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Hearing on
Transparency as an Alternative to Risk Retention
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Good morning Chairman McHenry, Ranking Member Quigley and members of the subcommittee. I am Janneke Ratcliffe, Executive Director for the Center for Community Capital at the University of North Carolina at Chapel Hill. I also serve on the Mortgage Finance Working Group sponsored by the Center for American Progress; a group of mortgage finance experts who have authored a plan for a responsible market for housing finance reform. Please note that the views expressed here today are my own, and further, that they focus largely on the housing finance aspects of the questions you have raised.

I am honored to have the opportunity to share some thoughts on the critical question of how transparency and accountability can help restore confidence in the once robust US mortgage system. Confidence in that system was shattered, among both the investors and the borrowers that stand at both ends of the system as well as the taxpayers who found themselves propping it up. The crisis of 2007/2008 was a result of abuses that arose in a regulatory vacuum and a climate of inadequate transparency, lack of accountability and misalignment of interests and incentives.

For the last 3 years, only the full faith and credit of the US government has kept investors in the market, while borrowers remain cautious. It is widely recognized that private capital must bear a greater share of the load going forward. The Dodd-Frank Act identifies several key steps to safety and soundness and avoiding a similar debacle in the future. These steps are necessary if we want private capital to re-enter the market and American families to resume investing in their homes, neighborhoods, communities and futures. Restoring confidence on both sides of the transaction is the first step to returning the housing market to one that is stable, affordable and largely reliant on private capital, while ensuring housing-market stability and taxpayer protection.

This is no small task. Applying lessons learned and keeping the end in sight are key -- Any such future market must be characterized by liquidity, stability, transparency and standardization, affordability, and consumer protection.

Transparency and accountability, as embodied in risk retention standards, are essential to achieving these ends. They must be balanced with each other, but also with reform of the mortgage secondary market, housing policy goals, and the interests of the broader financial market and economy. Importantly, there must be transparency and accountability to the borrower, as well as to the investor, for the system to be sound.

The importance of transparency and standardization.

During the housing bubble, the housing finance system experienced a seismic shift toward complex and heterogeneous products that could not be understood by consumers at one end of the chain to securities that could not be understood by investors at the other. The lack of transparency and standardization set the

stage for adverse selection because the issuers knew more than the investors. Even as the risk on private label securities increased, the yields demanded by investors declined (see Levitan and Wachter, 2010).[i] Similarly, for borrowers, complexity and opacity led many to take out loans where the consequences and risks were poorly understood.

These information failures occurred-- and need to be addressed--on several levels. First, underwriting and documentation standards must be clear and consistent across the board so consumers, investors, and insurers can accurately price risk and compare options, and regulators can hold institutions accountable for maintaining an appropriate level of capital. Second, in the pure private market, investors need loan level information, not simply pool level data, to more accurately assess the credit risk of a security. Third, as the private label market boomed, complexity at the security level served to further shroud information.

These concerns are particularly critical for investors who are exposed (either directly or indirectly) to credit risk. As Ginnie Mae, Fannie Mae and Freddie Mac take on 100% of the credit risk for their securities, investor need for transparency is much lower in the conforming and government segments. Moreover, in these sectors, investors can rely on regulations and standards to provide for a relatively homogenous and predictable risk profile, a condition which allows for the TBA market,[ii] and which also enables borrowers throughout the market to receive mortgages with well-understood terms that they can easily comparison shop. Even outside the US, successful securitization has generally been accompanied by government support, either implicit or explicit, and strict government product regulation. Secondary market transparency and standardization have the added benefit of lowering costs and increasing availability of financing.

As for the pure private market, more granular loan level information and more standardization in product structures will help enable the re-emergence of a competitive and efficient private mortgage-backed securities market. Loan level data would enable investors, insurers and ratings agencies to better evaluate the impacts of layered risks on individual loans, for example. The Project on Residential Securitization Transparency and Reporting launched in July 2008 by the American Securitization Forum calls for loan level reporting of some 160 data points on each loan[iii] as well as new standards for bond level reporting and strengthening reps and warrants.[iv] The additional transparency should be an important element in ushering a new and better mortgage market.

But not all by itself. Even with loan level data, investors will still be exposed to principal-agent problems and conflicts of interest. Originators and Issuers will still have access to greater information than investors can observe. Among the problems that will not be solved by provision of data is adverse selection – where originators/issuers may choose a different execution for loans they know to be of different risks. Potential conflicts of interest also arise with issuers who are also servicers and/or second lien holders. More blatantly, there remains the risk of misrepresentation, particularly with poor mechanisms for redress or in the case issuers are not financially able to fulfill rep and warrant obligations. These problems cannot be fully solved with data and standardization. (For a discussion of principal-agent problems see Goodman et al, 2010, pp 10 – 27.)[v]

Besides principal-agent risk, the mortgage market is prone to systemic, correlated risks and large risk tails which full information alone cannot fully correct. Detailed information does not assure that the right conclusions will be reached and the right decisions made. Weaknesses in the ratings process of the credit rating agencies[vi] and the fact that investors and insurers misapplied sophisticated financial models[vii] are well documented. For example, AIG believed "....that their risk models indicated that the underlying securities would never go into default." (Donnelly and Embrechts, p. 14).

These concerns confirm that transparency in the form of greater information is only part of the solution. Two other elements that go hand in hand with transparency are: 1) product and underwriting standards,

and 2) greater accountability for agents (namely, originators and issuers). Dodd-Frank recognizes the importance of these elements in the call for risk retention, in the designation of a Qualified Residential Mortgage and in prohibiting extension of mortgages without evaluating ability to repay.

The importance of accountability.
Risk retention at a 5% level is aimed at addressing the principal-agent problems mentioned previously, and at better aligning the interests of borrowers and investors with the agents in between them: originators, lenders, and issuers.

The recently released regulatory proposal implementing risk retention demonstrates, however, just how complex the issue is. The proposed QRM definition excludes nearly 70% of the loans acquired by the GSEs in 2009 (generally that share is above 75%) and an even higher percentage of FHA loans, suggesting that today, the vast majority of single family mortgages originated would require risk retention, as would a similarly large share of the multifamily market. Yet the implications for this sweeping provision remain unclear. What are the implications for capital requirements? Borrowing costs? The ability of many types of lenders and securitizers to make non-QRM loans? Will non-QRM loan risk concentrate on the balance sheets of large banks with both explicit deposit insurance and an implicit TBTF guaranty? Or will it all flow to the FHA, which is 100% taxpayer backed? Today, the GSEs – Fannie Mae and Freddie Mac – meet the risk retention requirement because they "hold" 100% of the risk of their issues, and the condition of conservatorship ensures that this position is solidly backed. (Note that this is not the same as an exemption from the risk retention requirements. The GSEs are just exempt from the premium recapture account provisions and the hedging restrictions). However, what will be the treatment of successor institutions? How will the rule ultimately consider certain types of third-party guarantees that are demonstrated to add safety and soundness? What will be the preferred form of non-QRM loans – that is, will they carry layered non-QRM risk factors such as adjustable interest rates? Will regulators adapt the QRM standards as de facto safety and soundness guidelines? With all these unknowns and potential unintended consequences, it is not clear whether the proposed risk retention standards will adequately protect against conflicts of interest.

One thing is clear – there is a high probability that risk retention requirements linked to a too-narrow QRM box will discourage private capital participation and possibly disrupt the limited market that exists today, which by all determinations is some of the safest lending in recent memory,[viii] and is overwhelmingly non-QRM. As the regulation itself states: "The Agencies recognize that many prudently underwritten residential mortgage loans will not meet the proposed definition of a QRM."[ix]

Our own research confirms this point and suggests that the restrictions on LTV – which were not called for in the Dodd-Frank Act -- and likely on debt to income as well, could quite possibly and unnecessarily act as a damper on the housing market.

We have ample evidence that many households who may not fit the "20 percent down, established credit, 36 percent debt-to-income" model can become successful long-term homeowners, when given access to well-underwritten, standard, affordable, fixed-rate financing.[x] At UNC, we follow a portfolio of nearly 50,000 mortgages made by banks across the country over the decade preceding the crisis; loans made under affordable housing and CRA programs. The median borrower earned $30,792 a year, more than half of them had credit scores of 680 or below, and 69 percent put down less than 5 percent on their home purchase. The delinquency and default rate on these loans is a fraction of that of subprime mortgages. In fact, the households have on the median, and over the period, managed to build more assets than through any other available mechanisms. They were able to do so because they had access to prime, fixed-rate, long-term amortizing mortgages that they could afford to repay.

In fact, by comparing the performance of these borrowers with those of similar borrowers who received non-prime loans, we were able to isolate the risk introduced by terms and conditions of the loans rather than the borrowers. Non-prime loans made to similar borrowers were three to five times as likely to have defaulted as those in our study population. Key factors associated with the increased in risk were adjustable rate, broker channel and prepayment penalty.[xi]

These findings underscore that the principal-agent problem is best addressed by the risk-retention requirement as applied to product and process factors, not to characteristics of the borrowers. Meanwhile, the Dodd-Frank provisions requiring underwriting for ability to repay should lead agents to use common sense and proven approaches to qualify borrowers for loans.

Importantly, the borrower-based criteria of the QRM are likely to have unintended consequences. As noted, most mortgages made today are non-QRMs. It is particularly unclear why the regulators sought to impose an LTV standard when it was not called for in the Dodd-Frank Act.

Access to safe and affordable financing for low down payment home purchases is critically important because home ownership continues to be the cornerstone of household wealth in the United States. At a macro level, real estate holdings comprise the largest element of household assets in the United States.[xii] Its value to individual families is equally profound, and increases as you go down the income spectrum, with home equity comprising more than three quarters of the wealth of low-income families.[xiii] Moreover, homeownership continues to be one of the best potential answers to the persistent racial wealth gap. The median wealth of black families is a fraction of that of the median white family ($5,000 vs. $100,000, respectively as of 2007).[xiv] This gap is echoed in homeownership rates: As of the end of 2009, roughly 72 percent of white households owned their own homes, less than half of African-American and Hispanic households owned theirs. Among Hispanic and Black households, owners have 39 and 85 times the wealth of renters, respectively.[xv]

According to the National Association of Realtors® the median sales price of a single-family home in the US in 2009 was $172,100; making a 20 percent down payment required $34,420 in assets, greater than the entire annual income of roughly a third of all U.S. households.[xvi] Restrictions on the availability of higher LTV loans will raise a substantial barrier to new households starting up the ladder of homeownership, to repeat buyers hoping to move up it, and to recovery of the housing market.

There is a right way to do high loan-to-value lending

It is well understood that low equity is associated with higher risks; if a borrower with little home equity loses their job, for example, they cannot easily sell the house to pay off the mortgage. But even in the wake of the foreclosure crisis, we have evidence that this risk can be managed through financing that has enabled hundreds of thousands of working families with modest incomes to become successful homeowners. This was accomplished not through exotic mortgages that created only an illusion of homeownership, but through consumer-centric policies and practices that removed barriers to homeownership for first-time, minority and low-income families, responsibly. These programs did not develop out of financially engineered sleight of hand that failed to account for risk. They evolved through decades of careful innovation, such as Community Reinvestment Act lending programs, new approaches introduced by mortgage insurance companies and GSEs, adjustments to underwriting guidelines, pre-purchase counseling, and down payment assistance programs. These efforts paid off in a steady increase in homeownership rates between 1995 through their peak in 2004. Note that the subprime boom was just getting into full swing then, and that during the peak years of the housing bubble, 2004 – 2007, homeownership rates actually leveled off and started to decline through the foreclosure crisis.

It is critical for regulators to recognize this distinction: fostering responsible lending to households who, despite low wealth or low income can still participate in the benefits of homeownership, is very different