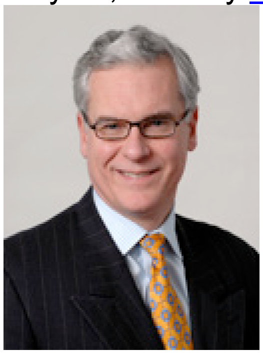
Premium Capture Kerfuffle: The Poster Child of What's Wrong with Risk Retention

May 25, 2011 by Rick Jones



The process of transforming 2,000 pages of Dodd-Frank into 25,000 pages of regulations is well under way. Front and center is Risk Retention. I assume you, like me, have been studying the 300 plus pages of the proposed Risk Retention rules (known to the cognoscenti as the Risk Retention "NPR") for the past several weeks getting ready for the June 10th deadline for comments, right? Oddly, almost a full month passed before the government actually posted the NPR to the Federal Register, something which is usually done in a matter of days. (Tea leaf readers, thoughts?)

We have visited Risk Retention in this Blog before, but today we want to really focus on premium capture as it seems to capture all that is wrong with the NPR. My first reaction to reading the words on the page: Where the hell did this come from? On the fifth read, same reaction. There was nary a hint of the premium capture monstrosity in either Dodd-Frank or in the whispering about the rule-making process before the NPR came out.

On its face, and we absolutely have to start here, it says a securitizer who monetizes either an IO or earns a premium on the sale of P&I bonds, has to put that money in a box. That box serves as a first loss reserve for any losses on the loans for the life of the deal. The authors muse (they almost seem to chuckle) in the commentary that it's unlikely that anyone will ever do this because it is onerous and therefore securitizations will be done without premium. Huh? Why, in Heaven, would a bank hire an origination team, build out technology, make loans, warehouse and hedge loans and assemble a pool for sale if it was not going to make a profit? I mean, we all know greed has a bad odor these days, but, good heavens, this is still a capitalistic economy, isn't it?

Now, about the actual text of premium capture. In conversations following publication of the NPR, the regulators have told anyone who asks that the premium capture provisions were not properly drafted, and that what it really is all about is ensuring that the securitizer, who elects to satisfy risk retention with a horizontal first loss piece, retains 5% of the value of the underlying loans (the NPR curiously uses the term "par" to mean value). Regulators have gone on to say this is easy to achieve if securitizers would just stop their nefarious practice of stripping coupon and attach that interest to the first loss piece where it should always have been in the first place. Then, the bottom 5% would equal 5% of the value of the loans in the pool.

Disturbing, huh? And on so many levels.

First, this suggests that the regulators think that originators and securitizers can and should be responsible for stopping the business cycle and consequently loan losses are mostly attributable to bad underwriting which can be fixed by a strong regulatory whip hand. Regrettably, in the real world credit cycles are, well, cyclical. Securitizations, which typically have a term in excess of ten years, will see a full cycle. There is no way to make loans that are so good that they will all perform for ten years. The NPR suggests that the regulators think that's tough nuggies and that if the originators and securitizers are sufficiently cowed by regulation, they will insulate investors from the cycle. Can not happen.

Second, the NPR suggests the regulators think if you put enough coupon on the B piece, it will trade at par and not at the deep discount common today. Wrong. This paper trades at a deep discount because of the likelihood of principal losses, not an inadequate coupon. See cycles, above. I cannot imagine how much coupon would need to be attached to the first loss bond to get a par bid, but it's sure to God more than the excess coupons floating around your typical securitization.

In the real world, to get 5% of value in the B piece, the B piece would have to represent more than 10% of the total deal, probably penetrating into the investment grade certificates. What would this accomplish, that is, besides vastly increasing the cost of funds to the borrowers and materially impairing capital formation? We're a touch light on B piece buyers right now. How many would we have if they need to buy 10% of the Pool? Buying that mezzanine paper is not the business model of the B piece investors and they will not want this paper. I simply don't get it. To make this scheme work, both originators and investors would have to do things for regulatory reasons they would not do when following their economic best interest. Anytime both counterparties to a trade are doing things for purely regulatory reasons, something is deeply wrong.

Let's put aside for the moment the whole notion of whether skin in the game has any science behind it (that train has regrettably left the station). Let's also put aside that the CMBS market has functioned relatively efficiently. The losses in CMBS are not vastly disproportionate to the underlying performance value of the real estate markets. (It's not resi, it's not resi, it's not resi.) We've got Dodd Frank and we're stuck with it. Yet Dodd Frank leaves enough wiggle room for the regulators to craft regulations that are fundamentally aligned with how business is really done, and which, in fact, will improve investor protections and facilitate the successful and efficient operation of capital markets.

Dodd Frank gave the regulators the tools. The Congress recognized the need for flexibility with respect to CMBS. The statute included the concept of a qualified commercial mortgage which because of its relative conservatism would require no risk retention. The regulators gave us a box that's so small that less than ½ of 1% of all deals done in the past ten years, would qualify. That's silly. The legislation gave the regulators the opportunity to use high quality reps and warrants as an ameliorative factor for risk retention. This opportunity was completely ignored. That's inexcusable.

Within the context of this law, the regulators should be using their regulatory power to improve the alignment of the interest of investors and securitizers. Look, investors are happy to take the risk of mortgage loans. That's the business they're in. What they cannot underwrite and where regulations can be useful is to protect against loans which are poorly underwritten, poorly documented and not properly and transparently disclosed. Now that's a doable and estimable goal for regulation. That's in the tradition of the Securities Act and the Exchange Act. Good regulation improving markets. This will not.

I think it's fair to say what Congress intended was a regulatory regime that encouraged good underwriting of mortgages, an embrace of industry best practices, support for strong representations and warranties, and good disclosure. That would improve the efficacy and sustainable operation of the capital monies. That's not premium capture.

Now, I kind of get how a retained interest by a sponsor or by a party whose business it is to take the enhanced risk of a first loss piece is a sort of short-hand for the protections promised by good reps, good underwriting and good disclosure. But risk retention ought to make sense in the context of how markets really function. If we're going to honor Dodd Frank's embrace of the B buyer as a risk retention modality, risk retention by B buyers has to make sense for the business plan of the buyer. That means the holder of the B piece should not be obligated to hold it forever, should be able to hedge and lever the paper. First, an investor will know if the originator and securitizer assembled a "good" pool within a couple of years at the outside. By that time, you know whether the loans were well-originated, well-structured and supported by good disclosure. Making the holder hold longer than that is to stick a B buyer with the consequences of the credit cycle. Second, why shouldn't a holder hedge? Hedges represent investment and reflect competent management. Finally, the B buyer needs to lever to make its business model work. That market is non recourse. They need to volunteer for recourse to satisfy risk retention? That's insane.

I am not sanguine about how we take the Risk Retention NPR forward and get to an outcome that enhances the alignment of interest between bankers and investors, and that improves the safe and efficient operation of capital markets. There's just so many bad ideas and so many missed opportunities in the NPR and it just seems unlikely that the authors will be prepared to walk back on some of the more startlingly bad choices made.

But we don't have much choice, right? We'll do our best to engage and provide constructive comments before the (completely unrealistic) June 10th deadline. Once a final rule is issued, we'll remain engaged and keep the conversation going until implementation confronts us sometime in the middle of 2013. What else is there to do?