Reform of Securitization

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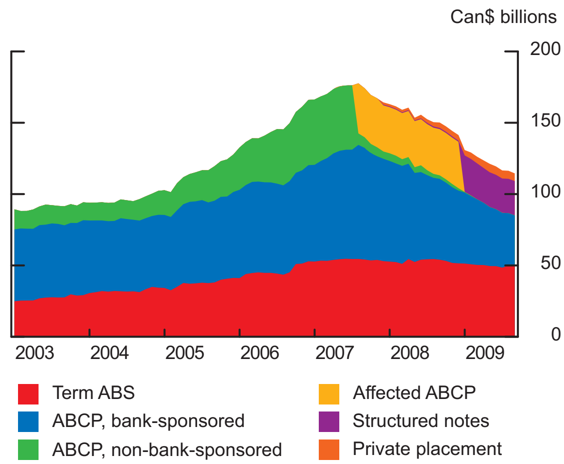
Securitization is the process by which non-tradable assets are transformed into asset-backed debt instruments that can be traded in financial markets. In Canada, securitized assets have become an important source of funding (e.g., auto and equipment loans and leases, trade receivables, credit cards, and residential and commercial mortgage loans) and have provided investors with increased opportunities for portfolio diversification. Prior to the financial crisis, the outstanding amount of asset-backed commercial paper (ABCP) peaked at $120 billion, which represented 50 per cent of the stock of private money market securities. Term asset-backed securities (ABS) peaked at $55 billion, which represented one-fifth of corporate bonds outstanding. Since the onset of the financial crisis, however, the outstanding amount of asset-backed debt instruments has declined considerably **(Chart 1)**.[1]

To be tradable (i.e., to be readily accepted by current and future investors), securitized debt instruments must have two basic attributes. First, the underlying assets should be of certain and predictable credit quality, so that investors know what they are buying and holding. Second, the credit quality of the instrument should be easily and quickly ascertainable, so that investors do not have to devote significant effort to monitoring their investment. The recent financial crisis has shown that, globally, many securitized products did not have these attributes, causing investors to lose confidence and trade in securitization markets to freeze.

Restoring investor confidence and restarting securitization markets will require a coordinated effort on the part of industry participants, investors, and regulators, in Canada and elsewhere. Significant reductions in the uncertainty surrounding credit quality and a reduced need for monitoring will be achieved only by improving the design of securitized products. This requires that securitizations be structured such that they are less complex and opaque, and that an appropriate alignment of incentives among the various participants in the intermediation chain is ensured (Paligorova 2009; Fender and Mitchell 2009). And, while securitization can provide benefits to the economy and the financial system by increasing the supply of credit and reducing the concentration of risk, the financial crisis that began in August 2007 serves as a reminder that a beneficial financial innovation such as securitization can become a source of financial instability if industry practice and regulation do not keep pace with innovation.

Chart 1: The rise and fall of securitization in Canada



Note: Bank-sponsored ABCP (programs of the six largest banks) was supported by the sponsors during the financial crisis. Non-bank sponsors were dependent on third parties for support. Affected ABCP was frozen under the terms of the Montréal Accord and later restructured (structured notes) through the efforts of the Pan-Canadian Investors Committee. For details, see Chant (2008).
Source: DBRS — Last observation: September 2009

1 Issuance stalled in securitization markets in the period following the bankruptcy of Lehman Brothers. Since then, there have been few public issues of ABS or ABCP, although there have been a number of private placements to Canadian and U.S. institutional investors.

The Economic Benefits of Securitization

The economic benefits of securitization derive mainly from the conversion of non-tradable financial assets into tradable instruments held by third parties. This conversion has the effect of expanding the potential supply of credit and reducing concentrations of risk. With more credit available, credit constraints are relaxed, and the production potential of the economy is expanded. In addition, with greater possibilities for portfolio diversification, the financial system can manage risk more effectively.

With securitization, the supply of credit expands because sponsoring financial entities do not need to hold capital (or reserves in the case of non-bank entities) against potential losses on loans that become securitized.[2,3] Instead, they can assign this capital (reserves) to other productive uses, such as new loans. This reduces the cost of intermediation and expands the supply of credit. Further, to the extent that these entities are able to finance their activities more cost-effectively through securitization, their cost of doing business is reduced.

Securitization also increases the ability and willingness of investors to take on risk because the tradability of these instruments means that investors can rebalance the risk in their portfolios should the need arise. Furthermore, credit quality can be structured to better match the specific needs of investors—for example, by making returns less sensitive to the performance of individual loans by pooling, and through over-collateralization and other credit-enhancement techniques.[4] Securitization can also allocate different risk characteristics to different asset-backed instruments, which can then be placed with entities that are better able to manage that particular risk characteristic. The result is an increase in the financial system's capacity for managing risk. Tradability and greater specialization facilitate risk management since, in principle, investors should hold only those risks that they understand and can best mitigate.

The prevailing view before the recent crisis was that securitization was good because it increased the resilience of the financial system by transferring credit risk to a broad range of market participants able to manage the risk (Shin 2009). Since the crisis, however, the consensus view has focused on the fragility created by conflicts of interest within the process of securitization (Paligorova 2009). Both of these views have merit. Securitization, as with any widely adopted financial innovation, is successful because of its perceived economic benefits. However, these benefits will not be realized unless industry and regulatory practice evolve to ensure that the new instruments are safe as well as effective.

Why Securitization Can Be Destabilizing

Realizing sustainable benefits from securitization requires that investors in ABS understand the inherent risks so that they are better able to manage those risks. Thus, it is necessary to reduce the complexity of these securities, introduce greater standardization, where possible, and increase transparency and disclosure. Achieving these goals requires that all of the various agents involved in the securitization process (borrowers, originators, arrangers, credit-rating agencies, asset managers, credit enhancers, liquidity providers, and sponsors) have the appropriate incentives to design and produce securitized products that function as intended.

Conflicts of interest

The potential for adverse selection[5] creates conflicts in many areas of the securitization process where agents have an incentive to act in their own self-interest rather than in the interest of the principal investor; for example, when the originator of individual loans knows more about the quality of the borrowers than does the arranger who pools and structures the loans, or when the arranger knows more about the quality of the loans than a third party, such as a credit-rating agency (CRA) whose task it is to assign a credit rating. In the originate-to-distribute model, where loans are originated for the sole purpose of securitization, such informational asymmetry makes it possible for "substandard" loans to be securitized, because there is no strong incentive for the originator to screen out problem loans. Misaligned or weak incentives can undermine the soundness of securitized products, because they make it profitable to under-report and distort information.

Another well-recognized conflict of interest relates specifically to the dual role that CRAs can perform in the rating of structured products, including ABS. They can provide advice on how to structure a product to achieve a desired credit rating, and they can then be asked to assign a credit

2 Capital is needed to cover unanticipated losses on bank loans, whereas reserves are needed for loans made by other financial entities. Securitization does not require capital or reserves because the risk of loss has been transferred to an independent third party. However, banks or other financial entities that retain an ownership interest or provide implicit contingent guarantees to the purchasers of securitized instruments would need to hold capital or reserves to protect their stakeholders from future claims.

3 The reduction in capital is not complete if the originator or sponsor retains an interest in the security (even if that interest is implicit or contingent).

4 Credit default swaps, for example, can be used to transfer default risk, or the securities may be structured such that the top-rated tranche has the first claim on returns. See Paligorova (2009).

5 Adverse selection occurs if one of the participants in the securitization process has more information than another, a situation that can exist at different stages in the process. This and other agency conflicts in securitization are discussed in Ashcraft and Schuermann (2008) and Paligorova (2009).

rating to that product. Conflict of interest arises if the CRA is paid by the same entity to both assign the credit rating and to provide advice on how to obtain that rating. In such circumstances, CRAs may have little incentive to make their methodologies, assumptions, and information used in the rating process transparent. Yet, investors and regulators need this information to manage and control risk. Furthermore, this dual role may have encouraged "ratings shopping," whereby an issuer may solicit preliminary ratings from several CRAs but pays for and discloses only the highest rating (IMF 2009).

Vanishing tradability in times of stress

Asset-backed debt instruments can lose their tradability in times of stress because these securities can be highly complex and, hence, difficult to value. Markets trading in complex instruments do not tend to work well during periods of heightened uncertainty, since unanticipated events can have significant unpredictable effects on the value of the security. Under such circumstances, market participants are reluctant to buy these securities out of a concern that they will make valuation mistakes and may not be able to sell at a similar, or higher, price in the future. There are several aspects to the complexity of securitized products. One is the above-mentioned problem of adverse selection, where complexity might be added artificially to hide the effects of incentive misalignments. A second is the use of market-making structures that do not generate public information about traded values. A third is the lack of consistent standards for legal agreements, transaction participants, and methods for building structures. The resulting complexity and uncertainty have meant that there is a risk that asset-backed debt instruments will lose their tradability in times of stress, causing markets to fail at a time when well-functioning markets are crucial for effective risk management.

Flawed prudential regulation

The potential for regulatory arbitrage arises when prudential regulation does not properly recognize implicit contingent claims. Ignoring these claims leads to the assumption that risk to the financial system is eliminated when securitized products are moved off the balance sheet of the original lender. As a result, capital is not required, even though the originator or sponsor, in effect, retains a partial liability associated with the instrument.[6] Thus, when markets for these products froze and values declined, there was instability in the financial system as retained but uncapitalized and uncommunicated liabilities came to light, causing investors to question the valuations they placed on the equity of financial institutions.

6 Many additional opportunities for regulatory arbitrage that were present in Basel I were addressed in Basel II. See IMF (2009).

Out-of-date accounting standards

Out-of-date accounting standards[7] increase the potential for misleading financial statements, partly because disclosure standards for exposures to securitized products have not kept pace with the growing complexity of the products. On one hand, accounting rules allow implicit contingent exposures to securitization risk to be off the balance sheet and, hence, undisclosed to investors and regulators. On the other hand, rules for reporting on-balance-sheet risk are not sufficiently refined to accommodate the heterogeneity and complexity of securitized products. This means that much of the information on instrument-specific risk needed by investors is not disclosed. This lack of transparency can create doubts about counterparty creditworthiness in times of financial stress, leading to market illiquidity and valuation volatility. Valuation volatility can impair the balance sheets of financial intermediaries that hold asset-backed debt instruments for trading purposes when accounting rules require the use of "fair market" valuation techniques.

Improving Securitization

Globally, recommendations to restart securitization markets are aimed at reducing conflicts of interest and realigning incentives in the securitization process, thus reducing the complexity of asset-backed debt instruments and increasing the transparency and tradability of securitized products in times of financial stress. Greater standardization is required to improve the contribution that securitization makes to the financial system: "Standards enable a market. They are part of the infrastructure for innovation-led growth" (Swann 2000).

Reducing conflict of interest

Numerous proposals have been made for reducing potential conflicts of interest (and other issues) related to the role of CRAs. Among these are a reduction in the use of credit ratings in regulation—which would put the onus on investors to perform their own due diligence—and a requirement to move to an investor-pay business model. Zelmer (2007) argues that the quality of ratings could suffer in a move to an investor-pay model. For example, few investors may have access to the ratings, and CRAs may not be able to fund an appropriate level of supporting research. Measures that would increase the transparency of rating methodologies, encourage greater disclosure of the information used in the rating process, and require the use of a separate rating scale for structured products could help to reduce conflicts of interest and improve the quality of ratings. Issues arising from the role of CRAs in the financial crisis, including those related to potential conflicts of interest in rating structured finance products, are discussed in IOSCO (2008a) and

7 This section draws on IMF (2009).

addressed, in part, in the recently revised IOSCO code of conduct for CRAs (IOSCO 2008b).

The alignment of incentives could be improved by requiring issuers to retain a portion of an issue of a new debt instrument, thereby sharing in the risk.[8] A sufficient sharing of risk would motivate issuers to perform appropriate due diligence on loan originators, continuously monitor the behaviour of originators, and, perhaps, seek representations and warranties from originators on the quality of loans and the underwriting process. The effectiveness of this proposal depends not just on the size of the retained interest, but also on how it is configured. For example, originators could be asked to hold an equal share of each tranche in the securitized structure (a vertical slice), or to retain the entire amount in a particular tranche—for example, the equity tranche, or the mezzanine tranche. This type of reform must be approached carefully, since there is some evidence that imposing a particular form of retention scheme could generate unintended costs and thus hamper efforts to restart sustainable securitization markets.[9] If, for example, retention requirements are too low, screening incentives may not be sufficiently high, but if requirements are too high, securitization may no longer be an economical form of finance.

Reducing complexity

If products are too complex, investors have difficulty understanding and managing the risks inherent in the asset-backed debt instruments they hold. Complexity can be reduced by requiring issuers to adopt common standards for the construction of products; to use standard documentation, terms, and templates in legal agreements when structuring products; and to refrain from novel techniques for enhancing credit quality. Choosing a single set of standards will not be easy and may require regulatory encouragement, since the benefits of standardization are not likely to fall evenly on all parties.

The incentive to create complex products can be reduced by eliminating opportunities for regulatory arbitrage and by encouraging issuers and investors to appropriately account for all risk exposures associated with securitized products, both on and off the balance sheet. It is important, however, to coordinate changes to securitization regulation with changes to accounting rules and standardization initiatives in order to minimize the risk of unintended consequences, especially those that might neutralize the benefits of securitization.

The ability of investors to understand the risks inherent in asset-backed debt instruments would be enhanced by increased disclosure and transparency regarding the loans included in the securitization pool, as well as details on product structure, issuer compensation, risk retention, and other elements relevant to the assessment of credit quality. Such information would also help CRAs to assess credit quality and would encourage investors to use expert advice to inform their own due-diligence assessment of credit quality. Counterparty risk assessment could be improved by revisions to accounting standards that recognize contingent claims, off-balance-sheet liabilities, and the reality that markets do not always provide fair valuation.

Improving tradability

The above changes would also lead to improved tradability. Tradability could be further enhanced by ensuring that all participants have access to the same information and that trading venues generate publicly available information about the values at which trades take place.

Progress Towards Reforming Canadian Securitization Markets

Globally, for securitization to become a stable form of intermediation, significant and coordinated reform is required to address the fundamental problems of conflict of interest, complexity, and a lack of tradability in times of stress. Additionally, investors must assume a greater role in performing due diligence. Reforms aimed at increasing transparency and disclosure would make it easier for investors to enforce market discipline. In Canada, there has been initial progress towards reforming securitization practices along these lines. This reform should be strengthened over time as various initiatives proposed by international standard-setters are implemented. Among these are the enhancements to the Basel II capital framework,[10] changes to international accounting standards for the off-balance-sheet accounting treatment of securitizations, and IOSCO's proposals to strengthen practices in securitization markets.[11] A recent report of the Financial Stability Board to the G-20 leaders (FSB 2009) lends support to these initiatives and calls on the official sector to implement various measures to restart securitization markets on a sounder basis. However, as the IMF (2009) has urged, it will be necessary to carefully examine their interactions before the initiatives are finalized, since some proposals may interact in ways that could impede securitization, rather than restart it.

In Canada, the destabilizing effects of a lack of transparency and disclosure, combined with highly complex securitization products, were evident in the ABCP market. In

8 See IMF (2009) and IOSCO (2009).

9 This is discussed in detail in Fender and Mitchell (2009).

10 These include stronger capital requirements for securitized products, higher risk weights for resecuritizations, a requirement for banks to conduct more rigorous credit analyses of externally rated securitizations, and improved disclosure of securitizations in the trading book. See "Enhancements to the Basel II Framework," July 2009, <http://www.bis.org/publ/bcbs157.htm>.

11 Among these are proposals for enhanced transparency by issuers of public offerings of ABS, improving governance and transparency of CRAs, and recommendations for regulators to address the issues in securitization markets along three dimensions: wrong incentives, inadequate risk-management practices, and regulatory structure and issues around oversight. See IOSCO (2009).

contrast to term ABS, issues of ABCP are prospectus-exempt and, hence, not subject to regulatory transparency and disclosure requirements. Consequently, the information available to investors and issuers was not symmetric—issuers did not always disclose material information, such as the composition and nature of the assets underlying the ABCP programs (both at issuance and over the life of the instrument). Since the crisis, considerable progress has been made towards increasing the transparency and disclosure of Canadian ABCP programs. These include measures undertaken by the Bank of Canada to introduce transparency requirements and minimum quality standards for ABCP accepted as collateral in its liquidity facilities,[12] increased transparency on the part of bank sponsors, and enhanced transparency and disclosure measures for both ABCP and term ABS introduced by credit-rating agencies. Of note, DBRS now includes monthly reports at the individual transaction level in its ABCP reporting process.[13]

The federal government announced in January 2009 that it would introduce the Canadian Secured Credit Facility to purchase up to $12 billion in term ABS backed by loans and leases on vehicles and equipment.[14] This program is intended as a temporary measure. One of its aims is to encourage renewed investor participation and confidence in the Canadian ABS market for the securitization of vehicle and equipment financing,[15] notably through the development of standardized terms and documentation. Although the issuance of term ABS requires a prospectus and, hence, is subject to the same transparency and disclosure requirements as other publicly issued securities, these prospectuses can be inordinately long, complex, and difficult to understand. Transparency could be enhanced by simplifying and standardizing the structure and terminology to facilitate due diligence on the part of investors and potentially reduce reliance on credit ratings. The responsibility, however, remains with investors to determine the level of due diligence required to make informed investment decisions.

Securities regulators, under the auspices of the Canadian Securities Administrators, have undertaken consultations on proposed policy responses to address the role of ABCP in the financial crisis.[16] Under consideration are investor suitability requirements, a possible amendment to the current prospectus and registration exemption for short-term debt to exclude ABCP, a review of the use of credit ratings in securities legislation, and the introduction of a regulatory framework for CRAs. As proposed in the consultation paper, the latter would require compliance with the revised IOSCO code of conduct and should provide securities regulators with the authority to require changes to a CRA's practices and procedures. Each province will be required to obtain the appropriate legislative authority to regulate CRAs, but it is probable that CRA regulation would ultimately fall under the jurisdiction of the proposed national securities regulator. A consultation document is expected to be published for comment by year-end, with implementation set for 2010.

DBRS is the only major CRA domiciled in Canada, and it is also subject to regulation by the U.S. Securities and Exchange Commission. Like Moody's, Fitch Ratings, and Standard & Poor's (the three major U.S.-based CRAs providing ratings for Canadian securitizations), DBRS is substantially in compliance with the recently revised IOSCO code of conduct. Globally, ratings agencies have taken a number of steps to restore confidence in their ratings methodology for structured credit products, including, for example, improved disclosure of ratings methodologies and the development of additional means of providing ratings information on structured finance products. These efforts have, however, stopped short of introducing a separate rating scale for structured products as recommended by the G-20.

Canada is committed to making the transition from Generally Accepted Accounting Principles to International Financial Reporting Standards by 2011. The currently proposed changes to IAS 39 ("Financial Instruments: Recognition and Measurement") with regard to the off-balance-sheet treatment of securitizations suggest that few, if any, future Canadian securitizations will be eligible for off-balance-sheet treatment. Indeed, it is likely that sponsors of asset-backed programs will be required to consolidate them on the balance sheet. Hence, the proposed changes, in combination with other initiatives such as increased capital charges and retention requirements, are likely to fundamentally alter the economics of securitization, making it a more expensive form of funding for borrowers.

In conclusion, ensuring stable, sustainable securitization markets will require a coordinated effort on the part of various stakeholders, including the industry itself, regulators, and standard-setters. Public sector leadership and coordination are also likely to be required in order to restart securitization markets on a sounder basis. Importantly, a coordinated effort will be required to ensure that the reforms are appropriate—contributing to enhanced transparency, simpler structures, and greater standardization—and that their interactions help to restart securitization, not impede it.

12 See <http://www.bank-banque-canada.ca/en/notices_fmd/2008/not310308.html>.

13 See "DBRS Initiatives to Enhance the Quality and Transparency of Its Rating Process," 5 March 2009. Available at <http://www.dbrs.com/research/227113>.

14 See <http://www.budget.gc.ca/2009/plan/bpc3a-eng.asp>.

15 See "Consultation on the Canadian Secured Credit Facility." Available at <http://www.bdc.ca/en/about/federal_budget_2009/cscf/consultation.htm>.

16 The consultation document "Securities Regulatory Proposals Stemming from the 2007–08 Credit Market Turmoil and Its Effect on the ABCP Market in Canada," October 2008, is available on the websites of the provincial securities regulators.

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