Article Title: ARCHIVE | Criteria | Financial Institutions | Other: Industry Overview: Non-Depository Mortgage Lenders Data: Introduction The national mortgage market has changed dramatically since its beginning in 1934, when the government created the Federal Housing Administration (FHA). The FHA-insured mortgage provided transferability and a stable source of financing, together with minimal risk, and set the stage for the development of a national mortgage market. In 1938, Congress formed the Federal National Mortgage Association (FNMA or Fannie Mae) for the purpose of providing a secondary mortgage market for FHA-insured loans. In 1968, legislation was passed enabling FNMA to operate as a government-chartered private corporation; also in that year, the Government National Mortgage Association (GNMA) was created to assume FNMA's duties of overseeing loan subsidies and below-market purchase programs. GNMA also received guaranty authority that led to the GNMA-guaranteed MBS program. The residential mortgage market was opened to a broad array of investors with the introduction of the GNMA security in 1970. The Federal Home Loan Mortgage Corp. (Freddie Mac) followed in 1971 with its participation certificate program, which opened the federally guaranteed MBS market to conventional mortgages. Adjustable-rate mortgages (ARM) were introduced in 1981, the same year that FNMA rolled out its own MBS program. This transformed the mortgage market by lowering the barriers to entry; it also led to the creation of a wide variety of MBS structures. FNMA and GNMA continue to further the standardization of the conventional mortgage market through new products, streamlined and automated underwriting, and improvements in workflow technology. The development of the MBS market initially helped thrifts by creating a mechanism by which mortgages could be removed from their balance sheets to reduce interest rate risk and meet regulatory capital requirements. It also lowered the barriers to entry for nonthrift competitors and changed the profitability dynamics of single-family originations. These changes began the "commoditization" of the single-family mortgage and led to lower profitability margins on the origination of residential mortgage loans. The competitive dynamics increased greatly, because the amount of capital required to be a mortgage lender was significantly lowered as a result of securitization. The "subprime" mortgage market was launched during the economic slowdown of the late 1980s and early 1990s. The slowdown, which culminated in a recession in 1991, left many borrowers unable to qualify for conventional mortgage loans, because high unemployment had led to poor credit performance. Borrowers who were once "A" credits were now classified as "B & C" or subprime borrowers. This event, coupled with the increasing use of credit scoring and Wall Street's continued creation of new asset-backed securities, provided the liquidity for the phenomenal growth of the subprime mortgage industry. The subprime mortgage market, with its wider spreads, has become more attractive to conventional mortgage lenders given the compressed profit margins of the highly commoditized "A" mortgage market. Consequently, prime or conventional mortgage companies are increasingly entering the subprime mortgage market, attracted not only by the wider profit margins, but also the continuing development of the secondary market. The development of the secondary market and the increased securitization activity among mortgage lenders led to changes in accounting standards that dramatically altered the profitability dynamics of mortgage lending. The typical practice in the mortgage banking industry is to package and sell the ownership and risk of holding mortgages, with or without the servicing rights. When a loan is sold and the servicing right is retained, a mortgage-servicing asset (MSA) is created. The introduction of SFAS 125, which came into effect on Jan. 1, 1997, accelerated the revenue recognition on the disposition of the underlying mortgage. Under SFAS 125, the servicing and interest income expected to be collected during the life of a transaction in excess of what has to be passed through to the MBS investor is recorded as earnings at the time of securitization. The early realization of revenues allows for a more rapid buildup of capital, which when combined with the ability to remove loans from the balance sheet through securitization, allows companies with relatively modest financial resources to be in business. The result has been an explosion in the number of nondepository mortgage lenders since the mid-1980s. Some of these have accessed the capital markets and have obtained a Standard & Poor's rating. Among the nondepository mortgage lenders rated by Standard & Poor's are mortgage real estate investment trusts (REITs), mortgage companies specializing in loans that conform to U.S. agency (for example, Fannie Mae) standards, and specialty finance companies targeting credit-impaired or subprime borrowers. In the report that follows, Standard & Poor's offers an analytical roadmap to the industry. Rating Considerations General risks. Mortgage companies, regardless of their legal structure, are active in a business that is inherently cyclical. Real estate markets are tied to regional and national economic cycles and are greatly affected by changes in interest rates. Because of this, a company's sensitivity to cyclical factors will vary greatly along the rating spectrum. Mortgage companies that specialize in the higher credit risk, less liquid mortgage markets typically are rated in the noninvestment-grade categories. Managing through a cyclical downturn proves extremely challenging for the higher-risk credit profile companies, as shaken investor confidence and market volatility quickly leads to illiquid whole loan and securitization markets. Conversely, mortgage companies that derive the bulk of their revenues and assets from the prime single-family mortgage markets, which are of higher credit quality and are more liquid, could see ratings in the investment-grade categories. This does not imply that a company whose business model is not centered around the prime mortgage market would be precluded from achieving investment-grade ratings. Upon further review, a mortgage company's business and financial management practices, including the critical rating factors discussed below, could influence its rating outcome. The basic business models and associated risks. A mortgage company makes three decisions that define its business model. Each of these entails trade-offs in terms of the risk to creditors. A lender must first decide on which product or array of products it will acquire and/or originate. The nondepository mortgage lenders rated by Standard & Poor's offer: Commercial real estate loans, including multifamily housing loans; Residential mortgages that conform to U.S. agency standards; Prime credit quality, nonconforming residential mortgages; Nonprime or subprime credit quality residential mortgages; and Home equity loans. The lender must then decide what to do with the acquired mortgages. If the lender has chosen to be a portfolio lender, the mortgages will be retained on the balance sheet to generate interest income. Alternatively, the mortgages can be sold as a whole loan or, more commonly, securitized to realize a gain on sale for the lender. While one form usually predominates, all of the nondepository mortgage lenders rated by Standard & Poor's contain features of both. Even so, only the mortgage REITS rated by Standard & Poor's could be described as true hybrids, incorporating conduit operations with a large permanent investment or loan portfolio. The third major decision a lender must make is where and how to acquire the mortgages and whether to retain the servicing of the mortgages. In other words, the lender must decide on the extent of vertical integration. This varies widely among the mortgage lenders rated by Standard & Poor's, from total vertical integration where all origination and servicing is conducted by the company, to nonintegration, where product is acquired from and serviced entirely by third parties. A company can acquire mortgages using three basic methods: direct loan production; wholesale loan production; and closed loan purchases from correspondents. Commercial Versus Residential; Conforming Versus Nonconforming; Prime Versus Subprime Differences in the degree of credit risk. The type of mortgage loan in which a lender specializes will affect its risk profile, as some types of loans carry a greater risk of credit loss. Residential mortgages are broadly perceived as carrying modest credit risk. The perception of residential loans as containing less credit risk, even in the subprime category, is based on the fact that a residential portfolio is more granular; that is, credit risk is more widely distributed and individual credit exposures are smaller. The perception that commercial mortgage lenders have higher credit risk is driven partly by Standard & Poor's experience with the industry; in the past speculative excesses in selected markets caused difficulties even for lenders with conservative underwriting standards. Further risk grading occurs within residential mortgages and is based on how a loan is underwritten in terms of a borrower's creditworthiness and the degree of collateral protection. As a rule, residential mortgages underwritten to conform to Fannie Mae and Freddie Mac standards are considered to have the least potential for loss, given the stronger credit profile of the borrower, limited loan size, strict loan documentation requirements in the underwriting process, and limited loan-to-value ratios (the maximum is 80%; higher than 80% requires private mortgage insurance coverage). The hierarchy of risk for the broad class of residential mortgages that does not conform to Fannie Mae and Freddie Mac standards is more ambiguous and judgmental. That these loans are nonconforming may be due to concessions in: The borrower's creditworthiness; The size of the loan; The degree of collateral protection; The lender's lien position; or A combination thereof. Although nonconforming loans do not display the same level of uniformity as conforming loans, they nevertheless exhibit a much greater degree of standardization in underwriting than commercial mortgages. The analysis of home mortgage lenders in general is facilitated by a common loan grading system for the industry, dividing borrowers into prime ("A" quality) and subprime categories and further dividing subprime borrowers into B, C, and D categories. Variations in grade definitions among lenders are usually not material, making it relatively easy to compare the risk tolerances of different residential mortgage lenders and to track changes in tolerance levels. Determining the credit risk of a commercial mortgage is more challenging, as underwriting tends to be less standardized and the risk variables more numerous. The source of repayment typically is not the borrower, but the income generated by the securing property. Consequently, servicing commercial real estate loans tends to be more labor-intensive and specialized, with more protracted workouts and greater carrying costs than for residential mortgage loans. Because commercial mortgage exposures are much larger, the margin for error is much smaller. While Standard & Poor's focuses on management and process as part of its ratings evaluation for all mortgage lenders, regardless of specialization, these factors carry greater weight when assessing the risks of a commercial mortgage operation. Of particular importance is a review of the property types in which a commercial mortgage lender may specialize, as not all property types carry the same risks. Differences in liquidity and market risk. Nondepository mortgage lenders typically fund themselves through secured borrowings, pledging as collateral the loans originated by the lender. Secured borrowing facilities are usually structured with advance rates that represent a percentage of the market value of the collateral. If the value of the collateral declines, the borrower is subject to margin calls, requiring either a paydown in the borrowing or the pledging of additional collateral. If the value of the collateral deteriorates too rapidly or the related MBS or whole loan market dries up, the lender may be unable to liquidate its holdings at sufficient values to cover its margin calls. Market liquidity varies substantially among mortgage classes. Mortgages guaranteed by Fannie Mae and Freddie Mac are the most liquid, as the associated MBS market is the oldest and hence the most established and deepest. The presence of the agency guarantee insures that credit concerns do not become the cause of market revaluations. The market for nonconforming residential mortgages is less established and can suffer from significant volatility arising from credit concerns. Nevertheless, the existence of more than one securitization structure and a reasonable standardization of loan grade definitions makes the associated MBS market more reliable as a means of liquidating assets than, for example, the CMBS market. Because of the lack of depth and diversity of deal structures in the CMBS market and the relative scarcity of whole loan investors, the market values of commercial mortgages are subject to considerable volatility. Liquidity squeezes brought on by margin calls from secured lenders are more likely to affect commercial mortgage lenders than conforming or nonconforming residential mortgage lenders. Moreover, market illiquidity can from time to time become acute for noninvestment-grade-rated tranches of CMBS. A lender must also be assured that it can sell or securitize its mortgages at a price that will allow it to pay back its secured lender. Lenders protect themselves from a loss of value by hedging their mortgages with a financial instrument that is readily marketable and whose value will move in the opposite direction of hedged mortgages. The ability to hedge against market and interest rate risk is problematic for both commercial and nonconforming residential mortgage lenders. Standard & Poor's believes that the basic risk is higher for the lenders of these asset classes than for U.S. agency-guaranteed home mortgages. The market for conforming mortgages closely correlates the market for U.S. Treasury securities, the instruments most often used for hedging activities. In terms of credit risk, U.S. agency-guaranteed mortgage securities and U.S. Treasury securities are viewed as similar credit risks, and their respective values and yields tend to track one another more consistently. Portfolio Lenders Versus Securitizers Differences in earnings quality. An important distinction between a portfolio lender and a securitizer lies in the quality of their earnings. Portfolio lenders clearly offer creditors the greatest protection, with more predictable, annuity-like earnings realized in the period in which they are generated in the form of interest spread income. Because a portfolio lender recognizes interest income as it is received over the life of a mortgage asset, its income stream is more predictable than that of a securitizer, the bulk of whose earnings are front-loaded. Recognizing earnings over the life of the assets benefits creditors in two ways. First, management is better able to match the yields and repricing terms from assets to the costs and repricing terms of funding liabilities. Second, a portfolio lender is not under as much pressure to constantly originate or acquire product in order to report earnings, which is particularly challenging in a deteriorating economic environment. Portfolio lenders' earnings can be sensitive to changing interest rates. Such lenders might be faced with prepayments and returning money to a lender to be invested in a new asset, perhaps at a rate of return less than the cost of the funding liability supporting the original asset. Alternatively, if a portfolio lender is intentionally running an interest rate mismatch between the funding liability and the asset it is supporting, a decline in interest rates could narrow the spread between the two. While these are very real risks, the effect tends to be less severe than for a securitizer. Securitizers report the bulk of their earnings as projected servicing income and/or gain-on-sale income. Both subprime and conforming mortgage lenders recognize servicing income up front, and this income has a large noncash component. The calculation of income, which is capitalized and recorded on the balance sheet as a mortgage-servicing asset (MSA), is based, in part, on the assumed life of the securitized assets. Subprime lenders' gain-on-sale income is also largely noncash and is recorded on the balance sheet as an interest-only (IO) security, reflecting the interest expected to be collected in excess of what must be paid to the mortgage-backed bondholders. The main variables affecting this calculation are the rate at which the securitized mortgages will repay and expected credit losses. For securitizers of conforming mortgages, the gains on sale are realized in cash and no receivable is recorded. Although a lender expects the income it has reported to be realized as cash, the amount of cash collected could differ from what was initially estimated, resulting in a special gain or charge to earnings. If the income to be received is less than the amount originally estimated, the impairment charge can be recognized by netting the impairment against the current period gain on sales or interest income received from the booked receivable, or as an accelerated amortization, which will be recorded as an expense item. In a declining interest rate environment, prepayments due to mortgage refinancing accelerate (either as a result of lower rates, or, in the case of subprime lenders, to the improving creditworthiness of the borrower). If management has assessed the likelihood of prepayments accurately, the impact would have been factored into the value of the IO or mortgage servicing asset when it was booked. Where prepayments exceed earlier estimates, the impact should be muted by greater-than-anticipated originations, whereby volume-driven increases in gain on sales offset or even exceed accelerated write-downs of the IO or MSA. The logic behind this theory is that the favorable interest rate environment and strong economic growth that led to accelerated prepayments would also add momentum to overall loan originations. However, as recent events have shown, particularly in the subprime mortgage sector, a limited pool of qualifying and willing borrowers and a low barrier to entry against new competitors has created a frenzy of refinancings that has overwhelmed even the most conservative prepayment assumptions. In a rising interest rate environment, prepayments from refinancings would fall and the value of the servicing asset and IO would increase as the average life of the securitized mortgages is extended. This scenario could be affected by an increase in credit problems, which would accompany a significant rise in interest rates and a slowdown in economic activity. The impact of this would come mainly in the form of higher foreclosures, which are a form of prepayment. Going by past experience, foreclosure rates would remain well within the prepayment assumptions of most securitizers and would not mitigate to any meaningful degree the benefit on the mortgage servicing asset or IOs value created by a rise in interest rates. This has held true even for subprime securtizers. Both Delta Financial and Contifinancial, subprime mortgage lenders already in business in the late 1980s, were heavily concentrated in the Northeast, where the real estate market and the economy in general experienced a severe downturn in the early 1990s. The foreclosure rates experienced in their securitizations containing the loans originated before the downturn show that the impact from foreclosures on prepayments remained well below assumptions. While this experience is likely to be repeated for securitizers of conforming mortgages in the next economic downturn, Standard & Poor's does not assume that this will be the case for subprime lenders. First, the industry has grown exponentially since the early 1990s, suggesting at least the possibility that some adverse selection of borrowers may be occurring. Second, many borrowers, by consolidating credit card and other higher cost debt into lower cost home equity debt, are improving their creditworthiness and hence qualifying for a higher grading. While some of these borrowers will maintain strong credit profiles, others can be expected to reload with credit card and other revolving debt over the longer term, weakening their credit risk profile as their debt service burden once again increases. Behavioral scoring is being introduced by some subprime lenders as an underwriting consideration, but the validity of the model has not yet been demonstrated. The level and degree of prepayments not only have a negative impact on MSA and IO valuations, and hence, earnings, but also on some securitization structures. A number of securitizations (at least those supported by bond insurance) contain covenants directed at servicers that limit the level of permitted delinquencies within the supporting mortgage pool. A violation could prompt the trustee or bond insurer to seek a transfer of servicing. The securitizer would not only lose the current servicing (and the associated income) but would also be subject to an increase in the costs of future securitization through a tightening of terms by the rating agencies and bond insurers and/or by making its MBS less attractive to investors. To prevent this, subprime mortgage lenders that undertake their own servicing would have a strong incentive to buy poorly performing loans out of the securitization, which would further affect prepayments. Indeed, this practice is already evident, although the volume to date has been modest. Differences in liquidity risk. A further distinction between securitizers and portfolio lenders is seen in their cash flow positions. Standard & Poor's traditionally has evaluated a company's liquidity risk in terms of balance sheet (that is, maturity mismatches between assets and the liabilities supporting those assets) and the management of and absolute level of readily accessible sources of liquidity on both a secured and unsecured basis. Because most of the nondepository mortgage lenders rated by Standard & Poor's are relatively young companies that are still growing aggressively, the operations themselves consume significant amounts of cash. Consequently, operating cash flow and the ability of lenders to cover cash costs with cash income has taken on greater importance in the liquidity analysis of these companies. In the case of portfolio lenders, cash streams from assets tend to match those paid on funding liabilities, leaving sufficient spread to cover the costs associated with managing the portfolio as well as return a profit. Rarely, however, does a portfolio lender exist solely to manage its investments; it will also operate a transactional business, typically acquiring and securitizing assets. Such transactional activities affect the cash position of the portfolio lender, but the existence of interest spread income frequently leaves that lender in a better cash position than a pure securitizer. Moreover, because a portfolio lender has some annuity income, its access to capital markets to raise bridge cash is likely to be better preserved than that of a pure securitizer if a difficult economic environment disrupts its transactional businesses. The amount of cash consumed in a transactional business depends on the nature of the business itself. In the case of products for which well-established ABS markets or government guarantees exist, the cash received from securitization is optimized as subordination requirements and securitization costs are minimized. Thus, securitizers specializing in conforming mortgages are in a stronger cash flow position than subprime securitizers. The costs and credit support requirements of securitizing subprime lenders' loans still consume significant amounts of cash, leaving most of these lenders unable to cover their cash operating costs. As subprime companies mature, cash arising from past securitizations, as well as better execution on their securitizations, should improve their operating cash flow. Moreover, longer warehousing of loans on the balance sheet or even the establishment of an investment portfolio—a strategy increasingly being pursued by subprime lenders—should also alleviate some of the short-term cash constraints (although, as discussed earlier, any salutary effect on the lender's liquidity position of longer-term mortgage or security holdings would depend on how these assets were funded and hedged against market revaluations). In the meantime, most subprime lenders that rely on securitization continue to have large negative operating cash flows, and very few are able to cover the cash expenses of their business with cash income. Some financial flexibility is provided by unencumbered IOs and servicing assets and by subordinated securities (which are created as an alternative to cash reserves to provide protection for the more highly rated mortgage securities against credit losses). Standard & Poor's discounts this flexibility to some extent, however, as the market for these assets is yet to mature. Differences in leverage and the quality of capital. The capital-to-risk asset ratios of each type of lender would seem to point at last to an advantage that securitizers have over portfolio lenders; namely, that securitizers look to be more conservatively levered. While the leverage ratios of portfolio lenders generally have been trending up, those of most securitizers have remained stable or even improved. This advantage disappears when adjustments to each group's equity base are made to incorporate quality of capital concerns, however. Three main factors lie behind the apparent strength of securitizers' leverage ratios. First, securitizers, especially on the subprime side, have been reporting strong income results for the past five years as loan production and securitizations have exploded, contributing to an equally rapid accumulation of capital. Second, many of the subprime lenders rated by Standard & Poor's did not pay out dividends during this period. Third, many securitizers sell the bulk of their loans before the end of financial reporting periods, enabling them to disclose relatively clean balance sheets. To be fair, securitizers have accessed the equity markets, but the effect of new equity on leverage trends has not been as material as the above three factors. Because portfolio lenders retain loans and related securities on their books for much longer periods, their leverage ratios are higher than those of securitizers. As most of these companies, like their subprime brethren, have also been growing, leverage has increased. Securitizers' stronger capitalization is apparent rather than real when adjusted for the quality of each group's capital, however. Because securitizers' capitalization consists mainly of retained earnings generated by gain on sales, a large portion of capital is unrealized. On the other hand, portfolio lenders' capital consists mainly of paid-in capital and realized earnings. It is often argued that full credit for the disclosed value of an IO and MSA should be given, because these assets have to be marked to market when reported to investors. The reality is that the market values of these assets can be exceptionally volatile in a declining interest rate environment, and unless a workable hedging program and strong loan production business are in place to preserve their values, accepting a point-in-time measure as capital credit is too generous. Moreover, the actual valuation process, in the absence of a liquid and deep trading market for these assets, is itself problematic. Revaluations often occur only when management decides to change prepayment and other assumptions that affect the value of assets. Standard & Poor's examines the accounting assumptions used by a lender in calculating its MSA and IO security and may discount their value against the lender's capital if assumptions appear aggressive relative to peer averages. Likewise, a haircut may be applied if Standard & Poor's believes the risk in the asset is magnified as a result of the pledging of the asset. For example, this would apply to net interest margin transactions where the IO secures the financing, giving the fund's provider first claim on any cash received from the pool of securitized mortgages assets that generated the IO. A net interest margin sale effectively subordinates the portion of the IO retained by the lender, amplifying the effects of any impairment. In such a case, the haircut taken on the value of the IO could be as high as 100%. A REIT presents a unique challenge in terms of evaluating capital quality. Given that a REIT's capitalization consists mainly of paid-in capital or realized earnings, the quality of capital is high. What a REIT lacks, however, is flexibility to add to its capital base. By law, a REIT must pay out as dividends 95% of its taxable income, limiting its ability to build up capital through the retention of earnings. It is Standard & Poor's view that a REIT's inability to retain capital poses a significant risk for creditors. Differences in credit risk. Residential mortgage lenders that securitize effectively remove the risk of credit loss from their balance sheets. Conforming home mortgage lenders retain no residual credit risk. Subprime securitizers always retain some residual risk, as the value of the IO security is partly determined by an estimate of expected losses over the life of the securitization. A change in loss assumptions would have to be of a severe magnitude (quadrupling as opposed to doubling) to have anything but a modest impact on the value of the subprime lender's IO, however, especially compared with the damage inflicted by changes in prepayment assumptions. It could be argued that the growing trend of buying delinquent loans out of a securitization is in fact transferring credit risk back to lenders. Any associated losses are usually absorbed within the securitization before the loan is repurchased, however. Subprime residential and commercial mortgage lenders that securitize using senior/subordinated structures may not only retain credit risk, but this may be concentrated on the balance sheet. The subordinated securities in a senior/subordinated structure serve as a first line of defense against losses hitting the 'AAA' and other high investment-grade-rated securities tranches. Consequently, the balance sheet exposure to credit loss for securitizers that do not sell these securities (which are rated 'BBB' and lower or go unrated) can be as high as that of portfolio lenders. Vertically-Integrated Securitizers Versus Unintegrated Or Partially Integrated Securitizers Total vertical integration for mortgage lenders means the ability to directly solicit and underwrite borrowing customers and to service loans once they are acquired. Admittedly, substantial costs can be incurred in creating the infrastructure to support these functions. However, the control vertical integration gives lenders over the underwriting process and customer relationships positively affects both asset quality measures and prepayment rates, regardless of whether a lender is retaining a loan or securitizes it (and retaining a residual exposure). With only few exceptions, this is the case regardless of the type of mortgage in which a lender specializes. The logic here is straightforward. On the origination side, the closer a lender is to a customer, the better informed the credit decision. This is especially important for subprime lenders, whose customers have blemished credit histories and as such represent "story credits," the merits of which can best be judged individually. The same tenet holds true for commercial mortgage lenders, whose knowledge of a developer and/or owner is often key to the successful performance of a loan. Likewise, the incentive to monitor closely a credit for signs of problems and to respond quickly to such signs are strongest for those most affected by a deterioration in credit quality, namely lenders. Consequently, Standard & Poor's prefers lenders with direct or residual exposure to the loans they acquire to retain their servicing. A similar rationale applies to prepayments. Companies that retain control of customer relationships are better able to prevent the resolicitation of customers by other lenders to refinance. Resolicitation of mortgage borrowers has become an increasingly common practice by mortgage brokers and other third-party originators that have the upside of earning origination points and not the downside of seeing a loan prepay or the value of a servicing receivable impaired. Similarly, prepayment activity can be better monitored and controlled by the lender servicing the loan. If nothing else, the lender can attempt to retain a customer by offering to rewrite the terms of a loan when the notice of early repayment is received. Since the early 1990s refinance market, prime mortgage lenders have instituted prepayment penalties in an attempt to receive some compensation in periods of high refinance activity. This practice has long been undertaken by commercial mortgage lenders, and is being implemented by subprime lenders with greater frequency. For subprime securitizers, the economics of acquiring loans from third parties have proven unpredictable. Throughout most of the 1990s, as growth in the industry was taking off, subprime lenders were able to acquire mortgages more cheaply through correspondents and brokers rather than retail channels, especially branch systems carrying high fixed costs. The market was changing by 1996, however, as lenders found themselves paying premiums for bulk whole loan purchases of subprime mortgage loans as high as 6% and yield spread premiums to brokers of 1%-2%. After several years of torrid growth, the subprime market reached saturation point, with a shakeout of the industry beginning in early 1998 and accelerating in the late summer of that year. At the time of writing, yield spread premiums to mortgage brokers were evaporating and premiums on whole loan purchases were being dropped like rocks as bidders pulled back or withdrew completely from the market. Nevertheless, Standard & Poor's is not sanguine that the basic features of the broker-derived and whole loan mortgage market have been altered fundamentally. Barriers to entry remain low, and while banks may presently be reluctant to fund new mortgage companies, these conditions may turn out to be cyclical rather than secular. Moreover, the banks themselves and other traditional lenders are entering the business or expanding their existing subprime lending activities. Standard & Poor's believes that they will be even more formidable competitors, given their lower cost of funds. Standard & Poor's believes that a strong direct origination capability can help alleviate the boom/bust tendency of the business by diversifying origination channels. On the one hand, when whole loan or broker premiums are increasing, the economics of retail origination can hold a major cost advantage.Since retail sourced, loans can be originated at an advance rate below or near the par value of a loan, the risk of a negative operating cash flow is mitigated because directly originated loans, at least in normal times, can be sold into the whole loan market at a cash gain. This can be a critical advantage if the traditional source for financing a lender's cash deficit, the equity and unsecured debt markets, shuts down, as occurred in the second half of 1998. This is not as important for conforming mortgage lenders. Because the underwriting of conforming loans is highly standardized and these loans are of a higher and uniform credit quality, the cash costs associated with securitization are low. Moreover, the gains are realized in cash, and the cash from servicing arrives more quickly than it does for subprime securitizers (where cash may be diverted to fill reserve accounts supporting a securitization). Finally, Standard & Poor's does not give equal treatment to all retail strategies but rather looks at the cost structure to gauge the quality of a direct origination strategy. After all, if the economic climate deteriorates, a high fixed cost could dramatically worsen the declining profitability of a lender, especially a securitizer stuck on the gain-on-sale treadmill. For this reason, a retail strategy focused on physical branches may not make as much sense as one geared toward telemarketing or mailings. Conclusion This report has attempted to offer an analytical framework by which all mortgage lenders can be judged against each other, regardless of the business model adopted. This is not to suggest that a black box can be created into which the risks of the individual components can be thrown and somehow averaged out to come up with a rating. As mentioned earlier, many other variables must be considered, including highly subjective variables such as management skill in mitigating the risks associated with securitization or with sourcing through third parties or with commercial real estate lending. Likewise, a relatively low-risk business model can be seriously botched by a determined management.