Risk Retention Contention

BY DAVID A. PRICE

In recent decades, financial assets such as home mortgages, auto loans, and credit card receivables have commonly been securitized — that is, investment firms combine them into pools and sell interests in those pools to investors as securities. The process of securitizing creates new options for investors while also creating new sources of funding for borrowers, lowering their cost of borrowing. In the period leading up to the 2007–2008 financial crisis, however, many mortgage-backed securities (MBS) lost value from borrower defaults, fueling the collapse of major institutions.

In response, when Congress passed the Dodd-Frank Act in 2010, it included a requirement that issuers of some securitized investments retain a portion of those securities in their own portfolios — the Act's "risk retention" requirement. The law requires issuers to retain 5 percent of the securities, with certain exceptions, and they are largely forbidden to hedge the risk that they retain. In October 2014, the Fed and five other regulatory agencies jointly announced the final version of the regulations for risk retention, which will take effect for securitizers of some MBS on Dec. 24, 2015. The regulations will take effect for securitizers of other assets a year later.

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The idea behind the risk retention requirement is that during the period before the financial crisis, sellers of MBS deceived investors about the riskiness of the mortgages. The sellers were able to carry out the deception, in this view, as the result of asymmetrical information: The investors lacked information about the mortgages and their underwriting standards, and the pools were structured in a complex way that was difficult for investors to make sense of. Risk retention forces securitizers to keep some skin in the game, so to speak, so that they are subject to the same credit risk as the investors.

The statute and regulations provide for a number of exemptions to the requirement. Perhaps the most significant exemption is that, under the Dodd-Frank Act, a securitizer does not need to retain risk if all of the securitized assets in a pool are mortgages that meet a standard of safety; such mortgages are known as qualified residential mortgages (QRM). Congress largely left it up to the agencies to define which mortgages are QRM and which are not.

In the final regulations, the agencies defined QRM in a way that created a broad exception; they did so by defining QRM to mean the same as a "qualified mortgage" under the Truth in Lending Act. As a result, mortgages can be exempt from the risk retention requirement without having any minimum down payment. According to a *New York Times* report, higher standards for the exemption were opposed by a coalition of mortgage lenders and consumer groups concerned about mortgages becoming more difficult to obtain. A commissioner of the Securities and Exchange Commission, Daniel Gallagher, dissented from the decision, stating that the agencies' standard was "meaningless at best, deleterious at worst."

The importance of risk retention to avoiding a future crisis is an open question, however. Economist Paul Willen of the Boston Fed noted in a 2014 article that institutions selling MBS prior to the financial crisis held significant amounts of it in their portfolios. "Indeed," he wrote, "the financial crisis resulted precisely from the fact that the losses associated with the collapse in the housing market were so concentrated in the portfolios of the intermediaries."

A 2008 analysis by economists Kristopher Gerardi of the Atlanta Fed, Andreas Lehnert and Shane Sherlund of the Fed's Board of Governors, and Willen of the Boston Fed suggests that the underlying issue was not a lack of risk retention, but unwarranted optimism about the housing market. In an article in Brookings Papers on Economic Activity, they examined reports from investment bank analysts, credit rating agencies, and the news media on subprime MBS from 2005 and 2006. They found that the likely effects of a housing downturn on MBS values were understood; where the analysts erred was in assigning a low probability to even a modest downturn, let alone a major one.

Another question is whether MBS buyers will demand risk retention or some other protective arrangement in the absence of a risk retention rule. Richmond Fed economist John Walter suggests that in the absence of the expectation of a government bailout, institutions will seek to do so.

"The lender has some information advantages, but asymmetric information problems occur in the economy all the time," Walter says. "For instance, cars are highly complex and it's hard for purchasers to know their quality. The way manufacturers and dealers respond is to retain some of the risk with warranties. Regulators don't require warranties, but this solution has emerged from market incentives."

While many low-quality mortgages were made before the crisis, Walter says, that is in part because the parties to the MBS deals were perceived as "too big to fail" or were doing business with "too big to fail" firms. "Coming up with prescribed solutions to this asymmetric information issue is dealing with the symptom, not the underlying problem." **EF**