How to Wake the Private-Label Securities Market from Its Slumber

Jim Parrott

December 2016

Issuance of private-label securities has collapsed since the housing crisis. It's down over 70 percent since 2001 and 95 percent since its peak in 2005. There's not a crisis in securitization per se: securitization of auto loans is up around 16 percent since 2001, and securitization of agency mortgage-backed securities (MBS) is up over 50 percent. The collapse appears almost unique to the securitization of private-label securities (PLS). In this brief I'll discuss why, focusing first on what about this corner of the economic ecosystem has kept it from bouncing back, then on what can we do to breathe some life into it.

We're seeing capital flow through virtually every other secondary market channel, so why is it avoiding this one?

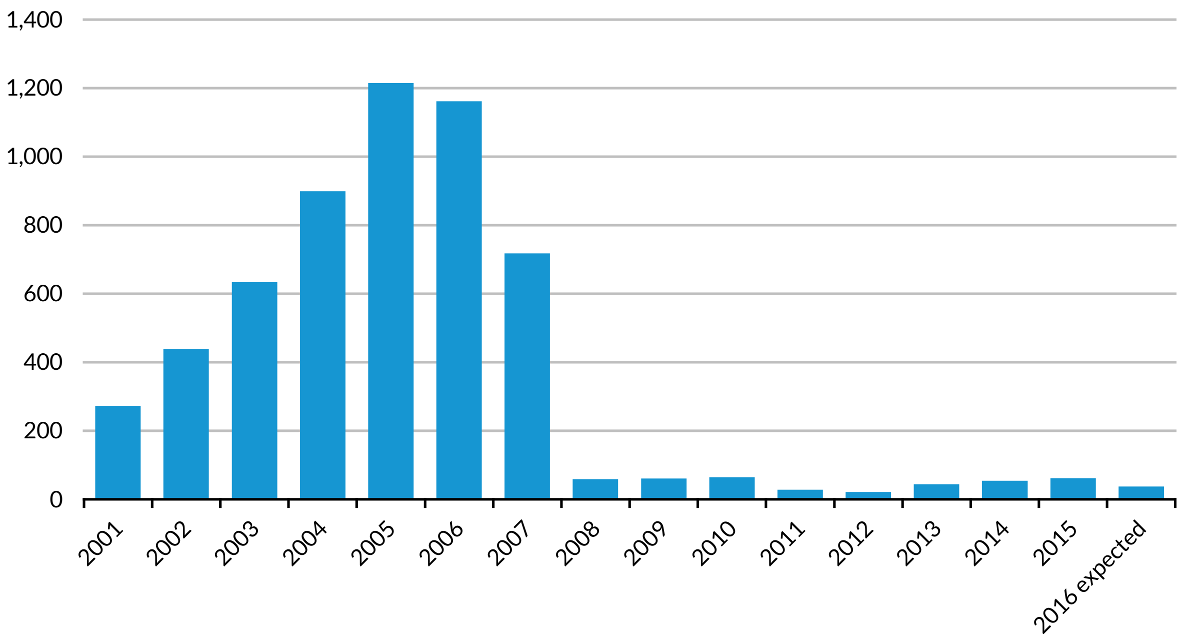
First, and for the moment most important, the economics for PLS just don't work right now. PLS issuers can't compete with government-backed issuance because agency MBS investors are able to get a better yield relative to the range of risks involved. And PLS issuers can't compete with portfolio lenders because the banks have a lower cost of funds and better capital treatment, and they're willing to price aggressively given the appeal of the high-single-digit returns on equity that this investment provides them right now.

These economics will eventually shift as banks find other investments more attractive. And of course, policymakers could change the economics even more quickly by cutting loan limits. Banks would be wary of taking more credit risk than they do already, leaving much of the new field open to PLS. Indeed, many policymakers have called for a drastic reduction in loan limits with precisely this logic in mind, arguing that it's needed to "crowd in" private capital.

FIGURE 1

Private-Label Securities Issuance since 2000

Billions of dollars



Sources: Inside Mortgage Finance and Urban Institute.

Unfortunately, this move wouldn't create a vibrant PLS market in the newly opened space, at least not in and of itself. Instead, it would create something of a secondary market desert in the space left behind by the government. Some investors would no doubt rush in chasing yield, but not many, and those that would, would only chase it for the lowest risk borrowers.

This is because of the second problem holding back the resurgence of the PLS market: the lack of a reliable securitization infrastructure. In the housing market earthquake of 2008 the bridges of trust that PLS investors depended on collapsed all around them, exposing a system far weaker than they had realized.

For decades PLS investors had relied on issuers, underwriters, due diligence firms, and ratings agencies to judge the quality of the securities they were considering; and, they had relied on trustees, servicers and attorneys to protect their rights once they had invested. Yet when a rise in defaults began to put pressure on the system, every one of these relationships failed under the strain.

It turns out that none of the groups charged with assessing or managing their risks did their job adequately, exposing the entire investment structure as an unnerving illusion, a Potemkin village that provided investors with a sense of confidence but no real reason for it.

Coming out of that dark experience, where before these investors saw a host of principal-agent relationships in which someone was looking after each risk that they could not, now they see a host of unnerving uncertainties. Investors are uncertain of the credit risk of any given deal because they don't trust the issuer, underwriter, diligence firm, or rating agency. They are uncertain whether the collateral in the deal will be well managed because they don't trust the trustee, the servicer, or the master servicer. And they are uncertain whether losses will be allocated appropriately, because they don't trust the architecture of the trusts that define their rights or those whose job it is to execute the trusts' terms. To top it all off, investors are uncertain whether the government will respect their property rights in the collateral when the market gets choppy, given local governments' flirtation with eminent domain and the federal government's allowance of servicers to pay down the investors' collateral to satisfy penalties for the servicers' alleged wrongdoing.

All in all, where before investors saw a well-developed system of parties looking after their interests, now they see a dizzying array of risks over which they have little control.

Not surprisingly, then, investors now want to replace their longstanding reliance on a network of agents looking after their interests with contractual provisions that define their rights in great detail, coupled with enough transparency and tools for enforcement to see that these rights are being looked after. In essence, investors want to take the responsibility for understanding and managing their risk into their own hands—because they no longer trust others to do it for them.

This is of course a monumental lift, requiring the creation of an extremely complex, and often much more expensive, deal structure to provide certainty across all the dimensions we're talking about. It means fleshing out granular terms defining representations and warranties, due diligence standards and disclosures, breach reviews and servicing oversight, bondholder communication and recourse … the list goes on and on.

Given the challenging economics discussed earlier, however, neither issuers nor investors have enough incentive to get this done. Even if a well-capitalized issuer and group of investors dedicated the considerable time and resources to paper over all these gaps, they may find at the end of that long and expensive road that the economics still don't make sense. In the face of that risk, few are willing to bother.

While this hesitance is entirely understandable for any given set of counterparties, it leaves the system in a bind, because only after someone goes to the trouble of papering over these gaps will we have a return of the PLS market. We thus have a Catch-22: only with a strong market is it worth spending the time and money to take the steps necessary to create a strong market.

In addition, a host of regulatory complexities make even modest, one-off attempts to transact in the PLS market prohibitively challenging. With uncertainty over how exactly to apply the qualified mortgage rule and TRID, for instance, the three or four entities charged with reviewing loans in a deal often come to different answers, leading to a dizzying escalation of still more documentation and disclosures that often bury a deal in cost and still further uncertainty.

With this frame for the problem in mind, I'd like to suggest three steps that could gradually build the infrastructure needed for the market to take off again once the economics come back.

The first is to have a self-regulatory organization (SRO) establish a baseline structure that provides enough investor confidence to do plain vanilla deals and a foundation on which to build out more complex structures over time.

Though it's not in any one company's interest to dedicate all the resources needed to solve this thicket of problems on its own, it is in its interest to dedicate some fraction of the resources needed. And if all the key market participants contribute that fraction, you have enough resources to solve the problem.

The goal here is a baseline structure that provides enough certainty to create a channel for relatively simple PLS securitizations. This will help us out of the Catch-22 by creating a market for these transactions that's finally worth expending resources to participate in, and by making it much easier to create more idiosyncratic deals, because both sides will only need to paper over and understand the difference from the baseline rather than an entirely new structure. For instance, an investor might be willing to pay for stronger representations regarding loan origination, more protective breach enforcement mechanisms, or meaningful oversight of the servicing of the loans, to give them comfort to take on more credit risk. This becomes much easier if both sides already agree on a common baseline off of which to build and price in these differences.

Fortunately, this is precisely the kind of work being undertaken by the Structured Finance Industry Group's (SFIG's) RMBS Task Force. In a letter to the Treasury, SFIG described its effort this way:

> The overall approach for RMBS 3.0 is to: 1. Promote standardization where possible, in a manner that reflects widely agreed upon best practices and procedures. 2. Clarify differences in alternative standards in a centralized and easily comprehensible manner to improve transparency across RMBS transactions. 3. Develop new solutions to the challenges that impede the emergence of a sustainable, scalable and liquid post-crisis RMBS market. [And] 4. Draft or endorse model contractual provisions, or alternative "benchmark" structural approaches, where appropriate to reflect the foregoing.

This effort is exactly what we need right now. But if it is to amount to anything more than another white paper, it must eventually move from concept to market adoption.

There are several ways of trying to go about this. One is to set up a benchmark deal with some of the market's most important investors on board, as the Treasury department attempted recently. Though that would no doubt be helpful, I fear that it wouldn't be enough, absent the kind of broad buy-in that we're unlikely to get for all the reasons I've already mentioned.

This is why I'm drawn to the idea of an SRO. It brings together the industry more broadly, to commit the resources and collective authority needed to establish a framework with broad enough buy-in to become an industry standard.

To help motivate that market adoption I'd also suggest a further step: providing regulatory relief for those investing through the SRO's structure.

This is not only in the interest of the investor and the broader market. If done right, it should also be in the interest of the regulators.

One crucial component of a baseline PLS deal would be to align the incentives of the key parties to each transaction. If the deal doesn't do that, then it won't get the market off the ground. But if it does, it will reduce the risk that misaligned incentives and conflicting interests once again drive some parties to take on excessive risk, precisely as it did in the runup to the crisis.

Market dynamics that incentivize excessive risk-taking is, of course, one of the key hazards that regulators are trying to manage throughout the system, so they should be willing to provide some relief for those deals that are shown to reduce that hazard. They should be willing to provide some capital relief, for instance, or to exempt such deals from the risk retention required under Dodd-Frank. After all, the whole point of risk-retention is to align incentives among counterparties.

If regulators were to provide relief along these lines, then it will improve the economics of these deals enough to attract more capital into the space, and into these structures in particular, helping get the market off the ground more quickly and in a way that's both more standardized and more sustainable.

This brings me to the third and final step: including these standards in the common securitization platform that's being built out by Fannie Mae and Freddie Mac (CSP), and opening up that platform to non-agency securitization.

Once you have standards that the industry agrees work in a baseline structure, and that regulators agree would reduce risk in the system, then it makes sense to integrate these standards into the market's core securitization infrastructure. We could do this by expanding the current scope of the CSP effort to include back-office infrastructure for the securitization of PLS as well as agency loans.

By setting the terms of pooling and servicing along the lines established by the SRO, the CSP would embed the standardization offered by the SRO marketwide, improving the long-term liquidity of the PLS market and making the securitization system more efficient. The only meaningful differences between agency and non-agency securitization would be the government guarantee and whatever more detailed provisions PLS investors want to take on specific kinds of credit risk. That is, the only differences in the deals would track the real economic differences of the transactions—which is as it should be.

Unifying standards through the platform also presents an opportunity for broader reforms to the secondary market. If policymakers allowed the joint venture that is building the CSP to aggregate loans as well, for instance, a wide range of originators could securitize their production through either the PLS channel or the agency channel. By expanding lender access to the secondary market this way, we would increase liquidity and its benefits still further.

One can think about these three steps as steps along a continuum. We have a system today that is so heterogeneous that it wouldn't work in any scalable way even if the economics worked. The challenge is thus bringing some initial uniformity to it, so investors and issuers begin to have enough confidence in a single system that they can begin to build a broad PLS market once again.

The question is how far one wants to take the effort. Do we want simply to get enough of a baseline structure in place that the PLS market can get back on its feet and then develop in whatever idiosyncratic ways a purely private market is inclined to develop? Or do we want to push for still greater standardization, to make the secondary market more liquid, more stable, and accessible to a wider range of lenders?

These questions begin to go to the heart of housing finance reform. They raise issues of who we want to manage the secondary market infrastructure and how we want it managed, where we want competition, and what objectives we want that market to serve.

I believe that we're best served going all the way, pushing all the core secondary market infrastructure into a single utility. This allows us to maximize liquidity, efficiency, and systemic stability, and it makes it easier to serve the range of policy ends that are in play in the housing finance system.

But that's an argument for another day, and one that luckily needn't be resolved here. What should not be in dispute, though, is that today's PLS market is bogged down in such uncertainty and mistrust that we desperately need some modicum of standardization to get it going again. The steps I've offered would provide that, and can be embraced whether or not one is of the view that we should build on them toward a still more integrated secondary market. It is the economically rational course, in other words, whatever view one has of the more complicated questions around comprehensive reform of the housing finance system.

That is not to say that it's the most politically likely course, however, so it's worth a few comments on how the new political landscape affects all of this.

As with virtually all other economic issues, a Trump administration presents some risk and some opportunity here. On the risk side, while we know that the Trump administration and Republican leadership are intent on "unwinding" much of Dodd Frank, it's entirely unclear what that might mean in practice. Even if one finds the notion of unwinding this regulatory structure appealing in theory, and I must say that I find it a bit forgetful at best, this structure has come to define the rules of the road on lending, risk management, and any number of core components of the housing finance system coming. If this structure is dramatically upended in the way that some are suggesting, then we're headed for the very sort of uncertainty that has rendered the PLS market dysfunctional across a much broader segment of the housing finance system. If that happens, then it will be a long time before we have a steady enough housing finance system to build out a vibrant PLS market.

On the opportunity side, virtually every Republican lawmaker who has given this issue any thought believes that we need to bring more private capital back into the system, and in particular that we should do what's needed to revive the PLS market. There is some confusion about what that means: some believe that we simply need to pull the government back out of the market, which as I've mentioned is a dangerous mistake. Assuming that we can provide greater clarity about what is needed, however, I'm relatively confident that we can get a critical mass of members of both the House and the Senate to help where they can. We just need to provide some clear direction on a topic that is utterly confounding to most lawmakers.

So who needs to do what to put a plan like this into place?

- First, the Structured Finance Industry Group (SFIG) needs to continue to do the important work of developing industry standards.
- Second, SFIG and other industry organizations need to push for industrywide adoption of an SRO that has the authority to adopt, implement, and enforce these standards.
- Third, industry and other thought leaders need to sit down with the relevant policymakers to make the case that some form of regulatory relief is warranted for deals that comply with the SRO's standards.
- And fourth, industry and other thought leaders need to sit down with key members of Congress to make the case that these standards should be part of a platform that is finally open to the broader market.

So a lot would need to be done. This of course raises the question: why bother?

After all, we already have a market for buying and selling credit risk through the GSEs' credit risk transfers. There we have relatively clear structures through which investors have confidence investing. And while it doesn't currently offer a sustainable mechanism through which to share credit risk through the economic cycle, surely it would be a good deal easier to build on this effort than to undergo the herculean effort of reviving the PLS market.

Why, then, do we even need a PLS market?

The answer is, there is a real difference between a market in which private actors take *almost* all the risk, as they would in the agency market, and one in which they take *all* of it, as they do in the PLS market. In the former some segment of risk remains on the back of the taxpayer, over which we see neither competition nor any of the benefits that flow from competition.

To be clear, a significant segment of the market should retain a government backstop, as that ensures broad access to long-term, fixed-rate lending. But putting the taxpayer on the hook for the tail risk in that segment of the market means putting in place measures to constrain the risk that we see taken on in that channel. By putting the taxpayer on the hook, we have an obligation to strike a conservative balance between flexibility, dynamism, and innovation on the one hand, and protecting the taxpayer on the other.

This by design leads to a more cautious lending environment within the agency channel, or it should anyway. So we are well served to supplement that channel with one in which the taxpayer is largely removed from the equation. This will allow market participants to seek more creative ways to connect investors and borrowers, and that in turn should lead to more liquidity and more lending. And, assuming that that segment of the market is well-regulated, it should do all of this without increasing the risk the taxpayer.

It's thus important to the health and vitality of the housing finance system that we find a way to expand the secondary market beyond the government's footprint, which is why it's important that we find a way to breathe life back into the PLS market.

That is *my* view in any case. Interestingly, though, it's one that may be falling out of favor. An increasing number of thinkers are coming to the view that the PLS market may not be as important as we once thought, that the nation may actually be adequately served by a robust market for whole loans and credit risk sold off by the GSEs.

So I end with a note of caution for those who see value in a healthy PLS market. The longer this market sleeps, the less help we may get in waking it from policymakers and other stakeholders, even those who for years have been poised to do what they can to help. That time has not yet come, so there is still a window of opportunity to pull together support for an effort like the one I've laid out here. But it won't be open forever.

About the Author

Jim Parrott is a senior fellow at the Urban Institute and owner of Falling Creek Advisors, which provides financial institutions with strategic advice on housing finance issues.

Before joining Urban in 2013, Parrott served for several years in the White House as a senior advisor at the National Economic Council, where he led the team of advisors charged with counseling President Obama and the cabinet on housing issues. He was on point for developing the Obama administration's major housing policy positions; articulating and defending those positions with Congress, the press, and the public; and counseling White House leadership on related communications and legislative strategy. He was previously counsel to Secretary Shaun Donovan at the Department of Housing and Urban Development, advising on a range of housing finance issues.

Parrott has a BA from the University of North Carolina, an MA from the University of Washington, and a JD from Columbia University School of Law.

Acknowledgments

This paper was first presented at the 4th Annual Structured Finance Industry Group RMBS Symposium in New York City on December 8, 2016.

The views expressed are those of the author and should not be attributed to the Urban Institute, its trustees, or its funders. Funders do not determine research findings or the insights and recommendations of Urban experts. Further information on the Urban Institute's funding principles is available at www.urban.org/support.