Banking Regulation and Mortgage Market Reform

Dwight Jaffee
Haas School of Business,
University of California, Berkeley

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Agenda

- Principle: Connect Bank and Mortgage Reform
- Bank Regulation:
  - Why It Failed
  - Dodd-Frank and Basel III responses
- Mortgage Regulation:
  - Why it Failed
  - The Treasury/HUD White Paper Proposal
- Securitization and Covered Bond solutions
- Conclusions for banking and mortgage reform

Evidence that Mortgage Regulation and Banking Regulation are Connected

- Estimates put total subprime loan losses < $1 trillion.
  - Total household wealth at YE 2006 > $75 trillion.
  - Subprime losses = one time, 1.3% hit, on wealth.
  - Nowhere near enough to sink US banking/finance.
- Mortgage risks were concentrated in banking sector, including CDS writers (AIG) and PMI firms.
  - This is likely to expand further in the future.
  - Thus, both banking and mortgage reform must reflect this fundamental connection.

The Failed Game Plan of U.S. Banking Regulation

- Prompt Corrective Action (PCA), adopted in 1991 after the S&L crisis, was supposed to avoid forbearance.
- Subordinated debt was endorsed throughout the 1990s to provide private market oversight for bank risk.
- Basel Bank Capital Requirements were to provide strong incentives for risk management:
  - The 8% Risk Based Capital (RBC) requirement set higher requirements on riskier asset classes.
  - PMI/CDS Hedges from AAA counterparties provided full exemption.

The Basel Risk-Based Capital Requirements for Mortgage Assets

Table 1: Bank Capital Risk Weights on Mortgage and Mortgage-Related Securities [10]

Asset Class	**Risk Weight**	**Capital/Asset Ratio** (Based on 8% Requirement)
Whole Residential Home Mortgages	0.50	4%
Agency Debt and Agency MBS	0.20	1.6%
AAA /AA Securitization Tranche	0.20	1.6%
A Securitization Tranche	0.50	4%
BBB Securitization Tranche	1.00	8%
BB Securitization Tranche	2.00	16%
B and Below Securitization Tranche	Dollar for Dollar Capital	100%

Basel III

- New Components:
  - Raise Tier 1 Capital Ratio by 2.5 percentage points + a countercyclical component. Only equity counts.
  - New 3% leverage requirement.
  - New short-term liquidity requirement.
  - New long-term liquidity requirement: “Net Stable Funding Ratio” (NSFR) approaches a duration match.
- The leverage ratio and NSFR could have impact on mortgage-intensive banking systems.
- But bank lobbying has reduced the requirements such that most major banks already satisfy the requirements.

Dodd-Frank Mortgage Actions

- Title XIV: Mortgage Reforms….
  - Subtitles A to D prohibit most predatory lending.
  - E creates new requirements for mortgage servicers.
  - F creates new, higher, standards for appraisals.
  - G charges HUD to expand its multifamily programs.
  - H commission GAO to study foreclosure scams, etc.
- Title IX, Investor Protections…
  - C imposes new responsibilities on rating agencies.
  - D imposes the 5% securitization risk-retention rule.
- Title X creates Consumer Financial Protection Bureau.

The Moral Hazard of Securitization: No!

- Sheila Bair:
  "All along the chain of securitization—from originators, to securities underwriters and rating agencies to investor and regulators—insufficient attention was paid to both safety and sound and basic consumer protection. With each of these parties acting in its own best interest, the system as a whole lurched toward disaster."
- Argument fails when investors at end of the line are the world's largest and most sophisticated firms.
  – Reflects misunderstanding of lemons market operation.
  – Also not supported by empirical evidence.
- The cost of Dodd-Frank 5% risk retention rule is high:
  Banks are now induced to hold <u>more</u> risk.
  Contradicts goal of securitization to distribute risks.

Enter Mortgage Reform with New Treasury White Paper

- GSEs to be closed down over the next 5 to 7 years with lower conforming limits, higher guarantee fees.
- Retain FHA/HUD programs for low income borrowers.
- Three Options on how to replace GSEs:

  Option 1 replaces GSEs with fully private markets.

  Option 2 adds FHA backstop for future crises.

  Option 3 has more complete government insurance.
- I favor plans 1 or 2.
  I would bet, however, on some version of plan 3.

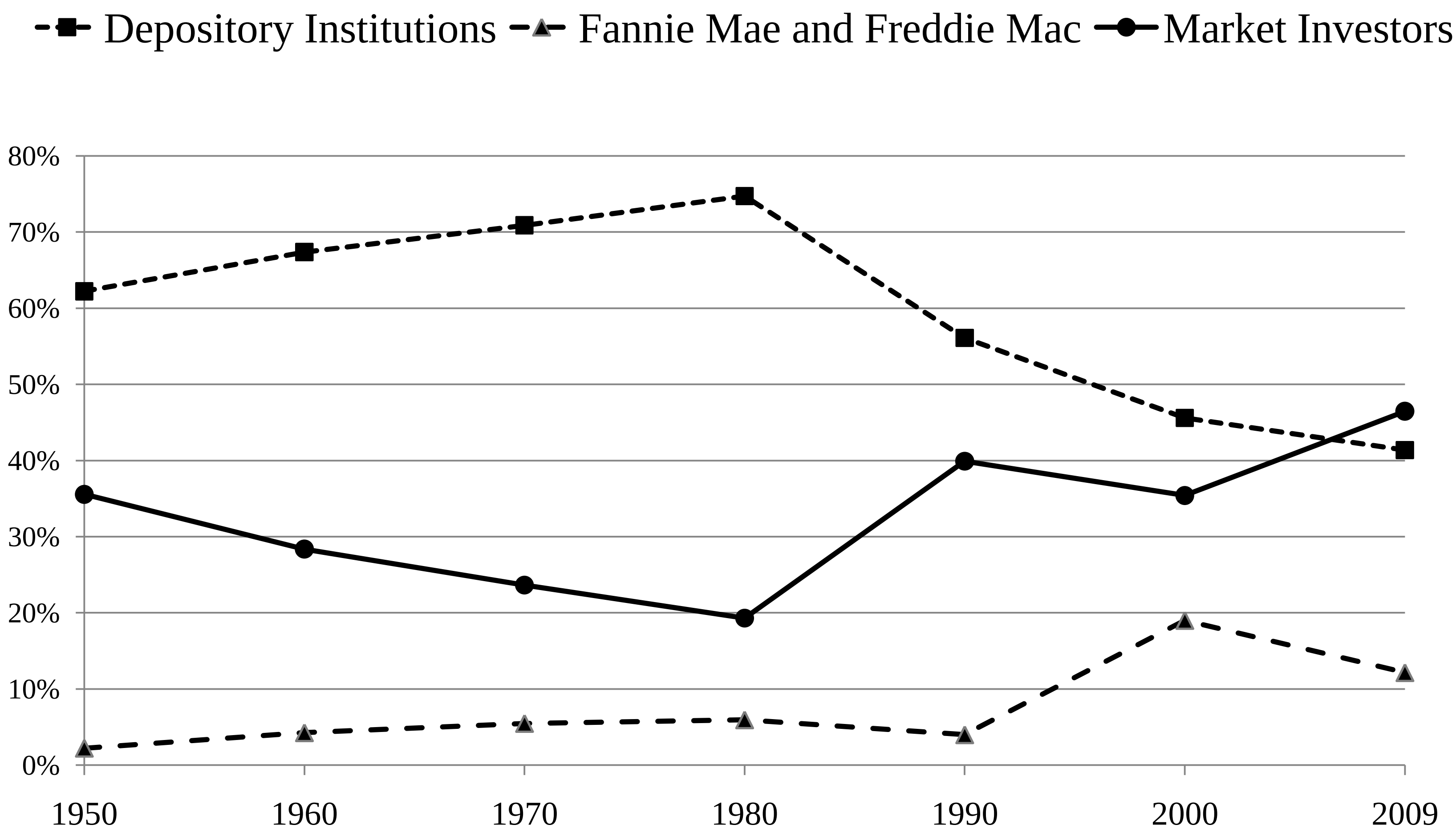
Will a Private Mortgage Market Work?

- Jaffee (2011) & Lea (2010) provide hard evidence:
  - Government interventions are minor in mortgage markets of all developed countries except U.S.
  - These mortgage markets have outperformed the U.S. on virtually every measure.
- Trick, so to speak, is that the home mortgages in these countries are substantially safer than in U.S.
- This also means that, even with loss of GSE subsidy, U.S. mortgage rates could well decline.

Who Will Originate, Securitize, and Hold Mortgages in a Private System

- Origination: The usual suspects.
- Securitization: The usual suspects (ex GSEs!).
- Contract Design: Menu choice with safer mortgages =>lower rates. Incentive for safety.
- Investors: With private market, both depositories and market investors will expand with specifics depending on securitization vs. covered bonds.
- Shift to safer mortgages has valuable externalities.
- Bank regulators must be much more vigilant!

Share of Total Home Mortgages Outstanding, by Holder



Covered Bonds and Securitization

- Covered bonds are senior bank debt, secured by prime mortgage collateral, replacement, and bank guarantees.
  - Bank regulators carefully evaluate collateral;
  - Banks must meet risk-based capital requirements;
  - Under Basel III, will also face A/L match.
  - Single-class security, consistent with safe collateral.
- Securitization based on off-balance sheet SPV:
  - Tranching structure allows clientele to choose risk level;
  - No capital requirements;
  - Must avoid undesirable regulatory arbitrage.

Legal Impetus Needed for Covered Bonds (CBs)

- The primary CB legal issue is to protect CB holders if the issuing bank fails. Fear is bankruptcy clawback.
  - Indeed, the FDIC has resisted U.S. CBs precisely because it does not want CB holders in front of it.
  - But EU and European country laws protect CB holders.
  - The 3 US CBs used 2-step issuer to try for protection.
- The fundamental issue is whether CBs are valuable:
  - Yes with safe mortgages/ high quality bank supervision.
  - CBs may then provide the low-cost channel to tap capital market funds, benefitting both the banks and borrowers.
  - GSE/FHLB CBs represent 23% of all US home loans.

Affirmative Impact of Mortgage Reform on Banking Regulation

- For riskier mortgages from bank lenders:
  - Securitization is best means to distribute risk to capital market investors based on risk tolerance.
  - Bank capital requirements must be set high enough to provide ample protection against bank risks from holding risky mortgages.
- For safer bank mortgage portfolios:
  - Banks could expand portfolios of safe loans;
  - Regulations should allow covered bonds.

Two Negative Impacts of Mortgage Reform on Banking Regulation

- Shift from GSEs to private market will expand role of banks in the mortgage market for good or bad.
- Two negative connections should be avoided:
  - Dodd-Frank rule on securitization moral hazard could, perversely, expand bank mortgage risk.
  - Bank mortgage risk has also become basis to argue for large government mortgage insurance.

    Requires confidence that government insurance will impose high standards and risk-based prices. No way!