Global Developments in Securitization Regulation

Consultation Report

THE BOARD
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

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Mr. Tim Pinkowski
General Secretariat
International Organization of Securities Commissions (IOSCO)
Calle Oquendo 12
28006 Madrid
Spain

Your comment letter should indicate prominently that it is a "*Public Comment on Global Developments in Securitization Regulation*".

Contents

This Consultation Report has been prepared by the Task Force on Unregulated Markets and Products ('TFUMP'). TFUMP is a multilateral group of staff experts from various IOSCO member jurisdictions. A number of IOSCO Technical Committee members are currently considering whether or not to adopt regulations related to securitization and the policy options, analysis findings and conclusions in this Consultation Report do not necessarily reflect the views of any one member.

I Introduction

In response to a request from the G20, the Financial Stability Board (**FSB**) has been developing recommendations to strengthen oversight and regulation of the shadow banking system. As part of this work the FSB agreed to assess the case for action in respect of a number of areas, including regulation of securitization. Based on the FSB's decision, the Financial Stability Board's Standing Committee on Supervisory and Regulatory Cooperation (**FSB SRC**) requested IOSCO to, in coordination with the Basel Committee on Banking Supervision, conduct a stock-taking exercise in relation to requirements for risk retention and measures enhancing transparency and standardisation of securitisation products, and to develop policy recommendations as necessary.

As a result of the FSB SRC's request, IOSCO's Task Force on Unregulated Markets and Products (**TFUMP**) was asked by the Technical Committee (**TC**) at its meeting in Tokyo in February 2012 to undertake a project (**Project**) which:

- Describes and analyses global regulatory and industry initiatives on risk retention, transparency and disclosure standardisation;

- Identifies and assesses material differences in regulatory and industry approaches and their impact; and

- If and where appropriate, recommends approaches to addressing differences identified as material.

The FSB SRC's request emphasised measures in the US and the European Union (**EU**), as they were seen as the largest markets globally and sought policy recommendations as necessary. The request also noted rule making in both the US and the EU was in progress. A report of the results of the work was sought by July 2012.

In September 2011, the Technical Committee noted that staff of the Securities and Exchange Commission (**SEC**) and the European Commission (**EC**) were undertaking a preliminary analysis of developments in the US and the EU. That analysis was undertaken during the fourth quarter of 2011 with a Confidential Report submitted to IOSCO's Technical Committee at its February 2012 meeting in Tokyo (the analysis is described as the **EC/SEC Staff Analysis**).

The EC/SEC Staff Analysis focused on incompatibilities and differences in regulatory approach between the US and the EU and the impact and materiality of those incompatibilities and differences. It considered both risk retention and transparency requirements (focusing in more detail on the former). The EC/SEC Staff Analysis carefully outlined the status of developments in both jurisdictions noting that rules were in the process of being implemented or complementary rulemaking being adopted, on both sides of the Atlantic.

Whilst the intent of both regimes was similar, the EC/SEC Staff Analysis concluded that although there were differences in regulatory details and approach, those differences did not amount to material incompatibilities (that is, it was possible for market participants to comply with both regimes without conflict). The Staff Analysis acknowledged, however, that rules may subject “cross border market participants in certain limited situations to the additional regulatory burden required to comply with two similar but independent regulatory regimes”.

The Project was based primarily on a survey of IOSCO members about global regulatory developments and industry initiatives during March 2012. The survey was supplemented by informal discussions with industry representatives. The survey built on the EC/SEC Staff Analysis.

This Consultation Paper:

- Provides background to the Project;
- Describes the work undertaken;
- Describes the Global Securitization Market;
- Draws together key themes and observations from the Project. In particular, it outlines the extent of differences in regulatory approach between jurisdictions; and
- Seeks public comment on policy issues arising from the work.

II Background

Previous IOSCO and Joint Forum Work

Both IOSCO and the Joint Forum have undertaken work since 2009 intended to support recovery of securitization markets. This work informed the FSB SRC's request.

IOSCO issued a report prepared by TFUMP in September 2009[1] which made recommendations about improvements in regulatory oversight of securitization markets intended to assist in restoring investor confidence and market quality. These recommendations included:

- Considering requiring originators and sponsors to retain a long term exposure to securitizations;
- Enhanced transparency by issuers about verification and risk assessment practices;
- Regulatory support for improved disclosure about underlying asset performance;
- Review of investor suitability requirements;
- Developing tools to assist investor understanding of complex financial instruments; and
- Assessing the scope of regulatory powers to promote international coordination.

During 2010, TFUMP conducted a survey about the implementation of these recommendations in member jurisdictions. It reported the results of that survey to the Technical Committee in a report published in March 2011[2].

1 IOSCO Unregulated Financial Markets and Products – Final Report, September 2009; http://www.iosco.org/library/pubdocs/pdf/IOSCOPD301.pdf

2 IOSCO Unregulated Financial Markets and Products – Implementation Report, March 2011; http://www.iosco.org/library/pubdocs/pdf/IOSCOPD348.pdf

Its report showed that these jurisdictions had at least one, if not multiple, initiatives in progress to implement the recommendations on disclosure, the retention of long term exposure, investor suitability and international coordination and regulatory cooperation. Its report also recognized that work remained to be done to improve disclosure standards for private and wholesale offerings of securitized products as well as to improve international cooperation towards convergence of national regulations, where desirable. TFUMP made recommendations to regulators in these two areas.

In July 2011, the Joint Forum published a report on *Asset Securitization Incentives*[3]. The report was based on industry interviews in a number of jurisdictions and a literature review. The report reviewed developments in securitization markets and explored reasons why there had yet to be a meaningful recovery in activity. It outlined a number of recommendations to authorities on the tools and approaches they can employ to promote a sustainable and responsible securitization framework. These included:

- Employing a broad suite of tools to address misaligned incentives, which may include measures to improve loan origination standards, and to align compensation arrangements with long-term performance and asset quality;

- Encouraging market participants to improve transparency to ensure that investors, other market participants, and supervisors have access to relevant and reliable information; and

- Encouraging greater document standardisation and less product complexity, which should assist in reducing information asymmetries and stimulating liquidity in secondary securitization markets.

The report noted differences in approach to risk retention requirements between the US and Europe and highlighted the importance of consistent and aligned approaches in developing a regulatory framework for these issues. The report also urged authorities to strive for consistency across global markets and sectors (taking into consideration local market circumstances, business models and legal systems). It also urged relevant authorities to resolve uncertainty as to the development and implementation of regulations and guidance in a timely manner.

The FSB SRC's Request

The FSB SRC's request to IOSCO indicated that securitization was a valuable funding technique and an efficient means of diversifying risk. The request referred to a number of problems with securitization that were revealed by the Global Financial Crisis, including an overreliance on ratings, lack of due diligence by investors and inadequate pricing of risk. Securitisation was also seen as reducing incentives for suppliers of securitisation (e.g. originators and sponsors) to conduct rigorous underwriting of credits that could potentially be included in the underlying assets pool. The request considered that further work could be done to review current national and regional initiatives regarding the regulation of securitization as well as measures aimed at enhancing transparency and standardisation of securitization products, and policy recommendation developed as necessary. The request also pointed to the benefits which other initiatives (such as product labelling and

[3] Joint Forum Report on asset securitization incentives, July 2011; http://www.bis.org/publ/joint26.pdf

standardisation of products and disclosure) may play in assisting recovery of these markets. TFUMP saw these requests as reflecting concerns about the slow recovery of securitization markets.

TFUMP's Perspectives

Market developments since the FSB SRC’s request (and TFUMP's work on this mandate) confirm the potential securitization markets offer in supporting economic recovery and the role regulation may play in supporting (or, conversely, in impeding) revival. Specifically:

- From a European perspective, there is a view that securitization is a viable alternative source of funding for the banking sector at a time when it needs funding diversification. Good functioning of, and access to, securitization as a funding alternative would, in turn, support recovery in the real economy.

- There is evidence of a revival in investor appetite, particularly among US institutions looking to secure yield opportunities in their own and European markets.

- Given investor interest in diversifying away from their home markets, and the appeal of offshore pools of liquidity for issuers, there is concern about the potential impact of differences in regulatory requirements across jurisdictions in impeding cross border investing and issuance in the securitization markets.

- There is concern among issuers, in particular, that securitization continues to be stigmatised by sub-prime crisis events.

In light of these observations, TFUMP's thinking and analysis proceeded on the basis of the following principles:

Securitization is an important market-based funding source for banks. Its effectiveness as a reliable funding alternative depends on a sound market system in which market participants have access to information that supports a comprehensive understanding of the features and risks associated with investments in securitizations.

- Securitization markets should not be seen as purely domestic. Cross border issuance and investment provide opportunities to deepen markets and increase the positive impact of securitization activity on the real economy. Differences in regulation between jurisdictions risks impeding cross border activity because they may impose additional costs on business without commensurate benefits to investor protection or financial stability. To this end, consistency or integration of regulatory approach between jurisdictions is desirable.

- Securitization markets are, however, heterogeneous. There are differences between and within jurisdictions in underlying assets, the form of issuance (e.g. public vs. private), parties to the structures and the structures themselves. These differences together mean disclosure and risk retention requirements across jurisdictions may vary considerably even as they facilitate achieving the objective of a sound securitization environment. Aspiring to consistency or integration needs to be understood in the context of these differences.

III Methodology

As noted, the project was based primarily on an analysis of a survey of Technical Committee and Emerging Markets Committee members in March 2012 (**Survey**).

The survey was based on a questionnaire designed by TFUMP to build on the approach and areas covered by the EC/SEC Staff Analysis. The core of the questionnaire dealt with upfront and ongoing disclosure about securitization products and risk retention in securitization transactions. It also included a number of other questions designed to assist in better understanding the structure and operation of markets in other jurisdictions and so provide a basis for better understanding the materiality of any differences in regulatory approach and opportunities for harmonization. High level feedback on covered bond regulation was also sought. A total of 19 jurisdictions (drawn from Europe, the Asia-Pacific, Africa, the Middle East and the Americas) responded to the survey[4].

The questionnaire sought information about both regulatory requirements and industry standards and practice. Respondent jurisdictions were asked to seek information from industry (both sell and buy side) to support these responses.

The questionnaire sought information on the following:

- **Industry Environment**

Questions sought information about Asset Backed Securitization activity, regulation of issuers, methods of initial offering and secondary trading for Asset Backed Securities (**ABS**) products.

By seeking to delineate the scope and framework of the regulation of ABS transactions, the primary purpose of these questions was to better understand the applicable regulatory framework and the similarities and differences between jurisdictions.

Questions were also intended to provide context around securitization markets in different jurisdictions to assist in identifying regulatory tools that may be available to harmonize any differences in regulatory approach.

- **Transparency and Standardization of Disclosure**

These questions were about upfront and ongoing disclosure requirements and practices. They also sought information about regulation and industry practice on matters which would be the subject of disclosure (in particular underwriting standards and due diligence).

In relation to initial disclosure, questions were intended to provide an overview and specific details about what information was provided to investors for ABS offerings. The underlying theme of questions was whether and how regulation in respondent jurisdictions contributes to investor understanding of certain key aspects such as investment objectives and risk of loss, and how this is done (whether by way of requirements to disclose up-to-date information, all material information and/or in standardized formats).

[4] List of respondents: 1 Australia ; 2 Brazil ; 3 Canada (Ontario/Quebec); 4 Dubai ; 5 Egypt ; 6 France; 7 Germany; 8 Hong Kong , 9 Japan ; 10 Lithuania ; 11 Mexico ; 12 Netherlands ; 13 Portugal ; 14 Romania; 15 Slovenia; 16 South Africa ; 17 Spain ; 18 Switzerland ; 19 UK.

In relation to ongoing disclosure**,** questions were intended to provide an understanding of what information is provided:

- during the life of the product, in relation to underlying assets, and credit risk reporting; and

- to enable investors to monitor general underlying risks, any breach of triggers, the structure of cash flows and evolution of risks.

The questionnaire also sought information in relation to both initial and ongoing disclosure about controls and sanctions in relation to the accuracy of information provided. This was intended to assist in assessing the comparability of the framework supporting the disclosure requirements in a jurisdiction.

- **Risk Retention**

These questions sought information about whether and how risk retention requirements were imposed by regulation (and relevant industry practice).

- **Other Issues**

These questions were about other aspects of the regulation of securitization markets. These questions complemented earlier questions that were more about the requirements relating to securitization incentives and obligations imposed on issuers of securitization products. Specifically, the following were asked:

- Questions about whether and how investors are regulated.

- Questions about information flows between credit rating agencies (**CRAs**) and ABS issuers and whether there are significant differences in disclosure practices for rated offerings.

- Questions about post-trade transparency. These were intended to assist in understanding what requirements exist in relation to transparency for secondary trading in different markets and to assess the development of these markets.

- Questions about the treatment of cross border activity. This was intended to assist in better understanding both the level of cross border activity and the regulatory treatment of offshore issuers and investors.

- High level information about the regulation of covered bonds markets in respondent jurisdictions. These questions were intended to provide a basis for any further work that may be considered on the regulation of these markets.

Respondents to the survey were encouraged to discuss the survey with market participants and industry groups in their jurisdictions. Responses from some national industry associations were sought directly.

Analysis of survey responses was supported by discussions with industry at a meeting in Paris in mid-April. Industry representatives from Europe and the US outlined current industry initiatives[5] to support recovery of securitization markets in Europe and the US (particularly in relation to measures to improve the information investors receive). The European Central Bank also outlined the disclosure framework it has developed to assist it in assessing the risks posed by securitization instruments lodged with it as collateral.

IV The Global Securitization Market

The TFUMP project sought to better understand changes in securitization markets since the Global Financial Crisis. The questionnaire, therefore, sought information about ABS activity in each jurisdiction. Data from other sources was also reviewed and industry input[6] sought during a meeting of the Working Group.

Survey Responses

Survey responses pointed to the following:

- Parts of the securitization market in the US appears to be recovering[7], while the securitization market in Europe still appears to be depressed[8]. Some European issuers are therefore offering ABS in the United States. Market participants are concerned about the effect that (CRD) IV and Solvency II will have on the European Securitization Markets.

- Outside the US and the EU there was little current securitization activity observed (confirmed by data available from independent sources). In a number of jurisdictions, issuing is limited to either one or two firms and in a number of cases involves government sponsored entities.

- There is currently limited or no cross border activity outside Europe and the US. Issuers outside Europe and the US generally limit their offerings to their home jurisdiction. In Europe, it seems that cross border activity may be more significant to the extent that some sponsors/originators may use offshore issuing vehicles. For example, most German ABS transactions involving German originators, sponsors or assets use a Special Purpose Vehicle (SPV) that is incorporated offshore (e.g. Luxembourg and Guernsey) and will often be listed on exchanges outside Germany e.g. Ireland. Dutch SPV's are also used to issue significant amounts of ABS originated outside of the Netherlands. Prior to the Global Financial Crisis issuers did engage in global offerings, however this activity has since contracted.

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5 Such as the Prime Collateral Securities (PCS). See Annex One.

6 Sources reviewed are listed in footnotes below as relevant for each jurisdiction. Industry representatives from the Association for Financial Markets in Europe, European Financial Services Round Table and the American Securitization Forum attended the Working Group meeting as well as a representative of the ECB. A representative of BNP Paribas presented at the meeting.

7 Mainly on the basis of federal mortgage agencies

8 OECD Outlook for the Securitization Market (Blommestein et al) - Financial Market Trends No. 100 Volume 2011/1; http://www.oecd.org/dataoecd/36/44/48620405.pdf

- In most jurisdictions, there is little or no retail investment in securitization markets and investors tend to be institutional or wholesale investors. This is thought to be due to a range of factors influencing how securitization markets have developed. In certain jurisdictions there are express restrictions on marketing securitized products to retail investors and in others there are additional compliance obligations when marketing to retail investors. For instance in Japan, soliciting 'retail investors' subjects distributors to a suitability requirement. Others do not have a prohibition *per se* on selling to retail investors but have rules against any direct proactive marketing of securitization products to such investors (e.g. France). The limited involvement of retail investors has important regulatory implications. In particular, offers to institutional and wholesale investors do not need to comply with public offer requirements in a number of jurisdictions (eg European Union and Canada) unless the offering is to be listed on a regulated market.

- Vehicles used for securitization offerings vary across jurisdictions. In most jurisdictions special purpose entities such as investment companies and trust vehicles were used. Vehicles are either a recognized or authorized scheme or are not subject to a form of legal recognition or regulatory authorization. However, in some jurisdictions this is not considered an issue due to the extremely limited activities carried out by SPV's and the fact that statistical data is collected on such entities.

- A range of different methods are used to place asset backed securities. Respondents indicated that asset backed securities are primarily placed by way of public offers and private placements. Use is also made of listed and unlisted markets, although on-market secondary trading is limited. Most trading of ABS occurs OTC, even when such securities are listed. Where trading takes place via a regulated exchange, the usual transparency requirements on transactions apply. These might include post trade reporting on price, quantity and time of transaction. Where trading is OTC there is little or no post trade transparency. Due to the fact that there are no reporting requirements relating to OTC trading, it is difficult to state with certainty how much trading occurs on secondary markets.

- Cross border dimensions are an important feature of securitization transactions[9], particularly in the global recovery of these markets. This was an issue that was confirmed in discussions with industry. There are differences in regulatory approach among key jurisdictions and, within jurisdictions, multiple regulators may each have responsibility for securitizations (i.e. securities and prudential regulators). Differing requirements between jurisdictions and between regulators may impede the process of securitization issuance. This issue occurs particularly with respect to risk retention and transparency requirements and the fact that some regulations apply only to certain categories of investors, so that not all investors equally benefit from such regulations. This is highlighted in more detail in Part VI.

Data from other sources

9 For example, the underlying assets of a securitization transaction can be subject to the law of jurisdiction A, the SPV subject to the law of jurisdiction B and the servicing entity to the law of jurisdiction C. Further, the securitization product can be listed in jurisdiction D and marketed in jurisdiction E.

Data from other sources confirmed the significant decline in issuance since pre-Global Financial Crisis peaks and generally slow recovery in jurisdictions covered by this work. (Data reported is generally to the end of 2011).

US[10]

New issuance totaled USD 124 bn in 2011, down from a 2006 peak of USD 753 bn. Roughly 50% of issuances are backed by auto loans, with student loans the largest other category. Industry participants in TFUMP's work pointed to anecdotal evidence of an increasing appetite among institutional investors in particular for investment in securitization markets both in the US and in other markets (in particular Europe).

Europe[11]

New issuance to November 2011 was Euros 207 bn, down from a peak of over Euros 700 bn in 2008. Residential Mortgage-Backed Securities (RMBS) accounted for 60% of issuance. In 2010 total global securitization issuance out of Europe was still over Euros 500 bn.

The largest issuing jurisdictions are the UK and the Netherlands (each accounting for 28% of issuance by value), Spain (accounting for 17%) and Italy (accounting for 14%).

Public placements are estimated by analysts to account for 38% of the value of deals with significant variation across asset classes. For instance, while 78% of all Auto ABS and 74% of RMBS transactions in the UK are estimated to be public, only 35% of other ABS (excluding autos) and 5% of other RMBS (excluding UK and Dutch RMBS) were reported as being publicly placed.

A significant percentage of issues are 'self owned' or 'retained'. SIFMA estimates place the percentage at 76% of the value of all issues during 2011 (down from 78% in 2010 and 94% in 2009).[12]

Industry participants in TFUMP's work pointed to an interest among banks and central banks in particular to see recovery in securitization markets, primarily because they offer diversification in funding sources.

Latin America[13]

Brazil

Securitization issuances rose from a total figure of Reais 32 bn in 2010 (Reais 23 bn for contractual investment funds (FIDC) and almost Reais 9 bn for Commercial Mortgage-Backed Securities (CMBS) and RMBS) to more than Reais 50bn in 2011 (Reais 37 bn for contractual investment funds and almost Reais 14 bn for CMBS and RMBS).[14].

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10 SIFMA Securitization Issuance 2011

11 European Structured Finance Annual Review, 2011-2012, Bank of America Merrill Lynch

12 SIFMA, Securitization Issuance 2011. Data sourced from AFME & SIFMA Members, Bloomberg, Thomson Reuters, prospectus filings, Fitch Ratings, Moody's, S&P, AFME & SIFMA.

13 Moody's Latin America Securitization, 2012 Outlook.

14 Year in Review Brazilian Real Estate and Structured Finance 2012, Uqbar

Private issuance included in the above numbers is thought to be substantial. The level of cross border activity is thought to be low.

Mexico

Securitizations in Mexico were down 26% in 2011 to USD 2.5 bn. RMBS account for 82% by value of Mexican securitizations. The market is dominated by two government related issuers (INFONAVIT and FOVISSSTE).

South Africa[15]

Issuance volumes dropped from ZAR 41 bn in 2007 to ZAR 3 bn in 2010. Volumes are expected to remain at this level with most activity understood to be refinancing.

RMBS accounts for 50% of rated public offers.

Japan[16]

Recent recovery of Japanese securitization markets from JPY 1,187 bn in first half 2010 to JPY 1,912 bn in first half 2011 (61% year on year) is led primarily by the increase in RMBS issued by Japan Housing Finance Agency as a government agency, accounting for 86% of the net increase during the period, while other products including RMBS issued by non-government agencies are still at their lowest levels.

Australia[17]

New issuance in 2011 was AUD 26 bn – comparable to 2010 levels and down from the 2006 peak of over AUD 70 bn. RMBS remained the dominant asset class accounting for just under 80% of these transactions by value. Foreign interest in Australian issuances returned in 2011, with some interest from Japan. Foreign investors accounted for less than 5% of total issuance.

Canada[18]

As at January 2012, the total amount outstanding in the Canadian securitization market was Cdn $93.9 bn. In 2011, new issuances returned to levels seen prior to the 2008 recession. The total volume of new ABS and ABCP issuance throughout the year was Cdn $23.4 bn, which represents an increase of 17% over the prior year and 7% over pre-recession levels of 2008.

The above figures do not include securitizations by government guaranteed securitization programs. The total amount of National Housing Association RMBS outstanding as of

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15 Fitch Ratings, Structured Finance, South African Outlook 2011.

16 Data provided by Japan Securities Dealers Association.

17 Australian Structured Finance Year Ahead 2012, Bank of America Merrill Lynch.

18 Canadian Securitization Market Overview January 2012, DBRS. Canadian Structured Finance 2011 Year In Review and 2012 Outlook, DBRS.

December 31, 2011 was Cdn $368 bn and the total amount of Canada Mortgage Bonds outstanding was $200.8 bn.

Other Jurisdictions

Evidence of activity in other jurisdictions reflects survey responses. The number of reported deals in each of Hong Kong, Switzerland, Dubai and Egypt is understood to have been very small in recent years.

V Key Observations and Findings

This section sets out observations and findings about regulatory and industry initiatives in the following areas:

- Risk retention;
- Disclosure (covering transparency and standardization);
- Securitization processes; and
- CRA issues.

These observations are based on survey responses and the EC/SEC Staff Analysis.

TFUMP has sought to assess how approaches in regulatory and industry approach may differ and the impact they may have. Our observations also highlight other factors that may help provide a basis for the sound operation of securitization markets.

These Observations and Findings form the basis of the policy recommendations discussed in the next Part.

1. Risk Retention

Risk retention or 'skin in the game' requirements have been a key focus of regulatory responses since the Global Financial Crisis[19]. These requirements are intended to avoid misaligned incentives that may be embedded in the 'originate to distribute' model of some securitization products.

Our analysis points to differences in approach to these requirements between jurisdictions which we see as significant.

EC and US requirements

The EC/SEC Staff Analysis noted that EU rules and the proposed US rules approach risk retention requirements from different perspectives.

- The EU rules focus on investors as the means to address risk retention requirements. The CRD prohibits EU credit institutions from investing in securitized instruments unless one

19 The G20 Leaders' statement of the Pittsburgh Summit (September 2009) recommended that securitization sponsors or originators should retain a part of the risk of the underlying assets.

of the relevant originating parties, originator (or sponsor or original lender) of the ABS retains no less than 5% of the economic interest in the ABS.

We note that similar requirements are being developed in the EU for investors in other sectors. AIFM and Solvency II have provided similar requirements which are currently awaiting technical rulemaking implementation in EU jurisdictions. For consistency across sectors, AIFM imposes requirements that alternative investment and collective investment vehicle managers conduct thorough due diligence to ensure that originators comply with retention requirements when investing in securitization structures, and Solvency II introduces similar requirements for insurers when they invest in repackaged loans.

- The EC/SEC Staff Analysis summarised that US agencies[20] jointly proposed rules for credit risk retention in ABS transactions focus on the sponsor and generally require a sponsor to retain an economic interest equal to at least 5% of the credit risk of the assets collateralizing an issuance of ABS (other than synthetic ABS structures).

At one level these two approaches achieve a similar outcome; however there are some differences in the detail, particular in relation to exemptions applicable to US ABS as pointed out that are worth noting. We see these differences as significant.

The EC/SEC Staff Analysis noted that US proposed rules provide that a sponsor need not retain any portion of the credit risk in the securitization if the ABS are collateralized by certain high quality assets that meet certain underwriting standards designed to ensure that the loans backing the ABS are of very low credit risk. Proposed exemptions would include certain high quality: commercial loans, commercial real estate loans, automobile loans and residential loans. The EC/SEC Staff Analysis also indicates that proposed US rules would also exempt from the risk retention requirements certain other securitizations—for example, those backed by government-insured or guaranteed assets.

Further analysis points to the clear significance of these proposed exemptions from risk retention requirements. Section 15G of *Securities Exchange Act 1934* (the **Exchange Act**) will include the exemptions for ABS collateralised solely by qualifying Commercial Real Estate (CRE) loans, commercial loans or auto loans, and for ABS backed by Qualified Residential Mortgages (QRMs) as those terms are to be defined by Joint Agencies rule making. The Joint Agencies have proposed a list of defining criteria for these asset types in terms of underwriting standards and product features[21] meant to ensure that such underlying assets are of very high credit quality.

The US Agencies have proposed conditions and characteristics for qualifying CRE loans, commercial loans or auto loans, as well as QRMs, designed to identify the lower credit risk loans for exemption. It is possible that these exemptions available in the US will apply to a significant proportion of the standard/homogeneous US issuer ABS offerings, which in practical terms, raises the possibility for a significant difference between the risk retention regimes in the EU and the US.

20 Pursuant to the the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd Frank Act"), the OCC, Federal Reserve Board, FDIC, SEC, FHFA, and HUD are expected to jointly prescribe rules to implement the credit risk retention requirements of section 15G of the Securities Exchange Act of 1934 (15. U.S.C. § 78o-11).

21 In terms of borrower credit history, payment terms, LTV, down payment, qualifying appraisal of valuation, ability to repay, points and fees payable by the borrower, etc.

A summary of some of the key details of current proposals for each of these asset classes are set out below.

QRM loans

It is proposed that a QRM will be a transaction to purchase or refinance a one-to-four family property that meets the following key criteria:

- A Loan to Valuation Ratio ('LVR') no greater than 70% or 80% (depending on whether it is a refinance or purchase) with the borrower meeting initial transaction costs and making a 20% down payment for a purchase, from its own funds;

- First mortgage, loan maturity does not exceed 30 years, no deferral of principal or interest payments, limitations on how much the interest rate applicable to the mortgage transaction may increase by and appropriate debt mitigation terms in the mortgage; and

- The borrower must meet certain debt-to-income ratios and satisfy credit checks.

Commercial Loans

The proposed qualifying criteria for exemption for a commercial loan, being a secured or unsecured loan to a company or individual for business purposes, as currently proposed include:

- A first lien security (if secured), covenants regarding ongoing provision of financial statements, limits on granting future security, limits on changing business structure, location or operations, no reinvestment periods, full amortisation on a straight line basis within five years; and

- The borrower's ability to service the debt must be assessed and certain ratios maintained. For instance, during the previous two years and for the two years following closing (based on projections) the borrower must maintain a debt service coverage ratio of 1.5 or greater, leverage ratio of 3.0 or less and total liability ratio of 50% or less.

CRE Loans

For a CRE loan qualifying criteria are currently proposed to include:

- Similar assessments to those noted above about a borrower's ability to repay debt;

- A debt service coverage ratio for the previous two years and for the two years following closing (based on projections) of 1.5 or greater or 1.7 or greater (depending on loan type and rental income) and a CLTV of less than 60% or 65%; and

- Similar covenants as for a commercial loan, but loan term can be up to 20 years and interest rate is fixed, or if variable, the borrower enters into a derivative to swap to fixed.

Automobile Loans

Automobile loans will be exempted under current proposals where a number of criteria, including the following, are met:

- The borrower meets certain credit assessment checks. For instance the borrower must never have been subject to bankruptcy proceedings, foreclosure or repossession action;

- The borrower meets a debt to income ratios of 36% or less and pays, out of their own funds, all fees and taxes on the purchase, as well as 20% of the purchase price; and

- Maximum loan term of five years (new cars), fixed rate loans and no deferral of principal or interest.

The EU does not provide any comparable exemption for ABS whose underlying assets might be deemed to be of very high credit quality. The main exemption applying to the EU states, as outlined in the EC/SEC Staff Analysis and confirmed in survey responses, is that the risk retention rules do not apply where CRD regulated entities invest in securitized products with exposures that are claims on, or are fully, unconditionally and irrevocably guaranteed by, the following entities:

- Central governments or central banks;
- Regional governments, local authorities and public sector entities;
- Institutions to which a 50% risk weight or less is assigned under CRD; or
- Multilateral development banks.

It is unlikely that this exemption will have as wide an impact as those being considered in the US. Furthermore, unlike the US proposed rules the EU retention rules are also applicable to synthetic ABS structures.

In addition to exemptions for ABS backed by qualifying assets (see above), the US Agencies can adopt or issue additional exemptions, to the risk retention requirements on certain conditions under section 15G(e)(1) of the Exchange Act. Rules for a foreign transaction safe harbor have been proposed with the intention to exclude from risk retention requirements "transactions in which the effects on U.S. interests are sufficiently remote so as not to significantly impact underwriting standards and risk management practices in the United States or the interests of US investors". The EC/SEC Staff Analysis outlines a proposed safe harbor for foreign transactions whereby the proposed US risk retention requirements would not apply to a securitization transaction if all of the following conditions are satisfied at the time of issuance of the ABS:

- the securities are not required to be and are not registered under the Securities Act of 1933;

- no more than 10% of the dollar value by proceeds (or equivalent if sold in a foreign currency) of all classes of ABS interests are sold to US persons or for the account or benefit of US persons;

- neither the sponsor nor the issuing entity is:

  (i) organized under the laws of the US or a US state or territory (US jurisdiction),

(ii) an unincorporated branch or office (wherever located) of an entity incorporated under the laws of a U.S. jurisdiction, or

(iii) is an unincorporated branch or office located in the US of an entity incorporated under the laws of a jurisdiction other than a US jurisdiction; and

- if the sponsor or issuing entity is incorporated under a non-US jurisdiction, no more than 25% of the assets were acquired by the sponsor, directly or indirectly, from:

  (i) any consolidated affiliate of the sponsor or issuing entity that is incorporated under the laws of a US jurisdiction, or

  (ii) an unincorporated branch or office of the sponsor or issuing entity that is located in a US jurisdiction.

There is no similar 'safe harbor' in the EU for foreign ABS transactions. For instance under the CRD legislative and regulatory framework the EU retention requirements apply to all-EU regulated credit-institutions that invest in any ABS transactions, regardless of the location or nationality of the originator, sponsor or underlying assets. This reflects the principle applied in the EU that the investor (bank or other credit-institution[22], asset manager or insurance company) effectively has the responsibility to check that an issuer retains the relevant interest, whereas the US has applied the principle that risk retention should generally apply to all sponsors regardless of what type of investor decides to invest in the securitization.

As for other jurisdictions, the US and a number of EU jurisdictions report that some form of market practice regarding risk retention exists for certain asset classes.

Other jurisdictions

Responses to the survey indicate that outside of the US and the EU few jurisdictions have imposed or are considering imposing risk retention requirements. However, in a number of jurisdictions, market practice or industry standards have existed, or are developing, that provide for a similar outcome.

For instance in Brazil, the most common market practice is for the issue of senior and junior shares. Senior shares are taken up by investors and the junior shares are underwritten by the originator/sponsor.

In Canada, the structure of securitization of standard asset classes is such that the originator of a pool of assets retains the risk of expected loss through mechanisms such as over-collateralisation, excess spread allocation to investors to offset losses, cash reserve accounts to cover debt service shortfalls and/or subordinated notes issued to originators.

In Japan, originators tend to hold subordinated tranches of RMBS.

[22] Similar retention requirements are being developed in the EU for investors in other sectors. AIFM and Solvency II have provided similar requirements and are awaiting technical rule making. AIFM imposes requirements on alternative investment and collective investment managers, Solvency II on insurers.

It is also worth noting that the German response makes clear that the view of regulators in that jurisdiction is that an increased retention requirement of 10% would be necessary for a prudent ABS market based on the following considerations:

- The incentive effect of the various retention options (e.g. first loss, vertical slice) depends on the retention level in relation to the originator's loss expectations. A uniform retention level must be set sufficiently high to achieve a positive incentive effect for as many potential portfolio compositions and scenarios as possible.

- In various securitization markets the retention levels required by investors have been well above 5%, even before the beginning of the financial crisis. In order to be meaningful the regulatory minimum retention level should not be lower than the market participants' expectations.

- A higher retention level leads to a corresponding increase in the alignment of interest between originators/sponsors and investors.

Other Aspects of Risk Retention

Those jurisdictions that had risk retention requirements generally did not permit hedging, transfer or financing of the risk.

Premium capture requirements were a proposed feature of regulation in the US. The EC/SEC Staff Analysis outlines the proposal by US regulators to include a 'premium capture' mechanism intended to ensure meaningful risk retention, whereby the premium received on the sale of tranches that monetise the excess spread would need to be kept in a separate account and used to cover losses, if certain conditions are met. These requirements were not in place in other jurisdictions.

Survey responses and the EC/SEC Staff Analysis also point to most jurisdictions having either regulatory requirements or industry practice about the disclosure of retained positions.

2. Disclosure

Analysis of disclosure regimes and development of principles for disclosure requirements have been the subject of recommendations in previous work conducted by TFUMP[23].

IOSCO recently released *Disclosure Principles for Public Offerings and Listings*[24], and it is now developing principles for on-going disclosure for public offerings and listings of ABS. Industry initiatives are also focused on improving disclosure through standardization of

23 On the theme of transparency, TFUMP's recommendations in the 2009 Final Report included enhancing transparency through disclosure by issuers to investors of all verification and risk assurance practices that have been performed or undertaken by the underwriter, sponsor and/or originator; and regulatory support for improvements in disclosure by issuers to investors including initial and ongoing information about underlying asset pool performance. Disclosure should also include details of the creditworthiness of the person(s) with direct or indirect liability to the issuer.

24 Disclosure Principles for Public Offerings and Listings of Asset Backed Securities – Final Report, April 2010; http://www.iosco.org/library/pubdocs/pdf/ioscopd318.pdf

documentation and greater transparency of granular data. Initiatives are in some cases jurisdiction specific (for instance in the US) and others were developed at a regional level (for instance in Europe)[25].

The EC/SEC Staff Analysis and the survey both covered elements of initial disclosure on ABS deals.

The EC/SEC Staff Analysis covered some specific issues such as disclosure of waterfall analysis, standardized loan-level information and substitution rights. The survey sought both general and specific information on a wider range of disclosure topics, and also included the issues raised in the EC/SEC Staff Analysis.

TFUMP's analysis points to well developed regulatory requirements in a number of jurisdictions about disclosure in relation to public offerings. Regulation, where it exists, points to similar outcomes being sought by regulation in participating jurisdictions and a general level of consistency in the information to be provided to investors. There are, however, some differences which reflect differences in market conditions and practices. Certain information which may be of significant interest to investors is also not required to be provided in most jurisdictions. An example is information about stress tests that illustrate the performance and the risk profile of a securitization structure in particular scenarios and under changing economic circumstances. These include potential default scenarios and scenarios of economic stress which could provide investors with an indication of the risk profile of both the securitization structure and the underlying assets. This information is understood to be provided by some issuers. Disclosure in relation to private placements (which account for almost all issuance outside Europe and the US) is a matter of contract and industry practice although in the EU, the CRD (for instance) imposes obligations on bank investors to ensure that that they receive adequate and comprehensive disclosure from originators and sponsors to satisfy their need for information irrespective of whether the transaction is public or private.

Upfront Disclosure

Respondents to the survey were asked whether there were any regulatory requirements or industry standards or practices mandating the content of disclosure documentation generally, and in relation to ABS specific areas.

Public Offerings

[25] There have been industry initiatives (e.g. ESF Template) that have been taken further, such as in Europe the loan level disclosure initiative of the European Central Bank (ECB) and similar initiative of the Bank of England (BoE). Those have been driven primarily by a need of these institutions to obtain standardized information to facilitate risk analysis on securitization products used as collateral for their lending facilities. The ECB has been keen on making this loan level information available publicly via a central repository ("European Datawarehouse"). Similarly, in the US, the industry via the ASF's RESTART project has been identifying for private-label RMBS transactions detailed disclosure and reporting to be provided by issuers (regarding loan-level information to be disclosed prior to the initial offering and to be updated on a monthly basis by servicers throughout the transaction's life). In rulemaking, the SEC has proposed rules on loan-level information that would be provided at the time the asset is securitized and on an ongoing basis.

Although responses indicate little retail participation in ABS markets, a number of respondent jurisdictions had detailed disclosure requirements (both upfront and ongoing) that are specific to ABS public offerings or listed ABS's.

For instance, in the US, Regulation AB, which was adopted in 2004, imposes detailed disclosure requirements (both upfront and ongoing) for ABS offerings.

EU countries are subject to the EU Prospectus Directive and Prospectus Regulation which contain specific requirements for disclosure in relation to public offerings and listings of ABS on regulated markets as well as the general content of that disclosure.

The specific disclosure requirements in the EU addressed such matters as waterfalls, trigger events, liquidity arrangements and the material risk factors relating to the ABS of which the issuer is aware. However, such risk factors are often quite technically worded and not concrete. There is no requirement to provide investors with standardized and concise risk factors or to indicate which risk factors should be considered the *key risks factors* related to the underlying assets.

In Canada, Mexico and Brazil, securities legislation also mandates general content requirements for public securities offerings as well as specific disclosure terms that are applicable to ABS offerings.

In Japan, under the Financial Instruments and Exchange Act, issuers must submit a Securities Registration Statement in respect of ABS public offerings that includes certain ABS specific disclosures, including on risk information. In addition, under the rules by the self-regulatory organization, distributors must disclose detailed information on risks when distributing securitized products, regardless of whether via a private placement or a public offering.

Other jurisdictions have only general disclosure requirements containing variations on the basic requirements that apply to any public offers for any type of security for a prospectus to contain sufficient or all material information to enable a reasonable investor to form an opinion about the company issuing the securities, e.g. Hong Kong and Australia.

The EC/SEC Staff Analysis also outlined requirements about the disclosure of waterfall analysis in the US and the EU.

- In the US, SEC rules require a prospectus to disclose the flow of funds for a transaction, including payment allocations, priorities and credit enhancement to facilitate timely payment to security holders. All fees and expenses payable out of cash flows must be disclosed on an ongoing basis. In April 2010, the SEC issued proposed revisions to the rules applicable to ABS transactions, which included a requirement that most ABS issuers file a computer program that gives effect to the flow of funds, or “waterfall”, provisions of the transaction. The proposal was designed to allow investors to analyze the ABS offering at the time of its initial investment decision and to monitor ongoing performance of the ABS. In July 2011, the SEC indicated its intent to re-propose this requirement. An

ABS issuer would be required to file on the SEC website such a program for use by investors [26].

- In the EU, the Prospectus Directive requires an explanation of the flow of funds including:
  - How cash flows will meet an issuer's obligations to security holders;
  - Credit enhancements and subordinated debt facilities; and
  - Payment allocations and priorities.

Private Placements

Regulatory requirements about upfront disclosure in relation to private placements vary between respondent jurisdictions. In most jurisdictions there are no specific requirements and in such situations, disclosure is generally a matter of negotiation amongst the various parties to the transaction and investor expectation.

In some jurisdictions there was evidence of an industry practice regarding the level of disclosure for private placements.

For instance in the EU, under the CRD, any EU investor credit institution may only become exposed to any securitization transaction if they can demonstrate a comprehensive and thorough understanding of, amongst other factors, the risk characteristics of any ABS they invest in. Any issuer wishing to sell ABS to EU investors that are subject to the CRD would be asked to provide sufficient upfront disclosure to allow that investor to perform the due diligence necessary under the CRD to form the relevant understanding. Similar considerations apply to any issuer who wishes to sell to EU insurance companies and asset managers that are subject to Solvency II and AIFM Directive and their respective rules. In Australia, the local industry body has developed standards for RMBS pre-issuance disclosure with further standards planned for ABS disclosure.

Disclosure to such EU investors may become even more relevant as there is currently a revision proposed to the AIFM Directive that would implement the principle that investment managers should not rely solely and mechanically on external credit ratings. Meanwhile, there is currently a proposed revision to CRA Regulation (CRA 3), and more specifically, a proposed provision on transparency of securitized products. Subject to technical specifications to be proposed by ESMA, a general principle would be that key information for an assessment of a securitization product by an EU party must be disclosed to the public (e.g. regarding credit quality and performance of the individual underlying assets, structure, cash flows and any collateral support as well as necessary information to conduct stress tests on the cash flows and collateral values supporting the underlying exposures).

Other Aspects of Upfront Disclosure

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26 For example, it would cover how cash collections are distributed to investors in the ABS, how losses or lack of payment will be divided among the investors, and when administrative expenses, such as loan servicing fees, are paid to service provider.

In response to other questions regarding particular disclosure issues the following themes emerged:

- There is a degree of consistency in the type of information required to be provided upfront. Stress test outcomes on the underlying assets (whether for a static or dynamic pool with substitution rights) are generally not required, nor is disclosure about precisely how substitution rights impact risks through the life of the transaction.

- Few jurisdictions provide exemptions from the disclosure requirements for public offerings.

- There are generally no specific requirements about disclosing how the risk/reward profile of the ABS structure differs from a direct investment in the underlying assets, though investors may gain an understanding of these differences and associated risks from other information provided. Furthermore, although there is generally no requirement for an issuer to provide a concise overview of the factors which may impact on the risk profile of a structure, in many jurisdictions there is a general requirement to disclose all the risks associated with securities offered. That said, some investors indicated a more formatted and standardized view of the risk of the potential investment positions might be useful.

- In most jurisdictions there are regulatory requirements applicable to public offers or listed products on a regulated market mandating the provision of up-to-date and material information to enable investors to understand how the issuer's investment objectives are to be achieved, how the risk of losses may materialize and to compare characteristics within the same asset class. In the EU, the Transparency Directive as transposed into national laws generally provides for some minimal periodic reporting providing a regular snapshot of certain quantitative and qualitative developments of the securitization products, such as via issuer accounts and management reports. However, such reports do not provide loan level data and the data could be considered to be fairly limited, although many originators provide more detailed information to investors on a voluntary basis. Few jurisdictions required that this information be disclosed in a standardized format. Those that did not reported counterbalancing general disclosure requirements regarding investment objectives, risk of loss or asset comparison, seeking to ensure that investors still received comprehensive information.

Ongoing Disclosure

Respondents were also asked to summarize any ongoing reporting in relation to securitized assets or structures. In many jurisdictions ongoing disclosure requirements apply in relation to public offerings. The content and format of disclosure requirements varies between jurisdictions. Some jurisdictions require this information to be disclosed in a standard way, however most do not.

The Prospectus Directive applying in EU jurisdictions does not of itself mandate ongoing reporting for ABS transactions.

There is no obligation to update or supplement a Prospectus if a significant change occurs during the life of a transaction (e.g. a modification to the terms and conditions, a material mistake or inaccuracy or any significant new factor). Nonetheless it mandates that the issuer must specify whether or not they intend to provide post-issuance ongoing and permanent reporting relating to the securities and if so, where and when. Reporting is also mandatory and regulated if securities are admitted to trading on a regulated market and as such become subject to the Transparency and Market Abuse Directives for the life of the listing.

In EU jurisdictions, the CRD due diligence requirements on investors in securitization products apply on an ongoing basis, the practical effect being that ABS issuers provide ongoing reporting to CRD-regulated investors to enable the investors to comply with their obligations. Similar approaches have been recommended in rulemaking for other entities under sector legislation (e.g. asset managers under the AIFM Directive and insurance companies under Solvency II[27]).

In a number of jurisdictions it was reported to be industry practice for the issuer to provide ongoing reporting on key issues particularly relevant to the credit quality of the asset class/pool. This is particularly relevant where an ABS offering has been made by way of private placement that may not be subject to any regulatory requirements mandating initial or ongoing disclosure.

The EC/SEC Staff Analysis also addressed ongoing disclosure. In the US, under revised Section 15(d) of the Exchange Act, ABS issuers must provide ongoing disclosure reports for the life of the security. In addition, the SEC has proposed rules requiring the filing of standardised information about the specific assets in the pool (this is similar to the loan level information required on securitization).

Disclosure Standardisation

Respondents were asked whether standardised initial disclosure information was required which would enable investors to understand how issuers seek to achieve investment objectives, understand risk of loss to principal and interest and to allow comparison between securities in the same class. They were also asked whether standardised information was required on an ongoing basis about underlying credit risk, risk of loss and cash flows. Responses to the survey indicated that most jurisdictions did not specify any standardised disclosure formats. There were some exceptions. In Japan a format for the Annual Securities Report was specified and in Brazil standardised quarterly information was required regarding various risks, cash flows and losses. In Portugal and South Africa there are also some standardised disclosure requirements.

Industry Initiatives on Disclosure Standardization

Industry initiatives have sought to encourage greater standardization in documentation and greater data transparency at a granular level.

In Europe initiatives have been advanced by public institutions through steps such as the loan level initiative of the European Central Bank (ECB) and the similar initiative of the Bank of England. These initiatives have been driven by a need to gain standardized information on

[27] Through Technical Advices ESMA and CEIOPS/EIOPA (respectively "ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive" and "CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Repackaged Loans Investment").

securitization products for risk analysis as an investor and by the desire to restart the securitization markets in Europe by the provision of additional transparency. The ECB has arranged for such loan level data available publicly via a central repository (the "European Datawarehouse"). A provision for comparable disclosure is now currently being considered in the revision of CRA Regulation in Europe.

Similarly, in the US, the industry via ASF's RESTART project has been identifying for private-label RMBS transactions detailed disclosure and reporting to be provided by issuers (regarding loan-level information to be disclosed prior to the initial offering and updated monthly by servicers throughout the transactions life). In Australia industry standards have been developed for reporting loan level data for RMBS transactions as well as standard pre-issuance disclosure. Similar ABS standards are being developed.

The SEC is considering what loan-level information would be provided at the time the asset is securitized and on an ongoing basis. Proposed rules would require loan-level or grouped account data about pool assets being lodged with the SEC in computer readable, standardized format.

Certification or Verification

Respondents were asked whether there was any certification or verification of information disclosed in offering documents or via ongoing reporting. Requirements for disclosure verification are in place in most jurisdictions. These requirements can be different in nature, including verification on the form of the disclosure (e.g. clarity and legibility), requirements about content (e.g. auditors' sign off on accounts), and self-certification or external verification requirements (e.g. senior management commitment or external verification in respect of representations and warranties or of custodial duties). Civil and in some cases criminal sanctions for misrepresentation and inaccuracy are in place in all jurisdictions.

3. Securitization process

It is generally acknowledged that sound and effective risk management practices across the securitization value chain will contribute to increased investor confidence in securitization and thus possibly support recovery of securitization markets. Key practices and processes for sound and effective risk management relate to underwriting and origination practices (such as procedures for accurate assessment of borrower's capacity to repay); the selection of underlying assets for the asset pool and investor due diligence.

The FSB, in particular, has recognized the importance of these issues. The FSB has developed an international principles-based framework for sound underwriting practices of residential mortgages[28]**.** Issues it has addressed include LTV criteria for loan underwriting and selection criteria for underlying assets. As RMBS are the dominant asset class in many jurisdictions these Principles are particularly relevant.

[28] FSB Thematic Review on Mortgage Underwriting and Origination Practices, March 2011 http://www.financialstabilityboard.org/publications/r_110318a.pdf and Principles for Sound Residential Mortgage Underwriting Practices, April 2012. http://www.financialstabilityboard.org/publications/r_120418.pdf

The EC/SEC Staff Analysis and the survey therefore covered both initial due diligence and asset selection requirements.

The EC/SEC Staff Analysis noted the following:

- Recently adopted SEC Rules are intended to drive and support initial due diligence. This includes issuers of registered ABS offerings being required to conduct a review of the assets and disclose the nature of the review performed to satisfy the review requirements. Information that issuers are required to disclose includes: information about how the loans in the pool differ from the loan underwriting criteria disclosed in the prospectus; loans that did not meet the disclosed underwriting criteria but were nonetheless included in the pool; and the entity that made the determination that such loans should be included in the pool, despite not having met the disclosed underwriting standards. Current SEC rules also require substitution rights to be disclosed. Current ongoing disclosure rules require disclosure of pool asset changes resulting from substitutions and repurchases as well as any material changes to origination or pool selection criteria.

- EU rules approach the issue indirectly with comprehensive due diligence requirements imposed on investing institutions. As a general principle, the CRD requires that any credit institution when acting as initiator or sponsor of an ABS transaction shall apply the same sound and well-defined criteria for credit-granting in accordance with the requirements of the directive to any exposures that are to be securitized as they apply to exposures to be held on their books. This directive is to be extended to apply also to investment firms within the EU. Under a similar rationale, the same standard of analysis is to be applied to securitization issues purchased from third parties whether or not the positions are held on trading or non-trading books.

In other jurisdictions participating in the survey, there were varying approaches to regulatory requirements around securitization processes. Survey responses pointed to other jurisdictions imposing prudent risk management practices on investors. In some jurisdictions there are specific limits on permitted investment exposure to ABS. In other jurisdictions there were regulatory requirements limiting the assets that could be selected for the pool at origination or during the life of the transaction. Selection criteria seem to be generally quite broad.

Responses to the survey also suggested that in many cases the underwriter of the underlying assets is related to the ABS sponsor or the originator of the securitization in some form of capitalistic way. This may provide the ABS sponsor, or securitization originator, with a degree of visibility to the underwriting practices used in respect of originating the underlying assets and some ability to control these practices.

The survey also indicated the following:

- Selection criteria are generally set out in the contractual agreements, disclosure documents or bylaws of the vehicles and can be reviewed by potential investors. Criteria in jurisdictions vary and can include nature of risks, quality of assets, governing law and currency.

- In most jurisdictions substitutions rights are not prohibited. Inclusion of such rights is a matter for industry practice and the specific structure of a transaction. Where substitution rights are present it appears that these rights generally would be disclosed. For instance in the EU the Prospectus Directive (to the extent that the product is offered to the public or listed on regulated market) requires disclosure of any substitution rights and a description of the manner in which and the type of assets which may be substituted. This information is mandatory at the time of issuance, and should be kept current on an ongoing basis.

- In some jurisdictions, it is a regulatory requirement or industry practice that the issuer or originator is obliged to repurchase/substitute assets that no longer meet eligibility criteria, or no longer meet the representations or warranties made in relation to the assets.

- In many jurisdictions, industry practice and external parties (e.g. CRAs or investors) influence the criteria applied to the asset selection at origination and on an ongoing basis. Where a rating is sought, an issuer would need to meet CRA requirements on asset pool selection and investors will have their own investment requirements regarding any assets they invest in regarding delinquencies and non-performing assets. An issuer seeking either a rating or targeting a particular investor or investor class would, in practice, need to meet the relevant requirements.

- Certain central banks and more generally "official or governmental investors" have become key investors for securitization products after the Global Financial Crisis, and as a consequence, they have imposed their own standards with regards to the nature and quality of underlying assets for securitization products deemed to be acceptable or eligible for their investment portfolio. For instance in Australia the Australian Office of Financial Management (**AOFM**) and the Reserve Bank of Australia will only invest in securitization deals that meet their eligibility respective criteria, e.g. AOFM will only invest in RMBS backed by pools containing high quality Australian residential mortgages. In Europe, much securitization activity is for the purpose of posting collateral at the ECB, therefore ECB requirements are critical. The ECB has developed their own disclosure requirements for loan level data that apply to any securitization instruments lodged with them.

- Some jurisdictions have key government related securitization issuers in their markets. Those are for instance Japan Housing Finance Agency (JHFA) in Japan, and Infonavit and Fovissste in Mexico. Such issuers also have limitations on asset selection. The JHFA is restricted to loans for developing and purchasing houses; and Infonavit has self imposed criteria reflecting its role as an agency providing housing credit to workers.

4. CRA issues

Survey responses also highlighted the following.

Standard structural features for CRAs

CRAs have specific requirements for particular ratings which issuers would need to meet for relevant ratings to be achieved. Each CRA has its own methodologies for assessing the ratings assigned to a securitization structure, and as such, it is possible for the same transaction to be assigned a different rating.

Information typically reported to CRAs at origination or during the life of the transaction

The general perception was there is a significant amount of information being provided to CRAs (including the specific points noted in the questionnaire). However, regulators are generally not privy to this information.

VI Policy Recommendations for Consultation

This Part considers the FSB SRC's request for policy recommendations to address issues arising from the implementation of risk retention requirements and measures aimed at enhancing transparency and standardization of securitization products in member jurisdictions.

TFUMP's observations and findings point to policy recommendations about the following for consultation with interested parties:

- Differences in approaches to risk retention;
- Improvements in transparency; and
- Standardization in product disclosure.

As illustrated in Part V, TFUMP's work also points to a number of other issues where further work may be needed to determine whether addressing those issues could help to support re-establishing securitization markets on a sound basis. These issues are summarized in **Annex Two**.

Views on the following issues are sought.

Differences in Approaches to Risk Retention

Most TFUMP members are of the view that differences in retention requirements between current US proposals and recent EC initiatives identified in this Report may have significant cost implications for and may impede cross border issuance.

The key issue is differences in approach to exemption provisions.

Exemptions proposed under the Exchange Act from risk retention requirements include issues collateralised solely by Commercial Real Estate (CRE), commercial loans and auto loans that satisfy certain underwriting criteria, or what are described as Qualified Residential Mortgages (QRMs). Rules under development could mean a significant proportion of standard US issuer ABS offerings would be exempted from risk retention requirements. (QRM's for instance are currently proposed to include most mortgages over residential housing that do not exceed 70% or 80% LVR).

Exemptions for sales to EU CRD-investors are limited to securitized exposures or claims on, or fully guaranteed by, public sector agencies.

Although TFUMP acknowledges that it would be technically possible for market participants wishing to issue into both the US and the EU to comply with requirements in both jurisdictions, complying with both sets of requirements may risk adding to the cost of cross border issuance between the US and the EU and into both markets from other jurisdictions.

US issuers benefitting from the US exemption may, for instance, have to structure their offerings differently to access EU investors the subject of the CRD (as these investors need to be satisfied the issuer has met relevant European risk retention requirements). This could either mean structuring their offering to all investors to meet EU requirements or developing two tiered structures (one for EU investors the other for all other investors). Either way, US issuers could be subject to costs driven solely by complying with different regulatory requirements.

EU issuers could also be at a competitive disadvantage to US issuers as the exemptions expected to be available in the US will not be available to EU issuers securitizing EU assets under current EU requirements.

Proposals:

TFUMP proposes that it monitor industry experience and views on the impact of the differences it has identified in regulatory approach between jurisdictions (e.g., the US and the EU).

TFUMP foreshadows that should industry feedback and experience point to the envisaged impacts emerging it will consider developing appropriate regulatory responses and mechanisms to address those differences.

Issue One:

Please comment on TFUMP's proposals regarding risk retention requirements.

Transparency Issues

TFUMP's analysis points to well developed regulatory requirements in many jurisdictions about disclosure in relation to public offerings (and in some jurisdictions, in relation to private placements).

Regulation, where it exists, points to similar outcomes being sought by regulation in participating jurisdictions and a general level of consistency in the information to be provided to investors. There are, however, some differences which reflect differences in market conditions and practices. TFUMP does not see the need to address these differences.

TFUMP notes, however, that issuers are generally not required to disclose to investors the outcomes of stress testing/scenario analysis undertaken on underlying assets. Increased transparency could also contribute to the broader objective of reducing investor's reliance on CRAs. Clear information on stress testing provided by issuers could assist investors in conducting their own due diligence and in understanding the risks associated with investing in ABS, thereby assisting in the development of improved in-house analysis capabilities by investors.

Proposal: TFUMP proposes that IOSCO consult (through TFUMP) with investors about their appetite for stress testing information and, if appropriate, provide guidance on the disclosure issuers should be expected to make about stress testing and scenario analysis of pooled assets.

Issue Two: Please comment on TFUMP's proposal on the disclosure of information about stress testing and scenario analysis.

Standardization

TFUMP has seen little evidence of standard disclosure templates being consistently required in the jurisdictions involved in the survey, other than a few exceptions. However, TFUMP notes industry and regulatory initiatives in this regard in Europe and the US and similarities in the types of data fields developed that would apply to various asset classes.

Consistent, again, with the objective of reducing investor reliance on CRAs, principles to develop standardisation and transparency could facilitate investors' due diligence and risk analysis. Improved legibility of risk transfer and risk management could foster investors' in-house analysis of their securitization positions by providing standard tools whether for pre-sale analysis or on-going surveillance of asset performance.

TFUMP recognises that securitization markets may benefit if investors are able to compare and benchmark the risk/reward profile associated with transactions through standard approaches to disclosure (using standard templates). Templates could cover core risk factors and fee structures (both for the structure and underlying assets).

Proposal: TFUMP proposes that IOSCO encourage industry to develop best practice templates and to encourage industry bodies to work with their counterparts in other jurisdictions to ensure consistent and harmonised approaches. IOSCO should consider developing principles to support harmonisation in these approaches.

Issue Three: Please comment on TFUMP's proposal regarding standardisation of disclosure.

Annex One

Prime Collateralized Securities (PCS)

PCS goals

PCS is an industry-led initiative that is aimed at revitalizing the securitization industry in Europe by establishing "market best practice" standards. The key goals are to:

- Signal to policymakers that the European securitization industry has proactively addressed concerns over quality, transparency, simplicity/standardization that are pre-conditions to enhanced secondary market liquidity; and
- Evidence to policymakers that PCS labeled bonds are a high quality investment, so that over time policymakers may consider a favorable regulatory and capital treatment for them, as already exists for certain other fixed income asset classes in Europe.

Background of PCS

- In 2011, AFME and EFR organized a cross-industry technical working group as well as a senior advisory group for PCS.
- The senior advisory group consisted of members of senior financial management (CFOs, Treasurers and CIOs) at European financial institutions. Bishopsfield Capital Partners is the independent consultant. ECB, EIB Group and the Bank of England were observers in 2011. Other associations also monitored progress.
- Likely eligible asset classes in the first stage of PCS are European residential mortgages, auto loans, SMEs and leasing, and consumer loans/credit cards.

Key features of the PCS organization

- "Not-for-profit" economic model.
- Business operations based on a "Hub and Spoke" approach, with swift access to market.
- Upfront funding of c. €3.6 million required. This is intended to primarily provide for start-up investment, operating losses for the first two years and a working capital reserve.

High level PCS principles agreed by the working group

- Not a credit rating.
- Grandfathering/ retrospective eligibility.
- Standardized reporting and disclosure.
- Dynamic over time to accommodate evolving markets.
- Recognizes existing market practices provided they are consistent with investor needs.
- A positive label for eligible securitizations and not a disqualifier per se for ineligible securitizations (e.g. for a different investor base out of scope for PCS).

- Cross referencing for public term securities market to existing or soon to be implemented initiatives (e.g. ECB/BoE transparency).

Progress update and next steps

- Detailed legal term sheet (containing set of eligibility criteria for the PCS) mostly completed, with remaining details to be finalized.
- Detailed business plan (governance, operational framework, financial forecast) completed.
- Fundraising process has reached its objective, with commitments from 30 institutions. First PCS labeled issue targeted for Q2-Q3 2012.
- Funders have agreed to invite a group of non-funding observers to the next meetings, including European investors, ECB, EIB Group, Bank of England and the European Commission.
- Important next steps are hiring of PCS Secretariat Executive Director, selection of PCS Association Board of Directors and finalization of key term sheet and operating details.

Annex Two

Further Policy Issues

1. Definitions and Terminology

Despite the survey using a restrictive definition of securitization, the responses covered a wide range of practices and structures (and with it risks), pointing to a diversity of understanding among IOSCO members on the meaning of relevant terms.[29] This makes it difficult to compare products.
If policy guidance is to be developed by IOSCO, consideration may need to be given to developing standard definitions for the different types of securitization products (which are consistent with other regulatory definitions such as under the Basel Framework) to which the guidance would apply.

2. CRAs

To perform their thorough testing and risk analysis CRAs often get access to much more detail about proposed offerings than investors. There may be scope for investors to be given equal access to the information provided to CRAs at the time of the offering and on an ongoing basis thereafter.

3. Governance of the securitization process: selection and eligibility criteria

Initial due diligence and asset selection by originators or sponsors are key elements to ensuring the quality of securitized products. It is therefore important to consider eligibility criteria for underlying assets. In parallel, the FSB has conducted important work to identify sound practices for mortgage origination.

It could be helpful to combine the two aspects into an integrated approach of good governance. It could, for instance, be achieved by helping investors through measures to identify securitization products backed by asset pools originated in compliance with sound practices for underwriting of mortgages or loans more generally. This could be done by considering RMBS and the existing FSB work. Initiatives such as a credible and transparent labelling initiatives that promote standardised disclosure of underlying loans originated using sound loan origination practices might be needed in that regard.

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[29] TFUMP used Asset Backed Securities (**ABS**) in the questionnaire to refer to securities that are primarily serviced by the cash flows of a discrete pool of receivables or other financial assets that, by their terms, convert into cash within a finite period of time. It explained that the questionnaire could cover RMBS (residential mortgage-backed securities), CMBS (commercial mortgage-backed securities), CLOs (Collateralized Loan Obligations), as well as short-dated securitization such as ABCP (asset-backed commercial paper). It deliberately chose to exclude multisequential securitization (e.g. Collateralized debt obligations (CDO) of ABS, CDO of CDOs), and non cash securitization (e.g. synthetic CDOs).

4. Liquidity : Standardisation and transparency

Survey responses pointed to secondary markets being OTC, even when the ABS are listed on a regulated market.

In 2010, IOSCO TCSC 2 identified recommendations based on the fact that pre-trade transparency (e.g. more standardised, more transparent products) and adequate post-trade transparency might help to develop liquidity for structured finance products, including securitization products.

As for derivatives, standardisation and transparency may help in the development of trading of securitization products on secondary markets.