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The TBA Market and Risk Retention*

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The Dodd-Frank Act ("DFA") imposes a mandate on various regulators acting jointly to promulgate regulations implementing the risk retention provisions found in section 941 of DFA, and they are in the process of doing so at the present time. The intellectual driving force behind that provision is to ensure that major participants in the securitization process originate and securitize less risky loans, and the mechanism to do that is a mandate that they retain a share of the credit risk of the loan. If the loan sours, they stand to suffer loss. But one of the ingenious devices found in the U.S. MBS market is the "To Be Announced" (TBA) market that permits buyers and sellers to make binding deals even though at the time of agreement neither party knows what securities are the subject of the trade. Can decisions made by the regulators on risk retention regulations have an impact on the TBA market, and if so, should anyone care?

For purposes of discussion assume that Fannie Mae and Freddie Mac and their private/public governance structure vanish after appropriate transition actions, and they are superseded by a similar structure along the lines of that being considered by The Financial Services Roundtable — i.e., a private entity that provides a guarantee, a different private or public entity that securitizes, and a wholly government guarantee that provides a backstop only for the securities (not for the entities) and then only when the entities go broke and the reserve they have generated for backstopping the MBS has been exhausted.

How will TBA work in this environment?

How the TBA market works

The TBA market has several distinguishing features that permit it, in the view of most observers, to provide lower prices for securitization, for

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residential mortgage funding, and for the prices the consumers pay for their residential mortgage loans. Yet, it is not a market whose operation is well understood, nor are the reasons why it provides these benefits well understood.

The TBA market works something like this: A buyer and seller of securities agree that upon a certain date they will buy a certain large number of securities at a specified price. Unlike most traditional sales, however, neither the buyer nor the seller know what securities will be included, although at the trade date they have certain information upon which they agree such as issuer, maturity, coupon, price, par amount, and settlement date. The mortgages may not even exist at that time.

Two days prior to the settlement date, the seller notifies the buyer of the pool of securities. Knowing the settlement date, the seller may sell mortgages to those parameters and may hedge against price fluctuations to reduce any risk it may have.

The price of the trade (which generally has preceded the settlement date by a number of days) is based not on the identification of the detailed securities in the pool, however, but on the assumption that the seller will adversely select against the buyer and deliver securities that are the cheapest to it among all options that meet the six parameters. With everyone operating under that same assumption (and all of the loans guaranteed by the Federal Government for timely payment of principal and interest), the pools are treated as homogenous in the market, making the liquidity of the market both broad and deep.

That liquidity creates a premium, just as does the government guarantee, and the seller receives that premium; that permits it to originate residential mortgages at a lower interest rate than otherwise would occur.

The TBA market has an exemption from the registration laws, and absent that exemption, the market would become specific to each issue. That would eliminate the homogeneity of the larger pool being delivered under "cheapest to deliver" rules, and though it would retain the homogeneity of the uniform government guarantee, research has shown that if the guarantee itself is less than the combination of the cheapest to deliver and guarantee features - part of the premium would vanish. Obviously, in periods of extreme stress, it is the government guarantee that permits any liquidity to exist in the market, but in normal conditions, the large homogenous pool adds to the premium.

How do risk retention requirements affect it?

Now, what about underwriting and the quality of the loans themselves? Does it matter to the TBA market whether or not the loans originated must meet the tests established by DFA in the risk retention Qualified Residential Mortgage ("QRM") and the ability to repay Qualified Mortgage ("QM") sections? Does it matter what those tests require?

This is not an uncomplicated question. It would seem to break out something like the following, however.

The goals of both QRM and QM are (1) to reduce credit risk of residential mortgages to avoid another systemic problem, and (2) to retain the liquidity and predictability of the market, since that permits mortgages to be originated at a lower interest rate. DFA requires that securitizers retain an economic interest in a portion of the credit risk that the securitizer transfers to third party. Generally speaking that will be 5 percent, though that can vary with decisions of the regulators. If a loan meets the definition outlined in the Act of a QRM, then no share of the credit risk need be retained.

The regulators have some discretion, but there are constraints. For example, the definition of QRM can be "no broader than" the definition of QM, notwithstanding that the two definitions have been created for entirely different reasons, and notwithstanding that the deadline for defining QRM is potentially considerably earlier than the deadline for defining QM.

In defining QRM, the regulators must consider features that will result in a lower risk of default, such as income documentation and verification, debt to income ratios, mitigation of payment shock features on adjustable mortgages, credit enhancements, and features that have been shown to increase risk of default such as balloon payments, interest only or negative amortization, or prepayment penalties.

In addition, the definition must be no broader than the definition of QM, and that definition contains not only the substance of what is in the risk retention sections, but also includes such restrictions as the length of loan, points and fees, limitations on adjustments in ARMs, full amortization on all loans, limitations on reverse mortgages, etc.

Faced with that, the regulators might make many different choices, and define QRM in such a way that it will cover a very large number of the residential mortgage loans that are originated. The broader the definitions of QRM, the more mortgages will fit within that category, and the fewer will not.

If the definitions are quite broad (higher DTIs, higher LTVs, etc.), then the percent of the total residential mortgage market that will not be subject to retained risk will increase; that should not create a systemic problem since the regulators will have concluded that the loans within the parameters of the definition present little or no credit risk. Originators will tend to make those loans. The TBA market for these loans will be broad and deep, and the liquidity premium will be generated.

Whether the market outside those parameters will be sufficiently deep to generate a meaningful liquidity premium is the question. If not, then those non-QRM loans will have to be kept on the originator's balance sheet, or not made at all.

As the definition becomes broader, the number of loans within the definition increases and the size of the market outside the definitions shrink. At some point, it will be too narrow to support a TBA market that is sufficiently deep enough to generate a meaningful liquidity premium. It is not clear exactly how many loans is enough to make the pool provide a good size liquidity premium, but at some point there wouldn't be enough.

If the definition is narrow (one can draft it in a way that it will cover a certain segment of the market — e.g., a certain LTV, DTI, etc. will generate loans that will comprise a certain percent of the market — change those and you get a different percentage), then the market share left for non-QRM loans will increase and at some point will be large enough to generate a desirable liquidity premium. Crafting definitions correctly, one might be able to get that TBA liquidity in both parts of the market.

The non-QRMs will, by definition, present more risk to the system. They also will be more expensive to generate, and require more capital for those generating them (they will carry the 5 percent credit risk mandate and lack the liquidity premium). If they are too risky, they may be excluded from TBA markets and be available for securitization only in a specific securities market or perhaps not as securitized products at all.

Ancillary effects and questions

In either of these versions, it appears that there will be a reduction in the number of loans available to those on the margin or beyond. Even with a broad definition of QRM, but one which still is not broader than the QM definition, most subprime loans made during the past decade and many of the Alt-A loans will not now be made, since many of them contained characteristics that will be most likely prohibited under the new definitions. Because that will drive the percent of total home ownership toward the lower percentages that existed before the past decade or so (think of the consequences of returning to a 64 percent homeownership ratio), it will increase the pressure on Congress to expand the role of government programs for rental housing or the role of FHA to generate even more loans, just when the administrators of FHA have told the public that it needs to tighten credit standards to avoid creating a new GSE pit of government supported risky loans.

There are other theoretical questions, the answers to which seem obvious, but they may not be. For example, will the tightening of the underwriting standards forced by the definitions in both QRM and QM create sufficiently less risk in the pool of securities based on those standards that a fair price can be obtained in a securitization without a government guarantee, or with a government guarantee that is not as extensive as that which would cover the entire payment of interest and principal? What would be the effect of phasing out the guarantee over time, say 15 years? What will be the effect of the loss of reputation suffered by the rating agencies in the last crisis, and what will replace them as validation of the securities? Will the new Consumer Financial Protection Bureau create additional limitations beyond those in QRM and QM, either through regulations or through court decisions interpreting such undefined terms as "abusive?"

These questions are not easily answered. The regulators, of course, must face all of them as they work to determine an appropriate definition of Qualified Residential Mortgage, keeping in mind the tremendous benefits that the TBA market have provided.

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