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ASF 2012 Conference Report

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ASF 2012 Conference Report

(Editor's Note: This summarizes a number of speeches and panel discussions at the ASF 2012 conference held in Las Vegas from Jan. 22-25, 2012. These summaries are intended to reflect the views of the panelists and are not intended to reflect the views of Standard & Poor's.)

1. The ASF 2012 conference in Las Vegas attracted about 5,000 attendees. The mood was decidedly more optimistic than at the ABS East 2011 conference in Miami Beach last October. Some speakers remarked that the large number of attendees was a reflection of the industry's positive prospects. Some attendees expressed a more cautious view, questioning whether there will be enough securitization activity to keep 5,000 professionals gainfully employed.

2. Issuance levels in many sectors are expected to exceed last year's levels, though they will likely remain well below the peak of the years leading up to the financial crisis. Many panelists expect the private-label RMBS sector to remain in a slump, at least until policymakers reach decisions about the future of the GSEs.

3. Many panelists identified the same key challenges facing the securitization industry. Regulatory uncertainty was the leading one. Panelists emphasized the damage that the industry could suffer from unfavorable outcomes on any of several regulatory initiatives now in the proposal stage. One key area is risk retention. Panelists criticized both the premium capture reserve fund feature and the narrow definition of "qualified residential mortgage," or QRM. Another key area is risk-based capital. The Dodd-Frank Act requires regulators to remove ratings from the regulations, but this makes it challenging for the regulators to craft capital standards that are sensitive to gradations of credit quality. A third area is the Volker rule, and whether securitizations will fall within the scope of the implementing regulations.

4. The housing sector remains another key challenge to the revival of U.S. securitization activity. Although homes are quite affordable--reflecting the combined effect of record-low interest rates and recent price declines--home sales remain sluggish. Credit is tight for potential buyers and only the strongest applicants can qualify for loans. In addition, there is lingering concern that home prices may have farther to fall. This keeps some potential home buyers on the sidelines. A number of panelist offered projections that home prices would hit a bottom sometime in 2012, with most suggesting that the additional drop would amount to a single-digit percentage. In addition, the huge pipeline of distressed or underwater loans exacerbates the supply-demand imbalance and has the potential to prolong this imbalance for years.

5. The potential for further home price declines may be constraining recovery of the private-label RMBS sector. Until there is confidence that home prices have gotten past their bottom, investors in private-label RMBS will demand incremental yield as compensation for downside risk. Government policies that prevent home prices from reaching their natural bottom in the short run may actually delay the revival of the private-label RMBS sector.

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

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Sunday, Jan. 22, 2012

Securitization And Its Role In The Financial Markets

7. ***What is securitization?*** Securitization is a technique for financing assets with predicable cash flows. The cash flows often are the source of payments on the issued security. A securitization typically uses bankruptcy remoteness to separate the performance risk of the assets from the bankruptcy risk of the issuer (the beneficiary of the financing). Securitizations produce fixed-income securities. In the fixed-income landscape, they fit alongside sovereign bonds, municipal bonds, and corporate bonds.

8. Many different types of financial assets have been the subject of securitizations. Attributes that are conducive to securitization include homogeneity, strong credit quality, and ease of understanding the drivers of performance.

9. Issuers favor securitization as a financing technique because it allows low-cost leverage. Securitization often provides reduced funding costs because credit enhancement can reduce the credit risk of the issued securities, which may attain high credit ratings. Securitization also may provide liquidity as an alternative funding source. It can serve as a risk management tool by transferring risk to investors. In the past, securitization provided accounting benefits by allowing companies to finance assets on an off-balance-sheet basis. Until recent regulatory changes, banks were able to use securitization as a way to reduce their required levels of regulatory capital.

10. Securitization delivers benefits to an issuer's customers by giving them increased access to credit at lower cost. Securitization has increased the range of credit products available to consumers and businesses and has helped those groups by increasing competition among lenders.

11. Securitization investors include traditional fixed-income investors such as money managers, banks, insurance companies, and pension funds. Many have a long-term investment horizon. Corporations and sovereigns also invest in securitizations to some degree. Nontraditional investors, such as structured investment vehicles (SIVs), collateralized debt obligations (CDOs), hedge funds, and private equity funds, invest in securitizations but usually have shorter investment horizons. Investors historically liked securitizations because of their diversification, perceived high credit quality, rating stability, liquidity, and strong transparency compared with other fixed-income securities. [Note: The financial crisis showed that some of those perceptions may have been incorrect.]

12. ***Anatomy of securitizations*** Common features of securitizations include (i) special purpose entities, (ii) credit enhancement, and (iii) liquidity support.

13. A secured corporate bond that has financial collateral triple-A-rated collateral would likely receive a rating tied to the unsecured rating of the corporate issuer. Despite the strong collateral, the bond would still be vulnerable to the risk of the corporation's bankruptcy. In contrast, a securitization backed by triple-A-rated assets likely could achieve a rating of triple-A by using a "bankruptcy remote" structure to isolate the collateral from the bankruptcy risk of the corporation. In the U.S., the common technique of isolating assets is to transfer them in a "true sale" to a special purpose entity, or "SPE." The SPE is formed so that it would not be consolidated into the corporation's bankruptcy estate. The true sale of the assets means that the transfer is without recourse to the corporation (other than for ordinary representations and warranties).

14. Credit enhancement provides limited coverage against the risk that a securitization's underlying assets perform worse than expected (i.e., that many of them default). The amount of credit enhancement necessary for a securitization to attain a triple-A rating depends on the credit quality of the underlying assets and other factors such as geographic diversity and sovereign risks.

15. "Pass-through" securitization structures are those where the cash flows on the issued securities are tied directly to the cash flows on the underlying assets. In contrast, some securitizations use structures where the issued securities have specified payment dates that might not match the cash flows on the underlying assets. The latter securitizations apply generally when the underlying assets are in the form of a revolving pool.

16. Securitizations often use "tranching," which refers to creating multiple classes of securities with a hierarchy of seniority. The securities with lower seniority absorb losses before the classes with higher seniority and provide credit enhancement to the classes with higher seniority.

17. Many types of entities are involved in securitizations: issuers, investment banks, investors, trustees, accountants, lawyers, and rating agencies. Basic issues for every deal include: asset type, accounting, regulation, bankruptcy/UCC,

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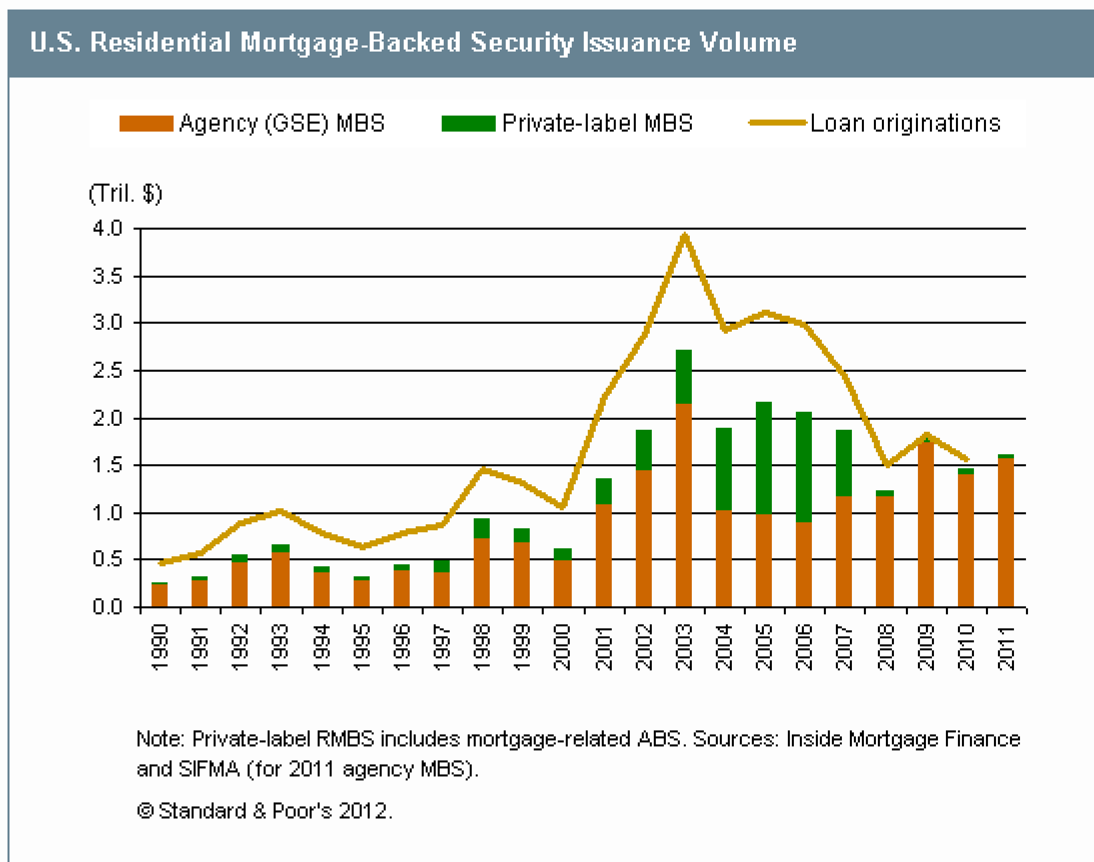
tax, securities law, investor issues/ERISA, and rating agencies.

18. ***History:*** Securitization started with the U.S. government-sponsored enterprises (GSEs): Ginnie Mae, Fannie Mae, and Freddie Mac. They started securitization in the early 1970s by packaging mortgage loans into residential mortgage-backed securities (MBS or RMBS). The 1980s brought the introduction of nonmortgage asset-backed securities (ABS) and asset-backed commercial paper (ABCP). Auto companies issued ABS backed by auto loans as funding alternative to issuing corporate debt. The 1990s saw the introduction of shelf registration (an expedited process for issuing securities in the U.S.) for nonmortgage ABS. U.S. accounting rules for securitizations started to change. Non-U.S. securitization markets CDOs and commercial paper (CP) arbitrage programs also got started in the 1990s. The 2000s saw the rise of the subprime mortgage asset class. There was global growth in securitization. Leverage increased with products like SIVs, CDOs-squared, and CDOs of ABS. Then the financial crisis came, which brought TALF and other facilities to help the market survive. The 2010s, so far, have been an era of regulation and low market volumes.

19. The volume of GSE MBS issuance grew rapidly after the 2000 recession. A few years later, the volume of private-label MBS issuance grew very rapidly and replaced the GSE issuance. The volume of ABCP issuance grew alongside the volume of private-label MBS issuance and was used to provide warehouse funding for the subprime mortgage loans that went into private-label MBS.

Chart 1



20. Today, the level of GSE MBS issuance is quite high and the volume of private-label MBS/ABS issuance is roughly where it was 15 years ago (i.e., much lower than it was during the mid-2000s). The government has supplanted the

private sector for mortgage finance. The private securitizations that are happening are almost entirely backed by assets other than mortgage loans. The total private securitization volume was $1.22 trillion in 2006 and just $150 billion in 2011. Also, the product mix has changed over time.

21. So, what went wrong? Low interest rates in the years after the tech bubble and the 2000 recession led to the formation of a credit-fueled housing bubble. Lenders used securitization as a tool for funding large volumes of loan originations. Benign economic conditions--years of rising home prices and low losses and delinquencies on mortgage loans--led to complacency and overconfidence in many quarters of the market. The risk in the loans ultimately became the subject of a game of musical chairs, being traded around among market participants with each trying to avoid being the one holding it when the music would eventually stop.

22. Today's securitization market is smaller but based on the real economy. There has been a broad repricing of risk. Both consumers and corporations have reduced their debt levels. The most egregious operators and products are gone. Lenders have abandoned the "originate to distribute" business model. Resecuritization arbitrage products (CDOs of ABS, CDOs-squared, SIVs) are gone.

23. Securitization is just a financing technique. The market has returned to where it was 15 years ago in terms of underwriting standards and issuance volumes. Today's environment, where government-supported programs account for most securitization activity, is not desirable or sustainable.

Methods Of RMBS Deal Performance Analysis

24. RMBS are different from other fixed-income securities because the timing of cash flows is uncertain. This is because homeowners can prepay their loans at any time. This means that investors need to consider prepayment risk.

25. There are several key types of drivers of performance on a residential mortgage loan. One driver is loan terms (e.g., fixed or adjustable interest rate). Different types of borrowers are drawn to different types of loans. Borrower attributes are a second type of driver. Examples include: occupancy status, location, and time in home. Other important borrower attributes include a borrower's credit profile and a borrower's reaction to prior refinancing or default opportunities. A third kind of driver is collateral. A fourth area is market conditions, such as interest rates, housing prices, and other economic conditions. Those factors can be simulated. However, regulatory changes and changes in servicer behavior cannot be simulated.

26. ***Borrower analysis: The three 'c's' of credit:*** Traditional analysis of a borrower considered the three "C's"--(i) character, (ii) capacity, and (iii) collateral. Character refers to a borrower's past payment behavior. Today, a borrower's credit score (e.g., FICO score) summarizes information about character. Capacity refers to a borrower's ability to afford payments on a loan. Collateral refers to collateral coverage for a loan in case the borrower defaults. There are three ways to measure collateral coverage with a loan-to-value (LTV) ratio. One is to use the LTV of a loan at the time of origination. A second way is to calculate the LTV taking into account any second (and higher) liens on the collateral. A third way is to estimate an updated LTV based on changes in the value of the home since the origination of the loan. There are various data sources from which an investor might try to determine an updated LTV on a loan.

27. An investor should always have the prospectus and the latest remittance report for each deal in its portfolio. Commercially available cash flow models/libraries sometimes do not correctly reflect the waterfall specified in a deal's prospectus.

28. Investors currently can get limited loan-level data. There are proposals to expand the range of loan-level data to

include a loan's origination channels (i.e., retail or wholesale) and the existence of second liens. Other data proposed to be provided include borrower debt-to-income ratios calculated in various ways, the length of employment, wage income, other income, level of income/asset verification, and number of mortgaged properties. Investors also want and need property-level information and security-level information.

29. The improved availability of loan-level data is one of the biggest changes in the market over the past 10 years. The data allows an investor to perform any type of analysis that it wants. Nonetheless, transaction remittance reports remain important. They allow an investor to observe the operation of triggers and other structural mechanisms within a deal. However, investors need to remember that mistakes happen in the calculation of monthly distribution amounts--sometimes the calculations do not adhere to the waterfall specified in the deal's prospectus. Loan-level data allow an investor to dig deeper than it can with just a remittance report. Analysis of historical prepayments and defaults is important, but it may not provide a strong indication of what the future will bring. Understanding future performance depends on understanding the key drivers rather than just extrapolating from the past.

30. Scenario analysis using a small number of specific scenarios is not enough to provide a real understanding of mortgage performance. Monte Carlo simulation analysis is the tool that can deliver real understanding.

31. Homeowner equity is a key driver of mortgage performance. Default risk increases as negative equity rises. Prepayments are constrained in negative equity situations. A mortgage loan is like a bond and two options. One option is the option to default. The second option is the option to prepay.

32. History shows that house prices are very volatile and very hard to predict. Projecting mortgage performance, bond values, and investment stability requires thorough house-price scenario analysis integrated with behavioral and cash flow models. One approach is to use historical home price movements to calibrate a simulation model of future home prices. The simulated path of future home prices can serve as the input to a model that estimates whether borrowers will have equity in their homes. Next, one can use a historical regression-based model to connect borrower behavior to the level of equity. Then, the level of equity can serve as the basis for estimating defaults and prepayments under each simulated path of home prices. Finally, the projected performance of the mortgage loans under each simulation path feeds into a waterfall model that allows valuation of a specific MBS under each path. [Note: The speaker does not say how to take the numerous path-specific valuations and combine them into an estimated unconditional value for the security.]

33. Valuing the prepayment option embedded in an MBS requires analyzing the volatility of home prices. In addition, the valuation of a security should consider the potential volatility of returns in addition to just the expected return.

34. House prices are "noisy as heck" (i.e., they display significant volatility). It is a fool's errand to try and predict them. The mission is to try and express the volatility in a model in a way that helps in valuing securities.

Securitization Pricing And Valuation Tools

35. ***Conceptual overview of valuation:*** There are several types of approaches. One is a "static spread" approach, which is based on turning a known market value on one security into a spread, which is then used for the valuation of other securities. Conversely, a known spread can be converted into an implied market price. A third approach is intrinsic value analysis. A fourth approach for estimating the value of a security is to calculate a "credit option adjusted spread" using simulations of both home prices and interest rates.

36. A static spread analysis is implicitly based on a single economic path. It is simple and highly transparent, but it may not be realistic. An approach based on a small number (two to five) of specific scenarios may also be transparent,

but still may not capture reality well. Monte Carlo simulation has low transparency and still may not capture reality well. A hybrid approach uses about 20 scenarios and assigns probabilities to them.

37. House price models have become an important subject. One approach is "geometric Brownian motion." Another approach is scenario inputs. A third approach is "momentum with mean reversion." A fourth approach is macroeconomic specification, which is based on income, employment, and interest rates.

38. Recipe for credit OAS: (1) an interest rate model, (2) a home price appreciation model (stochastic or other scenario), (3) a model for defaults and losses on the mortgage loans, and (4) a cash flow model to apply cash flows from the underlying to the cash flow waterfall of a specific bond.

39. The house price derivatives market is dead. This creates a challenge for getting inputs to calibrate a home price model. One approach is to make an ad hoc conservative adjustment to observed trends. Another approach is to use observed prices of bonds within the same deal to estimate an implied rate of home price appreciation.

40. ***What kinds of tools are available:*** Investors can choose between getting prices from third parties, such as dealers or pricing services, or getting tools to estimate prices themselves. Dealers provide static prices. They do not provide hypothetical prices for hypothetical conditions. Dealers provide an estimated market value but not a fundamental value. Prices from pricing services are similar to dealer prices. Pricing services produce estimates of market value and do not supply fundamental values. A key difference is that a pricing firm is focused 100% on producing prices. Pricing services get much of their information from their customers. However, there is a problem when a market becomes illiquid. Today, advisory services are also in the valuation businesses. Advisory firms provide feedback on a customer's portfolio and give feedback on the riskiest positions in a portfolio.

41. An investor that wants to estimate prices may need to get a whole family of models. The investor may need a cash flow waterfall model, a credit model, and a macroeconomic forecasting model. The investor will need to integrate the models. It may also need to get some way to obtain market color that influences prices. Most firms use a combination of outside services and tools licensed from vendors. In-house models are less common today.

42. The financial crisis brought an interruption of dealer marks (prices). Many firms have turned to increased use of valuation services and advisory services. Also, most users favor services and tools that reflect macroeconomic forecasting.

43. Using increasingly complex tools for estimating market values is a self-defeating exercise. Dealers and market makers tend to use simple models when they set actual prices. An investor shopping for a valuation service should look for one that supplies estimates for both market value and fundamental value. An investor should also favor a service that provides prices for different macroeconomic scenarios (i.e., prices conditional on hypothetical economic environments). An investor should favor pricing services that have experience both before and after the financial crisis. Some can provide fully integrated macroeconomic, asset-level credit, and waterfall models.

Consumer Credit Metrics And Evaluation

44. ***What is a credit score?*** A credit score apportions the total population risk of a credit product over the population that uses the product. That is, a credit score estimates the relative risk in different segments of the population defined by different score ranges. It does not assign probabilities of default. Rather it provides rank ordering of risk.

45. Most consumer credit scores are expressed as three digit numbers. The providers of credit scores periodically provide updated odds tables showing a frequency of default for each score band for recent periods. Over the past decade, as the economy has gotten riskier, the default frequencies for each score band have risen. Also, within each

score band, default frequencies differ for different credit products (e.g., mortgage loans versus bank cards).

46. Consumer credit scores are based on credit bureau data. Key types of data are trade lines, credit inquiries, and public records. Consumer credit scores do not use income data.
47. Population segmentation is a design feature of many consumer credit scoring models. The objective is to make each segment generally homogeneous so that the model can be optimally tuned for each segment.
48. Lenders use consumer credit scores to help define underwriting criteria for loans. They may define the criteria according to the highest loss rates that they will allow for loans of different sizes.
49. The OCC now requires lenders and score providers to perform validation tests on their scores. The validation test focuses on the KS (Kolmogorov-Smirnov) statistic. The validation exercise also examines consistency of a scoring model when it uses the data from the three different credit bureaus. A further part of the validation test is whether a model performs well in different regional economic environments, based on testing it on populations in different states with different combinations of home price declines and unemployment.
50. The distribution of the population in different VantageScore ranges (superprime, prime, near-prime, and subprime) has been stable over time. However, there is a lot of movement of individual consumers across categories. Default rates for the superprime and prime populations peaked in 2009 and have been coming down. Default rates for the subprime population have been high since 2006.
51. Consumer credit scores do not consider age, address, employment, income, or sex. This is to comply with the Equal Credit Opportunity Act (15 U.S.C. § 1691(a)(1)).
52. The objective of a consumer credit scoring model is to achieve separation or "divergence" in the scoring of the "good" population from the "bad" population.
53. Consumers with mortgage loans tend to have higher FICO scores than those who do not. Also, lenders are focusing new mortgage loan originations on consumers with the highest FICO scores (800-850). Performance is improving over time. However, consumers' payment preference has changed. Historically, mortgage loans had the highest payment priority. Following the financial crisis the payment priority has been auto loans first, credit cards second, and then mortgage loans.
54. The risk (default odds) for a given score range shifts over time as macroeconomic conditions change. As conditions change, a lender needs to determine when and how much to change strategies that use credit scores.
55. "Strategic default" refers to when a borrower who is able to afford payments on his loan defaults anyway. A borrower's propensity to strategically default depends on several factors:
    - geography (greater propensity in the states that have experienced the largest home price declines)
    - whether a state uses judicial or nonjudicial foreclosure (greater propensity in states that use judicial foreclosure)
    - whether a state allows a lender to seek a deficiency judgment against a borrower for the amount of a mortgage loan not recovered through foreclosure.
56. Compared with the general population of defaulters, borrowers who commit strategic default (about 28% of the defaulting population) have better FICO scores, lower credit utilization, lower retail credit balance, shorter length of residence in their homes, and higher incidence of credit inquiries prior to default.

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Featured Address: Congressman Ed Royce

57. One of the vexing problems in Washington is the implementation of the Dodd-Frank Act. We are about 13% of the way through the implementation. There ought to be a technical correction bill to fix various problems, but it is unlikely that such a bill will actually pass. The burden of compliance with the Dodd-Frank Act may be too great for smaller financial institutions. But the larger problem--one for the U.S. economy as a whole--is regulatory instability and complexity. Recently, Singapore offered 20 years of regulatory certainty and stability as an inducement to court a major financial institution to relocate to that country. Regulation is also a selling point for Europe. The heavy burden of capital market regulation in the U.S. is making U.S. capital markets less competitive than foreign markets. Capital is mobile and it might leave the U.S. for Europe and other locations. An example of capital mobility is the effect of Section 404 of the Sarbanes-Oxley Act on the pace of initial public offerings in the U.S. Last year only 11% of global IPOs were in the U.S., compared with more than 50% before the passage of the Sarbanes-Oxley Act. That fact should be a rallying cry to reduce the complexity and burden of the Dodd-Frank Act.

58. The GSE act in 1992 was a bad move, because it started the GSEs down the road to affordable housing goals (1). The GSEs were induced to get into subprime mortgages and to take on too much leverage. Leverage at the GSEs reached 100 to 1. By comparison, the right number for most financial institutions is around 10 to 1. Politicians pressured HUD to make the GSEs lower their mortgage loan standards to promote homeownership. The Federal Reserve had some insight about growing risk at the GSEs in 2004-2005, but politicians turned a deaf ear.

59. Another grave error was the Federal Reserve's policy of low interest rates for four years. They produced negative real interest rates and created the housing bubble.

60. Bifurcation of GSE regulation between OFHEO (for safety and soundness) and HUD (for housing goals) has been and continues to be a major problem. Likewise, the activities of the SEC and the CFTC need to be harmonized. America's system of balkanized regulation is very confusing to foreign regulators and will make it hard for the U.S. to coordinate financial regulation with foreign regulators.

61. Mandatory risk retention (2), including the definition of "qualified residential mortgage," is an additional item that needs to be addressed through a technical corrections bill. However, Senate Majority Leader Harry Reid has said that there will not be a corrections bill to Dodd-Frank. This is serious because the Dodd-Frank Act is blocking some of the things that America needs for an economic recovery. [Note: It seems that Congressman Royce would intend more than merely technical corrections.] The FDIC's new "orderly liquidation authority" under the Dodd-Frank Act is another area that creates problems and that could be fixed in a corrections bill (3). The orderly liquidation authority creates uncertainty about the rules for handling the bankruptcy of a major nonbank lender.

62. GSE reform is another area that demands attention. America created the GSEs, but has nothing to show for the effort in terms of higher homeownership rates compared with other developed countries. Private capital has got to play a role in fixing the GSE situation. A wise policy would be one that slowly eases the private sector back in and slowly eases the government out. Replacing the implicit government guarantee with an explicit one would not be a good solution. The federal government is not good at pricing risk. An example of how the government misprices risk is the federal flood insurance program.

Featured Address: Congressman David Schweikert

63. Learning about private-label MBS has been one of Congressman Schweikert's activities during his first year in Congress. If a new Congressman walked into Congress and proposed creating a replacement for the GSEs, he would be confronted with conflicting priorities from investors, issuers, and others involved in the process. The challenge is

creating a completely standardized process for lending, servicing, and securitization in order to have a smoothly functioning market that allows for trading on a "to be announced" or TBA basis. The chairman of the House Subcommittee on Capital Markets and Government Sponsored Enterprises (Rep. Scott Garrett) has a love of covered bonds. Rep. Schweikert has an interest in primary mortgage insurance. His staff keeps a role of butcher paper on which it is writing down all the necessary steps for mortgage lending and securitization. He wants to have to have standardized loan-level data. He wants to make the private-label market very standardized and tradable. For the GSEs, he wants the guarantee fees to reflect real risk.

64. FHA is undercapitalized. FHA-insured loans now account for about 40% of the new origination market. The high volume of current FHA production is bailing FHA out. However, FHA could be at risk if there is a "blip" next year.

65. Rep. Schweikert proposes a system where lenders would take deeds-in-lieu of foreclosure and then lease the homes back to the borrowers. However, the moral hazard problem has not been solved. Rep. Schweikert urges all audience members to reach out to their Congressman to talk about securitization and to urge them to fix the problems of Dodd-Frank.

Monday, Jan. 23, 2012

Welcome Address

66. Last year was a year of revival for some sectors. Auto ABS is firing on all cylinders. Investors in auto loan ABS indirectly set the interest rate that consumers pay on auto loans. Auto loan ABS help automakers provide financing to consumers. Auto loan ABS contribute to the vitality of the automobile industry. CLOs are a significant source of funding for loans to companies that have chosen to use higher leverage in their capital structures. CLO investors help the market for leveraged loans. The CMBS market also appears to be on the path to recovery.

67. On the other hand, the U.S. private-label RMBS sector remains stalled. The low level of RMBS issuance has created a dearth of supply in triple-A-rated bonds. Partly in response, U.S. investors have been purchasing covered bonds issued by overseas issuers. In a similar vein, U.S. investors have shown keen interest in foreign ABS.

68. New and emerging laws and regulations are posing serious problems for the U.S. securitization industry. Also, the policy responses to the financial crisis have created uncertainty that prevents securitization from achieving a healthy revival.

69. There are 4,600 registrants at the conference and the ASF expects the final tally to be close to 5,000. This makes the ASF conference the largest capital markets conference in the world. Las Vegas is the only place with suitable facilities for a conference the size of the ASF event. The event will likely be in Las Vegas again next year.

70. The hurricane of new laws and regulations that affect securitization has been one of the main areas of focus for the ASF. Educating policymakers and advocating for the securitization industry are key parts of what the ASF does. Also, after Washington produces new laws and regulations, the ASF helps the industry implement them by leading efforts to develop standardized approaches.

71. The top three issues are the Volker rule (4), the conflict of interest rule (5), and the market-risk portion of the bank risk-based capital rules (6).

Securitization Market Outlook

72. ***The U.S. economy:*** One panelist is cautiously optimistic about the U.S. economy. The auto ABS sector is strong. The CLO sector is coming back. But other securitization sectors are struggling. In particular, nonagency RMBS is stalled. Two challenges are uncertainty about the global economy and uncertainty about regulation.

73. Another panelist states that several countries in Europe are likely to have a recession but that the U.K. will not. The worst challenges are in the countries in the periphery: Greece, Italy, Spain, Portugal, and Ireland. The problems are serious and the banking systems of some countries are effectively insolvent.

74. A third panelist focuses on the issue of Greek debt and the proposed loss sharing arrangement and debt swap. He expects the debt exchange to happen and that Greece will technically avoid default. It is unclear whether the debt exchange will count as a triggering event for credit default swaps. It is also unclear whether there will be contagion effect on the other countries, like Portugal. The overarching problem is that the eurozone does not have a single, unified fiscal policy, which is an inherent disadvantage for addressing imbalances.

75. Loans from the ECB and from official lenders are senior to other debt. This creates uncertainty for bond investors and creates an impediment to bond issuance. European securitization issuance in 2012 will be around the same level as in 2011, but spreads are likely to tighten.

76. ***Regulation:*** One panelist emphasizes that the ASF has been active in working on regulatory issues. Another panelist remarks that TALF was an example of a positive policy reaction to the financial crisis.

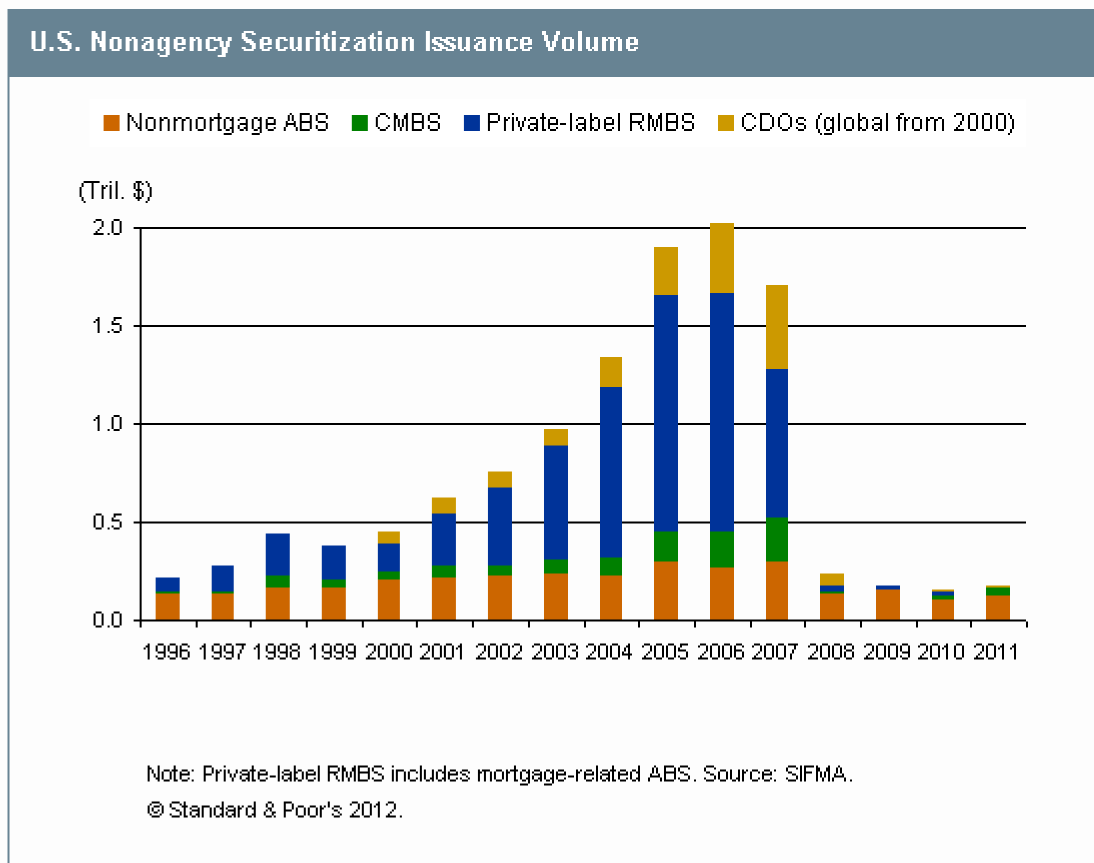
77. A third panelist observes that it is difficult to work on some of the policy issues, because the proposed rules to implement the provisions of Dodd-Frank have not been released. He notes that the Volker rule could impair liquidity of securitizations by limiting the degree to which dealers can bid and by limiting the ability to compensate traders. Another issue is that capital requirements for downgraded securitizations are too high compared with similarly rated corporate bonds. He suggests that capital regulations allow higher leverage (i.e., lower capital) for the performing portion of a security's underlying collateral.

78. One panelist highlights (i) the proposed Volker rule (7), (ii) the proposal for an alternative to credit ratings in the risk-based capital guidelines (8), and (iii) the proposed Basel liquidity rules (9). He notes that the proposed regulations are not just a matter for banks but also for the whole economy. The regulations will effect capital formation and job creation. Any rule or proposed rule in isolation might not be very damaging to the economy. However, the confluence of all the rules together is very dangerous for the capital markets.

79. Another panelist focuses on the change in consumer behavior with respect to the payment order of their debts. In the past, the conventional wisdom was that consumers would pay their mortgage loans before their auto loans and their credit card bills. The reality of the financial crisis was just the opposite. This requires a change in thinking. Likewise, the traditional view was that loss severities on residential mortgage loans would be modest because the homes would serve as strong collateral. The reality of the financial crisis was different. Residential mortgage securitization is likely to remain sluggish because banks have cheap funding from deposits and are holding mortgage loans on their balance sheets. Investors likely will accept new deals only if they are backed by super-high quality loans. He believes that it would be desirable for a market to develop for deals backed primarily by loans on nonowner occupied homes (i.e., loans on investor-owned properties). This would address the fact that millions of households are likely to move from being homeowners to being renters over the next few years. Also, the conflicts of interest in servicing must be addressed in order to restore investor confidence.

80. One panelist explains some of the legislative and regulatory proposals. One proposal would attempt to create a TBA market for private-label RMBS. It is not a GSE reform proposal, but rather an attempt to supplant the GSEs. Another proposal is to wind down the GSEs over the next 10 years. It calls for trying to create a TBA market for private-label RMBS. A third bill would attempt to streamline the primary housing finance system by creating a centralized database of mortgage ownership.
81. Another panelist explains that the market shares of the GSEs grew while the market share of the private sector declined. It will take a long time to wean the housing finance system from the GSEs. GSE reform is unlikely until after the presidential election. Whatever happens may depend on which political party has control of the Senate. A challenge to the development of a U.S. covered bond market is that the FDIC is concerned about a potential reduction in the assets that it could seize when a bank fails. The panelist expects no legislation will successfully pass both houses of Congress and be signed by the President in 2012.
82. Even if the proposed U.S. covered bond legislation passes, it would provide for a maximum amount of covered bonds of only $489 billion. That is only 11% of the amount of outstanding MBS from Fannie Mae and Freddie Mac.
83. There are 840 troubled banks in the U.S., but the FDIC closed only about 100 last year. The FDIC is dragging out the process of resolving troubled institutions. Also, the burden of complying with new regulations is very difficult for small banks.
84. U.S. structured finance issuance has been very low since 2008. However, securitization will not disappear, because it is very attractive to investors. Structured finance securities are generally backed by strong collateral. Structured finance investors will likely continue to use ratings even if regulators remove ratings from regulations. Other panelists generally agree.

Chart 2



85. ***Likely issues a year from now:*** The panelists identify the following items as ones that will likely be issues at next year's ASF conference:

- Regulations
- Presidential inauguration and its effect on regulations
- Investor rental housing and transfers of mortgage servicing rights from large to small banks
- Europe
- GSE reform

Implications Of European Sovereign Debt Crisis On Securitization

86. There are close connections between the European sovereign debt crisis and the financial sector and between the financial sector and the structured finance market. Banks are the dominant securitization issuers in Europe.

87. One panelist explains that the European sovereign debt crisis has three key themes. One is high debt levels in several countries. The countries had high debt levels (i.e., debt greater than GDP) for about 10 years before the crisis, but the market accepted it. The market's acceptance of the high debt levels was partly due to the mistaken belief that the eurozone treaty would lead to fiscal convergence. Of the 17 eurozone countries, only Finland and Luxemburg actually met the requirements of the treaty.

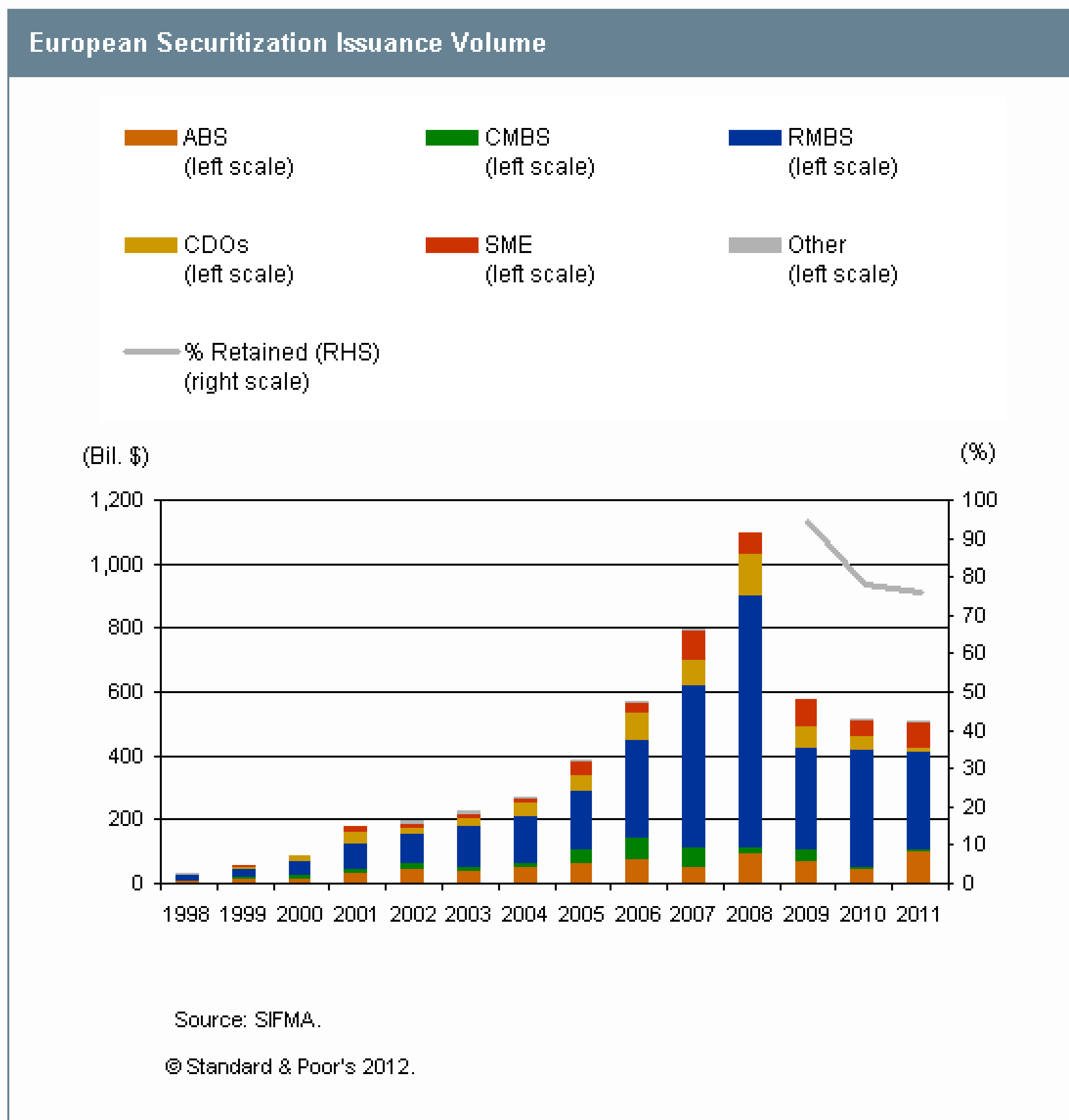
88. The second theme is that government debt is only part of the story. Bank debt rose even faster than government debt

in the decade leading up to the financial crisis. European banks are exposed to government debt and they are also exposed to weakening private sector debt in a period of weak growth.

89. The third key theme of the European debt crisis is the policy response. The policy response has been mostly in the nature of crisis management in terms of restructuring efforts and liquidity support. The longer-term policy response must be fiscal convergence. The crisis has highlighted a stark policy choice: there will be either stronger integration (fiscal and political) or there will be fragmentation. The political leaders have clearly chosen integration and the preservation of the currency union. However, there is domestic opposition in many of the countries because of the necessary austerity measures. Historically, part of the motivation for economic integration in Europe was to reduce the likelihood of political rifts that had led to two world wars. The current European debt crisis could be a modern motivation for the countries to continue the path toward stronger integration.

90. Another panelist notes that European banks are finding reduced availability of unsecured funding. Secured funding, through securitization or covered bonds, continues to available and attractive. Securitization issuance volume declined sharply in 2008 relative to 2007, but it has partly recovered in 2010 and 2011. For 2011, issuance was at roughly the same level as 2000. In the immediate aftermath of the financial crisis, the prevailing view in Europe was that all securitizations were bad and that sovereign debt was good. Later, the view evolved with the realization that most of the problems were concentrated in U.S. mortgage-related paper and that European securitizations had not suffered. Also, the issues with sovereign credit came to light.

Chart 3



91. One panelist asserts that a big issue in some countries is the link between sovereign ratings and the rating on securitizations. A downgrade of a sovereign's rating may trigger the downgrading of securitizations in the country. That, in turn, can disqualify the affected securities under investors' investment guidelines.

92. Another panelist states that U.K. RMBS account for 70% of total European securitization issuance, and the product has performed well, returning 2.1% in 2011. Also, U.K. RMBS spreads have been more stable that spreads on other products during 2011.

93. One panelist estimates that there is about $500 billion of legacy securitizations on European bank balance sheets, consisting of about half U.S. deals and half European deals. Some of the assets have been sharply downgraded and incur high risk-based capital charges. Selling the securities that have not been downgraded would not provide capital relief for a bank. Selling downgraded securities would provide capital relief but may force banks to book losses on

the sales.

94. Another panelist echoes and earlier comment that investors strongly favor secured exposures to banks over unsecured exposures. Interestingly, in the second half of the year, issuance of U.K. RMBS was greater than covered bond issuance. This may have been a result of lower value ascribed to the recourse feature of covered bonds, because the issuers have weaker credit quality. The panelist also echoes the point that capital changes for downgraded securitizations can be very high. He implies that that the downgrades tied to sovereign downgrades were too severe and that the associated risk-based capital charges are too high.

95. One panelist observes that the European policy response to the disruption of the securitization market has been less effective than the U.S. response. The TALF program in the U.S. was a good policy response, because it was directed at investors and helped to create a floor on values. The European policy, in contrast, was directed at issuers.

96. ***Final comments:*** Panelists offer the following final comments:

- Policymakers need to recognize the heterogeneity of securitizations and not tar the whole sector. In addition, many banks face higher capital charges because of securitization downgrades tied to sovereign downgrades, even though the underlying assets are still performing well.
- There will not be an exit from the currency union.
- The U.K. is not part of the currency union and it is somewhat insulated.
- The market is pricing for a "muddle through" scenario for the European debt crisis.
- Securitization is underutilized in Europe.
- Reliance on covered bonds raises risks for unsecured lenders of the issuing banks.

Global Securitization Policy Reforms

97. ***New and proposed U.S. securitization rules:*** One panelist highlights a number of new rules and explains whether they apply just in the U.S. or globally.

Geographic Scope Of New And Proposed U.S. Securitization Rules

Rule	Subject	Geographic scope
17g-5 (SEC)	Facilitates unsolicited ratings	U.S. only*
15Ga-1 (SEC)	Disclosure of repurchase requests	Unclear
193 (SEC)	Issuer due diligence	U.S. (public deals)
15d-22 (SEC)	Permanent periodic reporting	U.S. (public deals)
17g-7 (SEC)	Rating agency reports on representations and warranties	Global§
Third-party due diligence	Proposals to require filing of third party due diligence report	Unclear
Conflict of interest	Prohibits conflicts of interest in securitizations	Global†
Regulation AB	Securitization disclosure	U.S. (public deals)
Risk retention	Mandatory risk retention by securitization issuers	U.S.‡
Volker rule	Prohibits proprietary trading by banks	Global**

*The SEC has suspended global application. §Applies to a U.S. rating agency that rates securities of a foreign issuer. †Nothing in the Dodd-Frank Law limits the geographic scope. ‡Europe has a separate risk-retention rule. **Covers U.S. branches of foreign banks.

98. ***European regulatory system:*** One panelist explains that the European regulatory system now consists of both national regulatory bodies and supranational regulatory bodies. In the U.K., the FSA is going to be dissolved and replaced by three new agencies operating under the auspices of the Bank of England: the Prudential Regulation Authority (PRA), the Financial Conduct Authority, and the Consumer Protection and Markets Authority. At the top

of the EU framework there is the European Systemic Risk Board (ESRB). Under the ESRB there are three main bodies: the European Banking Authority (EBA), The European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities Markets Authority (ESMA). ESMA is the body that creates the European regulations on the rating agencies.

99. ***European Banking Authority:*** One panelist explains that the EBA is very new. It started operating at the beginning of 2011. Its mission is stability. It has a regulation department, which focuses on the capital regulation directive (CRD). It is also responsible for the European risk-retention rule. The EBA's second department is oversight. The oversight department, for example, analyzed what would be necessary for the European banks to achieve 9% tier I capital.

100. ***Rating agency regulation:*** One panelist focuses on Rule 17g-5. The rule has been around for more than a year, and it is designed to partly address rating agency conflicts of interest by facilitating unsolicited ratings. The rule works by making all information that a hired rating agency receives available to nonhired rating agencies. From an arranger's perspective, the increased cost of dealing with Rule 17g-5 is manageable. In addition, market participants have learned to work with the rule to avoid creating delays. However, there have been almost no unsolicited ratings. That may mean that the rule is not working as intended. On the other hand, some rating agencies have published a small number of "unsolicited commentaries" on deals they were not hired to rate.

101. Another panelist compares the situation for rating agencies in Europe with the situation in the U.S. The European model of rating agency regulation focuses on controlling the rating agencies with examinations and requirements (10). The U.S. model is to try to make rating agencies compete. A concern with the European approach is that it builds rating agencies into the financial regulatory framework. There is a danger of political influence on the regulation, especially in relation to ratings on sovereign issuers. There is even a debate in Europe about whether rating agencies should be allowed to rate sovereign issuers.

102. A third panelist says that regulators put rating agencies into a difficult position by using ratings in regulations (such as the capital regulations). There are conflicts of interest. The rating agencies now need to be regulated because of the position in which they have been placed by regulators.

103. A fourth panelist argues that the real issue is not regulation of rating agencies but rather disclosure--getting information into the hands of investors. Rating agencies are important in the dissemination of information. Rating shopping is the challenge. Underwriters always shop for "best execution." Increasing the number of rating agencies exacerbates the problem of rating shopping. Until Regulation AB (11) is updated, investors will not have enough information to do proper analysis themselves. Rating agencies allowed credit enhancement levels to decline on RMBS in the early 2000s while the risk of the underlying loans was rising. However, it is not clear whether the cause was conflicts of interest or weak judgment.

104. ***Risk retention:*** One panelist compares the proposed risk-retention framework for the U.S. (12) with that of Europe (13). The U.S. proposal focuses on the sponsor. It contemplates four forms of risk retention: vertical, horizontal, L-shaped, and representative sample. It provides for a premium capture reserve account to use as a first-loss buffer. The proposal would have extraterritorial reach, but the SEC would allow a limited exemption for foreign deals. A U.S. issuer that issues abroad would be subject to the U.S. rules. The U.S. proposal would have an exemption for qualified residential mortgage (QRMs).

105. Another panelist describes the European risk-retention rule, Article 122a. In Europe, the investor is responsible for risk retention. The investors must make sure that the issuer of a securitization has retained risk. This translates into information reporting that issuers must supply to investors. The EU allows for vertical and horizontal risk retention,

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and provides for risk retention with a revolving pool. The EU does not use the L-shaped structure for risk retention. Once an issuer picks a type of risk retention, it must stick with that approach. The EU framework has no QRM exemption.

106. A third panelist explains that the EBA overseas the European risk-retention rule. The EBA wants to achieve harmonized risk retention for the U.S. and the EU.

107. A fourth panelist says that the market is trying to figure out what the impact of risk-retention rules will be in the U.S. Market participants want to understand what risk retention will cost and how it will affect the volume of credit. Many market participants want the definition of QRM to be very broad, so that many loans would be exempt from risk retention. The current proposal has a very tight definition that would include only about 20% of existing mortgage loans. The premium capture reserve account feature is still not fully understood. The premium capture reserve account feature likely would upset the economics of how some loans are currently originated.

108. Another panelist explains that risk retention serves as a backstop that addresses the practical limitation of how well rating agencies can gauge credit risk. Risk retention limits leverage and may reduce the propensity for bubbles to form. A risk-retention rule needs to be tight in order to be effective. The rule should not allow for multiple forms of risk retention. The vertical form is especially weak in restraining leverage. Premium capture attempts to address potential evasion of the risk-retention requirement. It attempts to make sure that a deal's sponsor uses its own funds for risk retention.

109. ***Regulatory complexity risk:*** Regulators should not get bogged down in minutia. There is a problem of missing the forest for the trees. Markets that are functioning well can be made dysfunctional by ill-conceived regulation.

Future Of U.S. Mortgage Finance

110. ***Shadow inventory:*** One panelist states that the housing market is very sluggish. There is a terrible oversupply condition. The shadow inventory is huge. It includes almost 2.9 million loans that are a year delinquent or in foreclosure. There are roughly an additional 400,000 foreclosed properties awaiting liquidation from "real estate owned" (REO) status. There are likely to be around 8 million to 10 million homes in jeopardy over the coming years.

111. On the other hand, housing affordability is at a 20 year high. Despite strong affordability, home sales are sluggish because lending standards are very tight and many homeowners cannot qualify for refinancing loans.

112. The supply of home for sale greatly exceeds the demand. A potential solution to the supply-demand imbalance would be modifications of existing mortgage loans that reduce the principal amount of loans. That would reduce the oversupply condition by giving more homeowners an incentive to not default. Another potential solution would be to loosen lending standards to help revive the demand side of the housing market.

113. ***Challenges for originators:*** Another panelist asserts that regulations and rating agencies create challenges for mortgage loan originators. The regulatory environment has too much uncertainty. Rating agency criteria is in flux, which creates uncertainty for pricing and execution. Originators also encounter differing credit enhancement levels from the different rating agencies. Credit enhancement levels are much higher than they were in 2007. With the level of current uncertainty, it is difficult for trust and confidence to be reestablished.

114. ***Regulatory outlook:*** One panelist sates that the appearance of housing policy bills is a positive development. Congress moves slowly, but it is starting to move. The various bills that have been introduced reflect both options 1 and 3 from the Treasury Department's white paper on revamping the housing finance system (14). One issue is whether and how to wind down the GSEs and how to replace them with private-sector activity. A key question is

whether the U.S. residential mortgage market needs a government wrap. Some believe that a wrap is necessary (option 3). One bill would use an explicit government wrap but would add a private-sector first-loss exposure. A different bill would drop the government wrap and would try to create a fully private-sector substitute. A so-called option 4 (an option not contained the Treasury Department white paper) would be to retain the current system of housing finance. That option is reasonably likely because the current system has so much inertia and is so deeply embedded in the financial system.

115. ***FHFA and Fannie/Freddie conservatorships:*** Another panelist notes that the conservatorships of Fannie Mae and Freddie Mac are more than three years old. The Federal Housing Finance Agency (FHFA) is the conservator. The conservatorship was originally expected to last for six months. HARP 2.0 is about to start (15). FHFA is using lawsuits to enforce obligations of issuers and others (16). FHFA is trying to shrink the Fannie and Freddie portfolios.

116. ***Reviving private-label:*** One panelist observes that there is no nonagency execution right now. It is not economical for an originator to issue private-label MBS or to originate loans that do not qualify for GSE programs. Execution through the GSE programs is the only avenue right now. Various policymakers and commentators want to draw private capital back to the residential mortgage sector. To revive private-label MBS activity, policies need to make private-label execution competitive. Rating agencies appear to view residential mortgage loans as riskier than do other market participants.

117. Another panelist remarks that private capital is still leaving the mortgage sector. The industry needs to get past some of the open issues. The QRM standard is reasonable (17). Rating agencies are tough on all sectors, not just residential mortgages. On the other hand, there are some real policy problems. For example, capital charges on mortgage servicing rights (MSRs) are all wrong and have pushed MSR prices too low (18). A great policy would be to put agency MBS on the federal balance sheet and to give them a 0% risk weight under the risk-based capital rules. Good borrowers need to be helped to refinance their loans into lower interest rates; HARP 2.0 may not go far enough. The Fed's white paper is good, but it threw MSRs under the bus (19).

118. Another panelist argues that the private sector is not likely to take more risk unless it receives enough transparency to understand the risk. HARP 2.0 is a response to criticisms (limitations) of the earlier refinancing programs.

119. Most panelists are cautiously optimistic about the future of housing finance in the U.S. One believes the market will be the same five years from now.

Mortgage Underwriting And The Impact Of QM

120. ***Meaning of "QM" and "QRM:"*** One panelist asserts that there is a widely held belief that a main cause of the financial crisis was that borrowers received mortgage loans that they could not afford to repay. A qualified mortgage or "QM" is a traditional mortgage loan where the lender has assessed the borrower's ability to repay (20). QM is different from the notion of qualified residential mortgage loan or "QRM," which is a feature of the risk-retention rule (21). The law does not specify the underwriting requirements for a QM, but it does for a QRM. The key general requirement for a QM is that the lender assess the borrower's ability to repay. Failure to do so can result in liability for a lender and can create a defense to foreclosure.

121. The law provides for both a safe harbor and a rebuttable presumption. Operationally, the difference between the two is huge, because a safe harbor is much cheaper to work with. A rebuttable presumption framework may lead to excessive litigation.

122. The definition of QRM calls for a 20% down payment. That requirement is controversial, because there are many loans with small down payments. The 20% requirement may reduce the availability of credit to many consumers.

123. ***Recent underwriting:*** One panelist notes that recently originated mortgage loans have very strong credit quality. Lenders have tightened their standards. Loan-to-value ratios (LTVs) are low and borrower credit scores are high. The tightening comes from both concern about credit and concern about the risk of put-backs (i.e., repurchase demands) from Fannie Mae and Freddie Mac. Another panelist states that the tightening of underwriting standards may cause government enforcement actions, because the tight standards may discriminate against minority borrowers.

124. Another panelist focuses on the issue of potential assignee liability for violation of the QM requirements. The concept of QM focuses on consumer protection. In contrast, the concept of QRM focuses on the funding markets (i.e., through the risk-retention rule).

125. One panelist asserts that the private-label market is unlikely to replace the market for agency MBS within the next five years. Possible ways that the private-label sector could gain market share would be through a reduction of the GSE loan size limits or through expansion of covered bonds in the U.S.

126. Another panelist says that the capital markets will have only limited ability to fund non-QRM loans. Because of risk-retention requirements, such loans would likely have to remain on originator balance sheets.

127. A third panelist focuses on how the definition of QM may define the size of the mortgage market. The issue of safe harbor versus rebuttable presumption is important, because the latter has more legal risk. Another key issue is the types of loan products that can be QMs. Some alt-A products ("alternative" mortgage loan products) are not eligible for QM status. Those products accounted for around 10% of the market. The statutory QM definition does not specify a maximum debt-to-income ratio (DTI), but regulations might impose one. Another issue is points and fees. As written currently, 21% of the loans being originated today would fail the 3% limit on points and fees. This is a significant challenge that the Consumer Financial Protection Bureau (CFPB) is wrestling with now. The impact is much greater on small loans than on large ones.

128. Another panelist emphasizes the important difference between regulations that affect the price of a given loan product and regulations that entirely eliminate the product. He notes that the QM provision essentially reduces the HOEPA (22) limit on points and fees to 3%, because no lenders will be willing to make loans that fail to qualify as QMs.

129. ***Risk retention and ratings:*** One panelist explains that one of the rating agencies considers risk retention by an originator in its analysis of mortgage loans.

130. Another panelist asserts that the TBA market for agency MBS should be preserved with the government guarantee on the securities. However, the government should try to sell a "first-loss" exposure to the capital markets. He also recommends using a fixed-loss severity percentage for allocating losses to the first-loss exposure. The government should absorb the variability of losses and should manage loss mitigation efforts (i.e., activities that may affect loss severity). The technology for selling first-loss exposures to the private sector already exists. Freddie Mac did such a thing in its MODERNs deal in 1998 (23).

RMBS Restart

131. ***Regulatory environment:*** One panelist explains that it has been about three years since the "big meltdown," and America is now in the final stage of the reregulation of the mortgage industry. One of the main regulatory developments is risk retention (24). It is Washington's philosophical response to the mortgage side of the financial crisis. Key features of the rule proposals are the definition of QRMs and the premium capture reserve fund requirement. Because of backlash after the proposal, the panelist expects the risk-retention rule to be re-proposed in

a more acceptable form. Another key feature of the regulatory environment is the proposed rule on conflicts of interest (25). GSE reform proposals are another important area. There has been so much rule development that it has temporarily derailed the SEC's project to revise Regulation AB (26).

132. ***Efficiency of execution:*** There have been a small number of new private-label RMBS deals in the last few years, and they were very well received by investors. However, volume has been too small to give a real test of the market's depth. The GSE side of the RMBS market is so strong that it is completely dominating the residential mortgage space. Execution through agency MBS is very efficient. Both regulatory uncertainty and the level and variability of rating agency credit enhancement levels make nonagency execution much less attractive. The small proportion of loans that do not qualify for agency MBS execution are staying on lenders' balance sheets.

133. Another panelist (from a rating agency) states that although his rating agency is about to release an updated mortgage model, it wants to retain the ability to make qualitative adjustments on individual pools. The first panelist asserts that lenders and arrangers need to be able to precisely predict rating agency credit enhancement levels in order to price loans efficiently. He asserts that, in contrast to the uncertainty involved with private-label execution and the rating agencies, he has certainty about the cost of agency-MBS execution. There is simply too much uncertainty about the capital structure of private-label RMBS. A third panelist observes that the cost of credit to consumers has to be adjusted to cover the real cost of funding their loans.

134. ***Rebuilding investor confidence:*** One panelist states that some investors remain skeptical of the risk-return proposition of private-label RMBS. Others face significant regulatory impediments. Still others have senior managements that want to avoid securitizations because of fear a potential repeat of what happened (i.e., illiquidity of private-label RMBS and severe declines in market values). There will have to be a lot of rebuilding of trust. A key part of the ASF's project RESTART is addressing how the mechanics of many private-label RMBS deals broke down during the financial crisis. The deals always included the feature of repurchases for breaches of representations and warranties, but there was little focus on the ability of the relevant parties to fulfill that repurchase obligation. Likewise, although all deals included trustees, there was a lack of clarity about a trustee's role in enforcing rights and claims for the benefit of investors. Project RESTART should straighten out some of these issues.

135. ***Data:*** One panelist explains that there has been a strong improvement in the availability of loan-level data. Some of the improvement has come from the GSEs, which are demanding more data from servicers. One the private-label side, many issuers/servicers provided loan-level data, but there was no standardization. There are data aggregators who aggregate and sell the data. Nonetheless, loan-level data is not easily and cheaply accessible. It must become easily accessible and cheap in order for the private-label RMBS sector to revive. The ASF has done a lot to help with standardization of data. Investors need the data, because they cannot properly rely on rating agencies and investment banks to supply the data that they want.

136. ***Rating agency changes:*** One panelist states that many of the new regulations for rating agencies are appropriate. The regulations help to address conflicts of interest and promote completion. Rule 17g-5, which is intended promote unsolicited ratings, is a good thing because it attempts to address rating shopping. Another panelist (an investor) explains that an investor's reaction when a rating agency publishes an unsolicited rating or unsolicited commentary depends on whether the investor decided to buy the subject security. On balance, more views in the market (i.e., ratings) are better. A third panelist agrees. He notes, however, that the regulatory capital implications of an unsolicited rating can be detrimental to a regulated investor. This is an important issue for banks. It can be a shock for a bank to find out that a rating agency that it did not expect to be on a deal has published an unsolicited rating.

137. ***Deal mechanics:*** One panelist explains that deal mechanics are going to change because of both regulatory requirements and investor concerns. Issuers will have to build platforms that can do required due diligence and life-of-deal reporting. Issuers will have to make substantial investments in infrastructure. The new proposed

Regulation AB would apply all the disclosure requirements of the public market to private placements (27). This could alter the balance of relative costs and benefits for public and private execution. Documents for private-label RMBS are likely to evolve, but they will not become fully standardized across issuers. However, they will start to address repurchases and certain other issues more exhaustively. A second panelist argues that private-label RMBS need to become structurally simpler. Deal structures became too complicated in the period leading up to the financial crisis.

138. Two panelists debate briefly about the range of mortgage products that the private-label sector will include. One contends that the sector should return to straight, clean, prime-quality jumbo mortgage loans. A second one argues that the private-label business will never revive if it is confined to such loans.

139. One panelist ventures that some of the reforms may be misplaced. The next crisis for the market is unlikely to be a repeat of the last one. The reforms being deployed address the problems of the last crisis and are not forward looking

140. ***Washington:*** One panelist asserts that Washington wants a revival of the private-label RMBS sector. Another panelist asserts that many issues are interconnected. For example, the fact that there is no longer any demand from SIVs is an issue all by itself.

141. ***Conclusion:*** One panelist says that RMBS 2.0 (i.e., the new/next generation of private-label RMBS deals) must incorporate lessons from the housing crisis if the private-label sector is to endure and provide a stable source of funding for residential mortgage loans.

CLO Sector Review

142. One panelist explains that the panel on the CLO sector has become more prominent over the years as CLOs have favorably distinguished themselves from other types of CDOs.

143. Another panelist explains that the period from late 2008 through 2009 was a period of financial turmoil. Some types of deals displayed such high losses that they will never return (e.g., SIVs, CDOs-squared, and CDOs of ABS). The CLO sector was hit by both downgrades of their underlying assets and criteria changes at the rating agencies. However, the CLOs performed just as they were supposed to. Not a single CLO defaulted, while 64% of CDOs of ABS defaulted. The default rate on leveraged loans (the underlying assets of a CLO) is at a cyclical low, and the borrowers are flush with cash. CLO managers have traded executed trades that have made the underlying portfolios stronger. The financial crisis produced wider spreads on leveraged loans, which has increased excess spread in CLOs. This, in turn, has quickened the pace at which deals can cure breaches of overcollateralization covenants ("OC triggers") and thereby allowed for distributions to the deals' equity tranches. Moody's upgraded thousands of CLO tranches, partly because of good performance and partly because of criteria changes. Standard & Poor's upgraded hundreds of tranches because of good performance. [Note: Standard & Poor's has not changed its calibration of corporate CDO criteria since September 2009 (28).]

144. CLOs are arguably cheap relative to corporate bonds and other structured products. The volume of new CLO issuance is still much lower than it was before the crisis. New CLOs offer structural improvements over seasoned deals. New deals also may offer wider spreads, especially on mezzanine and subordinate tranches.

145. The key takeaway is that CLOs work and are doing even better now than before the financial crisis. The question is, "If CLOs are so attractive, where are the investors?"

146. Another panelist explains that at the start of the CLO market, insurance companies were buyers of the triple-A

securities. They were also active investors in the underlying leveraged loans. More recently, about 70% of the triple-A-rated tranches were purchased by banks. Japanese investors purchased a substantial share of the triple-A-rated tranches. Demand for the double-A-rated and single-A-rated tranches of CLOs has been primarily from insurance companies and money managers. Before the crisis, European banks had been frequent buyers of CLOs at the triple-A, double-A, and single-A layers of the capital structure. However, the European banks have retreated from the sector because of the European risk-retention rule (29). Even CLO issuers that retained the equity in their deals have been unwilling to make the representations that European banks would have needed to comply with the risk-retention rule. The issuers want to retain the ability to sell their holdings in the future. European insurance companies have stayed away because they, too, face a risk-retention regulation under their regulations (Solvency II) (30).

147. Discount Margins on tranches of the recent Symphony VIII CLO:

- triple-A 155
- double-A 330
- single-A 450
- triple-B 640
- double-B 900

148. Hedge funds are likely to be a growing investor class in CLOs. There are about six new CLOs scheduled to close in the first quarter of 2012. Total CLO issuance for the year likely will be in the range of $15 billion to $25 billion.

149. One investor asserts that a sign of the CLO sector's maturity will be whether investors are willing to reinvest in the sector as older deals mature. Many deals that are now in their reinvestment periods will move into their amortization periods during this year.

150. Another panelist explains that the favorable ratio of Standard & Poor's rating upgrades to downgrades is a reflection of the strong performance of the leveraged loans sector. The ratio of upgrades to downgrades on the underlying loans has been favorable, and leveraged loans have displayed a very low default rate in recent periods. The forecast for the speculative-grade default calls for defaults to increase but still remain below the long-term historical average. One issue for some CLOs is the ability to "amend-to-extend" loans (i.e., the power to extend loan maturities) after the end of the reinvestment period. New deals clarify whether a manager is allowed to do any trading after the end of the reinvestment period. Sometimes the manager is allowed to trade after the end of the reinvestment period as long as doing so does not deplete a CLO's cash.

151. One panelist explains that his firm invests in the triple-A-rated and double-A-rated layers of CLO capital structures. He emphasizes that investing in CLOs is really investing in corporate credit. His firm also invests directly in syndicated leveraged loans.

152. Another panelist explains that the market is waiting to learn the final outcome of the risk-retention rule proposals in the U.S. (31). There are five regulatory agencies working on the rule, and part of the challenge is getting the agencies to work together. Additionally, CLOs are not the main issue for the regulators working on the risk-retention rule. (The main focus is residential mortgage loans.) However, regulators understand the difference between CLOs and other structured products. This is evident in an exception to the proposed Volker rule (32) for loans to businesses. The comment deadline on the proposed Volker rule is Feb. 13. The proposed rule is intended to restrict proprietary trading by banks and to prohibit them from owning hedge funds. The proposed rule is not intended to interfere with

securitizations of any kind, including CLOs. However, as originally drafted, the proposed rule would prohibit banks from providing warehouse financing for CLOs. Work remains to be done to make sure that the final form of the Volker rule does not interfere with CLOs or other securitizations.

153. One panelist notes that the liquidity and transparency of the underlying assets is what differentiates CLOs from other types of securitizations. The assets are not created through an originate-to-distribute model. Another panelist echoes the view that CLOs are significantly different from other securitizations. Managers have "skin in the game" (i.e., risk retention) through the management fee structure. The panelist argues that CLOs should not be subject to the risk-retention rules.

154. For the CLO market to grow, the investor base must become broader. CLOs offer attractive spreads compared to auto loan ABS and credit card ABS. The attractiveness of the spreads likely will draw more investors to the sector. Another panelist adds that the CLO sector needs more investors in the equity tranches of the CLOs. New issue CDO equity offers expected returns of around 15%. In secondary trading, CLO equity offers somewhat higher expected returns, but for shorter time horizons.

155. Some older CLOs included tranches of other CLOs in the underlying assets. However, in the 2011 vintage of deals, the underlying collateral is just leverage loans. Tranches from other CLOs and other structured finance assets were excluded.

Tuesday, Jan. 24, 2012

Overview Of The Consumer Economy

156. One panelist observes that the housing market is the main issue for consumers. Things are on the mend and getting to where they need to be, but the process is slow. There is not a lot left for policy to do. The healing has been taking place, and the process has to be allowed to continue.

157. Household debt has leveled out since 2007. The household sector is not deleveraging, but rather holding its debt level stable and hoping that the economy grows to catch up. Mortgage debt has shrunk over recent years, but student loan debt has increased.

158. During the bubble, there was a sharp divergence between home prices and household incomes. The bursting of the bubble has brought home prices back in line with incomes. Now there is a divergence between college tuition and income levels. This calls into question whether today's college students will receive an acceptable return for their investment in education.

159. Credit card and auto loan performance has improved over recent years. Lenders have room to loosen their lending standards to increase profitability. Performance of student loans is worsening.

160. Housing affordability is very strong, but demand for homes remains very week. The traditional link between affordability and housing demand is broken. Some of the reasons for this include the tightening of lending standards and consumers' uncertainty about whether home prices will fall further. A key factor on the demand side is the rate of new household formation. The rate of household formation has been slow for the past several years, and it likely will remain low for the next several years. The main underlying driver is unemployment. Recovery is coming slowly because, along with the high unemployment rate, the rate of participation in the labor force has been declining.

161. The panelist's baseline forecast is that home price will decline 7% from third-quarter 2011 through first-quarter

2013, which would amount to a 38% decline from the peak. The bottom of home prices should occur in first-quarter 2012. The year-by-year forecasts are as follows: down 3% in 2012; flat in 2013; up 8% in 2014. From a bottom in 2012, home prices should start to rise again and converge with long-term "fair value" around 2018. The start of rising home prices should help revive confidence and demand. Homes are currently undervalued. There are likely to be around eight million liquidations to come. [Note: Compare that estimate to an earlier speaker's estimate in paragraph 110.]

162. The FHFA has an initiative on REO dispositions. The ultimate mission is minimizing the expense to taxpayers. Some market participants propose creating a program for turning REO properties into rentals (33). Diverting a portion of the REO properties from the liquidation pipeline could help reduce oversupply of homes and could allow home prices to recover more quickly.

163. Another panelist highlights that consumers are a more important factor in the U.S. economy than government or business spending. Consumers are unhappy now; confidence is low. However, they are spending money. Consumers have been paying down their debts. Access to credit is very tight. However, credit card companies are soliciting new accounts. Auto sales are up, as are auto loans. Student loan volume is up. Mortgage lending is subdued and credit underwriting standards are very tight. Consumer sentiment has improved in recent months. Consumers do not seem worried about the European debt crisis. Consumer spending is holding steady. Although some reported numbers are coming in below economist's expectations, the numbers have still been reasonably good. Mortgage debt continues to decline but nonmortgage debt has recently been rising.

164. Delinquency rates on nonmortgage obligations have recovered to their pre-crisis levels. In contrast, delinquencies on first mortgage obligations remain significantly higher than before the crisis.

165. Both the number of student loans and the total dollar volume of student loans have risen sharply since 2005. Delinquency rates have been very stable for the past seven years. [Note: This statement conflicts with the previous panelist's remark in paragraph 159.] Interestingly, the 90-day delinquency rate is higher than the 60-day delinquency rate, which is higher than the 30-day delinquency rate.

166. Mortgage originations are declining in spite of falling interest rates. Mortgage underwriting is much tighter today. The income distribution of households with a mortgage loan has shifted significantly to the higher end.

167. Audience Question: Wouldn't an REO rental program produce sharp home price declines, because homes would be valued based on projected rental cash flow? A panelist answers that an REO rental program would still help support home prices by reducing the number of distressed sales. Some of the stories that were used for justifying high home prices are returning as justifications for elevated home prices in certain high-end markets.

168. Audience Question: How would events in China affect the U.S. economy? A panelist answers that the U.S. "took its lumps" early compared to Europe and Asia. In the global economy, the U.S. is better positioned than other economies.

Keynote Address: John Walsh, Comptroller Of The Currency

169. It is unlikely that there will be strong revival of securitization until there is a recovery in the housing sector. Securitization had a role in the financial crisis as one of the factors that promoted bad lending. The Dodd-Frank Act embodies many initiatives to address issues revealed by the financial crisis. Since the passage of the Dodd-Frank Act, U.S. regulators have been busy trying to implement the law. The establishment of the Financial Stability Oversight Council (34) to provide closer scrutiny of systemically important institutions and the creation of the FDIC's new

orderly liquidation authority (35) are examples of how the Dodd-Frank Act has broadened the reach of regulation.

170. The Dodd-Frank law uses many approaches to addressing risk: restricting certain activities, imposing higher capital requirements, imposing closer oversight on certain activities, and other measures.

171. The need for regulators to coordinate their efforts slows down the creation of new regulations, which exacerbates uncertainty for the markets.

172. ***Risk retention (36):*** Regulators are reviewing the comments received. The proposed rule included alternative forms of risk retention, a premium capture reserve fund requirement, and a definition of QRM. The proposed definition of QRM attracted the greatest amount of criticism. The question really is how broad the QRM exception should be.

173. ***Role of ratings:*** Ratings are currently used in the Basel risk-based capital guidelines. Small banks also rely heavily on ratings, because they have limited analytic capabilities themselves. Section 939 of the Dodd-Frank Act requires regulatory agencies to remove ratings from their regulations. The OCC has a proposal for using alternatives to credit ratings, but some of the features are very complicated (37).

174. ***Volker rule (38):*** As the regulators worked on the Volker rule, they realized that it could have implications for securitizations. One of the issues is the relationship of securitization vehicles to their sponsoring financial institutions and whether certain securitizations might constitute hedge funds under the rule. The comment period ends on Feb. 13.

175. ***Swaps and derivatives:*** The OCC has substantial expertise in the area of derivatives. It publishes a quarterly report on bank trading in derivatives that is a major source of information on derivatives (39). Derivatives were a major factor in amplifying and concealing risk leading up to the financial crisis. Some problems came specifically from how banks used derivatives in the period before the crisis. Credit default swaps (CDS) were a key factor. The proposed swaps margin rule under Dodd-Frank is intended to motivate banks to move their derivative activities to exchanges and to improve transparency (40).

176. However, there is too much irrational fear about derivatives. The risk is often overstated. The key risk is not market risk but rather credit risk. The OCC spends a lot of time evaluating the counterparty credit exposures associated with derivatives. Bank charge-offs from counterparty credit risk have been extremely low. CDS represent only a small portion of the derivatives landscape. Moreover, the core problem was not CDS but rather the creation of synthetic CDOs that referenced low-quality subprime mortgage securities.

177. One area of Dodd-Frank that has produced controversy is the imposition of margin requirements. The issue is international harmonization so that U.S. banks are not placed at a competitive disadvantage relative to foreign banks.

178. Even though derivatives were implicated in the market collapse of 2008, they continue to deliver important benefits and continue to be an essential financial tool. Walsh is hopeful that 2012 will be year when the OCC wraps up many open issues, including Basel III and a number of major rule-writing projects.

Global Securitization Market Review

179. European securitization issuance has declined sharply in recent years. Issuers retain much of the issuance volume and repo it with the ECB. [Note: See chart following paragraph 90.] There is securitization activity all around the world. Australia, Japan, and Latin America all show growth since their lows in 2009-2010. The Canadian securitization market is active. Residential mortgages are the dominant asset class in most countries/regions but credit cards were dominant in Canada in 2011.

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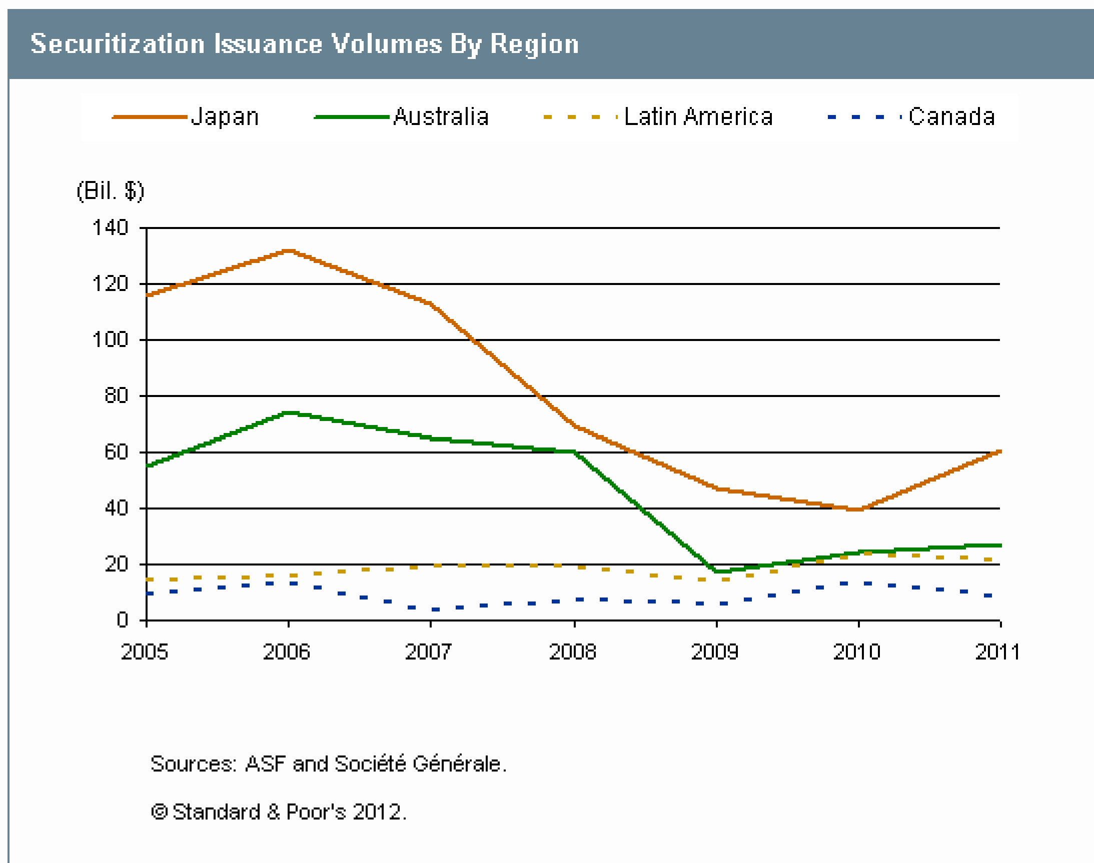
Chart 4



180. By comparison, U.S. securitization is much lower than it was before the financial crisis--home equity ABS issuance is entirely gone. On a global basis, the U.S. formerly accounted for around two-thirds of global securitization volume, and now the U.S. accounts for less than half. [Note: The comparison does not include agency MBS in the U.S.].

181. One panelist explains that the RMBS market is healthy in Europe, but the CMBS market is essentially dead. That is the opposite of the situation in the U.S., where the private-label RMBS sector is in slump but CMBS is recovering.

182. A panelist explains "covered CP." It is a hybrid product with elements of ABCP and covered bonds. It provides full recourse to the issuing bank. Another emerging area is risk transfer securitizations for hedging counterparty credit exposures of OTC derivatives (i.e., the credit valuation adjustments or CVAs). Another panelist highlights that this is example of securitization as a risk management tool rather than as a funding tool. A third panelist notes that the idea of covered CP is funding with no risk transfer.

183. One panelist observes that Japanese investors have recently shown interest in European securitizations. A recent European deal included a yen-denominated tranche. Investors from other Asian countries often buy domestic deals in their own countries. Their interest in American and European securitizations is generally confined to triple-A tranches from deals backed by mainstream asset classes.

184. One panelist observes that European deals tend to display stronger credit performance than U.S. securitizations. However, there is a higher degree of asset and structural variability among European deals. The investor base is

quite thin, with the ECB taking much of the total volume on repo. [Note see the "percentage retained" in the chart following paragraph 90.]

185. Another panelist observes that virtually all European ABS issuance is floating rate but the underlying assets are fixed rate. This requires using interest rate swaps in the deals, which is becoming difficult because many banks have been downgraded.

186. One panelist suggests that Europe has already handled many of the regulatory issues that are still in process in the U.S. The biggest ongoing issues in Europe are the proposed Basel liquidity coverage ratio (41) and Solvency II (42). CLOs are not happening in Europe, but there are deals backed by SME loans instead (i.e., loans to small and midsize enterprises).

187. Another panelist observes that Solvency II would impose extremely high capital requirements for securitizations. It would effectively prevent European insurers from holding securitizations. A third panelist remarks that the capital changes were calibrated based on observed price volatility of securitizations. A fourth panelist argues that the Basel II (43) capital framework was better than Basel III (44) and Solvency II. The newer capital standards create too many cliff effects and they have been calibrated too harshly, based on the performance of subprime RMBS. Another panelist asserts that rating agencies are being too harsh in basing their methodologies on the performance of the worst asset classes.

188. One panelist remarks that there are key differences between the regulatory philosophy in Europe and the U.S. In the U.S., regulators view securitization as a positive tool. European regulators have not fully accepted securitization as beneficial; securitization has to keep proving itself in their eyes. Supportive interventions in the U.S. were directed at markets (e.g., the TALF program). In contrast, European interventions are through the banking system.

189. One panelist states that Canadian regulators have focused on the commercial paper market. It was a reaction to deals that repackaged CDOs in a way that created cliff risk. Canada does not have the same problems as the U.S. It is very traditional. The residential mortgage market uses government guarantees.

190. One panelist criticizes the proposed rotation rule for rating agencies (45). He believes that mandatory rotation will create problems. He also notes that the proposal for updating the European regulations of rating agencies would require regulatory approval of changes to rating methodologies. Another panelist states that there is a critical difference between the European and U.S. views of rating agencies. The U.S. view is that ratings are opinions, and rating agencies formulate their opinions differently. The European view is that there is a "right rating" for a given security, which should be the same from any rating agency. The European view implicitly considers ratings from different rating agencies to be interchangeable. A third panelist argues that the European regulators should talk to investors about the value that they find in ratings and should particularly consult with investors about the issue of mandatory rotation.

191. A panelist explains that securitization is slow in Germany because Pfandbriefe (the German form of covered bonds) made it unnecessary for the residential sector. The commercial mortgage sector is stalled. However, auto loans ABS are happening in Germany.

192. The difference between the European risk-retention rules and the proposed U.S. rules could prevent European investors from buying U.S. deals (46).

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Future Of The Capital Markets For Secured Financing

193. One panelist compares securitizations to secured financing. Securitization is one way to finance assets. However, it is not the only way, and often it is not the best way. Securitization includes ABS, RMBS, CMBS, CDOs, insurance-linked securities, and whole-business securitizations. In contrast, secured financing structures include covered bonds, total return swaps, repos and term repos, asset-based lending, and most variable funding notes. Bankers should think of their mission in terms of financing assets with the most suitable tools, rather than just with securitization.

194. Another panelist explains that covered bonds have not become commonplace in the U.S. because they do not allow banks transfer the interest-rate (i.e., prepayment) risk of typical 30-year fixed-rate mortgage loans.

195. A panelist states that investors are quite hungry for high quality investments that offer attractive yields. There have been some of those opportunities in off-the-run asset classes.

196. One panelist explains that similarly rated securities are not necessarily identical. A Standard & Poor's rating primarily emphasizes a credit's relative likelihood of default and would give somewhat less weight to credit stability (i.e., the likely path of credit deterioration) (47). Credit is a multidimensional phenomenon and ratings are one dimensional. Expected recovery and likely path to default are secondary factors in a rating, but they may differ between similarly rated securities.

197. Another panelist observes that value to investors depends not only on credit risk but also on liquidity risk. Issuers can achieve better financing terms when they use collateral. One example is a company that used an accounts receivable securitization to get efficient financing. Another is in the rental car sector, where Hertz and Avis have been successful in issuing triple-A-rated securitizations despite having speculative-grade unsecured ratings. A third example is financings that have used cell phone towers as collateral.

198. One panelist states that the airline industry and elements of the auto industry rely heavily on asset-based financing (as opposed to securitization). Enhanced equipment trust certificates are essentially a type of covered bond in the U.S. Much of the secured funding world operates on an unrated basis. Instead, the deals use mark-to-market mechanisms for maintaining strong collateral coverage. Another panelist explains that it is also possible in the U.S. to create a triple-A-rated, full recourse arrangement using repos, which receive special treatment under the bankruptcy code.

199. A panelist states that disclosure for both securitizations and secured financings is still a challenge. Data rooms (i.e., secure online data libraries) can supply investors with more information than a prospectus. In some areas, such as insurance-linked securitizations, investors have called for access to underlying documents and analytic spreadsheets.

200. One panelist suggests that the U.S. RMBS market is transforming into a type of covered-bond market. He explains that issuers will have to retain substantial risk, both through the risk-retention regulations (48) and through representations and warranties.

201. One panelist notes that the proposed Basel III liquidity rules (49) are not yet finalized. They are likely to improve the stability of the financial system, but they may also increase the price of credit and may restrict the supply of credit. Another panelist observes the risk-based capital rules are causing banks to divest consumer lending operations. Accordingly, there is likely to be a resurgence of stand-alone, specialty-finance lenders.

202. Another panelist states that the basic paradigm of securitization has changed. In the 1990s, market participants

viewed securitization as entirely about the assets; the participants in a transaction did not matter. The new paradigm recognizes that securitizations have ongoing dependencies to transaction parties. Servicing is not a trivial job, and transaction parties matter a lot.

203. Secured financings that provide for explicit recourse to an issuer may be more attractive than ostensibly nonrecourse securitizations that still expose a lender or investor to the ongoing credit or performance risk of transaction parties. However, the financial system needs to have a mechanism for nonrecourse financing of mortgages. Recourse financing arrangements with mark-to-market and collateral posting requirements drove some corporate borrowers to grief during the financial crisis. In some asset classes, the challenge is to attract new investors.

204. Panelists assert that the disclosure requirements for private placements should not be as strict as the requirements for registered, public offerings.

Alternatives To Credit Ratings For Risk-Based Capital

205. ***Background:*** The Basel risk-based capital framework uses the rating agency credit rating as a factor in determining the regulatory capital requirements for banks. Basel II (the banking book rules) includes a hierarchy of approaches (50). The first is the ratings-based approach (RBA), which is eliminated in the U.S. by section 939A of the Dodd-Frank Act, which mandates the removal of ratings from regulations (51). The second approach is the internal assessment approach (IAA), which was a victim of the accounting consolidation rules under FAS 167 (52). The supervisory formula approach (SFA) is the third approach and is the only one left. Basel 2.5 is known as the trading book rules (53). Challenges for U.S. regulators include meeting the international timeline and achieving congruence between the banking book rules and the trading book rules. Basel III is the sum of Basel II and Basel 2.5.

206. One panelist states that regulators hoped that Congress would repeal Section 939A. The U.S. regulators cannot be consistent with the Basel guidelines because the Basel guidelines use credit ratings and the Dodd-Frank law requires the opposite. The regulators have issued a notice of proposed rulemaking for removing ratings from the risk-based capital regulations. The comment period ends on Feb. 3. The U.S. proposal is calibrated to produce similar results as the Basel framework. There are few securitizations on banks' trading books today, so the issue of Basel 2.5 is not significant.

207. Another panelist explains that the SFA was supposed to apply in only a small minority of cases. The RBA and the IAA were supposed to cover most situations. However, the SFA is all that is left, and it must now cover everything. The SFA is formula-driven and requires a bank to use a number of input parameters that may be impossible to obtain. The implementation guidelines for SFA are unworkable and leave out some key elements. It does not allow pool-level inputs. It omits the benefit of excess spread, and it omits the benefit of a book-value discount (which is essentially a form of credit enhancement). The ASF has proposed an alternative (54) that would:

    - allow measurement of asset performance on a pool wide basis;
    - require quarterly calculation of SFA inputs if a pool wide approach is used;
    - capture the benefit of book value discount;
    - incorporate excess spread and other credit enhancements; and
    - allow the use of cash flow projections.

208. The notice of proposed rulemaking includes a modified SFA as an approach for consideration but not as an alternative (55). Regulators are concerned that pool-level inputs would be used to camouflage the risk inherent in a pool. Large banks need to recognize that there has to be reconciliation of goals and the ultimate solution has to be workable for small banks.

209. The December rule proposal includes a simplified SFA (called SSFA) as part of the broader market risk portion of the risk-based capital guidelines. The SSFA consists of a core formula and a supervisory floor override feature. The core formula uses an asset performance proxy and parameters that describe a securitization's capital structure. The asset performance proxy (KG) is the weighted-average capital charge for the underlying assets under Basel I. KG is 4% for most first lien mortgage loans and certain other assets. KG is 8% for all other assets. The supervisory floor dictates a minimum capital charge based on actual cumulative losses on an asset pool. A panelist from a regulatory agency explains that regulators will need to receive convincing reasons for changing from the proposal. The ASF intends to submit a comment letter on the proposal with constructive feedback and ideas for improvement. A key idea in the comment may be to make KG more sensitive so that it has more than two possible values. There is also likely to be a comment that the supervisory floor should take account of the seniority of an exposure.

210. Section 939A will increase bank capital requirements unless it is specifically calibrated to be neutral.

211. One panelist explains that asset-backed commercial paper conduits were able to allow banks to fund assets and achieve lower capital requirement. But the ABCP conduits lost their off-balance sheet accounting treatment because of FAS 167. The U.S. is still operating under a modified form of Basel I. Europe is operating under Basel II. In Europe, banks that have off-balance ABCP conduits can use the RBA or the IAA. For on-balance sheet ABCP programs, European banks can use the RBA or the SFA (if practical).

212. The Collins amendment provides that changes in capital regulations mandated by Dodd-Frank must be no lower than capital charges were prior to Dodd-Frank (56). There is some question of whether the amendment applies to a bank as a whole or on an asset-by-asset analysis. The proposed changes to SEC rule 3a-7 should not have any effect on risk-based capital regulations. The final regulatory release is likely to be an 800-page single-spaced tome that covers everything for U.S. risk-based capital.

213. One panelist emphasizes that risk sensitivity is not the only objective in framing the SSFA. Simplicity is also a critical consideration.

Credit Rating Agency Reforms

214. The latest developments are the rating agency provisions of the Dodd-Frank law (57) and the proposal to extend the European regulatory regime for ratings (58). Rulemaking could extend through the rest of this year in the U.S. and in Europe.

215. ***Rule 17g-5:*** No rating agency has yet issued an unsolicited rating using SEC Rule 17g-5. One panelist explains that his rating agency has unsolicited surveillance ratings on 100% of outstanding CMBS, but it has not tried to do an unsolicited new issue rating. The challenge is that there are only a few days to market the rating to investors and to try to get them to pay for it. Another panelist remarks that, while it is important for a rating agency to make its views known, it is also important to avoid creating disruptions in the markets. He adds that Rule 17g-5 requires a rating agency to produce unsolicited ratings after it has looked at 10 deals under the rule.

216. One panelist questions that notion that investors consider a high volume of unsolicited ratings as a positive. He says that his rating agency would do an unsolicited rating or unsolicited commentary only when it feels that its view is different from other views in the market. His firm proposed changes to Rule 17g-5, including public disclosure of the identities of all rating agencies engaged to analyze a deal, even if they were not chosen to produce a final rating. That information would add transparency and potentially benefit investors. Another panelist argues that unsolicited commentaries are not helpful to investors.

217. A third panelist comments that it is impractical for a rating agency to use Rule 17g-5 for doing unsolicited ratings. The rule requires a securitization issuer to post all information that it shares with a hired rating agency to a secure website so that the information will be available to all other rating agencies. However, some issuers' websites impose onerous terms and conditions--including confidentiality terms--that make it impractical for a nonhired rating agency to use the information as the basis of a rating. A nonhired rating agency might have to disclose confidential information in its published rationale for the rating. [Note: Some market participants have proposed that all the information that rating agencies receive should be publicly disclosed. That would potentially eliminate the key problem with Rule 17g-5.]

218. One panelist counters that a positive effect of Rule 17g-5 is that it has added rigor, documentation, and transparency to the interaction between rating agencies and issuers and arrangers. Another panelist says that Rule 17g-5 is actually a failure. It has not deterred rating shopping. Mandatory rotation of rating agencies might increase competition and help smaller rating agencies get onto deals.

219. ***Franken amendment (59):*** The Franken amendment would mandate that the government or a separate body assign NRSROs to determine ratings. The proposal would undermine choice in the capital market. The SEC received numerous comments with about 40% supporting the Franken approach and 60% opposing it (60). There is a recent GAO study that is critical of the proposal (61).

220. ***European rating agency proposal (62):*** One panelist explains that the EU released a proposal in November. The proposal is out of step with anything else internationally. The EU uses the concept of "endorsement," which restricts the use of ratings made outside the EU to those from rating agencies regulated under a framework that is substantially as stringent as the framework of the EU. One troubling aspect of the EU proposal is mandatory rotation of rating agencies. A second is regulatory approval of criteria and harmonization of rating scales. A third issue is civil liability and the creation of private rights of action. A fourth issue is restrictions on ownership.

221. The rotation requirement would require a rating agency to stop rating an issuer on a solicited basis after a fixed period of time (three years or six years) or after a fixed number of deals. The push for convergence of rating scales and rating definitions would reduce the diversity of views in the market. Mandatory rotation would create choppiness in ratings and in measurements of rating performance.

222. Another panelist states that although there have been statements by European regulators that they would not regulate the substance of rating agency, it is unclear whether they would adhere to those statements in practice.

223. The EU proposal calls for a "harmonized standard" rating scale to which all ratings would be converted for purposes of comparison across rating agencies. The "harmonized standard" rating scale could create confusion, because it would be different from the rating agencies' own scales.

224. Another panelist notes that the EU proposal seems to embody internal inconsistencies. On one hand, the EU says that it wants to avoid creating the impression that ratings have been approved by the government. On the other hand, it proposes to require approval of rating methodologies. The EU claims that it wants to promote competition. On the other hand, it proposes to require converting all ratings to a "harmonized standard" rating scale, which makes it impractical for rating agencies to differentiate their products. The proposed civil liability provision is striking because it is embodies an entirely unique structure for EU law. Finally, although preliminary discussions considered a provision that would have allowed regulators to prevent the publication of sovereign ratings, the actual proposed regulation did not. However, there is continuing discussion of the idea.

225. *Unintended consequences:* One panelist observes that policymakers say they want to increase competition among rating agencies, but they also want to avoid a "race to the bottom." A small rating agency may be challenged by the burden of regulations, but it has the advantage of not having legacy systems that must be updated to comply with new requirements. Another panelist observes that a small rating agency has the ability to be nimble. He notes that the EU regulatory framework does not even acknowledge the existence of an investor-paid surveillance-based business model.

226. *Independence:* A few items in the SEC rule proposals threaten a rating agency's independence. One is a requirement to put a rating on CreditWatch if an analyst goes to work for an issuer. Another regulatory area that threatens independence is the push for standardizing rating definitions. The push for standardization may reduce rating agencies' ability to adapt to changing market conditions.

227. *Year ahead:* One panelist views continued uncertainty, both in regulations and in rated products, as a key challenge for rating agencies in 2012. Another focuses on the amount of regulation that is still coming. A third panelist agrees with the first two and adds that there are positive trends in the CMBS area that may spill over to other asset classes. A fourth analyst states that there is an adverse trend toward fragmentation in regulation that will make it harder for a rating agency to produce globally consistent ratings. The fifth panelist says that conflicting regulations in different jurisdictions will be tough issue for 2012.

Consumer ABS Traders And Research Roundtable

228. All members of the panel are researchers. There are no traders on the panel.

229. *Spreads:* One panelist asserts that the market is not likely to return to the tight spreads that existed before the financial crisis. One of the issues is the low absolute yields. Another factor is greater economic uncertainty, which causes investors to demand wider spreads on all credit products. A third issue is the lack of depth of the investor base for subordinate tranches. Another panelist notes that the issuers of recent auto loan ABS have retained the subordinate tranches, because there was little investor interest in those tranches.

230. A panelist observes that some recent deals have achieved all-time tight spreads. Liquidity is good for senior tranches, but the bid-ask spreads are wider for mezzanine and subordinate tranches. Another panelist adds that demand for short-maturity, high quality paper has been good. However, the student loan ABS sector has been an exception.

231. Another panelist focuses on the recent decrease the volume of outstanding securitizations. The outstanding volume of some sectors is declining, as new issuance is not enough to replace maturing paper. This raises the question of whether the recently lower issuance volumes represent a cyclical downturn tied to slower consumer spending or a secular change. Auto loan issuance has been strong. Student loan issuance has been weaker. Credit card ABS issuance has been growing recently. Investors remain strongly interested in new issue credit card and auto loan ABS. Another panelist ventures that issuance will likely pick up when consumer spending picks up and rates rise. A third panelist remarks that the ABS sector has traditionally relied on new issuance flow to provide price transparency. The slow pace of new issuance is reducing price transparency for ABS. Also, the credit card ABS was traditionally the sector with the strongest liquidity. Now that it is shrinking, liquidity for ABS overall is on the decline.

232. *Esoteric ABS:* Defining esoteric ABS is difficult. It obviously does not include ABS backed by auto loans, credit cards, student loans, or basic equipment leases. Many market participants would classify the following asset classes as slightly esoteric: timeshares receivables, dealer floorplan loans, and auto rental fleets. Examples of asset classes that are highly esoteric include: insurance premiums, structured settlements, shipping container leases, and insurance catastrophe risk. One panelist asserts that yields are not always high enough to compensate investors for the effort that they have to expend to understand and monitor deals backed by highly esoteric assets. On the other hand, the slightly esoteric asset classes are sufficiently well established (and require less effort), so that they can offer yields

that are worth the effort. Another panelist expects an increase in transportation-related deals backed by assets such as shipping containers, rail cars, and aircraft. Corporate bond investors have expressed interest in the transportation deals, especially enhanced equipment trust certificates backed by aircraft.

233. ***Term financing versus conduit financing:*** Because of changes in risk-based capital guidelines, some banks are encouraging companies that had financed esoteric assets through ABCP conduits to do term ABS deals. Investors should try to thoroughly understand a term ABS deal backed by an esoteric asset class before buying it. The move from conduit financing to term ABS drops key protections that ABCP investors receive through an ABCP program's liquidity support.

234. ***Changing environment:*** The rating agencies have changed their rating methodologies for a number of sectors that performed poorly in the financial crisis. The methodology changes have made market participants skittish even in sectors that performed well, such as auto loans. Some are concerned that rating agencies might suddenly change their criteria in those sectors and downgrade ratings on many securities. Regulatory uncertainty is an even bigger factor that dampens investor enthusiasm for securitizations in general. One panelist asserts that the market would benefit from standardized reporting among all issuers within each asset class. However, throwing regulations at the market is probably not the best way to achieve the desired result.

235. ***Market efficiency:*** Market efficiency is high from the perspective of speed of execution. Issuers can execute auto loan or credit card deals in a matter of days. Market efficiency is low from the perspective of the quality of disclosure. Investors do not receive information in a form that allows them to make useful comparisons across deals and across issuers. The information that investors receive makes such comparisons too slow to be useful for investment decisions.

236. ***Consumer Finance Protection Bureau:*** The CFPB has very broad jurisdiction. It has already started to focus on student loans. It may focus later on subprime auto loans. It is not yet clear whether the CFPB's activities will affect securitizations.

237. ***Asset quality, hedging:*** One panelist observes that market participants have few concerns about credit trends. Credit performance is good, and underwriting standards are tight. Although credit standards will eventually loosen, they will likely remain tight for the short to medium term. The main risk is potential macroeconomic shock. A possible shock scenario would be an increase in the yield on the 10-year Treasury note from around 2% to around 4% triggered by good news from Europe (i.e., progress toward resolution of the European debt crisis).

238. One panelist asserts that the strong credit performance of credit card ABS through the financial crisis should mean that credit card ABS spreads will be less volatile through the next crisis. During the crisis, spreads on credit card ABS widened to 500 or 600 basis points. Another panelist counters that the volatility of spreads in the next crisis will depend on whether the crisis comes from or is associated with securitizations. The issue is more a matter of liquidity than fundamental value. He adds that the market benefits when investors have the ability to take short positions.

239. One panelist remarks that issuers are reaching further down the credit spectrum. There has been recent growth in subprime auto activity. Standard & Poor's credit enhancement levels have been declining on subprime auto loan ABS over recent years even though the quality of the pools has been fairly steady.

240. A panelist focuses on the link between a deal's credit quality and the corporate credit quality of its sponsor or the related sovereign. Credit deterioration (and rating downgrades) of securitization sponsors and of sovereigns have caused numerous downgrades of securitizations. Lending standards for prime auto loans are getting looser. Lenders are financing older used cars. The loosening of credit standards is most pronounced in the subprime auto sector and is likely to lead to the mispricing of risk in the sector. Credit enhancement on subprime auto deals has declined

significantly over recent years. Some of the market's underlying drivers are changing. The panelist questions whether the decline in subprime auto credit enhancement levels is appropriate. Another panelist reiterates the earlier point about the need for investors to be able to compare underlying assets across deals and over time.

241. ***Rating agencies:*** One panelist says that rating agencies are still central to the whole structured products market. An important reason is that many investors use ratings as part of their internal investment criteria. Another reason is how strongly the market has come to rely on triple-A ratings. The fact that many sectors performed the way they were supposed to is a positive reflection on the rating agencies. There was rating volatility in some sectors, and the only direction in which triple-A ratings can move is down. Subordinate tranches of some subprime auto deals received downgrades that were reversed by later upgrades.

242. Another panelist asserts that investors do not rely on rating agencies. They want to do their own analysis of structured finance deals. However, the larger fixed-income market uses ratings as benchmarks for comparing credit risk across asset classes (63). A shortcoming of ratings is that they react slowly to changes in the environment. Rating agencies reacted too slowly to changes in the mortgage sector and they might be too slow right now in reacting to changes in the subprime auto sector. Rating agencies should not wait to observe after-the-fact performance deterioration before they adjust methodologies in response to changing market practices and conditions.

243. A third panelist emphasizes that although investors may not "rely" on ratings for making specific investment decisions, ratings are a key feature of investment guidelines imposed on money managers by institutional investors. Changes in ratings can create difficulties in managing a portfolio.

244. A fourth panelist observes that, although investors do not rely on ratings, rating actions may set the tone for a sector. The rating agencies have different opinions about the student loan area. This has led to split ratings, which may reduce liquidity.

RMBS Traders And Researchers Roundtable

245. The trading market for private-label RMBS took a big dive in March 2011. One panelist feels that there the trading market displays the influence of both positive and negative factors driving supply and demand. He notes a negative influence from the proposed Volker rule and changes to risk-based capital rules. Another panelist explains that prices reflected the assumption that many servicers would cease advancing principal and interest on delinquent loans. Investors are holding money on the sidelines. Investors who can withstand volatility can seize attractive opportunities. A third analyst asserts that only about 10% of the outstanding private-label RMBS market is investment grade. That portion of the market has behaved well. The volatility has been in the remaining 90%. Another analyst mentions the issue of dealer risk management systems based on value-at-risk (VaR) measures. Dealer VaR measures have been a driver of volatility. VaR at the large banks spiked in third-quarter 2011, which caused them to lose their appetite for risky assets. When VaR measures decline, the dealers will likely step back into the market. Another panelist asserts that there will be a greater trading link between structured finance and the larger financial market (e.g., equities, corporate bonds, municipal bonds, etc.).

246. Because of credit quality deterioration, outstanding private-label RMBS are no longer a regular fixed-income product. However, they are not like corporate equity, either.

247. One panelist explains that Freddie Mac is exploring ways to sell off credit risk from its portfolio. Part of the reason is to attract private capital to the housing market. Another purpose is to stimulate price discovery for the risk as an aid to setting guarantee fees.

248. A panelist observes that U.S. regulators have proposed a new set of risk-based capital rules (64) that would be more onerous than the Basel III standard (65), and which would not use ratings. The proposal would be based partly on the cumulative losses on a deal, which could result in very a high capital charge. Banks have objected to the proposal, and they are likely to go back and forth with the regulators for the next year. In Europe, most banks are starting to apply Basel III. Another panelist notes that the U.S. proposal would likely impose higher capital charges for consumer ABS. A third panelist favors the approach that the NAIC uses, which is based on projected lifetime losses. He ventures that the onerous capital treatment under the new U.S. proposal may push financing of consumer assets into loan form rather than securitization form.

249. One panelist notes that secondary trading activity is not an impediment to new issuance. The Redwood-Sequoia deals were the benchmark deals for last year. The panelist asserts that there should be more creativity in the structures to offer tailored securities to meet specific investors' needs. Ratings are not necessarily helpful on deals involving nonperforming loans, where the securities trade to recovery value. Investors need other tools to help with such deals.

250. ***Housing market:*** How does the view of the housing market affect the performance of private-label RMBS? One panelist explains that forecasts project a small further decline in home prices. However, there is substantial uncertainty around the base-case projection, with a significant skew toward downside risk. Another panelist says that dumping large volumes of foreclosed homes on the market would be detrimental to the prices of private-label RMBS. Another panelist agrees that the forecast for housing is negative. The story is about asset recovery values; what are the recovery values on distressed loans? A third panelist states that it is necessary to look at distressed and nondistressed situations differently. Although housing is highly affordable, buyers cannot get mortgage loans. Any programs that help homeowners will help stabilize prices of outstanding private-label RMBS. Another panelist projects a further 6% decline in home prices, with a bottom in first-quarter 2013. He feels that home price appreciation will remain near zero for several years and that private-label RMBS prices will react to how actual home price performance compares to economists' expectations. Another panelist says that the key challenges for housing are consumer confidence, unemployment and the availability of credit. [Note: Compare the outlook expressed in this panel the outlook of earlier panels covered in paragraph 162.]

251. ***Modifications:*** Modifications are performing reasonably well. The re-default rate after a year is around 25%. That means that 75% of modified loans survive for year without re-defaulting. One panelist notes that the re-default rate for modifications done in 2008 was about 55%. The modifications done more recently have performed better. Part of the explanation is HAMP (66). One way to estimate a long-term cumulative re-default rate for recent loan modifications is to compare the features of newer modifications to the older ones (e.g., size of payment reductions). Based on that, the panelist estimates that the long-term cumulative re-default rate for recent modifications will be around 45%. Another panelist states that re-defaults on recent loans were lower than expected. His model projects that about 40% of the surviving 75% will re-default (i.e., for a cumulative total of around 53%). The re-default rate on subprime mortgage loans is somewhat higher than the re-default rates on prime and alt-A loans.

252. One panelist, who invests primarily in senior tranches, favors loan modifications that include reductions in the principal balance of the modified loans. He asserts that principal reductions improve loan performance and, therefore, should be beneficial to investors. Another panelist emphasizes that investors have very little control in the area of modifications. Investors must struggle with trying to understand how to model the impact of servicers' modification strategies. He is concerned with the problem of moral hazard. The panelist worries that allowing principal reductions will encourage many prime and alt-A borrowers to become delinquent. Another panelist explains that FHFA's position is that interest rate reductions have a much higher impact than principal reductions. Freddie Mac does not allow principal modifications. Another panelist adds that principal reductions show slightly

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better re-default rates, but the reason may be that they produce larger payment reductions than pure interest rate reductions. He asserts that principal reductions are an oversold strategy. He acknowledges, on the other hand, that some modifications with principal reductions have been favorable for the related securitization trusts.

253. ***Liquidation timelines:*** One panelist explains that both loan modification programs and other programs intended to help distressed homeowners keep their homes have the effect of extending foreclosure/liquidation timelines. Longer liquidation timelines produce higher ultimate loss severities. Another panelist explains that timelines are still extending. The time required for liquidating defaulted loans is the single biggest factor in cumulative losses. Servicer advancing also is a key issue. A third panelist points out that a typical defaulted subprime loan has been delinquent for 28 months before it is liquidated. The timeline is likely to extend by another 10 months. Investors need to worry that a deal's servicing may be transferred from a major servicer that has a high advancing rate to a smaller servicer with a much lower advancing rate. Another panelist explains that investors can experience frustration in trying to determine the underlying cause when they do not receive the cash flow that they expected.

254. ***Washington:*** One panelist says that the key effect from Washington is uncertainty about cash flows on distressed loans. Therefore, he prefers performing deals with strong borrowers. A second panelist agrees and also favors performing deals with prime borrowers. Another panelist mentions the REO to rental proposal. He observes that there are still a lot of hurdles for such a program to overcome. Another panelist says that there will be more changes from Washington. Another panelist notes that policy changes from Washington are the biggest factor, but they are very uncertain.

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Emerging ABS Sector Review

255. ***Timeshare receivables:*** One panelist explains that a timeshare company has tried to increase interest rates on newly originated receivables at the same time that it has tightened lending standards, as reflected in higher consumer credit scores and higher borrower equity. However, there has also been an increase in the default rate on outstanding timeshare receivables.

256. ***Insurance securitizations:*** A recent deal was the first to securitize the "embedded value" of insurance policies. [Note: The deal is called Vecta I Limited and it closed on Dec. 23, 2011.] Embedded value refers to the profit in a policy. The transaction received a rating of 'BBB+' from Standard & Poor's, and the securities had a coupon of 8%. The sponsor was a Bermuda reinsurance company, and the size of the deal was C$120 million. Before the transaction, the policies had been financed by private equity. The block of policies consisted of 450,000 underlying policies underwritten by seven Canadian insurers. The total related death benefits were C$22 billion. The deal's risks to investors are (i) catastrophic mortality risk, (ii) a potential shift in mortality trends, and (iii) the risk that policyholders cancel their policies at a significantly greater rate than in the past (lapse risk). The deal was the first insurance deal in the Canadian market.

257. ***Receptivity to new asset classes:*** One panelist asserts that the market is absolutely open for ABS deals from middle-market and small issuers. An advantage of off-the-run asset classes is that they can offer somewhat more yield than mainstream assert classes. The yield pick-up is usually around 200 basis points. Investors and rating agencies apply intense scrutiny to deals backed by esoteric assets. They are very demanding in terms of data. The rating agencies use their corporate bond departments to scrutinize the sponsor of a deal backed by esoteric assets. Investors are keenly interested in the details of a rating agency's analysis, and they closely read rating agency pre-sale reports. Investors sometimes demand customized stress scenario analyses from issuers or arrangers. There are likely to be deals with new assets classes, including a new form of insurance-related cash flows. Last year there was a deal backed by truck leases.

258. Another panelist remarks that a speaker yesterday commented that changes in the capital rules were causing banks to withdraw from certain asset classes, and that such withdrawal would promote the growth of specialty finance lenders. [Note: See paragraph 201.] The first panelist agrees and observes that the aircraft sector is likely to be a source of several new ABS deals.

259. One panelist explains that a rating agency has a large analytic staff with very broad range of expertise. This means that it can bring expertise from diverse areas to bear in analyzing proposed deals backed by esoteric assets. This can be especially helpful to investors who may have narrower expertise. Investors perform their own analyses, but rating agency analyses are especially helpful in esoteric ABS. Another panelist remarks that pre-marketing is essential for ABS backed by esoteric assets. The deals require more time to complete because (i) the rating analysis may take longer and involve iterative dialog between the issuer and the rating agencies, (ii) additional legal opinions may be necessary, and (iii) investors need more time to understand such deals.

260. ***Servicing:*** Servicing is an important issue, because servicing esoteric assets is more involved than simply collecting financial assets. In some cases, servicing may involve remarketing or re-leasing physical assets or managing an operating business or a franchise system. For any given esoteric asset class, there may be only a small number of companies that can do the job. Servicing of many esoteric asset classes may require special skills and knowledge. Some of the servicers are thinly capitalized and may not survive periods of stress.

261. In some esoteric asset classes, the market has started to favor servicer termination provisions. The decline of the bond insurance sector has been a challenge for the esoteric ABS sector. Bond insurers not only provided credit enhancement but also served as "control parties" who had the power to terminate a servicer. This was a positive feature of the deals. Newer deals do not have a bond insurer to oversee the servicer. Newer deals use various solutions to create control mechanisms so that investors can quickly terminate a servicer. The mechanisms are not standardized and are still evolving. A related issue is the term of a deal's a servicing contract. One approach is to make the contract have a 90-day term with automatic renewals unless the investors choose not to renew it. A short-term contract has potential advantages in case a servicer goes into bankruptcy.

262. ***Regulations:*** Over the past year, regulatory burdens have become "bumps in the road." Rule 17g-7 (regarding rating agency reports on a deal's representations and warranties) adds time and cost to a transaction. The proposed update to Regulation AB (67) would be very onerous for the timeshare asset class, because it would require monthly loan-level data on thousands of timeshare loans in each deal. The ASF has proposed an alternative, less-burdensome disclosure regime for private placements sold exclusively to large institutional investors (68).

263. ***Mainstream versus esoteric:*** The market uses the term "esoteric" to label several asset classes that have been the subject of ABS deals for many years. Timeshare receivables are an example. Market participants should remember that esoteric asset classes performed mostly well though the financial crisis.

264. ***Deal environment/spreads:*** Although spreads widened for esoteric ABS during 2011, absolute yields remained very low and hardly changed because the benchmarks moved lower. Spread widening was more pronounced for subordinate tranches. Senior tranches of ABS backed by the most mainstream asset classes (prime auto loans and bank credit cards) experienced little or no spread widening. There have been no esoteric ABS deals yet in 2012, but there have been some mainstream ABS deals done at very tight spreads. This bodes well for the outlook on spreads for esoteric assets deals in 2012.

265. ***2012 outlook:*** One panelist asserts that investor interest in insurance-related securitizations (including catastrophe bonds) remains strong because the performance of the securities is not correlated with other bonds or with equities. The outlook for the insurance-related sector is positive. The volume of catastrophe deals may depend on

developments in the re-insurance area and on the pace of natural disasters. Life insurance-related deals are also likely to grow, because there is a substantial reservoir of potential collateral for deal. Another panelist states that the timeshare sector should see slow and steady growth. Issuance in 2012 will likely be around the same as in 2011. A third panelist observes that the flow of esoteric ABS deals was slow in the latter half of 2011 because of the European debt crisis. That means that some deals that otherwise would have been done in 2011 will now likely come in 2012. The low yields on mainstream deals are sustaining investor interest in deals backed by esoteric asset classes.

CMBS Sector Review

266. One panelist explains that 2011 was a generally bad year for CMBS because of high volatility. However, there were a few bright areas. Credit performance of the loans was generally good, and new deals brought a return of 30% credit enhancement for their most senior tranches. The uncertain economic environment was a challenge. Private-label CMBS issuance was $32 billion, and there was another $31.5 billion of CMBS issued by the GSEs. The combined issuance amount was still well below the $240 billion of issuance in 2007. Another panelist notes that 2011 brought positive structural changes in new deals (i.e., CMBS 2.0), including cash flow traps to prevent distributions to subordinate tranches ahead of senior tranches. It also brought a revival of SEC-registered deals.

267. Other panelists note that investors are scrutinizing the underlying pools more carefully. They are looking for underwriting based on actual cash flows (as opposed to optimistic projections of future cash flows). New deals also have simpler structures. There are about $45 billion of loans in existing conduit deals that are scheduled to mature in the next 12 months. Only about $12 billion of those loans would qualify for inclusion in new deals based on recent underwriting standards. This is a clear reflection that underwriting standards are tougher now than in the period leading up to the financial crisis.

268. A fairly common feature of new deals is an "operating advisor" that oversees the activities of a special servicer. Consider a public mortgage REIT. It has a board of directors that provides oversight. The operating advisor is like a board of directors. An operating advisor should be mostly passive when a deal functions well, and it should intervene with progressively greater intensity as performance deteriorates. One firm found that, on older deals, special servicers have behaved properly in 80% of dispute situations. The firm has served as an arbitrator for disputes between investors and special servicers and now serves as the operating advisor on new deals. The addition of operating advisors may represent a maturation of securitization structures. It gives securitization structures the necessary governance controls that have long existed in the world of corporate securities.

269. The commercial mortgage servicing industry is behaving better than before. Some of the companies contemplate future IPOs, and they realize that it is not worth jeopardizing their reputations over their handling of a few distressed loans. An operating advisor works for the trust (i.e., investors as beneficiaries of the trust), not the servicer. It is essential for an operating advisor to be independent of the servicer.

270. One panelist asserts that an operating advisor should also have a role as a purveyor of information. Another panelist counters that an operating advisor is an insider with respect to a deal trust and must not divulge information. However, an operating advisor can encourage a servicer or trustee to post more information faster. This is similar to the situation where a member of a corporate board encourages the corporation's public relations department to be responsive to investor inquires.

271. Another panelist adds that investors now universally expect CMBS deals to have operating advisors. A key benefit of having an operating advisor is that it is impossible to envision all the possible future conflicts of interest that may

arise in the future.

272. ***GSE CMBS:*** One panelist notes that the GSEs have increased their issuance of CMBS, because it helps them to keep their owned portfolios from growing. Last year Freddie Mac issued $14 billion through its "K" program. Investors like the program, because the deals look like regular CMBS, but the senior tranches also benefit from a GSE guarantee. The program has a strong track record. It has been issuing since 2009 and has zero delinquencies right now.

273. Another panelist remarks that it is interesting that Freddie Mac uses ratings in the "K" deals despite the fact that Congress has mandated the removal of ratings from regulations. Investors do their own analysis, but the ratings still matter. Interestingly, "K" deals do not use an operating advisor. The "K" deals have fewer tranches. A special servicer can buy a distressed loan at "fair value," but Freddie Mac can top a special servicer's bid if it considers the special servicer's bid to be too low.

274. A panelist observes that special servicers in older CMBS deals usually owned the unrated portion of the deals. The number of B-piece investors has grown recently. He notes that the conduit CMBS business relies on the originate-to-distribute model. Another panelist states that while the ASF has recently started to push toward standardized disclosure for RMBS and ABS, the Commercial Real Estate Finance Council (CREFC) created standardized disclosure, documentation, and representations and warranties for the CMBS many years ago. The CMBS sector is far more advanced than other securitization sectors in achieving standardization.

275. ***Risk retention (69):*** One panelist explains that the proposed premium capture reserve account is the biggest area of concern in the proposed risk-retention rule. Regulators want the premium capture reserve account to prevent originators from evading the mandatory 5% risk retention. The idea is that any premium above par must be held in escrow in addition to the 5% risk retention and must be used to absorb losses before the 5%. Although the goal of risk retention may be laudable, locking up the profit from a deal is not appropriate.

276. A second area of concern is the proposed mechanism for removal of a special servicer following a recommendation by an operating advisor. An operating advisor's recommendation would be binding unless a majority of each class voted to reject the recommendation. A third issue is the requirement for a B-piece investor to hold the 5% risk-retention piece for the life of a deal. The required holding period is too long. CREFC argues that after a specified period, the B-piece investor should be allowed to sell (70). The regulators have said that they will have a final rule in the second quarter of the year. That is unlikely, because the six regulatory agencies involved have not yet reached agreement. The panelist believes that there is a 60% chance that there will be a new proposal in the second quarter. A final rule is more likely around the end of the year.

277. This year is a critical one for the future of the CMBS sector. The rules that are finalized this year, including risk retention, the Volker rule, risk-based capital rules, and others, will shape the industry for years to come. There is risk that the dealer bid for many types of paper will dry up if regulatory developments go adversely.

Endnotes

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