REPORT ON THE INTERNATIONAL ABS CONFERENCE 2010

At the International ABS conference held in London on 15 and 16 June we started to see the emergence of a clearer picture of what securitisation is going to look like going forward. Many will recall that at the conference in 2008 the speculation was that the market would return. No one knew when it would return but everyone was sure it would definitely not look the same. Last year there was talk of the need for transparency and speculation of the sort of regulation we could expect in the future.

The conference this year was dominated by discussion of new regulations, especially those dealing transparency. We have also had some insights into the issues that have confronted trustees and investors in some of the failed structures.

Addressing the changing face of securitisation and the needs of investors, the feeling was that when the market does come back it will peak at the levels of 2003 and 2004 and not at the peaks of the halcyon days of 2008. The feeling was that origination is not dead but arbitrage is definitely over. It was felt that in the past regulation favoured banks at the expense of non-bank originators. The consequence of this is the current steep regulation on banks which will bring non bank origination back in due course.

Investors, in general, are still wary of the mortgage overhang. While it is true that most of them were buy-to-hold and would not therefore be affected by the overhang, it was pointed out that buy-to-hold did not necessarily mean hold to maturity, it meant hold until changing circumstances force a rethink. We certainly saw a change in the economic environment. The fundamentals (Greece etc.) are creating uncertainty for investors.

There was a feeling that tighter spreads would create greater confidence in the market and this would have a positive impact going forward. This would of course have to be linked to an improvement in the fundamentals and greater market certainty. Massimo Ruggieri of Deutsche Bank expressed the view that the industry must make sure that people get comfortable with ABS as an asset class. One way of achieving this is to increase the amount of information available. Investors need more than just outside ratings.

There was an appeal for longer lead times when deals come back to the market and a feeling that regulators must start standardising bank confidentiality laws to allow for better transparency.

I attended a number of talks and distilled these down to three topics. These deal with regulation, investors and the challenges facing trustees.

**Future Regulation of Securitisation:**

In the panel discussion on future regulation, Maria Fernandez of the European Commission said that the EC is looking at revising securitisation regulations. There is no doubt that securitisation can contribute to the economy but there are risks. The industry needs transparency and liquidity. The European Commission wants to achieve an alignment of the interests of all parties. It is introducing rules to ensure that originators retain sufficient skin in the game. It is also introducing rules to ensure that investors do not invest blindly. Rules governing SPV’s will be introduced in the next two years. New rules relating to rating agencies now require that information provided to contracted rating agencies must also be freely available to third party rating agencies.

Fernandez highlighted three areas which are under scrutiny:

Transparency – investors must have sufficient information to make a well informed decision.

Standardisation – products are complex and perhaps they need to be simpler and more standard. This applies to the products themselves, not just to standardisation of definitions.

Distribution – there is too heavy a weighting on the banks as investors. There is a need to bring in other investors. Simplification of these products will help to expand the investor market.

Fernandez pointed out that all of this will have to be done at a global level involving other international regulators.

The EC at this stage does not envisage any change to regulatory requirements for capital.

It appeared from the panel discussion that extra capital for resecuritisation will be introduced. Additional capital will be required on the bank’s trading book to avoid arbitrage. There is a renewed focus on leverage ratios. Most commentators are concerned that risk base will be tied to accounting practices rather than to actual risk.

New retention Requirements for Originators and Investors:

Draft regulation in Europe (Regulation 122a) requires that a credit institution may not have a position on its books unless the originator has retained at least 5% of the notional net economic interest. This regulation applies to all new issuances throughout Europe from December 2010. Existing transactions have an exemption until December 2014 after which they will also have to be fully compliant.

Regulators in the US and the EU have both settled on 5% retention of risk by originators for new transactions from next year. As part of a drive to get investors to perform thorough due diligence before investing in securitised notes, regulators will now require investors to satisfy themselves that the originators have in fact retained the requisite risk for the full life of the transaction. The message which is emerging is that all parties to the transaction have a duty to care and a duty to perform due diligence.

A valid question is who takes accountability for the accuracy of the information on which investors will be forced to rely. Consideration will have to be given to the accounting implications for these regulations. How will this apply to derecognition?

There is still a lot of confusion about what risk must be retained. Is it a vertical slice of the book or a horizontal layer of risk? Can risk be retained by keeping a percentage of the overall book which is not securitised? The EC has undertaken to publish guidelines before the regulations become law in December 2010.

The retention of risk is not new in South Africa and in Europe where originators have traditionally retained more than 5% of the risk. It is of particular relevance to the USA where traditionally none of the risk has been retained.

The EC has commented that they are aware that the retention rules will add costs but “. . we must look at the trade off between issuers and society in general.”

Moodys suggested that the new regulations will not change the way rating agencies look at deals.

Regulation on Transparency:

All regulators agree that they would like to see a major emphasis on greater transparency and due diligence.

Regulation is likely to be introduced by the EC in April 2011 requiring issuers to make data available to rating agents and investors at deal level. The final format of that information has still to be finalised but it is likely that regulation will require that data be made available which will allow investors to see the portfolio characteristics down to deal level, leaving out only the name and actual street address of the borrower. It seems that this may apply only to RMS transactions to begin with. It is also likely that this level of information will have to be made available irrespective of whether the notes are placed privately or publicly.

Issuers are likely to be required to make this information available in a manner that will allow it to be accessed by any investor. In the US a lot of issuers already follow this practice. The fear there is that issuers will “dump” data in the public domain in a way that complies with regulation but still creates a lot of confusion. In many cases this could be a lowering of existing excellent reporting practices.

There is a feeling that not all investors will be in a position to analyse the data and this may require some investors to outsource the data processing and analysis.

The view was expressed that there will be a painful period as computers and systems have to be adjusted but it will work its way through. There is of course no guarantee that these requirements will prevent the sort of systemic problems we have recently been through repeating themselves in the future.

Central Banks have had to look at securitisation transaction documents to understand the risks involved. They are considering standardised offering documents so people can get used to the format and can focus on the differences.

In the US there are four entities that are looking at possible new regulations. These are: the US Senate, the US Congress, the SEC and US Regulators. It was suggested that:

* There is no academic consensus that risk retention improves alignment between originator and investor.
* The way risk retention is being implemented puts pressure on banks because they will not be allowed to hedge their retention.
* A far more effective way of alignment is to improve transparency and information.

**Investor Needs and Improved Investor Reporting:**

The discussions focussed on the need for more information down to deal level. Some investors want to be able to look at geographic data to monitor equity levels in various areas. In the US they are also looking at the credit behaviour of borrowers to look for early warnings.

A view was expressed that some clients don’t trust the data. In the US they have looked at debtor level data for 12 years and this has not helped prevent the problems encountered there. It is about understanding the underlying credit issues, not just about the data. It is about understanding the quality of credit that has been granted. Loan level data on its own does not influence the market as we saw in the US.

In the USA, regulators are pushing for open source codes available to all investors. The ECB however suggests that it is sufficient that all information be made available. Investors can then do their own modelling or outsource the function to specialists. The ECB believes this is better than forced regulation on open source language.

One of the speakers said that he can’t understand the push for open source in the US as there is no lack of cash flow models in the US. In the US they have a variety of requirements imposed on issuers who regard this as a cost of doing business and place their data on a central site which complies with regulation but is very complicated and opaque.

In the USA investors demanded a lot more information than has been the case in Europe. Some issuers complied immediately and those that didn’t were then obliged to follow.

There seemed to be consensus that getting information out in the public domain is more important than standardising it. Investors can crunch the information if it is consistent and accurate.

The Bank of England, in its capacity as holder of security, has set out its requirements for collateralised assets lodged with the bank.

What BoE would like to see is:

* Enough information on a regular basis
* Standardised reporting based on standardised definitions
* All transaction docs must be in the public domain
* Cash flow analysis
* Documents setting out the key features – voting, waterfall etc.

BoE has made it clear that there will be no grandfathering. These requirements will apply to existing bonds. The bank advises that feedback has been positive and investors are very happy with these requirements. Originators do have a few reservations .The bank’s response is that the information being requested is no big deal. Originators should have all of the relevant information available anyway. Their aim is to try to co-ordinate all of this information with other agencies.

On the matter of standardised definition, the bank holds the view that the more information there is the less important standardised definitions become since investors can then draw their own conclusions.

BoE places a large emphasis on cash flow forecasts. The bank believes that modelling liabilities is easy; it wants cash flow modelling on the failure of counter parties and other similar events.

The central theme to this discussion is that we presently have information asymmetry. All parties must get the same information. Investors should get the same information as rating agents. Some have a fear that we could be killing the market with requests for so much information. There is however agreement that there must be some co-ordination by all of the parties, including Europe, the USA and the SEC. Rating agents must be part of this. Efforts must be synchronised so there is not too much extra cost. There will be a cost to originators but if this leads to a more liquid market, spreads will tighten and the additional costs will quickly be absorbed

It was suggested that some investors may not have the capacity to process this information but that some trustee organisations, not necessarily the trustees themselves, have the capacity to work this information for issuers. This could make it easier to centralise data bases.

One of the speakers felt that if too much emphasis is placed on consistency, we could see some of our over achieving issuers pulling back to the lowest common denominator to avoid being accused of not being consistent. This is especially true for requests for additional information.

Some European banks have serious concerns about customer privacy when the new data requirements are discussed. The central banks don’t see a problem with privacy? Many originators have no problem with privacy laws while others do. The regulators don’t require names and addresses; they just want areas and account behaviour details etc. Many feel that there may just be a knee jerk reaction against providing the information.

There is a lot of debate about whether the regulators are asking for too much information. Generally it was felt that there is no such thing as too much information. It comes down to what one does with it and how it is used and analysed. Some felt that investors are spending more time getting the information than analysing it.

One delegate suggested from the floor that in 2006 investors were given 48 hours to check the necessary documents. He queried how we are going to deal with this when the market comes back. From the response he got it seems that regulators may insist on a waiting period. Certainly BoE indicated that it will not be put under pressure. They will take as long as it takes.

**Trustee’s Role**

There were two panel discussions on the roles of trustees in distressed situations. As a professional trustee, it was interesting to follow these debates. One session opened with the question: Has the market matured to the extent that trustees must actively monitor for the life of the transaction? There are many market participants, especially investors who would argue that their interests would be best served by having a security trustee who is engaged in actively monitoring transactions.

While the role of the trustee is passive, it must switch to active if information comes to the attention of the trustee. He can’t simply sit on his hands until he has received written notice of default.

The panellists agreed that when the trustee’s role goes active he must:

Appoint a law firm.

Appoint a financial advisor

Speak to rating agents

Review proposals.

Facilitate noteholder meetings.

Consider the appointment of a receiver.

What a Trustee Must or Can Do Pre Default:

The powers of a trustee are contained in the trust instrument. Generally a trustee is not required to take any action until instructed to do so. But a trustee has a fiduciary duty and is on reputational risk to be proactive.

The panellists were in agreement that trustees need to carefully look at the interests of noteholders and the commerciality of issues when asked to exercise their discretion. A trustee must of course be prepared to exercise his discretion; he can’t simply sit on his hands.

There is a perception that the trustee is only required to be active after default. This is not the case, trustees need to be vigilant. Around the world, when it comes to remuneration, the sponsoring bank doing the work behind the scenes sometimes cannot understand what trustees are being paid for.

One panel discussed ways of working closer with investors in stressed transactions. Some of the suggestions were:

* Lines of communication need to be opened very early.
* Start a process to get noteholders together to talk to one another so as to give the trustee better direction.
* Apathy – Investors seem to be apathetic to respond. It is extremely difficult for trustees to know what to do if investors don’t respond.

When a deal is stressed, don’t wait for an event of default to occur; suggest that a bond committee be set up immediately. This makes life easier for the trustee to act. It certainly allows the trustee to act quicker.

One of the big challenges facing trustees in distressed transactions around the world is that the security held is through the clearing system. Trustees do not know who the holders are. This results in a huge delay in getting a response.

Trustee Discretion:

The matter of trustee discretion is as topical in Europe as it is in South Africa as can be seen from the following statements: The importance of discretion can’t be over emphasised. At present, discretion levels are just right. In the case of poorly drafted documents, err on the side of caution. Get counsel’s opinion if necessary. Look at the intention as well as the wording itself.

In workouts and distressed situations, the current role of trustees is analogous to that of a referee. They take flack when things go wrong. There is frequently a mismatch of expectations. Why then do we have trustees? Because they are independent, experienced and have stronger bargaining power. The trustee prevents a structure from collapsing into chaos if one investor brings an action against the issuer.

Is there a need for a Super trustee?

The question is whether trustees could undertake a more active role and take some risk. There is certainly a case to be made for this if investors have the appetite for it. If trustees go this route it will be expensive but it will put the trustee in a favourable position if things go wrong. Trustees would be taking on more work and more risk and would naturally want more rewards. Presently trustees also provide back-up servicer facilities.

Noteholder Communication:

There is increased talk about changing the mechanics of trustee communication. The European Securitisation Forum is pushing for an overhaul of the current system. Proposals were garnered from a variety of interested parties. Some of the proposals were aimed at speeding up noteholder voting. There was however not enough investor buy-in to get this project off the ground. Talks are still underway with custodians and clearing agents. The problem is that custodians and clearing systems redraft notices and place their own interpretation on events. Work is currently underway to develop a matrix which can be signed off by interested parties. The best way forward is to have a golden source of information but no one is prepared to put up the money for this. Investors need to drive service providers to come to the party. There is increased use of ad hoc investor committees in distressed deals. These channels are opening up and becoming effective.

Indemnity for Costs

In post default situations, a trustee has to act on the instructions and in the best interests of investors. To do this, it is usually necessary to incur costs, especially legal costs associated with obtaining opinion and launching applications. Before embarking on an expensive investigation, the trustee must get an indemnity for costs from the investors.

In Europe, investors give indemnities which are quite narrow. The problem arises when information gleamed from investigations make it necessary to take further action. The trustee then finds himself in a difficult position. He is not required to act without a cost indemnity but the investors expect him to act from his own volition. Trustees will also have to look at the credit worthiness of the party giving an indemnity.

Where the matter is endemic, a trustee will be reluctant to pay out significant upfront costs which could be financially draining. There is an increasing move to prefunding.

A comment was made that the crisis has been with us for three years and the documents have not changed.

Summary

This conference was perhaps more interactive than those in the past. We now have real issues to deal with and a number of experiences which can be shared. What became clear over the past few years is that things are going to be different going forward. The response from regulators is far more pragmatic than was feared in the last year or two. It is however important that investors and arrangers meet regularly to shape the way forward in conjunction with regulators. If we all passively await the intervention of regulators we may end up with a product that is simply not viable.

John Doidge