The Regulatory Overkill (?) of Global Securitization Markets

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The views expressed in this presentation are those of the author and do not necessarily represent those of the IMF or IMF policy.
Unintended Consequences and 1+1+1…=0

• Some parts of the securitization market are poised to restart, but recent and forthcoming accounting, legislative and regulatory initiatives, threaten to shut it right back down again.

• While they are all aimed in the right direction, in combination they may inadvertently make securitization too costly.
U.S. Private-Label Term Securitization Issuance by Type
(In billions of U.S. dollars)

Sources: IMF staff estimates based on data from JPMorgan Chase & Co., Board of Governors of the Federal Reserve Systems; and Inside Mortgage Finance.
Note: ABS = asset-backed security; CDO = collateralized debt obligation; CDO2 = collateralized debt obligation-squared and CDOs backed by ABS and MBS; MBS = mortgage-backed security.
Figure 3.1. Ratings of AAA-Rated U.S. RMBS-Related Securities  
(In percent of S&P's originally rated 2005-07 issuance as of July 31, 2010)

Source: Standard & Poor's.
Note: RMBS = residential mortgage-backed security; CDO = collateralized debt obligation; SIV = structured investment vehicle.
U.S. Private-Label Non-MBS Term Securitization Issuance by Asset
(In billions of U.S. dollars)

Source: Inside Mortgage Finance.
European Private-Label Term Securitization Issuance by Type
(In billions of U.S. dollars equivalent)

Sources: IMF staff estimates based on data from JPMorgan Chase & Co., Merrill Lynch, the Association for Financial Markets in Europe (AFME), the European Covered Bond Council (ECBC), and Fitch ratings.
Note: ABS = asset-backed security; CDO = collateralized debt obligation; CDO2 = collateralized debt obligation-squared and CDOs backed by ABS and MBS; MBS = mortgage-backed security.
European Non-MBS Term Securitization Issuance by Asset
(In billions of Euro)

Source: JP Morgan Chase
European Covered Bond Issuance
(In billions of U.S. dollars equivalent)

Sources: IMF staff estimates based on data from JPMorgan Chase & Co., and the European Covered Bond Council (ECBC).
Note: n/a
Japanese Securitization Issuance
(In billions of Yen)

Sources: Bank of America - Merrill Lynch
Australian Securitization Issuance
(In millions of Australian dollars)

Sources: Bank of America - Merrill Lynch and Standard & Poor's
Canadian Structured Finance Term Market Issuance

Source: Standard & Poor's
Latin American Securitization Issuance
(In billions of U.S. dollars equivalent)

Sources: Standard & Poor's
Insurance Securitization Issuance
(In billions of U.S. dollars)

Source: Guy Carpenter, Goldman Sachs and Swiss Re
FASB 166/167 = higher ABCP regulatory capital

- Bank sponsors of ABCP conduits will have to hold regulatory capital against all their ABCP-funded assets by year-end 2010. It will be phased in so that regulatory capital had to be held against 50 percent of such assets on June 30.
- Hence, outstandings are expected to continue to slide.

Source: Inside Mortgage Finance.
Basel II/III makes arbitrage ABCP uneconomic
Plus barrage of well-intentioned legislative and regulatory initiatives

– Risk retention requirements
– Disclosure and transparency
– Rating reliance reduction
– Simplification of structures

• European proposals are similar to U.S.’s, but investors (not securitizers) pay the price of non-compliance

• However, proposed European disclosure standards lag (and will lag) those in the U.S.
The 5+ percent retention requirement

- Embedded in Dodd-Frank Act, EU Article 122a, FDIC’s “safe harbor” rule and the SEC’s Reg AB
- Various “flavors” with respect to what is retained
  - Equity or first-loss tranche
  - Vertical slices (equal amounts of each tranche)
  - Representative sample of the underlying loans
  - Seller’s interest (for revolving trusts)
- Different exemptions and degrees of flexibility
- Different definitions of who retains the risk
Real problem with risk retention is bluntness

• The idea of getting more securitizer “skin in the game” is logically appealing, and some of the empirical evidence supports it.

• However, as currently drafted, the various proposals still seem too inflexible (why 5%?) and ignore some already existing risk retention, for example:
  – Seller’s interest in master trusts
  – Excess spread

• In some cases 5% is too much, in others it isn’t enough!?
Disclosure and transparency improvements

- CRD Article 122a requires originators to make sure necessary information for necessary due diligence is available to investors over life of the transaction
- BoE and ECB will require loan-by-loan data on ABS collateral
- SEC Regulation AB imposes extensive ABS disclosure requirements, including Python language cash flow “waterfall” program. Similar requirements will apply to Rule 144 and 144a and Regulation D
- Any wiggle room for banks thwarted by new FDIC “safe harbor” rules
Rule 144a issues limited to accredited investors and qualified institutional buyers

Source: Deutsche Bank, Thomson Reuters, Bloomberg
FDIC’s securitization “safe harbor” rule

• The FDIC can seize securitized assets not accounted for as a true sales. The “safe harbor” rule defines true sale for such purposes.

• New rule makes safe harbor conditional on the transaction meeting a number of sound securitization conditions on an ongoing basis.

• Undermines bankruptcy remoteness and may affect creditworthiness of affected bank-sponsored vehicles.

• However, shouldn’t safe harbor be based solely on legal definition of true sale?
Reducing credit rating reliance

• Raison d’etre for SEC’s proposed Regulation AB amendments is to reduce rating reliance
• SEC Rule 17g-5 aimed at thwarting “rating shopping” by facilitating unsolicited ratings – EC proposed similar measure in June 2010
• Dodd-Frank Act voiding of SEC Rule 436(g) aimed at increasing rating agency exposure to legal liability
• Not so much rating reliance reduction in Europe, but rating overreliance not as extreme as in U.S.
Amendments to SEC Rule 17g-5

• Effective June 2, NRSROs prohibited from publishing or maintaining a rating of an SF product unless they disclose to all NRSROs all information associated with the transaction.
• However, to maintain access, NRSRO must rate at least 10% of the transactions they access, when it accesses more than 10 transactions per year.
• Will apply to non-U.S. transactions on December 2!
• Designed to encourage unsolicited ratings and thwart rating shopping.
The voiding of SEC Rule 436(g)

- Section 939G of *Dodd-Frank* voided SEC Rule 436(g)
- Rule 436(g) effectively sheltered rating agencies from legal liability as experts under *Securities Act*
- Registration statement rating disclosures must now include NRSRO consent to be named as an expert.
- Regulation AB *currently* requires IG ratings in public deal prospectuses
- Public ABS issuance cessation averted by an SEC no-action letter to January 24, 2011
Simplification and standardization of structures

- For RMBS only, FDIC “safe harbor” rule limits capital structure to six tranches
- Nothing similar for ABS and CMBS?
- Nothing from European authorities?
- What about standardization?
Basel III Liquidity Coverage Ratio (LCR)

• Banks required to maintain a minimum level of unencumbered high-quality assets that can be converted to cash in 30 days in a stress scenario

• Eligible assets include two tiers:
  – Level 1 assets comprised of cash, central bank reserves and high-quality government debt
  – Level 2 assets include high-quality (AA- and better) corporate and covered bonds. Level 2 assets are subject to 15% haircuts and limited to 40% of LCR liquid assets

• ABS excluded from LCR making them less attractive for banks especially versus covered bonds
Basel III Net Stable Funding Ratio (NSFR)

- NSFR = ratio of “available stable funding” (ASF) to “required stable funding” (RSF) >= 100%
- ASF = equity + preferred stock >= 1y + etc.
- RSF = sum of assets multiplied by an RSF factor
- The more liquid the asset, the lower the RSF factor
- RSF factors for corporate and covered bonds rated AA- and better = 20%
- RSF factors for ABS and MBS = 100%? making them less attractive for banks especially versus covered bonds
But wait! There’s more

- Solvency II will make it very expensive for insurers to hold mezzanine tranches (rated A and below)
- New rules for European money market funds prohibit ABS holdings
None of this is to say that important regulatory and rule changes should be rolled back

- For example, by making “true sale” more difficult to achieve, the bankruptcy remoteness of remaining off-balance sheet entities will be strengthened
- Also, incentivizing better incentive alignment along the securitization chain, and better disclosure standards are clearly good things
- However, the process of getting there could be better thought out and coordinated, intra- and internationally
What about credit ratings....

• Latest IMF Global Financial Stability Report asks whether credit rating agencies and their ratings contribute to financial instability. It finds that...

• Ratings are inadvertently destabilizing because they are hardwired into rules, regulations and triggers

• Downgrades can lead to destabilizing knock-on and spillover effects in financial markets

• Rating agency downgrade smoothing policies create potential procyclical cliff effects
Two-Pronged Policy Recommendations

• Importance of ratings should be reduced and the rating agency “regulatory license” eliminated
• But recognize that smaller and less sophisticated institutions will continue to use ratings
• Ratings that retain their “license” should be subject to more rigorous validation requirements
• Push rating agencies on procedures, transparency, governance and conflict of interest mitigation
• Discourage rating change over smoothing
Looking ahead, credit ratings should be seen as one of several tools to measure credit risk, not as the sole and dominant one.
Further reading
