

THE DRIVE FOR MORE *Transparency*

TODAY THE SECONDARY MORTGAGE MARKET is facing growing pressure to provide greater transparency to investors.

One of the most telling signs of the new transparency era is the proposed Shays-Markey bill in Congress, which would require all of Fannie Mae's and Freddie Mac's securities—including debt and mortgage-backed securities (MBS)—to be registered. With the two agencies' outstanding MBS issuance at nearly \$2 trillion, according to the Congressional Budget Office (CBO), such a move would bring an unprecedented level of transparency to the market's bellwether issuers.

What's more, the financial markets have seen a spate of new requirements aimed at heightening overall financial transparency.

The Sarbanes-Oxley Act of 2002 requires the inclusion of off-balance-sheet transactions, among a host of new disclosures. In 2001, the Financial Accounting Standard Board (FASB) issued FAS 140, which aimed to improve the valuation of residual income resulting from securitization.

Another target of FAS 140 was major mortgage servicers, many of whom have had to take impairment charges on their servicing portfolios, prompted by falling rates and accelerated prepayments that cut into servicing fees.

In today's landscape, issuers that embrace disclosure stand to reap the benefits of lower funding costs, while demonstrating industry leadership in adopting best practices. Issuers slow to adopt more disclosure are seeing their

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Issuers that provide a wealth of data on collateral underpinning their securities are being rewarded with better pricing. There is growing appetite for such transparency in the asset-backed and mortgage-backed security markets.

funding options dwindle, thanks to a tiering of the market. Issuers with robust investor reporting can regularly tap the securitization market, issuing deals under their own shelf registrations. However, firms with poor disclosure are increasingly finding their only funding options to be whole-loan sales to agencies or Wall Street dealers.

The move toward more transparency in the MBS market can be seen as part of a trend to raise transparency across America's financial markets that started a decade ago.

Lessons from the past

The Orange County, California, derivatives debacle in 1994 is perhaps the first documented case of how derivative securities can obscure huge financial risks. (A securitization is a derivative transaction on a number of levels—the securitization tranches themselves are derived from the performance of the underlying loans, and many issuers include swaps, options and clean-up calls, only adding to the complexity of analysis.)

The problem Orange County experienced was derivatives held by its highly leveraged pension fund started to implode when interest rates spiked upward that year. With the pension fund facing staggering losses of \$1.6 billion, the county was ultimately forced into bankruptcy.

In the late 1990s, Ann Arbor, Michigan-based lender Greentree Financial Corporation ran into trouble over the accounting for the residual income in its securitization deals. Following Greentree's \$6 billion acquisition by Indianapolis-based insurer Conseco Finance Corporation in 1998, it came to light that the lender had used highly aggressive accounting in its booking of residual income—the monthly income that an issuer earns in a securitization after other parties, such as the trustee and investors, are paid. Greentree had misjudged the impact on residual income of prepayments and defaults of its underlying loans, which led to a \$500 million write-off.

Fast-forward to 2002, and a handful of high-profile deal blow-ups put transparency of asset-backed securities (ABS) in the news again. In February, Fort Worth, Texas-based auto lender AmeriCredit Corporation is forced to restate its earnings to reflect an additional \$17 million in write-downs. And in October last year, Indianapolis-based Union Acceptance Corporation, another auto lender, declares bankruptcy after taking a residual write-down that resulted in a \$30 million charge.

In 2003, Freddie Mac's accounting travails make the headlines. In May, the corporation announces it will restate its earnings for three years by several billion dollars when it is revealed that derivatives on Freddie Mac's books were improperly valued. There's also been some suggestion that Freddie Mac's problems may go beyond derivatives used as hedges, involving accounting irregularities for MBSs the company issued as well as for in-house securities sales-and-trading operations.

Market matures

Foreseeing the market's growing demand for transparency, a handful of home-equity and MBS issuers have been leading the trend toward increased disclosure well ahead of the regulators. Irvine, California-based New Century Capital Corporation, a leading home-equity MBS issuer, for instance, has invested significantly in a data warehouse and Web-based tools to provide enhanced performance data to its investors.

Kevin Cloyd, president of New Century Capital Corporation, cites an example of an investor that needed to evaluate a New Century issuance in preparation for credit committee review. The task involved comparing collateral characteristics on a current deal with that of two previous deals.

With New Century's reporting site, the analyst was able to pull performance data from a specific FICO® band, downloading it directly into a spreadsheet, and completed the presentation in a half-hour. Cloyd says two years ago the analysis would have taken several hours to complete, in addition to days going through the full credit approval process.

With the bar raised, MBS and other ABS issuers must now provide greater collateral performance data simply to do business. In part, it's a reflection of the maturing of the market. Chastened by market upheavals, investors have become more knowledgeable of the risks, demanding more sophisticated collateral data.

At Orange, California-based Ameriquest Mortgage Company, for example, another top home-equity issuer, the firm's consistent methodology for presenting collateral performance data has played an important role in getting investors more comfortable with the issuer's bonds.

In seeking to avoid so-called headline risk of investing in bad deals, investors are increasingly looking for more qualitative information to gauge the strength of an issuer's business.

Ketan Parekh, Ameriquest's vice president of capital markets, spends nearly one-third of his time meeting with investors, who increasingly query him about the firm's operations: What financial controls do you have in place to manage growth? What are your servicing and appraisal guidelines? What are you doing to protect against predatory lending?

For an issuer like Ameriquest, demonstrating strong origination guidelines, such as avoiding adverse loans—from a borrower lacking a FICO score to a loan that takes a borrower out of foreclosure—is a qualitative aspect that's key to achieving the tightest possible pricing on a deal.

In addition, investors want a platform where they can quickly access reliable, standardized performance data based on a consistent methodology. Prior to the advent of Web-based ABS investor-reporting sites like ABSNet (run by Lewtan Technologies, Waltham, Massachusetts), capturing such data was very manually intensive. Today that data is not only

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available through industry channels, but issuers' own Web sites as well.

Equity analysts, too, are seeking more transparency from publicly traded issuers. That's because a securitization changes the nature of an issuer's business, from spread income—interest earned on mortgage payments—to fee income such as servicing fees and residual income.

Simply put, in analyzing a securitized transaction, an equity analyst's and equity investor's job is one step more involved than that of the fixed-income analyst/investor. The first task is understanding the performance of the underlying credit risk. Next is assessing the ramifications of the capital structure on the security itself. However, the third step is unique to the equity analyst: understanding the issuer's underlying assumptions—to assess both the effects of prepayments or losses, and those effects on the projections reflected in the issuer's financial statements.

For example, an analyst might be trying to gauge whether a sudden spike in prepayments will hurt an issuer's earnings. That involves comparing the collateral's actual performance with the prepayment assumptions that the issuer used in its cash-flow models—although today issuers that employ FAS 140's more conservative gain-on-sale accounting methods typically build enough conservatism into their assumptions to avoid write-downs should a deal perform poorly.

The benefits from transparency

When it comes to transparency, the premium on information lies in performance data on deals trading in the secondary market. That's because at the initial closing of a deal, particularly for name-brand issuers like New Century, Ameriquest, GMAC and Washington Mutual, the deals are typically oversubscribed.

Investors' demand for data is essentially driven by where they sit in the credit hierarchy. Investors in the higher-risk mezzanine and subordinate tranches seek the most detailed performance data, which they use to perform sophisticated cash-flowing modeling of prepayments and losses. Senior bondholders, typically protected by a wrap from an insurer, often just want to confirm the deal's triple-A rating.

Subprime firms, whose collateral is lower on the credit spectrum, tend to release substantial data so investors can keep close tabs on the securities in the event performance deviates from expected levels. Also, large issuers that aggregate broad mixes of collateral, such as Washington Mutual and GMAC-RFC, disclose a lot of performance data to educate the market on the broad range of products and credit-risk levels.

As a result, issuers who demonstrate a commitment to supporting their deals in the secondary market through extensive investor reporting can expect to enjoy a lower cost of capital when they go to market on their next deal.

Ameriquest is a case in point. Parekh says that on the

pricing of Ameriquest-issued deals, the firm enjoys an average savings of 10 to 15 basis points over an issuance of comparable collateral quality under a dealer shelf registration. Parekh suggests another reason why Ameriquest realizes better pricing: An investor knows that an issuer going to market under its own name will pick up the phone when an investor calls with a detailed question about the collateral performance of a particular security.

This points to the growing stratification of the MBS market, where issuers with the volume and infrastructure to support deals enjoy more funding flexibility—either tapping the securitization market or issuing through a dealer shelf. By contrast, issuers that lack the infrastructure to support deals must offload their collateral to Wall Street firms, which pool the collateral of multiple issuers to bring deals to market.

New Century's Cloyd says another benefit of offering more robust investor reporting is expanded marketability. He notes that today New Century is seeing three times the volume of Web traffic to its current investor reporting site than it saw three years ago. Showcasing the firm's deep reporting capabilities expands visibility, helping increase investor demand, which ultimately leads to better pricing.

New Century also has been a pioneer in investor reporting. The firm is working to create an industry standard for MBS performance reporting, based on having built a standardized format for all of its performance data—from balances and delinquencies to foreclosures—covering every loan securitized since the start of its program in 1997.

What lies ahead?

Despite the significant advances in disclosure and transparency, a remarkable level of illiquidity and lack of transparency still afflicts structured finance markets like MBSs compared with the equity markets.

The accounting problems at Freddie Mac, among the market's 800-pound gorillas, are a sign that this is surely changing. It's one thing for the market to demand information from an individual issuer; it is quite another for the agencies to follow suit.

MBS and ABS transparency will hit Wall Street next. Wall Street underwriters issuing large volumes of securitizations with hybrid collateral already understand this.

What will spur change on the Street? When dealers recognize that transparency can affect their bottom line. By providing broader support for their deals in the secondary market, dealers can tighten the issuance spreads on deals issued under their mortgage-backed shelf registrations. **MB**

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