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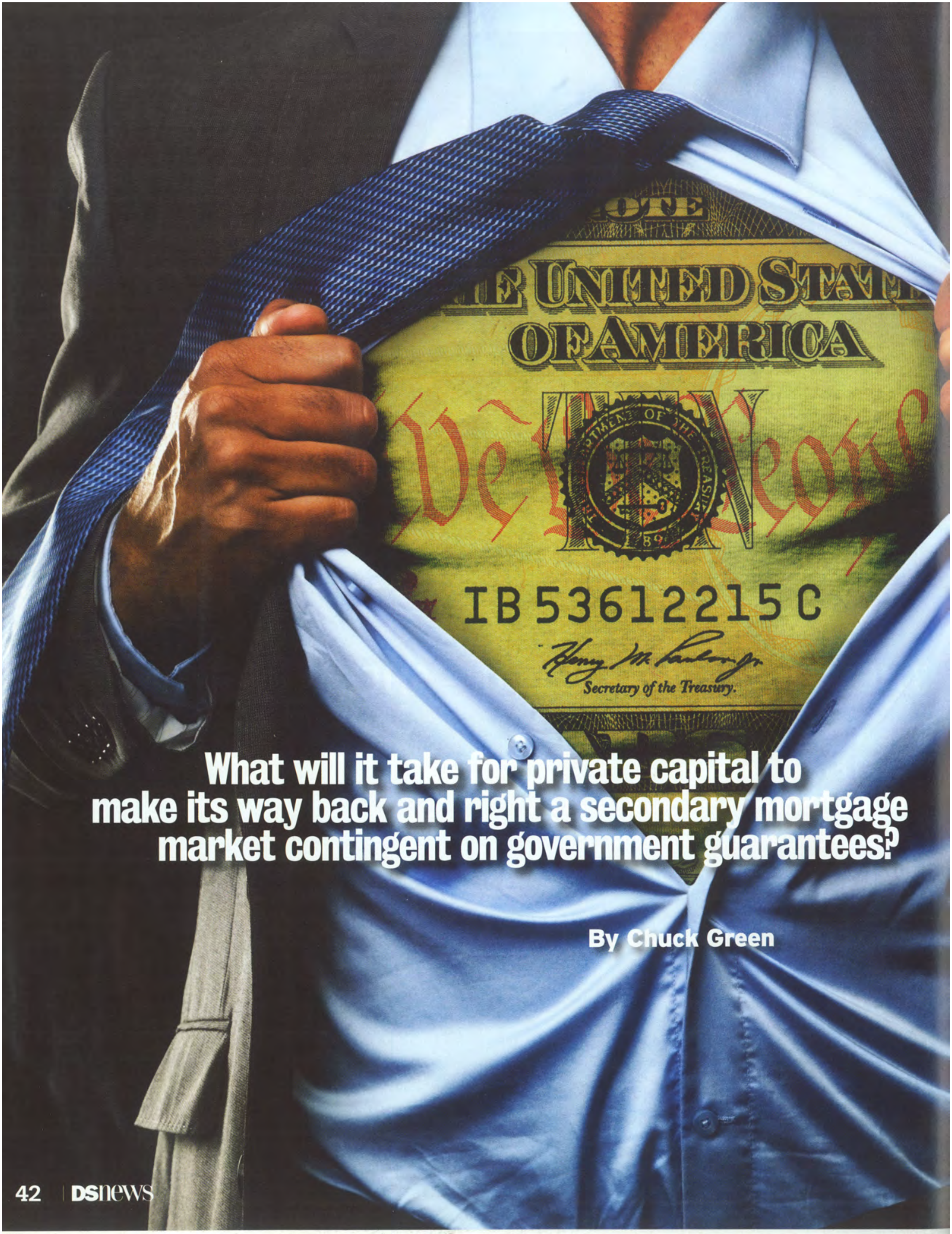
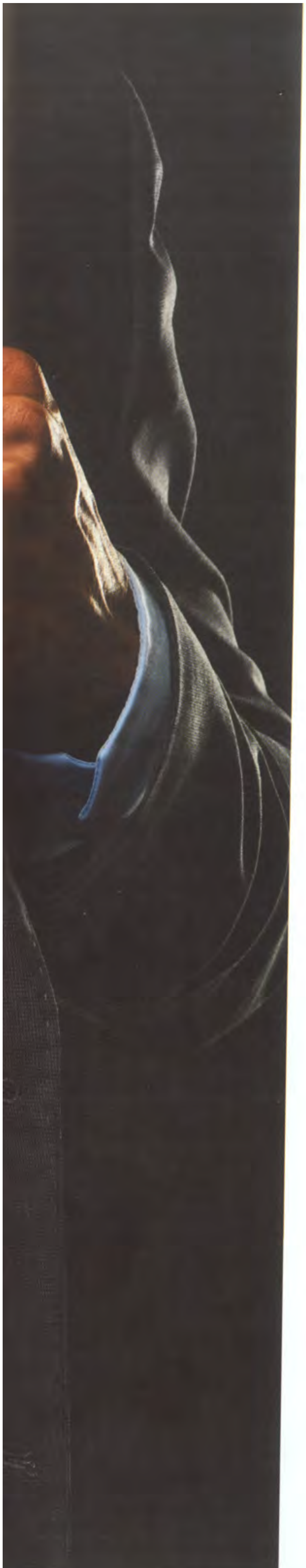


What will it take for private capital to make its way back and right a secondary mortgage market contingent on government guarantees?

By Chuck Green



COVER STORY

RETURN OF THE INVESTOR

As private capital creeps back into the secondary mortgage market, emboldened by housing's precipitous comeback from a near catastrophic slide, not surprisingly, some experts caution that the worst isn't over—and probably won't be for some time.

Jeff Freud, CEO of LoanMarket.net, labels the latest strides in housing as a mirage of sorts. "I think we're bouncing on another false bottom," he explained. "We see this seasonal uptick every year this time of year in every market, no matter how depressed it is. You're buying these non-performing loans at such a discount; everyone comes in with greedy expectations."

Mirage or not, expectations among private investors appear to be relatively high as they ride the wave of the current market momentum, Freud says.

"Investors are definitely more interested in putting capital into the housing market. We've seen a drastic uptick," he commented. "We're waiting for June results, but in terms of pricing and units sold, I think it will be one [of] our top three months on the non-performing side since ... 2008." The activity reflects the fact that buyers believe real estate prices are on the rise or, at least, have stabilized, Freud says.

He attributes private investor activity in the secondary market to his belief that "many of these guys are mortgaged with no skin in the game and have raised money with no skin in the game. You have to keep the engines going, [and to do that], you have to keep buying." Despite his skepticism, Freud concedes that successful investors have, with at least some success, maintained the pace through the sways in the market over approximately the last five years. "Their returns aren't 30 percent or 40 percent, but they're still high teens, and the investment capital's there for them," Freud said.

Investors are beginning to see improvements in market conditions. Investment U Research, which provides strategic financial recommendations for all levels of investors, notes that housing starts have posted consecutive monthly gains, with the number of units now exceeding an annual rate of 715,000. While that gets the market nowhere

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close to the 2.1 million starts seen in 2005, it's still a strong step in the right direction, the firm says.

Furthermore, building permits usually act as a reasonably good indicator for future construction. In March, permits exceeded expectations and, at 769,000, hit their highest annual rate since September 2008, reported Investment U. Better yet, signs point to more to come since new home inventories have been at historical lows for the past three years, the research firm notes. This means there aren't as many houses on the market, so any spike in demand—which Investment U anticipates—will need to be met with new developments and individual residences.

Investment U also points to the fact that the National Association of Home Builders/Wells Fargo Index of builder confidence climbed in each of the last five months. At the end of the first quarter of 2012, it reached its highest level in five years. D.R. Horton, the nation's largest homebuilder, reports new orders are up 19 percent.

For the first quarter of 2012, the Federal Housing Finance Agency reported that property values rose 0.3 percent month-over-month and 0.4 percent year-over-year. That's the first positive reading since 2007, Investment U reported.

Lisa Marquis Jackson, SVP at John Burns Real Estate Consulting, says while the housing market has bottomed and a slow recovery is underway, the real question is what the recovery looks like. While stating she could make a "bull case for a roaring recovery" based on overcorrected prices, great affordability, low construction, declining resale listings, and rising rents, "our exuberance dampens a bit as we think about financing's role in the future of housing," particularly during the next 12 to 18 months, she said.

New Risks Surface

Even with the market's recent relative improvements, Chris Katopis, director of the Association of Mortgage Investors (AMI), urged caution among private investors. Katopis insists investors would be sage to access and fully understand the risks associated with mortgage investments today, such as the eminent domain issue that surfaced in San Bernardino County, California, which he called "very troubling" to investors and private capital.

Under California's eminent domain law, the government is required to pay the "fair market value" of the property. As defined in the California Code of Civil Procedure, the fair market value of the property seized is "the highest price on the date of valuation that would be agreed to by the seller, being willing to sell under no particular or urgent necessity for doing, nor obliged to sell, and a buyer, being ready, willing, and able to purchase, but under no particular necessity for so doing, each dealing with the other with full knowledge of all the uses and purposes for which the property is reasonably adaptable and available."

This is different from the definition of market value used in the marketplace, according to the California Eminent Domain Law Blog. Put simply, owners in eminent domain proceedings are entitled to the "highest" price that might reasonably be expected, which is determined by appraisal opinion, despite the reality that the government's and investors' appraisers often differ substantially in their opinions of what the "highest" price should be, according to the California attorneys who wrote the blog posting. If the investors involved are dissatisfied with the city's value assessments, they wrote, it leaves the city or county with three options: pay the owner-investors an amount the two parties can agree to; force the sale through eminent domain; or drop the project completely.

Katopis says AMI and its members are bothered by many aspects of the issue, including government interference with markets and the group's belief that it will further depress home prices and chill home building. Additionally, Katopis worries it will impede the ability of borrowers in the subject markets to obtain financing from community banks and other lenders and damage individuals' 401k and retirement savings. "It will keep private capital out of the U.S. mortgage market," Katopis said.

Whatever the case, there is no doubt that private equity now sees housing as more attractive than it did in recent years, according to Ron D'Vari, CEO and co-founder of NewOak Capital, LLC. "A year ago, everyone was worried about [issues like] the U.S. budget and downgrades," he said. "Then, 'magically,' paced by consumers, the fourth quarter of 2011 and the first quarter of this year, the U.S. economy started flashing signs of recovering." In fact, D'Vari says, the primary worries are now the euro crisis and global economic slowdown.

Private Capital vs. Government Involvement

While Katopis also acknowledges a spike in activity from this time last year, he frets over the U.S. government gumming up investor interest. "Investors seek return, so if a lot of government policies are tied to an investment, or if there are any other issues that the government can increase the risk around the investment, they all have to be reassessed," Katopis said.

Freud echoes that sentiment. "You have to get the government out of it," he said, adding that if private capital plays a bigger role in the secondary market, it could help improve asset performance. "When private capital comes in, the regulatory issues will be nil. You won't have the risk," Freud said. "The best thing that could happen to our market is to shut down Fannie Mae and Freddie Mac. And you won't be answering to Dodd Frank."

Fitch Ratings says continued uncertainty associated with aspects of the Dodd-Frank Act has caused many traditional issuers of residential mortgage-backed securities (RMBS) to delay their issuance plans. Of particular concern are the details surrounding the definition and creation of an exemption from the risk-retention requirements for qualified residential mortgages. Federal agencies issued a Notice of Proposed Rulemaking on the risk-retention exemption in March 2011. Some further clarity on the matter is hoped for in the third quarter of this year.

The research and analytics firm CoreLogic, however, seems slightly more bullish about Dodd-Frank. Implementing the reform legislation should, over the long term, enable market participants to understand and chart their market involvement far more easily than in the past, CoreLogic SVP Brendan Keane wrote in a research paper he titled "Navigating the New Secondary Residential Mortgage Market." Keane did concede, though, that pending regulatory provisions may require recalibration to ensure they don't over-burden consumers and institutions and unintentionally hinder market recovery. Nevertheless, he says the regulatory certainty expected from Dodd-Frank should help pull the private-label securitization market from the dark, distrustful place it found in the wake of the crisis by providing transparent baselines against which all market activities can be openly measured.

In any event, an upswing in the secondary market notwithstanding, there aren't many deals on the private-label side, Katopis says. "One sentiment is that mortgage investors are on strike because they just can't invest in the current climate." That's particularly true because the U.S. government sends the market some troubling signals that require reevaluation, he says. "Investors need to be convinced it's a sound investment and government won't create risk."

Freud doesn't see private capital entering the new origination space anytime soon. "All the entities that would consider getting into private capital and the housing market, like Ranieri Partners and PIMCO, won't in the next three to five years. No chance," he said.

Foreign Investors Seek Value

Meanwhile, Katopis says foreign investors appear to be taking a wait and see attitude in restoring private equity to the U.S. housing market. "Foreign investors are intelligent; they're looking at things the same way all other private investors are," Katopis said. "If you're investing in something the government can nationalize or make risky, pass. Go on to the next thing. That's why there's not been a significant RMBS securitization in the last three or four years. People are risk adverse." On the other hand, Freud says his group regularly meets with a number of investors from foreign lands, including Chile, China, and Japan. However, while some of the larger banks from these countries "definitely are putting their feelers out, I just don't know if they'll ever get comfortable enough" to sink their capital into U.S. housing, Freud said. "Maybe they're smarter than we are and just aren't ready to come into the market yet." However, Freud says they might be particularly reluctant because they're unsure how to build the necessary infrastructure.

D'Vari says foreign investors typically rely on the big funds to time their entry into the market. "Given the inflow of capital to these larger funds, you would naturally see allocation to the residential sector," he explained. Capital is coming from both U.S. and foreign investors, such as Canada, the Middle East, and Asia, where they're trying to diversify from energy, D'Vari says.

Meanwhile, Freud notes there's been great interest in mortgage-backed securities comprised of so-called "scratch and dent" mortgages, meaning higher risk loans that fail to meet the lender's underwriting criteria. "Without a doubt, the scratch and dents are huge," Freud says. "I've talked to Wells Fargo and Bank of America, and they're just holding their scratch and dents on their books. [It's] such a great loss [that] you're not seeing those trading," Freud said, acknowledging the lack of a marketplace for such deals. "The smaller mortgage bankers don't have the warehouse lines anymore. The scratch and dent is kind of our space, and I think they're lumped with non-performing and re-performing," priced at points where they can't be sold, he explained.

D'Vari says institutional investors are generally targeting larger markets with diverse economic and population growth while smaller investors remain patient in markets such as Arizona and Nevada, where there's a huge supply of existing and shadow home inventories still tucked away from the market.

Foreign investors are seeking value with governments trying to ascertain ways of targeting investments in certain regions of the United States, according to Katopis.

Ultimately, though, he says private capital is not the solution. "There's, no sugar daddy," Katopis said. "People think, 'oh, the Chinese will save us,' but no. If our government has stupid policies, no one's going to invest here." DS

INDUSTRY INSIDER Q&A

Tom Deutsch, executive director of the American Securitization Forum (ASF), gives his take on private capital's return to the secondary mortgage market.

***DS:** Are investors interested in pumping capital into housing now that it appears the dust has settled from the crash?*

Deutsch: It's not clear what investors' appetite for investing in RMBS [residential mortgage-backed securities] is at this stage. Some still have a view that home prices have some ways to fall yet, especially in judicial states like New York that have three-year lags in foreclosures. Moreover, local government initiatives like the proposed seizures of mortgage loans by San Bernardino County continue to scare some investors off from populist takings of investments.

***DS:** What types of deals are currently taking place on the private-label side?*

Deutsch: Most deals that have been done post crises are extremely high-quality loans and are super jumbo. Until the loan limits come down for the GSEs and FHA, the private markets are likely to be relegated to this thin sliver of securitization for some time.

***DS:** How big a role does foreign investor activity and interest play in restoring private equity to the U.S. housing market?*

Deutsch: We can't underestimate the importance of foreign investment in the U.S. housing market. Certainly large U.S. institutional investors play a big role, but getting more foreign investors to return to purchasing U.S. private-label would be greatly beneficial.

***DS:** What effect is the scene in Washington having on the secondary market's private capital revival?*

Deutsch: When both sides of the political aisle are singing from the same hymnal that the U.S. has to reduce government backing of mortgages, there seems to be a clear policy alignment. Unfortunately though, the size of the U.S. mortgage market is so big, even if there is small disagreement between the parties in Congress, the length of time to resolve those differences to get to comprehensive reform could be interminable.