Holistic medicine needed to revive securitisation

In the immediate aftermath of the crisis, it's possible that those who identified securitisation as a financing model, rather than loan origination practices, as a principal cause of the crisis were all too ready to charge ahead with a multiplicity of regulatory reforms designed to prevent future crises. They were unprepared to see the broader picture. But with the perspective that often comes with the passage of time, it has now become clear that individual measures that target specific concerns may interact in negative ways, and cause the patient more harm than good.

As a financing technique, securitisation permits banks and other financial institutions to recycle capital, and make credit available to consumers. In the US, where the real-estate finance system has not fully recovered, more than 90% of all new residential mortgage originations are government funded or guaranteed. Private funding alternatives are essential. But actual or proposed US and international regulations are making securitisation's speedy recovery increasingly difficult.

Different regulators, different response

Let's consider the regulations affecting US securitisers. The Federal Deposit Insurance Corporation (FDIC) revised its securitisation safe harbour by requiring financial institutions to retain more of a securitisation's credit risk, and reflect US accounting changes that make it more difficult to obtain off-balance sheet treatment. The FDIC also imposed some quality controls on assets that are securitised. Regulations required by Title IX of the Dodd-Frank Act imposed new diligence and disclosure requirements on securitisers and credit rating agencies, and required the standardisation of securitisation-related representations and warranties. All information provided to a rating agency, including through oral discussions, is required to be posted to a website and made available to any competing rating agency.

The Consumer Financial Protection Bureau (CFPB), the US's newest regulator, has finalised regulations required by Title XIV of Dodd-Frank addressing all aspects of the mortgage loan origination and servicing process. These include a rule that sets standards that creditors must use in determining whether a consumer has the 'ability to repay' a mortgage loan, and provide either a safe harbour or presumption against a claim against the creditor if the creditor originates a 'qualified mortgage'. By and large, only the most conservative mortgage loans will be considered a qualified mortgages. Whether or not this is the same as a 'qualified residential mortgage' remains a highly anticipated matter.

Regulators have not finalised rules implementing Dodd-Frank's risk retention requirements in relation to securitisation. These requirements are subject to certain exclusions, including for 'qualified residential mortgages'. Action on risk retention requires coordination between the Securities and Exchange Commission (SEC) and federal banking agencies. Banks will also have to worry about a few other categories of mortgages. For Basel risk-weighting purposes, based on the loan-to-value ratio, a mortgage loan may be a Category 1 or Category 2 loan. For Basel liquidity coverage ratio purposes, certain residential mortgage-backed securities may qualify as high quality liquid assets. The Basel securitisation framework may be subject to even more fundamental changes following risk-weighting proposals made at the end of 2012.

> **US and European regulatory reforms are not consistent, making an international securitisation market impossible in the near term**

Caught by the knock-on effect

But there is even more to come. The Volcker Rule may affect a number of securitisation vehicles that would (unless the final rule provides clarification) be considered 'covered funds'. A related rule would prohibit material conflicts of interest relating to certain securitisations. Securitisation participants are grappling with various aspects of US derivatives regulations, including the potential characterisation of securitisation as 'commodity pools', margin requirements, and capital requirements. Other rules will impose swap clearing requirements, including on cross-border swaps. Although Dodd-Frank addressed certain transparency and disclosure concerns, the SEC is still expected to take action on Regulation AB II, which governs the registration and disclosure requirements for offerings of asset-backed securities.

Increased capital requirements for banks under Basel III and proposed capital surcharges on large banks will squeeze securitisation, which is capital intensive. And higher capital requirements for banks holding lower-rated securitisation pieces will adversely affect a large segment of the securitisation purchaser base.

Conflicting remedies

If the patient (securitisation that is) were healthy enough to withstand the effects of all of these remedies, it would still be left to confront the prospect of differences in the regulatory approaches taken by national regulators. Despite promises of harmonisation, US and European regulatory reforms are not consistent, making an international securitisation market impossible in the near term. And for residential mortgage securitisation, European regulators have suggested that most US deals would not qualify for liquidity coverage ratio purposes. There is also the specter of a Tobin tax (a tax on each trade of a security) in Europe, which will have extraterritorial effect.

It might almost go without saying that the most important participants in the mortgage origination and securitisation process – banks – are facing many other regulatory and litigation and enforcement challenges. The chilling effect of rep-and-warranty claims, foreclosure and servicing investigations and settlements, and US private label securitisation actions may pose as grave a threat to the restoration of a

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securitisation market as regulatory overload and lack of harmonisation. Large settlements on rep-and-warranty claims have recently induced several large banks to try including a sunset provision on their repurchase obligations, which is likely to be acceptable only to a reduced investor base.

Non-bank entities, not subject to the same regulatory oversight and public scrutiny, may become more important to the mortgage market. This seems an incongruous result. And regulators are turning their attention to the shadow banking system in the belief that many of the problems precipitating the crisis arose here. Various limitations are being considered to prevent a run on money market funds, including the imposition of capital requirements. Solutions are being sought to stabilise the huge repurchase market that provided much of the financing for the pooling of assets to be securitised. Non-bank entities face challenges acquiring sufficient capital.

Considering the dismal prospects for increased private sector funding of mortgage loans, and recognising the merits of securitisation as a financing technique, perhaps it is now time to propose a holistic approach to the regulation of mortgage finance.

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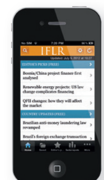

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