



International Centre for
Financial Regulation

ICFR Roundtable

Restarting the Securitisation Market

9 September 2010

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Background note

The loss of confidence in the US subprime market together with the resultant liquidity squeeze in August 2007 were the two key catalysts of the subsequent credit crisis, the repercussions of which are still being felt. Uncertainty on the quantity and quality of structured products on bank and investor balance sheets and the overhang of illiquid assets resulted in an almost total collapse of the securitisation market. This led to global issuance falling by 94% since 2007 levels, leveraged loan originations in the US falling by 70% in 2008 and bank lending also dropping. With the initiation of Term Asset-backed Securities Loan Facility (TALF) in the US, the government pumped a huge sum of money into those securitised assets held by the banks hoping to encourage private investors through a Public-Private Investment Partnership. In Europe, the ECB took €600 billion of such assets as collateral for its (short-term) credit to banks, with additional rescue packages from individual European governments between August 2007 and April 2009.

Some of the issues which caused the breakdown of the securitised market include¹:

- Extensive downgrades of securitised debt, when performance did not meet the rating agencies' expectations,
- Underestimation of correlation risk across securitised asset classes,
- The lack of liquidity in highly rated securities, that were "marked to model", resulted in values the market was unwilling to pay in a liquidity squeeze, thus leading to a downward price spiral and extreme uncertainty surrounding the correct valuation of these securities,
- Unequal access to information between issuers, originators, investors and rating agencies which made understanding of underlying asset values difficult,
- Usage of structures which maximised the proportion of highly rated securities,
- Distortion of incentives across all parties involved in securitisation as a result of the "originate to distribute" and "warehousing" business models.

The key concerns in the securitisation process include:

- **Complexity**² - Complexity is caused by a considerable number of key players involved and the process of creating layers of securities or "tranching" with differentiated access to cash flows from the assets. The increasing presence of complex products in the market, such as asset-backed securities (ABS)-squared (tranches of already securitised products), served as an additional difficulty in evaluating these instruments. Historically, securities were backed by simple instruments, such as home mortgages, car loans and other consumer loans.
- **Alignment of interests** - There is asymmetric information between key-players and a substantive misalignment of incentives. Originators were discouraged by bank capital rules from holding any of the subordinated or equity tranches of the transactions, which resulted in risk retention.
- **Information flow** - Investors were not fully aware of the risks in owning these securities and they could not make comparisons between tranches of different securitised products. Reputational concerns placed upon issuers seem to have failed. The question is: are new disclosure regimes now needed?

¹ European Central Bank (ECB), 2009. *Financial Stability Review*, June 2009, Available at: <http://www.ecb.int/pub/pdf/other/financialstabilityreview200906en.pdf?cb07724f637b985cbb4d36e42a9a5271> [Accessed 8 September 2010]

² Fender, I and Mitchell, J., 2009. *The future of securitisation: how to align incentives?* BIS Quarterly Review

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- **Credit Rating Agencies (CRAs)**³ - Investors and regulators had come to rely on ratings as a benchmark for credit quality, often as a substitute for doing their own credit analysis and, wrongly, as an assurance of liquidity. Weaknesses in CRAs' risk modelling were also exacerbated by the severity of the housing market downturn, limited historical data and underestimation of originator risk factors.

Given that official support programmes will soon end, the key question now is how to restart the securitisation markets and get those functioning without further government intervention. There has been a long inventory of official and private industry suggestions, some of which are listed below:

- **Tranche retention of the equity/first loss tranche** - Some proposals specify that a "vertical" slice of the securitised product must be held in contrast to a "horizontal" slice, which only ensures retention of a specific tranche. What should be the form and size of tranche retention by originators?
- **Increased transparency** - Enhanced disclosures of tranche retention policies, performance correlations with the market and other assets, illiquidity and concentration of loans. For example, the American Securitisation Forum's RESTART project, introduces new procedures for both disclosure and reporting to be submitted by issuers and servicers for new and outstanding securitisations.
- **Appropriate use of ratings** - This can be achieved through improved rating methodologies, provision of information regarding the sensitivity of model assumptions on ratings, public determination of rating agency rotation on structured transactions, public availability of all information used in rating a transaction and increased liability for rating agencies.
- Use of the "**covered bond**" model for mortgages and possibly other asset classes.

The ICFR roundtable aims to explore the above themes by following two key questions: Are the measures undertaken to date sufficient to restart the market? What else is required?

³ Ibid.

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Regulatory round-up

The Dodd-Frank Wall Street Reform and Consumer Protection Act:⁴

The Dodd-Frank Act attempts to address the problem of asset-based loan originators not adequately conducting due diligence, leading to bad loans being originated and packaged together as a whole to unsuspecting buyers. The proposals include:

- Lenders seeking to package and sell loans as ABS are now required to maintain an unhedged 5% of the credit risk of the security i.e. the 'skin in the game' provision. Low-risk mortgages that meet agency (i.e. Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac)) minimum underwriting criteria are exempt.
- Where the originator meets stricter underwriting standards, less than 5% risk retention may be required. A total or partial exemption of any securitisation may be allowed by the appropriate regulatory agencies.
- The Act may allow a total or partial exemption for the securitisation of an asset issued or guaranteed by the United States (US) government or an agency of the United States (but not including Fannie Mae, Freddie Mac or the Federal Home Loan Bank).
- The Dodd-Frank Act requires greater information disclosure, for each tranche or class of security, regarding the assets backing such a security.
- The newly created Systemic Risk Council is to conduct a study exploring the macroeconomic effects of the risk retention requirements; this report is to be presented to Congress within 180 days after the enactment of the Act.
- Federal regulatory agencies must present the regulations to Congress within 270 days of enactment of the Act.
- The Act regulates any conflicts of interest for CRAs by allowing the Securities Exchange Commission (SEC) to use its authority to prohibit or require the disclosure of, any conflicts of interest relating to the issuance of credit ratings by a ratings agency. The Act establishes a one year 'look back requirement' where the ratings agency must conduct a review to determine whether any conflicts of interest influenced the rating.
- The Dodd-Frank Act establishes an Office of Credit Ratings within the SEC, which will have authority to make rules, levy fines and penalties to a ratings agency that violates the requirements relating to credit rating regulation.

HM Treasury and the Department of Business Innovation and Skills, Consultation on "Financing a private sector recovery"⁵

⁴ Clifford Chance US LLP, 2010. *Dodd-Frank Wall Street Reform and Consumer Protection Act*, 28 June 2010, Available at: http://www.cliffordchance.com/publicationviews/publications/2010/06/dodd-frank_wall_streetreformandconsume.html [Accessed 6 September 2010] (pp. 71-78)

⁵ HM Treasury and the Department for Business Innovation & Skills, 2010. *Financing a private sector recovery*, 26 July 2010, Available at: <http://www.bis.gov.uk/assets/biscore/corporate/docs/f/10-1081-financing-private-sector-recovery.pdf> [Accessed 6 September 2010]

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- This paper considers the “range of finance options available to businesses of different sizes, and the extent to which market failures may constrain access to finance for some businesses.” (pp.5) It also considers whether there are “risks to the future provision of finance that should be addressed now, so that an appropriate range of business finance is available for viable businesses as the economy recovers.” (pp.5)
- In terms of securitisation, the government is keen for the industry to explore ways of “standardising and simplifying securitisation products to make them more attractive to investors and sustainable in the long-term” (pp.28) and whether schemes such as the TALF in the US could help support lending in the UK. The government is also interested in views about other roles it could play in developing stable securitisation markets.

Securities Exchange Commission (SEC) Proposals on Rules for Investor Protection in Asset-backed Securities:⁶

- In April of this year the SEC proposed rules intended to provide “investors with more detailed and current information about ABS and more time to make their investment decisions. The proposed rules also seek to better align the interests of issuers and investors by creating a retention or “skin in the game” requirement for certain public offerings of ABS.”⁷ At the end of August, the SEC proposed an extension⁸ of filing accommodation for static pool information required to be disclosed in the prospectus of an ABS. The SEC proposes to amend this rule to extend its application for an additional eighteen months. Under the proposed extension, the rule would apply to filings with respect to ABS’s filed on or before 30 June 2012. The deadline for comments to this proposal is 4 October 2010.

Amendments to the Capital Requirements Directive (CRD) 2 and 3:

- The CRD 2 is scheduled for implementation by the end of December 2010, while the CRD 3 is earmarked for implementation in early January 2011. The amendments to the CRD2 seek to improve risk management relating to positions in securitisation such as allowing firms to only invest in them after conducting extensive due diligence, and only permitting investments in structures where the originator retains or sponsor has retained a 5% net economic interest. The amendments in the CRD3 relate to re-securitisations and adopt higher capital provisioning for re-securitisations to reflect the higher risk of impairment. In the context of the trading book, firms with Value at Risk (VaR) model authorisation will need to apply standard securitisation charges to all securitisation positions. Firms for which standard rules apply will need to adhere to new standardised charges for securitisation positions.

⁶ SEC, 2010. *SEC proposes rules to increase investor protections in asset-backed securities*. [press release], 7 April 2010, Available at: <http://www.sec.gov/news/press/2010/2010-54.htm> [Accessed 7 September 2010]

⁷ SEC, 2010. *SEC proposes rules to increase investor protections in asset-backed securities*. [press release], 7 April 2010, Available at: <http://www.sec.gov/news/press/2010/2010-54.htm> [Accessed 7 September 2010]

⁸ SEC, 2010. *Extension of filing accommodation for static pool information in filings with respect to asset-backed securities*, 30 August 2010, Available at: <http://www.sec.gov/rules/proposed/2010/33-9137.pdf> [Accessed 7 September 2010]

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Committee of European Securities Regulator (CESR) Guidance relating to Credit Rating Agencies:⁹

- The European Union (EU) regulation on CRAs came into force in December 2009 and as a result; CRAs in the EU will need to apply for registration between 7 June and 7 September 2010 for their ratings to be used for regulatory purposes in the EU. This Guidance sets out the typical information that competent authorities would expect to receive for ongoing supervision of the registered CRA in order to assess its compliance with the provisions concerning credit rating methodologies as per the regulation. As per the Guidance, credit rating methodologies refer to criteria, models and methodological principles for a particular rating or practice.

⁹CESR, 2010. *CESR's Guidance on common standards for assessment of compliance of credit rating methodologies with the requirements set out in Article 8.3*, 30 August 2010, Available at: <http://www.cesr.eu/popup2.php?id=7116> [Accessed 7 September 2010]

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9 September 2010**Bibliography****Bank of International Settlements (2008): *Ratings in Structured Finance: What went wrong and what can be done to address shortcomings?***

- **Link to the publication:** <http://www.bis.org/publ/cgfs32.pdf?noframes=1>

The main objective of the paper is to highlight the overreliance on ratings and investor weaknesses in conducting proper due diligence of securitised products. The report outlines the errors in risk assessment that gave rise to poor ratings performance in structured finance products (severity of housing market downturn, model risk aggravated by limited historical data and CRAs' underestimating the originator risk factors). Moreover, the paper identifies some key lessons that need to be learnt from the recent episodes: "credit rating information should support, not replace, investor due diligence; CRAs should enhance the information underlying structured product ratings; better information on the key risk factors of SF ratings is needed; and CRAs should take system-wide risk into account". In addition, the paper sets out recommendations to improve investors' confidence through increasing the comparability of ratings reports within and across classes of different structured finance products and disclosure of the assumptions underlying the ratings. In conclusion, the paper notes that instead of creating a new alternative ratings scale for structured finance products, both regulators and investors agree in providing more information and additional indicators in order to improve ratings effectiveness.

IMF Global Financial Stability Report (2009): Chapter 2: *Restarting Securitisation Markets: Policy Proposals and Pitfalls*

- **Link to the publication:** <http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/chap2.pdf>

This chapter of the GFSR presents the recent problems concerning securitisation and outlines the possible policy solutions oriented towards restarting the securitisation markets. The chapter shows the positive effects of securitisation on financial stability and sustainable economic growth, but also highlights the ambiguity with current policy proposals. Proposals such as "tranche retention" aimed to align interests of issuers and investors seem to fail in many cases decreasing the incentives to monitor activity by issuers. Hence, according to the paper it is important for policy makers to give more importance to the role of credit rating agencies in the securitisation process, in order to improve disclosure and transparency of the ratings mechanism. Retention requirement policies should not be applied uniformly, but tailored according to the type of securitisation. In addition, recent accounting standards changes seem to improve the current remuneration system of arrangers (SPV) linking it to the long-term performance of securitised assets. In conclusion, policy makers should promote the simplification and standardisation of securitised products in order to improve liquidity and restart securitisation on sound principles.

IMF Global Financial Stability Report (2006): Chapter 2: *The Influence of Credit Derivative and Structured Credit Markets on Financial Stability*

- **Link to the publication:** <http://www.imf.org/external/pubs/ft/GFSR/2006/01/index.htm>

This chapter of the report reviews the growth of credit derivatives and structured credit markets, the factors influencing their growth, the way they have increasingly facilitated risk transfer and their implications for financial stability. Recent developments in securitisation, such as synthetic collateralisation, have been instrumental in opening newer markets. They have helped overcome legal and institutional frictions, which has resulted in a larger concentration of securitisation in the overall bond market and increased investor demand for these products. This chapter notes that measuring the risk transferred by these products can be difficult and that there is an ongoing debate on the best way to do this: any conclusions to this question will depend on

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details such as the seniority of the tranche and part of the capital structure that is being traded. Generally, securitisation is regarded as an efficient way to channelise capital; however, there are some financial stability and potential economic issues arising from its process. Firstly, the primary market can stifle the secondary market liquidity, especially if it mainly consists of buy-and-hold investors (i.e. insurance and pension funds). Secondly, the growing importance of credit markets in setting the marginal price of credit has important financial stability implications. In conclusion, the chapter recommends some policy initiatives aimed at better addressing and improving secondary market liquidity and mitigating operational risks.

IOSCO (2009): *Transparency of Structured Finance Products*

- **Link to the publication:**
http://www.crefc.org/uploadedFiles/CMSA_Site_Home/Government_Relations/CMSA_Issues/TALF_Treasury_Plans/IOSCOPD306.pdf?n=8317

This consultation paper examines the current debate about the provision of post-trade transparency information for structured finance products. Currently, there is no uniformity across different jurisdictions; in fact, mostly structured finance products (SFP) are exchanged in OTC markets where there is little or no post-trade transparency. There are two views about this: buy-side participants argue for the benefits of post-trade transparency, claiming that it would help them in valuing these products and at the same time increase liquidity. Sell-side participants, however, argue that post-trade transparency would imply a non-standardised, complex and illiquid nature of SFPs making price comparability impossible. In addition, sell-side participants are also concerned with the implementation costs of this regime. The Technical Committee believes that greater information would be useful for market participants though it also makes other recommendations: there should not be a uniform post-trade transparency regime; rather each jurisdiction should tailor its regime that best suits them, according to their assessment of time, scope and manner for enhancing post-trade transparency.

Joint Forum (2005): *Credit Risk Transfer*

- **Link to the publication:** <http://www.bis.org/publ/joint13.pdf?noframes=1>

The report outlines the main issues related to credit risk transfer activity and concludes with some recommendations for market participants and supervisory entities. The main issue linked to securitised products relates to the level of awareness of the risks undertaken by investors in such transactions. With regard to credit derivative transactions and their ability to achieve a clean transfer of risk, the Working Group believes that these products “achieved a relatively good record to date”; however, the presence of waterfall structures in these products complicates their understanding in comparison to credit default swaps. In particular, CDO products gave rise to some risk management issues. Firstly, tranching was able to achieve a risk profile similar to leveraged assets, even though the products did not appear to be as leveraged. Secondly, credit rating agencies failed to evaluate the full picture involved, by simply using the probability of default or expected loss based methods. In conclusion, the report lists some recommendations for market participants about various issues, such as external ratings, legal and liquidity risk and disclosure aspects.

Acharya V et al. (2010): *Regulating Wall Street: The Capital Dodd-Frank Act and the New Architecture of Global Finance* (Forthcoming)

- **Link to the publication:** <http://w4.stern.nyu.edu/blogs/regulatingwallstreet/>

This book is a collection of policy reform proposals for building a more robust financial system. **Chapter 17** tackles securitisation markets and starts out with an analysis of why securitisation failed during the credit crisis. Firstly, there were reasons associated with private markets that failed to solve perverse incentive structures: little or no “skin-in-the-game” and the role of rating agencies in the risk measurement of these

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complex products. Secondly, the collapse of the securitised market was facilitated through encouraging perverse capital provisioning incentives and the time preceding the crisis saw banks securitising assets “make an end-run around capital-adequacy regulations”, rather than to distribute. The chapter then goes on to evaluate the current proposals in the US, which include addressing risk retention and improving information flow to increase transparency to investors. However, according to the authors, whilst increasing “skin-in-the-game” may be an obvious solution, it is not all that straightforward. Mortgage lenders, for example, had enough “skin-in-the-game” due to the fact that a substantial portion of their revenue depended on mortgage servicing fees. Most importantly, the question arises as to why the private sector (securitisation firms and ABS investors) failed to enter into contracts with lenders, as a way of ensuring right incentives to screen and monitor loans. According to them, such failure will only occur if the full costs of poor quality loans are not being borne totally by the holders of ABS. Many of the players in the market have some type of implicit or explicit guarantee from the US Government, “as long as one of these guaranteed entities is active in the securitisation process – as a lender, securitiser or investor – incentives will be distorted somewhere, and potentially everywhere, down the chain.”

Altman E et al. (2010): *What Should Be Done about the Credit Rating Agencies?*

- **Link to the publication:** <http://w4.stern.nyu.edu/blogs/regulatingwallstreet/2010/04/what-should-be-done-about-the.html>

This article focuses on the role played by Credit Rating Agencies during the recent crisis, providing a brief history of these institutions in financial markets. During the 1930s, the use of ratings by investors was voluntary and bank regulators started to force banks to contemplate ratings provided by a select group of rating agencies. During the 1970s, with the creation of Nationally Recognized Statistical Rating Organisation (NRSRO), the SEC defined the requirements for the organisation, which included seven CRAs. SEC essentially acted as a barrier to entry during the last four decades, but the subsequent merger of three ratings agencies into Fitch, created a situation of oligopoly in the market (S&P – Moody’s – Fitch) and paved the way for potential conflicts of interest. In addition, during the 1970s, the relevant number of issuers did not influence the behaviour of rating agencies, which were free to ignore any single issuer’s pressure to give a better rating. In 2000, the situation changed radically: there were few issuers with large amounts of business and with increased complexity in the instruments issued. This situation fostered conflicts of interest between issuers and rating agencies with the subsequent subprime residential mortgage crisis taking place due to the excessively optimistic ratings on mortgage-related securities. The article concludes, by highlighting, three proposals for regulators: eliminate regulatory reliance on ratings, increase information along ratings grades and reduce potential conflicts of interests.

Ashcraft A and Schuermann T (2008): *Understanding the Securitisation of Subprime Mortgage Credit*

- **Link to the publication:** <http://ideas.repec.org/p/fip/fednsr/318.html>

This paper provides an overview on several topics: the subprime securitisation process, the seven key informational frictions that arise and discusses the ways in which market participants work to minimise these frictions and speculate on how this process broke down. According to the authors there are five key frictions that caused the subprime mortgage breakdown: (i) frictions between mortgagor and originator leading to excessive borrowing and lending, (ii) principal-agent problem between investor and asset manager, because there was no distinction between structured and corporate credit ratings, (iii) friction between the arranger and the asset manager because of due diligence incentives for the arranger were reduced, (iv) frictions between the originator and the arranger providing incentives for predatory lending and (v) friction between investors and rating agencies, due to the fact investors did not assess the efficacy of rating agency models. The paper then goes on to describe the different aspects of the subprime mortgage process, such as performance and valuation, after which it provides an overview of the credit ratings process. In conclusion, the paper states that many of the issues and frictions are generic to the securitisation process and reforms should focus on

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giving investors incentives for due diligence, improving risk retention and aligning incentives of investors and investment managers.

Deutsch T and Seid K (2009): *Path to Recovery for Residential Mortgage Bonds* American Securitisation Forum (ASF)

- **Link to the publication:** <http://www.americansecuritisation.com/uploadedfiles/ProjectRestart.pdf>

Following the recent credit crisis in the US residential mortgage market, the American Securitisation Forum (ASF) announced the launch of the RESTART project which aims to improve the process of securitisation. In particular, recommendations are aimed at persuading institutional investors to commit capital to the securitisation market, increasing the supply and lowering the cost of mortgages within consumer credit in the US. Another initiative is the Residential Mortgage Backed Securities (RMBS) Reporting Package that would allow investors to compare updated data files across issuers.

BIS Quarterly Review (September 2009): Fender I and Mitchell J: *The Future of Securitisation: How to Align Incentives?*

- **Link to the publication:** http://www.bis.org/publ/qtrpdf/r_qt0909e.pdf?noframes=1

This article outlines the reasons for the halt of the securitisation markets and presents possible measures in order to restart it. The principal aim for governments is to rebuild confidence in light of general investor mistrust of securitisation and to strengthen underwriting standards for securitised products. After detailing the process of securitisation and the key players involved, the paper identifies three main structural weaknesses: complexity, transparency and credit ratings. For each of the issues, the author sets out proposals to solve these shortcomings. In particular, there is a need to reduce complexity in these markets, to set stricter capital requirements for resecuritisations (CDO's squared) and to promote simpler and standardised products. With regard to transparency, governments have started to undertake measures to improve the quality and the speed of information by using standardised disclosure packages. Finally, improving the use of ratings by requiring credit rating agencies to provide additional information related to the credit rating process. In conclusion, the author presents three models to test the efficacy of tranche retention through vertical, equity and mezzanine tranches. The empirical test shows that equity retention applied equally, appears to be ineffective, therefore, alternative measures are presented (the so called "vertical slice").

Franke G and Krahen JP (2008): *The Future of Securitisation*

- **Link to the publication:** http://www.ifk-cfs.de/fileadmin/downloads/publications/wp/08_31.pdf

This paper demonstrates that, of all the possible reasons for the halt of the securitisation markets, the misalignment of interests of the key players could be considered as the main one. The problem of illiquidity of the markets is a consequence of the "ill-designed mechanisms of coordinating financial intermediaries and investors". For this reason, the author asserts that the best way to solve the problem is to rebuild a comprehensive incentive alignment system. Transparency plays an important role in achieving this aim. The publication outlines several regulatory measures. For example, the equity piece allocation must be publicly known, managers' compensation schemes need to be linked to long term incentives and the information of agency ratings for securitisation tranches has to be validated by independent institutions, such as supervisory bodies and auditors. These measures seem to be softer than the regulatory proposals currently debated, however, according to the author these proposals are too ambitious and, in some cases, can worsen market functionalities due to the lack of empirical research (i.e. the imposition of a fixed percentage of tranche retention).

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9 September 2010**Goldman Sachs (2009): *Effective Regulation: Part 3 Helping Restore Transparency***

- **Link to the publication:** <http://www2.goldmansachs.com/ideas/public-policy/3-regulatory-reform/effective-regulation-part-3.pdf>

In this paper, several proposals are presented in order to improve global transparency through the implementation of strict controls and restrictions. During the recent crisis, problems arose from the transfer of risk within the same financial holding company to subsidiaries, where accounting and regulatory regimes were favourable and weak. This does not reduce complexity but creates difficulties in evaluating the financial health of the holding company. Through the analysis of case study topics: spanning accounting, capital and ratings arbitrages, the paper proposes restriction of risk transfer between affiliates requiring risk to flow to the investment bank, by subjecting assets to full mark-to-market accounting. Regarding securitisation markets, “securitised loans must face the same capital requirements as the underlying loans would face if they were held on financial institutions’ balance sheets”. In addition, companies should organise themselves by creating two separate entities (Lending bank and Investment bank), which would help investors in assessing the health and profitability of financial institutions. The paper concludes, by highlighting, that the rules which encourage complexity or arbitrage should be restricted and markets should be able to provide a certain level of clarity and transparency.

Neville L (2008): *Can the UK Restore its Bulldog Reputation?* American Securitisation Forum (ASF)

- **Link to the publication:** <http://www.americansecuritisation.com/uploadedFiles/BulldogImage.pdf>

The article describes the current state of the mortgage-backed securities market in the UK, after the collapse of Northern Rock. The UK, whilst previously, a leader in this market and responsible for more than half of the mortgage bond volumes, is now trying to rehabilitate the mortgage-backed securities market. In particular, the UK government announced plans for restoring confidence between MBS investors, with the official grading of residential mortgages. The government aimed to push for better disclosure of the quality of the underlying assets and to increase documentation and reporting requirements. However, these aims seem to be excessively broad and time is needed in order to properly assess any changes.

O’Hara N and Currie A (2009): *Securitisation’s \$8.7 Trillion Challenge* American Securitisation Forum (ASF)

- **Link to the publication:** <http://www.americansecuritisation.com/uploadedfiles/WhitherABS.pdf>

The prelude to this publication rightly sums up the pertinent questions: “How does a market that is carrying the can for the credit crisis get back on its feet? Improving transparency and strengthening standards are crucial. [...] It ought to help restore confidence in securitisation’s ability to reclaim its role as a key – and legitimate – financing tool for consumers and businesses worldwide.” The article discusses the impediments to the revival of the securitisation market, which include: the risk from mandatory retention requirements, over-supply of distressed assets forcing a decline in prices, bid-offer spreads that are very wide and the need for a better pricing mechanism for securities that are seldom traded. In addressing all of these issues, the article casts some light on what went wrong during the crisis and calls for initiatives that encourage better due-diligence, better disclosure and greater transparency. For example, the Global Joint Initiative (GJI) aims to restore confidence in the securitisation markets, which is a collaboration between SIFMA, the ASF, the ESF and the Australian Securitisation Forum.

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- **Link to the publication:** <http://www.princeton.edu/~hsshin/www/securitisation.pdf>
- **Link to the publication:** <http://www.voxeu.org/index.php?q=node/3287>

The paper begins with some background on securitisation and then goes on to construct an accounting framework of the financial system as a network of inter-linked balance sheets. The idea is that the accounting framework helps to construct a model, which in turn, depicts a boom in lending fuelled by declines in measured risks. The author argues that securitisation, which was meant to disperse risk, actually worked to concentrate risks in the financial sector. The reason, according to this paper, is that banks wanted to increase short-term gains by taking on more leverage. The paper presents a description of what went wrong by discrediting the old view that securitisation works primarily to transfer credit risk. The new conventional wisdom is that securitisation simply involved the passing of bad loans down the securitisation chain. However, according to this paper, both forms of wisdom are wrong as they fail to differentiate between the passing of the “hot potato” and issuing of liabilities backed by bad loans. The latter is an illustration of what happened during the crisis, which affected not only the investors of these products, but also the leveraged issuers. Hence, the author suggests that securitisation should be viewed in the larger context of balance sheet management by banks. The paper concludes with a discussion on the implications for financial stability.

Speeches**Greenspan A (2005):** *Risk Transfer and Financial Stability*

- **Link to the publication:**
<http://www.federalreserve.gov/boarddocs/speeches/2005/20050505/default.ht>

Here, the speaker indicates some concern about the risks posed by the use of derivatives. The speech is divided into three parts: risk implications from the concentration in certain derivatives markets (OTC markets for US dollar interest rate options), the use of credit derivatives to transfer risk and the growing role of hedge funds in bearing risk in derivatives markets. Concerning the use of credit derivatives to transfer risk, the speaker presents the benefits from the use of collateralised debt obligations (CDOs) for banking stability, especially for largest banks, in order to manage credit risk more efficiently. However, some critics have noted that the use of credit derivatives can create concentrations of risk outside the banking system, representing a threat to financial stability. In some cases, CDOs can represent a challenge for market participants in understanding their risk profile. The speaker concludes that prudential regulation can be supplied by the market itself, through counterparty evaluation and monitoring, rather than by authorities.

González-Páramo JM (2010): *Re-starting Securitisation* Keynote Speech at Association for Financial Markets in Europe/ESF and Information Management Network Global ABS 2010 Conference

- **Link to the publication:** <http://www.ecb.int/press/key/date/2010/html/sp100616.en.html>

The speech begins by outlining the role in which securitisation should play in the financial system and why this role is important. It then assesses in more detail the current situation of the securitisation markets. It concludes by laying down some considerations on restarting of the ABS markets. In doing so, the speaker assesses what has been done so far and what still needs to be done to reach a sustained rebound of the securitisation markets. In addressing the issue of restarting securitisation, the speaker identifies that the structured credit markets remain dysfunctional in the EU, mainly for demand side related reasons, which has implications for the supply side: “The profit generating potential of securitisation remains insufficient, since spreads for various ABS still exceed the break-even levels from the issuer’s perspective. At the current levels of spreads, securitisation does not make economic sense for originators in most cases.” In conclusion, the speech

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calls for the need of transparency, standardisation and product simplicity in order to restore investor confidence.

Tucker P (2010): *Shadow banking, Financing markets and Financial Stability*

- **Link to the publication:**
<http://www.bankofengland.co.uk/publications/speeches/2010/speech420.pdf>

This speech provides an illuminating discussion about the workings of finance companies, structured investment vehicles and Asset Backed Commercial Paper market. It goes on to discuss how the RMBS/ABS market can combine with repo funding, to create investment structures, whose leverage and liquidity risk creates some of the brittleness of banking systems. The speech also analyses the link between RMBS markets, repo financing and shadow banking. It outlines some of the lessons to be learnt from the credit crisis, such as improved transparency through simpler standards and the need to be informed about the nature and extent of risks retained by the originators. In conclusion, the speaker stresses the need for policies and principles, in order to ensure the resilience of the system and healthy intermediation channels.

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