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Commentary

AN INTERNATIONAL PERSPECTIVE ON SECURITIZATION AND THE FINANCIAL CRISIS

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Andreas Fillman of Squire, Sanders & Dempsey discusses the role of securitization in the financial crisis and how reforms will be necessary on an international basis to address the global recession.

The future of asset securitization, an extremely popular financing tool considered one of the top factors of the current worldwide crisis, has been called into question amid cries for regulatory reforms. Representatives of 20 of the world's leading countries -- dubbed G-20 -- are reviewing proposals that are expected to change the face of global financial services regulation. This article provides some insight into the shape that reform may take.

Any true regulatory reform begins with a complete grasp of the different factors contributing to the crisis. In this instance, three major factors -- insufficient risk assessment, lack of transparency and inaccurate rating systems -- all came into play.

Market participants -- banks, financial firms, and regulators and supervisors -- didn't appreciate the risks associated with the new, highly complex financial securitization products. In particular, many of the board members and senior management of banks and financial firms were not aware of the aggregate exposure of their companies, thus seriously underestimating the risks they were running.

In fairness, even the most sophisticated market players would have difficulty assessing risk, given the complexity of structured financial products, sometimes involving several layers of credit default obligations or other financial instruments. Furthermore, none of the market participants expected a total freezing of the inter-bank or commercial paper markets. As a result, banks and financial firms couldn't manage their entire risk exposures or obtain sufficient liquidity.

Central segments of the financial markets lacked transparency, and market participants did not have a complete grasp of the size and location of specific credit risks. This created uncertainty among the parties involved regarding the credit quality of their respective counterparties.

Two factors contributed to the problem: equity capital regulations and the increased use of credit default swaps. Created by JPMorgan Chase & Co. more than a decade ago to hedge against losses from bank loans, CDS became standard fare for hedge funds, insurance companies and asset managers, which used them to speculate on the creditworthiness of companies. As a result, by 2008, total exposure was $48 trillion, according to the International Swaps & Derivatives Association. In particular, swaps isolated some of the risk of the underlying securities (or entities) by transferring it to third parties.

Credit rating agencies also fell short of the mark. The agencies lowered the awareness of credit risk by giving incorrect ratings to structured financial products such as collateralized debt obligations, primarily by using inappropriate rating methodologies. In addition, the conflicts of interests due to the issuer paying for the ratings have had particularly damaging effects in the area of structured finance.

Finally, regulation concentrated on the wrong trouble spots. Regulators and supervisors focused mainly on the supervision of individual financial institutions in their countries and not sufficiently on the systemic risks in an international environment. Many times, financial regulators and supervisors did not access all the relevant information about the excessive leverage of market participants across the globe. They did not fully understand or evaluate the size of the risks, and they did not adequately share the information they did possess with their counterparts in other states in Europe or the United States.

In particular, the business model of U.S.-based investment banks and the way they expanded in the structured finance market were not properly observed and supervised. Insufficient supervisory and regulatory resources, combined with an inadequate mix of skills as well as different national systems of supervision, made a bad situation worse.

Existing regulatory rules, such as the requirements of sufficient equity capital for banks, gave too much attention and placed too much reliance on both the risk management capabilities of the banks themselves and on the adequacy of credit ratings. Unfortunately, such rules did not cover the liquidity of the market participants, which was a major contributing factor in the financial crisis.

Interestingly, similar problems occurred in many segments, markets and countries at the same time, which resulted in those countries experiencing simultaneous financial crises. There was no system of information exchange or collective decision-making among central banks, supervisors and finance ministries. In addition EU regulators and their U.S. counterparts failed to recognize how many European financial institutions were exposed to highly complex financial assets -- often in off-balance-sheet constructions that later became illiquid.

The lack of a defined international standard has made the business of regulating liquidity risk more challenging for regulators.

The Future of Securitization

Moving forward, securitization transactions will be conducted amid a much more stringent regulatory framework, starting with further regulation of banks' capital adequacy.

One significant step is amendments proposed to the Basel II standards on bank capital, which were designed to achieve greater awareness of banks' capital levels and related risks. The proposed amendments come from the Basel Committee on Banking Supervision, which includes senior officials responsible for banking supervision or financial stability issues in central banks and authorities with formal responsibility for the prudential supervision of banking business. The commission proposed amendments Jan. 16 that would change existing capital requirements for both trading book and banking book exposures, require more supervision and risk management, and establish enhanced disclosure requirements.

The proposed trading book regulation amendments are designed to reduce “the incentive for regulatory arbitrage between the banking and trading books” by making the capital requirement for any securitization exposure the same capital requirement that would apply to that position if held in the banking book. The proposed banking book changes would affect several aspects of the securitization framework. The existing risk weight factors for both the standardized and internal-rating-based approaches would be revised to provide higher risk weights for securitization exposures, especially when one of the underlying exposures is itself a securitization exposure.

The committee has suggested that all the proposed changes be implemented starting in 2009 and finalized in 2010. However, actions proposed by the committee do not have direct legal effect in the United States (or other participating countries), so these proposals would need to be implemented through national laws and rules, with the opportunity for public hearings.

Secondly, regulatory institutions and other market participants have launched initiatives to develop disclosure requirements specifically tailored toward securitization transactions. The Institute of International Finance, a global association of financial institutions, has outlined in its report on market best practices the need for common information standards for securitized products. According to their proposals, market participants should have easy access to related information on transactions in the securitization market, the underlying asset portfolio and any further transformation of the securitization.

The information provided should include, among other things, details about any retention and the percentage of a share of securitized products on the balance sheet of the originator. The IFF's view is that this would reveal the originator's incentive structure and thus unveil possible moral hazard problems. In addition, the IFF says there is a strong need for international harmonization of common terminology as well as disclosure requirements.

Furthermore, the Financial Stability Forum has proposed that securities market regulators work closely with market participants to expand information on securitized products and their underlying assets and set up a comprehensive system for post-trade transparency of the price and amounts of credit instruments in the secondary market. The FSF is comprised of senior representatives of national financial authorities (central banks, supervisory authorities and treasury departments), international financial institutions, international regulatory and supervisory groupings, committees of central bank experts, and the European Central Bank.

On Oct. 10 the FSF presented to the G7 finance ministers and central bank governors these recommendations:

• Strengthen prudential oversight of capital, liquidity and risk management;

• Enhance transparency and valuation;

• Change the role and uses of credit ratings;

• Improve authorities' responsiveness to risks; and

• Set up robust arrangements for dealing with stress in the financial system.

The FSF also contemplated that market participants need to put in place central counterparty clearing for over-the-counter credit derivatives and achieve more robust operational processes in OTC derivatives markets. It added that accounting standards setters must work promptly to enhance and converge guidance on valuation of instruments and the accounting and disclosure standards for off-balance-sheet activities and their related risks.

Third, the Center for Economic Policy Research, which is a network of more than 700 research fellows and affiliates based primarily in European universities, has proposed a number of structural market reforms. These include a requirement that credit default swaps be exchange-traded and that naked credit default swaps (in which the purchaser does not own a stake in the underlying asset) should no longer be permitted.

In this regard it should be noted that the first credit default swap clearinghouse in the United States, ICE US Trust LLC, began processing and clearing credit default swap index transactions March 9, thereby establishing a central and neutral counterparty between market participants for credit default swap index trades. (Index-linked credit default swaps protect against credit events in a market as a whole, like the mortgage market.)

Finally, the FSF further proposed that credit rating agencies improve the quality of the rating process and manage conflicts of interest in rating structured products. The rating agencies would also demonstrate that they have the ability to maintain the quality of their services and allocate adequate resources to both the initial rating and the rating's regular review. They should also clearly differentiate, with either a different rating scale or additional symbols, the ratings used for structured products from those for corporate bonds.

Additionally, the Center for Economic Policy Research and other market participants propose that credit rating agencies be paid by investors rather than by issuers or at least that the link between rating agencies and the issuer be severed so that a rating does not affect the agency's future business with a given client. The CEPR also called for prohibiting indirect payments by issuers to rating agencies through the purchase of consulting or pre-rating services. Furthermore, it also proposed that rating agencies be regulated. Additionally, the content of the ratings given by these agencies should be validated by independent and credible institutions.

Conclusion

The current financial crisis has a finite lifespan, and recovery will ultimately follow. Its legacy will undoubtedly be the stricter regulation of financial markets, the players and the products involved including securitization. The respective legislators in the United States, the EU and other nations must generate effective solutions to minimize the possibility of a similarly severe global financial crisis occurring in the future. To this end, the G-20 nations are expected to propose implementing policies to strengthen financial market transparency, enhance sound regulation, promote integrity in financial markets and reinforce international financial institutions.

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