

Global Securitisation markets overview 2014

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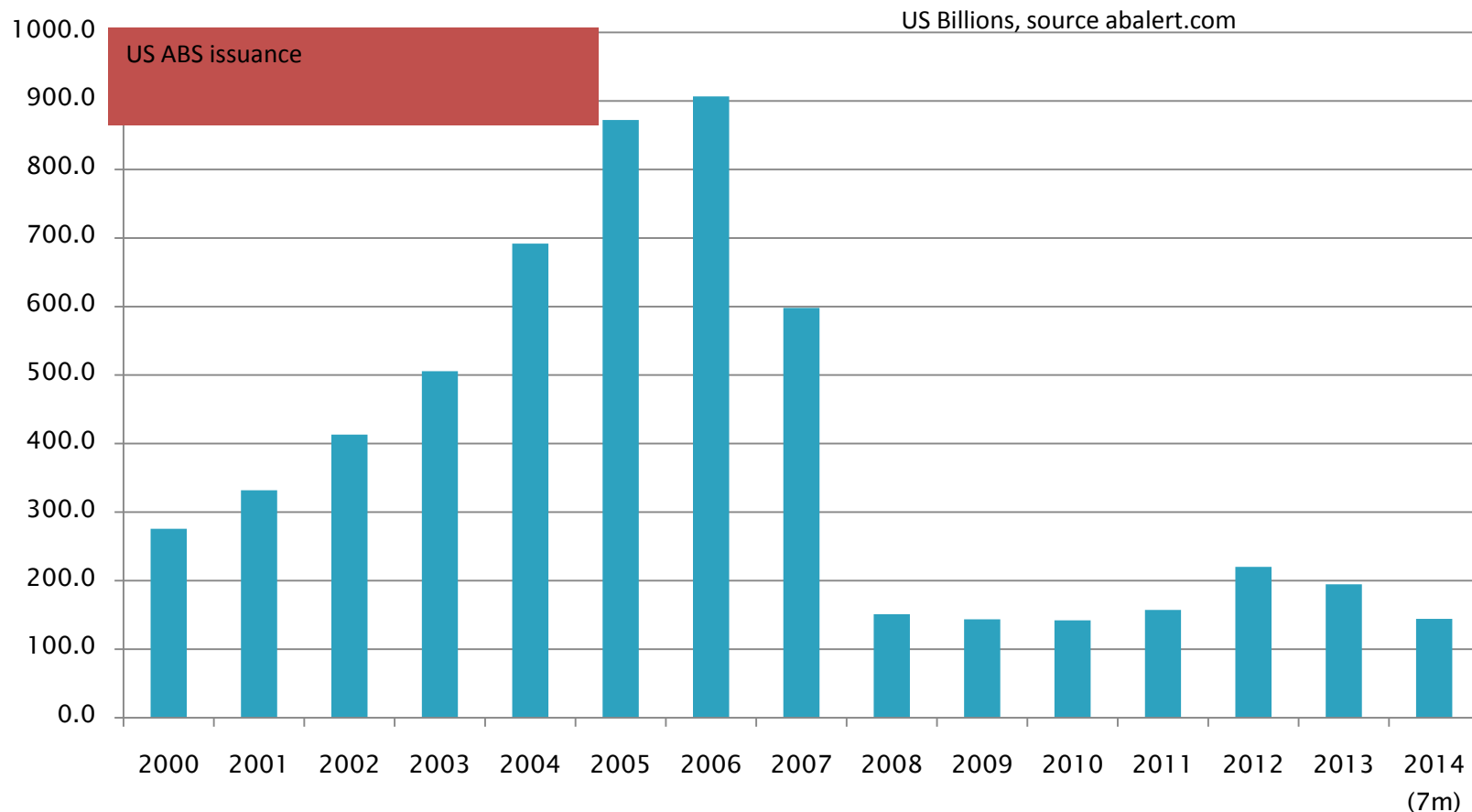
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Are the markets restarting at all?

- ▶ Joint Forum July 2011 report: “meaningful recovery in securitization markets in not imminent” – p. 28
- ▶ “A sustained recovery in private-label securitisation is unlikely to occur until policy makers have enough confidence in their economies to allow securitisation markets to be weaned off government support”. – OECD Journal Financial Market Trends, 2011
- ▶ A scene from ABS East 2011 (Oct 16–18, 2011) attended by 3000 attendees
 - Panelist asked audience to raise hands if they wanted to invest in securitisation transactions in near future
 - 6 members of the audience raised hands
- ▶ However, as seen in 2013, and 2014 YTD, there is substantial pick up in investor interest
 - CDO activity is also being seen
 - Investors have shown interest in CDO squares too

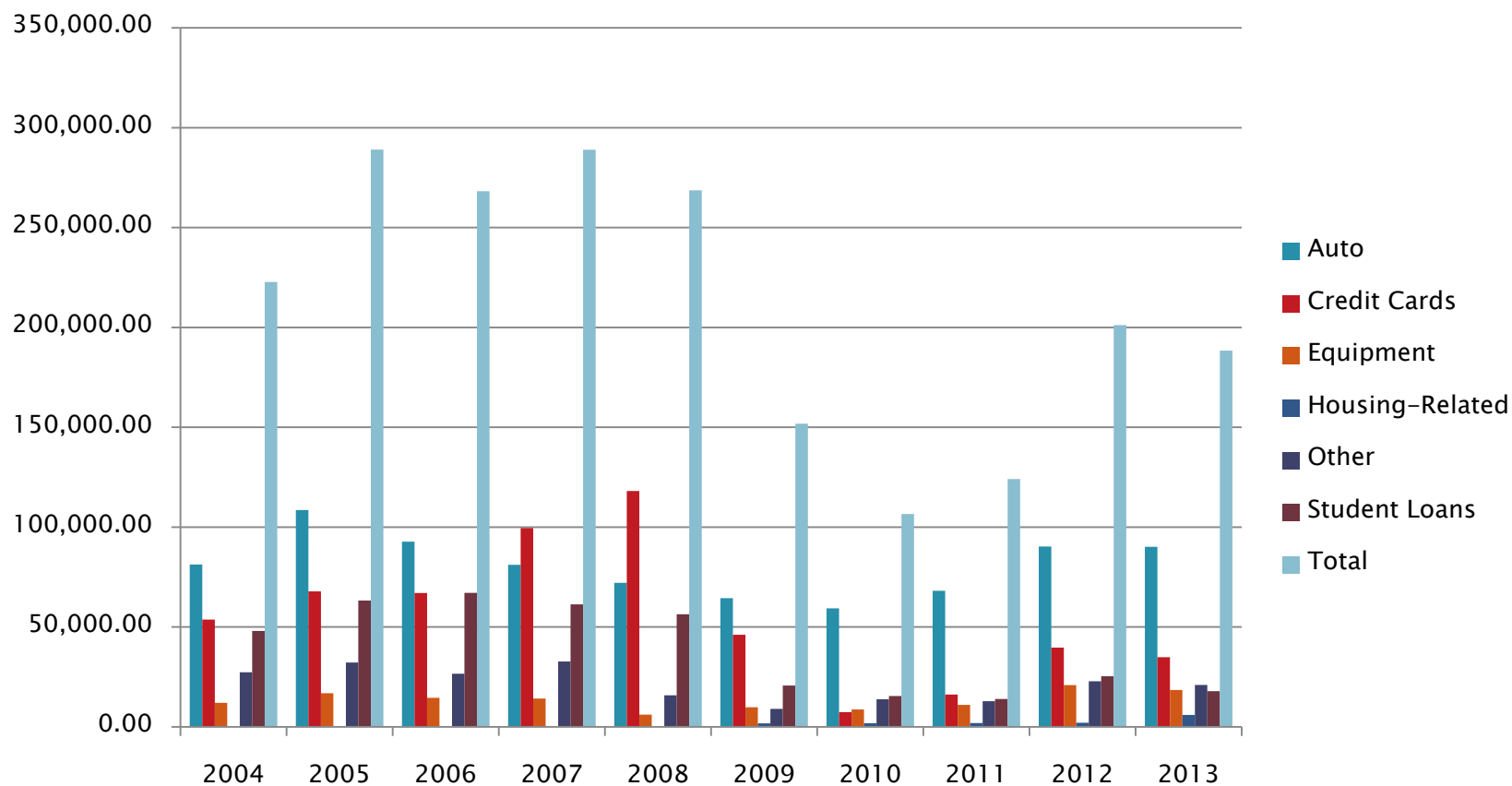
US ABS issuance



Compiled by author from
www.abalert.com

US ABS issuance

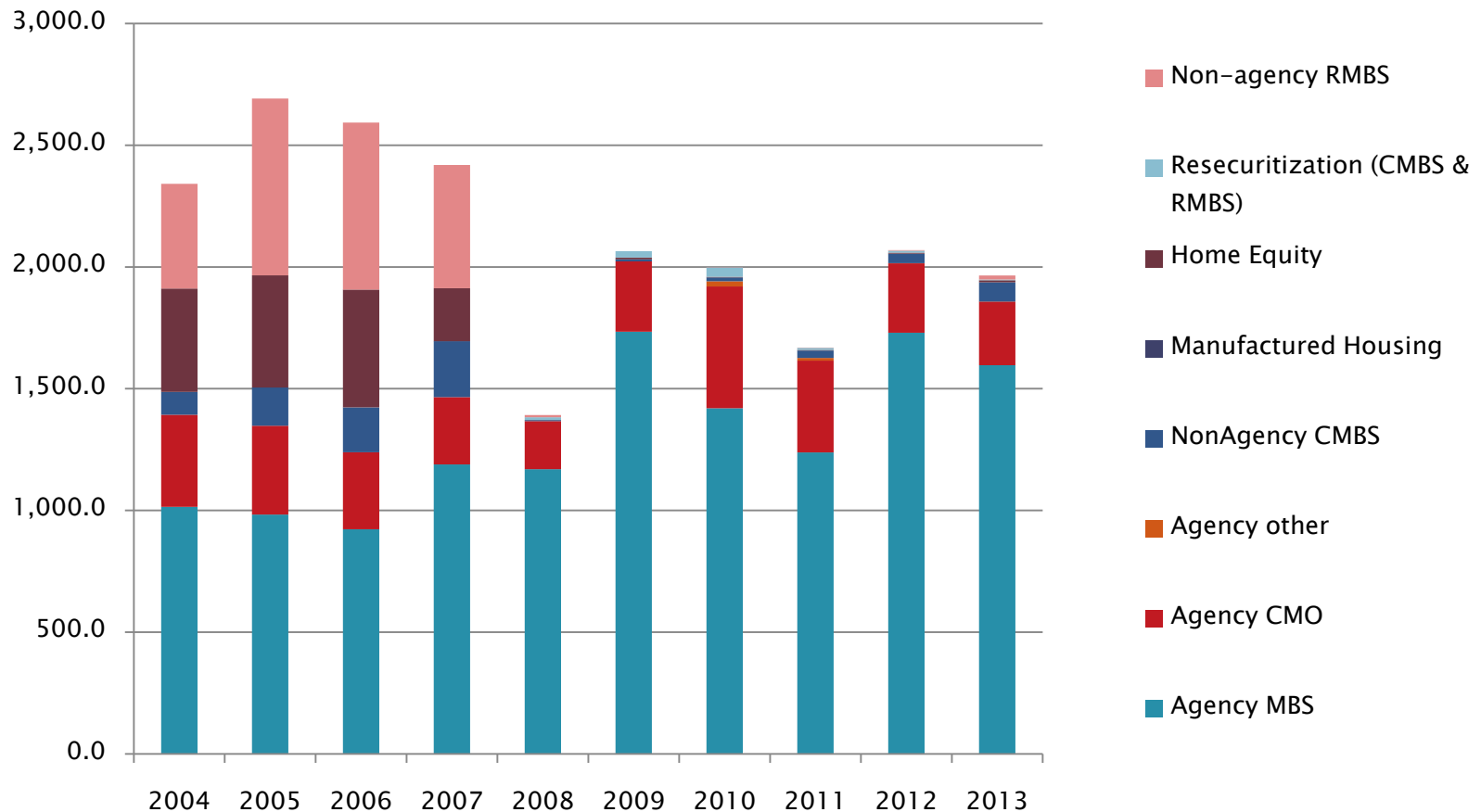
USD billions



From SIFMA site

US Mortgage-related issuance

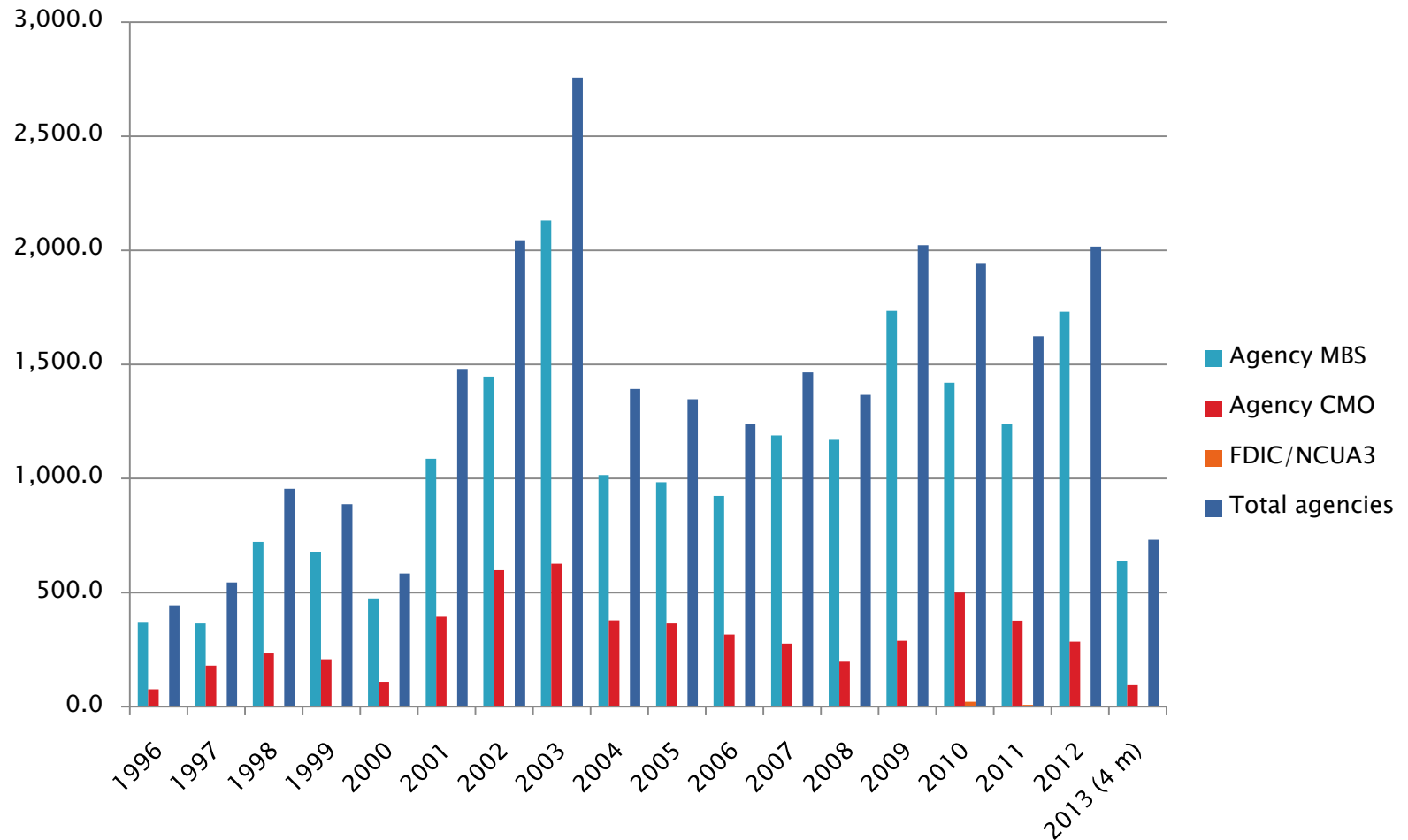
USD billions



From SIFMA site

Agency MBS data

USD billions



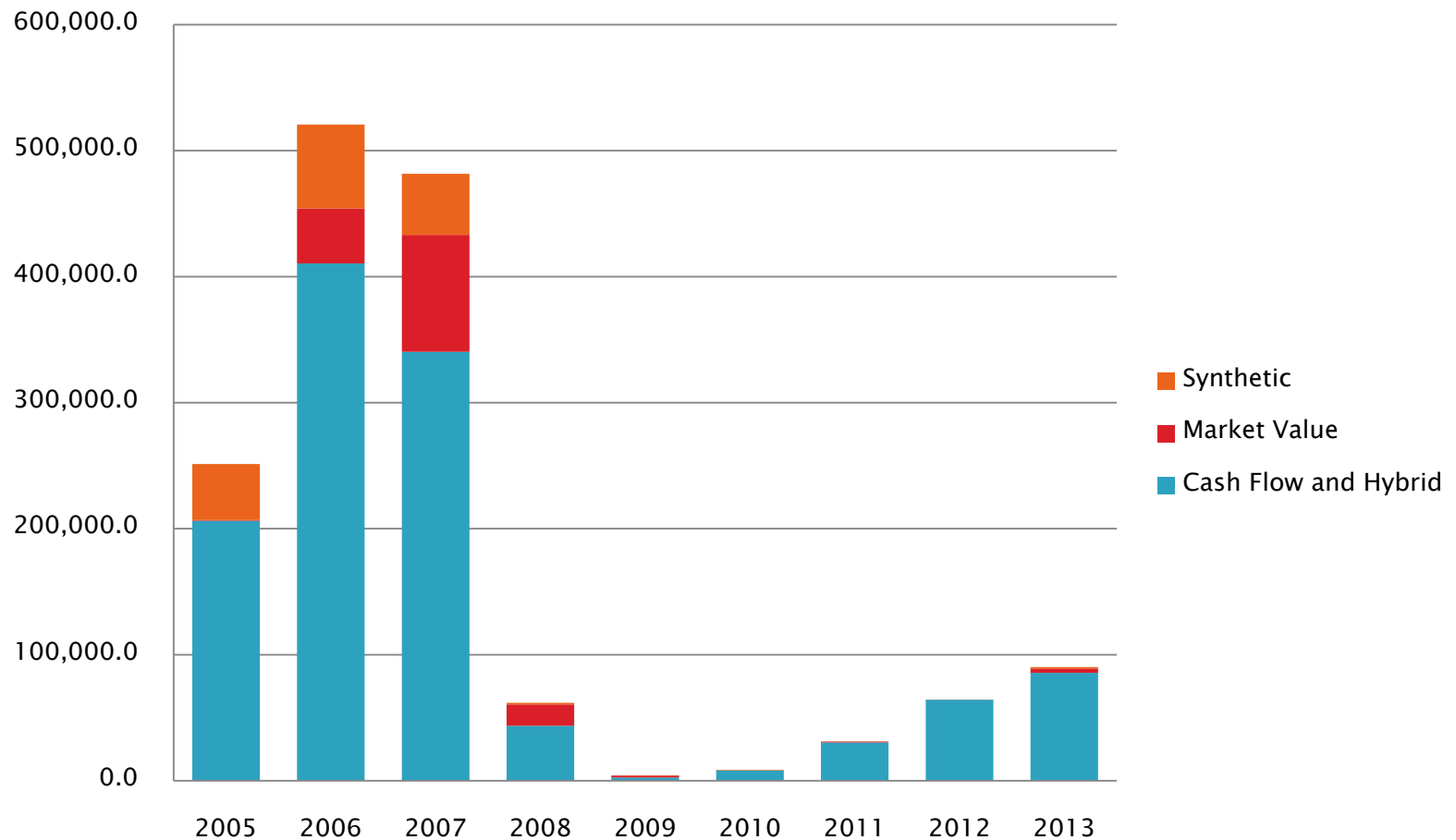
Based on data from SIFMSA site

European securitisation issuance

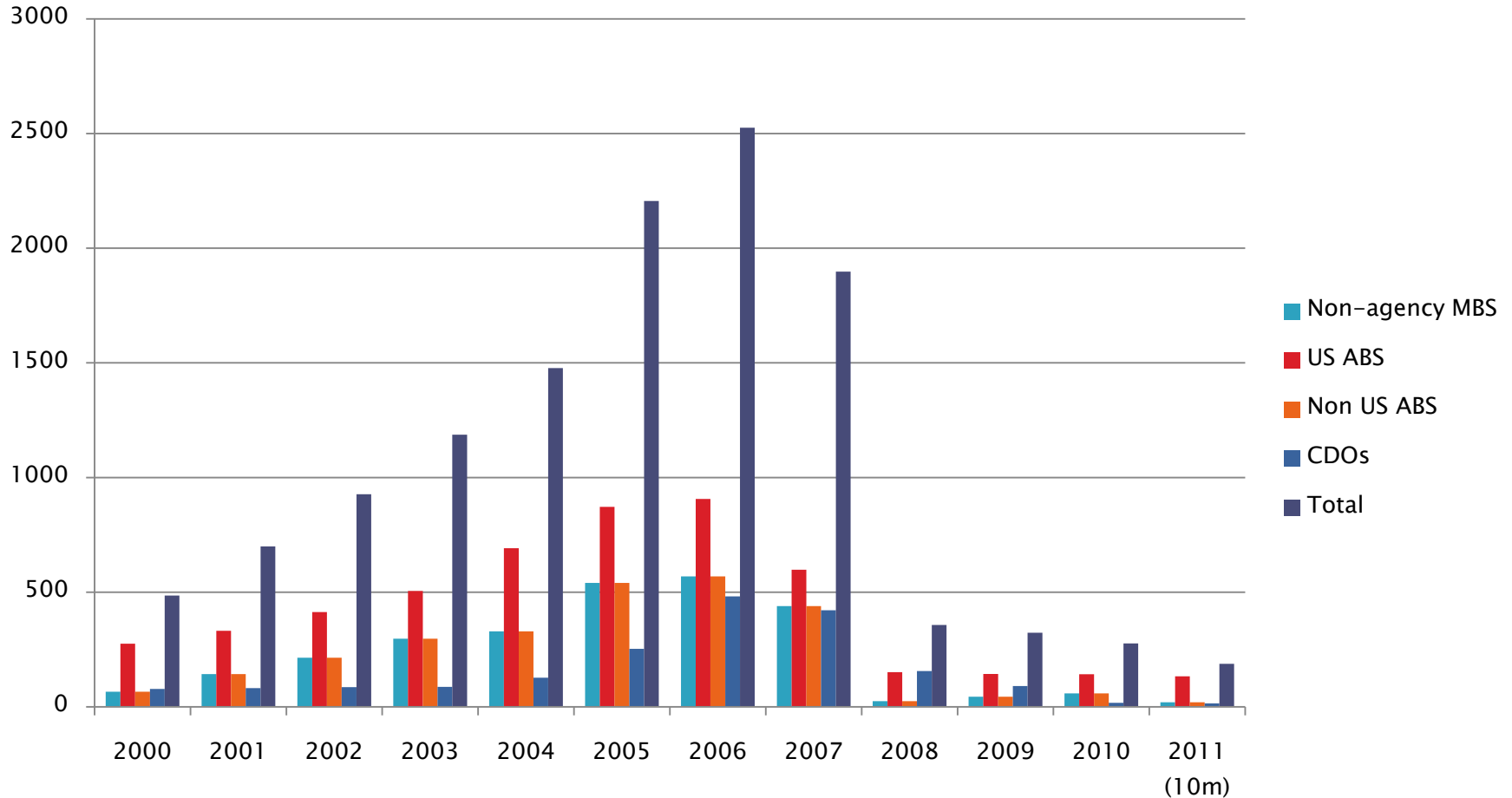
	<div> <div>Consu</div> <div>Credit</div> </div>												
	Auto	mer	Cards	Leases	Other	CDO	CMBS	Mixed	RMBS	SME	Other	Pubs	TOTAL
2004	9.53	2.49	8.23	10.99	27.01	43.50	26.41	0.06	161.93	14.74	5.97	2.80	313.67
2005	7.96	4.02	14.64	9.37	31.62	52.14	56.67	7.24	203.87	40.57	6.40	4.80	439.28
2006	14.82	16.07	3.79	8.88	37.06	81.86	82.22	2.18	330.54	35.60	3.03	3.58	619.63
2007	19.26	11.53	0.61	5.57	14.79	82.70	70.64	3.54	532.92	94.87	8.26	0.68	845.36
2008	18.63	36.69	18.21	19.18	5.51	130.56	8.12	7.27	894.73	67.89	0.00	0.00	1,206.81
2009	21.77	23.75	1.65	9.08	13.74	71.63	25.87	12.31	318.39	88.48	2.61	0.00	589.26
2010	18.85	9.65	7.58	2.46	2.79	38.80	8.02	0.84	360.08	53.09	5.90	0.00	508.07
2011	32.41	20.85	10.81	21.31	11.98	13.58	3.23	1.97	307.05	86.34	4.48	0.00	514.02
2012	34.51	16.04	10.73	2.32	3.39	17.74	6.55	0.00	170.76	57.59	2.76	0.00	322.39
2013	38.10	25.98	14.12	4.33	12.66	12.24	12.62	0.00	85.82	26.54	7.24	0.00	239.65

- large part of European issuance is “retained” issue under collateral program of the ECB

Global CDO issuance

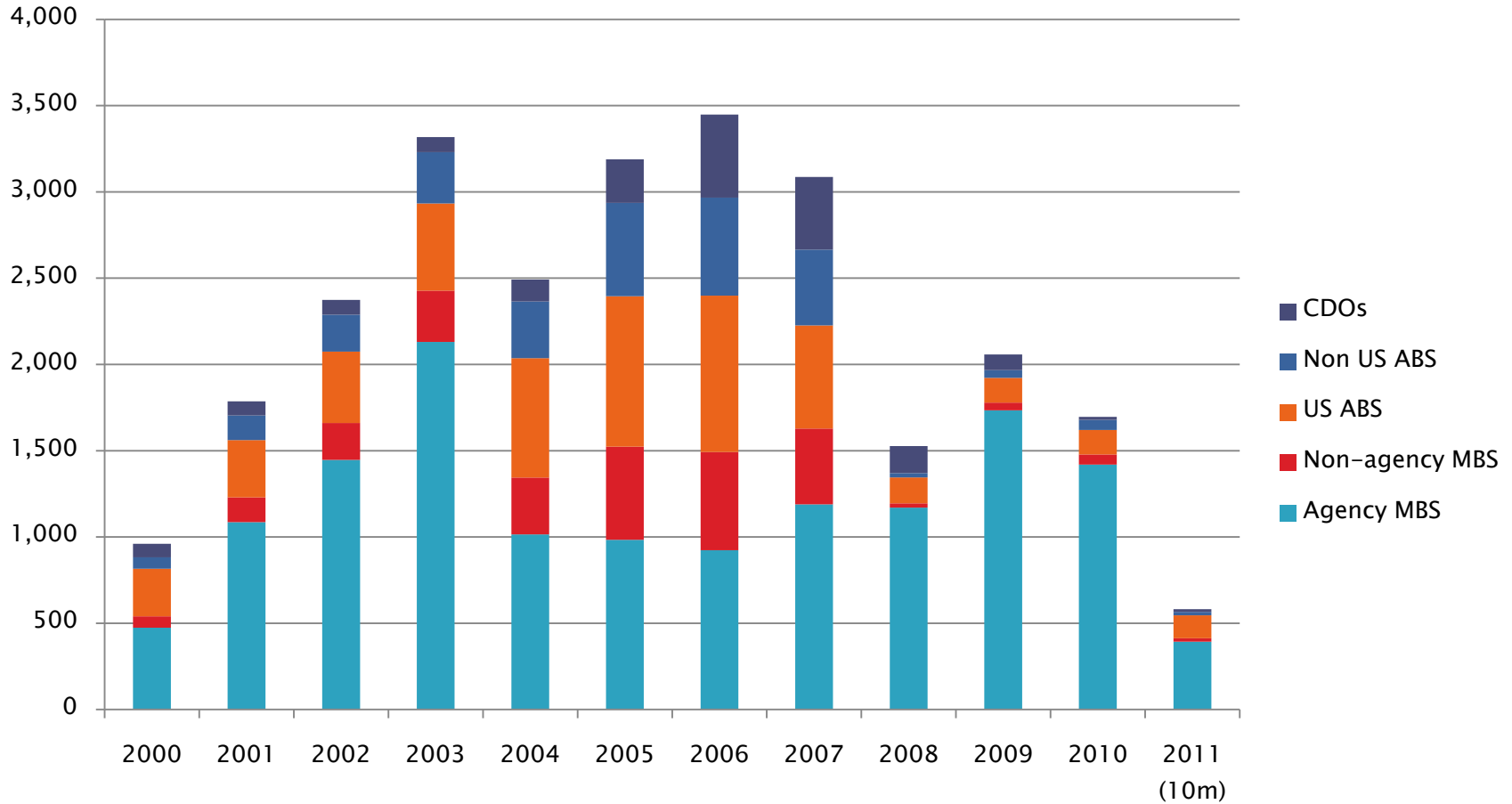


Worldwide securitisation volumes (excluding agency MBS)



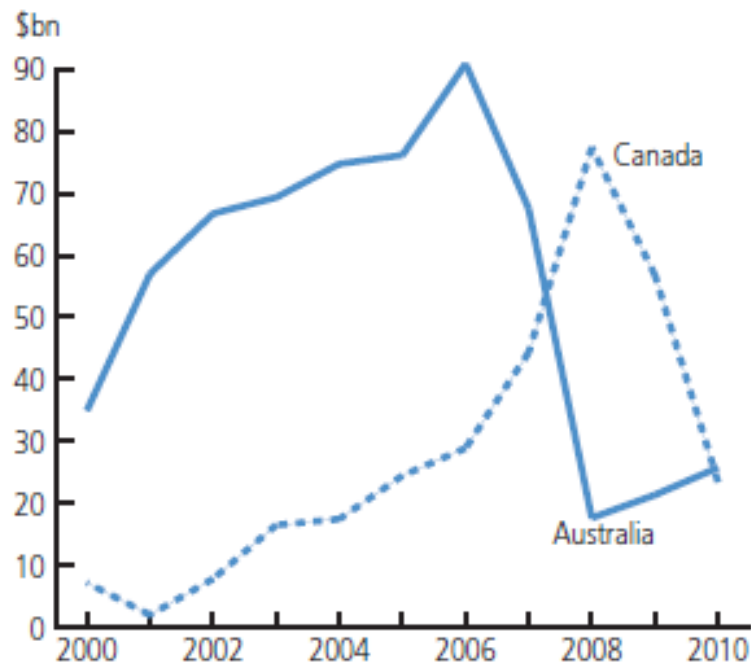
USD billions; compiled by author from data at abalert.com

Global securitisation volumes including agency MBS



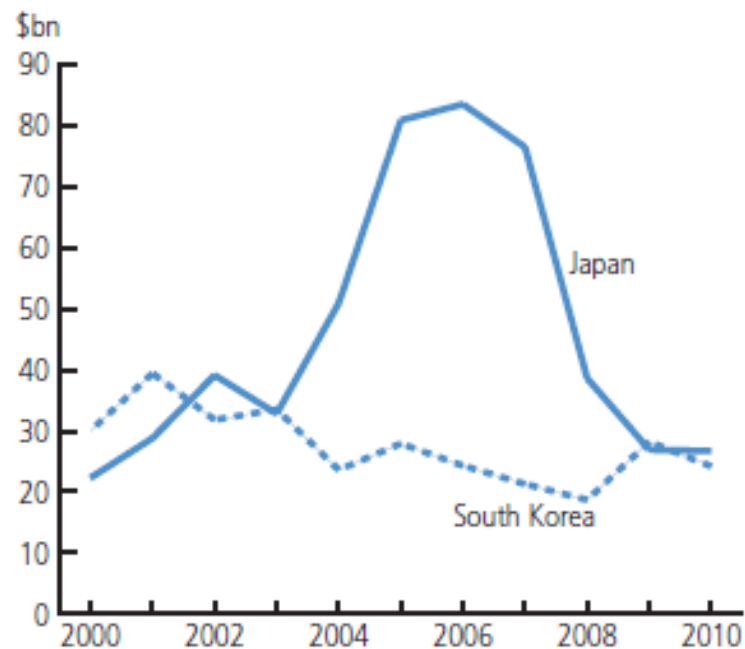
Non-US, non-EU issuance

Securitisation issuance in Australia & Canada



Source: Reserve Bank of Australia, Bank of Canada

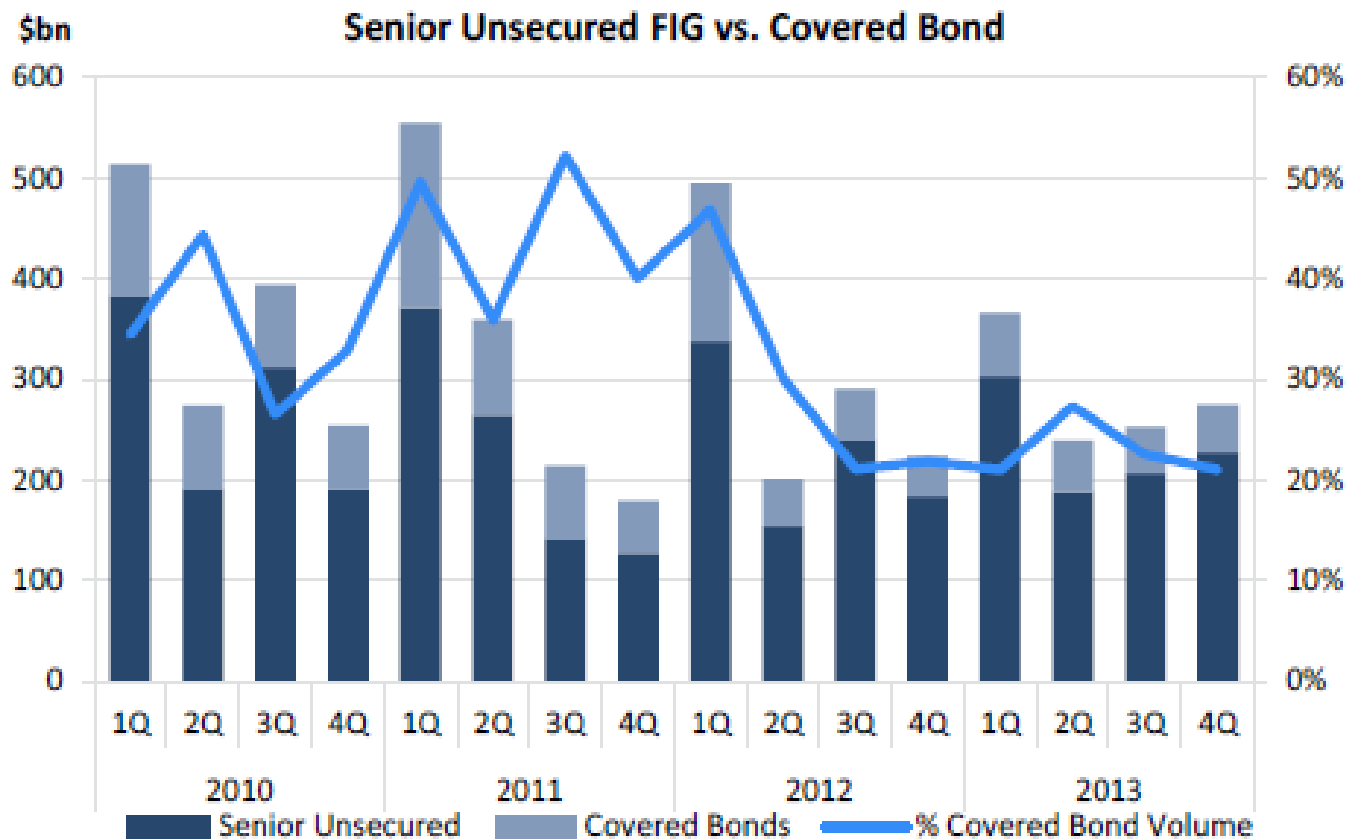
Securitisation issuance in Japan & South Korea



Source: Fitch Ratings, Thomson Reuters

Source: thecityuk.com
report on securitisation

Covered bonds issuance



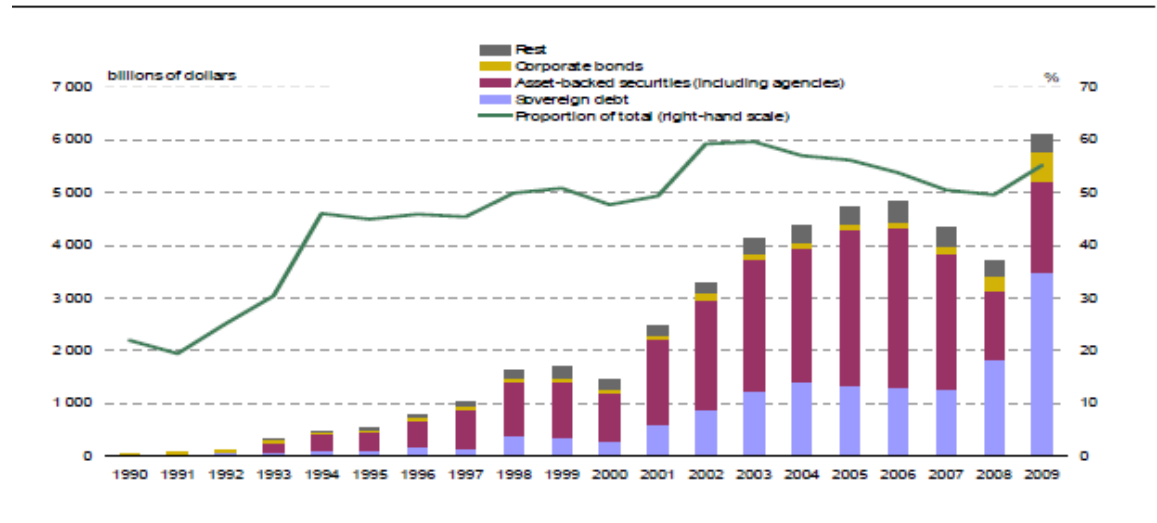
Regulatory moves to restarting securitisation

- ▶ Can regulation restart the market?
- ▶ Not sure. But regulatory efforts are on throughout 2008 till date to restart the market
 - TALF by FRB of New York in Nov 2008
 - ECB program for asset backed securities as collateral
 - Australian Office of Financial Management's investment in RMBS
- ▶ And some of the regulatory reports that speak positively:
 - Financial Stability Board Nov 2010 report to G20 leaders
 - Joint Forum (BCBS, IOSCO, and IAIS) report of July 2011 is possibly the most recent and most relevant
- ▶ In July 2014, the BCBS along with IOSCO set up a cross-sector group to study the scenario on securitisation and make recommendations for changes
 - Survey of market participants – responses were collected till end-July

What fuelled the ABS boom

World issue of AAA fixed-income

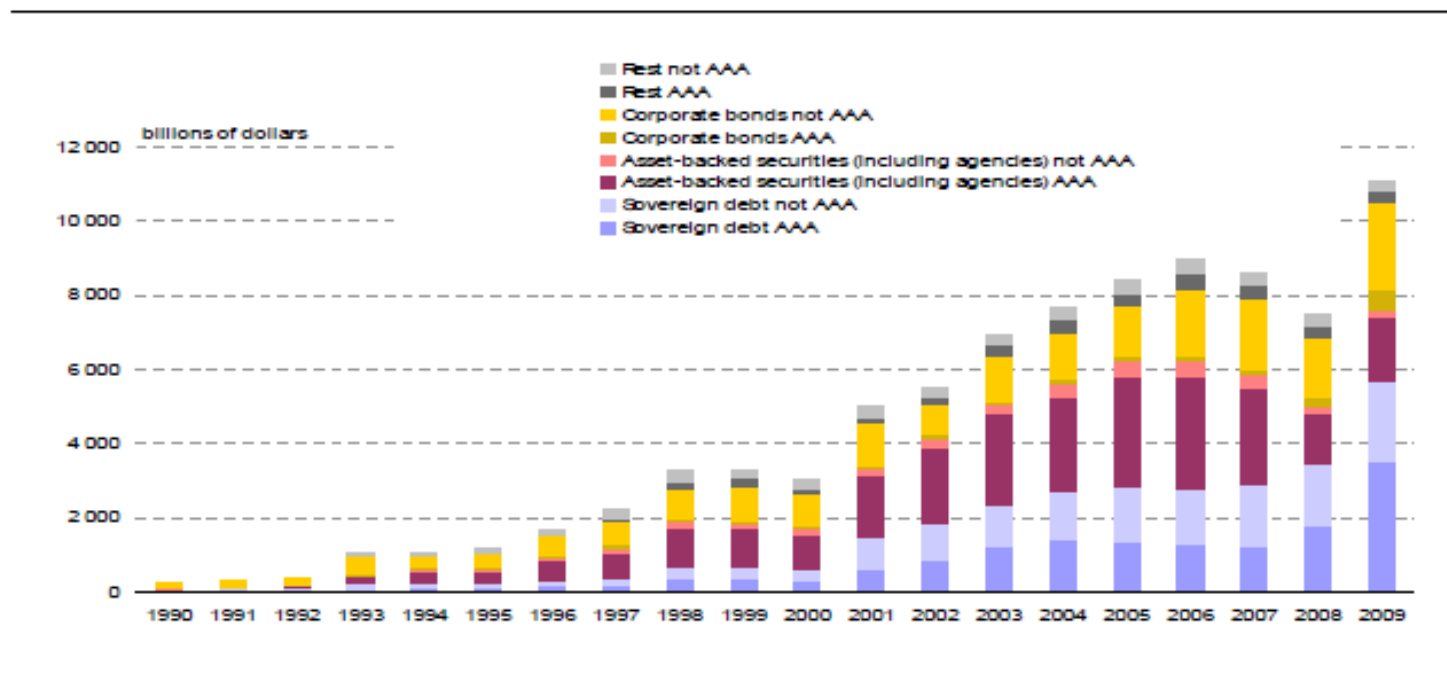
- ▶ This may be a bit of startling information, but BIS report shows most AAAs in 2006, 2007 were ABSs
- ▶ However, may not surprise anyone that in ABSs, proportion of AAAs abounds – next slide



Taken from BIS, Joint Forum July 2011 report

Proportion of AAAs in different types of fixed income securities

World issue of fixed-income



Source: BIS Joint Forum Report July 2011

Classic motivations

Issuer motivations	Investor motivations
Funding diversification	High risk-adjusted yields, meeting threshold yields with AAA ratings
Funding cost	Diversification of investments
Risk transfer	Intrinsic leverage in structured ABS investments
Revenue generation	Historically Low rating volatility
Regulatory capital	
Accounting benefits	
Ability to remain within concentration limits using ABCP	

Issuer motivations: Funding

- ▶ Levels of dependence on securitisation varied:
 - Substantial dependence on originate-to-distribute model, to just a means of diversified funding sources
 - Lesser dependence on retail deposits
 - Ability to structure products to pay investors high yields though with AAA ratings
 - Prepayment sensitive tranches
 - Credit sensitive tranches, such as bespoke CDOs, CDO²
 - Ability to park exposures in ABCP conduits, keeping concentration within limits

Issuer motivation – funding cost

- ▶ Attaining lower costs with AAA ratings
 - Particularly for entities with lesser ratings, the process of isolation ensured AAA ratings

Issuer motivation – risk transfers

- ▶ In retrospect, this may be seen as a conflict of interest
 - Plenty of transactions were structured with unseasoned, apparently risky assets
 - Litigation continues today as to whether these transactions amounted to fraud
 - FHFA suits against 18 investment banks
- ▶ The best examples of risk transfer-based transactions are seen in synthetic deals
 - Credit risk transfers
 - Insurance risk transfers
 - Non-life insurance
 - Excess of mortality risk in insurance securitisations

Issuer motivation: Revenue generation

- ▶ As a motive, this applies not only to originators, but several agencies
- ▶ Gain-on-sale rules
 - If it is off the balance sheet, the profit belongs to the point of transfer
- ▶ Repackagers:
 - Originate to distribute model
 - Relying on originations by others, generate spreads by buying and re-securitising pools
- ▶ Servicers
- ▶ Rating agencies

Issuer motivation: Off balance sheet

- ▶ Was regulatory arbitrage and accounting off-the-balance sheet a significant motive?
 - In practice, there has never been a doubt that practitioners search for off balance sheet solutions
- ▶ However, surveys have consistently denied regulatory arbitrage as a key driver:
 - Joint Forum July 2011 statement: “many of the issuers interviewed rejected regulatory arbitrage as a significant incentive to securitise, instead pointing to the benefits of funding diversification and lower funding costs as having been far greater in importance in the decision to securitise.”
 - At the same time, the Joint Forum notes – supervisors are not necessarily convinced that regulatory arbitrage was only a minor motive
 - Several other studies/surveys also corroborate this observation
 - Academics, however, strongly contend that gain on sale accounting has been a significant motive:
 - Dechow and Sakespeare paper – Do Managers Time Securitization Transactions to Obtain Accounting Benefits?

So, have the originators' motivations disappeared?

- ▶ Clearly, regulatory arbitrage, off balance sheet, etc have appeared
- ▶ However, none of these affect the intrinsic economics of securitisation
- ▶ In any case, none of the arbitrages had any relevance for investors.
- ▶ Eventually, investors' motivation is issuers' motivation
- ▶ Reasons for which investors lost motivation
 - Not so much for losses, but for repricing of existing investments due to sharply widening yields
 - Losses for most assets are still less than corporate finance securities
 - Revelations of misalignment of interests and intransigency of structures
 - Concerns about complexities, pending litigation from all spheres
 - Borrowers
 - Senior investors – for example, in a US transaction called Zing V
 - Liquidation of structured vehicles such as SIVs, ABCP conduits, CDOs
 - Disappearance of structured credit focused hedge funds

Investors motivation – high credit quality

- ▶ The AAA rating reliance overshadowed much of other concerns or considerations
 - Leading investors have confessed being inspired by the rating document
- ▶ Though with AAA ratings, many structured deals gave substantial spreads
- ▶ The rating-based investment policies also led to the “cliff effect”
 - As ratings get downgraded, several investors are simultaneously forced to sell, causing the security to be completely illiquid
 - So, the bad quickly becomes worse

Investor motivation – spreads

- ▶ In the dull and staid world of Fixed income, ABS added glamour
 - Providing the high yield option
 - The most stark example of yield-driven investments is the bespoke or single tranche CDO
 - Where the investor dictates the rating and the yield
 - The structure, as well the composition of the assets, is created around investor's expectation
- ▶ Presence of several investors where manager's compensation depended on yields stressed the search for yields

Regulatory responses

- ▶ Risk retention rules
- ▶ Rules to check conflicts of interest
- ▶ Disclosure and transparency rules
- ▶ Rating agency rules
- ▶ Accounting rules
- ▶ Regulatory capital rules
- ▶ Compensation rules

Risk retention rules

- ▶ G20 leaders in Pittsburgh statement (Sept 2009) talked of risk retention by originators
- ▶ IOSCO report (Sept 2009) on Unregulated Financial Markets and Products
- ▶ CRD amendments in Europe
 - Uniform 5% risk retention
- ▶ Dodd Frank law in the USA
 - The Act provides for 5% risk retention, subject to exceptions
 - Important difference between US and UK rules
 - Synthetic transactions in USA are not subject to the risk retention requirement
 - Outside the definition of “asset backed securities” in the Securities Exchange law
 - Several exemptions in the proposed rules for “qualified assets”
 - Actual rules have not been framed
- ▶ Other countries that have enacted or are enacting these rules:
 - Australia, Brazil, Canada, Hong Kong, Japan, India
- ▶ Even as regulators have proposed risk retention rules, the market is already talking of the escape routes:
 - Originator SPVs

Conflicts of interest rules

- ▶ Several US litigations have focused on tell-tale stories of investor deception in sale of securitised products:
 - One such litigation is the much published Goldman Sachs ABACUS 2007-AC1 CDO
 - A synthetic CDO referenced to near BBB tranches of 90 subprime securitisations
 - Allegations are that hedge fund that had a role in selection of the 90 tranches also bought protection on those very tranches
 - Another examples – Class V Funding III CDO of Citibank – settled out of court
- ▶ The SEC has proposed Rule 127B
 - Rule to implement one of Dodd Frank requirements
 - Proposed in September 2011; comment period ended in Dec 2011
 - Rule proposes prohibition of material conflicts of interest among any of the “covered entities”
 - Final rule yet to be notified

Volcker Rule

- ▶ Sec 619 of the Dodd Frank Act is known as the Volcker Rule
 - Prohibits regulated banking entities from engaging in proprietary trading
 - Essentially, will affect CLO, CDO and ABCP conduits by banking companies
- ▶ Rule was enacted on Dec 20, 2013
- ▶ Implemented
 - With effect from 30th June 2014 for banks with above \$ 50 billion gross trading assets
 - With effect from July 21, 2015 for other banks

Disclosure and transparency rules

- ▶ EU CRD amendments that became effective from 31st December 2010 requiring additional disclosures
- ▶ SEC revised Reg AB
- ▶ Canada – disclosure requirements for public offerings and listing of ABS
- ▶ Japan – rules for traceability of underlying assets
- ▶ New regulation in Spain
- ▶ New regulation in Italy
- ▶ European Central Bank's loan level data template published 16th Dec 2010
- ▶ Several voluntary disclosure templates have come from Industry forums
 - American Securitization Forum
 - Association for Financial Markets in Europe
 - Japan Securities Dealers Association
 - FINRA's TRACE effective 16th May 2011 applies to asset backed securities too

Credit rating agency regulations

- ▶ IOSCO' revised code of conduct
- ▶ Dodd Frank provision on regulation of rating agencies

Regulatory capital rules

- ▶ Basel II published Enhancements to Basel II Framework in July 2009
 - Enhancing capital requirements for re-securitisation exposures
 - Tightened operational criteria for banks to rely on ratings
 - To reduce dependence on ratings
 - Increased CCF for revolving transactions to 50%
 - Higher market risk capital for securitisation exposures held as part of trading book
- ▶ BCBS published, in Dec 2012, a proposal to recast the securitisation capital guidelines completely
 - Second consultative paper was issued in Dec 2013
 - Final rules may be framed this year
- ▶ Basel III liquidity ratios
 - Liquidity coverage ratio
 - Does not include asset backed securities as liquid assets
 - Net stable funding ratio
- ▶ Insurance sector capital rules
 - NAIC, USA has increased risk capital requirements for RMBS and CMBS held by insurance companies

Compensation rules

- ▶ Financial Stability Board sound compensation rules

FATCA provisions applicable to offshore securitisation vehicles

- ▶ The US law Foreign Account Tax Compliance Act (FATCA) treats certain foreign financial institutions (FFIs) as “non participating FFI” unless such institutions agree with IRS to report transactions of US tax payers
- ▶ The rules are applicable to securitization vehicles too
- ▶ There is a carve out for “Limited life debt investment entities” for securitization vehicles in existence upto Dec 31, 2013

European initiative: prime collateralised securities

- ▶ Several European originators have formed an association for labelling certain securitisation transactions with a PCS label
- ▶ PCS label is assigned based on
 - Simplicity of the transaction
 - Transparency
 - Collateral quality
- ▶ Only the following asset classes are eligible
 - Auto Loans and Leases
 - Consumer Loans
 - Credit Cards
 - Dealer Floorplan Loans
 - Non-auto Leases
 - Residential Mortgages
 - SME Loans

Upshot of the discussion

- ▶ Securitisation, like other financial instrument, has its own virtues
 - It does not thrive because it beats the regulation or beats the rules
 - So, it will learn to thrive on its economic rationale
- ▶ Economic rationale of securitisation
 - To integrate asset markets with capital markets
 - Integration and differentiation of risks
 - As a principle of pooling of risks and their slicing into tranches, structured finance principle will continue to remain valid forever

Pockets of growth to look at

- ▶ With cosmetic benefits of securitisation becoming extinct, the stress has to be on use of securitisation as a funding source
- ▶ Hence, potential growth pockets to explore
 - Traditional, prime asset classes such as RMBS
 - The growing acceptance of covered bonds as a halfway house may only be a preparation to restarting of securitisation
 - One market participant says – RMBS volumes are healthy once again
 - Recent UK RMBS deals – Barclays Gracechurch Mortgage Financing, Santander, Lloyds, National Building Society
 - Future flows
 - Emerging market securitisations
 - That is where credit is fast expanding
 - Take money where money is needed
 - Affordable housing
 - microfinance

Traditional prime classes

- ▶ RMBS
 - Agency-backed issuance has been going on in the USA
 - Practitioners confirm strong interest in UK and Europe too
- ▶ Retail ABS
 - Rating agency reports show very strong performance of retail ABS through the crisis as well

U.S. Consumer ABS Rating Stability Summary^a

(%, July 1, 2007–June 30, 2011)

	Stable/PIF
U.S. Auto ABS	95.3
U.S. Credit Card ABS	97.8
U.S. Student Loan ABS	83.3

^aExcludes insured and interest-only bonds.

Fitch Report of 1st Dec 2011

Future flows

- ▶ Future revenues securitisations
 - Film revenues securitisation by Miramax
- ▶ Pool of power sector projects being planned in India

Emerging market securitisations

- ▶ The volumes in these countries may not be significant, but relative to the size of banking in these countries, there is a strong interest:
 - India:
 - The non-banking financial sector and the micro finance sector depends heavily on securitisation
 - Indonesia
 - African markets
 - Small, less known jurisdictions like Morocco have been experimenting with domestic transactions
 - Middle East
 - A recent prospect from the Saudi Arabia seems evaluating the securitisation option

Other non-traditional issuances

- ▶ Whole business securitisations
 - Sonic Corp
 - Church's Chicken – franchise fee securitisation through Cajun Global
 - NUCO2
 - Adam's Outdoor Advertising revenues
- ▶ SME loan securitisations from Spain

RMBS versus covered bonds

- ▶ Some market participants feel RMBS is preferred over covered bonds as:
 - Credit support required for RMBS is lesser than the overcollateralisation in case of covered bonds
 - For lower rated entities, the recourse back to the originator does not have much meaning
 - In any case, covered bonds do not lead to notching up the tranching more than 6 notches above
 - Non legislative countries – rating agencies find it difficult to be convinced with even 6 notches
 - Rating volatility in case of covered bonds
 - Recent European issuers
 - Reflection of sovereign risk on covered bond spreads
 - In case of certain nationalities, the swap spreads have gone upto 500 bps
 - Robustness of legal structure is far higher in case of RMBS as compared to covered bonds