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SPECIAL REPORT

Reworking Risk Retention

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Reworking Risk Retention

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U.S. regulators are working hard to implement the changes to the financial system set in motion by Congress' most recent reforms. In general, these reforms should make the system more stable, with fewer and less severe financial crises in the future. Yet some elements of the reform were poorly crafted and have the potential to significantly impair the financial system if their flaws are not corrected. Among the most salient examples are the rules for lenders to retain part of the risk when they repackage loans into securities.

The concept of risk retention represents a laudable effort to fix the securitization process, which allows consumer and business loans to be traded in secondary markets like stocks and bonds. Securitization became a cornerstone of the global credit market over the past few decades, but it broke down during the period leading up to the financial crisis, particularly for residential mortgages. An overheated securitization market encouraged lenders to originate millions of loans that were never likely to be repaid; when they were not, the financial system was brought to its knees. A massive government bailout forestalled complete collapse, but a severe credit crunch and the Great Recession followed nonetheless.

While the financial system is now performing much better—banks are lending again and credit markets for corporate bonds are functioning well—the securitization process remains troubled. Few, if any, residential mortgage loans not backed by the government are being securitized, preventing the government from reducing its role in the housing market. There are ways private mortgage lending might revive without securitization, but it is hard to see how these could adequately fill the void without a wholesale and unnecessary reworking of the financial system.

Besides, done properly, securitization provides significant economic benefits. It deepens the pool of capital available for lending, making credit more available and less expensive. It spreads risk more widely through the financial system, making the system more stable. Policymakers and

regulators are thus rightly focused on fixing securitization's flaws.

While the risk retention rules apply broadly to all asset classes including auto loans and credit cards, those markets continued to perform reasonably well throughout the credit crunch with little need for government bailouts or other interventions. Participants in these markets are rightly concerned that they are being subjected to a set of rules that is unnecessary and potentially destabilizing if not properly implemented. For the purposes of this analysis we choose to focus on the market that did break down: residential mortgage-backed securities.

Among the problems with securitization that became evident during the financial crisis, perhaps the most fundamental involved misaligned incentives. Those who originated and packaged loans into securities were motivated to produce as much volume as possible; during the boom they appeared generally unconcerned about the quality of the loans underlying those securities. Investors, naturally, are concerned about the quality of the securities they buy, but during the boom few examined securities closely themselves; most relied on the rating agencies for assurance.

Risk retention is an effort to address this incentive problem. Under the new rules, securitizers will be required to keep an ownership stake of at least a 5% in the securities they create. The Dodd-Frank financial reform legislation laid out the rule in general but ordered regulators to provide details. Various federal agencies, including the Treasury, Federal Re-

serve, Federal Housing Finance Agency, and the Federal Deposit Insurance Corp., proposed specific risk-retention rules in April and have requested public comment by August 1¹.

The appeal of risk retention, more colloquially known as "skin in the game," is intuitive: If securitizers own a stake in the securities they produce, they will produce better securities. Investors will thus have more confidence and will be willing to purchase them as they did before the crisis. Stronger investor demand will drive a rebirth of securitization.

This makes sense in theory, but making risk retention work efficiently and effectively in practice is another matter. Should the risk-retention rules apply to all mortgages, even those where the borrower puts up a large down payment, has low monthly debt payments and has a sterling credit record?² If not, how can such loans be separated out? Even more slippery is how to keep securitizers from circumventing the risk-retention rules. Should securitizers be restricted from hedging their risks altogether? No, but what kinds of regulations will allow securitizers to hedge in a way that is prudent and transparent, and aligns securitizers' and investors' incentives?

The risk-retention rules being proposed are unlikely to meaningfully improve securitization's incentive problem. At the same time,

1 The risk retention rule as proposed by regulators can be found [here](#).

2 For more on risk retention with regard to residential mortgage securities, see our companion piece, "[The Skinny on Skin in the Game](#)."

they will raise borrowing costs significantly for many homebuyers and make loans difficult to get for others. For homebuyers who cannot make large down payments, do not have substantial income to back their monthly payments, or do not have pristine credit scores, the interest rate on a 30-year fixed-rate mortgage will rise between 75 and 100 basis points. The proposed risk-retention rules could also distort the development of the mortgage finance system, further concentrating an already-concentrated mortgage lending industry and blocking the government's efforts to withdraw from the market.

This is not to say that securitization will revive without reform. It will not. But it could be fixed more efficiently by tightening standards at the point where loans are originated and strengthening the existing "representation and warranty" system that has served much of the mortgage industry well for most of the past half-century. Regulators have already made good progress redefining standards and securitizers are making strides in rethinking the rep and warranty system. Much more work needs to be done, but regulators need to be very circumspect as they implement risk retention, lest the unintended consequences further delay the day when securitization is once again an important part of the U.S. financial system.

QRM defined

Central to the risk-retention rule is identifying which mortgage loans require risk retention. Mortgage securities backed by loans that are deemed to be "qualified residential mortgages" will be exempt from the risk-retention rules. Getting the QRM definition right is vital. Too narrow a definition could meaningfully raise the cost of mortgage credit and reduce its availability for many potential borrowers. Too wide a definition could blunt the risk-retention rules' ability to raise investor confidence in securitization. The current QRM definition proposed by regulators is too narrow.

The assumption behind qualified residential mortgages is that investors understand the underwriting quality and risks of these loans sufficiently that additional skin in the game is unnecessary. Lenders and investors have long historical experience with these

kinds of loans, and their performance has generally been good. It would thus be unnecessarily restrictive to limit such lending. On the other side of the fence, non-QRM loans are less well understood by lenders and investors; it was the rapid growth of such loans that inflated the housing bubble.

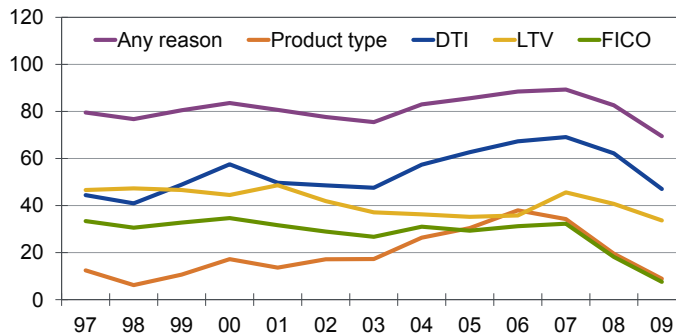
That being said, how QRM is defined will have little near-term impact on the mortgage market. The Dodd-Frank legislation stipulates that all Federal Housing Authority loans are QRMs, because of their explicit government backing. Loans guaranteed by Fannie Mae and Freddie Mac also qualify, as long as the two agencies operate under government control. These institutions originate more than 90% of all new mortgage loans in the U.S.

However, the QRM definition could make a big difference longer term, depending on what happens to Fannie and Freddie and on how the future mortgage finance system is designed. Recently introduced legislation to establish a hybrid mortgage finance system (similar to one we proposed) would limit catastrophic government insurance on mortgage securities backed by QRM loans.³ If the QRM definition is too narrow, then under this legislation the proportion of the mortgage market that could be backed by the government would also be very limited.

Some aspects of the proposed QRM definition are straightforward. A QRM loan must be a closed-end, first-lien mortgage used to purchase or refinance a one- to four-family property, at least one unit of which is the principal dwelling of the borrower (see Table 1). Negative-amortization, interest-only and balloon-payment loans are not QRMs. Construction loans, bridge loans of 12 months or less, loans

Chart 1: Why Mortgage Loans Are QRM-Ineligible

% of GSE acquisitions ineligible for QRM by reason



Source: FHFA

Note: "Product type" includes low documentation, negative amortization, interest only, etc.

to purchase time-share properties, and reverse mortgages are not QRM-eligible. Adjustable-rate mortgages are QRMs if they have specific interest rate caps that mitigate payment shock to borrowers.

Other aspects of the current working QRM definition are quite restrictive, particularly with regard to underwriting standards. For a loan to be a QRM, a borrower must have a front-end debt-to-income ratio of no more than 28% and a maximum back-end DTI of 36%.⁴ The maximum loan-to-value ratio is 80% for a purchase loan, with a lesser LTV permitted for refinances. A QRM does not require a specific credit score, given the variety of scores available to lenders, but it does require specific borrower payment behavior. Most notably, a QRM borrower cannot be 30 or more days past due on any debt obligation, and could not have been 60 days or more past due on any debt obligation within the preceding 24 months.⁵

According to an FHFA analysis of Fannie Mae and Freddie Mac's portfolios, only a fifth of the loans they purchased and insured between 1997 and 2009 would have met the QRM underwriting criteria (see Chart 1).⁶ Not unexpectedly, the QRM share was lowest,

⁴ Front-end DTI is the ratio of monthly mortgage payment to income; back-end DTI is the ratio of all debt payments to income.

⁵ Further, a borrower must not, within the preceding 36 months, have been a debtor in a bankruptcy proceeding, had property repossessed or foreclosed, engaged in a short sale or deed in lieu of foreclosure, or been subject to a federal or state judgment for collection of any unpaid debt. The proposal would require the originator to verify and document, within 90 days prior to the closing of the mortgage, that the borrower satisfied these requirements.

⁶ See "Qualified Residential Mortgages," *Mortgage Market Note, FHA, April 11, 2011*.

³ The Housing Finance Reform Act, H.R. 1859, was introduced in mid-May by Congressmen John Campbell and Gary Peters. Our proposal for Mortgage Finance Reform is presented in "The Future of the Mortgage Finance System," Zandi and DeRitis, February 7, 2011.

Table 1:

QRM Eligibility

Loan Characteristic	Requirement
Lien position	Closed-end first-lien mortgage.
Purpose and property type	Purchase or refinance a one- to four-family property, at least one unit of which is the principal dwelling of a borrower. Construction loans, "bridge" loans with a term of 12 months or less, loans to purchase time-share properties, and reverse mortgages are not QRM-eligible.
Amortization	Only fully amortizing loans allowed. Negative-amortization, interest-only, and balloon-payment loans are not eligible.
Variable rates	Adjustable-rate mortgages are QRM if they have specific interest rate caps (TBD) which mitigate any payment shock to borrowers.
Debt-to-income ratio	The sum of the monthly housing payment including interest taxes and insurance (i.e. "front-end" debt-to-income ratio) must be no greater than 28% of gross monthly income. The sum of all monthly debt payments (i.e. "back-end debt to income") can be no greater than 36%.
Loan-to-value ratio	Maximum LTV of 80% for a purchase loan; lower maximum LTV (TBD) for refinance loans.
Credit history	No specific credit score criteria, but borrowers cannot be 30 or more days past due on any debt obligation at origination. Borrower cannot have been 60 or more days past due on any debt obligation within the preceding 24 months.

close to one-tenth of originations, during the bubble years 2004-2007, when nontraditional lending was at its apex. The QRM share peaked at almost a third of originations in 2009, when lending standards were tightest.

Under the current proposals, amortization features are not very important in determining whether a loan is a QRM. Even during the housing bubble, Fannie and Freddie were not insuring many negative-amortization or interest-only loans. Credit history is also a less significant factor in determining QRM status. These would likely be more important factors for loans not backed by the GSEs.

Debt-to-income ratios would play a much larger role in determining which loans are QRMs. The FHFA study indicates that nearly half of all GSE loans originated in 2009 that

were deemed ineligible to be QRM fell short because their DTI was too high. The impact of debt-to-income ratios on QRM eligibility is overstated, because it is well established in the mortgage industry that these ratios are notoriously difficult to measure consistently. Borrowers tend to report only the income necessary to qualify for a loan.⁷ The actual fraction of loans

⁷ The measurement of debt-to-income ratios also suffers from a vicious cycle. Lenders in the past found DTI to be of little help in forecasting mortgage losses once credit scores, loan-to-value ratios, occupancy, loan purpose and other factors are considered. Given the complexity of calculating the ratios and some borrowers' reluctance to provide information, lenders did not invest significant resources in better information-gathering. The resulting measurement error contributed to further weakness in econometric models, thereby "confirming" the insignificance of the variables. If borrowers and lenders had a strong financial incentive to provide better information—as they will under the QRM rule—the quality of the variables would improve.

that would be disqualified because of excessive DTIs would be substantially lower if DTI were measured accurately. However, even accounting for this, probably far less than half of all current Fannie and Freddie originations are QRMs.

The 80% maximum LTV requirement is also a very high bar for many households, causing about one-third of GSE loans in 2009 to fail QRM eligibility. Just over two-thirds of all U.S. homeowners have more than 20% equity in their homes and closer to one-third if those without mortgages are excluded (see Chart 2). Relaxing the maximum LTV for purchase originations from 80% to 90% would have increased the share of Fannie and Freddie loans that were QRM in 2009 by more than 10 percentage points.

While delinquencies and defaults increase as loan-to-value ratios rise—and substantially for borrowers whose down payments are less than 5% of the purchase price—loans with LTVs between 80% and 95% were quite common, and quite successful, during the decades prior to the housing boom.⁸ Fannie and Freddie have long been lending with LTVs above 80% when backstopped by private mortgage insurance. Even during the current crisis, with the housing and mortgage markets under severe pressure, losses on these high-LTV loans have been manageable. Given this experience, it would seem prudent to allow loans with LTVs as high as 95% to be QRM-eligible provided they carry third-party private mortgage insurance and provided the loans meet all other QRM restrictions.⁹

With this change, as much as two-thirds of the mortgage market would consist of QRMs. This seems a more appropriate target; it would keep lower-cost mortgage capital flowing to most borrowers while still ensuring that only high-quality loans receive the QRM designation.

Also complicating the QRM definition is the inclusion of mortgage servicing stan-

⁸ The increase in delinquency rates reported by the FHFA on Fannie and Freddie loans when relaxing the LTV requirement probably overstates the actual increase that would occur, as the results do not control for other risk factors. For example, borrowers who take on high-LTV loans probably have lower net worth than other borrowers. This, and not the high LTV ratios, may be the cause of higher delinquencies.

⁹ Policymakers could choose to further restrict high-LTV lending to buyers with stronger credit scores to offset some of the additional credit risk.

dards for QRM loans. Under the proposed rule, loan documents must spell out policies and procedures that, among other things, allow for loan modifications if the net present value on distressed loans would be greater than the foreclosure proceeds and address how second liens will be treated when the same lender holds both first and second liens.¹⁰ The motivation for including servicing standards in the QRM definition is clear, given the revelations about muddled servicing procedures during the current foreclosure crisis. But this proposal has the odd effect of regulating the best quality borrowers, those least likely to require intervention, more heavily than the rest of the market. Moreover, a separate regulatory initiative is developing national standards that would apply to all mortgage servicers.

Premium capture

A major problem for regulators is how to keep securitizers from dodging the risk-retention rule. Regulators are particularly concerned that securitizers will compensate for the extra cost of having some skin in the game by raising fees, rather than by better underwriting. To try to avoid this problem, regulators have introduced what they call the premium capture rule. Unfortunately, the rule is less likely to accomplish its goal than it is to increase borrowing costs and restrict mortgage credit.

Mortgage securitizers charge borrowers a higher rate than what is provided to the bond investors who purchase mortgage-backed securities.¹¹ In addition to covering the costs of originating and servicing the mortgages, this excess spread helps cover the securitizers' costs, provides a return to securitizers, and is used to build a reserve against future loan

defaults. While the spread is collected over the life of the loans, securitizers were historically able to collect the full discounted stream of income up front, by selling an interest-only bond backed by the spread. The premium capture rule will effectively end this practice by making it prohibitively expensive.

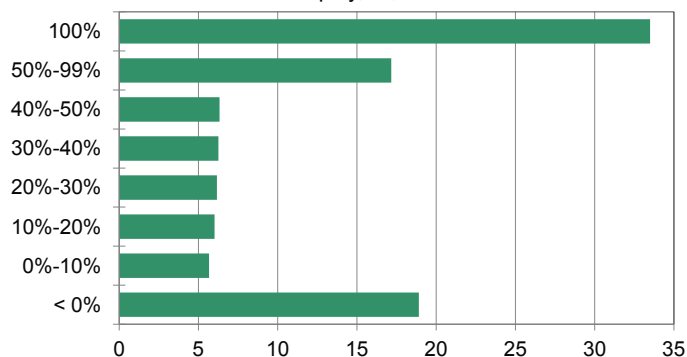
While it is not clear in the proposed rules whether regulators expect securitizers to be compensated for their costs, it is likely they will allow securitizers to effectively charge what they deem to be a customary reasonable fee. Determining the appropriate fee will be difficult to get right. Too small a fee and securitizers will not find it worthwhile to securitize; too large a fee and securitizers will not have as much skin in the game. Complicating matters is that the appropriate fee could vary substantially depending on the individual securitization and will change over time, making it very tough for regulators to keep up and adjust their fee assessments appropriately.

An example of how the premium capture rule could complicate matters is the interest-rate hedges originators use to manage their interest rate risk. These hedges are necessary to account for any change in interest rates during the period between when a loan is originated and when it is packaged into a security. In the past, securitizers could pass along their hedging costs through the excess spread. The premium capture rule could make this very difficult.

It is also not clear that the premium capture rule is necessary—or even able—to stop the kind of risk retention dodging regulators are focused on. Given the massive losses suffered by investors in the interest-only bonds sold by securitizers during the housing bubble, future investors will be very circumspect and require significant assurance that the bonds are appropriately

Chart 2: Many Homeowners Have Little or No Equity

Distribution of homeowners' equity, %, 2010Q4



Source: Moody's Analytics

priced given the risks involved. It is very unlikely securitizers will be able to slough off their risk without paying for it appropriately. Market forces will thus work well on their own to limit bad securitizations.¹²

It is possible that securitizers will charge borrowers fees they would pay with cash at the time of origination, and not include the cost of the fees in the mortgage rate. It is even conceivable in this scenario that securitizers could charge enough in fees to avoid the costs of risk retention altogether. Mortgage rates would be higher, but securitizers would have no additional skin in the game.

The premium capture rule may also create incentives not to originate as many 30-year fixed-rate mortgage loans. Securitizers who traditionally fund themselves with shorter-term liabilities may not be able to effectively match the fees they will earn over a longer period of time given the impact of premium capture.

The premium capture rule is well intentioned, but it runs afoul of that old adage that regulators are always fighting the last war. The consequences of the rule are very difficult to gauge, but odds are the costs will exceed the benefits. In addition, the rule could lead to unintended consequences by encouraging securitizers to find creative ways around it. Increasing up-front fees or altering the securitization structure are two obvious outcomes but there are likely to be others.

¹² It is also important to note that securitizers could only benefit from increasing their excess spread if they decided to satisfy the risk-retention requirements by holding a horizontal slice of the securitization—the equity tranche.

¹⁰ The QRM proposal also requires that loss-mitigation efforts start within 90 days of delinquency, includes appropriate compensation arrangements with servicers, and bars servicers who do not maintain these policies from acquiring new business.

¹¹ This is a form of credit enhancement and is more common on securitizations backed by riskier subprime, alt-A and second-lien mortgage loans. Because of their greater risk, some securitizations build in excess spread by requiring that the weighted average interest rate on the underlying mortgage loans is greater than the weighted average coupon rate for the tranches in the security. If there are credit losses from any of the loans within any given month, then this excess spread is applied against them; otherwise, the holder of the equity or residual portion of the security collects this income.

Higher rates, weaker housing

The risk-retention rules as proposed will have little near-term impact on mortgage rates, but over time they will result in much higher rates, particularly for non-QRM borrowers.

Mitigating the near-term impact on rates is Congress' declaration that loans insured by Fannie Mae, Freddie Mac and the FHA are QRM eligible and that their securities are exempt from the premium capture rule. The three federal institutions insure approximately 90% of all new mortgages; the rest are held on the balance sheets of the financial institutions that make them and are not affected by risk retention.

This will change eventually: Fannie and Freddie will either be spun off or eliminated and, along with the FHA, will account for a much smaller share of the mortgage market. In this future mortgage finance system, the typical non-QRM borrower could see mortgage rates rise by between 75 and 100 basis points.¹³ Pushing up rates will be three factors: 1) QRM eligibility, which will add 30 to 50 basis points to non-QRM loans; 2) the premium capture rule, which will add 10 to 15 basis points; and 3) the lack of direct government backing and reduced liquidity in the non-QRM mortgage market, which will add approximately 35 basis points.

To understand the reform's impact on mortgage rates, suppose that without the risk-retention rule, the mortgage rate charged to a borrower for a non-QRM loan backing a private residential mortgage security was 6%.¹⁴ Now assume the securitizer must retain 5% of the risk and, for simplicity's sake, assume that the risk retention is in a "horizontal" form—meaning the 5% is retained in the equity or "residual" tranche of the security.¹⁵

Investors who purchased the other 95% of the tranches in the security would not require

a higher yield than they would have previously just because the securitizer retained some of the risk; the yield might in fact be a bit lower because of the securitizers' skin in the game, but assume it is still around 4.8%. Further assume that the securitizer requires a higher return on its 5% stake than the equity holder would have previously. This could be due to accounting or regulatory reasons—the largest securitizers are systemically important financial institutions that will likely have to hold more capital than other institutions under proposed capital rules—or perhaps securitizers' capital is not completely elastic.¹⁶ Such factors would ultimately determine the rate of return the securitizer would demand to participate.

If securitizers' required return was 6% higher, then the increase in mortgage rates would be 30 basis points (5% of 6%). If the required rate of return were 9% higher, the impact on rates is 45 basis points in this simple example.¹⁷

If instead in this example the securitizer wanted only to take a "vertical" slice of the security—meaning the 5% is retained across all of the tranches in the security—the only way to make a higher return would be to charge borrowers a cash fee at origination. The overall rate impact on borrowers would be roughly the same but in the previous case the borrower could capitalize fees into the interest rate thereby reducing up-front expenses. In the second case this would not be possible. During the housing bubble, it was common practice for certain subprime and alt-A borrowers to serially refinance their loans every two or three years while house prices were rising by simply rolling any refinance costs into the note rate. Such higher rate loans generated lucrative fees for mortgage brokers and originators. Cash-constrained borrowers will be unable to pay upfront fees so much of this refinance activity will simply disappear.

The mortgage rate impact of the premium capture rule is the expected value of the interest rate impact of regulators' incorrectly determin-

ing the customary reasonable fees of securitizers. If regulators set the fees and excess spread too low, then there will be less securitization, requiring other sources of mortgage credit to fill the void, requiring a higher return and thus higher rates to borrowers. Borrowers will also pay higher rates if the fees and excess spread are set too high. Under reasonable assumptions regarding the magnitude and frequency of regulatory error, it is not difficult to see how the premium capture rule would add between 10 and 15 basis points to mortgage rates.

Also pushing up mortgage rates for non-QRM loans is the fact that this part of the mortgage market will not be backstopped by the federal government.¹⁸ Government support subsidizes borrowing rates, and it is reasonable to expect rates to rise as the subsidy is withdrawn. The minimum interest rate impact of this can be gleaned from the difference in rates on conforming and jumbo mortgage loans. Between 2000 and 2007 before the financial crisis, this rate spread was close to 30 basis points. While the spread spiked during the recession, it is currently just under 40 basis points.

The mortgage rate impact will vary considerably across different types of borrowers. Borrowers on the credit margin, those who tend to have lower incomes, poorer credit histories and fewer resources for a down payment, will be most affected. Continued federally subsidized lending through the FHA will mitigate some of this impact, but certain parts of the country where lower-income housing is prevalent will be hit hard. Some non-QRM borrowers who otherwise would be able to refinance will find the higher cost of credit rules that out. And borrowers seeking to extract equity from their properties through a cash-out refinancing will be more affected than will others who refinance to obtain a lower rate or shorter term. This may not be all bad, given how equity extraction was abused during the housing boom.

The higher mortgage rates resulting from the risk-retention rules will have significant ramifications for the housing market and, by

¹³ This is a conservative estimate of the rate impact of the risk retention rules on non-QRM loans. Besides the costs shown here are compliance costs associated with adopting and monitoring aspects of the rule.

¹⁴ A private-label residential mortgage-backed security is one not insured by Fannie Mae, Freddie Mac or the FHA.

¹⁵ The risk retention rules as proposed would allow securitizers to decide how they will hold their 5% stake. They could hold a horizontal slice, keeping the most junior or equity tranche—the portion that would absorb any losses first. Or they could hold a vertical slice, owning a part of all of the tranches in security. The rule allows for other methods of holding the 5% stake although they are likely to be less popular.

¹⁶ See ["Regulating Systemically Important Financial Institutions,"](#) speech by Federal Reserve Board Governor Daniel Tarullo before the Peterson Institute for International Economics, June 3, 2011.

¹⁷ This may be more realistic. Mortgage insurance companies, which put skin in the game when they insure mortgage loans, require a 15% return on their equity.

¹⁸ This estimated mortgage rate impact on non-QRM loans only accounts for the impact of adopting the risk retention rules and not the rate impact of other potential requirements imposed on loans not explicitly government-backed. This could be considerable, if, for example, capital requirements for this lending and the required rate of return on that capital is higher than for government-backed lending.

Table 2:

Impact of 30-Year Fixed Mortgage Rate

	Change in Mortgage Rates, basis points		
	50	100	150
Change in:			
Home sales, ths	-185	-423	-688
Median existing house price, ppt	-3.7	-8.5	-13.8
Homeownership rate, ppt	-0.4	-1.0	-1.7

Source: Moody's Analytics

extension, the broader economy. Based on simulations of the Moody's Analytics model of the macroeconomy, a 100-basis point increase in 30-year fixed mortgage rates reduces the pace of new- and existing-home sales by nearly 425,000 units per year, lowers median existing-house prices by 8.5%, and drops the homeownership rate by a full percentage point (see Table 2).¹⁹

The future of mortgage finance

The risk-retention rules have the potential to meaningfully alter the shape of the mortgage finance system.²⁰ By influencing how quickly and extensively private mortgage securitization will revive, the rules will determine when the government will be able to reduce its role in mortgage lending and whether the largest mortgage lenders will increase their already sizable hold on the market. The rules will also have an impact on how large a role the government will ultimately play in the mortgage market.

The pace at which the government exits the mortgage market critically depends on how quickly private securitization comes back. The only other potential source of private mortgage credit is the balance sheets of major lenders, but these institutions lack the capital necessary to make a

significant number of new loans. This will be an even larger constraint in the future when the Dodd-Frank bill raises capital requirements for systemically important financial institutions.

A good test of the big mortgage lenders' capacity to increase lending will occur in October, when the size of loans that can be insured by Fannie, Freddie and the FHA is set to be reduced.²¹ These so-called conforming loan limits were temporarily raised during the recession to help the government fill the void left by the collapsing private lending market.²² The higher loan limits affected approximately \$120 billion in loans originated in 2010, or about 8% of the \$1.5 trillion in mortgages made that year. The nation's largest financial institutions appear to have the necessary capital to make up for the lower limits—assuming a 10% reserve rate, it will take \$12 billion in capital to support \$120 billion in new mortgage lending—thus the resulting increase in mortgage rates should be manageable. But even if this test goes reasonably well, it is hard to see how these institutions could increase their lending much more than that without significantly

²¹ Delaying the reduction in conforming loan limits for another year to help shore up the weak housing market is proposed in "To Shore Up the Recovery, Help Housing," by Mark Zandi, Moody's Analytics special report, May 25, 2011. There would be no meaningful cost to taxpayers of delaying a reduction in the conforming loan limits, but the cost to the housing market and economy of a misjudgment would be high.

²² Fannie and Freddie's loan limit will fall from \$729,750 in the highest-cost areas of the country to \$625,000. FHA loan limits in these areas are likely to fall even more, since they are defined as the lesser of 115% of an area's median-priced home or \$625,000. The high-cost areas that would be significantly affected are primarily in the Northeast and California but also include some parts of Florida and the Chicago metro area.

raising rates. Their capital requirements seem too great.²³

Mortgage rates will also rise as big lenders consolidate their grip on the mortgage market. With the government trying to pull back from housing and the private securitization market dormant, the big lenders will increase their already sizable market shares. The top three lenders already account for more than half of all mortgage originations, and the top five lenders about two-thirds. Unless private securitization revives, small mortgage lenders will be further squeezed out of the marketplace as Washington exits.

Until private mortgage securitization is reborn, it will be difficult for the government to reduce its current outsized role in the mortgage market, and if it tries, the nation's mortgage industry will grow more consolidated in the hands of a few very large lenders. The risk-retention rules are supposed to restore investor confidence in securitization and thus prompt its rebirth, but it instead risks raising the costs to securitization so high that it will make it more difficult to come back.

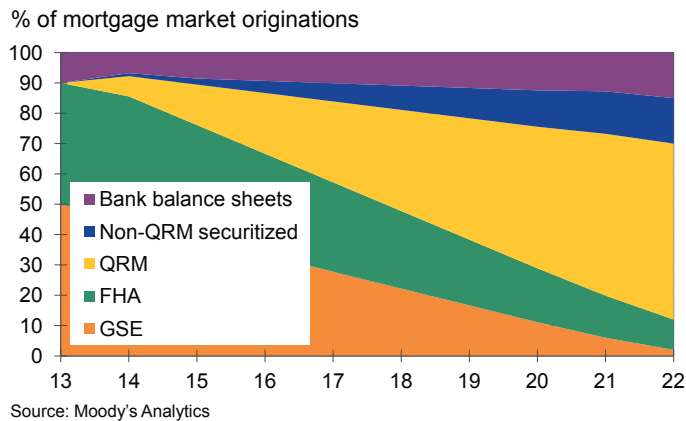
The risk-retention rules, and QRM in particular, will also be a key determinant of the government's long-term role in the mortgage market. While the structure of the mortgage finance system post Fannie and Freddie is still undecided, it is clear that the government will only backstop QRM loans. FHA loans will always be QRM, but under nearly all visions of the future mortgage finance system, FHA lending will be no more than 15% of all lending and probably closer to 10%. There is much debate about the role of government in the rest of the mortgage market, but many visions, including our own, feature the government providing a catastrophic insurance guarantee to a sizable portion of it. But this portion will be determined by the QRM definition. If QRM is too narrowly defined, the government's role will be inordinately small with all of the attendant negative consequences.

In the ideal future mortgage finance system a decade from now, the GSEs would

²³ Assuming, for example, that the goal is to have private lending account for at least a third of mortgage lending, with \$1 trillion in new mortgages originated annually, these institutions would have to raise \$33 billion in additional capital each year (\$1 trillion * 33% * 10%).

¹⁹ It is important to note that the relationship between changing mortgage rates and housing market activity is very nonlinear. The estimates provided here are based on raising the fixed mortgage rate from 6% to 7%. The housing market impacts would be measurably greater if fixed rates were to rise from say 7% to 8%.

²⁰ Given the importance of the U.S. residential mortgage market to the global credit markets, the risk-retention rules have the potential to shape the entire global financial system.

Chart 3: QRM Would Lead Future Mortgage Market

fade away, the FHA would account for 10% of lending, non-FHA QRM lending backed by a catastrophic government guarantee would account for 60%, non-QRM balance sheet lending by financial institutions would be 15%, and non-QRM securitized lending would account for the remaining 15% of lending (see Chart 3).

Policy recommendations

The risk-retention rules proposed by regulators have a number of significant problems. To address these problems, regulators should consider making several changes, including:

- » Expanding the QRM definition to include loans with LTVs as high as 95%, provided they carry third-party private mortgage insurance and meet other QRM restrictions. Private mortgage insurance has the added benefit of providing a second underwriting for the loan, independent from the originator or securitizer. It would also put private MI on a more equal footing with the FHA, encouraging private capital to take on more of the risk in providing mortgage credit. Policymakers could choose to further restrict this higher-LTV lending to buyers with stronger credit histories to offset some of the additional credit risk.
- » Expanding the QRM definition to include loans in which total monthly mortgage payments do not exceed 31% of the borrowers' documented, stable income. Total monthly debt service obligations should not exceed 40%. This

is particularly important for homebuyers in higher-priced housing markets, who historically have devoted more of their income to debt repayment. Regulators should also consider allowing DTI to vary according to borrowers' income. Very high income borrowers could easily manage a higher

DTI, while lower income households would be better off with a lower DTI.

- » Eliminating the mortgage servicing requirements specific to QRM loans. Servicing requirements should be consistent across all mortgage lending and determined in a regulatory process independent of the risk-retention rules. This process is already under way and has resulted in some positive changes in servicing procedures.
- » Eliminating the premium capture rule. This rule adds significant complexity to the securitization process and could have numerous unintended consequences. It is unlikely to prevent securitizers from avoiding the risk-retention requirement, but it is likely to raise mortgage rates and make credit less available.
- » Requiring a third party review of the mortgage loan information used to evaluate the quality of the mortgages backing a security. During the housing bubble, information regarding a borrower's income and occupancy status and the value of the property was often wrong and even fraudulent. There was no good mechanism to uncover this before the loans were packaged into securities. A review by an independent party of the accuracy of the data used to evaluate the creditworthiness of loans packaged into securities would address this problem.
- » Establishing a conflict resolution mechanism for when there are disputes between the parties involved in

a securitization. Binding arbitration within six months of realization of a problem would be a good example of such a mechanism. The lack of a clear conflict resolution process has significantly complicated working through the myriad of problems that have developed during the housing crash.

Requiring mortgage servicers who invest in mortgage securities to invest in a vertical slice of those securities. During the housing boom, mortgage servicers were avid buyers of the interest-only bonds backed by the excess spread. This incited servicers to be less aggressive in pushing troubled mortgage loans through to a foreclosure, as the losses would be born most severely by these interest only bonds. Holding a vertical slice would better align the incentives of servicers and all other investors in mortgage securities. Note that under this proposal, servicers would not be required to invest in securities—as ideally servicers would act independently to collect borrower remittances and mitigate losses.

Regulators should also consider steps outside of the risk-retention rules to better align incentives in the securitization process and create higher-quality mortgage securities. These include:

- » Tightening requirements for residential mortgage origination. Regulators issued guidelines during and since the financial crisis that include common-sense requirements for originations. These should be strengthened, made transparent, and adopted by all federal and state regulators.
- » Working with securitizers to strengthen the existing representation and warranty system so that there is 100% repurchase of mortgage loans found to be different than originally advertised, in ways that materially and adversely affect the interests of investors.²⁴ The risk retained through enforceable reps and warranties probably puts even more skin in the game than the 5% risk-reten-

²⁴ Another potential method for addressing the agency problem in mortgage securitization is the origination certificate proposed by Andrew Davidson and Eknath Belbase in "Origination Risk in the Mortgage Securitization Process: An Analysis of Alternative Policies," FDIC/Fed joint conference on housing and mortgage markets, October 25, 2010.

tion requirement.²⁵ Reps and warranties are the ultimate skin in the game—if there is a problem with the mortgage loan the securitizer and originator own all of the risk. To this end, policies are needed to insure that counterparties are well-capitalized and have sufficient funds to cover loan repurchases due to rep and warranty issues.

Conclusions

The U.S. financial system is finally regaining its footing. Nearly three years after it collapsed and had to be bailed out by the federal government, the system is once again providing affordable credit to much of the economy. Financial institutions have raised significant amounts of capital and are profitable again, and financial markets have rebounded.

But the system remains far from normal. Hundreds of small banks are on the FDIC's troubled list; many will ultimately fail. Fannie Mae and Freddie Mac remain stuck in conservatorship, and thus the government

continues to provide the bulk of the nation's residential mortgage credit. And private securitization markets remain a shadow of their former selves. Credit will not flow freely until these problems are fixed.

The financial system must also adjust to a wide array of regulatory reforms. While Dodd-Frank, Basel III and Solvency II will overall produce a substantially more stable system, regulators must be careful not to overstep in the nitty-gritty of their work. There is a line, difficult to identify, that should not be crossed if regulators wish to do more good than harm.

The risk-retention rules for securitization threaten to cross that line. Regulators are right to focus on securitization; without reform, it is unlikely to revive. This is particularly important for the nation's housing market. Banks and other mortgage loan originators have insufficient capital to make enough mortgage loans. Given the current structure of the U.S. financial system, securitization is necessary to attract capital from pension funds, mutual funds, foreign central banks, and other private investors.

The risk-retention rules are well intentioned, but as with all public policy, the devil—and the macroeconomic impact—is in these details. The rules are supposed to better align incentives; since securitizers will be required to keep an ownership stake in the securities they make, they will make better

securities. Perhaps more importantly, this will convince investors that these securities are safe to buy.

As proposed, however, the risk-retention rules are unlikely to accomplish this goal. It is unclear how much more skin securitizers will actually put into the game, but it is clear that mortgage rates will be higher and credit less available. Investors will remain unconvinced and securitization impaired. It will be harder for the government to resolve Fannie and Freddie, and the mortgage lending industry will become even more concentrated. The rules as proposed could also significantly complicate the debate on the government's role in mortgage finance in the future.

The risk-retention rules are part of the Dodd-Frank reform law, and regulators must implement them, but it would be better to soften the rules and make them less binding. Regulators should work to better align incentives and restore confidence in securitization by focusing on setting clear lending standards at the time of origination and tightening the rep and warranty system long used throughout mortgage lending in the agency market. The plumbing in the residential mortgage securities market collapsed in the financial crisis and it must be fixed, but this does not require a whole new set of pipes. Rather, add some new gaskets and safety valves and make sure the existing joints are safely tightened.

²⁵ A good description of the representation and warranty system and current efforts by securitizers to improve the system is provided in testimony to the Senate Banking Committee at a hearing on ["The State of the Securitization Markets,"](#) by Tom Deutsch of the American Securitization Forum on May 18, 2011. Another proposal for reforming the rep and warranty system is provided in "Moody's Criteria for Evaluating Representations and Warranties in U.S. Residential Mortgage Backed Securitizations," by Kathryn Kelbaugh and Yehudah Forster, Moody's Special Comment, October 5, 2009.

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