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SESSION 2 : PROSPECTS FOR STRUCTURED FINANCE SECURITISATION AND COVERED BONDS - MAIN ISSUES FOR DISCUSSION PAPER

prepared by the OECD Secretariat

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Prospects for Structured Finance Securitisation and Covered Bonds

Main issues for discussion

(Note by OECD Secretariat)

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This ***main issues-for-discussion*** document has been distributed as Background to the debate in **Session II** of the *12th OECD-WBG-IMF Global Bond Market Forum*, to be held on 5 and 6 May 2011, beginning at 9.00 am on the first day. Questions concerning this document can be addressed to Hans J. Blommestein, Head of the Bond Market and Public Debt Management Unit, OECD, mailto:hans.blommestein@oecd.org.

Prospects for Structured Finance Securitisation and Covered Bonds

I.1. Introduction to structured finance securitisation[1]

1. The US "subprime-cum-securitisation" crisis was a key catalyst for the global liquidity crisis that mutated into a full-blown credit crisis, bringing the international financial system to the edge of the abyss[2]. In hindsight, the numerous structural shortcomings of (structured finance) securitisation markets (in particular in the US) may have seemed obvious. For example, the misalignment of incentives was evident at every link along the structured finance securitisation chain.[3] Proper risk evaluation (as part of professional due diligence) by professional investors and intermediaries was often not undertaken, while too much faith was put in credit rating agencies whose own methodologies for valuing (complex) structured finance products were at times flawed. But also other gatekeepers of the public trust (auditors, securities lawyers, regulators, supervisors, etc.) failed in different respects and degrees.

2. However, it is important to note that not all structured finance securitisation was as unsound as in the US subprime mortgages sector[4]. For example, European securitisation activities reflected to an important degree securitisation as a legitimate funding tool (as opposed to securitisation as an '*end in itself'* for arbitrage reasons as was often in the US the case). Moreover, there was much less disengagement by European underwriters (aka more 'skin in the game') than by their US colleagues.

3. Many (or even most) structured products became overly complex and opaque, while risks were seriously underpriced[5]. In Europe this underpricing reflected mainly liquidity risks, while credit risk was often properly priced. The key benefit of structured finance securitisation had been its ability to disperse and redistribute credit risk to a broader and more diverse investor base – but, instead, risk concentration turned out to have increased sharply.

4. In the wake of the crisis, structured finance securitisation issuance has dropped away sharply in the past few years. Key segments of the market continue to rely on government-backed liquidity and asset purchase programs. The first part of this session will assess how likely it is that structured finance securitisation will return as an important market-based channel for lending markets (and also to what extent).

I.2. Issues for discussion of Structured Finance Securitisation as a source of funding

5. The volume of securitisation issuance remains at low levels, with net issuance projected to be negative (again) in 2011. In Europe, issuance was (before the 2008 crisis) to an important degree driven by funding needs. Securitisation no longer offers capital relief to banks now that regulators require full on-balance sheet consolidation, but rather, has become just one of a handful of funding options. However, on the positive side of the ledger, the funding cost of securitisation has returned to more competitive levels following the dramatic widening in spreads seen during the global credit crisis. As a result, European issuance bounced back in some

countries. (However, also eligibility of securitisation products (such as ABS) in ECB's liquidity programme is an important driver of new issuance.)

6. ***Suggested questions on funding:***

B.1: How do you assess the (current and future) economics of structured finance securitisation as a funding tool?
B.2: Or might other factors better explain the current weakness in the structured finance market?

I.3. Investor Demand Remains Weak

7. Investors were badly burnt by securitised assets during the global credit crisis, with the entire asset class continuing to be stigmatised. All segments within the securitisation market were tarred with the same brush as capital flight and illiquidity infected the wider market. Investors are demanding stricter credit terms, improved disclosure, tested single-layer structures and a reputable originator.

8. Heightened sovereign risk has also impacted upon securitisation in some countries. Demand for securitisation could also diminish through until 2013 as some European investors perceive senior bank debt to carry an implicit guarantee up until this date, in light of developments in Ireland. However, investor demand for highly-rated securitisations is slowly recovering as narrowing corporate bond spreads (and increased risk appetite) encourage them to reanalyse (and reassess) these higher-yielding assets.

9. ***Suggested questions on Investors:***

B.3: How are investors ranking the importance of stricter credit terms such as improved disclosure, tested single-layer structures, a reputable originator and proper legislation?
B.4: As a key investor, are banks in sufficient health to kick-start demand in the structured finance securitisation market?
B.5: If not, which other category of investor could pick up the shortfall in demand, including for riskier tranches?

I.4. Will Regulatory Reform Inhibit a Recovery of Structured Finance Securitisation Markets?

10. Risk retention rules are likely to lead to an increase in the administrative and capital costs of origination, and increase the due diligence burden on both issuers and investors.

11. Basel III banking reforms propose that the list of securities that are eligible to meet the Liquidity Coverage Ratio (LCR) exclude Asset Backed Securities (ABS). In contrast, covered bonds will attract a more favourable 20% risk-weighting.

12. Credit Rating Agency reforms propose that regulators remove all references to credit ratings from their rules. International reforms have also targeted an improvement in the transparency, disclosure, internal governance and registration requirements of CRAs.

13. Some central banks (such as the ECB) have tightened their collateral eligibility criteria for the Asset Backed Securities they accept in repo operations.

14. ***Suggested questions on new regulations impacting on structured finance securitisation:***

B.6: To what extent will (suggested or adopted) regulatory changes (including risk retention rules, Basel III, Solvency II, CRA reform and collateral eligibility criteria of central banks) hamper the recovery in structured finance securitisation?
B.7: Is more international co-ordination of regulation (impacting on structured finance securitisation) required and in which specific areas?
B.8: Will higher securitisation costs (and reduced demand) lead to significantly reduced bank lending?

I.5. Impact of US housing finance reform on future securitisation in the US

15. A February 2011 report on US housing finance reform[6] proposed a number of strategies that would allow for the eventual exit of the Government Sponsored Entities (GSE's) from the housing market.

16. ***Suggested questions on new regulations impacting on US Agency pass-through securities:***

B.9: How do participants assess the impact of a reduction in US government support for future private-label securitisation (RMBS)?
B.10: What form or structure might a private-label RMBS market take in the US (including covered bonds; see next section)?

II. Issues for Discussion of Covered Bonds

II.1. Introduction to covered bonds

17. Covered bonds can be seen as a type of securitisation[7]. This prompts the key question whether covered bond markets are capable of filling the void left by structured finance securitisation, by providing a direct source of competition for funding in both Europe and the United States. As noted, both structured finance securitisation and covered bonds are linked to asset backed funding. Analytically, there are issues which are shared and those which are different such as the use of SPVs (they remain on-balance) and tranching. Certainly they are receiving some different regulatory treatment - and there are those who argue that the distinction is perhaps too great because of the preferential regulatory treatment of covered

bonds. There have traditionally been separate investor bases, although there may be more convergence in the future.

II.2. Is the covered bonds market *the* way for addressing the shortcomings of SF securitisation?

18. Covered bonds are viewed as a relatively secure asset class by investors, and a cheaper longer-term funding option for banks compared to regular bank bonds. Compared to structured finance securitisation, a covered bond offers seniority and a simpler structure, in a market that is highly regulated. And unlike a mortgage-backed security, a covered bond does not transfer ownership (or credit risk) of the underlying mortgages/loans to the investor. Instead, investors benefit from dual recourse to both the issuer, and the underlying assets which are “ring-fenced” on the issuer’s balance sheet. Covered bond holders have seniority over all other creditors, including deposit-holders and senior unsecured bondholders. They address the long intermediation chain problem (associated with structured finance securitisation) by realigning incentives, with issuers retaining 100% skin in the game. They also correct for the adverse selection problem that has proved a shortcoming for structured finance securitisation. However, not all structured bonds are created equal. The quality of the underlying assets (at origination) might differ sharply (also within the same jurisdiction). Moreover, (the quality of) the underlying assets might change significantly.

19. ***Suggested questions on the advantages of covered bonds:***

B.11: In view of the size and composition of the investor base, are covered bonds capable of replacing bank bonds?
B.12: How effective do you rate (and rank) the alleged advantages of covered bonds in addressing structural problems with structured finance securitisation?

20. ***Suggested questions related to the European and US covered bond market:***

B.13: How likely is it that covered bonds will provide a significant and cheap source of funding outside Europe?
B.14: Which European ‘covered bond market model’ is the one most likely to be adopted outside Europe?
B.15: What are the near-term prospects of a sizeable covered bond market in the United States?

II.3. What are the general drawbacks of covered bonds?

21. Covered bonds have drawbacks for lower-ranking stakeholders. Because covered bond investors have first rights to “ring-fenced” mortgage collateral (the cover pool) in the event of bankruptcy, deposit holders and senior unsecured bank debt holders effectively become subordinated. While a number of countries have embraced covered bond issuance in recent years, the subordination of deposit holders has led to regulatory limits being imposed on covered bonds in some countries[8]. In addition, legislative frameworks can differ vastly across

jurisdictions, provided a further challenge to investors. Some countries have specific covered bond laws whereas others favour general legislation. In either case, the role of credit rating agencies and supervisory bodies are likely to remain critical for investors. Another limitation for the wider market is that covered bond issuance may not be a one-to-one feasible alternative to structured finance securitisation for "non-deposit-taking" primary lenders because they do not have the same capital base to retain loans as banks.

22. ***Suggested questions related to the drawback of covered bonds:***

B.16: Are the two asset classes (structured finance securitisation and covered bonds) chasing the same money, or are they indeed complementary?
B.17: Do covered bonds crowd-out unsecured debt and deposit holders? Or do they actually improve the creditworthiness of the issuer?
B.18: What is the main focus of Credit Ratings Agencies when assessing different applications and legislations across countries?

II.4. Are covered bonds a threat to SF Securitisation? And might they also crowd-out sovereign issuance?

23. 2010 was a record year for global covered bond issuance, with volumes up 20% to an estimated USD 356 billion (Dealogic). Investor interest in private-label SF securitisation remains fairly limited, with the possibility that new regulations (in particular Basel III and Solvency II) may not be conductive for a major shift of demand towards securitisation. Investor demand for covered bonds has also benefited from heightened risk aversion relating to the European sovereign debt crisis, and the need for investors to replace maturing government-guaranteed bonds with alternative triple-A rated assets. Redemptions of government-guaranteed bonds are projected to peak at around EUR 250 billion in 2012. Additionally, some investors are worried about bank resolution schemes in Europe, and are choosing to migrate away from senior unsecured bank debt and towards covered bonds.

24. As the covered bond market matures and the investor base expands, might covered bonds also increase the direct competition with government bonds, including *highly-rated sovereign bond markets*? Might the dual-recourse offered by covered bonds be perceived to outweigh the benefits associated with a sovereign's ability to tax, especially in light of the current European sovereign debt crisis? Investors could look to diversify their portfolios in favour of covered bonds due to the heavy sovereign debt redemption profile due in 2012, coupled with large and persistent budget deficits of some developed countries. Finally, creation of a covered bond market in the United States might also provide a significant boost to the expansion and liquidity of this relatively low risk asset class.

25. ***Suggested questions related to crowding out by covered bonds:***

B.19: To what extent are covered bonds likely to replace RMBS?

B.20: Are covered bonds a good substitute for government guaranteed-bank debt?
B.21: How serious is the competition between covered bonds and government debt?

Notes

[1] Structured finance securitisation refers in this document mostly to private-label securitisation products. Strictly speaking, covered bonds are also a form of structured finance but we will treat them as a separate category because they do not involve SPVs (they remain on-balance) or tranching. A third category of securitisation is linked to the (pass-through) securities of government-sponsored enterprises (e.g. Fannie Mae and Freddie Mac in the US). [IMF, (2009), Global Financial Stability Report.]
[2] Hans J. Blommestein (2008a), Grappling with Uncertainty, *The Financial Regulator*, Volume 12, No. 4, March.
[3] Structured finance securitisation involves SPVs (off-balance sheet operations) and tranches.
[4] Even in the US not all securitisation can be classified as 'unsound'. For example, securitisation of several prime assets (such as automobile loans) can be considered as a 'proper' securitisation activity.
[5] Hans J. Blommestein (2008b), Difficulties in the pricing of risks in a fast-moving financial landscape (A Methodological Perspective), *Journal of Financial Transformation*, Vol 22 - March 2008.
[6]The Department of The Treasury and U.S. Department of Housing and Urban Development report on "Reforming America's Housing Finance Market: A Report to Congress: February 2011".
[7] Strictly speaking, covered bonds are also a form of structured finance but do not involve SPVs (they remain on-balance) or tranching.
[8] In Australia and New Zealand, limits of 8% and 10% of total bank assets have been proposed.