The Rebirth of Securitization

Where Is the Private-Label Mortgage Market?

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In the wake of the financial crisis, new securitization activity ground to a halt in all asset classes that did not have an implicit or explicit government guarantee. Though securitization has since resumed in most asset classes, including automobiles, credit cards, collateralized loan obligations (CLOs), and commercial mortgage-backed securities (CMBSs), the private-label residential mortgage-backed securities market remains stagnant. In this brief, we discuss why the residential mortgage market experience has been so different and attempt to provide guidance about what remains to be fixed.

Securitization is the process by which cash flows from multiple debt obligations are pooled and sold to investors. By passing the risk of the debt obligations on to investors, lenders are freed up to extend more credit. Securitization thus significantly affects the amount of lending done in a given market. For example, if automobile loans were not securitized, they would have to be held on bank balance sheets, and substantial capital would be required to back them. Fewer automobile loans would thus be extended, and the cost of those loans would likely be higher.

Though securitization of loans backed by Fannie Mae, Freddie Mac, the Federal Housing Administration (FHA), and the Department of Veterans Affairs (the latter two compose the bulk of Ginnie Mae securitization) has remained strong or strengthened since the financial crisis, securitization of loans with no government backing has collapsed. This collapse has not affected the availability or cost of credit for loans made to high–net worth borrowers or borrowers with perfect credit, because banks compete to put those loans on their balance sheets. As the profitability of holding those loans declines, in the absence of a private-label securities (PLS) market, access for those borrowers will become more difficult and expensive. That change may prove the impetus to solve many of the outstanding PLS market issues.

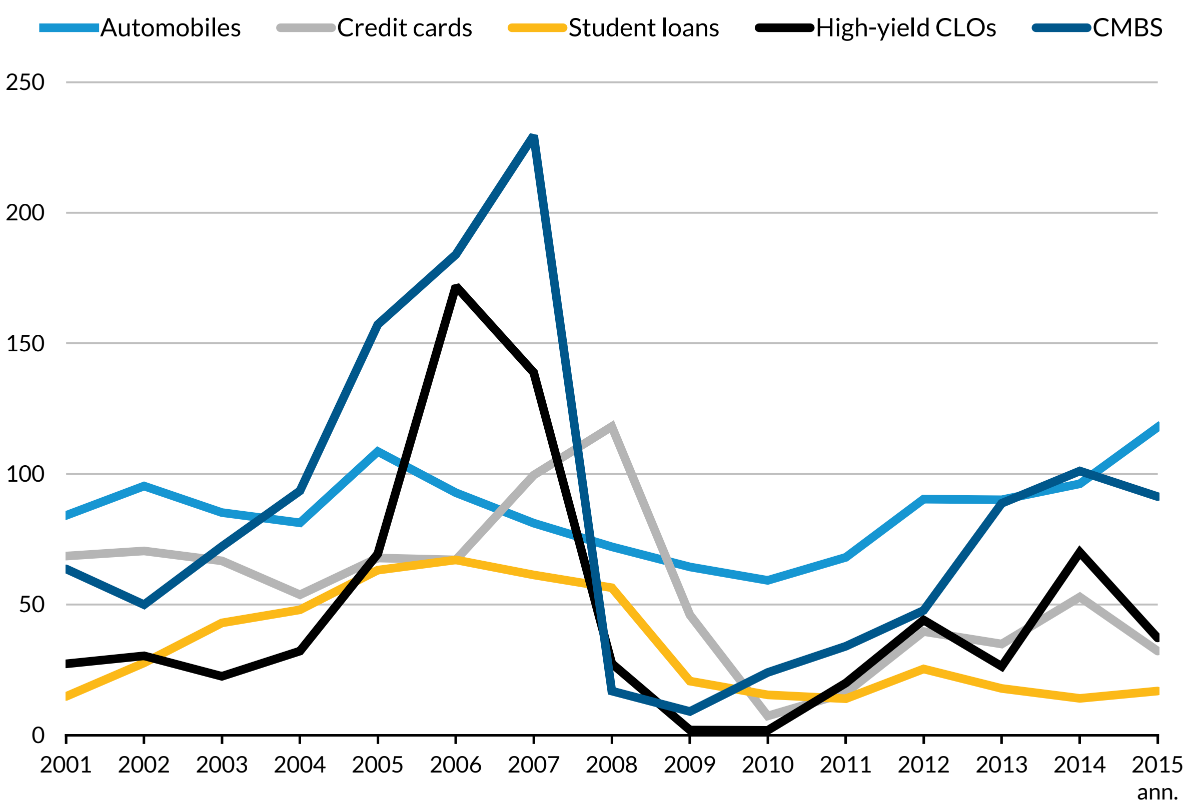
By contrast, borrowers with less wealth and imperfect credit who do not qualify for government-backed loans currently face limited credit availability and high rates. Banks are unwilling to put these borrowers' loans on their balance sheets, and the securities market for such loans has disappeared. With no market for these loans, few lenders will make them. And securitization for imperfect credit will take much longer to emerge because market participants will likely demand "proof of concept" with pristine collateral.

Figure 1 shows the experience of the largest classes of securitized assets from 2001 through the first half of 2015, excluding mortgages.[1] (For consistency, we have annualized the 2015 numbers.) Issuance of all these securitized products rose dramatically in 2005–07, fell in the wake of the housing crisis, and has since recovered. Both automobiles and high-yield CLOs are back above 2001 levels. Figure 2 shows the contrasting pattern for mortgage volumes over the same period; issuances peaked in 2005, fell sharply after 2007, and remain low through 2015. Table 1 shows the percent change in issuance from 2001 to 2014. During this period automobile securitizations increased 14 percent, high-yield CLOs increased 156 percent, CMBSs increased 58 percent, and student loans and credit cards decreased 5 and 23 percent, respectively. By contrast, private-label securities decreased 84 percent.

FIGURE 1

Securitization of Nonmortgage Asset Classes, 2001–15

Billions of dollars

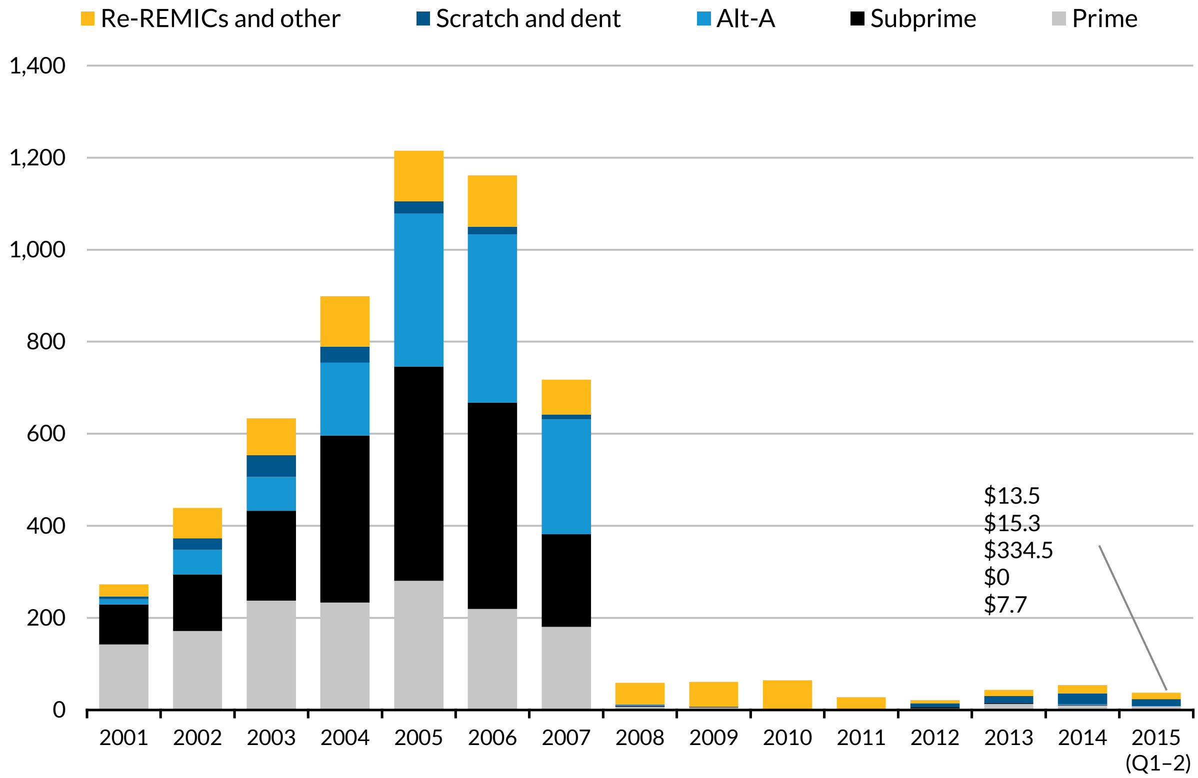


Sources: Securities Industry and Financial Markets Association and Urban Institute.
Note: CLO = collateralized loan obligation; CMBS = commercial mortgage-backed securities.

FIGURE 2

Private-Label Residential Mortgage-Backed Securities Issuance, 2001–15

Billions of dollars



Sources: Inside Mortgage Finance and Urban Institute.
Note: REMIC = real estate mortgage investment conduit.

TABLE 1

Percent Change in Securities Issuance, 2001–14

Automobiles	14.4
Credit cards	-22.9
Student loans	-5.3
High-yield CLOs	155.8
CMBSs	58.8
Private-label RMBSs	-84.2

Source: Securities Industry and Financial Markets Association, Inside Mortgage Finance, and Urban Institute.
Note: CLO = collateralized loan obligation; CMBS = commercial mortgage-backed security; RMBS = residential mortgage-backed security.

Investors are, however, willing to take mortgage credit risk. The 8 Fannie Mae Connecticut Avenue Securities securitizations and the 14 Freddie Mac Structured Agency Credit Risk deals are proof of that. Through these securitizations, which have gained widespread investor interest, the government-sponsored enterprises (GSEs) have laid off a significant portion of the risk on their new originations.

Three factors explain the difference in recent volumes between other asset-backed securitizations (automobiles, credit cards, student loans, high-yield loans, and commercial mortgages) and private-label residential mortgage-backed securities (RMBSs):

- Mortgages exhibited the most severe dislocations of any asset class. These dislocations exposed flaws in the cash flow waterfall and the collateral that backed private-label securities.
- Mortgages were the only asset class to experience significant policy changes affecting already-outstanding securities in the wake of the crisis.
- Though the interests of investors and issuers were largely aligned in the securitizations of other asset classes, private-label securities were riddled with conflicts of interest among all key players.

As we explain, many issues underlying the first factor have been corrected, but more work needs to be done on the second and third. We recommend several steps, many of which have already been proposed by either the Structured Finance Industry Group or the group of market participants convened by the US Treasury Department to address PLS reforms, or both. If most of these changes are implemented, we should see at least the beginning of a resurgence in the securitization of prime jumbo mortgages. The securitization of less pristine mortgages will require more work and more time to rebound because investors must gain a level of comfort with prime jumbo securitization. Our view is that securitizations for these loans will initially emerge as financing transactions; over time and well after the reestablishment of the prime jumbo market, credit risk will be transferred on less than pristine collateral.

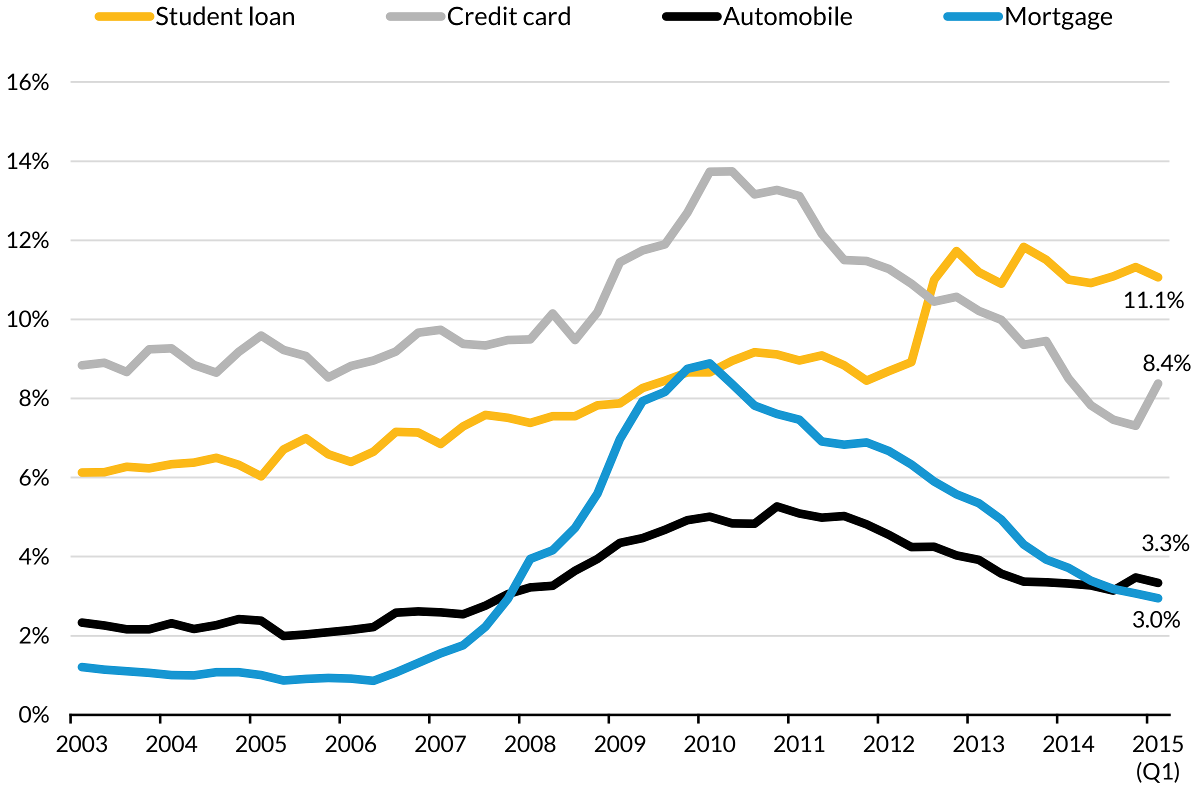
Mortgages Exhibited the Most Severe Dislocations of Any Asset Class, Exposing Structural Flaws in Private-Label Securitizations

Figure 3 shows the share of loans, by dollar volumes outstanding, that are more than 90 days delinquent for each class of asset. From 2003 to the peak in 2010, delinquencies increased 625 percent for mortgages versus 124 percent for automobile loans, 51 percent for credit cards, and 45 percent for student loans. Though the mortgage delinquency rate in 2003 was considerably lower than each of the other categories, by 2008 it was higher than that of automobile delinquencies, and by 2010 it was higher than both the student loan and automobile delinquency rates, though still lower than that of credit cards. Note that the mortgage delinquency rate is now again the lowest among the four rates.

With this surge in delinquencies, the vast majority of the AAA-rated PLS were downgraded, and many incurred losses. As risk and losses began to flow through the system rather than revenues, investors and policymakers began to discover flaws in the design of private-label securitizations.

FIGURE 3

Delinquency Rates by Loan Product, 2003–15



Sources: Federal Reserve Bank of New York Quarterly Report on Household Debt and Credit and Urban Institute.
Note: Delinquency indicates loans 90 days or more past due.

Weaknesses in the Cash Flow Waterfall

In many cases, subordinate bonds offered less protection for the senior classes than expected, imposing unexpected levels of loss on senior PLS noteholders. In particular, if the deal was performing satisfactorily, cash flows were released to the subordinate bonds pro rata relatively early in the life of the deal, providing inadequate protection to the AAA-rated bonds if losses were incurred later. In 2010 the issue was addressed for deals going forward, which now require a minimum level of subordination for the AAA-rated bonds. The lower-rated bonds are not entitled to any principal unless that level is met.

Weaknesses in Loan Underwriting

There is a legitimate role for many of the nontraditional products that were offered at the height of the crisis, including loans with less than full documentation, interest-only features, and adjustable rate mortgages with short resets. However, these products must be underwritten to account for their greater riskiness by requiring compensating factors. This was clearly not done. Every stage, including income checks, employment checks, and appraisals, showed sloppiness. After the crisis, the market began to demand that loans be fully documented, and most lenders either eliminated nontraditional products or began using them very selectively. This was codified by the ability-to-repay rules promulgated by the Consumer Financial Protection Bureau. These rules required institutions making a mortgage to, as part of their due diligence, acquire enough information to determine that the borrower has the ability to repay the loan. We argue that the market has overcorrected for sloppy origination pre-crisis and is not currently taking enough risk (Bai, Li, and Goodman 2015; Li and Goodman 2014).

Lack of Consistent Loan-Level Information

Investors did not have adequate information about the loans in the deal, and reporting varied substantially across deals. Income and the debt-to-income ratio were often missing or misreported. There was no indication whether the loan originated through a broker. The investor often did not know whether the borrower had a second mortgage on the same collateral. Definitions of full documentation were unclear, and often loans were made without full documentation. The source of each borrower's income was often not reported even if it was collected.

Project Restart, a collaborative effort between issuers and investors working under the auspices of the American Securitization Forum, an RMBS trade group, attempted to address the problem in 2009 with the release of a RMBS disclosure package. This document suggested that investors be provided with 157 fields of information on each loan, in a standardized format. The package was enormously helpful in standardizing the information and setting a minimum standard. Most new deals provide more information than this requirement.

Sloppy Due Diligence

Due diligence, in which the loans in the deal are verified by a third-party provider to be as represented, was not taken seriously before the financial crisis. The due diligence provider was supposed to check a certain percentage of the loan files to make sure the loans were complete, that they met the necessary regulatory guidelines, that they conformed to the underwriting standards of the originator, and that the credit and property values disclosed were properly verified. Not only were the checks often perfunctory, but when a defective loan was found, it was often simply removed from the deal without any analysis to determine whether it indicated a broader problem. Moreover, the defective loans were often put into subsequent deals in the hope that they would not be one of the loans selected for sampling in those deals.

Today, due diligence is taken much more seriously. The rating agencies require unseasoned originators to perform due diligence on every loan and require even seasoned originators to perform due diligence on most loans.

While many of the due diligence issues have been solved, the due diligence process is not standardized. Different due diligence providers look at items differently (some may be more perfunctory than others), and rating agencies get comfortable with the work of the due diligence provider in relation to a particular deal. With trust still missing, stronger minimum standards of what is required for due diligence would improve investor comfort.

The new deals (the so-called RMBS 2.0) have thus eliminated most of the flaws in the cash flow waterfall and in the collateral that plagued RMBS 1.0 deals. In particular, the cash flow waterfall has been reengineered to provide more protection for AAA-rated investors, mortgages are being underwritten much more carefully, information disclosure has been substantially increased, and due diligence has improved dramatically. None of these changes, however, appear to have affected issuance. This leads us to the other impediments.

Mortgages Were the Only Asset Class to Experience Significant Policy Changes after the Crisis

Mortgages are by far the largest consumer debt instrument, with close to $10 trillion outstanding. The next largest markets are student loan debt and automobile debt, at $1.2 trillion and just under $1 trillion, respectively. Moreover, home equity is the primary source of wealth for most borrowers. Not surprisingly then, the mortgage market experienced the most aggressive regulatory response to the crisis of any asset class. The policymakers' responses were designed to both keep borrowers in their homes and punish institutions for wrongdoing. In many cases, the mortgage-backed securities investors bore both the costs and uncertainty of these policy changes. There was no significant change in policy for any other asset classes except student loans, and the changes to it were much more modest.[2]

It is useful to outline some of these policy changes, which affected securities already in the market, and then view them through the lens of the investor.

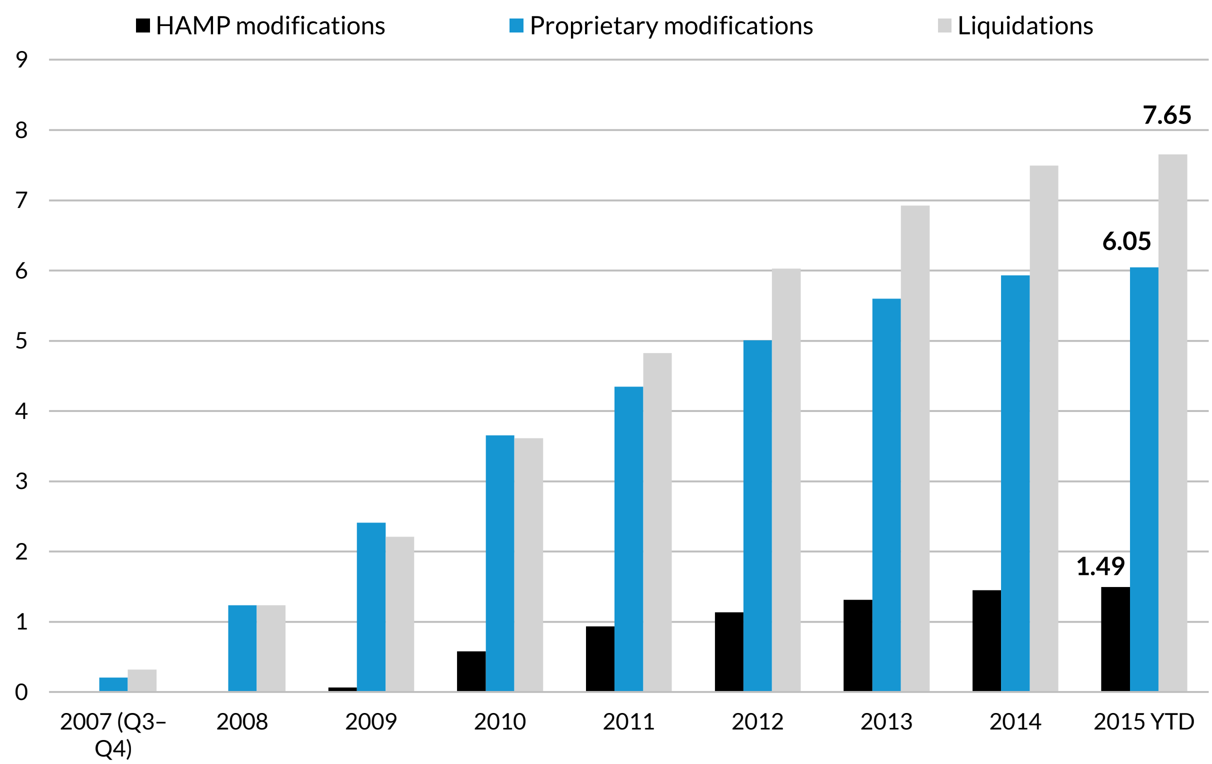
Lack of Disclosure for Wave of Loan Modifications

Before the crisis, no standardized tools for mortgage loan modifications existed, because mortgage defaults were relatively uncommon. During the crisis, the Home Affordable Modification Program (HAMP) was enacted, providing a blueprint for modifications. As shown in figure 4 (which covers the vast majority of mortgage servicers), since the second quarter of 2007 the mortgage market has experienced 7.65 million liquidations (out of approximately 50 million homes with a mortgage) and an equal number of modifications. Though only 20 percent of these were HAMP modifications, the program set the blueprint for the modification of loans in PLS and on bank balance sheets. Controversial though this and other modification programs were, the collapse of the housing market would clearly have been deeper and more protracted were it not for them.

FIGURE 4

Cumulative Modifications and Liquidations

Millions of loans



Sources: Hope Now Reports and Urban Institute.
Note: HAMP = Home Affordable Modification Program. Liquidations include both foreclosure sales and short sales.

The problem was that many details on this large wave of modifications, critical though they were to the market, went entirely unreported to the investors that owned pools of these loans. Investors were required to infer them by observation. Did a loan that was delinquent become current and experience a payment decline when it was not scheduled to reset? Was there a principal loss on a now-performing loan? Was this forbearance or forgiveness? Did the servicers apply the net present value (NPV) rules correctly? Investors did not know the answers to these questions and had no way to find them.

Servicing Settlements

The settlements among the Department of Justice, various state attorneys general, and many of the nation's largest bank servicers were designed to punish banks for poor servicing practices and relieve consumers. In doing so, however, some of the cost of consumer relief was pushed onto investor first-lien note holders. Though banks primarily settled by providing consumer relief on their own loans, the fact that they were able to cover some of their obligations by providing relief on loans owned by investors angered many investors; a view further aggravated by the fact that neither GSE nor FHA loans could be used for the settlements.

The settlements all required an NPV test, which should have ensured that investors' loans would be written down only where it was in their financial interests, but the lack of disclosure over the NPV test's contents left investors skeptical that they were being treated fairly. Moreover, many investors believe that the modification or foreclosure alternative that produces the highest NPV should be used. That is, allowing for a modification because it is better than a foreclosure is misdirected: servicers should find the highest-NPV alternative. Fuller disclosure to investors on the details of the NPV test used, and which loans were modified and on what terms, would have made a significant difference. Monitoring to ensure that the servicers were behaving as required under their contracts with investors would also have helped. Though most of these settlements fell under various monitors, these monitors have been charged with ensuring that lenders are meeting their obligations under the settlements; investors are not a party to the settlements.

Expansion of Timelines

The long foreclosure timelines in many states, particularly those that require judicial review before foreclosure, have added to the severity of losses on liquidated loans. In most private-label securitizations, servicers are required to advance principal and interest payments to the trust (i.e., the investors) as long as the amount advanced is deemed recoverable. When recovery is cast into question, such as when a loan enters the foreclosure pipeline, payments are withheld until the loan is liquidated. Thus, the longer the foreclosure timeline, the longer the period in which the investor is unable to collect and the more the property tends to deteriorate, driving down the amount ultimately collected.[3]

Eminent Domain

What arguably generated the most investor ire was a program that never took effect. Several cities proposed programs under which performing, underwater loans were to be seized out of private-label securitizations using eminent domain. The investors would be paid whatever the city deemed appropriate, and the loans would be written down and then refinanced into an FHA loan. Though cities claimed that they would pay a fair market rate, investors pointed out that the only way the economics worked was if the loans were purchased at a deep discount to the market value of the property. Moreover, bank portfolio loans and loans from the FHA, GSEs, and the Department of Veterans Affairs were not subject to this program; eminent domain essentially took advantage of the weak investor protections in the PLS market.

The proposals were never implemented in any municipalities, in part because of loud protests by investor groups and in part because of steps taken by regulators. On August 8, 2013, the Federal Housing Finance Agency (FHFA) released a statement throwing cold water on the proposal:

> FHFA…continues to have serious concerns on the use of eminent domain to restructure existing financial contracts and has determined such use present a clear threat to the safe and sound operations of Fannie Mae, Freddie Mac and the Federal Home Loan Banks…Therefore, FHFA considers the use of eminent domain in a fashion that restructures loans held by or supporting pools guaranteed or purchased by FHFA regulated entities a matter that may require use of its statutory authorities.[4]

The issue was finally settled in December 2014, when Congress prohibited the FHA, Ginnie Mae, or HUD from insuring, securitizing, or establishing a federal guarantee on any mortgage or mortgage-backed security that refinances or otherwise replaces a mortgage that has been subject to eminent domain condemnation or seizure.

Even though no municipality actually moved forward to use eminent domain in this manner, more than any other single factor, this issue highlighted to investors that the private-label securitization structure did not adequately protect their interests. It is also the factor for which policymakers are most clearly at fault. By allowing the issue to sit idly for several years as a real risk, policymakers allowed much angst to build unnecessarily, angst that has in turn helped hold back the return of PLS.

Issuer and Investor Interests Were Better Aligned in Securitizations of Other Asset Classes

In most consumer lending (credit cards, automobiles, and student loans), the issuer retains significant equity after securitization, aligning the interest of the issuer and the investor. That is, the securitizations are primary designed to provide funding rather than transfer credit risk.[5]

Securitizations of commercial mortgage loans and CLOs do have a general alignment of interests, with conflicts arising if the deal is doing very badly. In CMBSs, servicing control is retained by the holder of the B note, which is subordinate to the other securitized bonds and has "duty of care" responsibilities. Thus, the B note holder is required to police the servicer on behalf of all the investors. (The weakness of this approach is if the deal is doing very badly, the interests of the most junior noteholder may differ from those of investors in the rest of the deal.) In CLOs, the alignment is achieved because the manager is given incentive fees for good performance and often holds equity (again, in certain instances if the deal is doing very poorly, the interests of the manager may differ from those of the more senior investors).

In residential mortgage lending many conflicts of interest exist among the originator, the servicer, and the investors. Moreover, the incentive structure is often misaligned, accentuating these conflicts of interest. It is worth walking through how the misalignment of interests in the residential mortgage market actually plays out.

Enforcement of Representations and Warranties

In the precrisis securitizations, there was no mechanism to enforce the representations and warranties (reps and warrants) that lenders made to investors at the point of origination. The trustee for the securitization (who was very modestly compensated) was generally charged with enforcement once a violation was detected, but that trustee lacked access to the loan files and thus lacked the information to detect the violation. (The only way a trustee could gain access to the loan files was if a threshold percentage of investors could agree to work together, give the trustee access to the loan files, compensate the trustee for the outside services used for the evaluation, and indemnify the trustee against claims. But there was no mechanism to organize investors.) In short, the trustees had neither the ability nor the incentive to detect breaches of reps and warrants. The servicer was charged with detection, but had no incentive to do so because the originator that would be forced to buy back the defective loans was often a related party. In short, investors had no mechanism to enforce the reps and warrants in PLSs.

Misplaced Incentives Due to Ownership of Second Liens

When the originator serviced the first lien and owned the second, decisionmaking was subject to distortion when the first lien became delinquent. For example, the servicer may be more reluctant to do a short sale on the property, even though it is the best alternative for the first lien because the second lien would be wiped out entirely. On HAMP modifications, the servicer is required to modify the second mortgage in the same manner as he or she modifies the first; thus, the two mortgages are treated as though they are equally senior. Servicers who own the second lien may be less willing to do principal reductions on the first mortgage if the second mortgage is still paying.

Vertical Integration in the Servicing Process

Many servicers own shares in companies that provide ancillary services, such as property maintenance, during the foreclosure process. The advantage of this ownership is that the servicer can schedule maintenance activities more efficiently. In some cases, however, the servicer overcharges the trust for these services. But no one is monitoring the conflicted servicer or otherwise looking out for the investors' interests.

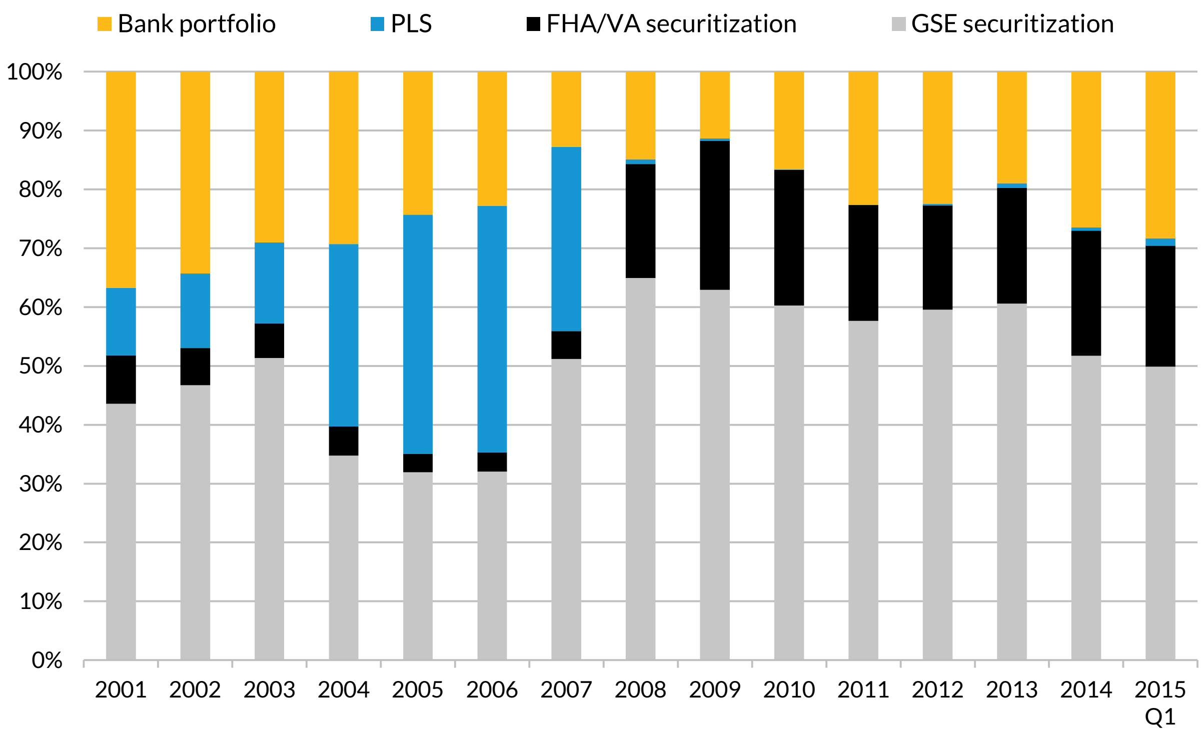
Does the Much Larger Role of the Government in the Mortgage-Backed Securities Market Explain Much?

Many investors have argued that PLSs are in competition with the government in the mortgage market. Other asset-backed loan products do not compete against a government-backed agency with pricing advantages and unlimited funding. The student loan market is the only other asset class with a sizable government presence, but in that market the government guarantees some of the loans but does not run a securitization vehicle.[6] Though these statements are true, they don't quite explain the disappearance of the private-label securities market. In particular, the government has always had a role in the mortgage market. Figure 5 shows new mortgage originations by channel. The PLS share increased from 11.5 percent in 2001 to 42.4 percent in 2006; it is now 1.2 percent. As the PLS market grew, the bank portfolio share shrank from 36.7 percent in 2001 to 12.8 percent in 2007. It is now 28.3 percent.

Yes, the government does have an advantage in funding. Yes, the government did step in and raise loan limits in 2008, allowing the GSEs and the FHA to insure loans they had not been able to before. But bank portfolios face the same competition, and they have grown considerably. It is very difficult to argue that the government funding advantage is a significant issue for the PLS market.

FIGURE 5

First-Lien Origination Share



Sources: Inside Mortgage Finance and Urban Institute.

Notes: FHA = Federal Housing Administration; GSE = government-sponsored enterprise; PLS = private-label security; VA = US Department of Veterans Affairs.

In fact, for most prime, jumbo PLS deals, the choice is to either sell into a bank portfolio or go the PLS route; most jumbo loans are selling into bank portfolios. Of the $35.1 billion in PLSs in 2014, only $10 billion was prime jumbo collateral (see figure 2). The remainder is reperforming and nonperforming loan deals and resecuritizations. Alt-A and subprime were missing entirely. To put this $10 billion in perspective, in 2014, bank portfolios retained $320 billion in loans, of which $225 billion represented jumbo prime production.

With current PLS pricing, it is more economical for an originator to sell the loans to a bank than into a PLS (or equivalently, it is more economical for a bank to retain its own production than to sell the loans into a PLS). This is because the AAA-rated bond in a PLS, which is 94 percent of the deal, is the hardest bond to sell: investors demand a hefty premium over agency mortgage-backed securities to buy these bonds. This reflects three factors: the increased prepayment risk (because, all else equal, jumbo mortgages have a greater propensity to refinance), a small amount of credit risk, and a liquidity premium. The first two factors are relatively modest; most of the difference between AAA-rated PLSs and agency MBSs can be explained by the liquidity premium. This liquidity premium is high because there is relatively limited issuance and the deals do not all look the same. If the liquidity premium for the AAA-rated bonds were to decrease, originators would reconsider this decision. And a decrease in liquidity premium for AAA-rated bonds requires that the governance rules on private-label securities be standardized and structured in a more investor-friendly form, a point to which we now turn.

What Has to Change in the PLS Market to Restore Issuance?

Several major changes are needed, which we detail here.

Standardization

Each securitization sponsor has its own documentation; there is no standardization. When investors bought a deal before the crisis, they generally read the deal summary but not the prospectus or the pooling and servicing agreement. In some cases, these agreements contained ambiguous language or contradictory instructions. Today, post-crisis, investors read every page of the documentation, totaling many hundreds of pages (including the deal summary, the prospectus, and the pooling and servicing agreement), because investors are concerned that something adverse to their interests could be buried deep inside one of the documents. This does not produce a scalable market.

The market needs to standardize the documentation so investors can quickly understand how each deal differs from others. Given that bank and nonbank originators have different needs, several standard ways to handle the enforcement of reps and warrants may be needed: standard language needs to be used for each securitization across issuers, and investors must be able to assess quickly which set of clauses has been selected for each deal. In the derivatives market, there is a standard International Swap Dealers Association contract in which the definitions that apply to the contract are checked. Creating something similar is critical to the revival of the PLS market.

Introduction of a Deal Agent

Under RMBS 1.0, no one was effectively charged with looking after the investor. Moreover, investors could not look out for themselves. Though in theory, investors could have organized to protect themselves, there was no mechanism for communication. A deal agent (who should not be the trustee) can fill this role. Ideally, the deal agent would be charged with (1) rep and warrant review on every loan that goes 60 days delinquent (and on other loans as needed) as well as enforcement of rep and warrant breaches, (2) servicing oversight, (3) cash flow reconciliation (making sure the trust received the money it was supposed to), and (4) communication and reporting to investors. The deal agent would most likely be selected by the sponsor, but it would have a duty of loyalty and a duty of care to the trust as a whole.

Though investors generally agree that a deal agency is essential, they have not reached a consensus on which entities can be deal agents. How are they to be selected and compensated? If they are not regulated, will investors require certain minimal levels of capital? Moreover, the PLS structures must be explicit about who has what responsibilities to the investor. Where do the responsibilities of the trustee end and the deal agent begin?

Better Transparency in and Monitoring of Servicing Operations and Other Servicing Improvements

Investors would like to see much clearer servicing standards. That is, they would like to see servicers provide better transparency on all loan modifications (e.g., new rate and term, extension, forgiveness or forbearance amount, and capitalization of delinquent payments). This includes modifications generated by mortgage settlements. Servicers should be charged with maximizing the value of the collateral to the trust as a whole;[7] for modifications, the servicer would document the available modification alternatives and the NPV model used in the calculations. Investors would like to see more standardization in NPV models and inputs to ensure consistency in treatment of loans across servicers. Servicers should also be charged with providing transparency on decisions as to when to employ foreclosure alternatives (short sales and deeds-in-lieu) instead of foreclosures. The deal agent would be charged with seeing that investor interests are upheld in the loan modification and loss mitigation process. The deal agent would also be charged with doing a loan-level cash flow reconciliation as well as a line-item reconciliation of loan liquidation proceeds.

Market participants broadly agree that the servicer compensation structure needs to be reformed to better align the incentives of servicers and investors. This can best be done on a fee-for-service basis. Many investors are supportive of a stop-advance trigger at 120 days because it increases standardization and reduces subjectivity. This view is not universal, however, because under certain circumstances it means the senior tranche either does not receive the contractual interest payments, or the subordinate bonds must be written down to pay interest to the senior tranches. As discussed, if a servicer services the first and owns the second, it presents serious conflicts of interest. Investors would like to see the servicing rights on one of the two liens transferred if the first becomes delinquent.

The Structured Finance Industry Group has been focusing heavily on the standardization issue. The US Department of the Treasury brought together many stakeholders, including issuers, investors, and potential deal agents for weekly discussions, to focus on the role of the deal agent, servicing oversight, governance, and transparency.

Though progress is being made, it is slow. In addition, the collateral being discussed is exclusively prime jumbo collateral.

The Future of Nonprime Mortgages

We have a hard time believing the market for securitizing nonprime mortgages will return to its old form in the near term. We expect that for the next several years, the market for riskier loans, most of which will be loans that do not fall under the safe harbor of the qualified mortgage rule, will likely be held in portfolio by private equity funds, hedge funds, and real estate investment trusts. These market participants will need leverage (financing) to buy the assets in a way that meets their required return threshold. This leverage is likely to come from three major sources—bank or repurchase agreement funding, Federal Home Loan Bank (FHLB) advances, or securitizations that are merely financing vehicles—in which the loan holder retains the credit risk.

Bank and repurchase agreement funding is generally locked in for relatively short terms. Many will prefer longer-term financing, which they can get through either FHLB advances or perhaps through securitizations. The entities that are likely to be the ultimate holders of the riskier loans cannot join the FHLB system directly because only depository institutions and insurance companies can join directly, but they often can join by forming a captive insurance company. However, the Federal Housing Finance Administration is considering prohibiting captives from joining the FHLB system, which we believe would be a mistake. The market for PLS as a financing vehicle for less-than-pristine new origination is largely untested. The rating agencies are apt to be very conservative in rating this collateral, and the securitizations may not make sense economically, even for financing transactions. And there may be considerable investor resistance. Securitizations of nonperforming and reperforming loans, which constitute much of new PLS market origination, are done as financing transactions, but securitizations backed by newly originated loans are much longer in duration than their nonperforming and reperforming counterparts. It will take both time and data showing the performance history of these loans to make both the rating agencies and the investor base more comfortable. Meanwhile, origination of these loans is apt to be fairly limited.

Conclusion

Securitization has returned to the market for every asset class other than mortgages. In this brief, we take a close look at the landscape, investigating why other asset classes have returned to the market and mortgages have not. We conclude there are three major differences:

- Mortgages exhibited the most severe dislocations of any asset class, exposing flaws in both the cash flow waterfall and the collateral that backed the private-label securitizations. Most of these issues have been corrected.
- Mortgages were the only asset class to experience policy changes that affected investors in already-issued securities. Though it is hard to ensure that this will never happen again, the changes discussed here (better transparency, better alignment of interests, and better communication) will allow investors more confidence that they will not be singled out unfairly for losses.
- Securitizations of other asset classes have better alignment of interest between the issuer and the investor. Again, most of the investor trust issues that arose from the misalignment of interest among the various parties could be mitigated if the changes discussed here were implemented.

Industry efforts to address standardization, conflict of interest, transparency, and communications are under way. These efforts can somewhat improve the relative economics of securitization. However, a macroeconomic environment in which balance sheet retention of pristine collateral is less attractive would certainly accelerate the reemergence of a robust private-label securities market for prime jumbo collateral.

The successful resolution of the issues discussed in this issue brief and the return of a robust PLS market for pristine collateral are preconditions for securitization on less-than-pristine collateral as a vehicle for risk transfer. In the near term, we believe these loans will be held on the balance sheets of private equity funds, money managers, and real estate investment trusts; securitization will be rare and occur only as a funding vehicle for these assets, not to transfer credit risk. And without a robust financing vehicle, we expect origination of these loans to be fairly limited.

Notes

1. Mortgages are not included in figure 1 because the scales of issuance are totally different: mortgages reached $1.2 trillion in 2005 (dropping to $42.2 billion in 2013), much more than figure 1's $250 billion maximum.
2. For example, the income-based modifications to student loan debt (payments limited to 10 to 20 percent of a borrower's discretionary income; all unpaid loans forgiven after 20–25 years) only applied to government-guaranteed debt. Though the trusts could experience some loss of income, the principal ultimately forgiven was guaranteed. And income-based modifications are not applicable to private student loans. Some might consider risk retention a change in the rules, but the risk retention guidelines for assets other than mortgages do not go into effect until December 2016, and they affect only new securitizations (or refinancing or restructuring of existing deals), Thus, there was no ex-post change in the rules on existing deals, as was the case in the residential mortgage market.
3. Servicing advances is one item up for reevaluation. Redwood Trust has adopted a policy where no servicing advances are made after the loan is a certain number of months delinquent; this replaces servicer discretion with a fixed policy. Of course, this policy does not solve the timeline extension issue.
4. Federal Housing Finance Authority, "FHFA Statement on Eminent Domain," August 8, 2013, http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Statement-on-Eminent-Domain.aspx.

5. One part of the PLS market has done better than the rest: the "scratch and dent" market, which mostly consists of deals backed by nonperforming and reperforming loans. Like automobile loan securitizations, these are structured as financing vehicles: the subordination level is so high as to make the possibility of a credit loss remote, and the subordination is held by the owner of the loans. Similarly, beginning in 2013, the market has seen the emergence of single-family rental securitizations. These too are financing transactions, where the single-family rental operator holds significant equity.
6. Historically, government-guaranteed student loans were included in securitizations. However, the 2010 elimination of Federal Family Education Loan Program origination in favor of the Direct Loan Program, in which loans are owned by the US Department of Education, means the only government loans being securitized are legacy government-guaranteed loans, and these are being securitized on a far smaller scale than in the past. Thus, the recent growth in the student loan securities market has been in private student loans, which explains the overall drop in issuance in this asset class in figure 1.
7. One issue in PLSs is whose returns the servicer is trying to maximize. The standard should be to maximize the total value of the collateral, not the value to any one tranche. The interests of various tranches are not always aligned.

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About the Author

Laurie Goodman is the director of the Housing Finance Policy Center at the Urban Institute. The center is dedicated to providing policymakers with data-driven analyses of housing finance policy issues that they can depend on for relevance, accuracy, and independence.

Before joining Urban in 2013, Goodman spent 30 years as an analyst and research department manager at a number of Wall Street firms. From 2008 to 2013, she was a senior managing director at Amherst Securities Group, LP, where her strategy effort became known for its analysis of housing policy issues. From 1993 to 2008, Goodman was head of global fixed income research and manager of US securitized products research at UBS and predecessor firms, which were ranked number one by *Institutional Investor* for 11 straight years. Before that, she was a senior fixed income analyst, a mortgage portfolio manager, and a senior economist at the Federal Reserve Bank of New York. She was inducted into the Fixed Income Analysts Hall of Fame in 2009.

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