

CSFI

CENTRE FOR THE STUDY OF FINANCIAL INNOVATION

5 DERBY STREET
LONDON W1J 7AB

TEL: 020 7493 0173
FAX: 020 7493 0190

The future of securitisation: A round-table discussion with Rick Watson (European Securitisation Forum), Vikrant Vig (London Business School), and Michael Hampden-Turner (Citi) held on Wednesday, May 21, 2008, at Armourers' Hall, 81 Coleman Street, London, EC2R 5BJ, from 12:30-2:15pm.

Securitisation is dead – long live securitisation. The first speaker said the market had been through a tough time but would survive – albeit in a different form – because the business model made sense. In 2006 European deals were worth €450bn and almost the same in 2007 despite a flat second half. The first quarter of this year had seen €5-7bn. But different parts had been affected in different ways because the European market was fragmented – by country, half came from the UK and by type, half were residential mortgage-backed securities (RMBS).

Now the dust is settling people are asking questions. Did investors know what they had bought and had they done due diligence? Did they comb through the prospectus or just check the credit rating? One member said there was a major problem with information. For RMBS it was not possible for investors to get granular information on loan-to-value ratios and credit records of the assets that were in the buckets of risk. The speaker said the industry was looking to improve that and overcome particular problems of data protection in Europe that might prevent disclosure. He said the industry was also to follow the model of IOSCO's valuation principles designed for hedge funds.

One member said this was simply "frolicking at the margins". Surely there was a more fundamental problem stopping people investing. The speaker agreed there were four broader conditions for a market revival. Mark-to-market investors needed price stability to avoid the fear of sudden write-downs in new assets. An agreement on regulation of rating agencies was needed to get the issue off the table. The US subprime issue needed resolution as there was money waiting in the wings. The last was an end to the perception of a supply overhang, as investors feared banks would use a price recovery to flood the market and drive prices down.

Looking to the future, the speaker said the industry would survive by focusing on simplicity. The RMBS market would come back first because investors could see what the underlying assets were. The collateralised debt obligation (CDO) market was virtually dead but the collateralised loan obligation (CLO) market should be in a strong position.

The second speaker took the roundtable through academic research that sought to see if securitisation had lowered the screening banks did on products. His team used the US FICO credit score that rated products between 350 and 800 and where the divide between good-and-securitisable and bad-so-unsecuritisable was 620. However examination of a batch of 620+ and 620- products showed a big jump in loans on 620+ products with weak documentation even though there was no massive improvement in defaults or interest rates

at that point. Since the 620+ in the sample performed worse than the 620- it showed that the securitisation process had reduced the amount of diligence and focus on “soft” information that banks should do. He stressed he was not a critic of securitisation – but it was clear not all assets should be securitised. Information was lost in the process. Under questioning he said the industry had been unaware of this pattern until shown the figures in his presentation.

The last speaker focused on the CDO market, which had had the most poisonous effect on the market. In particular, mezzanine CDOs of ABS took segments of the lowest rates tranches of ABS and repacked them in a way that gained an AAA rating and yet had a potential loss of 75%. In Citi’s case it had written down \$40bn of a \$50bn portfolio. He struck a slightly upbeat note, saying the £360bn of writedowns so far was probably close to the stage where most of the loss was “out of the woodwork”.

He said that while the CDO of ABS market was dead, the CLO market had also been affected even though CLOs were constructed so that likely losses were just 10% in a negative situation. There was some new issuance going on although that was mainly banks printing deals at a loss to get the market moving. In the same vein a lot of European issuance was a deal being done in order to create collateral to lodge with the European Central Bank. It was worth pointing out the crisis was having a real impact on ordinary people. He said the number of UK mortgage products available to buy-to-let subprime borrowers has fallen by 90% in the six months to January.

One member said he could not understand why securitisation was thought able to make an illiquid asset liquid when it was no more than wrapping paper. Securitisation had originally been a device to separate ownership of assets for tax purposes. The last word went to the first speaker. He said securitisation per se did not create value. Where it makes sense is institutional preference. Investors who cannot hold junk-rated products but want higher yield are able to access that higher yield by buying AAA-rated paper. That, at the end of the day, is the major driver.