SunTrust Mortgage

***Memorandum***

**Date:** **February 11, 2008**

**To:** **All Sales Associates**

**From:** **Tuck Reed, EVP, Capital Markets**

**RE:** **New conforming loan limits – estimating the benefit**

After many months of anticipation, we are finally getting a glimpse of the government's response to the mortgage liquidity crisis. An "economic stimulus package" containing higher mortgage limits for both FHA and FNMA/FHLMC has been passed by both the House and the Senate and awaits the almost certain signature of the President (I know those of you from my generation are right now envisioning that tired and lonely little animated bill from "School House Rock" sitting on the steps of the Capital).

Given what the housing industry has been through over the past year I would feel disgustingly unappreciative if I did not say "Thank you!" to our political leadership, but I also feel the need to caution that the plan will provide limited benefit to specific geographic areas. While it is clearly a positive step, I want to make sure you understand the plan and why I recommend we be careful not to over-promise its benefits.

## I. What we know today (but things could change)

- The bill sets the FHA and conforming (FNMA/FHLMC) loan limits to the lesser of $729,750 *or 125% of an area's median home sales price*. If 125% of an area's median home sales price is below the current conforming loan limit of $417,000, don't worry; the $417,000 still applies. In other words, you will not be any worse off than you are today. The area median home price is determined by HUD and is based, in part, on the National Association of Realtors data for each MSA.
- The FHA and conforming limit changes are meant to be temporary and are set to expire on Dec 31, 2008 (unless extended, which wouldn't surprise me).
- The new limits will apply to 30 year and 15 year fixed rate, fully amortizing (sorry, no IO), and owner occupied.
- ARMs are being considered, but if allowed, the increase will likely apply to one ARM type (for example, 5/1s).
- FNMA will have other credit overlays including LTV limitations (probably 90%).
- The limits will be effective as soon as the bill is signed, FNMA determines pricing, and we can update systems.
- OFHEO, which regulates FNMA and FHLMC, is not very pleased that the bill does not include complete "GSE reform" and will most likely have the final say in its implementation schedule.

## II. Who will see an increase in limits?

Since the new FNMA limits are restricted to 125% of an area's median home price, it's estimated that only twenty of the larger MSAs across the country will see an increase in conforming loan limits and only six will see the limit go to $729,750 (see table below). Of the six big winners, five are in California and the other is in Hawaii (like we need another reason to be jealous). However, two MSAs within our footprint should see limited benefit: Washington DC and Miami-Fort Lauderdale-West Palm Beach FL. However, the DC area limit will only go to approx. $550K while the benefit in FL should be even less - approx. $433K.

If we layer on the likely guideline and product restrictions (e.g. 90% LTV, no IOs, etc.), based on industry data as well as our own, we estimate that around 15% of current non-agency volume would be eligible. However, we can assume that with significantly better pricing, borrowers may opt for the "synthetic jumbo" or shift from other non-eligible products (IOs, etc.) to standard 30 year agency which could help increase production in the new conforming loan sizes.

Table 2. Median Home Prices & New Loan Limits — Effected MSA Sample

| # | Description | Q3-07 Median Home Price ($k) | Q3-07 Med Home Price ($k) (x1.25) | New Loan Limit ($k) |
|---|---|---|---|---|
| 1 | Anaheim-Santa Ana, CA (Orange Co.) | 700.70 | 875.88 | 729.75 |
| 2 | Barnstable Town, MA | 400.60 | 500.75 | 500.75 |
| 3 | Boston-Cambridge-Quincy, MA-NH** | 414.70 | 518.38 | 518.38 |
| 4 | Boulder, CO | 367.50 | 459.38 | 459.38 |
| 5 | Bridgeport-Stamford-Norwalk, CT | 491.10 | 613.88 | 613.88 |
| 6 | Honolulu, HI | 649.90 | 812.38 | 729.75 |
| 7 | Los Angeles-Long Beach-Santa Ana, CA | 588.40 | 735.50 | 729.75 |
| 8 | Miami-Fort Lauderdale-Miami Beach, FL | 346.80 | 433.50 | 433.50 |
| 9 | New York-Northern New Jersey-Long Island, NY-NJ-PA | 476.10 | 595.13 | 595.13 |
| 10 | New York-Wayne-White Plains, NY-NJ | 550.90 | 688.63 | 688.63 |
| 11 | NY: Edison, NJ | 391.80 | 489.75 | 489.75 |
| 12 | NY: Nassau-Suffolk, NY | 470.00 | 587.50 | 587.50 |
| 13 | NY: Newark-Union, NJ-PA | 459.70 | 574.63 | 574.63 |
| 14 | Riverside-San Bernardino-Ontario, CA | 377.00 | 471.25 | 471.25 |
| 15 | Sacramento–Arden-Arcade--Roseville, CA | 335.70 | 419.63 | 419.63 |
| 16 | San Diego-Carlsbad-San Marcos, CA | 589.30 | 736.63 | 729.75 |
| 17 | San Francisco-Oakland-Fremont, CA | 825.40 | 1,031.75 | 729.75 |
| 18 | San Jose-Sunnyvale-Santa Clara, CA | 852.50 | 1,065.63 | 729.75 |
| 19 | Seattle-Tacoma-Bellevue, WA | 394.70 | 493.38 | 493.38 |
| 20 | Washington-Arlington-Alexandria, DC-VA-MD-WV | 438.00 | 547.50 | 547.50 |

Source: National Association of Realtors

The biggest beneficiaries within our footprint will be FHA-eligible borrowers for whom the loan limit increase from current levels will be more substantial. Today, the limit for FHA is the lower of 95% of the median home price in the area or 87% of the conforming loan limit making the new 125% of area median price rule much more inclusive. In addition, the Secretary of HUD has the right to increase the FHA limit by up to $100,000 in “high-cost” markets.

### III. How much better could pricing get for the new FNMA conforming balances?

Pricing is still the big question. How much, if any, improvement the lucky loan balance winners will receive is a function of two things: how much of the current spread between agency and non-agency pricing FNMA decides to keep for the home team and how well investors accept the new loan balances in agency MBS (i.e. “liquidity”).

As for the credit costs, we can safely assume that FNMA and FHLMC will charge higher fees to compensate for the higher risks (I agree, the “higher risks” are debatable, especially if they impose overlays, but let’s be realistic - they’re not charities).

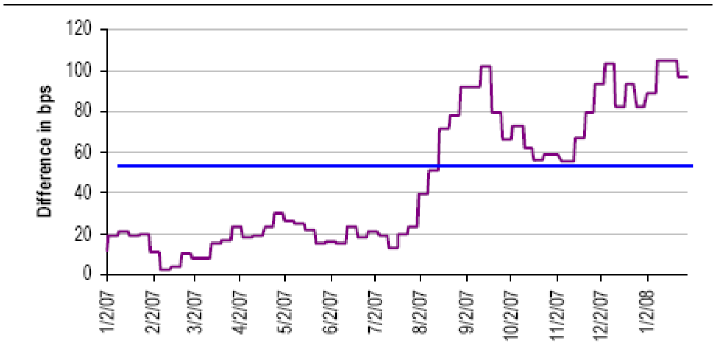
As for liquidity, things get a little more complicated. (I know what you’re thinking…”Oh Lord, here he goes”…but bear with me a minute.) Today, agency MBS trade with excellent liquidity thanks to very clear and highly controlled rules about what kinds of loans can be used to back “generic” agency MBS. These generic agency MBS are called “TBAs” since the actual loans that will go into the bonds are not known when the bonds are initially sold but are “to be announced” just before the investor takes ownership. These rules allow forward trading in bonds that haven’t even been created yet since investors feel certain they know what they will get once the bonds are made several months later. Certainty around the types of loans they will get in TBA securities also helps investors to get comfortable they can estimate the prepayment behavior of the bonds they’re buying. If anything happens to that certainty and our ability to sell TBA bonds for future delivery, we’ve got *big* problems. The industry would seize-up; imagine last year’s liquidity crisis times ten. As you can imagine, no one’s interested in tinkering with something so important to the industry and it’s not clear yet if the larger balances will be allowed in TBAs.

If the securities dealer association that governs MBS decides to allow some or all of these larger balances to go into "TBAs", we could expect a reduction in the spread between agency and non-agency mortgage rates – but mostly because today's agency balances would be penalized. In other words, the spread between today's agency and non-agency note rates would likely decrease, but only because today's agency rates would increase as investors lose interest in TBAs.

On the other hand, if the bond market association decides to leave today's TBAs alone and create special MBS for the new agency balances, we should not expect much reduction in the rates for the new conforming balances right away. However, like the market for 30 year IOs and other non-TBA agency MBS, the liquidity premium for the new bonds will likely drop over time as investors get comfortable they understand the collateral. Let's put it all together to estimate the total benefit for all those lucky winners in CA and Honolulu.

Figure 1 below shows the spread between non-agency and agency mortgage rates over the past year. The difference now sits at about 90 bps. Assuming FNMA charges a reasonable premium over today's fees to compensate for the higher credit risks and assuming reasonable liquidity for the new MBS, **we estimate the 90 bp spread could drop to as low as 50 bps** – significantly better than today.

Figure 1. 30-year Jumbo Fixed Rate – 30-year Conventional Fixed Rate




Source: UBS

### IV. Conclusion

Solving the mortgage liquidity troubles through legislative means is an extremely tricky business and I know we all applaud the effort. However, this particular stimulus package could have been a bit more stimulating if it had addressed two important points:

1. The liquidity problem is national and pegging the new limits to area median home prices ignores the distributions of prices within MSAs and concentrates the affordability improvements in those markets that saw the greatest wealth creation when prices were rising.
2. Creating agency MBS with larger loan balances is a good first step, but someone needs to buy the bonds. We still need something to stimulate investor demand for all MBS.

The good news is that there is still more than can be done and I'm confident that with so many Americans really hurting and the potential for the pain to get worse, more help is on the way.