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The re-emergence of RMBS as a funding mechanism – will it be different this time post crisis?

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What I am going to cover

- Securitisation - a quick recap
- The growth and subsequent demise of the leveraged funding models
- RMBS performance
- Why RMBS is a good funding tool
- Retail funding an alternative?
- Continued barriers to issue
- Looking forward – funding outlook
- Conclusion

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Securitisation – a quick recap

- Assets such as loans and cash flows
- Importance is to be able to determine risk and cash flow characteristics
- Subject to this most things can be securitised e.g. Formula 1 receivables and Lansons Champagne production
- Residential mortgages are particularly good because:-
  - Large market
  - Cash flows and credit performance is well documented over credit cycles
  - Charge over the residential property and cash flows can be taken

Securitisation – a quick recap

- Loans are first pooled and then transferred into a special purpose vehicle
- A trust arrangement is created across the entire structure giving noteholders the benefit of any security and credit enhancement structures within the transaction
- RMBS deals are structured so as to be able to independently survive significant credit stresses such as major house price collapses (in the order of 50% across the board) and borrower defaults
- Credit support is provided through capital injected by the originator, further subordination structures between different note classes and external liquidity support mechanisms
- The credit and operational risk of third parties managing the issue is taken into account
- Losses within European RMBS transactions has been extremely low and their resilience has stood up to recession - it works!

The growth of the leveraged model – some UK history

- UK mortgages traditionally retail funded, but then the model changed in the 1980s and lending really took off in the 1990s
- Mortgage backed securities started to be issued in 1984 but didn't become mainstream funding mechanisms until the late 1990s
- This was because of the 'magic' of leverage
  - Basel played a part in 'sophisticated' risk weighting tools
  - Banks, regulators, rating agencies and investors were convinced that their analysis of risk and structured products to deal with it were robust
  - Investors were able to fund their investments through highly leveraged facilities secured on the bonds purchased
  - Investors were:
    - Banks
    - Hedge Funds
    - SIVs and
    - Pension funds
  - 100 times leverage wasn't out of the question!
- Funding was plentiful and cheap

The death of the leveraged investment model

- Leveraged investors were among the first casualties of the credit crisis
- Facilities funding leveraged investment funds were secured on bonds purchased
- Falls in secondary market value – ‘mark-to-market’ - of bonds led to cash calls and then failure
- Although not a measure of underlying bond or mortgage performance, with no buyers and no liquidity, prices fell to fractions of face value, followed by:
- Total withdrawal of the Mortgage Backed Securities markets, and
- Freezing of the wholesale markets

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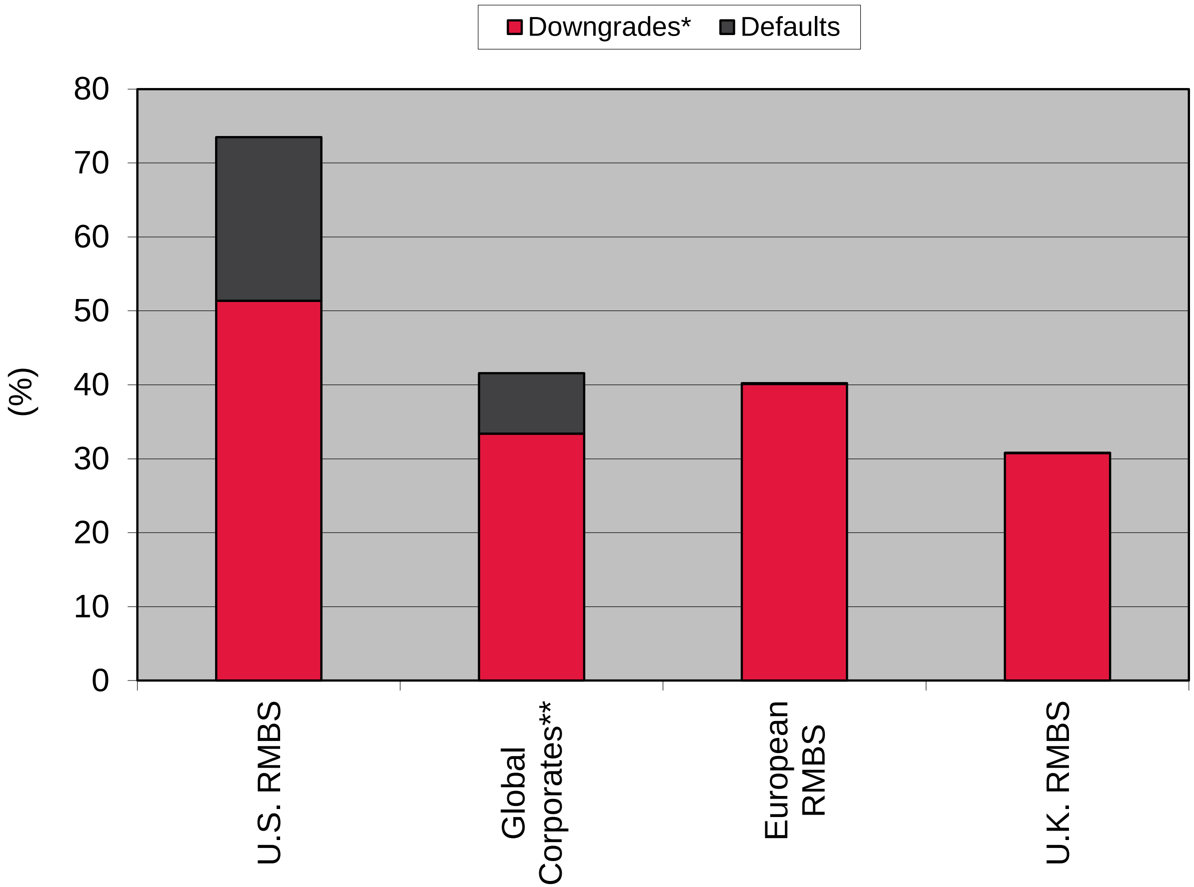
But the UK and European market has performed well

- The Global Financial Crisis and subsequent recession tested mortgage lending and RMBS quality and structural integrity
  - UK mortgage assets have performed well because:
    - We did not have the scale of over-building seen in the US, Spain and Ireland
    - Lending standards did not fall in the way they did in the US
    - Risk retention by RMBS issuers was the norm in the UK – not in the US
    - Lower interest rates and forbearance have helped underpin the market but lenders report that more expensive fixed rate loans have performed nearly as well
- Mortgage funding now has a demonstrable track record of performance through difficult times

European RMBS has seen very few defaults

Rating downgrade and default rates, Q2 2007-Q4 2013



* Excluding defaults; ** By number of ratings. Source: Standard & Poor's

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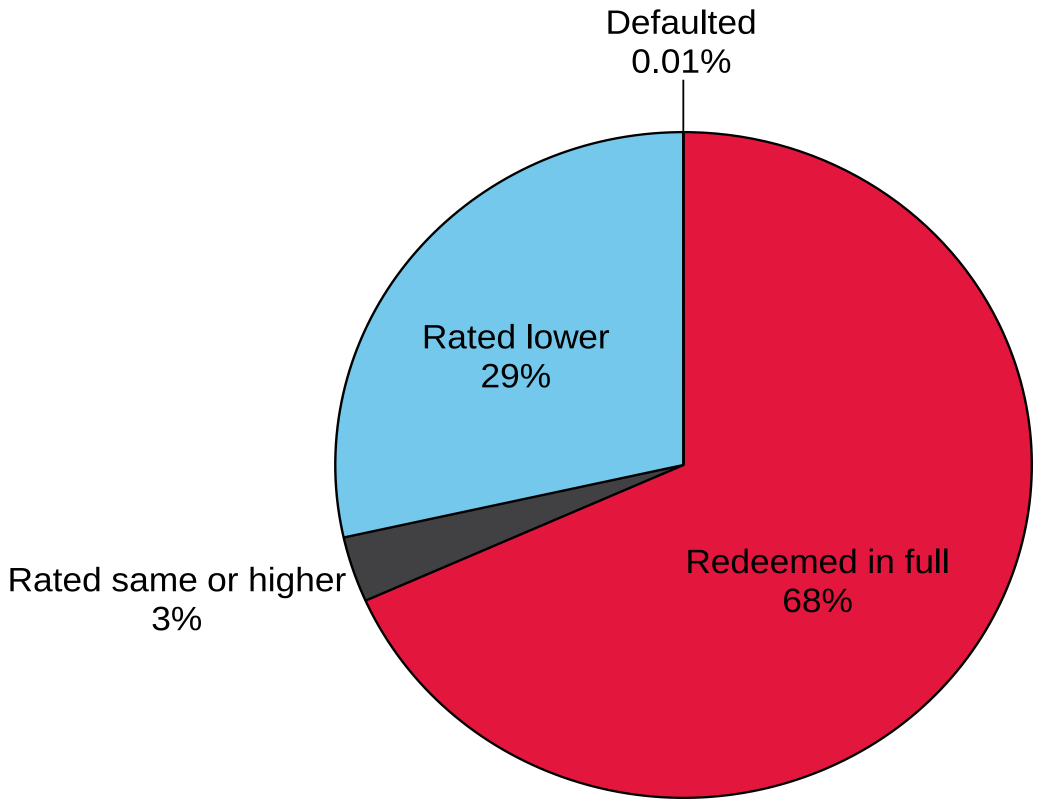
Many pre-crisis bonds have fully redeemed

Status of U.K. RMBS outstanding in mid-2007, as of Q4 2013



Source: Standard & Poor's

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Securitisation – why it's so good

- Securitisation has provided a significant proportion of all mortgage funding – 27% in the UK in 2006
- It is excellent funding for three reasons:
  - it matches funds to maturity of mortgage assets
  - it has undergone a stress test by ratings agencies to ensure it can survive the sort of downturn we have experienced
  - most importantly in these times, it is subject to continuing external oversight
- A largely good track record in Europe
- In the UK - prime RMBS issuance between 2003 to 2005 was broadly sound and the performance of assets maintained – AAA/AA senior investors have not lost a penny

Exploding a few myths on retail funding

- Retail funds – how useful?
- Good but not the panacea to funding problems as inherent pricing and maturity mismatch
- More competition means costs escalate and less monies available to fund longer term assets – duration shortens
- And it's a new world – who knows how mortgages will behave in terms of duration?
- Likely less redemptions so average term increase
- Retail funds become less useful and more costly way of funding going forward
- Net Stable Funding Ratio
- Need to execute other instruments

Perceived weaknesses in RMBS

- Lack of liquidity in securitisation markets
- Structures too opaque and too complex
- RMBS thought to be ‘risky’ instruments
- Over reliance on rating agencies and lack of transparency/consistency between agencies
- Investors didn’t understand the collateral
- No ‘Skin in the Game’

Transparency Initiatives

The most popular measure to increase investor understanding of collateral is loan level data

- Initial proposals to standardise across rating agencies and regulators have not materialised
- Bank of England, ECB and SEC require loan level data and greater disclosure in reporting
- Clearer Offering circulars
- Issues over availability and completeness
- Secure data rooms to be used but access will need to be managed

Looking forward

- Lack of leveraged investors has dampened demand significantly – for good?

- Positively:
  - RMBS/Covered bond issuance has been stable to rising
  - CRD IV, transparency and "high quality" initiatives should have a positive impact
  - RMBS should gain significance against covered bonds given these initiatives, but

  Covered bonds continue to have no common transparency or supervisory framework and benefit from preferential risk weights under Capital Requirements Regulation – which seems illogical to me

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Looking Forward

- Volumes of issuance have been depressed in line with economic activity, eurozone ‘wobbles’, deleveraging activities of banks and Central bank support which has negated the need for issuance e.g. in the UK the FLS
- Expectations are that securitisation issuance will be stable to slightly increasing in 2015 as economies rally and central bank support falls away
- Yves Mersch Member of the Executive Board of the European Central Bank, ***”There is a growing consensus that an instrument once seen as part of the problem could in fact be part of the solution.”***

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Conclusion

- I make no apology – I am a fan of securitisation. Critics have failed to understand European market dynamics with those in US and those associated with leveraged investors failing to maintain collateral against market falls
- Central Banks have been slow to see the positive benefits of a match funding mechanism which is designed to survive significant credit stress – and has. But this is changing.
- Different regulatory regimes regarding risk weights and disclosure requirements remain and are unhelpful
- Covered bonds should not be seen as better instruments in my view – quite the opposite
- Investors are now reappearing for high quality and well managed RMBS instruments – the market is recovering but not rapidly