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TESTIMONY

# TRANSPARENCY AS AN ALTERNATIVE TO THE FEDERAL GOVERNMENT'S REGULATION OF RISK RETENTION

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Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs

Chairman McHenry, Ranking Member Quigley, and distinguished members of the Subcommittee, thank you for inviting me to testify today. I have been asked to offer opinions on the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") and its impact on Securitization, particularly risk retention.

There were a host of contributing factors to the rise and subsequent collapse of housing prices that decimated households, financial institutions and investors (including pension funds). For example, it has been argued that the Federal Reserve's expansionary monetary policy supplied the means for unsustainable housing prices and unsustainable mortgage financing.[1] In Figure 1, I show the Fed's reduction and eventual slow increase of the Fed Funds rate while house prices were rising quickly. The Fed Funds rate reached a plateau at the peak of the housing bubble, but the Fed was slow to lower the Fed Funds rates as housing prices began to collapse. As long as Fed policy can contribute to forming bubbles in asset prices (and in this case, housing), no simple risk retention rule will protect investors or taxpayers.

### Securitization Provisions in the Dodd-Frank Act

Dodd-Frank requires that securitizers retain at least five percent of the risk in all loans that do not qualify as a Qualified Residential Mortgage (QRM)[2] and are sold into the securitization market. In theory, five percent risk retention would lead securitizers to be more careful in the loan origination and underwriting process.

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[1] Lawrence H. White, "Federal Reserve Policy and the Housing Bubble," *Cato Journal*, Vol. 29, No. 1, Winter 2009, http://www.cato.org/pubs/journal/cj29n1/cj29n1-9.pdf.

[2] A qualified residential mortgage (QRM) is one with an 80 percent loan-to-value ratio, full documentation, and more traditional underwriting standards. This generally includes the 30 year fixed-rate mortgage and excludes exotic mortgages such as interest-only mortgages.

To be sure, five percent risk retention would be the simplest approach to implement to encourage improved loan origination and underwriting. Unfortunately, risk retention also appears to be the least useful approach.

First, the house price collapse resulted in house price declines that far exceeded five percent; for example, Las Vegas fell 56 percent from peak to trough.[3] [See Figure 1 for the collapse of housing prices]

Second, risk retention does not directly address origination risk.[4] Representations ("reps") and warrants that are found in Mortgage Loan Purchase Agreements (MLPAs) and related documents directly address origination risk. The avalanche of loan repurchase requests in the aftermath of the housing collapse makes reps and warranties less viable for non-agency mortgage-backed securities.

Third, the Federal Housing Administration (FHA), Fannie Mae and Freddie Mac are exempt from risk retention rules. Exempting these players in the mortgage market defeats the spirit of risk retention since a loan originator will be tempted to sell to or be insured by Fannie Mae, Freddie Mac and the FHA rather than keep the retained risk.

Fourth, given Reg AB (Dodd-Frank 942) and the anticipated transparency of the ABS markets, the retention rule implies that Qualified Institutional Buyers (QIBs) are not sophisticated enough to understand origination risks and need to be protected beyond greater transparency. QIBs (or "sophisticated investors") such as Fannie Mae, Freddie Mac, PIMCO and others do not require the additional security of five percent risk retention since they perform substantial due diligence and analysis before purchasing securities.

In summary, it is unclear how risk retention will be implemented (e.g., vertical versus horizontal versus "L" cuts) and if it is even effective in reducing origination risk.

There are more effective alternatives to risk retention: transparency and improved representations and warranties.

**Greater Transparency**

One solution to origination risk is to provide greater transparency to investors. Greater transparency would permit more accurate pricing. Greater transparency potentially reduces the asymmetric information between securitizers and investors.

There has already been a movement in the industry towards greater transparency. Prospectuses and Prospectus Supplements for both agency and non-agency mortgage-

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[3] Free exchange, "Recovery comes to Las Vegas," *The Economist*, January 26, 2010, http://www.economist.com/blogs/freeexchange/2010/01/recovery_comes_las_vegas

4 Origination risk refers to the risk of breaches of underwriting standards, misrepresentations, fraud, poor data quality and other legal breaches.

backed securities provide detailed breakdowns of the underlying loans in terms of critical risk measures such as loan-to-value ratio, loan type, credit score, etc. Freddie Mac in 2006 took loan transparency to a new level by providing a file of loan level information.[5] The non-agency market (as well as the FHA) could provide similar loan level disclosure.

I would prefer that the Securitizers provide transparency themselves rather than be forced through regulation. Some investors may prefer having less information disclosed which should result in a higher expected yield compared to fully-disclosed loan information. Investors should retain the right to choose how much information that they want disclosed by Securitizers.

But additional loan disclosure is just one prong to providing a better alternative to retained risk. The other is to enact an "origination certificate" approach to reducing securitization risk.

**Origination Certificate**

Even though Securitizers could release great loan-level information, the market would still be concerned that the information is inaccurate. There should be mechanisms to insure that the disclosed information is actually correct. Andrew Davidson and I proposed a "securitization certificate" in our paper "Securitization after the Fall."[6] In the paper, we write:

> *We propose a "securitization certificate" which would travel with the loan and would be accompanied by appropriate assurances of financial responsibility. The certificate would replace representations and warranties, which travel through the chain of buyers and sellers and are often unenforced or weakened by the successive loan transfers. The certificate would also serve to protect borrowers from fraudulent origination practices.*

The securitization or origination certificate approach has the potential to be effective because it directly addresses origination risk and contains a fraud penalty.[7] The origination certificate would travel with the loan and would verify that the loan was originated in accordance with law, that the underwriting data was accurate, and that the loan met all required underwriting requirements. This certificate would be backed by a guarantee from the originating firm or other financially responsible firm and would travel with the loan over its life. The seller must provide a means of demonstrating financial responsibility,

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[5] See data reports provided by Freddie Mac and available at: http://www.freddiemac.com/mbs/html/data_files_5bd.html

[6] Andrew Davidson and Anthony B. Sanders, "Securitization after the fall," Second Annual UCI Mid-Winter Symposium on Urban Research, "Housing after the Fall: Reassessing the Future of the American Dream," February 2009, http://merage.uci.edu/ResearchAndCenters/CRE/Resources/Documents/Davidson-Sanders.pdf.

[7] Andrew Davidson and Eknath Belbase, "Origination Risk in the Mortgage Securitization Process: An Analysis of Alternate Policies," *The Pipeline*, Andrew Davidson & Co., 2010.

either via capital or insurance, for the loans to be put into a securitization. There should be a penalty for violations of reps and warrants beyond repurchase obligations and tracking of violations of reps and warrants available to all investors.

Thank you again for the opportunity to testify. I look forward to your questions.

Figure 1. Case-Shiller House Prices and Fed Funds Rate