Mortgage securitization: Some Lessons from the Crisis for New Markets

Workshop on Housing Finance in South Asia

Jakarta, May 27-29, 2009

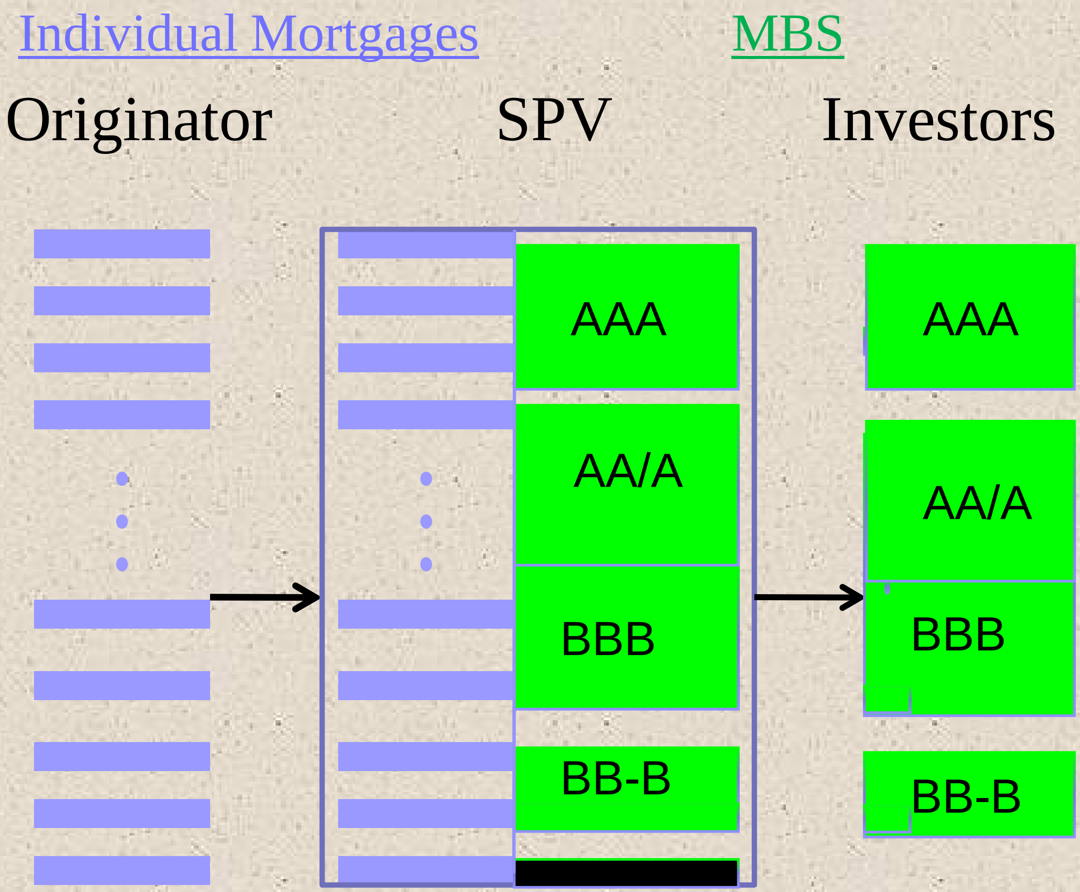
Olivier Hassler
Housing Finance Program Coordinator
ohassler@worldbank.org

The World Bank
Financial and Private Sector Development

OUTLINE

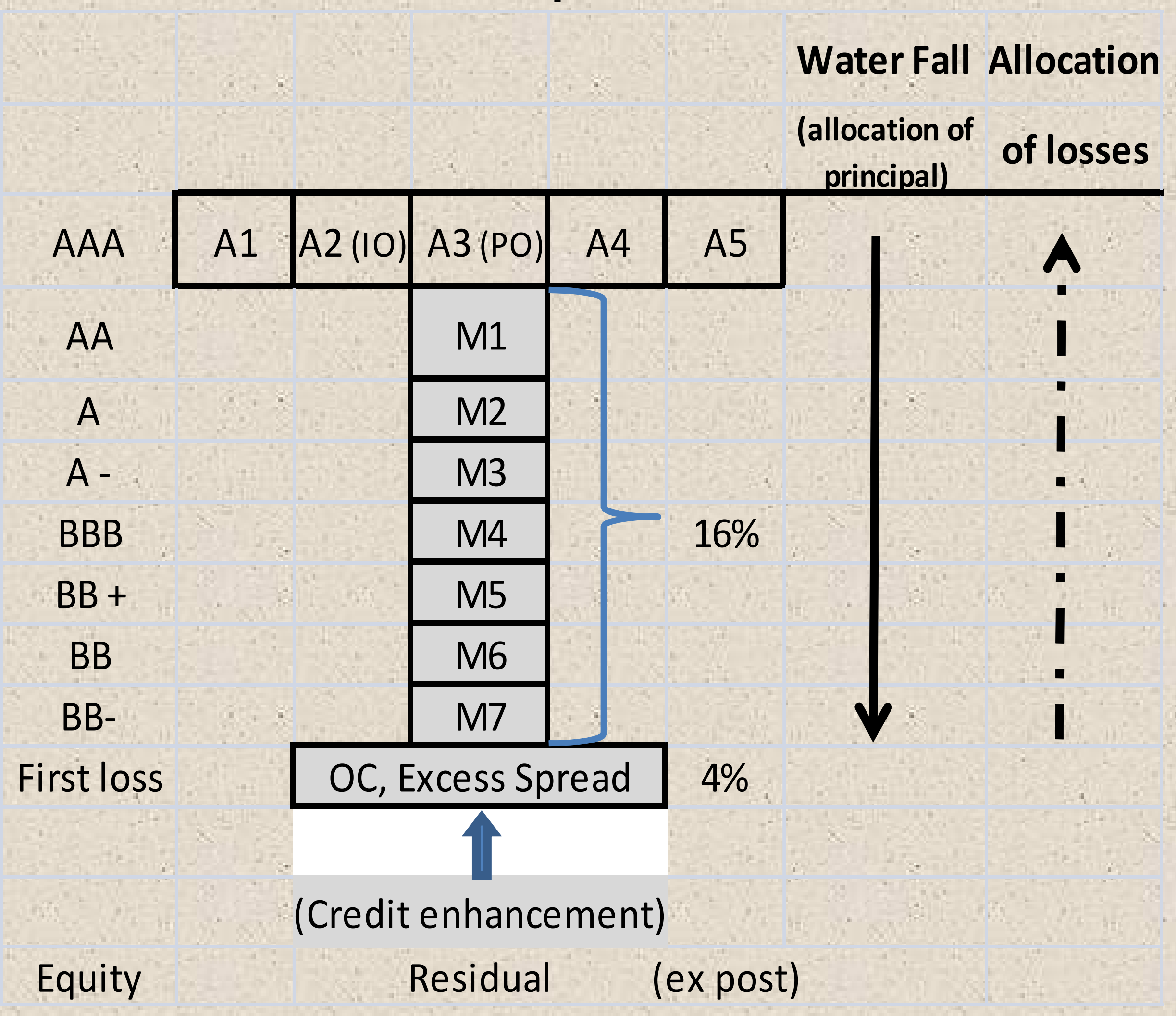
- Most develop markets are closed since Sept.2008 (private label MBS in the US)
  - MBS issues mostly target Central Banks' lending
  - Warehouse lending and servicers advances also stopped lack of funding
- The subprime crisis revealed that securitization markets could be dangerous, hence a deep loss of confidence in the instrument: a brief explanation
- Intrinsic benefits of securitization however still remain
- International initiatives to establish it on a more solid ground and restore trust are relevant for new markets
- In some emerging markets that have already shown the way, the securitization market is still open:
  - Mexico Example
  - Colombia Example

Securitization – Basic Structure



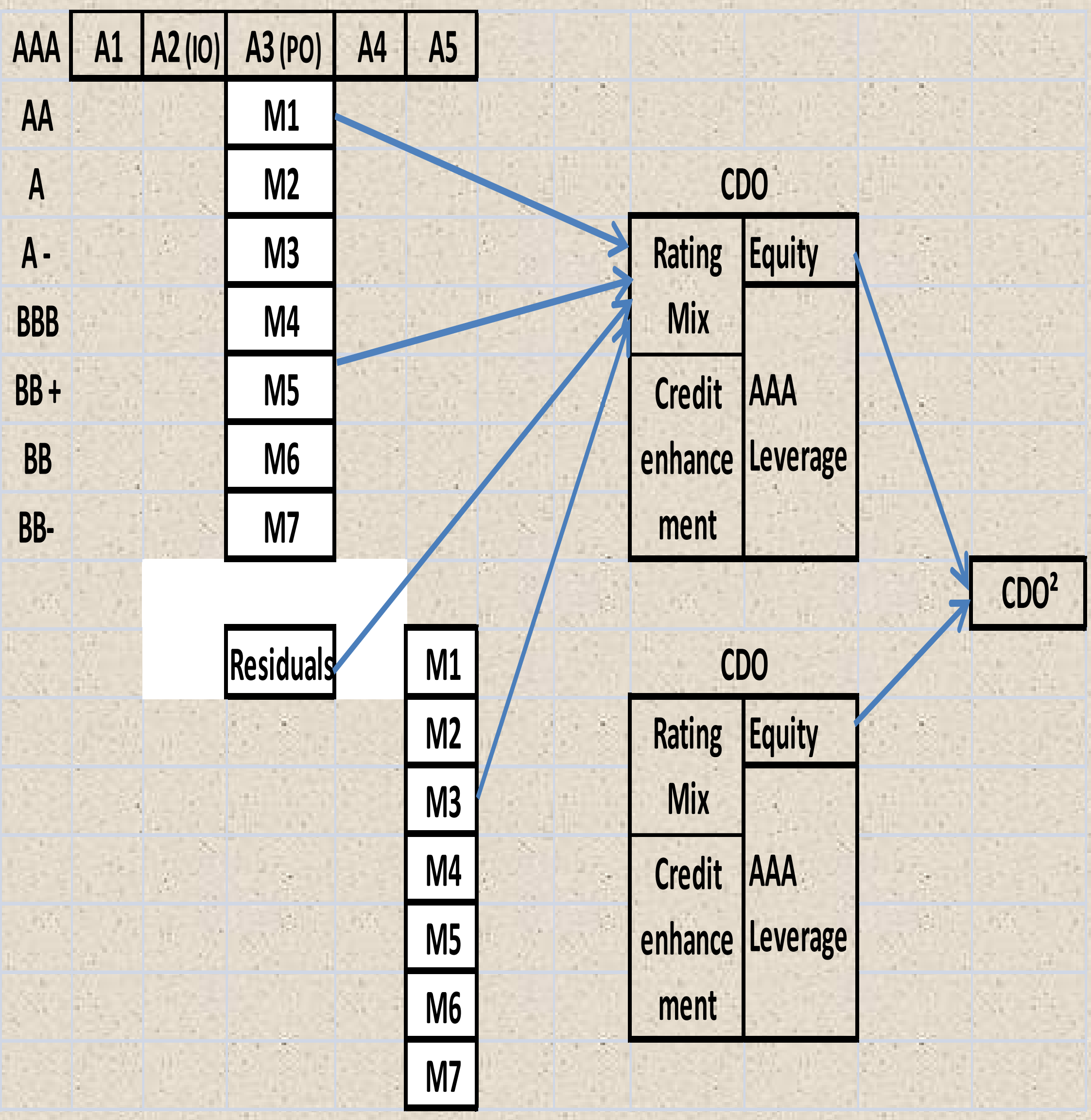
- Portfolio sold to a Special Purpose Vehicle
- Bankruptcy remoteness
- Condition: “True Sale” (independent SPV, originators relinquish control over assets)
- Investors’ direct exposure on the portfolio → various degrees of protection (credit enhancement)
- Restructuration of cash flows
- Issuance of bonds with different profiles (tranches)

Many Securitization structures did not withstand subprime losses – A typical case



- Multiple tranches/bonds (CUSIP) with different characteristics and behaviors
- Normally, credit enhancement increases over time since AAA bonds are repaid first
- Sub-prime/ Alt A 2005-2007: losses quickly exceeded credit enhancement (20% typical for subprime), overflowing on senior tranches

Re-securitization : a major contagion vehicle



- Second, or third level structures, based on leverage and rating arbitrage
- Credit enhancement created an illusion of safety :
  - Either internal and overwhelmed by actual losses
  - Either external ("bond wraps") by monoline financial guarantors. *Incurred large losses, leading to drastic downgrades and weakening of the support*
- Leverage mostly short term (credit, ABCP), based on investors' illusion- banks, money market funds- that a AAA paper would always be liquid

Many Factors of the Crisis were **context specific** (developed markets)

- Very low level of interest rates in the context of a large national savings deficit *(USA)*

- Extreme Fragmentation of the regulatory Structure *(USA)*

- Huge Transaction Volumes leading to Operational Deficiencies *(USA and other developed markets)*
  - Explosion of claims within the financial system . Growth of MBS disconnected of the real economy (*4, or +27% p.a. 2000-07)
  - Millions of mortgages , millions of bond tranches, re-securitization, illegible trustee reports
  - Inability of rating Agencies to adequately assess and monitor all the bonds
  - Lags and weaknesses of valuation models(e.g. use of CDS to price credit risk)

- Extreme Complexity of Capital Markets Products *(USA and other developed markets)*
  - Sophistication of products – e.g. multiple tranches with specific behavior
  - Leveraged structures
  - Regulatory vacuum (“shadow banking systems”)

But the crisis also emphasized issues that are **instrument specific**

- Moral hazard (origination)
- Principal/agent problems (servicing)
- Valuation of complex securities
  - Understanding of risks
    - Direct exposure on loan portfolios
    - Meaning of rating, underlying models and assumptions
    - Assessment of risk /return trade off for tranches of different profiles
  - Projection of cash flows
    - Delinquencies
    - Prepayment option
- Market liquidity

Basic premise: transformation of loans into easily tradable assets, rarely achieved

- For issuers: true sale, bankruptcy remoteness and the transfer “off balance sheet” of risks questioned

The Fundamental Benefits of Securitization are still valid

- Immunization of intermediaries against financial risks - liquidity, interest rate, prepayment -

--> Removal of a major roadblock to the extension of housing finance, especially of fixed rate home loans

Securitization took off as the remedy to the Savings &Loans crisis , largely triggered by major financial mismatches

- Re-allocation of credit risks → capital relief, and re-investing of the originator's capital in new lending

- Restructuration of cash flows:→ customization of bonds to investors' needs (various grades, various sensitivities to interest rates, inverse floaters, fixed or variable maturities, etc.)

Ongoing International Initiatives

Either aim at managing the crisis

- Provide liquidity (Eligibility to Central Banks repo windows, US Term Asset Backed Securities Loan Facility-TALF)
- Clean up legacy (impaired) portfolios

Or at strengthening the basis of securitization in the future

- Clarify Rating Agencies Role
- Restore trust –policy or industry level initiatives, in particular:
  - Financial Stability Forum
  - Basle Committee
  - European Central Bank
  - IOSCO
  - Global SIFA /American, Australian & European Securitization Forums
  - National initiatives: ASF (project RESTART), ESF

→ Recommendations to improve confidence and stability, relevant for the sustainable development of recent securitization markets

Enhance Transparency

1) Increase available data
   - loans characteristics
     - Initially
     - On going, post issuance reporting

Issues: unmanageable volumes, confidentiality if information loan/loan

   - Underwriting and origination practices

Ex. Income verification, broker intermediation, appraisal conduct, new loan or refinancing,

2) Standardize definitions

Homogeneity in defining LTVs ,debt-to income ratio (net or gross?),defaults, etc.

3) Improve accessibility and processing capacity

Information channel, standardized format directly usable by investors

Limit: Publicity of information if loan/loan ?

Ensure the reliability of information and strengthen market discipline

Independent oversight and certification

- Initial due diligence standards
  - Independent reviewers
  - information on checks actually performed (sampling guidelines, verification of sources)
  - Inclusion of lending practices
  - Due diligence attestations

- Post issuance reviews
  - Importance of "master servicers"
  - Standardize buy-back obligations

Align incentives:
Originators and servicers should keep “skin in the game”

- Interest retention by originators / servicers
  - US: Draft Mortgage Reform and Anti Predatory Lending Act

5% of credit risk (adjustable by theFed) retained by originator for non-standard loans

  - EU: Reform of the Capital adequacy directive (decided by the EU Parliament in May):
    - Banks must keep 5% stake in loans they securitized
    - Capital surcharge if investing in securities not in compliance
- Servicers performance
  - Clear servicing standards

Ex: clear rules for loss mitigation and loan restructuring, interest rate resetting,

  - Monitoring servicers performance: objectives and indicators for maintaining asset quality

Enhance Valuation and Pricing Infrastructure and Capacities

- Post trading reporting (prices, volume)
  - Important, but can it provide valid references if secondary transactions rare ?
- Accounting rules
  - Mark-to market: appropriateness in “inactive” markets?
  - Accounting alternatives?
  - Conditions for accepting mark-to-model?
  - Take into account actual marketability, and not only rating, in the investment and accounting rules
  - [Consolidation of off balance sheet vehicles are being considered under certain conditions]
- Valuation methodology
  - Need of building capacities of investors and intermediaries

Investors should be able to make their own simulations and not only rely on rating

  - Development of industry wide standardized models?

Mexico Market

- Already obligation of equity retention by servicers
- Sociedad Hipotecaria Federal

(Second tier public institution entrusted with multi-faceted funstions to support the mortgage market)

  - Provides credit enhancement on MBS complying with precise rules: nature and content of documentation, existence of trustees, investors representation agent, master servicer (verification and validation of information)
  - Standardizes information
  - Provides public calculators
  - Monitors the secondary market
  - Established a mortgage market wide data base

Colombia: Role of Titularizadora Colombiana

- Central private sector securitization agency
- Select originators and servicers
- Define lending standards and loan eligibility criteria, e.g. scoring
- Provides valuation model
- Acts as a master servicer
- Provides regularly market information

→ Ensures transparency and allows investors' confidence