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Overview

- Over the last 2 ½ years, the question has been asked whether securitization is dead. Unlike others, I’m more optimistic about the future of securitization.

- Securitization’s recent experience reminds me of the mythical phoenix. At the end of its 1,000 year life, phoenix ignites in a fierce flame and is reduced to ashes and from the ashes a new, young phoenix emerges reborn to live again.

- Securitization will be reborn like the phoenix, but securitization’s rebirth – unlike that of the phoenix – will not be mythical.
A strong, safe securitization market ...
Overview

- Prior to the wide-spread use of securitization, a significant source of funding for large US banks was uninsured wholesale deposits
  - This “hot” money would have left the bank very quickly during the recent crisis
- Banks will continue to use securitization for a necessary source of funding
- Some have advocated the expanded use of covered bonds as a panacea
  - However, overreliance on these instruments could potentially be detrimental as their use could restrict liquidity, particularly if a bank is in trouble, as high-quality assets are encumbered; any deteriorating asset collateral must be replaced; and creditors have a residual claim on the bank
  - When an originator defaults, banks are unable to access collateral until the bond matures as investors have preferential claim on the segregated assets
US Issuance of MBS/ABS
(millions of dollars)

Agency MBS
Private MBS
ABS
The misalignment of incentives in securitization, as well as the asymmetric information available to issuers versus investors, have been cited as factors in the crisis because they are viewed as contributing to the decrease in the level of underwriting standards.

The thought is that if an originating bank doesn’t retain an interest in the assets sold and securitized, then the bank has less incentive to underwrite good credits.

In addition, since a issuing bank has more information regarding the quality of the securitized assets, they can sell off “bad” assets to investors.

This view disregards the fact that banks are going concerns that often continue to service the underlying assets and earn fees doing so. In addition, not adequately servicing the underlying assets could lead to lawsuits from investors and reputational risk could restrict the bank’s continued access to the market for funding.
Another view suggests that the crisis was a result of systemic failures of risk management on the part of investors and guarantors who both incurred significant losses.

The shortcomings in risk management include among other things:

- Lack of due diligence, including overreliance on credit scores and external credit ratings
- Inadequate disclosures regarding asset quality and structure of MBS/ABS/CDOs
- The mispricing of risk, particularly with structured products due in large part to the first two shortcomings, such as the monoline guarantors that incurred large losses, but were paid very little to assume the risk
Supposition?

- It would appear that both misalignment of incentives and shortcomings in risk management contributed to the recent crisis.
- Therefore, both issues have to be addressed in order to adequately resolve the shortcomings that have been arisen in the securitization market.
If an originating bank retains “skin in the game,” one view is that this will incent the originating/servicing bank to underwrite assets to a higher standard in order to reduce the potential loss to its retained interest.

The EU has adopted, and the US Congress has proposed, a 5% retention requirement.

FDIC and the SEC also have proposed a 5% retention requirement.

- FDIC – proposed “safe-harbor” from repudiation of contracts
- SEC – proposed shelf registration requirements
So ....

- Will a retention requirement resolve the misalignment of incentives issue or promote higher underwriting standards?
While a retention requirement may be useful, such a requirement will not, in and of itself, correct potential misalignment of incentives nor promote higher underwriting standards.

Many, if not most, international banks that securitized assets generally retained a first loss position prior to the crisis.

- In synthetics, many also retained a super senior position.
In addition, originating banks typically sell assets, particularly mortgages, with loan representations and warranties. A breach of these reps and warranties trigger a repurchase obligation, which is a form of risk retention that has long existed. For example, this may include repurchasing mortgage loans that default in the first 3 to 12 months after origination, as well as fraud.
While banks typically retained a first loss position, many large institutions booked these exposures in the trading book and applied the market risk rules, which resulted in a much smaller regulatory capital charge than would have been assessed if held in the banking book.

The relatively lower trading book capital treatment may have mitigated the potential usefulness of retaining a first loss position.

- Recognizing the low level of required capital, the Basel Committee has revised the trading book treatment for first loss positions by requiring them to be deducted from capital if it is required in the banking book.
Asset classes and transaction structures will differ and may require different degrees risk retention

A strict 5% retention requirement, required by the EC and suggested by others, appears to be a very simple tool

For example, it may be too high for prime residential mortgages and too low for subprime mortgages

As a result, the requirement should be flexible and based on the inherent credit quality of the underlying pool of securitized assets (e.g., multiple of EL)

° Current US legislation appears to provide for some flexibility by allowing supervisors to revise the 5% requirement if warranted
Retention Requirement

As level of risk retention increases
(tension with Basel significant risk transfer requirement)

Less credit risk transfer
Retention Requirement

- Also, retained positions likely should be an economic first loss position rather than a vertical slice.
- It subjects the originator/securitizing bank to all of the first losses as opposed to sharing them pro-rata with investors.
- In the mid-80’s, the US regulators permitted use of a vertical slice approach for assessing capital against assets sales with recourse, but it was not used as investors wanted the selling banks to absorb all losses up to a multiple of expected losses on the securitized pool.
- If a vertical slice is required, it is likely that the market will demand that an issuer retain a first loss position.
  - Would result in an “L” segment being retained.
Instead of implicitly addressing issue thru a retention requirement

A more direct way of improving underwriting would be to establish minimum underwriting standards that must be met to obtain regulatory capital relief

For those assets – particularly residential mortgages – securitized & sold into the market
Improved Underwriting Standards

- Such minimum standards could also be applied to those mortgages retained on the originator’s balance sheet
  - This could be viewed as micro-managing banks, which might not be all that appalling given our recent experience

- Competition from the unregulated mortgage originators helped drive down the level of underwriting standards

- Need to subject the unregulated segment of the market to the same standards applied to banks
Whether certain asset types should not be permitted to be securitized

If such an approach were agreed upon, how would it be determined which assets would be precluded from the securitization market?
- Non-homogeneous assets?

What principles could be applied? A better approach might be to limit securitization to higher quality assets based on minimum:
- Asset age or seasoning (e.g., one year)
- Credit quality (e.g., FICO – 700)
- LTV (e.g., 80% or lower)
- Geographical diversification
Simpler Structures

- In order to obtain regulatory capital relief, Supervisors also could require that securitization structures must be simpler and more standardized, which could improve liquidity.
- To minimize wrong-way risk and leverage in the system, require that structures rely on internally-generated credit enhancements, such as excess spread, overcollateralization or senior/substructure:
  - Reduces likelihood of guarantors' downgrading/defaulting adversely affecting securitization transactions.
  - Similar to early 90’s when international banks that provided letters of credit to securitizations were downgraded, which lead to deals being restructured quickly to rely more on the senior/substructure.
Simpler Structures

What does it mean to require a structure to be “simple”?  
- Some have suggested that it means to only have a AAA-rated tranche with no lower mezzanine tranche – essentially a two tranche structure  
- FDIC recently proposed in a revision to its safe-harbour rule that, for RMBS, the structure should be limited to a maximum of six tranches
Disclosure & Due Diligence

- Investors appeared to have relied solely on credit rating agencies’ external ratings when making investment decisions.
- It has become apparent during the crisis that collateral information based on weighted averages/minimums/maximums of the underlying exposure or borrower characteristics can be deceptive.
- Increased transparency of securitization transactions by requiring loan level data would better enable investors to make investment decisions based on information regarding the quality of the underlying asset pool.
Increased disclosure is already required, or being called for, by...

- Basel (Pillar III revisions)
- FDIC (Proposed Safe-Harbor rule)
- U.S. GAAP (FAS 166 & 167)
- SEC (Proposed Reg AB revision)
- Legislative Proposals in Financial Reform Bills (EU / US)
Disclosure

- Just increasing the amount of disclosure may not be sufficient, there may also be a need for standardization of the required quantitative disclosures so there can be comparability and aggregation of the information.
- Issuers should provide sufficient standardized information regarding the underwriting of the securitized assets, as well as the structuring of the transactions.
- Basel’s new operational due diligence criteria reinforces the calls for increased disclosure by requiring investors to conduct their own independent credit analysis of a securitization exposure.
Under Basel, banks on an ongoing basis must ...

Have a comprehensive understanding of:

- Its individual securitization exposures
- The asset pools underlying their securitization exposures
- On-balance sheet
- Off-balance sheet
Basel Due Diligence Requirement ...

- Applies to both Standardized and IRB approaches
- Must be met to use any approaches in securitization framework
- Requires deduction of securitization exposure if not met
Banks must understand all the structural features that would materially impact the performance of their exposures to the transaction, including ...

- Cash-flow waterfall
- Credit & liquidity enhancements
- Market value triggers & deal specific definitions of default
Banks must be able to access performance information on the underlying pools, including...
Due Diligence

- The Basel Pillar I requirement is heavily dependent on the adequacy of the Pillar II application.
- If Pillar II application is lacking, then the Basel due diligence requirement may be reduced to nothing more than a reporting exercise where the required information is placed in a file.
To sum up …

- **Lower volume**
  - Due to recent US accounting changes that keep deals on-B/S, which subjects the underlying assets to the leverage ratio
  - Also, internationally proposed leverage ratio.

- **Simpler structures**
  - reduced number of tranches
  - Internal credit enhancements

- **Retained loss positions**

- **Higher quality loans**
  - Higher FICOs
  - Lower LTVs

- **Redwood – first private label RMBS issued since 2008 – exhibits all of these characteristics**