Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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Risk Retention and Supply and Demand*

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The most fundamental concept in economics is that the supply and demand curves intersect to set the quantities of a product to be bought and sold at a particular price. It is not a moral or ethical theorem, but rather a reflection of what happens when certain conditions occur. Sometimes it reflects what you want to see and sometimes it doesn't.

Take any of a number of the new provisions that will become law following final passage of H.R. 4173. Use the risk retention provision as an example. An analysis of supply and demand will inevitably lead to a conclusion that this law will dramatically reduce the number of non-prime loans, increase the price of loans, and place more loans under the guarantee of the government — i.e., the government will bear the risk of loss on these mortgage loans.

In its pristine form, created during the early period of the economic downturn when the popular argument was that the problems in residential mortgage lending occurred because many participants in the process retained no "skin in the game," risk retention required all participants in the financial process to retain some of the risk that the loan would not perform. The theory was that such a requirement would indirectly persuade participants to ensure that only mortgages that would be repaid would be created.

To think what this leads to, consider an originator as the participant in a securitization model.

Without that retention requirement, it was argued, an originator could sell the entire loan and be indifferent to the performance of the loan. Reality was otherwise since the seller was bound by representations and warranties it had made to the buyer, but nevertheless that was the conclusion upon which policy decisions were made. There was some truth to it.

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In economic terms, the supply or demand curves can be created by plotting on the horizontal axis of a graph the quantity of a product or service that will either be supplied or demanded at every price on a scale that is plotted along the vertical axis. Linking all of those points, the supply curve will slope from lower left to upper right and the demand curve from upper left to lower right. Suppliers will be willing to offer more of a product or service and buyers will be willing to buy less of it as the price increases. A transaction occurs, therefore, where those two curves intersect, at equilibrium in economic terms. The quantity the buyer wants to sell at a price is the same as the amount the seller is willing to sell at that price.

This is just a description. It describes what happens, nothing else.

In the case of a sale of a mortgage loan, the originator might want to sell the loan at a better price than the market is offering, but unless there is something about that loan that makes it more desirable to the buyer it will be sold at the same price as other loans of comparable quality and duration. That price will have been determined by hundreds or thousands of buyers and sellers all ultimately settling on the price equilibrium point, that point where the supply and demand curves intersect.

That price would, of course, be net of the amounts it paid others in the chain for services or products it supplied to the originator. All of those services and products would have been subject to their own supply and demand curves. Similarly, the amount that the originator can charge for his loan will depend upon a variety of circumstances such as the amount of similar loans that are in the market at the same time, the demand for the loans from third parties as compared with their demand for loans with other characteristics or other financial products and services, predictions on movements in interest of buyers and sellers, the local and global cost of funds, portfolio strategies, and a variety of other circumstances.

But those will sort themselves out and will result in a price received by an originator for that loan.

Now, if H.R. 4173 requires the originator to retain some of the risk that the loan will not perform, beyond reps and warranties, what will happen? The net price the originator will receive for the sale of the loan will be reduced by the expense of the capital charge that must be retained against that risk. Capital cost money just like any other product. To the extent

capital must be held against a loan, the originator makes less money on the sale of that loan.

What has happened to our graph of the intersection of the supply and demand curves? If the price is less for all sellers, then ultimately price equilibrium will be achieved between supply and demand at a lower point on the supply curve — i.e., at a point where the quantity provided will be less than before at the same price as before. It is reasonable to assume demand won't change. The entire supply curve will shift to the left because at each price level the seller will be willing to sell fewer loans (they make less money per loan). The buyer, of course, remains less willing to pay any more per loan (the buyer has other more profitable places to spend its money). So the effect of placing a requirement on the originator to retain some share of the risk will result in fewer loans being made.

But that is not the end of the discussion. There still are potential borrowers who want mortgage loans at the right price. If an originator makes less on each loan, how will its actions be affected? Well, it still wants to make loans or otherwise it will go out of business. But the demand for its stock - the price of it staying in business in a sense - will decrease if on each dollar of capital invested the originator makes less money. To keep the public interested in investing in its company (there is a supply and demand curve for its stock, too), the originator must make some appropriate return on its capital.

To do so, it can either find loans to make that it can make more cheaply, that will not default and hence not ultimately be a charge against capital, or loans for which it can charge a higher price. In mortgage lending, a field in which competition prevents an originator from charging more than other originators for a comparable loan for any but the briefest moment, and in which most large originators already have come close to maximizing the efficiency of their production, the only possibility is to make loans that will not default, since there is a cost to default such as additional expenditure in meeting reps and warranties and charges against capital.

The loans least likely to default are probably those in which the borrower has its own equity invested to the greatest extent, borrowers who have a history of repaying loans, borrowers with sufficient net income and wealth to make the payments required, borrowers who use collateral that has a value well in excess of the size of the loan, and a variety of other similar features.

A selection of those terms and conditions eliminates some borrowers from the pool of applicants the originator will want to target; these loans will not be available for everyone. Similarly since some of the capital must now be used as a reserve, some capital is not available to make loans, and therefore the supply of loan money available to the originator drops accordingly.

The net of that is that mandating retention of risk will result in fewer loans being made, and those loans will be of a higher quality. Whether there is a profitable business in making such loans will become a strategic business question for each firm. Hurdle rates will have to be met, trends predicted, competing uses of capital considered, etc.

Assume that Congress decides that it should exempt certain loans from risk retention requirement — really safe ones made to really reliable and resource-rich borrowers. These are the really "vanilla" loans. The immediate reaction from observers is that those loans will be the only ones made. Will that be the case, and if so, why?

One immediate effect will be that the cost of the exempt loans will remain at the level they currently are. There will not be a reduction in cost for those loans, just a maintenance of the current cost. Other non-exempt loans, however, will cost the lender more since additional capital will have to be retained against the risk. Comparatively speaking, therefore, the vanilla loans will offer greater opportunities for lenders to make the necessary profit. Non-exempt loans will only offer that profit if the price lenders can charge will be high enough to take into account the additional cost of retaining the capital.

Secondary effects will also follow that will have an impact on the supply curve. Non-exempt loans will carry with them not only a higher cost, they will also carry with them a "bad" reputation — "riskier loans." Lenders who make such loans will be seen as carrying a reputation risk, and examiners as well as the public will take that into consideration in evaluating their condition.

In order to make it worthwhile to make non-exempt loans, therefore, the price that a lender needs to receive for those high-priced loans must be large enough to compensate it for those additional costs. History has shown that sometimes some lenders in comparable situations say it is not worth the risk and stop offering such loans. At a minimum, the price will increase for those

who choose to offer them — how much is hard to judge at this point, but most likely very significantly. At the present time, there is no market for the sale of such loans.

There might be an assumption by some who are generating the legislation that originators have steered consumers into higher priced loans when in fact they could qualify for vanilla loans, and that the legislation will force them to consider those borrowers for those better loans — namely the exempt ones. To the extent that is the case, then the number of loans originated will not decline by as much as feared, — i.e., the supply curve will not shift as far to the left in our model. Time will tell if that is the case, but while there may be a few consumers that might fit that model, the chances of many fitting it are slim.

Finally, if certain loans are exempt because they are government funded or guaranteed loans, such as Rural Housing loans, VA loans and FHA loans, those loans become relatively cheaper and more of them will be sold than otherwise. The government will assume more risk generally in the market than if those loans were not exempt simply because more will be sold.

This analysis does not take into account the effect of the accounting changes found in FAS 166 and 167. It is unclear what the impact on capital the operation of those standards will bring, although a statutory exemption from risk retention will likely prevent the consolidation on the originator's balance sheet that otherwise might apply.

Requiring retention of risk will lead to fewer mortgages being made, and in particular, fewer risky mortgages. Exempting certain classes of mortgages will lead to an increase, relatively speaking, in production of these classes of mortgages. To the extent government guaranteed mortgages are exempt, the government will assume more risk because more of those loans will be sold.

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