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SECURITIZATION'S SURVIVAL A BALANCING ACT

With the boxes stacked up against the securitization market's survival, industry players have to play a careful balancing act: How to make the case for the future but still survive in the current hostile environment?

Despite a near two-year pause of virtually no public RMBS transactions – the biggest piece of the pie – as well as mounting accounting and regulatory pressures up ahead that threaten the market's viability, there are still those who say a case can be made for securitization.

by Nora Colomer

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The problem is convincing issuers and investors alike that securitization could still add value.

Brendan Keane, senior vice president at **First American CoreLogic**, calls the lack of investing and transaction momentum, "frightening." Still, Keane believes the market's need to make mortgages from nonconforming loans to agency loans requires that there be a source to fund growth.

Securitization, he said, is the most effective way forward that allows for that growth and, at the same time, provides an efficient way for banks to shift risk.

"Look back to the 1980s when there was a substantial amount of collateral originated with good underwriting standards — the process was fairly easy and the collateral was understood by investors — I believe the primary and secondary markets are similarly situated in today's world," he said.

Keane pointed out that, despite a seemingly hard-line policy stance on the use of securitization, it's fair to say that regulators understand the need for the instrument as they themselves have been apt to employ it as a means to control the rate environment through the **Federal Reserve**'s RMBS purchase program.

The **Federal Deposit Insurance Corp.** (FDIC) is also reportedly developing plans to package $36 billion in a deal that could help jump-start the market.

"The FDIC's move to package and sell loans through securitization is a positive step for the securitization markets and our economy," said **Securities Industry and Financial Markets Association** president and CEO **Tim Ryan**. "These deals will provide a model for future private market issuances, could help kick-start nonconforming loan securitizations and secondary markets, tighten pricing for securities and strengthen the interests of real money investors."

The Battle Plays Out on Several Fronts

The securitization market is fighting for its life on four fronts. On the one hand, there are the accounting developments with FAS 166 and 167. The market must also deal with the proposed risk retention or, "skin in the game," provisions made by the House and Senate committee as well as the proposed true-sale provisions proposed by FDIC.

For issuers it's meant coming to terms with the fact that one of the past significant roles of securitization, getting debt off balance sheet — could be a hard feat to accomplish given the changing accounting environment.

The accounting rules that have been formulated require that securitization structures identify a consolidator, which means that every securitization deal should be on some ones balance sheet.

FAS 166 considers whether securitizations and other transfers of financial assets are treated as sales or financings. It also covers the accounting for servicing. FAS 167 addresses whether certain legal entities often used in securitization and other structured finance transactions should be included in the consolidated financial statements of any particular interested party. Together, these two standards determine the extent to which a securitization transaction is on or off the financial statements of originators, servicers, and investors.

Ann Kenyon, a partner at **Deloitte & Touche**, said that there are some situations — such as when multiple unrelated parties share power such that no one party has the power to direct the activities of the special purpose entity — whereby the application of the new rules would result in no one entity consolidating but that the presumption is that the deal must be accounted for somewhere, on someone's balance sheet.

"If you look at the elements that made securitization attractive in its overall context it allowed most issuers to release regulatory capital and to derecognize the assets," she said. "A rule that takes away the ability to record the deals off balance sheet removes one of the incentives for securitization."

Unfortunately, it's not solely the accounting rules with which the market must contend. Kenyon said that the next level that the market must contend with is banking agencies' regulatory capital rules that "will not undo what the new accounting rules have done," and the FDIC's proposed conditions to achieve a safe harbor legal isolation.

Regulators finalized risk-based capital treatment for newly consolidated assets in Jan. 21, and the new rules will require banks to hold more capital for securitization/structured finance activities.

"This combination of issues is quite discouraging from a securitization perspective," said **Jerry Marlatt**, senior of counsel at **Morrison & Foerster** (MoFo). "The accounting issue has essentially put assets and liabilities back on the balance sheet, which means that there is no more securitization for capital relief purposes and there is no relief from leverage ratios. What FDIC purposes for true-sale treatment of structures means is that issuers will face a much more difficult time to get sale treatment, and it's hard to achieve securitization if you can't get that. The whole idea is to separate the assets from the originator."

Thinking Outside of the Box

The market won't be substantial unless the larger sectors like mortgages come back into play.

"The problem is that, while there is some interest present in reviewing the market, it is understood that the Fed wants a hand in everything and the last

thing they want as a response to this crisis is innovation," a market source said.

Marlatt said that the combo of issues that face the market will undoubtedly diminish the number of securitizations done by banks. "The top banks in the U.S. are sitting on a tremendous amount of cash so they are not having troublef funding themselves at the moment," he said. "Banks can always issue bonds."

These issues that the securitization market must contend with will likely constrain growth, although historically the market has proved its resiliency and adaptability to change.

Kenyon said that at Deloitte they have seen proposed transactions whereby the conduits might rely on structures that the market has not seen since the early days of securitization. These structures are consistent with the FAS 166 concept that an entire pool of receivables may be sold in its entirety.

"Some conduit sponsors may begin purchasing the entire asset pool, and the purchase price paid to the seller would be settled in a combination of cash and a deferred purchase price note issued by the conduit," she explained.

Ken Kohler, a partner at MoFo, said that people are good at finding solutions to market obstacles. He believes that, in the interim, originators will rely on more club-like, or multi-seller, deals, where risk is divided among several issuers. He also anticipates seeing more servicing-released whole loan sales where banks sell portfolios of whole loans to each other.

Some banks are already considering securitizing pools of whole loans and, if achieving sale accounting, receiving part of the beneficial interests as proceeds. Depending on the risk-weighting of the pool (first-lien one-to-four-family residential mortgage loans originated using prudent underwriting standards are risk-weighted at 50%, not 100%) and depending on how many securities rated single-A or better can be created, a bank might be able to reduce the overall capital requirements on the pool and increase liquidity, explained Kenyon. However, the bank will be able to convert whole loans into securities on the balance sheet only in a transaction that meets the criteria for sale accounting.

A partner at major securitization law firm said that he has seen financial warehousing transactions where issuers have been allowed to account for the structure off balance sheet via a two tier structure that is something, he said, people are currently pursuing. "Issuers and their accountants seem to be the most receptive to this structure," he said.

Jefferies recently worked on a trust of a revolving pool of eligible mortgage loans and eligible securities. Eligible mortgages for the trust dubbed Station Place Securitization Trust 2009-1are first-lien, fixed-rate mortgages secured by residential properties originated by Provident in accordance with the criteria of **Fannie Mae**, **Freddie Mac** or **Ginnie Mae**.

The eligible mortgage loans and securities are sold into the trust by Provident pursuant to a master repurchase agreement. This revolving facility has a term of one year and the notes are expected to be paid in full at the end of this period. If the notes are not paid in full at the expiration of the facility or if any other event of default is to occur, the trustee will attempt to auction the collateral to pay off the notes.

Clayton Services performed third party due diligence on 100 mortgage loans that are similar to the mortgage loans that will be included in the revolving pool. Additionally, every 60 days following issuance, Clayton will randomly select 150 mortgage loans to perform ongoing due diligence.

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Tom Gere, senior managing director at Clayton, said that the Jefferies deal creates an alternative to banks that assists larger mortgage bankers in creating liquidity.

"Banks have to fund loans with deposits or with outside bank borrowings and this facility establishes independent liquidity to do that," Gere said. "Our role in that type of transaction is to underwrite a random bulk selection of the loans at the onset of a deal and then every 60 days for a year to ensure that investors are not left standing with unacceptable collateral due to a downward drift in underwriting representation or quality. It would appear that banks are reticent to make large lines available to larger independent mortgage bankers. This concern

or limitation may come from influences outside of the banking system, and it continues to present investment banker opportunity."

Gere said that the due diligence process has shifted to become more granular in its transparency. Transparency is a term currently used to validate that the loans within a security are in fact selected and underwritten as issued, with a lower risk of undisclosed poorer quality product. Prior to 2008, rating agencies relied heavily on rep and warranties by issuers or were validated by an internal underwriting source. In some cases, those underwriting results were considered benchmarks, and some issuers made their own decisions about what actually was included in the pools. "Going forward, loans included in rated mortgage pools will be required to hold an extra level of validation, a process that is performed by the third party due diligence industry," he said.

And Gere believes that the improved services in his industry provide a link between the lapse in ratings and a desire to get more transparent understanding at the loan level. "When we start seeing traditional bulk securitizations return to the market, issuers are going to be looking to provide that sort of transparency to the marketplace on every deal, and allow the rating agencies to tip toe back into credit adjusted ratings," he said. "Today, if the credit is not perfect it probably will not get a rating, and the private placement business, including pool insurers, will be leading the charge into jumbo trading."

Sue Allon, CEO at **Allonhill**, a third party due diligence provider, believes that the efforts made on behalf of her industry have the potential to revolutionize the market. At the end of January, Allonhill unveiled its turn-key approach to the securitization market by meeting the requirements of all four major credit rating agencies for third party review firms.

Allonhill's approach is the first complete securitization solution that incorporates the latest industry requirements after the mortgage collapse. It provides a high level of transparency and reliability concerning the loans underlying securities.

The firm said that it worked with two out of the four rating agencies that promulgated their requirements, which are then plugged into the system. "We then met the highest requirement of what any of the four rating agencies require," she said.

At the moment the deals that are being reviewed using Allonhill's due diligence process include a review of 100% of the loans. This is possible, Allon said, because the deals today are much smaller and less complex in nature but once the market kicks off and deals begin to grow the system will employ a sampling technique that ensures that the characteristics of the remainder of the pool are reliably disclosed, and those characteristics will contribute to determining how the pool will perform.

The market at the moment is mostly driven by privately placed offerings, which means that little is disseminated in terms of details on these deals. However, Allon believes that the securitization market would benefit from talking more about what is happening behind the scenes as it would serve as a signal that there is still appetite for this product and could in turn encourage other players to jump in.

For example, of these privately placed deals that have come through, some have had a rating agency involved and 100% due diligence performed on the loans, which could be eligible for public market issuance. "The problem is that issuers are reluctant to adhere to a rating agency protocol for publicly placed deals because that process can be very expensive to undertake," Allon said.

She is hopeful that the industry will begin to see a handful of smaller, pristine deals come issued on the public market by the end of the first quarter. "Issuers like hedge funds are working on that but to get the rest of the issuers back they have to know that investors are willing to pay enough to make securitization funding viable," she said. "The cost to get these deals done has become much

more expensive and the kind of verification that investors are asking on the loan level brings those costs up."

Marlatt said that he believes auto loan originations will also do well in the interim, as the market tries to solve its dilemma of a changing regulatory landscape. The market is likely to see cases where issuers sell these assets outright to private equity firms that have an interest in outright raw auto loans, but this would be a very small development that would result in small volumes.

Dave Hurt, senior vice president at **First American CoreLogic**, said he expected to see more structures that flashback to the late 1970s or 1980s similar to the U.S. League agreement styles that existed before securitization came into play.

These loan participations could again become a very popular means to spread risk concentration in specific assets or pools of mortgage from one lead lender to several institutions. Similar to securitizations, lead institutions could sell up to 90% to 95 % of the assets to several peers in varying sizes of participation. Many of these participating institutions will have large amounts of excess liquidity needing these types of investment opportunities to perpetuate their participation in the secondary market while the dislocations continue in the non-agency RMBS marketplace.

Hurt said that, as a result of the crisis, traditional investors in securitization as well as hedge funds and private equity firms have developed a sophisticated understanding of loan level data, which means that these buyers are likely to feel comfortable buying these assets directly as whole loans.

But these "solutions" as a permanent fixture would be an unsatisfying outcome that would fail to distribute risk and provide access to the global capital markets to the levels that securitization did.

Finding the Missing Link

The bottom line is that people don't want to trade into uncertainty. Issuers and investors don't want to do a deal and be uncertain of what the outcome will be six months down the line. How that mentality shifts the other way largely depends on how to make the case for an industry that has from the very beginning born the stigma of being the underlying cause for America's problem.

The question now that the industry must answer for survival is where it intends to add value.

"The real value added is that it brings in all this capital because securitization put it in a form understandable across the globe — in the form of rated securities," Hurt said. "But these guys are developing a level of sophistication as well, and they understand the info that is being put out as a result of the transparency drive. Ratings once had some meaningful bite to them; now these investors may just want to look at the assets on a whole loan basis as well."

MoFo's Kohler describes the "feedback loop" the securitization industry has entered — where securitization, because of accounting rules, increased capital requirements, risk retention and increased regulation of loan terms, is less profitable for banks and other securitizers, originators will decrease origination of mortgage and consumer assets in favor of other lines of business and/or increase rates to cover costs. As originations decrease, it creates less of a need for securitization as a funding source.

This, in turn, may lead to more public outcry about banks not opening up lending to get the economy moving and could perhaps over time lead to the loosening of restrictive regulatory and accounting rules once policy makers concede this unintended consequence.

A key point to remember is the difference between securitization and on-balance-sheet lending. Securitization recycled cash, and if issuers can't get the assets off their balance sheets, they cannot do nearly as much lending.

"Americans are still buying homes; there are new originations out there," Allon said. "On the one hand you have the FHAs being done on a regular basis, and on the private side banks are beginning to gather originations. Larger institutional investors can't invest in whole loan pools. It's not on their agenda, but someone has to be willing to break the ice by bringing a securitization to market." ASR

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