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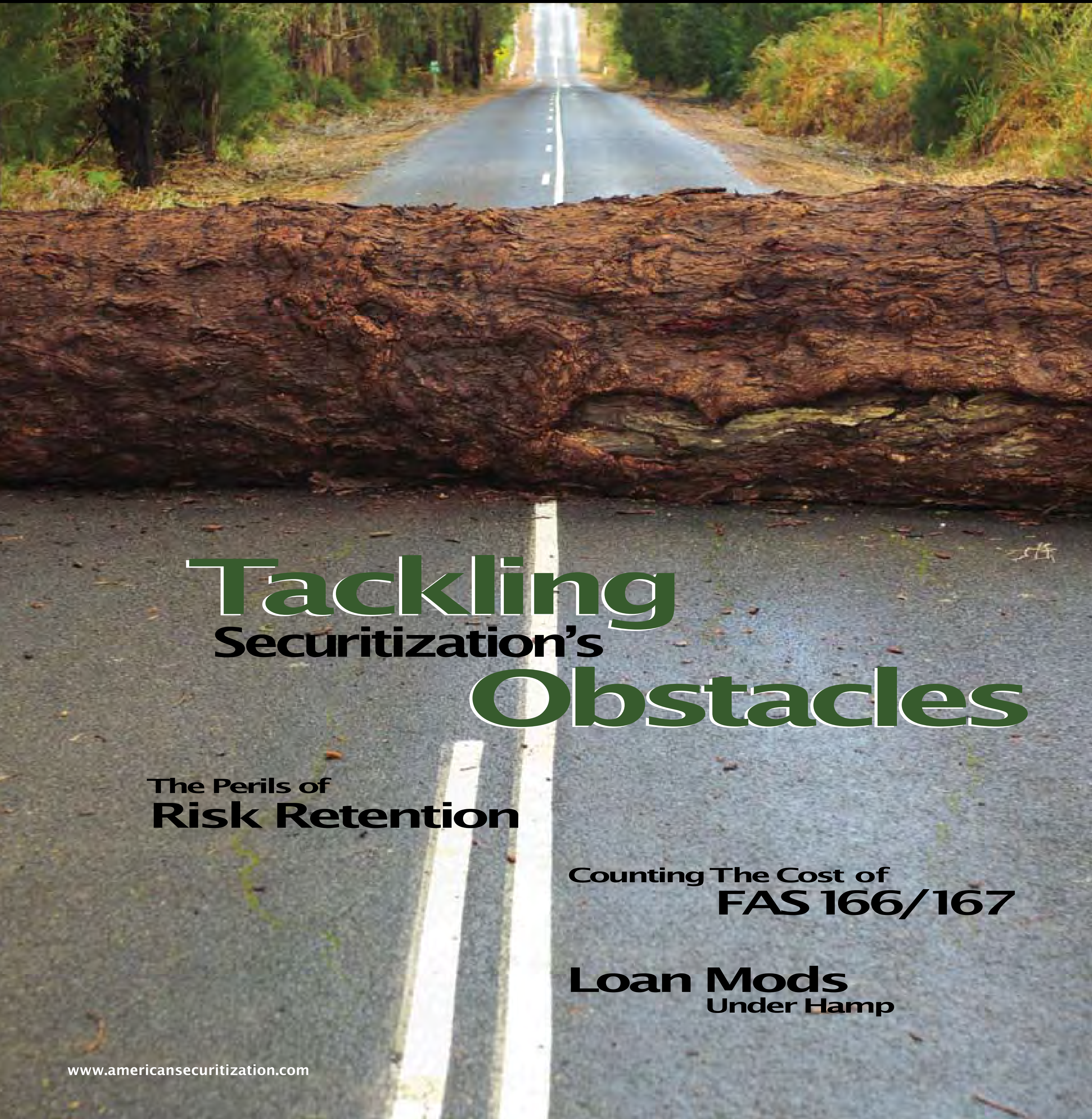
American Securitization

The Official Journal of the **American Securitization Forum**



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INTRODUCTION FROM THE

CHAIRMAN

Consider a world where bank lending replaces securitization. Immediately, U.S. banks would have to take on some $12 trillion of outstanding securitized assets, almost doubling their combined balance sheets from $13 trillion to $25 trillion. Regulators would require the banks to raise another $1.2 trillion of equity capital, nearly twice the amount of the TARP bailout, to support the additional assets — more, if regulators stipulated a lower leverage ratio than 10 to one.

But equity capital is more expensive than debt capital because it's less available and returns are more uncertain. So banks would have to pay progressively more for each dollar of equity capital raised.

They would then have to charge more for their loans to produce the returns required by their shareholders, making credit unaffordable to many Americans. With consumer spending accounting for two thirds of our nation's GDP, less cash would flow from consumers into the real economy. The banks' huge demand for additional equity capital would crowd out others who need it, dampening economic and job growth. In the end, banks would consume more equity capital, produce less credit and the economy would grow more slowly or even shrink.

Not only does securitization allow borrowers to pay less, it enables investors to earn more. Securitization allows the fireman's retirement fund to own the policeman's mortgage, and vice versa. The fireman earns more on his money while the policeman pays less for his. If this process were taken through the banks, they would have to take a margin from both to feed their equity investors. All in, it would work out to be more expensive than the two percentage points or so it costs to arrange a securitization. This same relationship holds true across all consumer credit types. Though created by Wall Street, securitization links Main Street to Main Street. It is essentially the democratization of credit.

That allows investors and borrowers to participate in the same pool of capital on their own terms. Since borrowers' combined activity in repaying their loans generates more available cash than any single borrower's repayment behavior, financial engineers can fashion the pooled cash into investments that look and behave differently from the loans backing the investments. What emerges is a market clearing mechanism that maximizes choice and minimizes cost for the borrower while also maximizing both choice and return for the investor. There is simply no other way banks can match their assets and liabilities as efficiently as securitization can.

That's why securitization served the country so well for a quarter century before the crisis. The crash doesn't suddenly mean it is an inherently flawed model; rather its faults stem from the speculative and self-defeating excesses that grew upon it. The American Securitization Forum, lawmakers, policymakers and regulators are working hard to remove these excesses, to assure the causes and effects of our financial crisis are not repeatable. However, we have reached a fork in the road. One path lets us harness the power of securitization and discover America's full economic potential. The other takes us back to a more conventional, costly and inhibiting deposit-based banking system. Of course, untapped potential is hard to measure, so the consequences of a wrong decision are not always easy to discern. That increases the chance of making a poor choice. It's important to be aware of this as we construct our future financial system.

Ralph Daloisio
Chairman of the Board
American Securitization Forum

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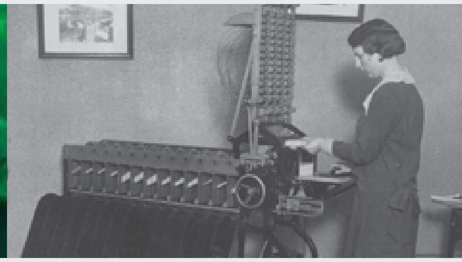

Cover Story

American Securitization

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Editor: *Antony Currie*
Email: acurrie@mpacpublishing.com

Journal design: *Carolina Zalles*

Sub-editors: *P.J. Johnson, Julian Marshall*
Production director: *Carolina Zalles*
Production and artwork: *Clare Brew*
Photography: *Viola Yesiltac*
Crossword: *Chris Scarafile and Dan Marcellus*

Writers

Neil O'Hara

Steven Abrahams

Mark Selick and Andrew Burke- Blake, Cassels & Graydon LLP

Bill Berliner - Berliner Consulting

Matthew Tomiak - 12th Street Capital

Publisher: *Matthew Perks*
Tel: 845 440 7800
Email: mperks@mpacpublishing.com

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ASF Professional Staff Contacts

Tom Deutsch, Acting Executive Director
Tel: 212.313.1135
Email: tdeutsch@americansecuritization.com

Tere Petersen, Associate Director, Events and Marketing
Tel: 212.313.1136
Email: tpetersen@americansecuritization.com

Chris Killian, Associate Director, Advocacy
Tel: 212.313.1126
Email: ckillian@americansecuritization.com

Evan Siegert, Associate Director, Advocacy
Tel: 212.313.1178
Email: esiegert@americansecuritization.com

Justin Ross, Senior Analyst
Tel: 212.313.1138
Email: jross@americansecuritization.com

Caitlin Wood, Analyst
Tel: 212.313.1137
Email: cwood@americansecuritization.com

For information on ASF membership, contact:
Janet Brathwaite, Executive Assistant
Tel: 212.313.1134
Email: jbrathwaite@americansecuritization.com

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The American Securitization Forum (ASF) is a broadly based, not-for-profit professional forum through which participants in the U.S. securitization market can advocate their common interests on important legal, regulatory and market practice issues. ASF also provides substantive and timely informational and educational programs of value to securitization market professionals, including major industry conferences and topical, issue-specific workshops and seminars. ASF is an adjunct forum of the Securities Industry and Financial Markets Association.

EDITORIAL

It is always tempting for lawmakers and regulators to be seen taking a hard line on whatever can be blamed for causing a crisis. And what better way to do that this time round than to restrict the ability of securitization to contribute to a crash?

On the face of it, there's no harm in that. After all, it's a goal shared by the American Securitization Forum and its members. In response to the crisis, ASF has undertaken a number of measures in the past two years to improve industry practices: witness the ASF Loan Identification Number Code, known as ASF LINC, a joint-venture initiative with Standard & Poor's Fixed Income Risk Management Services announced last September to provide detailed data on the underlying loans in asset-backed securities. In fact ASF's commitment to market transparency stretches back before the credit crisis to when the forum played an integral role in shaping RegAB.

But a number of the actions Washington either has already put in place or is considering risk taking reforms too far. The plan to enforce issuers and other players in the securitization chain to retain 5% of the risk of each deal they sell, for example, might sound like common sense to many; even a fifth of ASF members reckon it has merit, according to an exclusive poll conducted by *American Securitization* (see page 32). In practice, though, constructing rules nuanced enough to work for the variety of asset classes securitization deals with is a complex affair. So much so, in fact, that one of our guest authors, Steve Abrahams, who is also sympathetic to the idea, argues that disclosing what risks are retained would work better than mandatory quotas.

What really has the industry up in arms, though, is the move by regulators to link risk-based capital requirements to the infamous FAS 166 and 167 accounting changes which came into force at the end of 2009. Even the head of the Financial Accounting Standards Board has said the latter should not influence the former. Yet that is what is happening, even though, as the panelists in our roundtable explain, the consequences will be either less credit available to consumers or interest-rate hikes of as much as three percentage points on loans (see page 34).

That is why *American Securitization* is taking the unusual step of not just explaining the benefits of securitization, giving our take on what caused the crisis or admitting where the industry erred, as we have done in the past. We're using this edition to go on the offensive, to argue why some of these measures under consideration in Washington to rein in securitization could end up doing more harm to the economy than good.

Antony Currie
Editor
American Securitization

Update from the ASF

During another tough year for the economy and the markets, the American Securitization Forum has underscored its role as a vital organization for the health of the industry. With the close collaboration of our members, ASF continues to undertake crucial initiatives that affect our collective livelihood and enable us to meet the challenges of the current environment.

As we continue to work together to achieve our industry's shared objectives, our core values and goals remain unchanged:

- **Consensus**: ***To build consensus within the U.S. securitization industry on issues of broad importance to the industry;***
- **Advocacy**: ***To mount principled and focused efforts to advance ASF's substantive positions, chiefly by interacting with appropriate governmental, regulatory, accounting, legislative and other policy-making bodies; and***
- **Education**: ***To inform and educate not only the securitization community and related constituencies but also the public at large, and to sponsor substantive, high quality conferences and educational programs.***

ASF Update

- During the summer we successfully completed our scheduled annual changes to member leadership, following a ballot in June to elect new board members as well as committee and subforum leaders. Approximately one third of ASF leadership positions are rotated annually to help ensure that all ASF constituencies and participants are represented.
- As our activities are run by and for the securitization industry, member participation in advocacy and educational initiatives is crucial to ASF's accomplishments. More than 8,000 individuals from member firms are involved with ASF in some capacity, and more than a quarter — some 2,100 — regularly participate in ASF committees, subforums, task forces and working groups. ASF conducts a variety of weekly meetings and conference calls on a wide range of topics, providing an exceptional number of opportunities for planning, communication and consensus building.
- ASF has approximately 350 member firms representing nearly all constituencies within the securitization market. We have more than 90 investors, 60 issuers, 55 financial intermediaries, 50 law firms, 30 information and technology vendors and 20 servicers, along with numerous other types of firms. We also have several individual members in a new category created in 2008 for former securitization market participants no longer affiliated with a firm.

Legislative Advocacy

- Throughout the past several years, ASF has maintained a commitment to communicate clearly and effectively with federal and state legislators. ASF has successfully developed collaborative relationships with several legislative representatives and their staffs, ensuring that the voice of the industry is heard.
- ASF is frequently consulted on developments and upcoming proposals that affect securitization. Throughout the past several months, ASF has testified before Congress, submitted written feedback and met with representatives on issues pertaining to securitization including mortgage finance reform, loss mitigation and foreclosure prevention, credit risk retention, mortgage servicing and developments in consumer ABS.
- In October, ASF testified before the Senate Banking, Housing and Urban Affairs Subcommittee on Securities, Insurance and Investment in a hearing entitled *Securitization of Assets: Problems and Solutions*. Our testimony focused primarily on the role and importance of securitization to the financial system and economy; current securitization market conditions; limitations and deficiencies in securitization revealed by the financial market crisis; and views and recommendations on certain policy and market reform initiatives.
- In November, we submitted a number of proposed revisions to the bill entitled *Credit Risk Retention Act of 2009* to the House Financial Services Committee. This bill includes language regarding asset-backed securities risk retention, suspensions of reporting, loan level reporting and representations and warranties. ASF's markup, which is based on previously established ASF positions on these topics, was produced after broad-based member feedback.
- ASF hosted two Sunset Seminars in the fall to provide information and updates on current legislative developments. *Securitization Policy Reforms — A Primer on Current Legislative and Regulatory Proposals* was held in October in Charlotte, and *Securitization Legislative Reforms: The State of Play* was held in November in New York.

Legal and Regulatory Advocacy

- Our dialogue with federal regulatory agencies has continued throughout the year, as government agencies continue to respond to the current economic conditions. We frequently interact, both in person and via written comments and responses, with the Treasury Department, the SEC, the Federal Reserve Board and Federal Reserve Banks, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Housing Finance Agency and many others.
- We held dozens of face-to-face meet-

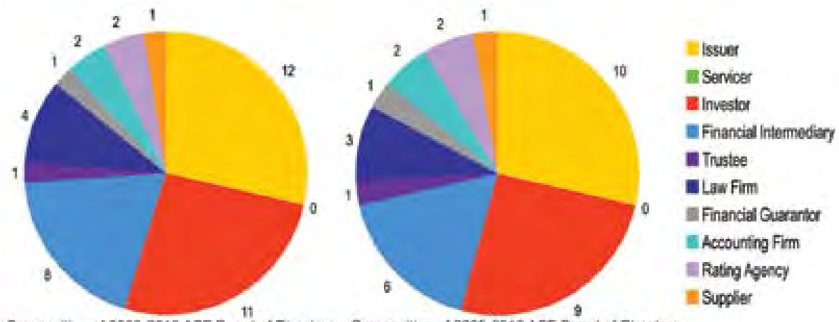
ings with regulatory agencies throughout the fall on a broad spectrum of issues including the Home Affordable Modification Program (HAMP), principal forbearance, the Second Lien Modification Program, Basel II and additional forthcoming regulations.

■ In September, we submitted a letter to federal banking regulators requesting the near-term announcement of a six-month moratorium on any regulatory capital rule changes related to the implementation of accounting standards FAS 166 and 167, and the proposed elimination of the option for ABCP conduit sponsors to disregard consolidation of conduits for risk based capital purposes, as proposed in the regulators' September notice of proposed rulemaking. ASF followed up this letter with meetings with the regulators throughout the fall, as well as additional letters submitted in October to regulators and Senate representatives.

■ In August, ASF submitted a proposal to the FDIC to amend its 2000 rule on legal isolation to account for the changes made by FASB in FAS 166. This letter was followed by a meeting between ASF and the FDIC in September. In August and September, ASF also sent requests to the FDIC to modify its true sale rules for bank-originated securitizations.

■ In September, ASF submitted a letter to the IRS and the Treasury noting ASF member concerns with the Income Tax Regulations issued on September 16, 2009 under Sections 860A and 860G of the Internal Revenue Code of 1986, as amended. The letter indicates concern over a potentially serious consequence of one of the new provisions regarding the alternative test for releases of real property collateral that could cause breaches by REMICs of existing loan agreements or impede the successful resolution of defaulted loans. Additionally, ASF met with the IRS in October and submitted an additional letter as a result of that meeting.

■ We responded to the SEC's request for comments regarding its *Extension of Filing Accommodation for Static Pool Information in Filings With Respect to Asset-Backed Securities* (Release No. 33-9074). Our comments were consistent with those contained in an August letter in which ASF requested that Rule 312 of Regulation S-T be amended either to make permanent or to extend the filing accommodation for static pool information.



Composition of 2009-2010 ASF Board of Directors (Including Officers) Composition of 2009-2010 ASF Board of Directors (Excluding Officers)

■ In November, we submitted a letter regarding FINRA's proposal to expand its TRACE reporting requirements to ABS. The letter focuses on a number of the most significant technical issues related to the implementation of this proposal and generally supports the approach FINRA is taking with respect to this issue.

■ ASF submitted a letter to HUD and Ginnie Mae in October urging Ginnie Mae not to remove features of its securities that provide important protections to their investors and directing the agency to consider utilizing existing market models to handle prepayment interest shortfalls. ASF representatives followed up on the letter with a productive meeting with staff from HUD, Ginnie Mae and the FHA.

■ ASF submitted a comment letter in response to the SEC's money market fund reform proposals in September. The letter expresses concerns that additional money market mutual fund regulation may restrict bank liquidity which could be particularly harmful in the current period of capital markets dislocation as it would negatively impact access to credit by consumers and businesses. The submission followed an August meeting between ASF and the SEC to discuss ASF's preliminary views on the proposals.

■ Throughout the summer and fall, ASF communicated with the International Organization of Securities Commissions (IOSCO) on several issues. ASF commented on a consultation report entitled *Transparency of Structured Finance Products* in November, a consultation paper entitled *Disclosure Principles for Public Offerings and Listings of Asset-Backed Securities* in August and a consultation report on unregulated markets and products in June. Additionally, ASF staff and members participated in a consultation meeting of the IOSCO Task Force on Unregulated Markets and Products Industry Consultation during the summer.

■ ASF also monitors developments in local governments and submitted a letter in August to the New York City Council describing the potential impact that changes to the New York City Code's definition of "debt collection agency" that became effective in July could have on the secondary market. ASF staff met with New York City Council members prior to submitting the letter to discuss proposed legislation to correct the definitions.

ASF Project RESTART

■ ASF continued its work on ASF's

Project on Residential Securitization Transparency and Reporting (ASF Project RESTART), an industry-developed initiative to help rebuild investor confidence in both mortgage- and other asset-backed securities, restore capital flows to the securitization markets and increase the availability of affordable credit to all Americans. In July we released a request for comment on proposed ASF Model RMBS Representations and Warranties, designed to enhance the alignment of incentives of mortgage originators with those of investors in mortgage loans. ASF also released its final Project RESTART RMBS Disclosure and Reporting Packages in July, which should increase the transparency of RMBS to investors and credit ratings agencies. When those items were released, ASF held a Sunset Seminar to offer industry views on the impact that the Obama Administration's financial regulatory reform proposals could have on the securitization industry and how these proposals relate to recommendations contained in ASF Project RESTART.

- In September, ASF and Standard & Poor's Fixed Income Risk Management Services launched the new standardized global code for identifying critical information about individual loans that are securitized in the mortgage- and asset-backed securities markets. This new global ASF Loan Identification Number Code (ASF LINC™) is a 16-digit identification code that captures underlying loan type, origination date and country of origin, in addition to randomized alphanumeric data, to create a unique ID for a wide range of loans that may be pooled and sold into the capital markets.
- Another phase of ASF Project RESTART, the ASF Project RESTART RMBS Trustee Bond-Level Reporting Package request for comment, was released in November. The proposed reporting package consists of a standardized layout containing 28 fields of bond-level information. Standardization of trustee reports would provide investors and credit rating agencies with consistent fields of information across issuers and enable them to efficiently review bond performance information.
- ASF staff and members meet frequently with regulators regarding current and upcoming phases of ASF Project RESTART to ensure that government officials are updated on industry progress. Federal Reserve Governor Daniel K. Tarullo referenced ASF Project RESTART in his written testimony for the House Financial Services Committee's October hearing entitled *Systemic Regulation, Prudential Matters, Resolution Authority and Securitization.*

Education and Training

- ASF 2010 will once again be the premier securitization event of the year, bringing together thousands of industry participants for education and networking. This year the event is in Washington D.C., at the Gaylord National Hotel between January 31st and February 3rd. The program covers an extensive array of substantive panels on critical policy challenges confronting the market. Sessions will feature key regulators, policymakers and thought leaders from the various public sector organizations with whom ASF regularly interacts, and whose views and actions directly influence and shape the future of our industry.
- In the fall we offered two sessions of the ASF Securitization Institute on securitization fundamentals and applied securitization. An industry-developed education and training curriculum covering core securitization market concepts and topics, the Institute is designed and taught by distinguished securitization market participants.
- Our annual meeting was held on June 17th at ASF Headquarters in New York. It included an ASF organizational update, a series of concurrent meetings covering current market issues, related legislation and regulatory initiatives, and a luncheon program featuring Hayley Boesky, Adam Ashcraft and Zoltan Pozsar of the Federal Reserve Bank of New York.
- Sunset Seminars in 2009 focused on ASF Project RESTART and financial regulatory reform initiatives, legislative and regulatory proposals and changes to accounting standards. All Sunset Seminars are available via webinar both during and after the event, enabling users to listen to the seminars and view the accompanying materials.
- In June, ASF released the results of a study assessing the long-term impact of securitization, with a focus on the residential mortgage-backed securities market. The study analyzed the impact of securitization on the cost and availability of credit as well as how securitization affects market liquidity and the distribution of risk. Based on an extensive review of loan-level and other data between 1990 and 2006, the study found that securitization has produced significant economic benefits. ASF released a companion piece to the study, which notes several important perspectives that should be considered in any critical examination of the role, impact and benefits of securitization.
- ASF issued a discussion paper on principal forbearance modifications in June. It serves to explain the effects of principal forbearance on the cash flows of the two most frequently used structures in the RMBS industry: the shifting interest structure and the overcollateralization structure.
- ASF has continued to disseminate relevant information to ASF members and the industry via multiple formats. The ASF Weekly Report provides updates on securitization market developments as well as ASF advocacy projects and events. ASF's website, **www.americansecuritization.com** is frequently updated with news and information. And twice a year we publish our official journal, American Securitization, which offers in-depth analysis, commentary and insight on market events.

By Steven Abrahams

There is widespread pressure for those involved in mortgage securitization to retain a portion of the risk in order to keep their interests in line with investors and thus reduce poor lending decisions. Retaining risk sounds straightforward in principle but is complex in practice.

Weighing up the *risk*

Some good ideas have a tendency to add too onerous a burden Shutterstock

Analysts and politicians on both sides of the Atlantic in the past 12 months have called for all the key players in the home loan securitization process to hold on to some of the risk. Forcing the various participants to invest in their own cooking, the argument goes, will align their interests with the end investors and help breathe life back into the market for private-label mortgage securitization.

Under the right circumstances, the argument is, this would help ensure reliable credit in the underlying loans. But in practice, the complexity of using mandatory retained risk to align interests argues for a more efficient approach: disclosure sufficient to let the market put a price on alignment.

The case for retaining risk goes right to the problem of potentially misaligned interests between mortgage-backed securities investors and the long line of agents working for them. After all, these investors rely variously on mortgage brokers, bankers, underwriters, ratings agencies and servicers to screen and later help monitor and manage credit risk in the securitized loans. Investors rarely have the capacity to do all this on their own. It's the role of efficient agents to help investors buy a more diversified pool of risk at a lower cost.

With diversification and efficiency, however, comes the risk that one or more of the agents end up at odds with the investors. Mortgage brokers, for instance, may get paid more for cranking out loan volume than for ensuring loan quality. Bankers and underwriters may have incentives to wax poetic about loan quality to get securities distributed at a lower yield. And servicers getting paid a fixed, and some may argue low, fee may have incentives to reduce costs rather than reduce losses.

All of these agents already do have a stake in producing quality loans — not least their reputation and the desire to win more business in the future — but that can be overwhelmed by other incentives or made irrelevant by an agent's lack of capital or other resources to back up their implied or actual obligations. All of these potential conflicts have surfaced in different diagnoses of the abysmal credit in many 2006-2008 private-label securitizations.

If investors have reason to doubt agents' alignment, then the compensation required to bear new securitized risk might end up just about where it is today — off the charts. Securitization of new non-agency originations has dropped from a peak of more than

$1.1 trillion in 2005 and 2006 to zero in the first nine months of this year (See chart on pg. 12). Certainly, a lot of factors have contributed to the drop including regulatory pressure on originators, lack of financing for new loans, limited capital at banks and occasionally better investment opportunities elsewhere.

Ultimately, however, the market has struggled to find a price for credit that readily brings new private-label borrowers and investors together. The argument would appear to be strong, then, for distributing risk and creating clear and compelling economic incentives for everyone along the securitization chain to think like an investor about credit.

The case for retaining risk goes right to the problem of potentially misaligned interests between mortgage-backed securities investors and the long line of agents working for them.

Retain Some Risk? Not So Fast ...

Retaining risk sounds straightforward in principle but gets complex in practice. Effective retention should parallel each agent's ability, in both magnitude and timing, to influence the credit of the securitized loans. That implies matching one or more classes in a standard securitization to the influence of each key agent, or even structuring new classes just for retention.

An originator selling loans into a securitization, for example, arguably only has primary influence on performance for a few years, and even then mainly in a normal housing market. If borrowers then default more or less than average during that period, the originator should bear corresponding penalty or reward. This loosely lines up with the risk/return profile of a first-loss class in many securitizations, a class where small differences in the rate of principal loss can drive big differences in returns. Retaining part or all of a first-loss class would give the originator incentives commensurate with its influence.

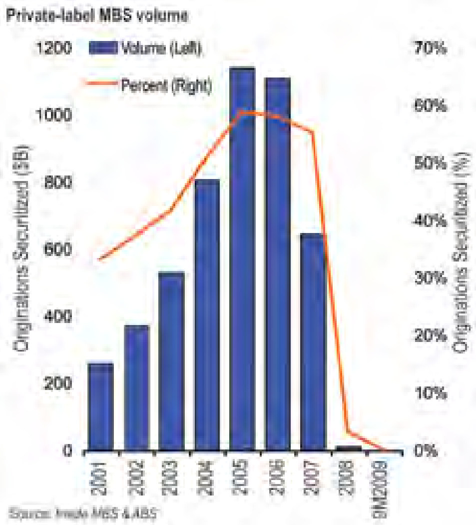
However, the selling originator should not have to bear risks beyond its control, such as a catastrophic downturn in housing or poor loan performance long after origination. Catastrophic housing risk — downturns that traditionally generate losses in the highest investment-grade classes — seems better borne by investors. Operational credit risk seems best borne by servicers, who continue to influence loan performance long after origination. A servicer, for example, might be required under new rules to hold a vertical slice of a securitization, a pro-rata participation in each class, to parallel the servicer's influence throughout the life of a loan.

But this raises two other issues. First, how much risk should each player retain? To keep the agent aligned with the investor, the value of the retention should make up a material part of the agent's total profits. If an originator's fees from making loans dwarf the value of risk retained, for instance, then the originator could still sanction poor credit without sacrificing material profitability.

Likewise, if a servicer's stake is small, the servicer has little incentive to defend it. Second, no matter the design or size of the retention, allowing the agent to hedge away the risk would similarly defeat the purpose behind retaining it. Aligned agents need to bear material unhedged credit risk.

Getting all of this right is tricky. In a report published last October entitled *Restarting Securitization Markets: Policy Proposals and Pitfalls,* analysts at the International Monetary Fund (IMF) argued that effective retention would require a complex matrix of rules difficult to operate in practice. U.S. and European proposals to require a 5% minimum retention by issuers, the IMF analysis argues, seem too simple. That approach might align issuer and investor interests in some securitizations but not in others. Where loan quality would lead to a cumulative 5% loss in a normal housing market, for instance, the issuer and investor might be aligned.

But a subprime issuer expecting higher losses might see a 5% retention as an inevitable and quick loss, and not worth the effort to aggressively police loan quality. And a prime jumbo issuer expecting much lower losses might see 5% as a burden well beyond its ability to influence credit. Fixed retention consequently could have the unintended effect of distorting the cost and supply of mortgage credit. Any risk retention rules would require much more subtlety.



Source: Inside MBS & ABS

Disclosure Over Diktat

That's why disclosure may work better than diktat to encourage retention in forms and amounts that best align securitization agents and investors. German academics Günther Franke and Jan Pieter Krahnen argue a similar line in their 2008 paper *The Future of Securitization*. Disclosure would give investors enough information to allow the market to put a price on the quality of agent alignment. Loans securitized by a tightly aligned set of originators, issuers and servicers would trade at a higher price than otherwise. And if that price is high enough, then the tightly aligned set of agents would enjoy a pricing advantage over competing lenders.

Those agents would win share in the lending market. And competition should then drive lenders to refine risk retention to forms and amounts that command the highest price from investors, justifying the effort and potential capital required for the retention.

The market has struggled to find a price for credit that readily brings new private-label borrowers and investors together.

The Committee on Capital Markets Regulation, a private research group, has argued for exactly the kind of disclosure that would help investors evaluate most of the major facets of agent alignment. In a paper released in May last year entitled *The Global Financial Crisis: A Plan for Regulatory Reform*, the committee recommended releasing more information on the following areas: the value of the retained interest; the structure of the retained interest; the intended period of retention; the ability and intent of the agent to hedge; and the estimated amount of fee income or other profits earned by the agent through the securitization

This kind of disclosure, regularly updated and audited, would enable the market to put a price on the alignment of investors and agents in a securitization. The market could determine the amount and form of risk and the agents that retain it. Securitized markets may have proven themselves imperfect in recent years at pricing risk, but disclosure and market pricing offer a more refined and flexible approach to creating alignment than mechanisms requiring rule-making, oversight and enforcement.

Most analysts and policymakers still recognize the benefits of healthy securitization: the operating efficiencies, the risk diversification, the transfer and restructuring of risk to suit the preferences and abilities of different investors, the lower cost of capital. The continuing robust activity in the agency mortgage market shows the potential of securitization as long as investors have the ability to readily evaluate risk in the securitized asset.

But the private-label mortgage market is currently broken. Back in 2006, private-label securitization funded 36% of U.S. residential mortgage loans. Through September this year, although origination of all mortgage loans has totaled $1.4 trillion, private-label securitization has funded none. Its proponents have a lot of work to do to lure back an audience. High on the list should come the clear alignment of interests between securitization agents and investors. Disclosure may be the fastest and most efficient way to get us there.

Steven Abrahams *is an independent capital markets analyst in New York.*

By Mark J. Selick and Michael E. Burke

After two years in a near-death state, Canada's securitization market appears to be coming round. This is no miraculous recovery, though: rehabilitation will be slow and steady.

Canadian ABS Shows Signs of Life

In the film *Awakenings*, Robin Williams plays a doctor who, through creative medical treatment and after much trial and error, is able to bring patients out of long-lasting comas. The Canadian securitization market fell into its own coma in August 2007 but now seems to be coming to. It has been slow going. A combination of federal government support, new rules and improving market conditions, however, means the Canadian securitization market should be able to get back on its feet.

What put the market into a coma was Coventree Capital's inability to place new asset-backed commercial paper (ABCP) in August 2007. That quickly shut down most of the C$32 billion ($30.4 billion) non-bank-sponsored ABCP conduit market and the commercial mortgage bond market, while bank ABCP and term asset-backed deals slowed significantly.

It took more than a year of negotiations to reach for a resolution to the non-bank ABCP problems. In January 2009, new term notes were issued to replace the affected ABCP, and a modest secondary market for them has since started to develop — driven, apparently, by yield-hungry hedge funds.

The Canadian government's support helped shock securitization back to life Getty

As the general market crisis continued, though, calls for the Canadian federal government to get involved increased, culminating in the C$12 billion Canadian Secured Credit Facility (CSCF), which was announced in January 2009. It went right to the heart of one of the most affected parts of the securitization market, vehicle and equipment financing and leasing. ABCP backed by such assets plummeted more than 60% in the two years since mid-2007 from C$32 billion to just C$12.3 billion. Term deals fell by more than two-fifths to C$3.3 billion from C$5.9 billion.

Ottawa characterized the CSCF as part of a support package promised to the auto industry in December 2008. But while limited to equipment and vehicle financing and leasing, it also served as an important statement of the government's desire to help restore confidence in the broader Canadian securitization market.

After consultations with industry, parameters for the CSCF were jointly developed by the Federal Department of Finance and the Business Development Bank of Canada (BDC), a Canadian federal government agency. BDC was also assigned responsibility for establishing and managing the CSCF.

Between them, they developed some creative and proactive medicine for the market. The CSCF has a two-tier structure: C$11 billion was set aside for Large Enterprise Originators (LEOs) and C$1 billion was set aside for Small Enterprise Originators

(SEOs). LEOs must commit to a minimum transaction size of C$300 million and SEOs must commit to C$100 million. All securities purchased by BDC must be publicly issued under a prospectus and must have two triple-A ratings. Eligible underlying assets are limited to vehicle and equipment loans and leases and floorplan loans for vehicle and equipment dealers.

Minimum Requirements

BDC recognized that different factors affecting each originator may drive different transaction structures and so has largely avoided dictating what structure to use. It has, however, set out certain minimum requirements.

The first is the use of template documents for the basic deal documentation, including a template declaration of trust to establish the issuing entity — Canadian structures typically involve a trust as the issuing entity — and a template form of trust indenture under which the asset-backed debt is issued. BDC also imposed certain minimum terms for the conveyance documents, including minimum representations, covenants and eligibility criteria.

Two years ago, there were many who described the Canadian securitization market as dead and buried.

If these start to serve as market standards for future transactions outside the CSCF, the CSCF will have not only helped the current market, but also helped cut down on execution costs for other transactions.

One of the few structural requirements imposed under the CSCF deals with the uncertainty that had surrounded some vehicle lease securitizations. To achieve certain income tax objectives, Canadian lease securitizations generally use a structure involving a master lease of the relevant equipment from the originator to the issuing special purpose entity (SPE), leaving title to the equipment in the hands of the originator. But a recent change to the Canadian Bankruptcy and Insolvency Act (BIA) permits a restructuring debtor to, in effect, repudiate certain contracts including possibly personal property leases, with the approval of the monitor, trustee or the court. There have always been some concerns about the originator retaining title, but the perhaps unintended consequence of this new BIA change is that the originator may be able to repudiate the master lease underpinning the whole structure.

There's still debate about what this means. But the BDC is taking no chances for CSCF deals, requiring either that title to leased vehicles be initially moved to an intermediate SPE or that the ABS-issuing trust have a call right to acquire title to the vehicles if certain early warning triggers occur. Exercising such a call right, however, could expose the trust to significant income tax concerns and, therefore, while using an intermediate SPE upfront can add structuring costs to the transaction, it may be the preferred alternative.

While there was initially significant interest in the CSCF, the program was slow to take off because the industry ended up regarding the initial pricing — announced in late spring 2009 at 350 basis points over the applicable Government of Canada bond benchmark — as too costly. The CSCF reduced its pricing to 150 basis points over the benchmark in September 2009, and the first deal was announced at the end of November when CNH Capital Canada sold a C$300 million structure backed by loans to agricultural and construction equipment dealers.

There was other positive news for the market soon after the government first announced CSCF: starting in April, CIT, Nissan and BMW all placed private deals. And in June Ford Auto Securitization Trust sold a C$600 million triple-A public deal without any assistance, only the third public securitization since the crisis began and the first in a year.

The private deals also benefited from having a much larger buyer base — U.S. investors. That was impractical until the 2008 change to Canada's Income Tax Act eliminated withholding tax on most arm's-length cross-border interest payments; tax on non-arm's-length payments between Canada and the U.S. was gradually phased out by the start of this year. Before 2008, such deals were either uneconomic or required a complex five-year-plus term loan structured to fit within various constraints.

U.S. conduits are also now looking at funding Canadian receivables. There are still some Canadian tax issues that need to be addressed, especially the new limitation on benefits rules contained in the recently revised Canada-U.S. tax treaty. But structures have been developed to work around them. There were 11 cross-border conduit deals worth more than C$2.9 billion between March 2008 and April 2009, according to Standard & Poor's.

Two years ago, there were many who described the Canadian securitization market as dead and buried. Certainly, the past two years were exceptionally challenging. Many market professionals have moved on to other areas and companies that relied on securitization as a primary funding source are still struggling to find alternative sources of financing. Many smaller and mid-size finance and leasing companies, for example, still cannot access securitization funding, although the Canadian finance minister and the BDC are considering a number of ways to fix this.

But there is now, at last, a sense that the market didn't die after all. True, term deals are hardly coming at a furious pace and Canadian bank-sponsored ABCP conduits are only just starting to show interest in new deals. But at least there's some movement. And as more deals come to market, it gives hope that, unlike the patients in *Awakenings*, emerging from its coma won't be temporary.

Mark J. Selick *and* Michael E. Burke *are partners at the law firm of Blake, Cassels & Graydon LLP, and both work in the Toronto office in the Financial Services Group. Mark's practice focuses on securitization and leasing. Michael's practice focuses on securitization, leasing and asset-based lending.*

By Matthew Tomiak and William Berliner

The home loan crash has made restructuring mortgage bonds hard enough. The government's HAMP initiative for loan modifications layers on more levels of difficulty.

The Complex New World of RMBS Shortfalls

The downside of trickle-down structures Shutterstock

How to restructure the overwhelming number of troubled loans backing mortgage bonds remains one of the major challenges of the credit crisis. It's not just that virtually no private-label residential mortgage-backed securities (RMBS) were structured with subordination levels sufficient to absorb current losses on their loan collateral, making even senior and super-senior securities subject to potential downgrades and writedowns.

The other major issue is that multiple generations of deals were created and codified without sufficient guidance on how loan modifications should be treated. This frequently pits owners of different bond tranches against each other. Meanwhile, some solutions, including government-mandated programs, can bring bizarre and counterintuitive results for bondholders. Below we'll examine issues arising from loans under consideration for modification under the Obama Administration's Home Affordability and Modification Program (HAMP).

First, let's quickly outline the two primary structures used in RMBS transactions. The shifting interest structure is the simpler of the two. Subordinates provide the only credit support to the senior bonds, the principal balance of the collateral and the bonds are the same, and principal and interest cash flows from the collateral are matched to the principal and interest obligations for the securities. Interest from the underlying loans is used to pay interest to the security holders, and principal cash flows are directed to amortize the bonds.

The overcollateralization (OC) structure is more complex. It was used to build in extra support for products with greater exposure to credit risk, including subprime, second-lien loans and some Alt-A. The principal balance of the loan collateral is greater than that of the bonds being sold, creating the deal's overcollateralization. And the weighted average interest rate generated by the collateral is greater than the weighted average coupon rate for the securities being issued, meaning excess spread is also used to support the senior certificates.

Multiple generations of deals were created and codified without guidance on how loan modifications should be treated. This frequently pits owners of different bond tranches against each other.

For either structure, an interest shortfall is the inability to pay the aggregate interest owed to the securities from the proceeds collected from the collateral. These typically result from delinquencies and defaults by borrowers on the loan collateral. Interest shortfalls from a mismatch between the weighted average note rate of the deal's collateral and the weighted average coupon rate of the certificates is basis risk. The treatment of basis risk has important implications for the allocation of resulting shortfalls. A principal shortfall represents the losses realized when the principal balance of the collateral is less than that of the associated bonds.

Mortgage holders are learning a thing or two about butting heads Shutterstock

Loan Modifications Within Structures

HAMP seeks to reduce a borrower's debt-to-income (DTI) ratio to 31% by a set of iterative calculations: reducing the loan's note rate, extending its term and reducing its principal balance by either forgiving or deferring principal. We shall focus on the first and third points, as the impact of extending loan terms will be limited — we anticipate that it might throw off the schedules of tranches in the senior sector, mainly impacting PACs, super-stable bonds and corridor floaters.

The initial issue addressed by trustees in handling rate reductions and resulting interest shortfalls is whether the deal contains provisions for a net WAC cap (NWC) which means that the coupon rates of *any* bonds, whether senior or subordinate, cannot exceed the deal's net WAC — the weighted average coupon of the deal after taking costs and expenses into account. If NWC provisions exist in the governing documents, the net WAC cap shortfall is the difference between the rate of interest the bonds would have received based on their contractual coupon rate and the net WAC.

Whether or not the deal was structured with a net WAC cap will impact how interest shortfalls are treated. With a NWC, all certificates are potentially subject to interest shortfalls, depending on their coupon rate vis-à-vis the transaction's net WAC. Without it, interest shortfalls are treated as an undercollection of interest and losses are allocated to the certificates in reverse order of seniority.

To illustrate these decisions and their impact, consider a hypothetical OC transaction with one senior and one subordinate tranche. Assume that the deal's original net WAC is 8%, that Libor is 2%, that the senior bond pays L+150 basis points — giving it a 3.5% coupon — and that the subordinate bond resets at L+300 for a 5% coupon. The excess of the deal's WAC over the weighted average of the bonds' coupons is treated as excess spread, which serves as part of the overall credit support and typically is the first component to absorb losses.

If the net WAC declines sharply and the transaction contains an NWC, neither bond is allowed to pay an interest rate above the net WAC. Therefore, a decline in the deal's net WAC to 4% means that holders of the subordinate bond can receive only 4% on their bonds, forcing them to incur a shortfall of 100 basis points. If the net WAC drops to 3%, both the senior and subordinate bonds incur a net WAC cap shortfall of 50 and 200 basis points, respectively.

If the deal does not contain NWC provisions, both bonds accrue interest at their full coupon rate, irrespective of the deal's net WAC. Interest shortfalls resulting from a decline in the deal's net WAC are instead treated as an undercollection of interest and impact the last bonds in the capital structure scheduled to receive payments. In this case, the senior bond is only impacted once the subordinate's interest — and in certain transactions, principal — distribution is reduced to zero.

HAMP modifications attempt to reach a 31% DTI by first reducing a loan's note rate. Done in large enough numbers within a transaction, modification activity could reduce that deal's net WAC. It is unlikely that senior bonds in a structure will experience shortfalls due to NWCs, given the excess spread built into the deals at issuance and the relatively low coupon rates associated with senior tranches. However, the senior securities do have some exposure to shortfalls in deals where an NWC is present, were the deal's net WAC to decline sufficiently. More importantly, higher-rated subordinates have exposure to NWC-related shortfalls. This suggests that large-scale modifications could cause interest shortfalls in more senior bonds than is commonly believed.

Trustees, servicers and securities administrators do not want to act unless they are certain that they are free from all liability.

Other classification issues affect whether an interest shortfall is treated as a net WAC cap shortfall or simply passed on as a loss to the most junior certificate. When loans are modified within a deal, the servicer must decide whether to consider the new, modified rates as the official rates for the loans or use the original rates. If the former is chosen and an NWC is present, the result is a reduction in the deal's net WAC, creating shortfall risk for the transaction's more senior bonds. If the latter is taken, shortfalls are not considered to result from basis risk but treated as an undercollection, with shortfalls allocated as losses to the subordinates in reverse order of seniority.

Whether the bond has an OC or a shifting interest structure doesn't change matters much. An OC deal may still have enough excess interest to cover any shortfalls, since the overcollateralization itself creates excess interest. By contrast, a shifting interest structure has no mechanism except a subsequent recovery to pay back interest shortfalls. However, the treatment of shortfalls resulting from interest rate modifications can vary. An excess IO — in other words, an IO tranche created from the difference between a deal's net WAC and the bond coupons — may bear all net WAC reductions resulting from rate modifications before they are allocated to the other certificates. In a fixed-rate deal with a single coupon created by dividing the collateral into discount and premium groups — which would create WAC IOs and POs — rate reductions down to the deal coupon rate are allocated to the IO. Any further rate reductions are treated as undercollections and allocated to the certificates in reverse order of seniority.

Further complicating the determination of the correct mortgage rate is how to treat subsidies received by investors under HAMP. The amounts involved are small, so the economic impact is limited. But it does create the potential for bizarre outcomes. The Treasury will reimburse investors for half the costs of reducing monthly payments from a 38% DTI ratio to 31%. The current rate can be viewed as either the actual note rate being paid by borrowers, which would result in an artificially low net WAC, or an adjusted rate that reflects the Treasury payments.

In either case, this can cause unintended results. Using the subsidy to gross up a loan's coupon and thereby the deal's WAC means deciding how to treat with delays in receiving the reimbursements. Any delay between the loan's due date and receipt of the subsidy would create a shortfall in interest collections that would be passed on to the most junior certificate. To avoid such a shortfall, the servicer could advance, and later recover, the delayed payments; alternatively, they can be accrued only upon receipt. The latter could, however, create problems, since it would be the only cash flow within the structure with such a lag.

If the current rate remains the one paid by the borrower, the subsidy must be classified as either a principal or interest collection. If classified as principal, the bond balances would be artificially reduced by the payments; combined with the reduced WAC, this creates potential shortfalls in entitlements. In an OC structure, if classified as interest the subsidy effectively creates additional credit support. In instances where it is not needed, the payments would be released to the residual holders. In a shifting interest structure, the subsidy would probably simply flow to the residual as such structures typically do not contemplate interest in excess of the bond-to-loan parity.

Certain servicers say they will not use the subsidy to gross up deals' WACs, but will treat it as excess interest. This would create unintended and counterintuitive results. For example, most OC structures use excess interest to first build or restore OC. This means that excess interest could be directed to pay down the balances of senior bonds even when they are absorbing an interest shortfall in the same period.

Principal Forbearance

Under HAMP, reducing a loan's principal balance is advised if lowering the loan's interest rate and extending its term still do not yield the savings necessary to reduce the DTI to 31%. In most cases, principal is not considered permanently forgiven but forborne — basically deferred — with a permanent resolution expected at some point.

Almost every non-agency RMBS tranche now has potential exposure to shortfalls. Even bonds at the top of the credit stack can be exposed to credit-related losses.

Given that most deals do not have specific terms addressing the issue, it was unclear whether forborne principal should be treated as a current loss subject to an immediate writedown. If so, such a loss would flow through the deal's waterfall, resulting in a writedown for the most junior outstanding subordinate tranche. Alternatively, the amount of forborne principal would be held in abeyance as an open item until the loan is either fully liquidated, at which time the entire principal balance is written down, or the forborne principal is paid by the obligor.

An immediate writedown of forborne principal would benefit the senior bondholders at the expense of the subordinates. They support their position by arguing that an immediate writedown is a better reflection of reality, and avoids a mismatch between the interest accrued on the certificates versus the loan collateral, since the deferred principal does not accrue interest. By contrast, subordinate holders would benefit by deferring the writedown, as they would continue to receive interest payments on the principal balance in question. These bondholders argue that the forborne principal is still due and payable; it is also inconsistent with the notion that losses should be taken only when a loan is liquidated.

Will his administration add some clarity to HAMP? Getty

The Obama Administration believes that forborne principal should be written down immediately. The HAMP FAQs dated November 12, 2009 state: "…servicers, securities administrators and other transaction parties should treat HAMP principal forbearance amounts as realized losses…under any applicable securitization pooling or trust agreement" unless the deal documents "explicitly and affirmatively" require an alternative treatment.

This should have the force of law and fall under the safe harbor for servicers and trustees. But it remains a polarizing topic, since one category of bondholders will benefit at the expense of another in every instance. Trustees, servicers and securities administrators do not want to act unless they are certain that they are free from all liability. They are seeking further Treasury guidance. In December, ASF sent a letter to the U.S. Treasury recommending measures that would enable participants to allocate principal forborne as a realized loss under HAMP. The letter can be found at http://www.americansecuritization.com/story.aspx?id=3825.

Loss Allocation Once Subordinates Are Exhausted

In all RMBS deals, losses are applied to a deal's subordinate securities in reverse order of seniority, irrespective of whether they represent principal or interest shortfalls. However, there are various combinations of cash flow and loss allocation mechanisms for the senior certificates once the related subordinate certificates have been completely eroded due to losses, including those resulting from modifications.

For shifting-interest structures, almost all transactions provide that once the subordinate certificates have been eroded, the remaining senior certificates will take losses and receive principal payments pro rata regardless of their principal payment priority before such event. OC structures are more complicated. In some deals, mainly those before mid-2005, the senior bonds are not written down when losses are realized after the subordinate balances have been reduced to zero. These seniors' principal balances are only reduced through payments made by the obligors, not by the allocation of losses. The senior certificates allow for negative overcollateralization, and the losses are considered implied. In these deals, losses are realized only when all the collateral pays off and the trust terminates with some bond balances remaining unpaid.

When negative overcollateralization occurs, principal can continue to be paid according to the deal's senior pay rules, or shift to a pro rata payment structure. Where the transaction remains in a sequential principal payment structure, with shorter bonds receiving principal before longer ones, the longer bonds have a greater exposure to losses, since losses are only allocated once the loan collateral is completely paid off.

In later deals, the structures mandate that principal losses are allocated to the senior bonds as they are realized, once the principal value of the subordinates is reduced to zero. Losses in this case are typically allocated pro rata, since the ratings agencies' position was that no senior bond can be ranked above another. Without a pro rata treatment, some senior bonds in the structure are subordinate to others, disqualifying them from being rated triple-A. This view evolved to allow the creation of super-senior and senior mezzanine bonds with explicit prioritization within the senior bonds in the structure.

One conclusion to be drawn is that almost every non-agency RMBS tranche now has potential exposure to shortfalls. Even bonds at the top of the credit stack can be exposed to credit-related losses. This means that all private-label investors have to be prepared and able to dive into the minutiae of deal documents. Also, the controversies over principal forbearance show how the lack of an understanding of the ripple effects of loan modifications has hampered efforts to deal with the foreclosure crisis. This has complicated an already tricky situation and slowed the process of cleaning up the housing mess.

Matthew Tomiak *is a partner at 12th Street Capital LLC, a capital markets group based in Southern California that specializes in mortgage- and asset-backed securities.*

William Berliner *is a mortgage and capital markets consultant based in Southern California.*

Securitization fights back

The court of public opinion has passed some harsh judgments on the asset-backed market for its role in the crash. Some may be justified, though the case can also be made that securitization was just another product that was abused during a bubble blown by cheap money and heady expectations. But the backlash has gone too far, fostering potential new rules and regulations such as mandatory risk retention that could undermine the market's long-proven advantages. Here leading industry experts make the case for why securitization should remain a lynchpin of the capital markets, and what can be done to achieve that: better access to data, less complexity, more attention to detail and, like wine and cheese markets, the need to establish a brand that can be trusted.

The Panel:

The Moderator
Antony Currie – *American Securitization*

American Securitization Forum
Tom Deutsch

The Investors
Ralph Daloisio – Natixis
Ron D'Vari – NewOak Capital
Sanjeev Handa – TIAA-CREF

The Issuers
Bradley Brown – Bank of America
Richard Johns – Capital One

The Advisers
Tom Hamilton – Barclays Capital
David Jacob – Standard & Poor's
Brendan Keane – First American CoreLogic
Tony Nunes – Bank of New York Mellon

The Lawyers
Steve Kudenholdt – Sonnenschein Nath & Rosenthal
Stuart Litwin – Mayer Brown

Antony Currie: Perhaps the biggest issue for securitization in the short term is what happens when direct government support is removed. TALF and the Fed's MBS buying program are both scheduled to end soon. Are the markets ready for that?

Richard Johns: A lot of it depends on what the economy is looking like when they do. But I actually have to say I've got some concerns about the March deadline for TALF. We have seen a lot of issuance coming out of folks this year, so the demands on TALF have been substantial. Sure, issuers have certainly been able to get non-TALF deals done, but that doesn't necessarily mean that the volume that needs to get done this year can be done in a non-TALF environment. Back in 2007 as spreads ballooned out a lot of issuers funded at the short end of the curve because they didn't want to carry that cost of funds for too long. So there are some sizable maturities coming up that I'm not quite sure we're yet ready to refinance outside of TALF.

And on the basis that TALF's been substantially underutilized compared with the initial amount set in place for it, I'm struggling to see the harm in leaving it out there until it's proven that it's no longer needed. There's almost a natural trend here that's the opposite of "if you build it, they will come," which is "if you leave it there and people stop coming, then you can knock it down." But forcing it down could have some nasty consequences for the market.

Tom Hamilton: Why do we have to shut the program down? If the Fed and Treasury really want to wean the market off it, why not just say loans now cost Libor plus 125, and then Libor plus 150? You don't want to cut off fringe issuers from being able to issue just because three or four are issuing inside 100 outside TALF. As long as they broadcast the fund cost in advance, they can dictate how quickly, or not, we're going to wean off this program. That would probably be a more methodical exit that allows them to exercise more control over a period of time. If everyone is issuing inside of the rate, fantastic. But just pulling the program isn't the best solution.

Bradley Brown: Yes, letting the market wean itself off by calibrating the use of TALF through haircuts and pricing makes a lot of sense, particularly for those product types that are executing consistently without TALF. However, a few deals were done recently in more off-the-run product types such as servicing rights, non-prime cards and lower credit equipment leases. Those types of deals are pretty critical for providing access to credit and may not get done today without TALF support.

from left: Natixis's Ralph Daloisio, Richard Johns of Capital One, Mayer Brown's Stuart Litwin, Barclays Capital's Tom Hamilton and Steve Kudenholdt of Sonnenschein

The risk of doing away with TALF is that such issuers are unable to access the market or can only sell at overly wide spreads, which runs the risk of moving overall ABS credit spreads wider.

Tom Hamilton: Yes, if you want to move the cost of funds, that's one thing, but you don't want to put them out of business.

Antony Currie: What about the MBS program?

Steve Kudenholdt: It's a similar situation: the market has to be weaned off rather than suffering a sudden halt. The effect of the program is certainly to keep interest rates low, but it's also had some adverse effects. First, it's really keeping the non-agency RMBS market from starting again, because new loan originations just can't be originated on a market clearing level that would give the investors what they need and cover all the costs of securitization into the non-agency markets.

Once the government winds down these RMBS purchase programs and rates creep up, that will be part of what's needed to get the non-agency RMBS market started again. But, of course, currently what it's doing is protecting property values, and if they pull out of it too quickly, then we could take a step in the wrong direction.

Tom Hamilton: Stopping buying is a very different thing from starting to sell. If exiting the program means just stopping buying on April 1, I don't think that's nearly as big an issue. How they sell what they have is a much bigger problem. If all the Fed does is stop buying, spreads will widen, but perhaps only modestly, up to 50 basis points or so. But that ought to be met with some pretty decent demand as private investors are, in general, underweight the sector. It's kind of ham on rye. But if the Fed also suggests it needs to shrink its balance sheet, that's another issue entirely.

Antony Currie: Given the problems of the past couple of years, should there be a role for securitization?

Ralph Daloisio: Unequivocally there needs to be a future for securitization and, fortunately, that's a view shared not only within the industry but outside, even among those who have been vocal critics. There's a concise rationale: securitization is a more efficient financial technology than the traditional banking system.

How does that happen? Banks are basi-

Richard Johns of Capital One

cally brokers of money, so they have to pay less on their money and charge more for it when they turn around and lend it back out in order to drive the returns required by their equity investors. Take them out of the middle and borrowers pay less for their loans and investors earn more from the money that they lend. Though it's hard to measure what contribution that efficiency has delivered to aggregate GDP growth, my speculation is it's very significant and that the total benefit over the years far exceeds whatever the cost of cleaning up this crisis will be at the end of the day.

Richard Johns: We need the housing market and the economy to pick up, and we want consumer confidence to increase. It's hard to see how that happens if there's no readily available supply of credit to the consumer. Even if you strip out the $6 trillion of agency paper, that still leaves $4 trillion or more of total consumer securitization out there. To remove that market would have a huge impact on the availability of credit.

We're also facing increased capital requirements as well as a reduction in available liquidity if these markets aren't functioning. That combination is disastrous for the nation's economy. I just don't see how the economy can function without a performing securitization market.

Antony Currie: But with lending down and more cash on bank balance sheets, are banks reliant on securitization anymore? Can't you do without it?

Bradley Brown: Well, there's a natural reduction in the balance sheet because lending demand has declined, so yes, at the moment we are not as reliant on it. But at the same time, banks issued a significant amount of debt funded through TLGP. That will need to be refinanced and securitization is certainly an option that could be effective both in terms of offering longer-term funding options but also in appealing to an investor base beyond senior unsecured paper.

Even with all the potential regulatory and capital changes, there are pockets of money looking for the risk reward profile that gets issued through the securitization market. It makes a lot of sense to leverage that.

Richard Johns: Banks will survive without securitization. Sure, we might have some issues refinancing some maturing debt but ultimately we can scale back our balance sheets and we will survive.

The question I think you have to ask is: does the consumer survive as a consequence of that, because it is going to mean massive balance sheet shrinkage across the banking industry. If we're lending less to consumers that creates a significant issue trying to kick start the economy. We're already there today, with house prices falling and a lack of availability of credit. It's a vicious cycle and if we don't get out of it things will get worse.

Steve Kudenholdt: Securitization is simply how we get capital from investors that are not in the lending business to people who need loans. The concept of disintermediation has been around since the '80s. We can't do away with that. There is a need for this capital, there is a desire to put it to work in quality fixed-income assets that fund consumer and business borrowing.

We need much better diligence and disclosure on these assets and controls over origination quality. And we should be most mindful of making sure that we build into new structures and processes some certainty that securitization is not, in the future, going to contribute to excessive loosening of credit standards down the road. That's what went wrong with securitization. It became a method by which origination standards became drastically over-relaxed, and as long as we make sure that never happens again, securitization can be safe for the capital markets and the world.

Brendan Keane: I'm not so sure where we failed as a market. We've certainly failed in getting the message out about the advantages of securitization, because clearly we have gone from the court of economic efficiency to one of public opinion and political unpopularity. But I don't think the structures failed. It was a discrete set of assets that helped bring things down. The structures have generally proven their merit.

Sanjeev Handa: What has happened in the years leading up to the crash is what constitutes securitization expanded. Back in the old days — and most of us here, unfortunately, can remember the old days — you had 30-year residential mortgage loans, you had credit card debt and you had auto debt. It has ballooned from those three asset classes to a host of alphabet soup creations that had, sometimes, little relationship to the economic value that was created in the marketplace.

We lost that connection between how, say, a pool of auto loans can fund the sale of cars, which keeps people working, which makes the process worthwhile. Instead, we created structures that were essentially directional bets, nothing more than if the statistical probability of an event happening is X, then a product must be triple-A or double-B and thus a good or bad investment. It was less connected to economic facts. So what we need to ponder is not whether securitization will be necessary in the future, because the answer is unequivocally yes. Instead the question is: what does securitization mean in the future?

David Jacob: Going back in history, securitization was used to solve the problem banks had of duration mismatch. But it also allowed us to tranche up the prepay risk to create a plethora of short-, medium- and long-term assets to match investors' own risk and duration appetites.

Tom Hamilton: We are in a court of public opinion and the baby is getting thrown out with the bath water. But there was a confluence of events that no one saw. We created a massive negative feedback loop that few if anyone ever thought could happen in mortgages. Even as much as those problems with subprime underwriting and fraud existed, no one came close to guessing the losses, including in prime, where 5% of mortgages are delinquent over 90 days. These are massive numbers, and no one predicted that because no one understood the velocity of this negative feedback loop. The question is: how does securitization tie itself to that?

Barclays Capital's Tom Hamilton

I don't know the answer. There are certainly all sorts of different medicines. But there isn't one single solution — we can't just hold the first loss piece, or make the structures simpler. There's a whole laundry list of things that need to change to avoid getting trapped in a similar feedback loop again. We've got, say, 10 things to fix here, and they're all interrelated. The problem is this thing bubbled up for three years. Nobody wanted to really admit what was happening. And it was only when the crisis was splashed all over the front pages that everyone had a come-to-Jesus moment.

Richard Johns: This crisis would have happened irrespective of the securitization market. Confidence bubbles happen. They've been happening since the South Sea Bubble, and they will continue to happen.

The securitization market did, perhaps, create more leverage in the system than previously existed, when banks were simply portfolioing their loans and funding through new branch deposits and corporate and bank debt. Once that changed and we moved into a more leveraged environment, not only did that help exacerbate the bubble, but clearly when the bubble burst and that leverage unwound, the speed of acceleration and deceleration of how the economy shifts really changed.

David Jacob: You're right, Richard. Risk-taking got out of hand across the credit markets, whether bonds or loans. People got lax, so we were in a credit bubble beyond the securitization market — banks were putting loans on their books which were not meant for securitization. Credit standards deteriorated everywhere.

David Jacob of Standard and Poor's

Stuart Litwin: Many of the market reforms that people are now considering would not have prevented many of the losses of the past couple of years. A lot of really smart people lost a lot of money because home prices declined so much. And there's nothing in any of the regulatory reforms that anybody is talking about that would have stopped home prices from declining.

Tony Nunes: There has to be a fundamental change, so the new assets being created have to be structured in a different fashion — once home price depreciation has stabilized. Deals are going to have to be less complex. And investors must be much more detailed in their due diligence, rather than just relying on reps and warrants. All of us have to do the work we said we were doing, possibly more diligently, instead of just assuming someone else is assuming the risk.

Steve Kudenholdt: As Brendan said, it wasn't the structures, it was the assets. There are some things that we now know will cause problems if they happen again: high loan-to-value ratio loans over 90% or 95%, loose second lien practices, loan products that have built-in payment shock elements, lack of full documentation, stated income and so on. We need to make sure that those types of assets do not get originated in substantial volumes such that they would create another housing bubble. That would make a difference if it were achievable, as opposed to things like risk retention, which may well not be able to prevent another housing bubble.

Ron D'Vari: The real culprit may be excess liquidity and the desire for triple-A assets driven by somewhat irrational capital rules. But natural triple-A assets are rare in the marketplace. And I assure you that same problem will come back because our capital rules are still the same. It's still too easy to take on a lot of triple-A assets with somebody else's funding and pay yourself some fees and call that revenue. And we still have excess liquidity. Investors cannot let cash burn a hole in their pockets. That's just not how it works. If you have the cash in the system, it will go somewhere, that's the way credit works. But lending hasn't picked up, so where does the excess cash go? It goes to buying secondaries. That's sent markets rallying, which has upset a lot of distressed buyers who think assets have run way ahead of intrinsic value because people are taking risk again in places where it may not be as appropriate for them.

So let's not blame the securitization market for something that the market really was set up for. Securitization is a tool. It's the incentives that enabled using those tools wrongly.

Antony Currie: We're already seeing a relaxation of lending standards, in small pockets at least. Just in the last few weeks of the year, private equity firms have managed to secure funding for dividend recaps, while PIK toggles have returned to the credit markets. There has even been a CLO deal. So it seems we can't stop ourselves from repeating at least part of the cycle.

Tom Hamilton: What's interesting is, isn't the government doing the same thing? Doesn't Ginnie Mae now account for half of the securitization of new mortgages? That means 50% of all purchased mortgages coming to the market are backed by the U.S. taxpayer.

Meanwhile, the government and Congress and politicians are saying: "Listen, we should put more constraints on the securitization market." Yet unbeknownst to many, they're doing the exact same thing, providing leverage through TALF. I'm not saying that was right or wrong, but they're providing leverage: 97% LTV loans at Ginnie Mae for basically every house that's available. Maybe their underwriting is fantastic, I'm not making any judgment on that, but they're solving the leverage problem with leverage.

By the way, I think they should: if they weren't doing this, we would be facing a much bigger problem. We have to wean ourselves off of offering near-100% LTV loans, though. But it's a process. We can't, say tomorrow: "Listen, you've got to have 20% down on your house. I don't care what happens." The housing market would go into a freefall.

David Jacob: You can draw interesting comparisons with Australia. One big difference is the notion that we in the U.S. don't have recourse. Or if there is recourse, we don't really enforce it. Yet many countries in the mortgage-backed market take recourse seriously. If you don't pay your mortgage, they go after you, they go after your assets, whereas here we had people owning five, six homes. Who cares? You had a free call option. In fact, you were paid to have the call option on real estate because you had negative equity when you started out with your mortgage, so you had an option on the upside of real estate. And with no recourse, why wouldn't you take a free option if someone gave it to you?

There's also the difference between Australia's originate-to-distribute model and ours. Of course they do securitize in Australia, but it's very, very well known who the originators are. If there's a problem with a mortgage, it kicks back to the originator. Maybe if the U.S. market was serious about recourse, people would think twice about taking — or making — a high LTV loan.

Richard Johns: The recourse issue creates a dangerous precedent. There's a very real risk that consumers now believe it's okay not to pay their debts, whether that is a mortgage or a credit card or an auto loan. Somehow that needs to be corrected. I don't think it's going to happen during this administration, but for the future of the securitization industry, it's imperative that investors are able to take some comfort that the loans in a securitization are going to perform in lockstep with how the economy performs, rather than there being the risk that consumers are just going to feel they can walk away at any point

Antony Currie: Would forcing issuers — and perhaps other key players in securitization deals — to retain some of the risk not help improve lending standards and loss rates?

Brendan Keane: I'm not convinced, as it should be investors who drive the market. What we saw were issuers and originators driving the market, but what we need is a way to understand and price the 95% of the risk that stays with investors. I'm not so sure that 5% risk retention, or whatever the magic number is, will necessarily be enough on its own to convince investors that their 95% is properly priced.

Stuart Litwin: If you're going to have risk retention, you've got to recognize that there's a tradeoff. On the one hand, your origination standards will probably be better in the long run. On the other hand, when you no longer have as much liquidity because you can't sell what you've originated, you have less financial capacity to originate more loans. In other words, risk retention, by definition, is going to put downward pressure on the amount of lending.

Bradley Brown: We certainly could benefit from more effective governance, regulation and oversight. But we must be careful not to go too far. Largely what's being discussed from a regulatory initiative perspective is a one size fits all approach. And there are definitely dangers that this could dramatically impact the availability of credit to consumers. For us, as a bank, funding is not our limiter, capital is. So effective funding tools help, but they don't help with the velocity of capital.

Whether it's the FDIC, whether it's the accounting regulations, whether it's regulatory or legislative initiatives that really prohibit that, then at some point you're going to have to price for that risk or you have to pull back from the market. In effect, that's telling banks — and not just the big firms but smaller banks as well — that they need to develop a very different business model. That would have a big, negative impact on a sustainable economic recovery.

Antony Currie: And surely the crisis taught us that issuers do actually retain risk: early payment defaults and fraudulent loans get put back to the lender at face value. Many lenders just ignored it.

Bradley Brown: That's a great point. When you think about nonconforming residential loans, first we've got to get originators and investors to agree on economics. But before you can even do that, you have to understand how you price risk today, if that's even possible given the uncertainty presented by the number of initiatives currently in plan. For example, you have to think about early payment default language, appropriate rep and warranty clauses, and how to enforce it all. Investors need to get comfortable that they can underwrite the credit profile, and originators need to be comfortable that they understand the risks they are left with.

That could very well be uneconomic initially. Say, for example, that regulators look at the reps and warranties and determine that certain reps constitute an indirect credit substitute. That could put originators in a position where they're holding more capital on an asset than if held outright. That would make no sense.

Sanjeev Handa: As an investor in senior securities and subordinated securities, and I've said this to anyone who would listen, risk retention is a red herring. Oftentimes, whether or not the sponsor retains the risk has little to do with the performance of the deal.

The real issue is alignment of interests. Let's take a subprime pool of the future. If someone buys a first loss piece, everyone needs to be able to rely on the reps and warranties. Maybe make the reps and warranties more substantive with some bite to them. Make the people that sell these securities really believe in what they're selling — throw in proper recourse, too. Then issuers ought to be selling paper that they have to believe in. Presumably that will feed in because all sides ought to have more faith in the overall system. Once you have more integrity of asset quality throughout the system, the risk retention argument ought to disappear. Risk retention is just like anything else when there's a complicated subject. People want to believe there is an easy solution. Make the issuer retain 5%, 10% or 20%, whatever the number is. But there's no such thing as an easy fix for a complicated situation.

Ron D'Vari: Consider this — my wife would love this: if you buy a dress at Bergdorf and there's something wrong with it, you return it and get your money back. Bergdorf does that for its reputation and can charge a premium for it. And the customer has perhaps learned that buying cheap is not always the most economical thing to do.

We investors aren't like that. We haven't the proper training. We always go out and try to not really pay for a brand, not pay for people who do the most to get the proper security out in their hands. Yet we expect to get the same insurance that you can get at Bergdorf. But we have not paid for better behavior. So in a boom or bubble, issuers' spreads collapse between top tier and the bottom tier.

Selling bonds is no different than selling retail products, yet that market has been tested very well, and there are those who know that they can charge a premium. Retention isn't required, though, whereas in the securities market it is. I don't quite understand that.

Steve Kudenholdt: Risk retention is a reform too far. It's very susceptible to politicization and very difficult to do in a way that really gets it right. An IMF study analyzed the effect of risk

Sonnenschein's Steve Kudenholdt

retention on the behavior of an originator and concluded that, forget the first loss piece, it only works if they retain the mezzanine slice.

It's too complicated to get right as a regulatory matter. It's very easy, though, to politicize. If you look at the House version on risk retention, it has carve-outs for loans originated under GSE standards — those would have lower retention requirements. It's easy to foresee more exemptions. It almost looks like it's moving in the direction of a tax on risky underwriting. If that's really what it should be, then maybe the right thing to do is simply to prohibit some of the risky underwriting practices themselves as opposed to indirectly doing it through risk retention.

There's a lot that can be done to make reps and warranties more effective. As it stands investors don't feel they can be confident that the reps and warranties are going to be valid or that they're going to be enforced — though ASF is going to work on some best practices on this. One idea could be to include a requirement that every loan that goes 60 days delinquent has to undergo a diligence review by a trusted third-party to determine whether there were underwriting violations. The results of that review should be disclosed to investors as part of the periodic reporting.

Tony Nunes: To return to the example of your wife, Ron, the point is that she knows what she bought.

Ron D'Vari: Exactly. She's an experienced buyer.

Tony Nunes: So it goes back to doing the homework to understand the underlying collateral and possibly requiring some additional diligence on that collateral. People are going to have to do that to gain confidence that it's performing or to validate their models.

Sanjeev Handa: But in Ron's example, Bergdorf has 100% of its retention. When I first started doing deals, we had things in securitizations like limited repurchase obligations, where the issuer was responsible, via pool policy, for the first X% of losses right up to where they could get a true sale opinion. That aligns interest real quick.

So there are ways to do that, which may make the market more inefficient at the beginning but will perhaps enable it to develop reforms and then get to a point where people can differentiate between good issuers and bad issuers. Although ultimately there shouldn't be such a thing as good or bad, because if someone wants to take the risk in a more aggressive originator, they should be allowed to do so.

Antony Currie: Let me point out the results of the survey of ASF members we conducted at the end of the year. A fifth of respondents reckon there should indeed be mandatory risk retention of at least 5%. Another third said that there should be risk retention but 5% is too inflexible. So more than half of members, if we extrapolate, believe in risk retention.

Brendan Keane of First American CoreLogic and NewOak Capital's Ron D'Vari

Ron D'Vari: Ultimately the investors have to make these decisions, not regulators. If investors are not willing to do their homework and want to essentially delegate that task to others, be that issuers, ratings agencies or whomever, that's a problem. That said, there should be a quality control agency of some sort — not a regulatory body but quality control.

If you get on an airplane, for example, you're relying on the FAA requiring that it has all the records of when every single rivet was produced, did it really meet the requirements, and so forth. Maybe financial engineering needs a similar agency.

Antony Currie: Can you really have an effective quality control agency without granting it some kind of regulatory power?

Ron D'Vari: It would come down to who's paying for it. If the incentive is just to do more deals, they're going to look the other way. So it has to be investor paid. Otherwise, if investors want to have a free lunch, they're going to have to live with the volatility.

Stuart Litwin: It doesn't need to be a regulatory agency. I don't think it needs to be a rating agency, either. Of all the things people have found to be a problem since 2006, accountants' attestation reports have not been one of them. There's no reason why accountants couldn't do this through attestation reports without any regulatory body.

Ron D'Vari: It could, for example, be an industry-selected body paid for by the industry.

Brendan Keane: What about Project RESTART? Isn't that what that was trying to do?

Tom Deutsch: Ultimately we have to create the legitimacy for the new process. Investors have lost some confidence in private-label mortgage-backed securities, in how the reps and warranties process works, or doesn't — the repurchase process, in particular. How do we get that process back to working? Part of that is having investors who have vetted what may be a new process, reviewed it, evaluated it and stress tested it to see whether it works — and ultimately having other investors find that that is the right process.

When it comes to repurchase provisions, for example, you need some party to have some skin in the game to effect the repurchase. In the good old days, it was the handshake and a promise that "I'll buy it back if need be." Now it's a process, as we're seeing in very stressed times, of who has the appropriate incentive to not only detect the breach of the rep and warranty, but also the capability to breach that rep and warranty and the incentive to go through the legal process of putting that loan back. Each of those is a very extensive and expensive step in the current system.

We've got to reduce those transaction costs to make that happen, which, on the front end, then gives a lot more and better incentive for the originators to get it right so they don't have to get it on the back end. Having said all that, the investors do have to incur risk. Loans will default, loans will go delinquent, and they'll have to accept the credit risk associated with that. But on the reps and warranties, we need to better control the operational and fraud risks to create that incentive for the originator to have to revamp their process to get it right, particularly for subprime and Alt-A loans.

Antony Currie: It sounds like you're talking about a clearinghouse of some sort.

Tom Deutsch: I don't know if it would be a clearinghouse, but, effectively, a party within the transaction. One might say it would be the trustee in existing transactions. It could be some form of collateral risk management. It could be the accountant. But who has the direct charge, the direct compensation and the direct incentive to effectively root out evil within securitization? And when I say evil, that is the 100% risk retention that should be there, that if you originate a loan that didn't meet certain standards as prescribed in the reps and warranties, you have to purchase that whole loan back, not 5% of that loan, but all of it.

Tony Nunes: Project RESTART is the first step. A lot of other things need to be done as well as doing active diligence on the portfolio and being able to enforce the reps and warrants. That's where we lost our way, because the enforceability of the reps and warrants has been pretty weak, or at least unclear. Everyone waits for the next person to accept the risk.

Richard Johns: Clearly there needs to be some real effort to create the right incentives with originators, and you need to balance that out by creating and understanding the risks they're going to be taking. It's a great theoretical debate. But at the same time, let's stare at the writing on the wall. That 5% risk retention is coming at us. There is no doubt, in my mind, that this has such a head of steam on it that it's going to happen.

Europe is further ahead on that than the United States. But we've looked at oncoming trains several times in the past two or three years and said that they're going to pull up before they reach us. But none have.

We need to look at ways to accept that 5% risk retention is inevitable. We need to look at ways to work with the administration to make sure that number is workable so that it doesn't create a system of risk retention that puts more capital burden on the originator than if it had just originated it, portfolioed it and funded it through deposits. Because if you remove the incentive to securitize, you limit the provision of credit to what true banks funding with deposits are able to provide, and consequently you are going to stall, at the very least, any housing market recovery.

So we have to take our great theory about how reps and warranties risk should be looked at and try to find a way to quantify that risk and work with the administration to imbed that into a system of risk retention or quantified risk retention that works.

Steve Kudenholdt: That could happen. But there is some potential for tinkering with this as it's still being baked. So I don't really agree that 5%, as a flat rule, is inevitable. As an example, look at an amendment that was put into the House version of this just a couple of weeks ago, with strong backing from an industry organization that basically got in a rule that said if you structure and sell a first loss class to a third party as part of a securitization, it eliminates the retention requirement. That's an eye-opener and gives me hope there is room to maneuver. A very well crafted rep and warranty diligence and enforcement mechanism could be an alternative to a risk retention requirement.

Richard Johns: Steve, I'm not necessarily disagreeing with that point. The issue is if there's a general basis that's 5% has a head of steam, we have to find a way to be able to quantify the benefits of what you're talking about so that you can reduce that 5% requirement, or say that instead of that 5%, I've got X amount of risk already in this form so I shouldn't need to hold any more. We need to find a way to nuance this thing versus just trying to make the argument that risk retention is a bad thing for the market. Because if we just do that that alone we might as well be talking to the wall.

Bradley Brown: When I read the language, in both the House and the Senate's versions, it did strike me as pretty open. Maybe the question is how much of this is to be defined in law versus worked through as a best practice to be adopted, whether that's through the ASF or some other avenue. That's a real path that should be assessed.

Tom Deutsch: I want to pull the lens back a bit on the panoply of policy responses that are out there, including the risk retention. Coupling these together, it goes back to what is the alternative to the private-label mortgage-backed securities market.

Let's assume we have a GSE reform that keeps Fannie and Freddie in some similar format that they have now, that they effectively guarantee some form of conforming mortgages. That still leaves a massive spectrum of nonconforming mortgages — however you define that — that needs to be originated. If we have a 5% risk retention requirement that isn't properly structured, that doesn't have some flexibility and thus ultimately doesn't really work, that creates a real disincentive for originators to be able to get risk off of their book as they're trying to sell it to others.

You couple that with regulatory capital changes and other proposals that are out there in the legislative and regulatory realm, and what does it leave you with if you have a dramatic pullback of subprime RMBS in a steady state economy as opposed to the crisis economy now?

What you may see, as an alternative, is the continuation of the government support that you're seeing right now during the crisis. A bone of contention among political scientists and economists is whether a Keynesian market, where you have tremendous government intervention after a crisis, is always the right thing to do. The difficulty is being able to pull that back because once it's in place you expect the government to continue to spend the money and offer the same support that they were during the crisis.

So the question and the challenge is: can the private market replace that public market, or is that public market going to have to continue, is the FHA going to have to, effectively, take the place of all private subprime mortgage lending over time? Or does the government want to go back to this private-label market?

Bank of New York Mellon's Tony Nunes and TIAA-CREF's Sanjeev Handa

Antony Currie: Let's jump on to a related topic, transparency. Our survey asked ASF members what effect improved information and transparency would have on their willingness to buy ABS — and 40% said it would have no effect at all. So what role can and should it play? And at what cost?

Brendan Keane: This goes to Sanjeev's point earlier in the discussion: everyone must play a role. And there is a responsibility among certain parties in the process, perhaps the ratings agencies as well, that they have to have better understanding of market dynamics. And we, as a provider of that data, have an obligation to make it more transparent and more efficient. You might say cost efficient. I would say perhaps more informational efficient. If we all truly want to see the market get back in shape, there's a heightened responsibility to grasp that information.

With that responsibility, though, should come some benefit, and hopefully that benefit comes to the investors in terms of their ability to make those decisions, because we will have a lot of regulation and so we need to get more organic in our approach.

Tony Nunes: That's true, but we mustn't look at it just in a silo. We have to connect the dots with the deal data, current loan information and underlying collateral information. Having all those components is key. We use the word transparency a lot, and everyone says: "Well, what's the payback?" We have not been looking at it holistically and connecting the dots. The power of transparency is if you can tie data together efficiently, electronically and scalably. In the early days of private securitization, we used to go to the originator, dig out loan files and perform our detailed loan reviews. That's not scalable, but being able to connect everything electronically to ensure we have the specific collateral, perfection of lien and knowing where the collateral resides — you know how it was modeled but drilling down into the current loan performance is how we get value out of transparency.

Ron D'Vari: The bothersome thing is the quality of the data, or lack of it. To this day, you don't get updated FICOs, you don't get updated credit of the borrowers. The borrower may or may not reside on that property, but they don't have to report it. We use the privacy argument way too much here, because if you're a borrower, you've taken advantage of the benefit of either the public market or the semi-public 144a.

Providing certain information should be

mandatory and easily available. Someone with a credit card account is constantly monitored by the lender. But when you borrow on a house for 30 years, you say good-bye to the lender, who only comes after you if you stop paying back your debt. That's not right when the stakes have gone up. So as an investor, I would like to see all of this information — like in commercial real estate, where lenders are required to put in their unaudited financials every year.That's why commercial real estate trades better still today than residential, in addition to the fact that the laws hold the borrower more accountable when they default. The residential market is benefiting more than it should from the political aspect of this process, and we need to de-processize that and bring to the table, as a willing borrower and a willing lender, rules to the game that both sides adhere to.

Daloisio and Johns

Richard Johns: Let me push back on that as a credit card and a mortgage originator. The key difference between the two is that because a credit card is revolving credit, as the lender we effectively re-underwrite that customer every six, seven, eight months before we lend back. Whereas once you've extended a mortgage, that money is out with the customer, and unless he prepays it, you're not going to pull that back through in the same timespan as you would with a credit card.

So it's tough to put the onus on an originator to be continually monitoring, say, FICOs or credit bureaus. Once they have made the loan, their credit decision has been made and that can't necessarily be reversed. Consequently, there is very little benefit in continuing to monitor that credit obligation. I'm not suggesting for one minute that, for investors, that might not be useful information, especially in the secondary trading market. I just don't know who foots the bill.

Antony Currie: Tom Hamilton, as a banker who speaks to both issuers and investors, how can the gap between what the two want be bridged?

Tom Hamilton: RegAB initially took a step in the right direction. We have the data. But I would agree that just because we have it, doesn't make it useful to you, and nor do we provide it in the most useful fashion possible to everyone. So I can definitely see the need for a central depository of information. That need for having ease of access and consistency of data exists regardless of what securitization looks like.

To Ron's point, the originator sometimes doesn't get good data; we might not always provide it in the most friendly format. There's no one person to blame. The industry needs a one-touch solution to get this kind of data to bring confidence back to the market.

What scares me about what Richard says is I fear that what the government would reply is: "Well, if I made you hold 10% first loss, I would bet you would do that guy's credit every six months." I understand Richard's position about the mortgage originators having made their credit decisions, but if they were responsible for monitoring and for a good portion of that risk, they would follow up and get that data on a more regular basis.

I don't think that's the solution. But we have to be careful, as an industry, how we express ourselves. In general, we always want to provide more data. I'm not suggesting the originators should pay for it. Maybe the investor should pay them to do that work. I'm not sure exactly how it works, but more frequent, transparent and, most importantly, accurate data and delivery to clients is what we need. That's easy to say but very difficult to do.

Richard Johns: Sure, the market needs much more transparency to build confidence back. There's no other way. My point is: who has more of an incentive to have that data?

Clearly, everyone has seen that it's important to be on top of portfolios, to do the credit work. The lax habits such as relying blindly on credit ratings, which everybody got into, hopefully have been cured, at least for the next few years before we all forget our history.

Sanjeev Handa: That's the whole point: you can have the transparency, but you can't force someone to read a prospectus.

Brendan Keane: To Tony and Richard's point, you could have data, you could have analytics, but people are not going to look at it and take a view unless you have some sort of information that comes out of those data and analytic points and you're able to make decisions — and then be able to monitor it. So without those different elements, participants aren't going to take a view, and you won't have transparency.

Bradley Brown: Bank of America has been a frequent prime auto ABS issuer this year and I have never had a question from investors about increased transparency. It has never come up, no one has ever said: "You're not providing enough." Granted, the primary issuance market is triple-A tranches of equipment, credit cards and auto deals we've been selling, although we've seen sub tranches being sold primary and certainly traded secondary as well. So I scratch my head. Is it really, then, specifically the mortgage product that needs it? A sector where we have historically had loan level detail that is updated monthly, or is it really a question of data integrity and refreshment of FICOs? I think we need to get specific on what information is needed and most helpful, rather than just falling back on big-picture calls for more data and transparency.

Ron D'Vari: Compare the problem with our brand and image with the wine industry after, say, what happened in Austria in the late '60s to mid-70s. They were all producing bad wines, the labels were not accurate and so on. Then what the industry as a whole got slammed, and maybe five, 10 years later, they collectively decided to create rules that self-punish. Or take the example of a communal parmesan cheese factory in Italy. If you happen to be the bad guy who pours in the bad milk, the rest of the guys are coming after you, because you have damaged the product's integrity.

Ours is a fragmented industry with a lot of tourists. People come in, come out, and we are really looking at an industry that doesn't have a label or a brand behind it. The end product is some six or seven letter CUSIP. This is the problem. We're trying to avoid all the things that make sense in other industries. Quality control is the answer, not regulation, and accountability is the answer, not anything else. If you have a bad oyster, believe me, they trace it down to the fisherman who caught it and brought it in. Why can't we do that with mortgages?

Stuart Litwin: If there is no new regulation and no new legislation mandating greater transparency, the fact is that at some point the mortgage ABS market will recreate itself anyway.

Eventually, some lender who is respected as a really good originator with a really good portfolio, who gives investors what they're looking for, whatever that is, will have a really successful deal at an attractive spread for investors, and then they'll do another deal, and then some rival will say: "If I do just what that originator did, I could have a really successful deal and a really successful program as well, and I can make money in this business because I'll be able to finance myself."


Bank of America's Bradley Brown and BNY Mellon's Nunes

That's how it starts, and then it builds and builds, more investors come into the market because they like the spreads, spreads come down, more issuers enter the market and eventually because a mortgage crisis happens every 10 years, you can set your watch for the next crisis to occur in 2018.

Ralph Daloisio: That's right. It's universal across all commercial enterprises. You create a reputation, that reputation makes you wealthy and then you look to expand the distribution of your reputation to consumers who otherwise can't afford it. Whether you're Mercedes-Benz and you start going downmarket, yet your hood ornament stays the same, or whether you're Giorgio Armani and you create a line of clothing that still bears the name but is cheaper and, therefore, more affordable to segments of the market that couldn't afford you before, or, unfortunately, in this case, if you're even a ratings agency.

There are incentives, near-term financial incentives, built in that push you towards relaxing quality control, and when that happens systemically, I think we end up with part of the explanation for what we've experienced. And it's not just particular to securitization or to finance, generally. You find it across the board whenever a product or service is being sold.

Antony Currie: So how do ratings agencies fit into the process? Some 36% of our survey respondents are in favor of scrapping the NRSRO status and letting them compete with all other credit analyzers.

David Jacob: Well, one big issue is whether or not you should have many, many rating agencies, for example. That's not the result of the crisis of course — there was a movement afoot throughout Congress beforehand and, of course, the SEC came in as a regulator a number of years ago to increase the number of ratings agencies. We learned in economics class that having more competition is supposed to be a good thing. In most cases in economics, it's probably true that by increasing competition, you can foster better quality and maybe better quality at a lower price.

I don't come to that conclusion for the ratings agencies. Perhaps prices come down. You may get that. But what happens as you introduce more ratings agencies is that ratings agencies end up primarily competing on their chief offering, which is not price, but criteria. And if they end up competing on criteria because that's what would get them a transaction, then we end up with issuers going ratings shopping. That risks creating a race to the bottom.

The notion of having a regulator, which the ratings agencies now do, has been quite a shock to the system. The changes taking place are meaningful. I can't speak for all the ratings agencies but the changes that I've seen over the past 16 months are making a massive difference to how they operate.

But the case for having ratings agencies is solid. Sure large investment firms might not take that view as most will say they have their own staff to do the credit work. Those big investors should never rely solely on the rating agencies. But as long as we have an industry which has many medium-sized investors, money managers and other purchasers of assets, it's going to be hard for them to be able to do the analysis.

Having a third party do it is not such a bad thing. Maybe they shouldn't rely on them, but otherwise in a marketplace where there's no way the smaller guys are going to have the staff, I can help fill that gap. I've got the biggest structured finance research group around, so I should be able to turn that into an effective tool or product for the marketplace, not simply a rating but wholesale analysis.

Brown, Nunes and Handa

Stuart Litwin: As an industry and as a bigger society, we've got to decide what we want from ratings agencies. We seem to be going from one extreme to the other. On the one hand, the SEC started out with the idea that we're going to get rid of all the rating requirements in the securities laws, and we're going to go to a model that's more like movies and restaurants. Now, you may like Siskel, someone else may like Ebert, but no filmmaker goes to them and says: "If I change the ending, will you give me four stars?"

On the other hand, some of the legislation is going in exactly the opposite direction. The proposed legislation would try to make sure that the few ratings agencies that we have get their ratings right. We're going to wind up limiting, by barriers to entry, who can be a ratings agency. Does the market want to work with the movie and restaurant regimen or is it necessary that we have regulated ratings agencies that always have to get it right?

Sanjeev Handa: Ultimately, the ratings agencies are not to blame. They said right out: "Read the prospectus." They said it in big, bold letters: "Make your own decision." It falls upon the buyer of the security to get it right. If the investor is not willing to take the risk, or the purchaser of the securities is not willing to take the risk, they shouldn't buy it.

Antony Currie: Can anything be done to avoid ratings shopping?

David Jacob: The Fed did something with TALF that I think could be an interesting wrinkle on this. First with ABS and then with CMBS legacy and then CMBS new issue, the Fed came up with the notion of deals needing to have two triple-As and no third ratings agency not giving a triple-A to be eligible for TALF. I think the Fed was thinking about rating shopping by saying that we could have this third ratings agency, which even though not selected to rate the deal could say it's not triple-A, and therefore make the bond ineligible for TALF.

That hasn't played out so well in new-issue ABS because it is essentially asking agencies to offer an unsolicited rating. But that's hard if you don't have access to all the data. Not to do so is the correct stance for a ratings agency: you'd end up putting a lower rating on a deal just because you don't have all the information. And that's wrong.

But because the information was in the marketplace for legacy CMBS, one could rate it and effectively de-TALF something. So the question is where the SEC and other regulators around the world might take this. It's a controversial issue, of course: could regulators force issuers and arrangers to post all the information to a website so that any other ratings agency who wasn't selected as part of the rating process can actually issue an unsolicited rating?

Hamilton, Kudenholdt and Keane

Unsolicited ratings could well alleviate some of the problems with ratings shopping. The issue with this, of course, is who would pay for it? It's an expensive process.

Steve Kudenholdt: The idea of unsolicited ratings is very interesting. It's probably more theoretical than real as I am skeptical that there will be large volumes of investor-paid ratings and that this can be a viable business model. But it might be nice to have that option as an investor. Fortunately I don't think that we're moving in the direction of posting all the information on a public website. The SEC ended up not requiring that instead favoring that the information be made available, on request, to any ratings agency that would want to issue an unsolicited rating.

David Jacob: It was never going to be public. There was going to be a website for the ratings agencies. But there are alternatives to unsolicited ratings. You could put out a report on a deal, let's say, without doing the rating. But that introduced another interesting issue: you then have obligations for surveillance and so on and so forth. That's a costly exercise for a ratings agency, and I imagine some ratings agencies might just decide to have benchmark transactions to the marketplace just to introduce that potential dynamic.

Ron D'Vari: We can all put together a model in less than six months that allows us to hit a button and say here are our vectors and here is our opinion of this deal — as long as we have standardized data for all of the broad product categories of, for example, auto, residential: all the fields are properly defined, the format is clear and the quality of data is standardized and verifiable. If that becomes available, believe me, new capital will be in the market, setting up new firms to publish research, not calling it a rating. CreditSights is a good example of that in corporate credit research.

Antony Currie: Could we see a resurgence in sell-side research at the investment banks? There are only a handful of firms now providing research on securitization, after all.

Tom Hamilton: Firms have pulled back from publishing research due to unfortunate regulations, which had a negative impact three or four years ago. So people just stopped publishing, which was not a good thing. We've taken a different tack, and it would be great if everybody published research and there was more banter about it.

On the ratings agencies, it would be interesting if we entered a market dynamic into the process. Right now we price all these new issues that come on spread and syndicate basis. I don't see any reason why we can't apply that same kind of function to ratings and say: "Listen, we're going to sell this bond at Libor plus 100 to everybody. Why don't you tell me how much you'll take a triple-A for, what's the subordination you require?" You can Dutch auction the rating on new deals until you get a market consensus. This would help the smaller investors who really don't have the capacity and maybe they want to trust a larger investor's models.

Richard Johns: Conceptually, that's a very good idea and drives right onto Sanjeev's point earlier, that a lot of the responsibility here lies with the investors. I'm not sure that having unsolicited ratings necessarily cures the problem, because investors are going to say: "Well, it was rated well by these two or three guys, and, look, no one has come out and said that that wasn't a good rating." That plays into the hands of decreased investor activism.

Sanjeev Handa: The only thing I would quibble with you on, Richard, is that I call them purchasers, because many of the people that lost money on this stuff weren't investors. A lot of Wall Street firms bought this stuff and lost money on it too. So I call them the purchasers of these securities, because investors implies something else.

Richard Johns: At the same time, I would be conscious of swinging the pendulum too far in any one direction. Looking to the original question of what should the role of credit ratings agencies be in the future of securitization, I'd argue that it should be fairly similar to what it always has been, which is to provide an objective, independent assessment of the credit worthiness of the transaction.

Now, clearly a lot went wrong, especially on the mortgage side. But credit cards, autos, a lot of products have actually held up pretty well. You might have seen some instances of support, you might have seen some downgrades, but we're not talking catastrophic downgrades of triple-As down to single-Bs.

David Jacob: Let me back that up with some numbers. Between 2007 and 2009, no triple-As have defaulted in global ABS — by which I mean non-CMBS, non-RMBS, non-CDOs. No double-As have defaulted, and just half a percent of single-As have. This is from '07 to '09.

Steven Kudenholdt: Ratings have a role to play. But they are absolutely no substitute for the investor doing their own modeling and their own analysis.

One element of the reforms working their way through Congress that I think is a good idea is to require an initial rating report to be published with every rating to provide detail on things like loss assumptions and other assumptions that can make the rating volatile. There's a lot of detail in the proposal that, if implemented, would be very useful.

Antony Currie: Final comment to you, Sanjeev. With all we've discussed — and more besides — how would you sum up what we need to do get the market back on track?

Sanjeev Handa: To get people back in the game, get people back interested in this market, we need to go back to the old model of the 1990s, when there were no CDOs and no SIVs and the like. Real investors are going to lead the securitization market back with fundamental analysis. On top of that, we will now have Project RESTART, we have better transparency, and we all know we've got to read the prospectus and not just rely on a rating. While that may mean it's going to be a much smaller economy with less availability of credit, that's where we have to start if we are to put the pieces back together.

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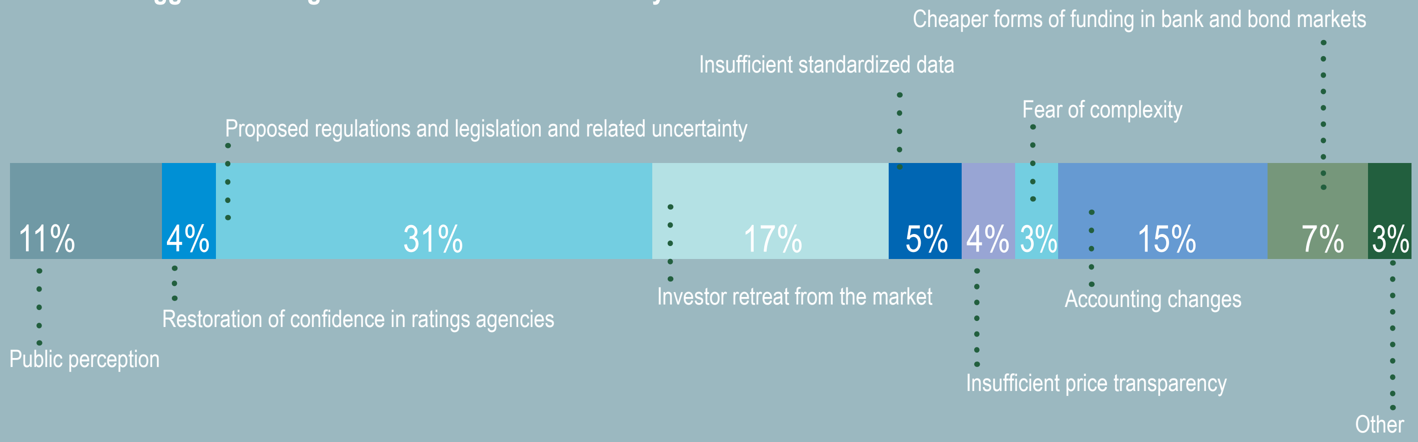
American Securitization and ASF would like to thank all participants, and in particular our sponsors, for their support of this roundtable.

The Challenges Ahead for Securitization

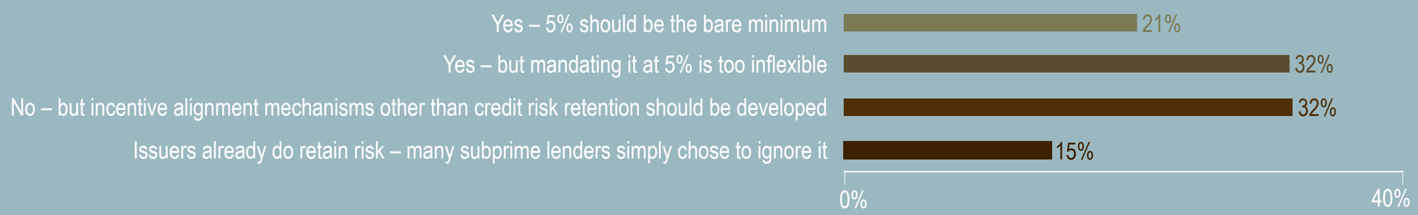
At the end of last year, *American Securitization* conducted an exclusive survey of ASF members' views on the future of securitization. Some results confirm anecdotal evidence: a majority, for example, is against ABS-specific legislation, which is also perceived as the biggest single potential hindrance to the market's recovery. But other responses were more of a surprise: members are far more concerned about what will happen when the Fed's MBS program ends than when TALF winds up. A full 40% say more transparency wouldn't change whether they buy ABS deals. And even though many are against legislation, a majority reckons issuers should have to retain a portion of the risk in any deals they sell.

We publish some of the results here; the rest can be found at www.americansecuritization.com.

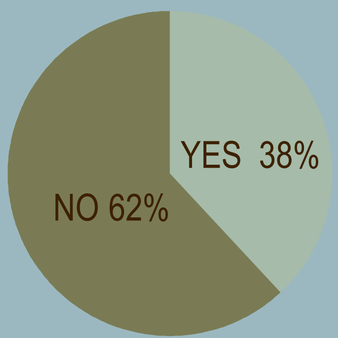
What are the biggest challenges to securitization's recovery in the next 12 months?



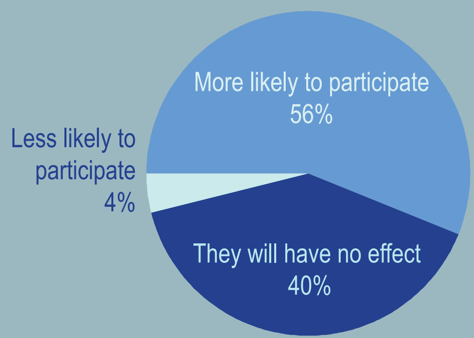
Should ABS issuers be forced to retain a portion of the credit risk in their deals?



Does securitization require specific legislative reform, as suggested by SEC chief Mary Shapiro and in bills introduced in Congress?



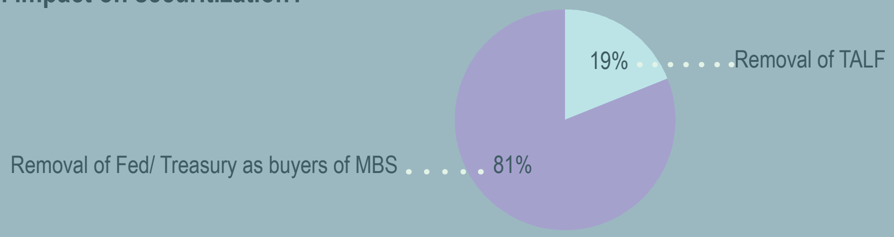
What effect will having improved information on underlying loans in ABS deals – such as ASF's Project RESTART – have on your willingness to participate in securitization transactions?



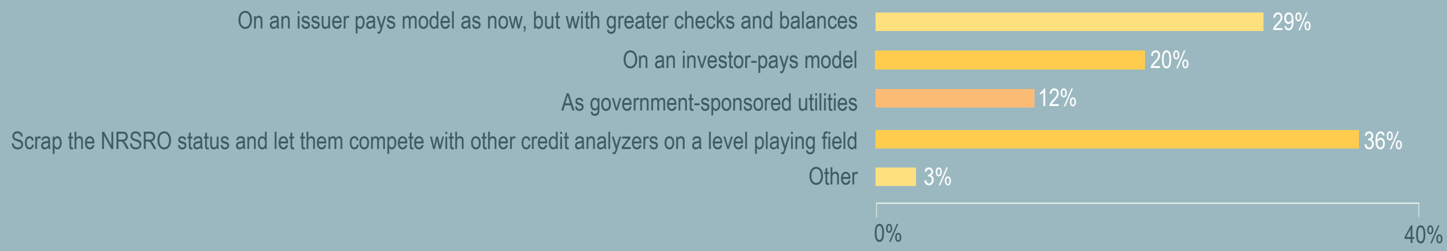
What will happen to spreads if TALF ends/when the Fed ceases buying mortgage bonds?

	credit card ABS	auto ABS	student loan ABS	CMBS	MBS
They'll go much wider and stay there for some time	10%	13%	19%	53%	43%
They'll go much wider initially but come back in within a few months, given a decent economy	18%	16%	20%	21%	30%
They'll widen, but not significantly for most names	28%	31%	32%	15%	18%
Only the least creditworthy names will widen. The end of TALF is already being priced in to the rest	43%	40%	29%	11%	9%

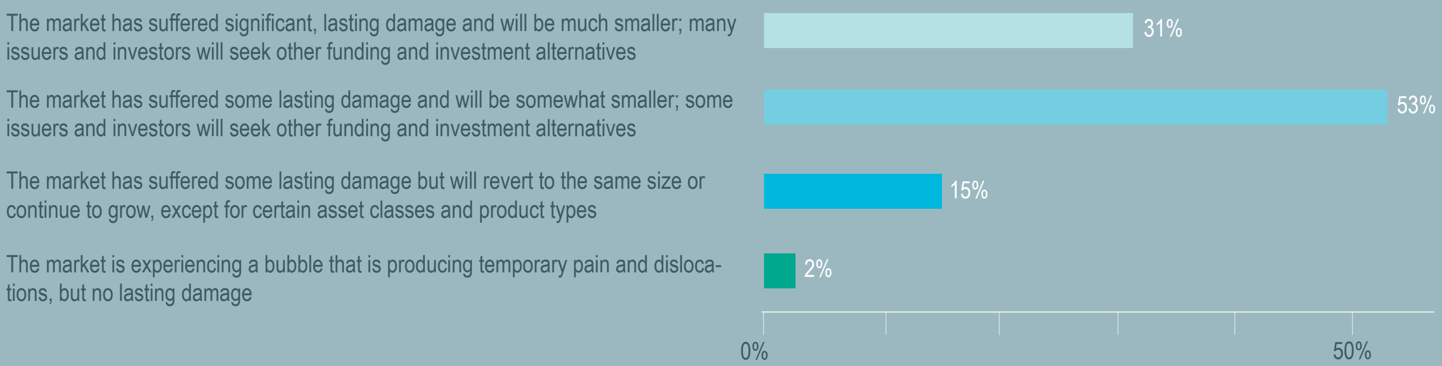
What will have more of an impact on securitization?



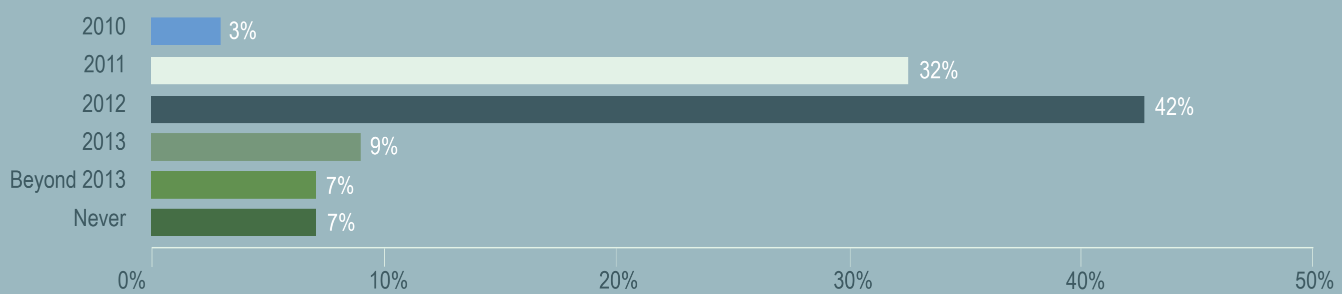
How should credit rating agencies be structured?



Which of the following statements best characterizes your view of the future of the securitization market in light of recent events?



When will mortgage and consumer asset securitization markets reach a new equilibrium (i.e. a return to "normal")?



Securitization Tots Up
The Cost of Accounting Reform

At its worst, argue some market participants, FAS 166 and FAS 167 will spell the death of securitization. But beyond the hyperbole, what do the proposed changes to accounting standards really mean for securitization and for the broader economy? And can the industry successfully make its case to lawmakers and regulators that the new accounting regime will do more harm than good? Leading industry figures recently gathered at ASF headquarters to debate and discuss the road ahead.

The Panel:

The Moderator
Antony Currie – American Securitization

The Accountant
Ann Kenyon — Deloitte and Touche

The Advisers
Craig Shallcross — LCP Capital
Debbie Toennies — JPMorgan

The Issuers
Richard Johns — Capital One
Gregg Silver — First Financial Funding & Investment

The Lawyers
Jason Kravitt — Mayer Brown
Kenneth Marin — Chapman and Cutler

Antony Currie: Are new accounting rules killing off securitization? JPMorgan chief Jamie Dimon cited them on the bank's second-quarter earnings call last July when he said the firm, as of 2010, probably wouldn't issue any more credit card securitizations, largely because of new accounting rules.

Richard Johns: It really is a question of whether you need liquidity or not. If you look at what has driven securitization over the years, it's a combination of being able to avail yourself of low-cost financing combined with the capital relief and the ancillary earnings benefits from not having to hold loan loss allowance against assets that you have no contractual obligation to absorb losses for.

The latter two go away with the introduction of FAS166, FAS167 and the associated notice of proposed rulemaking (NPR). So it comes down to whether you need to use securitization as a funding tool. If we assume that the NPR comes down as the final rule in substantially the same form as it is now, then combined with FAS 166 and 167, you land in a situation where if you have alternative forms of liquidity that offer lower-cost funding than ABS, then you almost have an obligation to your shareholders to avail yourself of that liquidity. JPMorgan is probably coming from a perspective where they, as opposed to a lot of other institutions, have a pretty good liquidity outlook.

We're in a similar position at Capital One. If the cost of funds of securitization comes in dramatically, then we may look at it. But when you have branch deposits offering significantly lower cost of funds and you have to hold the same amount of capital against the assets funded by deposits as you would against assets funded by securitization, then why wouldn't you opt for the deposit funding?

For other issuers, it depends on what maturities are coming due, not just in ABS land, but in corporate and bank debt — and whether they are a bank or not. That's going to make a big difference. If they're not depositary institutions, they may feel that even at wide spreads ABS gives them the lowest cost of funding, and they may all decide to go that route.

I can understand where Jamie is coming from. My suspicion, though, is that JP is not going to walk away totally from the ABS market.

Antony Currie: What's the thinking at JPMorgan, Debbie?

Debbie Toennies: My understanding is that, as Richard pointed out, it will depend on where spreads are at the time and the relative advantage of that form of financing as an alternative source of liquidity to the company.

Jason Kravitt: Issuers have had many reasons for securitizing. The four biggest were balance sheet management, capital management, liquidity and risk transfer. The accounting changes ought normally to affect only balance sheet management, not capital management. But since the federal bank regulators have put out a proposal more closely tying capital to accounting, accounting now is like a com pital as well.

But you still have risk transfer, and you still have liquidity, and while I agree that you've got to look at your overall circumstances and decide when it's advantageous to fund in the securitization market or not, liquidity isn't just about tapping the cheapest finance. It may be that you have sufficient volume that you need to have alternative forms of liquidity. You attract different investors to buy unsecured CP or term debt to those who invest in ABS.

Kenneth Marin: There is a lot of doom and gloom among banks about securitization prospects — and rightfully so given the developments at FASB and the FDIC's NPR.

But that's not the case outside the banking world. For many non-bank finance companies, consolidation of securitized assets is not a major concern. So long as there are no debt-to-equity ratio covenants in their corporate debt agreements that would be impacted by a change in balance sheet accounting, and so long as these companies are not pre-occupied with optics in their financial reporting, FAS 166 and 167 are not major impediments. Liquidity, diversity of funding and risk transfer are the main drivers for securitizing in the non-bank world, so we may see a robust securitization market return for these types of companies as the capital markets continue to thaw.

Ann Kenyon: While Ken's point is correct for many non-bank securitizers, there are many who are concerned that there transactions are coming back on balance sheet—they think that it is just bad financial reporting. Additionally, many are concerned that the regulatory capital ramifications will also result in making their facilities more expensive.

Antony Currie: Is the FDIC's decision to grant a six-month reprieve on raising capital against assets that are being brought back on balance sheets helpful?

Richard Johns: It's a question of what the moratorium means. Is it just a grandfathering of existing transactions, or will you continue to get off balance sheet treatment for whatever you do in the following six months? Will the moratorium extend just to risk-weighted assets, or will it also make an adjustment for the loan loss allowance and maybe give an exception to loan loss allowance as it pertains to securitized assets and adjust your Tier 1 capital as a consequence?

If they do things like that and also signal that beyond the six-month moratorium there will be a transition period that takes you to a point where the economy has begun to recover — in other words, well into 2011, instead of ending at the end of 2010 — you then have the ability for issuers to recognize that they will not have to raise capital now to deal with that issue.

Because if we put ourselves in a time machine and accelerate forward to January 1, 2011, are loan loss reserves going to be significantly different than on January 1, 2010? My suspicion is no, given that recent economic data seem to indicate, for example, that unemployment is topping out at 10%. Reserves may be a little lower as you look ahead to the remainder of 2011, but you are going to be in a situation where the capital effect of adding risk-weighted assets combined with the loan loss allowance is still going to be detrimental.

Issuers are not going to wait until the end of the reprieve in June before they act. They're going to act now. They already have. Look at the amounts raised in common equity and the hybrid markets. And balance sheets are being shrunk across the banking industry. If the regulators or the administration think they can wait until six or even 12 months down the line before taking action, it's not good news.

Ann Kenyon: The uncertainty is ultimately not helpful. To Jason's point, some organizations significantly impacted by the accounting changes might take a wait-and-see approach, and, if so, that may not benefit the credit markets.

Gregg Silver: Any kind of delay — and the longer the better — means that banks have more chance to create new capital without going to the markets. Holding retained earnings is far cheaper than going to the market and getting equity that way.

Antony Currie: And some actions banks are taking now might even be perpetuating the problem. A lot of banks have ramped up the amount of cash and liquid assets like mortgages on their balance sheets in the last year as they sit and wait to see how the rules shape up.

Richard Johns: Yes, the system's paralyzed by indecision at the moment. And sure, I recognize there's a lot of focus on why we should disclose what's off balance sheet, et cetera, but good God, if there was ever a time in history when people were aware of the risks of securitization, it's now. If there are still people who don't read the financial statements and don't look at the risks off balance sheet, they should think twice about whether they should be investing.

Stepping back from these rule changes would be an opportunity, what with all these TARP monies committed and all these sound bites about the cost to the taxpayer, to do

LCP Capital's Craig Shallcross

something that doesn't involve the government putting its hand in its pocket. It's a way to create some relief that will stimulate lending and reduce the cost of credit and help get this economy back on track. I get all the arguments from FASB and the regulators as to why they're going where they're going. But those are vastly outweighed by the potential impact to the economy of the new rules.

Jason Kravitt: Richard made a very good point about taxpayer money: Congress is worried that the economy is not improving fast enough, that unemployment isn't coming down fast enough, so they're thinking about spending another $150 billion that we don't have. Letting securitization do its job would do far more for employment and the economy than spending another $150 billion.

It's madness, and to say that a phase-in or a postponement is a solution flies in the face of Logic 101. If an action is wrong, phasing it in doesn't make it right. It may limit the negative effect, but phasing it in it doesn't turn it into something good if the rules don't make sense in the first place.

Antony Currie: What would you suggest be done to mitigate some of the effects of the rule changes?

Jason Kravitt: First of all, decouple risk-based capital from accounting. That used to be a very tough argument to make as accounting was focused on risk, and risk-based capital was focused on risk, or supposed to be focused on risk.

To make matters even clearer, the regulators all stated that the principal difference between Basel II and Basel I was the focus on real risk and the elimination of the arbitrages that existed because Basel I didn't focus on real risk. Decoupling risk-based capital from a standard based on control seems the height of logic in terms of mitigating the negative effects.

The chairman of FASB has made at least two speeches where he stated that risk-based capital and accounting are different, their rules are produced for different purposes, neither one should be superior or trump the other and they should be dealt with separately instead of being tied to each other. And this is the man who makes the accounting rules. Now, unfortunately, the NPR more closely ties the risk-based capital outcome to accounting. The next idea would be to work very hard to find ways to keep things off the balance sheet in structures that will become acceptable to the market and are within the spirit of the rules. I don't think that it's impossible to do, though the new rules have made things much more difficult. But there are structures that can work — and the regulators should look at them with an open mind.

Finally, the disclosure that's required now, to go along with consolidation, is detailed enough for an equity analyst who works hard enough to be able for the most part to figure out how much risk is on the balance sheet and how much risk is off the balance sheet. So I would make a plea that equity analysts not just look at the balance sheet but also go to the footnotes and all the other disclosure and do a thorough job analyzing what's actually going on. Because if they do, people will be punished less for the presentation of over-consolidation, because people will focus on the substance of what's happening.

Ann Kenyon: I agree that while accounting changes have removed the reasons for securitization, they haven't removed all of them. With respect to what the future may hold, we, as accountants, are looking at rules that are based on control. But it's still rules based, not principles based, and so if structures come to us and conform to the rules, then we will follow the rules, regardless of whether the structure is on or off balance sheet.

The new rules were written, of course, to bring most structures, as we know them now, back on to the balance sheet. Nevertheless, should new structures come along with substantive changes to the old models — and there would have to be some commercial changes involved — then we would be more than happy to consider the correct accounting treatment, and that could be off balance sheet.

Kenneth Marin: To Jason's point, decoupling risk-based capital from accounting would mitigate the effects of the FASB rule changes, but that doesn't seem to be where the FDIC is heading in the NPR. If the effect of linking accounting to risk-based capital is that market participants develop creative structures to cede control and obtain capital relief simply by meeting off-balance sheet accounting rules, that puts a spotlight on the problem with linking risk-based capital and accounting. In other words, capital relief would come without a commensurate reduction in risk.

Antony Currie: Perhaps lawmakers, regulators, or both, feel that, after WorldCom and Enron and now the mortgage-led credit crisis, there should be no place for troublesome off-balance sheet vehicles?

Gregg Silver: What Enron did and what WorldCom did is entirely different to what we do in securitization. What happened at those two firms was not securitization. That was basically an off balance sheet tool that used some of the structures that we use but was not securitization as we know it. It's wrong to tar what we do with that brush.

Debbie Toennies: What's more, the problem with assets in the current crisis wasn't that they were off balance sheet. Whether or not they're on your balance sheet doesn't impact the health of the bank after securitizations go wrong. The problem is that some of theses structures, like ABS CDOs, didn't work, that the underlying assets in the securitizations were bad loans and there wasn't enough capital in the system relative to these transactions. But if we get capital aligned with risk, then we're on the right path.

Kenneth Marin: Securitization is a very efficient means of financing the consumer economy. As Debbie said, the problems stemmed from bad collateral. Certainly some securitization structures exacerbated collateral problems by providing investors with the means to double or triple down on subprime mortgages. For those issuers represented at this table

JPMorgan's Debbie Toennies and Richard Johns of Capital One

and the majority of other issuers, however, securitization was used prudently and served a very important function for the economy. It's a shame that overreaction by policy makers may result in removing the incentive to securitize high quality assets.

Antony Currie: The point is that a lot of people in Washington will not make that distinc-

tion, nor care about it. It goes down to the lowest common denominator which is that they see off balance sheet vehicles, which they don't understand, creating problems. Thus, they react against them.

Gregg Silver: I don't disagree, but it's because they don't understand fully what we do for a living — nor do they fully understood what Enron and WorldCom were doing.

Jason Kravitt: To focus on a few misuses of structured finance and produce rules that make it very difficult for that form of finance to continue is beyond shooting yourself in the foot — it's tantamount to shooting yourself in the head.

Jason Kravitt of Mayer Brown

First Financial's Gregg Silver

Antony Currie: That's a pretty bold statement. How do you quantify that to make the case to Washington?

Jason Kravitt: If you eliminate securitization, you've got to find a way to finance the equivalent of what the entire U.S. banking system finances now. ASF chairman Ralph Daloisio wrote an article on this that I believe is appearing in this very journal (see page 3). He points out that there's about $12 trillion of outstanding securitized product in the U.S. The banking system currently produces $13 trillion of credit. So you've got to double the amount of credit creation if securitization ceases to exist. Just tell me how you're going to do that.

How much capital does that mean needs to go into the banking system, in addition to the capital they have now and that everybody claims they're short of? Assuming leverage of 10 to one, that's another $1.20 trillion of capital. Where are you getting that $1.20 trillion from? One thing you're going to do is take it away from manufacturing companies or service companies or people who Congress and the press love to call the real economy.

The reason that capitalism has been so successful for the last few centuries is credit creation. It's not just the improvement in technology, it's not just democracy and rule of law, it's also finding new ways to create credit. Securitization is part of that and people have to think very carefully before they wound it to the point where it becomes a shadow of its former self.

Kenneth Marin: Just consider the effect the rule changes will have on multi-seller commercial paper conduits. Banks have been permitted to hold the assets in these vehicles off their balance sheets or exclude consolidated assets from risk-weighted assets. While capital was required to be held against a sponsor's liquidity commitment to its ABCP vehicle, a conversion factor of 10% was applied. Under the new rules proposed in the NPR, no such conversion factor would be applicable and the sponsoring banks will be subject to significantly higher capital charges, to the tune of 10 times what they've been in the past.

Yet that extra capital charge comes without any real change in the risk that the assets are bearing. The sponsors for these vehicles have done thorough underwriting on the assets, they have done their due diligence and monitor the assets on an ongoing basis, they carefully negotiated the transactions that are brought into the conduit, and for the most part they have a tight grasp on what the risk is. To increase the capital charges based on an accounting change doesn't seem appropriate.

Richard Johns: We'll have to hold, when you combine the addition of risk-weighted assets with the loan loss allowance that you have to add in, probably something like four to five times the contractual risk that we bear on those. Yet all that's changed as a result of consolidating assets on our balance sheet as of January 1st is the disclosure. But the transaction doesn't, so how you can then say that the risk has potentially changed and that you must thus hold more capital against it is nonsensical.

A lot of people agree more capital should be in the system, fair enough. But to misapply the accounting math, and come out with a number that represents four or five times the multiple of your true risk feels like we've swung the pendulum too far in one direction.

That said, I don't think FASB has finished what they need to do. Okay, they've gone with control as the basis upon which they're going to consolidate transactions. But they have FAS 5 on accounting for contingencies. And that's based much more around the risk-based standard rather than around control. They're mixing and matching their accounting basis. So we have to hold a loan loss allowance against assets that we might control, but because we control them, we have the right to pass contractual risk losses onto investors or, alternatively, could choose to support a transaction — although we haven't seen that in the mortgage space, in auto land or in certain credit card issuances. But you have the right to control those losses.

FASB needs to take a look at the loan loss allowance provisioning, and if they're looking at control of the assets, they should look at how they can make the linkage to the substance of the transaction and then tie the risk of loss on the assets with the compensating write-down you would see on a security value if those assets ever lost money.

Antony Currie: Gregg, are you facing similar capital hikes?

Gregg Silver: We have a structure that would continue to keep us off balance sheet. However, several of our investors are going to have to consolidate our conduits onto their books, and what's interesting for them is that they have no incremental exposure. They're triple-A investors and they now have to consolidate everything on their books, even though they have no contractual risk through that piece.

If we were to consolidate them, we would probably have to more than double our capital. Or, to have the same capital ratios, we would have to cut assets in half. From a credit creation perspective, having to either double all my capital or halve my book is going to be significant for our sector of the market.

Cards are much more prone to reduced issuance because as unsecured credit they're going to need more loan loss reserves than a secured product, where the losses are typically lower. So credit card issuers will wind up needing more capital. If we're really saying the consumers will drive the economy and we're saying that a $900 billion credit card market is now going to need to double its capital — or more in some cases — then how is the consumer going to be helped by that?

Richard Johns: It's an unintended consequence — a term I promised myself I would use at least once today. Industry losses on credit card portfolios are running to maybe 10%. You have to hold loan loss reserve against that, and that's the equivalent of well-capitalizing your whole portfolio.

Antony Currie: What are the consequences of that for borrowers?

Richard Johns: Let's posit a situation where for whatever reason you can't raise any more capital. Then to manage that additional 10% capital, you've got to shrink your portfolio down to zero, wiping out all existing credit. Alternatively, let's say you can raise the capital. Then apply the increased cost of raising that capital to new originations, and you could be looking at raising your customer APR by 300 hundred basis points or more.

Now, that's assuming it's on the new business as the card legislation out there is going to stop you increasing your prices on existing customers, so it may very well come down to when you raise that capital, the only place you can put that increased cost is on your new customer base.

I'm not insinuating that all credit card customers are going to have 300 basis points hiked on their APRs. But if that doesn't happen, then credit card margins are reduced, which discourages lending. It's a no-win situation.

You can apply the same math to mortgage and auto loans, though you won't see the same allowance impact on these assets because they have lower losses, though clearly the mortgage product is much bigger in terms of the amount of dollars outstanding, so you're going to see that ripple through and impact on the cost of consumer credit. If the cost of mortgages is going up, then you don't need to be Einstein to work out what that does to the prospects of the housing market recovery and how that bleeds into consumer confidence.

Gregg Silver: In some cases there's even double counting going on. For example, if I were to have a card transaction that was in Debbie's conduit, not only do I have to hold the capital as the issuer, but she's going to hold it from the conduit side. How does that make sense?

Richard Johns: Does the investor in the CP have to hold capital as well?

Debbie Toennies: If they're a bank, yes.

Richard Johns: So, it might not be double, it could be triple.

Craig Shallcross: Let's not forget what all this means for investors, either. Securitization products have created a very important segment of the capital markets. These allow investors to delink their investments from the enterprise risk of the companies that are in that business.

Through securitization an investor can focus just on mortgages or just on the consumer and not be caught up with some other line of business that that bank is in that's going to bring it problems. The concept of throwing assets back on balance sheet jeopardizes, from the investor's perspective, his ability to preserve access to those assets.

As we blur the accounting lines, the legal ones also get blurred and our ability to protect those assets and keep them away from some other creditor gets challenged. We're already seeing some of that in the developments that have taken place in the marketplace and obviously the FDIC safe harbor discussions go straight to that particular point. Some very important products are at risk of disappearing.

Jason Kravitt: One of my favorite quotes came from the ESF-sponsored annual conference in London last June. One of the keynote speakers, a senior officer at the FSA, made the point that because of what had happened in securitization, the regulators no longer had a consensus that securitization was the way to go and the industry had to remake its case. So we asked him: "What's the alternative to securitization?" He said, after thinking for a while: "It would be a deposit-funded system with a standard of living equal to about 1970." That was a popular statement, given the audience.

Antony Currie: Jason mentioned earlier that disclosures should now allow analysts to get a full picture of what is on or off the balance sheet. But there's still a good deal of opacity. Wells Fargo's recent announcement that it was practically halving, to around $25 billion, the assets it would have to take onto the balance sheet left many scratching their heads, for example.

Richard Johns: The rules are not as clear-cut for mortgages as they are for credit cards and autos, where originators who service the portfolios also retain some residual or retained interest and it's black and white that those assets are coming back on. I wonder what U.S. taxpayers would say to their congressman if they realized that out of all the asset types it's mortgages that may avoid some of the consolidation issues and stay off balance sheet?

If FASB thinks they've cured the problem with the sledgehammer they've taken to the nut, they should probably think again.

Jason Kravitt: It's difficult to write a consolidation rule that will make everybody happy and be adequately transparent. That's one of the difficulties about securitization: it is such an intricate form of finance that it's very difficult to write a set of rules. No matter how good your intentions, how skilled you are and how knowledgeable you are, it's very difficult.

But the balance sheet is merely presentation. It doesn't change people's legal rights to the assets, it doesn't change the amount of risk they have or the upside or downside. It's merely one form of presenting a snapshot of the enterprise and what's important is the substance of the enterprise's relation to its financing, not the snapshot.

People have to recognize the limitations that accounting has, and the limitations in the whole concept of consolidation, and focus on the substance of what's actually going on. That's why the disclosure that surrounds balance sheet presentation is so important, so that analysts can do their job and understand where the risks and rewards lie. That's why no other form of capital should be tied to presentation, because it's presentation and not the substance of the relationship of the enterprise to its financing.

I don't think consolidation would be as significant as it might turn out to be next year if capital were decoupled from it and analysts were to go behind presentation, just as the ratings agencies do. If that were the case, then presentation would assume a much more natural perspective and we wouldn't be having a fight to the death over whether assets are consolidated or not.

Richard Johns: Yes, accounting should be just about disclosure. We don't care whether it's disclosed on the balance sheet or not. Credit card issuers already disclose a net balance sheet and a managed balance sheet in their financial results so that everybody can see whether you securitize or didn't securitize.

Antony Currie: It's a long list of problems and unintended consequences. And these do, at least, seem to have helped get a stay of execution on capital raising from the FDIC. But the accounting rules are still in place, so what do you do next?

Debbie Toennies : We haven't given up the fight yet. The story is no stronger anywhere than it is with regard to ABCP conduits. We have shown the regulators that over the structure's 26-year

Kenneth Marin of Chapman and Cutler

history losses on the more than $1 trillion of financing it's provided are de minimis, and that in the worst of times capital covered seven times what was needed.

If the NPR comes through as it stands, it is almost by necessity going to cause a reallocation of capital dollars within banks. Banks today, more than ever, have limited risk-weighted assets, limited regulatory capital, and they have to put that to work in the highest return businesses. If you multiply by 10 the capital that you require them to hold on this kind of business, it's a natural progression that they're going to take that capital and put it somewhere else where it can earn a more attractive return.

Interestingly, that's into more risky forms of lending, so I'm not sure that the economy has been helped by that decision. And it's also probably true that in reallocating capital the banks are going to lend less because it is more risky — and they're not going to have the comfort of doing the size financing that they've done on a secured basis in bankruptcy-remote ABCP conduits, if they're doing it unsecured, let's say, on their balance sheet to a non-investment grade company.

So either credit shrinks in that world or we'll see an increase in pricing to our customers. Many of them go out and lend to consumers or small businesses. They can't absorb that increase in pricing, so it ends up going back through the chain to the consumers or the small businesses that will end up having to pay for any credit they can get from this market.

Kenneth Marin: Debbie, I'm curious as to what you've been telling your customers who use the CP conduit. What's going to happen with respect to increased costs for things like accounting consolidation events? For a borrower with an outstanding draw out of your conduit, the deal documents likely contain standard market provisions that permit the conduit to assess these increased costs. For deals that are currently being negotiated, I would guess that its an understatement to say that there is an element of uncertainty about where pricing will go if the conduit has a ten-fold increase in capital charges for CP-funded assets and invokes increased cost provisions. Also, Gregg, what have you heard and what are your concerns as to the game changing in terms of your pricing?

Debbie Toennies: Given that the NPR could come out in any different direction, we start by saying we're not sure where this is going to come out. This fight is not over yet and we are still making our case. Customers in ABCP conduits wrote to Congress and the regulators expressing concern at what they had been told by people such as ourselves, that: "I'm going to lose availability or have a sizeable increase in my pricing — or both. I'm concerned. This is not good for our economy, and, from what I understand, not warranted given the experience."

Kenneth Marin: Is it possible to give your customers any level of certainty on increased costs? Is it feasible to set a maximum pricing increase that borrowers may be exposed to as a result of an accounting consolidation event?

Debbie Toennies: It depends on the sponsor and what they've been willing to do. My understanding is that has not been consistent from one sponsor to the next.

Gregg Silver: There's a lot of potential for increases in costs, because those provisions are open-ended. It's not like it says they're capped out, although there are also counter-provisions that require that if there are alternative jurisdictions where you could put it, where you would have a smaller impact on those capital charges, that could happen.

I don't know how an American bank gets around that, but foreign institutions aren't subject to the same restrictions. So what is likely to happen is that some of this financing which had previously been done by U.S. institutions may be done by foreign institutions that aren't subject to the same type of accounting. That could be a competitive disadvantage for a lot of U.S. institutions.

Ann Kenyon of Deloitte and Touche

Debbie Toennies: It absolutely could be, given that non-U.S. firms are on Basel II. It probably creates an interesting dynamic for a treasurer of a company who's looking at foreign competitors some of whom, over the last three years, have had more difficulty getting themselves funded, versus going with a U.S. institution that might have had an easier time with that but their pricing has gone up significantly.

Kenneth Marin: Another unintended consequence.

Gregg Silver: A lot of issuers have been finding alternative sources. For example, we use the 144a market far more than we used to do, partly because we are concerned about what happens to our conduit sponsors. We're not the only issuer in that boat.

Craig Shallcross: These new rules, 166 and 167, are very similar to the rules that exist in Europe with respect to consolidation activities. Those sets of rules provide for some mechanisms for deconsolidation, and some banks in Europe are using these as a way to do this. Why are these techniques not being adopted here in the U.S.?

Ann Kenyon: I'm not an international accounting standards maven. But it's true: the foreign banks that sponsored commercial paper conduit under SIC 12 had consolidated most of them. The new U.S. GAAP rules will impact any U.S. bank or any branch that was using U.S. GAAP, and those conduits will have to be primarily consolidated.

Craig Shallcross: Actually, I'm asking the opposite question. There are banks in Europe which avail themselves of SIC 12 and IS 37 to keep their conduits off balance sheet using a combination of third-party capital and control. Why aren't the U.S. banks doing that?

Jason Kravitt: As we discussed earlier one way to mitigate the effects is to come up with structures that allow you not to consolidate and are consistent with the rationale behind the rule. Well, a rule based on control means you have to give up some real control, and some banks are willing to do that, and some banks are not.

I'm familiar with foreign banks that have put their conduits on balance sheet and have put their conduits off balance sheet. In just about every case the sticking point wasn't economics, it was whether they were willing to surrender control or not.

It's that simple. I don't think the biggest issue is going to be economics, because you can always work out how to share the economics. But a lot of banks are very leery about giving up control because they believe in their business, their customers, their staff. They tend to see the warts on other people's businesses, staff and structures, etc.

We've just gone through a period where people have suffered a lot of losses, and so people are skittish about giving up control. If the market does begin to return to normal, people will be much more willing to enter into joint ventures and we will see some conduits come off balance sheet down the line, in 2010 or 2011 perhaps. I don't think there will be a lot of joint ventures, for example, between JPMorgan and BofA, but there may be joint ventures between JPMorgan and somebody like Lord.

Debbie Toennies: There is this looming comment in the NPR about reservation of authority, and while regulators had the right to evaluate any structure from the beginning, the fact that they chose to put that language in the NPR caused us to take a step back. It made us think about whether we want to go to all this trouble and consider whether we would be willing to give up any level of control to make this happen, which is, as Jason said, a very tough decision, when it could potentially be all for nothing if a regulator is allowed to come in and say: "I don't really think you did enough. I think you're going to hold full capital."

Richard Johns: Beyond the fact that it could be taken away from you at any point in time, how on earth is giving up your control reducing your risk? Let's take a conceptual step back here. We have this disclosure change, and the solution to looking as if you have transferred more risk is to give up control to conform with the accounting standard.

I just don't see how that can work. If it's your business and you believe in it, then giving up control increases the risk, because you're passing the reins into somebody else's hands. If you believe in your ability to manage your business, you want all the control you can get.

Craig Shallcross: I understand the issues relating to control that have been raised, but there are significant financial institutions that have found a commercially viable way to interact with third parties to avoid these adverse consequences from a capital standpoint.

Richard Johns: I don't know whether it's FASB or the SEC, but at some point this week we've also seen them advise all the auditors that while they're saying 166 and 167 appears to be working, the auditing firms need to watch out for structures that try to find the loophole and remain off balance sheet.

So, Craig, I take your point, but I don't know how long that is going to last if there is a risk that folks take an action only for them to have their hand slapped a day later and told that it still goes back on the books.

Antony Currie: Shouldn't you all be camped out down in DC?

Jason Kravitt: We have been. The ASF has repeatedly sent delegations to Washington. Not everybody is willing to talk with us, if you can believe that. So the question becomes: why aren't they listening? And I don't know why. The case seems compelling and we need to keep trying to find different ways to get our message across.

Antony Currie: Have you hit them with numbers that hurt most, the ones that hit their own pocketbooks? Surely the message needs to be blunt: "If you allow these changes to go through, the cost of your home loan is going to shoot up and you'll be forking over between X and Y extra a year."

Debbie Toennies: We have told them the effect on APR. And as Richard said, that math works for everything — a 300 basis point jump is a significant number.

Gregg Silver: It's very difficult, politically speaking, or from a regulator's standpoint, to take the side of the banks. The media has made us the pariah of society, which makes it's difficult to be the one guy standing up saying: "Hey, you know what? We need to help these people out." Because they already think we've taken their money, despite the fact that many of the institutions that got the TARP money didn't want it in the first place, and then when they realized what it had morphed into, decided to pay it back with interest, which actually reduced the taxpayers' burden. But that seems to have been lost completely in all of these discussions.

Ann Kenyon: We have to be careful, because members of the administration have been very open in saying they support securitization, and they have put programs into place that support securitization, such as TALF. It's the accumulation of the accounting changes and the regulatory impact and how it bleeds through the system that needs to be articulated, not just countering the notion that securitization is bad. Because their obvious push-back is that they've openly supported securitization as a facility.

Jason Kravitt: The Fed clearly recognizes that securitization, overall, is a good thing, and TALF is one of the best government programs of the entire credit crisis. But to say, abstractly or theoretically, that you want securitization to work and then every single regulation and law that is proposed is going to make it harder to work doesn't produce the outcome that, abstractly, you say you're in favor of. Risk retention makes it much harder. Accounting makes it much harder. Risk-based capital makes it much harder. Attaching conditions to the FDIC rule makes it much harder.

I believe them when they say that they're in favor of it. But everything they're proposing is going to make it harder. They have to focus on the long-term effects of the short-term actions that they're taking.

Gregg Silver: Their actions and the unintended consequences of their actions are defeating the goals at hand.

Let's take TALF. Yes, it is a fabulous program, but there were a lot of unintended consequences there, too. While it helped open up the triple-A market, it gave a disincentive for any investor to take a subordinated position because the returns offered to those triple-A investors was so significant that it made the cost for the sub notes substantively higher than it needed to be.

And the government has made a lot of money on the TALF program. To my knowledge, there has not been a single default on any of those transactions, and the government is getting 100 basis points for it. That's a large amount of money made off the back of the securitization industry. While they've supported us, I want to make it clear that the taxpayer absolutely benefited from that process.

Richard Johns: I would say the government's probably making about 140 basis points considering they raise money at a Treasury rate rather than swaps.

Antony Currie: In sum, what's the message you as a bank treasury executive and as a representative of the ASF, want to make sure gets across to Washington?

Richard Johns: What we've always been pushing for at ASF is for the regulators to recognize the linkage between the asset and the security and how the risk effectively manifests itself as a consequence of that linkage. I don't know if that's necessarily a question for accounting, although it might be as far as the accounting for contingencies and FAS 5 goes. But it is certainly an aspect that needs to be taken care of through the reg cap provisions.

This is a "speak now or forever hold your peace" moment for the administration and the agencies, because it will be too late to come back to this six months after everybody has pulled in balance sheets and increased their capital.

We need to turn this economy into a virtuous cycle, and what's about to happen accentuates the vicious cycle we're still in.

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American Securitization and ASF would like to thank all participants, and in particular our sponsors, for their support of this roundtable.

By Neil O'Hara

Have Re-REMICS *hit* their peak?

Patching up battered mortgage bonds was a brisk business last year. But a combination of a market rally, uncertain house prices, tougher ratings criteria and changing accounting rules have prevented the first-aid kit from being more widely utilized. But even if it's more limited, the re-REMIC still has a purpose to serve.

Not such a straightforward path after all i-stock

Surely the re-REMIC ought to be the hottest product on the market. That might sound odd. After all, it has become a popular method of providing battlefield triage to battered real estate mortgage investment conduits (REMICs) —some $40 billion-worth of reported deals were completed in the first nine months of last year, more than double the amount undertaken in the whole of 2008, according to Bloomberg data.

But there are many more commercial and residential mortgage bonds (CMBS and RMBS) that, on paper at least, could benefit from some tender loving resecuritization. In a report last June, for example, analysts at Barclays Capital estimated up to $580 billion of mortgage bonds could be re-REMICable.

The advantages for many buyers are pretty clear, at least on paper: building some extra protection into an underperforming triple-A mortgage bond by carving out and selling part of the tranche into a new junior security allows its owner to benefit from either capital relief or improved liquidity for the senior bonds it retains at better prices — or both.

That's what sparked the market back to life. Many of the biggest holders of MBS — insurance companies, banks and money managers — face constraints on their ability to hold bonds rated below investment grade. So once the first wave of ratings downgrades on mortgage bonds hit in 2007, some of them turned to re-REMICS.

Of course, it's the way the ratings agencies craft their methodologies that make re-REMICS both necessary and possible. Though the agencies have developed ever more sophisticated models to cope with the increasing complexity of securitized debt, they have never altered the fundamental premise that a bond must be downgraded if it is expected to suffer any loss of principal, no matter how small.

The consequences of default for corporate bonds are usually dire: a loss of principal seldom less than 30% and potentially much higher. Default has a more nuanced effect on a diversified structured debt pool, however. While the junior parts of the capital may be wiped out, the senior bonds often have much higher recovery rates. This nuance is not reflected in the rating process.

Take, for example, a prime RMBS securitization where as much as 95% of the capital structure is usually rated triple-A. If losses in the pool amount to just $1 more than that 5% cushion, the entire senior tranche will no longer qualify as investment grade even if the underlying mortgage collateral pool suffers no additional losses. Rating to the first dollar of loss can leave structured bonds that are still expected to return better than 95% of principal rated double-B or lower — the same rating applied to a corporate bond that will pay back 70% or less.

Like battlefield triage, re-REMICs can only achieve so much Getty

That carries expensive consequences. If a bank owns a mortgage bond that is downgraded from triple-A to single-B, for example, it has to set aside around 20 times more capital. Insurance company holders would, under similar circumstances, have to quadruple their reserves against losses on such paper. And if these institutions' investment guidelines forbid them from holding anything but investment-grade paper — or indeed just triple-A-rated paper — they would be forced to sell the instruments at what would likely be far less than the recovery value of the bonds.

The re-REMIC structure is designed to offer a relatively simple do-over for bonds that have taken bigger hits than their original structure allowed but that should still recoup much of the principal. The unrated junior bonds provide enough additional credit support for the ratings agencies to confer a triple-A rating on the new senior bonds, which typically represent the majority of the capital. The new triple-A senior bonds will then trade at a premium to the depressed price of the original tranche.

In essence, then, the re-REMIC is a form of ratings arbitrage — and thus for bank holders also a form of regulatory capital arbitrage. So it's no surprise that many have explored it as a means of getting relief on chunks of their non-agency RMBS portfolios. Scott Buchta, head of investment strategy at Guggenheim Securities, a financial services boutique in Chicago, says his firm has underwritten $2.4 billion in re-REMIC for banks and insurance companies in 2009. "We can take assets that already exist on a client's balance sheet and restructure them to improve their capital standing," he says.

The re-REMIC structure is designed to offer a relatively simple do-over for bonds that have taken bigger hits than their original structure allowed but that should still recoup much of the principal.

But re-REMICSs are not just blind ratings arbitrage like the now infamous subprime mortgage collateralized debt obligations. Re-REMICs, many argue, serve a useful purpose and don't deserve to be tarred with the same brush. Scott Eichel, co-head of asset-backed and mortgage trading at RBS Americas in Greenwich, points out that re-REMICs are less an arbitrage play than a way to overcome investor reluctance to buy the underlying MBS bonds. The banks and insurers that buy the senior tranche can't, or won't, hold paper rated below investment grade while the hedge funds and other junior bond buyers are looking for higher yields. A re-REMIC puts the two camps together in a way that satisfies both their needs.

Regulators would have cause for concern if the transactions turned one plus one into three, but not if they just improve liquidity in a battered asset class. In fact, one industry source finds a sympathetic hearing among regulators once they understand that rating agencies may cut the rating on a former AAA bond all the way to CCC even though it will repay 95% of principal.

"Rating a re-REMIC is essentially like carving out a portion that we think is principal safe."
Quincy Tang, DBRS

Some investors will do re-REMICs even if they can't get capital relief. Denise Crowley, who manages $1.3 billion in ABS and MBS for Zais Group, a money management firm in Red Bank, New Jersey, says many institutions that bought triple-A MBS tranches may not be able to hold them if the rating falls below investment grade. "They have to either get rid of them or use re-REMIC technology to be able to hold these assets, or at least a portion of them," she says.

Crowley explains that in a typical Alt-A RMBS 90% of the capital was rated triple-A, but losses in that category are expected to be 25%–30% rather than the original estimate of less than 10%. The former triple-A bonds are now rated triple-B to triple-C and if losses come in at the top end of the expected range they will all end up rated no better than triple-C. With about 15% of the average Alt-A deal in some stage of delinquency, she says the ratings agencies will demand an additional 35% credit enhancement to support a triple-A rating on re-REMIC bonds that represent 65% of the original triple-A tranche. The senior bond then has credit enhancement equal to 35% of the original triple-A layer plus the original 10% cushion below that — about 40% in total.

The case for using re-REMICs, then, seems strong. So why haven't there been more of them? One reason is the overall rally in the markets since last spring. In mid-November 2009, the senior re-REMIC bonds in Crowley's examples traded at yields of 6% or less, while the junior bonds were at 12%–14%. That followed a huge rally over the preceding three months in which junior bond prices ran from about 18 cents on the dollar to 30 cents or more. "A few months ago, money managers like Pimco were buying the senior re-REMIC bonds for their funds that track the Barclays Aggregate Index and putting the junior bonds in their distressed funds," says Crowley. "That was a pretty good deal when the junior bonds were cheaper."

The rally squeezed the profits out of re-REMICs for the highest quality paper, says Sandeep Bordia, head of U.S. residential credit strategy at Barclays Capital in New York, but issuance volume held up as arrangers turned their attention to lower quality paper. The bonds are still triple-A, but the underlying collateral shifted toward Alt-A mortgages or prime and

Some mortgage buyers are trying to come up with other ways of dealing with the shortcomings of the first dollar loss model: the National Association of Insurance Commissioners (NAIC) was scrambling to implement before the end of 2009 a regulatory capital scheme to replace traditional ratings-based calculations with a framework in which a third party — Pimco Advisors — would evaluate affected residential mortgage-backed securities and assess the recovery rates expected in defaulted MBS bonds. "NAIC is looking for a way to write to severity of loss as opposed to first dollar," says Michael Monahan, director of accounting policy at the American Counsel of Life Insurers. "It will be mandatory for all RMBS and also re-REMICs."

The NAIC proposal could eviscerate insurance company demand for portfolio re-REMICs, although Monahan points out that capital relief is not the primary reason insurance company bondholders use the structure anyway. Regulators have expressed concern that insurers should not derive a capital benefit because the cash flows don't change, but a re-REMIC adds liquidity to MBS portfolios, too. "Each bond has its own rating, and an updated rating," says Monahan. "Some companies may sell the junior bond and keep the highly rated piece while others may go the other way. It depends on the need of management at the time and gives companies a lot more flexibility."

jumbo loans with subpar delinquency performance. Bordia says investment banks and more sophisticated investors were quicker to change their models than the ratings agencies as the market deteriorated and expects many vintage 2008 re-REMIC bonds to be downgraded in time. "Some of the rating model changes only happened in the second quarter," he says. "It is more likely that recent re-REMICs will not get downgraded."

That may be so. But with the housing market still in intensive care, the ratings agencies are left with a dilemma: how much credit enhancement is enough in a market that continues to soften? Quincy Tang, senior vice president, U.S. RMBS, at ratings agency DBRS in New York, notes that deals done in late 2007 and early 2008 that added just 10%–20% credit enhancement to the new senior bonds have already faced downgrades. "Re-REMICs these days typically need about 40% or 50% credit support due to continued performance deterioration," she says.

And the fundamentals of the housing market have not yet improved: despite the recent uptick in the S&P Case-Shiller Index, she still expects another 10%–15% drop before house prices hit bottom. Even prime borrowers now have negative equity in their homes on an unprecedented scale, which makes it hard to predict how they will behave. "In a deteriorating market, you have to evaluate the non-delinquent population to ensure that enough defaults are forced through," she says. "The position in the capital structure is critical. It's a race between how fast bonds are paying down from the top versus how fast losses are coming up from the bottom." Even within the triple-A tranches, "front pay" bonds have a clear advantage over "back pay" bonds that receive no principal until the front pay bonds have been paid down in full — by which time losses may have reached up to the triple-A capital.

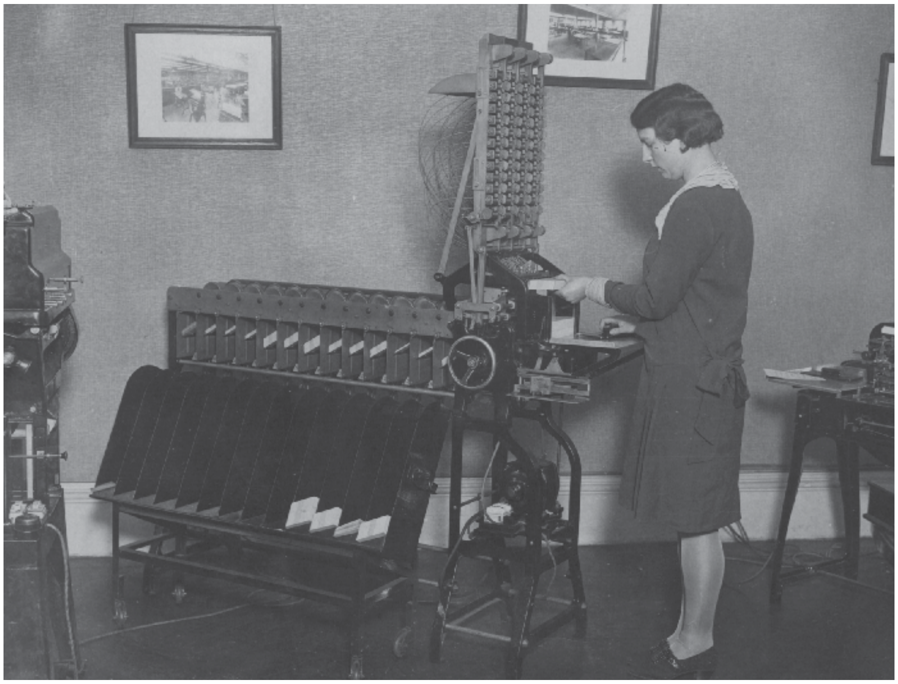
Timing of losses plays an important part in the rating process as well. Up to now, foreclosure moratoria and loan modifications have delayed the day of reckoning for some bonds. Tang says that could change if servicers see a pickup in prices and decide to accelerate the processing of delinquent loans; in that case, losses would come through much more quickly. On the other hand, it is also possible that continuous pressure on foreclosure moratorium and loan modification may further push out loss occurrence. In order to capture all likely circumstances, DBRS runs multiple scenarios that apply different prepayment speeds, loss timing and changes in interest rates; it will only assign a triple-A rating if there are no interest shortfalls or principal write downs even under the worst case. "Rating a re-REMIC is essentially like carving out a portion that we think is principal safe," says Tang.

The ratings agencies aren't all on the same page, though. Moody's takes a skeptical view of portfolio re-REMICs in particular. In some cases, an insurance company or bank has created a re-REMIC structure and retained both the new triple-A and the new junior tranche, only later selling enough risk to qualify as a legal true sale, a procedure known as a springing true sale. Navneet Agarwal, a senior vice president at Moody's, says that although some law firms have blessed the concept, the ratings agency does not accept that interpretation and insists that a true sale must be established when the re-REMIC is set up. "If the product is not a true sale on that date, anything you do after the close of the transaction may not cure that defect," says Agarwal.

Moody's rating method recognizes the re-REMIC structure does not diminish the expected losses in a portfolio. If a bond rated B1 is divided into two pieces and one attracts a triple-A rating, Moody's will almost always rate the junior bonds lower than B1. Some agencies assign ratings based on the probability of default, an alternative approach that may permit the new junior bonds to retain a B1 rating.

"We can take assets that already exist on a client's balance sheet and restructure them to improve their capital standing."
Scott Buchta, Guggenheim Securities

Accounting rules are also proving to be more of a sticking point than many expected. Marty Rosenblatt, a partner in Deloitte & Touche' securitization group, says a bank generally has to sell at least 15% of the value of the re-REMIC transaction to third parties for the deal to qualify as a bona fide sale — a prerequisite to getting capital relief. The sale also triggers a book loss if the original asset had not been written down to the value realized when the deal was done, as is often the case.


Updating the accounting rules can complicate matters Getty

That in turn holds little appeal to those banks that have been trying to avoid taking losses for as long as possible. Since the start of this year they'll have an even harder time talking themselves into using re-REMICs. That's because of the new accounting rules, FAS 166 and 167. Under the old rules, if a bank created a new junior tranche using 30% of the original deal and sold half of that, it would only be required to book a loss on the portion it offloaded. The new regime stipulates that all tranches must be marked to the sale price, regardless of how much is sold. That is bound to be off-putting for a number of banks, regardless of whether they have enough capital or earnings to absorb the loss.

The implications of the new accounting rules don't stop there. For those banks that do decide to go the re-REMIC route, many will simply retain the triple-A bonds. "The sponsors are not necessarily buying any new securities," Guggenheim's Buchta says. "They are retaining credits they already understand." But others have created a super senior sliver with, say, an 85% credit enhancement that fetches a premium, which sometimes helped mitigate the loss under the old rules.

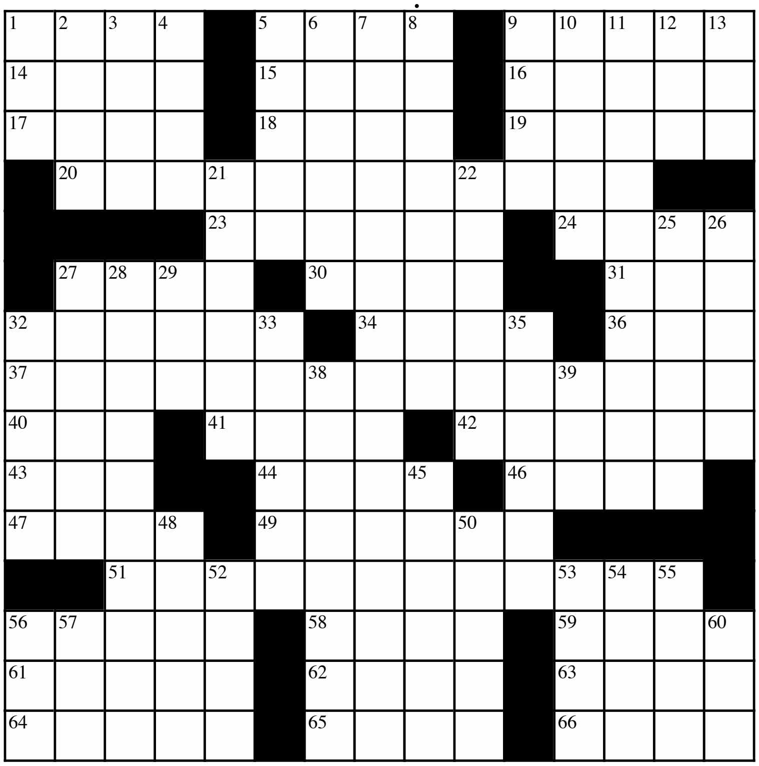
A slice off the top will not work now that the new accounting rules have kicked in, however. Selling the best cash flows debases the quality of what is left and cuts the value to the point where there is no net benefit. "The portion you keep has the worst cash flows," Rosenblatt says. "It would have to go on the balance sheet at such a deep discount that you still have the loss."

Throw in the accounting rule changes with greater scrutiny of loss assumptions from the ratings agencies and improving mortgage bond prices now that the worst of the credit crunch has passed, and re-REMICs have a number of obstacles to overcome. So it's little wonder that they have not managed to live up to early expectations of being a tool that could have widespread appeal among mortgage bondholders looking for ways to manage regulatory capital in a tough environment — not least banks.

Despite al the challenges, though, re-REMICs do still have appeal — not least as a means of creating some liquidity for owners of mortgage securities battered by the financial crisis. And despite recent improvements in prices in the secondary markets, that advantage isn't going to disappear overnight. Until the spate of bond downgrades comes to a close, or the housing market recovers — or both — re-REMICs will still have a place at the operating table.

Neil O'Hara *is a freelance writer based in Lincoln, Mass. He is a contributing editor to FTSE Global Markets and writes for a variety of other publications including On Wall Street, Wealth Manager and Alpha.*

Hard Currency



Chris Scarafile & Dan Marcellus

ACROSS

1 'Empire Strikes Back' planet
5 Animal lovers org.
9 Part of an act
14 Gin order
15 Gaelic homeland
16 Sanctuary
17 80s movie mom Garr
18 Change direction
19 Prepare to swig
20 Pancake option
23 Cut into
24 Ness, for instance
27 Hip Manhattan hood
30 Diminutive suffix
31 '___ Can It Be Now?'
32 Voids
34 2006 Pixar release
36 Partner with games
37 Crash survival aid, for many execs
40 "Help me Cassius, ___ sink!"
41 Air pressure unit
42 Up ___ ears (deeply involved)
43 Stimpy pal
44 Marries
46 Turner and Danson
47 Neck of the woods
49 Holy Roman emperor 955-83
51 Wall Street's Charging Bull, for one
56 Silo contents
58 Julia's Oscar portrayal
59 Coup d'___
61 Thick
62 K-P connector
63 Letters on a spacesuit
64 Jabs
65 USMC rank
66 Where to keep a 39D

DOWN

1 President before DDE
2 Chihuahua cheers
3 Songwriter Amos
4 Nazi salute
5 Wonders number
6 Puncture
7 Discover fine print?
8 Early Ford minivan
9 Kind of food or music
10 Panama attraction
11 Third party account
12 Actress Long
13 Medium power
21 Deep purple
22 Ogle
25 ___ & Ladders
26 Sharpens
27 Sleep disturber
28 Where to find an e-teller
29 1963 Paul Newman role
32 Greek marketplace
33 Cover in white stuff
35 Nova ___
38 Party twists
39 Garden tool
45 Sending distress msgs.
48 Wake
50 "Was ___ I who ordered the men counted?" Chronicles 21:17 (two words)
52 Singles
53 Hamiltons
54 Mormon state
55 Simplicity
56 Economic strength meas.
57 Speedwagon lead-in
60 Bit