

Structured Finance Markets

Comments before the
European Securitisation Forum
Workshop on European Securitisation Markets

London

28 November 2007

Dr. Thomas F. Huertas
Acting Managing Director, Wholesale and Institutional Markets
Financial Services Authority

Structured finance is at the centre of the storm that has embroiled financial markets and financial institutions over the past months. How structured finance evolves is critical, not only to participants in that market, but to all issuers, investors and intermediaries – and to the economy as a whole.

When it works, structured finance provides significant benefits to issuers and investors alike, as well as substantial profits to the intermediaries who structure the transactions and distribute them to the market. The theory, and for many years the practice, suggested that structured finance would allow

1. issuers to get a lower effective cost of funding and to tap a wider pool of investors.
2. investors to better risk-adjusted returns from an asset class that was free from event risk at the originator of the assets underlying the structure
3. intermediaries to make more efficient use of their capital by limiting the amount of assets that they would have to hold on their balance sheet.

Indeed, there was talk that the preferred model for intermediaries had become an "originate and distribute" model. Just as important, in my view, were two complementary models:

- the "raise and invest" model, where entities such as SIVs, CDOs and CLOs would raise capital from investors to purchase portfolios of assets. Frequently, but not always, the assets acquired were structured finance instruments.
- The "dissect and repackage" model, where intermediaries would dissect the risks contained in assets acquired from investors and repackage these risks into instruments that conformed to what investors wanted to buy. This required intermediaries to hold not only instruments that are marked-to-market, but also instruments that are marked to model as well as instruments that are marked to "independent price verification" or, as some wags have put it "marked to myth". This may have also required banks to retain risks, such as liquidity risk – a point to which I will return.

Over the past three months structured finance has stalled, and this has threatened to stall the financial markets as a whole. Although many factors are at work, two perhaps stand out.

The first factor is complexity, and the second is liquidity, and the two factors are related to one another.

By mid-2007 structured finance had become very, very complex. Synthetic CDOs, CDO-squareds, CPDOs, SIVs, SIV-lites are but a few examples.

The hope that the rating agencies could provide a means to handle complexity has proven misplaced. It appears that some investors – indeed perhaps a very large proportion of investors – may not have been as diligent in their review of investments as they could have been. It seems that many investors, including many institutional investors, had assumed that a AAA rating on a structured finance instrument meant not only an infinitesimal probability of default, but also deep market liquidity and low price volatility. It has now become abundantly apparent that a AAA rating on a structured finance instrument means exactly what the fine print said it meant:

- The AAA-rated instrument had a lower probability of default than other similar instruments with lower rating (e.g. that a AAA-rated mortgage-backed security had a lower probability of default than a AA-rated mortgage backed security)
- The AAA-rating was based on information provided to the rating agency by the issuer and the rating depended on the veracity of that information. Specifically, the rating did not take into account the possibility that fraud might have contaminated the information provided to the rating agency.
- The AAA-rating could be revised in the light of subsequent performance by the issuer or subsequent deterioration in the underlying assets. A AAA rating is not forever.

Close readers of the fine print would have noticed that the rating said nothing about market liquidity and nothing about price volatility. But all too few investors read and heeded the fine print.

Without the short cut that ratings were thought to provide, valuation of structured financial instruments has emerged as the critical problem. What are the underlying cash flows in these instruments? What are the claims of various tranches to those cash flows, and what are the contingencies that will cause those cash flows to be cut off?

The answer to the first question involves a huge amount of data and the ability to process it. The answer to the second requires a very close reading of fairly complex documents by someone with sufficient training in law and finance, and the answer to the third frequently requires a Ph.D. in mathematics. Clearly, this is a task of a much different order of magnitude from simply buying the security on the basis of the rating.

The second factor stalling financial markets is liquidity – both market liquidity and funding liquidity. Market liquidity denotes the ability to sell an asset readily at close to a quoted price, and a usual measure of market liquidity is the narrowness of the bid-offer spread as well as the volume of the trade that can be conducted. Well, for most structured financial instruments the spread has widened considerably and the volume contracted dramatically.

For some instruments there are no bids at all and consequently no liquidity whatsoever. Coupled with a deterioration in the quality of the cash flows underlying many structured finance instruments (especially those based on sub-prime mortgages), the result has been a dramatic fall in the value of structured finance positions.

This has adversely affected funding liquidity in two ways. First, investors have gone on what amounts to a buying strike for structured finance assets, removing the securitisation market as a source of funding for issuers and intermediaries. This has raised funding liquidity challenges for issuers. This was especially true for issuers under utilising the "originate and distribute" model, such as Northern Rock, who took significant warehousing risk by accumulating assets pending securitisation. But it has also posed issues for firms that chose to finance assets through conduits and/or sponsored vehicles, such as SIVs, that operated on the "raise and invest" model. As market liquidity evaporated, so has funding liquidity started to dry up – ample proof that the assumption of liquidity risk made the "originate and distribute," as well as the "raise and invest" models work.

Secondly, the decline in value of structured finance instruments on the books of banks and other intermediaries has a much more direct impact on funding liquidity. By reducing profits and in some cases capital, it raises credit risk and poses the possibility that investors will refrain from providing liquidity to the firm because they fear the firm will default. The rise in credit default spreads on major banks is ample evidence of this.

So much for diagnosis. What is the prescription? We believe one bit of medicine can be particularly effective.

That medicine is transparency – transparency about structured finance instruments themselves and transparency about the condition of firms that have structured finance positions. Transparency will enable investors to price obligations more accurately and should lead to a reduction in bid-offer spreads, although not necessarily to an increase in the price of the instruments concerned, especially for those instruments that are based on cash flows of deteriorating quality.

With respect to transparency of the instruments themselves, we believe that the market can find ways to assure that investors have access to information about the underlying cash flows and that investors have access to the models that may help them value such cash flows. If market participants feel that we can help facilitate such transparency of instruments, we stand ready to talk and, if appropriate, act.

With respect to the transparency of firms, this must come with respect to the condition of firms that hold significant exposures to structured instruments, especially those based on sub-prime mortgages. We recognise that these instruments are difficult to value, but we encourage firms to take a conservative view of values and to mark their books accordingly. This will provide investors with a better basis for evaluating the creditworthiness of the firms with whom they deal.

Should firms come to the conclusion that marking down their positions could cause their credit situation to worsen, not improve, I would urge those firms to consider raising new capital, such as some firms have recently done. The market appears ready to recapitalise firms with sound business models that have suffered a temporary setback – much the way that the market recapitalised insurance companies after the hurricanes of 2004.

From a regulatory perspective, we will certainly be vigilant in our supervision of firms to make sure that they have plans in place to maintain adequate capital and liquidity in the weeks and months ahead. These are difficult times, but we, and I hope you, continue to have faith in the power of the market, if accessed in a timely and open fashion, to cure many ills, including the power to cure the excesses in the structured finance market. We at the FSA look forward to working with you to make this happen.