Report from Miami Beach 2012:
Coverage of Selected Sessions of ABS East 2012

28 October 2012

by Mark Adelson*

Introduction

Last week's ABS East 2012 conference in Miami Beach attracted around 3,000 attendees. Most attendees shared a positive outlook for the U.S. securitization market. Many panelists noted the modest rebound in home prices that has started to happen. Many also noted that consumer confidence is strong and home affordability has hardly ever been better. On the other hand, overhanging risks also featured prominently in the sessions and in casual conversations: the U.S. fiscal cliff, ongoing high unemployment, and the threat of complications from the European sovereign debt crisis spilling into the U.S. A few speakers remarked about potential for serious disruptions when interest rates eventually rise. The general positive mood was tempered by the realization that whatever recovery is occurring is fragile and that the risks for 2013 and 2014 are decidedly skewed to the downside.

Somewhat surprisingly, geopolitical risks were hardly mentioned. The presidential debate on foreign policy occurred on the second night of the conference. In that debate, each candidate stated emphatically that under his leadership America would absolutely not allow Iran to acquire nuclear weapons. Both indicated that *every* effort should be made to achieve that objective by diplomatic means. However, each also emphasized that no options were "off the table" if a diplomatic solution is impossible. By contrast, several panelists discussed the issue of the fiscal cliff as a real risk, while in the debate, the President appeared quite certain that sequestration will not actually happen (even if Congress has to adopt unwise policies to prevent it).

The key issues on the legal/regulatory front were the anticipated definitions for the terms "qualified mortgage" and "qualified residential mortgage," both of which were introduced by the Dodd-Frank Act. Compared to past conferences, there was less discussion of regulatory capital guidelines and accounting standards.

The following summaries reflect remarks of the panelists who participated in selected sessions at the conference. For the most part, the summaries have been drawn from notes that I took during the sessions. The summaries have not been reviewed or approved by the panelists. While I have tried to capture panelists' remarks accurately, I apologize in advance for any

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inaccuracies and omissions. In addition, I wish to acknowledge the excellent work of Information Management Network in organizing and hosting the conference.

Sessions Covered Page

Sunday, 21 October 2012

2:00pm – Bond Pricing and Valuation Tools

One panelist remarks that, according to some estimates, losses on residential mortgage loans will exceed $2 trillion. This suggests that there were weaknesses or deficiencies in some of the data and models that mortgage professionals used in the period before the financial crisis.

A second panelist focuses on valuation from the perspective of regulation. The SEC and the PCAOB have both focused on asset valuations. There is an emphasis on hard-to-value positions; particularly Level 3 and "low" Level 2 assets (within the fair value hierarchy under FAS 157).

Regulators expect auditors to assess both the data and the models used by their audit clients. In some cases, regulators also expect auditors to independently estimate the value of a position (*e.g.*, by using an independent pricing service). Auditors are now asking their audit clients to provide greater support for asset valuations. Pricing services are increasing transparency to show the assumptions that underlie their valuations. Auditors are delving more deeply into how pricing services and brokers create their valuation estimates. New accounting standards require additional disclosures about the inputs to a valuation and about the sensitivity to unobservable inputs.

A third panelist, who works at a firm that builds option-based valuation models, explains that using a model to estimate residential MBS values is necessary because the securities do not trade frequently. He asserts that a valuation model should reflect not just market data, but also an outlook on interest rates and home prices. The challenge is that interest rates and home prices are volatile and a good model should also reflect that volatility. The panelist argues that valuations should be given as ranges rather than point estimates. [Note: That is one way to deal with the practical reality that any estimate has an inherent margin-of-error.] Loan level data is essential because RMBS display non-linear sensitivities to the relevant underlying factors. Accordingly, using averages can be dangerous.

The relationship of home price indices to interest rates is not stable. Over the past few decades there have been periods of both rising and falling home prices during periods of rising and falling interest rates. Some of the new models allow for users to adjust for the impact of potential policy decisions.

A fourth panelist works in the data analysis group of a data vendor. He explains that, starting in November, FINRA will disseminate trade-level data on agency MBS trades. FINRA intends to eventually expand its TRACE system to cover more structured finance trading activity. However, the market needs more than transparency about actual trades. The market needs transparency about the underlying assumptions used in valuation models and transparency about how values of untraded securities are interpolated from securities that do trade. An even deeper layer of transparency would allow the customers understand the pricing service's procedure for creating models.

Valuations from an independent pricing service avoid the conflict of interest problems associated with valuations from broker-dealers. In addition, an independent pricing service has the ability to talk to all market participants, while a broker-dealer likely would not get information from its competitors.

A fifth panelist argues that the valuation industry needs to recognize its limitations and communicate those limitations. Even when a firm uses third party valuations, it needs to have the ability to produce valuation estimates itself so that it can judge the reasonableness of what it receives from outside services. Also, the low volume of secondary trading of securitizations (other than GSE MBS) combined with the complexity of securitization cash flow structures, means that valuation estimates are necessarily based on models and assumptions. Third, the industry needs to think in terms of ranges for valuations, and in terms of valuations under particular scenarios, rather than just focusing on point estimates. Fourth, a firm should build and have a model-risk framework through which it considers the purpose of valuations. Valuations created for one purpose (*e.g.*, risk management) may not be the most useful for another purpose (*e.g.*, trading). Even the best models with the best data are very limited. Fifth, a firm has to keep risk management – particularly scenario analysis and stress testing – as part of the framework through which it uses valuation models.

One panelist observes that the poor-performing mortgage loans made in the years immediately before the financial crisis were not like the loans from earlier times. The change in the essential character of the loans meant that models calibrated on the performance of the older loans could not be strong predictors of the performance of the newer loans. [Note: The panelist omits the equally important point that a when model's development sample covers only a period of benign conditions the model may not be strong predictor of loan performance during stressful conditions.]

2:50pm – Latest Developments in Mortgage Analytics for Investors

One panelist states that a customer should demand zip-code-level granularity in a home price index. Operating at an MSA-level is far too coarse. Additionally, a superior index product separately indexes price tiers within each zip code. The objective is not just economic analysis but rather estimating prices of individual properties. A home price index is essential for estimating loss severities on defaulted mortgage loans. It is necessary to incorporate a discount for short sales and REO properties. The LPS McDash database covers 70% of the residential mortgage loans in the U.S. The company also has separate data on home equity loans. The company collects data on the effect of loss mitigation programs.

A second panelist explains Morningstar's activities in rating residential MBS. Before the financial crisis, rating agencies focused on rating new deals. Morningstar bought Realpoint, which was in the business of supplying investors with research on outstanding CMBS. Morningstar has started publishing ratings on new issues, but its surveillance activities are supported by investor subscriptions. The company uses the same criteria for rating new issues as it does for surveillance. Morningstar has spent the past two years building a loan-level credit model. Each rating level corresponds to a level of macroeconomic stress. Morningstar's single-A rating corresponds to the stress of the recent crisis. Morningstar "re-rates" every deal every month and updates its macroeconomic outlook every calendar quarter.

Delinquencies on the Sequoia Mortgage Trust deals have been extremely low; there have been only 15 loans that became delinquent by 30 days and all of them subsequently cured. The B1 tranche of the 2011 deal would now qualify for a triple-A rating from Morningstar.

The NAIC-PIMCO evaluation of RMBS is expensive and updated only annually. Morningstar uses a similar approach but provides monthly updates. The company expects a strong rebound to the private-label RMBS sector "in 2014, plus or minus five years." The company expects home prices to fall in 2013 and believes that there is significant regulatory uncertainty.

A third panelist remarks that investors have four particular modeling needs. The first is the need to estimate property values at key times of the loan resolution process because those values are part of determining the optimal loan resolution strategy (*e.g.*, short-sale, courthouse sale, or REO). The second modeling need relates to the REO to rental process. Fulfilling this need entails creating property-level capitalization rates, vacancy rates, and rent cash flows. A third modeling need relates to the prime-quality ***agency*** sector. There have been proposals for the GSEs to sell bonds with credit risk and investors would need a model of conforming loan credit performance to analyze those bonds. Lastly, some customers need a model for analyzing repurchase risk. The current process involves a considerable opportunity for human error and the reasons for a loan repurchase (*i.e.*, the specific representation or warranty that was breached) may not relate at all to the reason why the loan defaulted.

A fourth panelist focuses on the analysis of REO to rental opportunities. His company's analysis focuses on rent levels for apartments of different sizes in individual zip codes. He turns to the practices of different loan servicers with respect to advancing principal and interest on delinquent loans. Although the underlying data is somewhat sketchy, it has been enough to draw conclusions about the behavior of different servicers and to feed into the analysis of securities. He adds that tools are available that enable investors to generate reports and conduct analysis without having to wrangle loan-by-loan data themselves.

The fifth panelist argues for pool-level analysis. He recommends sorting loans into cohorts for purposes of estimating default risk and recovery. The best approach is to combine loan-level data with pool-level data. Pool-level data can be revealing about the behavior of cohorts. Ignoring pool-level performance by relying on just loan-level data can lead to "garbage results." Pool-level performance lends insight into the influence of macroeconomic factors.

3:55pm – CLO Analysis 101

One panelist observes that CLO issuance has been strong in 2012. Year-to-date issuance stands at roughly $34 billion, compared to $8.6 billion at this time last year. CLO issuance peaked in 2007 at nearly $90 billion, but it declined sharply with the financial crisis. CLOs have displayed strong credit performance – a sharp contrast to the weak performance of certain other securitization products such as residential MBS and CDOs backed by residential MBS.

A second panelist explains that he uses both historical default rates and third party estimates of default rates for modeling and valuing CLOs. He indicates that he thinks in terms of scenarios as well. A third panelist explains that in the past he focused primarily on the market value of a CLO's underlying assets and later started to focus on modeling assumptions about default frequencies, recovery rates, and correlations. His analysis focused on restrictions on reinvestment. That required not only reviewing CLO indentures but also constructing rational modeling assumptions based on indentures provisions.

The fourth panelist adjusts default rate assumptions based on fundamental assessments of the underlying credits. Loans traded at substantial discounts a few years ago, but now they command prices close to par. This partly reflects an improvement in the market's view of the credit risk in the loans.

The second panelist cautions investors to include fees and swap payments in their analyses because those items would be factors in the liquidation of a CLO. Just comparing the fair value of the assets to the amount of outstanding CLO notes is not a sufficient analysis.

LIBOR Floors: The fourth panelist observes that the proportion of a CLOs' underlying loans with LIBOR floors has increased. While LIBOR is very low, the floors produce a benefit for CLO deals, especially for the equity tranche, because the CLO notes float without floors. The second panelist observes that when interest rates eventually rise, the impact will be adverse for CLO equity holders.

Covenant Lite Loans: The fourth panelist argues that the default risk on a loan is more important than the loan's covenant structure. The third panelist agrees, asserting that the "cov lite issue" has been a red herring. A typical investor does not want to use covenants as a way to take over a defaulting company, but rather as a way to compel renegotiation of a loan's interest rate if the risk becomes worse. The popularity of covenant lite loans declined sharply during the peak of the financial crisis, but now the proportion of covenant lite loans has climbed back to around 30%.

Break-Even Analysis: The second panelist asserts that an investor should use realistic assumptions for a break-even analysis. Current trends and conditions may not persist. It is necessary to make sure that a break-even analysis reflects the possibility that default rates, recovery rates, and correlations can move adversely at the same time. The first and third panelists observe that break-even analysis can offer a way to differentiate two bonds that appear similar based on other measures.

The third panelist states that analyzing a security's yield is the key factor in his decision-making. The second panelist asserts that a CLO manager must possess current market knowledge for deciding how to handle defaulted loans – deciding whether to sell the loan or to work it out.

The fourth panelist explains that an investor should consider not only a CLO manager's effectiveness at achieving recoveries on defaulted loans, but also on the manager's effectiveness at reinvesting the proceeds. If a manager liquidates a defaulted loan at 70 of par and buys a replacement loan at 80, which later appreciates to par, the manager has not lost 30 on the defaulted loan, but only 10%.

4:45pm – Key Economic Variables for the Housing Market and Consumer Finance

Recent Trends in Non-Mortgage Asset Classes:[1] One panelist observes that U.S. household debt increased sharply in the period leading up to the financial crisis. The increase included both mortgage debt and non-mortgage debt. Mortgage debt reached $35,000 per capita, but has since fallen to roughly $30,600 per capita. Household debt service ratios and financial obligation ratios have declined.[2] All categories of consumer debt, except for student loans,[3] have declined since the onset of the financial crisis. Moreover, there has been a very sharp decline in the number of credit card accounts, as banks closed consumers' accounts.

[1] See Federal Reserve Bank of New York, *Quarterly Report on Household Debt and Credit* (Aug 2012) http://www.newyorkfed.org/research/national_economy/householdcredit/DistrictReport_Q22012.pdf.

[2] Federal Reserve Board, *Household Debt Service and Financial Obligations Ratios* (27 Sep 2012) http://www.federalreserve.gov/releases/housedebt/.

[3] Federal Reserve Bank of New York, *Student Loan Debt History* (undated) http://www.newyorkfed.org/studentloandebt/.

Economic data is mixed. Consumer confidence, home prices, and the unemployment rate appear strong or are improving. However, exports, defense spending, and job creation are weak. The overall picture is uncertain.

Student loans are in the news almost daily. About 40% of households aged 35 or less have student loans. There is some indication that student loan debt is affecting the spending behavior of the consumers who have it. Recent college graduates are increasingly living with their parents and the proportion of first-time home buyers aged 25-30 has declined. Long-term unemployment is a concern because studies have shown that long-term unemployment imposes a drag on the eventual recovery, causing structural unemployment to increase by 0.2% for each 1.0% of long-term unemployment.

Many countries, including the U.S., experienced sharp increases in household leverage from 1997-2007. The greatest increases were in Ireland, Netherlands, Denmark, Estonia, Australia, Spain, Norway, and Portugal. The U.S. and the U.K. have gone the farthest toward household deleveraging.

Mortgage Credit: A second panelist observes that the post-crisis rebound in household formation is not manifesting itself as a rebound in the demand for homeownership but rather in the demand for rental housing. The mortgage credit environment is very constrained. Under a variety of metrics, lending standards have gotten much tougher than they were before the financial crisis. [Note: The point that credit standards have tightened since the onset of the financial crisis is rather obvious. Credit standards were clearly too lax in the period leading up to the crisis. The tougher question is whether credit standards are tighter than they ought to be.]

Mortgage credit standards likely will loosen to accommodate demand. Also, Fannie Mae and Freddie Mac have announced modification to their framework for representations and warranties.[4] Under the new framework, certain representations and warranties on loans with clean payment histories would essentially expire after three years.

The private-label RMBS sector is hurting because of uncertainty about how regulators will ultimately define the terms qualified mortgage ("QM")[5] and qualified residential mortgage ("QRM").[6]

[4] Federal Housing Finance Agency, FHFA, Fannie Mae and Freddie Mac Launch New Representation and Warranty Framework, press release (11 Sep 2012) http://www.fhfa.gov/webfiles/24366/Reps_and_Warrants_Release_and_FAQ_091112.pdf.

[5] ***Qualified Mortgage ("QM"):*** The Dodd-Frank Act introduced the term "QM" as part of its framework requiring a mortgage lender to determine that a potential borrower has a reasonable ability to repay his loan. Making such a determination is difficult and a lender faces potential liability if it fails to do so. Enter "QM." A mortgage lender is permitted to presume that a borrower has the reasonable ability to repay his loan if the loan falls within the QM specification. Thus, from a lender's perspective, originating loans that are QMs involves less work and less legal risk than originating non-QM loans. Section 1412 of the Dodd-Frank Act placed the QM definition in section 129C of the Truth in Lending Act (15 U.S.C. § 1639c). The final specifications for QM will come from the Bureau of Consumer Financial Protection, which took over responsibility for the regulations under the Truth in Lending Act.

Housing Recovery: Another panelist notes that although housing has started to show some signs of recovery, it has hardly recovered to its best conditions of the past. A key factor is the labor market. Lending standards were a key driver of a strong housing market in the years leading up to the crisis. Tighter lending standards today create something of a drag, in relative terms. Also, about 20% to 22% of current homeowners are underwater on their current loans, which makes it difficult for them change homes. [Note: A panelist from a later session pegged the percentage of underwater loans at 17% (see page 17).] Down payment requirements are higher now than they were leading up to the crisis. Home price growth will likely revert to track the pace of GDP growth over time.

Monday, 22 October 2012

9:15am – Identifying the Major Global Macro-Economic Risks to the U.S. Securitization Markets

Key issues include (i) the European debt crisis, (ii) the U.S. fiscal cliff, (iii) the potential for a Chinese hard landing, (iv) the Fed's policy, (v) regulatory burdens, and (vi) the U.S. consumer and housing markets.

European Debt Crisis: One panelist explains that Europe has been struggling with sovereign debt crises for the past three years. It has been a roller coaster, but now things seem to be coming together. There is general agreement to form a banking union but no specifics yet. On the other hand, the austerity imposed on the Southern European countries is very onerous. The positive scenario is one in which Western Europe shows little or no growth for the next several years.

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[6] ***Qualified Residential Mortgage ("QRM"):*** The Dodd-Frank Act introduced the term "QRM" as part of its risk retention framework for securitizations. Section 941 of the Dodd-Frank Act (15 U.S.C. § 78o-11) generally imposes a 5% risk retention requirement on securitizers. However, a securitization backed entirely by QRMs is exempt from the risk retention requirement. Federal housing and banking regulators are charged with finalizing the definition of QRM, but the law requires that the definition of QRM be no broader than the definition of QM. The definition of QRM is extremely important for the private-label RMBS sector because securitization of QRMs will be much less expensive than securitization of mortgage loans that are not QRMs. Thus, it is likely that the future of private-label RMBS will be concentrated in QRMs. The regulators published a proposed regulatory definition of QRM but it has not been finalized. See Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, Securities and Exchange Commission, and Department of Housing and Urban Development, *Credit Risk Retention*, 76 Fed. Reg. 24090 (29 Apr 2011) (proposed rule) http://www.gpo.gov/fdsys/pkg/FR-2011-04-29/pdf/2011-8364.pdf.

However, there is also interplay with the loan quality standards used by Fannie Mae and Freddie Mac. The sweet spot for private-label securitization may be in QRMs that do not qualify for the Fannie Mae/Freddie Mac programs. If the QRM definition ends up being no broader than the loan quality standards used by Fannie Mae and Freddie Mac, then the only remaining space in which private-label mortgage securitization may be economical would be QRM loans that exceed the Fannie Mae/Freddie Mac size limits. Those size limits are now at very high levels, leaving very little grist for the private-label mortgage securitization mill.

A second panelist observes that the European sovereign debt crisis has had only slight impact on U.S. securitizations, so far. One effect has been a decline in the availability of swap counterparties because of bank downgrades. A second effect has been a reduction on the availability of refinancing for securitized commercial mortgage loans. Most of the credit rating downgrades of European securitization transactions have been caused by downgrades of swap counterparties rather than by poor asset performance.

A third panelist notes that U.S. equity fund managers no longer consider the European situation to be their top concern. Larry Summers recently compared the EU's efforts to consolidate bank regulation to the U.S.'s involvement in Viet Nam.[7] The structured finance sector is slowly reviving. Issuance increased in 2011 relative to 2010, and issuance is higher in 2012 than it was in 2011. In addition, securitizations are closing at very low absolute yields, which indicate strength in the sector. A major share of U.S. issuance has been short duration and fixed rate. European buying of recent U.S. issues has not been a major factor.

Fiscal Cliff: A fourth panelist asserts that the fiscal cliff could trigger a U.S. recession. It would likely produce a dampening of investor risk appetite. There will be very great political pressure to resolve the fiscal cliff immediately after the presidential election. However it is not clear which political side will blink first or what the resolution will be. A fifth panelist remarks that the fiscal cliff is a huge risk to the economy. A sixth panelist asserts that if the fiscal cliff is not resolved unemployment will rise to 10.4% in 2013.

The first panelist remarks that a political solution will be very difficult to achieve because both sides of the political debate seem entrenched in their views and unwilling to compromise. However, there might be a "TARP moment," similar to the market events that prompted Congress to enact the TARP legislation after having initially refused to do so. The current political dialog might make the potential for compromise appear less than it really is because the political rhetoric does not reveal whether policymakers have fallback positions that they would be willing to accept in order to avoid the cliff.

Another panelist contends that the key issue is tax cuts for high income taxpayers. The first panelist counters that another key element will be whether the eventual policy response will be sufficient to close the fiscal imbalance.

A different panelist remarks that a recent study concluded that hitting the fiscal cliff would cause global economic growth to decline by half.

Fed Policy: One panelist argues that the Fed's continuation of quantitative easing is counterproductive. Quantitative easing squeezes real income for households. The low-rate environment (including negative real interest rates) is hurting retirees, pension funds, and others who need to get yield. The Fed has already kept interest rates too low for too long.

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[7] Summers, L., *The Perils of European Incrementalism*, Reuters blog (19 Sep 2011) http://blogs.reuters.com/lawrencesummers/2011/09/19/the-perils-of-european-incrementalism/.

Another panelist asserts that the Fed's policy has favored debtors at the expense of creditors. A different panelist counters that modest disinflation preceded both prior rounds of quantitative easing and that a modest period of inflation followed each round. This implies that quantitative easing "works mildly well." Viewed from another perspective, quantitative easing may be the Fed's only option other than merely sitting on the sidelines. Because sitting on the sidelines would not be acceptable, quantitative easing becomes the inevitable choice. He observes that Japan has had 10 years of quantitative easing and it's still in trouble.

Other panelists observe that policymakers have a range of views about the Fed's quantitative easing policy.

Another panelist asserts that quantitative easing has helped to boost the economy a little bit. Another argues that quantitative easing is the reason for the extremely low yields in the structured finance sector as well as the fixed-income market generally.

U.S. Consumer and Housing Market: One panelist remarks that the housing market has not yet recovered but that it is in recovery. House prices have risen in each of the past four years. However, there have been seasonal declines each autumn. A factor that is different now is that the supply-demand balance has recently improved. Supply has declined a lot, helping to bring it into line with the modest level of demand. Home price appreciation is important because it will help to bring many households out of negative equity situations, which prevent them from selling their homes and participating in the housing market. The mortgage market recently has been dominated by refinancings, rather than home purchases.

Another panelist notes that the health of the U.S. consumer affects the performance of consumer ABS. At the onset of the crisis, competition among credit card and auto loan lenders was basically rational, and it remains so today. This explains why non-mortgage, consumer ABS have performed well through the crisis. The sub-prime auto sector is potentially a concern because many lenders are entering the sector and competition is affecting lending standards.

One panelist observes that the prices of used cars have been very strong for the past few years. This may partly explain the strong performance of the auto ABS sector. The government's "cash for clunkers" policy a few years likely helped to strengthen used car values. Another panelist observes that changes in auto rental fleet management and the declining prevalence of consumer leasing may cause a reduced flow of used cars over the next few years.

One panelist explains that Ginnie Mae, Fannie Mae, and Freddie Mac are crowding out activity in the private-label RMBS sector and preventing a revival of the sector. He argues that the guarantee fees that the GSEs charge are too low and that the private sector cannot effectively compete with them. Although there is general agreement that the government should be less involved in the housing sector but there is little agreement about how to accomplish that result.

Chinese Hard Landing: One panelist asserts China has reached the stage of development where it cannot realistically continue to grow at a rate of 10%. A growth rate of 7% or 8% is more realistic for the future. However, China is one of the few countries that still have the capacity to execute both effective fiscal policy and effective monetary policy. Therefore, the fear of a Chinese hard landing is probably overblown. A second panelist generally agrees.

Regulatory Burdens: One panelist argues that the stress testing that the Fed is requiring of banks is very severe. Levels of bank capital have substantially recovered. It is ironic that the Fed is simultaneously implementing quantitative easing and encouraging banks to lend, while at the same time discouraging lending with a regime of highly onerous stress testing. The panelist argues that the Fed should try to identify banks that have hidden risks in their portfolios while also encouraging banks to increase their lending activities. This means that the Fed's stress tests should penalize banks for bubble-type activities but should not discourage banks from taking risk in subsectors that have not attracted so much interest that bubbles start to occur.

Housing Outlook: The panelists offer their predictions for the U.S. housing market over the next year: (i) up 4%, (ii) up 5% unless the fiscal cliff occurs, (iii) price appreciation will remain at its current pace for several years, and (iv) current values may be above sustainable levels, but there is nonetheless likely to be low-single-digit growth for several years.

10:15am – Legislative and Regulatory Developments and How They Will Shape the Landscape of the U.S. ABS Market

Risk-Based Capital:[8] One panelist explains that in the spring of 2007 none of the banks used stress testing that showed they could experience negative earnings. Risk management policies were clearly deficient in light of what happened. Capital is a buffer against mistakes and missteps. Key changes in risk-based capital guidelines relate to (i) the treatment of the trading book, (ii) recalibration of capital levels (including no longer using ratings in the U.S.), and

[8] ***U.S Regulatory Capital Rules:*** One 7 June 2012, the U.S. banking regulators announced a set of three proposals for significant changes to the regulatory capital rules for banks. Collectively, the three proposals take up more than 260 pages when they were later published in the Federal Register on 30 August 2012. The first proposal (the "Basel III NPR") would tighten bank capital requirements by narrowing the definition of capital and by introducing a supplementary leverage ratio test for large banks. The second proposal (the "Standardized Approach NPR") introduces a new methodology for calculating a bank's risk-weighted assets. The methodology eliminates the use of rating agency credit ratings from the calculations. The second proposal also introduces the simplified supervisory formula approach ("SSFA") to calculate risk-weighted assets for securitization exposures. The third proposal (the "Advanced Approaches and Market Risk NPR") would remove the ratings-based approach and the internal assessment approach for securitization exposures from the advanced approaches rule. This means that the advanced approaches rule would include only the supervisory formula approach ("SFA") and its newly created cousin, the SSFA. Removing credit ratings from the regulatory capital rules was required by § 939A of the Dodd-Frank Act. However, it creates a rift between the U.S. rules and the international standards, which retain the use of credit ratings. The comment period for all three of the proposals closed on 22 October 2012. See Department of the Treasury, Federal Reserve System, Federal Deposit Insurance Corporation, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action*, 77 Fed. Reg. 52792 (30 Aug 2012) http://www.gpo.gov/fdsys/pkg/FR-2012-08-30/pdf/2012-16757.pdf; Department of the Treasury, Federal Reserve System, Federal Deposit Insurance Corporation, *Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements; Proposed Rule*, 77 Fed. Reg. 52888 (30 Aug 2012) http://www.gpo.gov/fdsys/pkg/FR-2012-08-30/pdf/2012-17010.pdf; Department of the Treasury, Federal Reserve System, Federal Deposit Insurance Corporation, *Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule*, 77 Fed. Reg. 52978 (30 Aug 2012) http://www.gpo.gov/fdsys/pkg/FR-2012-08-30/pdf/2012-16761.pdf.

(iii) changes to accounting rules that limit capital relief from certain activities, such as credit card trusts.

Another panelist agrees that the key changes include the elimination of reliance on external credit ratings and the recalibration of capital levels. Under the new system, a bank must perform due diligence in order to receive advantageous capital treatment for securitizations.[9] A bank must be able to demonstrate that it has a comprehensive understanding of the risks associated with any securitization that it holds. It must show that it understands the structure of a securitization, including the cash flow waterfall and the triggers. It must also show that it understands the measures and underlying drivers of asset performance. The penalty for not having performed the necessary level of due diligence (*i.e.*, not having the required level of understanding) is a punitive risk weighting of 1,250% Market participants hope that the rule will be finalized in a form that is less punitive to minor or unintentional deficiencies in due diligence.

Another panelist states that the market hopes that the rules will not disrupt the availability of repo financing for securitizations.

One panelist notes that the 1,250% risk weight amounts to *more* than dollar-for-dollar capital if an institution maintains a capital ratio higher than 8%. He argues that the proposals should be amended to never require more than dollar-for-dollar capital.[10] According to some analysts, the simplified supervisory formula approach ("SSFA") is favorable to residential MBS because it allows banks to hold well-enhanced securities without worrying about whether they will be downgraded by rating agencies.

Risk Retention:[11] One panelist asserts that the risk retention proposal is flawed because the full exemption for certain assets creates a cliff effect in the system. He argues that there should be graduated tiers of risk retention and that asset pools containing a mix of qualified and non-qualifying assets should receive a weighted-average treatment. The proposed definition of QRM is too restrictive and should not require a DTI of 28%. The proposed definition of QRM should be revised to match the definition of QM. The QM definition should require full documentation and underwriting at a loan's fully indexed rate. The definition should not set LTV and DTI thresholds and should not limit points and fees paid at origination (which do not affect ongoing ability to pay).

Another panelist observes that the risk retention rule should be fixed to allow a bank's unfunded commitment to support an ABCP program to qualify as risk retention. In addition, the

[9] Standardized Approach NPR, 77 Fed. Reg. at 52961; Advanced Approaches and Market Risk NPR, 77 Fed. Reg. at 53206.

[10] The panelist's point may already be covered in the regulatory proposals. The proposals state that "[e]xcept for exposures that are deducted from common equity tier 1 capital," the 1,250% risk weight applies if a bank fails the due diligence requirement on an asset.

[11] See notes 5 and 6 above.

rule is too restrictive with respect to the common identity of the seller and the issuer. The 90-day maturity limit on CP issued is also more restrictive than under Basel III.

A third panelist observes that the SEC's mandate in defining QRM was to be at least as restrictive as the definition of QM. The mandate also directs a focus on loan underwriting.

Another panelist notes that securitizations performed better in sectors where risk retention was customary. The proposed risk retention rule is too lax rather than too stringent. Vertical risk retention should not be allowed. The premium capture element of the proposed rule is an anti-evasion measure. It is necessary because of the first point (*i.e.*, that securitizations performed better in the sectors that had risk retention than in the sectors that did not). A different panelist counters that the premium capture proposal is unrealistic because it fails to recognize that the costs of origination can be above par.

Another panelist asserts that Congress may intervene in the QRM-QM debate, particularly on the issue of creating a true safe harbor rather than a rebuttable presumption. Some members of Congress were surprised by the 80% LTV feature of the proposed rule and the possible impact on the cost of capital. If Governor Romney wins the presidential election, his administration would likely intervene in the risk retention issue.

Regulation AB:[12] The original proposal to update Regulation AB (the "Reg AB2" proposal) was partly superseded by the Dodd-Frank Act. The SEC then re-proposed the regulation in modified form. A controversial element of the proposal is the application of the rule to private placements of securitizations. Another controversial element is the requirement for an issuer to supply a computer program to allow investors to understand the cash flow waterfall of a securitization. The SEC eliminated the computer program element in the re-proposal, but it intends to eventually re-propose it separately.

Another panelist has a generally positive view of the Reg AB2 proposal. The information contemplated by the proposals has been generally available, but not in standardized form and not necessarily to all market participants. However, the proposed treatment of resecuritizations is too onerous. The application of the rule to resecuritizations will essentially prevent resecuritizations entirely. The application of the proposed rule to private placements and to transactions executed under Rule 144A also would be a problem. In some asset classes there are no public deals and it is not practical to simply "follow the public-deal template" for private/144A deals in those asset classes.

GSE Reform: One panelist explains that GSE reform is likely to be one of the main issues in the next session of the House of Representatives. GSE reform is likely to be one of the top agenda items if Republicans retain control of the House. In order to wind down the GSEs, there

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[12] Securities and Exchange Commission, *Asset-Backed Securities*, Release Nos. 33-9117, 34-61858, 75 Fed. Reg. 23328 (3 May 2010) (proposed rule) http://www.gpo.gov/fdsys/pkg/FR-2010-05-03/pdf/2010-8282.pdf; Securities and Exchange Commission, *Re-Proposal of Shelf Eligibility Conditions for Asset-Backed Securities*, 76 Fed. Reg. 47948 (5 Aug 2011) http://www.gpo.gov/fdsys/pkg/FR-2011-08-05/pdf/2011-19300.pdf.

might have to be standardization of private-label securitization documents and practices through legislation. Another panelist asserts that private-label RMBS cannot come back as long as investors and issuers are suing each other. A different panelist counters that investors have strong demand for private-label RMBS. The factors that are suppressing revival of the private-label RMBS sector are (i) the below-market level of GSE guarantee fees and (ii) the excessively high conforming loan limit.[13] The effect is a crowding-out of private-label activity by the GSEs.

Volker Rule:[14] One panelist explains that the main challenge of the Volker rule is complexity. There is not sufficient clarity about the distinction between permissible market making activities and prohibited proprietary trading. Another issue is what constitutes a "covered fund" or a "commodity pool," because securitization trusts might be caught in those definitions.

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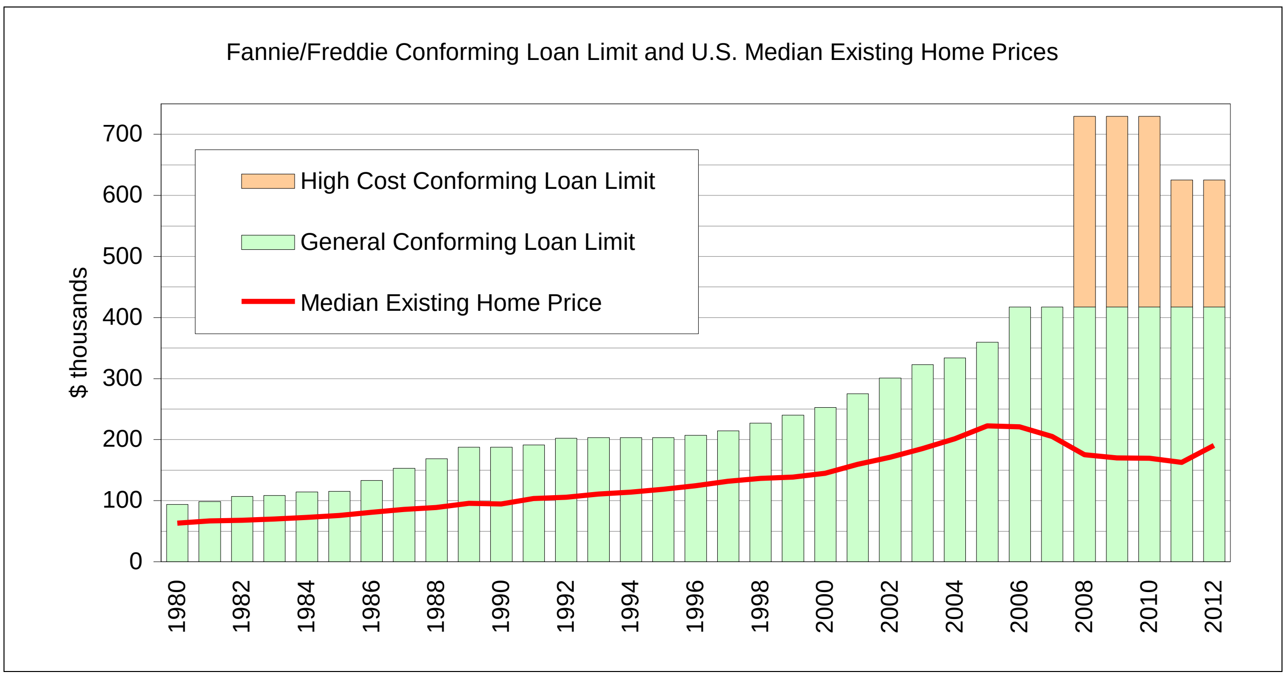
[13] The following chart shows the evolution of the Fannie Mae/Freddie Mac conforming loan limit compared to the U.S. median home price:



Sources: Bloomberg (EHSLMP <index>), Fannie Mae http://www.fanniemae.com/resources/file/aboutus/pdf/historicalloanlimits.pdf

[14] 12 U.S.C. § 1851 (2010) http://www.gpo.gov/fdsys/pkg/USCODE-2010-title12/pdf/USCODE-2010-title12-chap17-sec1851.pdf; Dodd-Frank Act § 619; Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Securities and Exchange Commission, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, 76 Fed. Reg. 68846 (7 Nov 2011) (notice of proposed rulemaking) http://www.gpo.gov/fdsys/pkg/FR-2011-11-07/pdf/2011-27184.pdf; Commodity Futures Trading Commission, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Covered Funds*, 77 Fed. Reg. 8332 (14 Feb 2012) (notice of proposed rulemaking) http://www.gpo.gov/fdsys/pkg/FR-2012-02-14/pdf/2012-935.pdf.

Panelists' Top Issues: Each panelist gives his view of the top regulatory issue on today's securitization landscape:

A. Overly broad regulations may produce unintended consequences.

B. Securitization professionals do not participate sufficiently in the policy debates.

C. Resolving the GSEs at an appropriate pace.

D. Whether the economy achieves a soft landing while delivering credit and liquidly.

E. Whether excessive regulation will send the housing finance market off the rails. Mortgage loan underwriting quality should be improved and risk loan features should be eliminated. The key is asset quality. The regulatory approach should not favor the GSEs but rather should provide a level playing field for private sector participation in the mortgage sector.

F. Regulation should provide investor protection. Producing good regulations is very challenging.

11:15am – Keynote Address, Congressman David Schweikert

The Dodd-Frank Act is producing uncertainty because many implementing regulations have not yet been finalized. Also, the result of this year's elections will have a major impact in defining the agenda for financial services policy over the next year.

Market participants now have to contend with political risk – legislative and regulatory uncertainty – in addition to interest rate risk, credit risk, and liquidity risk.

Today's top issues include (i) what to do with ongoing Dodd-Frank uncertainty, (ii) what to do with the GSEs, and (iii) what to do with the FHA. A likely theme in future legislation will be increasing standardization of residential mortgage processes and products. The private-label market needs to become more efficient and standardized to compete with the GSEs. This will likely be implemented through the QRM and QM definitions. Standardization is essential. So is the availability of loan-level data. Data providers are likely to be big winners over the next decade.

One idea is to have a well-defined universe of prime-quality residential mortgage loans that really lies outside the Dodd-Frank sphere. Getting that established is a pre-requisite to unwinding the GSEs.

The GSEs are not holding excessive inventories of REO properties because there is generally strong demand for properties at lower price levels. Investors can find opportunities in buying such homes.

Both Democrats and Republicans are trying to understand the issues pertaining to student loans. Some members of Congress want to make student loans dischargeable in bankruptcy. Maybe there should be different pricing for student loans to students who major in different subjects (*e.g.*, offering lower rates for to students who major in subjects that lead to high-paying jobs).

Some policymakers hold the view that data is the ultimate regulator. That is, the market ought to be able to regulate itself effectively if there is complete information.

The national debt is $16 trillion. Social security is underfunded by $15 trillion. The federal prescription drug benefit is underfunded by $20 trillion. Medicare is underfunded by $90 trillion. The aggregate of those commitments by the federal government is greater than the wealth of the entire world, which is roughly $138 trillion. The government has promised too much. Look at the Medicare actuary report; the head actuary concludes that the numbers are implausible. The Medicare hospital benefit has only about 50 months of capacity left. The aging of the baby boomer generation is a crushing demographic reality.

The reality of Congress is that the main axes of disagreement are not Democrats vs. Republicans or liberals vs. conservatives, but rather "those who do math" vs. "those who do not." An example is that areas of the country that imposed foreclosure moratoria are the ones that have experienced the worst housing declines. The "good politics" of imposing a foreclosure moratorium was "bad economics." It damaged the local real estate markets. Regions where distressed assets are quickly liquidated experience recovery more quickly.

In three and a half years 75% of all federal spending will be consumed by the combination of interest on the debt, Medicare, Medicaid, Social Security, and veterans' benefits.[15]

The current interest rate environment is not sustainable. There will be a major price to pay in the future for the misallocation of capital that is now happening because of low interest rates.

Lots of major policy changes become effective between now and January 2013. The next few months will be an extremely interesting time. Depending on the outcome of the elections there could be lots of Congressional activity or very little.

12:15pm – Overview of the State of U.S. Housing

State of U.S. Housing: One panelist asserts that home prices have bottomed. However, home price growth will likely be slow from here. Also, there is a seasonal factor and home prices are likely to slip lower over the winter. Seasonal fluctuations are becoming a larger factor because the share of distressed sales is declining. Non-distressed home sale volumes have a strong seasonal tempo, while seasonality is less of a factor in distressed sale volumes. Home prices will likely rise about 3% over the next year, followed by slower, lethargic increases beyond that.

Another panelist observes that home price growth is tied to vacancy rates. Higher vacancy rates are generally associated with lower home price growth. Home prices have likely hit bottom, but there is a material chance that they could decline further. There has been a change in

[15] ***Federal Spending:*** Summary charts showing the components of federal spending are available online from a number of sources including the National Debt Awareness Center at http://www.federalbudget.com/ and the website maintained by conservative writer Christopher Chantrill at http://www.usfederalbudget.us/.

price tiers. When interest rates start to rise, it will be difficult for homeowners to trade-up because they will not be able to replicate the interest rates on their current loans. This would encourage strengthening of the lower price tiers and softening of higher price tiers.

A third panelist expects home prices to decline by roughly 3% and that the bottom of home prices will come in 2014. A fourth panelist counters that home prices have already bottomed. A fifth panelist agrees that home prices have bottomed and that further growth in home prices will be slow. However, the overall trend should be less important to investors than the status of the individual homes backing the deals that they hold. A sixth panelist adds that there is pent-up demand from potential new homeowners who have been living with their parents since the onset of the financial crisis.

One panelist argues that investors should focus on home prices at the zip code-level rather than at the MSA level or at the state level. Within a given MSA, home price appreciation can vary materially from one zip code to another. In addition, home price appreciation can vary from one price tier to another within a zip code. Also, the average discounts for different kinds of distressed sales (*e.g.*, REO liquidations and short sales) can vary. Better analysis takes account of those differences and considers the changing components of distressed sales over time.

The liquidation timeline in different states is important. The states that use the slower, judicial foreclosure process, account for an increasing share of the foreclosure/REO inventory because the states that use the faster, non-judicial process are working down their inventories more quickly.

Shadow Inventory: One panelist asserts that the shadow inventory stands at roughly 2.3 million homes and is about as large as the volume of new and existing home sales.[16] The shadow inventory alone represents many months of sales volume. The states with the greatest amount of shadow inventory are New York, New Jersey, Florida and several others that use judicial foreclosure. The average time for judicial foreclosure is around 25 months, compared to just 12 months for non-judicial foreclosure. Liquidations through short sales have increased markedly and investors have purchased many homes through short sales.

Another panelist uses a different definition of shadow inventory, including homes that are in foreclosure or for which the related mortgage loan is more than 12 months delinquent. By that definition, shadow inventory is roughly 2.7 million homes. The panelist argues that the pace of loan liquidations is likely to decline over the next few years. This implies that the distressed share of home sales will decline and should not create too much downward pressure on home prices going forward.

Another panelist generally agrees but highlights that there may be pressures in non-judicial states, where the inventory is moving more slowly. About 17% of current loans remain

[16] CoreLogic, *CoreLogic Reports Shadow Inventory Continues to Decline in July 2012* (9 Oct 2012) http://www.corelogic.com/downloadable-docs/q2-2012-shadow-inventory-report.pdf.

underwater. However, there are variations among states. In Nevada the proportion is 49% and in Florida it is 32%.[17] [Note: Compare to discussion of underwater loans on page 8.]

One panelist highlights that distressed homeowners fail to perform normal maintenance on their homes and this may exacerbate problems in a way that is not captured in the numbers. Another panelist observes that the liquidation pipeline may be "saving the worst for last" and that defaults on interest-only loans may rise over time.

There are 2.7 million to 2.8 million homeowners who have not made a payment in a year. The national homeownership rate has declined from 69% to 65.5%.[18] If you subtract the 2.8 million homeowners who have not paid their mortgage loans in a year, then the rate is roughly 63%. This means that there likely will be increased demand for rental housing and increases in rents. This, in turn, means that turning REO inventory into rental housing is important. However, it works for low priced homes (generally below $200K) but not for high priced homes.

Housing turnover is slower than it would otherwise be for two reasons. First, many homeowners have negative equity, which means they cannot easily sell their current homes. Second, many young potential homeowners are living longer with their parents and delaying the move to becoming homeowners themselves.

2:20pm – The Pipeline for Esoteric ABS

It may not be practical to define the term "esoteric ABS," but, paraphrasing Supreme Court Justice Potter Stewart's famous remark, "you know it when you see it."[19] The volume of esoteric ABS issuance has been rising and accounts for a growing share of total ABS issuance. This year's volume of esoteric ABS issuance is $13 billion so far.

What's Motivating or Deterring Issuers of Esoteric ABS: One panelist explains that issuers gravitate toward issuance of esoteric ABS because they can achieve better financing terms. Sometimes they can achieve lower funding costs and sometimes higher leverage. However, issuing ABS requires an issuer to create servicing systems and reporting systems and may require the creation of special purpose legal entities. The cost of those steps and the time to implement them sometimes deters potential issuers. Another panelist adds that a company's maturity level matters. An established company may already have the systems and infrastructure

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[17] Compare CoreLogic, *Corelogic® Reports Number of Residential Properties in Negative Equity Decreases Again in Second Quarter of 2012*, press release (12 Sep 2012) (reporting that 22.3% of all residential properties with a mortgage were in negative equity at the end of 2012Q2 and that the proportion of negative equity mortgage loans in Nevada and Florida were 58.6% and 42.7%, respectively) http://www.corelogic.com/about-us/news/asset_upload_file516_16435.pdf.

[18] Recent Census Bureau statistics on homeownership rates are available at http://www.census.gov/housing/hvs/files/qtr212/q212press.pdf.

[19] *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964) (concurring opinion) http://www.law.cornell.edu/supct/html/historics/USSC_CR_0378_0184_ZC1.html or http://laws.findlaw.com/us/378/184.html.

to support securitization activities, while a start-up company likely would not. A third panelist adds that the ability to diversify funding sources and the potential base of investors is an additional factor that motivates firms to use securitization.

Improving the Speed of Executing Deals: As an esoteric asset class matures, deal execution becomes routine and streamlined. This allows for faster execution. The new requirements of the Dodd-Frank Act do not create significant delays.

Another panelist adds that an issuer should do significant groundwork and try to reach a go/no-go decision before it invests too much effort in a potential transaction. Key steps for laying the groundwork include assessing system expansion requirements and premarketing with potential investors.

One panelist explains that the initial securitization of tobacco-related legal fees took two years. Subsequent deals have taken only a fraction of that time. Other examples include deals back by cell tower leases and whole-business securitizations. A different panelist adds that an issuer should look for investors that have both prior experience with esoteric ABS and the ability to tolerate delays in closing the transaction. Stated differently, an issuer should look for investors that already "have the plumbing" for dealing with esoteric ABS. In addition, an issuer should look for investors who may be able to bring in other investors on future deals.

Another panelist explains that although rating agencies cannot engage in structuring they can pursue "methodological discussions" with underwriters and potential issuers. SEC Rule 17g-5 means that much of an issuer's or underwriter's dialog with a rating agency must be in writing. SEC Rule 17g-7 requires rating agencies to report on the representations and warranties in asset-backed securities. Many esoteric deals do not fall under Rule 17g-7 because the assets are not self-liquidating financial assets. A provision of the Dodd-Frank Act (§ 933) requires a rating agency to get third-party verification of key facts; the issue is which facts are key. A different panelist observes that although most market participants view Rule 17g-5 as a bother, it is helpful to have a complete record of the dialog with a rating agency.

One panelist asserts that esoteric ABS are attractive to long-term investors because they can earn a liquidity premium for investing in illiquid securities and can get paid for doing hands-on credit analysis. Some long-term investors, including certain large life insurance companies, have investment departments that can properly analyze esoteric deals. Additionally, such an investor can participate actively in structuring esoteric deals to meet its needs. Deals backed by esoteric assets offer higher yields than the plain vanilla, on-the-run ABS offerings. There is an added benefit to being one of the initial investors in an esoteric sector because the securities tend to appreciate as the market becomes familiar with the asset class. The panelist favors esoteric ABS that achieve credit ratings of single-A or better (to qualify as category NAIC-1 for insurance company capital purposes).

The panelist remarks that esoteric asset types have generally performed well through the financial crisis and that there have not been disappointing rating changes. Although the rating agencies have a good track record in esoteric ABS, the panelist's firm does its own analysis, in addition to using credit rating from the rating agencies.

Creating Credit Rating Methodologies for Esoteric Asset Classes: Moody's does not publish a methodology for an esoteric asset class until it has rated a number of deals in the asset class. The rating agency tries to ask all the relevant questions and to discern what the key credit drivers are. It attempts to identify what the drivers of risk might be under unlikely scenarios. The task is one of finding all the needles in a haystack. After the rating agency has identified the key drivers, it constructs a quantitative model, often featuring Monte Carlo simulations.[20]

Moody's published an article on operational risk in June 2011.[21] The article addressed the issue of how a deal might be exposed to operational risk in the event that the deal's sponsor collapses. A remedial strategy can be to use a backup servicer.

Esoteric Asset Types in Recent Deal: One panelist identifies three recent deals. One was the whole business securitization of Domino's Pizza.[22] It is performing well and trading around 110, corresponding to a yield of roughly 3%. A second deal was the SBA Communications cell tower lease deal.[23] Both of those deals were executed quickly, requiring only about a month from the initial rating meeting to closing. A third recent esoteric deal is the billboard deal by Fairway Media that closed last week.[24]

Another panelist refers to a securitization of Canadian life insurance policies.[25] Another deal, which closed in September, was backed by aircraft engines.[26] A third panelist describes a deal sponsored by a life sciences company.[27]

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[20] For an example, see the Moody's press released cited in note 27 below.

[21] Becker, K., Rosa, D., and Weill, N., *Global Structured Finance Operational Risk Guidelines: Moody's Approach to Analyzing Performance Disruption Risk*, rating implementation guidance (28 Jun 2011).

[22] Domino's Pizza, Inc., Domino's Pizza Announces Recapitalization Through a Proposed Refinancing of Existing Securitized Debt, press release (28 Feb 2012) http://phx.corporate-ir.net/phoenix.zhtml?c=135383&p=irol-newsArticle&ID=1666478.

[23] SBA Communications Corporation, *SBA Announces Pricing of $610 Million of Secured Tower Revenue Securities*, press release (27 Jul 2012) http://ir.sbasite.com/releasedetail.cfm?ReleaseID=696096; Eiger, G. and McDermitt, M., *Rating Action: Moody's Assigns Definitive Ratings to Wireless Tower Backed Securities Sponsored by SBA Communications*, press release (9 Aug 2012) http://www.moodys.com/research/Moodys-assigns-definitive-ratings-to-wireless-tower-backed-securities-sponsored--PR_252721.

[24] Ott, A., Vrchota, R., *Fitch to Rate Fairway Outdoor Funding, LLC Secured Billboard Rev Notes, Ser 2012-1; Presale Issued*, press release (17 Oct 2012) http://www.businesswire.com/news/home/20121017006305/en/Fitch-Rate-Fairway-Outdoor-Funding-LLC-Secured.

[25] Credit Agricole Securities, *Credit Agricole Securities Announces Placement of C$120 Million of Note for Aurigen Reinsurance -- First Canadian Life Insurance Securitization*, press release (27 Dec 2011) http://www.businesswire.com/news/home/20111227005371/en/Credit-Agricole-Securities-Announces-Placement-C120-Million.

[26] Sohl, B., Manofsky, P., and Bella, J., *Fitch Rates Willis Engine Securitization Trust II*, press release (17 Sep 2012) http://www.businesswire.com/news/home/20120917006169/en/Fitch-Rates-Willis-Engine-Securitization-Trust-II.

[27] Oxford Finance, LLC, *Oxford Finance Completes $271.4 Million Securitization Transaction*, press release (4 May 2012) http://www.oxfordfinance.com/news/2012/5_4_12.html; Labuskes, M. and McDermitt, M., *Rating Action:*

Prediction for Emerging Esoteric Asset Classes: One panelist states that he expects lots of activity in esoteric assets because market conditions are good. However, he cannot predict which specific esoteric asset classes will be most active. Another panelist identifies solar energy production as a likely new asset class. A third panelist suggests that there could be securitization of energy efficiency retrofits.

3:10pm – Navigating New Waters for SLABS in 2013

The Current State of the Student Loan Market: One panelist observes that private student defaults are roughly 4%, which is below the peak level of 7% during the crisis, but still far above the pre-crisis average of roughly 2%.[28] Newer vintages of private student loans have stronger attributes than older vintages, and older vintages are experiencing burn-out (*i.e.*, the weakest loans in those vintages have already defaulted). However, high unemployment and weak prospects for the labor markets dampen optimism that delinquencies can soon recover to pre-crisis norms. The 2001-2004 vintages have moderate default rates. The 2005-2007 vintages are quite weak. The 2008-2011 vintages fall in the middle. Voluntary prepayment rates on private student loans have been low since 2008, largely because households do not have funds with which to prepay. Prepayments on Stafford and Direct Lending loans also have been slow since 2008, except for a brief spike in early 2012 attributable to consolidation loans. SLABS issuance so far this year has been slightly below $20 billion, including roughly $4 billion of private student loan ABS.

Another panelist explains that the recent consolidation opportunity came from a brief window of statutory authority and budgetary availability. It is not likely to be repeated soon.

A third panelist observes that the level of private student loan ABS issuance was only $2.1 billion in 2011 but will be at least double that level in 2012. A large portion of the FFELP loans securitized this year came from the "Straight-A Funding" asset-backed commercial paper conduit. Another panelist explains that potential SLABS issuers can achieve better funding through bank lines than through securitization. However, market conditions are improving and may start to favor funding through securitization in the near term. An early revival of SLABS issuance could trigger a virtuous cycle of improving market conditions that could fuel further issuance.

Moody's assigns definitive rating to Oxford Finance Funding Trust 2012-1 ABS Notes, press release (30 Apr 2012) http://www.moodys.com/research/Moodys-assigns-definitive-rating-to-Oxford-Finance-Funding-Trust-2012--PR_244358.

[28] For official performance metrics on federal student loans (*i.e.*, not private loan) see Department of Education, *First Official Three-Year Student Loan Default Rates Published*, press release (28 Sep 2012) http://www.ed.gov/news/press-releases/first-official-three-year-student-loan-default-rates-published. For information about the size, condition, and performance of the U.S. student loan sector see College Board, *Trends in Student Aid 2012* (16 Oct 2012) http://trends.collegeboard.org/sites/default/files/student-aid-2012-full-report.pdf; see also Department of Education, *FY 2013 Department of Education Justifications of Appropriation Estimates to the Congress - Student Loans Overview - Fiscal Year 2013 Budget Request* (17 Feb 2012) http://www2.ed.gov/about/overview/budget/budget13/justifications/r-loansoverview.pdf;.

Another panelist observes that there is another $30 billion of loans from the Straight-A Funding asset-backed commercial paper conduit that should be available for securitization before the end of 2014.

Trading, Value, and Investor Perspective: SLABS can appeal to all types of investors. Total rate of return investors focus on the most liquid issues. Other investors favor securities with long average lives. Still others focus on the strong credit quality of SLABS backed by FFELP loans. The liquidity premium is quite large for issuers that do not receive strong sponsorship from the dealer community. Sallie Mae has the strongest sponsorship. Investors are having difficulty analyzing SLABS credit because they receive only pool-level information, rather than loan-level information. Thus, a key element of growing the market for ABS backed by private student loans would be providing loan-level information. The panelist likes all kinds of student loan-backed securities, including rate reset notes, which command a very large liquidity premium. Those securities can be very attractive to an investor who can accept illiquidity. The embedded call feature of such securities offers a chance for quick gains if the paper is called. The panelist argues that an issuer should demand that its underwriters make markets in its outstanding securities as a condition for hiring them to underwrite new deals.

Another panelist remarks that the relative value trade for SLABS has been established and that the SLABS market is back on its feet. The SLABS asset class has been somewhat slower to revive than the auto loan and credit card sectors, but it is back. SLABS offer investors better opportunity than ABS backed by auto loans and credit card receivables. They also offer longer average lives, which is critical to some investors. Another panelist adds that non-Sallie Mae issues are more attractive than Sallie Mae issues because the non-Sallie Mae issues offer a much larger liquidity premium.

One panelist observers that ABS is no longer just about the assets backing a deal. Investors now appreciate the importance of the issuer and underwriter and make pricing distinctions based on the identities of a deal's issuer and underwriter.

Regulatory Environment and Developments: One panelist observes that non-profit and state agencies generate loan production volume of roughly $1 billion. Higher education finance cannot be divorced from education policy. Tuition is up 73% over the past decade, while loan issuance is up by only 11%. The outcome of student's education is supposed to be a job that allows him or her to repay education-related loans. The issue is whether there will be jobs for graduates, not whether student loans should be dischargeable in bankruptcy. The issue is ability to repay, not willingness. At a recent congressional debate on student loans, the central issue was the amount that students borrow for attending proprietary trade schools, not whether private student loans are necessary or good. A white hot topic on the Hill is refinancing private student loans. Another idea under consideration is to tie repayment to post-graduation income (similar to how student lending works in New Zealand).

FFELP 2.0: One panelist asserts that there should be a role for private capital in higher education finance. [Note: The panelist essentially argues that the federal government should stop doing direct loans so that private lenders can resume making federally-guaranteed loans.]

CFBP Report:[29] One panelist observes that FFELP loans are an entitlement. A large percentage of borrowers would not qualify for consumer loans. Private sector involvement in the student loan space, by contrast, focuses only on the creditworthy segment. The noise in Congress about the dischargeability of private student loans is not meaningful because the great majority of loans are federally guaranteed. Just the same, the proportion of co-signed private student loans has grown. The debt crisis in student loans is not just about private student loans but includes all student loans, including the federally subsidized loans. Another panelist contends that higher education policy should consider the issue of affordability and be willing to tell a student that he or she must attend a cheaper school than the one he or she wants.

The squeeze on higher education is motivating state schools to accept higher proportions of out-of-state students, who are charged much higher tuition.

Another panelist argues that the credit quality of current student loan production is higher than it has ever been.

4:30pm – Investor Reporting Concerns

Servicer Advances: One panelist explains that most servicers do not have the technical ability to develop the models necessary to support their stop-advancing policies.[30] They need to turn to third parties. The typical stop-advance formula should consider recoveries under different loan resolution paths. Servicers need to get a good disposition model that can figure out recoveries under different loan resolution scenarios.

Another panelist, who works at a master servicer, observes that different servicers use different reporting formats and sometimes a single servicer may use multiple formats. Servicers sometimes have to correct errors by resending reports. The most frequent category of reporting discrepancy relates to stop advances by servicers. The next most frequent category of discrepancy relates to security balances. Reporting errors are frequent. Servicers should report whether a loan modification produces a loss or a deferment. Some servicers report deferments as losses. There are many errors in reporting modifications.

A third panelist is from a firm that maintains a data library covering 18,000 deals. Each deal in the library must be updated monthly. The non-agency MBS sector includes many deals that do not provide loan-level data. Those deals provide pool-level reporting. Loan-level data about modifications is often incomplete and inconsistent across servicers. The same is true of data

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[29] Chopra, R., *Annual Report of the CFPB Student Loan Ombudsman* (16 Oct 2012) http://files.consumerfinance.gov/f/201210_cfpb_Student-Loan-Ombudsman-Annual-Report.pdf.

[30] ***Stop Advance:*** The term "stop advance" refers to a situation where the servicer of a securitized mortgage loan stops advancing delinquent principal and interest on the loan. In a typical residential mortgage loan securitization, the servicer is required to advance principal and interest on a delinquent loan unless it has determined that amounts to be advanced would not be recoverable upon the liquidation of the loan. Once the servicer makes such a determination, it stops advancing on the loan.

about servicer stop advances. Often the data is internally inconsistent with respect to remaining term, monthly payment, and current coupon.

Freddie Mac started providing loan-level issuance data in 2005 and started providing monthly updates in 2006. However, the monthly loan-level data updates do not include delinquency data. Freddie Mac provides delinquency data only at the pool level.

Fannie Mae started providing loan-level issuance data this year, but no updates. Fannie does not provide any delinquency data, even at the pool level. Ginnie Mae does not provide loan-level delinquency data but does provide data at the pool level. CDO investor reports generally provide good data at the asset level. However, there is a lack of standardized naming conventions, which makes comparisons difficult across deals. Reported bank loan data is sometimes incomplete (*e.g.*, relating to LIBOR floors). For consumer ABS, reporting is generally at the pool level; loan level data is generally not reported.

Investor Perspective: Another panelist observes that variations in reporting practices and deficiencies in reporting are a problem for every investor who wants to perform analysis. There has been much discussion of loan-level analysis in RMBS. Pool level numbers can generally be reconciled with bond distributions. This suggests that pool-level data may be more reliable than reported loan-level numbers. The panelist contends that an "uncontrolled" analysis, based solely on loan-level data, is unwise because of the garbage-in-garbage-out problem. The better approach is to include pool-level data as an important part of the analysis because it may be more reliable. The panelist recommends against using Monte Carlo simulations for analyzing residential mortgage loans. Loan level analysis has too many parameters and not enough history to validate interdependencies. Also, a highly detailed analysis that emphasizes loan-level characteristics may divert attention from macro-economic factors, such as unemployment and interest rates, which can exert an overwhelming influence on performance.

Changes to Improve Reporting: One panelist observes that older RMBS deals cannot handle the cash flow stresses that have occurred. The solution for future deals would be to improve the cash-flow waterfall provisions of documents. The next generation of RMBS documents should address the situation where principal or interest is negative. Negative principal or interest makes the waterfall provisions in some existing documents completely fall apart. For example, calculations that call for allocation in proportion to principal just won't work when principal is negative. Documents sometimes contemplate subsequent recoveries but not trailing losses. Do seniors receive a loss allocation after subordination is depleted? Losses in excess of 100% can produce negative principle. Documents on existing deals also fail to address loan modifications. They fail to cover the various types of modifications and the treatment of interest and principal. Future RMBS documents will need to cover the extreme cash flow variations experienced in the past few years. The market would benefit from simpler deal structures. The industry should embrace standardized documents and terminology. Documents must cover both the most pessimistic and optimistic scenarios.

Another panelist remarks that Fannie Mae and Freddie Mac standardized loan originations. However, they did not standardize loan servicing. That is what the market needs right now.

Tuesday, 23 October 2012

9:00am – The Top 5 Biggest Threats to the ABS Market Going Forward: The Investors' List

One panelist explains that there are three categories of threats: economic threats, credit and liquidity threats, and regulatory threats. Moody's base case projection is that GDP growth for the G20 countries will be 3.4%. However, the risks are skewed to the downside. Moody's triple-A rating of the U.S. is on negative outlook. The fiscal cliff scenario would likely produce no rating change. However, a scenario of simply extending the current situation without any solution (*i.e.*, "kicking the can down the road") would likely produce a one notch downgrade.

There are some positive signs in the economy. Consumer confidence has improved and home prices have started to rise.

Auto loan ABS issuance has been strong. Credit card issuance has been greater than last year, but still much lower than before the Dodd-Frank Act. The flow of deals backed by equipment leases has been reasonable strong. The flow of student loan ABS has been week.[31]

On the regulatory front, the OECD has projected that the higher capital requirements under Basel III may suppress the growth rate of global GDP by roughly 0.15 percentage points.[32]

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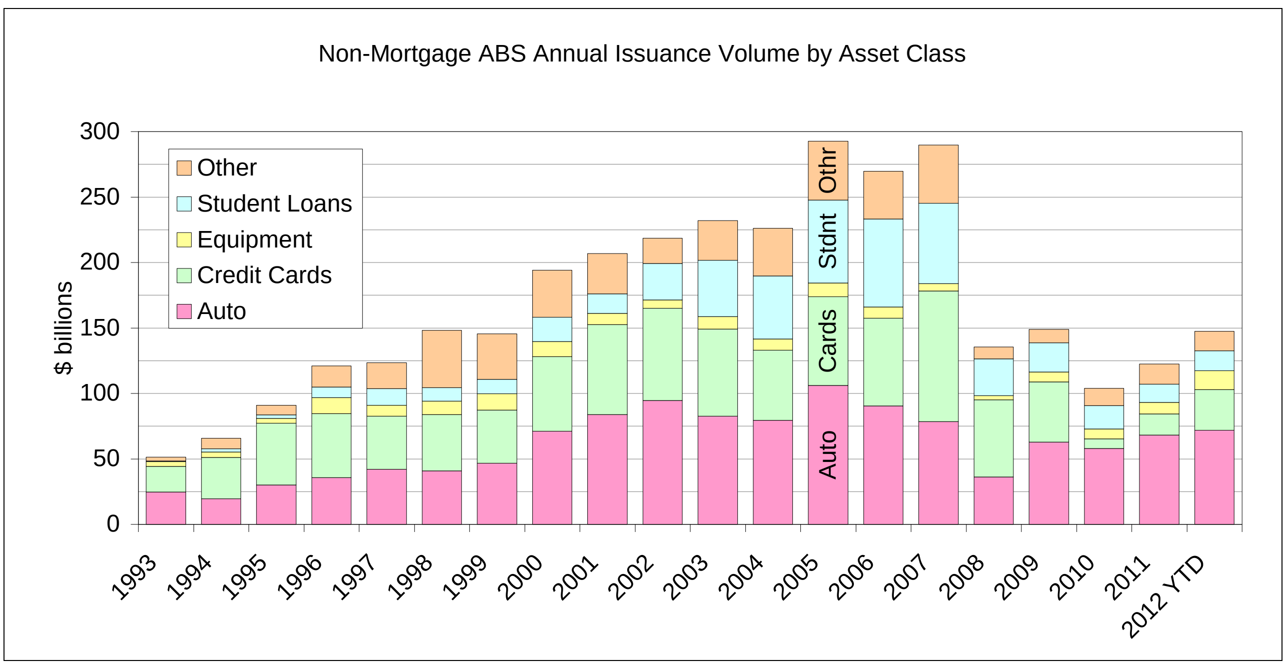
[31] The chart below shows the issuance volumes for non-mortgage-related ABS over time:



Source: SIFMA (http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/SF-US-ABS-SIFMA.xls)

[Note: The OECD paper actually estimates the effect to be in the range of 0.05 to 0.15 percentage points.]

A second panelist identifies three themes in the current economy: (i) the European sovereign debt crisis, (ii) unemployment and the fiscal imbalance in the U.S., and (iii) declining growth rates in emerging markets. Against that backdrop, yields are at very low levels, which seemingly do not reflect the size of the macro risks. There seems to be greater risk of severe or extreme downside scenarios that would be implied by current absolute yield levels.

A third panelist explains that investors understand the macro risks and are nonetheless comfortable investing if they perceive that their investments can withstand severe or extreme downside credit scenarios. For example, the performance of credit card ABS has been very strong and stable and this suggests that holding credit card ABS would be safe, even under highly stressful conditions. However, there is still the risk of overall spread widening if a macro-level risk event occurs.

A fourth panelist observes that the Fed's monetary policy is holding yields at low levels and will likely continue to do so for the foreseeable future. As long as the underlying, asset-level fundamentals remain strong, the low absolute levels of yields and spreads are acceptable. The fifth panelist counters that the low absolute level of yields is a problem. The second panelist acknowledges the risk of overall spread widening but argues that ABS are better than other investment alternatives.

The first panelist observes that there has been spread tightening on credit card ABS and the sector has recently attracted an influx of non-U.S. investors. Issuance in the sector has remained low because banks can achieve cheaper funding through deposits.

The third panelist counters that some sectors, such as subprime auto loans, may be attracting excessive investor demand, which can lead to mispricing of risk. The first panelist observes that investors' risk appetite has recently increased but he questions whether that is an appropriate response to market conditions or whether it represents a slippage back to the mistakes of the past.

One panelist remarks that there is an improvement in asset quality and in the pricing of RMBS. Some RMBS prices have risen above par. An insurance company has only slight appetite for buying RMBS priced significantly above par because of capital requirements. The tightening of spreads dampens insurance companies' interest in buying RMBS. Another panelist observes that the SSFA capital calculation[33] means that U.S. banks will have greater appetite for many low-rated securities. On the other hand, European banks, which must still operate under the ratings-based, Basel III framework, have little appetite for speculative-grade securities.

[32] Slovik, P. and Cournède B., *Macroeconomic Impact of Basel III*, OECD Economics Department working paper no. 844 (14 Feb 2011) http://dx.doi.org/10.1787/5kghwnhkkjs8-en.

[33] See note 8 above.

A third panelist states that a smart investor can still find securities that offer yields in the range of 6% to 8%, compared to yields of roughly 2% to 3% on most securities.

One panelist remarks that U.S. insurance companies may get a proposal for a new capital framework over the next several years. The scenarios being used by PIMCO are too rosy.[34] PIMCO's base case projection of 20% home price appreciation over the next three years seems unlikely. [Note: The published base case does not appear to include 20% appreciation over the next three years.] Additionally, the downside scenarios that PIMCO uses are not given sufficient weight and are too mild.

Regulatory Uncertainty: One panelist observes that deals are really tested in extreme scenarios. The new "orderly liquidation authority" of the FDIC (to handle the insolvency of systemically important non-bank financial institutions) is an example of an extreme scenario that market participants should start to consider.[35] It remains to be seen whether the FDIC will offer some kind of safe harbor for securitizations. Another panelist asserts that the FDIC does not actually have the authority to overturn property rights created under state laws.

One panelist observes that the RMBS sector has two distinct dimensions of regulatory uncertainty. One relates to changing state laws about servicing. The second relates to new originations and both risk retention requirements and potential liabilities stemming from the QRM and QM definitions.[36] The uncertainty is a great problem for mortgage lenders and servicers. It produces overpricing of loans to homeowners. Another panelist says that there is simply too much regulation and that policymakers are attempting to decide issues that should be determined by market forces.

The No. 1 Threat for 2013: Each panelist gives a view on the top threat for 2013:

A. The unintended consequences of regulations and monetary policy are the main threat. Too many investors are hunting for yield and may be mispricing risks.

B. Rating agencies may allow credit enhancement levels to decline too far. Regulatory risk may be slightly exaggerated because the market always finds a way to deal with regulatory changes.

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[34] National Association of Insurance Commissioners, *Proposed Macroeconomic Assumptions and Scenarios to be used for the Year End 2012 RMBS and CMBS Financial Modeling Project*, memorandum to industry and interested persons (26 Sep 2012) http://www.naic.org/documents/committees_e_vos_121004_proposed_rmbscmbs_assumptions.pdf.

[35] 12 U.S.C. §§ 5381-94 (2010) http://www.gpo.gov/fdsys/pkg/USCODE-2010-title12/pdf/USCODE-2010-title12-chap53-subchapII.pdf; Dodd-Frank Act §§ 201-17; Federal Deposit Insurance Corporation, *Certain Orderly Liquidation Authority Provisions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 76 Fed. Reg. 41626 (15 Jul 2011) (amending 12 C.F.R. Part 380) http://www.gpo.gov/fdsys/pkg/FR-2011-07-15/pdf/2011-17397.pdf.

[36] See notes 5 and 6 above.

C. Regulatory uncertainty, especially about insurance company capital requirements, is the top risk. The cost of dealing with auditors is becoming so great that it is cutting into the yields on securitization investments.

D. Macro-economic risks are the main threat. Asset fundamentals are strong right now and the risk of deterioration of underwriting standards and the risk of declining credit enhancement levels are at least several years off.

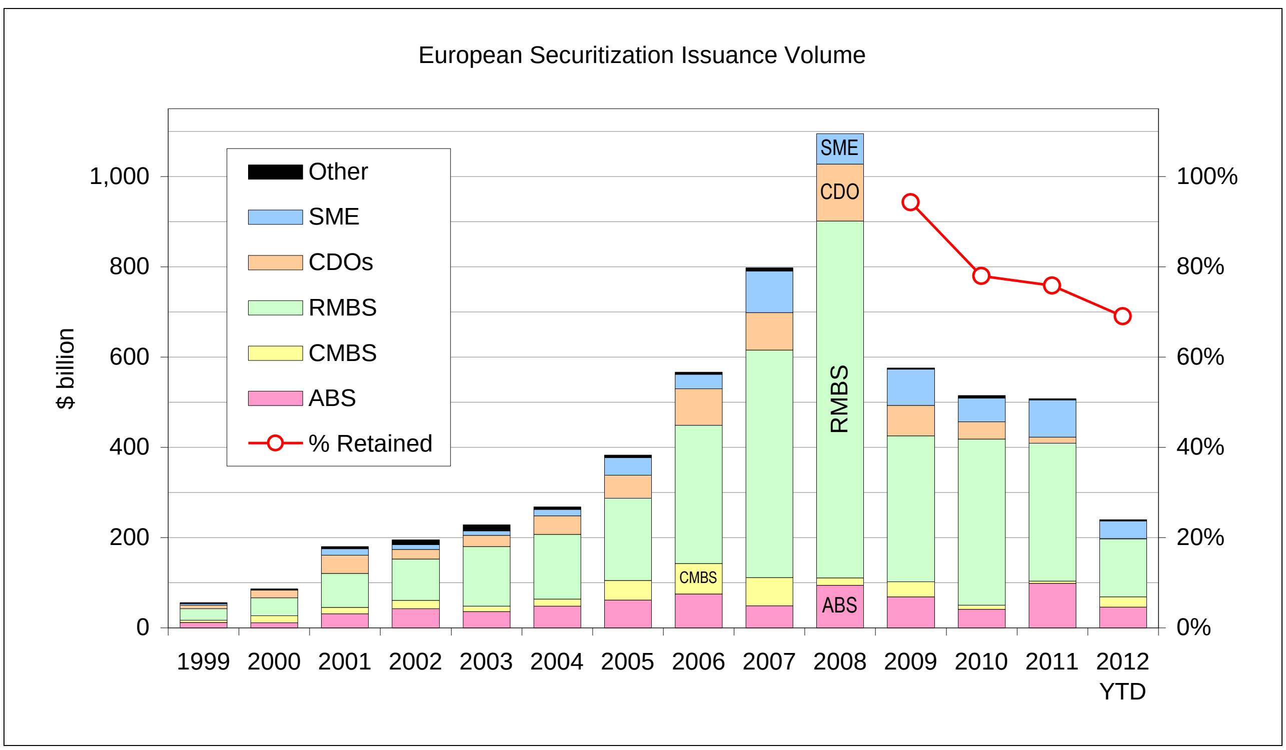
E. The question should be "who will be blamed in the next blow-up," not "what is the top threat."

10:00am – The European ABS Market's Response to the Current Challenges Faced by the EU

One panelist remarks that the euro common currency project is "not going according to plan." The desired economic convergence is not happening.

A second panelist observes that the European securitization market is slower than before the crisis, but this year is on track to at least equal last year.[37] Deals denominated in euros are easier to execute than deals denominated in other currencies. Another panelist remarks that the euro

[37] The following chart shows the level and composition of European securitization issuance over time and the proportion of issuance retained by issuers (rather than sold to investors):



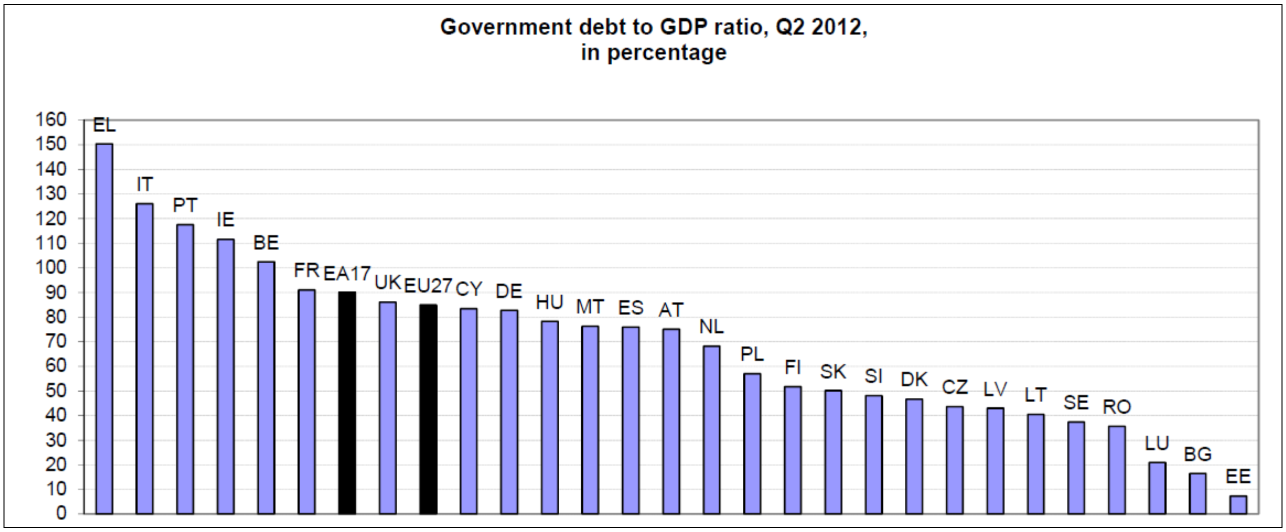
Source: SIFMA (http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/SF-Europe-Securitisation-AFME-SIFMA.xls) crisis is not as big a problem in the U.K. The European governments have been very supportive of their banks and now recognize that securitization is not evil.

Another panelist identifies three issues that U.S. investors face when investing in European securitizations. One risk is the currency risk and the related issues tied to the viability of the euro. A second risk is the macro-level risk associated with the European sovereign debt crisis. A third group of risks relates to the particular policy responses that governments are executing to deal with their problems. A different panelist agrees that the investors must now consider much more than simply asset performance risk.

Another panelist remarks that concerns over the European problems may be overblown because all the debates are open and in public view. If the debates occurred behind closed doors there would be less grist for the media mill and less agitation in the financial markets. A feature of the inter-government political dialog is that the governments cannot enforce contractual obligations against each other. This means that they move in small steps, waiting for each other to move forward before taking another step, but they do get results eventually. The risk of the Eurozone breaking-up is very small. However, if it does, holders of claims against northern countries will likely do better than holders of claims in the south.

One panelist observes that the U.S. ratio of government debt to GDP is worse than the ratios of many European countries.[38] A likely outcome in the U.S. is severe inflation at some point in

[38] The U.S. federal debt-to-GDP ratio has recently been reported as 102.4% as of 30 Sep 2012. See Durden, T., *September 30, 2012 US Debt-To-GDP: 102.4%*, blog (26 Oct 2012) http://www.zerohedge.com/news/2012-10-26/september-30-2012-us-debt-gdp-1024. The ratio would be even worse if it included state and local government debt. By comparison, only the most distressed European countries have debt-to-GDP ratios worse than 100%. Significantly, however, the ratios for France (FR), the U.K. (UK), and Germany (DE) all exceed 80% and are on a rising trend.



Source: Eurostat, *Second Quarter of 2012 Compared with First Quarter of 2012 Euro Area Government Debt Up to 90.0% of GDP EU27 Debt Up to 84.9%*, press release (24 Oct 2012) http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-24102012-AP/EN/2-24102012-AP-EN.PDF.

the future. Europeans, especially in some countries, are much more scared of inflation than Americans.

Another panelist observes that Europe is experiencing the curse of the "three D's:" (i) **D**eleveraging of the public sector, (ii) **D**eleveraging of the banks, and (iii) **D**eleveraging of the household sector.

One panelist contends that there will be few, if any, defaults of ABS deals backed by assets in northern Europe. By contrast, there will likely be a notable number of defaults of deals backed by assets from the periphery, such as Ireland and Portugal.

Another panelist argues that the potential exit of Greece from the euro would not be a significant issue for euro's viability. The larger issue is the potential for Spain to exit.

A different panelist explains that there is a lot of uncertainty about how a Greek exit from the euro would play out in securitizations backed by Greek assets. One factor would be the governing law specified in such deals. Another factor would be the practicalities of enforcement. Investors would prefer to retain their claims in euros, rather than having to endure a redenomination of their claims in a new Greek currency.

One speaker argues that the impact of Greek exit from the euro would be very small. It would be no more significant than "Alabama leaving the U.S." [Note: !?!][39] The real issue for Greece is making the austerity measures stick. Greece establishes a precedent for dealing with the potential for tough austerity measures in Italy and Spain. The panelist favors RMBS backed by U.K. and Dutch mortgage loans. He also favors deals backed by countries that formerly had triple-A credit ratings but which have lost them.

Another panelist observes that, in contrast to banks in the U.S., banks in Europe have not yet been under pressure to dispose of distressed assets. In Europe, the banks have the ability to explore creative disposition strategies if and when they dispose of distressed assets. They may explore arrangements where they sell an asset but retain some of the upside if it recovers.

Outlook: One panelist states that policy responses in Europe are buying time but not really solving the underlying issues. Extra time allows fine tuning of capital regulations for banks and insurance companies so that the final standards are not too disruptive. Another panelist asserts that the Eurozone crisis is farther along than most people think. He states that the securitization market will have a slow road to recovery. Although the regulators have tempered the harsh regulatory proposals for securitizations, they have implemented most of their policy measures in support of the European banking system. A third panelist counters that nothing really has improved in Europe with respect to sovereign debt issues. Bank balance sheets still contain many of the bad assets that are simply financed through repurchase contracts with the ECB.

[39] Perhaps Europeans do not study American history as much as Americans study European history. For an account of the causes and early stages of the American Civil War and the political significance of preserving the union see Goodheart, A., 1861 – THE CIVIL WAR AWAKENING, Vintage Books/Random House (2012).

11:00am – Keynote Address, Lew Ranieri

Home prices have bottomed in more than half the states. The securitization industry's goal should be to re-establish a mortgage market where there is a meaningful role for private financing. Government sponsored programs should not account for nearly all mortgage loan production. Going "retro" is what we need to do in order to re-establish a private-label MBS market.

There are three key "retro" principles. The first is the sanctity of contract. The second is the need to originate loans. Loans need to be fully underwritten and fully documented. Loans that were fully underwritten and properly documented generally performed well through the crisis.

Sanctity of Contract: The use of eminent domain power to seize loans is improper and bad policy. The attempted use of eminent domain power to seize mortgage loans would completely undermine the ability of the capital markets to fund loans. Undermining the sanctity of contracts will curtail the availability of mortgage financing to consumers. Investors will not be willing "to stick their heads down the barrel of a cannon to see whether the fuse is lit." In a similar vein, states hurt themselves when they allow or promote delaying tactics by borrowers that prevent lenders from foreclosing or otherwise enforcing their rights. If lenders cannot enforce their rights in a timely fashion, they will impose excessively stringent lending standards, which will cause credit to become scarce. California's homeowner bill of rights is essentially converting California into a judicial foreclosure state.[40] The move is in exactly the wrong direction. States that use non-judicial foreclosure are getting past their problems and are now in much better shape than those using the slower, judicial foreclosure process.

[40] California's homeowner bill of rights is embodied in primarily in two pieces of legislation, one from the California Assembly (AB 278) and the other from the California Senate (SB 900). They are available online at http://www.leginfo.ca.gov/pub/11-12/bill/asm/ab_0251-0300/ab_278_bill_20120711_chaptered.html and http://www.leginfo.ca.gov/pub/11-12/bill/sen/sb_0851-0900/sb_900_bill_20120711_chaptered.html. An announcement from the California Office of the Attorney General briefly describes the homeowner bill of rights as follows:

> The Homeowner Bill of Rights prohibits a series of inherently unfair bank practices that have needlessly forced thousands of Californians into foreclosure. The law restricts dual-track foreclosures, where a lender forecloses on a borrower despite being in discussions over a loan modification to save the home. It also guarantees struggling homeowners a single point of contact at their lender with knowledge of their loan and direct access to decision makers, and imposes civil penalties on fraudulently signed mortgage documents. In addition, homeowners may require loan servicers to document their right to foreclose.
>
> The laws will go into effect on January 1, 2013, and borrowers can access courts to enforce their rights under this legislation.

State of California, Dept. of Justice, Office of the Attorney General, *California Homeowner Bill of Rights Signed into Law*, press release (11 Jul 2012) http://oag.ca.gov/news/press-releases/california-homeowner-bill-rights-signed-law. Additional details are available at http://www.oag.ca.gov/hbor.

The FHA and the FHFA may restrict purchases or financing of loans from jurisdictions that employ eminent domain to seize mortgage loans.[41]

When an American company considers doing business in another country, the most important thing for it to consider is whether property rights are respected and contracts can be enforced in the other country. America itself must remain a country where property rights are respected and contracts can be enforced.

Good Loans: Reviving the private-label MBS market must start with originating good loans. It was not an accident that the U.S. mortgage finance system is based on the 30-year, fixed rate mortgage loan. It provides for affordability and stability. At the inception of the market, underwriting and documentation were thorough. Originators made representations and warranties that they actually believed to be true. The idea of an issuer issuing a security that it expected to blow-up was unfathomable. Such conduct is not a formula for the market to survive, much less thrive. The market needs to be clear about how loans are "manufactured."

The mortgage industry should strive for "six-sigma" quality standards in manufacturing loans. That means that virtually all defaults should come from borrowers' life events rather than defects and deficiencies in the loan origination process. To restore confidence, investors need to be able to see into the entire loan manufacturing process.

One company is returning to traditional underwriting standards. In underwriting a loan it is essential to ask both whether there is a reason to make the loan and whether there is a reason not to make the loan.

The mortgage industry has lost its credibility. Now it needs to be pristine in order to restore confidence and regain its credibility.

Making good loans needs to be a permanent strategy. Making risky loans on the basis of pricing for risk always ends up causing problems. Allowing borrowers to take equity out of their homes always ends up causing problems. Unfortunately, second lien loans and home equity loans are on the rise again.

Both investors and borrowers are best served by high standards that promote a smoothly functioning private-label RMBS market. You cannot simply price the private-label market into existence. The market must have good loans.

The current loan limits for conforming loans and for FHA loans are crowding out the private sectors.[42]

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[41] Federal Housing Finance Agency, *Use of Eminent Domain to Restructure Performing Loans*, 77 Fed. Reg. 47652 (9 Aug 2012) http://www.gpo.gov/fdsys/pkg/FR-2012-08-09/pdf/2012-19549.pdf; Prior, J., *FHA 'Concerned' With Eminent Domain Proposal*, Housingwire (21 Aug 2012) http://www.housingwire.com/news/fha-concerned-eminent-domain-proposal.

[42] See note 13 above.

How broadly will the CFPB define QM?[43] If they get it wrong, neither warehouse lenders nor investors will buy them. The QRM definition can be no wider than the QM definition. If QM and QRM are defined properly, it should not be necessary to have the premium capture reserve account feature in the risk retention framework. The CFPB has stated that it will publish a QM definition by the end of November. Next year will be pivotal for the mortgage industry, as key rules are proposed or finalized.

There are two ways that the government can control a market. One is through guarantees, as in the case of the GSEs. The other is through excessive regulation.

Covered bonds are not an effective solution for funding 30-year mortgage loans. The U.S. cannot switch to a covered bond system to support mortgage finance.

12:00pm – Liquidity Challenges in Secondary ABS Markets: Traders' Roundtable

One panelist observes that the securitization industry is going through changes. The investor base for securitizations is likely to be a smaller in the future.

A second panelist remarks that things are much better today than they were a year ago. The European crisis has moderated. Financial institutions have stabilized. And there is a surfeit of liquidity searching for yield. Strong security prices are a challenge for traders. There are new issuers entering the market.

Another panelist observes that there is excessive demand in some sectors and for some risk tiers. For example, subordinate tranches of subprime auto ABS deals are oversubscribed by considerable multiples. The credit curve is very flat. Also, every investor willing to sell a bond is automatically asking what he can buy to replace it in his portfolio to preserve yield.

A different panelist remarks that there are many more buyers than sellers. Buyers are hungry for yield. Off-the-run asset classes often do not have loan-level data availability. Investors often receive higher yields in exchange for lower transparency. Another panelist agrees that off-the-run assets offer opportunities. Examples of attractive asset classes included aircraft leases and middle-market CLOs (*i.e.*, not CLOs backed by broadly syndicated loans).

One panelist asserts that data and transparency are key drivers of liquidity in mainstream asset classes, such as private-label RMBS. BlackBox Logic is a data provider for RMBS data. It supplies both data and analytics and is less expensive than the larger data vendors.

Another panelist asserts that smaller broker-dealers can provide better, more individualized service to investors. Smaller broker-dealers cover fewer accounts than the large firms and can give more attention to each account. A different panelist, also from a small broker-dealer, states

[43] See notes 5 and 6 above.

that his firm has developed a strong track record and substantial expertise in niche asset classes. That expertise allows the firm to find opportunities that investors might not see just dealing with larger firms. In the current environment, where credit spreads are very tight, security selection is very important for capturing opportunities and avoiding landmines.

One panelist argues that investors can gain opportunities by working with broker-dealers that originate assets and that have many issuer/borrower relationships because those channels produce securities that would not be available from other broker-dealers.

Another panelist remarks that, when investing in a new asset class, an investor should run extreme stress scenarios to "break" the bonds in a computer model. Then the investor should compare the model results with what the prospectus says. The investor should ask the issuer and the dealer to explain how things work. The student loan sector is changing. Changes in loan programs create uncertainty about what loans will be produced in the years ahead and which companies will produce them. Many of the companies that specialized in originating FFELP loans may not survive. Student loans are very difficult to analyze because performance depends on many factors, including the school that a student attends, and there may be deferments and forbearances over the life of a loan. Modeling student loans is very complicated.

A different panelist observes that post-crisis securitizations generally use simpler structures than pre-crisis transactions.

One panelist adds that understanding the assets behind a deal is essential. He expects that today's traders who trade whole loans will become tomorrow's MBS traders. The knowledge of the loans and loan quality will make them highly effective in trading the securities.

3:05pm – RMBS Traders' and Researchers' Roundtable

One panelist favors seasoned subprime RMBS from pre-crisis vintages, provided that they are passing their triggers (*i.e.*, performance covenants). Because the deals pass their triggers, the mezzanine tranches can receive pro rata cash flow distributions. Small changes in prepayments can produce significant changes in the average life of a bond. Shortening the average life can be very beneficial for a bond acquired at a discount. A key credit factor for mezzanine tranches from pre-crisis vintages is keeping losses below the level of excess spread.

The panelist argues that ethics are a big issue for deal performance. He argues that it is unethical for borrowers to avail themselves of the non-recourse features of their loans. Another panelist counters by posing the question of whether the states that have non-recourse mortgage lending should convert to a full recourse framework. A third panelist observes that many borrowers simply look at "what everybody else is doing" to resolve any ethical qualms that they have about strategically defaulting on their loans. The panelist asserts that there likely has been burn-out of strategic default by borrowers who are able to pay their loans. That is, many of the borrowers who would pursue strategic defaults have already done so.

Another panelist stays on the issue of ethics in relation to tactics that defaulted borrowers use to delay or thwart lenders from enforcing remedies. Some borrowers get to live in their homes for years after defaulting on their mortgage loans. The panelist implies that delaying a creditor's exercise of remedies is unethical. A different panelist observes that other types of consumer debt, including credit card debt and student loans, are full recourse obligations.

Upside: One panelist asserts that there is upside in the mezzanine tranches of pre-crisis subprime deals (different panelist but same idea as in ¶ 0). Another panelist remarks that there is potential upside in deals that can gain from claims related to breaches of representations and warranties. A third panelist ventures that investors will start to observe material performance differences among deals based on the identities of the servicers. Another panelist notes that as of January 2013, banks will no longer use ratings for determining capital charges but rather the SSFA. That panelist focuses primarily on senior tranches, many of which have experienced defaults of very minor severity, but which carry credit ratings of Ca/D because of being of their defaults. Such securities represent an opportunity. In particular, deals with low loan counts may be had at attractively cheap prices.

One panelist, who trades distressed RMBS, dislikes fixed-on-fixed deals because there is no excess spread. He likes securities that are not covered in the LoanPerformance database. If the securities are cheap enough, the lack of granular data for analysis is not a problem. He focuses on securities with low levels of hard credit enhancement (*e.g.*, subordination) that have high levels of excess spread. He holds many bonds with prices in the range of 7 to 20. They are illiquid and out of favor. They receive much less interest than bonds trading in the range of 50 to 70.

Loss Severity: One panelist asks: How can an investor tell what the loss severity on a defaulted mortgage loan really is when servicers are "monkeying around" with the numbers? What does it mean when a deal reports 300% loss severity three months in a row? The reporting from servicers does not offer sufficient detail to allow investors to understand what is happening.

Another panelist states that investors should look at severities in different ways (*e.g.*, severity on liquidation vs. all-in severity). Another panelist observes that many investors are already using optimistic severity assumptions in their analyses; the assumptions reflect stabilized severities that have little realistic room for further improvement. A different panelist observes that liquidation proceeds drop by 8% for each year that a loan lingers in the resolution pipeline.

One panelist observes that investor purchases of foreclosed homes are concentrated in lower-priced homes. Lower priced homes produce much better returns as rental homes. There is the potential for deals with low-balance loans to perform better if the underlying homes are protected from further value declines by demand from investor buyers

Predictions: Panelists give their home price predictions for the coming year and their views about the likelihood of a significant crisis:

A. Home prices will rise by 5% and there is less than a 10% chance of a really scary crisis but a 50% chance of a moderate crisis.

B. Home prices will rise by 2%. The likelihood of a fiscal cliff crisis is low.

C. Home prices will rise by 7% in 2012.

D. Home prices will be up by 5%. Central banks will prevent a liquidity crisis. Congress will avoid the fiscal cliff. However, markets may need to convince politicians to come to the table. A year from now senior RMBS will be quoted in terms of spreads rather than dollar prices.

E. Home price appreciation will be in the range of 5% to 6%. Senior bonds will continue to tighten, while mezzanine and subordinate bonds will continue to fluctuate widely in response to small changes in prepayments. There is a reasonable likelihood of gut-wrenching crisis coming from Europe. Volatility is likely to continue for years.

– END –