



FINANCIAL SERVICES

Better Braking for ABS: Reform Proposals for the Asset-Backed Securities Market

By

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- The market for asset-backed securities (ABS) – financial instruments backed by underlying assets such as mortgages – suffered a major setback in 2007, as a cascade of downgrades and defaults brought turmoil to credit markets and the world economy.
- Authorities in the United States have since proposed sweeping changes to the ABS market. The Canadian Securities Administrators, representing provincial securities commissions, recently released a discussion paper proposing similar reforms, which would require: (i) sharply enhanced transparency in ABS structures, (ii) CEO certification of the adequacy of such structures, and (iii) disclosure of previous asset repurchases by the securities' sponsor.
- Transparency is an important building block for market comfort, but the reform proposals need to go a step further. They should require, as a condition for allowing a potential ABS issue to be sold on the public market, participation by investors who have the expertise and incentive to assess the viability of the ABS.
- As in the motor vehicle insurance market, where insurers have a vested interest in reviewing car systems' engineering, we recommend that Canadian reform proposals include a requirement for participation by specialized third-party institutions who would take risk positions ranking behind senior investors in creditor priority. This would serve as a ratification of the intentions of issuers and a validation of the views of rating agencies.

Imagine this: the failure of a popular new antilock brake system causes a rash of automobile accidents. In addition to property damage and personal injury, the situation casts a shadow of uncertainty over the world economy, as auto sales slow and nervousness over car safety deals a blow to consumer confidence and commercial activity. All of this uncertainty arises in the face of and in part because of the express approval of the new technology by all recognized automotive publications, putting in doubt the effectiveness of the entire regulatory system and safety checks within the industry.

The government, in our hypothetical example, acts to quell the crisis. It brings forth legislation requiring auto manufacturers to publish every relevant technical detail on new braking systems and to provide safety test data in sufficient detail to allow potential retail buyers to review and confirm or reject both the parameters and results of the testing. Vehicle manufacturers' CEOs are also required to provide to buyers a certificate stating that, to the best of their knowledge, the antilock brakes would safely stop the car in all foreseeable circumstances; senior officers are required to own and drive cars produced by their companies. Finally, manufacturers are required to disclose to prospective buyers the recall data for all of their vehicles.

The regulatory response to this hypothetical crisis sounds entirely reasonable, but on deeper reflection inadequate. Are all drivers expected to be experts in the engineering of ABS, and to be capable of interpreting technical and safety test data? Are they really expected to rely on certificates from CEOs, who might be engineers by training, but whose day-to-day function is far more oriented towards business and finance? Will forcing disclosure of all recall data help, or make manufacturers more reluctant to conclude that safety concerns merit issuing recall notices?

The answers to these questions seem obvious, yet this is exactly the "fix" that has been proposed in North America for another kind of "ABS" – the asset-backed securities market. In 2007, a cascade of downgrades and eventual defaults of highly rated securities, backed by US subprime residential mortgages, brought global credit markets to their knees. Once investors, including banks, lost confidence in the reliability of ratings, they lost confidence in the creditworthiness of each other, as suspicions grew over the extent and composition of each institution's holdings of rated structured securities. Credit markets reached a point of near lock-up. Only drastic interventions, including unprecedented infusions of liquidity by governments around the world, spared us from a complete lock-up of capital markets. In the wake of the crisis, legislators and regulators signalled that changes were needed to ensure that a run on confidence in ratings could never again bring global markets to the brink of disaster.

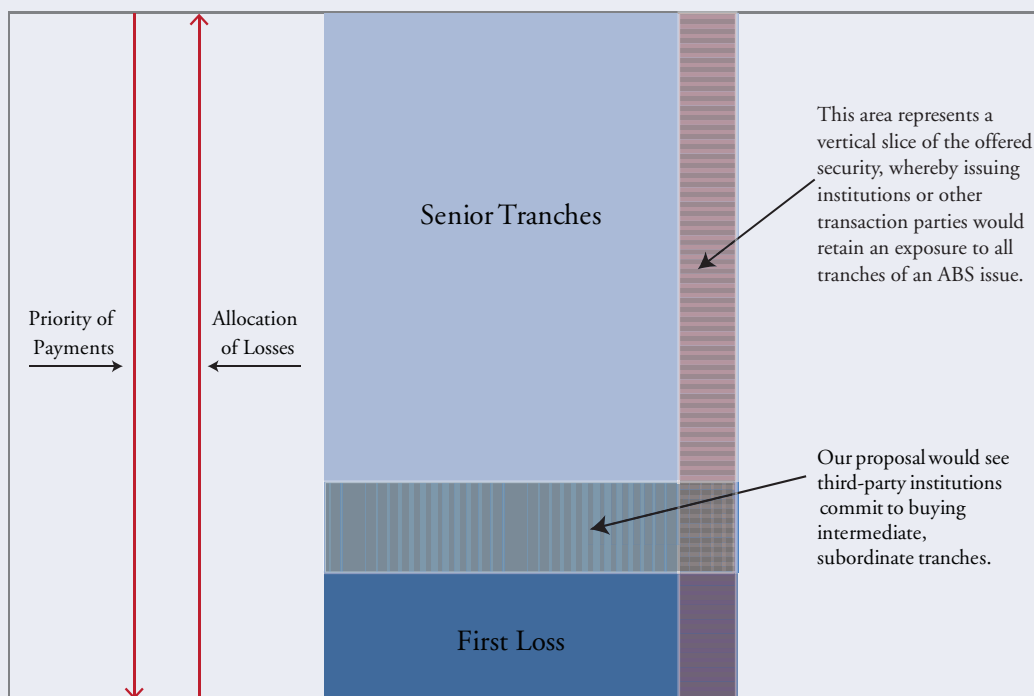
The US response was as described in the analogy above. Issuers in the broadest public market for ABS¹ will in future be required to provide (i) sharply enhanced transparency with respect to the mechanics of the structuring of ABS, (ii) CEO certification of the adequacy of those structures, and (iii) disclosure of the history of asset repurchases by the same sponsor. Further, sponsors, issuers or other transaction parties will be required to retain a proportionate vertical slice of the offered securities, meaning that they will have to maintain a net economic exposure to all the different classes of an ABS offering (Figure 1). In April 2011, the Canadian Securities Administrators, representing provincial securities commissions across Canada, released a discussion paper proposing much the same regime, with a request for comments to be received by August 31, 2011.

Few will take issue with the principle of transparency as a building block for investor confidence in a complex market. Even if not every car driver or securities investor can understand ABS engineering, the availability of the structures' details might ensure that the small group of market participants that can interpret such information has the ability to do so, and that goes some way to protecting all of us. However, a more complete solution would ensure that there existed a mechanism to place this information in the hands of someone, other than the engineer, who has appropriate expertise and who will put himself at financial risk, based on an independent judgment of the technology's merits.

We have that assurance in the auto market. Government regulations in most of North America require cars to be licensed, and a condition of licensing is that drivers maintain third-party liability insurance on their vehicles. Insurance companies have the first risk of loss in the context of a third-party liability event with respect to an insured vehicle. To protect themselves in the context of this exposure, insurance companies employ experts who review the engineering of crucial systems and examine accident statistics, and raise the price of insurance or refuse to insure models or technologies that

¹ The US proposals described herein only apply to ABS issuance through so-called shelf prospectus eligibility, whereby issuers are able to qualify large amounts of securities for subsequent issuance, a process that offers some timing advantage to issuers.

Figure 1: Stylized Structure of an ABS Issue



Source: Authors' calculations.

appear too risky. This makes them more than experts providing opinions: they are market participants at economic risk on the basis of their own risk assessment.

It is this second component that is missing from current regulatory proposals for asset-backed securities. As we have argued recently (Allan and Bergevin 2010), transparency without a mechanism for ensuring participation by objective market gatekeepers – specialized investors who have the expertise and experience to put that transparency to use² – will not facilitate participation in the ABS market by as many senior institutional investors as possible. The best gatekeepers are investors who have the level of specific asset class and structural expertise to assess the adequacy of the first-loss protection available, with respect to a particular asset-backed security, and determine the price they are willing to pay for such a security. Buyers of intermediate tranches of ABS will tend to take into account the stated rating in benchmarking price relative to other market-traded securities, but they do not rely on rating agency assessments in evaluating the underlying credit risk. Their actions can serve to validate rating agencies' assessments of those securities.

The Canadian Securities Administrators current proposals are more likely to limit participation as senior ABS investors to people or institutions who consider themselves experts. That may sound desirable from a regulatory standpoint, but a new

² In the context of every asset class (residential and commercial mortgages, vehicle and equipment leases and loans, credit cards, etc.), there are institutional investors who purchase portfolios of whole loans that have been originated by third parties. These same institutional investors will also from time to time leverage their asset class expertise by buying subordinated tranches of securities that are backed by portfolios of assets of that class. In doing so, they can earn a premium return on their exposure to such a portfolio, without exposing themselves to the first loss risk that they undertake in the context of their whole loan purchases.

model for the senior ABS market that limited itself to those who are intimately conversant with structured credit models could not offer the liquidity needed to meet the demands of a North American economy seeking to shake off a recessionary outlook.

A new regime for the asset-backed market must include a requirement for participation by the functional equivalent of auto-liability insurers: third-party institutions who commit to buying securities that rank just behind those held by senior investors and upon whose expertise those senior investors can rely, as a ratification of both the intentions of the issuers and the views of rating agencies. We hope regulators in the US and Canada recognize this shortcoming in their current proposals, and incorporate requirements for the participation of subordinated third-party investors in the public issuance of senior ABS. Only then could we safely, once again, venture out into the traffic.

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