their lending activities in favor of other, more profitable businesses, leaving nonbanks with greater opportunities to compete
Bank functions in mortgage and consumer lending markets

• If banks de-emphasize mortgage and consumer lending, what business functions will be impacted?
  • Origination
  • Funding and short-term “accumulation” financing
  • Servicing
  • Long-term financing of portfolio holdings
What current businesses will have opportunities?

- Mortgage banking
  - Increased potential for market share and volume if banks reduce activity
  - Banks no longer have preemption advantage
  - Largest drawbacks remain: origination funding and warehouse finance
- Mortgage REITs
  - Similarly, increased potential for market share and volume
  - Also, can provide an additional “service” holding in portfolio
  - Mortgage REITs can originate (or purchase) to distribute (through TRS) or hold (in parent REIT)
- Warehouse finance
  - Desperately needed by mortgage bankers; banks have been major suppliers, but have cut back in the past several years and may cut back more in light of more Dodd-Frank's more stringent requirements
- Servicing
- Hedging
  - Hedging essential for pipelines and portfolios; banks and GSEs have been providers
Mortgage Banking and Mortgage REITs
Role of mortgage REITs in housing finance

• Mortgage REITs offer a particular opportunity – the ability to hold loans in portfolio
• Someone has to “own” mortgage loans. Banks’ capacity will continue to be limited because of regulatory capital requirements.
• Mortgage REITs are accustomed to on-balance sheet financing of mortgage portfolios
• Mortgage REITs can finance long-term mortgage portfolio holdings through capital markets offerings of equity, debt or on-balance sheet securitizations
• As a result, mortgage REIT market share has the potential to increase substantially relative to banks – even more so if the GSEs are substantially reduced or eliminated
Real Estate Investment Trusts

• A REIT is an investment vehicle designed to allow investors to pool capital to invest in real estate assets
• Publicly traded investment vehicle
• Pass-through entity for U.S. federal income tax purposes
• Mortgage REITs
  • Invest indirectly in real property through investments in mortgages, CMBS, RMBS, etc.
  • Generate income from interest earned
Why investors Like REITs

• Access
  • Provide retail investors with an opportunity to participate in real estate and mortgage investments
  • Tax advantages
  • Highly liquid
  • Dividend-paying
  • Professionally managed
Mortgage REIT Market

• Background
  • Types of mortgage REITs
    • Agency – invests only in RMBS issued by a GSE
    • Credit – invests in commercial loans and CMBS
    • Hybrid – invests in agency RMBS, residential and commercial credit or securities and other real estate related assets
  • Finance investments with short-term debt
    • Repurchase agreements
    • Securitizations
  • Management structure
    • Internal – majority of employees work for the REIT
    • External – managed by an asset manager
Growth of Mortgage REITs

- Mortgage REIT market cap has grown ~ 450% in last 3 years
- 15 IPOs completed
- Follow-on stock offerings have exceeded $7 billion in 2012

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**TOTAL**                                 |        | **59,821**| **13,286**|

Source: Bloomberg and company filings
# Mortgage REIT Market Update

**Market Data as of June 30, 2012, Source: Bloomberg LP**

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<th>Company</th>
<th>Share Name</th>
<th>Market Cap ($mm)</th>
<th>LTM (%)</th>
<th>YTD (%)</th>
<th>3 Months (%)</th>
<th>1 Week (%)</th>
<th>2010</th>
<th>2011</th>
<th>Book</th>
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<td>Capstar Mortgage Corp.</td>
<td>CMX</td>
<td>1,301.57</td>
<td>4.19%</td>
<td>9.44%</td>
<td>6.43%</td>
<td>(0.78)%</td>
<td>9.34</td>
<td>7.81</td>
<td>1.067</td>
<td>N/A</td>
<td>1,279.66</td>
<td>-2.33%</td>
</tr>
<tr>
<td>Two Harbors Investment Corp.</td>
<td>TMO</td>
<td>2,219.29</td>
<td>(1.43)%</td>
<td>6.47%</td>
<td>2.17%</td>
<td>(0.10)%</td>
<td>6.37</td>
<td>9.96</td>
<td>1.071</td>
<td>1.071</td>
<td>1,544.40</td>
<td>3.50%</td>
</tr>
<tr>
<td>Anworth Mortgage Asset Corp.</td>
<td>ANH</td>
<td>967.20</td>
<td>(5.75)%</td>
<td>0.86%</td>
<td>7.80%</td>
<td>1.15%</td>
<td>8.80</td>
<td>8.20</td>
<td>0.96</td>
<td>N/A</td>
<td>1,276.60</td>
<td>-1.00%</td>
</tr>
<tr>
<td>Armour Residential REIT, Inc.</td>
<td>ARR</td>
<td>1,263.27</td>
<td>(3.53)%</td>
<td>(9.43)%</td>
<td>6.44%</td>
<td>1.43%</td>
<td>9.70</td>
<td>41.82</td>
<td>1.047</td>
<td>N/A</td>
<td>1,940.93</td>
<td>N/A</td>
</tr>
<tr>
<td>New York Mortgage Trust Inc.</td>
<td>NYMT</td>
<td>122.15</td>
<td>(5.94)%</td>
<td>1.37%</td>
<td>5.78%</td>
<td>3.00%</td>
<td>11.70</td>
<td>8.49</td>
<td>1.086</td>
<td>N/A</td>
<td>1,518.81</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Commercial REITs</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stanwood Prop Trust Inc.</td>
<td>STWD</td>
<td>2,480.04</td>
<td>5.23%</td>
<td>(1.71)%</td>
<td>2.26%</td>
<td>0.86%</td>
<td>13.87</td>
<td>13.49</td>
<td>1.114</td>
<td>1.114</td>
<td>825.90</td>
<td>6.33%</td>
</tr>
<tr>
<td>CreXus Investment Corp.</td>
<td>CXS</td>
<td>779.23</td>
<td>(7.46)%</td>
<td>(23.30)%</td>
<td>(2.31)%</td>
<td>(1.64)%</td>
<td>13.91</td>
<td>6.56</td>
<td>0.845</td>
<td>0.845</td>
<td>1,150.44</td>
<td>5.50%</td>
</tr>
<tr>
<td>iStar Financial Inc.</td>
<td>SFI</td>
<td>544.11</td>
<td>(19.27)%</td>
<td>(19.78)%</td>
<td>(12.13)%</td>
<td>6.26%</td>
<td>N/A</td>
<td>N/A</td>
<td>0.372</td>
<td>0.372</td>
<td>0.00%</td>
<td>N/A</td>
</tr>
<tr>
<td>Colony Financial Inc.</td>
<td>CNY</td>
<td>572.77</td>
<td>(13.64)%</td>
<td>5.10%</td>
<td>0.17%</td>
<td>12.32</td>
<td>12.01</td>
<td>0.767</td>
<td>0.767</td>
<td>758.79</td>
<td>5.50%</td>
<td></td>
</tr>
<tr>
<td>Newcastle Investment Corp.</td>
<td>NCT</td>
<td>966.00</td>
<td>16.52%</td>
<td>(1.03)%</td>
<td>8.77%</td>
<td>7.20%</td>
<td>5.09</td>
<td>5.15</td>
<td>2.696</td>
<td>N/A</td>
<td>1,266.66</td>
<td>N/A</td>
</tr>
<tr>
<td>NorthStar Reality Finance Corp.</td>
<td>NRFS</td>
<td>506.13</td>
<td>31.82%</td>
<td>4.61%</td>
<td>3.15%</td>
<td>(0.95)%</td>
<td>N/A</td>
<td>N/A</td>
<td>0.731</td>
<td>N/A</td>
<td>957.85</td>
<td>N/A</td>
</tr>
<tr>
<td>Appollo Commercial Real Estate Capital</td>
<td>ARI</td>
<td>330.57</td>
<td>(0.00)%</td>
<td>(2.70)%</td>
<td>2.60%</td>
<td>(1.03)%</td>
<td>16.24</td>
<td>13.79</td>
<td>0.977</td>
<td>N/A</td>
<td>995.64</td>
<td>7.50%</td>
</tr>
<tr>
<td>Gramercy Capital Corp.</td>
<td>GKK</td>
<td>128.21</td>
<td>(16.57)%</td>
<td>(10.39)%</td>
<td>(6.02)%</td>
<td>0.00%</td>
<td>N/A</td>
<td>0.97</td>
<td>N/A</td>
<td>N/A</td>
<td>0.00%</td>
<td>N/A</td>
</tr>
<tr>
<td>Arbor Realty Trust Inc.</td>
<td>AER</td>
<td>148.46</td>
<td>14.32%</td>
<td>(8.08)%</td>
<td>(4.80)%</td>
<td>4.29%</td>
<td>N/A</td>
<td>N/A</td>
<td>0.723</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Capital Trust Inc.</td>
<td>CT</td>
<td>65.02</td>
<td>(24.21)%</td>
<td>92.00%</td>
<td>(26.15)%</td>
<td>(2.04)%</td>
<td>N/A</td>
<td>0.77</td>
<td>N/A</td>
<td>N/A</td>
<td>0.00%</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Market Data as of June 30, 2012, Source: Bloomberg LP
## Mortgage REIT Registrations

<table>
<thead>
<tr>
<th>Initial Filing Date</th>
<th>Current Filing Date</th>
<th>Issuer</th>
<th>Deal Value ($mm)</th>
<th>Manager</th>
<th>Asset Class Focus</th>
<th>Incentive Fee?</th>
</tr>
</thead>
<tbody>
<tr>
<td>7/3/2012</td>
<td>7/3/2012</td>
<td>JAVELIN Mortgage Investment Corp.</td>
<td>115</td>
<td>ARMOUR Residential Management, LLC</td>
<td>Residential</td>
<td>No</td>
</tr>
<tr>
<td>11/21/11</td>
<td>12/30/2011</td>
<td>Independence Mortgage Trust, Inc.</td>
<td>2 to 1,650</td>
<td>Independence Mortgage Advisor, LLC</td>
<td>Commercial</td>
<td>No</td>
</tr>
<tr>
<td>4/5/2011</td>
<td>7/22/2011</td>
<td>PIMCO REIT, Inc.</td>
<td>600</td>
<td>PIMCO REIT Management, LLC</td>
<td>Diversified</td>
<td>Yes</td>
</tr>
<tr>
<td>12/23/2010</td>
<td>6/29/2011</td>
<td>Free &amp; Clear Equity, Inc.</td>
<td>300</td>
<td>Internal</td>
<td>Commercial</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Note: This list includes only registrations that were commenced after January 1, 2010
## Recent Mortgage REIT IPOs

<table>
<thead>
<tr>
<th>IPO Date</th>
<th>Issuer</th>
<th>Manager</th>
<th>Completed IPO Size ($mm)</th>
<th>Gross Proceeds ($mm)</th>
<th>Asset Class Focus</th>
<th>Incentive Fee</th>
</tr>
</thead>
<tbody>
<tr>
<td>5/9/2012</td>
<td>Western Asset Mortgage Capital Corp</td>
<td>Western Asset Management Company</td>
<td>160</td>
<td>160</td>
<td>Residential</td>
<td>No</td>
</tr>
<tr>
<td>7/21/2011</td>
<td>Apollo Residential Mortgage, Inc.</td>
<td>ARM Manager, LLC</td>
<td>200</td>
<td>200</td>
<td>Residential</td>
<td>Yes</td>
</tr>
<tr>
<td>6/29/2011</td>
<td>AG Mortgage Investment Trust, Inc.</td>
<td>AG REIT Management, LLC</td>
<td>110</td>
<td>110</td>
<td>Residential</td>
<td>No</td>
</tr>
</tbody>
</table>

Source: Company Filings
REIT Qualification

There are 4 major requirements to qualify as a REIT

- Organizational
- Asset test
- Income test
- Income distribution
Organizational Requirements

- Managed by trustees or directors
- Transferable shares or certificates
- Held by more than 100 or more persons
- Not closely held…50% of shares can’t be held by 5 or fewer individuals
- Can’t be a financial institution or insurance company

Note: a REIT can be either publicly or privately owned
REIT Tests

• REITs are required to meet both quarterly and annual tests
  • Quarterly Asset Tests
    • At least 75% of the value of the total assets (measured on a tax basis) must consist of real estate assets, cash and cash items, and government securities.
    • Not more than 5% of the value of total assets (measured on a tax basis) can be represented by securities (other than government securities, stock of a qualified REIT subsidiary and securities that otherwise qualify as real estate assets).
    • Tests are measured at the close of each quarter
  • Annual Gross Income Tests
    • 75% of gross income (measured on a tax basis) must be derived from transactions which are closely connected with real estate activities
    • 95% of gross income must be derived from transactions which meet the 75% test or from dividends, interest or gains from sale of stocks/securities
    • Distribute at least 90% of taxable income
Other Organizational Considerations

• Investment Company Act of 1940 ("40 Act")
  • The 40 Act places limits on use of leverage
  • Mortgage REITs rely on leverage to earn returns
  • Mortgage REITs are generally exempt from the 40 Act if they hold at least 55% of their assets in agency whole pool RMBS

• Taxable REIT Subsidiaries
  • IRS rules allow non-qualifying assets to be held in a Taxable REIT Subsidiary ("TRS")
  • The TRS is owned by the REIT but pays taxes on the income earned in that entity
Taxable REIT Subsidiaries

• A REIT may enter into otherwise prohibited activities through a TRS.
• The TRS itself is taxable as a corporation.
• For purposes of the asset tests, 25% of a REIT’s assets can be held in stock of TRSs.
• With respect to the income tests, the Code allows the TRS to perform noncustomary services which would otherwise not qualify as good income.
• TRSs are an essential feature in “operational” mortgage REIT structures.
Allocation of Activities

• General principles:
  • Encapsulate non-REIT activities in a TRS
    • creating and holding mortgage loans for sale
    • loan sale activity
    • loan modifications
    • dealing with foreclosures
  • Maximize REIT holdings of permissible assets and activities
    • optimize tax benefits of a REIT
    • need to maintain relative size of REIT in 3-to-1 ratio (TRS may be 25% of total for key asset metrics)
  • Validate economics of transfers between REIT and TRS
Allocation of Activities (cont’d)

• Some activities can be safely conducted at both levels, including loan origination for portfolio and servicing of portfolio loans
• Nonetheless, from a business standpoint it is simpler to have all origination and all servicing in a single corporate entity
• Many mortgage REITs therefore choose to allocate the entire “operational” mortgage business in a TRS – including origination and servicing – with the REIT acting as a passive repository for long-term portfolio holdings and financings
• There are variations – some choose to do servicing at the REIT level (or in a QRS), subject to income tests
The Role of Securitization

- Securitizations can be undertaken at either level – REIT or TRS
- REIT-level securitizations are on-balance sheet, long-term financings
- TRS-level securitizations can be either sales for accounting purposes or on-balance sheet at the TRS level
- Even if a sale (off-balance sheet) at TRS, a securitization may be consolidated as a financing on REIT’s balance sheet
Financing the Mortgage REIT

• Availability of short-term funding during liquidity crises is “Achilles' heel” of mortgage REITs
• Favorable long-term funding also critical given U.S. 30-year mortgage tradition
• Financing options include:
  • bank-supplied warehouse lines of credit
  • warehouse lines supplied by non-bank finance companies, hedge funds or asset-backed commercial paper vehicles
  • bank term loans
  • bank revolving lines of credit
  • the issuance of commercial paper at the corporate level
  • the issuance of public debt securities
  • the issuance of senior securitization interests, which constitute debt on the mortgage REIT’s balance sheet
  • equity offerings by the mortgage REIT
Mortgage Servicing
Mortgage Servicing

• Historically, majority of servicing has been undertaken by four banks
• Banks generally focused on conventional mortgages, performing loans
• Financial crisis has changed the landscape
  • Challenges of addressing non-performing loans
  • Mortgage modifications
  • Regulatory issues like DOJ/AGs settlement
  • Servicing standard
Mortgage servicing transactions

- 2007 – American Home MSR sale to Wilbur Ross
- 2009 - Thornburg sale of MSR to Credit Suisse
- 2010 – Barclays servicing sold to Ocwen
- 2011 – Saxon Capital sale to Ocwen
  Litton Loan Servicing to Ocwen
- 2012 – Nationstar purchases servicing assets
Hedging MSRs

• MSR is established when a loan is sold and a servicing fee is contractually established
  • The MSR is accounted for separately from the loan itself
  • Applies only to owner of primary servicing; fee-for-service or sub-servicing does not generate an MSR asset under GAAP
• The MSR is capitalized as the present value of expected net profits from servicing, accounted for using:
  • Fair value with mark-to-market changes accounted for in current period income, or alternatively
  • Amortized cost, subject to impairment
• Valuing an MSR is complex due to lack of a liquid MSR market
  • Treated as a Level 3 asset and generally valued using complex models, which uses as inputs interest rates, prepayment speeds, discount rates/option adjusted spreads and various operational metrics
• An MSR’s value is extremely volatile due to the interest-only nature of servicing compensation
  • Due to prepayments, MSR value falls as interest rates fall and vice versa; more downside than upside due to interest rates
  • Many servicers attempt to hedge their MSR through a complex derivatives portfolio of swaps, swaptions, Treasury futures and available for sale securities
  • MSR hedging is imperfect and sometimes ineffective, particularly in periods of high market volatility
Capital Treatment of MSRs

- The Basel proposals substantially change the capital treatment of MSRs for the worse, and are likely to cause banks to shun the retention of MSRs in future loan sales and securitizations.

- Current treatment
  - Intangible assets, including MSRs, limited to 10% of tier 1 capital
  - MSRs valued at lesser of 90% of FMV and 100% of unamortized BV
  - MSRs assigned a 100% risk weighting

- Proposed treatment
  - MSRs capped at 10% of common equity tier 1 capital, with any excess deducted from common equity tier 1 capital
  - MSRs, deferred tax assets and investments in common stock of other financial institutions subject to an aggregate cap of 15% of common equity tier 1 capital
  - To the extent not deducted from common equity tier 1 capital, MSRs assigned a 250% risk-weighting
  - MSRs valued at 90% of FMV, marked-to-market quarterly
Opportunities with Nonbanks
Private equity investments

• During the financial crisis, there was great anticipation that private equity would invest in banks
  • Banking agencies remain skeptical of private equity investments in regulated institutions
  • Difficult to navigate many of the ownership limitations in connection with an investment in a bank
  • Private equity investors would not necessarily want to subject themselves to regulatory scrutiny associated with an investment in a bank
Investing in a nonbank entity

• Mortgage REITs are able to capitalize on many of the opportunities that now present themselves in the mortgage market
• An external manager to a mortgage REIT essentially follows a private equity type compensation formula
  • Recent examples of private equity/asset manager – sponsored mortgage REITs
• Although agency model is most common, mortgage REITs may engage in other activities, like servicing, distressed investing, etc.
Other mortgage market opportunities

• Mortgage originators
  • Some state licensing considerations where an investment may be deemed to constitute a “change of control”
  • Little uniformity in terms of the definition of “change of control”
  • Nonetheless, easier than investing in a bank
Investing in servicing

• A nonbank can service
  • Servicers must be approved by GSEs
  • Nonbank may rely on a subservicer

• Investing in servicing asset
  • Taking an economic interest in MSR position
Covered Bonds
Covered bonds

• The market interest in covered bonds indicates that there is investor appetite for mortgage exposure (maybe not in RMBS format). Also, covered bonds have a number of regulatory benefits.
• No legislation in the United States that provides a framework for issuance by regulated institutions; however, there is a thriving market in the U.S. for covered bonds issued by foreign banks, and a legal framework is less significant for non-bank issuers
• For a mortgage REIT, covered bonds or collateralized bonds may provide an answer to the short-term funding conundrum
What Are Covered Bonds?

Covered Bond Characteristics

• Senior debt of a regulated financial entity.
• Secured by a pool of financial assets.
  • Mortgage loans – residential and commercial
  • Public sector obligations
  • Ship loans
• Protected from acceleration in the event of issuer insolvency.
  • By statute or legal structure.
  • Collateral is isolated from insolvency estate of the issuer.
  • Collateral pays bonds as scheduled through maturity.
• A dynamic collateral pool – refreshed every month.
• Typically bullet maturity, fixed rate bonds.
• Repayment liabilities remain on the balance sheet of the originator.
• Most countries have statutes enabling covered bonds.
• Very strong implicit government support in many jurisdictions.
Benefits to Issuing Banks

Attributes of Covered Bonds

• Lower funding cost than senior bank debt.
• Extension of WAM for bank funding.
  • Typical maturities for covered bonds of seven years or more.
• Diversification of funding base.
  • Investors typically do not buy RMBS or senior bank debt.
• Mortgage modifications to accommodate borrower is easy; no competing interests
• Brings mortgage finance out of the ‘shadow banking’ world
• Levels the playing field
  • Foreign banks currently have access to this investor group, including in the US, while US banks do not.
Covered Bond Investors

Covered Bond Characteristics

• Covered bond investors buy sovereign and agency debt
• Some of these same investors buy FNMA, FHLMC, GNMA debt
• Typically they will not buy senior bank debt
• They do not buy CMBS or ABS or RMBS
• To attract these investors you need statutory covered bonds
• Predominantly banks, central banks, funds and insurance companies
• A €3 trillion market in Europe
• The US investor base is opening up; foreign banks issued almost $30 billion in covered bonds in the US in 2010, almost $40 billion in 2011 and almost $29 billion in 2012 to date
Benefits to Investors

Attributes of Covered Bonds

- High credit quality – most bonds are triple-A rated.
- In Europe, favorable capital treatment for bank investors.
- Higher yield than sovereign debt.
- Diversification – sovereign or agency debt is viewed as similar risk.
- Good liquidity.
- Issuance regulated by statute in many European jurisdictions.
- More investor friendly than RMBS or CMBS
- Not an ‘originate-to-sell’ model
- No complex tranching – good transparency
- No negative convexity (prepayment) risk
- 100% ‘skin in the game’
European Jurisdictions with Legislation

- Legislation countries of the EU/EEA/CH
- No Legislation
- Legislation in other countries
Questions