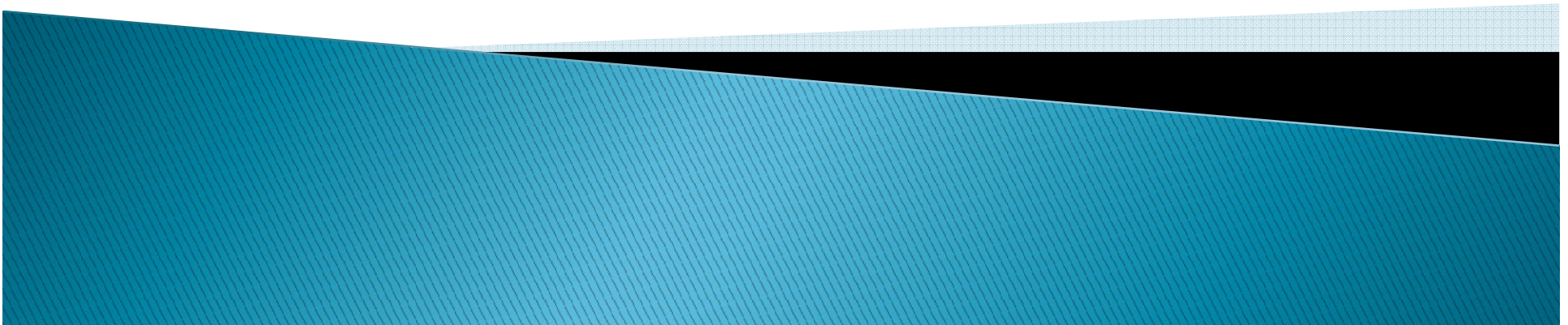


Mortgage refinancing post-Crisis MBS and covered bonds markets

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Mortgage refinancing: pre and post-Crisis

- ▶ The crisis caused realignment of mortgage refinancing strategies:

	Pre-Crisis	Post-Crisis
USA	<ul style="list-style-type: none"> •Agency MBS •Private Label RMBS •On-balance sheet 	<ul style="list-style-type: none"> •Largely agency MBS •Very little private label RMBS •Some extent of covered bonds •On balance sheet methods
Europe	<ul style="list-style-type: none"> •Covered bonds •RMBS •On balance sheet 	<ul style="list-style-type: none"> •Covered bonds •RMBS •On balance sheet
Asia-Pacific	<ul style="list-style-type: none"> •On balance sheet methods •RMBS 	<ul style="list-style-type: none"> •On balance sheet methods •Very little RMBS

Impact of the Crisis on Mortgage refinance markets

- ▶ Clearly, MBS became a dirty word
 - Difficult to see much reason behind a general investor flight away from the market – except the legacy of the past
 - There is nothing to indicate the securitisation model itself was wrong
 - Regulatory reaction is only helping to increase investor apathy
- ▶ Covered bonds have got a new reason for popularity
 - Partly, this is explained by the unpopularity of MBS
 - Partly, structured covered bonds seem possible even in jurisdictions which do not have the benefit of special laws
- ▶ Is RMBS market completely dead?
 - Not really – there have been several UK issuances in 2011
 - Some transactions from Australia
 - Sporadic activity from emerging markets also continues

Are the markets restarting at all?

- ▶ Joint Forum July 2011 report: “meaningful recovery in securitization markets is 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

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
 - 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”
- ▶ 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 ends in Dec 2011
 - Rule proposes prohibition of material conflicts of interest among any of the “covered entities”

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

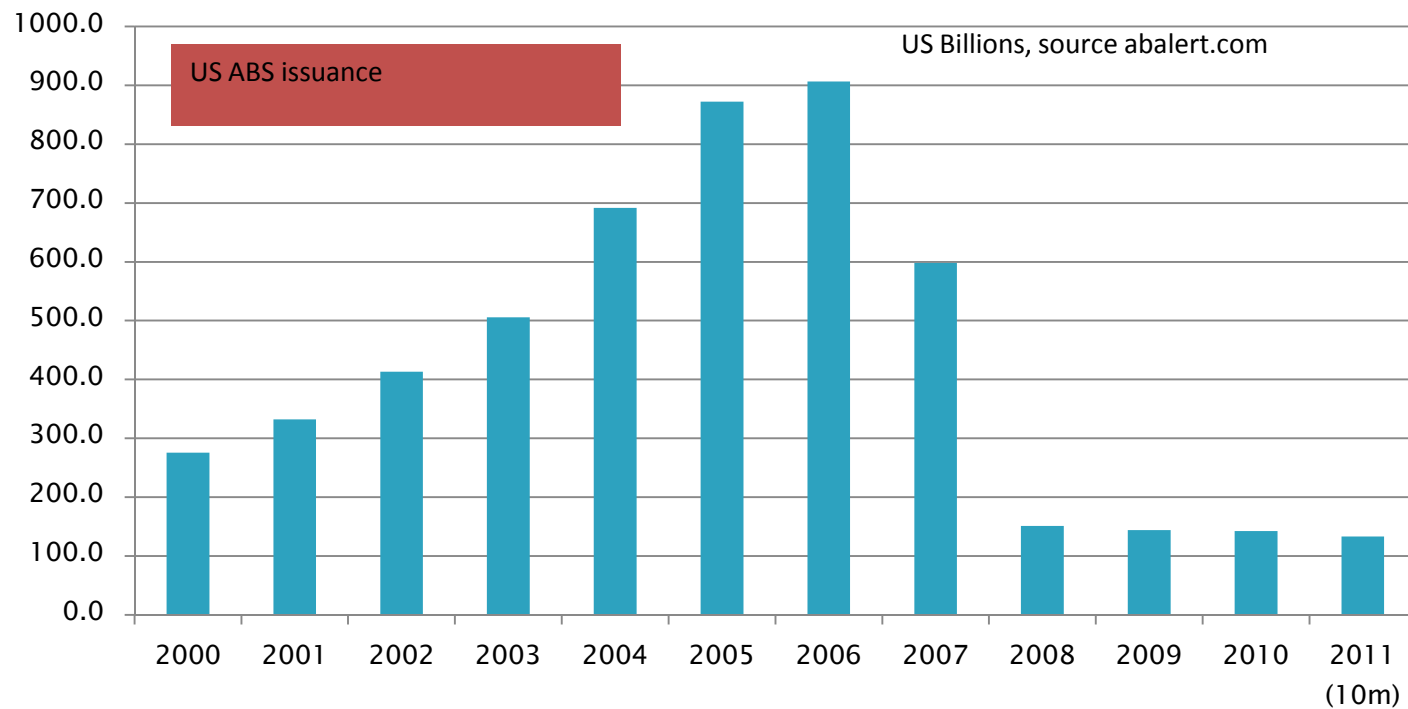
Regulatory capital rules

- ▶ 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
- ▶ 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

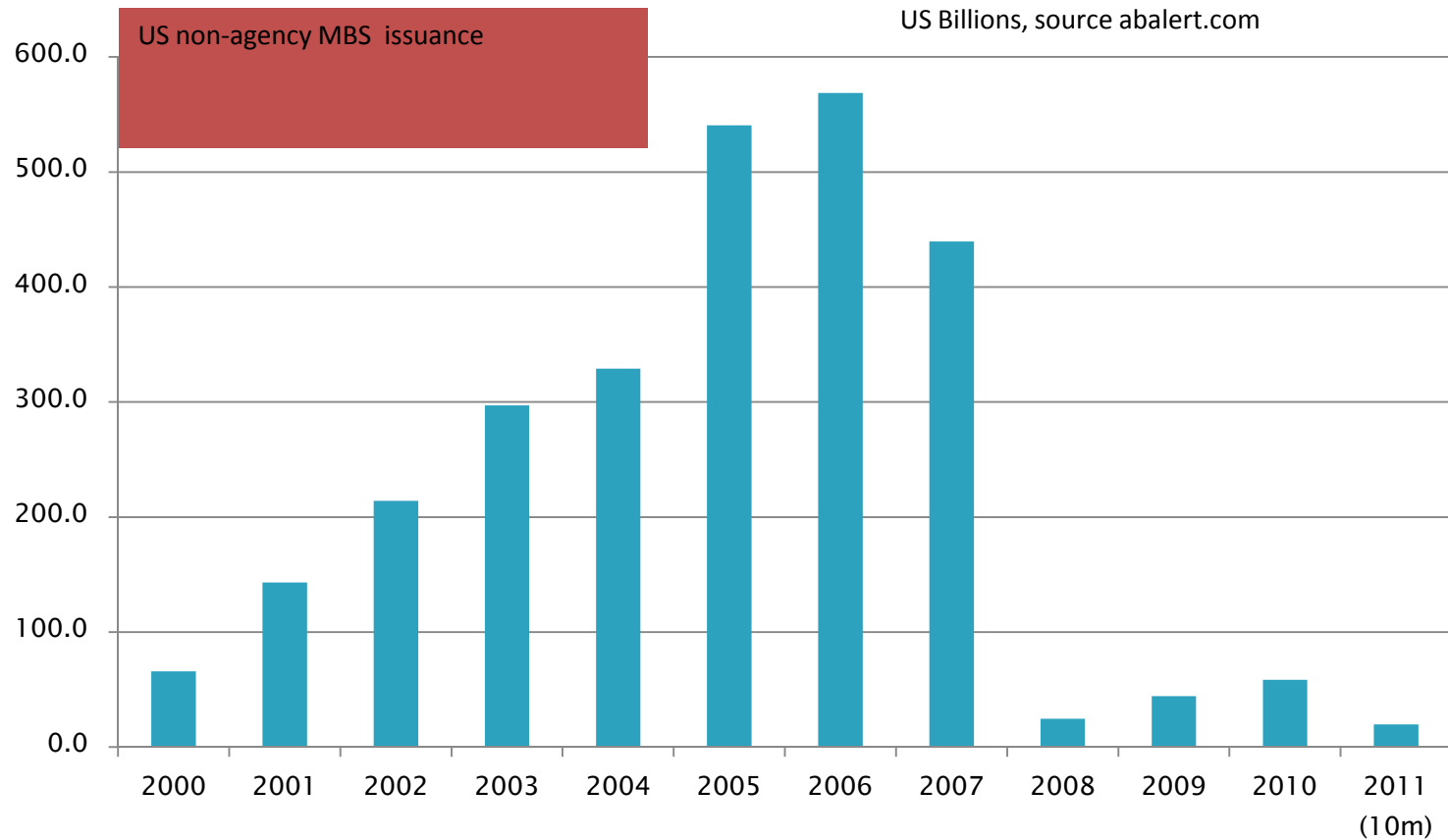
Compensation rules

- ▶ Financial Stability Board sound compensation rules

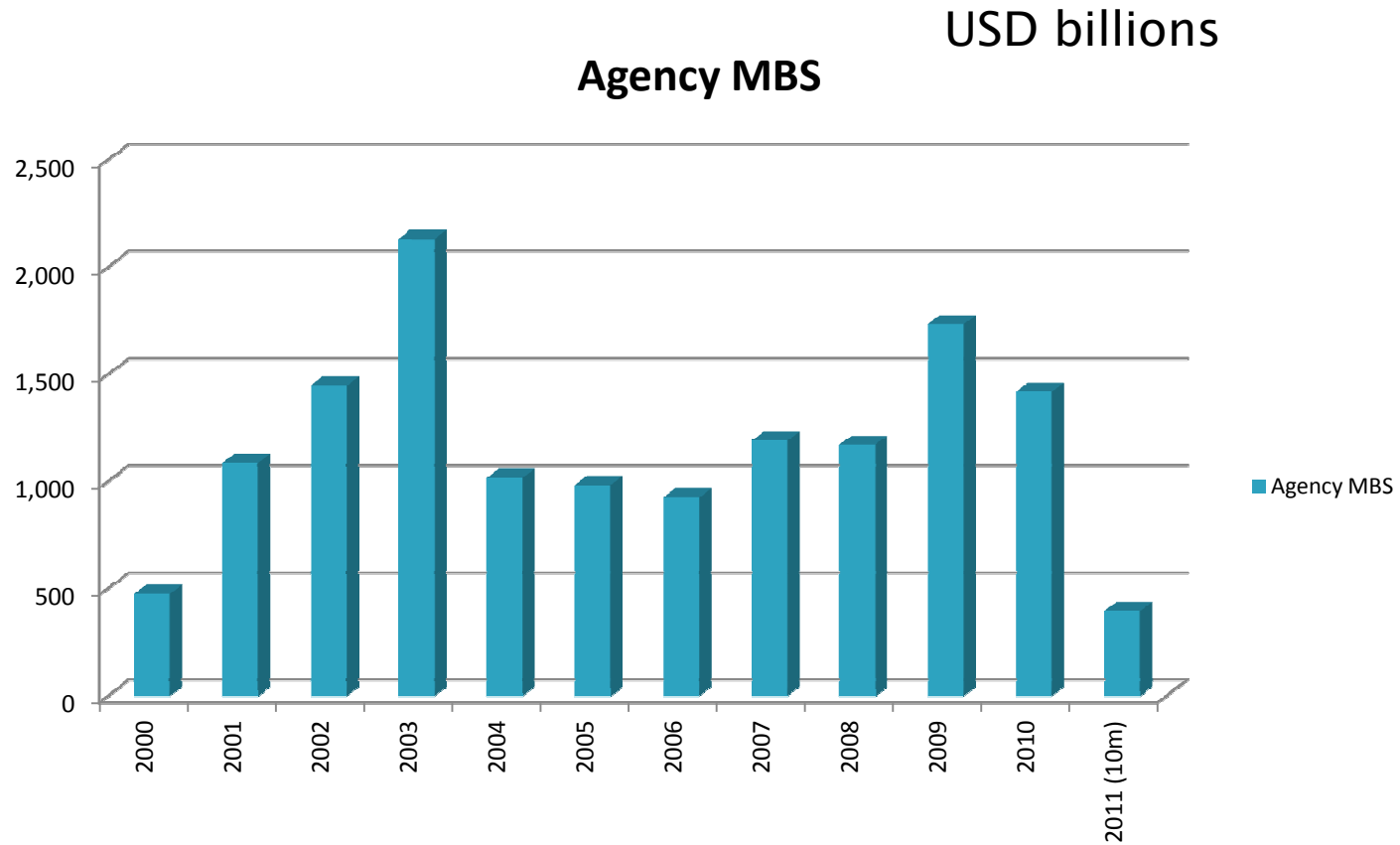
US ABS issuance



US non-agency MBS issuance

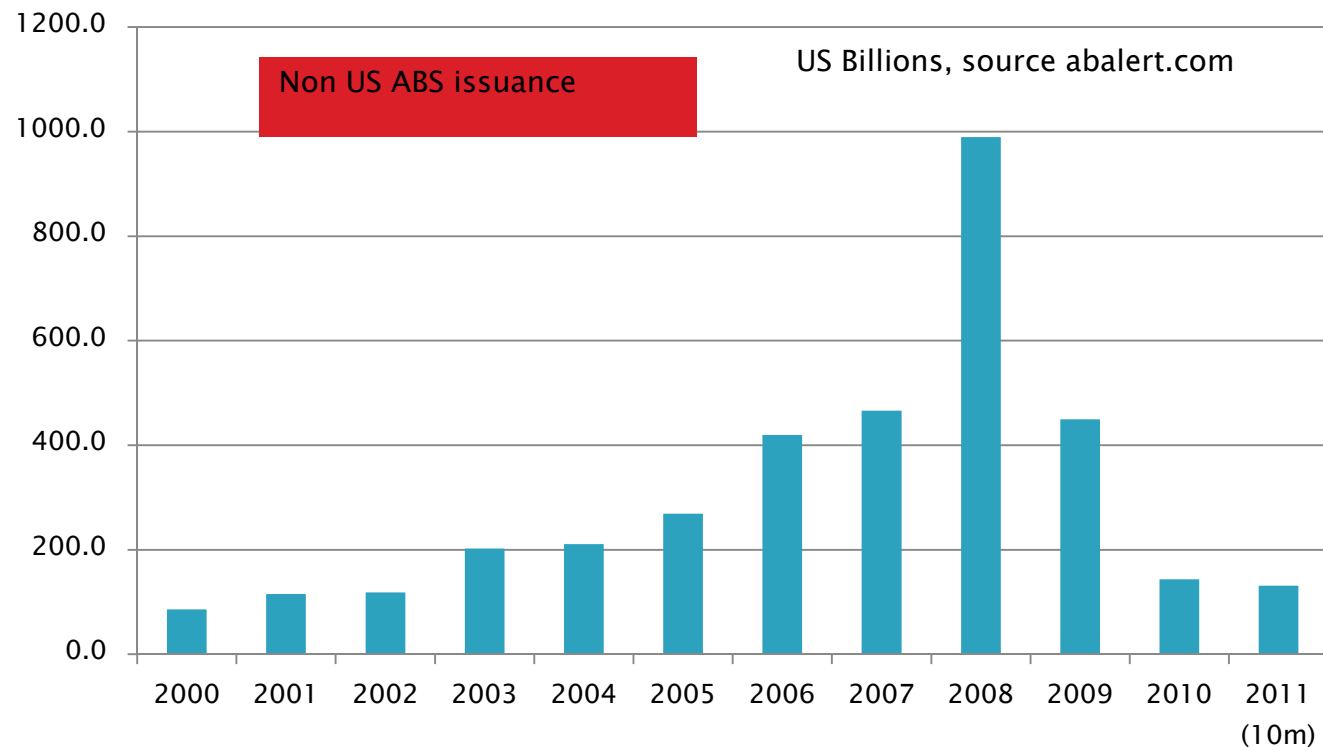


Agency MBS data



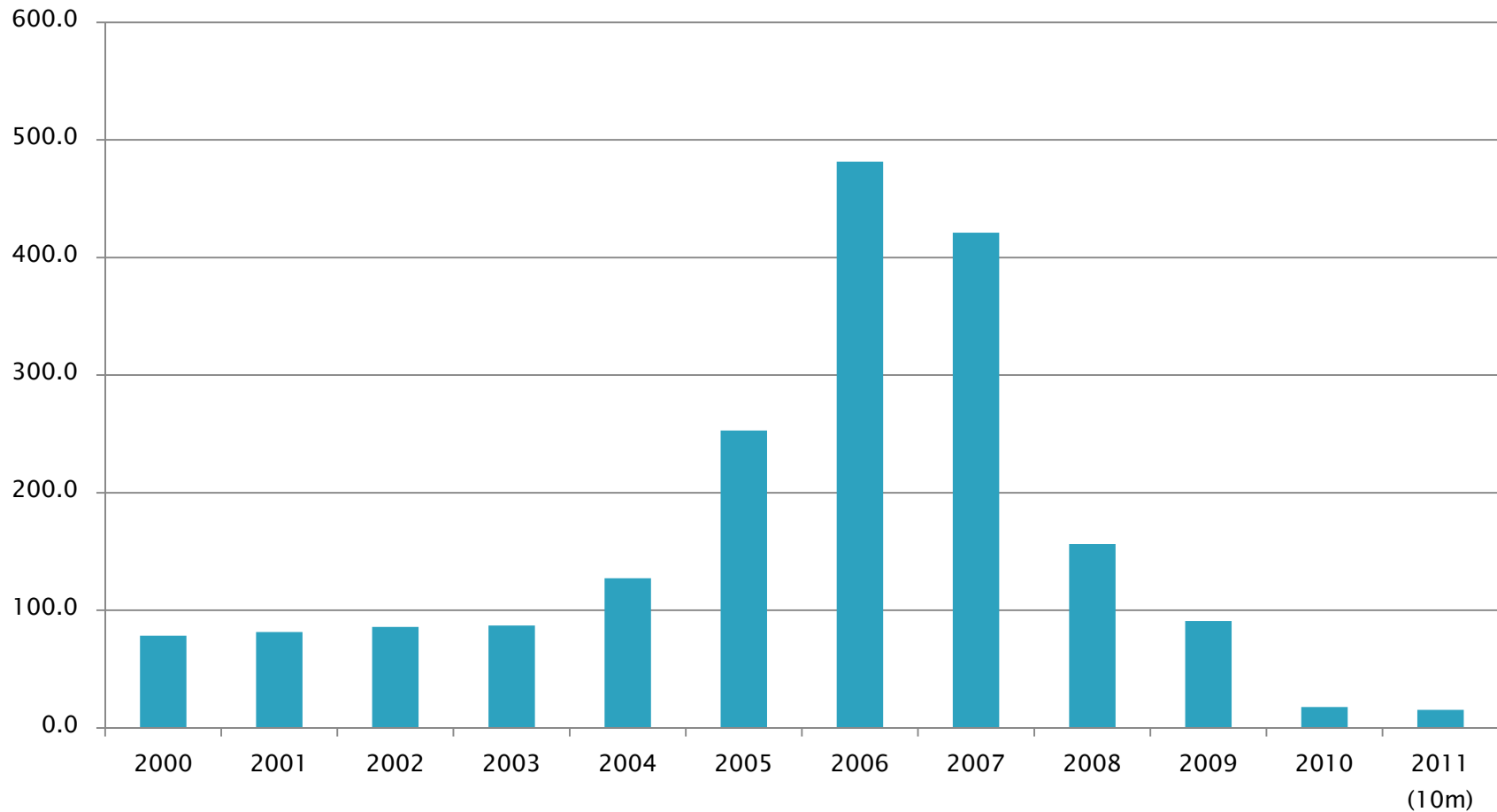
Based on data from SIFMSA site

Non US ABS issuance

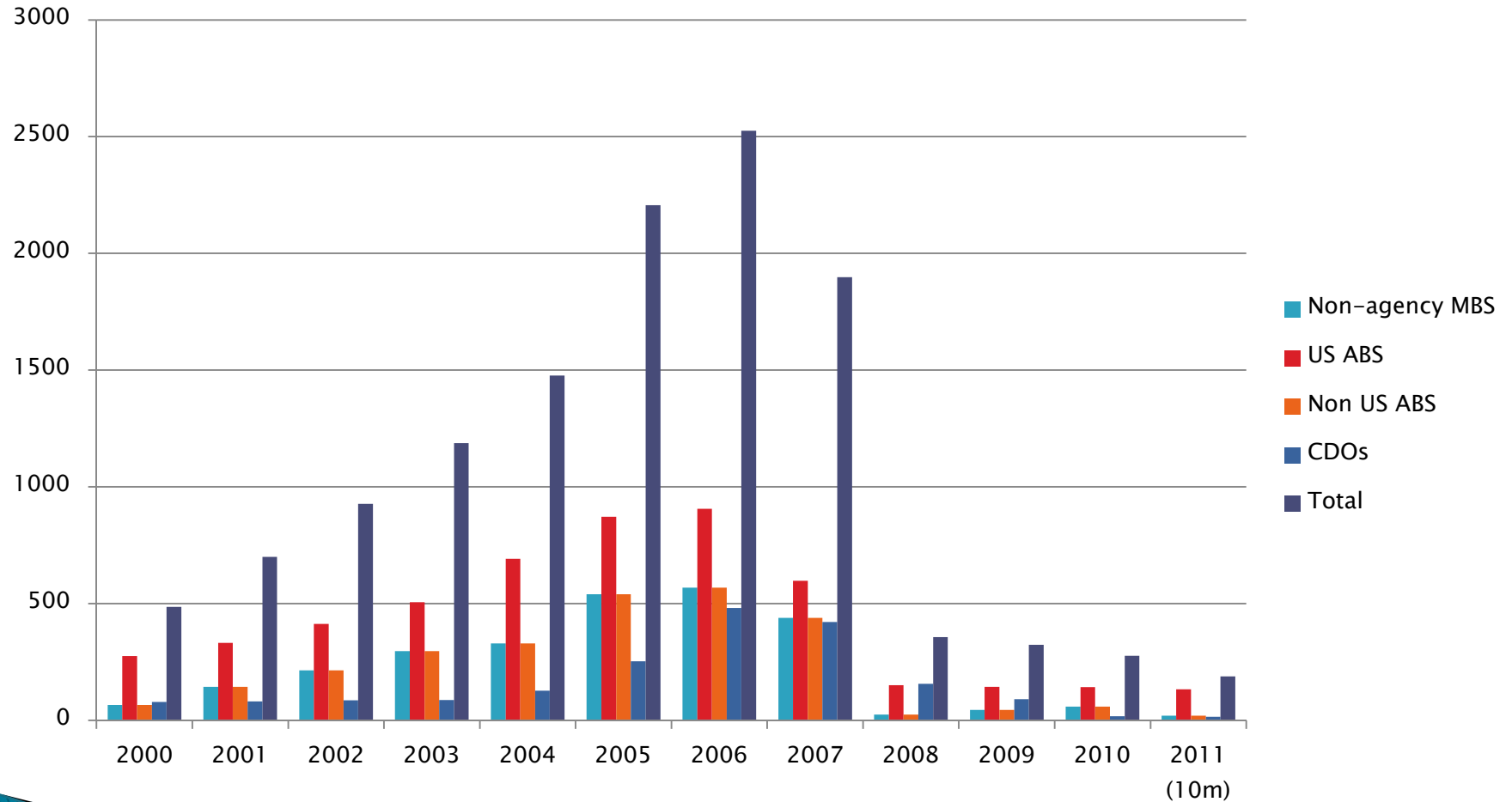


- large part of European issuance is “retained” issue under collateral program of the ECB

Global CDO issuance

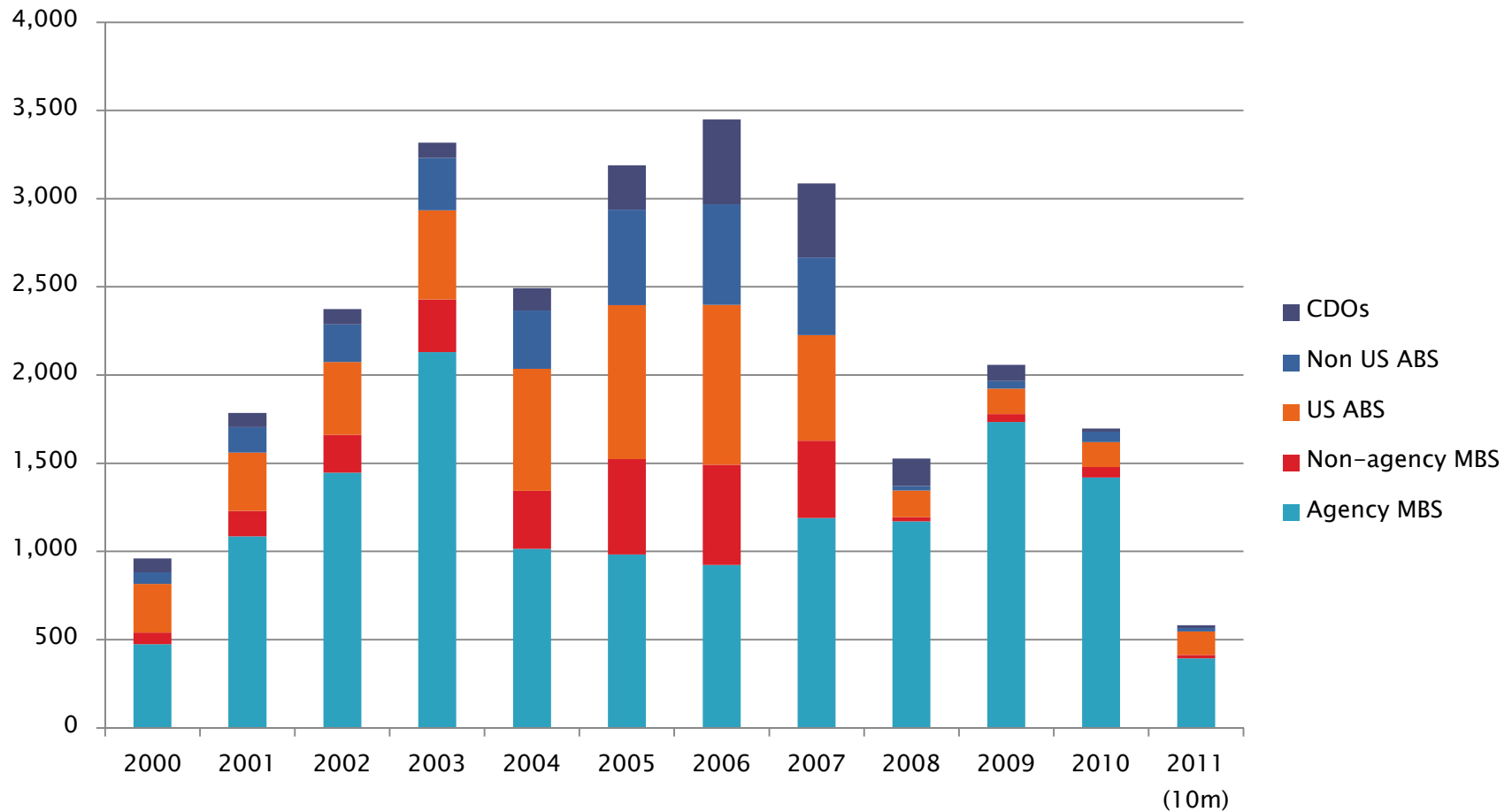


Worldwide securitisation volumes (excluding agency MBS)



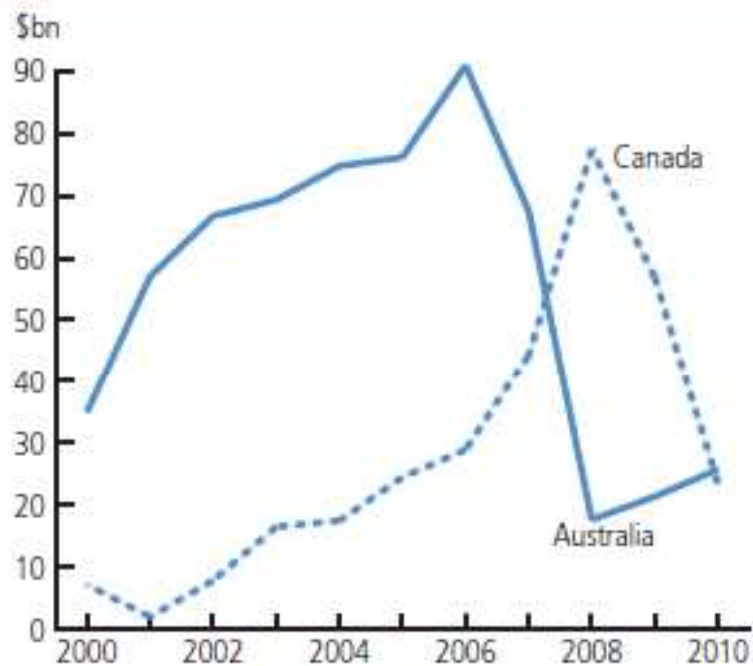
USD billions; compiled by author from data at abalert.com

Global securitisation volumes including agency MBS



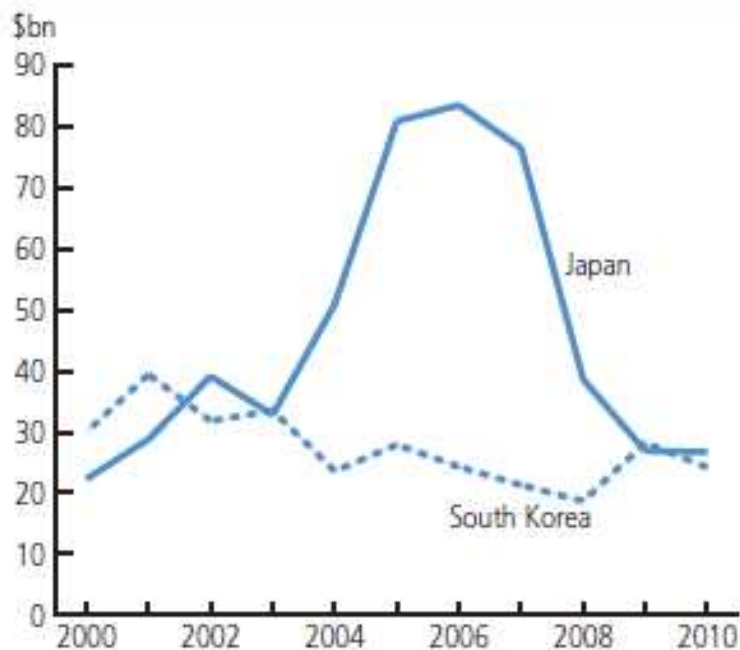
Non-US, non-EU issuance

Securitisation issuance in Australia & Canada



Source: Reserve Bank of Australia, Bank of Canada

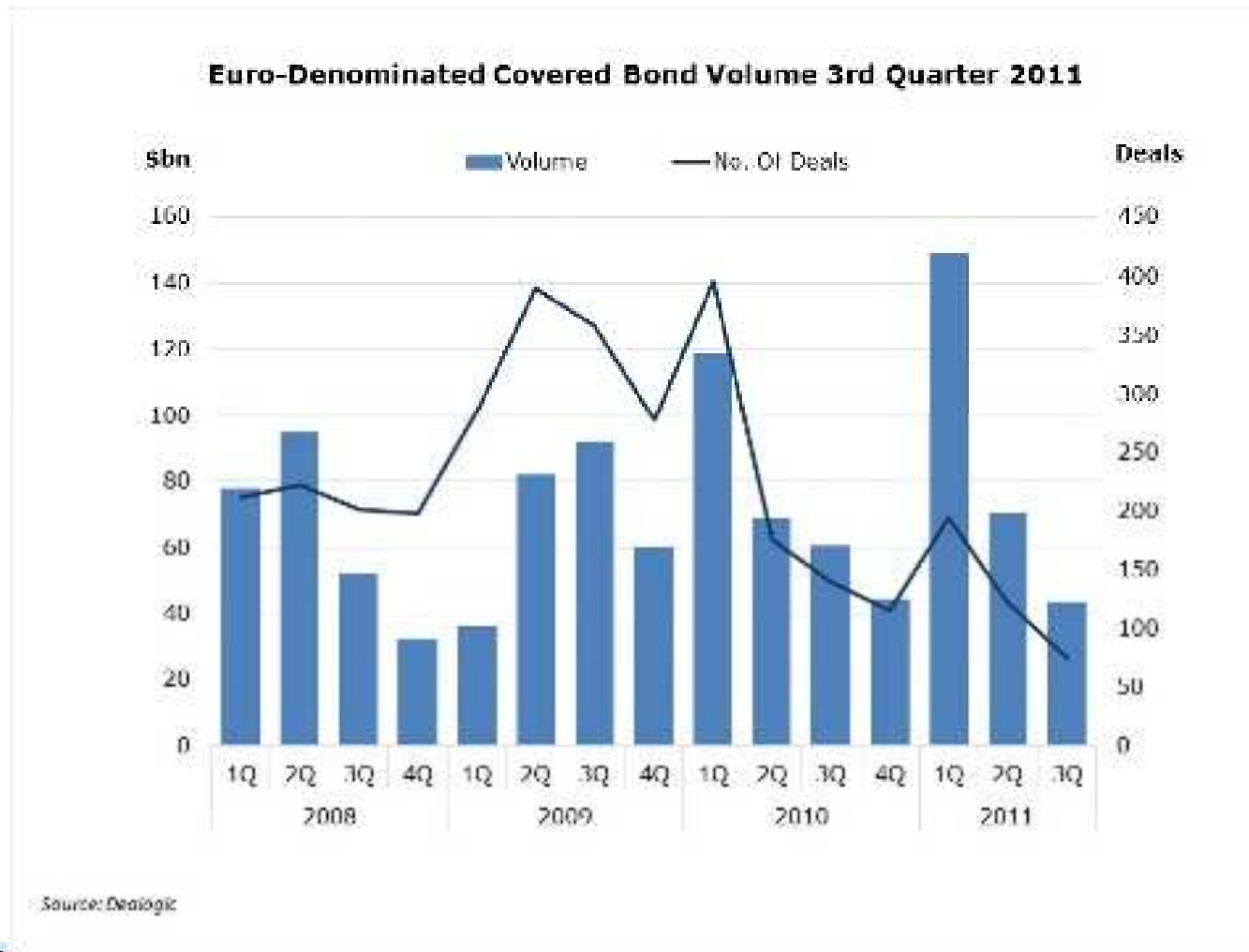
Securitisation issuance in Japan & South Korea



Source: Fitch Ratings, Thomson Reuters

Source: thecityuk.com
report on securitisation

Covered bonds issuance



What are covered bonds?

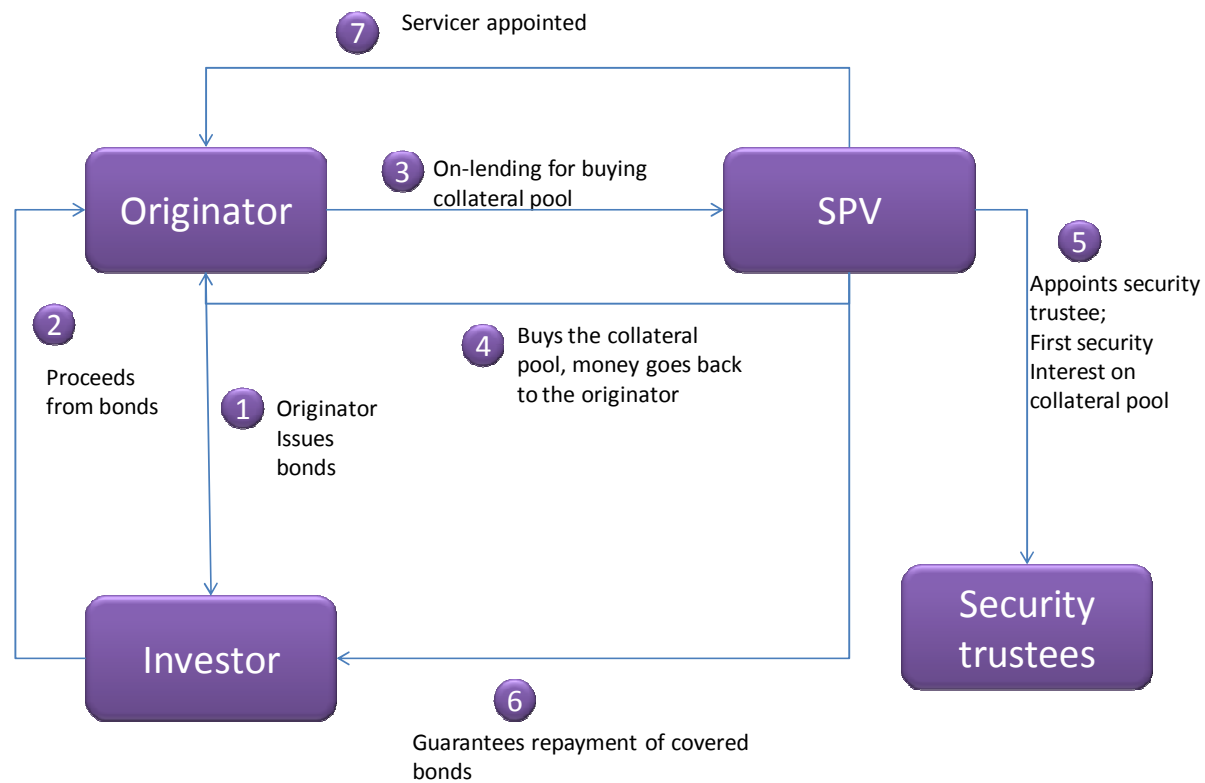
- ▶ A half-way house between corporate bonds and MBS, relying on the strengths of the issuer as well as the collateral pool
- ▶ Basically a device to get ratings above rating of issuer
- ▶ Features:
 - Full recourse obligation of the issuer – hence on the balance sheet
 - Collateral pool is identified and ring-fenced, as in case of MBS
 - However, collateral pool is dynamic
 - Mismatches between the cash inflows from the pool and cash outflows to investors
 - Investors presumably have bankruptcy-protected claim on collateral
 - In legislation countries, based on the special legislation
 - In common law countries, based on true sale devices
 - The collateral pool typically uses over-collateralisation as device of credit enhancement
 - Backed by bankruptcy protection and credit enhancement, transaction gets rating upliftment
 - Rating agencies go upto 6 notches above the rating of the issuer

Basic structures of covered bonds

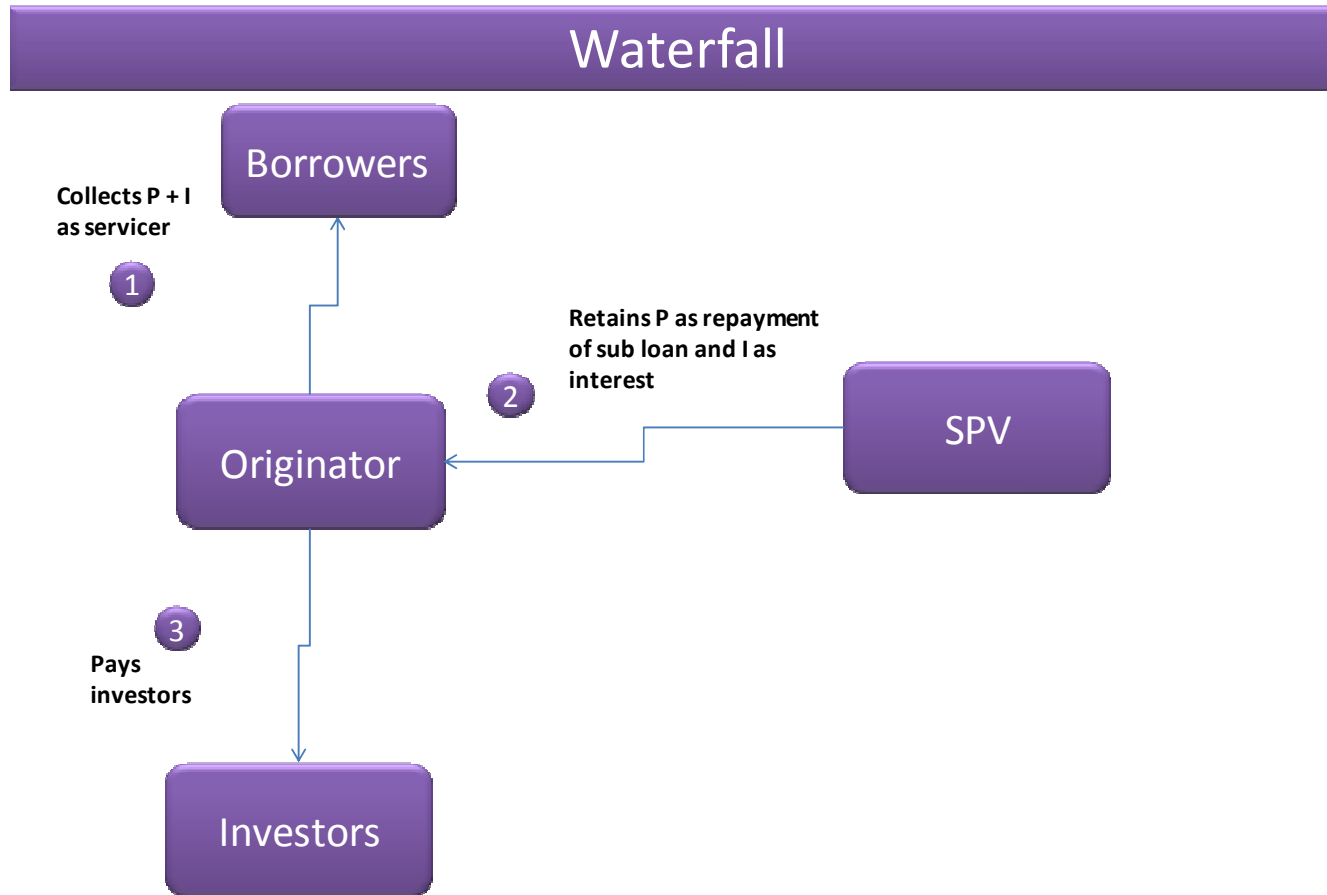
- ▶ Legislative structures
 - Most of continental Europe, including Germany, France, Denmark, Spain, etc
- ▶ Quasi-legislative structures
 - Not enabled by law but subsequent legislation recognises covered bonds
 - UK, Australia
- ▶ Purely common law structures
 - USA, Canada, New Zealand, Korea

Structured covered bonds

At the time of issuance



Structured covered bonds – cashflow structure



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