Credit Commentary – May 08

Доверяй, но проверяй
Doveryai, no proveryai
Trust, but Verify

By Andrew Davidson

"Trust, but Verify" was the Russian proverb used by President Ronald Reagan to describe his approach to arms control with the Soviet Union. The same standard should be used by investors in mortgage backed securities.

Trust is not the word that investors are using to describe their relationship to participants in mortgage securitization. Just about anyone and everyone involved in the process of creating loans and transforming them into securities is being blamed for the subprime crisis. The accusations are flying: Borrowers sought to make a quick buck and were over leveraged. Brokers engaged in underwriting deceptions or encouraged borrowers to do so on their applications, and earned excessive profits. Lenders ignored their own underwriting guidelines and looked the other way on fraud to boost loan volume. Dealers put together packages of loans they knew would default to gain underwriting fees. Rating agencies used models that were inaccurate so they could earn the fees from rating more deals. CDO managers put risky bonds in flawed structures to earn management fees.

Even if these accusations are not true, severe damage has been done to the reputations of all involved. Despite the damage, many are seeking to find a way to restore securitization as a viable outlet for loans. One avenue that is being traveled is the enhancement of disclosure. Some say, had there been additional disclosure, bad loans would not have been made since investors would have seen the problems; additional disclosure of borrower characteristics, broker compensation and rating agency methods would have been sufficient to alter the market.

Personally, I don't see it that way. While I am strongly in favor of additional disclosure, I do not believe that lack of disclosure was a significant cause of the subprime meltdown. (Lack of transparency, however, may have been a significant contributor to the liquidity crisis that ensued.)

Let's look at the facts. The main sources of the growing inventory of delinquent and defaulted loans were:

1. End of the bull market in home prices
2. Excessive use of piggy-back second mortgages
3. Excessive use of limited documentation loans for borrowers with poor prepayment histories
4. Excessively optimistic diversification assumptions in ABS CDOs

There was more than adequate disclosure of each of these items. For several years economists have been pointing out the divergence of home prices from median incomes. “Affordability products,” originally designed as cash management products for wealthy borrowers, were being used to bridge the gap between borrowers’ incomes and home prices. It was clear to many that home prices would not continue rising. The greatest uncertainty was whether the end of the bull market in home prices would result in flat home prices, or a decline in home prices.

Piggy-back second mortgages are an odd idea. While you might be unwilling to make a 90% loan to value (LTV) loan to a borrower with poor credit history, you would be willing to make them two loans, one with an 80% LTV and one for an additional 10%. In some cases the additional loan was for 15% or even 20%, bringing the combined LTV up to 95% or 100%. It is hard to imagine this working out well in any but the most optimistic of economic scenarios.

Limited documentation loans were a great innovation to allow homeowners with non-W2 earnings and substantial savings access to credit. However when limited documentation was extended to borrowers with poor credit and little savings, it again distorted the original intent and could only result in severe problems. Limited documentation was also a pathway to fraud. During 2005 and 2006 there was much discussion of growing levels of fraud, but there was no clamp-down on limited documentation lending.

In rating CDOs, the rating agencies use reasonably sophisticated models to determine the amount of credit enhancement required. While these models are somewhat complex and the data necessary to analyze individual deals is not readily available, the general principles and basic assumptions were generally available to investors. Mortgage-backed securities (including subprime) represent diversified pools of loans. Therefore, they are mostly subject to systematic risks (unemployment, home price declines). Combining these already diversified investments into a new pool can only marginally improve diversification. If the underlying securities are all triple B-rated, then it is likely that when one triple B-rated security takes a loss then others will as well. In fact, if the CDO was rated like a mortgage-backed security, based on the underlying loans, it would have been impossible to create a significant amount of triple A-rated securities out of triple B-rated collateral. Under the triple A-rated stress scenario virtually all of the triple B-rated cash flow would be wiped out. No additional disclosure beyond understanding the rating agencies published methodologies is required to reach this conclusion.

Additional evidence illustrates that the lack of disclosure was not the cause of the MBS/ABS meltdown. During 2005 and 2006, the market did not differentiate between issuers who provided more detailed disclosure and those who did not. Excessive trust was more likely the cause of the meltdown than insufficient disclosure.

Since the lack of disclosure was not the cause of the meltdown, by itself, disclosure, by itself, will not be the solution.

Suppose you find that your mechanic was repairing or replacing parts that were in good working order. What would you do? Ask to see the replaced parts on your next repair or find a new mechanic. If you don’t trust your mechanic, you will likely find a new mechanic. The practice of giving the customer the old part is not intended to turn a crooked mechanic into an honest one, it is a way for a good mechanic to communicate his reputation to customers, and it serves as a deterrent to the replacement of working parts. In this case, disclosure (seeing the old part) can be

used to strengthen a trust relationship, but once there is distrust, disclosure alone will not restore the relationship.

The proper functioning of markets, particularly in securitization, requires that there are trusted agents. If the investor needs to assess the quality of workmanship along the entire chain of production, then they might as well originate the loans themselves. The power of securitization is its ability to separate the origination of loans from the investment in loans. Trust is a key element in this process. It seems that trust went a bit too far. Investors trusted borrowers, brokers, lenders, bankers, rating agencies and CDO managers, and in many cases that trust was abused.

Restoring securitization first means restoring trust. It may be that the existing (remaining) players can work to restore investor confidence, or it may be that new institutions will be needed. Once trust is reestablished, then disclosure can be used as a tool to allow verification and retaining that trust.

Viewed in this way it becomes clearer what type of disclosure is necessary. Disclosure should be designed to verify that parties are acting in the investor's interest without the investor having to assume their functions and responsibilities.

1. Investors need disclosure to understand the risks that they are taking.
    a. Information about loans that affects prepayments, defaults, losses
        i. Information about borrowers' capacity to take on the debt
        ii. Information about the property
2. Investors need disclosure about loans that were made improperly
    a. Good representations and warranties
    b. Monitoring of violations of reps and warrants
    c. Enforcement of reps and warrants
3. Investors need disclosure of which agents are trustworthy
    a. Performance history
    b. Compensation schemes

While additional disclosure is useful, it won't have any effect if it is not used. Investors must use disclosures to verify that securitization is being conducted in the manner they expect. Without verification, trust is blind faith and can easily be abused.

For example, when ratings are used, investors need to understand the methodology behind the ratings. This means understanding the strengths and weaknesses of the methodology, the implicit assumptions and the extent of the analysis conducted by the rating agencies. An investment grade rating, or even a triple A-rating, is not a license to skip due diligence.

As another example, in the subprime market, issuers disclosed that a substantial portion of loans were undocumented exceptions to underwriting policy. Investors should refuse to invest in such deals until the exceptions are documented, because undocumented exceptions cannot be validated. Investors should not be required to review the underwriting data directly to determine if the exception is warranted, for that would be taking on the underwriting function. Instead they should demand a disclosure of the amount and reason for the exceptions.

Where disclosure is a substitute for trust, it will not create a fully functioning relationship. Where disclosure is an adjunct to trust, a strong relationship can blossom. Just as in nuclear disarmament, let's try "Trust, but Verify," rather than continuing to rely on "mutually assured destruction" (MAD) for the future of securitization.

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