Restoring Confidence in Securitization – Why and How

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Public attention has focused on the need to revitalize our credit markets to halt the downturn and speed economic recovery. Much of this effort has focused on the need to "get banks lending again" at the cost of hundreds of billions of tax dollars. While this is an urgent goal, it is equally important to resume the flow of consumer debt securitizations, a goal which we believe can be accomplished without the expenditure of public funds.

The securitization markets have become a key part of global credit markets. Since the turn of the 21st century, a majority of credit provided to consumers including residential mortgages, auto loans, student loans and other consumer loans has been financed through the sale of asset-backed securities. Such securitizations, when well-executed, help add value to both borrowers and lenders/investors, improving access to credit at lower costs.

Unfortunately, most securitization markets are now solidly frozen. Securities that were once referred to as "senior" or "AAA" are now called "toxic" (or more euphemistically, "legacy" assets). In some securitizations, particularly a number of recent subprime securitizations, accountability to the end investor broke down at nearly every stage of the process. Public policy is now focused on ways of eliminating the overhang of "toxic" assets currently held by financial institutions. However, to finance growth in our economy we must also re-establish confidence in the securitization process.

We believe that significant steps can be taken to restore confidence in the securitization process ***at no cost to taxpayers***. The government's role in this effort would be merely to convene a committee of leading participants in securitization markets and give them a mandate to improve the transparency of these markets and to realign the incentives of each agent with those of final investors. This Securitization Transaction Approval Review (STAR) Committee would include leading institutional investors – pension funds, mutual funds, insurance companies, banks and endowments – and various service providers – underwriting investment banks, originating lenders, lawyers, accountants, rating agencies and monoline insurers, all of whom share an interest in revitalizing the securitization process.

Investors would be assured that each new securitization meeting the STAR standards meets industry-wide best practices for transparency, due diligence, and communication of all relevant details to prospective and ongoing investors, and that all service providers have financial incentives that align their goals with those of the investors in the transaction. The STAR Committee would not only evaluate each initial security offering, it would also monitor the transaction over its life, and provide investors with a warning if

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a service provider failed to provide a promised service. If the STAR process successfully minimizes the risks of the securitization ***process***, market forces will lead to efficient pricing of securities based on the fundamental risks inherent in the underlying collateral and the associated tranching of the various securities, without adding the large uncertainty premium for the process itself, which now exists.

The key to the STAR evaluation is the establishment of explicit best practice hurdles for all service providers. Below is a starting point for discussion of such best practices, which the Committee would, of course, refine.

- Originating lenders would be held to high standards concerning ongoing access to lending documents by investors and other service providers. Originators would also be required to keep "skin in the game" by holding a material pro-rata percentage of the loans in the pool or the junior securities created in the securitization on their balance sheet for the life of the securitization.
- STAR securitizations would require a credible auditing firm to provide due diligence by auditing a random sample of loan applications and assuring that the information contained therein was honest and accurate. In the event that a material number of "liar loans" appeared, the securitization would stop, and the originating lender would face the prospect of needing to hold those loans on their balance sheet for the life of the loans.
- Rating agencies would continue to opine on the credit quality of the securities based on their own criteria, but would be subject to two rigorous transparency requirements: (1) full disclosure of the assumptions that were used in assessing the rating; and (2) disclosure of the stress tests designed to provide insight into the likely stability of the rating in response to changes in assumptions.
- As rating agencies need to be heavily scrutinized concerning their assumptions about correlations in the underlying collateral, lawyers and underwriting investment bankers would be required to assume an affirmative obligation to look for and report any undisclosed correlations in the underlying collateral, or structural anomalies in the securitization that could adversely affect performance.
- Monoline insurers would be required to disclose the reserves they maintain for each security insured.
- All service providers would be required to review all documentary data, and publicly report any further non-standard element of the transaction. These obligations would weigh heavily on the lawyers, underwriting investment bankers, and rating agency analysts who appear to have merely rubber-stamped deals in the past.
- Most importantly, to financially align incentives between service providers and investors, fees paid to regular service providers would be paid pro-rata with return of principal to investors. Only in unusual circumstances would any fees be paid up front. By back-ending fees, service providers would be putting their fees at risk in the event of defaults in the underlying loans held as collateral, and would share in the economic risks of the transaction as partners with the investors.

The STAR standards would be those that investors have come to expect of a well-functioning securitization process. Given recent market failures, assurances of scrutiny from a broad array of market participants may be the best way to effectively restore the confidence of institutional investors. This approach is more efficient than a cumbersome regulatory regime, and will assure a quicker revival than waiting for the market to achieve this goal through a piecemeal approach.

Nothing in this proposal would stop institutional investors from buying securitizations that have not earned a STAR designation. However, in the near term, the STAR designation could go a long way toward restoring confidence in the securitization process among non-specialized investors, which would help unfreeze our credit markets and speed economic recovery.