

Regulation & Legislation

Mortgage market needs tougher standards By Bruce I. Jacobs

The current financial market crisis has revealed the inadequacy of a system of patchwork regulations. We need a regulatory regime that is consistent across our large and integrated asset markets, one that can regulate financial products with a focus on their potential effects on systemic risk.

The Obama administration's proposals now in Congress address many of these issues. In addition, they recommend some changes that would improve transparency in the huge, highly leveraged over-the-counter market for credit default swaps, including standardization of some products and centralized clearing. A better solution would involve even more standardization of products and trading on organized exchanges.

Tougher standards for all participants in the mortgage-investment market would reduce the chance of another crisis. The beginnings of the current economic crisis were characterized by a lack of due diligence on the part of mortgage brokers, lenders and investors, a lack of oversight by banks and credit-rating agencies, and a lack of regulation and enforcement by government agencies. At the core of the crisis, however, is a tower of structured finance products erected on a base of risky subprime mortgages. While these structured products seemed to be reducing the risks of lending and investing, they were actually multiplying those risks and spreading them throughout the globe.

Subprime and other mortgages are essentially risk-shifting with regard to underlying housing prices. That is, if the value of a house declines below the value of the mortgage, the home buyer can default on the loan. Subprime loans are likely to be substantially more sensitive than prime loans to declines in housing prices because subprime borrowers are less creditworthy to begin with and because the average size of the loan in relation to the home's value — the LTV ratio — is higher for subprime than prime borrowers (by 15 percentage points in 2006). If housing prices decline, subprime borrowers, with high LTV ratios, are more likely than prime borrowers to be “underwater,” owing more on their mortgages than their homes are worth, and more likely to default.

Diversification of mortgage loans can reduce a lender's exposure to default by a given homeowner when that default is the result of a specific, diversifiable event. But a decline in the value of one house might signal broader woes that affect the prices of surrounding houses. The risk-reducing benefits of diversification are more limited when the underlying risk is more systematic. Mortgage lenders, however, do not have to retain this systematic risk. Mortgages can be pooled, repackaged and sold to various types of investors. The relatively high interest rates on subprime mortgages (generally two percentage points over fixed prime mortgages) made them particularly appealing candidates for securitization and resale in the form of residential mortgage-backed securities and collateralized debt obligations in particular.

Rather than taking on the risk of default by one or a few borrowers in a given locality, a single RMBS or CDO diversifies risk exposures among numerous individual mortgages spread over a large area. The primary risk-reducing mechanism of mortgage-backed securities, however, is not risk sharing via diversification but, rather, risk shifting. Within an RMBS or CDO, structured securitization takes the payments on the underlying mortgages and redirects them to different tranches, thereby shifting risk from upper to lower tranches; in most cases, the upper tranches of these structured products appeared safe enough to warrant the highest investment-grade ratings from credit-rating agencies. The sale of these tranches then shifts the risks, and returns, of the underlying mortgages —

especially the largely non-diversifiable, systematic risk of a decline in housing prices — from mortgage lenders to investors.

A seemingly final shift of risk might be undertaken via credit default swaps. A CDS seller agrees to “make whole” the buyer of the contract if the latter suffers because a default or other specified credit event causes a loss on a specified underlying asset — a particular debt issue, a tranche of an RMBS or CDO, or an index referencing a tranche. Credit default swaps were purchased by sellers of structured products to procure higher ratings for given tranches and by buyers of structured products to hedge their investments.

Structured products based on subprime loans were able to pass on some of the benefits of the relatively high rates on subprime mortgages, while being accompanied, thanks to the diversification of pooling and the risk-shifting of tranching, by seemingly low risk. Securitization of subprime mortgages thus became an ever-larger portion of the structured product market. It enabled financial institutions to free up capital for lending, to pass the riskier portions of mortgage loans to investors such as hedge funds, to earn profits on sales and to retain supposedly low-risk products for their own (highly leveraged) portfolios. In essence, the disconnect between the relatively high returns offered by subprime-mortgage-based products and their perceived low risk fueled demand for the products, thereby increasing funding for mortgages, facilitating home purchases and raising housing prices.

Of course, the entire tower of structured products rested on a shaky foundation: loans to high-risk borrowers. Furthermore, subprime loans had themselves become increasingly leveraged, with LTV ratios rising more than six percentage points between 2001 and 2006. Then, in 2006, as the pool of possible home buyers began to be exhausted at the elevated housing prices, prices began to decline. Many subprime borrowers with high LTV ratios found themselves underwater; some exercised the put options in their mortgages, passing the downside risk of housing-price volatility back to lenders. Delinquencies and defaults in the subprime sector increased beyond the expectations reflected in mortgage rates, RMBS yields and CDS premiums. The real underlying risk of subprime mortgages, hidden for so long by the instruments used to shift that risk, became apparent.

At the same time, the extent of the problem remained opaque, thanks to the complexity and opacity of instruments such as CDOs and CDS. It was difficult for market participants to discern which instruments and which entities were going to disintegrate next. The solvency of some critical institutions began to be questioned. Liquidity dried up as banks hoarded their capital and declined to lend.

Sophisticated, highly complex financial instruments and mechanisms were devised to shift risk from one part of the financial system to another. As in a shell game, the risk itself seemed to disappear in the shifting. But the underlying systematic risk remained, and, magnified by leverage, blew up the very foundations of the financial system and, in turn, the economy.

Bruce I. Jacobs is a principal of Jacobs Levy Equity Management Inc., Florham Park, N.J. His commentary is adapted and updated from his article “Tumbling Tower of Babel: Subprime Securitization and the Credit Crisis,” Financial Analysts Journal, March/April 2009.