
Continued Obstacles to Ratings, Accounting, and Valuation in MBS

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(Today's Commentary is a summary of my talking points for my May 15, 2008 presentations at the Reinsurance Association of America Current Issues Forum and the Federal Reserve Bank of Chicago Conference on Bank Structure and Competition.)

The past couple of weeks have seen the retirement of Brian Clarkson – previously hailed as the father of the modern client-centric movement with respect to bond ratings – from Moody's and the hiring of Mark Adelson – proponent of a more balanced approach – at S&P following S&P's complete withdrawal from rating closed-end second lien home mortgages. Hence, it appears that the world now recognizes the need for structured finance ratings reform.

But while the focus of and need for such reform remains constant, little has been done. Worse yet, as we learn more about practices and procedures in structured finance it becomes more apparent by the day that major accounting reforms are needed to properly evaluate not only structured finance securities, but also to make sense of the relationship between those securities and the sellers of the loans.

Perhaps worst of all, however, is that Congress' continued debates about politically unpopular homeowner bailouts continues to create volatility among MBS values, keeping spreads wide. Those continued shortcomings, with respect to ratings reform, accounting policy, and valuations, prevent the resolution of the credit crisis and continue to pose substantial risk to US economic growth.

RATINGS REFORM

By now, the cries that bond ratings are broken are old news. The characterization of ratings differences between corporate and structured finance, characterized in my May 2007 white paper, are now well-known: SF ratings are a moving target addressing skewed expected losses that generally don't recover,

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where the skewed loss distributions narrow over time with seasoning. But the situation is actually worse than that.

Virtually no structured finance pool is truly separate from its sponsor, the seller of loans into the pool. Sponsors typically have some vested interest in maintaining the pool, if only to sell into another pool tomorrow. But it gets even worse.

ACCOUNTING REFORM

Many sponsors use “removal of accounts provisions” allowed under FASB140 to repurchase delinquent or defaulted loans from existing pools. Two implications are important. First, the pool cannot survive without the sponsor’s continued existence. If a sponsor goes bankrupt and stops selling and servicing, there are no more good loans to go into the pool and the pool reverts to defeasance – meaning it runs off to the full life of the loans. Defeasance is bad because investors expected to get their money back in five years or so. While most of the loans will pay off relatively soon, some will tail off for twenty or thirty years. In the experience of the NextBank credit card portfolio, servicing will suffer and delinquencies will spike. The portfolio will take years to resolve.

Second, if the pool experiences problems it will pass those back to the sponsor (I naively used to think there was something resembling a true sale here!?!?!). Such practices maintain pool quality (in the short term) while putting the sponsor at greater risk as the sponsor accumulates increased levels of delinquent loans. Moving assets around in this fashion is classic risk shifting, which manifests itself in cliff risk: everything looks fine until the entire construct of the seller and the pool collapses.

VALUATION DIFFICULTIES

So what is Congress doing about their own regulatory role? Attempting to bail out borrowers. But what seems so noble on the face is actually wreaking havoc on MBS markets.

Valuations of MBS are simply a net present value calculation of expected cash flows. Change the expectations and you change the net present value and thus the price. Hence, to the extent that Congressional proposals can actually make a difference in individual mortgage payments and recoveries, the continuously changing expectations of what will come out of Congress create unnecessary volatility in MBS prices, widening bid-ask spreads. At the same time, volatility makes an option, including an option to sell, valuable, and low interest rates make waiting relatively inexpensive. So investors wait to sell. And wait, and wait, and wait. All the while, investors’ reluctance to sell and invest the proceeds in productive assets helps the economy slowly slide into recession.

SUMMARY

In summary, we can reform the industry now or we can reform the industry later. The decision is in regulatory and legislative policymakers’ hands. But the longer they wait, the longer they maintain the existing susceptibility to a severe economic downturn.