



International Centre for
Financial Regulation

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Regulation without Borders - G20 Ideals and National Interests

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Session Bibliographies

Restarting the Securitisation Market

9 November 2010**11:00 – 12:30****Restarting the Securitisation Market**

“The BCBS and authorities should take forward work on improving incentives for risk management of securitisation, including considering due diligence and quantitative retention requirements by 2010. Securitisation sponsors or originators should retain a part of the risk of the underlying assets, thus encouraging them to act prudently.” – G20 London, Washington and Pittsburgh, July 2010

The G20 called for reformation of the securitisation market. However, a durable recovery will depend on a consistent supply of consumer and industrial lending which will be difficult without some form of securitisation. This session will focus on the necessary steps required to get this market re-started.

Session Background and Points for Consideration

Loss of confidence in the US subprime market and the resultant liquidity squeeze in August 2007 was a key catalyst of the subsequent credit crisis, the repercussions of which are still being felt. Uncertainty on the quantity and quality of structured products in bank and investor balance sheets and the overhang of illiquid assets resulted in an almost total collapse of the securitisation market, with global issuance falling by 94% since 2007 levels. With the initiation of TARP 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 accepted as collateral €600 billion of such assets on short term repo contracts, with additional rescue packages from individual European governments between August 2007 and April 2009.

Some of the contributors to the breakdown of the securitised market included¹:

- 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 'marked to model' at values the market was unwilling to pay in a liquidity squeeze, 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,
- Perceived conflicts of interest where structures maximised the share of highly rated securities, and
- A breakdown in the identity of interests across all parties to securitised transactions as a result of the 'originate to distribute' and 'warehousing' business models.

The key concerns in the securitisation process include:

- Complexity
- Alignment of interests
- Asymmetric information flow
- The role of Credit Rating Agencies (CRAs)

Whether that support remains necessary or whether it kept assets from reprising to a level when securitisation becomes economically viable again. These plus other subjects will be discussed.

¹ European Central Bank, "Financial Stability Review" June 2009

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Topics for discussion:

- 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?
- What initiatives could the industry develop to increase the transparency and liquidity of the securitisation markets?
- Increased transparency through enhanced disclosure regarding 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, which introduces new procedures for disclosure and reporting by issuers and servicers for both new and outstanding securitisations.
- Public sector determination of rating agency rotation on structured transactions.
- Alternative liquidity programs as another option to wean the market off ECB funding.
- Appropriate use of ratings including improved rating methodologies, provision of information regarding the sensitivity of model assumptions on ratings, and more conservative estimates of key parameters (such as probabilities of default, recovery rates and default correlations).
- Increased liability for rating agencies.

This session proposes to explore the following themes two key questions:

- Are measures undertaken to date sufficient to restart the market?
- What else is needed?

Bibliography:

The ICFR has prepared a core bibliography on works relating to reform of financial regulation. Many of the works in that bibliography have sections relevant to this topic.

ICFR Roundtable on Restarting Securitisation:

- **Link to the summary of the roundtable:** <http://www.icffr.org/getdoc/1272afec-d6c5-49fe-923c-39f44fbab115/Restarting-the-Securitisation-Market-Roundtable-Se.aspx>

Association for Financial Markets in Europe (AFME) (2010): *Prevention and Cure: Securing Financial Stability After the Crisis*

- **Link to publication:** <http://www.afme.eu/document.aspx?id=4328>

In September the AFME published some new proposals to secure financial stability. The report considers progress made in reforming financial regulation since the 2008 crisis and proposes ideas for further steps that could be taken specifically to reduce systemic risk and to avoid taxpayers being called upon to support failed financial institutions in the future. Furthermore, in the light of concerns about transparency and volatility in the markets, it reviews the various options for making them more efficient and reducing risk without stifling the fundamental need to trade.

Bank of International Settlements (BIS) (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 have provoked the 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 spots some key lessons that need to be learned 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"². In addition, the paper sets out recommendations to improve investors' confidence through increasing the comparability of rating 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 rating scale for structured finance products, both regulators and investors agree in providing more information and additional indicators in order to improve the ratings effectiveness.

International Monetary Fund (IMF) (2009): *Restarting Securitisation Markets: Policy Proposals and Pitfalls*

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

² Quotations in all the summaries are from the works summarised

This paper presents the recent problems with the securitisation and outlines the possible policy solutions oriented to restart 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 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 boost for the simplification and standardisation of securitised product in order to improve liquidity and restart securitisation on sound principles.

International Organisation of Securities Commissions (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 but mainly structured finance products (SFP) are exchanged in OTC markets where there is little or no post-trade transparency information. Therefore 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 increasing at the same time liquidity whereas sell-side participants argue that post-trade transparency would imply a non-standardised, complex and illiquid nature of SFPs making price comparability impossible. In addition, they are also concerned about the implementation costs of this regime. The Technical Committee believes that greater information would be useful for market participants but it also makes other recommendations. There should not be a uniform post-trade transparency regime but each jurisdiction should tailor its best regime according to its assessment on 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. 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”. Another issue linked to credit risk transfer are the legal uncertainties surrounding the transaction. The last question raised by the Working Group is whether these transactions are able to transfer a large portion of credit risk. The main issue linked to securitised products relates to the level of awareness about risks undertaken by investors in such transactions. The presence of waterfall structures in these products makes more complicated their understanding (comparing to the credit default swaps). In particular CDO products provoked some risk management issues. In the first instance tranching was able to achieve a risk profile similar to leveraged assets even if the products apparently look not leveraged and the underlying portfolio well-diversified. Secondly, credit rating agencies failed to evaluate the full picture involved using just 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 risk, and liquidity risk and disclosure aspects.

United States Treasury (2010): *Best Practices for Residential Covered Bonds*

- **Link to the publication:** <http://www.ustreas.gov/press/releases/reports/USCoveredBondBestPractices.pdf>

The US treasury issued this paper following the release of the Federal Deposit Insurance Corporation policy statement, stating the imminent expansion of the US market of covered bonds. The document was prepared “in order to encourage the growth of the covered bond market in the United States” and “to represent a standardised model for covered bonds issued in the United States in the absence of dedicated legislation”.

The paper lists some requirements adding to the ones listed by the FDIC that bonds must conform to; among others that mortgages must be current when added to the pool, their maximum loan-to-value and covered bonds should be issued only by well capitalised institutions. The other requirements cover topics such as acceleration of covered bonds, the regularity of the “asset coverage test” and “over-collateralisation”.

Other Publications:**Acharya V et al. (2010): *Regulating Wall Street, Chapter 17***

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

As the title of the book suggests 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 due to the 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 complex products. Secondly, the collapse of the securitised market was facilitated through encouraging perverse capital provisioning incentives; the time preceding the crisis saw banks securitising assets not to distribute but to “make an end-run around capital-adequacy regulations”. It then goes on to evaluate the current proposals in the US to address risk retention and to improve information flow to increase transparency to investors. However according to the authors as increasing skin-in-the-game may be an obvious solution they contend it is not all that straightforward. Mortgage lenders had enough skin-in-the-game as a substantial portion of their revenue depends 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 to ensure they had 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 that these loans back as many of the payers 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 '70s the SEC with the creation of NRSRO – Nationally Recognised Statistical Rating Organisation – defined the requirements including in this category seven CRAs. SEC essentially acted as a barrier to entry during the last four decades and the subsequent merger of three ratings agencies into Fitch created a situation of oligopoly in the market (S&P – Moody's – Fitch) underlying the potential conflict of

interest. In addition, during the '70s the relevant number of issuers did not influence the behaviour of rating agencies which were free to ignore any single issuer's pressure for a better rating. In 2000 the situation changed radically: there were few issuers with large amount of business and increased complexity in the instruments issued. This situation fostered conflicts of interest between issuers and rating agencies with the subsequent subprime residential mortgage crisis due to the excessively optimistic ratings on mortgage-related securities. The article concludes highlighting three aims for regulators: eliminate regulatory reliance on ratings, increase information along rating grades and reduce potential conflicts of interests.

Ashcraft A and Schuermann T (2008): *Understanding the securitization of subprime mortgage credit*

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

This paper provides an overview of the subprime securitisation process and 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 due diligence incentives for the arranger are reduced, (iv) frictions between the originator and the arranger providing incentives for predatory lending and (v) friction between investors and rating agencies because investors did not assess the efficacy of rating agency models. The paper then goes on to describe the different aspects of the sub-prime mortgage process such as performance and valuation, after which it provides an overview of the credit rating process. In conclusion, the paper states that many of the issues and frictions are generic to the securitisation process and reforms should focus on giving investors incentives for due diligence, improving risk retention, and align the incentives of investors and investment managers.

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

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

Following the recent credit crisis on the U.S. residential mortgage market, the American Securitisation Forum (ASF) announced the launch of the RESTART project which is aimed to improve the process of securitisation. In particular recommendations are aimed at persuading institutional investors to commit capital to the securitisation market again, increasing the supply and lower the cost of mortgage in consumer credit in the U.S. Another initiative is the RMBS Reporting Package that would allow investors to compare updated data files across issuers. In order to evaluate Project RESTART's achievements, the ASF has established a standing committee of the ASF directors for the purpose of updating data and the related market standards.

Fender I and Mitchell J (2009): *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 securitisation markets and presents possible measures in order to restart it. The principal aim for governments is to rebuild confidence in the light of general investor mistrust of securitisation and to strengthen underwriting standards for securitised products. After presenting the securitisation process and the key players involved, the paper identifies three main structural weaknesses which are complexity, transparency and credit ratings. For each of 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 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. Another important measure is to improve 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. 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 Krahn 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 of the halt of the securitisation markets, the misalignment of interest of the key players can be considered to be the main one. The problem of illiquidity of the market is a consequence of the “ill-designed mechanisms of coordinating financial intermediaries and investors”. For that 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 and the author outlines several regulatory measures. For example 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 but according to the author those 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).

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

- **Link to the publication:** <http://www.americansecuritization.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.” This 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 prices lower, 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 draws 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) to restore confidence in the securitisation markets – collaboration by SIFMA, the ASF, the ESF and the Australian Securitisation Forum.

Shin HS (2009): *Securitisation and Financial Stability*

- **Link to the publication:** <http://www.princeton.edu/~hsshin/www/securitisation.pdf>

In this paper 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 involved basically passing on bad loans i.e. the “hot potato” down the securitisation chain. But according to this paper both forms of the wisdom are wrong as they fail to differentiate between passing on the “hot potato” and issuing liabilities backed by bad loans. The latter is 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 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 using

which it models a lending boom fuelled by declines in measured risks. The paper concludes with a discussion on implications for financial stability.

South A and Bugie S (2010): *Securitisation's Role in Mortgage Funding Remains Uncertain*

- **Link to Publication:** <http://www2.standardandpoors.com/spf/pdf/media/SP-Quarterly-Autumn-2010.pdf>

This article sets out to examine the possible effects a withdrawal of “government and central bank support” programs would have on residential mortgage-backed securities (RMBS), by illustrating how important residential mortgage funding is to the overall sustainability of them and their prominence in European markets. There has been an apparent shift recently; rather than traditional investors it seems central banks have become the primary investors using RMBS as “collateral for loans.” The result of this potential withdrawal and shift in RMBS users could mean “mortgage credit could become more “constrained or more expensive” especially considering the reluctance of traditional investors to re-enter the RMBS market.

Speeches:

Greenspan A (2005): *Risk Transfer and Financial Stability*, delivered at the Federal Reserve Bank of Chicago's Forty-first Annual Conference on Bank Structure, Chicago, Illinois

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

In this speech the by then chairman of the Federal Reserve of the United States 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. On the other hand 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*, delivered 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>

In this speech the Member of the Executive Board of the ECB first outlines the role 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. Lastly, it lays down some considerations on the way forward for the restarting of ABS markets. In doing so, the speaker assesses what has been done and what still needs to be done to reach a sustained rebound of the securitisation markets. In addressing the issue of re-starting securitisation the speaker identifies that the structured credit markets remain dysfunctional in the EU mainly for demand-side related reasons, and this 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 calls for the need for transparency, standardisation and product simplicity in order to restore investor confidence.

Tucker P (2010): *Shadow banking, Financing markets and Financial Stability*, delivered at a BGC Partners Seminar, London

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

In this speech by the Deputy Governor for Financial Stability of the Bank of England, provides an illuminating discussion about the workings of finance companies, structured investment vehicles and Asset Backed Commercial Paper market and 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. It then goes onto analyse the link between RMBS markets, repo financing and shadow banking outlining some lessons to be learnt from the credit crisis such as improved transparency by using simpler standards, and the need to be informed about the nature and extent of risks retained by the originators. In conclusion, it stresses the need for policies and principles to ensure the resilience of the system so that intermediation channels remain healthy.

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