NYU Leonard N. Stern School of Business, Center for Real Estate Finance Research
Winter Symposium: The Return of Private Capital to the Mortgage Market
RECENT CHANGES TO MORTGAGE REGULATION Summary

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Recent activity in the private-label market

In the "recent activity in the private-label market" panel, Fred **Matera,** Managing Director and Chief Investment Officer, Redwood Trust, spoke about how issuance of non-agency RMBS post crisis has been marginal compared to the 2006-2007 peak of the market. During the boom, investors saw over a trillion dollars in issuance compared to $2 billion issued in 2011 and $6 billion issued in 2012. That said, Matera expects a significant pickup in issuance to hit $12-15 billion in 2013 with about two deals per month and a further pick up to perhaps $25 billion or more in 2014.

In terms of the players in the market, it is mostly banks and money managers that have been investing in higher-rated non-agency issuances (AAA jumbo Prime MBS). On the lower end (AAA subprime MBS), the main investors are again banks and money managers, but also hedge funds. As housing prices continue to normalize, investors and the rating agencies are looking at the credit performance of RMBS increasingly favorably. Tightening private-label RMBS spreads arise not only because of improving home prices but also because of the high quality of the collateral (indicative of the jumbo market), and strong governance structures that were put into place.

Brian **Lancaster**, Managing Director and Co-Head of Structured Transactions, Analytics, Risk and Strategy, RBS, and Adjunct Professor of Finance at NYU Stern, commented on how further growth of the private label market is highly dependent on changes in GSE guarantee fees ("g-fees) and private label MBS regulations. At the end of 2012, g-fees were on average in the low 50bps range. If g-fees increased another 20bps, as is expected by the end of 2013, private-label MBS should become highly competitive with Agency MBS deals. This will likely give a significant boost to the market.

Qualified Mortgage and Ability-to-Pay Rules

After the financial crisis in 2008, the Federal Reserve Board adopted a rule to force creditors to assess a consumers' ability to repay before making a loan. The new Ability to Repay rule issued by the Consumer Financial Protection Bureau (CFPB) is a natural consequence of that regulatory process.

Kelly **Cochran**, Deputy Assistant Director Regulation at the Consumer Financial Protection Bureau, explained the CFPB's new Qualified Mortgage and Ability-to-Pay Rules rules and Barry **Zigas**, Director of Housing Policy at the Consumer Federation of America, commented on the rules. A Qualified Mortgage (QM) is defined as a mortgage that meets the "Ability to Pay" requirements of the Truth in Lending Act. Basic features of the ability to repay rule include: 1) requirements for creditors to make a reasonable good faith decision on a consumer's ability to repay the mortgage at the time of confirmation, and 2) QMs have the presumption of compliance with the ability to repay requirements. These rules require that creditors look at the long term viability of loan instead of their short-term viability (e.g., based on teaser rates).

For industry professionals, it is encouraging that a QM definition has come out, as it provides some level of protection for lenders from lawsuits and resolves uncertainty. The industry also likes the absence of an LTV restriction and the generous debt-to-income limits in the definition of QM. However, now that we have a definition of QM, there is a question of viability for non-QM loans. Will lenders make non-QM loans, and are there any legal implications if they do? These are issues that may have to be answered before we can have further growth in the non-QM market.

Qualified Residential Mortgage and Risk Retention Rules:

April **Snyder**, Senior Counsel at the Board of Governors of the Federal Reserve System, and Andrew **Miller**, Senior Vice President & Director of Regulatory Policy at PNC, discussed the Qualified Residential Mortgage (QRM) definition that is currently being debated by six Federal regulators. The significance of a QRM is that it is a mortgage that can be securitized without risk retention on the part of issuer, an exemption to the Dodd-Frank Act's risk retention rule. Under the risk retention rule, securitizing parties would be required to retain at least 5% of the credit or default risk of the underlying mortgage assets that constitute the security. QRM rules are being designed in response to the financial crisis, where often poorly underwritten loans to highly leveraged borrowers were securitized. These loans massively defaulted during the downturn. The QRM requirement would increase the quality of the underwriting process by aligning the incentives of the issuer and MBS investor since both would share in the losses on nonperforming loans.

Conceptually, QM can be thought of as a minimum standard for mortgages while QRM is more like a maximum or gold standard. Industry professionals are in favor of QRM being equivalent to QM requirements, which they argue would decrease the complexity and inconsistencies when securitizing mortgages while increasing the amount of collateral available for private label RMBS issuance. Others have argued for a stricter definition of QRM, including LTV restrictions, in order to provide stricter underwriting, establish a first layer of equity with the homeowner, and reduce the amount of systemic mortgage risk in the system.

Both QM and QRM rules provide exemptions for GSE- and FHA-guaranteed loans. This has the perverse effect of further entrenching these institutions in the mortgage market, and further complicating the returns of private capital. This situation continues to locate a big chunk of the credit risk in the mortgage space with these entities, ultimately keeping the taxpayer on the hook.

Mortgage Servicing Rules

Kelly **Cochran**, Deputy Assistant Director Regulation at the Consumer Financial Protection Bureau, explained how the new mortgage servicing rules, recently implemented by the CFPB, were in part a response to some complaints about how mortgage servicers treated consumers that fell behind on their mortgage payments. Most complaints stemmed from the lack of a prompt response to payments or requests regarding loan modifications. Kenneth **Adler**, Co-head of Mortgage Servicing and Secondary Group at Citibank, commented on the implications of these new mortgage servicing rules.

The CFPB aimed to protect consumers and increase the level of service that mortgage servicing provides. The rules are a positive step toward improving the consistency and quality of servicing in the industry and may ultimately foster greater confidence in the sector. They level the playing field in that they apply to both banks and non-banks. But they also raise the playing field, and the industry will have to invest time and money to comply. The mid-size servicers that have not pre-emptively changed their servicing standards already will feel the adjustment the most. Ultimately, the compliance costs may trigger consolidation in the sector. They may also direct lenders away from non-prime loans. The CFPB will look more closely into transfers of servicing. Adler expects the cost burden to be shared more equally between buyer and seller of mortgage servicing rights.

Reg AB and Disclosure Rules

Peter **Sack**, Managing Director at Credit Suisse, and Stephen **Kudenholdt**, Partner at SNR Denton, discussed how following the credit crisis and the Dodd-Frank Act, the SEC proposed changes to Regulation AB, called Regulation AB2, which governs disclosure and reporting requirements for asset-backed securitizations. The changes concern the use of loan-level rather than pool-level disclosure on RMBS offerings, eliminating the use of credit ratings and replacing it by a depositor certification process, and changing the conditions for shelf registration.

Reg AB2 differs from the first version in that the certification must disclose that the security is designed to produce a certain waterfall of cash flows going forward. This is a very important distinction from guaranteeing the actual cash flows because as long as the security was "designed" properly, the certification would be considered valid. An additional disclosure that may be included is the waterfall computer program that would "re-create" the waterfall of cash flows, which would then be filled with the SEC along with the prospectus.

There are numerous questions going forward regarding Reg AB2 and disclosure rules. For example, who decides whether there is a breach in the transaction and when would such breaches be established? What the rule requires is that transactions disclose a "credit risk manager", someone who acts as an independent third party who will be subject to determine if there are any breaches in the deal. When the credit level has deteriorated below certain level, or group of investors request that it be done, then the appointed "credit risk manager" would be called to determine if any breach was made.

RMBS Litigation, Representations and Warranties, and Securities Laws

Jon **Van Gorp,** Partner at Mayer Brown, and Robert **Madden**, Partner at Gibbs & Bruns, both commented on how the legal landscape for RMBS representation and warranty litigation is currently characterized by a high degree of volatility and uncertainty. Van Gorp discussed how litigation is a primary reason for inefficiencies in RMBS transactions because it is quite challenging for bondholders to get access to the information that they need to make a claim. A particularly big hurdle is the conflict of interests that often exists between the holder of the information and the party liable for repurchase claims. New transactions will improve on this model. For bondholders, detailed provisions are being added to transaction documents that are intended to provide a fast and predictable remedy for substantiated breaches of representations and warranty claims without litigation.

Three recent decisions in the last quarter of 2012 exemplify this state of play. In *Assured Guaranty Mun Corp. v. Flagstar Bank, FSB*, 2012 WL 4373327 (S.D.N.Y. 2012), the court addressed the meaning of contractual language providing that a breach of a representation or warranty gives rise to a repurchase claim only where the breach "materially and adversely affects" the interest of certificate holders or insurers in the mortgage. Language similar to this appears in virtually all RMBS governing agreements, and its meaning is subject to significant dispute. In *MASTR Asset Backed Sec. Trust 2006-HE3 v. WMC Mort. Corp.*, 2012 WL 4511065 (D. Minn. 2012), the court held that where a mortgage has been liquidated through foreclosure, no claim for repurchase based on a breach of representation or warranty remains. The court reasoned that repurchase requires delivery of a mortgage loan, foreclosure extinguishes the mortgage loan, and therefore the claim for repurchase is extinguished as well. In *Policemen's Annuity and Benefit Fund of Chicago v. Bank of America, N.A.*, 2012 WL 6062544 (S.D.N.Y. 2012), RMBS Trustees who were accused of injuring their trust estates by failing to give notice of, and pursue, repurchase claims based on breaches or representations and warranties argued that: (i) under the relevant agreements, they were not required to give notice of breaches absent actual knowledge thereof; and (ii) they had no obligation to act to pursue trust claims absent an event of default. The court held that an inquiry notice standard applied to the trustees' obligation to give notice of breaches, and that the trustees were on inquiry notice because of publicly available information regarding pervasive misconduct in mortgage underwriting.

Risk-based Capital Rules for Securitizations in the United States

In December 2012 the Basel Committee on Banking Supervision (BCBS) proposed changes to banks' methods for monitoring risk-based capital related to securitization. Jason **Kravitt**, Partner at Mayer Brown and Eric **Wise**, Managing Director at RBC Capital Markets, commented on how the proposals would affect the capital requirements for securitizations going forward and how the process would decrease the dependence on external rating agencies. The BCBS is considering two alternate methods for determining risk weights of securitization exposures. The two methods are different from each other as well as those included in the standardized approach and internal ratings-based approach outlined in Basel II. Essentially for both approaches, hierarchies of steps are to be made when determining the capital requirement for underlying securitization exposures. The Internal Ratings-based and Supervisory Formula approaches will be revised. They will lead to a higher minimum risk weight of 20% compared to the current 7%. **Wise** expects risk capital requirements for securitizations to rise dramatically under Basel III. The capital requirement for banks regarding retained securitization exposure will not be higher than if the bank directly held all underlying exposure. Finally, originators would no longer be required to deduct below investment-grade retained exposures in all cases.

The Need for Government Guarantees

Matthew **Richardson**, Professor of Finance and Director of the Salomon Center for the Study of Financial Markets at NYU Stern commented on the subject of the need for government guarantees in the residential mortgage market, echoing proposals laid out in his co-authored book *Guaranteed To Fail*. Michael S. **Canter**, Director of Securitized Assets at Alliance Bernstein discussed a policy proposal his firm had put out on the same topic. The federal government does not want Fannie and Freddie Mac to hold 90% of the mortgage risk in the country nor does it want to be in a position of first lost. The emerging consensus is that the government should be in a last-loss or catastrophic loss position. The discussion centered around how to best share the credit risk that Freddie Mac and Fannie Mae (the GSEs) bear, as a result of their guarantee business, with the private sector. The pilot risk-sharing program in single-family and the existing programs in multi-family provide a great opportunity for more private capital to return to the mortgage market. Given the search for yield among investors, there likely is considerable appetite for a bond that lets private capital take mortgage credit risk exposure. The main difference between the two proposals that were discussed is whether the GSEs would be the insurer and capital markets the reinsurer (with the GSEs holding a senior claim), or whether the capital markets would be the insurer and a newly created Public Guarantor be the reinsurers (again holding a senior claim). In the first case, bonds or credit derivatives would be issued by the GSEs to accomplish the reinsurance, and the current GSE infrastructure would remain in place. In the second case, a group of new and existing private insurance companies would be required to be the reinsurers. The latter would see the GSEs phased out, but would need to operate in the more complicated insurance landscape.