

Article

VINOD KOTHARI CONSULTANTS PVT LTD

New developments in Securitization

Analysis of the state of the market in 2010, 2011

Vinod Kothari
vinod@vinodkothari.com

Check at:

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Article

Talking about the developments in securitization market in 2010 and 2011 may sound like a euphemism with a sick sense of satire, as the market by and large remains moribund. The general overview may be that all that is happening in the market is regulation and control, which is so paradoxical, because what is needed right now is oxygen. But isn't that very usual that regulators come with a catena of controls when what a sector needs is a dose of Viagra?

However, we search for the signals of growth in the global securitization market.

Regulatory scenario:

Global regulators have been recently active laying down minimum risk retention requirements for securitization transactions. The skin-in-the-game issue was one of the highlights of surveys into what might have caused the debacle in lending pre-2007. Hence, regulators have imposed minimum risk-retention requirements for securitisation transactions.

European risk retention guidelines:

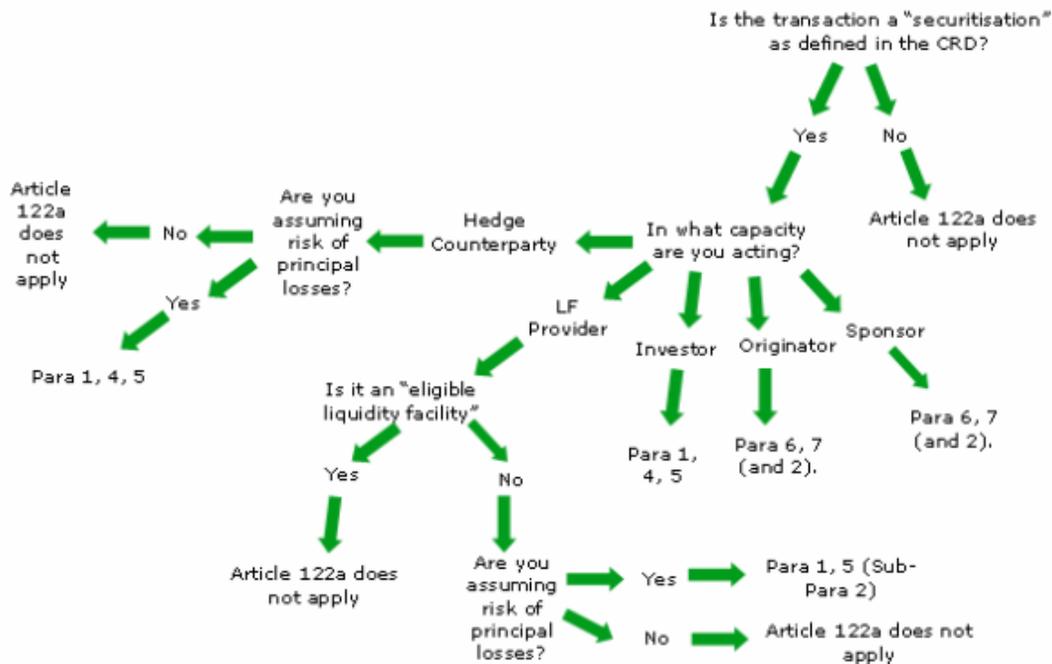
One of the early movers in this respect was European regulators, who acted quickly after the crisis and imposed risk-retention requirements for European banks investing in asset-backed securities. In December 2010, final risk retention guidelines were issued by the Committee of European Banking Supervisors, applicable from Jan 1, 2011¹. These have come in form of Article 122a to the Capital Requirements Directive (CRD) of the EU.

The essence of Article 122a of the CRD is to require a minimum economic risk retention of 5% by the originator. However, in that the requirement is applicable to all stakeholders in a securitisation transaction – originators, investors, sponsors, liquidity facility providers, swap counterparties, and so on, there are several paragraphs of the article that apply depending on what role the party is performing. A matrix showing which Para of Article 122a will apply based on what role the party is performing in the transaction is given by the following flow chart, taken from the CEBS report cited above:

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<http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Application%20of%20Art.%20122a%20of%20the%20CRD/Guidelines.pdf>

Article



US risk retention guidelines:

In the USA, the culmination of the process of laying down risk-retention requirements came in form of the Dodd-Frank Act which empowered regulatory authorities to lay down risk retention requirements for securitization transactions.

In Oct 2010, the Board of Governors of the Federal Reserve System in the USA submitted a nearly-100 page² report to the Congress on Risk Retention³. This study emphatically suggests that straightjacket risk retention requirements – for example, 5% of first loss risk, irrespective of the nature and type of the asset, would do considerable damage. The study says: “Overall, the study documents considerable heterogeneity across asset classes in securitization chains, deal structure, and incentive alignment mechanisms in place before or after the financial crisis. Thus, this study concludes that simple credit

² The reference to the number of pages may not be astounding at all, as several people mistake prolixity for erudition. The Dodd Frank Act which runs in nearly 900 pages, and envisages nearly 90 sets of rules [http://www.sec.gov/spotlight/dodd-frank/accomplishments.shtml], once completed may run into nearly 3000 pages or 3 million words of the law itself.

³ <http://www.federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf>

Article

risk retention rules, applied uniformly across assets of all types, are unlikely to achieve the stated objective of the Act—namely, to improve the asset-backed securitization process and protect investors from losses associated with poorly underwritten loans.” In other words, the study recommends asset-class specific requirements, rather than one-size-fits-all approach.

Pursuant to this, the Federal Regulators, on 31st March 2011, released draft proposals for risk retention in securitization transactions⁴. The highlights of these proposals are below:

- retention of risk by holding at least 5 percent of each class of ABS issued in a securitization transaction (also known as vertical retention);
- retention of a first-loss residual interest in an amount equal to at least 5 percent of the par value of all ABS interests issued in a securitization transaction (horizontal retention);
- an equally-divided combination of vertical and horizontal retention;
- retention of a representative sample of the assets designated for securitization in an amount equal to at least 5 percent of the unpaid principal balance of all the designated assets; and
- for commercial mortgage-backed securities, retention of at least a 5 percent first-loss residual interest by a third party that specifically negotiates for the interest, if certain requirements are met.

Changes in Regulation AB

The Securities and Exchange Commission in April, 2010, had proposed revision to regulation AB. Regulators were of the view that investors ended up investing in securities without understanding the underlying risk associated with their investment; coupled with the issuers lax underlying standards and use of originate to distribute model, absence of aligned interest saw the debacles of the markets, freezing liquidity and leaving industry players pointing fingers alike at the complexity of the product.

The proposed rules sought to revise the disclosure, reporting and offering process for asset-backed securities (ABS), with the intent to gain investors confidence back and revive the structured finance market. Pursuant to Section 943 of the Dodd Frank Wall Street Reform and Consumer Protection Act, any registered offering of asset-backed

⁴ <http://www.federalreserve.gov/newsevents/press/bcreg/20110331a.htm>

Article

securities commencing with an initial bona fide offer on or after February 14, 2012 must comply with the information requirements of new Item 1104(e) of Regulation AB.

Representations and Warranties in Asset Backed offerings

The final rules⁵ require securitizers of asset-backed securities to disclose fulfilled and unfulfilled repurchase requests, which would mean disclosure with regard to demand, repurchase and replacement history of asset by adopting Rule 15Ga-1 to Regulation AB. The rules require nationally recognized statistical rating organizations to include information regarding the representations, warranties and enforcement mechanisms available to investors in an asset-backed securities offering in any report accompanying a credit rating issued in connection with such offering, including a preliminary credit rating. Earlier, in the underlying transaction agreements for an asset securitization, sponsors or originators typically make representations and warranties relating to the pool assets and their origination, including about the quality of the pool assets. This rule has come into effect from 28th March, 2011 and would help investors identify asset originators with underwriting deficiencies.

SEC Re-proposes New Shelf Eligibility Requirements for Asset Backed Securities

The Securities and Exchange Commission in July, 2011 re-proposed rules regarding greater accountability and enhanced quality around asset-backed securities (ABS) when issuers seek to use an expedited registration process known as shelf registration. These rules were first proposed in April, 2010 however in light of the Dodd Frank Act and comments received from public, SEC decided to re-evaluate its proposals.

Under the existing rules, ABS is not eligible for expedited shelf offering, unless securities are rated investment grade by credit rating agency. While ratings would continue to be allowed for ABS offerings, the proposed rules eliminate the need for ratings from shelf eligibility test.

FDIC's Safe Harbor Rules

FDIC in 2009 proposed safe harbor rules to ensure that under these rules, FDIC, as receiver or conservator of FDIC-insured US banks, will not question the true sale inherent in securitization transactions and issued an Advanced Notice on Proposed

⁵ <http://www.sec.gov/rules/final/2011/33-9175.pdf>

Article

Rulemaking, regarding Safe Harbor Protection for Securitization. If the transferred assets meet all the conditions for sale accounting treatment under the generally accepted accounting principles (GAAP), the assets would remain 'isolated' providing a 'safe harbor' to the sale inherent in securitization transactions. Thus the investors would be very sure of their rights at the onset of the transaction.

Impact of Basel III

Bank regulatory capital requirements have been increased for structured finance securities specifically for resecuritisation, asset backed commercial paper conduits and first loss pieces. Solvency 2 capital requirements for insurance companies with respect to structured finance securities would be higher than those of banks under Basel III. Under the Basel III, bank liquidity coverage and new stable funding ratios, sovereign bonds and corporate bonds are treated more favorably also the hair cuts for securitization are comparatively higher.

Accounting standards:

The development of accounting standards continued to be volatile during the period under review.

Under the International Financial Reporting Standards (IFRS), it may be noted that IAS 39 had been amended in early 2009 to provide that if the originator had continued involvement in the transaction, other than merely as a servicer, the off-balance sheet treatment by way of de-recognition would be denied. Denial of off-balance sheet treatment would mean recognition of gains on sale would also not be permitted.

The de-recognition project of the IASB⁶ led to additional disclosures in case of a derecognition, way of amendments to IFRS 7.

The Financial Accounting Standards Board of the USA had come up with FASB 167 which similarly provided that in order to derecognize assets, the seller must show having done a meaningful surrender of control, besides, of course, demonstrable transfer of risks and rewards.

⁶ <http://www.ifrs.org/Current+Projects/IASB+Projects/Derecognition/Derecognition.htm>

Article

If one combines the regulatory risk retention requirements with the off-balance sheet accounting requirement, it seems that as the regulators require retention of risk, accounting standard setters provide that if there is a more than nominal risk retained, the transaction would not be off the balance sheet. This apparent paradox has been examined by the Federal Reserve System report to the Congress on Risk Retention. The report says: “A risk retention scheme that requires the originator or holder of assets to retain a subordinated interest directly in each securitized asset may require the originator or holder to continue to recognize the entire assets, including the proportion backing the senior interests.”

This would practically mean we are heading towards on-balance sheet securitization. There may, of course, be possibilities of complying with the regulatory risk retention requirements and yet achieve off-the-balance sheet treatment, as one of the ways to satisfy the regulatory requirement is to have a fully-proportionate risk in the entire portfolio - something that may meet the regulatory requirements and yet not lead to assets coming back on the balance sheet.

Basel II and Basel III guidelines

If securitization is turning on-the-balance sheet, will that also mean the sale of the assets would be disregarded for the purpose of regulatory capital requirements? In general, banking regulators lean on the accounting standards to capture assets. Hence, if assets are on the balance sheet for accounting purposes, they are not off the balance sheet for the purpose of capital rules.

Basel III guidelines seek to increase the risk capital requirements of banks, and impose maximum leverage ratio. Basel III requirements also impose a liquidity requirement for banks.

Thinking on restarting securitisation markets:

While most regulatory write-ups and reports during the period under review went investigative into the past and prescriptive as for the future, there are some scanty reports that also talk about restarting or reviving securitization markets. These may be either regulators' reports or academic reports, or just industry advocacy papers.

To begin with, the Global Financial Stability Report of the IMF dated 21st September, 2009 spent a full chapter on Restarting Securitization.

Article

One meaningful report is Redwood Trust's report on Restoring Private Residential Mortgage Securitization⁷. This report also goes into things like risk-retention.

A Financial Stability Board (FSB) was set up under a mandate from heads of G20 countries at a summit in London in 2009 with a view to implement effective regulatory, supervisory policies for the financial sector and set guidelines and framework for regulatory reform at global level. The first report published by the Board – *Enhancing Market and Institutional Resilience*⁸ recommended on strengthening the capital, liquidity and risk management requirements and enhancing transparency and valuations.

In 2010, again published in a Report, Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability some of the recommendations⁹ of the Board with respect to structured finance emphasized the need for re-starting securitization on a sound basis and rebuilding investor confidence, improve transparency and the alignment of incentives in the area of structured finance globally.

In July 2011, the Joint Forum of the BCBS/ BIS came with a report on Asset Securitisation Motivations¹⁰. Though the following comments in the Report are based on surveys of market participants, however, they are very relevant as whatever silver linings are visible around a dark cloud might be pleasant:

- **On the scope for revival of the market in near future:** “Interviewees generally expect that markets will only recover to roughly half of their pre-crisis levels (similar to activity in 2004). This is mainly due to the disappearance of highly-leveraged vehicles such as structured investment vehicles. Many market participants viewed the loss of this segment of the market to be permanent. Interviewees also did not expect complex securitisation products to return in the foreseeable future and predicted that plain-vanilla ABS and MBS are likely to compose the bulk of the market.”
- **On the relation between economic recovery and securitisation:** Improved macroeconomic conditions are seen as a necessary precondition to any significant recovery in securitisation activity. There is a general view that investor

⁷ <http://www.snl.com/Cache/1001157919.PDF?D=&O=PDF&IID=103579&Y=&T=&FID=1001157919>

⁸ http://www.financialstabilityboard.org/publications/r_0904d.pdf

⁹ Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability, Report of the Financial Stability Board to G20 Leaders, http://www.financialstabilityboard.org/publications/r_100627c.pdf, June, 2010

¹⁰ <http://www.bis.org/publ/joint26.pdf>

Article

confidence and demand will only return in a meaningful way when the underlying economies become more robust. Additionally, market participants interviewed also noted that the current abundance of alternative cheap funding sources allows originators/sponsors to be less reliant on securitisation as a funding vehicle.

- **On factors impeding the development of the market:** “Existing literature and industry interviews suggest that meaningful recovery in the securitisation markets is not imminent. In addition, the findings of this report suggest that recovery is being hampered by a number of factors, including but not limited to:
 - negative perceptions of securitisation as an investment class;
 - an uncertain macroeconomic environment in a number of countries;
 - concerns about the timing and content of regulation across sectors;
 - unattractive yields relative to other debt market opportunities;
 - illiquid secondary markets; and
 - reduced confidence in ratings.

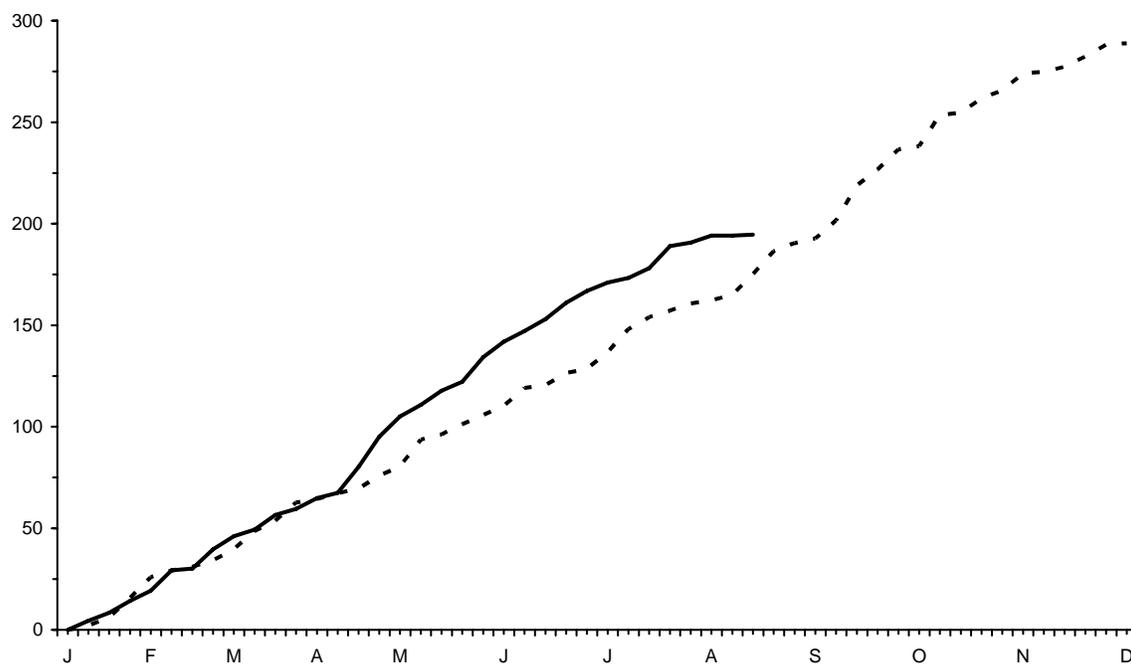
State of the market:

The US ABS market remains subdued as may well be accepted. The following graph shows the cumulative build up of volumes over 2010 and 2011, giving some hope that 2011 may be better than 2010¹¹:

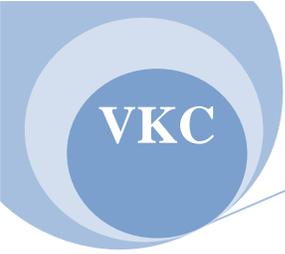
¹¹ based on www.abalert.com, data picked up on 1st Sept 2011



Article

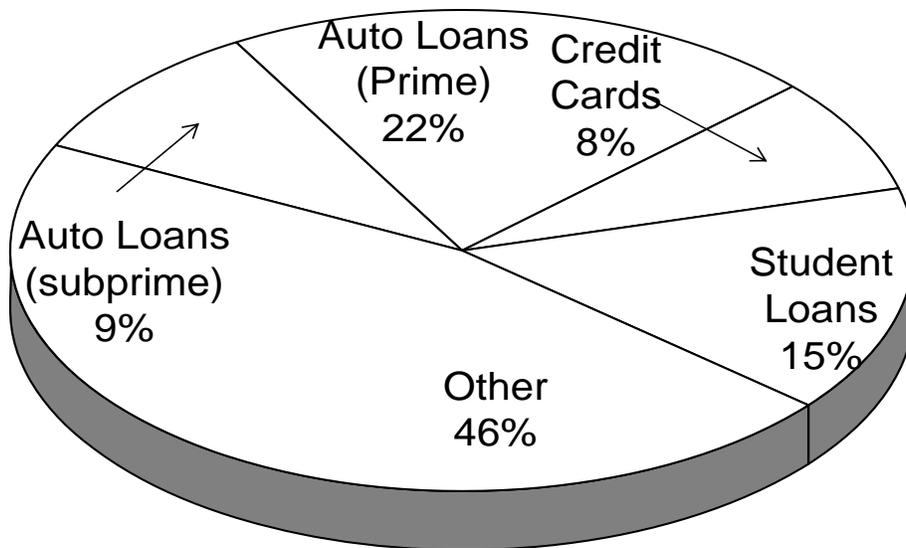


It is notable that in the US market distinction is made between MBS and ABS and the data for ABS only has transactions other than mortgage-backed loans. In the ABS segment, in earlier years, home equity loans and auto loans occupied bulk of the volumes. Home equity has completely disappeared; however, the market has also moved from traditional domains to non-traditional domains, showing a highly reduced share of traditional asset classes.



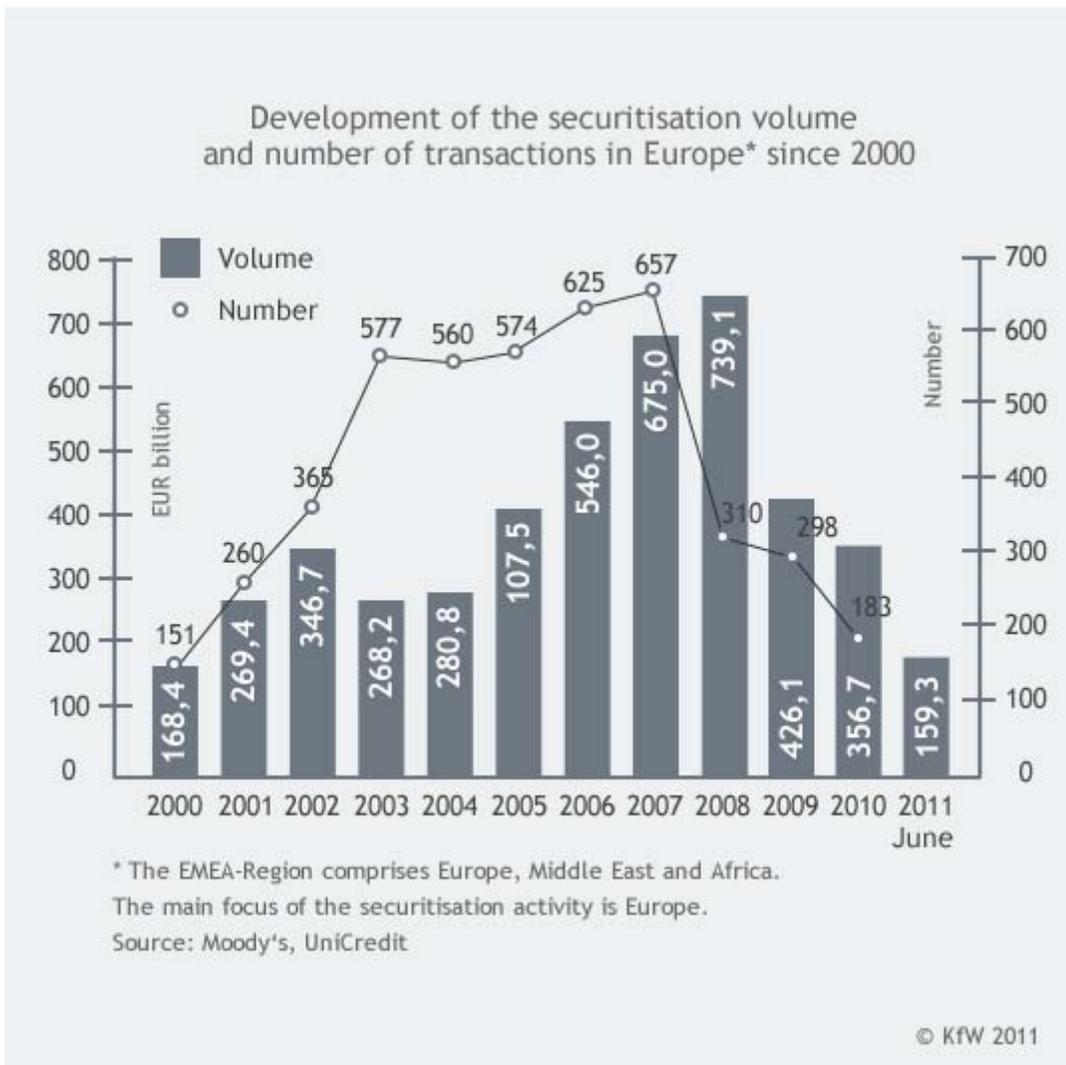
Article

The following graph, based on www.abalert.com as on 1st Sept 2011 shows the following break up of volumes:



The state of the European market is apparent from the following data:

Article



As is very apparent, the dip in volumes since 2008 is continuing unabated. Given the situation of several European countries, it does not seem likely that there will be a material improvement in the situation soon.

Transactions moving in the market:

Based on rating agency websites, it seems that non-US market is not without activity, of course, the levels are nowhere compared to what they were in good times. However, most

Article

of the transactions are of non-traditional types. A quick view of Fitch Ratings site (pre-sale reports of ABS) shows some future flows deals from emerging markets, some student loan receivables securitizations, several auto loans receivables deals, equipment lease receivables securitisations, and so on. Home equity transactions that took most of the space are obviously out; credit card receivables transactions have also become very few and far between.

Looking at RMBS transactions, there are barely few transaction pre-sale reports in June, July or August 2011 – hence, this market is lying very very dull.

There seem to be some revival of interest in CMBS.

Will the US GSEs revive?

One of the most significant issues facing the securitisation market, particularly in the USA, is whether Ginnie Mae, Fannie Mae and Freddie Mac will continue, or they will be dissolved. The relevance of this question to the vigour of the securitisation market has been noted in several commentaries. However, the issue is totally political in the USA, and as of now, there is total uncertainty as to their revival. Jason Kravitt, one of the leading commentators on securitization, has this to say¹²: “perhaps the most important set of issues facing the US securitization market is the fate of the government-sponsored entities (GSEs), Fannie Mae and Freddie Mac. Will they survive? Be broken up? Something else? Will government participation in the primary or secondary mortgage market disappear? Will, perhaps, the government’s role be relegated to an insurer of catastrophic risk? It is unlikely that anyone can predict the outcome with assurance (though it seems likely that the GSEs will eventually be liquidated and the government’s role reduced to providing some form of insurance after a very long transition period)”.

¹² <http://www.mayerbrown.com/publications/article.asp?id=10708&nid=6>