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# Report From ASF 2010

**Chief Credit Officer**
Mark Adelson
New York
(212)-438-1075
mark_adelson@
standardandpoors.com

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(**Editor's Note**: This article is not intended to reflect the views of Standard & Poor's Ratings Services. Rather, it summarizes a number of speeches and panel discussions at the ASF 2010 Conference held near Washington, D.C., Jan. 31, 2010, to Feb. 3, 2010, and thus reflects the panelists' views.)

The overall mood of the American Securitization Forum 2010 (ASF) was positive. The sessions also conveyed a generally bright outlook for the securitization industry. However, there were a few negative tones. Panelists at several sessions expressed concerns that new policy initiatives to improve oversight of the securitization industry could have unintended consequences.

In particular, proposals to institute mandatory risk retention by loan originators and securitizers were the subjects of repeated criticism. Of course, risk retention through excess spread or residual interests has been a common feature of many securitizations all along. However, the proposals for mandatory risk retention, combined with changes to accounting standards and bank capital guidelines, would potentially require securitizers to hold more capital against the risks that they retain. In other words, the proposals would potentially force lower leverage for banks. There is a real conflict between competing policy objectives on this score: One objective is to strengthen the financial sector by helping banks shed risk by selling assets. The competing objective is to deter lax underwriting and shoddy origination practices through mandatory risk retention by aligning the interests of originators and securitizers with those of investors.

Mortgage loan modifications also received attention in many sessions. Somewhat ironically, during the conference the *New York Times* featured an article on the growing number of homeowners who walk away from their loans because the loan balances significantly exceed the values of the homes.[1]

A few ASF sessions featured content that seemed to be targeted primarily at policymakers and regulators who attended the event in large numbers. A key theme was that securitization helps Main Street by recycling capital to boost the volume of credit available to meet the needs of American families. The notion that American families might have used too much credit never came up.

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

## Sessions Covered

Securitization Global Perspective (Sunday workshop) .......... 2
Securitization Pricing And Valuation Tools (Sunday workshop) .......... 4
Welcome And Chair's Address .......... 5
Featured Address: Greg Medcraft, Commissioner, Australian
Securities & Investment Commission .......... 6
2010 Securitization Market Outlook .......... 7
Securitization Policy Reforms .......... 9
Unwinding Government Support .......... 11
Featured Address: Michael Barr, Assistant Treasury Secretary .......... 13
Mortgage Underwriting Trends .......... 14
Auto ABS Sector Review .......... 15
Featured Address: John C. Dugan, Comptroller of the Currency .......... 17
Overview Of The Consumer Economy .......... 18
Mortgage Modifications And Loss Mitigation Trends .......... 20
The Future Of The GSEs .......... 22
Relative Value Opportunities In ABS .......... 23
U.S. Mortgage Finance Policy Reforms .......... 25
RMBS Traders/Researchers Roundtable .......... 27
Commercial Mortgage Securitization .......... 30
Trustees Roundtable .......... 32

## Sunday, Jan. 31, 2010

### *Securitization Global Perspective (3:10 p.m.)*

The focus of the session was on non-U.S. securitizations. Every market has idiosyncrasies, but there are a number of consistent themes. Deals backed by future revenue streams (*i.e.*, "future flow deals") dominated the securitization landscape in emerging markets, but that is changing. Also, another feature

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[1] Streitfeld, D., *No Help in Sight, More Homeowners Walk Away*, New York Times, p. A1 (3 Feb 2010).

of many non-U.S. securitizations is that they involve cross-border flows. Securitization has been used in times of economic crisis, such as the 1994 Latin American crisis, the 1998 Asian crisis, and Europe in 2008. The emergence of residential mortgage-backed securities (RMBS) in a market is sometimes a sign that it has "matured."

Global securitization activity, including the U.S., peaked at $2 trillion in 2006 and declined to $1.7 trillion in 2007.

A future flow securitization is a deal in which a company securitizes off-shore receivables that do not yet exist. Sometimes it is said to characterize a "right company" in a "wrong location." The originator is domiciled in a weak country, but generates high quality receivables from a strong country.

Latin America: In the early 1990s, Latin America had a volatile financial market. It is less volatile now. Many of the countries in the region have followed similar development paths. In some countries, the main economic drivers are exports and commodities. In contrast, in Mexico and other countries near the U.S., the markets developed in ways more closely tied to the U.S.

Latin America is accustomed to economic crises. They occur frequently in the region. Every few years an economic crisis occurs in at least one country in the region.

The first deals in Latin America were cross-border, future flow transactions involving export receivables. Later deals involved financial receivables. The deals were designed to mitigate sovereign risk of the countries. Domestic securitization markets developed later. So far, they exist in Mexico and Brazil. International investors remain focused primarily on future flow deals. The Latin American domestic markets have been largely sheltered from the problems in the U.S. Recently, as much as 96% of Latin American securitization activity has been in domestic deals. Cross-border deals in 2009 came from Brazil (47%) and Peru (53%). Deals backed by remittances (*i.e.*, money transfers by foreign workers to their home countries) were the only type of cross-border deals in 2009.

Mexico: Government support for the residential mortgage asset class has been a key factor in maintaining investor confidence in Mexico. RMBS is the largest segment of the Mexican securitization market. Issuance volume started to recover in fourth-quarter 2009. Large commercial banks, government-related entities, and automakers are currently the main issuers. Issuance volume may recover further in 2010 if economic conditions continue to improve.

Brazil: The Brazilian securitization market has been poised for growth, but has not yet fully taken off. The main asset types so far have been trade receivables and commercial mortgage loans. RMBS is gaining momentum in Brazil, but is still limited by regulatory disincentives for banks and by other factors. Recent changes in the Brazilian bankruptcy law may help promote RMBS deals.

Argentina: Argentina's 2002 default was one of the most famous sovereign defaults of the past 50 years. The country had an active RMBS market before 2001 to 2002. It has steadily grown since 2005 to 2006. Most local-currency securitizations successfully weathered the sovereign default in 2002. The asset classes that now dominate the Argentine securitization market are consumer loans, personal loans, credit cards, and trade receivables. The market features a strong flow in terms of the number of deals, but the par amount per deal is quite low. The government recently nationalized the pension funds and has become a significant buyer of domestic ABS.

Asia: The most important event in Asia in 1997 was the handover of Hong Kong to China. That was also the year of the Asian financial crisis, which started with the devaluation of the Thai baht. There had been securitizations in Asia since the mid-1990s in Hong Kong, Korea, Thailand, and Indonesia. In the late 1990s, the period of the "Asian contagion," many countries tried to access the securitization

market through the "future flow" structure that the bankers were adapting from Latin America. Since 2000, many of the countries with stronger credit quality have started doing securitizations of existing assets (*i.e.*, not future flows). The countries with weaker credit quality have continued to focus primarily on future flow deals.

Asian future flow deals are somewhat different from Latin American future flow deals. They started in 1996 when Philippine Airlines securitized its future ticket sales. The deal survived the company's bankruptcy. Cosco, a Chinese shipping company, securitized the future flow of its shipping receivables in 1999. A year later, Korea's Asiana Airlines did a similar deal. The ability to do all of those deals was based on the notion that a "true sale" of the receivables could survive the company's bankruptcy. In the Philippine Airlines bankruptcy, the securitization investors agreed to take less than the full cash flow specified in the securitization contracts (slowing down repayment of their bonds) in order to avoid having the true sale tested in Philippine courts.

Securitization has been slow to develop in China partly because there is an excess of bank lending capacity in the country. Also, there is continuing concern about the rule of law in China, which makes international investors skittish about accepting Chinese deals.

Hong Kong, Singapore, and Taiwan are the most "international" of the Asian markets.

Europe: The most surprising thing about Europe is that a great majority of securitization issuance is retained by the originators. That is, the originators securitize financial assets but do not actually sell the securities. Rather, they retain the securities and finance them through repurchase transactions with the European Central Bank (ECB). This has been the case since August 2007. (In a sense, the "retained" securities never enter the market and market's true size is much smaller than the "deal volume" would suggest.)

Despite the dominance of the retained market, the "placed" market is starting to accelerate. The volume of the placed market likely will be in the range of $60 billion to $80 billion in 2010. The U.K. is still the dominant issuer country and the dominant source of "market" activity. RMBS accounts for three-fourths of the market in 2009.

Although European securitization has grown dramatically (including retained deals), covered bond activity has been comparatively flat for the past 10 years.

"Whole business securitizations" are a particular type of European securitization. The mainstay has been pub deals in the U.K. The technology was applied in the U.S. to Dunkin' Donuts and Domino's Pizza.

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

Overview of approaches and available tools: A "traditional" investing approach is to avoid overpaying for securities based on a macroeconomic outlook. Such a strategy relies on being able to test broad scenarios by having a deal library and a cash flow model. Intex is the main provider of a deal library and cash flow model to meet those needs. Intex requires the user to specify a macro outlook in terms of prepayment and default vectors and interest rate projections. Markit is introducing a tool to compete with Intex.

A "middle of the road" approach also needs a deal library and cash flow model. However, it also needs loan-level data and loan-by-loan models for prepayments, defaults, and losses. Users can (i) build their own loan-level models, (ii) license models from third-party vendors, or (iii) use broker-dealer models. LPS is the largest vendor of loan-level data. 1010 Data provides a powerful database system

for querying loan-level databases. With this full set of tools, an investor is arguably fully equipped to invest at all layers of a securitization's capital structure.

A "next generation" approach uses updated information from credit bureaus to discern whether loans are becoming more risky based on (i) additional liens, (ii) credit utilization rates, (iii) number of credit inquiries, or (iv) a billing address different from a property address. Some believe that such information can be a huge advantage for predicting the transition of current loans to delinquent status over the coming 12 to 18 months. In other words, the "next generation" approach can provide an extra early warning indicator that may be most valuable for pricing "cuspy" bonds (*i.e.*, bonds where the amount or timing of cash flows could change a lot because of small changes in the rates of defaults or prepayments).

Judgment and experience: Every new month of data is "outside the sample" from which today's models were developed. Also, government policies about loan modifications and foreclosures are new. This means that users of pricing and valuation tools must (i) understand the implicit assumptions in the tools and (ii) understand the strengths and weaknesses of different tools. Users need to understand the causes that can make the assumptions turn out to be false, and they need to understand the potential consequences if that happens. They need to be mindful of complexity because it may reflect a larger number of implicit assumptions. They need to be willing to change their assumptions as the environment changes in ways that challenge the validity of their assumptions.

Different players' different needs: A buy-side, mark-to-market account would likely use a "middle-of-the-road" or "next generation" approach. However, it still may need independent prices. A buy-side, impairment-sensitive account likely uses a traditional approach and may need a pricing service to help with analysis when positions become impaired. A broker-dealer likely uses a traditional approach and may use an independent pricing service for marking inventory prices. Some new "valuation services" offer essentially consulting services to conduct impairment analyses using a middle-of-the-road approach. Pricing services generally use a traditional approach to generate daily prices.

Markit is trying to develop its independent pricing service for RMBS. Markit's stated objective is to replicate prices from broker-dealers. It is not attempting to discern relative value; rather it simply wants to indicate price at which a bond would trade. Markit subdivides the RMBS universe along several dimensions: (i) vintage, (ii) product type, (iii) relative performance within the product type and vintage, and (iv) bond type (both prepayment and write-down characteristics). Markit collects prices on roughly 1,000 RMBS each day. It calculates yields from the prices, and then it groups bonds into cohorts. Bonds in the same cohort should command the same yield. Then Markit calculates prices from the yields.

Conclusion: Each investor should create an overall strategy based on its own strengths and weaknesses. For example, a firm with a large stable of quants can favor a heavily quantitative approach.

## Monday, Feb. 1, 2010

### *Welcome And Chair's Address (8 a.m.)*

Welcoming remarks: It is important that the conference is happening near Washington because the future of securitization will be profoundly influenced this year by U.S. policymakers and regulators. Looking back, securitization has helped many sectors of the American economy and has helped boost the volume of lending in many sectors, especially consumer lending. But the size of securitization does

not inherently justify its existence. In the absence of securitization, the banking system might have grown larger and provided the volume of credit that came from securitization. On the other hand, banks have historically left certain markets underserved. Those markets arguably were better served by securitization lenders. Also, banks are not necessarily the lowest cost lenders. Banks have higher expenses than efficient securitization lenders.

Securitization exists not because of Wall Street, but rather because of Main Street. Investment by Main Street pension funds in securitization vehicles helps to recycle capital to meet the credit needs of Main Street consumers. The core benefit – the durable essence – of securitization is its power to efficiently recycle capital to serve the needs of Main Street.

The credit crisis, however, tests the overall benefit of securitization by demonstrating that it can potentially exacerbate systemic shocks. On the other hand, the securitization industry, through the ASF, has been active in trying to help Main Street, for example, by encouraging the application of deal cash flows to fund credit counseling for borrowers in financial distress.

The Treasury's recent announcement gives some comfort that HAMP (Home Affordable Modification Program) loan modifications will result in sustainable loans and not merely delayed foreclosures. Loan modifications should be made to work for both sides of Main Street (borrowers and institutional investors).

The ASF board recently decided to remain independent of SIFMA. (SIFMA refers to the Securities Industry and Financial Markets Association.) No single constituency (financial intermediaries, issuers, or investors) controls ASF decisions.

Chairman's address: More than 4,200 individuals are registered for the conference. Attendees include more policymakers and regulators than ever before. This is the time to reaffirm that securitization is good for the American economy. It is important to demonstrate that point here – at this conference – where it is visible to policymakers and regulators.

A key objective of securitization has to be making more mortgage loans, auto loans, credit card accounts, and other forms of credit available to American consumers.

The ASF performs a key function in participating in the dialogues that address regulatory capital, accounting standards, and other key regulatory issues. The ASF also coordinates with international securitization industry groups and is an important American voice to international policymakers and regulators.

***Featured Address – Greg Medcraft, Commissioner,***
***Australian Securities & Investment Commission (8:20 a.m.)***

As stated in a recent IMF *Global Financial Stability Report*: "Failure to restart securitization would come at the cost of prolonging funding pressures on banks and a diminution of credit."[2] Governments around the world have recognized the importance of securitization. Three themes need to run through the global regulatory approach to securitization: coordination, convergence, and caution. They are the three "Cs." Two other important themes are clarity and certainty.

There needs to be coordination between regulatory authorities in different jurisdictions to avoid unintended consequences. Convergence of regulatory standards is a desirable result of coordination.

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[2] International Monetary Fund, *Global Financial Stability Report*, at 78 (Oct 2009) http://www.imf.org/External/Pubs/FT/GFSR/2009/02/pdf/text.pdf.

Ideally, convergence is achieved through mutual recognition or equivalence. Caution is necessary to avoid overburdening the market with too much regulation. Caution is shown through prudent transitional arrangements and extensive dialogue between regulators and the securitization industry.

Signs of recovery are starting to emerge. Stimulus programs in the U.S. have been important in supporting issuance, and now a growing share of issuance is not relying on TALF. New ABS issuance in Europe is driven by the ECB repo program. However, there have been a few "placed" (nonretained) deals in Europe, and secondary trading prices have somewhat recovered. The Australian government has provided support for the Aussie securitization market.

Key regulatory initiatives: In September, the International Organization of Securities Commissions (IOSCO) released recommendations on disclosure, investor suitability, and mandatory risk retention by originators.[3] IOSCO recommended improved disclosure on collateral delinquency and due diligence efforts. The American disclosure standards are already consistent with the recommendation. The industry was also ahead of IOSCO in trying to improve disclosure. IOSCO's disclosure principles were likely embodied in ASF's Project RESTART. IOSCO also recommended that risk retention should be coordinated with accounting and regulatory capital policies. One of the proposals was a rating-based approach. The suitability recommendations addressed the issue of selling highly complex securities to less-sophisticated institutional investors, such as not-for-profit corporations. The IOSCO recommendations were developed in consultation with the securitization industry.

The Basel Committee has issued proposals to strengthen capital rules for securitizations. These include proposals for (i) higher capital for certain resecuritizations, (ii) increased scrutiny of externally rated exposures, and (iii) stronger focus on due diligence standards.[4]

IASB/FASB convergence. If we cannot have one standard around the world, the industry should push for mutual recognition that can serve as a "passport" for doing business around the world.

***2010 Securitization Market Outlook: The Way Forward (8:45 a.m.)***

ASF survey respondents identified (i) regulatory and legal uncertainty, (ii) investor retreat, (iii) accounting changes, and (iv) public perception as the biggest challenges for the securitization industry over the coming year.

Present versus past: One panelist feels that many market participants are under-pricing risk; they have returned to the risk appetite that they had before the financial crisis. A second panelist jokes that the market is still going through the five stages of grief. Two years ago, the market was in *denial*. Last year it was *angry*. This year the market is working through *depression* and *acceptance*. A third panelist remarks that the past year has been mostly an effort toward trying to restore confidence, compared with just trying to keep pace with the hot market of three years ago. A fourth panelist feels that the market has improved compared with a year ago. This is revealed in the willingness of both investors and dealers to take risks and in dealers' willingness to make markets. Also, the ASF has made important strides toward trying to improve the market's infrastructure. Conditions are arguably better

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[3] Technical Committee of the International Organization of Securities Commissions, *Unregulated Financial Markets and Products, Final Report* (Sep 2009) http://www.iosco.org/library/pubdocs/pdf/IOSCOPD301.pdf.

[4] Basel Committee on Banking Supervision, *Enhancements to the Basel II Framework* (Jul 2009) http://www.bis.org/publ/bcbs157.pdf.

than they were three years ago because investors are more responsible about due diligence and risk taking. A fifth panelist feels that the market is on the rebound because new issue volumes are rising and spreads are rallying. Three-year auto paper has tightened from Libor plus 200 basis points (bps) to Libor plus 30 bps. The market is safer because there is less leverage, safer assets, and better due diligence. On the CMBS side, about $1.5 trillion is going to mature over the next few years, and that is still a little scary. The sector might just use extensions to delay problems as loans mature (*i.e.*, a "kick the can down the road" strategy for dealing with problems). A sixth panelist notes that before the crisis, issuers had not been willing to accept the notion that investors could entirely turn away from securitization and that their funding could dry up. Many issuers have collapsed and those that have survived have had to learn to deal with a new reality.

Expiration of stimulus: Most survey respondents feel that the expiration of the Treasury program for purchasing agency RMBS will have a larger impact than the expiration of TALF.[5] One panelist feels that the RMBS sector will be able to weather the expiration of the stimulus programs. The main issue for the private-label RMBS sector is crowding out from the high conforming loan limit for government-supported entity (GSE) eligible loans (currently $729,750). He notes that the resurgence of the private-label RMBS sector should not be driven by a revival of high loan-to-value (LTV), no-documentation loans. If that's what it would take, then it would be better to let the private-label market die. The removal of stimulus will not necessarily raise mortgage interest rates to consumers, but it may squeeze profitability for the mortgage industry.

Another panelist asserts that the expiration of the TALF stimulus will have varying affects in different nonmortgage sectors. Interestingly, the market now views spread movements of 30 bps as ordinary for some asset classes.

Mortgages: One panelist feels that the CMBS sector is slowly coming back. Another panelist agrees with the earlier remark that the real challenge for private-label RMBS is crowding-out from the high conforming loan limits for agency RMBS. He also agrees that high-risk residential loan products should not be revived and that they should not be the driver for reviving the private-label RMBS market. A third panelist observes that investors and issuers still cannot agree on a pricing. Most survey respondents expect the private-label RMBS market to recover in 2011 or later.

Credit rating agencies: The SEC has approved rules that will require issuers to make data available for rating agencies to do unsolicited ratings.[6] A panelist from a rating agency notes that unsolicited ratings done with integrity would be a good thing. However, not all rating agencies may act with integrity. There are now ten "nationally recognized statistical rating organizations" (NRSROs) registered with the SEC. Issuers may start to provide less information than before. Another panelist,

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[5] Housing and Economic Recovery Act of 2008, Pub. Law No. 110-289, 122 Stat. 2654, §1117 (2008) (amending 12 U.S.C. §§ 1455, 1719 to give the Treasury temporary authority to purchase agency MBS to provide stability to the financial markets and to prevent disruptions to the availability of mortgage finance). The program terminated on Dec. 31, 2009, and the Treasury estimates that it purchased approximately $220 billion of agency MBS. The Fed has a separate program to for purchasing agency MBS and had purchased $1.17 trillion as of Feb. 3, 2010, representing around 94% of the program's entire capacity of $1.25 trillion. The Fed's purchase program will likely exhaust its capacity in March.

[6] SEC Release 34-61050, 74 Fed. Reg. 63832 (4 Dec 2009) (adding new paragraph (a)(3) to Rule 17g-5, 12 C.F.R. 240.17g-5).

from an issuer, expects issuers to provide just as much information as in the past. He wonders how often rating agencies will bother to do unsolicited ratings and how issuers will react to unsolicited ratings from rating agencies that don't have strong track records. A third panelist, from the buy side, feels that all the information provided to rating agencies should be provided to investors. A fourth panelist, from a broker-dealer, thinks that the prospect of unsolicited ratings may make it more difficult to sell bonds. Even so, more information is always better. However, there is the issue of how reliable the new information really is.

The mortgage market does a good job of pricing risk, even without ratings. However, it is expensive to conduct all the analysis. The problem with the new rule to promote unsolicited ratings is that it creates potential "randomness" about the regulatory capital treatment of a given security because the treatment can change when an unsolicited rating appears.

***Securitization Policy Reforms: The Shape Of Change To Come (10 a.m.)***

Question: Even if there is a dialogue among regulators around the world, how effective can the dialogue be in achieving convergence? Answer: The European regulators observed Project RESTART in the U.S. and viewed it as a benchmark for developing local regulations. This is an example of the effectiveness of international dialogue. Also, dialogue around mandatory risk retention resulted in both U.S. and European proposals centering on 5% risk retention levels.[7] Risk-based capital rules and their interpretation are another example of successful international dialogue. Areas that require the most coordination are (i) disclosure, (ii) risk retention requirements, and (iii) risk-based capital rules.

Where is the greatest need for restraint? Risk retention may be the area where regulators and policymakers need to exercise the greatest caution. They need to coordinate accounting policies and regulatory capital requirements with any proposed risk retention requirements.

Risk retention proposals: The EU risk retention policy focuses on issuers. However, the EU cannot reach issuers outside the EU, so the regulation works on investors. The EU policy calls for a 5% risk retention level. The U.S. Senate bill calls for 10% risk retention. The House bill calls for 5% risk retention, but allows for adjustment.

In the U.S., risk retention would interact with FAS 166 and 167. In particular, retained risk of 5% raises the question of whether the retention could undermine derecognition for purposes of risk-based capital standards. Depending on how the risk retention policies evolve, it may become impossible for issuers to remove securitized assets from their balance sheets, in which case they would need to hold capital against the full amount of the assets.

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[7] *See*, Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. § 1502 (2009); S. Banking Comm., *Restoring American Financial Stability Act of 2009*, S. Comm. Print (unnumbered) § 941 (2009) http://banking.senate.gov/public/_files/111609FullBillTextofTheRestoringAmericanFinancialStabilityActof2009.pdf; Federal Deposit Insurance Corporation, *Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation After March 31, 2010*, Advance Notice of Proposed Rulemaking, 75 Fed. Reg. 934 (7 Jan 2010); Directive 2009/111/EC, O.J. L 302/97 at 110 (17 Nov 2009) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0097:0119:EN:PDF (adding new Article 122a to the Capital Requirements Directive).

Regulatory capital: Capital requirements are strongly influenced by the accounting consolidation rules, which now generally require consolidation of most SIV and ABCP conduits onto bank balance sheets. There are still open issues about how to treat the assets once they are consolidated onto the balance sheets: For example: should the assets be marked-to-market or carried at amortized historical cost?

Many observers have remarked that institutions should hold more capital than in recent years. However, few are willing to really address the question of how much capital is necessary. One view is that the regulatory requirement should be augmented with greater reliance on market discipline. In other industries, the market is the primary mechanism for determining the amount of capital that firms have. The problem in the banking sector is that some institutions are "too big to fail," so market discipline does not work. A problem in the U.S. is that regulatory capital requirements are too strongly driven by accounting standards. The regulators should consider adopting separate accounting standards for regulatory purposes. However, there needs to be some system to prevent regulators from practicing inappropriate laxity (forbearance) during times of stress.

One panelist feels that there should be different levels of risk retention for different types of assets. One problem with risk retention policies is that they would require banks to retain more risk just when the market wants banks to shed risk. The ASF position is that risk retention is not the best way to align the interests of different market participants. Risk retention policies may diminish the volume of securitization and the market's ability to recycle capital to provide more credit to consumers.

Another panelist explains that policymakers have the tough job of balancing the conflicting objectives of (i) restoring the flow of credit and (ii) toughening regulatory requirements to prevent a recurrence of the financial crisis. The regulatory stress tests of banks were important because they helped to restore some confidence. The market needs more independent service providers, like appraisers and collateral evaluators, to supply independent views.

FINRA is working toward expanding the TRACE system to include securitizations. This would improve price transparency for both market participants and regulators. The original implementation of the TRACE system revealed some unanticipated features of the corporate bond market. FINRA also is working with the Fed to improve transparency around transactions in derivative contracts. Improving transparency may require changes in how some trading desks operate. Trading in a transparent environment is different from trading in an opaque market. Transparency is critical toward restoring trust in the markets.

There is also a push to improve offering disclosure. The financial crisis revealed that some investors did not know what they were buying and some issuers did not know what they were selling. Regulation AB in the U.S. is a good example of focusing on information that is relevant and useful to investors. However, disclosure and transparency are not enough by themselves. Policymakers will be focusing on additional things to help make the market safer (presumably substantive regulation).

Due diligence is a tough question. It is necessary to balance the cost of increasing the intensity of due diligence activities against the benefit.

Investors and issuers have some common interests. Investors want to know what they're buying and how it is performing each month. However, some privacy laws limit the detail of information. The ability to get property addresses and updated credit bureau information would be valuable to investors. Privacy rules should be reconsidered because they impair transparency. Risk retention affects both issuers and investors. One view is that risk retention has always been a feature of securitizations

through representations and warranties. What is the purpose of risk retention? Is it to support representations and warranties? Will risk retention continue to support representations and warranties even after the demise of a sponsor? Will a risk retention requirement crowd out investors who previously had purchased the highest-risk tranches? If banks are required to retain risk positions then they may not be willing to make loans to the riskiest borrowers.

***Restoring The Private Securitization Market And Unwinding Government Support Programs (11 a.m.)***

The Fed liquidity programs have targeted funding of nonbanks. Until last fall, the focus had been on stabilizing banks. Then the Fed expanded its focus to try to stabilize nonbanks, including the GSEs. The Fed's term liquidity has given institutions time to wait for market conditions to improve and time to formulate new origination strategies. The stimulus has also helped to stabilize and restore pricing in secondary markets. The Fed's liquidity stimulus worked together with other federal programs (*e.g.*, TARP) to help stabilize the financial sector in response to the crisis.

The Public-Private Investment Program (PPIP) funds are invested mostly in private-label RMBS, with a smaller share in CMBS. There is lots of additional work to be done to revive the markets and to create new laws and regulations for the market.

TALF has been strongly beneficial for the market. It gave issuers access to the market when they otherwise would not have had any access. TALF allowed spreads to recover from unreasonably wide levels. However, the 80/20 rule applies: Just 20% of investors buy 80% of the volume. This means that the market is still vulnerable to the whims of a small number of investors. Therefore, the market still may be vulnerable when the TALF program expires. Another panelist notes that the TALF's liquidity was a real solution where the market's problem truly was illiquidity. However, in sectors were the problem was something else, such as poor credit performance, the TALF program cannot provide a real solution.

The agency MBS market is benefiting from strong support from many government programs: tax credits for homebuyers, the MBS purchase programs, support for the GSEs, and others. The government's exit will be somewhat difficult. The (Fed's) MBS purchase program is scheduled to end in March. Mortgage interest rates will likely rise after the MBS purchase program ends. However, the real story is more about credit than about interest rates. The residential mortgage market has to "renormalize" around notions of higher credit quality and stronger underwriting than in recent years. The risk-reward proposition is simply not appealing or the near term.

Loan modifications are still a problem. Loan modifications create additional uncertainty about future cash flows, which impair security valuations. This is not a problem that can be fixed by a simple liquidity solution, like TALF. The market would be better off if the loan modification problem gets resolved quickly.

Trade ideas: There is relative value in subordinate tranches in on-the-run sectors. The trade is mostly gone for off-the-run collateral. Another panelist feels that there is opportunity in high-yield corporates (yields 8% to 9%) and high grade corporates (yields around 5%). Within structured finance, 'AAA' CMBS offer returns of 8% to 10%. The private-label RMBS market also offers 8% to 10% opportunities. Both CMBS and private-label RMBS should be treated as high-yield sectors that justify additional work to analyze risks.

The IMF's *Global Financial Stability Report* criticized the notion of a flat, 5% standard for mandatory risk retention.[8] Indeed, there is scant evidence that required risk retention would improve asset performance. Representations, warranties, and "implicit" recourse (*i.e.*, forms of risk retention in existing deals) do not seem to have helped securitized assets to perform well. The IMF calls for a quantitative impact study to assess the consequences of mandatory risk retention. Another panelist agrees. He concedes that required risk retention has a gut level appeal, but he doubts that it would make investors behave any differently than they did before. Issuers also probably would not act differently because they have always had retained risk through representations and warranties and through implicit recourse.

Another panelist asserts that the real problem is that returns on senior tranches are not sufficient to compensate small investors for doing their own credit analysis. Those investors want to piggyback on the work of others who take more risk. The investors who take more risk receive higher yields and can bear greater expense in doing their own analysis. The fundamental problem is finding a way for senior investors to piggyback on the analysis of others.

A third panelist agrees that many investors were not doing enough analysis themselves. They probably placed too much reliance on rating agency ratings. The panelist likes re-REMIC transactions because they allow institutions to address the problem of securities that have suffered substantial losses but for which there is reasonable certainty about future cash flows. He distinguishes re-REMICs from other resecuritizations. He notes that there is a rating arbitrage in the re-REMIC area. He is disturbed by the absence of Moody's ratings from most re-REMICs. Rating agencies are here to stay. They have made improvements in governance. They are more transparent, and they are producing more reports. They are examining dimensions of risk beyond just expected loss.

A proliferation of rating agencies may not be favorable to investors. It would be hard for investors to keep track of too many opinions. On the other hand, diversity of opinions is valuable and investors are used to keeping track of many opinions in Wall Street research. Investors want and use rating agency ideas and outlooks, but they also apply their own analysis to formulate strategy and make decisions.

Over the past year, rating agencies have been appropriately stubborn in some areas. Right now it is good that issuers and bankers are pushing on rating agencies to be "commercial," and rating agencies are more demanding about information.

Do the securitization markets need a permanent backstop from the government? One view is that the system has proven to be too fragile. However, it is not clear how much of the credit in the economy should be funded with leverage and liquidity transformation (*i.e.*, vehicles that issue short-term securities to fund longer-term assets). Another panelist feels that there should be some notion of "too big to fail" for banks but not for securitization. A permanent backstop would impose too much regulatory overhead for the industry. The focus of the industry should be on making appropriate risk-reward judgments based on the macro-economic outlook. The drivers of the securitization market should not be the changes, expirations, or renewals of government programs. A third panelist remarks that the U.S. market can learn from the Canadian experience. In Canada, the products are simpler and mandated by the government, and credit standards are higher overall.

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[8] International Monetary Fund, *Global Financial Stability Report*, at 100-107 (Oct 2009) http://www.imf.org/External/Pubs/FT/GFSR/2009/02/pdf/text.pdf.

***Featured Address – Michael S. Barr, Assistant Secretary For Financial Institutions, United States Department Of The Treasury (12 p.m.)***

Economic conditions have improved substantially over the past year. There is no longer fear that a second Great Depression is looming. Nonetheless, the unemployment rate remains unacceptably high and small businesses face tight credit, which constrains growth. The president is building on the successes of the past year to promote jobs and economic growth.

The financial system needs a new foundation for future growth. The current system is unchanged from precrisis days. The same gaps and loopholes that allowed Lehman and AIG to operate with too much risk still remain. The derivatives market remains largely unregulated. The government still lacks the authority to wind-down major nonbank financial firms. The system of financial regulation remains fragmented into too many different agencies. Creating a new foundation will require changing many of these things.

Securitization will have a role going forward. However, it too must change. Securitization must not promote unreasonable risk-taking or imprudent lending. Securitization contributed to the housing bubble and hurt many American households and families. Through securitization, nonbank entities operated a "shadow banking system" that conducted bank-like activities without the regulatory safeguards that apply to banks. The government eventually had to step in to stabilize the financial system when the shadow banking system collapsed.

Securitization needs a new infrastructure based on clear rules and transparency. It needs to promote innovation, and it needs to bring capital to families and small business. Industry initiatives like the ASF's Project RESTART are an impressive step toward trying to build the necessary new infrastructure. Also, the Obama Administration has proposed improved disclosure of loan-level data that would allow investors to do more analysis themselves.[9] The Administration also has proposed mandatory risk retention that is intended to promote better due diligence practices.[10] The proposal also would require rating agencies to disclose fees, potential conflicts of interest, and other information.[11]

The Obama Administration's initiatives should provide the option of homeownership for responsible households going forward. For existing loans, the Administration's program for loan modifications is helping many families stay in their homes. Dealing with second liens has been an ongoing challenge. Negative equity and unemployed borrowers are other ongoing challenges. The loan modification program is being revised to require documentation of a borrower's income before starting a trial modification.[12] There is a role for the government to alleviate suffering. It has the challenge of balancing the interests of taxpayers and the interests of borrowers.

GSE reform will have to focus on maintaining strong market stability in the housing sector.

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[9] Department of the Treasury, *Financial Regulatory Reform: A New Foundation*, at 45 (17 Jun 2009) http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

[10] Id. at 44.

[11] Id. at 47.

[12] Treasury Department, *Supplemental Directive 10-01, Home Affordable Modification Program–Program Update and Resolution of Active Trial Modifications*, (28 Jan 2010) https://www.hmpadmin.com/portal/docs/hamp_servicer/sd1001.pdf.

There were many failures under the current system. Borrowers, brokers, lenders, Wall Street, and rating agencies all have some measure of responsibility. The new infrastructure needs to include strong consumer protection, reform of securitization markets, and reform of the system of housing finance.

***Mortgage Underwriting Trends (2:15 p.m.)***

Freddie Mac, Fannie Mae, and the Federal Housing Administration (FHA) are focused on strengthening their underwriting while promoting sustainable homeownership. Fannie Mae observes that most deliveries of newly originated loans are well within its eligibility criteria. It is necessary to apply judgment in underwriting, especially with respect to the reliability of loan data.

Origination of FHA-insured loans has grown dramatically. Much of FHA's insured portfolio was originated in the past year. FHA is able to handle the growth. The key measure is performance. FHA's portfolio is running with delinquencies of around 7%. FHA's claims paying rate is in the range of 1.5% to 2%. All of that is very predictable and manageable. The strength of the new book is evident in the FICO credit scores of the new borrowers. Now the average is around 700 and only about 7% have scores below 620. A year ago, the average was around 640. The change is from the combined effect of more applicants with higher scores and more rejections of low-score borrowers. Also, the rate of early payment defaults is very low, in the range of 1% to 2%. Overall, the book of business is performing well, despite the rapid increase in the flow of new business.

Freddie Mac is providing ongoing support to the mortgage market. Freddie Mac has had a high level of purchases over the past year and it has securitized a very large portion of what it purchased. A second focus for the company is avoiding a high level of foreclosures. Freddie Mac works with Fannie Mae and the Treasury Department to find and develop programs to help borrowers stay in their homes. Fannie Mae also is committed to providing liquidity to the market, helping borrowers who face foreclosure, and supporting affordable housing.

Recent articles in the press have asserted that FHA's reserves have shrunk because of losses. The reserve account is required to be 2% of the entire portfolio. The reserve account is below the required level because the portfolio has grown rapidly. FHA can increase the reserve account by "overcapitalizing" its financing account. FHA is doing that, in part, by tightening underwriting standards so that projected future losses should be less.[13]

The Administration's "Making Home Affordable" program has a refinance component that allows a borrower to refinance an underwater loan at a lower rate. The refinance component allows the borrower whose loan is owned by a GSE to take-out up to $5,000. It also allows refinance LTVs up to 125%. Another component of the program is for loan modifications. About 125,000 trial modifications have been done, but there are challenges in converting the loans to permanent modifications. Both Fannie Mae and Freddie Mac are participating actively in the program. The viability of the refinance component depends partly on interest rates. As rates rise, refinancing may not be advantageous. Another refinance alternative for some borrowers could be to refinance conventional (uninsured) mortgage loans into FHA-insured loans.

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[13] *See* Department of Housing and Urban Development, Federal Housing Administration, *Annual Management Report Fiscal Year 2009* (Nov 2009) http://www.hud.gov/offices/hsg/fhafy09annualmanagementreport.pdf.

LTV is a constraint on refinancing some loans because their LTVs are above 125%. Freddie Mac achieves a pull-through rate of 15% to 20%. The pull-through rate is the proportion of loans seeking refinancing that ultimately can be refinanced through the program. Another panelist notes that some refinancing is driven by borrowers' desire to switch from adjustable-rate mortgages (ARMs) to fixed-rate mortgage loans (FRMs), rather than a desire to switch from one FRM to another at a lower rate.

Shrinking availability of private mortgage insurance has boosted the demand for FHA mortgage insurance.

Some market participants expect spreads on agency MBS to widen by 20 to 30 bps when the government stops buying securities to support the market. Freddie Mac's chief economist expects residential mortgage rates to stay in the range of 5% to 6%.

For 2010, the GSEs will continue to face many of the same challenges. It will be incumbent on the GSEs to continue to supply liquidity to the market. New borrowers need to understand the credit process. Lenders need to understand the GSEs' demands concerning loan quality. Lenders need to understand that borrowers must have both the ability and the willingness to pay their loans and that collateral must be sufficient to support new loans.

All the panelists place primary emphasis on keeping families in their homes. (They do not talk about responsibility to taxpayers.)

One panelist asserts that the GSEs are committed to both homeownership and promoting rental housing.

***Auto ABS Sector Review (3:20 p.m.)***

Last year was not an easy ride for the auto sector. The year started with little liquidity and little trading. New issue volume was small and spreads were wide. There was uncertainty about credit both at the issuer level and at the collateral level. During the year, the market had to deal with the bankruptcies of GM and Chrysler and with vehicle sales of only 10 million units. There was about $150 billion of nonretained ABS issuance. The prime auto loan sector dominated the market, but there were also subprime auto loan deals, auto lease deals, and dealer floorplan deals. Spreads started the year at Libor plus 475 bps and have now tightened to Libor plus 35 bps. Many factors helped the auto sector to be resilient. The lenders continue to apply an "originate to service" philosophy. They routinely retain risk in the assets. They ascribe very little value to the collateral (*i.e.*, the vehicle) when they make a loan. Also, government intervention in the GM and Chrysler bankruptcies, as well as the cash for clunkers and the TALF programs, were all key factors in helping the auto ABS sector remain resilient.

TALF: One panelist feels that TALF was an obvious success. The TALF program was so much of a success that the Fed will likely end the program on schedule in March. Spreads have tightened tremendously since March 2009. There is talk of extending the TALF program for off-the-run auto deals, but not for the mainstream auto deals. Another panelist remarks that TALF restored confidence and created a floor for prices. He expresses concern that the auto ABS market might suffer some deterioration after the termination of the TALF program. However, there already has been a transition from TALF investors to non-TALF investors for auto ABS.

Another panelist notes that auto loan delinquencies peaked early in 2009. Annualized net loss rates peaked at 2.23% in January 2009 and are now around 1.50%. The subprime loss rate peaked near 12% and was roughly 9% around the start of 2010. Cumulative net losses for the 2007 vintage have

been around 2.5%, and the projection for the 2009 vintage is around 3%. By contrast, cumulative net losses for older vintages were only around 1%. Credit difficulties have been concentrated in the 2006 and 2007 vintages. The impact of rising unemployment was visible in the performance of those vintages. In 2008 and 2009, LTVs on auto loans declined, FICO scores improved, and loan tenors shortened. All those factors helped to improve loan quality. The used car marked softened. It is better for a lease deal to have lease maturities distributed over time. ABS backed by dealer floorplan loans performed well through the manufacturers' bankruptcies, but it is not clear how much of the good performance was due to government intervention in the bankruptcies.

A panelist from a subprime lender asserts that credit performance of her company's portfolio has just started to improve, despite the fact that the portfolio is shrinking. The company changed its credit appetite when liquidity dried up. It toughened its loan underwriting. A virtue of auto loans is that they are short-lived assets that amortize relatively quickly. The 2005 through 2007 vintages will have higher losses than the 2008 and 2009 vintages. The company expects losses on the 2006 and 2007 vintages to be in the range of 10% to 12%.

An interesting development is that many borrowers default on their mortgage loans before they default on their auto loans. However, both loans enter delinquency close together in time. Once an individual defaults on his mortgage, he is likely to cure his auto loan more rapidly than his mortgage loan.

Legal and regulatory: One panelist focuses on the proposed FDIC safe harbor.[14] The safe harbor would preserve the prior FDIC treatment even though the securitizations might not qualify as sales under new accounting standards. In crafting the proposed safe harbor, the FDIC was focused primarily on mortgage loans rather than other asset classes. The proposed safe harbor would require ongoing loan-level disclosure. Even though FDIC rules apply only to banks, the disclosure provisions could set a market standard for all types of issuers. Other features of the proposed safe harbor include (i) requirement that payments on the securities come primarily from asset cash flows, (ii) separate documents covering the purchase and servicing aspects of a deal, and (iii) mandatory risk retention.

The main themes in proposed legislation are (i) risk retention, (ii) increased disclosure and reporting, and (iii) representations and warranties. The House bill would not specify new requirements but would direct regulators to make rules. The House bill would apply risk retention not only to securitizers but also to loan originators that sell loans.[15] The typical standard would be 5%, but would allow variation. Some versions of risk retention would allow vertical slices rather than subordinate interests. There would be restrictions on hedging the risk. Current disclosure rules allow suspension of SEC filing after the first 10-K filing. The new proposals would change that.[16] The proposals push for loan level data disclosure. While that might make sense for mortgage loans, it might not make sense for other asset

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[14] Federal Deposit Insurance Corporation, *Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection With a Securitization or Participation After March 31, 2010*, Advance Notice of Proposed Rulemaking, 75 Fed. Reg. 934 (7 Jan 2010).

[15] Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111$^{th}$ Cong. § 1502 (2009).

[16] Id. § 1503.

classes. The proposals would require rating agencies to describe representations and warranties for deals and how they differ from other deals.[17]

Relative value: One panelist feels that 2009 was a very good year for returns on ABS and securitizations. If one is bullish on the economy, then the environment is good for buying risky assets. On the other hand, if one is bearish, concerned about regulatory risk, or worried about a potential double-dip recession, then the right strategy is to be more cautious. Either way, short duration auto and card ABS are among the safest securities. The panelist favors seasoned subprime auto paper and likes subprime RMBS if carefully selected. Seasoned CMBS (pre-2005) also may offer opportunity.

Another panelist agrees that choice of strategy depends on one's outlook for the economy. The market has recently displayed an optimistic mood, with spreads tightening. Improving conditions argue for taking somewhat more risk. New deals have higher credit enhancement than older deals (sometimes double or triple the amount of credit enhancement) and that gives greater confidence in the strength of the deals. He feels that subordinate tranches of floorplan deals offer opportunity. There is room for spreads to tighten further on subprime auto deals.

## Tuesday, Feb. 2, 2010

***Featured Address – John C. Dugan, Comptroller Of The Currency, Office Of The Comptroller Of The Currency (8:20 a.m.)***[18]

The Office of the Comptroller of the Currency (OCC) administers banks that collectively account for about two-thirds of all bank assets in the U.S.

The financial crisis has shaken the securitization industry and it likely will be fundamentally changed by new reform measures under consideration by policymakers. Asset securitization played a significant role in the crisis and no one should think that we can just wait for the market to stabilize and then go back to the way things were before. At the same time, we must remember that securitization delivers significant benefits and is an important source of credit for the American economy. It is not realistic to think that the banking system can fully replace the amount of credit provided through securitization. In short, America needs a vibrant, credible securitization market to help fund credit in the future.

Changes are needed in key areas to help revive securitization. There has to be better risk underwriting, disclosure, and alignment of incentives. However, policymakers must avoid swinging the pendulum too far.

Change is already in the process of happening. Recent accounting changes (*e.g.*, FAS 166/167) already make it harder to move assets off balance sheet. Mandatory risk retention is a prominent feature of legislative proposals in both the House and Senate and in the FDIC Regulatory Safe Harbor Proposal. Regulatory capital charges have increased or may increase for (i) resecuritizations, (ii) securitization positions held in an institution's banking book or trading book, (iii) liquidity facilities, and (iv) positions for which a bank relies on third-party credit ratings instead of doing its own credit analysis. Disclosure requirements also are changing.

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[17] Id. § 1504.

[18] The text of Comptroller Dugan's remarks available on the OCC's website at http://www.occ.treas.gov/ftp/release/2010-13.htm.

All the different proposals now in the market could have profound effects on how securitization evolves. Policymakers need thoughtful and constructive input from market participants in order to help the evolution proceed well.

The purpose of mandatory risk retention proposals is to align the interests of loan originators with the interests of subsequent loan purchasers. The central notion of risk retention is to promote strong underwriting practices because lax underwriting was a key cause of the poor credit performance of loans originated in recent years. However, mandatory risk retention creates difficulties from the perspectives of accounting and regulatory capital. The new accounting standards (FAS 166/167) bring may assets back onto institution balance sheets and make it more difficult for institutions to derecognize assets in the future. The OCC believes that the accounting treatment under FAS 166/167 is appropriate. The OCC also believes that the resulting incremental regulatory capital requirements are appropriate because securitizations often did not remove risk from the sponsoring institutions.

But this prompts the question of whether securitizations that do transfer risk will be possible in the future. Mandatory risk retention could preclude accounting sale treatment for future deals, with the result that securitizers might have to hold capital against the full amount of securitized assets (*i.e.*, as if the assets had not be securitized). This creates a tension. The purpose of mandatory risk retention would be to help restore confidence and to revive securitization. However, it might impede the revival because it would defeat true sale treatment producing disadvantageous capital results.[19]

A better alternative to mandatory risk retention would be to impose minimum underwriting standards for residential mortgage loans. That would be a direct solution to the problem of lax underwriting. It could be more effective than mandatory risk retention in dissuading market participants from practicing lax underwriting. Minimum underwriting standards would include maximum debt ratios, verification of borrower income, meaningful down payments, and no rising payments.

Minimum underwriting standards would set true minimums. Dugan expects that the market could embrace somewhat higher standards for most loans.

***Overview Of The Consumer Economy (9 a.m.)***

The first panelist is bearish on housing. She notes, however, that there are a few recent positive developments. Even so, she expects home prices to head lower in the near term.

An area of good news is housing affordability. Consumers have a very high debt burden. The 30% decline in home prices has caused a loss of equity. The average LTV is 62%. But, after adjusting for homeowners who own their homes free and clear, the rest have an average LTV of 92%. Because of skyrocketing delinquencies, the GSEs required originators to repurchase $7 billion of loans. This is

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[19] This line of reasoning applies appropriately to securitizations that are motivated primarily by accounting or regulatory capital objectives. Examples of those types of securitizations include, traditionally, asset-backed commercial paper programs, and many credit card securitizations. However, the majority of securitizations are motivated by other objectives, such as asset-liability matching, lower funding costs, and improved liquidity. Most mortgage securitizations fall into the latter category, as do most securitizations of auto receivables. *See* Adelson, M. and Jacob, D., *Thirty Years Later Securitization Is Still Good for America*, Nomura Fixed Income Research, (15 Mar 2002) http://www.securitization.net/pdf/nomura_later_031502.pdf or http://www.vinodkothari.com/Nomura%20-%20Securitization%20Is%20Still%20Good%20for%20America.pdf.

making lenders tighten their standards. FICO scores are rising, down payments are rising, and debt-to-income ratios (DTIs) are lower. FHA accounts for a large share of current loan production (48%) because FHA allows down payments as low as 3.5%.

There are nearly 4.4 million mortgages at more than 90 days delinquency or in foreclosure. This compares with Moody's prediction of 7 million foreclosures. Foreclosures are taking much longer and foreclosed homes are coming to market slowly. The overhang of homes coming through the pipeline is huge. The nominal inventory of homes for sale is a seven month supply, but with the shadow inventory the supply is more like 17 months. Also, the distressed inventory has shifted to mid-priced homes from low-priced homes.

Servicers believe that the best-case outcome of loan modification programs is that they can reduce foreclosures by about 25%, but not more.

The panelist asserts that as many as 1,500 to 2,000 of FDIC-insured banks are zombies and will have to be closed.

New home prices are much higher than prices for existing homes.

The second panelist focuses on the general economy rather than focusing on housing. He has a bearish outlook. GDP growth will be about 3.5% this year, which is slow for post-recession recoveries. The recovery is very weak by historical norms. There are two competing stories: lenders don't want to lend and borrowers don't want to borrow.

Payroll income is the main source of consumption and is weak because of the weak labor market. Wages are being squeezed as workers' hours are being cut. Also, the decline of the housing market makes it harder for unemployed workers to sell their homes in order to move where job prospects might be better.

Falling home prices are very important. Households feel the hit of declining wealth more acutely than in the past because most of them have 401(k) retirement accounts rather than defined benefit pension plans.

The panelist asserts that the federal deficit is too high, and the proposed budget is appalling.

A key measure is bank reserves at the Fed. Before 1980, banks had to hold 12% reserves at the Fed and the system was very stable, and bank failures were very rare. Then the "Decontrol Act" allowed reserves to shrink ultimately to about 3% by 2008.[20] But now reserves are back up to around 10%. This is not driven by a regulatory requirement but rather by a desire to hold cash.

All this reinforces the outlook for anemic growth.

The third panelist has a brighter outlook. He believes that strong growth in the second half of the past year was on target for a recovery. We are now in the 48th recovery since George Washington.

When the financial crisis broke wide open in late summer 2008, central bankers did what they are supposed to do and cut interest rates. However, in spite of the rate cuts, credit contracted dramatically. Yields on speculative-grade credits widened sharply but they have since recovered (though not to precrisis levels).

Home prices have now fallen to a level that puts them on track with overall family income growth since 1970. The upshot is that the U.S. housing market is no longer inflated.

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[20] Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (1980).

Interestingly, corporate profits have been strong during the recession. After-tax profits are likely to reach all-time highs as a percentage of GDP. Capital expenditures are on the rise, and hiring is about to pick-up.

Although economists focus primarily on growth, unemployment is a bigger political factor. Under the best outlook, unemployment is likely to improve by half a percentage point a year. The "full employment" level is around 5%. It will take many years before the economy is able to get to that level from the current unemployment rate of around 10%.

***Mortgage Modification And Loss Mitigation Trends: Impacts On RMBS Performance (10:15 a.m.)***

The ASF and its members have been active in the ongoing debates about loan modification initiatives.

One panelist remarks that housing is an important priority for the current Administration. The Administration feels that stabilizing housing is important for promoting economic recovery. Initiatives for loan modifications are just one of the Administration's actions to support housing. Other actions have included supporting the GSEs and providing tax credits to homebuyers. Over 100 servicers have signed up for the government's loan modification program. The goal of the program was to help between 3 million and 4 million borrowers who could potentially afford to stay in their homes. Servicers participating in the program have offered trial modifications to over 1 million borrowers, and more than 100,000 loans have received permanent modifications. More than three-fourths of borrowers in trial modifications are making payments.

In addition to the main loan modification program (HAMP), there are other programs for (i) modifying or cancelling second liens that impede modification of first-lien loans, and (ii) using alternative loan resolutions like short sales or deeds-in-lieu of foreclosure. A recent change in the main loan modification program is to get income documentation before granting a trial modification to a borrower.

Another panelist describes the Hope Hotline operated by the Homeownership Preservation Foundation. The Hope Hotline collects data from distressed borrowers and provides advice and counseling. A recent survey reveals that there is a significant portion of borrowers who have been denied HAMP modifications because of failing the net present value (NPV) test.[21] Newly unemployed borrowers are slow to fully grasp their situations. They are slow to apply for benefits. They are slow to accept lower paying jobs. They are slow to realize that they might have to accept cutbacks in their lifestyles. The average borrower counseled by Consumer Credit Services of Atlanta has a total debt ratio of 80% (!!!) and needs overall credit counseling and mortgage counseling.

The first panelist observes that one of the key challenges to converting trial modifications to permanent modifications is that 25% of borrowers fail to make their modified payments. For other

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[21] The HAMP guidelines include a test for whether the net present value of a modified loan would be greater than the net present value of the loan without modification. *See*, Treasury Department, *Retrieving and Interpreting the NPV Test Results* (12 Nov 2009) https://www.hmpadmin.com/portal/docs/job_aids/npvtestresults.pdf; Treasury Department, *Home Affordable Modification Program Base Net Present Value (NPV) Model Specification* (updated 11 Jun 2009) https://www.hmpadmin.com/portal/docs/hamp_servicer/npvoverview.pdf.; Treasury Department, *Base Net Present Value (NPV) Model v3.0 Model Documentation* at 36 (8 Dec 2009) https://www.hmpadmin.com/portal/docs/hamp_servicer/npvmodeldocumentationv3.pdf.

borrowers, submitting the required documentation is a challenge. Wage earners are supposed to submit two pay stubs and a Form 4506-T (Request for Transcript of Tax Return). All borrowers seeking modifications are supposed to submit an affidavit of financial hardship and a signed modification agreement. Although there are millions of borrowers who do not qualify for HAMP modifications, the 900,000 now in trial modifications are the ones that the program is designed to target.

Another panelist notes that HAMP is just one program for loan modifications. His institution has other programs as well. The success rate on modifications is somewhat disappointing. Of modifications offered, 23% are successfully completed and pay as agreed, 29% fail to pay, and the rest fail to submit complete documentation. Some of the institution's non-HAMP programs are targeted at loan products such as ARMs, which have difficulty qualifying under HAMP. The expanded programs try to address forbearance plans, unemployed borrowers, short sales, and coordination with the FHA's Hope for Homeowners Program. Borrowers have continuing frustration with how long it takes to complete a modification, but that is a necessary by-product of the trial modification process.

A main focus of the HAMP program is getting a borrower's mortgage payment ratio down to 31%. However, that focus downplays the issue of negative equity. Delinquency cure rates have declined markedly compared with several years ago and the likely cause is negative equity. Negative equity increases the risk of a loan becoming delinquent and reduces the risk that it will cure after it becomes delinquent. Also, some modifications simply delay problems by lowering interest rates only temporarily, creating future payment shocks.

Another panelist notes that the first thing that must be done to address negative equity is to address second liens, to give borrowers some equity in their homes. Second, it is necessary for investors/lenders to be willing to forgive principal. The problem of second liens is heightened when different investors/lenders own the first and second liens.

Another panelist observes that about 14% of all mortgage loans are in some stage of delinquency and that there will ultimately be 7.1 million foreclosures. Modifications that include forgiveness of principal are more likely to succeed. HAMP modifications are likely to be largely ineffective.

The Administration is not trying to stop all foreclosures or to prevent corrections in home prices. Rather the HAMP program's ambition is to drive for modifications that make economic sense. The biggest challenge of the HAMP program is improving the conversion rate from trial modifications to completed modifications. Years from now, the Administration's housing policies will be judged not only by the results of the HAMP program but also by the long-term redefault rate and how the market deals with absorbing the large overhang of foreclosed homes.

One panelist observes a material improvement in redefault rates on loans modified through his institution's programs.

The ASF has offered a proposal that would give servicers and trustees legal immunity for allowing principal forbearances. The proposal would treat forbearances as realized losses under securitization pooling and servicing agreements.

One panelist feels that there is now greater uncertainty, which makes it more difficult to accept tight spreads on RMBS. Part of the uncertainty comes from conflicts of interest between different classes of investors. Another portion comes from documentary ambiguities revealed by the financial crisis (*e.g.*, how to deal with second liens in modifications). The best case would be for the issues to be resolved quickly to mitigate the uncertainty.

***The Future Of The GSEs (11:20 a.m.)***

Contrary to expectations, the Administration did not include GSE reform in the recent budget proposal.

- What went wrong?: Everything went wrong. Minimum capital standards were too low. Leverage was excessive. The GSEs focused intently on interest rate risk but ignored credit risk. The Office of Federal Housing Enterprise Oversight's (OFHEO) regulatory powers were too weak. GSE affordable housing goals were pushed too far. The housing bubble was fed by all types of market participants. There was no discipline on debt issuance because the market believed in the implicit government guarantee of GSE debt and, therefore, debt issuance was driven by the equity side's desire for leverage.

Fannie Mae and Freddie Mac dominate the single-family mortgage market. Origination of nonconforming loans has virtually stopped.

The first question about the future of the GSEs is, "what should be the role of the secondary mortgage market?" It must provide capital efficiently and safely to the $11 trillion residential mortgage market. It must provide consumer protection and choice. It must facilitate innovation and transparency. The second big question is, "how to structure a potential new GSE to take over the role of Fannie Mae and Freddie Mac?" The GSEs need to have well defined and consistent missions. There needs to be a clear demarcation between private- and public-sector roles. Regulatory and governance structures need to be strong.

Countercyclical policies can help curb asset bubbles and improve the odds that institutions will survive a crisis.

One option is to nationalize the GSEs or to merge them into the FHA or Ginnie Mae. This would create huge moral hazard because government insurance would insulate the market from the cost of imprudent risk taking.

Another panelist feels that a key priority is to separate the conflicting missions of (i) promoting affordable housing and (ii) creating a secondary mortgage market. Solid risk-adjusted returns are the key to keeping investors interested in the market. A third panelist notes that government ownership is an appealing model for the GSEs because it would take too much money to recapitalize them. He feels that a "public utility" model for the GSEs may be a desirable option.

Can the mortgage market function well without a government guarantee? This raises the question of what the underlying policy objectives are. They are (i) providing stability of funding for the housing sector and (ii) providing affordable housing. Private sector options may not serve the key policy objectives, and they have their own risks of moral hazard. The government has to be the final backstop in times of crisis. That implies that the GSEs would become government agencies, but they could have a role that expands and contracts to offset expansions and contractions of the private mortgage market.

A different view is that relying on the government is very risky. The government could not be trusted to practice the proper restraint without the influence of market forces.

Panelist have divergent views. One argues that the mortgage market could not have developed without the GSEs. Another emphasizes that the TBA market (*i.e.*, the "to be arranged" market for newly issued MBS from the GSEs) was the key.

Should the remade GSEs have standardized underwriting guidelines? Some say there are already standardized guidelines, like 80% LTV and the conforming loan limits. However, going forward, there

should be stronger standards for the main portfolio and possibly an allowance for a second portfolio of potentially riskier loans (this sounds like overlapping with FHA or the subprime sector).

A completely different vision would be to remake the mortgage market as a private-label business. Would there be TBA trading? Panelist generally feel that a private-label solution would not really work. One panelist notes that a possible future for the GSEs could be that their MBS might be guaranteed by the government but their debt would not be guaranteed. Interestingly, a very homogenized market could be adequately served by only two GSEs (for minimal competition), rather than four or five, as has been proposed by some commentators.

One panelist remarks that public ownership of the GSEs did not work. He wants maximum private sector involvement in the mortgage market and, therefore, he wants to minimize the role of the GSEs. Another panelist argues that having a high level of GSE activity is necessary in order to have a TBA market. A different panelist challenges that view, arguing that it is impossible to tell where stabilizing activities end and arbitrage activities begin. The risk of managing a portfolio for arbitrage is very great because it may leave the mortgage finance system vulnerable to low frequency but high severity problem scenarios.

One panelist feels that mortgage rates would be higher by at least 150 bps without the GSEs. Another panelist would like to see higher interest rates. A third panelist notes that a permanent liquidity facility for MBS could help to keep rates down if the GSEs did not exist. From 2002 to 2006, Fannie Mae and Freddie Mac MBS backed by 30-year fixed-rate mortgages (FRMs) traded at a spread of roughly 110 bps over the 10-year Treasury Note. Later the spread widened past 225 bps. One interpretation is that widening was driven by uncertainty about the guarantee. Another view is that it was a reflection of illiquidity.

***Relative Value Opportunities In ABS (2:35 p.m.)***

One panelist notes that spreads on credit card ABS are now at Libor plus 30 bps, compared with Libor flat before the crisis and Libor plus 600 bps at the peak of the crisis. Credit quality, as measured by borrower FICO scores, has not changed very much compared with before the crisis. He expects issuance to be flat in 2010 compared with 2009.

Another panelist notes that the market is in a better condition now than it was a year ago. The mood of the conference can be characterized as one of “relief.” This means that liquidity is better than it was a year ago, but the market is hardly strong in absolute terms. TALF may have created some artificial stability and there is strong tiering between on-the-run and off-the-run assets. Structures of new deals are much stronger than they were a year ago because underwriting has become more conservative (notably in autos).

A third panelist considers the question of whether deals are over-enhanced. She feels that it is not necessary to apply a Great Depression stress to every ‘AAA’ security and that not every structured finance security needs to achieve ‘AAA’ status. The rating agencies should “lighten-up” a little bit. It is not in the market’s interest for standards to be so tough that issuers do not want to issue. Another panelist disagrees, noting that issuers are pushing back and trying to streamline structures. The third panelist notes that we have the benefit of observing the performance of consumer ABS over the past two years and that performance has been quite good. Another panelist observes that recent rating agency research concluded that credit card deals would not have violated their early amortization triggers even without purchases of discounted receivables to strengthen their enhancement.

Given that many issuers would now have to keep securitized assets on their balance sheets, why should they even issue ABS? One panelist asserts that securitization provides lower funding costs for the underlying assets than when originators fund assets through unsecured debt.[22] However, after the expiration of the TALF program, two sectors – floorplan loans and private student loans – may have trouble. Those sectors have not proven that they are ready to stand on their own.

One panelist notes that the high volatility of ABS returns affects different kinds of investors differently. The buy-and-hold investor may not be affected and may not be bothered. However, the investor with a shorter time horizon may have had serious problems because of the total return volatility. Another panelist notes that poor total returns during the financial crisis were largely a reflection of illiquidity, contagion, and panic. There was fear that the consumer was dead, but now we know that the consumer has survived.

What matters now for consumers? One panelist notes that the consumer is hardly "robust" but the overall picture is not distressed. Consumers generally are paying their nonmortgage obligations. Another panelist notes that consumer performance ultimately ties back to employment and household wealth, which is tied to home prices. The consumer has been deleveraging and is still reluctant to spend freely.

Lending conditions are tight but there is political pressure for lenders to provide credit to consumers. Are lending standards too restrictive? One panelist feels that the pendulum has swung too far. It used to be too easy to get credit and now it is too hard. The strongest impact is in subprime. It is going to stay tough for subprime borrowers to get credit. If they get credit, it will be with tougher terms and probably on a secured basis. Policymakers likely will create special programs to encourage lenders to offer auto loans and credit cards to subprime borrowers. TALF was a blessing. If it had not happened, there would have been a bloodbath. Investor confidence has now come back.

Who will move first, lenders or borrowers? One panelist feels that as consumer credit performance continues to be strong, lenders will grant easier terms. We are in a manufacturing-led recovery; not a consumer-led recovery. Hopefully lenders will not go too far and create another bubble. There should be a natural progression for increasing lending. The regulatory capital regime for banks is a hindrance.

The future role of the government is uncertain. Will the government become the sole or primary lender for education?

One panelist observes that subprime lenders have existed as profitable businesses for a long time. The subprime sector may be temporarily untouchable, but it is likely to come back.

TALF and the "cash for clunkers" program were two examples of highly successful government programs in the past year. In contrast, the new credit card law has made it more difficult for banks to supply credit through cards. The new credit card law[23] and other new regulations make it more difficult for card issuers to apply risk-based pricing. This is promoting a shift in focus toward higher quality borrowers. Credit card lenders are designing new fees to be able to price for risk. Credit card lenders face more headwinds than do auto lenders.

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[22] See note 19 *supra*.

[23] Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. Law No. 111-24, 123 Stat. 1734 (2009).

One panelist focuses on legal uncertainty. Priority of different creditors in bankruptcy proceedings is a key issue. There may not be a second lien market in the future if first-lien lenders feel that their rights have been trampled (by loan modification programs).

Small business equipment loans and leases: One panelist favors the equipment sector. He likes leases on equipment manufactured by solid manufacturers. He feels that there is risk in rental car leases because of both residual risk and dependence in the rental company.

Other worries: One panelist worries about the potential for a double dip recession. Another panelist feels that investors should worry about the outcome of the FDIC's safe harbor proposal because the safe harbor would depend on an originator's conduct after the closing of a securitization transaction. She worries that assets need to be protected in an originator's insolvency. A third panelist worries about the pace of new regulation; the market is being forced to absorb too much change too quickly. Recovery may be stalled as market participants wait for more clarity. Another panelist notes that the credit card sector has drawn regulatory attention because of the very large profits generated by the banks from their credit card operations.

***U.S. Mortgage Finance Policy Reforms (3:50 p.m.)***

There are lots of proposals right now for mortgage finance reform. These include licensing requirements, notices to consumers, assignee liability provisions, and mandatory risk retention.

One panelist from the Office of Thrift Supervision states that (i) GSE reform, (ii) bank regulatory reform, (iii) the proposed Consumer Financial Protection Agency, (iv) rating agency reform, and (v) accounting and regulatory capital reform are all subjects that have already been addressed at the conference. One subject that always comes up in discussions about housing and mortgages in Washington is "closing the gaps." Bank regulators are currently focused on mortgage loans underwriting requirements. It is likely that either regulators or Congress will mandate changes in underwriting requirements. One aspect of closing the gaps is licensing for individuals who originate mortgage loans. The notion has evolved over the past several years. The 2008 S.A.F.E. Mortgage Licensing Act required states to create licensing systems for mortgage lenders.[24] Most states adopted a model law on mortgage originator licensing.[25] The definition of "originator" is a person who takes an application *or* negotiates terms. The federal scheme uses a narrower definition, applying an "and" standard (takes an application *and* negotiates terms).[26] At the federal level, the federal regulatory agencies are working together to create a final rule that accommodates the state licensing platform. Individuals who work on loan modifications may be originators under the new standards. Another issue is the status of outside consultants as "employees" under the standards.

Another dimension of "closing gaps" is the notion of required underwriting guidelines. Any action along those lines would occur slowly because it would have to be an interagency action. Also, there is going to be much more consumer protection in the mortgage system in the future. Additional protections will include both disclosures and substantive provisions.

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[24] Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (Title V of the Housing and Economic Recovery Act of 2008, Pub. Law No. 110-289, 122 Stat. 2654 (2008)) (also known as S.A.F.E Mortgage Licensing Act of 2008).

[25] For the text of the model state law see http://www.hud.gov/offices/hsg/ramh/safe/modellaw.pdf.

[26] S.A.F.E. Mortgage Licensing Act of 2008 § 1503(3).

Another panelist focuses on "cramdowns" (explained below) and assignee liability. There have been many legislative and regulatory proposals since the start of the credit crisis. Some have been enacted: Hope for Homeowners, HAMP, modifying or cancelling second liens, and the safe harbor for services (to protect them from liability for loan modifications). Cramdowns and assignee liability are important legislative proposals that have attracted a lot of attention.

Cramdowns: The cramdown proposal would permit a bankruptcy court to cram down the balance of a first-lien residential mortgage loan secured by a primary residence to the value of the home. The remainder of the loan would be an unsecured claim. The policy would apply only to loans originated in the past and not to new loans. The Helping Families Save Their Homes Act of 2009 was enacted without the cramdown provision.[27] Representative Barney Frank continues to push for enactment of the cramdown provision because he views it as an essential way to force principal forgiveness as part of loan modifications.[28] Even though the cramdown proposal would not apply to new loans, it may create uncertainty about whether a similar provision could be enacted to cover future loans.

Assignee liability: The proposed federal standard for predatory lending would require a tangible net benefit to a borrower and would impose potential liability on assignees and securitizers.[29] Assignees and securitizers who exercise reasonable due diligence can avoid liability if they satisfactory cure for the violation within 90 days of being notified of the violation. Assignees and securitizers would not be subject to class actions. The Mortgage Reform Act would permit securitizers to presume that certain mortgage loans meet applicable requirements. The Mortgage Reform Act passed the House on May 7, 2009. The Senate has not yet acted. It failed to approve a similar bill in 2007.

The third panelist focuses initially on proposed mandatory risk retention.[30] The House bill would apply not only to securitizations but also to whole loan sales. It would require any originator to retain an economic interest. It would also require securitizers to retain risk. Thus, the legislation could potentially require "double" risk retention: once by an originator and once by a securitizer. In a resecuritization transaction, there might even need to be a third level of risk retention. Most lawyers expect there to be mandatory risk retention but that regulators will have the option to waive the requirement.

Disclosure proposals would require an issuer to perform a due diligence analysis and disclosure of the results. Both the House and Senate bills would require ongoing filing of monthly servicing reports with the SEC (current rules require filing for only one year). The proposals would require rating agencies to discuss representations and warranties when they publish reports on deals.[31]

The proposed FDIC legal isolation safe harbor proposal is being used as a back door vehicle for imposing a variety of disclosure requirements and substantive regulations on securitizations. The proposal would require risk retention, substantially increased disclosure for both public and private

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[27] Helping Families Save Their Homes Act of 2009, Pub. Law No. 111-22, 123 Stat. 1632 (20 May 2009).

[28] The House recently rejected the cramdown proposal on 12/11/09 when it was proposed as a late stage amendment to the Wall Street Reform and Consumer and Consumer Protection Act of 2009. *See* H.R. Rept. 370-111 at 12, 199-203 (10 Dec 2009).

[29] Mortgage Reform and Anti-Predatory Lending Act, H.R. 1728, 111th Cong. §§ 202, 204 (2009).

[30] See note 7 *supra*.

[31] See notes 7, 15-17 *supra*.

deals, regulation of origination and servicing, and limitations on (i) compensation of various parties and (ii) what loans may be securitized.[32]

The SEC staff is working on a potential overhaul of the whole ABS disclosure and offering scheme.

Consumer financial protection agency: The proposed new agency is now less likely because Senator Dodd has announced his retirement. The proposal would create potential liability of up to $1 million for each violation of consumer protection requirements.

***RMBS Traders/Researchers Roundtable (4:55 p.m.)***

Loan defaults: What is really driving the massive amount of residential mortgage defaults? One panelist feels that the key drivers in the past were cumulative home price appreciation and mark-to-market LTV. Going forward he expects that the unemployment rate will be a stronger driver. Another panelist feels that the key is in a combination of risk factors: home price appreciation (HPA) layered with high unemployment. He feels that unemployment has been the strongest driver of roll rates[33] for prime-quality loans. He expects delinquency roll rates for prime-quality loans to improve as unemployment improves. A third panelist feels that mark-to-market LTV[34] is the key driver of the roll rate from the “current” category to the 30-day category. He sees unemployment as a driver also. His expects that unemployment will be a key driver of home prices, making the two factors collinear as predictors of delinquency roll rates. He expects unemployment to peak in first-quarter 2010.

Interestingly, trading levels are much more strongly driven by current roll rates than by projected roll rates. Traders pay careful attention to roll rates and then apply additional stresses. Although the market watches roll rates closely, actual trades seem to reflect assumptions that are more conservative.

One panelist uses an approach of separating the underlying collateral for a deal into four cohorts and applying customized assumptions for each cohort. Although the approach is more computationally intensive and requires more work, it can produce better insight and allow the trader to differentiate bonds that would otherwise appear (misleadingly) similar.

Another panelist feels that it is not reasonable to expect credit to remain as tight as it is today for the next 30 years. A year from now, there may be easier credit for middle-tier borrowers. That could make a huge difference in refinancing activity, which can change loss projections dramatically. A different panelist pushes back, arguing that refinancing will remain slow in the near term because LTVs on many loans are too high to qualify for refinancing.

The same panelist notes that updated FICO scores could be a valuable tool for projecting defaults. A borrower’s FICO score generally declines shortly before he defaults on his mortgage loan. The impact is strongest for loans that have relatively high FICO scores. Selection bias can work both ways. The weakest borrowers may already have defaulted and the strongest may have refinanced.

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[32] See note 14 *supra*.

[33] The term "roll rate" refers to the proportion of loans in a given delinquency category that move to the next worse category. For example, if half of the loans in the "30-day" delinquency category move to the "60-day" delinquency category, then the roll rate from the 30-day category to the 60-day category is 50%.

[34] The phrase "mark-to-market LTV" refers the ratio of a loan's current balance to the current value of the related home. A mark-to-market LTV of less than 100% means that the borrower has equity in the home. A mark-to-market LTV of more than 100% means that the borrower has "negative equity."

Another panelist asserts that 80% of prepayments come from the strongest 20% of a pool. He expects to observe a "burn-out" of refinancing activity as the strongest borrowers refinance out of the pools.

One panelist addresses loan modifications. He notes that documentation has been a big issue for the HAMP program. According to the Treasury, three-fourths of the borrowers in trial modifications are making their required payments. But, only a much smaller percentage has delivered the required documentation – affidavits of hardship and proof of income – to achieve final conversion. In addition to documentation, other challenges include second liens and the treatment of principal forbearances. The Treasury has given guidance that principal forbearance should be treated as a realized loss.[35] However, some servicers shave been reluctant to apply the Treasury's guidance, presumably because they believe that it conflicts with their contractual commitments. A bigger issue is the redefault rate. Modified loans are displaying high re-default rates. Improving the redefault rate may require stronger measures such as principal ***forgiveness*** or rescheduling nonmortgage debt.

One panelist feels that a better strategy for modifications should comprehensively address principal reductions and second liens. He notes that the redefault rate is lower for loans with principal reduction even though the loans were generally weaker than those that receive only interest modifications. He is concerned, however, about the moral hazard of principal forgiveness. He proposes a system of applying principal forgiveness gradually over time as a reward to a borrower who makes steady payments on a modified loan.

During the summer, the problem was starting the modification process. Now, a large number of loans have received trial modifications and the challenge is converting the loans to permanent modifications.

Recent months have shown improvements in prices for nonagency RMBS. Is this due to changes in risk premiums, or due to changes in assumptions about future performance? One panelist answers that the key change is in current risk premiums. However, he expects that investors eventually will apply different assumptions after observed credit performance improves. Another panelist counters that there is still a lot of uncertainty, and computer models cannot produce a reliable "best case" prediction. He feels that the right way to deal with the high uncertainty is to consider a broad range of potential performance scenarios. He feels that loan modifications are one of the many sources of performance uncertainty.

Another panelist agrees that modifications are driving higher uncertainty. He agrees that the right strategy is to consider a wide range of scenarios that cover varying rates of trial loan modifications and varying rates of success in converting the trials to permanent loan modifications.

Although there have been some signals of stabilizing home prices, that is not a key driver of security pricing. Policy initiatives and uncertainty are larger drivers. Typical MBS investors or traders would want to see a much stronger move in home values before it would affect their views of security prices.

Stabilization: One panelist feels that the stabilization is only temporary. Foreclosure paralysis has created a huge overhang. He expects loss severities to rise by four to eight percentage points over the

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[35] Treasury Department, *Supplemental Documentation—Frequently Asked Questions Home Affordable Modification Program*, question no. 33 (8 Jan 2010) https://www.hmpadmin.com/portal/docs/hamp_servicer/hampfaqs.pdf.

next two years. A second panelist agrees about rising severities. He notes that the HAMP NPV test[36] allows for larger modifications of loans that would have high loss severities. This can be a somewhat positive factor. Also, increasing use of short sales is helping to moderate loss severities. Holding back some of the REO (real estate owned) supply may be helping as well. Although the S&P/Case-Shiller Home Price Index has been stable for six months, it may not be a reliable signal because of the big supply of homes that has been held back. A third panelist agrees that severities are likely to rise. He notes that subprime loss severities have improved. There has been a rising proportion of cash transactions in the past year. He expects severities on subprime loans to rise slightly to the mid-70s (percent) range. Severities on prime-quality loans are in the mid-40s, and they could rise to the mid-50s or high-50s. He thinks that the housing markets will be relatively softer at the high end (expensive homes).

Stimulus expiration: One panelist asserts that the expiration of tax incentives and the MBS purchase program will be bad for the market. Many dealers expect HPA to decline by another 10%, but not by another 30%. Another panelist focuses on the shadow inventory of 5.5 million distressed properties. That represents a whole year's worth of existing home sales. He is concerned that the liquidation of the shadow inventory may create significant adverse pressure. A third panelist feels that the government will stay involved and may extend stimulus programs. He feels that the government would actively respond to any negative feedback loops that develop. He believes that time will be a healing factor. Household formation will help with the absorption of excess housing supply. Another panelist feels that the government will stay involved in loan modification programs. He sees potential for rising short-term interest rates to hurt option ARM borrowers whose loans are about to "recast."[37] So far the low level of the "moving Treasury average" (the index to which many option ARM interest rates are tied) has helped those loans to avoid payment shock. However, if short-term rates follow the forward curve, 20% to 25% of the 2006 vintage (which is scheduled to recast next year) could get into trouble. In the subprime area, payment shock could occur if Libor starts to climb before the borrowers can refinance into FRMs. The last panelist agrees that there are many issues and that the government will remain involved. Stimulus programs have had varying effectiveness but they are reassuring because they show the government's commitment to helping the market.

Trade ideas: One panelist is bullish and expects tightening of risk premiums and improvements in assumptions (scenarios) used for analyzing and trading securities. He perceives potential opportunity in Alt-A MBS with a high level of underlying delinquencies. Those securities can trade near worst-case assumptions and may offer a lot of upside. Another panelist notes that spreads for the whole private-label RMBS sector have tightened. He notes that subprime MBS offer some of the highest yield opportunities. He likes hybrid, option ARMs because the borrowers have strong incentives to refinance and there is upside in moving from a 1% voluntary refinance rate to 2% (a seemingly small change but one that can significantly affect returns on a security). He likes securities with dollar prices in the range 40% to 60% of par. A third panelist likes securities in the price range of 80% to 90% of par. He sees

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[36] See note 21 *supra*.

[37] "Recast" refers to adjusting the payment on a mortgage loan so that the loan will fully amortize over its remaining term. Many option ARM loans include a provision for a recast upon the earlier of (i) the loan balance reaching a specified level as a result of negative amortization or (ii) the expiration of a specified time (*e.g.*, five years) since the origination of the loan.

potential opportunity in option ARMs. A fourth panelist likes derivatives (*i.e.*, interest-only securities) in the nonagency space that can benefit from extension and delay. He views the principal sector (*i.e.*, ordinary MBS that have both principal and interest) as a trading space and the derivative side for investment. The last panelist likes last cash-flow, subprime MBS because of the potential for gains from significant prepayments (up to 5% CPR). He leans away from MBS backed by prime-quality loans. He likes super-senior MBS tranches backed by hybrid ARMs.

## Wednesday, Feb. 3, 2010

***Commercial Mortgage Securitization (8:30 a.m.)***

The CMBS market is starting to *think* about resuming loan originations.

State of the market: A key issue is that the CMBS market has been largely frozen since 2007. Another is that there is a huge wave of loan maturities coming between 2010 and 2013. A third issue is the general economic recession.

One panelist asserts that the CMBS market declined before the commercial property markets. The main underlying story is unemployment. Financing activity will likely revive this year. Another panelist focuses on the pipeline of maturities. He feels that there is a huge gap between the demand for financing and the supply. Also, there has not yet been true capitulation in property values. Only after substantial numbers of properties change hands at lower prices will the opposite sides of the market come to agreement on financing terms. A third panelist expects delinquencies to rise to roughly 12% from the current level of around 5%. He notes that many securities have been downgraded, and he now expects the ratings to be stable for the next several years. The first panelist asserts that property prices are down about 50% from the peak of the market to the trough. The price declines in this cycle occurred more quickly than the price declines of the early 1990s. The fourth panelist anticipates that the refinancing bottleneck will be addressed by extensions and modifications of existing loans. He does not expect a glut of distressed sales because they will be avoided by extensions.

What will the "new world of CMBS" look like?: One panelist expects to see up to $20 billion of CMBS deal activity in 2010. The government wants securitization to be revived. There will likely be both single-borrower and multi-borrower deals in 2010. Hedging remains a very difficult problem. Commercial real estate professionals realize that new loans are of very high quality because "the best loans are originated in the worst markets." Another panelist notes that only strong borrowers, who are willing to accept low LTVs, are able to get loans. He observes that the right strategy for most borrowers is to negotiate modifications or extensions with their current lenders rather than trying to get new loans. That is likely to remain the main type of activity in the near term. He notes that new lending is happening in the multi-family area as part of GSE programs.

Role of the government: One panelist remarks that the TALF program has brought the market to where it is now. The program did what needed to be done, but now the market is ready to accept non-TALF deals. The program will expire at the end of March. Another panelist observes that TALF restored confidence when irrational panic had gripped the market and was driving pricing. Now the market should be able to operate on its own. The PPIP program is another source of potential stimulus and support, but so far purchases by PPIP funds have been slower than anticipated. One panelist feels that borrower groups may push for continuation of government stimulus programs to help restore the flow of originations. He asserts that one of the market's key challenges is that lenders do not want to take aggregation risk.

Another panelist states that new loans are completely uncorrelated with the older series of the CMBX index. He feels that there has to be a new series of the CMBX index to facilitate hedging.

Several panelists view the FDIC as a potential CMBS issuer. The FDIC may acquire lots of loans when it closes insolvent banks. However, they generally do not expect the FDIC to "reinvent" the CMBS market as the RTC did in the 1990s.

Impact of changing regulations and accounting standards: One panelist urges regulators to exercise great caution and to consider potentially unintended consequences. Another panelist asserts that the combination of diverse changes is what creates problems. He highlights the combined affect of FAS 166/167, mandatory risk retention proposals, and changes to regulatory capital guidelines. (Together they substantially boost capital requirements.) He believes that mandatory risk retention is a bad idea. He feels that the key drivers of asset performance are underwriting standards and rating agency due diligence. Another panelist asserts that securitization is a valuable financial technology. It only got into trouble when it started running "on steroids."

A key difference between the residential and commercial areas is that the residential side had not previously suffered nationwide price declines. In contrast, the commercial real estate sector has had nationwide declines. That difference made the rating agencies more cautious about commercial real estate than about residential real estate. Another panelist asserts that underwriting may have become lax, but was still a constraining factor in the commercial real estate sector, even at the height of the market. On the other hand, he feels that underwriting was essentially absent from the residential side. So, for all the problems and deterioration in the commercial mortgage sector, it is still not nearly as bad as what happened on the residential side.

Loan modifications: Some servicers had taken the view that REMIC tax rules prevented modifying loans before they became delinquent. The IRS has clarified that a servicer can pursue a modification before a loan becomes delinquent as long as default is reasonable foreseeable.[38] Separately, the IRS is expected to publish a notice soon that would allow certain releases of collateral on loans with LTVs greater than 125% (which is appropriate, for example, in certain casualty and condemnation situation).

Information about loan modifications creates tough challenges. As the information flows from special servicers and through the systems of Intex, Trepp, and Bloomberg, it is not always handled consistently. Investors need to analyze each situation individually because the absence of reliable standardization makes useful generalization impossible. Also, the pooling and servicing agreements for different CMBS transactions have varying provisions for allowing loan modifications. Those differences also require investors to take a deal-by-deal focus for dealing with loan modifications.

Several panelists agree that properties will need to change hands at lower prices in order for the market to "reset." That may not happen as long as underwater properties meet their debt service requirements. However, once property cash flows decline and no longer can meet debt service, then properties will start to quickly change hands.

One panelist recommends trading "down in credit" (*i.e.*, favoring subordinated tranches) on new issues because new originations are very strong.

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[38] Rev. Proc. 2009-45.

***Trustees Roundtable (9:35am)***

Repurchase requests: Are investors making more requests for asset repurchases for breaches of representations and warranties? One panelist remarks that investors continue to request repurchases. The challenge for trustees is finding a party against whom to pursue a remedy. A further challenge is providing information for an interested party to determine if there has been a breach. Another panelist notes that trustees are sometimes stuck in the middle between (i) investors or bond insurers who want to see loan files and (ii) originators who want to withhold access to the loan files. Also, there is a challenge with determining whether a breach has a material adverse impact. (If there is no material adverse effect, repurchase is not required.) The trustees must perform a balancing act, providing access to loan files for appropriate forensic analysis of compliance with representations and warranties while preserving the confidentiality of protected borrower information. One panelist remarks that trustees have to focus on the specific provision about access to loan files in each pooling and servicing agreement because the agreements vary from deal to deal. Most insured deals provide for access by the bond insurer.

Bankrupt originators & sponsors: It is tough for trustees to pursue breaches of representations and warranties against bankrupt originators and sponsors. The challenge is working through the bankruptcy process and the need to file "proofs of claim" with the bankruptcy courts. This requires estimating the value of the claims and makes the whole process more cumbersome.

Interpretive issues in pooling & servicing agreements: One approach is to amend documents to clarify ambiguous language. However, a challenge to amendments is getting investor consent; it may be hard to identify security holders and to get them to respond. When an issuer is still in business, it may be possible to make minor amendments with only issuer consent. Another panelist notes that sometimes holders disagree about a proposed amendment. The easiest case is when an amendment is for fixing a clear error or inconsistency in a document. Identifying the holders and getting a written notice to them is difficult but essential. One panelist notes that old documents contain many errors and discrepancies, but that newer ones are better because they benefit from the lessons from the older ones.

Access to files and information: One panelist states that trustees have to try to meet information requests and requests for file access by holders and bond insurers. However, they should not promote fishing expeditions by nonholders.

There have been many lessons learned over the past 24 months. Servicers have learned that they have the responsibility to respond to certain types of investor requests. Servicers who want to survive need to be responsive to investor needs. On the other hand, investors need to learn what rights they have to information and to files, and the limits of those rights. One panelist counters that there has been resistance among certain types of market participants to learning the recent lessons. They do not want to update documents (for new deals) to apply those lessons. Another panelist says that investors should not buy deals if they do not like the documents. (He seems to think that investors read the documents.)

Loan modifications: How are HAMP modifications being handled in outstanding transactions? The program provides for forbearance of principal to meet the target DTI level of 31%. The forborne principal becomes noninterest bearing and is due as a bullet at a loan's maturity. The Treasury Department believes that the forborne amount should be treated as a realized loss for purposes of cash flow waterfalls in transaction documents.

One panelist notes that some documents explicitly conflict with the Treasury's guidance and some documents are silent. Investors holding securities at different levels of a deal's capital structure have

differing views on the applicability of the Treasury's guidance. The panelist expects that the treatment of loan modifications and principal forbearances will remain a contentious issue in the future. Panelists note that the Treasury's guidance does not actually provide a safe harbor for trustees with respect to the application of waterfall provisions (though it may provide a safe harbor for making loan modifications).

So far there has been only a small volume of HAMP modifications, and it is still too early to tell how servicers will report principal forbearances on modified loans (*i.e.*, will the servicers report the forbearances as realized losses).

Due diligence and oversight: Policymakers and market participants are pushing for somebody to provide independent due diligence and oversight for securitizations. Trustees could have expanded roles to provide such services. A recent Education Department directive requires trustees to monitor and audit the issuer's compliance with applicable policies and procedures in deals backed by student loans.[39]

Caps on trustee indemnifications from cash flows: The flip side of fees is indemnities and caps on indemnities. One panelist feels that it is troubling that trustees are now being asked to accept caps on indemnities from deal cash flows while they work for such low fees. Another panelist complains that deal documents do not provide for increasing servicing fees when it is necessary to find a replacement servicer, and none is willing to take the job for the original fee. He argues that there should be provisions for adjusting trustee fees to handle extraordinary circumstances.

[39] Department of Education, *Responsibilities of Lenders Serving as Eligible Lender Trustees under the Federal Family Education Loan Program*, FP-09-07 (2 Oct 2009) http://www.ifap.ed.gov/dpcletters/FP0907.html.

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