

# DealPoints

Newsletter for community lenders

Volume One, No 1 Fall, 2008

## Constructing the Residential Housing Solution By Emil Fanelli

*"We are all faced with great opportunities that are brilliantly disguised as impossible situations."* - Charles Swindoll

As the real estate housing market continues its abysmal slide, our leaders in Washington continue to debate about whom to blame for the current debacle. With fingers pointing in a seemingly infinite number of directions, one can hardly weigh in without getting an eye poked.

At the risk of losing an eye, I'm not here to tell you how we can stop the real estate slide, but I can tell you who will play a significant role in the long-term solution. You, the friendly neighborhood community-based financial institution, will be prominent in the U.S. residential housing market in the coming years.



Emil Fanelli

Today we are in the midst of a mortgage lending sea change and make no mistake about it, opportunity abounds. It won't be easy to assert your place in the U.S. residential

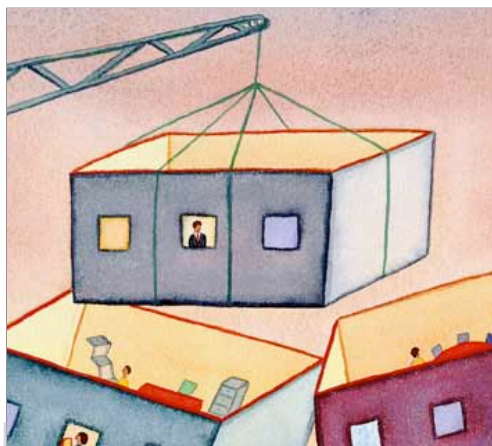
lending model, but there are ways to navigate the short-term risks—and build momentum for the future.

### We're Not in Kansas Anymore

The mortgage market of the 1980s was dominated by thrifts. Fannie, Freddie and Wall Street did not emerge as major players until the Financial Institutions Reform and Recovery Act (FIRREA) was passed in 1989. Following FIRREA, the balance of power shifted to mortgage banks, led by some of the same management talent that created lending franchises for thrifts.

At around the same time, mortgage brokers inserted themselves into the loan origination channel, securing their place in the process. This structure has served as the industry's backbone for nearly two

decades. The 1990s up to the recent past was a period of innovation for Wall Street, the dominant source of mortgage capital. Investment houses saw insatiable demand for mortgage-backed and mortgage-related



securities and developed exotic loan products for consumers—and even more exotic securities for investors. Buoyed by rising home values and a desire on the part of consumers to jump on the home gain bandwagon, loan origination volumes and home ownership rates rose to historic levels, peaking in 2005.

Today, mortgage capital markets are suffering a historic liquidity crisis caused by the perfect storm of falling home values, a softening jobs market and a global economy weakened by rising energy costs.

Companies that led issuance of mortgage securities have discovered that exotic instruments such as Collateralized Mortgage Obligations (CMOs) and Collateralized Debt Obligations (CDOs) are not "off-balance sheet" transactions. They loom large on the balance sheet, particularly when they are non-performing. In turn, mortgage bankers and their broker partners have been swept up in the turbulent wake, forced to repurchase questionable loans and scramble for mortgage capital.

The future of the mortgage securities

market has been permanently altered. The time will come when the regulatory hounds will be unleashed and the demand for "transparency" will reduce many of the former advantages of securitization. Issuers will likely have to reserve capital, which will level the playing field between portfolio lenders and (Wall Street) conduits. Spreads will normalize, creating investment opportunities for portfolio lenders. And, yes, real estate housing will achieve equilibrium between real incomes and home prices. In other words, collateral will improve and yields will return.

### A Call to Action

American consumers are disenchanted with the "power brands" of the past. They now want to deal with companies they're familiar with from first-hand experience. It's time for smaller financial institutions to come out of the shadows cast by large, commercial banks and Wall Street and leverage the trust they've earned with their constituents.

### Why Mortgages? Why Now?

Despite the recent upheaval, housing will always play a key role in the growth of the U.S. economy. More than ever before, American consumers need effective and responsible lending choices. More importantly they feel a need to trust their lender.

For community lenders, mortgage products have always been and will continue to provide a powerful mechanism for broadening financial relationships with consumers. While the opportunity is not without risk, there are ways there are ways to manage the shorter term housing and capital risks as you build a mortgage presence in your local community.

### The New Market Model

The securitization era is about to take a back seat to the portfolio model. The GSEs are over leveraged and they face increased

*See backside to continue*

## ... the Residential Housing Solution

regulation by legislators who are about to open Treasury coffers to strengthen the Federal government's support of their charter. Look for their roles to diminish drastically over time.

Wall Street has been burned by its own highly leveraged practices. The Street has to nurse its way back to health by drinking from the Federal Reserve's generous liquidity vehicles. Accordingly, it will be subject to more regulatory oversight. In Wall Street optics, government regulation equals modest returns, which equals death. Don't look to Wall Street to reenter the mortgage market in a meaningful manner for years to come.

Expect an increase in regulatory pressure on mortgage brokers, focusing on accountability (read "disclosure") and licensing requirements. The exodus of mortgage brokers will continue as regulators add new layers of accountability and barriers to entry.

Portfolio lending will become a major source of mortgage capital. As the playing field levels between security issuers and portfolio lenders (the market will no longer reward risk), credit spreads for portfolio lenders will normalize and stabilize, which will also help improve margins. Improved margins will make the mortgage product a compelling investment. Most importantly, housing will find a bottom.

### When is the Right Time to Enter?

In the near term it will be necessary to preserve cash and capital. As the real estate problems ripple from residential housing and into the commercial lending side, banks will continue to add to loan loss reserves. Until our economy works through the de-leveraging cycle, cash will continue to be king.

If you are funding mortgages today you might want to consider moving to a wholesale model. You can reduce your infrastructure, and continue to offer the product to your deposit base, thus minimizing capital exposure. However, beware of wolves in sheep's clothing. Many wholesalers pay handsomely for your client relationships because they want the cross-sell opportunity. In other words, they want your deposits.

If you aren't offering mortgages today, you can test the water by entering with a model that minimally impacts your infrastructure by forming a relationship with a mortgage service provider. In this model you have the opportunity to leverage their efficiencies, experience, and capital market relationships without investing heavily in brick and mortar. You secure the opportunity with the customer and the mortgage service provider processes and closes the loan.

Look for a mortgage service provider who is willing to work with your management team to devise a customized solution that fits your organization. Too often you'll run into companies that say they offer a customized solution, but after you have spent countless hours and dollars rolling out their products you'll find that you've been handed a shrink-wrapped program.

Those of you in the mortgage market today have learned that there are plenty of secondary market options for your company. Most of those options are paying up to get a firm grip on your customer/depositor. You need to find creative ways to build a firewall between your client and the power brand competitor. Find a mortgage service provider that will not only help you offer mortgages, but work with you to develop a deposit solicitation firewall.

In the short term you can contain your capital and credit risk, but

### What to Ask a Mortgage Service Provider

- **How much experience do you have in lending in my communities?** As the market retrenches to quality, you want to work with a company that understands real estate values in your local markets. When you entrust your customer to a third party, their requirements and decisions reflect on you, so choose a mortgage service provider that will not make unreasonable judgments about your customer's loan.
- **Are you willing to tailor a relationship to my bank's business model?** Some mortgage service providers offer cookie-cutter solutions, where you are expected to operate within very rigid guidelines. Your role may be diminished in the transaction, and your protections against cross-sell may be few. Choose a provider that is willing to structure a program that helps you meet your strategic objectives.
- **Do you have experience to weather tough market conditions?** For obvious reasons, durability of the mortgage service provider is a major consideration. Factors such as years in operation, the breadth of investor relationships and the quality of staff and management are key indicators here.
- **Do you have a strong service discipline?** While you are handing your clients over to a mortgage service provider, and your company will reap the rewards of a good experience, be mindful that you will suffer the consequences of poor execution.
- **Will you work with me to help my bank succeed at mortgage lending?** The ideal mortgage service provider is interested in your long-term success, and should be enthusiastic about structuring a customized program, helping you implement and promote the program to your customers and willing to make adjustments along the way. Investigate the level of investment the provider is willing to make in the relationship, as it reflects their commitment to your success.

you'll require a longer-term strategy that assumes manageable levels of risk as the housing market moves through the down cycle. You might not recognize the bottom until after the fact, but you can put your institution in a position to take advantage of the improving economy. When the market turns positive, you will want to have momentum so you can take advantage of emerging opportunities. Look for a mortgage service provider that can help you formulate your longer-term strategy.

## FirstCal

First California Mortgage Company

5401 Old Redwood Highway North  
Petaluma, California 94954  
Call 661.369.2774 for DealPoint

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