

Reviving Securitization

The Need for Improved Transparency, Risk Measures and Professional Practices



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Reviving Securitization:

The Need for Improved Transparency, Risk Measures and Professional Practices

The economic effects of the financial crisis continue to ripple violently across the country and around the globe in the forms of scarce credit availability, illiquid asset markets, depressed property values, and high unemployment. At the center of the maelstrom is securitization. For the past 25 years, securitization technology introduced investment capital to loan financing, with structured debt capital markets becoming the greatest source of lending capital, especially for consumer debt. As of the end of Q2 2009, roughly two thirds of residential mortgage debt outstanding balances (\$6.6 trillion out of \$10.4 trillion) and more than a quarter of consumer non-mortgage debt (\$618 billion out of \$2.465 trillion) were financed through securitizations.¹ Yet the process was flawed by deteriorating underwriting standards, fraudulent borrowing and lending practices, excessive leverage and inadequate due diligence. Now what is emerging is a clear consensus that deficient credit risk metrics and insufficient access to critical information about underlying collateral have been significant contributors to the financial crisis. What is more, the resuscitation of the structured debt capital markets is contingent on fixing these shortcomings.

Now functioning on a limited scale, securitization markets remain in a state of near suspended animation. Initiatives sponsored by the FDIC, US Treasury, and the Fed to prop up the market have lured some investors, but doubts are widespread with respect to demand durability once programs such as TALF, which offers attractive non-recourse term funding, are phased out in 2010. The consequences of permanent damage to the structured debt capital markets would be a severe blow to credit availability, and a colossal drag on economic growth. To rebuild capital markets financing for securitizable assets, the integrity of the process must be strengthened.

Industry and market overseers are putting forward a host of potential fixes. On October 28, the House Finance Committee promulgated the *Accountability and Transparency in Rating Agencies Act* (Accountability bill) aiming to eliminate the NRSROs' exemption from the SEC's fair disclosure rules. On November 6, the National Association of Insurance Commissioners adopted a proposal to abandon conventional credit ratings in favor of a new model and risk metrics for assigning Designations on specific RMBS for purposes of risk-based capital calculations. On November 10, the American Securitization Forum released for comment the ASF Project RESTART RMBS Trustee Bond-Level Reporting Package, a standardized format designed to increase transparency and elevate the quality of collateral performance data available to investors and rating agencies. On November 11, FDIC Chair Sheila Bair announced plans to submit to the FDIC Board in December rules for governing structured finance activities to ensure "...the securitization process does not create landmines for banks, investors and our financial system."

¹ Federal Reserve Board

The Crisis: How did we get here?

Leading up to the crisis, liquidity was abundant. Mortgage loans were originated, packaged and sold at a frenetic pace, with some loan products amounting to junk. Under steady pressure to consistently improve earnings and facing heavy competition for loan origination, lenders increasingly created and sold mortgage products ostensibly designed to be more affordable for nearly any consumer. More often than not, borrowers were sold products unsuitable for their credit profile. For example, ARMs with minimal introductory teaser rates ultimately proved unaffordable for borrowers at their fully-indexed level. Add rampant document misrepresentation enabling borrowers to more easily qualify for loans, and the consequence was steady weakening loan quality. These developments went largely unnoticed...until housing prices began their inevitable drop.

Mortgage bankers accumulated whole loan pools that were sold to investment banks (including affiliates) with little or no recourse, often at substantial premiums over par. Without meaningful retained interest that would be subject to the pool's ongoing performance, lenders had little incentive to originate high-quality products likely to hold up as risk drivers: property values, interest rates and general economic conditions all became less salutary. Nevertheless, because of the tremendous fees earned structuring and selling RMBS, investment banks competed fiercely for all types of collateral. Traders, planning to have exposure for just a short period, didn't consider the fundamental risk of the assets in the way a prudent investor would. Furthermore, the speed at which transactions were offered and closed did not allow for proper analysis and due diligence, and the lack of available data made it virtually impossible for investors to independently analyze collateral backing the RMBS. With the market largely relying on the rating agencies to perform the analysis, there was little means to measure collateral quality and forecast the wave of defaults in the offing.

Could greater transparency plus rigorous investor analysis and thorough due diligence have prevented the crisis? Possibly... Yet ABS loan-level data was difficult to access and process, and investors came to rely on NRSRO diagnostics that ultimately under-estimated risk. Warning signs would have become apparent if investors had done their own research and analysis. For example, in early 2007, RangeMark loan-level credit models predicted losses severe enough to cause widespread downgrades and likely security losses on about half of the investment grade sub-prime REMICs on the basis of the then relatively modest deterioration in home prices.

Transparency and Professional Accountability

Those issuing and creating the structured securities have a tremendous information advantage over investors shouldering the risk and in those circumstances it is unlikely investors get a fair shake. The solution is to identify and ameliorate areas of misaligned interests and inequitable access to critical information. Restoring investor confidence in the quality underlying assets, legal structures, the veracity and efficacy of lenders and servicers, and the process through which deals are constructed, documented, managed, and reported will only materialize through enforced disclosure and the resolve to hold all agents accountable for their conduct.

Key elements of the *Accountability* bill include:

- Greater regulatory oversight of the rating agencies;
- Improved corporate governance at the rating agencies;
- Greater transparency with respect to the ratings process and methodologies used by the agencies; and
- Disclosure to the market of issuer and asset level information used in the rating process.

While enactment of the *Accountability* bill and other proposed measures will bring greater integrity to the ratings process, equally important is the greater transparency into underlying portfolio data supporting securitization transactions. Specifically, issuers or the rating agencies will be required to disclose "...a description of relevant data about any obligor, issuer, security, or money market instrument that was used and relied on for the purpose of determining the credit rating."² What's more, investors will be armed with information to perform due diligence themselves. The improvement in obligor-level transparency will enable market participants to conduct independent analysis of a deal's underlying risks. NRSRO published research and credit ratings may continue to provide valuable insights, but conducting an independent analysis must become standard practice in the market. Investors should insist originators retain a portion of the exposure they generate, aligning the interest of the originator and investor.

Investor Responsibility: Better Analytics and Best Practices

Theologian Thomas Merton suggests: "There is a natural laziness that moves us to accept the easiest solutions – the ones that have common currency among our friends."³ Those with investment responsibilities, as well as senior-level executives tasked with ensuring best practices, must be held accountable -- not just for performance but for abiding by principles and processes of prudent asset management. Reliance on NRSROs for credit assessments and investment banks for assurances of value, once common and acceptable practices, has proven to be a poor substitute for investors' own research and due diligence. The federal government is now directly and indirectly exposed on a large scale to structured credit products through TARP, TALF, PPIP and other programs; so government officials too must use the most advanced risk management techniques and analytical tools to manage these complex exposures.

Investment Decisions - Sound decisions and effective management of structured finance risk requires integrating fundamental credit analysis, quantitative modeling, product expertise and market knowledge. Investors should be armed with tools to properly model underlying loan collateral and quantify the full distribution of risk associated with structured credit products like RMBS, ABS, CMBS and CDOs. Deal analysis involves several layers of due diligence. Before analyzing the expected asset performance, certain qualitative factors should be examined and understood, including:

² H.R. 3890 "Accountability and Transparency in Rating Agencies Act", dated October 21, 2009; Proposed Amendment to the Securities Exchange Act of 1934; Section 15E, paragraph (s)(3)(E) Transparency of Credit Rating Methodologies and Information Reviewed.

³ Thomas Merton, *No Man is an Island* (New York: Harcourt, Brace and Company, 1955).

- the creditworthiness of the counterparties in the transaction, including the originator and servicer, their ability to perform their duties and honor any representations and warranties made about the collateral, their obligations to repurchase early defaults, and their degree of “skin in the game”; and
- the legal documentation, especially the terms describing the deal’s legal structure, class structure, payment waterfall, triggers, control rights and remedies.

This effort should be followed by a collateral analysis performed at the obligor level in order to achieve the most accurate assessment of credit risk and expected performance. Analysis based on aggregate pool data summarized by weighted average statistics (e.g. WAC, WAM, WARM) can lead to inaccurate quantitative risk measurements. Identifying and quantifying the key factors that influence decisions to pay, prepay and default can lead to effective forecasts of credit behavior when performed on a forward looking, non-stationary basis. Specifically as it relates to RMBS, proper credit and quantitative analysis should involve the following:

- a review of each obligor’s credit profile, including FICO score, debt ratios, payment history, delinquency status, geographic location and other demographics;
- a review of the loan’s contractual terms, including tenor, interest rate, payment type and terms, property type, LTV, purpose, occupancy status, documentation and lien status;
- an integration of macro and local economic factors that affect these variables, such as the level of interest rates, housing prices and unemployment trends;
- the use of dynamic quantitative models to conduct stochastic analysis and forecast asset level cash-flows, including the timing of prepayments, the timing of defaults and degree of loss severity, and deriving a probability distribution of performance outcomes using the asset level and economic factors noted above;
- the establishment of metrics to measure the results of the analysis, quantify risk, assign value and returns, to assess the risk / return tradeoff and to conduct relative value analysis;
- consideration of correlation, concentration and systemic risks.

Furthermore, to the extent an investor is entitled to direct access to the underlying loan files, a hands-on due diligence should be performed on loan file documentation, to include:

- confirmation that the files are properly segregated and custody is being maintained on behalf of the investor;
- confirmation of the completeness and authenticity of the documentation, including the existence of the original note, assignment in proper form, and evidence of insurance and security interest;
- validation to confirm that the data used in the asset valuation models is accurate;
- identification of any suspected fraudulent representations or warranties on the part of the mortgage lender or underlying loan obligor.

What about legacy assets? Many investors still hold vast portfolios of hard-to-value securities. Collateral losses are expected to be several orders of magnitude higher than levels contemplated by deal arrangers and rating agencies, making already complex securities even more difficult to evaluate as ratings become obsolete and prices previously available from market makers vanish. Using the proper credit and quantitative analytic tools enables investors to better value their illiquid assets and make more informed investment decisions.

The Work Ahead

Restoring credibility in the market, increasing accountability and transparency, and ensuring that market participants have the tools, including the people, expertise, analytics and processes to properly manage the embedded risks in these assets, are vital to restoring capital markets finance. Passage of the *Accountability* bill, and its proposed improvements in data transparency, will facilitate necessary change and set the foundation for a more stable market governed by standard practices that benefit all parties. Rebuilding will require the participation of everyone involved directly or indirectly in the markets. Their work must involve a reexamination of the culture, policies, procedures and discipline surrounding risk management and valuation. The focus should be on:

Improved Modeling and Risk Metrics - Internal investment guidelines and regulatory risk-based capital calculations using NRSRO ratings as the sole or primary diagnostic encourage complacency and the farming out of fiduciary responsibility. Provisions based on simple credit ratings must be supplemented or replaced by risk measures that capture the complete distribution of risk. More than *expected* risk, metrics need to consider perfect storm events – such as when liquidity disappears and markets become perfectly correlated, or a localized credit problem becomes systemic.

Internal Controls – What is needed is a culture of transparency, responsibility, discipline and accountability. Management should be rewarded for their attention, and held accountable for inattention to risk management and valuation duties. If internal capability or technology is insufficient for dealing with current or prospective holdings, management needs to make and implement a plan to change, ensuring appropriate risk and valuation tools and policies are in place *before* underwriting or acquiring assets.

External Oversight – Industry regulators, private organizations having oversight responsibility and leaders of trade groups should do everything possible to encourage the development of internal know-how and quantitative tools. Improvements will be accomplished by introducing and enforcing transparency laws like the *Accountability* bill (or revamping existing ones like Reg A-B). Relevant government organizations then must hold actors along the whole chain accountable for obeying the rules of conduct, practices and fairness.

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