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Reviving the securitisation and structured debt market

The causes of the credit crunch are well rehearsed. It is clear that no-one wanted to be the regulator or politician who called time on the boom that was fuelled by mortgage and consumer debt. Once the party was over, it fell to Western governments to exhort their national banks to lend to creditworthy businesses and consumers. However, the result was a dearth of lending owing to a combination of battered balance sheets that were still hung over with distressed assets originated at the height of the bubble and a temporary lack of liquidity caused by the drying up of the wholesale markets.

In this climate, central banks have become, somewhat unwillingly, the most significant investors in asset-backed securities (ABS). European banks have placed billions of Euros of asset-backed securities collateral with the European Central Bank (ECB). The Bank of England has also provided UK banks with liquidity that has been backed by ABS through first the Special Liquidity Scheme and subsequently the Discount Window Facility. No wonder then that central banks are keen to find real investors to refinance these assets and even to use securitisation to exit the positions they have been forced to acquire themselves.

Despite the financial crisis giving rise to much soul-searching about whether the legal model of tranching assets and distributing them to other market participants has any useful economic function, one consistent theme throughout 2009 and 2010 has been the clear support by national governments, regulators and supra-national bodies for the re-emergence of a functioning securitisation market.

José Manuel González-Páramo, member of the executive board at the ECB, stated in an interview in January 2010: "Securitisation markets provide an important source of additional funding for banks. They also allow banks to transfer risk, optimise their balance sheet structures and use capital in a potentially more efficient way. If done correctly, under the right market conditions and in compliance with the regulatory framework, the benefits of securitisation can be passed on to borrowers in the form of lower borrowing costs."[1] For industry participants, González-Páramo's statement perfectly encapsulates the role of securitisation as a prerequisite for a sustained recovery and the availability of credit to the wider economy.

However, it is clear that regulators and politicians see some room for improvement; more recently on the other side of the Atlantic, Federal Deposit Insurance Corporation (FDIC) Chairman Sheila Bair stated on 27 September 2010: "We want the securitization market to come back, but in a way that is characterized by strong disclosure requirements for investors, good loan quality, accurate documentation, better oversight of servicers, and incentives to assure that assets are managed in a way that maximizes value for investors as a whole."[2]

Encouraging signs in public issuance

A renewed appetite for securitisation led to a trickle of deals flowing into the public market in the latter part of 2009 after a two-year hiatus in public issuance. This was followed by an encouraging level of issuance in the first half of 2010, emanating primarily from consumer assets such as residential mortgages, auto loans and credit cards, and, following the European sovereign crisis in the early summer, a considerable number of deals came to market in September 2010 which augurs well for a healthy level of issuance for the remainder of 2010. Although contagion fears caused significant mark-to-market losses on European ABS because of a period of forced selling and illiquidity, it is instructive to note that, for example, there has been no principal loss to AAA investors in UK residential mortgage-backed securities (RMBS) transactions to date.

The need to revive the securitisation market in a sustainable way that addresses the investor concerns that emerged during the financial crisis has given rise to various regulatory initiatives

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[1] Remarks by José Manuel González-Páramo, a member of the executive board at the ECB, in an interview with Credit dated 22 January 2010. *http:www.risk.net/credit/news/1588142/transparency-key-securitisation-revival-ecb-s-gonz-lez-p-ramo*

[2] Remarks by Sheila C. Bair, FDIC Chairman, in a press release from FDIC, dated 27 September 2010, entitled *"FDIC Board approves Final Rule regarding Safe Harbor Protection for Securitizations".*

in Europe and in the USA. The future of the securitisation market depends on the success of these initiatives. It is therefore crucial to analyse and understand their likely impact and to evaluate other practical steps that can be taken by market participants to continue to restore confidence in the product, particularly at the origination stage. Reform of securitisation structures are doomed to failure unless investors are confident they understand and want to invest in the underlying collateral.

Proposed Fixes

The proposed cures for perceived weaknesses in the pre-credit crunch model of securitisation fall into three main categories:

- aligning the interests of originators and investors through the so-called 'skin in the game' retention requirements
- permitting investors to assess and analyse risk properly through enhanced due diligence, increased transparency and a slower offering process
- reducing over-reliance by investors on credit ratings and regulating the perceived conflicts of interest associated with the 'issuer pays' rating agency business model.

One of the main amendments to the Capital Requirements Directive (CRD) is set out in new Article 122a which requires the originator or sponsor to disclose that it retains (on an ongoing basis) a five per cent net economic interest in the underlying assets. As the increased regulatory capital charge penalty for non-compliance bites on investors that are European Union (EU) credit institutions, the requirements to retain 'skin in the game' will bind any originator wishing to sell to European bank investors (likely to be the largest

European investor base), thereby creating a level playing field which does not apply solely to European originators. Similar retention proposals are set out in the amendments to Regulation AB put forward by the Securities and Exchange Commission (SEC) as well as the proposed FDIC rule and these may be adopted by other international regulators.

It remains to be seen whether compliance with the retention requirements will align the interests of originators with those of investors and consequently improve the quality of underlying assets. Although many existing European securitisations already comply with the new requirements, they will deter transactions in which sponsors have acquired portfolios of mortgages, sub-prime or otherwise, as the sponsors will no longer be able to distribute the entire portfolio to the market through securitisation and also comply with Article 122a.

Another aim of a large portion of the new and proposed regulations is to ensure that investors perform their own credit analysis of the assets underlying the securities. Article 122a includes fairly onerous investor diligence requirements to put in place formal policies and procedures to analyse issues such as the risk characteristics of the securitisation position and the underlying exposures; the reputation and loss experience in other securitisations of the originator in the relevant asset class; the level of due diligence conducted on the portfolio and the structural features of the transaction.

The sanction for non-compliance by the investor will be penal capital charges – in many cases this is effectively a deduction from capital. There is a danger that the risk of inadvertent non-compliance will discourage investment altogether. Further guidance is needed from national regulators in implementing the CRD to allay such concerns as far as possible. The Commission of European Banking Supervisors (CEBS) is expected to publish a set of detailed guidelines on Article 122a of the CRD on 31 October 2010. A draft of the guidelines was sent to market participants for consultation in July 2010. Although the draft guidelines do clarify some aspects of the legislation, further clarification will be required before a practical path to compliance becomes

clear. Crucially, the draft guidelines suggest investors will not be penalised where originators are negligent in initial or ongoing compliance with the requirement to retain a net economic interest in the securities. For a detailed analysis of the consultation paper please see our client briefing *CEBS Guidelines on CRD Article 122a – Lifting the regulatory fog part 2.*

Although regulators are keen to improve origination procedures through retention requirements and wean investors off a perceived over-reliance on credit ratings by stipulating enhanced investor due diligence, European legislators appear to have decided that some products are too complex for investors to understand and these are effectively penalised under the proposed amendments to the CRD. Transactions that fall within the ambit of 'resecuritisation' will attract approximately double the capital charge which applies to a normal securitisation position. These measures are designed to avoid the re-emergence of a market in securitisations of tranches of other asset-backed securities known as CDO^2 or CDO^3 which proved to be extremely difficult to price and created systemic problems for many institutions.

While few market participants would advocate a return to the levels of 'slicing and dicing' or tranching of assets that took place in the collateralized debt obligations (CDO) market before the financial crisis, some have sought comfort in recent months from national regulators to ensure that economically benign transactions such as certain dual-SPV (special purpose vehicle) structures or certain commercial paper conduit trades are not inadvertently caught within the ambit of the resecuritisation regime. The consultation paper on the CEBS guidelines relating to CRD Article 122a helpfully uses the example of a dual-SPV structure to illustrate instances where "the substance of the transaction is not that of a resecuritisation", giving market participants comfort that the intention is not to capture such transactions within the definition of resecuritisation.

Comfort has also been obtained in relation to commercial paper transactions in the Financial Services Authority (FSA) CP09/29 consultation paper in December 2009 entitled *Strengthening Capital Standards 3* and in the FSA's response to feedback on its consultation paper set out in CP10/17 which was issued in July 2010. In this paper the FSA explains that "investors in commercial paper issued by an ABCP programme will not generally be considered a resecuritisation position provided the conduit funds itself entirely with a single class of paper and either of the following conditions are met: (i) the paper is fully supported by the sponsoring bank (i.e. where the sponsor provides support to an extent that leaves the CP effectively exposed to the default of the sponsor, instead of the underlying pools or assets) so that the external rating of the CP was based primarily on the credit quality of the bank sponsor; or (ii) the programme-wide credit enhancement is not a resecuritisation".

In addition to the above, there are several different initiatives which seek to increase transparency and to promote better understanding, particularly in relation to the underlying assets. These initiatives stem from a combination of market-driven efforts from industry bodies such as the Association for Financial Markets in Europe/European Securitisation Forum (AFME/ESF), legislation, and central bank practice. Among these initiatives is a consultation launched in December 2009 by the ECB on loan-by-loan information requirements for asset-backed securities in the Eurosystem collateral framework.

The ECB is looking at developing a form of standardised loan-level reporting template for RMBS. The aim is to increase the level of loan-by-loan data that will be made available to investors and other market participants in a uniform format through central data portals. The ECB intends to extend the template to other asset classes over time. Given the significance of ensuring that transactions meet the ECB's eligibility criteria for originators and investors alike, and the broadly positive feedback the consultation has received, it is to be expected that this initiative will be widely adopted.

On a similar theme, the Bank of England published a consultation paper in March 2010 on proposed enhanced disclosure requirements for all forms of asset-backed securities and covered bonds that are accepted by the Bank in its operations, including the extended-collateral long-term repo operations, the Special Liquidity Scheme (while it remains outstanding) and the Discount Window Facility.

The Bank of England expects that increased disclosure will apply publicly to all transactions and will therefore increase market transparency. The consultation paper specifically includes:

- provision of loan-level data and inclusion of certain stratification tables in investor reports
- availability of cash flow models
- availability of legal documentation and summary of structural features
- provision of monthly investor reports (including disclosure of mark-to-market of swaps, account balances and permitted investments).

To complete the picture, on 7 April 2010 the SEC published sweeping and detailed proposals to update and

expand the regulation of asset-backed securities in both public and private markets in the USA. If the proposals in the SEC regulatory statement (ABS Release) are implemented, they will have a very significant impact on domestic US transactions and on overseas issuers and underwriters seeking to access the US market, including for private transactions under Rule 144A and Regulation D of the Securities Act of 1933.

Although the ABS Release contains certain requirements which mirror the ECB and the Bank of England initiatives, such as the provision of asset-level data for a range of different asset classes, it also goes further – for the first time disclosure in Rule 144A transactions will be effectively regulated by the SEC.

One of the proposed requirements is that the provision of asset-level data should be accompanied by a computer program that allows investors to perform stress tests on portfolio cash flows so that they can make their own assessment of the ability of the cash flows to service the debt in a range of scenarios.

On 27 September 2010, the FDIC confirmed an extension to the Safe Harbor Protection for Treatment by the FDIC as receiver of financial assets transferred by a US bank by securitisation until 31 December 2010. The safe harbour, which has been in place since 2000, provides important protections for securitisations by confirming that in the event of bank failure, the FDIC would not try to reclaim loans transferred into such transaction so long as an accounting sale had occurred.

Following changes to the relevant accounting standards in June 2009, most securitisations no longer meet off-balance sheet standards for sale accounting treatment and therefore do not comply with the preconditions for the existing safe harbour.

Following expiry of the extended Safe Harbor, the FDIC's new safe harbour will come into effect. It will apply, among other things, a 5 per cent risk retention requirement as required by the Dodd-Frank Act as part of a package of enhanced standards.

In addition to these initiatives, there is a parallel shift to a de-emphasis of ratings.

This is most notable in the USA. One of the proposals in the ABS Release is that the current requirement for ratings for a shelf-registration should be removed.

Both US and European regulators have put in place new regimes to regulate rating agencies. The SEC has issued a new rule (Rule 17g-5) to improve the quality of ratings by increasing transparency, competition and accountability for Nationally Recognized Statistical Rating Organizations (NRSROs).

Under the rule, NRSROs that are hired by a sponsor on a transaction to provide credit ratings for structured finance products have to disclose these transactions and all relevant information to other NRSROs that are not hired by a sponsor on the relevant transaction by requiring the sponsor to place such information on a password-protected website.

In the SEC's view, the opportunity for non-hired NRSROs to use the information to provide unsolicited credit ratings will provide an independent check on all credit ratings of structured finance products. The fact that investors potentially will be able to subscribe to request a rating from a non-appointed NRSRO is thought by the SEC to reduce the inherent conflicts generated by the 'issuer pays' rating model.

However, it is not readily apparent that there is significant investor demand to pay for a separate rating, nor is it apparent why NRSROs will invest the resource in rating transactions for which they are not appointed, particularly as there will be a requirement to publish a rating for 10 per cent of the transactions that have been accessed by the NRSRO for information. While anecdotal information on the subjects is limited, we have yet to hear of a case where a non-appointed NRSRO has accessed such a website since Rule 17g-5 came into effect.

The European Commission also published a set of proposals in June 2010 for changes to the EU Regulation of credit rating agencies, including disclosure requirements which are modelled closely on the SEC's Rule 17g-5.

In addition to the practical questions encountered for those transactions that must comply with Rule 17g-5, such as how to provide information simultaneously to non-appointed NRSROs and the extent to which oral information provided to an appointed NRSRO should also be provided to a non-appointed NRSRO, there is a risk that European issuers could be subject to two parallel and potentially inconsistent regulatory regimes to achieve ratings on their transactions.

It is debatable whether increased loan-level data and transparency or encouraging unsolicited ratings will really assist in reopening the market further by restoring investor confidence in ABS, or if they will add another layer of cost and 'hassle factor' to transaction execution that will further impede the already fragile recovery of the public market. Only time and further clarity from national regulators will reveal whether these reforms will achieve their stated aims.

A New Way Forward?

Apart from these regulatory initiatives, an alternative approach which could be followed is to focus on the underlying assets instead of the securitisation product. After all, a significant trigger of the credit crisis was the lax underwriting standards in the US sub-prime mortgage market. CDOs were the conduit which globalised exposure to these risky assets. Similarly, many of the problems currently facing the commercial mortgage sector, whether in the bank market or commercial mortgage backed securities (CMBS), stem from too much money having been lent against inflated property values at the peak of a property bubble. This issue is illustrated by the fact that balance sheet lenders are facing exactly the same loss experience for assets retained on their books.

In an environment where equity markets remain highly volatile, investors face a limited choice between low-yielding government debt and riskier asset classes such as high-yield bonds. It seems likely that a product which facilitates investment in prudently originated residential and commercial mortgages, for example, will be welcomed by institutional investors and possibly by retail investors.

One approach that may be particularly useful for commercial property is for the market to require specific underwriting standards and limits that are based on standardised and conservative valuations with an accepted covenant package which falls within prescribed criteria.

The ECB is currently supporting a similar concept, initially for residential mortgage securitisation, through the 'Prime Collateral Securities' initiative. The initiative's stated objective is to "meet the requirements of investors seeking well-defined, high-quality standards". The scheme is not proposed as a replacement for due diligence and is designed to provide a notional "gold standard" for securities to help restore confidence and to establish a more liquid market.

Ultimately, any initiative that is implemented must retain flexibility to contemplate changes to products over time without compromising the essential criteria that will set the benchmark for lending against assets, including residential and commercial property. The capital markets provide a potentially excellent method for enabling investments in these asset classes without over-reliance on credit ratings. It is crucial that the securitisation market re-emerges but the products have to be transparent, simple to understand, and, most importantly of all, investors must be confident that they are backed by assets that are soundly originated.

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