A Progress Report on the Private-Label Securities Market

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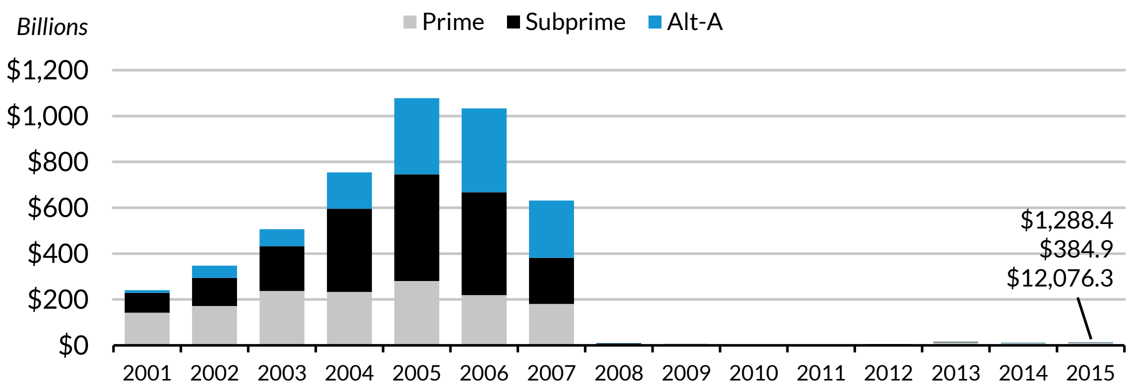
Issuance in the private-label securities (PLS) market has faded significantly since the financial crises. For the past eight years, securitization of products with no government involvement has been trifling compared with both 2005–07 and earlier periods. New prime securitization was just $12.1 billion in 2015—less than 9 percent of 2001's $142 billion total. Private-label securitization of newly prime, Alt-A, and subprime mortgages totaled $13.7 billion in 2015, versus $240.6 billion in 2001 (figure 1).

FIGURE 1

Non-agency Mortgage-Backed Securities Issuance, 2001–15



Sources: Inside Mortgage Finance and Urban Institute.

The low PLS issuance reflects two factors:

- Packages of loans are generally worth more to banks than what they would fetch in the PLS market; and
- Many investors are unwilling to engage in the PLS market because of the weak governance structures of these securities.

During the crisis, the PLS mortgage market suffered the most dislocation of any securitized product group because of severe and widespread home price depreciation, which highlighted the structural weaknesses of these securities. Some of these weaknesses have been corrected in recent deals: the cash flow waterfall is more favorable to the senior bonds, the loan underwriting process is rigorous, due diligence standards have been implemented, and loan-level information is more robust and more consistent across deals. However, many investors remain on the sidelines, in large part because they believe that the conflicts of interest between the deal sponsors/servicers and the investors have not yet been adequately addressed.

Two noteworthy efforts have tried to address these governance issues: the US Department of the Treasury's PLS initiative, announced in 2014, and the Structured Finance Industry Group's RMBS 3.0 Task Force, established in 2013. As part of the PLS initiative, the US Treasury has spent the past 18 months convening market participants—including institutional investors, issuers, servicers, ratings agencies, due diligence firms and other key stakeholders—to discuss reforms needed to restart the PLS market. As expressed by Monique Rollins, Treasury's deputy assistant secretary for capital markets, in a February speech,

> While the PLS market can provide a channel for mortgage financing that is responsible and not reliant on a taxpayer-backed guarantee, its return must happen in a reformed and sustainable way….While we do not see the PLS channel as a total panacea, it is one of a number of channels that can responsibly improve access to credit and strengthen the housing recovery. (Rollins 2016)

In a tangible sign of progress from the PLS initiative, some participants recently published key principles governing the role of deal agents, who are charged with looking out for the interests of investors. This concept is largely missing from existing deals.

The RMBS 3.0 Task Force was founded by the Structured Finance Industry Group (SFIG), an industry trade association. Task force participants include issuers, investors, rating agencies, servicers, lawyers, trustees, and diligence firms. The task force has summarized its efforts in the third edition of its green paper, released in November (SFIG 2015). More participants, but fewer large investors, are involved with the SFIG effort than with the PLS initiative. Some participants are in both groups.

In September 2015, we wrote about the state of the PLS market and what was needed to revive it (Goodman 2015). In particular, we made the case that action was needed along three dimensions: the introduction of an agent to look out for the interests of investors (the deal agent), standardization of deal documentation, and servicing improvements. We believe the Treasury and SFIG reform efforts have made considerable progress on our first two goals and some progress toward the third.

Why Is This Important?

The disappearance of the PLS market has already affected the availability and cost of mortgages for borrowers who do not have the necessary credit to qualify for government-backed loans. And this group of borrowers is larger than it might otherwise be. Many mortgage originators impose credit overlays on Federal Housing Administration (FHA) and government-sponsored enterprise (GSE) loans. These originators still fear repurchase and indemnification requests, litigation, and the high cost and reputational risk of servicing nonperforming loans. In addition, self-employed borrowers with good credit often do not qualify for government-backed loans because they pose documentation issues; households with more than two borrowers or income sources that fluctuate substantially from year to year are also likely to experience difficulties in qualifying for government backed loans. Banks are generally not interested in holding in portfolio loans made to these borrowers.

The one group unable to obtain government-backed lending not yet affected by the absence of a PLS market is wealthy borrowers with loans over the conforming loan limits (for GSE loans, $625K in high-cost areas, $417K nationwide). Banks are willing to put these loans on their balance sheet. If banks retreat from holding mortgages before the PLS market restarts, then these borrowers will also be affected.

The failure to restart the PLS market could have a much deeper and more problematic impact should policymakers ultimately decide to pull back on the government's role in the market, as many housing policy reformers have proposed. If this occurs, and banks do not step up, creditworthy borrowers with conforming loans will face both higher rates and credit availability issues.

The Introduction of a Deal Agent

In the pre-crises deals, which are now commonly referred to as Legacy RMBS or RMBS 1.0, most market participants believed that no one was charged with looking after investor interests, and there was no practical mechanism for investors to look out for themselves. As a result, a brutal combination of conflicts of interest and lack of enforcement in securitizations worked to the detriment of investors: representations and warranties were not enforced, decisions made on behalf of the trust had no transparency, investors received no communications or reports about the status of their deals beyond standard servicing reports (which contained less detail than investors felt was necessary), and servicing oversight was minimal. Many of these issues have not been corrected in RMBS 2.0, the post-crises deals done to date. But recent efforts are beginning to move the market in the right direction.

The Treasury Department's PLS initiative made its largest impact by outlining the concept of a deal agent—a concept that has the support of a wide ranging group of investors, issuers, and potential deal agents. Investors have long believed that they need a party to look out for their interests, but prior discussions typically broke down on specific roles and responsibilities and the scope of liability. Under the "Proposed Deal Agent Agreement: Key Principles," one document that arose from the Treasury group's effort, the deal agent would be selected by the deal sponsor and would have a duty of loyalty and a duty of care to the trust as a whole. That is, the deal agent would be charged with "protecting the interests of the RMBS trust, maximizing the net present value of its assets and making certain strategic decisions in the limited circumstances that doing so becomes necessary" (Pagani and Callahan 2016). The responsibilities of the deal agent would include (1) reviewing representations and warranties, (2) overseeing servicers, and (3) reporting to bondholders monthly.

Under many RMBS 2.0 deals, certain events (such as delinquency) after a certain number of days (generally 120) would trigger a third party to determine whether a breach of representations and warranties has occurred. The key principles formalized and strengthened this role under a deal agent. The deal agent is authorized to obtain all information necessary to make such a determination, including credit files, servicing files, and underwriting guidelines. If a breach has occurred, the deal agent is authorized to enforce repurchase demands. The deal agent would also have some discretion to conduct reviews not generated by trigger events, such as when there are patterns of unusual loan behavior.

On the servicing side, the deal agent would make sure servicers focus on maximizing the value of the assets and do no self-dealing. The deal agent would ensure the servicer was complying with its own articulated standards and would have the authority to review breaches of servicing obligations. The deal agent would also have the ability to pursue claims against servicers, even terminating them if necessary. The deal agent would also be responsible for ensuring that all cash flows from the transaction are reconciled monthly.

In this effort, SFIG has developed a comprehensive list of all roles and functions and who will play each role within an RMBS 3.0 transactions. This matrix contained in the green paper (SFIG 2015) included a deal agent. Because of the work being done under Treasury's PLS initiative SFIG chose to focus exclusively on functions; it did not address the deal agent's scope of liability (duties of care and loyalty). The green paper also recognized that not all securitization sponsors will opt to include a deal agent.

Yet, agreeing what the deal agent should do is not the same as agreeing on implementation. In particular, no consensus has been reached on which entities should be deal agents and how they should be compensated. If they are unregulated, will investors require minimum levels of capital? Will rating agencies give "credit" for the inclusion of a deal agent (through lower subordination levels), which would make the economics of deals with an agent more favorable? Moreover, the structures must be explicit about who has what responsibility to the investor. Where do the responsibilities of the trustee end and those of the deal agent begin? In short, while there has been huge progress, many operational issues remain to be resolved. While market participants generally agreed that this role would be very valuable on less-than-prime deals, some have doubts about whether a deal agent is cost-effective in prime transactions. This number may grow or shrink depending on the costs of the deal agent in the first few deals.

Standardization

Each security sponsor has its own documentation, and deals are not standardized across sponsors (although there are many "standard elements"). When investors purchased a tranche of an RMBS 1.0 deal, they generally satisfied themselves by reading the deal summary, if that. They did not realize that in some cases, RMBS 1.0 agreements contained ambiguous language or contradictory instructions. Since the crisis, many investors claim they are reading every page of the documentation of RMBS 2.0 deals, including the deal summary, the prospectus, and the pooling and servicing document, totaling many hundreds of pages. Sometimes investors read certain sections twice, as they are concerned something adverse to their interest is buried in the documents.

The need for this level of due diligence does not lend itself to a scalable market. There is clearly a desire for more standardization and/or transparency of documentation in a manner that reflects best practices, making it easy for investors to quickly understand how the deal they are evaluating differs from the standard.

SFIG has taken a huge step in this direction with the release of the third version of its green paper (SFIG 2015). This 272-page paper is the culmination of an effort that began in October 2013. The first 224 pages of this document suggest standardization of the clauses governing representations and warranties, repurchase governance, and other enforcement mechanisms. The paper goes through the language that a number of originators are using and proposes standardized language that accomplishes the same objective.

Even in the green paper, many representations and warranties have more than one standard form. This variation stems from several factors. First, banks that rely on retail origination and nonbank aggregators have differences in what they are willing to attest to in a securitization they sponsor. Second, issuers have different levels of risk tolerance and different internal policies and procedures. As a result, certain items require several standard variants. In other cases, investors prefer a stronger form of the representation some deal sponsors are willing to make. When there are a number of different forms, SFIG identified Category 1 reps as the most investor friendly.

Again, there is no guarantee that securitization sponsors will adopt this standard language, but it is another huge step in the direction of progress.

Servicing

The market participants convened by the Treasury discussed servicing issues at length, and they felt strongly that minimum servicing standards need strengthening by requiring servicers to provide better transparency, maximizing the value of the collateral to the trust, and better aligning interests between servicers and the trust. The formalization of the deal agent concept addresses some of these concerns. However, many servicing issues still need to be addressed.

Investors 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. The deal agent would be charged with seeing that servicers follow the policies the servicer has laid out, upholding investor interests in loan modification and loss mitigation. The deal agent would spot-check loan modifications, making sure the net present value test had been applied properly, and spot-check loans using foreclosure alternatives (short sales and deeds-in-lieu of foreclosure) to make sure investor interests were upheld. The deal agent would also be charged with doing (or overseeing) a loan-level cash flow reconciliation, as well as a line-item reconciliation of loan liquidation proceeds; the servicer would need to provide the information for the deal agent to complete or oversee this.

While it is clear that the servicer compensation structure may need to be reformed to better align the incentives of servicers and investors, it is less clear how to do this, and conflicts abound. Below are some of the remaining issues, along with some potential solutions.

Maximize or Optimize?

"Maximizing the value of the collateral to the trust as a whole" means different things to different investors. Some investors believe that modifications should maximize net present value—that is, optimize the result. Other market participants are comfortable as long as the modifications are NPV positive and the servicer's policies are clearly stated.

Servicer Compensation

Some market participants have suggested that the trust, rather than the primary servicer, should own the mortgage servicing rights. The primary servicer would then be compensated on a fee-for-service basis, allowing for the higher costs of servicing delinquent loans. However, the servicing rights on a performing loan are valuable, and this would significantly change the economics of the deal. Some issuers and servicers have said this suggestion is a nonstarter.

Advancing Issues

Many market participants would like to see a 120-day trigger, after which servicers would stop making advances to investors, as they believe such a trigger increases standardization and reduces subjectivity. However, such a trigger has drawbacks. Under certain circumstances, the senior tranche would not receive the contractual interest payments or the subordinate bond would be written down to pay interest to the senior tranches.

First-/Second-Lien Conflicts

A serious conflict of interest arises if a servicer services the first mortgage and owns the second. One solution is to require transfer of the servicing rights on one of the two liens if the first becomes delinquent. Another solution is to disclose the conflict, and have the deal agent monitor these loans more closely.

Vertical Integration of the Servicer

Many servicers outsource some items, including default management and real-estate-owned servicing, to affiliated entities. One solution: The deal agent could review the agreements for the use of an affiliate, and make the servicers document that the charges are consistent with current market prices. If the deal agent does not get proper documentation or is not convinced of the results, they could prohibit the use of an affiliated party.

Solicitation for Refinancing of Borrowers in PLS Transactions

Many servicers are also originators of new loans and have an incentive to aggressively solicit pristine borrowers with perfect credit histories for refinancing. Legacy PLS transactions did not allow for solicitation, but there was no enforcement vehicle. And, it may be counterproductive *not* to offer to refinance loans that are delinquent or in imminent default. This problem can be solved by requiring the servicer to provide annual certification of nonsolicitation of current borrowers who are not in imminent default. The deal agent could review refinancing activity and terminate the servicer if the certification has been violated.

Conclusion

The development of the deal agent concept and the recommendations to bring more standardization to PLS documentation are important steps forward in the revival of the PLS market. But more work needs to be done to refine and implement these principles. Perhaps the biggest unknown on the deal agent concept is the costs. If the rating agencies give "credit" for the inclusion of a deal agent, which makes the deal more economical, and/or the costs are small, deal agents will likely be adopted broadly for prime deals. If no "credit" is given, and the costs are large, it is unclear when or if the deal agent concept will be broadly adopted for prime jumbo deals. Moreover, conflicts of interest between the servicer and the investors still need addressing.

Nonetheless, the tremendous amount of work done through the Treasury's PLS initiative and the SFIG's RMBS Task Force has created a much more positive working relationship between investors and securitization sponsors. This relationship allows for an easier, or at least more collaborative, resolution of the remaining issues. The real test for the PLS market will be when the banks pull back and the economics of private-label securitizations become more compelling. When that happens, the groundwork has hopefully been set for a PLS revival.

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About the Author

Laurie Goodman is the director of the Housing Finance Policy Center at the Urban Institute. The center provides data-driven analysis that policymakers can depend on for relevance, accuracy, and independence.

Before joining Urban, 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, a boutique broker/dealer specializing in securitized products, 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 was ranked first by *Institutional Investor* for 11 straight years. She has also held positions as a senior fixed income analyst, a mortgage portfolio manager, and a senior economist at the Federal Reserve Bank of New York.

Goodman was inducted into the Fixed Income Analysts Hall of Fame in 2009. She serves on the board of directors of MFA Financial, is an advisor to Amherst Capital Management, and is a member of the Bipartisan Policy Center’s Housing Commission, the Federal Reserve Bank of New York’s Financial Advisory Roundtable, and the New York State Mortgage Relief Incentive Fund Advisory Committee. She has published more than 200 articles in professional and academic journals, and has coauthored and coedited five books.

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