



Bad Times for Information

The mortgage technology industry is in its own recession. To get some sense of the origins and depth of the technology recession, we went back to our raw MORTECH 2007 data (updated December 2007). From those data, we calculated the technology spending from companies that either went out of business in 2007 or closed a significant portion of their business. We stopped counting at \$300 million.

Roughly 10 percent of core technology spending suddenly disappeared.

Beyond the ephemeral \$300 million, for some time we have been arguing that important market segments of the mortgage technology market were mature. It may not feel like it, but it is true. For instance, in the loan origination system (LOS) market, the growth in the number of new technology users (companies) peaked all the way back in 1996–1997. Increasingly, the bulk of technology sales being made has been displacement sales—business that has to be wrested away from an already installed competitor.

The decimation of the subprime markets has blown up the segment of the core applications market having the greatest growth over the past five years. The sudden loss of revenues from subprime lenders leaves the technology suppliers with instant overcapacity.

Technology spending is falling off in many places. To be sure, mortgage technology is not the only sector in distress. In February 2008, RBC Capital Management, Toronto, Canada, polled 400 individuals from a survey panel of 11,000 information technology (IT) early adopters within 7,500 companies across industry lines. RBC Capital showed that most information technology sectors were in a downturn.

RBC Capital reported that 74 percent of those surveyed had no software purchasing plans for the next 90 days. Even growth in areas such as software as a service (SaaS) was negatively affected. Only 23 percent of respondents said they plan to spend on SaaS technology, down from 35 percent in RBC's previous survey. Spending plans were cut for

corporate purchases of PCs in the next 90 days, IT services and networked hosting services.

“Without a doubt, this is the most severe spending downturn. It's clear there's been a 'come to Jesus' moment for tech spending across corporate America,” says Marc Harris, co-head of RBC's global research.

There is no doubt that mortgage technology spending has been diminished by the realities of structural change and the specter

of a bank run in 140 years. President George W. Bush and U.K. Prime Minister Gordon Brown have agreed to step up cooperation over the crisis in financial markets. They are setting up a joint working group that will develop plans to monitor and regulate the international banking system.

This threat to the modern era of asset financing is not yet passed. Its salient trait has been the inability of the financial system to both provide and allocate credit effi-

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of a deeply disturbing crisis in the mortgage derivatives market.

Attack on the credit market structures

Can the business environment be worse than the data imply? Change in the structure of housing finance following the savings-and-loan crisis in the 1980s was designed to fend off periods of financial illiquidity. The critical reform came as mortgage lending moved away from depository balance-sheet lending to a market-based system of securitized mortgage finance.

Under the new structures, liquidity in housing finance no longer was subjected to artificial constraints created from monetary policy or non-economic regulatory shackles. Financial market reform begun in the 1980s was sure to eliminate severe and crippling liquidity seizures in the 1990s forward, or so it was thought.

The 2007–2008 crises in the credit markets have been an extraordinary threat to not just the financial system of the United States but to that of the entire interdependent world. Consider that Britain had its first

of a deeply disturbing crisis in the mortgage derivatives market. The mere possibility that a threat of illiquidity could materialize is responsible for recurring weakness in various corners of the credit markets. The Goldman Sachs Group Inc., New York, forecasts global credit losses stemming from the current market turmoil will reach \$1.2 trillion, with Wall Street accounting for nearly 40 percent of the losses.

Parts of the credit market are truly dysfunctional. For instance, issuance of asset-backed securities (ABS) has vaporized. Monthly issuance of private-label mortgage-backed securities (MBS) fell from \$99 billion in May 2007 to a mere \$3 billion in January 2008—nearly a total market shutdown (see Figure 1). So much of the industry's growth can be linked to a growing non-agency securities market.

And there's more. From time to time, high-yield bond markets have essentially closed. Leveraged asset and acquisition deals have gone wanting for financing. Bank balance sheets have been under continual pressure. Financial assets have suffered from historically high spreads to the

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pricing of less-risky assets. The operating environment has been filled with doubt and divisiveness.

The Bank for International Settlements (BIS), Basel, Switzerland, went on record saying that central banks around the world were starting to doubt the virility of U.S. financial philosophy, policies and principles. Their concerns are centered on the propensity for U.S. regulators to let asset bubbles build up without strong intervention. The assumption made in the United States of such policy is that financial bubbles safely can be “cleaned up” after the fact. BIS concluded that such *laissez-faire* financial management “. . . was more or less the strategy pursued by former Fed Chief Alan Greenspan after the dot-com bust.”

BIS has concluded that the United States will continue to have difficulty compensating for serious economic and financial imbalances. BIS pointed to the United States’ current account deficit at 6.5 percent of gross domestic product (GDP), U.S. external liabilities rising by more than \$4 trillion and a frightening drop in the U.S. savings rate. “Dollar-denominated assets are clearly vulnerable to a precipitous loss of private-sector confidence,” it said.

BIS warned about reliance on conventional monetary tools such as cutting interest rates. While using policy tools to lower

interest rates in a crisis may seem to help, it has the effect of transferring wealth from creditors to debtors and “sowing the seeds for more serious problems further ahead.”

It is a frightening thought, but BIS compared current conditions and policy application to the conditions leading up to the Great Depression. BIS observed that conventional approaches were implemented and had failed in the United States in 1930 and in Japan in 1991. BIS concluded that there are striking similarities across time. Then and now, excess debt and ill-considered investments built up in boom years. Consequently, the excesses suffocate the financial institutions on which all commerce relies.

Financial Stability Forum (FSF)

A high-powered council of financial experts thinks that the engine of mortgage growth may be permanently disabled. The Financial Stability Forum (FSF) is an independent body housed within BIS. This Basel, Switzerland-based forum of senior representatives from many national financial authorities has severely criticized the running of collateralized debt obligation (CDO) markets. Remarkably, FSF is on record as predicting that the ABS-CDO business will disappear.

The FSF consensus holds that CDO market discipline has been weak. Investors in ABS CDOs have failed to look through

complex credit-risk transfer (CRT) structures to the underlying risks of the subprime mortgage market. CDOs of subprime mortgages are the CRT instruments at the heart of the current credit crisis. A massive number of senior tranches of these securitization products have been downgraded from triple-A ratings to non-investment-grade. CDOs are a failed market.

Business is awful

Vendors want to see the best in every situation. Optimists sell more than do pessimists—seems logical. What is not true is the myth that lenders will buy more technology when business is down and they have time to implement what they buy.

It does make strategic sense to build new capability to prepare for the next business recovery. It is illogical, however, to invest new capital in turbulent times—times when managers have difficulty valuing their businesses.

Can vendors find a way through the damp of a down market? There is one category of technology application that could become a substantial opportunity for vendors even in the midst of such profound industry dread. The storm over credit losses and a rash of business and securities lawsuits are producing a maddening array of complex and generally unproductive legal and regulatory red tape. Compliance is notably a labor-intensive function. Displacing labor by automating legal and regulatory compliance may be the vendors’ deliverance from the depths of this business cycle.

According to the Securities Industry and Financial Markets Association (SIFMA), New York, investment bankers spend in excess of \$25 billion complying with national and local laws and regulation. SIFMA estimates that 94 percent of expenditures on compliance activities is for salaries.

The cost and effort to comply with law and regulation in investment banking may be analogous to what can be expected in mortgage banking. It is possible that technology vendors can find a substantial business opportunity arising from the credit crisis. Inventive technology suppliers might see considerable gain from automating something akin to the \$23 billion spent on compliance staffing in the new and more highly regulated mortgage industry. Opportunity is shining in the darkest corner of the industry.

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Figure 1 Monthly Private-Label MBS Issued (March 2007–February 2008)

