EXAMINING THE GROWTH OF THE COLLATERALIZED MORTGAGE OBLIGATION MARKET

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DTCC®

The Depository Trust & Clearing Corporation

OVERVIEW

The rapid growth of collateralized mortgage obligations (CMOs) in combination with low interest rates have increased the volume of related principal and income payment processing handled by The Depository Trust & Clearing Corporation's (DTCC) depository. The lack of industry-agreed standards or consistency in the procedures for handling such payments, together with the extremely tight time frames for processing them, have exacerbated existing problems. The high volume of late notifications on paydowns handled through partial calls and the resulting "post-payment" adjustments have adversely impacted the depository and the industry. This paper outlines recent trends, examines CMO processing practices and the resultant issues, and provides an update on current and prospective CMO processing initiatives.

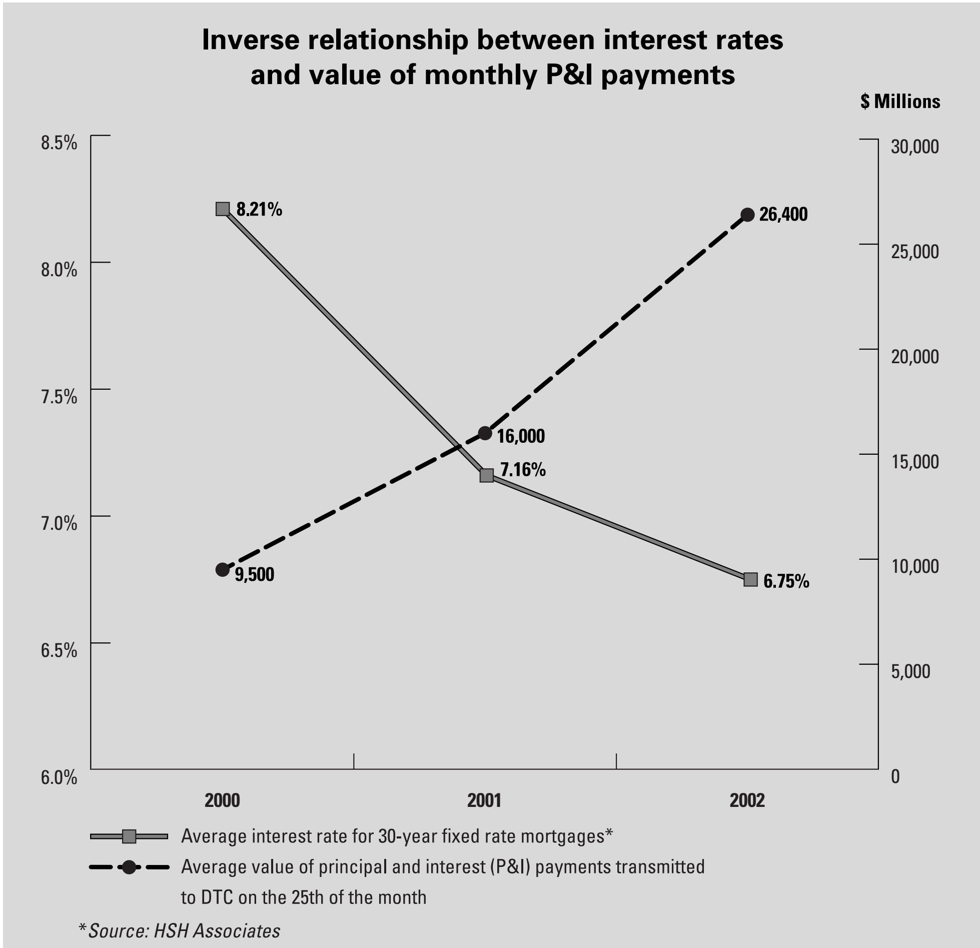
BACKGROUND AND RECENT TRENDS

The CMO is a multiclass bond backed by a pool of mortgage pass-throughs or mortgage loans. The issuer or servicer of these pass-through securities collects the monthly payments from the homeowners whose loans are in a given pool, and "passes through" the cash flow to investors in monthly payments that consist of both interest and repayment of principal.

As the payments on the underlying mortgage loans are collected, the CMO issuer, through its paying agent, pays a coupon rate of interest to the bondholders along with all scheduled and unscheduled principal payments generated by the collateral, as loans are repaid or prepaid.

As with other fixed income securities, interest rate movement has an impact on CMOs because it affects prepayment rates, which in turn affect yields. When interest rates decline, prepayments generally increase as many homeowners choose to refinance their mortgages at a lower interest rate and thus reduce their monthly obligation. Conversely, rising interest rates may decrease the volume of prepayments.

Recent historically low interest rates have translated into a greater number of mortgage refinancings. As a result, the volume of principal distributions has skyrocketed for CMO issues. In the past two years, the average distribution of principal and interest payments on the 25th of the month, through DTCC's depository, has gone from \$9.5 billion to \$26.4 billion, with a high of \$38 billion on November 25, 2002. Consequently, the processing challenges associated with CMOs, which have always existed, have been exacerbated by these larger than normal amounts of principal repayments. Adding to the problems is the nearly 95% increase in the dollar value of new CMO and other asset-backed issues coming to market through DTCC, when comparing 2002 with 2000.



PRACTICES AND KEY ISSUES IN CMO PROCESSING

The principal players in the CMO market include servicers, paying agents, DTCC's depository and broker/dealers, each of which has a key role in the process. Servicers collect and pool principal, interest and escrow payments and then pass the proceeds as well as the detailed payment information to the paying agents. Additionally, they perform loan payment follow-up and loan analysis. Paying agents, acting on behalf of issuers, pass the detailed payment information to the bondholders and, on payment date, distribute interest and principal to the same bondholders. DTCC's depository is usually the only registered bondholder, as most CMO issues coming to market are distributed in book-entry-only form through the depository. When the depository receives the detailed payment information, it immediately makes it available to its participants (which include broker/dealers) and on payment date credits its participants' accounts with the interest and principal received from the paying agents.

In most instances, payment information — i.e., the principal amount, interest rate and factor information — is not available until very late in the process (usually beginning three days before the established payable date). In fact, approximately 25% of payment information is still open on the morning of the payable date, with missing information streaming in sporadically throughout the day, and approximately 2% is still outstanding by the end of the day. Furthermore, payments received by DTCC's depository are not always clearly identified by paying agents as to specific CMOs or whether the funds represent call proceeds, principal paydowns or interest.

In addition to receiving the bulk of the payment information in a condensed time period, a significant amount of this information subsequently changes. Currently, approximately 0.33% of the payments allocated to the depository's participants require adjustments as a result of inaccurate interest rates, principal or factor information being sent to the depository by paying agents. These adjustments are more problematic today due to the increased volumes and value of payments being adjusted. Complicating the issue is the fact that the required adjustments are often not known until months after the payment date. Since there is no industry convention as to when announcement information should be made available or at what point accountability for incorrect announcement information should reside with the responsible party, depository participants must decide (in cases where the correction means taking money back from their clients) whether to assess their clients for the funds or to absorb the loss.

Paying agents, sharing DTCC's concern about increased volumes, cite frustrations in receiving timely payment information from multiple servicers and the short window to process the information when it is received. Servicers, who collect and pool principal, interest and escrow information and then pass detailed payment information to the paying agent, hold volumes responsible for the delays and inaccuracies. Broker/dealers identify faulty factor information as a major concern, as it often causes adjustments to principal and interest payments, and may also affect the settlement amount of trades. (Most CMOs maintain original face value throughout the life of the security, and as principal is paid down, the remaining value is stated as a factor of the original — e.g., a CMO with a $1,000 original face value and having paid down $200 in principal would have a factor of 0.8. Thus, a sale of $50,000 bonds with a coupon rate of 10% paid monthly would be calculated as follows: $50,000 x 0.8 *plus* $50,000 x 0.8 x 10% x number of accrual days ÷ 360.)

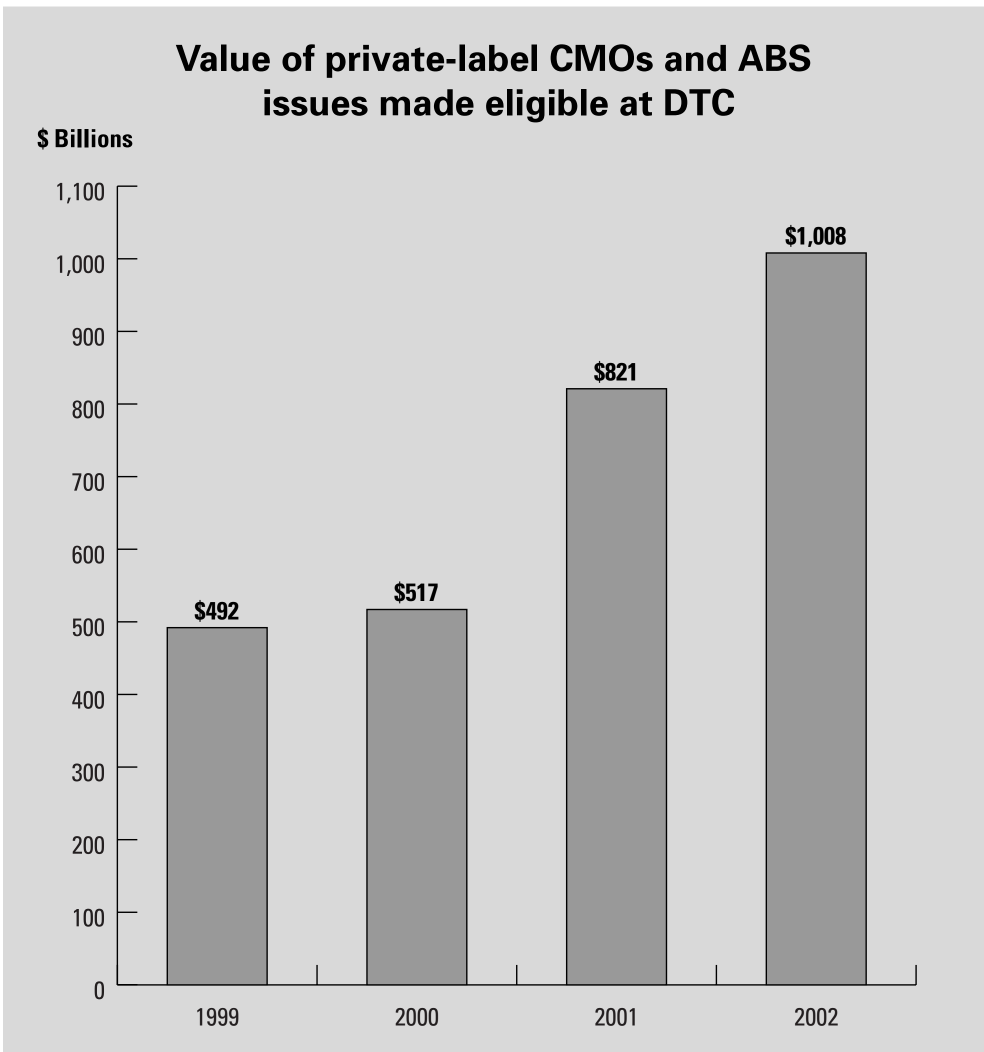
A major reason these problems continue to trouble the industry is that there is no single regulatory agency that oversees and monitors CMO activity.

Concerted Industry Action

CMO market participants agree that the structure of deals and associated reporting require fundamental changes. A task force of issuers, paying agents, servicers, underwriters and broker/dealers — with the active participation of DTCC, the sponsorship of The Bond Market Association (BMA) and the support of the Securities and Exchange Commission (SEC) — is mapping out a strategy that includes: 1) greater standardization, 2) increased automation, 3) timeliness requirements for transmitting announcement information, and 4) clearly defined accountability and time limit parameters on adjustments.

The task force will continue to refine its strategy in 2003. It has already made good progress on one of its four key recommendations: greater standardization (the task force has agreed on a standardized file layout for information that is sent to DTCC's depository.) During 2003, it will develop action plans for the three additional components of the strategy. The BMA will continue to facilitate the task force meetings.

In addition, DTCC has taken a number of steps to address the issues, and has planned several new initiatives to be implemented in 2003, as outlined in the following section.



Between 2000 and 2002, the dollar value of CMO/ABS securities issued through DTCC's depository increased 95%. During the same time period, the average dollar value paid out in principal and interest increased 178%, while the number of payments jumped 33%. DTC also experienced a 31% increase in overall call volume in this same two-year period.

KEY DTCC INITIATIVES

DTCC has implemented a number of initiatives to help strengthen CMO processing. For example, several reports have been created and enhanced to help depository staff monitor announcements and to detect and prevent potential errors before they occur. In addition, to help identify missed calls, the depository reviews all unidentified overpayments over $5,000 on payable date+1. Prior call history is checked and agents are contacted on all "round dollar" credits — i.e., multiples of $1,000 — that suggest payment for a called issue. The depository has added staff to assist in the research of overpayments, including this specific task. The paying agents that handle the highest volumes now receive monthly "report cards," which include detailed information on late and revised calls, as well as announcement and payment information on CMOs. These report cards provide a comparison of volumes and deficiencies for high-volume agents and help pinpoint problems.

Additional DTCC projects scheduled for implementation in 2003 include:

- Capturing redemption information contained in an issuer's documentation by adding more fields to DTCC's security masterfile
- Generating a warning message if a depository staff member attempts to create an announcement contrary to the information maintained on the security masterfile
- Automatically announcing floating payable dates
- Creating a link between the announcement data base and the security masterfile to ensure that changes to payment attributes made to the announcement database are updated to the masterfile
- Identifying inconsistencies between the masterfile and the announcement database

As a result of the industry's most recent efforts, adjustments made after the payable date that are attributable to inaccurate rates have decreased 34%. On the call side, late notices from the highest-volume agents are down 10%, while processing revisions are down 11%. In addition, as a result of the depository's payable date +1 overpayment review, it identifies sooner than in the past, call money that has insufficient identification, which paying agents have sent to the depository.

The initiatives undertaken by DTCC, The Bond Market Association and the industry overall to address these growing issues are steps in the right direction. Through both internal processing enhancements and a broad effort to establish more rigorous reporting standards for agents and trustees, development of industry-wide solutions is well under way.

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