

Secondary Market-Based Versus Depository-Based Housing Finance Systems

Jack Guttentag

The US is unique in having two distinct housing finance systems. The first is the depository-based housing finance system (henceforth DHFS), composed of savings and loan associations and some banks, who originate loans for portfolio and borrow when needed from their Federal Home Loan Banks. The Federal Home Loan Bank System is a quasi-governmental entity that can raise funds in the capital markets almost as cheaply as the US Treasury.

The second system is the secondary market-based housing finance system (henceforth SMHFS), which is more complicated. Mortgage bankers are temporary lenders who originate loans for sale in the secondary market. Retail mortgage banks deal directly with consumers, while wholesale mortgage banks buy loans from correspondents which are other (usually smaller) mortgage banks.

Wholesalers also acquire loans from mortgage brokers which, in contrast to correspondents, do not close and fund loans but deliver applications to wholesalers. Retail and wholesale mortgage banks assume "pipeline risk"—the risk that interest rates will rise between the time they have made a

commitment to a borrower and the time the loan is sold. (Correspondents and mortgage brokers do not assume this risk.)

Retail and wholesale mortgage banks, which I will henceforth refer to as "temporary lenders," sell loans to conduits, who convert them into securities which are sold to a variety of investors. The conduits include Fannie Mae and Freddy Mac, which are quasi-governmental entities with credit standing comparable to that of the Federal Home Loan Banks, plus a number of private conduits who operate in the segments of the market not served by Fannie Mae and Freddy Mac.

While there is overlap between the two systems—for example, many depositories deal in the secondary market and/or have some sort of cooperative relationships with entities belonging to the SMHFS—the two systems are fundamentally competitive. Hence, the US experience constitutes a unique laboratory for assessing their relative strengths and weaknesses. For the most part, this comes down to explaining why SMHFS has been clobbering DHFS for at least two decades.

I NON-SYSTEMIC FACTORS

It is not difficult to develop a list of country-unique or special historical factors that have affected the relative performance of DHFS and SMHFS, but which have little or nothing to do with the inherent differences between

the two types of systems. Such a list would include differences in regulatory burdens, and in the relative generosity of Federal support programs. No attempt will be made in this paper to assess the importance of such factors in explaining the relative decline in DHFS. As we shall see, systemic differences favoring SMHFS are so important that they suffice in themselves to explain the relative decline in DHFS, without recourse to non-systemic factors.

My approach will be to examine the relative performance of DHFS versus SMHFS in executing a number of specific housing finance functions. In every case we will find that *SMHFS imposes a discipline, lacking in DHFS, that increases efficiency.*

I MANAGING PIPELINE RISK

I begin with pipeline risk not because it is the most important function that a mortgage lender must perform but because it illustrates so well the major reason that SMHFS is winning the war.

Pipeline risk is the risk that between the time a lender makes a binding commitment to a borrower and the time the loan is either sold or placed in portfolio, the value of the loan will decline. SMHFS manages pipeline risk more efficiently than DHFS, even though the people involved in the process are often unaware of it. Few people appreciate discipline that is applied to them.

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I have heard temporary lenders complain that they are disadvantaged in managing pipeline risk, relative to depositories, because "if I make a mistake I must take a loss when I sell the loan whereas the depository simply places the loan in its portfolio." Of course, the reality is exactly the opposite — having to take the loss results in the temporary lender managing its pipeline risk better than the depository.

The depository who makes a mistake and books a loan at its commitment value rather than a lower market value that prevails at the time of closing does not avoid loss. What it does is to bury the loss by diffusing it through the income statements of many future periods. Whereas the temporary lender gets immediate market feedback on how well its pipeline risk is being managed, for the depository both performance and accountability are obscured.

It is a universal rule that when performance is not measured it suffers. While I don't have any direct evidence that temporary lenders manage pipeline risk better than portfolio lenders, there is persuasive indirect evidence. All the temporary lenders deploying the MARS System to provide rate/point quotations to mortgage brokers or the public adjust them daily as a matter of course, but the depositories using MARS adjust prices weekly. This is a telling indication that the depositories are less sensitive to the risk of value decline during the commitment period.

II MANAGING INTEREST RATE RISK

Under SMHFS interest rate risk is segmented into three components: pipeline risk, discussed above, is managed by temporary lenders; packaging risk, the risk of a price decline (rate increase) between the time loans are purchased and the time they are packaged for sale, is borne by conduits; and portfolio risk, the risk that the value of a portfolio of assets and liabilities will decline in response to a change in market interest

rates, is borne by those widely dispersed portfolio entities who buy the securities issued by the conduits. To the degree that conduits retain any mortgages in their own portfolios, which both Fannie Mae and Freddy Mac do, they are among the group of portfolio entities.

It would be difficult to design a more efficient system than this for allocating interest rate risk in an optimal fashion. The temporary lenders are specialists in managing pipeline risk. The conduits can select from among the loans they buy those that they can manage most effectively in their own portfolios, taking account of their liabilities. The remainder they sell off in the form of multiple securities designed to meet the diverse portfolio needs of the investment community. These include securities that vary greatly in duration and price sensitivity to changes in market interest rates.

In the DHFS, depository lenders assume both pipeline risk and portfolio risk. Since depositories must meet the needs of customers on both sides of their balance sheet, and since mortgage borrowers want longer claims than depositors, their portfolios tend to be unbalanced. Where SMHFS can direct long-term claims to pension funds and other entities with long liabilities, depositories cannot. They either refuse to originate such claims, which means not meeting the full range of customers' needs, or they accept the interest rate risk and try to live with it¹.

III LOAN SERVICING

Loans are serviced more efficiently in SMHFS than in DHFS, for the same reason that pipeline risk management is more efficient in SMHFS: the information feedback and discipline generated by secondary markets.

Temporary lenders having servicing capacity have a choice of selling loans with servicing retained by the seller or servicing released to the buyer. The difference in price is the

market's estimate of the value of the servicing, which generally runs from .5 to 1.5 points.

From the standpoint of the seller, retaining servicing is akin to an investment where the amount invested is the price foregone and the return is the net future servicing revenue. To the individual seller, the return is much affected by the seller's efficiency as a servicer. The market is constantly sending the message to high-cost servicers that their investment return is low, and to low-cost servicers that their return is high. High-cost servicers find that they do better selling loans with the servicing released to the buyer, with the result that servicing gradually drifts into the hands of the low-cost servicers. This process accelerates as the secondary market in servicing rights becomes increasingly efficient because low-cost servicers find that they can buy servicing in the market.

In contrast, originators in DHFS who portfolio their loans almost always service them as well, despite the fact that many of them are high-cost servicers. Since they are not selling the loans, they ordinarily do not know the return they are earning by investing in servicing. Further, even if they knew that the return was low many would be averse to having "their customers" serviced by others.

Of course, depositories who are high-cost servicers may well make a rational decision to service anyway if they can mine the information in the servicing file to create additional value, such as, e.g., by cross-selling other products to the borrower, or by forestalling loss of the borrower through a refinancing by another lender. This is important because it points up that DHFS does have potential advantages over SMHFS in that depositories are multi-product firms able to exploit potential synergies between mortgages and other products. But so far very few depositories in the US have exploited these potential advantages. Some reasons for this will be discussed in Section VI below.

IV MEETING THE DIVERSE NEEDS OF BORROWERS

In meeting the diverse needs of borrowers, SMHFS is far superior to DHFS. . .

In a recent article in *Mortgage Banking*³, I pointed out that in the US there really is no such thing as a generic home loan. Rather, the market must be viewed as a collection of niches. As an illustration, a group of 12 lenders on the MARS System currently recognize the following categorizations either in pricing, in setting underwriting requirements, or both: 15 rate/point combinations, 5 lock periods, 5 loan size categories, 4 credit quality categories, 4 levels of required documentation, 4 LTV groups, 9 property types, 3 loan purposes, and about 100 loan types and options. Multiplying these out gives millions of niches, and while many of them are empty — for example, no lender will offer a no-doc loan to a D-credit borrower — the number remaining is nevertheless enormous.

The typical temporary lender offers loans in a much larger number of market niches than the typical depository. Temporary lenders offer any loan demanded by borrowers that can be sold in the secondary market, and salability in the secondary market depends ultimately on whether or not a loan can fit in the portfolio of some investor. The secondary market tells the lender the price that must be charged the borrower.

In contrast, loans offered by portfolio lenders without access to a secondary market must fit in the portfolio of that lender. And even some loans that might fit in the portfolio are avoided because, without the information provided by a secondary market, the lender doesn't know how to price them and/or how to adjust the underwriting requirements. Depositories seem to be particularly allergic to high-risk loans for this reason. They look for what the market terms A or A- credit ratings, whereas some temporary lenders price B, C and D-quality loans!³

Furthermore, a large and growing share of the loans originated in SMHFS come through correspondents and mortgage brokers, who deal with multiple wholesalers, and who therefore can cover a much larger number of niches than any single lender. This is the major reason they have been growing so rapidly despite their handicap in not having recognized identities.⁴

As in the case of servicing, there is a partial offset. Depositories who design ARMs that precisely fit their portfolio needs generally can offer them at better terms than temporary lenders, since the depositories can avoid all the costs of transferring ownership from a specialized loan originator to an investor, including the costs of securitization.⁵

This suggests that there is merit in a mixed system such as that of the US where depositories originate loans of a type that meet their interest rate risk configurations, and temporary lenders originate other loans that fit best in the portfolios of investors who are not originators.

V HOME LOAN DELIVERY

In contrast to the other functions discussed above, SMHFS has not developed a method of delivering home loans that is unambiguously superior to that employed by DHFS. The commissioned loan officer system developed within SMHFS is a far more costly delivery system than the depository branch, but it offers a much higher level of commitment by loan officers, who cultivate relationships with real estate sales agents in a position to refer customers to them. In effect, potential customers don't get to the depository branch because they are intercepted at the real estate office. And while the branch office closes at 4pm, the commissioned loan officer is rarely in the office, and carries a beeper that may summon him to meet with a customer anywhere at any time.

The nichification of the home loan market over the last decade has heightened the comparative disadvantage of the depository office as a delivery vehicle. An office with little loan traffic cannot afford to offer full-time loan counselors with the expertise to deal with all the complexities involved in counseling and qualifying customers.

The upshot is that SMHFS has rendered the low-cost delivery system of depositories essentially useless, and forced them to adopt the high-cost commissioned loan officer system if they want to be major loan originators. Thrifts have usually elected to add loan officers within the firm while commercial banks have often opted to purchase a mortgage banking firm, but the results have been much the same: a clash of cultures,⁶ and a lack of synergies between the home loan operation and other parts of the depositories' business. The typical depository runs two separate businesses, often with clientele having markedly different demographics, and with little connection between them.

VI CONCLUDING COMMENT: SYNERGY, FOCUS AND TECHNOLOGY

The struggle between SMHFS and DHFS may be usefully perceived as a struggle between the relative strengths of synergies associated with a depository system, and the focus associated with a secondary market system.

An advantageous synergy is the ability of the depository to fund its pipeline, without the costs and constraints faced by mortgage banking firms in obtaining and using warehousing lines. Unfortunately, that about ends the list of useful synergies. Depositories have generally not been able to cross-sell other servicers to borrowers, and they sell very few home loans to depositors. In part this is due to an unwillingness to offer complete product lines, as discussed earlier, and in part to the clash between mortgage banking and depository cultures.

To date, the advantages of focus have far outweighed the benefits of synergy. Focus within SMHFS arises not only because it deals with only a single product, but also because of the discipline and information provided by the secondary market in all the various areas discussed in this paper.

Focus stands the SMHFS in good stead in still another arena that I haven't mentioned as yet: technology. An entire software industry is devoted to mortgage banking,⁷ and while in principle depositories could be just as effective as mortgage banks in deploying this software, in practice usually they are not. And the reason, I believe, comes down to focus, which manifests itself in a variety of ways. One obvious one is that the head of management information in a depository has much more on her plate than her counterpart in a mortgage banking firm, and delegation of authority may be derailed by the culture clash.

NOTES

¹ Of course, depositories in the US where DHFS and SMHFS operate side by side can sell their long-term loans in the secondary market, which is what most of them do.

² "A Marketplace of choices", December, 1996.

³ The major problem in servicing different loan-quality niches is the reluctance of lenders to delegate authority to make quality determinations to the loan officer at the point of sale, and the related problem of having to inform the lower-quality applicant that he must pay a higher rate than others. This is why in SMHFS most of the B-D loans are made by specialized lenders who price them for the quality they are prepared to accept. An A customer who walks in by mistake will be offered the same terms.

⁴ A second reason is that correspondents and mortgage brokers can often offer better deals within any particular niche. This reflects that the wholesaler offering the best deal in one niche,

or at one point in time, is unlikely to be the one offering the best deal in another niche or at another point in time.

⁵ Depositories that adopt this strategy, however, cannot take full advantage of the cross-selling opportunities open to a multi-product firm because they are not prepared to meet all the home loan needs of their customers.

⁶ The culture clash arises partly out of tensions associated with compensation. A loan officer who makes \$500,000 a year does not make waves in a mortgage banking firm because the CEO probably makes \$1 million or more, but in a depository the CEO may make only \$250,000.

⁷ Of course, there is another (even larger) industry devoted to various aspects of depository operations, but there is no or virtually no overlap between the two. This reflects the lack of synergies noted above, though I suppose one could argue that to some degree the lack of synergies reflect specialization in the software.