Housing Finance Reform: Mortgage Securitization Utility

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The views expressed in this presentation are those of the speakers and not those of the Federal Reserve Bank of New York or the Federal Reserve System.
Design Principles

• Goal: maintain flow of mortgage credit during periods of stress, and to reduce cyclicality of credit more generally.

• Design Principles:
  – Alignment of public and private incentives requires:
    • Restructuring of incentives across securitization chain
    • Restrictions on structure and business activities
    • Regulation and governance restrictions
  – Fixed rate mortgages can still be attractive when fairly priced.
  – The benefits of standardized securitization are meaningful.
  – Economies of scale and scope → small number of securitizers.
  – The government owns the tail risk in housing finance.
  – Any housing subsidies should be transparent and on government’s balance sheet (rather than via a private entity).
### What to Change

- Require government tail risk insurance to be explicit and fairly priced.
- More capital, and liquidity standards consistent with risks of the business.
- No retained investment portfolios.
- Align risk-taking incentives across private sector participants (lenders, securitizer, private insurers) and the government.
- Clearly distinguish affordable housing goals from business activity.

### What to Keep

- “Skin in the game” for originators and the securitizer.
- Standardization, economies of scale in current securitization infrastructure.
- The liquidity benefits of the market for issuing and trading agency MBS.

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A Lender-Owned Cooperative Utility for Securitization

A highly regulated, mutually-owned utility
Capitalized by fees from mortgage originators
Required to purchase mortgage tail risk reinsurance from the government

- One business: securitizing residential mortgages
- Utility insures credit risks in MBS it issues
- Mutually owned by lenders: credit losses are shared in proportion to securitization activity
- Vintage-based triggers for payout of government catastrophic reinsurance
- Restrictive charter, regulation, and governance structure

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Cooperative Capital Waterfall

- Mutualized Loss Pool
  - Backstopped by lenders’ representations & warranties
  - Coop “capital”: joint obligation of members
  - Priced Government Guarantee
  - Down Payments
    - Retained earnings
    - Guarantee fees
    - Ownership shares
    - Membership fees
  - Tail Loss Insurance

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Cooperative Capital Waterfall with Vintages

- **Coop “capital”: joint obligation of members**
- **Priced Government Guarantee**
- **Down Payments**
  - Expected Losses
  - Vintage 1
  - Vintage 2
  - Vintage 3
  - Vintage 4
  - Vintage 5

- **Tail Loss Insurance**

  - Annual credit losses covered by same-year fees.

  - Government guarantee pays out only if losses exhaust mutualized pool for a given vintage.
    - Gov’t payout only in infrequent, systemic events.
    - Coop is still a “going concern” conditional on a payout.

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How Much Capital for Vintages and for How Long?

• Loan performance displays stratification within 8-12 quarters of origination:
  – Supports the vintage concept.

• Assumptions:
  – Capital against original balances (versus remaining) held for 3 years.
  – 40% LGD and 3% “capital” → tail loss triggered at 7.5% cum default rate.

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• Assumed tail loss (private plus government) of 6% every 30 years. Tail loss fee is calculated assuming full government payout of remainder of tail loss insurance beyond Utility’s vintage specific capital.
• G-fee is highly sensitive to assumed ROE, minimum capital requirement, and sensitive to government tail loss trigger point.
• “going concern” examples of g-fees; upfront capitalization of g-fees also possible.

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Why a Cooperative?

• Academic literature indicates mutualization is appropriate for:
  – Homogenous and sophisticated owners, engaged directly and frequently with the business;
  – The party with less market power in the pertinent transaction (here, the lenders, not their securitizer).

• Advantages
  – Narrow mission, less risk taking
  – Weaker profit motive; lower required/expected returns
  – Facilitates monitoring & risk management
  – Aligns incentives of lenders and securitization entity (contrast to private securitization)

• Disadvantages
  – Less innovation
  – More limited access to capital markets
  – Governance is complicated; need to manage via charter and regulation

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Governance: The Regulator

• Manages government reinsurance program
  – Sets tail risk insurance fee & oversees the reinsurance fund
  – Approves risk-based pricing and sizing/structure of risk transfer bonds (if any)
  – Approves credit/underwriting standards and new products

• Sets capital standards and governance framework
  – Minimum regulatory capital standards
  – Prompt corrective action for threats to safety and soundness
  – Oversees governance structure and sets standards for risk management
  – Supervision via examinations, stress tests, etc.

• Sets guidelines for the liquidity portfolio of the utility
  – Pipeline / warehousing
  – Modifications, foreclosures, REO, and loss mitigation
  – Not investment or relative value
Appendix: Formulas in Guarantee Fee Model

G-Fee = Tail Loss Fee + Expected Losses + Admin. Costs

\[
+ \left( \frac{\text{(ROE – return on cash)} \times \text{RWA} \times \text{(Required Capital Ratio)}}{\text{(1 – Tax Rate)}} \right)
\]

Tail Loss Fee = \[
\text{Tail Loss} – \text{Expected Loss} – \frac{\text{(RWA \times Required Capital Ratio)}}{\text{(Horizon for Tail Loss)}}
\]