

A Long Goodbye

As private equity slowly returns to mortgage finance, Fannie and Freddie continue their extended departure plan, but is it reasonable to count the GSEs out, and just how long will it take to see a true transition? **By Manoj Singh, Ph.D.**

The transition of Fannie Mae and Freddie Mac (the GSEs) into a more restricted role in housing finance and the participation of more private capital for providing equity funding has been a desired objective for both the administration and Congress as the nation has continued to witness the collapse of the housing market.

As the debate on developing the most efficient housing finance framework for the future progresses among industry professionals, the administration, Congress, and various other stakeholders, there are three major impediments that have prevented private capital from entering equity funding of mortgages.

What's Standing in the Way of a GSE-Free Future?

The first impediment is the price of credit risk that the GSEs have established, which has

resulted in roughly 70 percent of mortgages within conforming loan limits eligible for their guarantee being issued through the GSEs, with most of the remaining mortgages getting a direct government guarantee from the Federal Housing Administration (FHA) and the Veterans Administration (VA). Depository institutions simply find it more economically viable to eliminate credit risk through GSE guarantees. This decision is based on the credit risk of the mortgages that are being originated in conjunction with the capital requirements that banking institutions have, as well as the requirements foreseen in Basel III guidelines.

In essence, the guarantee fees paid to the GSEs are a bargain compared with the risk that is eliminated.

The other channel for reducing and distributing the credit risk for the financial institutions would be through private label securities (PLS). In the case of PLS, a certain class of investors would bear the credit risk inherent in mortgages by investing in subordinate tranches or first-loss pieces of the PLS deals. The discount in prices demanded by those investors to take the first loss risk again makes it more economically viable to unload credit risk through the GSEs. Hence, the first necessary condition to invite private capital participation in the credit risk of mortgages is to increase the price of guarantee that the GSEs charge to level the playing field between the government-supported entities and private financial institutions. More recently, the regulator for the GSEs, the Federal Housing Finance Agency (FHFA), has announced guarantee price increases in the near

future for both the entities to begin the process of price discovery for private capital to step in.

In addition to increasing the price for credit guarantee, the second impediment is around the regulatory framework. The Dodd-Frank risk retention rules place restrictions on securitization as a vehicle for credit transfer by requiring the lenders to have "skin-in-the-game" in the form of retaining a slice of the securities created from loans that do not fall under the umbrella of qualified residential mortgages (QRM). Large lenders may be able to keep loans on their portfolios if the implicit price of credit risk provides a viable rate of return, but the capacity for funding mortgage loans in the banking industry is limited. Securitization introduces a vast spectrum of investors, such as insurance companies, pension funds, mutual funds, hedge funds, and foreign investors, who will remain untapped in the absence of securitized products. Providing regulatory clarity along with a clear capital

As most mortgage lenders and the GSEs continue to struggle with the legacy issues of unprecedented levels of default, foreclosures, and inventories of houses for sale, it is also time to look forward toward a better housing finance model and ways to attract private capital for mortgage credit risk-taking.



framework for investing in the securities retained by the issuer is a prerequisite to jumpstarting the securitization business through PLS.

The third impediment to the entry of private capital in taking mortgage credit risk is the issue around the exposure to representations and warranties that originators make to the securitizers, such as the GSEs or the private trusts that create the

securities. There are indications the GSEs will increase the guarantee fees and may also test some pilot securitizations similar to PLS. In the case of PLS-type securitization by the GSEs, a first-loss security making up a small proportion will be carved out of mortgage pools and sold to investors without any government guarantee. The remaining portion may then benefit from a GSE guarantee but would

loss to the securities to benefit from the liquidity and the wide spectrum of domestic and foreign investors that such a guarantee would attract.

A second model of credit risk disposition for mortgages is through the framework of PLS under consideration by the GSEs as a pilot. A simple two-tranche securitization would be performed, where the subordinate tranche or the first-loss piece would be sold without a credit guarantee to investors looking to take the credit risk of mortgages in return for a high expected yield. The senior tranche would then have minimal credit risk and would have government-provided catastrophic insurance.

The GSEs can encourage private financial institutions to enter the credit business with an attractive return on their capital by implementing a plan to increase the guarantee prices steadily over time. In the operating company model, some institutional changes will be required to allow other participants to enter this business and start guaranteeing the credit risk of mortgages currently in the domain of the GSEs. This would allow the guarantors to deliver the securities through the current existing framework of government agency securitization. This can be accomplished by the creation of fully owned AA+ subsidiaries or trusts to guarantee mortgage credit risk within large diversified financial institutions or well-capitalized mortgage insurance (MI) companies and REITs.

It would wean the GSEs away from taking credit risk, and we could foresee one single GSE in the future confined to the role of creating and monitoring the credit parameters of the loans that would be eligible for agency securities, monitoring and enforcing servicing standards, and maintaining the framework of securitization. As an alternative, financial institutions may also be encouraged to start issuing PLS as the GSEs increase prices and create a more level playing field for the price of credit risk.

Long-term durable regulations that do not change with changing political environments will go a long way in instilling confidence among the investors.

PLS. In the event of default on the loans, if on investigation the loans are deemed ineligible for sale to the GSEs or the trusts, they are put back to the originators in the form of a repurchase demand. As a consequence, with the recent explosion of put-backs, the originators have been subject to unprecedented amounts of demand and suffered tremendous loss. This has reduced the appetite of most lenders to venture beyond the most pristine credit among the loans, and a vast proportion of creditworthy borrowers have been locked out of the mortgage market. A solution to the representation- and warranties-related risk for the lenders is essential to open up credit and private equity participation.

Clearing the Hurdles

The process of dealing with the first impediment to the entry of private capital in mortgage credit investment appears to be on the horizon. This is related to the prices charged by the GSEs to guarantee mortgages to create government agency pass-through

have minimal credit risk for the taxpayer. Given the current price of credit guarantee charged by the GSEs, this structure would result in an immediate loss to the agencies since the price discount offered to lure private investors to buy the first-loss piece will be substantial. However, as the GSEs increase their guarantee fees and the increasing rates charged to borrowers start reflecting a market price independent of the GSEs, the subsidy for creating the PLS-like securities will diminish.

If the GSEs experiment with different pilots for laying off credit risk of mortgages, it is worth noting that there are two competing models of investment in mortgage credit. One is the operating company model akin to that of the GSEs, where a regulatory capital regime is the centerpiece of the framework. In such a model, a number of GSE-like entities enter the guarantee business and back the credit guarantee for mortgage-backed securities with a capital base prescribed and monitored by the regulator.

The government then provides a guarantee against catastrophic

Operating Co. Model vs. Senior/Sub Structure

The difference between the operating company model for taking risk and the senior/subordinate structure to distribute credit risk is the manner in which credit risk analysis and pricing are performed. In the former approach, the analysis of credit risk is more of a centralized function embedded mostly in institutions much closer to the loan origination and can create a more streamlined process for costing and pricing of credit risk. In the latter framework, credit risk analysis and pricing is much more dispersed, and the burden lies on each individual investor to monitor each securitization deal separately to estimate the risk and return tradeoff.

We believe the operating company model with regulatory capital will provide a more efficient framework for the pricing of risk and will lead to better rates for borrowers and an equal amount of protection to taxpayers in the event of a catastrophic scenario. As the FHFA moves ahead with guarantee price increases and the pilot projects with PLS-type securitization, it would also be worthwhile to start providing the large lenders the option to create trusts or AA+ mortgage subsidiaries for offering credit guarantees to loans that are delivered into the government-backed mortgage securities. This option may also be extended to MI companies and REITs. This would provide a much more diversified and efficient framework of valuation, pricing, and investing in mortgage credit risk that would benefit borrowers and taxpayers and provide better regulation of the industry.

Much Ado About Dodd-Frank

Regarding the second issue of regulatory uncertainty around Dodd-Frank risk retention rules,

there has been a tremendous amount of feedback provided by various industry participants to the regulators for crafting the final proposals. This is to ensure that the rules are not overly restrictive and do not end up limiting the borrowers whose mortgages can be granted QRM status and get securitized through the GSE-like guarantor agencies of the future. If the choice for credit risk-taking in the future is through senior/subordinate structures, the securitization agencies should have a clear understanding of the risk they will eventually have to retain. Political uncertainty around the rules does not prevent the markets from quantifying and pricing the risk. Long-term durable regulations that do not change with changing political environments will go a long way in instilling confidence among the investors.

Risky Business: Representations and Warrants

The third impediment to the entry of private capital in mortgage credit risk-taking is the representation and warrants exposure. If the large lenders/originators establish a AA+ subsidiary or trust to guarantee the credit risk for securitization through a government agency, then the risk from representation and warrants is inherently bundled with the credit guarantee and the guarantors would do their underwriting due diligence and charge guarantee fees to cover that risk. However, if the originators deliver the loans to some other financial institution—such as another large lender, an MI company, or REIT to provide the credit guarantee or, in the case of PLS, a securitization trust—the representation and warrants risk has to be priced and borne by some intermediary. In this case, there are two models. There is at least one instance where private equity has been raised to



provide representation and warrants insurance for a fee.

In a different model, at least one large lender has started providing representation and warrants “waivers” for a fee to select customers who deliver their loans to be held in the bank’s portfolio or for securitization through the GSEs. These models can be extended and better price discovery achieved as guarantors and securitization trusts start making use of this insurance.

As most mortgage lenders and the GSEs continue to

struggle with the legacy issues of unprecedented levels of default, foreclosures, and inventories of houses for sale along with contentious issues like put-backs of loans due to representation- and warrants-related problems, it is also time to look forward toward a better housing finance model and ways to attract private capital for mortgage credit risk-taking. There are impediments arising from pricing of credit risk by the GSEs, lack of clarity from regulation, and conflicts from representation and warrants

exposure. The impending initiatives from the GSEs on pricing and solutions around the other two issues will eventually bring in the much-needed participation of private capital to take an equity position against mortgage credit risk.

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