SIFMA Spotlight Series: Risk Retention and Qualified Residential Mortgages

May 9, 2011 by Laurie Nelson

On May 5, SIFMA hosted a Spotlight Series: Risk Retention and Qualified Residential Mortgages. It was immediately apparent that unintended consequences of the proposed risk retention rules (pdf) abound.

The panelists acknowledged that the regulators had a very tough mandate, and that the rules are way more complicated than anticipated. It was estimated that approximately 60% of the proposed rule will make its way to the final rule, and that while feelings of annoyance with respect to the drafting of the proposed rule may linger, it is up to the securitization market participants to help the regulators provide us with a clear, workable final rule.

Under the proposed rule, calculation of the amount of required risk retention would be based on a percentage of the par value of the ABS interests in an issuing entity. The discussion began with a couple questions some of us have already been asking …

What do regulators mean by “par value”? What is an “ABS interest”?

The par value of a security generally refers to its stated value or face amount. However, par value as used in the proposed rule doesn’t seem to be tied to underlying asset balance, but instead to a valuation concept. This is a critical distinction. It was noted by a panelist that the regulators have envisioned that par value may be either higher or lower than the pool asset value. But in a REMIC, regular interests cannot be issued in excess of the pool principal balance. Regulators refer to par value of the residual interest in a horizontal risk retention scenario as representing 5% of market value or gross proceeds, but since that 5% -- say it’s $5 -- takes the first loss, it’s not worth even $5. More than 5% of the face amount of a security would need to be retained in order to get to the required 5% of “par value”.

The proposed rules state that an ABS interest includes “any type of interest or obligation issued by an issuing entity … payments on which are primarily dependent on the cash flows of the collateral owned or held by the issuing entity.” Does an ABS interest include servicing fees? (One panelist says likely not because the rules say interest or obligation issued …) Are trustee fees, administrator fees, master servicer fees, etc. included? Are swap payments included? The definition of ABS interest remains unclear, but clarity in the final rule will be crucial for sponsors to determine the required level of risk retention.

The consensus as to the greatest flaw in the proposed rules: Premium Capture. I'm certain there will be numerous comment letters filed requesting that this aspect of the rules just plain go away, never to be heard from again. As an initial matter, we don't really know how premium capture works anyway. As written, it seems like the regulators are preventing securitizers from making any profit from a securitization, as the proceeds of any excess spread that is monetized on the closing date is redirected to a cash reserve that is first in line to absorb losses. Which brings us back to the question of what is meant by par value. If par value is elastic, a sponsor would want par value to be high enough such that there is no premium capture in the transaction. Premium capture is a significant deal penalty. One panelist notes that the regulators may not know what par value is or what an ABS interest is, but they took care of that with premium capture, basically telling market participants "if you're doing something we don't like, we'll fix that (whatever it may be that we may not have thought of yet) with premium capture." One panelist thinks the premium capture concept may have stemmed from transactions where excess interest was paid to the residual due to a deal's stepdown trigger while senior bonds were still getting written down. Regardless of origin, this is a huge economic constraint that is expected to hinder securitization if it makes its way into the final rule as proposed.

In the May 6, 2011 Asset-Backed Alert, *Regulators Give In on Risk-Retention Rule*, it was reported that the regulators acknowledged they made a mistake and are prepared to allow issuers to keep IO proceeds instead of putting them in a cash reserve for the life of the deal. As one panelist noted, if premium capture is taken out of the rule, it will be more expensive to originate non-QRM loans, but it will at least be feasible, whereas with premium capture, it would be impossible to securitize non-QRMs. 5% risk retention coupled with the inability to monetize excess spread would make the economics unworkable. It appears that will no longer be a hurdle.

On that QRM front, it was the panel's consensus that you can't consider QRM without considering how bad it would be to securitize non-QRMs. If you can still securitize non-QRMs, QRM isn't as big an issue. One panelist asked whether QRM is really supposed to be the gold standard of mortgages or rather indicative of prudent mortgage origination. There is no doubt that the current standard will raise borrowing costs and reduce lending.

As to servicing standards and QRM, one panelist said he thought this would attract more attention. It's hard to argue against a servicing standard, but RMBS investors will surely be concerned about foreclosure timelines. If the assertion that servicing standards were not followed is a defense to foreclosure, foreclosure will prove more difficult. In the RMBS sector, it would reduce the value of the mortgages to be to securitized. Further, the servicing standards required to be included in loan documents are currently vague. And it isn't clear whether the standards will conform to a future national servicing standard. Aggregators could very well end up buying loans with a variety of different servicing standards. How will these various standards be disclosed to investors?

On the accounting front, the panelists reiterated that the vertical slice risk retention option is the most friendly. It's likely to get a true sale legal opinion and will not command balance sheet consolidation, whereas the horizontal option is problematic for consolidation. With the L-shaped option, the vertical slice is consolidation friendly but the horizontal piece is not. In any event, premium capture adds a horizontal layer to whatever option is chosen, including the vertical slice option, so consolidation may result.

GSEs may get smaller over time, but they will likely still finance a meaningful part of the housing market along with banks and the capital markets for the next few years. However, under the risk retention rules as currently proposed, despite robust demand from plenty of would-be investors, financing for housing will not come from the capital markets as extensively as in the past.

By Laurie Nelson and Ralph Mazzeo.