

## **Interactive Data Report: Observations from the 2010 American Securitization Forum Conference**

*Interactive Data sent a team of senior representatives from our Evaluations, Sales and Account Management groups to the 2010 American Securitization Forum Conference, held January 31, 2010 – February 3, 2010. Below is a report of their observations on the proceedings and notable items. We hope you find this report informative and we encourage you to contact your Interactive Data representative with any follow-up questions on the topics presented below.*

The American Securitization Forum (“ASF”) Conference, one of the premier annual conferences for the securitization industry, was held at the new Gaylord National Resort and Conference Center on the outskirts of Washington D.C. The estimated attendance of 3,500 was up significantly from last year and included a noticeable regulatory presence.

The theme of the conference could best be described as “How do we get securitization going again?” The overall mood was much improved from last year’s event; but any optimism regarding the recovery of securitization was tempered by concerns about economic weakness (particularly housing and employment), pending regulatory reform, and the future of government support/intervention programs.

There were over forty sessions offered at the conference. A summary of our observations and points of interest includes the following:

- The market for securitizations of residential mortgages is still “quite broken” according to one panelist.
- Approximately 66% of pre-conference survey responders believed that the RMBS market will not recover before 2011.
- There are widely held expectations that the CMBS market will face challenges going forward.
- There was a consensus view that the TALF program has been a success, but only helped sectors where liquidity was the problem. Markets for sectors with structural problems (such as RMBS and CMBS) were largely unaffected by TALF.
- A significant challenge to restoring the securitization market going forward will be how to deal with the overhang of impaired legacy securities.
- Regulatory reforms remain a hindrance due to the uncertainty of their form and substance. Government policies are increasingly politicized and may impede the recovery of securitization markets.
- “Skin in the game” retention proposals are seen as more problematic to the market than previously thought; possibly crowding out lower tier investors and causing regulatory capital problems for issuers.
- There will be a role for credit rating agencies going forward. The Nationally Recognized Statistical Rating Organizations (NRSROs) have made many enhancements, but the onus is on investors to understand what they are buying and what risks they are taking.
- Over-leveraged and overly complex deals will be less prevalent. Deal structures are likely to be more robust and collateral will be underwritten to higher standards.
- FAS 167, now codified as ASC Topic 810, will change the way issuer’s businesses are structured and organized.
- The exact future role of the GSEs (FNMA & FHLMC) is uncertain, but they are likely to remain a major factor in the residential mortgage market for the foreseeable future.
- FINRA is working on plans to extend reporting of trade information via TRACE™ to the securitized market, and eventually to CDS and OTC derivatives.

## **Selected Session Notes and Observations:**

### **Pricing and Valuation Challenges: Tools for Illiquid Instruments and Volatile Markets**

This panel generally agreed that markets had improved over the past year and that increased activity had improved transparency for pricing purposes. There was discussion led by a “Big 4” Accounting firm partner about the role of pricing services and the need for due diligence and a firm understanding of what they provide. There were also discussions about the difficulties of dealing with widely disparate broker dealer quotes.

### **2010 Securitization Market Outlook: The Way Forward:**

While not quite optimistic, this panel felt the markets had improved in the last year, but that considerable challenges remained. Results of a pre-conference survey of attendees revealed the following:

- 31% said that regulations and pending legislation are the biggest challenges to the securitization market
- 25% said that performance issues are the biggest challenge for the RMBS market
- 66% believe that the RMBS market will not recover until 2011 or beyond

*Other points of interest:*

- There is concern about the scheduled reduction of the Federal Reserve MBS purchase program. Spreads are expected to widen (25-50 bps.); only to tighten again in a few months as the market adjusts to the increased supply.
- There are \$1.4 trillion of CMBS maturing in the next three years. Most underlying loans will be extended and amended, as opposed to facing foreclosure and liquidations.

Another interesting topic the panel raised was whether rating agencies will bring more transparency to the ratings process. The panel agreed there will be some reforms needed for the risk-based capital treatments. With ten different ratings agencies there is some concern that ratings will change often and banks will have to adjust their cash reserves frequently. The market has clearly lost confidence in the NRSRO process and expects investors to bear the burden of additional credit research and due diligence.

### **Restoring the Subordinated Funding Market:**

This panel initially focused on the drivers of the crisis including the Community Reinvestment Act, loose monetary policy and aggressive mortgage lending. They indicated concern that reforms and cures such as loan modifications, are being politicized and may be counterproductive to the restoration of normalcy to the securitization markets. The following were deemed requirements for any restoration of subordinated lending (though consensus on the panel was that formal reform measures would not occur any time soon):

- De-politicizing of reform proposals
- Proper documentation requirements
- Return to strong underwriting standards
- Transparency into structure and collateral details
- Market finding the right “pricing point” (meaning that buyer demand price levels re-converge with seller supply pricing)

An optimistic observation was made that in the current market, “not the worst case scenario is starting to come into view”. This bodes well for markets given these worst case scenario fears have exacerbated market dysfunction. The panel suggested that the biggest current problem is that market spreads for subordinated bonds are simply too wide to support new issuance. However, investors are now more inclined to do better research and credit analysis to evaluate subordinated bonds.

### **Restoring the Private Securitization Market and Unwinding Government Support Programs**

This panel discussion focused on disclosures, due diligence and reform proposals. However, much of the discussion devolved into challenges and hurdles the markets face rather than ways to restore normalcy. It was suggested that the government must be careful in exiting support programs and that investors need to do more and better due diligence and not rely blindly on credit ratings. However, the sophistication of market analysis is already much greater since the crisis began. The only buyers left are smart buyers with good models.

The panel suggested that issuers must provide well underwritten and disclosed deals with resilient structures; that ratings agencies must do more to restore shattered confidence in their processes, and above all else, that underlying economic conditions (employment and housing) will drive any recovery, though the market still has a large number of impaired legacy issues to deal with.

### **Agency Mortgage Market Conditions and Outlook**

The Federal Reserve has been the largest buyer of MBS securities in the past year. This support program is scheduled to end in March 2010 and spreads are expected to widen. “Buy-outs” of troubled loans are expected to increase, causing prepayment speeds to increase. (Note that this prediction was realized with significant buy-out announcements from FNMA and FHLMC on February 10th). It was estimated that it will take at least 2 years for these buy-outs to work themselves out as foreclosure and disposition times are extending.

It was noted that the TBA market has functioned well throughout the crisis, lending credibility to an ongoing role for the GSEs. Current GSE pools contain some of the highest overall FICO scores ever, reflecting tighter underwriting standards. This is great for investors, but it’s making it harder for potential home buyers to access credit.

### **The Future of the GSEs**

This session was held in a large ballroom to accommodate the large number of attendees, although there was nothing particularly new introduced in the session. Panelists did note in detail the GSEs role in the financial crisis and how they were complicit by being over-leveraged (100 to 1) and lacking financial discipline. However, they acknowledged that government fiscal and monetary policy played a large role in the crisis as well, and that now the GSEs are a major element of government support for what Newt Gingrich called a “socialized” mortgage market. As such, there was general agreement that the GSEs are not going away, though there are various proposals to split them up or shut them down. There was universal agreement that such scenarios were unlikely in the near term, as general consensus is that it will take several years for the mortgage markets to fully recover. In fact, it was suggested that the opposite is likely to happen, and that the GSEs will remain the primary support pillars of the RMBS market.

### **Global Regulatory Outlook**

Greg Metcalf, Commissioner of the Australian Securities & Investment Commission (ASIC) described three C’s for the global regulatory outlook:

- *Coordination* - Accounting & regulatory bodies must work together and ensure there are no unintended consequences.
- *Convergence* - Rules & regulations should be decided on a global level.
- *Caution* - Consideration should be taken to make sure the market is not overloaded with new regulations that cause too much burden.

Other statements he made were about improving disclosure, risk retention requirements (“skin in the game”) and investor suitability requirements. He said disclosure should be standardized at a global level and that loan level data for collateral should be available on an ongoing basis, not just at issuance.

He also advocated that issuers should be required to retain the first loss piece to ensure that proper due diligence is performed. However, this is not a consensus recommendation for reform. In addition, in a repudiation of the “sophisticated investor” concept, he suggested additional suitability requirements need to be put in place to make sure conservative investors are not sold inappropriate investments.

### **Securitization Policy Reforms - The Shape of Things to Come:**

FINRA is currently receiving ABS/RMBS/CMBS trade reports from the broker/dealer community. They are studying the possibility of creating a trade reporting feed for this data. They are also considering transparency initiatives for CDS and ABS. FINRA considers transparency critical to returning trust to the markets and RMBS in particular.

One panelist commented on the danger that new laws and regulations will reduce securitization to secured financing. There is also concern that the combination of new risk based capital requirements, together with cessation of government support for the securitization markets, could create a more difficult market environment. In fact, no one on this panel was predicting any significant improvement in securitization markets in 2010.

There was some debate about whether risk retention (“skin in the game”) proposals are necessary on top of properly stated and disclosed reps and warranties. There was debate about the value of disclosure since much of the information desired is not available (property addresses, existence of second liens, etc.)

Another challenge is that the current market has too narrow a base of investors. Since the crisis, GSEs, SIVs, proprietary trading desks and many other traditional buyers have not returned and may not return. Covered bonds could be a securitization option, but they don’t allow for the transfer of risk that banks need to get the multiplier effect of securitization.

### **Credit Rating Agency Business and Regulatory Reforms:**

This panel was populated by rating agencies, legal and regulatory personnel. It was observed that the ratings agencies have instituted the following reforms as a result of the crisis, and to comply with reform proposals:

- Changed rating criteria
- Issued more presale reports
- Requested public comments on new methodologies
- Increased surveillance
- Strengthened analytical integrity
- Applied methodologies more consistently across asset classes
- Separated rating and non rating based activities
- Started offering stress testing reports
- Introduced loss severity ratings

Possible SEC Reforms discussed included:

- Disclose how ratings agencies differ from each other
- Require disclosure of preliminary rating assessments
- Provide loan level data
- Hold ratings agencies liable for ratings
- Change from issuer pay model (though there are no specific proposals yet)

### **RMBS Due Diligence and Quality Assurance**

As one might expect during or after a crisis, this panel commented regarding the need for due diligence and quality assurance. They agreed that, as investors, they must validate the processes and procedures of the originators to detect fraud at the beginning of the process. Fraud detection measures need to be employed by originators; there are software tools readily available which need to be implemented. The sampling and testing of loans included in deals must be improved before acceptance of collateral pools.

The interesting observation here is that outright fraud was a relatively minor element of this crisis. Lax underwriting standards, aggressive lending and leveraged deal structures were a much greater part of the problem. Nevertheless, investors are following the old adage “once burned, twice shy” with respect to pre-purchase due diligence.

#### **RMBS Traders/Researchers Round Table:**

This panel commented that Home Price Appreciation (“HPA”) is not currently as much a factor in modeling delinquency rates as it was in the past. Unemployment will be the driving factor for delinquencies over the next couple of years. Delinquency roll rates for prime loans is still rising, while subprime and Alt A rates have peaked.

The “shadow inventory” of unsold homes is about equal to current annual home sales. Given that new demand for homes increase at about one-sixth of annual sales, it will take 4-5 years for inventory supply to come into balance with demand.

FICO scores continue to rise for new agency issuance, reflecting tighter underwriting standards. Loan to Value (“LTV”) ratios are the biggest determinant of ability to refinance, not FICO scores. If LTVs improve, good borrowers will refinance out of subprime pools leaving the remainder of pools more risky.

Subprime severities are coming down, but prime loan severities are going up. Loan modifications rarely move out of the trial period due to borrowers not providing affidavits and proof of income. This is an ominous pattern revealing serious underlying problems with these loans and borrowers. On a positive note, 75% of borrowers in modification trial periods are current on their loans. However, only 4% move out of trial periods into finalized modification. Principal reduction modifications have performed poorly. The panel noted that this may reflect the fact that principal reductions are offered in extreme situations and to poor quality borrowers. It is possible that no form of modification can cure these types of loans.

It was suggested that tightening (price improvements) in subprime and Alt A markets has had much more to do with the reduction in risk premiums than changes to default and severity assumptions.

#### **Mortgage Modifications Loss Mitigation Trends: Impacts on RMBS Performance:**

This panel reported that modifications of troubled loans are currently being performed by over 100 servicers and are expected to be offered to 3 to 4 million borrowers by 2012. To date, one million borrowers have been offered modifications and 900,000 have accepted. However, only 100,000 modifications have been made permanent due to borrowers not completing affidavits and verification of income. Chase stated that 51% of their modifications have paid as agreed, but borrowers with loan LTVs of >120% (i.e. negative equity of 20% or more) are likely to abandon properties instead of continuing any payments. Only 33% of 30 day delinquencies are curing (i.e. returning to current payment status). The comparable number was 80% in 2005. Negative equity was cited as the greatest driver of defaults and second liens are a major reason for negative equity status. Overall, 51% of all borrowers have a second lien and 43% of defaulted loans have a second lien.

#### **Risk Managers Roundtable**

A memorable quote from this panel was “interest rate risk can wound, but credit risk can kill”. They all felt that risk management needed a better audience with boards so they can understand the true risk profile of company operations. They also talked about getting the “lab coats” off the risk managers, and engaging more with front line personnel.

### **Distressed Debt Investment Strategies:**

This panel was fairly pessimistic. Current security price levels may appear attractive, according to one panelist, but must be approached with caution. There are instances where bond prices, though low on an absolute basis, seem rich compared to intrinsic value. Fundamentals still appear to be worsening relative to last year (or at least flat), yet some paper is still getting bid up to rich levels.

Liquidity continues to be a key factor. Not many investors have the infrastructure or ability to profit from technical market opportunities. Exit strategy and execution are critical to exploiting opportunities in these distressed markets. Going forward there are many unknown variables for distressed investors including regulatory factors, the time to resolution for distressed properties, and loan modifications.

### **Reverse Mortgage Securitization**

Given the relative immaturity of this product, this session was somewhat tutorial. The first reverse mortgage deal was done in 1999. That deal currently has a factor of .50 reflecting the fact that these deals pay down slowly.

Reverse deals have actuarial risk as they typically pay down only from mortality and mobility. Refinancings are extremely rare. In a reverse deal, borrowers do not make periodic payments. The deal assets are the accreting unpaid balance of loans. Rating agencies require that reverse deals must be able to handle the stress of a 30% HPD (home price depreciation). Reverses are currently trading at 175-200bp discount margin, which is cheaper than better known SBAs and FNMA DUS.

All reverse mortgage loans have HUD insurance, but not to 100% of the loan balance. There is crossover risk (risk that value of homes crosses over value of loans due to declines in home prices). However, unless loans are in default, investors can put them back to HUD when the LTV reaches 98% of predefined maximum claim amount. Approximately \$5.5 billion of fixed and \$3.5 billion of floating HMBS have been issued. Remittance reporting by servicers needs improvement. Structures and cash flows will be provided to Intex and Bloomberg by the end of 1st quarter 2010.

### **Emerging Securitization Sectors:**

This session focused on non-traditional securitizations such as: franchise fees, broadcast rights, intellectual property rights, pollution credits, cell towers, windmills, aircraft, life settlement contracts and whole business securitizations. The theme was that investors are looking for transparency into collateral and that deal structures must be robust and resilient in the face of market distress. It was acknowledged that liquidity was not a prominent feature of these types of issues, but there are yield opportunities because of that. Panelists talked about the concept of “junk in the box”, meaning some previous securitizations were supposed to have AAA rated collateral, but wound up with re-securitized CDOs and other risky assets. New securitizations will have to have greater protections from insolvency, though recent judicial actions related to Lehman and others cast doubts on the impenetrability of these structures.

### **Commercial Mortgage Securitization:**

It was noted in this panel that the CMBS market is trading again, but there have been few new deals. Issuance was \$250 billion in 2007, \$12 billion in 2008 and \$3 billion in 2009. Estimates are for \$20 billion in new deals in 2010. The average Loan to Value ratio in new deals has been 52%, which is high from traditional averages. There is huge demand for high quality deals, but very little demand for marginal deals. CMBS spreads have tightened from 1500bp to 300bp. This was the first market to tighten after the crisis, but recovery of issuance will be related to economic recovery and will have much tighter underwriting standards.

About \$1.4 trillion CMBS come due in the next three years. CMBS is trending toward “amend and extend” policy for troubled loans rather than foreclosure. However, deeply underwater properties will still need to be foreclosed. There is too much uncertainty in loan modifications for most investors to accept them. Delinquencies appear to be

headed from current levels of 5% to 12%. The 2008 vintage is at the highest risk, but there is also little or no equity behind 2006/2007 issuance, putting them at risk as well. CMBS have had a much worse decline in this crisis than that of the early 1990s. The panel's opinion was that the commercial real estate market is still far from the bottom. If recovery is slow, there will be further downgrades.

CMBS has been the best performing part of the private market. The multi-family market is doing well due to FNMA/FHLMC purchases. TALF will be winding down, but the CMBS market is beginning to function without it. FDIC liquidation of small banks will put a lot of commercial loans on the market creating possible supply challenges.

Pooling and servicing agreements of different CMBS deals are often quite different because they are tailored to satisfy the B-piece buyers. It is often unclear as to whether the special servicer can modify loans prior to actual default. It is also often unclear what the tax implications of loan modifications are. The CMBS recovery may not occur any time soon since real estate is down approximately 40%, but appreciates at an average of only about 3% per year.

#### **Auto ABS Sector Review:**

TALF was noted as a great success for this sector. As for the post-TALF environment, panelists generally believe that the market should be able to stand on its own as non-TALF buyers will step in. Concern seems to be more focused on fundamentals, such as consumer credit and auto sales in the absence of stimulus programs such as the "cash for clunkers" program.

#### **Overview of the Consumer Economy (Panel of Economists)**

There was little optimism from this panel of economists. While housing affordability is at its best level in years, consumers are too over-leveraged to take advantage of it. The negative equity issue is also a big problem. Home owners with negative equity will not be able to refinance or move to where the jobs are. This will hamper the employment picture putting further pressure on the economy and the housing market. Shadow inventory will also put pressure on the housing market for years to come. One panelist does not see the housing market getting better until 2012, with house prices potentially falling an additional 10% from current levels.

#### **Limitations & Additional Information**

*This document is provided for informational purposes only. The information contained in this document is subject to change without notice and does not constitute any form of warranty, representation, or undertaking. Interactive Data Pricing and Reference Data does not provide investment, legal, tax, accounting, or other professional advice. Clients should consult with an attorney, tax, or accounting professional regarding any specific legal, tax, or accounting situation.*

*Interactive Data Pricing and Reference Data makes no warranties whatsoever, either express or implied, as to merchantability, fitness for a particular purpose, or any other matter. Without limiting the foregoing, Interactive Data Pricing and Reference Data makes no representation or warranty that any data or information (including but not limited to evaluations) supplied to or by it are complete or free from errors, omissions, or defects.*

*Interactive Data<sup>SM</sup> and the Interactive Data logo are service marks of Interactive Data Corporation. Other products, services, or company names mentioned herein are the property of, and may be the service mark or trademark of, their respective owners. Pricing, evaluations and reference data are provided in the U.S. through Interactive Data Pricing and Reference Data, Inc. and internationally through Interactive Data (Europe) Ltd. and Interactive Data (Australia) Pty Ltd.*

© 2010 Interactive Data Pricing and Reference Data, Inc.