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Projecting the future regulation of securitisation

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IOSCO TASK FORCE – BACKGROUND, FOCUS & MEMBERSHIP

As you are all no doubt aware, a key focus of the G20 has been the consideration of the causes and effects of the Global Financial Crisis and the development of recommendations for regulatory action to restore confidence in the international financial system.

In November of last year, the G20 called for a review of the scope of financial regulation with a special emphasis on institutions, instruments and markets that are currently unregulated.

It is through global bodies such as the International Organisation of Securities Commissions, or IOSCO, that national regulators are able to co-operate to develop consistent and appropriate regulatory principles, and in support of the G20 mandate, IOSCO announced a number of initiatives designed to strengthen financial markets and investor protections, including the establishment of the Task Force on Unregulated Financial Markets and Products, or TFUMP In November 2008.

IOSCO has charged the Task Force with examining ways to introduce greater transparency and oversight to segments of the unregulated financial markets, such as the OTC markets for derivatives and other structured financial products.

In considering its mandate the Task Force has focused on those systemically important markets and products that are integral to the restoration of trust and confidence in international financial markets.

The Task Force is co-chaired by Australian Securities Investment Commission and the Autorité des Marchés Financiers of France and its 12 member countries include a number of other key regulators, which have been active in seeking to shape the international regulatory framework following the Global Financial Crisis. The taskforce includes UK Financial Services

Authority, US Securities Exchange Commission and the Commodities Futures Trading Commission regulators of 10 other countries including:

- Germany (BaFin)
- Hong Kong (SFC)
- Italy (CONSOB)
- Japan (FSA)
- Mexico (CNBV)
- The Netherlands (AFM)
- Quebec (AMF)
- Spain (CMNV)

All of the members of the Task Force have provided invaluable input.

CONSULTATION REPORT - OVERVIEW

The IOSCO Technical Committee released the Consultation Report of the Task Force on the 5th of May.

The Consultation Report focused on securitisation and Credit Default Swaps or CDS.

The Task Force has considered these particular areas of unregulated financial markets and products due to the significance of securitisation and CDS to credit availability in the real economy, their contribution to the management of individual and systemic risks, their recent rapid growth and the important role they play in global markets.

The Consultation Report, while encouraging industry initiatives, identifies in general terms possible areas for initial and immediate regulatory actions that could be undertaken within the context of the current market situation and sets out interim recommendations in this regard.

Consultation Report acknowledges that industry bodies have proposed, and in some cases implemented, important changes in their respective industries.

However, the Consultation Report also acknowledges that industry initiatives have limits and therefore should, where appropriate, be supplemented by regulation.

As I previously mentioned, the aim of the interim recommendations, and indeed the Task Force, is to restore the confident participation of investors in these markets by promoting fair, efficient and orderly global financial markets.

In seeking to achieve this, taskforce recognises the need for regulators to address the risks posed by these unregulated financial markets and products in a structured and rational way and acknowledges the important input which industry can provide regulators in developing regulatory architecture.

The Task Force held industry consultation last Friday in Madrid and from taskforce's perspective we found it extremely helpful in better understanding the concerns that industry has in respect of the securitisation interim recommendations.

No doubt, the various representative bodes of the securitisation industry will update market participants on the consultation and submit formal written comments on the Consultation Report in due course (as a reminder, the consultation period finishes on the 15th of June), but I will touch on the main themes of the consultation at the end of this address.

Post-consultation, the Task Force will be updating the IOSCO Technical Committee on the progress of its work and presenting our final report to the Financial Stability Board in June/July. The final report, in addition to a range of work conducted by other IOSCO committees will feed into the ongoing work of the G20.

As the name of this address suggests, I will now focus on the future regulation of securitisation markets in the context of the interim recommendations of the Consultation Report.

The interim recommendations for securitisation are grouped under three categories:

- wrong incentives;
- inadequate risk management practices; and
- regulatory structure and oversight issues.

Given the time that we have for this address, I will not attempt to outline all of the interim recommendations of the Consultation Report.

Instead, I will draw out what I see as the three key interim recommendations that will have the most impact on the securitisation market and its participants.

These key interim recommendations in turn raise a number of different considerations for regulators and for industry participants, which will no doubt feature in the panel discussion.

The three key interim recommendations are:

- mandating enhanced disclosure and transparency;
- the review and strengthening of investor suitability requirements; and
- retention of a long-term economic exposure to securitisations (also known as 'skin in the game').

DISCLOSURE & TRANSPARENCY

Disclosure is one of the areas in which the Task Force has considered industry initiatives and the interim recommendations are aimed at ensuring that the quality of information provided to investors allows them to accurately assess and price their investments.

The Task Force both recognises and encourages a number of important industry proposals in this area, and I would like to briefly mention two of these:

- the European Securitisation Forum's RMBS Issuer Principles for Transparency and Disclosure; and
- the American Securitisation Forum's Project RESTART.

As a regulator, it is encouraging to see industry-led developments such as these, nevertheless given the magnitude of the Global Financial Crisis, the current state of the securitisation market and the importance of securitisation markets to international financial markets as a whole, it is apparent that industry initiatives alone will be insufficient to restore transparency, integrity and quality to the securitisation market.

The perceived flaws in the "originate-to-distribute" model are an example of this. The Consultation Report focuses on the flaws in this model and seeks to address these flaws through a realignment of the incentive structures within a securitisation transaction.

The **first** element of the interim recommendations for disclosure and transparency is enhancing transparency through the disclosure by sponsors, underwriters and/or originators of the due diligence, verification and risk assurance practices conducted for a securitisation.

Regulators must monitor the consistency of due diligence, verification and risk assurance practices within markets, and where industry does not establish sufficiently consistent practices, regulators should consider mandating best practices.

The **second** element of the interim recommendations is, consistent with industry proposals, requiring improved initial and ongoing disclosure of information about the underlying collateral.

The **third** element is the disclosure of the details of the creditworthiness of those parties who have direct or indirect liability to the issuer of the securitised product.

This element is particularly focused on repurchase arrangements in securitisation transactions where there has been a breach of a representation and warranty as to the eligibility of the underlying collateral.

In order for investors to be able to assess the strength of any repurchase obligation the counterparty risk of the party with the ultimate repurchase obligation should be disclosed.

INVESTOR SUITABILITY

The enhancement of disclosure and transparency is only one side of the regulatory equation. Improved information disclosure and dissemination to investors may not be effective if investors do not undertake, or do not have the capabilities to undertake, appropriate risk assessment and management of the securitised products they acquire.

In considering investor suitability, we are reminded that one of the criticisms of the securitisation market has been the sale of securitised products to investors who may have:

- failed to comprehensively understand and assess the risks attached to the securitised product; and
- relied too heavily on credit rating agencies.

The broad theme of Investor suitability again can be broken into a number of different elements:

- mitigating the issue of inadequate risk management practices by imposing an obligation on sell-side (distributors/issuers of securitised products) to ensure the product is suitable for the investor.

  This could be based on a reasonable assessment of the financial and other characteristics (such as understanding of the product or ability to assess and manage risk) of the investor; and
- individual jurisdictions reassessing their respective tests and/or exemptions for "sophisticated investors", including focussing on the skill set required by investors to comprehensively assess and manage the risks of a securitised exposure.

In addressing investor suitability the interim recommendation of the Consultation Report provides for strengthening:

- investor suitability requirements; and
- the definition of a sophisticated investor.

SKIN IN THE GAME

This brings me to the third and final key interim recommendation of the Consultation Report - requiring originators and sponsors to retain a long-term economic exposure to a securitisation.

I will refer to this requirement as "skin in the game" and I am sure many of you will be keen to discuss this in the panel discussion following my address.

Without going into the subtleties of the amendments and put simply, the net economic interest can be held in a number of ways by retaining;

- a portion of the issued tranches sold to investors;
- in a revolving securitisation, a seller's share;
- randomly selected exposures; or
- the first loss positions in the capital structure.

Any discussion of a skin in the game requirement must acknowledge the developments in Europe and the United States in addressing what policy makers and regulators clearly see as a fundamental issue for the securitisation industry.

In Europe, the amendments to the Capital Requirement Directive will restrict regulated credit institutions from taking on an exposure to a securitised product unless originators, sponsors, or the original lender has explicitly disclosed to the institution that it will retain, on an ongoing basis, a material net economic interest. The amendments impose the skin in the game requirement on the buy side.

In the United States the skin in the game requirement is included in the Mortgage Reform and Anti-Predatory Lending Act. The Act has been passed by the House of Representatives and is currently before the Senate.

The Act requires any creditor that originates a residential mortgage loan (that is not a **qualified mortgage loan**) to retain an economic interest in a material portion of the credit risk for any such loan that the creditor transfers, sells, conveys or assigns.

The material portion of the credit risk must be at least 5%.

In contrast to the European amendments to the Capital Requirements Directive, this legislation imposes the skin in the game requirement on the sell-side.

Again, without going into the subtleties of the legislation and put simply, a qualified mortgage loan is essentially a loan that has 'prime' characteristics.

This is important to understand because it appears that the legislation in the US only affects those creditors who are selling "non-prime loans".

Given the legislative developments to date, and the prominence that this issue receives in the Consultation Report, I am sure you will agree that the imposition of a skin in the game requirement is the main issue for the securitisation industry.

However, the skin in the game requirement is also an important issue for national regulators as they consider the economic cost of any requirement and the impact on credit intermediation within their jurisdiction.

The two approaches outlined above are not the only measures that may be taken by national regulators in seeking to realign the incentives within the securitisation value chain and indeed national regulators are likely to consider

the specifics of any skin in the game requirement in their jurisdiction, such as the percentage level of the exposure to be retained or whether a more risk-sensitive approach is taken.

That said, the Consultation Report emphasises the importance of national regulators considering the appropriateness of a skin in the game requirement for their particular regulatory regime.

INDUSTRY CONSULTATION

Last week the Task Force conducted a consultation forum with a number of industry participants from both the Securitisation and CDS markets.

I would like to take this opportunity to publicly thank all participants for their time, and for their useful contributions to the development of the final report and recommendations. There were 3 major themes from the consultation

1. The first theme was that the infrastructure of securitisation is being strengthened across the value chain by recent and prospective steps both mandated and adopted as standards by the industry. And there is general support for mandating many of these standards. A good example of industry standards is the ASF's Restart Project, and the ESF's disclosure guidelines, but also industry initiatives in investor education and due diligence standards. Already mandated measures include the Responsible lending rules from the US Fed
2. The second theme to emerge internationally has been that global co-ordination among industry is critical. We must ensure that consistent standards are developed to strengthen investor trust and confidence
3. The third theme: that there must be global co-ordination between IOSCO and industry to deliver consistent consultation and regulation across borders and jurisdictions

Conclusion

The future of credit intermediation will involve a combination of traditional on balance sheet financing and securitisation and the Consultation Report recognises that securitisation when managed appropriately can facilitate credit intermediation and diversify risk.

From the taskforce's perspective, the challenge for industry and regulators is to work together to appreciate and evaluate the risks inherent in complex financial transactions and for the taskforce to consider regulation which addresses the risks posed by securitisation in a structured and rational way.

And to those who have yet to contribute, our consultation phase is open until June 15, and I'd encourage you to contribute to this very important discussion.