Future Regulation – Connecting the Dots

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OBSERVATION

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Securitization Focus

In the autumn of 2007, as credit market turbulence, a lack of liquidity and a reduction in investors' tolerance of risk took grip, few would have predicted the eventual ramifications. The elasticity of the structured finance market allowed it to soak up the strain. This contributed to the build up of an epicenter that in the end caused ruptures in every corner of the financial markets. The greater the stored strain, the greater the release of energy.

Regulation has questioned virtually every aspect of the financial markets, resulting in a maelstrom of rules designed to improve the overall quality and quantity of bank capital, strengthen liquidity requirements and control excessive leverage. The stability of securitization is core to a blossoming economy. There is commitment from the highest level to implement a global framework that enables securitization to relaunch on a sound basis.

Standardization and disclosure is the path being beaten as regulators seek to eliminate barriers to entry and improve investor confidence. Simpler, more transparent structures are being encouraged. More public disclosure of transactions, their underlying collateral and rating agency methods are the right steps toward a more transparent global structured finance market. The secret to success in the long term though will be how the industry translates more openly available data, into more standardized and useful forms that genuinely add value to investors. More information is one thing, but a sound footing requires a level playing field.

Out of the Shadows

Sometimes legislation is the answer but it is limited in how it can be applied. Outright, clear mandates on the investor base are inevitably hard to implement in a free market. Currently there is a two pronged approach to deliver the tools and transparency that will encourage best practices to emerge in structured finance. Originators are being pushed to do everything they can to give investors the level of transparency they need to understand every aspect of their investments. This comes from direct proposals such the **Securities and Exchange Commission** (SEC) Regulation AB amendments, and indirectly from central bank requirements that will effectively force issuers to comply with new standards. On the flip side, regional policies reflecting Basel II, although harder to implement, will affect how investors perform due diligence when investing in new issues.

Basel Baseline

It is difficult for regulators to enforce investor best practices per se. How do you dictate how investors should price securities, or risk manage their positions? Regulators can however prescribe penalties if specific qualitative measurements are not undertaken in the analysis of securitizations when allocating capital.

And where capital is King, liquidity is Queen. The requirements established within the *Basel II Securitization Framework Enhancements* and *Basel III* are the main reigns regulators have over investors in the international regulatory response.

The regional interpretations of Basel II mirror the qualitative measures it sought to impose in the management of structured finance assets. The **Financial Services Authority**'s Strengthening Capital Standards 3, states that it, "seeks to improve risk management for securitized products by only allowing firms to invest in the securities after they have conducted comprehensive due diligence. If firms fail to do so, they will be subject to heavy capital penalties." The **European Union** (EU) *Capital Requirements Directive* states that, "before investing and on an ongoing basis, credit institutions must be able to demonstrate at all times …that they have a comprehensive and thorough understanding of and have implemented formal policies and procedures for analyzing (securitizations)." Basel II will also be introduced in the U.S. during 2011. In each interpretation investors are faced with the same practical challenges:

- Gaining access to performance information on the underlying pools on an on-going basis (e.g. loan delinquency rates; default rates; prepayment rates; loans in foreclosure etc)
- Undertaking their own stress testing appropriate to their securitization positions
- Having a thorough understanding of structural features including waterfall and waterfall-related triggers, credit and liquidity enhancements, market value triggers, and deal-specific definitions of default.

Work to improve the provision and standardization of loan level and issuance related data takes aim at these pieces of the puzzle. It provides the basis to allow investors to address very real policy requirements. Investors themselves are not being told they have to analyze and access loan level data directly, but it is vital that assumptions about transactions are based on this granular detail being modeled in the structuring and disclosure of the securitization. Investors will have to access and make use of the world of data that is increasingly available. Central to this will be the extent to which issuance data, waterfall model disclosure and pool performance data are provided in standardized formats (at issuance and on an ongoing basis). How investors adjust their own operations to integrate this data into investment management and risk surveillance will largely determine whether they can meet the requirements outlined above.

Legacy securities aren't directly subject to the new Basel requirements but diligence in the management of these securities is clearly a continued market concern. Waterfall models in Europe in particular have often been based on aggregate, summary level issuance data rather than the behaviour of underlying loans. Few issuers provided full disclosure of loan level data before the crisis. The future promises a new world with new rules.

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Indirect Affect

The **European Central Bank** (ECB) and the **Bank of England** (BoE) can indirectly force issuers and investors to adhere to the rules of this new world.

Access to the ECB repo facility and the BoE Discount Window Facility are fostering the transition by making sound and transparent collateral a pre-condition to receiving funding for structured finance assets; this funding is vital to organizations' liquidity management. Investors will likely only purchase securities that match up with this required level of enhanced transparency, disclosure and analysis. In principle, issuers will find it harder to market deals that fail to meet these criteria.In Europe, central bank funding will clearly remain important until an active, liquid secondary market returns.

Hang on a SEC

The SEC amendments to issuer disclosure in Regulation AB aim to better protect investors in the securitization market. This involves giving investors the tools they need to accurately assess risk (including more detailed and current information about ABS and more time to make their investment decisions) and a better alignment of interests between ABS issuers and investors.

Unlike in the EU, the SEC is mandating issuer requirements as part of the registration of structured finance assets. Not only does it go further in imposing regulation on issuers, the rules are the first to really connect the dots between new issuance standards and what the investor base will have to do in a capital conscious environment. The proposal suggests that issuers should provide and publicly disclose a computer program of the securitization's waterfall. In theory investors could then input their own performance assumptions to assess the cashflows and payments for each security. On paper, this could bridge the gap between loan level data and an investor's actual investment. The SEC points out that the benefits of this include cutting costs in modelling the waterfall for each security and better initial and ongoing analysis — reducing an overreliance on ratings. Currently investors may only receive a textual description of waterfall information in the prospectus, making it difficult to perform rigorous analysis.

The industry has taken big strides to introduce and agree standard forms and templates for loan level and bond issuance disclosure. The extension of these efforts into other aspects of disclosure will be critical if investors are able to truly capitalize on the work done so far. Standardizing the way cashflow waterfalls are defined and scripted and trying to implement a common language when non-standardization is the prevailing characteristic, may be nigh on impossible. There is an opportunity here to create a basis from which models' input assumptions and output cashflow calculations can be standardized across issuers and asset classes. Finding this happy medium, without oversimplifying the modelling that must be provided to investors, will be a sizeable but important barrier to overcome.

Lost in Translation

One size fits all is the impossible dream but with coordination a solid platform for securitization can be established. Governments are committed to adopting standards in spirit but regional mutations present the biggest stumbling block on the road to an internationally stable structured finance markets. Even within regions the direct and indirect nature of policies have caused some alarm. Upon final adoption of the revised Regulation AB proposals the FDIC anticipates that compliance with the SEC's requirements will satisfy its own Safe Harbor stipulations. The convergence between the two wasn't always so clear though.

In Europe there are similarities between regional responses, for example between the ECB and BoE. While both promote the same underlying principles and there is a dedication to moving forward, the subtleties between each are telling. The BoE nods its head toward waterfall disclosure but the ECB has focused solely on loan level transparency. The BoE has put more emphasis on standard descriptions of collateral stratification data points that should be disclosed by issuers and monitored by investors — much more so even than the SEC in its recommendations.

Industry bodies such as the **American Securitization Forum** and **Association for Financial Markets in Europe/ European Securitization Forum** are doing much to provide a foundation for the most prominent asset classes. The ECB, BoE and SEC have all stated the need for standard data points for loan level, pool level descriptors and information in deal documentation, with variations for each asset class. But they have not yet come to a consensus as to what those should be. For an issuer working with investors around the world the confusion over what formats to provide to which investor is a potential headache. Investors need this clarity too. They will go wherever the barriers to participation are lowest and where they can employ the same methodologies on a regular basis.

Take international accounting standards and securities law as examples of standardization in action. They provide a framework for comparability. In securitization, this framework isn't coming organically. It's up to each region to compel issuers and investors to adopt best practices. Once the data is disclosed, market participants can find the tools, models and mechanisms to understand it. But if a lack of comparability is part of the equation then we lose the whole point of having readily available information.

The End Game

Turning more commoditized, voluminous data into a value add for investors is the desired end game. Investors should be able to focus on their core business rather than spending a disproportionate amount of time collecting data or reverse engineering loan level information and waterfall structures.

Before now ratings provided a level playing field of sorts. Trades were made on the same (albeit misguided) assumptions. Wider adoption of standards can deliver the ammunition to understand investment performance and the fundamental differences between transactions. A mechanism to capture the dynamic nature of the market is also important. As new structures are introduced they will affect the standardization process. They must be constantly monitored and integrated into best practice. Only then will the commoditization and transparency of information truly be able to play its part in steadying securitization's footing.

Principia will be conducting market research to explore the industry's attitude and adoption of best practices as described in this article. The results will be published in *StructuredFinanceNews.com*, ASR's Web site. To take part you can visit the Principia Web site (*www.ppllc.com*) or visit the company booth at *Global ABS* in London.