

Credit Commentary – February '08

Reinventing Securitization:

If It Ain't Broke, Don't Fix It. But What if It is Broken?

By Andrew Davidson

Securitization has been an important driver of economic growth and efficiency. Securitization has increased the amount of money available for home ownership and has facilitated the growth of a myriad of economic sectors. However, in the past year, securitization itself has been the cause of a major disruption in the global economy.

Securitization is the process by which loan investment is separated from loan origination. Through this separation, securitization provides the economy with certain benefits. One clear benefit of securitization is increasing the availability of capital beyond the capacity of the loan originators. Securitization also offers the benefit of spreading risk and allowing more market participants the ability to impact the pricing of assets.

However, the separation of origination and investment can become counterproductive if the link becomes too attenuated, and excessive risk seeps into the markets. It may never be possible to ascertain whether sub-prime securitization was the cause of the housing bubble or a symptom of the bubble; however, it is clear that sub-prime securitization will have the impact of exacerbating the fallout from the realignment of housing prices with median incomes levels.

Investors have lost confidence in the securitization process for mortgages. Even in the prime mortgage market, there has been a significant reduction in securitization volumes. Perhaps these volumes will return over time with no changes in the securitization process. However, it may take fundamental changes in securitization to restore investor confidence. To assess what potential changes might be valuable, it is useful to assess the shortcomings of the current state of securitization.

The standard for assessing securitization must be that it benefits borrowers and investors. The other participants in securitization should be compensated for adding value for borrowers and investors. If securitization does not primarily benefit borrowers and investors rather than intermediaries and service providers, then it will ultimately fail.

At the loan origination stage of the securitization process, there was a continuous lowering of credit standards, misrepresentations, and outright fraud. Too many mortgage loans, which only benefited the loan brokers, were securitized. This flawed origination process was ignored by the security underwriters, regulators, and ultimate investors.

In the middle of the process, we saw the creation of complex structures that shifted value from higher rated bonds to lower rated bonds. Step downs, triggers, and credit enhancement targets may be good tools to make securitization structures more efficient, but when they allow credit enhancement to leak out of a structure in a manner that is not transparent to investors, they become counterproductive. Further, the re-securitization of mortgage bonds into collateralized debt obligations (CDOs) can create instruments with risks that cannot be assessed using current analytical capabilities.

In the final stage of the securitization process, investors were too reliant on rating agencies assessments. This created a herd mentality that served to reduce the intensity of critical assessment of investment risks. Bonds often traded at spreads that seemed to be driven solely by rating. Such trading would imply that the rating agencies always got their assessment right and that market participants had no additional insights into the pricing of assets.

Restoring the value of securitization to borrowers and investors will take significant changes in the securitization business.

First, originators should be held responsible for the quality of the origination process. Investors in mortgage-backed securities rely on the originators of loans to create loans that meet underwriting guidelines and are free of fraud. Borrowers rely on originators to provide them with truthful disclosures and fair prices. Currently, investor requirements are supported by representations and warranties that provide for the originator to repurchase loans if these requirements are not met. However, when there is a chain of sales from one purchaser to another before a loan ends up in a securitization, investors may find it hard to enforce these obligations. Similarly, borrowers who have been victimized by an originator may have nowhere to go to seek redress if the company that originated their loan goes out of business. Some in Congress are proposing “assignee liability” as a solution to this problem. Assignee liability, however, may create risks for investors and intermediaries that they are unable to assess.

As an alternative to assignee liability, an updated form of representations and warranties – an origination certificate – would be a better solution. An origination certificate would be a guaranty or surety bond issued by the originating lender and broker. The certificate would verify that the loan was originated in accordance with law, that the underwriting data was accurate, and that the loan met all required underwriting requirements. This certificate would be backed by a guarantee from the originating firm or other financially responsible company.

The origination certificate would travel with the loan, over the life of the loan. By clearly tying the loan to its originators, the market would gain a better pathway to measure the performance of originators and a better means of enforcing violations. Borrowers would also have a clear understanding of whom to approach for redress of misrepresentations and fraud.

While risk arising from economic uncertainty can be managed and hedged over the life of the loan, the risks associated with poor underwriting and fraud can only be addressed at the

initiation of the loan. Such risks should not be transferred to subsequent investors, but should be borne by those who are responsible for the origination process.

Second, the current senior/subordinated structure should be revised, simplified or, perhaps, even abandoned. The beauty of the senior/subordinated structure is that the credit quality of the senior classes is based on the quality of the underlying assets, not on the guaranty of any third party. In principle, the diversity of loans in a pool should create a better quality guaranty than even a highly rated corporate guarantor.

The structure works by locking the subordinate investments in place until the senior classes are assured of full payment. To increase the value of the subordinate investments, structures have been devised that allow payments to subordinate investors when that subordination is no longer needed. Herein lies the problem. Issuers, investment bankers, and investors in subordinate classes are always seeking to reduce the amount of credit enhancement and increase the early cash flow to subordinate classes. This has led to complex overcollateralization targets, multiple triggers, and early step-down dates. These structures are designed to meet specific rating agency scenarios and may not provide the desired protection in real world scenarios. In addition, the ratings process has led to the creation of very “thin” classes of subordinate bonds. Some bonds may make up only a small percentage of the total collateral, so when losses rise they can face a complete loss of principal over a very small range of performance change. This makes these bonds extremely difficult to analyze as they may be worth near par or near zero.

The securitization market would function more smoothly if these classes were less complex and were not so finely divided. The “gaming” of rating agency models by underwriters needs to be eliminated. Perhaps it is time to consider whether newer financial tools, such as credit default swaps, could be used to design a more transparent and financially efficient structure.

Third, increase investor capacity to perform independent investment analysis. While there may not be a way to force investors not to rely ratings in making investment decisions, it may be possible to increase the amount of information available to investors to improve the quality of their decision-making. Over the past few years, too many bonds were sold with insufficient information for investors to form independent views on performance. Ratings should not be a safe harbor against independent analysis. Without detailed loan level information, clear underwriting criteria, and assurances against fraud, it is nearly impossible to form an independent view of a security. The investor’s motto should be: If you can’t assess, then don’t invest.

Finally, the cost of securitization must be reduced. The securitization process is overly complex; it involves too many parties and lacks sufficient standardization. Investors face a myriad of issuers, definitions, and structures. Each transaction must be analyzed individually, not just from the collateral point of view, but from the point of view of structure and service providers. All of this complexity increases legal costs, operating costs, and marketing costs.

No matter what changes are implemented, there will still be volatility, losses, and probably even asset bubbles. However, if the securitization process is restructured with the idea that it should

benefit borrowers and investors first, then, rather than being a destabilizing force, securitization can once again add value to the economy.



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