ORIGINATE TO OBLIVION?

The Fate of the U.S. Secondary Market

Karen Shaw Petrou
Managing Partner
Federal Financial Analytics, Inc.

Prepared for the

Conference of Counsel
Washington D. C.

September 30, 2010

When we met together last year, large banks were just looking down the barrel of what now has been fired dead-on at them: the Dodd-Frank Act. We talked about far-reaching changes to U.S. secondary markets resulting from several provisions in the original version of the legislation, most notably language to require securitizers to retain risk to reform the "originate-to-distribute" model many blamed for the market debacle. Last year, this language all on its own argued for a wholesale reconsideration of asset securitization. Now, risk retention has combined with so many other proposals that the structure of U.S. credit markets will be profoundly redefined. Before the crisis, they depended on the secondary market for half – yes, half – of all U.S. credit formation. Now, absent a government guarantee, securitization will be far, far less significant. But, where it remains and who gets to do it how will dramatically affect critical business lines throughout the U.S. financial-services industry.

In addition to final risk-retention language, critical policy initiatives for asset securitization now include the Basel capital-and-liquidity rules – issues I've long enjoyed discussing with all of you. And, that's not it – there's also GSE-reform to consider, with one proposal from the FRB suggesting that its preferred model for Fannie and Freddie govern not just mortgages, but also all asset-backed securities (ABS). Credit-rating agency reform also emerged from the Congress in far tougher form than many – myself included – expected. This too will drive securitization, as we clearly saw when secondary markets briefly froze when the rating agencies realized what had befallen them. The SEC then gave them a reprieve, but it won't last long.

What I'd like to do today is briefly review each of the key global and U.S. policy initiatives that affect asset securitization. It's a long list, so I'll try to go through it quickly. I know some of you may now be thinking, "I can check my Blackberry because my bank doesn't do mortgages." Maybe not, but your bank for sure does corporate finance and trades in an array of ABS (many of which will still be allowed at the trading desk after the Volcker Rule takes hold). I think that these issues are thus germane to all of your banks, not just to those active in mortgages or other retail-finance sectors.

The Long List of Secondary-Market Challenges

As I said, we're way past risk retention as the most significant challenge to U.S. asset securitization. The list of strategic policy initiatives is long, but all of them count. What I'd thus like to do is briefly summarize each of the initiatives I think poses strategic, business-redefining challenges. It's only with a clear scan of all the looming challenges on the horizon that a realistic strategic and advocacy plan emerges. Indeed, given the tentative nature of many of these initiatives, advocacy is the first critical priority.

What's on the long list?

- **FDIC Safe Harbor**: Although Dodd-Frank risk retention gets top billing, rules the FDIC issued on Monday in final form will be the first strategic border U.S. asset securitization must cross. To be sure, they affect only insured depositories – suggesting others may ignore them even if you can't. But, banks now originate virtually all assets sold into whatever's left of the secondary market. This means that the FDIC's rules are vital. The FDIC has promised to conform its rules to the Dodd-Frank ones. But, given that it has also decided to close its safe harbor at the end of this year, a significant disparity in ABS rules results that could put many of your banks out of this business until clarity dawns. Until we know which ABS are exempt from risk retention, the capital hammer will fall so hard on banks that any securitizations subject to risk retention will, I think, halt.

- **Dodd-Frank Risk Retention**: Section 941 of the Dodd-Frank Act. Congress set forth a broad set of directives for federal regulators and told them to be quick about reform – the rules must be final 270 days after enactment. But, as Congress did so, it left a lot – a whole lot – up to the agencies. What risk retention applies when and to whom is yet to be determined. Commercial MBS could get a break and "qualified residential mortgages" must be exempt from risk retention. What's qualified, though, is yet to be defined. As noted, this is an absolutely vital issue for U.S. banks because all of the rules soon to apply to them could create a painful vise that makes it impossible both to hold certain loans in portfolio or securitize them.

- **Basel III Capital Requirements**: The new Basel rules will alter every segment of U.S. finance, not just asset securitization. But, here, they'll make a particular difference. Final Basel rules on resecuritization will sharply curtail structured finance, especially in concert with the rating-agency reform to which I'll turn shortly. New market-risk rules will also make it harder to make money trading ABS. But, the big impact for secondary markets in Basel III is the cost of the new capital regime for securitizable assets. If the capital rules cost as much as contemplated, banks will be hard pressed to hold anything deemed a risky asset on portfolio, with the risk-retention rules of course preventing any gain from securitization. A vicious squeeze could well result for U.S. banks, in which they don't have enough capital to originate assets and aren't allowed to benefit from securitization. Another major issue here is the treatment of mortgage servicing rights (MSRs). They are at huge risk in the Basel III rules and, if they go, so goes much of the mortgage secondary market.

Favorable capital rules to promote prudent portfolio lending is of course one part of the solution here. If Basel III rewards sound lending, then there will be more of it – or there will be if other key initiatives don't stand in the way:

- **Basel III Liquidity Rules**: This part of Basel III doesn't get the attention it deserves, in part because it is even more complex than the capital requirements. But, the liquidity rules are critical strategic drivers. Under the new standards, banks won't be allowed (I hope) to borrow short to lend long. That's good as far as it goes, but the day-to-day funding matches required by the proposal can be so stringent that banks will have to switch to far more conservative asset holdings matched by far higher-quality liabilities. Lending long will thus be very hard if asset securitization doesn't permit selling loans off in ways that liquefy the market.

- **Credit Rating Agency Reform**: Secondary-market liquidity is dependent not only on the rules of the road, but also on the ability of investors to judge credit and related risk and, thus, to trade it freely in the global financial marketplace. The rating agencies fulfilled this purpose by making credit-risk judgments on which investors relied. Of course, they over-relied on the rating agencies which, in turn, were more than over-generous with the AAAs. What gets rated how by whom and who can rely on ratings will be a critical driver to U.S. secondary markets.

- **Disclosures**: Whatever makes it through this thicket and is sold to U.S. investors must comply with SEC registration requirements. The SEC proposed to rewrite them before Dodd-Frank through sweeping changes to its Rule AB. The new law codifies its authority to do so and, in several respects, tells it to go further. Some of the SEC's proposed disclosures are so detailed – 137 for residential MBS at issuance and 151 over the life of the security – that I think issuers and investors might just give up, especially if they can't count on reformed rating agencies to guide them.

A solution to all of this might be simply to let Uncle Sam do it. Think about it: USG-backed securities are exempt from risk retention, get the best capital treatment, are smiled upon in the liquidity rules and may be the only paper left that can still get a AAA. Where capital rules hit too hard or private-market capacity doesn't accommodate borrower need – think mortgages – Congress and the Obama Administration will be sorely tempted to bring the government in in a big way. Where the federal government starts and, I hope, stops is thus another vital strategic question confronting asset securitization – and not just mortgages.

Like all of the rules I've already described, decisions here have to be made fast. The Dodd-Frank Act demands an answer on GSE reform by the end of January. That might slip, of course, but Treasury's capacity to stand by Fannie and Freddie must end on December 31, 2012 absent new law.

- **GSE Reform**: Although all ABS are up in the air, RMBS are at a particularly tricky point because of the virtual complete reliance of this sector now on Fannie Mae, Freddie Mac and Ginnie Mae. Given the impact of this $14 trillion sector, it's not just mortgage lenders with an interest in the outcome of the Obama Administration's deliberations on GSE reform and subsequent Congressional action on them. Time doesn't today permit the attention to this question. I'll just say it seems clear to me that the federal government must stay in the sector, especially if thirty-year fixed-rate mortgages are to have a prayer under the new liquidity rules. But, a USG solution won't secure mortgage secondary markets if the Basel III rules bite too hard. The MSRs I just mentioned must retain their capital advantages if markets are to continue in anything like their current configuration.

- **A USG Guarantee**: Because of all the challenges I've briefly described, policy-makers are already despairing of the prospects for renewed private asset securitization through the U.S. banking system. As a result, various schemes under consideration go beyond mortgages to contemplate all ABS. I'll just mention one here: an FRB-staff proposal in which the USG provides a guarantee for catastrophic risk. Where this risk is seen to start, how much private credit enhancement or risk-taking is allowed before it kicks in and whether capital and liquidity benefits apply will determine both the market impact of this concept and whether any private parties remain standing were it implemented.

Given the panoply of challenges to private securitization, a lot of thought is going into a complete alternative to ABS: covered bonds. These have characterized European financial markets for centuries, but were only brought into the U.S. at the height of the mortgage frenzy. They thus haven't much history here and what there is isn't pretty. Legislation was introduced this year to push covered bonds through some of the statutory impediments – most notably FDIC claims – that have so far quashed them. Interestingly, the legislation (H.R. 5823) brings the USG into the market in a big way even though its sponsor, Rep. Scott Garrett, is one of the most conservative Republicans in Congress and strongest voices for full privatization of Fannie and Freddie. I think this speaks volumes about the remaining role the USG will have to fill in mortgages and other forms of asset securitization.

Conclusion

With all of these critical and – at times – cross-cutting policy initiatives, the future of U.S. secondary markets is wholly uncertain. I know we need a secondary market for mortgages because I can't think of a way to offer thirty-year, fixed-rate mortgages without them. I think we should have a secondary market for other asset classes because this increases credit availability, enhances market liquidity and reduces market concentration because millions of investors hold assets that would otherwise have to stay on a few big-bank balance sheets.

I think policy-makers know all this too. They just want the impossible: secondary markets that ensure ceaseless incentive alignment between issuers and investors, flawless matching by banks of all their related risks and, for good measure, a dose of policy mandate to protect the borrowers we like with loans we think they should have.

Of course, just listing all the pending initiatives doesn't answer the critical question: what can your banks do about them? For provisions in Dodd-Frank, ours is not to reason why. Instead, it's time to consider the best possible configuration of implementing rules. Hopefully, these will prevent the regulatory lapses that led to the crisis, discipline future industry excess and – just as important – preserve a secondary market that isn't in whole a government enterprise of some sort or other.

We've had about as much fun as we need from Fannie and Freddie. Of course, they were "hybrids" – public/private charters – but just fixing that won't fix asset securitization, as looming problems in the Federal Housing Administration make clear. A balanced solution among all of the competing policy initiatives I've briefly described is a pressing challenge. If policy-makers get this wrong and are unduly stringent with risk retention, assets might stay on your bank's balance sheet to good effect unless the bogeymen in Basel get them. If the bogeymen do, then credit availability dries up and, even if they don't figuring out how to restart asset securitization with credit rating agencies – while doable – isn't going to be easy.