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RiskSpan Thought Leadership: Promoting the Return of Private Liquidity: Removing a Barrier to Entry

While there is bipartisan agreement that the role of the Federal Government in the U.S. mortgage market must be reduced, the transfer of credit risk from the public sector to the private sector will require fundamental change and transparency to the new holders of risk. Certain conditions must change to enable the entrance of private capital flow before measures to significantly curb federal support are implemented.

To date, several such changes have been proposed to facilitate a revival of private-label securitization, including higher Fannie Mae and Freddie Mac (the “GSEs”) guarantee fee pricing and lower conforming loan limits as set by the Federal Housing Finance Agency (FHFA). Lower conforming loan limits will shrink the volume of loans eligible for agency securitization, and higher guarantee fees will reduce the attractiveness of securitizing mortgage loans through the GSEs. Accordingly, shrinking GSE presence—the dominant players in the secondary market today—will relieve the “crowding out” of private capital, but it will only partially facilitate the revival of private-label securitization.

While the GSEs dominated the market for conforming loans, banks and non-bank financial institutions securitized mortgage loans for a less homogeneous, non-conforming market. Over time, investors in the non-conforming market had access to predictive tools and loan-level data to enable them to observe performance and manage associated credit and prepayment risks. However, investors in GSE securities had no exposure to credit risk—as it had been absorbed by the GSEs—and

therefore had no need to observe credit performance. Access to loan-level prepayment, delinquency, default and loss data for conforming mortgage loans is and has always been prohibitively limited, as it is proprietary to the GSEs—evidently even while they are in federal conservatorship.

As the Administration implements its plans to wind down the GSEs, it should consider how the loan-level data on prepayments, delinquencies, defaults and loss severities from the GSE portfolios can be shared in a responsible manner with third parties seeking an historical understanding of the relationship between loan-level characteristics and loan performance. Increasing access to the GSE loan-level performance data is essential for private firms to develop accurate and meaningful risk management models and tools. Moreover, such data would afford the transparency necessary for private investors to confidently fill the gap that will result from a reduced GSE role. The development of robust private-label securitization activity is crucial, as it has the potential to decrease the cost of mortgage financing to consumers.

The Administration should permit responsible risk management credit and modeling entities access to historical GSE loan-level performance data. Market disruptions will be minimized as private liquidity gears up for re-entry, but entry is a strategic decision that must be grounded in sensible, risk-based pricing strategy. By reducing information disadvantages and leveling the playing field, private capital is enabled to return to the mortgage markets once more.

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