



# Rebuilding the Mortgage Market— Loan By Loan



BNY MELLON

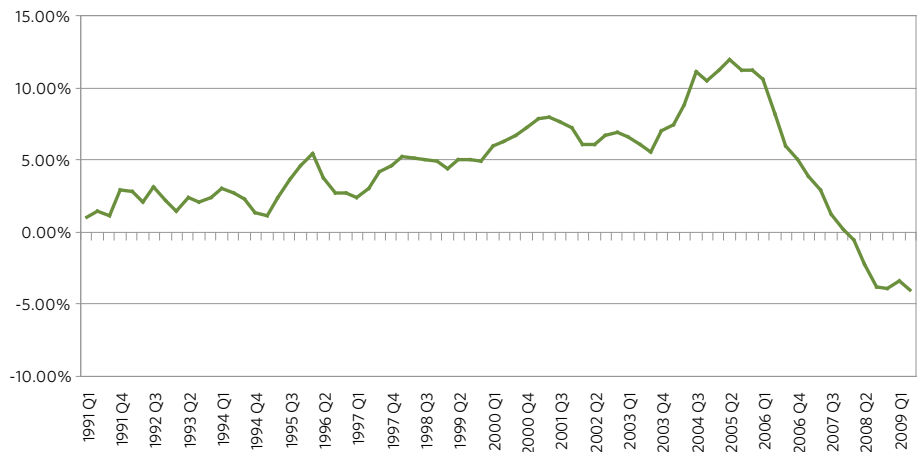
“At BNY Mellon, we consider it a responsibility of leadership to stay current with other thought leaders on the major issues of the day. To that end, we routinely explore these issues with key clients, and other experts in both formal meetings and informal discussions. The authors are grateful to the panelists at a recent BNY Mellon forum as well as to other colleagues and associates for sharing the expertise and wisdom on which many of the insights in this paper are based.”

Patrick Tadie

## Setting the Stage for Market Renewal

With the recession “very likely over,” as Fed Chairman Bernanke has said, both in the U.S. and around the world, the economy as a whole seems poised for recovery. At the same time, the domestic housing market, a key driver of overall recovery, is itself beginning to show encouraging signs of regaining stability. Housing affordability is at an all-time high, thanks to both government programs and the plunge in housing prices. Most experts expect to see a slowing of foreclosures and thus a cap on excess housing capacity by the end of 2010, which is also when the housing price decline is projected to level off and begin to rise.

**Housing Price Index**  
(% Change Over Previous Four Quarters)

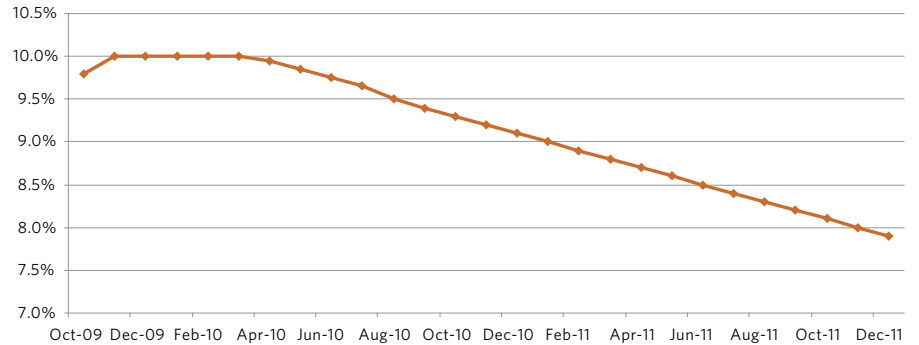


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Moreover, many analysts project a slight ebbing of unemployment in 2010, and since employment is the basic engine of the housing market—people without jobs or worried about holding onto their jobs do not buy houses—this too is a positive sign.

### Projected Unemployment Rate



Source: Royal Bank of Scotland

The stage is being set, therefore, for a renewal of mortgage activity and a rebuilding of the mortgage market.

The question for market participants is whether the information flow underlying the life-cycle of a mortgage loan will be ready for this renewed activity. Will there be a process in place that not only corrects the mistakes that led to the current collapse but also is sufficiently simple, rational, and transparent that it creates confidence in all the players in the market? That is the question. The issue it raises is how to transform the process to make it ready; resolving this issue successfully is key to rebuilding a viable and rewarding mortgage market.

### Information: Transforming the Process

Yes, economic recovery and a reborn housing market constitute the essential context for a renewed mortgage market. But experts and market participants alike know that the driver of a rebuilt market is the transformation of the underlying process that defines the life cycle of a loan: the flow of information from origination through interim financing and warehouse lending all the way to the sale or securitization of the loan.

There's a simple reason this process must be changed: Investors, burned and chastened by the market collapse of 2007, will accept no less. What burned them was information that was inadequate, inaccurate, opaque, and very difficult to find, examine, and control; as a result, today's chastened investors doubt the very credibility of the mortgage product itself.

If that credibility is to be recovered—even better, renewed—investors will rightly ask to test the information process at every stage along the life cycle of a loan, and they will demand new levels of due diligence, information transparency, simplification, and standardization, along with monitoring and surveillance activities for ongoing validation and control. Unless and until the process can fulfill these demands, investors will not be ready to invest, and there will be little certainty that originated loans will find an outlet in a secondary market. Yet it is that certainty of takeout down the line that is required to fuel the market and enable mortgages to be written.

Mortgage market participants have no power to influence macroeconomic recovery, nor can they turbo-charge domestic employment. Those drivers of a rebuilt mortgage market are not within their control. What is within their control, however, are the operational aspects of the information process, and that is where the market's focus needs to be today. The challenge is to ensure access to, transparency of, and control over the information that flows from origination to securitization. It is a challenge that is being addressed today by participants from various corners of the market, who are at work on a range of operational, procedural, and regulatory changes that may help forge information guidelines in which investors and others can have confidence. Notable among these efforts are e-registry initiatives by MERS (Mortgage Electronic Registration Systems), Project RESTART by the American Securitization Forum, our own BNY Mellon efforts on auction pricing, trading analytics, and e-vault efficiencies, and initiatives by other financial institutions and government agencies working individually or collaboratively.

For all of us engaged in these efforts, the question is what changes are needed across the information process of the loan life-cycle in order to re-ignite investor confidence and give originators the certainty that there will be a secondary market eager to invest in mortgage loans.

### **Origination: No Way to Go But Up**

What will jump-start the mortgage market out of its current doldrums? In terms of transactions, there is a fairly solid consensus that, as one expert has put it, “clean jumbo paper” will lead the way—safe, predictable, low-risk. But there is an equally solid consensus that whatever the specific battery that eventually re-charges the market, the infrastructure itself needs work. Where the information process is concerned, that work must start with underwriting at the point of origination. Flawed underwriting standards and procedures were certainly among the causes of the current decline in nonconforming origination—down from a peak in 2007 of \$4.35 trillion in mortgages to about \$2.1 trillion in new loans this year.

Instead, origination today is virtually all agency product. With uniform standards and of course government guarantees, government-sponsored enterprises (GSEs) are supporting some 60 to 70 percent of all new single-family home loans and 80 to 90 percent of the multifamily market.

Moreover, the Federal Reserve is buying more legacy loans than all the new originations and is putting them on its balance sheet. While this may well result in increases to interest rates and risk spreads by some 30 to 50 basis points, the Fed is likely to slow its buying over the next nine months, and it is already exploring how to dispose of these loans.

Nevertheless, there is no denying that government involvement has certainly been the stabilizing factor in today's mortgage market.

In the private sector, big-bank originators are today in the forefront of new mortgages—Wells Fargo, Bank of America, J.P. Morgan Chase, Citibank. These institutions have the balance sheet to be in the market despite the uncertainty of a takeout down the road. Their entry into the market is not passive; indeed, they are creating homegrown information standards to inspire their own investors with comfort, and these standards are writing a new page of due diligence for the market as a whole. Similarly, the large regional banks—TD, Commerce, PNC—have some balance sheet they can apply to mortgages, but it is limited and costly, and they are setting extremely high standards for net worth. In many cases, these lenders are requiring that the loan be sold to them as a condition of financing.

Bottom line: new nonconforming origination, while minimal, is already beginning to tighten and strengthen the information process.

It is at the mid-tier of the private market that the real paucity of origination is so dramatic, for this is where the great volume of mortgages has traditionally been written. The recent failures of Colonial and of Taylor, Bean & Whitaker (TBW) demonstrate the point vividly: Colonial was a lender to TBW, which in turn funded more than a hundred mid-tier originators. The loss of these two institutions therefore was really an exponentially greater loss—in a sense, the loss of several links in the “food chain” that could satisfy mortgage appetite—and it has closed down almost all origination for this important tier of the market.

### **Needed: A Change in Mind-Set**

What will get origination going again?

Investors say the mortgage product itself is flawed—too complex, too opaque—and needs to be re-designed.

The government, now in the process of re-addressing the policy goals that will shape its marketplace role, is likely to offer recommendations on such issues as fixed-rate mortgages, pre-payment penalties, and foreign capital, and these policy recommendations will doubtless affect the shape of the mortgage product going forward. Some reforms now being suggested would require originators to have skin in the game; the current proposal would compel originators to bear up to five percent of the credit risk of loss on every loan. Such a demand would certainly change the shape and content of the origination marketplace and encourage more stringent standards. It would also conceivably price a lot of originators out of the market altogether.

Still, while market participants wait for ultimate product changes, we must nevertheless work on transforming the origination process to correct some of the fundamental flaws of current underwriting standards related to loan verification, portfolio analysis, transparency, and document custody reviews at the very outset of a loan's life cycle.

### **Changing Roles and Quality Control**

The changes must start with rigorous underwriting standards for loan-level detail including details on borrowers and collateral. It must also include surveillance of the detail at key points during the life cycle of the loan.

BNY Mellon is collaborating with leading market vendors to offer a proprietary suite of analytic and surveillance tools—a detailed data-validation service—that confirms such borrower data as credit scores, financial statements, and collateral profiles. Such validation establishes the benchmark for ongoing valuation and risk metrics on the loan and is essential to the investor who may want to sell the underlying security.

Ratings by nationally recognized statistical rating organizations (NRSOs) will continue to be important. Today, the criteria for a triple-A rating are much higher than they have ever been, and regulatory reform proposals that would build higher walls between rating agencies and the businesses they rate can only strengthen rating agency credibility further. The fact is, as one expert has put it, “from a regulatory standpoint, you're going to need a rating in order to see what your risk-based capital guidelines are going to be and whether or not that is the standard.” Again, without such a standard, investor confidence in the securitization process is apt to be shaky, and it needs to start at origination.

Some experts believe, however, that investors should not rely solely on the rating agencies. Instead, investors will need to do their own homework, and they will need to see data sorted across a range of filters and parameters and then normalized for their analysis. This is precisely the sort of gap BNY Mellon stands ready to fill with our portfolio analytic services.

In addition to underwriting standards that are both more rigorous and uniformed, accounting standards must also be consistent and in accord on a global basis. Accounting standards are one language where what gets lost in translation can be very costly indeed.

### **Interim Warehouse Financing: The Well Is Dry**

Virtually all experts agree that the assurance of stable and secure interim financing is essential in a viable mortgage market, yet today, for individual or securitized loans, much interim financing has virtually dried up. With no equity cushion, private independent mortgage bankers lack the liquidity necessary to maintain a healthy business flow, and although interim financing—warehouse lending—is a key stage in a loan's life cycle, the industry right now has too few originators with too little capital to sustain profitability. One expert estimates that the universe of warehouse lenders has shrunk from approximately 100 at the market peak in 2005 to fewer than 30 today, and of the 30 that remain, "many are smaller lenders, certainly not able to meet the demands." It is likely that there are 20 mid-size borrowers in line for every dollar of warehouse lending available. Reinforcing this reality is the recent entry of big players into the market; they are looking only for clients with large equity positions.

Moreover, for many, the interim-financing cash bucket is empty. Parties long in cash who once would lend against an asset for a short term or overnight repo were badly burned in the credit crunch—and were negatively affected by the lack of transparency and control over collateral.

Meanwhile, the question of an interim financing role for Fannie or Freddie is being discussed and debated. One idea is for GSE participation in a warehouse line similar to the way syndication works. Alternatively, the GSE might use its authority to offer a performance guarantee—i.e., to stand as a backstop in case of loan failure. Ultimately, this is an issue to be decided at the policy level, but that it is being raised at all is significant.

### **Electronics and Efficiencies**

Within the immediate scope of control of market participants, however, is the operational intensity of the interim financing phase, which involves numerous clearing, settlement, and document custody functions. By definition, these functions are heavily paper-based—with all the risks paper entails. Indeed, add those risks to the failures of information transparency and accuracy, and you have a recipe for the financing collapse we're seeing today. That is why market participants like BNY Mellon are heavily involved in addressing such issues as data validation, collateral valuation to quantify risks accurately, and collateral management through strong document custody—all essential operational processes for warehouse lending.

In our view, valuation of the servicing rights, fraud prevention mechanisms, and quality assurance tools must all be pushed upstream to the point of origination to serve as a benchmark. In fact, all the data entered and checked at origination needs to be monitored and validated again before interim financing can be credibly established.

How is this to occur? The best answer is in electronic form—the soundest way to ensure control of data transparency as well as to achieve benefits of speed and lowered cost. In the pre-2007 paradigm, a loan would move from origination to a document custody shop, where time and resources would be spent on re-review, then, when sold, to another custodian, again requiring time and resources for re-review, and again to another and yet another custodian. The expenditure of operational effort and dollars for transit, re-review, and re-certification at each sale of the loan was enormous. Moreover, the time spent in re-review was time registered on the internal balance sheet, as the holder of the loan would be unable to obtain external funding at that time. All in all, this represented a cumbersome, inefficient, and costly process.

Electronic processing and validation in this and subsequent stages of a loan's life cycle could greatly diminish the cost, the inefficiency, and the encumbrance while mitigating risk and fraud, increasing liquidity, and thus effectively raising the value of the portfolio. Such e-enabling is the surest path to standardization and an eventual central e-repository that can ensure the accuracy and comprehensiveness of essential data. Most observers agree that the industry is headed down that evolutionary road in any event, and the nascent tracking and validating models being designed by a number of market participants, including MERS and BNY Mellon for the dematerialization of tri-party repo and document custody, are welcome harbingers of this desirable inevitability.

### **Securitization: Down, But Not Out**

There is little question but that off-balance sheet securitization is today regarded in a bad light. Investors remain nervous and apprehensive, deal parties are at odds with one another, and there is little product available. What seems certain, however, is that the advantages of securitization for investors are formidable, and what seems almost as certain is that investors want back in. “Securitization is still a viable financing alternative,” says a high-ranking executive of BNY Mellon, “and there is still a demand for bonds.”

But information failures in the market really come home to roost at the point of securitization, certainly on the nonconforming side. And the emergence of new asset classes, including covered bonds and Islamic finance, do not as yet seem sufficient to re-ignite this stage of the mortgage market. Still, most experts expect that securitization products will re-emerge—as both new originations and legacy assets.

Some analysts see movement on the part of large investors and some new niche players on the market sidelines. Flush with cash, these investors appear willing to move into the legacy loan arena because of the higher yield offered by the subprime bonds. And although the risks are also higher, there is recognition that these troubled assets are not “unknowns”. Investors can see where they have come from and how they arrived where they are today. Equipped with models and performance curves, they can therefore derive reasonably accurate valuations of these investments—and seem willing to put money behind the valuations.

### **Evergreen—With Total Quality Management**

“Simplification, standardization, transparency.”

That is the simple formula offered by the managing director of a premier investment bank to define what it will take to ensure evergreen securities—securities about which investors feel perfect assurance that comprehensive and exacting due diligence has been performed.

Other experts speak nostalgically of “getting back to basics” with simpler structures and more attention to detail and more pertinent data plus the standardization and wider disclosure embodied in a process of central notes tracking. In some cases, oversight may be necessary to ensure that a product is evergreen—conceivably by an independent third party engaged for just such a purpose.

Two sets of market participants are primarily responsible for the changes that can affect this needed clean-up to ensure the viability of securitization. One is investors. They need to be more of an activist in their examination of the underlying loans—down to the level of checking performance in specific zip codes or of specific borrowers. In the past, all the checking was at the point of origination, and those checking tended to be pretty passive about a case of credit score drift or a borrower’s less-than-stellar payment history. Just as passively, they awaited a servicing report on a portfolio, secure in the assurance that prices were going up and they were covered. No more. Participants now must take on some of the responsibility for their assets and their pools—and must do so proactively. All they need is the tools.

That is where the second set of market participants comes into the picture—namely, service providers. They will need to create the tools that can substantiate the due diligence—some sort of Good Housekeeping seal of approval that certifies the product as evergreen. To ensure that they do this, there are investors who say that providers too need skin in the game, with some asserting that providers need to “put your name personally behind the product, as well as institutionally.” Such a requirement, the thinking goes, can compensate for the fact there is currently little incentive for total quality management from the point of origination through to securitization. And total quality management across the range of the loan life cycle is a sine qua non of replenishing investor confidence, renewing securitization, and thereby rebuilding the mortgage market.

### **One-Stop Administration of the Loan Life-Cycle**

Simple, standardized, transparent: We concur with the investment banker who articulated the formula; it provides a sound basis for the kind of total quality management—from origination to securitization—that can restore confidence in the mortgage product and process. We believe that the ideal way to achieve the formula is through a single, central point of service—electronically based—for collateral control, dematerialized document custody, and loan administration. Dematerialization eliminates the paper that proved so costly and cumbersome in the pre-2007 paradigm. Standardizing the process through e-enabling ensures the transparency that is at the heart of effective collateral control.

Such a model must be envisaged and realized as a core competency, not a servicing support or afterthought. As the core of trusteeship, the model does more than simply avoid the kind of market collapse that now afflicts the industry. We believe it will build a new mortgage market on a stronger foundation and usher in a new era of activity that will enrich all the participants in the market.

For further information, please contact:

**Jean Wynn**

1 212 298-1945

Jean.wynn@bnymellon.com

**Patrick Tadie**

1 212 815-2128

patrick.tadie@bnymellon.com



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[bnymellon.com](http://bnymellon.com)

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