WHERE *Do We* *Go from* HERE?

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A look back over the history of mortgage finance reveals how the industry survived past market turmoil. Today's competitors are plotting their strategies for surviving this time around.

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It was 5:00 on a Friday afternoon, and the men in suits had arrived at the headquarters building of the bank that I, Jeff Levine, worked for. I was over at the bank's mortgage operation center overseeing a team of file clerks endorsing notes that had been pledged to the Federal Reserve Bank to backstop a liquidity line of credit. The bank had been borrowing from the Fed for more than a month to stem a run on the bank that had been precipitated by large corporate clients fearful of the bank failing. ■ The bank—once the largest and most successful in the state—had run afoul of mortgage loan problems, having acquired an underperforming thrift saddled with bad residential mortgage loans and poorly underwritten construction and land-development loans. The government was about to intervene. ■ Sound familiar? This happened nearly 20 years ago, during the nation's last real estate crisis of the late 1980s and early 1990s. ■ In this article, we discuss the recent evolution of the mortgage banking industry, the policy issues that helped set the landscape for some of the problems we are experiencing, and our view on what the industry may look like in the future. ■ Core to our industry is the American dream of homeownership—a vision as old as Jimmy Stewart's Bailey Bros. Building & Loan Association in the film *It's a Wonderful Life,* and part of the bedrock of our consumer-driven economy. So how did we get into this mess? ■ The federal government's push for homeownership began in 1934 when President Franklin Roosevelt and

Congress created the Federal Housing Administration (FHA). At the time, the U.S. economy was struggling amidst the Great Depression and the housing industry was devastated. Would-be homebuyers had difficulty meeting mortgage loan terms.

Mortgage loans at the time required a borrower to make a down payment of at least half the property's market value. Mortgage loans had shorter terms (three to five years) and ended with a balloon payment. As a result, Americans continued to rent homes, and the homeownership rate hovered around 40 percent, according to the Department of Housing and Urban Development (HUD).

The establishment of the FHA provided federally backed insurance for long-term amortized mortgages. Thirty-year fixed-rate mortgages (FRMs) were encouraged to help keep the monthly mortgage payment low and prevent borrowers from being forced to refinance every three to five years.

Furthering the federal government's commitment to homeownership, the FHA administrator chartered the National Mortgage Association of Washington (quickly renamed the Federal National Mortgage Association) four years later, on Feb. 10, 1938. Through purchasing, holding or selling FHA-insured mortgage loans, Fannie Mae ensured there was a reliable supply of mortgage credit and a highly liquid mortgage loan market for private lenders. With this step, the federal government successfully gave birth to the secondary mortgage market.

Fannie Mae's authority expanded to include home mortgages guaranteed by what was then the Veterans Administration (VA). Tract housing and the growth of the American suburbs rode on the backs of returning World War II veterans, financed by VA mortgages. Commercial banks did not focus on residential lending, and sold their 30-year mortgages to Fannie Mae. Thrifts or savings-and-loans (S&Ls), most of which were mutuals with regulated deposit rates, kept mortgages on their books financed by lower-rate savings accounts and certificates of deposits.

Initially, Fannie Mae financed its loan holdings with debt but, over time, began securitizing loans to add more velocity and efficiency to the ever-growing mortgage market. Enabled by the 1968 Charter Act, Fannie Mae's securities were called mortgage-backed securities (MBS).

Created by the same act, the Government National Mortgage Association (GNMA—known as Ginnie Mae) guaranteed the full collection of principal and interest to investors on FHA and VA loans that were securitized into GNMA pass-through bonds. Freddie Mac—created by the Emergency Home Finance Act of 1970—issued securities called participation certificates (PCs).

The deals were very straightforward—mortgages were written in quarter-point increments and the bonds were issued at 50-basis-points-lower pass-through rates. The originating lender serviced the loan and earned a 25-basis-point service fee, and Fannie Mae and Freddie Mac earned a 25-basis-point guarantee fee. The thrifts that securitized loans through Freddie Mac usually retained a 5 percent to 10 percent participation interest in the deals (a concept being examined once again today).

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The 1968 Charter Act also transformed Fannie Mae from a government agency into a government-sponsored private corporation. Thereafter, Fannie Mae was to be owned by private stockholders. Fannie Mae completed the transition into a government-sponsored corporation two years later, in 1970.

In that same year, Congress created Freddie Mac under a charter similar to that of the newly private Fannie Mae. Once simply "protected" by federal ownership, Fannie Mae now needed to meet the growth and return expectations of private owners and faced new competition in a tight-margin business.

Inflation in the 1970s caused the thrift industry to de-leverage its balance sheets as deposit costs soared in excess of the 30-year FRMs they owned. Fannie Mae and Freddie Mac responded with product innovation in the 1980s, and innovation continued with jumbo loan conduits formed by master servicers such as Residential Funding Corporation (RFC), Sears Mortgage, Shearson-Lehman Mortgage and Citibank Mortgage. Jumbo loans conformed to agency guidelines except for loan size.

Out of these jumbo loan conduits grew alternative-A loans designed for self-employed professionals. They typically conformed to agency loan-size requirements and fairly-fully-documented underwriting guidelines but allowed for non-pay-stub income verification. With higher cash reserves and lower loan-to-value (LTV) ratios, alt-A loans accommodated doctors, lawyers and commissioned sales executives who did not have stable weekly/bi-monthly cash flows but could ultimately support monthly loan payments. Borrowers also could utilize alt-A loans to finance second-home purchases, but they, too, were subject to tighter and more conservative underwriting requirements.

The federal government's push for American homeownership was working. By the end of the 1970s, the U.S. homeownership rate had reached 65.4 percent, according to the U.S. Census Bureau. Improved liquidity gave Americans the ability to move, refinance and trade up.

Recognizing American homeowner mobility and demand for alternatives to the static 30-year mortgage, Freddie Mac and Fannie Mae introduced a five-year and seven-year balloon loan in the late 1980s and early 1990s to take advantage of the lower rate for shorter-term obligations on the yield curve.

Private lenders continued to drive product innovation. Around the same time, Merrill Lynch & Co. introduced an interest-only jumbo loan, as well as a 35- and 40-year interest-only loan, to its stockbrokerage clients, allowing them to pledge securities as additional collateral to either finance a second home or buy additional stocks with the equity in their house.

The tax-reform acts of the late 1980s and early 1990s led to the creation of new forms of mortgage securities. Real estate mortgage investment conduits (REMICs) allowed for financial engineering of cash flows and

fostered securitization-market expansion.

Credit scoring, automated underwriting and asset valuation also emerged and opened the doors of securitization to non-banks and non-traditional mortgage products (i.e., alt-A and subprime). Mortgage banks flourished with abundant liquidity, and raised capital through private and public offerings to build large origination and servicing platforms.

Deal velocity for raising capital and acquisitions increased significantly. During the 1990s and early 2000s, more than 50 mortgage banks, mortgage real estate investment trusts (REITs) and mortgage-focused banks and thrifts made initial public offerings (IPOs) and/or follow-on equity offerings raising more than $6 billion.

Mortgage brokers were a key part of the origination process as wholesale lending platforms enabled these new lenders to grow volume quickly. Subprime, 80/20 and 125 percent home-equity lines of credit (HELOCs) were all being pumped through the manufacturing system.

With the economy stalling after the bursting of the dot-com bubble and the 2001 terrorist attacks, the Federal Reserve began lowering the intended Federal Funds Rate (see Figure 1). Concurrently, the Wall Street securitization engine was just warming up. Mortgage-backed securities were repackaged into collateralized mortgage obligations (CMOs) and collateralized debt obligations (CDOs). Wall Street firms that underwrote these securities began vertically integrating to capture even a larger wallet share of these loans from origination to servicing (see "The Vertical-Integration Strategy," by Jeffrey M. Levine, *Mortgage Banking,* February 2007).

Wall Street successfully convinced investors and rating agencies that even the lowest-quality borrowers and lowest tranches of securitization could be repackaged to create desirable new securities when the underlying collateral was sufficiently dispersed. With ample access to liquidity, mortgage loan originators' product innovation was escalating, and underwriting guidelines were becoming more creative and flexible. A poor credit score, income that could not be documented, and no savings did not preclude individuals from homeownership.

A self-fulfilling prophecy materialized as lower interest rates and low-down-payment/interest-only loans inflated housing prices and enabled borrowers to purchase more expensive homes. These inflated housing prices bailed out defaulting mortgage owners and encouraged even more aggressive lending. And, as if those loans were not enough, lenders combined the worst features of interest-only, pay-option, no-documentation, investor loans into one product.

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Equipped with exotic loans, speculators left the busted dot-com market and invested in homes and condos instead, pumping up even more demand. Houses sold as fast as home builders could build them. Community banks, enticed by higher coupons and "quality" collateral, happily financed small developers with land-acquisition and land-development loans.

Encouraged by the pro-housing administrations of Presidents Bill Clinton and George W. Bush, Fannie Mae and Freddie Mac also were investing in the non-prime mortgages and/or "expanded approval" agency loans. Homeownership rates were at all-time highs; the American dream of homeownership was alive and attainable for everyone.

The party was spectacular. Mortgage banks could readily originate and unload loans, making exceptional profit along the way. Armed with the pitch that anyone can buy a home, mortgage brokers thrived. Mortgage brokers could make six-figure incomes with no prior experience. The federal government cheered as homeownership rates neared 70 percent in 2004, 2005 and 2006, according to the Census Bureau.

And then it was 5:00 on a Friday afternoon, and the men in suits showed up at the bank.

The looming crash, in hindsight, seems pretty obvious. Under the conjecture that home values would always improve, the mortgage industry came to focus on driving production and cutting costs rather than quality underwriting and risk management. Loan originators had lost touch with common-sense underwriting, and investors had distanced themselves from the borrowers.

Servicers had let their default-management capabilities lapse during the rosy economy, as troubled borrowers could easily sell their homes. Industry consolidation meant a delinquent loan might be serviced by a call center thousands of miles away from the borrower or, in some cases, overseas. Automated valuation models (AVMs) could not distinguish between two similarly sized houses six blocks away from each other but worlds apart in value, and an overseas collector couldn't differentiate between the housing market in Irvine, California, and Irving, Texas. Borrowers heard about loss-mitigation programs but did not know how to respond.

There were some early-warning signs. A *New York Times* article published on Sept. 30, 1999, warned that "In

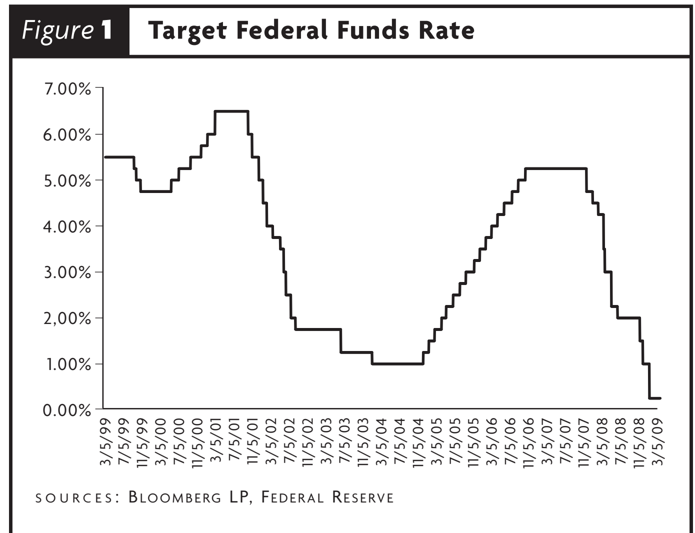


Figure **1** **Target Federal Funds Rate**

Sources: Bloomberg LP, Federal Reserve

moving, even tentatively, into this new area of lending [subprime], Fannie Mae is taking on significantly more risk, which may not pose any difficulties during flush economic times. But the government-subsidized corporation may run into trouble in an economic downturn, prompting a government rescue similar to that of the savings-and-loan industry in the 1980s."

Just short of nine years later in September 2008, James B. Lockhart III, director of the Federal Housing Finance Agency (FHFA), announced that Fannie Mae and Freddie Mac had been placed under the conservatorship of the FHFA. The variation between home-price appreciation and income improvement also suggested home-price inflation. From 2000 to 2006, new-home prices nearly doubled while median income only increased 15 percent, unadjusted for inflation, according to the Census Bureau.

Down payments and moderate LTVs will again become industry standards.

Strategic opportunities ahead

What's done is done. The devastated housing market and tanking economy will continue to dominate headlines. Politicians, businesspeople and citizens will undoubtedly offer their opinions on who is to blame. Our clients, however, are asking us the following important questions: Where do we as an industry go from here? And what will be the strategic challenges and opportunities presenting themselves from a mergers and acquisition (M&A) perspective?

Our views on the future of mortgage lending are anchored on the following premises:

- Americans will continue to buy and own homes;
- There is no substitution for a qualified loan officer or mortgage counselor;
- One mortgage product and underwriting approach does not fit all;
- Consumers want timely responses;
- Technology will continue to play a key role in lowering costs, but it cannot substitute for common-sense underwriting and servicing practices; and
- Securitization is a critical tool to create healthy banks.

Short-term stimulus and economic reform

During the next several months, the banking industry and subsequently the mortgage industry will need to come to terms with the state of the economy and digest the variety of stimulus and bailout bills being passed by the federal government. On Feb. 18, 2009, President Barack Obama announced a $275 billion housing bailout program. As announced, the plan will provide $200 billion to enable homeowners to refinance their homes with Fannie Mae or Freddie Mac. The remaining $75 billion is allocated to encourage lenders to modify loan terms. Similar to previously announced financial rescue plans, the dollar value is staggering, the potential effects are uncertain and the terms will likely change.

Regardless of who is to blame, the housing bubble and its subsequent burst reiterates the need for qualified loan officers or mortgage counselors. Borrowers need to be well informed of their obligations under a mortgage loan and loan officers need to be incented to encourage borrower acceptance of an appropriate loan and to fully disclose the loan's terms. As a result, originator licensing and compensation will face tighter restrictions from the federal and state government, and independent regulators.

We believe industry regulation will likely extend into loan structures as well. Mortgages will not be limited to 30-year FRMs, but the days of an exotic no-money-down, interest-only, pay-option adjustable-rate mortgage (ARM) with no documentation are a thing of the past.

Down payments and moderate LTVs will again become industry standards. Further, we predict new forms of rent-to-own programs will provide a path to homeownership for individuals with poor credit histories or insufficient savings to make a large down payment.

Faced with few options, borrowers are fairly powerless against creditors taking a long time to make lending decisions. As credit markets normalize, customers will again demand timely responses to loan applications. To facilitate timely decisions and lower origination costs, investment in new technology will be revitalized.

We believe advancements will focus on organization and presentation of data in order to expedite underwriting and credit decisions. Having failed in many circumstances, "black-box" credit-decision models will no longer be the sole determinant of credit approval.

Over time, we believe the role of Fannie Mae and Freddie Mac is likely to continue to diminish, past the current refinance and loan-modification initiatives. As their balance sheets shrink, there is a strong likelihood that both entities could be combined. While the Federal Home Loan Banks initially served as a source of financing, they are currently experiencing capital challenges and are not positioned to grow their balance sheets.

The large bank lenders stand to benefit from the shrinking of Fannie Mae and Freddie Mac, but possibly at the expense of the consumer who benefited from the standardization, technology and innovation that the government-sponsored enterprises (GSEs) delivered to the market. It seems natural that some form of securitization (velocity of capital) will be required to enable growth in the mortgage market, particularly with consumers who want a flavor other than the "vanilla" 15-year/30-year fixed-rate mortgage.

Perhaps former Treasury Secretary Henry Paulson's model of the GSEs acting as a utility providing government insurance to securitizations represents a viable future alternative. Regulators will foster this innovation to help banks diversify their funding sources. The exact form this alternative non-agency market might take is unclear and could include a combination of private conduits, covered bonds and REITs, all coupled with more common-sense underwriting and credit enhancement.

The outlook for M&A activity

In 2008, there were only 22 mortgage banking M&A trans-

actions announced—down substantially from 41 in 2007 and 50 in 2006 (see Figure 2).

In 2009, we will see an uptick in activity, but focused around access to funding and the sale and disposition of distressed-loan assets.

Access to funding is the biggest challenge facing independent finance companies today. Starved for capital themselves, banks are not renewing lines of credit and are looking to pull in lines of credit at any opportunity.

As a consequence, owners of independent mortgage banks are forced to make business decisions they otherwise would not make. This decision may be as simple as agreeing to a lower advance rate and higher interest rate on a warehouse line of credit or as dramatic as having to sell the company at a discounted or no-upfront premium. (As of the date of this article, the Mortgage Bankers Association [MBA] is meeting with the Treasury and FHFA to provide solutions to this warehouse-lending problem. Milestone Advisors, LLC is assisting MBA in this effort.)

Companies able to maintain access to financing will be positioned to drastically pick up market share. We foresee access to funding being the primary driver of M&A activity in 2009— healthy institutions (banks and independent companies) will opportunistically acquire assets at deep discounts; finance companies will look to acquire smaller banks to establish a more stable financing base; and, to a lesser extent, top-performing platforms will partner with larger financial institutions able to provide a stable funding source.

There is an abundance of assets (including whole loans, MBS, CDOs, CMOs and servicing rights) available as a result of companies de-leveraging their balance sheets, the closure of finance companies and divisions, and from bankruptcies. Ample supply and necessity to complete a transaction have significantly reduced asset prices, and well-capitalized borrowers are able to handpick assets and dictate the terms of the purchase agreement.

We anticipate deeply discounted asset acquisitions to continue throughout 2009. Milestone Advisors has completed a number of distressed-asset transactions on both the sell side and buy side. Through creative transaction structures, Milestone has provided distressed sellers with the opportunity to participate in the upside of asset sales. Similarly, Milestone has assisted buyers in valuing assets and structuring deals to provide protection where there is asset-value uncertainty.

Intrigued by the perceived stability and low cost of funds, many mortgage bankers are looking to acquire depository institutions.

In some cases, a servicing or special servicing platform will be acquired along with the loan and servicing assets (Milestone advised on two such transactions recently—the sale of the American Home Servicing platform to WL Ross and the sale of the First Horizon Home Loans platform to MetLife Bank).

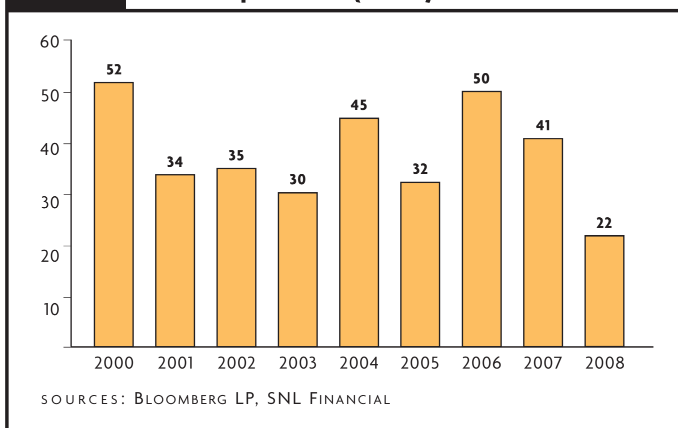
Intrigued by the perceived stability and low cost of funds, many mortgage bankers are looking to acquire depository institutions. Financial distress within many banks seems to suggest there is an abundance of potential targets. Before pursuing this strategy, however, we make sure our clients fully understand the regulatory process and capital requirements.

Recent examples of this depository acquisition strategy include Taylor, Bean & Whitaker's acquisition of Platinum Community Bank, Matlin-Patterson's recapitalization of Flagstar Bank, affiliates of Provident Funding's acquisition of Colorado Federal Savings and PHH Corporation's recent application for a shelf charter.

Finally, we are seeing top-performing loan-acquisition and special-servicing companies and management teams partnering with larger financial institutions and institutional investors to obtain a stable funding source and take advantage of opportunistic asset pricing. This partnership typically takes the form of a fund being raised around a management team or platform that functions as an asset manager.

Having completed a number of such transactions in the residential mortgage space in 2008, Milestone Advisors thinks the appetite for such residential mortgage loan "opportunity funds" is declining, but sees new opportunities in funds focused on land and development, construction and commercial loan assets.

Finally, we see disruption in the credit markets continuing through 2009, and survival will be the measuring stick of success. We anticipate restructuring initiatives being in the forefront of 2009 business goals. Having completed 16 M&A and restructuring deals in 2008, our firm is acutely aware of the types of transactions being completed and which restructuring strategies are effective. Regardless of health, we encourage companies to consult third-party advisers on the value of their assets and the stability of their funding. **MB**



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