

## Ten Observations

*Editor's Note:* The following information is summarized from the general sessions, breakout sessions, conversations with presenters and discussions with attendees of The Mortgage Bankers Association Secondary Marketing conference. While this is not a typical Actionable Strategies White Paper, the information is highly relevant to strategists in the Mortgage industry. Written by Frank Poiesz, an Expert Advisor in the field, it is very timely and reflects information from originators, servicers, ratings agencies and funding sources. Additional insight was also provided by other observers as part of the editorial process.

### Industry

Clearly the mortgage industry has suffered tremendously and has undergone dramatic changes in landscape. However, the situation is far from settled and both private sector and government sponsored enterprises will continue to evolve and also see dramatic change, although the ultimate structures are unclear.

### Mortgage banking conference reflects industry

The Mortgage Bankers Association Secondary Marketing conference in Chicago was a shadow of its former self – attendance was around 700, and there were only 37 exhibitors, compared with several thousand attendees and more than 100 exhibitors in a more typical year. This may seem as expected given the times, but it was palpable, even shocking, to those attending. The difference was a constant reminder of the state of the economy and more directly of the state of the mortgage industry.

As with most industries, conferences directly reflect the health of the market and the outlook of its participants.

### The bottom has not been reached

Despite some signs of a bottom, speakers from the rating agencies and others signaled that home prices are likely still 10-20% away from stabilizing. Imbalance in supply and ongoing price drops in many markets is an indicator that there is additional downward pressure on real estate values.

### Trust as a barrier to re-entry to private investment

Lack of trust in the market's basic structure is a significant barrier to re-entry of private investment. All the participants are considered culpable here – originators, servicers, rating agencies, MI companies, issuers and government. There was no confidence that regulation or government leadership would solve this soon. Since industry leadership is sidelined by its current lack of credibility, the government is unlikely to arrive at a suitable solution, at least on first try. Some of the suggestions, such as requiring originators to hold an interest in the loans they sell, are certain to crush non-depository lenders, if not the banks. Hopefully much of the current talk is political bluster. Nevertheless, it would be far better if a consensus about reform emerges soon.

With the U.S. government emerging as a more central actor in the market, decisions could possibly be politicized, influenced by a social agenda rather than a free market focus or otherwise based on imperfect advice.

### Eventual form of GSEs unclear

Reorganization of the GSEs being inevitable, speculation about what form would emerge to replace them was common, and all over the board. The range of options included a replacement government agency,

privatization resulting in a re-born Fannie/Freddie-like entity, and creation of an FHA-like government guarantor for loans of all types but absent portfolio capabilities. Until this comes clear it will be difficult to justify private investment in infrastructure to support a new MBS market.

## **Liquidity**

The dearth of liquidity remains an ongoing problem. With a lack of private investment and TARP et al failing to stimulate the flow of capital, government sponsored enterprises are the sole source of liquidity.

### **Liquidity gaps in non-conforming loans and warehouse financing**

Two huge gaps exist today and no participant suggested they will close soon. The market for non-conforming loans (jumbo beyond conforming/jumbo, and any form of non-prime) is nonexistent. The only players for the foreseeable future may be those banks who provide portfolio loans to well-known customers. The second gap was a huge worry to participants at the conference – warehouse financing is difficult to obtain, leaving most non-depository lenders severely constrained. Even with Wells' announcement of a new operation, and GMAC's continued interest in adding customers (albeit with a 40% capture requirement), the warehouse lending market can be reasonably characterized as in crisis.

### **Private investment still sidelined**

Of strategic concern is the lack of private investment in the mortgage market; none of the speakers considered abatement of this concern in the short run to be likely. The combination of credit, collateral and systemic risks remains daunting (see the items that follow), so one can hardly blame investors. Risk premiums are likely to be significant if private capital is to be lured back to the party. Higher mortgage rates, possibly much higher, are the probable result.

Compounding this effect is the fact that many institutions are working on remediation of their existing portfolios and have stated an aversion to adding other investment vehicles during the course of 2009.

### **TARP and liquidity measure are ineffective**

The government programs aimed at restoring liquidity (TARP, TALF and PPIP) have been slow to start and to date largely ineffective. Complexity, political concerns and lack of clarity about some of the structures have kept participants away. Despite protestations from panelists, absent substantial change – either in the programs or the perspectives of their target 'markets', they may have marginal long term benefit.

The lens of some observers may be colored by their benefit from TARP and other spending and therefore lead to a more optimistic view. Current lack of liquidity is an indication of ineffectiveness and without an exogenous event or other impetus to invest, participants may be sidelined for an inordinate amount of time.

### **GSEs absorbing virtually all production via printing money**

Speakers asserted that Fannie, Freddie and Ginnie are taking about 99% of current production. Further, it was asserted that most of this production is being funded by Treasury (printing money vs. selling bonds). The question is how to transition to a normal market – if treasury tries to liquidate its mortgage holdings, it will surely drive rates up significantly, though higher rates are a likely consequence of current policy in any event. A corollary – one can easily be skeptical that the current rates include any semblance of the proper risk premium. In fact, if one believes that real estate values have not bottomed, then the current rates are irresponsible.

Implication:

- wider credit spreads, magnified by inflation and government debt-induced increases
- = much higher rates
- = drag on real estate values

This is an interesting repeat of the risk-ignorant behaviors (especially at FHA) that are being cited as causing this crisis.

## **Forward Observations**

Clearly the market will undergo major shift in addition to experience ongoing change. There is no clear path, especially given the fluid nature of the global situation.

### **Manual processing to restore trust**

The trust issues have some of their roots in underwriting standards and processing shortcuts that were engineered to increase processing efficiency. This may have long-term implications for the evolution of automated decision technologies, and could result in an indefinite return to traditional manual processing and underwriting, driving up cost (yet another contributor to higher rates).

### **Path to MBS market reform is unclear**

Reform of the ABS/MBS market is judged necessary if private investment is to return, but there is no consensus about how to achieve this. Rating agencies were subject to scorn, but there is no clear way put forth on to make their motives (their revenue) match investor risk concerns. Some postulate that MBS ratings will be ignored in favor of investors having their own risk assessment capabilities, but how this would be achieved is unclear as well. Certainly, community banks can't assess structured debt risks as well as a large private equity fund or global bank. Does that mean that small banks are out of the game except as whole loan investors to customers they know?

## **Conclusion**

Many participants reinforced the belief that US Treasury Debt-related inflationary pressures coupled with the higher rates required to attract private investment would act to further slow the real estate market in 2010 and beyond. This seems inevitable unless the administration changes course significantly, accepting a slower recovery by tightening credit carefully.

The current market for mortgages is in a significant respect artificial – one cannot reasonably characterize the US Government as a 'willing buyer' in a free market. The Treasury's political agenda (to support housing and therefore the economy) is enough to justify this position. True recovery and a return to a free market requires the Treasury to be replaced (as the mortgage funding source), at least in large part by private investment. Bank portfolios will be the first to return (in my opinion), but cannot absorb enough volume to cement the recovery. Until a vibrant MBS market returns, and until the US government is not the only source of credit for housing, there will be a cloud over the US Real Estate market. Given this outlook and the likely long duration of mortgages at today's price levels, portfolios are well advised to invest in loans with care –the Treasury-guaranteed bonds are a better option until spreads more accurately reflect risk.

All this uncertainty makes it difficult for those responsible for strategy anywhere in the industry. The market flexibility of the past 10 years will not return any time soon. The only certainty is that shops need to

be nimble in responding to changes in an increasing portfolio of government programs – loan servicing operations in particular will face significant stress in this regard.

This pessimism notwithstanding, there will be opportunities for companies able to respond appropriately. In fact, there is huge potential among small to medium size banks who could, with proper strategic guidance and diligent execution, seize the opportunity to achieve dramatic returns with a reasonable level of risk.

## **About The Author**

An Expert Advisor of Actionable Strategies, Frank Poiesz is an acknowledged expert in the mortgage field. He ran both Operations Services and Production Services for Aurora Loan Services (Lehman Brothers), owning the lifecycle from origination through to post-production while overseeing 476 staff. Mr. Poiesz has served as an executive in various institutions including President and COO at Fairfax Savings Bank and Chief Lending Officer at Third Federal Savings Bank and as SVP of Strategic Planning and Marketing at Pamex Capital Partners. He has also led the creation of several products in the space including a patented direct-observation loan valuation system, several paperless workflow applications, a correspondent lending platform, and a loan portfolio analysis system. Mr. Poiesz began his executive track in lending in 1984 as Director of IS at Virginia Federal Savings Bank eventually rising to CFO and attended Temple University's Undergraduate School of Business Administration.