Box 8

TRANSPARENCY IN SECURITISATION MARKETS

Since the outbreak of the ongoing financial market turbulence, liquidity in both the primary and the secondary securitisation markets has virtually vanished. Often cited reasons for this development in the securitisation markets are the lack of reliable valuation frameworks and the inadequate transparency of complex structured finance products, such as different types of asset-backed securities (ABSs). As a consequence of this post-outbreak analysis, many proposals aimed at restoring market liquidity, put forward by market participants and policy-making bodies alike, have focused on the need for firms to enhance the transparency of, and disclosure in, the securitisation markets. This box discusses the causes of the turbulence in terms of transparency and highlights what is currently going on to restore market confidence.

Structured finance products are generally heterogeneous in nature. This implies that standardisation in terms of disclosure, as well as performance analyses, has its limit on account of the high level of complexity and the differences between the transactions. The performance of structured finance securities depends significantly on the fundamental credit quality of the underlying assets that are being financed through the securitisation process.[1] Thus, to evaluate the fundamental credit quality of these assets should involve both qualitative and quantitative assessments. Missing data stemming from the lack of transparency hinder a proper overall assessment. In particular, when markets are stressed, the absence of reliable and credible information may drive market participants to assume the worst with respect to those financial instruments.

In response to the ongoing turbulence in the financial markets and the vanished liquidity, many initiatives have been put forward by various stakeholders with the aim of revitalising the markets. Approaches that are intended to enhance transparency and standardisation – and therefore liquidity and market efficiency – include:[2]

- The recommendation by the Financial Stability Forum (FSF) to "strengthen transparency at each stage of the securitisation chain, including by enhancing and standardising information on an initial and ongoing basis about the pools of assets underlying structured credit products".[3]

1 See also Fitch Ratings, "Unstructuring Structured Finance", July 2008.
2 There are also several other proposals concerning the securitisation markets, such as the recommendations of the Committee of European Banking Supervisors (CEBS) for banks to disclose their exposures to structured finance products, as well as the European Commission's draft legislative text concerning rating agencies.
3 See Financial Stability Forum, "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience", April 2008. In October, the FSF published a follow-up on the implementation. On transparency in securitisation, it is referring to market-led initiatives.

- The recommendations of the Institute of International Finance (IIF) which set out principles of conduct and market best practices for the global financial services industry across a wide range of areas, including transparency and disclosure issues.[4] In particular, the industry should, according to the IIF, develop harmonised guidelines on transparency and disclosure for structured products across major markets.

- The European Securitisation Forum (ESF), in response to the Ecofin Council's roadmap to stability of November 2007, is exploring a project for European RMBS transactions by updating the existing ESF Securitisation Market Practice Guidelines. This effort will likely focus on either developing country-specific reports, or, eventually, a single pan-European format to the extent that differences in national regulatory reporting can be overcome. In addition, the association is discussing further enhancements to transparency via a greater digitalisation of reporting formats and the inclusion of loan-by-loan reporting to increase the granularity of information provided to investors. Furthermore, the association aims to standardise disclosure practices and to enhance the accessibility, usability and comparability of information.

- Witnessing deterioration in the disclosure standards of rating agencies for some of the ABSs in recent times, the Eurosystem decided, within the scope of this year's review of the risk control framework, to require better rating disclosure standards. To be eligible as collateral for Eurosystem credit operations, ABSs will need a rating that must be explained in a publicly available credit rating report, i.e. a detailed pre-sale or a new issue report, which should include, inter alia, a comprehensive analysis of structural and legal aspects and a detailed assessment of the collateral pool. Moreover, rating agencies would need to publish rating reviews of ABSs on at least a quarterly basis.

Steps by the industry to agree on common standards and definitions, and to monitor these effectively, could facilitate the development of a "gold standard" for securities. It could include several standards, spanning different eligibility criteria over different types of assets. In a global marketplace, consistency of approach across national borders would clearly be desirable. This could, over the longer term, help promote investor confidence, extend the appeal of ABSs, improve conditions for an enhanced valuation framework and strengthen the market.[5] All such practices will need to be considered carefully to ensure that the data provided to investors does not result in a violation of relevant data protection or banking secrecy laws.

However, a distinction needs to be made between the standardisation of the ABS products and the transparency of these products. A requirement on standardisation does not imply transparency. For example, an RMBS investor would – given the magnitude of individual mortgage loans in the underlying portfolio and the related cost of analysing information on these loans – not necessarily be interested in having information on all underlying assets and its debtors. Instead, the challenge this market is facing is to build meaningful aggregates which reflect the profile of an RMBS portfolio and make it comparable to other RMBS portfolios. Thus, as there is a trade-off between ultimate transparency (detailed information on every single asset/debtor) and related information costs, the market may end up using

4 See Institute of International Finance, "Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations", July 2008.

5 It is equally important to improve the valuation practices, including the modelling of default correlation in CDOs, and the modelling of house prices in the case of standard RMBSs. Better transparency on the underlying assets should contribute to this.

standardised and best-practice aggregates to analyse and characterise ABSs. These aggregates would not necessarily have to include the identity of each single underlying asset/loan/debtor, and confidentiality rules might not be affected. Standardised transparency would be a more appropriate attitude in which the amount and level of information should be specified.

Despite the broad scope of various initiatives, there is no room for complacency. Serious efforts are needed to restore deep and properly functioning markets that offer true secured funding possibilities. The responsibility for identifying areas of improvement and providing useful disclosures that allow investors to assess the risk/return profile of financial instruments rests primarily with the industry. It is therefore of utmost importance that individual market participants follow these recommendations and try to comply with most of them. At the same time, there should be no stretching of timetables for enhancing disclosure, as the latter is essential to bring back market confidence.