

# How A Centralized Loan Exchange Can Aid Secondary Market Stabilization

*A proposed solution could help bring a positive change to the industry.*

By Dave Parker

In the aftermath of the credit crisis and the collapse of Fannie Mae and Freddie Mac as private entities, it is clear that a new model of participation and oversight must emerge in order to revive and fulfill the government's role of maintaining liquidity and stability in the aftermarket.

In August 2009, the Mortgage Bankers Association's (MBA) Council on Ensuring Mortgage Liquidity presented "Recommendations for the Future Government Role in the Core Secondary Market." This particular report recommends a new framework for government involvement in the single-family and multifamily secondary mortgage markets, with a focus on the roles currently played by the agencies.

In reviewing this report, it is prudent to assume that some variation of the recommended model will be enacted. Equally important is being able to identify the impacts that the suggested model has on current mortgage processes, particularly as it relates to origination data management and how originators and lending institutions sell and securitize mortgages in the secondary market.

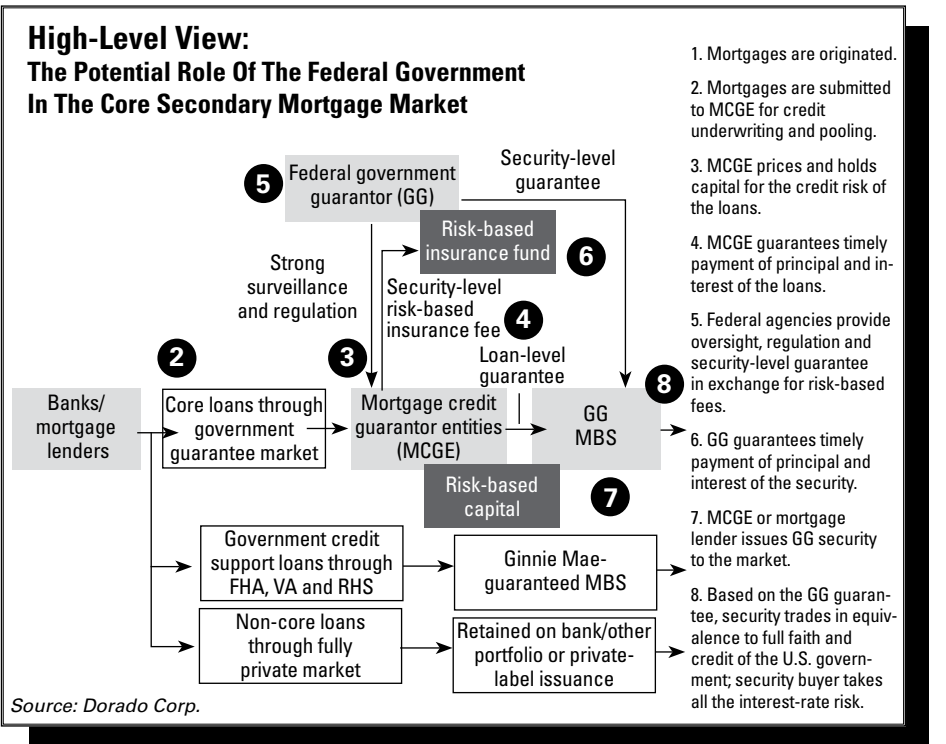
The target state being recommended by the council in its report is summarized in the accompanying diagram. The report recommends that mortgages be submitted from originators and mortgage banks to mortgage credit guarantee entities (MCGEs). The number of MCGEs would be

based on the goals of encouraging competition, providing strong and effective regulatory oversight, developing efficiencies of scale, creating standardization, maintaining security volume and liquidity, ensuring no single MCGE becomes too big to fail, and facilitating the transition from the current government-sponsored enterprise (GSE) framework.

The report also envisions an environment where MCGEs would be over-

seen by a strong regulator and would be required to manage their credit risk by using risk-based pricing, originator retention of risk, private mortgage insurance and risk-transfer mechanisms. In essence, what is being advocated is a model whereby many originators and mortgage banks will sell loans to a multiple but "select number" of MCGEs. MCGEs will compete with one another in different ways as regulators allow and as MCGEs deem appropriate via self-regulation.

One concern with this proposed model is that the introduction of pri-



vately owned MCGEs will not differ substantially from the current GSE model. Upon closer examination of the goals and the intent behind the recommendations, however, the desire is to create an environment that spreads the risks across multiple unrelated entities such that no single MCGE could become too big to fail, or whose demise would trigger a negative chain reaction across the market.

And if this fractionalized market is going to be competitive, each MCGE would be able to enact unique pricing, different investor guidelines, differing private insurance guidelines, and specialized reps and warrants that they would pass to originators. In such a world, regulators would need to have this complex commerce between sellers and buyers monitored and tracked such that the credit risk in the overall system can be gauged, and the level of risk being taken by various participants is known.

In addition, the recommendation appears to have the intention of promoting free market competition as much as possible, with only the healthiest and most competitively equipped entities able to prosper without dominant market share. Outside the basic requirements of regulators regarding the specific attributes required for a loan to receive government guarantor status, the model will likely incentivize the MCGEs to operate and market in more nimble and efficient ways to compete, and this will carry over to originator and mortgage banks needing to innovate in the area of non-core products. Essentially, the recommendations raise the bar for the industry in both operations and process management.

### ***The mortgage exchange***

Given the public demand for (and the government momentum toward) market reform, it isn't too early for the industry to start preparing for a move toward the MBA council's recommended model today, or at least some form of it. One implication of the proposed model is that it introduces a more complex environment to support equally complex commerce among buyers, sellers and

regulators. One way to best deal with this complex commerce and ensure it is regulated and transparent is by introducing an exchange.

There are a number of reasons for having an exchange. Let's examine the goals identified by the Council on Ensuring Mortgage Liquidity and see why introducing an exchange is the most efficient and effective means for achieving these goals.

### **Goal A - Ensuring competition.**

Competition requires a market structure in which there are large numbers of fully informed buyers and sellers of a known line of products and there are minimal obstacles to entry or exit of firms into the market. In the mortgage industry, the obstacles to entry must exist.

There needs to be an ability for originators and sellers to have adequate capital to back up their reps and warrants, and there needs to be enough capital for MCGEs to hold capital reserves sufficient to cover the credit risk of loans in their portfolio. Not unlike many trading exchanges, membership is earned and renewed by demonstrating an ability to meet the prerequisites to participate in the exchange.

An exchange then provides all originators and mortgage banks with a listing of all firms to which they can submit loans. Conversely, it provides a listing to MCGEs from which they can acquire loans. Creditors have a central marketplace where they can rapidly gauge the level of credit risk in the "system" and identify when it is appropriate to introduce more MCGEs to ensure that no single MCGE is too large to fail. In this system, there would be numerous MCGEs, rather than the recommended handful, to ensure competition and to foster an environment where only the most robust and stable of the MCGEs participate.

In addition to providing transparency about the market participants at any point in time and having the efficient mechanisms in place to modify membership, the regulators also have created efficient ways to see the credit risk being taken by all exchange members.

**Goal B - Strong and effective regulatory oversight.** With the introduction of an exchange, regulators have a single marketplace to oversee. In the previous section, we discussed how regulators will grant membership to the exchange and how they can see, in real time, the credit risk and, if mandated, the ration of credit risk to capital reserves held by various participants. In addition, if MCGEs are not banned from participating in non-core government guarantor loans, the level of non-core activity any MCGE is engaging in will also be monitored and factored in when considering the caps in MCGE portfolios, given levels of capital reserves.

Furthermore, regulators would have the advantage of a single mechanism they control in case an event is unfolding that requires timely intervention. Not unlike the ability of other exchanges to temporarily suspend trading, similar controls exist if all commerce is being conducted using a single, centrally monitored exchange.

**Goals C and D - Efficiencies, scale and standardization.** These shared goals are reasons why exchanges exist today. Without standardization, an exchange would not work. And with regard to efficiencies and scale, one needs to look no further than the track record of worldwide financial market exchanges. There are highly workable models that exist today from which we can garner best practices and have a very efficient marketplace that scales to meet all the needs of the mortgage market.

**Goal E - Security volume and liquidity.** While the council's focus was on how the market should be restructured in a post-GSE era, the introduction of an exchange would be beneficial to regulators, because having all the loan commerce centralized - whether government guarantor loans or other types - creates a level of market transparency that, in itself, can self-regulate to a great extent, through market forces.

The exchange that supports all loans originated in the U.S. provides regulators with the information that is critical to tracking the level of credit risk in the market and dis-

tributing credit risk across various exchange participants. This readily available information, coupled with responsible oversight and an exchange where regulators can intervene immediately, creates a system where security volume and liquidity goals are more achievable.

**Goal F - Ensuring no single MCGE becomes too big to fail.**

The creation of a single central exchange not only provides real-time information flow and data analysis about credit risk and reserve ratios, but it also provides regulators with mechanisms for capping MCGEs and introduces additional MCGEs as the

total level of credit risk and capital reserves in the market dictate.

The resulting quantity of MCGEs will ensure competition while also controlling the size of each MCGE, ultimately driving the need for an exchange. If only a select number of MCGEs exist, then having an exchange would be less necessary.

However, ensuring no single MCGE becomes too big to fail implies the need for numerous entities. History tells us that having only two is not adequate. To ensure volume, liquidity, competition and scalability, there will need to be more MCGEs. With a larger number of MCGEs and

their continual change in risk and reserve positions, the need for a central exchange is vital.

**Goal G - The transition from the current GSE framework.** The introduction of an exchange provides regulators with a more coherent way to transition from the GSE framework. The exchange would be implemented to support the existing GSE framework. **SME**

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