Reason Foundation Policy Summary

Restoring Trust in Mortgage-Backed Securities: How the Private Sector Can Return to Mortgage Finance

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The mortgage finance market has leaned heavily on government support over the past few years. More than 90 percent of mortgages originated in 2011 were securitized by government entities using taxpayer funds to guarantee investors against default risk. This support cannot continue forever. The status quo perpetuates many of the policies that contributed to the housing bubble and consequently promotes an unstable mortgage market. In order to avoid another crisis, the government must exit mortgage finance and private capital must shoulder mortgage default risk.

Policy proposals from both Republicans and Democrats, a white paper from the Treasury Department and the Department of Housing and Urban Development, and a host of research groups and academics have almost all focused on reform ideas that view the private sector as the foundation for the housing market. Despite this uniform focus, a number of roadblocks severely limit the pace and scope of mortgage finance risk to the private sector:

- A profound lack of confidence in the models used by credit rating agencies to assess residential mortgage-backed securities (RMBS) and in the rating agencies themselves;
- High conforming loan limits which perpetuate market share dominance of Fannie Mae and Freddie Mac, and the growing market share of Ginnie Mae and FHA;
- Risk retention requirements in the Dodd-Frank Act; and
- The complex legal framework governing RMBS.

The proposed rating-agency changes in Dodd-Frank are not enough to overcome this distrust. What we propose instead to overcome private sector skepticism is a series of legislative policy reforms, industry led reforms, and regulatory reforms:

- First, Congress should authorize underwriters to include property-level address data in RMBS disclosures so that investors or independent analytic firms can perform more detailed and accurate risk assessments at lower cost.

- Second, the mortgage-finance industry should create an organization—a Mortgage Underwriting Standards Board—to provide self-regulation against misrepresentation and to enhance liquidity by replacing QRMs with industry established categories of mortgages that are transparently defined by risk appetite to compete with the status quo binary standard (i.e., AAA, BB-, CCC+) that improperly shields investors from the true nature of the mortgages they are investing in.

- Third, the mortgage-finance industry should encourage common formatting of RMBS collateral data and the inclusion of cashflow-waterfall models with prospectuses to make investor due diligence easier, more competitive, and less costly.

- Fourth, the NRSRO system should be completely abolished. While it remains, regulators should encourage greater access to RMBS offering materials prior to origination (so that they are not only available to the issuer-hired rating agency), and allow third parties to challenge overly optimistic ratings used in the determination of bank regulatory capital requirements.

These proposals would encourage investor due diligence and facilitate the availability of third-party analysis. By increasing access to information and insight, they should encourage investors to buy private-label RMBS, enabling the government to scale back its involvement in residential mortgage finance without precipitating a collapse in home prices. Attracting private capital to residential mortgage finance is challenging. But perpetuating government control of housing finance in today's era of high deficits is unaffordable.

To read the full study, go to http://reason.org/studies/show/trust-in-mortgage-backed-securities or contact: anthony.randazzo@reason.org