

The Journal

Breaking the ice: Using transparency and accountability to thaw the securitisation markets

The securitisation markets were at the centre of the financial crisis. In this article we discuss what happened to the securitisation industry and the future landscape.

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The subprime mortgage scandal's impact on the securitisation markets was immediate and devastating. Between 2006 and 2008, global securitisations fell by 56% while the value of transactions dropped by \$2.45 trillion.¹



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The consequences of this dramatic decline reach far beyond the securitisation industry. Because they play a key role within the global capital markets, the securitisation markets' struggles have substantial implications for continued economic growth.

In its *Unregulated Financial Markets and Products Final Report*, the International Organisation of Securities Commissions (IOSCO) declared: "The absence of a well functioning securitisation market will impact consumers, banks, issuers and investors. The price of credit is likely to be higher for the consumer and the availability scarcer. Banks will no longer have a tool to reduce risk and diversify their financing sources."²

The securitisation markets need to repair their damaged reputation and restore investor confidence. In our view, they should seek to do so by embracing transparency and accepting greater accountability. In this article we summarise some of the key points raised in *Breaking the Ice: Using Transparency to Thaw the Securitization Market Viewpoint*.³

What went right?

Securitisation took its first tentative steps in the United States in the late 1970s. Thereafter, securitisation techniques spread across North America and were adopted and adapted in Europe, Asia and Australia. Financial institutions were quick to recognise a good idea when they saw one: securitisation offered the opportunity to free up capital to support additional underwriting activity, reduce credit costs, and extend the funding requirements to a broader base of the capital markets, to the benefit of both consumers and businesses.

The early securitisation structures proved highly popular with investors because they were simple, easy to understand, and provided competitive returns. The risks, meanwhile, were clear and comprehensible. Fixed income investors found they could diversify their portfolios with consumer credit exposure. With time, variable rate securities evolved and customised securities were developed to satisfy specific investor requirements.

In less than 30 years, securitisation evolved into a mainstay of the financial markets. Nowhere did the concept gain greater acceptance than in the country that gave it birth. In the two decades before the financial crisis, the percentage of home mortgages securitised in the United States increased from 10% to approximately 55%.⁴ From 2005 to 2007, US financial institutions securitised approximately 46% of the total mortgage credit they originated.⁵

What went wrong?

At times, however, this progress came at a price to investors, as quality and transparency levels fell and risk levels rose.

Initially, the majority of mortgages that were securitised were seasoned mortgages that were subject to robust underwriting. However, as the securitisation markets became more efficient, the time from loan origination to securitisation decreased. The shortened timeframe and the desire to increase origination volumes led to a slippage in the discipline around underwriting and credit evaluation.

As more investors entered the mortgage-backed security (MBS) market, some chose to make a limited independent

¹ *Restoring Confidence in the Securitization Markets*, global initiative, Securities Industry and Financial Markets Association (SIFMA) – 3 December 2008.

² *Unregulated Financial Products and Markets*, IOSCO – August 2009.

³ *Breaking the Ice: Using Transparency to Thaw the Securitization Market*, PwC – February 2011.

⁴ *Restoring Confidence in the Securitization Markets*, global initiative, Securities Industry and Financial Markets Association (SIFMA) – 3 December 2008.

⁵ *Restoring Confidence in the Securitization Markets*, global initiative, Securities Industry and Financial Markets Association (SIFMA) – 3 December 2008.



evaluation of the risk or performance of their structured products. Instead, they relied heavily on the associated ratings assigned by Nationally Recognised Statistical Rating Organizations (NRSROs).

Industry demand for new product origination resulted in the expansion of the origination process traditionally performed by mortgage lenders and banks. The independent broker network grew and niche service providers and specialists entered the market. Because they were often paid up front, these brokers were not incentivised past the point of origination. Moreover, much of this new activity was subject to little or no regulation.

While early market innovations had proved advantageous to investors, the industry came to rely on increasingly complicated securitisation structures and decreased credit enhancement levels. Lenders, meanwhile, introduced a wide range of new mortgage products, some of which were highly complex and untested in markets with significant economic stress.

The advent of the originate-to-sell model created an environment in which lenders had minimal risk once the mortgages were securitised. Because of the inherent risk associated with subprime mortgages, lenders were sometimes encouraged to securitise a large portion of the subprime loans they originated.

In early 2007, credit rating agencies changed the models they used to evaluate the subprime mortgage market. By the summer of that year, tens of billions of dollars of MBS had been downgraded, many to below-investment grade.

Investors, guarantors and credit rating agencies were slow to respond to these fundamental changes. They continued to rely on pricing and structuring models built on historical data that did not fully anticipate the impact of the emerging macroeconomic trends on consumer behaviour. As a result, the markets did not adequately assess and price credit risk. Moreover, there had been a change in the underlying credit quality of the borrowers and, in some cases, dramatically different payment performance.

The outdated pricing models assumed that the housing market would continue to follow historical patterns of rising home values and low defaults. Based on the prime mortgage market, the models did not take into account the unprecedented percentage of MBS that contained subprime mortgages and weakened underwriting practices. (In 2001, subprime or Alt-A loans comprised

just 9% of all US securitisations; by 2006, that figure stood at 40%.⁶) The pricing models also failed to account for the loss severity and economic deterioration associated with the then current market conditions and declining house prices.

Prior to the financial crisis, 80–95% of a typical subprime or alt-A MBS deal was assigned the highest possible AAA rating.⁷ In early 2007, credit rating agencies changed the models they used to evaluate the subprime mortgage market. By the summer of that year, tens of billions of dollars of MBS had been downgraded, many to below-investment grade.

⁶ *The Rise and Fall of Subprime Mortgages*, Dallas Fed – November 2007.

⁷ *MBS Ratings and the Mortgage Credit Boom*, Federal Reserve Bank of New York – May 2010.

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The results were, of course, catastrophic. As the value of these securities fell, banks were subject to stress, and investor confidence in the capital markets evaporated.

A roadmap for rebuilding the securitisation markets

In our opinion, the securitisation markets should focus on six guiding principles. They should seek to:

- restore investor confidence through transparency, expanded disclosures, and enhanced quality of data and other relevant information;
- improve reporting and disclosure requirements by ensuring the financial reporting and disclosure models meet the needs of investors, regulators and other stakeholders;
- enhance accountability for all market participants (borrowers, issuers and investors) through robust underwriting (including standards and disclosures), appropriate representation and warranties for compliance with the document terms, and effective governance and oversight of the process over its entire life;
- implement cost-effective oversight to improve accountability in and oversight of the markets;
- properly align and balance the risks, rewards and costs of securitisation among all participants; and
- re-examine regulatory capital rules to ensure that they strike the right balance for on- or off-balance sheet securitisations, are implemented consistently across the globe, and do not disincentivise the process.

55%

In the two decades before the financial crisis, the percentage of home mortgages securitised in the United States increased from 10% to approximately 55%.

Expanded trade information

The Securities and Exchange Commission (SEC) is considering the introduction of a requirement that all MBS transactions be disclosed in a manner similar to other exchanges or regulated markets. This requirement would include the currently exempt private structured finance market, where some types of asset-backed securities (ABS) are issued. It is hoped that such a move would not only increase transparency but also boost demand and liquidity.

An Office of Credit Rating Agencies is being established under the auspices of the SEC. Recent legislation includes provisions for enhanced disclosure of ratings methodologies and third-party due diligence, and would require agencies to consider independent information as part of their rating methods.

Further disclosure

Investors need more and better information about the asset pools that back the securities. That information must be detailed and current and must be provided in such a manner that investors can use the information effectively. Sponsors must not only provide investors with information at the time of the inception of the securitisation but also give them ongoing performance data.

A raft of new regulations will seek to address problems highlighted by the financial crisis and provide investors with the data and tools they need to make independent risk assessments. Both the European Securitisation Forum (ESF) and the American Securitisation Forum (ASF) are endeavouring to make data more standardised and readily available for investors.

However, we do not believe that a ‘one size fits all’ approach to pool asset characteristics and performance data is appropriate for all consumer asset classes. While asset-level disclosure may be appropriate for the RMBS (residential mortgage-backed securities) market, loan-level data may not be appropriate for prime auto securitisations.

Issuer responsibility

One of the problems with the MBS market that came to light during the financial crisis was investors' inability to enforce contractual provisions efficiently. Issuers of MBS should, therefore, be looking to strengthen and standardise the representations and warranties they provide to investors.

The SEC is proposing new 'shelf eligibility' criteria for MBS. These would require that the CEO of the MBS issuer certify that the assets have characteristics that provide a reasonable basis to support cash flows as described in the prospectus. Similar to the Sarbanes-Oxley certifications, the assertion would have to be given in a specified format and could not be altered. The certification would not be a guarantee of payment, but merely a statement of what was known at the time of the offering. The liabilities of a signing CEO are not yet clear and many practical questions remain, including what assumptions or scenarios must be considered when making the certification.

The SEC is also considering a requirement that the filing of a prospectus for an ABS transaction include a computer program that models the contractual 'waterfall'

(the mechanism that determines, among other things, how cash and losses are distributed to or divided between investors). The computer program would allow investors to input their own assumptions and loan-level performance data and so analyse the ABS offering. Since the requirement adds incremental costs to the securitisation process and additional responsibilities for issuers, it will surely be the subject of significant debate.

Investors want to know that the quality of the assets underlying an MBS transaction is not deteriorating. They should seek to develop a common understanding of the scope of servicers' contractual duties and responsibilities, and establish adequate benchmarks for evaluating the servicers' performance over collections and maintaining the asset base. Expanded information would facilitate investor analysis and raise confidence in servicer performance.

Several industry groups have recommended the development of industry-wide servicing standards and stressed the importance of periodic monitoring of servicer performance. They suggest that these standards should be backed by contractual, reporting and

enforcement mechanisms to create an incentive system based on greater transparency around servicer performance. The Global Joint Initiative (GJI) has recommended the development of market-standard performance metrics, servicing provisions for pooling and servicing agreements, more consistent expectations of mortgage borrowers in relevant countries, and the clarification and streamlining of procedures for removing or replacing servicers who fail to live up to the relevant performance standards.⁸

Investor responsibility

Investors should focus their due diligence efforts on the pre-securitisation process. By demanding enhanced market practices and greater transparency, they can obtain reassurance about the characteristics of a securitisation's underlying assets.

The Global Joint Initiative recommends that core standards be developed regarding the pre-securitisation due diligence process, as well as disclosure of information about that process. It advocates that credit rating agencies publish assessments of origination practices and relative performance of underlying collateral, measured against the industry-backed standards, by originator. It suggests that originators publicly disclose information around their own internal quality assurance practices for all origination activity.

Investors should establish procedures to ensure that their investments in securitised products are monitored at all times. The GJI has recommended that enhanced ongoing reporting of RBMS performance should be made available to investors throughout the life of an RMBS transaction. Investors should then be able to monitor and reference this information and make independent evaluations of the ongoing performance and risk of their structured investments. The GJI has also made a number of proposals to improve the accuracy and transparency of securitised product valuations. Most notably, it has recommended the formation of a Valuation Task Force ('Project Value') to determine guidelines for the range of securities for which valuations would be contributed, and the expectations of participants and contributors.



New trading book rules introduce higher capital requirements to capture the credit risk of complex trading activities and include a stressed value-at-risk (SVaR) requirement.

We believe that investors in the securitisation and structured credit markets have the capabilities and resources necessary to assess and monitor the risks embedded in those products. Rather than rely exclusively on credit rating agencies, investment firms should have processes in place to assess risk and the creditworthiness of securitisations. Financial intermediaries and investors should revisit their policies and procedures to ensure that their own capabilities, as well as those of their counterparties, are consistent with the minimum standards mandated by regulators and supplemented by industry-leading practices.

Directors and senior executives of financial institutions must develop a better understanding of the risks inherent to the securitisation markets and the potential ramifications of ongoing changes in those markets. Greater knowledge of the industry would allow participants to have more informed dialogues regarding exposures and would enhance their ability to assess their institutions' own capabilities. Educational programs should be established or enhanced for directors, investors and executives who oversee securitised and structured credit groups.

Balancing risk and costs

With many new regulations yet to come into force, it is not possible to determine the overall impact of the new rules on balance sheet exposure. It is to be hoped that the regulators will not implement rules that are not securitisation friendly.

At the present time, the European Union's balance sheet requirements are, in broad terms, similar to those of the US. There are, however, some key differences, the most notable being the retained risk requirement recently introduced by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

While European rules place additional responsibility on investors, Dodd-Frank stipulates that securitisers of asset-backed securities (and, potentially, originators of the collateral securitised) collectively retain at least 5% of the credit risk of assets transferred or sold through the issuance of ABS. While ABS backed by collateral deemed to be of low risk will have a lower retention threshold, securities backed by 'qualified residential mortgages' will be completely exempt.

The requirement's goal is to align the interests of the issuer with those of the investor. It is not possible to gauge the requirement's impact at this time.

A recent report⁹ suggests that risk retention requirements, if set too low, might impose substantial macro costs – by increasing the risks of instability in the financial markets, for example. Conversely, an excessive requirement could unduly limit credit availability and economic growth, thereby outweighing the deemed systemic benefits. As and when the picture becomes clearer, the costs of securitisation should be monitored to ensure the system is attractive to all parties.

Basel III

The need to strengthen the Basel framework's risk coverage has been one of the key lessons of the financial crisis. To this end, in July 2009 the Basel Committee issued revised capital requirements for trading book exposures and complex securitisation transactions. The new proposals focus on strengthening capital requirements for counterparty credit risk arising from derivatives, repo and securities-financing activities. The enhancements to the framework are designed to raise capital buffers backing these exposures, reduce procyclicality and provide additional incentives to move over-the-counter derivative contracts to central counterparties and exchanges.

New trading book rules introduce higher capital requirements to capture the credit risk of complex trading activities and include a stressed value-at-risk (SVaR) requirement. The committee believes that this requirement will help dampen the cyclical nature of the minimum regulatory capital framework and promote a more forward-looking approach to provisioning.

The committee is also strengthening the treatment for certain securitisations in Pillar 1 (minimum capital requirements). It is introducing higher risk weights for resecuritisation exposures to better reflect the risk inherent in these products, and requiring that banks conduct more rigorous credit analyses of externally rated securitisation exposures. Higher capital requirements for trading, derivative and securitisation activities will be introduced at the end of 2011.

The committee has issued a number of guidelines in relation to securitisation. Capital charges calculated under the standardised method and applied to the banking book will be extended to apply to securitised products on a bank's trading book, with the exception of correlation trading. Resecuritisation exposures (collateralised debt obligations of ABS or RMBs) will be treated differently from securitisation exposures to reflect their risk levels. Capital requirements for resecuritisation positions will generally be double the requirements for simple positions.

Securing the future

The securitisation markets were at the centre of the financial crisis. By rebuilding investor confidence through greater transparency and accountability, they could help lead the way towards global economic recovery.

PwC provides an array of services to the financial markets, including assistance with the challenges faced by the securitisation markets. To discuss any aspect of the issues raised in this article, please speak to your usual PwC contact or one of the article authors.

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