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Statement No. 311

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Statement of the Shadow Financial Regulatory Committee

Risk-Retention in the Dodd-Frank Act

May 2, 2011

The risk-retention requirements of the Dodd-Frank Act (DFA) were enacted in the belief that they would improve the quality and reduce the risk of securitized mortgages by requiring securitizers to have “skin in the game.” The general rule is that unless all mortgages in a securitized pool meet certain minimum quality standards, the securitizer must retain at least a 5 percent interest in the pool—an interest that cannot be hedged or insured. However, now that the bank and securities regulators have filled in some of the details in a recent notice of proposed rulemaking (NPR), it has become clear that the risk-retention idea will not achieve what was intended. In fact, there is little likelihood that the risk-retention system will result in better quality mortgages. This is true for several reasons.

First, the DFA exempts the Federal Housing Administration from risk-retention requirements. This is logical in light of the purposes of risk-retention; the FHA insures 100 percent of its loans. But the DFA imposes no restrictions on the FHA’s underwriting standards, putting the agency in a position to accept any subprime or other low quality mortgage. It could thus become an entry point for subprime and other low quality mortgages, defeating the purpose of the risk-retention mechanism.

Second, the NPR makes this problem worse by also proposing to exempt Fannie Mae and Freddie Mac from the risk-retention requirements. Thus, if the rules are ultimately adopted as stated in the NPR, Fannie and Freddie—like FHA—are likely to become another conduit for weak and risky mortgages. This will also make it very difficult for the private market to compete with Fannie and Freddie,

since the GSEs' securitizations will not have to bear the additional cost of carrying the assets associated with the 5 percent retention. Accordingly, although the administration has proposed to enlarge the role of the private sector in the housing finance market, and to eliminate Fannie and Freddie, the NPR goes in precisely the opposite direction. Nor would it be a good policy to apply the risk-retention requirement to Fannie and Freddie. This would only enlarge their portfolio holdings over time.

Third, the risk-retention rule also favors the largest banks, because only financial institutions with large balance sheets will be able to retain, for the extended periods necessary, 5 percent of all the securitizations they complete.

Fourth, it is also unlikely that the risk-retention required by the NPR will impose substantial additional risks on securitizers. One of the risk-retention options is what is known as a "vertical slice"—5 percent of each of the tranches in a securitized pool. This is likely to become the favored method for risk-retention because accounting rules have recently been changed so that securitizers can only get immediate sale treatment, and thus record a profit, for sales of participating interests if the risks of the retained interests are proportional to the risks sold. Unless there is a huge loss in a pool, a five percent vertical slice does not represent a significant risk for a securitizer that will earn most of its profits from origination, distribution, servicing and management of the mortgage pool. Thus, the risk-retention provisions in the DFA and the NPR are unlikely to have much effect on the quality of the mortgages that are securitized.

Finally, as noted above, the DFA provides that no risk-retention is necessary where a mortgage is of high quality—called a "qualified residential mortgage" (QRM) in the DFA. The bank and securities regulators were charged with defining this term, and the NPR contains the regulators' initial proposal. The regulators concluded that a mortgage with an 80 percent loan-to-value ratio (LTV)—that is, a 20 percent downpayment—would be of sufficiently high quality to warrant the elimination of risk-retention. A 20 percent downpayment has for years been a constituent of a prime mortgage, but that does not make it risk-free. On the other hand, that level is considered too high by many special interests in the housing business, which argue that most home-buyers cannot come up with a 20 percent down-payment and will thus be required to bear the additional costs associated with the 5 percent retention. This will produce substantial political pressure to funnel more mortgages through Fannie and Freddie or FHA, which are exempt from risk retention. In addition, the NPR excluded the use of the borrower's FICO credit score as a standard for judging a loan's quality and substituted standards such as the number of late payments over a prior period. Avoiding the use of the widely-accepted FICO score will make it more difficult for securitizers and investors to judge mortgage quality.

All these deficiencies—and very few benefits—suggest that this section of Dodd-Frank cannot achieve its purposes, and if implemented as suggested in the NPR will have many adverse effects on the housing finance system. Accordingly, the Committee believes that these provisions should be repealed and rethought.