GSE Activity Report

Monday, February 12, 2018

To Retain or Not to Retain?

Summary

A new post on the Federal Reserve Bank of New York's blog provides interesting insights into the risk-reducing impact of risk retention. In short, it's uncertain.

Impact

Although the exemption from risk-retention rules doesn't run out for the GSEs until 2021, any action anytime sooner – e.g., the Administrative reorganization of the conservatorships we addressed last week – would bring GSE securitizations under the Dodd-Frank risk-retention requirements. The conservatorships would then have to downstream the risk to originators or bear it themselves at considerable capital and funding cost not now contemplated in their design. And, as we've noted before, some CRTs (especially deep front-enders) could come under risk retention well before 2021. The post-GSE structure in the Senate bill would also trigger retention absent a statutory exemption.

All of which makes the FRB-NY post a timely contribution to the question of whether risk retention makes mortgage finance safer. Clients will recall that Dodd-Frank requires a 5% risk-retention piece (structured in several permissible ways that ease the pain under the final agency rules). Any loan that's a QM is a QRM for purposes of a risk-retention exemption, but the QM exemption for any loan acquired by a GSE runs out. With it, so goes the QRM carve-out. A 5% tranche is costly even for the conservatorships and punitive for banks; for non-bank securitizers/originators, it's a bit easier, but still forces funding costs that led CLO managers to fight – and on Friday win – a significant risk-retention exemption.

The FRB-NY post renders an equivocal verdict, but we think it strengthens the case against risk retention. Looking at mandatory risk retention for national banks before the Great Depression, the Fed staff study finds that the double-liability requirements then imposed on national-bank shareholders didn't make their banks any safer than state-chartered ones without this requirement. The issues are different and the Great Depression's cataclysmic impact is also a major distinction between then and now. Still, the study notes that this version of risk retention may well have led to adverse selection, with riskier depositors picking the better-protected banks. National banks subject to double liability were more liquid than exempt banks, but less well capitalized.

Outlook

For the current debate, these findings drive not who would or wouldn't retain risk – the rules do not distinguish between banks and non-banks. Rather, they drive which loans a bank would portfolio versus securitize and which loans a non-bank would be able and willing to book. Adverse selection is definitely likely here because a fee-based business such as securitization creates incentives to move

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the risk even if it costs a bit to do so.

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