

Wall Street Trading Desks Battle For A Share Of Mortgage Product

Large investors with their own trading desks are giving Wall Street firms a run for their money.

By Jerry DeMuth

Wall Street securities trading desks are losing mortgage product to large financial institutions who have entered the securitization world just as the government-sponsored enterprises (GSEs) have been losing mortgage product to the nonagency market, and the Federal Housing Administration has been losing market share to subprime lending. That's the view of speakers at the Mortgage Banker's Association's (MBA) Secondary Market Conference held in Chicago last month.

Even the credit rating business may be opened to more competition.

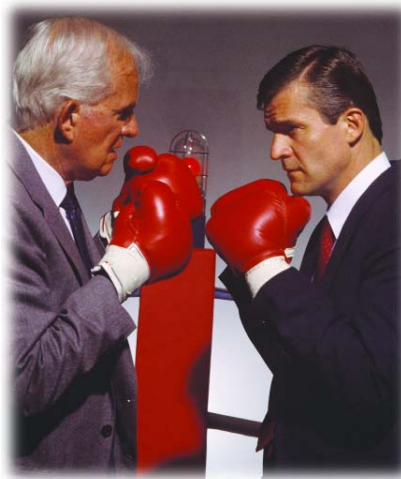
"We also think the mortgage insurers, as well as the GSEs, will struggle going forward," said Paul J. Miller, managing director Friedman, Billings, Ramsey Group in Arlington, Va.

Acquisition and merger activity will continue, said John M. Robbins, MBA chairman-elect and CEO of San Diego-based American Mortgage Network, which recently was acquired by Wachovia.

"It's about accumulating mortgage service and market share," he explained. "Those that have the most retail branches and are dominant

will get to digest the lion's share of the opportunities that are possible."

The changing secondary market is transforming how loans are being originated and will determine who



will be dominant and successful. The nonagency market, he predicted, will continue to increase and the GSEs will become less important, just as FHA lending has.

"I think the GSEs don't really understand what's going on," Robbins charged. "They keep thinking we're going to go back to the 30-year, fixed-rate mortgage and the days of the GSEs' dominance are going to come back, but the secondary markets are now very mature. They've passed the GSE time span."

The nonagency market is not only much larger, but also more savvy, as technology has narrowed the in-

formation gap, Miller explained. Strong market appetite has increased demand for nonagency securities, boosting liquidity to the overall market.

Even nonagency securitizations of prime loans have grown tremendously since 2000, he pointed out. "This was stuff that always went to the GSEs, and now it's going directly out into the market through credit enhancements without Fannie and Freddie."

Robbins hailed the GSEs' move into Alt-A, calling it "a very good move" that will provide the much-needed additional liquidity. The move also will enable small and medium lenders to sell Alt-A loans they originate without having to go through a correspondent purchaser.

Wall Street perspective

Over on Wall Street, Lehman Brothers, which has a large trading desk, is trying to increase its wholesale and correspondent staffs, Miller pointed out. "They know that the big pipelines of Countrywide and WaMu are being siphoned away from their own trading desk. Countrywide is now trading two-thirds of all the mortgages they produce on their own capital markets trading desk."

Countrywide will be the model in the near future - one that already is being replicated by WaMu as well as Wells Fargo, he said.



ROBBINS

“Upstarts” like Countrywide and IndyMac, Miller said, are boosting the secondary market for option ARMs with their plans to sell, rather than portfolio, these loans.

“We never had a really huge demand for ARMs in the secondary market until about two years ago,” he said. “The only ones who originated ARMs were the huge thrifts who put them in their portfolios. The old thrift models that did portfolio this product will come under more pressure to sell them into the secondary market.”

“The five big aggregators are going to be able to do two-thirds or three-quarters of their own production,” predicted Douglas G. Duncan, MBA senior vice president and chief economist. “If the investment banks that have these big trading desks for mortgage-backed securities don’t get some type of production on their own, they will probably have to exit their trading desks because they won’t be able to get an adequate return on their capital. Either they go out and acquire it, or they build it or

they exit somewhere down the road.”

To remain strong, large mortgage players must become vertically and horizontally integrated, Miller explained. They will originate, service and portfolio loans



DUNCAN

they think provide better return on equity. They will also trade the loans in capital markets, and securitize and issue the product themselves, taking business away from Wall Street.

Those players also will have to originate prime, Alt-A, subprime and other niche mortgage products, Miller maintained. Mortgage banks that are doing well can deliver all these products, while unsuccessful ones are mainly niche players.

“The big originators have to either diversify into other products or they will continue to become less important in the mortgage world,” he concluded.

The fact that large financial insti-

tutions, said former Securities and Exchange Commission (SEC) Chairman Arthur Levitt, have gotten into mortgage securitizations is “very positive” because it has added liquidity at a time when “mortgage products have, as a result of institutional interest, become as much a part of an investment portfolio as stocks and bonds.”

“It’s critical to the explosive growth of the market and to the transparency of these markets,” he added.

The SEC will open the credit rating business to competition “as a result of Congressional pressure,” but there will be a limited number of new players, he predicted.

If the credit rating business was opened up to anybody, he explained, the business may “play to the lowest common denominator,” lowering the accuracy of ratings.

“How soon this will come and what standards will be like, I’m not quite sure,” he admitted. “But recent market disciplines in terms of the

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multiplicity of new products and the fact that risk measurement has become a major American industry makes this extremely important and essential.”

End of the 30-year loan?

“There is a structural change underway, and the 30-year fixed-rate is going to be less important in the future than it was in the past,” Duncan said. “It will be a little while before it goes away but certainly the trend is in that direction.”

People are going to match the time of their mortgage to the time they expect to be in the house, and also match the type of their mortgage to their life style or to where they are in the life cycle because costs have been lowered and there are many flexible products available, he said. That means the share of adjustable-rate and adjustable payment mortgages will be higher than in the past.

These mortgages include interest-only loans, which are “relatively low risk,” Duncan said. At least nominal appreciation will occur since never

in history has there been a 10-year period without house appreciation. Thus families will be left with at least some equity. Price appreciation this year, he said, should average 6% nationally.

Duncan predicted that interest rates will stay low, but will continue to rise slightly by another quarter of a percentage point by the end of the year. The 10-year Treasury will be at about 5.2%, and the 30-year fixed rate at 6.9% or 7%.

“That’s still a good interest rate,” he said.

Delinquencies, which are at about a 20- to 25-year average, will go up a little bit over the next few quarters, but this has already been priced into the market. He forecasts about a \$2.5 trillion mortgage market this year, down from an estimated \$2.9 trillion for last year.

Miller doesn’t see a credit issue until late next year. “And even if we had it in late ’07 or early ’08,” he said assuredly, “we think the secondary market will adjust very rapidly and just move on. So if there is a major credit

hiccup, we don’t think it will lessen the liquidity out there for mortgages in the secondary market.”

While important changes are occurring in the mortgage industry, one important change has yet to occur, according to Miller. That is the need for the large originators to streamline their servicing platforms so that they can hold onto their current customers.

“Countrywide, WaMu, Wells Fargo and Citi have very large servicing portfolios, but they have not, to date, done a very good job to streamline those platforms in order to get their customers to come back. Usually the local mortgage banker or the wholesale broker is able to refi those loans over and over again and take a quarter point out of the transaction,” he said.

“If they ever get to the point where they are getting 40 to 50 percent of their servicing portfolio to refi with them, I think these big originators will be able to completely dominate the space. And that’s where we think things are heading.”

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Jerry DeMuth is a freelance writer based in Chicago.