

The synthetic debate

Here's a thought: does the burgeoning credit-default swap market create a new way for investment banks to create mortgage-backed securities, obviating the need to buy a lender? It seems the market cannot agree. Below two mortgage experts share their opposing views:

"The credit market has already proved that you don't need to be a big corporate bond underwriter to succeed in structured credit. If I get really efficient in the mortgage-backed synthetic market, I can afford to pay the whole gain on-sale-price to the originator yet not have the costs of owning and running an origination platform. It might be worth buying a sub-prime business in, say, six months. It's still an outdated strategy, but once the prices really come down it's not a bad one. Then when the Fed drops rates, there'll be another refi wave to ride."

David Martin, UBS

"Not really. The synthetic market is still very young, for starters. Also consider what will happen in the next refinancing wave or upswing in the housing market after all the consolidation and closures we're experiencing now. With less capacity, the lenders that are left will be able to command a larger whole loan premium from originating mortgages and selling them to the MBS market. Synthetic deals won't capture that."

Jeff Verschleiser, Bear Stearns

Buy or Build

The vertical integrator's dilemma

Vertical integration — also known as eliminating the middlemen from the food chain — is one route capital-markets underwriters are taking to boost earnings. But owning a piece of all parts of the business is not everyone's cup of tea.

What's an investment bank to do? Former customers like retail banks and finance companies that used to be handy sellers of loans to fuel their mortgage-backed securities business are now becoming competitors. Meanwhile, a couple of rivals have just profited handsomely from the last boom in the housing market by doing precisely what others eschewed in the last few downturns — buying mortgage lenders. Now new players are jumping into the game. CDO managers are considering acquisitions to gain better access to mortgage loans to stuff into their next deal. And cash-rich private equity firms are sniffing around looking for their own piece of the pie.

Welcome to the myriad considerations that are driving one of the most important changes in the securitization markets — vertical integration. What is it exactly? No detailed answer would be the same as another. But at its simplest, it "means taking out as many of the middlemen as possible from the value chain," explains Michael Commaroto, head of home equity whole-loan trading for Deutsche Bank in New York. "In a narrower sense, it means capturing the spread from the creation value of the loan to the full offer price of the bonds." Everything from making the loan to trading the asset-backed securities gets done by one firm. Look at it as a full self-service model, if you like.

It's a strategy that can be applied to any lending market, anywhere. Lehman Brothers, which already has a strong mortgage origination operation, bought two different platforms last year. One was small-business lender

Capital Crossing, a similar business to one Lehman already owns in California. Such loans are increasingly in demand for CLO product, and have a potentially broad and global investor base.

The second was Campus Door, a student loan provider. Increasing college attendance and fees have driven up borrowing, and made student loan-backed bonds the fastest growing securitized sector in the U.S. after CDOs. [See article, page 22.]

Lehman's competitors are doubtless looking at these markets as well. But the U.S. sub-prime mortgage sector is still the most enticing. "Integrating the mortgage product first makes sense," says Commaroto. "It's one of the most prominent fixed-income products, and sub-prime mortgage attracts a lot of fo-

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cus as it requires a lot of capital both to originate the loans on a profitable scale, as well as hold residual risk. That means there's more benefit to be reaped from integration."

The key point to remember is that it's not just the buying that counts. It's the integration. "Simply buying a mortgage originator and having it operate in a stand-alone capacity without leveraging the infrastructure of your institution is not something I would consider vertical integration," says Jeff Verschleiser, co-head of mortgage trading at Bear Stearns.

The recent sharp downturn in the sector has complicated strategic decisions. Delinquencies are on the rise, some loan quality isn't as good as was once presumed, and there has been a spate of downgrades of mortgage-backed bonds. Says David Martin, global head of residential- and asset-backed trading at UBS in New York: "Sub-prime platforms are already toning down their lending, especially after a spate of poor loans this year. It could look like the airlines industry — there's massive overcapacity with a need for a lot of volume to make money." Ownit Mortgage Solutions and Sebring Capital both went out of business at the end of 2006, and it's likely others will follow this year as the downturn squeezes out overcapacity.

In the past, predicting what investment banks would do at this stage of the housing cycle used to be simple. Having ramped up the business while the going was good, they would then shutter it at the first sign of trouble. That's what happened with the mortgage conduit business in the 1980s, and again in the early 1990s. This time, it's different. Wall Street seems to have thrown out its old and trusty playbook. Instead of pulling back in 2006, several major firms went on a spending spree.

[See table, page 42.]

That might sound strange to some. Buying at the start of downturn surely risks overpaying for an asset whose business is in decline. So why do it? Well, despite the gloomy outlook, competition is not letting up. First, clients have been setting up capital-markets desks to securitize their own loans in their own version of vertical integration. Countrywide is the most renowned for doing this, but others from SunTrust to IndyMac have taken the plunge, and still others are following.

Second, more players are trying to buy loans that are still for sale. That's especially true of the mortgage market, where vertical integration has been most rampant. "In 2000 we'd have maybe five or six groups bidding on a loan sale," says Commaroto. "Now there are 20 or more. And it's not just us banks bidding, but hedge funds and whole-loan trading boutiques." The more bidders, the higher prices can go, and that, of course, can undermine the economics of a securitization. It also means a desk has more chance of not getting enough loans in a timely manner.

That being the case, it sounds much more preferable to have access to a captive pool of loans by owning an originator. As more investment banks reach this conclusion, it increases the likelihood that even more loans will be taken out of circulation. It's not just other investment banks that might be buying up the assets. Private equity firms are keenly eyeing the plummeting valuations of mortgage lenders. Last year, Cerberus bought both Centex Home Equity and KeyCorp's Champion loan-origination platform. That means not only more competition for assets, but also that private equity interest may well provide a floor for the share prices of mortgage lenders, raising the possibility that investment banks might feel they have to pay more than they might like for a platform.

How much this could affect the supply of loans is debatable. But every investment bank has its own assumptions. One seen by *American Securitization* laid out a worst-case prediction of how its mortgage securitization business would fare if it didn't buy a lending platform. Under that scenario, the investment bank would lose access to as much as half the loans it currently buys to fuel its mortgage-backed securities desk.

It can pay to own one

But it would be unfair in the extreme to characterize vertical integration as little more than a headlong rush into lending as a way of staving off ABS underwriting desks' death spiral because of a lack of access to product. There are also significant advantages to owning a lender.

For starters, having a captive lender eliminates the need to hunt for as many loans in the marketplace. Next, as owners, the investment banks earn all the fees from originating the loans to the gain on selling into a securitization. And they can even become loan sellers themselves should the product not fit their MBS vehicles — though it's more likely they would sell to a CDO fund or a whole-loan investor than to a rival player.

Finally, there are the risk-management benefits of integrating the lender and structurer together. These are harder to

quantify. On the one hand, if you own a lender, you obviously have much more information about the quality of the loans going into your capital-markets deals. But it's also about how the two markets interact on pricing. When it works, it's a powerful combination. "The late summer and fall of 2005 provides a case study for the benefits of vertical integration," says Verschleiser at Bear Stearns. "Interest rates were rising, credit spreads were widening and mortgage originators were still setting rates based on where their last whole-loan sale executed. When they went to sell their pipeline, they were shocked to see the premiums they were accustomed to were gone. They were forced to either hold mis-priced loans in their portfolio, or sell and recognize the loss. True vertical integration wouldn't let that happen."

For many, the longer-term benefits of integrating sub-prime mortgage originators outweigh trying to time the market. "Given our franchise, we need to be a player in the mortgage markets," says David Sidwell, chief financial officer for Morgan Stanley. "It's too important a business." Last year his firm bought Saxon Capital for \$706 million, a 30% premium to Saxon's stock price before the deal was announced. It also snapped up a handful of smaller players, including two foreign mortgage lenders, and hired Wes Iseley from Fremont to manage the lending business.

Morgan Stanley was not alone. Barclays Capital, Bear Stearns and Deutsche Bank also bought U.S. sub-prime mortgage platforms of varying sizes. Merrill Lynch made the largest acquisition, buying sub-prime originator and servicer First Franklin from National City Corporation for \$1.3 billion.

It's not just lending, either. Servicing the loans can bring in more business, and can provide a vehicle for snapping up other non-performing loans on the cheap. [See box, page 44.] All you need is the right economic environment to push issuance up.

That's what happened in the last boom. Sub-prime mortgage loan originations totaled more than \$600 billion in 2005, accounting for more than one-fifth of all mortgage loans that year. That's a record, and more than triple both the volume as well as the market share sub-prime mortgages enjoyed in 2002. "Stand-alone originators did well because the market was fabulous for lending in recent years," says Bear Stearns' Verschleiser. "We had a steep yield curve, premiums on whole-loan sales

If you ask 10 people to define vertical integration, you're likely to get 10 different answers.

were high and defaults and repurchases were low." That, of course, has changed, he adds. "Now with whole-loan premiums low and mortgage fraud at all time highs, we are in a very different paradigm. We've already seen several fail or falter. Many won't survive the downturn."

Verschleiser's firm recognized early the value of owning a piece of all parts of the business, Bear Stearns established its presence in the early 1990s, setting up lender and servicer



Getting in at the top can sometimes be a good thing

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EMC. As did Lehman Brothers, which bought minority stakes in several originators at the end of the 1990s, in sub-prime's last nuclear winter. In 2003 it assumed control of a couple of them. The following year the investment bank bought another three lenders. The result? In 2005 Lehman sold \$133 billion of mortgage-backed securities. Its own platforms originated about two-thirds of them, or \$86 billion — almost double Morgan Stanley's total MBS issuance.

Lehman also bought the franchises cheaply. The prices for the initial stakes taken in the 1990s aren't available. But according to the company's annual reports it paid a total of \$35 million for its controlling stakes in 2003, and \$184 million for its acquisitions a year later — and more than half of that was for Preferred, its UK mortgage platform. Acquisition multiples are harder to come by. But the general belief is that Lehman paid less than book value, and no more than six times forward earnings. "We think the internal rate of return is more than 50% a year," says an institutional investor specializing in financial-services firms, who asked not to be quoted. "In other words, the acquisitions have already paid for themselves at least a couple of times over."

A question of timing

Those are tempting numbers. But last year's acquirers are less likely to enjoy the same economics as the first movers like Lehman. Outright prices were higher, as, probably, were book values. Barclays Capital, Deutsche Bank and Morgan Stanley each paid about 1.2 times book for their mid-year deals. By the

end of 2006 sub-prime platforms from IMPAC and Fremont to Accredited and New Century were trading between 0.6 and 0.9 times book. That said, the book price doesn't say it all. For example, of the \$469 million Barclays paid for servicer HomeEq, \$209 million covers advances that seller Wachovia has fully indemnified. Throw that into the mix, and Barclays actually paid about two-thirds book.

With Saxon, Morgan Stanley bought a platform with one of the industry's highest cost structures. Just before Christmas the investment bank announced it was cutting 14% of Saxon's workforce, including the chief executive. Saxon's cost structure will also benefit from carrying its new owner's higher credit rating.

What's more, both firms now have an in-house servicer for their loans. Previously, they outsourced the business. That could save Barclays \$50 million a year, according to outsiders familiar with its plans. With its larger business, Morgan Stanley could perhaps save more than double that.

Merrill's purchase of First Franklin was an outlier. The \$1.3 billion price tag valued National City's former subsidiary at 1.7 times book. Estimates vary, but Citigroup's banking analyst Keith Horowitz puts the sub-prime lender's earnings that are going to Merrill at about \$195 million. That puts the multiple Merrill paid at just under seven times earnings.

Merrill has said little about the transaction to the market — the deal did not close until the end of the year — so it is more difficult to estimate what the investment bank could save by bringing servicing in-house, or what the potential is for expanding First Franklin's businesses into other areas, be it Alt-A lending or using the servicing business as a distressed debt platform to buy non-performing loans. While the acquisition might be more aggressive than others, in a wider context it captured for Merrill one of the leading lenders in this coveted market for less than half the investment bank's third-quarter earnings.

The road less traveled

But some are less enthusiastic about buying their way in, at least at this stage of the market. "If access to product is shrinking, the logical conclusion is to buy a platform," says UBS's Martin. "But the math only works for investment banks if you buy lenders,

and especially sub-prime lenders, at low earnings multiples and then ride a refi wave, as Lehman and Bear Stearns have done. Buying at 12 times earnings doesn't appeal to us. There's little or no value for our shareholders at those levels."

Martin has instead chosen to build a mortgage-lending business in the U.S. for the Swiss bank called UBS Home Finance. It launched in the middle of last year and, says Martin: "We're not trying to compete with Countrywide, and we're not jumping into sub-prime. This is an Alt-A platform, and we're targeting \$20 billion a year in loans."

Martin believes there is another good reason against owning a lender: "You can lose 20 basis points on gain on sale mar-

In the past, predicting what investment banks would do at this stage of the housing cycle used to be simple. Having ramped up the business while the going was good, they would then shutter it at the first sign of trouble. This time, it's different.

gins by taking a lender captive," says Martin. "What's the incentive to pay the best price once you own it? You lose the ability to run an auction, or to capitalize on a buyer's inefficiencies and mistakes."

Others contend, conversely, that while some capital-markets desks might like to believe a captive lender brings them cheaper loans, it's not likely going to be their call. "Cheap loans might work for the MBS desk, but it's not in the interest of the investment bank as a whole," says one. "Most ought to have procedures in place to ensure the lending arm gets the best price."

Martin's counterpart at Credit Suisse, Andy Kimura, has a similar strategy to UBS, building on the Alt-A platform that the Swiss bank inherited from its purchase of Donaldson, Lufkin & Jenrette six years ago. He, like Martin, remains unconvinced that now is the time to buy. "A large number of acquisition targets is out there, and few of the lending platforms carry a signifi-

Selected recent acquisitions of loan originators

Acquirer	Target	Announced	Price	Company Type
Morgan Stanley	CityMortgage	December 2006	not disclosed	Russian mortgage bank
Fortress	Champion Mortgage	December 2006	\$130m (estimate)	Mortgage originator
Bear Stearns	Encore Credit Corp	October 2006	\$26m	Mortgage originator
Lehman Brothers	Capital Crossing	September 2006	\$210m	Small/medium business lender
Merrill Lynch	First Franklin	September 2006	\$1.3bn	Mortgage originator & servicer
Morgan Stanley	Saxon Capital	August 2006	\$706m	Mortgage originator & servicer
Lehman Brothers	Campus Door	August 2006	\$100m (estimate)	Student loan originator
Deutsche Bank	MortgageIT	July 2006	\$429m	Mortgage originator/REIT
Barclays Capital	HomeEq	June 2006	\$469m	Mortgage servicer
Deutsche Bank	Chapel Funding	May 2006	not disclosed	Mortgage originator & servicer
Fortress	Center Home Equity	May 2006	\$550m	Mortgage originator
Credit Suisse	SPS	November 2005	\$144m	Mortgage servicer
Lehman Brothers	Preferred Mortgage SIB Mortgage Corp Finance America *	2004	\$184m	Mortgage lenders
Lehman Brothers	Aurora * BNC Mortgage *	2003	\$35m	Mortgage lenders

*To take to controlling stake; already owned minority interest

Sources: Analyst Estimates; Bloomberg; Company Reports

cant premium to book value any more,” he explains. “That might sound attractive, but the question is, does the platform you acquire continue to lose money? Does it need resizing? What is the extent of its loan purchase obligations? It’s a big challenge.”

He is also skeptical that the recent wave of consolidations will inexorably lead to a decline in business for those who stay on the sidelines: “It doesn’t keep me up at night. It’s critical that whatever one buys is the right fit, from management to reputational risk. We do have a viable alternative: we can scale up our Alt-A platform. And there will still be independent platforms. We’ve invested in some, or have financing vehicles with them.”

Another firm conspicuous by its absence from the list of acquirers is Goldman Sachs. According to equity investors, its executives give a lot of credit to Lehman and Bear Stearns for spotting the opportunity in mortgages early on. There might even be a hint of regret that they didn’t see it too. But that hasn’t made them want to play follow-the-leader now.

Speaking on the day the firm released its full-year 2006 results in December, Goldman’s chief financial officer David Viniar shared some of his thoughts on the mortgage business: “Sub-prime forms just a small part of our fixed-income, currencies and commodities division. Should we buy? I never say never, and in terms of timing the prices are certainly better than they were six months ago. But there are several issues with some of these lending platforms, and it’s a retail business. We’re cautious.”

That’s a typical Goldman refrain — it has never displayed much interest in owning retail-facing businesses. Largely that’s a question of culture. Motivating and managing retail mortgage brokers compared with, say, credit derivatives traders or M&A bankers require different skill sets. Goldman seems to be sticking with what it knows best.

But in the background is the reputational risk associated with retail businesses, especially with sub-prime lenders. Citigroup and HSBC both came under fire from anti-predatory lending groups when the former bought Associates First Capital and the latter Household Finance. And Lehman still has a few paragraphs in its annual report outlining a legal case against it stemming from its capital raising for an independent sub-prime mortgage platform in the 1990s. If the current downturn worsens, other cases are sure to surface, regardless of their legitimacy.

Those who have so far chosen not to buy lending platforms will no doubt watch any developments here as closely as they are checking the share and book value prices of potential targets. The threats and opportunities that have fostered vertical integration to date will drive more deals at some point, but the old way of doing business isn’t dead yet. “If one doesn’t purchase an origination platform, there are still many profitable ways to be involved in whole-loan trading.” And that’s from Deutsche Bank’s Commaroto, whose firm was one of the major buyers of origination platforms last year. If he still feels there are ways to make money without having to snap up a mortgage lender, that should give potential rivals some comfort that they still have time to consider their options. ▼

Security through servicing

When an investment bank buys its way into the sub-prime mortgage business, it’s the lending platform that commands most of the attention. That makes sense, not least because each bank is no doubt hoping to ramp up its loan capabilities in time for the next housing and refinancing boom. But don’t forget the value of the servicing business that most deals also brought to the table.

In fact, some acquisitions have been solely or largely to snap up a servicer. HomeEq, which Barclays Capital bought from Wachovia last year, does nothing else. Morgan Stanley’s major purchase in the sector, Saxon Capital, is both a servicer and a lender, but only had a portfolio of about \$6 billion in mortgage loans. Credit Suisse moved earlier than its two rivals, having bought SPS in 2005. It’s a way to grow an origination business by the back door, explains the bank’s head of mortgage trading Andy Kimura: “There are a lot of synergies between having a good servicing platform and bringing in a lot of refi business. The more efficient fulfillment is, the better service the customer gets. That means you have more chance of building customer loyalty that’s not just based on the best price.”

Better risk management is another benefit of owning such a business, says Jeff Verschleiser, co-head of mortgage trading at Bear Stearns. “I believe having a captive servicer is integral to being in the mortgage-backed security issuance business. In the aftermath of Hurricane Katrina we tried to ascertain the status of certain properties. On loans where we weren’t the servicer, we had a very difficult time getting this information.”

If there are still investment bankers out there who remain unconvinced, consider this argument from Kimura: “Creating an efficient channel for the loan product with a servicer improves the value of your MBS shelf. Better servicing means better loan recoveries. That can help overcome some of the perceived differences between lenders and vintages that, because of the growth of synthetic trading, has created a tiering of MBS issuers.” In other words, that dull-sounding back-office business could be the very thing to make your vertical integration strategy fly. Best not to overlook it.