2008 Subprime Mortgage Crisis vs. 2020 COVID-19 Economic Collapse
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Market Summary
The US mortgage market in February 2020 had fully recovered from the 2008 Subprime Mortgage Crisis ("2008 Crisis") that crippled the US economy. The mortgage market operated in an economy that enjoyed low unemployment, historically low interest rates, and stable home values. The vast majority of new mortgages were conventional loans that were sold to Freddie Mac, Fannie Mae, and FHA. Additionally, in the years following the crisis the industry's compliance oversight increased with the addition of Consumer Finance Protection Board (the "CFPB") and intensified internal banking compliance procedures. The CFPB oversees and requires that loan terms are not predatory and gives borrowers a voice with large institutions. Post 2008 internal lender compliance standards acted as another level of oversight so that new mortgages fit a bank's capital requirements to protect their balance sheets. These moves by government regulators and banks proved to stabilize and grow the mortgage market.

Thesis
The cause of the of the 2008 Crisis was fundamentally different than the current 2020 COVID-19 Economic Collapse. However, the technical mechanics that exist within the mortgage market today combined with outside economic pressures produced by COVID-19 will result in the destabilization of the US mortgage market. The economic conditions that have emerged will require stabilization activities that the US mortgage market used during the 2008 Crisis in order to manage the expected tsunami of residential borrower delinquencies and return financial health to lenders and borrowers.

Market Comparison
The 2008 Crisis: The crisis started in the housing sector and quickly spread throughout the entire US economy – and through securitization, to the rest of the world's economies. It took years for elements within the subprime lending industry to create the housing crisis. Here are just some of the events which lead up to the 2008 Crisis:

- 2007
  - The US Economy starts the year strong
  - Subprime lenders start to file bankruptcy and these filings persist throughout 2007
  - Warehouse Lenders increase net worth requirement on non-bank lenders causing liquidity to tighten
  - The DJIA hits a record high in July of 2007
  - Fed begins to lower interest rates in Q3
  - Fed begins to inject capital into the banking system to create liquidity in Q4
  - President Bush asks congress to intervene in Fannie Mae, Freddie Mac, and FHA in December
- 2008
  - By February the DJIA is down 20% off of its high in July of 2007
  - Banks announce significant layoffs
  - Investment banks like Bear Stearns and Lehman Brothers start to fail and require government assistance
  - The Dodd-Frank proposal by congress in June was a sweeping overhaul of the United States financial regulatory system
  - TARP is announced and is presented as a $700,000,000,000 bail out of the banks
  - HAMP is announced to help borrowers stay in their homes by legally mandating servicing requirements that avoid foreclosure
  - In October the DJIA drops 22% in 8 days
  - Banks and non-bank servicers begin to experience liquidity problems because the servicing activities include a commitment to advance payments for their positions in mortgage servicing rights ("MSR's") – billions of dollars required to forward principal and interest into mortgage backed securities trusts on behalf of delinquent borrowers
  - Federal takeover of Fannie Mae and Freddie Mac
  - 9 US Banks are forced to take liquidity through Emergency Economic Stabilization Act
  - The impact of the crisis begins to hit the European banking system
  - 10,000,000 subprime loans are left that need to be liquidated through a mortgage servicing infrastructure that is designed to liquidate about 800,000 a year

2020 Covid19 Economic Collapse: The cause of the mortgage market downturn in 2020 is COVID-19's impact on the macro economy which will flow downhill to the mortgage market and the resulting impact on the mortgage industry will be similar. One significant difference the mortgage industry faces today vs the 2008 Crisis is timing. The problems with subprime lending took years to build up and the corresponding economic correction took years to playout. COVID-19 has created an economic collapse that took months to realize but like the 2008 Crisis will take years to recover. While oversight and lending standards have improved, the mortgage market problems (i.e. payment advancing by banks and servicers to bondholders) still exist which will cause the same liquidity restraints that emerged in the 2008 Crisis. These forces will take years to resolve in a similar manner to the previous recovery. Here are some economic impacts that have escalated over the first 3 months of 2020 that are similar to the 2008 Crisis:

- February – Market peak
    - US Economy is strong with historically low unemployment
    - DJIA average hits all time high on the 13th
    - Covid-19 begins to be widely reported and impacting people outside of mainland China
    - DJIA has its worst day in 2 years on the 24th
- March
    - Economic impacts are felt in unprecedented filings for unemployment insurance
    - US Government passes $8.3B emergency spending bill in early March
    - Fed cuts interest rate to 0.0%
    - Warehouse lenders begin to increase net worth requirements on non-bank lenders tightening liquidity
    - Non-QM (qualified mortgage) lending all but disappears
    - FHA, Freddie Mac, Fannie Mae announce 3 month payment forbearance
    - FHA, Freddie Mac, Fannie Mae announce 60 day moratorium on foreclosure/evictions by servicers of their mortgages
    - Jobless claims by the 22nd are over $3M
    - Servicers express a going concern regarding making their monthly payments for their MSR portfolio with a 90 day deferral period
    - US Government passes $2T economic stimulus on March 27, 2020
- Likely near-term events (based on past industry experience and current market knowledge):
    - Residential default rates will rise dramatically and instantly
    - Mortgage lenders who only do non-QM lenders will be driven out of the business
    - Warehouse lenders will force the sale of warehoused notes increasing the supply of whole loans on the market
    - Smaller mortgage lenders will be forced to exit the space directly resulting from increased capital requirements from warehouse lenders
    - Reduction or elimination of FHA lending that allow for loans with low FICO scores and 3% down payments
    - Servicers will require a $100-$200B government bailout for payment advances to securitization bond holders
    - There will likely be an announcement of a loan modification program that similar to HAMP
    - Institutional investors that have large rental real estate portfolios will place these assets (homes) on the market causing a drastic oversupply of residential homes with few economically able buyers
    - Investors that do have a capital source that have participated in this market over the last 2 years will likely be driven out due to liquidity constraints

<u>Market Opportunity</u>

It is true some industries within the US Economy will face fundamental changes when this current down cycle is complete which creates uncertainty in the economy. However, the demand for housing will remain a fundamental need to a US population that is still growing. The investors that will be able to take advantage of these market conditions will need a stable source of capital with the oversight of an experienced portfolio management team that implement a risk based transparent approach. The portfolio managers during this crisis that will be successful will understand how to purchase distressed mortgage assets and also have a firm understanding of the servicing and real estate disposition strategies and actions of each loan or REO.

The economic turmoil in 2008 and 2020 will have the same result in the mortgage default rate. The increased default rate on mortgages due to short term volatile unemployment rates create a strain on the broader US economy and the US mortgage market. Mortgage loan portfolios in 2020 are not subprime but FHA mortgage portfolios with 3% down payment minimum combined with a low FICO eligibility requirement will mirror a subprime like result. FHA currently has 7,982,070 active loans (Forward). The loan portfolios funded with low down payments, low savings requirements, and/or self-employment will see an increased default rate. The impact of an increased default rate will have a corresponding strain on liquidity for lenders and investors which will likely force banks/investors to sell the loans into the markets to free up capital – their first loss is often their best loss. The investors likely to benefit the most are those who have locked in capital to invest that meet this risk profile and also have a portfolio management team that gained experience and knowledge from the 2008 Crisis utilizing their operational expertise of three key areas; capital markets, loan servicing, and real estate disposition.