
REGULATORY REACTIONS TO THE CURRENT CRISIS

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Authorities rarely respond to crises in any meaningfully constructive way. I anticipate this crisis will be no different. One of the biggest risks is that authorities impose significant restrictions on the markets and that those restrictions take generations to erode. Such a move would place a significant tax on the financial system and the economy for years to come. Equally risky, however, is that the authorities bail out the industry, leaving participants no incentive to fundamentally improve the assumptions underlying the financial structures that are the root cause of current difficulties. The solution, therefore, lies in allowing investors to take losses, which will force lenders to securitize subprime loans using simpler and more conservative financial structures.

AUTHORITIES HAVE CONSISTENTLY OVERLOOKED THE DEVELOPING STRUCTURED FINANCE MARKET

What type of reaction can we reasonably expect to current difficulties in structured finance? U.S. authorities have a track record of generally ignoring the sector. While technically violating FAS140, During the early- and mid-1990s, regulators routinely looked the other way while lenders provided recourse to their securitizations. In some cases, regulators did so explicitly for the purpose of providing forbearance, reasoning that the bank would be rendered critically undercapitalized if recourse was disallowed. Nonetheless, such actions provided little incentive for issuers to be more conservative about the legal and financial structures that defined risk in the arrangements.

Similarly, authorities consistently ignored repeated crises that arose from inadequate legal or financial structures. Funding crises arising in credit cards (1998), home equity lending (1999), and other receivables like aircraft leases and 403-b mutual fund fees (2001) were deemed too small to be of concern. The US Securities and Exchange Commission examined RMBS markets four times between 1998 and 2007, each time claiming no significant concerns with transparency. Authorities have therefore been consistently reluctant to examine market dynamics at incipient stages of development to infer larger-scale risks, which has turned out to have been a fatal oversight.

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IN THEORY, EXISTING REGULATION COVERS THE PROBLEMS

SEC Regulation AB and Sarbanes-Oxley both specifically address transparency in non-bank loan underwriting, servicing, and securitization. Unfortunately, neither has been effectively pursued in a manner that can provide adequate transparency.

Section 404 of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") requires the management of publicly-owned companies to assess the effectiveness of internal controls over financial reporting. Because of the increased focus on maintaining strong internal controls, Sarbanes-Oxley should have had a meaningful impact on servicing stability, both for publicly-owned servicers as well private servicers that voluntarily take similar steps.

Nonetheless, one of the key problems that led to the current difficulties has been servicers' use of loan modification and re-aging policies to mask the true condition of subprime loans as they deteriorated. Servicers used aggressive (and largely unreported) loan modifications to avoid classifying loans in default status even though the payment plan typically resulted in lower periodic loan yield and modified loans typically post a 35% - 40% re-default rate and higher re-default loss rate than non-modified loans. When loans went in to default, servicers again used modification to restore payments in conjunction with aggressive (and, outside banks, largely unreported) re-aging policies to restore the loans from default to current status. Nonetheless, authorities are seeking to increase modification, with no accompanying reporting requirements to modification or re-aging, as a policy fix for subprime borrowers.

The Securities and Exchange Commission introduced Regulation AB in 2004, which includes enhanced reporting requirements for RMBS issuers. Regulation AB was supposed to require collateral-level performance reports for RMBS, but allowed issuers to choose how to make those reports publicly available. As a result, most collateral reports are made to one company, FirstAmerican Loan Performance, who refuses to sell the data to academics or other researchers off Wall Street, even at the exorbitant price charged for the product.

MARKET IS NOW "TOO-BIG-TO-FAIL"

Lack of attention from the authorities led the market to fund approximately 70% of consumer credit before authorities began to learn the mechanics of structured funding. Hence, authorities have a great deal of catching-up to do before any hope of imposing meaningful constructive guidelines.

Furthermore, securitization functions most economically on a large-scale basis, providing a means of rapid growth for securitizing firms. Hence, it is very difficult, if not impossible, for lenders to curtail issuance without facing severe financial distress or, most likely, failure. If outside factors, like restrictions on securitizations (imposed from authorities or the investing public) result in a market slowdown, many issuers are not likely to survive. Given that securitizing lenders cannot shrink without severe distress or failure, industry participants who have grown primarily on the basis of securitization are promoting themselves as effectively "too-big-to-fail."

The Bank of England's move to bail out Northern Rock will lead others to claim they, too, are too-big-to-fail. But this is a rocky path. Loans have not once

helped firms in times of systemic distress. The reason is simple: more leverage does not help firms that are already suffering from capital stress. The only real aid, if one wishes to prop up banks, is recapitalization. Typically, recapitalization is achieved through government purchases of voting bank stock, which is a movement away from the trend over the past several decades of worldwide denationalization.

THE MARKET DOES NOT NEED TO FAIL, BUT IT DOES NEED TO CHANGE

The problem this time is not the banks, per se, but the intermediation technology employed by banks. Investor losses will force the most economically efficient change to a more conservative application of that technology. Regulation will not meaningfully force that conservatism because the technology, itself, is financially engineered to arbitrage regulatory requirements. Bailing out the technology will only spread the application of the risky variant. Investors and banks will only change their ways when some firms fail as a result of their risky choices.

How can securitization be altered to better ensure market stability? It is important to recognize that some subprime sectors outside mortgages are not currently sharing the difficulties. In particular, credit cards and automobiles have long lent to subprime consumers. But those sectors long ago learned to structure their securitizations in a manner that does not create the kind of funding risks now facing the mortgage industry. Both sectors securitize with far simpler structures than mortgages, using only a few tranches and virtually no sophisticated strips, PACs, and PIK-able instruments. Both are very conservative in setting tranche cutoffs, although it has long been recognized that different quality issuers may have AAA tranche compositions that vary by as much as 10% or more and may rise to 30% or even 40% of the total of securities issued to finance the loan pool. Credit cards fundamentally restructured their typical securitization platform to an issuance trust paradigm following the 1998 Russian crisis, de-linking the risky and less-risky debt issuance so that they could better assure continued market liquidity in the event of a temporary market disruption. The lesson from other subprime sectors is that subprime mortgages need simple transparent structures so that the idiosyncrasies arising from the riskier loans can be accounted for by investors. The sectors are still sensitive to fundamental decline, but transparent funding mechanisms have, so far, insulated the sectors from funding deficiencies that can cause disintermediation and the concomitant feedback that perpetuates cyclical economic declines.