

(Re-)Creating a Market for Mortgage Credit Risk

Remarks as Prepared for Delivery to
the American Enterprise Institute's Fourth Annual
International Conference on Housing Risk

Washington, D.C.
Oct. 28, 2015

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The last decade's financial crisis saw the evaporation of the private-label market for mortgage-backed securities (MBS) and the collapse of Fannie Mae and Freddie Mac. The resulting surge of taxpayer-backed financing of mortgages helped stem the crisis, but has left taxpayers the dominant holders of mortgage credit risk in a \$10 trillion market.

The good news is that lawmakers and the administration appear to be unanimous in wanting to restore a prominent role for private capital in this market. More good news is that critical steps towards that end have been, and are being taken.

The bad news is we are stuck with a host of policy disagreements about just how far the government should go and the path it should take to get there. Besides this critical issue of housing finance, there are policy debates surrounding housing subsidies and whether government should tip the scale on home ownership opportunities.

Today I would like to contribute to the discussion of housing risk my perspective on the progress being made to equip market participants with greater capacity to assess and prudently manage housing risk and the opportunities available to further that process. In the spirit of this conference's focus on collateral risk, I will focus on the appraisal as a particular example of how we need to rethink housing risk from investors' point of view.

The Secondary Mortgage Market

I take as given this audience's familiarity with the secondary mortgage market, but let me emphasize just a few points for context.

In broadly rounded numbers, the average mortgage in the United States is \$200,000 and the total mortgage debt outstanding for single-family homes is \$10 trillion. The purpose — and the beauty — of the secondary mortgage market is that it aggregates millions of small loans into securities of a size and predictability that institutional investors and money managers provide the bulk of this \$10 trillion in financing.

These investors have not, and as a practical matter, cannot, review and approve the creditworthiness of the individual borrowers, or the value of the homes. Instead, they rely upon the representations and warranties of the lenders and the security issuers that the loans have been underwritten to a prescribed set of standards, that the house has been properly appraised and that the appraisal supports the valuation.

In the mortgage-backed securities issued by Ginnie Mae, investors further rely upon the fact that the individual loans are all credit insured by a federal program, such as FHA or VA, and on Ginnie Mae's guarantee of timely payment of principal and interest. The Ginnie Mae guarantee carries the full faith and credit backing of the United States.

In the mortgage-backed securities issued by Fannie Mae and Freddie Mac, investors further relied upon the corporate guarantees of those two companies to make timely payments of principal and interest. It was widely believed that investors also relied on a so-called "implied guarantee" from the government that it would backstop Fannie and Freddie, if needed. That is exactly what happened in 2008 when the companies were placed in conservatorships. Since then, Fannie and Freddie mortgage-backed securities trade among investors confident in the ongoing support provided by the Treasury Department's stock purchase agreement with each firm.

In the private-label, mortgage-backed securities market, investors lacked these government supports so the securities typically were carved into numerous tranches to sort the mortgage pools into different credit risk classes.

This meant that Fannie and Freddie, with roughly \$5 trillion in security guarantees and mortgage investments, concentrated the credit risk from half the outstanding mortgage debt in the U.S. on their two balance sheets. Taxpayers implicitly, and now explicitly, backstopped those guarantees. The government's support in Ginnie securities has always been fully supported by taxpayers. And, since the financial crisis, the private-label market has shrunk to almost nothing and continues to struggle to regain a meaningful presence.

It is in this environment we find ourselves today. The effect is the underwriting, pricing, and managing of mortgage credit risk — once thought to be largely a private market function — is now largely dominated by the government. Yet since the early days of the crisis we appear to have had broad

political consensus that far too much housing risk is shouldered by taxpayers and that we want to shift much of it back to private market participants.

Since the crisis, how far have we come in making this \$10 trillion credit market more attractive to investors? What more is needed?

Envisioning Housing Finance in a Post-Fannie and Freddie World

Answering that question begins with envisioning a secondary mortgage market in a post-Fannie Mae and Freddie Mac world. It is not as hard as you think. The work to get there is already underway.

Fannie and Freddie issue mortgage-backed securities in which, beyond the borrower's down payment and any mortgage insurance, Fannie and Freddie retain 100 percent of the mortgage credit risk. Pre-crisis, competition between the two firms for volume led them to compete vigorously for market share from the large lenders.

As we learned, these lenders sold Fannie and Freddie a lot of poor quality production, which Fannie and Freddie failed to notice and respond to until it was too late. Back-end quality reviews at the time of delinquency allowed years of poor production to accumulate on their books.

We also learned that Fannie and Freddie allowed their underwriting standards to weaken, allowing riskier mortgages on their books than traditionally was the case. There are a lot of reasons behind this but the bottom line is that management judgment allowed these weaker standards to take hold. In addition, they substantially underpriced credit risk and relied heavily on cross-subsidization, whereby stronger credit borrowers paid for the risk of weaker borrowers.

From the investors' perspective, this world worked pretty well — until it didn't. In particular, capital markets created a To Be Announced (TBA) market that produced remarkable liquidity for these securities and allowed lenders to hedge their interest rate risk as borrowers locked in a mortgage rate. But the TBA market appears to have relied upon participants' belief in the implied guarantee (and now a direct guarantee). Investors in Ginnie, Fannie, and Freddie securitized mortgages paid no attention to credit risk, as if it either didn't exist or Treasury would cover it if something went wrong. Investors' focus was on interest rate risk and the associated prepayment risk.

In the private-label market, the complicated tranching of mortgage pools contributed to a general belief that investors picked their risk-reward comfort point and that senior tranche holders were essentially protected from any credit risk. Yet these non-standardized loans and security structures, with their opaque terms and unreliable documentation, collapsed in the crisis. The private-label market continues to struggle to resolve these issues.

So if we want the country to have a liquid and robust secondary mortgage market, and if we want to shift mortgage credit risk away from taxpayer-supported entities to capital markets, these are the problems we need to fix.

In particular, we need a system that:

- Enables investors to develop a market in which all mortgage credit risk, or all but catastrophic mortgage credit risk, is routinely analyzed, priced and traded by market participants.
- Allows these investors to trade with the information needed to efficiently manage and price risk and the legal standards that gives them confidence in how their interests will be protected.

Setting aside questions of housing subsidies, that's it. Rather than concentrate half of all mortgage credit risk on the balance sheets of Fannie and Freddie — the old model — we are seeking to create a normal market for expected and unexpected mortgage credit risk. This should result in market pricing and management of credit risk, just like we have for interest rate risk.

Beyond that, we want to preserve what we have, including:

- The benefits of the TBA market, with its rate locks for borrowers and liquid trading of forward contracts for mortgages to be pooled in standardized mortgage-backed securities.
- Accessibility to the secondary mortgage market for all mortgage originators, regardless of charter or size.
- Liquidity in the mortgage market through the business cycle — liquidity that is not disrupted by interest rate movements, regional downturns or national recessions.
- Lending to credit-worthy borrowers of all income and wealth strata, and across all geographies and local neighborhoods.

So, the question is: What does it take to create a market for mortgage credit risk? What do investors need to develop a liquid, robust market for mortgage credit risk that satisfies the conditions I've just outlined?

What Investors Need

I will describe six issues that need to be addressed in order to produce an orderly, efficient market in mortgage-backed securities, including for mortgage credit risk.

1. Data standards
2. Disclosures
3. Security uniformity
4. Reliable reps and warrants
5. Standardization around credit risk transfer structures
6. Enforceability of contracts and investor protections

Let's take each of these in turn.

Data Standards

In order to assess risk, credit markets need reliable data. Because Fannie and Freddie monopolized the holding of mortgage credit risk, they also monopolized the defining and warehousing of mortgage data. In May 2010, FHFA began to address this issue, announcing the start of the Uniform Mortgage Data Program, or UMDP.¹

UMDP is an umbrella for separate projects covering data submissions for:

- Loan originations
- Appraisals
- Loan servicing

The purpose of UMDP is to:

- Standardize mortgage-related data definitions in the marketplace, and
- Standardize the technology used for electronic data submissions, using the mortgage market's industry standard-setting body, MISMO (short for the Mortgage Industry Standards Maintenance Organization).

FHFA said at the time this would take years to develop, so let's get it started. Five years later, much has been accomplished.

For loan originations, the Uniform Loan Delivery Dataset (ULDD) and the Uniform Closing Dataset (UCD) are up and running today. They are also helping to form a broader set of industry data standards. For example, the Consumer Financial Protection Bureau (CFPB) recently announced changes to the Home Mortgage Disclosure Act (HMDA) that align reporting requirements with ULDD. Similarly, the Uniform Closing Dataset has just been modified to align with the bureau's new TILA/RESPA Integrated Disclosures (TRID), which became effective earlier this month. These datasets create a uniform standard for defining and reporting mortgage loan and mortgage closing data.

For appraisals, the Uniform Appraisal Dataset (UAD) is up and running. It sets common definitions for appraisal data. Also, the Uniform Collateral Data Portal® (UCDP®) is operating. It serves as the technology system for electronically submitting appraisal reports. I will return to the subject of appraisals shortly, but keep in mind the data developments in this space.

Work has begun on standardizing mortgage-servicing data but progress on that front appears to have stalled. This is unfortunate as standardizing data definitions and data reporting for loan servicing will be important to providing reliable data on mortgage credit quality. Investors will need data informing them not just of mortgage delinquencies but also of the modifications or other payment adjustments made to

¹ See FHFA News Release [UMDP](#), May 24, 2010. Also see [Fannie Mae's UMDP Portal](#) and [Freddie Mac's UMDP Portal](#).

remedy the deficiency. Therefore, it remains important that we standardize our language for collecting and reporting this information.

Disclosures

Loan Level Disclosures

Pre-conservatorship, investors in Fannie MBS received no loan-level data and investors in Freddie MBS received little. After all, the credit risk remained with Fannie and Freddie, so investors were not clamoring for it. For a post-conservatorship market in mortgage credit risk to function effectively, the MBS disclosure regime needs to change.

Some work is already done. Over the past few years, at FHFA's direction Fannie and Freddie have released a considerable volume of historical, loan-level data on mortgage characteristics and performance.

A new disclosure regime can rely upon the standardized data and electronic reporting being created by the Uniform Mortgage Data Program. FHFA announced this as a goal several years ago. Hopefully we will see the fruits of this effort as the agency's work on a common security and common securitization platform proceed. The progress made by FHFA in driving developments in the Fannie/Freddie market segment has the added potential of establishing standards that may be adapted by other segments of the mortgage market.

The disclosure regime should provide data on the borrower's credit characteristics, the terms of the mortgage, appraisal information describing the loan collateral, and monthly updates on payment performance, among other things.

With standardized data terms and an appropriate disclosure regime, we will have democratized the assessment of mortgage credit risk. No longer will the critical loan-level data be isolated within Fannie and Freddie, or available for inspection only to rating agencies. In the sort of disclosure regime I am describing, anyone with a computer and a mortgage default model can make their own assessment of mortgage credit risk. While we may still experience a future price bubble, a market with robust, real-time disclosures and risk spread among many private investors should temper the consequences.

Appraisals

In the spirit of this conference's focus on housing and collateral risk, I would like to expand a bit on the subject of appraisals in the context of disclosures.

Our goal is to create a private market in mortgage credit risk. As I've said, the borrower's ability to repay, and hence the borrower's credit parameters, should be part of the loan-level disclosures to investors. These are critical indicators of default risk. But the collateral backing the mortgage loan, and the risk parameters associated with that collateral, should also be part of the disclosures to investors. Among the conditions I believe are necessary for private investors to price and manage mortgage credit risk is confidence in the value of the collateral supporting the mortgage. Yet mortgage investors today lack this information. An appraisal report should provide the lender with an unbiased, professional

opinion of value to support the credit decision. Any assessment of mortgage credit risk depends upon an accurate assessment of collateral value and collateral risk, even though the collateral itself is not the primary basis for the credit decision.

So, here is the key question: In a world in which private markets have a meaningful first-loss position, what can an appraisal report tell the credit investor that enhances their knowledge and understanding of collateral value, and its associated risks? Taking it a step further, how could that information enhance the market's stability and soundness?

I suggest that a future disclosure regime for mortgage-backed securities could include appraisal data to assist in evaluating collateral risk. When the banks and thrifts that originated mortgages also held those mortgages in their portfolio, they had this information. Fannie and Freddie as mortgage guarantors have had this information. In a world in which investors now hold this risk, shouldn't they have access to this information?

In short, I believe that providing investors meaningful collateral data could strengthen the marketplace. This effort can build on the appraisal data standardization and collection system I described a few minutes ago. But it will also require rethinking the appraisal report, including what information is collected and for whom. Elsewhere, I have offered some thoughts on this topic.² Suffice to say I believe the content of the appraisal report itself needs to change, and we should give serious consideration to how it can be modernized to better reflect collateral risk. This could include replacing or supplementing the point estimate of value with a range and adding one or more measures of collateral risk or volatility. Fortunately, this topic will be covered in depth later in this conference.

Security Uniformity

FHFA is working on an updated mortgage-backed security structure that would initially be the same for Fannie Mae and Freddie Mac and ultimately could be the framework for a common security issued by other securitizers. It is also directing work on a common securitization platform that will ultimately replace the proprietary and outdated securitization infrastructures of Fannie Mae and Freddie Mac.³ These efforts should be the foundation for a common security in a post-Fannie, Freddie world. The common securitization platform creates a single platform for manufacturing eligible mortgage-backed securities, which should add transparency, consistency, and liquidity to the MBS market. While not required, the CSP could also be a backbone for issuing private label securities.

Representations and Warranties (Reps and Warrants)

When a mortgage originator sells a mortgage to Fannie, Freddie, or some other securitizer, it represents and warrants that the loan has been originated in conformance with the securitizer's underwriting standards. This allows a more rapid securitization process, relieving the security issuer from undertaking a loan-by-loan re-underwriting of every mortgage. Unfortunately Fannie and Freddie did not have a

² See Edward J. DeMarco, [Rethinking Appraisals in a Modernized Housing Finance System](#), June 29, 2015.

³ See FHFA reports [An Update on the Structure of the Single Security](#), May 15, 2015, and [An Update on the Common Securitization Platform](#), Sept. 15, 2015.

robust system of sampling loan deliveries to test for compliance. Rather, they typically waited until a loan went delinquent before such checking took place. This allowed a lot of loans to accumulate on their books just before the housing collapse that had not been inspected. As a result, the rep and warrant review process, and the resulting putbacks, were costly and time consuming.

FHFA announced in 2012 that it was directing Fannie and Freddie to overhaul their approach to reps and warrants. The first step was a move to up-front quality control reviews rather than waiting until delinquency. FHFA also allowed for waiving many reps after three years of timely payment.

This new program continues to develop. Earlier this month, Fannie and Freddie announced that, at FHFA's direction, they were making additional enhancements to the new rep and warrant regime.⁴ With these changes, the companies are giving more certainty for identifying, classifying, and remediating origination defects. They are also setting a standard that can be adapted more broadly in the market.

Standardizing Credit Risk Transfers (CRTs)

Credit risk transfer (CRTs), the shifting of mortgage credit risk away from Fannie and Freddie (and taxpayers) to private investors is the transition process for building a market for mortgage credit risk. What began in 2013 as a series of experimental transactions has continued to grow.⁵ Eventually, it must lead to repeatable, regular transactions, which will lead to greater liquidity and trading in CRTs. All the elements I've just described — data, disclosures, and so on — are inputs into this developing system. In the end, we should have a market for credit risk via CRTs and a market for interest rate risk — the funding market — each of which is deep and liquid and each of which is tailored for their respective investors.

Enforceability of Contracts / Investor Protection

The sixth and final element for establishing a market in mortgage credit risk may be the most important. After the complete meltdown of the private-label market and years of enforcement actions, investors rightfully wonder if contractual rights will be protected in some future downturn. After all, investors will only invest in mortgage-related assets, and take responsibility for managing credit risk, if the terms are clear and enforceable. Without certainty of contractual rights and responsibilities, no market can exist. Many investors believe their rights have been trampled in the enforcement actions taken since the crisis. Such investors will not return to this market until they are convinced that appropriate investor protections are in place.

To that end, the work being done by the U.S. Treasury⁶ and the Structured Finance Industry Group (SFIG)⁷ is critical here. Together with FHFA's work on a common security, their efforts should produce

⁴ See, for example, Fannie Mae's announcement [Fannie Mae Announces Improvements to Repurchase Policies](#), October 7, 2015.

⁵ See FHFA's recent status report, [Overview of Fannie Mae and Freddie Mac Credit Risk Transfer Transactions](#), August 21, 2015.

⁶ See The Treasury Department Request for Public Comment, [Treasury Seeks Comment on Private Label Securities Market](#), June 26, 2014.

⁷ See Structured Finance Industry Group, [RMBS 3.0 & Other PLS Market Initiatives](#).

security structures and contractual requirements that spell out the protections available to investors. This would include how contracts, and reps and warrants will be enforced.

Positive developments that have already taken place include the work on national mortgage servicing standards. A lot of thought has also gone into the establishment of an investor advocate, or deal agent, or credit risk manager, or whatever name you want to give the role. The basic point is to establish an agent who acts on investors' behalf to ensure mortgages are originated and serviced as represented in deal documents. Such a role would have some of the features that Fannie and Freddie have in what they call master servicing of their guarantee book. Another important component of investor protection is a reliable dispute resolution process, which also is being examined by Treasury and SFIG.

Conclusion

The essential step in transitioning from a Fannie/Freddie-centered market to one where private capital manages the bulk of mortgage credit risk is standing up a reliable market for mortgage credit risk. It is not a radical idea. It requires building infrastructures such as data standards and disclosures that didn't previously exist because all that risk resided within Fannie and Freddie. With continued active participation from mortgage investors, this work should continue.

We must not lose sight of another key advantage to a competitive market relative to the Fannie/Freddie model. As we recently experienced, concentrating all that mortgage credit risk on two balance sheets is a recipe for systemic risk. In my view, no amount of regulation can effectively control that risk, especially given the degree to which political considerations play into housing. A competitive, transparent market would diversify the risk across countless investors and other market participants. It also could be developed in a way that results in far more skin-in-the-game by loan originators than existed in the prior model.

While I have focused my remarks on market structure, there will also be impediments to the market that require government action. Two examples are the need to reconsider bank capital rules appropriate for this new secondary market and the legal impediments to certain market participants, such as real estate investment trusts.

In sum, while Congress defers action on housing finance reform, the collective efforts of FHFA, Fannie and Freddie, and many others are producing the six ingredients essential for a market in mortgage credit to develop. In the end, continued progress on these six elements will make the job for Congress that much easier and the final transition away from the conservatorships that much smoother.

About the Author

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