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# Report From ABS East 2010: Positive Sentiments Despite Lingering Uncertainty About The U.S. Housing Market

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# Report From ABS East 2010: Positive Sentiments Despite Lingering Uncertainty About The U.S. Housing Market

*(**Editor's Note:** This article summarizes a number of speeches and panel discussions at the ABS East conference held in Miami Beach, Florida, Oct. 3-5, 2010. These summaries are intended to reflect the views of the panelists and are not intended to reflect the views of Standard & Poor's.)*

The overall mood of the ABS East 2010 conference was very positive. At the sessions, panelists were quite candid about the tough challenges facing the securitization industry. A strong revival cannot happen without the private-label residential mortgage-backed securities (RMBS) sector, and that is the area that seems to face the greatest obstacles.

An important challenge noted by many panelists was the substantial "shadow inventory" of homes likely to be foreclosed and sold over the next several years. (See "Second-Quarter Shadow Inventory Update: Liquidations Drop As Foreclosure Timelines, Modifications Increase," published Sept. 24, 2010, on RatingsDirect.) Until the shadow inventory works its way through the system, there will be continuing uncertainty about whether the U.S. housing market has found its bottom. Finding the bottom is important, because only after that occurs will confidence really be restored to the private-label RMBS sector.

A second key challenge is the high limit on conforming loans (i.e., loans that can qualify for inclusion in Fannie Mae and Freddie Mac programs). The current limit of $729,750 for a single-family home in a high-cost area means that the jumbo mortgage sector has contracted. As long as the government-sponsored entity (GSE) programs handle loans of such large size, there will be less need for private-label securitization to handle jumbo loans.

A third challenge is regulatory uncertainty. This extends beyond the residential mortgage area into every corner of securitization. Many panelists noted the flood of new laws and regulations affecting the securitization market. However, most felt that the cloud of regulatory uncertainty will have mostly dissipated within a year's time. By this time next year, the regulations mandated under the Dodd-Frank law will likely have been published, the SEC will probably have decided what to do with its sweeping proposal to revise Regulation AB and related rules, inconsistent risk retention requirements will likely have been harmonized, and the emerging Basel III framework will probably have been clarified. However, even assuming that all regulatory issues get resolved, the challenges to the residential mortgage sector may continue to hamper the industry's recovery.

Some attendees seem exasperated by what they see as the stringency of new laws, regulations, and proposed regulations. They point out that securitization was not the primary cause of the financial crisis and that most sectors other than private-label U.S. RMBS and CDOs of ABS (collateralized debt obligations of asset-backed securities) have performed satisfactorily.

Nevertheless, securitization professionals should consider the possibility of increased regulation as a fact of life. They should consider the possibility that regulators may close loopholes that permit or encourage regulatory arbitrage. Indeed, it is interesting to consider the possibility of a regulatory environment that was entirely neutral with respect to whether a bank finances its activities through securitization or on its balance sheet. In such an environment, banks would use securitization only when there was a real economic benefit such as lower cost of

funds, diversification of funding sources, and asset-liability matching. (See Adelson, M. and D. Jacob, "Thirty Years Later Securitization is Still Good for America," Nomura Fixed Income Research, March 15, 2002, http://www.securitization.net/pdf/nomura_later_031502.pdf.)

Two other themes bear mention. First, a common refrain among both panelists and attendees was that the recent financial crisis was the worst since the Great Depression. However, it is interesting to note that on a national basis, home prices reached their high point in 2006 and then declined to their levels of 2003. In other words, the crisis entailed a give-back of just three years of home price appreciation. From that perspective, one's view of the magnitude of the crisis may depend on the data that one uses.

Second, another common refrain among certain panelists was that investors can benefit from continuously updated and increasingly detailed information about the loans, properties, and borrowers included in securitizations. However, if an investor relies on a vendor's data and an error in the data causes a loss, who should be responsible? The vendors license the data without warranties, on a use-at-your-own-risk basis.

The following summaries reflect the remarks of panelists at selected ABS East 2010 conference sessions. For the most part, they are based on my notes, and they have not been reviewed or approved by the panelists. I have tried to capture panelists' remarks accurately, and I apologize in advance for any inaccuracies and omissions. In addition, I wish to acknowledge the excellent work of Information Management Network in organizing and hosting the conference.

## Sessions Covered

- Carbon and Green Financing and Securitization
- Latest Developments in Mortgage Analytics for Investors
- Bond Pricing and Valuation Tools
- Protecting Investor Rights in Default and Workout Scenarios
- Restoring Confidence and Rebuilding the Industry: The Role of Securitization
- Assessing the Changing Face and Needs of ABS Investors
- Keynote Address--Theodore Tozer, President, Ginnie Mae
- Regulatory Developments and the Impact on Structured Finance
- Capital Reserve Requirements and the Impact on the Banking Sector
- RMBS Traders' and Researchers' Roundtable
- Relative Value Opportunities and Hedging Techniques
- Lessons from the Financial Crisis: Required Steps for Rebuilding the Investor Base and Future Sources of Liquidity
- Global Regulatory Initiatives and the Broader Impact on U.S. Securitization Practices

## Sunday, Oct. 3, 2010

### Carbon And Green Financing And Securitization (2 p.m.)

One panelist states that interest in financing "carbon credits" (and green financing in general) is growing because of imperatives around sustainability and social responsibility. One scheme for reducing greenhouse gas pollution is to create a carbon emissions market. A carbon emissions market is a market where entities trade carbon credits, which

are essentially licenses to produce a specified amount of carbon emission pollution. Greenhouse gases (GHG) are a serious global issue. One piece of evidence of the impact of GHG on global warming is the shrinking of Greenland's glaciers in recent years. There are several emission trading mechanisms (ETMs), but they are fragmented in different parts of the world. Currently, more than 80 funds focus on trading carbon credits. Securitization has a potential role in financing green projects like wind-power generators and other new-technology capital projects. The U.S. needs to adopt a nationwide standard for the treatment of renewable energy tax credits, which currently varies too much from state to state.

Another panelist explains that rating securities tied to carbon financing uses the same basic principles as rating other types of securitizations backed by nontraditional assets. Analysis focuses on (i) the stability and predictability of cash flows, (ii) historical performance of the asset class, (iii) servicing and the availability of potential replacement servicers, and (iv) the ability to transfer the assets to achieve legal isolation from the bankruptcy risk of the transferor. Analysis can be challenging when historical performance information is scant. Information about the sector as a whole may be more important than information about the performance of assets from a single originator. The ability to replace a servicer is a key factor that differentiates structured finance from corporate finance. The analysis of potential losses considers (i) historical data, (ii) pool diversity, (iii) counterparty default risk, (iv) payment timing risk, (v) correlation risk, and (vi) balancing quantitative modeling with qualitative analysis.

A third panelist, from a company that specializes in trading carbon credits, explains that the U.S. is unlikely to be part of the cap-and-trade world. There is carbon trading in the EU, and the current regime extends to 2020. In Europe, there is trading of two major types of carbon credits, one issued by the EU, and one issued by the U.N. The EU is likely to support trading of credits from Brazil, Russia, India, and China, as well as from developing countries. European countries are the only ones that have actually reduced their emissions, and they are weighing whether they will try to reduce them further. The EU will likely restrict the trading eligibility of certain U.N. emission credits. The key risk in financing a carbon abatement project is that the project will not be completed and that the carbon credits will not be delivered.

A fourth panelist emphasizes photovoltaic solar power as an important sustainability initiative. His company focuses on subutility-sized photovoltaic projects. The company is the leader in selling and installing photovoltaic systems for homes and individual businesses. The main challenge with deploying the technology is financing the original cost of the equipment. The company finances the cost of the equipment. The typical ticket price for a residential installation is $25,000 to $50,000, and the typical ticket size for commercial installations is equal to or greater than $1.5 million.

The fifth panelist is an investment manager who focuses on investments in sustainability projects. Apart from GHG and pollution, other sustainability issues are the world's supply of fresh water and the supply of arable land. The panelist focuses on companies that are leaders in their fields, all centered on a "clean earth" theme. His firm has a proprietary "clean earth" score that provides a disciplined, thematic approach to investing in sustainability projects. The analysis of investment opportunities looks at all the traditional metrics of fixed-income investing and also at the clean earth score.

### Latest Developments In Mortgage Analytics For Investors (2:50 p.m.)

One panelist, from a rating agency, discusses her firm's RMBS surveillance platform. She notes that automating part of the process may be necessary because of the large number of RMBS transactions that must be monitored. Automated systems are intended to identify performance outliers and flag specific deals and securities for analytical

review. The firm has introduced recovery analytics to complement its ratings.

A second panelist, from a software company, explains his company's product for visualizing large data sets. He presents a chart mapping the delinquency behavior of mortgage loans against deterioration in borrower quality (as measured by updated consumer credit scores) and deterioration in equity cushion (as measured by updated loan-to-value ratios). The chart shows essentially what one would expect: Loans that have not suffered deterioration display the lowest (best) delinquency rates, while those that suffer deterioration along both dimensions display the highest (worst) delinquency rates.

A third panelist, from a credit bureau, focuses on linking updated information from consumer credit databases to securitized mortgage databases to make the updated consumer credit data available to investors for asset selection and risk management. For example, by using consumer credit data, an investor may be able to estimate the combined loan-to-value ratios (CLTVs) on first-lien loans in a securitized pool by identifying borrowers who have second-lien loans and home equity lines of credit (HELOCs). Another example is using the utilization rate on credit lines to spot high debt-to-income ratio (DTI) borrowers who generally have a greater likelihood of becoming delinquent on their mortgage loans. A third example is the ability to track information about loan modifications. Data about loan modifications eventually may produce models that attempt to predict default risk based on modifications.

A fourth panelist, from an ABS analytics service, focuses on automated appraisal systems (sometimes called AVMs, or automated valuation methodologies). The latest AVMs do not rely solely on movements in home price indices, they also take into account the individual characteristics of a property (hedonic variables). New data mining tools match data from a deal's loan schedule to public record data to deduce the addresses of properties that secure mortgage loans included in a deal. With the addresses, it is possible to use AVMs to obtain updated loan-to-value ratios (LTVs) for the subject loans. Good AVMs can give better estimates of value than just using home price indices.

A fifth panelist, from another credit bureau, explains innovations in the availability of consumer credit data. There has been great progress in achieving anonymous matching ABS data with consumer credit data. As the third speaker emphasizes, the objective is to offer updated loan-by-loan information that may allow for better predictions of losses and prepayments. The firm is trying to provide the data and the models for predicting cash flows. It achieves predictive improvement by augmenting loan and home price data with updated borrower credit information. The company has produced a tool that rank orders RMBS transactions by the predicted default rates on their underlying loans. Another use of updated data is for detecting when a key variable, such as owner occupancy status, has changed. If the owner occupancy status of a loan changes, then the change should be reflected in how the loan's default or prepayment risk is modeled (the loan might start to behave like a loan secured by an investment property).

### Bond Pricing And Valuation Tools (4:10 p.m.)

One panelist focuses on the distinction between intrinsic value and market price. When a market is in turmoil, the two can diverge. Traditional model inputs, including data about the assets backing a securitization, may not reflect current market conditions. Pricing services may attempt to close the gap between intrinsic value and market prices by incorporating some market price information into their valuation algorithms. This is tricky because the typical daily trading volume of private-label RMBS represents less than 1% of the total outstanding amount. Moreover, the trading activity that does occur is not evenly distributed across different RMBS subsectors.



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Would the TRACE system be useful to investors in structured finance products? (Note: The TRACE system reports trades on corporate and government bonds. FINRA sponsors the TRACE system.) The implementation of TRACE for corporate bonds in 2002 reduced the dispersion or corporate bond valuations. TRACE does not cover the structured finance sector, but investors arguably can get effective price knowledge by having multiple dealer relationships and access to price quotes from multiple dealers.

A second panelist observes that, before the financial crisis, the process of providing bond prices was relatively simple. Pricing services estimated the prices of outstanding securities by using the same forecasts of prepayments and defaults that dealers used for pricing new issues. That is, pricing assumptions from the primary market fed the process of estimating prices of outstanding securities. Pricing services also used standardized recovery assumptions, reinvestment assumptions, and discount rate assumptions. Following the crisis, pricing services have had greater challenges because of the lack of a primary market. Also, in the post-crisis environment, pricing services have had to embed explicit macroeconomic forecasts into their valuations. The process today has become more granular. Pricing services use a greater number of cohorts into which they group similar securities for applying valuation assumptions.

Broker price indications are an alternative to pricing service valuations. However, a broker's indicated price is not the same as a firm bid. An investor should ask whether a broker uses all available information in developing its pricing indications and whether it provides indications as part of a regular business and not just as a courtesy to trading customers. Regulators want more transparency on valuations and might extend TRACE to structured finance products.

A third panelist observes that before the financial crisis, the securitization market had a huge amount of primary issuance and active secondary trading. The high level of activity provided a good measure of transparency. High structural complexity created challenges for pricing some tranches, but the difficulty was not widespread. During the financial crisis (really starting in February 2007), activity fell off in both the primary and secondary markets. There were many distressed sellers, and big disparities between modeled prices and actual market prices emerged. Also, structural changes, such as government-sponsored loan modification programs, created uncertainty about how loans and bonds would be affected. Additionally, because of their growing prevalence, credit default swaps (CDS) on ABS had to be taken into account as further indicators of security prices. Pricing challenges became increasingly difficult as actual market prices continued to drop. Pricing services had to maintain compliance with accounting standards to preserve their validity/eligibility (FAS 157), but customers started to challenge their prices when the prices became very low. Following the crisis (starting in 2010), the flow of new deals has increased, but it's still far below pre-crisis levels.

A fourth panelist, an investor, highlights the difference between price and value. Intrinsic value is estimated with models that use projections of prepayments and losses. However, the models do not necessarily catch what trustees and servicers are doing right and what they are doing wrong. In contrast to a pricing service, which must price thousands of bonds every day, an investor needs only to evaluate the bonds that he holds or is considering trading. The panelist advocates using scenario analysis to assess the range of potential outcomes, given that the models might not be reliable at predicting the future. The panelist asserts that his firm can largely ignore pricing services most of the time and can trade based on its own assessment of intrinsic value. However, at least occasionally, the investor must validate its pricing (marks) by using pricing service valuations. A challenge for the investor is that when it judges a bond to be undervalued, it can suffer a mark-to-market hit as soon as it buys the bond.

A sixth panelist works on the advisory side of a major asset manager. He explains the notions of intrinsic value, fair

value, and market value. He distinguishes fair value from market value as follows: Fair value is the price that would occur in an open market sale between a willing buyer and a willing seller. In contrast, market value may reflect fire sale conditions in the real world. The panelist identifies various valuation challenges including (i) calibration of pricing models, (ii) the qualitative impact of third-party actors (such as servicers), and (iii) asset idiosyncrasies. He says that scenario analysis is important for understanding the sensitivities of individual bonds to changes in valuation assumptions.

**Protecting Investor Rights In Default And Workout Scenarios (5 p.m.)**
The panel has a trustee-oriented perspective. The moderator and one panelist are from trustees. The remaining panelist is a lawyer who represents trustees.

Early warning signs that a deal may be in trouble include: (i) delays in delivery of periodic reports, (ii) restatement of reports, (iii) staff turnover at the servicer, and (iv) an increase in inquiries from investors.

Investors sometimes become frustrated when they cannot find the primary individual at a trustee who is responsible for the trustee's activities with respect to a troubled deal. It is often hard for an investor to contact other investors in a deal. Registering securities through DTC makes things more difficult. This can be a problem for a trustee as well. Because of DTC registration, a trustee might not know the identity of a single investor in a deal. Sometimes trustees have agreed to post an investor's message on the webpage for a given deal, stating that the investor is trying to reach other investors to organize an initiative.

A "steering committee" is the vehicle through which investors take enforcement action or handle workouts. Investors in distressed deals need to be aware of the timelines and the schedule for enforcement or corrective action on a troubled deal. Investors in a troubled deal should focus on the information that is provided and should participate to make themselves heard and to protect their interests. Significantly, there can be competing interests among members of a steering committee. One issue is that investors may hold different classes of securities with differing payment priorities in a deal's waterfall.

One of the challenges to amending a deal can be the process of getting investor consent. Long delays can occur in getting the necessary proportion of investors to consent to a corrective action. In fact, investors on the steering committee may fail to alert their administrative staffs to expect receipt of documentation for giving consent and how to handle the documentation when it arrives. Sometimes there is difficulty in getting investors to agree on the selection of third-party service providers such as auction agents or forensic accountants.

One panelist recommends that, in selecting counsel, a steering committee should pick a law firm that is both familiar with the specific product as well as with workouts, restructuring, enforcement, and litigation.

***Some recurring problems.*** One panelist, from a trustee, explains that some deals define the "controlling class" as 25%, which means that there can be four controlling classes in a deal. The trustee now insists on language that defines controlling class as a majority. Another issue is amendments that call for rating agency confirmation when the rating agency no longer rates the deal. A third problem is that a deal may fail to provide for fees to service providers after the original depositor (who was providing the services) has gone out of business. Many deals would have been better off if there had been greater specificity of enforcement remedies. Issuers are likely to resist greater specificity, but the proposed changes to Regulation AB (Reg AB2) may help to bring about greater specificity of remedies. See Reg AB2 Item 1111(e)(1).

An example of a solution that can be worse than the problem it was intended to solve is a requirement that any

liquidation of collateral must be at a price of at least 100% of par. Such a provision may prevent a trustee or an investor steering committee from making a beneficial liquidation of collateral, even at the desire of the investors.

Documents for many deals fail to provide a remedy for the depositor's or the servicer's failure to deliver a required compliance certificate. Documents should provide that the failure to deliver any required certificate or to fulfill any obligation constitutes a default with remedies.

Investors should focus on how a deal's cash would be held following an event of default. A good choice is to have funds held in cash, in U.S. dollars, in the U.S. Alternatively, investors should be able to direct that funds be held in cash if the normal alternative provided in a deal's government document would have required investing at a loss.

## Monday, Oct. 4, 2010

### Restoring Confidence And Rebuilding The Industry: The Role Of Securitization (9 a.m.)

***Recent history.*** Structured finance default rates have been very high since 2007, compared with earlier times. Tranches of U.S. private-label RMBS rated 'AAA' experienced a default rate of 6.81%, while 'AAA' rated tranches of CDOs of ABS had a default rate of 28.45%. The credit card ABS sector has performed well, as has the auto ABS sector, in spite of the demise of GM and challenges at Chrysler. (For a comprehensive update on defaults and downgrades of structured finance securities for the 2005 to 2007 vintages, see "Structured Finance Rating Transition And Default Update As Of July 31, 2010," published Aug. 30, 2010, on RatingsDirect.)

***New issuance.*** Private-label RMBS issuance remains stalled. Mainstream ABS issuance is slow. Agency RMBS issuance was quite strong in 2009 but has been slower in 2010. A possible reason RMBS issuance is slow could be legal uncertainty about enforcement of mortgage loans since the inception of the federal loan modification programs. Market participants are becoming more discriminating; they focus on good assets and good structures and shy away from weak assets and weak structures. The crisis has made the market smarter and more knowledgeable.

Confidence arguably has been restored based on the huge tightening of spreads since January 2009. Tight spreads may reflect an emerging view that most of the credit problems have essentially passed. On the other hand, even if the credit problems are not over, market participants may feel that recently originated loans, created in the immediate aftermath of the crisis, will be of a very high quality (low risk) and should command tight spreads. However, that does not explain the tight spreads on secondary trading of older bonds. One panelist ventures that tight spreads reflect not only a restoration of confidence, but also a surfeit of investable funds and, perhaps, better structures (including higher credit enhancement levels) in newer deals.

The commercial mortgage-backed securities (CMBS) market found a natural bottom because it did not receive nearly as much government support as the residential mortgage sector. Continuing government support for homeownership and residential mortgage finance leads to continued pressure on and uncertainty regarding pricing. The high loan limit for conforming loans (i.e., loans that are eligible for Fannie Mae and Freddie Mac programs) is not the only problem. An even greater issue is the shadow inventory of not-yet-foreclosed homes from troubled loans that will come to market over the next several years. The current inventory of foreclosed homes (i.e., real estate owned, or REO) plus the shadow inventory poses a major impediment to the revival of the private-label RMBS market. Until the shadow inventory overhang is absorbed, there likely will be uncertainty about the path of home prices.

The conforming loan limits are so high that there is little room for private-label RMBS. U.S. investors want



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private-label RMBS, and they are turning to foreign deals. This year's Redwood Trust private-label RMBS deal was hugely oversubscribed. Another factor impeding private-label RMBS issuance is that when banks originate jumbo mortgage loans, they retain them on their balance sheets. One panelist feels that the market is waiting for further guidance from rating agencies.

***Does the securitization market need ratings?*** A panelist from a rating agency explains that rating agencies supply not only ratings, but also research and analysis on a globally comparable basis across all fixed-income sectors, including corporates, banks, insurance companies, sovereigns, municipals, RMBS, CMBS, ABS, and CDOs and other securitization subsectors. Another panelist asserts that investors will continue to use ratings as one of their tools for asset selection and risk management, but not as the only tool. A third panelist feels that rating agencies set the capital requirements for the securitization sector (i.e., the credit enhancement levels for deals), and, therefore, that rating agencies should be regulated. A fourth panelist says that investors should not be required to use ratings and that investors should be allowed and encouraged to perform their own, independent analysis. However, ratings are still very useful because they can provide a common language about credit risk that enhances liquidity. A fifth panelist emphasizes that rating agencies need to improve transparency. He notes that the emerging Basel III regulatory capital standards for banks likely will continue to use rating agency ratings, which means that ratings likely are here to stay. The second panelist emphasizes that there needs to be standardized approaches to analyzing credit so that the market will be liquid.

(Note: The idea that ratings provide a common language of risk assumes that ratings are comparable. Comparability can be viewed in at least two ways: across rating agencies and within a given rating agency. With respect to the first way, there is mixed evidence about the comparability of ratings across rating agencies. With respect to the second, different rating agencies can take different positions about whether they intend for their ratings to be comparable across different sectors, currencies, geographic regions, and over time. For more about comparability and the design of rating systems, see "Understanding Standard & Poor's Rating Definitions," published June 3, 2009, and "The Time Dimension Of Standard & Poor's Credit Ratings," published Sept. 22, 2010, on RatingsDirect.)

The first panelist asserts that investors should receive exactly the same information that rating agencies receive in connection with rating a deal. He emphasizes that there is a lot more to analyzing or pricing a structured finance transaction than simply looking at the cash flows. There can be risks associated with the parties to the deal, as well as political risks and sovereign risks.

***Is SEC Rule 17g-5 working?*** (Note: SEC Rule 17g-5 is intended to deter rating shopping by structured finance issuers. The rule is designed to facilitate unsolicited ratings by rating agencies other than the ones engaged by an issuer to rate a deal. The rule requires an issuer to make all the information that it has furnished to any rating agency available to other NRSROs. The rule has not yet produced any unsolicited ratings.)

One panelist from a rating agency explains that the notion of unsolicited ratings can be a strong positive for the market. The timing of unsolicited ratings is important; they help when they are released before the pricing of a security. The panelist's rating agency has not used Rule 17g-5 as the basis of publishing unsolicited ratings, but it has published commentaries about deals that it did not rate, and the market reaction to those commentaries has been positive.

Another panelist observes that investors have been fighting for more information on the assets behind securitizations. He asserts that rating agencies currently get more information than investors. The proposed changes to Regulation AB would help investors get better information and would enable them to rely less on the rating agencies. Investors want to understand the reliability of the data that they receive.



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A third panelist notes that it is expensive for issuers to provide more information and for investors to analyze it. Massive amounts of information about residential mortgage loans have been available for a long time through LoanPerformance. Comparatively, there has been much more information available on residential mortgage loans than on auto loans. However, despite the availability of more information, the market did not avoid the problems in the residential mortgage sector. (Note: The third panelist essentially argues that additional information may not be relevant if it does not actually alter decisions or behavior.) Another panelist emphasizes that investors really want better reliability and accuracy in the information that they now receive, rather than simply more information that may be unreliable or tainted by high error rates.

***Does Washington want a vibrant securitization market?*** One panelist feels that Washington ultimately must support securitization because it is an important financing tool that can really help the U.S. economy. However, right now, some federal agencies may not be focusing on the big picture and instead may be viewing securitization's role and impact too narrowly. For example, in pursuing its own, specific regulatory objectives, an agency may create impediments to the revival of securitization. The Federal Deposit Insurance Corp.'s (FDIC) new safe harbor regulation arguably is an example. Another panelist observes that the Federal Reserve clearly supports securitization. However, Congress is still focused on assigning blame for the financial crisis and is pursuing measures to curtail securitization. A third panelist replies that regardless of whether Washington wants securitization, it needs securitization as a vehicle for helping the economy.

***Outlook.*** One panelist indicates that the next few months will bring clarity around many issues, such as Basel III. A year from now, the securitization market likely will be healthier as uncertainty abates and issuance volumes increase. A second panelist feels that there will be fits ands starts for several years on the regulatory front. Securitization is necessary as a way to transmit credit through the economy. This year is a transition year--a lot of portfolios have been cleaned up and new deals are getting done. Next year, volumes will be higher. A third panelist states that he believes the economy is at a critical juncture in terms of credit demand. He feels that banks will lend more aggressively next year. The fourth panelist feels that the big question is the private-label RMBS market and the GSEs; the new risk retention requirements under the Dodd-Frank law and various regulations are not a major impediment. The fifth panelist feels that there will be intensive regulatory efforts to fine tune new laws and regulations to address unintended consequences.

### Assessing The Changing Face And Needs Of ABS Investors (10 a.m.)

One panelist states that in the period preceding the financial crisis, structured finance products were misvalued, credit risk was misestimated, accounting standards were unrealistic, and investors' risk appetite was too high.

Another panelist asserts that the biggest recent change is that there are fewer highly leveraged investors investing in structured finance products. The remaining investors are more diligent and do not rely as heavily on bond insurance or credit ratings as substitutes for doing their own analyses. Smaller issuers cannot issue insured bonds because bond insurance is generally not available. Investors are now willing to buy the senior tranches of deals from smaller issuers if the price is attractive, even if the securities do not receive triple-A ratings. The market is basically in good shape, and it likely will grow through next year. However, it is unlikely to reach the size that it was before the crisis. The market benefits from the fact that many former traders have moved to the buy side.

Another panelist draws a contrast between the recovery of the nonmortgage sectors and the continuing stagnation in the RMBS sector. He sees the need for more research to help investors. He expects the structured market to evolve toward the norms of the market for distressed securities: higher yields and more analysis for each trade or position.

***Are investors getting the reforms that they need?*** One panelist feels that investors are slowly receiving what they need, but they have not yet got it all. There are many changes happening all at once, including (i) risk retention by issuers, (ii) loan-level disclosure, and (iii) regulation of rating agencies. He notes that, leading up to the crisis, investors who failed to perform their own analysis essentially crowded out those who did. The challenge is that all the reforms raise costs; they lead to slower growth and less issuance. Growth was overly aggressive leading up to the crisis.

Another panelist focuses on the issue that the proposed revision to Regulation AB applies equally onerous disclosure standards to both private-label RMBS and ABS backed by other types of consumer credits. He feels that current disclosure is adequate for nonmortgage asset classes and that increased information is appropriate just for residential mortgage loans. He approves of the recent legislative changes that impose potential liability on rating agencies (see Dodd-Frank §933).

A third panelist asserts that rating agencies get more information than investors. He says that investors want the same information that rating agencies get. He adds that an equally important issue is what investors do with the information when they get it. Will the additional information actually help them to make better decisions?

A fourth panelist notes the problem that trustees are not paid enough to be able to really act on behalf of investors when deals get into trouble. Trustee fees are too low to compensate trustees for all the work that they need to do in troubled deals. In fact, the incentives are so distorted that trustees sometimes act to block investor access to loan files.

***What should investors want to say to regulators?*** The structured finance market is not what it used to be. The benefits of the Dodd-Frank law are not yet known because implementing regulations have not yet been crafted. The FDIC's safe harbor/risk retention rule will make it hard for banks to achieve off-balance-sheet treatment for securitized assets. The proposal to enhance Regulation AB is good for investors because more disclosure is better for investors.

Another panelist feels that regulators and legislators have done a good job and have responded quickly to the financial crisis to help the markets recover. He feels that the FDIC's safe harbor/risk retention rule reflects a proper understanding of the market's dynamics. The overarching question should be whether the overall effect of the regulatory changes will be to discourage institutions from taking risk. There are still plenty of "real money" investors ready to invest in securitizations.

A third panelist emphasizes the need for balance. Regulation should promote caution, but it should not kill securitization. Long-term, real money investors are still around and interested in structured finance.

***Has credit analysis improved in assessing tail risk?*** One panelist describes how the "credit enhancement pendulum" swung in past business cycles. He asserts that the pendulum always swings too far. He expects that new deals likely will be backed by assets of very high quality and will have disproportionately high levels of credit enhancement. He also questions the analysis of nontraditional assets for which long-term data do not exist. He argues that conservatism (i.e., a large cushion of protection) is the proper approach. Another panelist feels that there is greater complexity today than in the past, especially with respect to residential mortgages. He feels that the tail risk in RMBS relates to assessing not only whether a borrower has the willingness and ability to pay his loan, but also whether the servicer will foreclose when a loan is delinquent. A third panelist asserts that it has been easier to predict credit performance on nonmortgage consumer asset classes than on residential mortgage loans. He feels that the rating agencies "got it right" on nonmortgage consumer assets. A fourth contends that some types of policy stimulus are failing to reach the intended recipients and, therefore, may be creating unintended bubbles. Most



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corporations want the securitization market as an avenue for diversifying their funding. Likewise, investors want the securitization market to exist as an alternative forum in which to invest with limited correlation to other investment sectors. A fifth panelist agrees with the fourth, emphasizing that securitizations offer investors a wide range of choices in terms of risk and tenor. He notes that asset classes that have gotten into trouble are ones where the sellers retained no interest in their securitized assets.

***Relative value opportunities.*** One panelist feels that there are no longer appealing investment opportunities in the sectors that have "fully repriced" (i.e., those that have experienced the greatest tightening of spreads). He says that there are appealing opportunities in the AM and AJ classes of CMBS, which can offer returns of 8% to 12%. For private-label RMBS, he feels that there is some good value, but the market has done so well (i.e., spreads have tightened) that the sector is less appealing than it was earlier in the year. A second panelist agrees, noting that values have improved a lot during the year. A third panelist likes subordinate tranches and favors dealer floorplan ABS. A fourth panelist likes the top of the capital structure in CMBS and asserts that student loan ABS offer attractive value. In his opinion, market participants are using very conservative assumptions for analyzing and valuing private-label RMBS.

### Keynote Address--Theodore Tozer, President, Ginnie Mae (11 a.m.)

Ginnie Mae is trying to become more customer-centric. Ginnie Mae's history goes back to the creation of the Federal Housing Administration (FHA) during the Great Depression. Originally, the U.S. Treasury made funds available for the purchase of FHA-insured loans. In 1968, Ginnie Mae essentially replaced the Treasury's role by funding FHA-insured loans without using Treasury funds. The Ginnie Mae model has worked well in the sense that it has maintained funding to the housing market (for FHA-insured loans and VA-guaranteed loans), even through the financial crisis.

In contrast to Fannie Mae and Freddie Mac, Ginnie Mae does not release issuers from recourse. If there is a shortfall on FHA insurance (or a VA guarantee), a Ginnie Mae issuer is responsible for the entire shortfall. Ginnie Mae's only exposure is if the issuer has gone out of business.

Ginnie Mae outsources all its actual operations. Ginnie Mae is beefing up its issuer oversight and risk management (because Ginnie Mae has exposure to its issuers).

Ginnie Mae has changed the GNMA II program to eliminate the requirement of at least three loans to a pool. Also, Ginnie Mae has started producing GNMA II securities every day, instead of just once a month. Early next year, it intends to expand its disclosures to enhance transparency. The GNMA II program is a good program because the multilender pools provide both enhanced geographic diversification and diversification across lenders. Yields are higher than for Ginnie Mae I's, and the protections are strong.

Ginnie Mae arguably is not suppressing activity in the private-label market because it focuses just on FHA/VA loans. Ginnie Mae does not want to squeeze out private-label securitization and, in fact, wants to encourage all types of mortgage lending to promote housing.

Ginnie Mae is increasing the minimum capital requirement for issuers to $2.5 million.

The government's role in the U.S. housing sector should be as a shock absorber, but it is difficult to extricate the government right after it has intervened to provide support. A challenge is that policies are prolonging the overhang of shadow inventory, which means there will be more delay before the market finds it natural bottom from which it can recover.

Ginnie Mae's "short pay" refinancing program faces challenges because there is an open issue about who bears the loss on a short-refi of a loan in a GNMA pool.

### Regulatory Developments And The Impact On Structured Finance (12 p.m.)

The session addresses the last question from the first panel: Does Washington really want securitization to go forward and thrive?

***FDIC safe harbor.*** The FDIC just issued its new safe harbor rule with a controversial risk retention requirement. (See Federal Deposit Insurance Corp., "Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection With a Securitization or Participation After September 30, 2010," 75 Fed. Reg. 60287, Sept. 30, 2010.) The good news is that there is a safe harbor provision that allows highly rated securitizations from depository institutions to go forward. The key to the safe harbor is that it protects securitized assets from the receivership or conservatorship estate of an insured depository institution. The new safe harbor does not prevent the FDIC from repudiating a securitization and seizing the subject assets. The safe harbor provides that the FDIC may pay full economic damages, but does not require the FDIC to do so. If the FDIC does not pay damages, then it must turn over the subject assets. Two rating agencies have said that the safe harbor provision will allow securitizations to achieve triple-A ratings. Significantly, the FDIC has grandfathered all existing master trusts, which will continue to apply prior standards to those trusts.

Another panelist notes that it was important for the FDIC to act decisively to create a safe harbor. The market needs the safe harbor to be able to function.

***ABCP conduits.*** Recent changes to accounting rules have brought asset-backed commercial paper (ABCP) onto banks' balance sheets. New regulatory requirements have imposed many new burdens on banks that sponsor ABCP programs, including (i) tougher capital treatment, (ii) challenging disclosure requirements, and (iii) disqualification under certain exemptions from rules under the 1940 Act. One panelist argues that bank sponsors of ABCP programs should get an exemption from new risk retention requirements because of the risk that they have through credit enhancement and liquidity facilities that they provide to their sponsored programs. Alternatively, he argues, the exposure through credit enhancement and liquidity facilities should count toward meeting some or all of the risk retention requirement.

***Removing ratings from regulation.*** The Dodd-Frank law requires regulatory agencies to study how to remove rating agency credit ratings from their regulations (§939A). The agencies have issued a concept release to solicit input on potential alternatives to the use of ratings. (See Treasury Department, "Advance Notice of Proposed Rulemaking Regarding Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies," 75 Fed. Reg. 52283, Aug. 25, 2010.) One panelist from a regulatory agency believes that it would be impractical to write regulations to embody credit analysis methodology as an alternative to using credit ratings. Also, the less reliable any methodology would be, the higher the capital requirement would have to be. The best solution would be to find an alternative that would not require expressing an analytic methodology in regulations.

One panelist (not a regulator) emphasizes that poor performance of securitized assets was isolated to just two sectors: RMBS and CDOs of ABS. He believes that bank sponsors ABCP conduits should be allowed to use an internal assessment approach. He notes that the acting Comptroller of the Currency has argued that regulators should be allowed to use ratings when they want to and that they should be allowed to require calibration of ratings when they slip. Another panelist notes that even before the enactment of the Dodd-Frank law, the regulators were leaning toward reducing the use of ratings. Another panelist remarks that the regulatory agencies might be willing to embrace expanded use of the internal assessment approach for banks to determine their regulatory capital requirements.



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***Conflict of interest provisions of Dodd-Frank.*** One panelist criticizes section 621 of the Dodd-Frank law, which prohibits transaction participants from engaging in activities that could create conflicts of interest. Sen. Carl Levin, the sponsor of the provision, explained that the purpose of the provision is to prevent a transaction sponsor from betting against its own deal. Sen. Levin stated that disclosure should not be a cure for the conflict. Everything depends on SEC rulemaking. The potential range of conflicts that could fall within the ambit of a rule is huge. Panelists state that they hope SEC rulemaking will be narrow and will not become impractical.

***Securities regulation.*** Under proposed Rule 424(h), an issuer would be required to provide a nearly complete prospectus five days before the pricing of a deal. See 75 Fed. Reg. at 23437 (May 3, 2010). This would be a major change from current practice, which relies heavily on term sheets and allows for making changes to a deal even while securities are being offered. Another proposal is to extend all the requirements of the 1933 Act and the 1934 Act to all structured finance products sold in reliance on Rule 144A or Regulation D. See Proposed Rule 144A(d)(4)(iii), 75 Fed. Reg. at 23436 (May 3, 2010). That proposal would be difficult for CDOs and resecuritizations because it would require disclosure of the full required information on every underlying instrument. In other words, it would make resecuritizations impractical under the rule. There are also conditions for the availability of shelf registration. One example is the requirement that the CEO of a depositor certify that the cash flows from a deal's assets are sufficient to pay the registered securities. See General Instruction I.B.1(c) of proposed Form SF-3. Another requirement is certification that decisions not to repurchase loans for breach of representations and warranties in prior deals were appropriate. See Proposed Regulation AB Item 1121(c), 75 Fed. Reg. 23427 (May 3, 2010).

Broadly, the proposed changes to the registration process would eliminate the requirement of an investment-grade rating for securities to eligible to for shelf registration. However, there would be new eligibility requirements in at least four areas: (i) risk retention, (ii) third-party review of repurchase obligations, (iii) certification by CEO of the depositor, and (iv) performance reporting for life of the deal.

The proposal to require public-style disclosure for private deals was a key reason the SEC vote on the proposal was 3 to 2. If the proposal goes forward, the effect of extending the disclosure rules to the 144A market is so huge that it could become a political issue.

***More risk retention.*** There are three sources of risk retention rules: the proposed SEC eligibility requirements for shelf registration, the Dodd-Frank law (§941), and the FDIC securitization safe harbor rule. The SEC seems to favor a vertical slice approach. Dodd-Frank specifies risk retention for all securitization unless specifically exempted. FDIC risk retention is only for banks and calls for a flat 5% vertical slice. The FDIC has announced that it will conform its securitization safe harbor to the final outcome of the interagency rulemaking on risk retention mandated by the Dodd-Frank law. Another panelist notes that if the disclosure rules do not kill resecuritizations, then the risk retention rules may do so.

***GSE reform.*** A proposal for reforming the GSEs has to come from somewhere. Washington seems to have avoided coming to grips with the issue. The Treasury has said that it plans to have a proposal by January 2011. If the Republicans take control of the House in November, there will likely be extensive Congressional oversight hearings. A possible approach may be to have the government provide an explicit guarantee on the mortgage loans and receive the guarantee fee. The remaining role of the GSEs would be merely administrative. It is far from clear how to make the transition from the current structure of the GSEs to one where they become truly private companies that are separate from the guarantee.

One panelist explains that the securitization market is like a garden that has some weeds. The regulatory response to the crisis was too much. It was not like pulling the weeds out carefully, but rather more like tearing out the whole garden. Leading up to the crisis, the financial markets suffered from poor asset underwriting, excessive leverage, and

undisciplined investors. Corrective actions should have been directed at those specific issues. The panelist states that the SEC should examine the rating agencies to see whether they apply their methodologies (criteria) and whether the methodologies are based on significant historical experience. Regulators should spend more time focusing on the difference between what went right and what went wrong. Then they should zero in on fixing what went wrong without damaging what went right.

***Final remarks.*** A year from now, the market will be in a better position because there will likely be less regulatory uncertainty and consumers will demand more loans than they do now.

### Capital Reserve Requirements And The Impact On The Banking Sector (2:15 p.m.)

Small U.S. banks are under pressure to raise capital because they have suffered some asset deterioration from the credit crisis.

***Liquidity coverage ratio under Basel III.*** The emerging Basel III framework covers both capital and liquidity standards for internationally active banks. (See Basel Committee and Banking Supervision, "The Group of Governors and Heads of Supervision Reach Broad Agreement on Basel Committee Capital and Liquidity Reform Package" press release, July 26, 2010, http://www.bis.org/press/p100726.htm.) There are two parts of the liquidity side. The first is a "liquidity coverage ratio" (LCR) that focuses on a time horizon of 30 days, and the other is a "net stable funding ratio" (NSFR), which focuses on a time horizon of one year. The LCR is moving forward, but the net stable funding ratio is on the back burner. The LCR focuses on both scheduled maturities and contingencies, including collateral posting obligations. The LCR considers the full exposures under liquidity facilities to ABCP programs, and it assumes that consumers' lines are drawn 10% and that other facilities are drawn 100%. There is a requirement to look at noncontractual obligations (such as supporting money market funds) that can burden an institution's liquidity. The LCR formalizes and standardizes a risk metric that is likely similar to what institutions were using for their own liquidity management.

***Focus on ABCP.*** One panelist observes that banks already focus on their liquidity postures. The regulators have not yet finalized the exact calculation of the LCR. The panelist argues that the literal reading of the LCR requirement suggests an unnatural calculation that would produce an excessively high coverage number in relation to ABCP conduits. The catch is that it would require holding capital for the full amount of the liquidity facility, plus 10% of the credit enhancement facility, plus the scheduled maturities over a 30-day time horizon.

Another panelist asserts that the proposed LCR requirement could kill ABCP as a financing vehicle for short-term receivables.

The net stable finding ratio (NSFR) also would impose an excessively onerous burden on banks that sponsor ABCP programs.

***Smaller banks.*** One panelist explains that even though smaller banks do not have ABCP programs, liquidity can become a problem for them. The Office of Thrift Supervision (OTS) regulates small banks at both ends of the spectrum: some that "do liquidity well" and some that don't. It is proper that the Basel Committee is focusing on liquidity, and it likely will take some time for the regulators to create the optimal framework. There is a long period of observation before the LCR starts to get phased in.

***Outlook for ABCP.*** The ABCP market has shrunk from a peak of more than $1.2 trillion outstanding to about $400 billion. There is now more communication with investors, and the sponsors of programs have learned more about what investors want.

The proposal for LCR and NSFR would motivate banks to move away from unfunded commitments. One panelist

argues that would be bad because unfunded commitments help the banks to provide more credit to the real economy.

***Incentives and disincentives for securitizations.*** One panelist explains that new rules may increase the cost for banks to hold assets on their balance sheets. However, when one factors in the cost of occasional economic dislocations, there is a net benefit from increasing the stringency of the capital standards. Regulators neither support nor oppose securitization. However, they want to make sure that securitization is done in a safe and sound manner. Accounting and regulatory capital changes have influenced banks' appetites for using securitization. Even if the cost is increased by new requirements, that is likely appropriate if it improves safety and soundness.

Tougher bank regulations could drive certain activities to the shadow banking market (i.e., the services will be provided by nonbank entities). Regulators should focus on activities motivated by capital arbitrage. They also should focus on the potential for heightened systemic risk from having activities move to unregulated entities.

### RMBS Traders' And Researchers' Roundtable (3:15 p.m.)

***Private-label RMBS valuations.*** One panelist states his belief that technicals are exceptionally strong (i.e., there is strong investor demand for private-label RMBS and only limited supply). He feels that technicals are a supporting factor for fundamental strength. The economic fundamentals have been somewhat overshadowed by servicing issues. Another panelist observes that the private-label RMBS market has negative net supply every month (i.e., new issuance is less than the amount of securities retired), which strongly influences technicals. Additionally, the past two years have brought about a shift in private-label RMBS holdings into the hands of traditional RMBS investors and out of the hands of hot money investors who had entered the sector only temporarily.

***The financial crisis.*** Many market participants underestimated the prevalence of borrower fraud. Homeowner leverage was much higher than commonly believed. Borrowers lied rampantly about their incomes. Also, foreclosures take three times as long as many had expected.

One panelist explains that most market participants grossly underestimated the laxity of underwriting. Market participants are tempted to attribute the financial crisis to declining home prices. However, according to the panelist, the real story is more complicated; lax underwriting was an essential factor. Some market participants focused on inflated home prices and a smaller number focused on deteriorating underwriting. Virtually none focused on both. A different panelist observes that the GSEs had become overly aggressive in their own eligibility standards for loans.

Another panelist counters that macroeconomics will be the key driver of recovery. Unemployment has to improve, and the declining trend of home prices has to be arrested. The market has already embraced conservative credit assumptions for private-label RMBS. The regulatory capital treatment of private-label RMBS will also influence the revival of the sector.

The high conforming loan limit (i.e., the limit on loans eligible for Fannie Mae and Freddie Mac programs) means that only very large loans are not eligible for GSE programs. On the other hand, the GSEs have become increasingly aggressive in forcing lenders to buy back loans for breaches of representations and warranties. Lenders may be drawn to use private-label securitization if they feel that there is less risk that they will be required to repurchase loans for breaches of representations and warranties. It is very laborious for an investor to litigate to get access to loan files to look for breaches of representations and warranties. An easier way for a trustee or servicer to improve recoveries for investors is to pursue deficiency judgments in states that permit them.

The general consensus among panelists is home prices will likely decline by another 5% to 10%. One panelist

expects that the real bottom will be about 10% to 12% below current levels and will occur in about three years. He feels that the overhang of "shadow supply" is the key factor. Another panelist says that, in his opinion, prices have room to decline by another 10% to 15%. He feels that market participants should factor in the potential for a deflationary spiral. This means that there is not likely to be room for home prices to rise significantly in the short to medium term. A third panelist is concerned about tail risk with respect to home prices. He says that investors need to consider scenarios where there is insufficient demand to absorb the overhang of supply and home prices decline by more than 15% from their current levels. A fourth panelist notes that there is no sign of recovery in some markets. A different panelist remarks on the experience of Japan, where home prices have gradually, but consistently, declined for nearly 20 years. Panelists have differing views about inflation/deflation risk and the use of quantitative easing as a factor in shaping both inflation expectations and ultimate inflation.

One panelist counters with the observation that the emerging signs of economic recovery (GDP growth) suggest that the market should be less concerned about tail risks. Another panelist expects a U-shaped recovery for mortgages. He says that the weakness in the labor market is likely to keep driving weak performance and high delinquencies on subprime mortgage loans. A different panelist amplifies on the point, asserting that there are still many subprime mortgage loans that are current now but that will eventually default.

One panelist contends that market participants are using the same credit and prepayment assumptions for modeling mortgage loans that they used at the height of the crisis. However, they are using lower discount rate assumptions, which drive higher valuations.

One panelist believes that "default burnout" is a real phenomenon. He notes that 80% of borrowers on underwater loans are current on their loans. They are survivors. He expects those borrowers to stay mostly good. He thinks that performance of deals will not be highly sensitive to changes in the macroeconomic climate. Another panelist disagrees. He feels that nondelinquent borrowers who have not refinanced have some kind of problem; they should not be viewed as immune to macroeconomic conditions. A third panelist agrees with the second, asserting that the slight stabilization in delinquencies may simply reflect the fact that job losses have slowed (although job creation remains stagnant).

***Picks and pans: each panelist offers his view on opportunities in the market.***

- The first panelist expects neutral to positive price movement for the overall securitization. There is opportunity in bonds that appear regular on the surface but that have a deeper story.
- The second panelist generally favors private-label RMBS. For investors with appetite for greater risk, he recommends private-label RMBS backed by option adjustable-rated mortgage (ARM) loans.
- The third panelist feels that high yields are obtainable only by accepting optionality (i.e., refinancing/prepayment risk). He recommends picking bonds individually and not trading on the basis of sectors or subsectors.
- The fourth panelist recommends underweighting private-label RMBS. The only types of private-label RMBS that he favors are strips (i.e., interest-only or principal-only securities). Among agency MBS, he favors those with premium coupons backed by seasoned loans.
- The fifth panelist observes that there is potential opportunity to profit from rising prepayments by investing in split-rated, front-pay sequential tranches. He focuses on situations that would be affected by a slowing of foreclosure processing (i.e., extension of the "liquidation timeline"). He notes that Alt-A and Alt-B floaters could get hurt by timeline extensions, while some IOs could be helped.
- The sixth panelist generally perceives opportunity in private-label RMBS backed by fixed-rate loans from the



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2006 and 2007 vintages. He also likes the last-cashflow tranches from RMBS backed by subprime mortgage loans. (Note: These views suggest that the panelist believes the market has overestimated the remaining credit risk in the securities.) He recommends against using leverage because he feels that market risk (i.e., price volatility) may be high.

### Relative Value Opportunities And Hedging Techniques (4:45 p.m.)

***Agency MBS coupons selection and prepayment expectations.*** One panelist asserts that it is a difficult time in the agency RMBS sector because additional quantitative easing by the Federal Reserve pressures agency RMBS. He favors agency RMBS with 5.5% coupons backed by pools that contain a disproportionate share of loans secured by investor properties. In his opinion, many of the loans backing RMBS with coupons of 6% and 6.5% are credit impaired. He generally favors trading into RMBS with higher coupons because he feels that the market is unrealistically optimistic about the underlying borrowers' prospects for refinancing their loans. In the area of MBS backed by loans with original maturities of 15 years, the panelist favors MBS with coupons of 4% and 4.5% over those with lower coupons.

A second panelist agrees, asserting that refinancing will absolutely not be available to all high-coupon borrowers. Servicers are now checking all their work to avoid having to repurchase loans for breaches of representations and warranties. This is increasing friction in the mortgage origination system and slowing down all kinds of refinancing activity.

A third panelist also agrees, stating that the issue of streamlined refinancings is already fully priced into securities.

***Sector selection.*** One panelist says that he is active in all types of structured finance securities, but not in whole loans. He is focusing on the Alt-A, near-prime, and prime sectors within RMBS. Yields on private-label RMBS are more attractive than yields on agency RMBS. Private-label RMBS remains attractive on a relative basis, even though it has appreciated a lot over the past year. Technicals are favorable because there is so little new issuance.

Another panelist remarks that he is active in securities that were initially rated triple-A, but have since been downgraded. Those securities traditionally have been the focus of real money investors, but hedge funds are now interested as well. Hedge fund interest stems from volatility in the outcome attributable to servicer behavior and loan modifications (i.e., because of uncertainty about the impact of servicer behavior and loan modifications the securities command a relatively high yield). The subsector is appealing on an unleveraged basis.

A third panelist likes RMBS backed by hybrid loans to prime-quality borrowers. He likes the severity story and the larger loan size. He had anticipated higher prepayment speeds. The bonds produce strong cash flows. He has so far avoided RMBS backed by option ARMs, but he is now starting to take a harder look.

***Hedging techniques.*** One panelist states that his firm tries to hedge interest rate risk efficiently and that the firm focuses on buying bonds that have interest rate risk. He asserts that it is cheap to hedge interest rate risk by shorting 10-year Treasuries or by buying interest-only securities. He also hedges the firm's exposure to LIBOR. It is necessary to run sensitivity analyses to analyze the mismatch between the hedged instrument and the hedging instrument under various scenarios. It is necessary to have enough yield on the overall investment to be able to withstand scenarios with limited mismatch. Another panelist notes that there is substantial uncertainty about the reliability of prepayment and default models.

The first panelist adds that he is concerned about the possibility of legislative action that would allow all borrowers to refinance their mortgage loans (i.e., the risk that legislative action causes prepayments to increase markedly).

***Potential impact of a double-dip recession on technicals.*** One panelist asserts that private-label RMBS are attractive now and could become more attractive as uncertainty diminishes over time. However, a double-dip recession or a major drop in the stock market could hit RMBS valuations very hard and could cause investors to demand yields above 10%. A second panelist generally agrees. He notes that RMBS valuations are more likely to improve than to decline. However, there is pressure from the overhanging shadow inventory of homes. A third panelist notes that credit rating downgrades forced some investors to sell downgraded securities, but that issue has worked its way through the system and the forced selling is largely over. He does not expect valuations to retest their recent lows.

***Refinancing programs.*** One panelist observes that the programs intended to promote refinancing of troubled loans have not been very successful. A key impediment is the liability that servicers and originators have on new loans. It is risky for a servicer to refinance a loan that will have a loan-to-value ratio greater than 100%, because if the loan defaults, the servicer may be forced to repurchase it. Likewise, it is laborious and difficult to do a fully documented refinancing of a loan that was originally underwritten with little or no documentation. Another panelist observes that a good by-product of the government programs to promote loan modifications was the extension of foreclosure timelines. He believes that effective policy should come from stimulating housing demand with homebuyer tax credits.

***Outlook for one to three years.*** One panelist feels that spreads are more likely to tighten then to widen. The Federal Reserve will eventually use further quantitative easing. This argues for keeping some powder dry (i.e., holding some cash) to exploit potential opportunities that emerge as a result. Another panelist notes the uncertainty about the future of the GSEs and their balance sheets. He expects to see volatility on agency RMBS. A third panelist expects that the basic revival of the securitization market will be tied to the fate of the GSEs. If the GSEs become smaller and there is less activity from them, then there likely will be a resurgence of private-label activity to fill the void.

***Models.*** One panelist explains that his firm uses Bloomberg and Intex but remains skeptical of the reliability of models to properly capture event risk. Another panelist uses Yieldbook in addition to Intex. A third panelist emphasizes that models are only as good as their inputs. He says that his firm runs "a gazillion" scenarios. Panelists generally agree that scenarios are the key to successful security selection. The most important step is selecting the range of scenarios and focusing on trades that offer more potential upside than downside.

***Data reliability.*** One panelist argues that the proper response to high error rates in loan-level data is to focus on pool-level data on delinquency buckets and roll rates.

There likely will be a sudden increase in reported mortgage default rates when the loan modification logjam gets cleared. Credit IOs (i.e., securities that are currently receiving interest cash flow that will stop when credit losses are realized) will suffer badly when that happens. That is, once a loan modification fails, the foreclosure process will get fired up and loans will be foreclosed and liquidated. Another panelist observes that it will be painful for the market to deal with eventually liquidating the overhanging shadow inventory of homes.

One panelist remarks that his leading concern about event risk is a default of a major sovereign.

## Tuesday, Oct. 5, 2010

### Lessons From The Financial Crisis: Required Steps For Rebuilding The Investor Base And Future Sources Of Liquidity (9:30 a.m.)

***What is the key to restoring investor confidence?*** Panelists are mostly split between "more transparency" and "more new issuance" as the main factor that will restore investor confidence. One panelist states that before the crisis, investors really did not understand what they were buying. Another panelist indicates that investors are more sophisticated today and are able to use the additional data that have become available. Other panelists say that

simpler structures will help investors to more easily understand what they are buying.

One panelist states that, in the current environment, the economics of mortgage securitization do not work. Banks make loans that they can put into GSE pools but not into pools backing private-label RMBS. The panelist indicates that she feels banks are unwilling to hold loans on their balance sheets. She demonstrates that today's interest rates on jumbo mortgage loans are too low to make securitization possible.

In another panelist's opinion, credit and liquidity spreads need to tighten to make securitization economical. However, the panelist states that, for that to happen, investors would need to have more confidence that defaults and losses were finally under control. A different panelist remarks that accounting changes that require banks to carry securitized assets on their balance sheets have reduced the incentive for banks to use securitization.

One panelist indicates that the regulatory pendulum has swung too far and so has the trend toward deleveraging (i.e., banks reducing their leverage). Another panelist disagrees, contending that there was too little regulation and too many regulatory loopholes that allowed banks to operate with excessive leverage. He notes that banks increased their leverage by using SIVs and similar vehicles with far too little capital. Another panelist emphasizes the need for regulation to create a level playing field among different types of market participants. (Note: The panelist essentially argues that regulation should not deny banks any of the advantages that unregulated entities may receive from using securitization.)

One panelist states that confidence cannot really be restored until the housing market finds its bottom. Another panelist predicts that when private-label RMBS revival occurs, the sector will be confined to high-quality mortgages. However, this seems contrary to the need for looser credit to deal with the immediate problem of so many borrowers being at risk of default (as many as 11.5 million). She believes that home prices are likely to decline by 5% to 10%.

***Regulatory environment.*** One panelist notes that the FDIC safe harbor calls for a 5% vertical slice for risk retention. Additionally, both the Dodd-Frank law (§941) and the SEC proposed regulations (requirements for shelf registration) mandate risk retention. The problem is too much regulatory uncertainty. Market participants are frozen while they wait for clarity to emerge, which likely will happen over the next six to nine months.

Another panelist states that the long-term health of the U.S. banking system will require much more intensive regulation to achieve safety and soundness. He argues that banks were extremely over-leveraged and that strict regulation is necessary to prevent that from happening again. A third panelist indicates that she believes improved disclosure from changes to the securities regulations will help the market. However, she is concerned that mark-to-market accounting will create too much volatility. A fourth panelist feels that, although recent regulatory changes are positive, they are impeding the revival of securitization because market participants have difficulty absorbing the changes. He adds that apart from regulatory changes, market participants need to change their behavior. A fifth panelist emphasizes that an exemption from the Dodd-Frank risk retention retirements for "qualified residential mortgages" (§941(e)(4)) is likely to drive private-label securitization activity to concentrate exclusively on loans that qualify for the exemption. She also thinks that the failure to address second-lien loans is a serious deficiency in the recent regulatory initiatives.

***Rating shopping.*** One panelist feels that unsolicited ratings (potentially using Rule 17g-5) will help to curtail rating shopping. Another panelist disagrees, noting that rating agencies need to prevent rating shopping, rather than encourage it. Another panelist agrees that rating shopping must be stopped, but he says he believes that Rule 17g-5 presents unreasonable administrative burdens on issuers.

***Relative value.*** One panelist feels that there is value in investment-grade tranches from highly seasoned deals where virtually all borrowers have totally clean payment histories. He believes that there are high-yield opportunities to profit from rising prepayments because prepayments have been too low for too long on some types of loans. Noneconomic prepayments, including those from deaths, divorces, and moves, are likely to increase prepayments in deals were there have been literally zero prepayments for a year or more. He broadly favors RMBS backed by seasoned loans.

Another panelist likes stable, front-pay tranches from private-label RMBS because they offer relative value compared with corporates. In the high-yield space, she generally favors residential mortgages over other sectors based on the view that the sector will display better stability than others in a further downside scenario.

***New issuance predictions for 2011 relative to 2010.*** Panelists offer their predictions for securitization issuance volume in 2011 compared with 2010. One panelist expects issuance will be the same to up, three predict it will be up, one expects volume will be up by a lot, and one projects it will be up by a little.

### Global Regulatory Initiatives And The Broader Impact On U.S. Securitization Practices (10:30 a.m.)

One panelist observes that four years ago, he never would have imagined that securitization would be at the center of the financial crisis and that the crisis would be the worst one since the Great Depression.

***Securities regulation.*** The new proposed regulations would mandate 5% vertical risk retention as a requirement for shelf registration. It would also require delivery of preliminary prospectuses five days before sales. The proposal would require periodic reporting for the life of a securitization transaction, and it would include disclosure requirements on transactions under Rule 144A. Additionally, the CEO of a depositor must certify that a securitization has enough assets to repay the securities. (See SEC, "Asset-Backed Securities," Release Nos. 33-9117, 34-61858, 75 Fed. Reg. 23328, May 3, 2010, proposal for significant revisions to Regulation AB and other rules affecting asset-backed securities.)

***Are there too many cooks?*** One panelist indicates that strong coordination among the regulatory agencies is necessary. She offers the example of "qualifying residential mortgages" that can be exempt from risk retention requirements under the Dodd-Frank law. Until the new regulatory requirements are finalized, uncertainty will hamper the market's revival. Another panelist adds that new regulatory requirements will increase costs and slow down the securitization process. For example, the proposal to require delivery of preliminary prospectuses five days before making any sales will necessarily slow down the process. Likewise, the requirements of Rule 17g-5 slow down the process of dealing with rating agencies. The proposal to extend disclosure requirements to securities offered under Rule 144A would make certain types of deals ineligible under the rule. Those deal types would include single-borrower CMBS, collateralized loan obligations, and resecuritizations.

***Risk retention.*** Risk retention appears in three forms: Dodd-Frank, the FDIC safe harbor, and the proposed securities regulations. One panelist notes that 5% risk retention seems to the "magic number," but there is not agreement about the form. Also, the interplay of risk retention with the new accounting rules is sensitive. One of the factors that drives consolidation under the accounting rules is retention of a material interest and whether 5%, in potentially different forms, constitutes a material interest.

Another panelist observes that risk retention requirements potentially affect the mortgage sector more than other sectors. Resecuritizations also likely will be dead for awhile.

***Investor perspective.*** One panelist states that investors want more information and that the proposed disclosure regulations should deliver more. Issuers are concerned about incurring liability for errors or omissions in the information that they provide. Deal flow in 2011 is likely to be slow. Another panelist remarks that issuer decisions about how to handle risk retention will be a key factor driving the volume of deals.



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***Accounting.*** The impacts of FAS 166 (derecognition) and FAS 167 (consolidation) are still being worked out. Some banks managed to avoid consolidation by selling interests that they had initially retained. The anticipated Basel III calculations would be rough on mortgage servicing rights and the treatment of unrealized gains and losses. There is an exposure draft on the fair value treatment of financial assets, which would call for carrying financial assets at fair value. (See Financial Accounting Standards Board, "Update No. 2010-06—Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements," January 2010.)

***Two years from now.*** One panelist feels that two years from now, market participants will look back favorably on enhanced disclosure and, possibly, on risk retention. Another panelist states that the market will adapt to regulations and that regulation is most needed in areas where the market is not effective at regulating itself. The third panelist expects that the economy will be better in two years and that the market will have fully adapted to the new regulations.

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- Treasury Department, "Advance Notice of Proposed Rulemaking Regarding Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies," 75 Fed. Reg. 52283 (Aug. 25, 2010)

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