Private Mortgage-Backed Securitization Under Dodd-Frank, GSE Reform and Beyond

Date: Monday April 4, 2011  
Time: 12PM EDT  
Duration: 60min  
Speaker:  
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Cliff Rossi is Tyser Teaching Fellow and Executive-in-Residence of the Center for Financial Policy at the Robert H. Smith School of Business, University of Maryland. He has nearly 25 years of industry and regulatory risk management experience at senior executive levels. Dr. Rossi’s last position was as Managing Director and Chief Risk Officer for Consumer Lending at Citigroup, where he was intimately involved in TARP funding and government stress tests, overseeing risk on secured assets of 300+B. He also served as Chief Credit Officer at Washington Mutual (WaMu) and as Chief Risk Officer at Countrywide Bank. Cliff’s background includes senior roles at Freddie Mac and Fannie Mae, the Treasury Department and the Office of Thrift Supervision, and as an adjunct professor in Finance at the Robert Smith School of Business. Dr. Rossi holds a PhD in financial economics from Cornell University.
Key Questions & Themes

• What is the state of mortgage securitization today?

• What are the risk retention and qualified residential mortgage rules in Dodd-Frank?

• How could they be implemented and what impacts could they have on markets and participants?

• Where does GSE reform fit in to all of this discussion?

• What are likely outcomes?
Level-Setting: Mortgage Securitization Dominated by Government Activity

• Securitization of residential mortgages an ingredient that fueled expansion of mortgage market culminating in collapse beginning in 2007

• MBS Market Destabilization
  • Prior to the housing collapse, private label securitization (PLS) accounted for about 50-60% of mortgage securitizations.
  
  • Today, 98% of mortgage securitization is done by the GSEs and FHA.

• In addition to market disruptions, Dodd-Frank and other regulatory proposals such as the recent GSE Reform blueprint cast a great deal of uncertainty over mortgage markets

• What exactly are these rules about?
Dodd-Frank Act & Mortgage Securitization

• Risk Retention Provisions
  • Establishes conditions under which securitizing firms must retain an interest ("skin-in-the-game") in the credit risk of a transaction
  • Reporting and disclosures of transactions
    • Includes mortgage servicing standards, not to contravene any subsequent interagency standardization
  • Due diligence/quality control requirements

• Qualified Residential Mortgage
  • Describes the characteristics of underlying mortgages that would qualify for exemption from risk retention requirements

• How specifically does risk retention and QRM operate?
Risk Retention

• A securitizer will be required to hold a minimum of 5% of the credit risk of a transaction in the event the underlying loans do not meet the QRM requirements.

  • Something less than 5% retention is allowed where the federal banking regulators determine that the origination underwriting complies with their standards.

• For all securitizations where the mortgages are deemed QRM-eligible, no risk retention requirements are imposed on the securitizer.

• For resecuritizations such as CDOs, the banking agencies will determine risk retention requirements.
Risk Retention Considerations

• Forms of risk retention
  • Vertical or horizontal slice, L-shaped, other forms to allow flexibility for other ABS arrangements

• Duration of risk retention
  • No expiration – means sponsor/securitizer retains exposure until pools are paid off

• Hedging and risk transference
  • Disallowed for securitizers/sponsor on specific securities where they retain risk

• Risk sharing arrangements
  • Allows flexibility for securitizer to allocate part of risk retention to an originator providing at least 20% of a pool’s assets
Risk Retention: Vertical or Horizontal Slice?

In a securitization, a key objective of risk retention is to better align incentives among securitizers and investors.

Two ways to accomplish this is to create a vertical or horizontal risk retention requirement as shown below.

### Vertical Slice

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<tr>
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<tr>
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<tr>
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<td>Subordinate</td>
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<tr>
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### Horizontal Slice

<table>
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Risk Retention Structural Issues & Incentives

- A vertical slice ensures the securitizer has an interest in each tranche
  - Ensures greater consistency of servicing practices across tranches
- A horizontal slice imposes greater first loss onto the securitizer
  - Greater incentive for securitizer to ensure quality assets in a transaction
- Accounting implications from 5% horizontal retention requirement could be prohibitively costly if banks are forced to hold dollar-for-dollar reserves
- Risk-based capital treatment is a potential issue for banks that might be forced to hold capital on all of the securitized assets rather than just 5%
- Vertical retention may obviate the need to consolidate assets onto the balance sheet if the risk retained is not deemed to be an obligation to absorb losses
Qualified Residential Mortgages

• Determination of what mortgages qualify for exemption of risk retention rules is critical

• QRM designation would establish a bifurcated mortgage secondary market built around loans that carry the QRM designation and those that do not

• Mortgages meeting the QRM test should be less costly and as greater standardization is set for this segment of the market
QRM Guidance – Back to the Future

• QRM to be defined no broader than the definition of "qualified mortgage" under Section 129(C) of the Truth in Lending Act.
  • Maximum combined LTV 75%/80% for refi/purchase transactions
  • No negative amortization,
  • No large balloon payment,
  • Verified income and assets
  • DTI based on a fully-indexed rate
    • 28%/36% front- and back-end ratios
  • Compliance with regulations established by the Fed with respect to back-end DTI,
  • Total points and fees not in excess of 3% of the loan amount and
  • Maximum term of 30 years.

• What does this really mean?
QRM Implications – Short-Term Credit Availability

• Limited effect likely due to continued domination of markets by GSEs and FHA

• QRM-eligible mortgages represent about 30% of 2009 GSE-eligible loans
  
  • Only 4+ % of GSE-eligible loans represent non-QRM eligible product types in 2009
  • Larger effect due to DTI ratios – 17+% of GSE-eligible loans no longer QRM-eligible

• However, with risk retention exemptions in place for GSEs (in conservatorship only) and FHA, expect limited impact on credit availability in the short-run
QRM Implications – Short-Term Borrowing Costs

• In the short-run, expect limited comeback of private label securitization due to exemptions for GSEs and FHA

• Risk retention and QRM therefore in the short-run will have limited impact on raising borrower costs

• Of greater impact will be GSE increases in loan and guarantee fees and FHA insurance premiums
QRM Implications – Long-Term

• QRM rules in conjunction with federal actions to gradually lessen GSE and FHA market share could introduce some credit constraints along with higher borrowing costs for non-QRM loans – Why?

• Some evidence in GSE reform proposal of over time requiring at least 10% borrower downpayments

• Lower loan limits, higher fees and tighter underwriting begin to open the door for private capital

• Over the long-term, is this a bad outcome from a social policy standpoint?
Other QRM Implications

• Smaller banks
  
  • Exemption for GSE loans provides a measure of relief
  
  • No expiration of risk retention may also level the big bank/small bank balance sheet capacity issue
  
  • Mortgage insurance – proposal abstained from allowing MI to count toward QRM eligibility at this time until further study
    
    • The issue is does MI lower default frequency not just loss severity?
    
    • Could be a major issue to MI industry depending on what the future structure of the GSEs looks like
Toward a QRM Definition - Basic Criteria

• Limit risk layering of attributes
  • Focusing on single attributes (e.g., LTV) without regard to interactions with other attributes (FICO) can invite adverse selection into securitizations
  • A matrix approach to eligible combinations?

• Attributes Missing from QRM
  • Credit Score
    • Concern over changes in proprietary scoring models
  • Broker-originated loans
GSE Reform

• Administration’s proposal to reform GSEs reveals little other than what we knew already – expect greater private focus on successor institutions

• Current dilemma is with housing market so shaky, significant policy shift away from overt federal support could backfire by eroding confidence; thereby further putting stress on house prices and foreclosures

• Meaningful reform will likely wait until clear signs of stability in housing materialize

• Measuring Success
  • Availability of mortgage credit
  • Stable housing and mortgage markets
  • Taxpayer exposure
  • Degree of housing investment subsidy

• What are the options on the table and what do they mean?
GSE Reform Option 1

• Private market for all but narrowly defined FHA, VA, USDA loans

• Advantages
  • Limits moral hazard in theory – depends if investors believe government would still act in the event of a crisis
  • Vastly reduces subsidy to housing, although others still exist (e.g., mortgage interest deduction)
  • Improves resource allocation to other sectors of the economy (i.e., alleviates over-housed argument)
  • Should lessen too-big-too-fail issue

• Disadvantages
  • Raises borrowing costs for large segment of population
  • Industry/Regulatory balance uncertainty
GSE Reform Option 2

• Same as Option 1, but add government guarantee during crisis
  • Acknowledges explicit guarantee market may otherwise assume exists
  • Advantages
    • Largely same as Option 1 and,
    • In theory is supposed to moderate effects of a downturn by stepping in as private capital retreats
  • Disadvantages
    • Determining fair guarantee fee
    • Higher borrowing costs as in Option 1
    • Not clear how this would operationally apply
GSE Reform Option 3

- Option 1 but government provides direct backstop (catastrophic reinsurance)

- Advantages
  - Provides support for market collapse
  - Lower borrowing costs despite guarantee fee and private capital during normal times by expanding investor participation, increasing market liquidity
  - Could improve mortgage competitiveness of smaller community banks

- Disadvantages
  - Exposes taxpayer to risk and moral hazard
  - Subsidy to mortgage market reduces resource allocation efficiency
GSE Bailout Elimination & Taxpayer Protection Act

- Re-introduced bill by House Republicans to “put GSEs on a path toward privatization”

- Features
  - Eliminates GSE conservatorship 2 years from enactment
  - Eliminates affordable housing goals
  - Caps portfolios and runs them down over time
  - Reduces loan limits back to $417,000
  - Raises guarantee fees
  - After 3 year assessment period, charters revoked, full privatization
Toward A Broader Mortgage Perspective

• Risk Retention and GSE reform proposals illustrate fundamental fragmentation in public policy regarding housing

• A well-coordinated and comprehensive strategy for housing is required
  • Tax Policy
  • Federal Home Loan Bank System
  • FHA/VA/USDA programs
  • GSEs/Mortgage Securitization
  • Risk Retention
  • Foreclosure/Modification Crisis
  • Mortgage Servicing
    • Standards
    • Fees
Mortgage Securitization Outlook

- Vibrant mortgage securitization dependent on re-emergence of private label securities
- Government today crowding out potential for private market; dependent on housing stabilization
- Risk retention and QRM rules needed
  - Flexible risk retention structures a positive direction
  - QRM fairly restrictive
    - Should consider allowing for up to 90% Combined LTVs
    - Adequate mortgage insurance required for 80-90% LTVs
    - No broker originated loans
    - Provide greater flexibility in risk attribute combinations
Mortgage Securitization Outlook

• Cultivate larger role for covered bonds (possibly)
  • Revisit FDIC limit (4% of total liabilities)
  • Revisit FHLB model and advances as funding mechanism
• Private mortgage issuers with government backstop on MBS (likely)
  • Need strong oversight
  • Few issuers still creates TBTF issues
• Other keys to securitization
  • Strong underwriting
  • Vigilant oversight of originators
    • Mortgage broker regulation essential
  • Significant reporting and data collection enhancements (e.g., 2nd liens)
Wrapup and Final Thoughts

- Risk retention and QRM rules will redefine mortgage securitization
  - Who gets a mortgage and who won’t
  - What mortgages will be available and what won’t
  - How much government will play in mortgage finance – FHA
- GSE privatization will move forward most likely with a catastrophic backstop on the security
  - Timetable – next 5 years or so
  - Gradual unwinding most sensible approach
    - Let loan limits expire and move down
    - Shrink portfolios
    - Raise insurance premiums
- Must be mindful of current housing weakness