Recent developments in the US securitisation market

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The financial markets have experienced unprecedented turmoil over the past 18 months, exacerbated by historic pricing levels for food, housing and energy. The net result has been financial stress on consumers leading to escalating loan delinquencies and defaults, and a broad imbalance between the supply and demand for credit.

The roller coaster ride the market has experienced is due to a number of factors – weakness in underlying economic fundamentals, rising prices, falling home values, credit tightening, looser underwriting standards in past years and reductions in discretionary income, leading to reductions in spending levels.

The financial market is reacting immediately to any news creating volatility, and the global credit crunch that began with the US sub-prime mortgage markets is now a broad based concern. While there is some evidence that the markets are starting to improve, we are still in the early stages of recovery. Hopefully, there will be more stability in the markets in 2009, however, we can expect that the impact of the past 18-24 months will have a lingering affect, and in some respects a permanent affect, on the global market.

What we do know is that the days of cheap and easy financing have disappeared. But how we will evaluate the factors that will continue to affect the cash markets?

The SEC has tightened up the short selling rules for the financial institutions and the Federal Reserve has extended the credit line for the investment banking firms until 2009. Both actions are intended to provide stability and more certainty to the financial community.

Credit related losses due to the credit crunch across the financial services industry are expected to be approximately US$400bn. In the US the impact has seen a number of bank failures, including the collapse of IndyMac Bank, which was the third largest US bank failure in history. The impact of asset write-downs on capital and liquidity has stressed the financial community. Today's market conditions have impacted all participants in the marketplace including the GSEs.

Housing prices haven fallen dramatically since 2007, and defaults in mortgages, home equity loans and credit card receivables continue to rise. Home foreclosures have risen to record levels. Energy prices, unemployment, and the risk of rising inflation have contributed to the financial stress on the economy.

The securitisation markets are struggling to keep pace with the management of the credit failures. In addition, the threat of litigation is emerging due to the poor performance of the securitisations originated between 2005 and 2007. Transaction participants and regulators are analysing the origination, underwriting, collateral, and ratings of transactions. Nearly everyone is analysing the underlying characteristics of the portfolios to assess whether they met the representations and warranties of the transaction documents.

As the performance of the 2005 through 2007 vintage securitisations deteriorate, we have noticed a heightened focus on loan servicing and transaction surveillance. Servicers are overwhelmed by the increased number of delinquent loans and mortgage foreclosures.

New strategies are being employed to keep people in their homes, extending terms, lowering rates for a period of time are all being contemplated. In addition, the regulatory authorities are requiring servicers to spend more time 'working out' mortgages as opposed to foreclosing.

CURRENT SECURITISATION MARKET

Securitisation evolved over the past decade from an 'originate to hold' model to the 'originate to distribute' model.

The 'originate to distribute' model permitted the extension of credit with the transfer of risk, in some cases entirely, to outside investors. This model was fueled by fees, yield chasing to some degree the insatiable interest of investors for new product.

The current credit crisis has resulted in the lowest securitisation originations since 2005. There has been limited new activity in student loan, autos, prime mortgage, and recently some collateralised loan obligation (CLO) issuances, since the crisis started. A substantial majority of the mortgage market since mid-2007 has been GSE conforming product.

Some noticeable trends have emerged in structures, specifically less leverage, higher collateral quality, and smaller transaction size. Reverse inquiry transactions have become more commonplace as investors want specific attributes built into the transactions. In addition, many investors are looking to move up in the capital structure and are demanding higher spreads. As the flight to collateral quality continues, underwriting discipline has become more rigorous.

Liquidity continues to be a challenge in the current market. In early 2008, there were warehouse liquidations, margin calls and other disposals of securities causing pricing stress in the market. These types of sales have continued to put downward pressure on prices product, especially for the problematic vintages. A 'liquidity spiral' continues to be a major concern of market participants, and pricing levels are being driven by vintage, geography, and borrower behaviour.

PRODUCTS IN THE MARKET

Asset backed securities (ABS) CDOs. Many of the ABS CDOs originated between 2005 and 2007 have experienced poor performance due to delinquencies and non-performance of the underlying credits. Many ABS CDOs have failed their deal triggers resulting in diverted principal cash flows to pay the senior classes.

In addition, many ABS CDOs have declared an 'event of default' where the majority holder can elect to liquidate the structure. The origination of ABS CDOs have come to a halt and it is unknown if this product will be salable again. For example, due to the poor performance of ABS CDOs and the significant amount of leverage in the structure, CDO squared transactions have been written down dramatically, with some near zero.

Collateralised loan obligations (CLOs). CLOs have continued to perform fairly well during the credit crunch despite the stress in the leveraged loan markets. To date, the default rate for leveraged loans is still below 1%. Market participants are focusing on developing structures with less leverage and increasing diversification quality of the collateral. The contractual rights usually provide the lender the ability to continue to credit enhance the product during the term of the loan.

For example, CDO light is a new structure in the market that incorporates less leverage with increased focus on higher quality collateral. We expect to see deals structured with better credits and targeted to certain investor groups looking for specific risk exposure.

Residential mortgage backed securities (RMBS). Government sponsored securitisations with prime mortgages have continued during this crisis. Most prime collateral has performed well in comparison to sub-prime and Alt-A; however, there has been some recent deterioration in prime or near prime performance.

Fannie Mae and Freddie Mac continue to originate securitisations on a monthly basis, with the vast majority of the current residential market share. Their focus on operational effectiveness and strict servicing and underwriting guidelines has contributed to better performance in their product. Since Late 2007, sub-prime mortgage origination has effectively ceased with origination platforms focused on liquid product meeting the FHLB, GSE or other similar criteria.

Automobile securitisations. Increases in oil and gas prices have impacted the automotive securitisation market, particularly the leasing market. The market for used cars, especially trucks and SUVs has been adversely affected by rising gas prices and the economy, leading to a decline in residual values and the performance of automobile securitisation transactions.

Student loan. The student loan market has dramatically changed due to recent legislation. The two major segments in the US are FFELP (Federal Family Education Loan Programme – Government guaranteed Student Loans) and Private student loans.

Student Loan rates have been legislated and the government subsidies have been reduced to lower levels starting in October 1, 2007. Profit margins have been severely constrained forcing consolidation in the industry.

The percentage of government guarantees are being phased down over a period of five years. The government guarantee of FFELP loans will be reduced from 97% to 95% beginning in 2012. FFELP loans along with the private loans' constitute the primary source of funding for college students in the US.

Auction rate securities. Beginning in mid-2007, auction rate securities backed by structured investment vehicles (SIVS), contingent capital facilities and other esoteric asset types began to fail. By March of 2008, the entire ARS market was at a standstill, with limited successful auctions. The lack of liquidity resulted in limited price discovery and few channels for investors to liquidate positions.

State and federal regulators are investigating the marketing practices by major financial institutions of auction rate securities. Settlements between several institutions with the New York State Attorney General have begun to emerge.

Covered bonds. Covered bonds are debt securities backed by the cash flows of mortgages or private sector loans. Covered bonds are similar to asset backed securities except that covered bonds remain on an issuer's balance sheet; and credit enhancement is provided structurally and through a guarantee of the sponsor of the transaction.

If the issuer becomes insolvent, the investors are protected by a lien on the assets within the structure, and then become a general creditor. Covered bonds are popular across Europe and may play a larger role in the future of the US securitisation market. The critical factor in this product is the credit rating of the sponsoring entity.

The Federal Reserve and regulators view covered bonds as a partial solution to the credit crunch. The mortgages remain on the balance sheet of the originator providing accountability and transparency, while opening up a new funding source.

TRANSPARENCY IN THE SECURITISATION MARKET

Since the beginning of the credit crunch, investors have considered a lack of transparency as a major issue within the securitisation market. Investors feel they have an inability to adequately assess the credit risk associated with each of the underlying assets within a securitisation structure.

Additionally, there is a lack of standard documents and disclosures for all products, especially complex products such as CDOs and structured investment vehicles (SIVs). Greater disclosure and transparency is currently being discussed in the market, and we expect progress in this area in 2009.

ACCOUNTING GUIDANCE AND VALUATION

FAS 157. Some have argued that the largest contributor to current valuation stress has been the application of FAS 157, which was effective for early adopters beginning in the first quarter of 2007. At first glance, the guidance provided by FAS 157 was not expected to significantly impact companies' financial statements or the way fair value is measured.

The standard's provisions are focused on a common definition and disclosure process. The definition of fair value in FAS 157 is based on exit value and has resulted in changes in how market participants must value their assets. The fair value focus on exit value has been difficult in light of current market conditions, a dearth of trading, and wide spreads for uncertainty and illiquidity.

FAS 157 and fair value. Probably the most significant change from current practice introduced by FAS 157 was that it clarified that the term 'fair value' is intended to mean a market-based measure, not an entity-specific measure. The standard emphasises that a company should use a valuation technique and inputs what a market participant would use in their valuation process.

Accordingly, a valuation technique should include all risk adjustments that market participants would include in pricing a specific asset or liability. Historically, some companies may have used entity-specific methods and assumptions to measure fair value without a focus on market participants.

Companies must carefully evaluate all available information and cannot simply assert that current observable transactions reflect 'forced' or 'distressed' transactions. For example, to the extent that prepayment speed, default rate, or discount rate assumptions can be derived from transaction prices observable for similar securities and/or credit default swaps, such data should be evaluated and considered for estimating a market based exit price. The challenge is that market participants have varying degrees of access to information, and structured product value is driven by collateral and transaction attributes.

Many companies have sought the assistance of specialists and pricing services to help them develop an estimate of fair value. In response, the accounting regulatory bodies have re-issued guidance emphasising the responsibilities for evaluating the work of specialists and pricing services. In general, the guidance requires the company and the auditor to develop a detailed understanding of the methods and assumptions used by these third parties, and take responsibility for the values.

The diligence surrounding the use of third parties is also compounded by the disclosure requirements of FAS 157. FAS 157 requires a leveling or classification model when presenting fair value disclosures. This is known as the FAS 157 hierarchy.

The preparation of the fair value level disclosures is based on the inputs that significantly influence the fair value measurements. The need to understand the mechanics of the valuation process requires detailed discussion with third party valuation resources and market makers.

FAS 140 and FIN 46R. The market is currently reacting to the proposed accounting guidance that could affect both the recognition of transfers of assets as sales as well as the consolidation of securitisation vehicles previously recorded off-balance sheet.

The FASB is expected to release exposure drafts amending both FAS 140, *Accounting for the Transfer and Servicing of Financial Assets and the Extinguishment of Liabilities*, and FIN 46R, *Consolidation of Variable Interest Entities*. These standards, working in unison, could make it more difficult for securitisers to remove assets from their balance sheets. An increase in balance sheet assets may lead to higher amounts of capital in order to satisfy their regulatory requirements.

Other revisions to the standards could force large holders of securities issued by these entities to consolidate the issuance entity.

The potential outcomes of the revised standards could effect the valuation of both existing and future transactions.

In response, market participants and some industry regulators have commented that the accounting rule changes should not drive incremental capital changes. It is too early to judge how this issue will be resolved.

In early 2007, sponsors and servicers of mortgaged-backed securities were faced with the need to expand their servicing activities that stressed the off-balance sheet accounting for transactions to maximise the cash flows from the underlying assets for the benefit of investors.

The dilemma was resolved by the SEC in June 2007 when it clarified that performing work-out activities when default is reasonably foreseeable is not inconsistent with performing those same activities when a default has occurred, preserving off-balance sheet treatment for those transactions.

OUTLOOK

Is the securitisation market going away? No. Will the market return to the levels seen in 2005? Not right away, and in some cases certain product offerings and structures may never be seen again. We expect a focus on simplicity, quality, transparency, and wider spreads. There are some positive trends with increased activity during the past quarter in certain market segments.

When will trading levels and market fundamentals return to normal? That depends on a wide variety of factors including asset type, vintage and structure. From a credit perspective, deal performance is very diverse with very poor performance on some deals in contrast with good performance on older deals and those with higher quality credits and more traditional underwriting.

Obviously, there are many transactions that are incurring credit losses that will not be recovered. The affect of spread widening and liquidity premiums is far less predictable. As deals season and more data becomes available, one would expect more normal pricing. A key security risk that has emerged is the extension of expected lives, driven by slower prepayments.

The past year or so has been unique in many respects. The implementation of FAS 157 and the greater focus on fair value could not have occurred in a more challenging environment. Hopefully, the lessons learned can be used to strengthen the markets and facilitate a recovery resulting in a broad and healthy market for securitised product.

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