

Rating Research Services

Executive Comment:

How Taiwan's Capital Markets Could Benefit From Post-Crisis Developments In The Global Securitization Market

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How Taiwan's Capital Markets Could Benefit From Post-Crisis Developments In The Global Securitization Market

The global securitization market has slowly recovered from the lows brought by the recent global financial crisis, with issuance volume across the world picking up step by step. Lessons learned from the market's failure in 2008 and 2009 have been reflected in more recent deal structuring, and stringent regulations now force more responsible asset underwriting and risk sharing. It is now widely accepted by global investors/markets that securitization is a valuable instrument to address economic needs, but market participants and regulators need to understand its limitation and the potential risks involved.

Throughout the securitization market's initial stage of recovery, Taiwan has once again deviated from the global trend being set in this sector. New securitization issuance has almost ground to a halt since 2008, with some market participants even questioning the necessity of such product in Taiwan. Taiwan Ratings Corp. believes there remains some misunderstanding about the nature of this product and what it can achieve. We also believe that what has happened in other markets could help to resolve such misunderstanding, particularly of the many macroeconomic benefits from a sound local securitization market.

Overview:

- The global securitization market has learned in an unpleasant way that a transaction's structure cannot compensate for bad underwriting and misaligned interests.
- Through insights gained from the market's recent failure and the recognition of securitization's benefit to the general economy, new securitization deals have returned to the purpose of providing funding flexibility for issuers and investment flexibility for investors, accompanied by a slow recovery in issuance volume.
- We believe global market experience provides important reference notes for Taiwan's capital market, particularly regarding direct financing to share the banking sector's burden, alternative funding channels for banks and non-bank issuers, the prevention of excessive debt accumulation, and the availability of diversified investment targets.

Lessons Learned: Structuring Cannot Compensate For Bad Underwriting Transaction Failures Stem From Weak Securitization Practices

The turmoil that befell the global market in 2008 tells us one important thing--the structure of a securitization transaction cannot compensate for bad underwriting and misaligned interests. Deal failure was evident particularly in offerings linked to U.S. sub-prime residential mortgages, which led to later questioning of many of the assets' underwriting practices and sellers' buy-and-sell business models.

Moreover, markets are now aware highly leveraged structure, no matter within a single transaction or across a class of deals, could contribute to a quick and sharp deals failure when market conditions change or concentration rises. Transactions with leveraged-up exposures to the market values or concentration on particular financial institutions did suffer for either the market price

fluctuations or the indirect impact of collapsing sub-prime residential mortgages.

The Majority Of Securitizations Remained Resilient Even During The Crisis

Despite investors' general impression, the majority of structured finance transactions performed well during and after the financial crisis. Other than the sectors highlighted above, most structured finance notes under Standard & Poor's and Taiwan Ratings' surveillance have been resilient in terms of asset performance and ratings (see table 1 and table 2).

Table 1

Standard & Poor's Global Structured Finance Original-To-Current Rating Transition (%), 1978-2012														
From/to	Beginning number of ratings	AAA	AA	A	BBB	BB	B	CCC	CC	C	D	NR	Upgrade/Stable/Not Rated	Downgrade
Global SF														
AAA	120,305	7.82	4.42	2.59	2.02	1.17	1.4	5.03	2.72	0	9.72	63.11	70.93	29.07
AA	25,432	1.52	10.84	3.48	2.67	3.1	3.7	6.34	4.33	0.02	25.6	38.39	50.75	49.25
A	24,836	0.66	1.97	11.23	2.92	2.19	2.96	6.66	5.29	0	30.13	35.99	49.85	50.15
BBB	23,728	0.17	0.64	1.29	8.74	2.54	2.84	4.88	6.28	0	41.5	31.13	41.97	58.03
BB	9,854	0.05	0.25	0.39	0.78	8.79	4.52	5.76	5.18	0	48.71	25.57	35.83	64.17
B	5,005	0	0.06	0.06	0.2	0.58	5.67	4.3	5.61	0	61.46	22.06	28.63	71.37
CCC	177	0	0	0	0	0	0.56	7.34	1.13	0	58.76	32.2	40.11	59.89
CC	12	0	0	0	0	0	0	0	16.67	0	33.33	50	66.67	33.33
C	0													
Global ABS														
AAA	15,564	8.08	5.77	1.44	0.84	0.34	0.4	0.45	0.28	0	0.07	82.34	90.42	9.58
AA	1,984	0.86	29.99	3.38	1.56	0.55	0.71	1.71	0.86	0	2.27	58.11	88.96	11.04
A	4,539	0.15	4.01	19.04	2.34	0.68	0.88	0.57	0.35	0	3	68.98	92.18	7.82
BBB	2,486	0.04	2.29	2.21	15.61	1.49	3.54	2.37	0.76	0	6.44	65.25	85.4	14.6
BB	675	0	1.04	1.63	0.3	14.81	2.07	1.93	2.22	0	9.78	66.22	84	16
B	128	0	0	1.56	0.78	0	28.91	2.34	0.78	0	11.72	53.91	85.16	14.84
CCC	29	0	0	0	0	0	0	3.45	3.45	0	72.41	20.69	24.14	75.86
CC	4	0	0	0	0	0	0	0	25	0	0	75		0
C	0													
Global CDO														
AAA	12,052	8.54	8.49	1.45	1.17	1.53	1.1	2.13	0.42	0	15.51	59.67	68.2	31.8
AA	5,053	1.5	11.36	4.85	1.11	1.17	1.58	3.4	1.09	0	20.76	53.18	66.04	33.96
A	3,813	0.84	2.31	15.03	7.68	1.84	1.36	3.83	1.49	0	22.58	43.04	61.21	38.79
BBB	3,596	0.06	0.19	1.06	14.88	8.04	4.09	5.67	2.47	0	29	34.54	50.72	49.28
BB	1,784	0	0.06	0.34	0.73	20.24	11.94	10.37	3.81	0	21.02	31.5	52.86	47.14
B	278	0	0	0	1.08	1.44	9.71	7.19	0	0	18.71	61.87	74.1	25.9
CCC	64	0	0	0	0	0	0	9.4	0	0	42.19	48.44	57.81	42.19
CC	5	0	0	0	0	0	0	0	20	0	40	40		40
C	0													
Global CMBS														
AAA	5,747	26.73	2.44	4.05	3.01	2.04	2.31	0.94	0	0	1.44	57.04	83.77	16.23
AA	2,433	3.82	9.04	4.85	4.48	4.64	6.37	6.66	0	0	5.59	54.54	67.41	32.59
A	2,691	0.63	3.79	8.51	4.01	4.42	6.47	9.1	0.11	0	10.37	52.58	65.51	34.49
BBB	3,407	0.26	1.14	2.47	7.98	3.76	4.61	10.54	0.21	0	20.96	48.08	59.94	40.06
BB	1,906	0.21	0.73	1	1.94	10.28	6.24	10.02	0.16	0	45.38	24.03	38.2	61.8
B	1,383	0	0.22	0.07	0.07	1.37	9.98	8.82	0.22	0	67.82	11.42	23.14	76.86
CCC	38	0	0	0	0	0	0	2.63	0	0	76.32	21.05	23.68	76.32
CC	0													
C	0													
Global RMBS														
AAA	85,667	6.47	3.62	2.86	2.29	1.23	1.58	6.61	3.7	0	11.35	60.29	66.76	33.24
AA	15,489	1.3	8.75	2.52	2.94	3.9	4.47	8.03	6.65	0	34.07	27.36	37.41	62.59
A	13,072	0.83	0.67	7.47	1.34	2.16	3.52	9.46	9.45	0	47.28	17.82	26.78	73.22
BBB	13,785	0.2	0.35	0.75	5.79	0.86	1.92	3.87	9.96	0	57.19	19.09	26.19	73.81
BB	5,424	0	0.06	0.04	0.29	3.72	1.81	3.3	7.8	0	64.25	18.73	22.84	77.16
B	3,181	0	0	0	0.16	0.19	2.55	2.2	8.71	0	65.07	21.13	24.02	75.98
CCC	39	0	0	0	0	0	2.56	12.82	2.56	0	66.67	15.38	30.77	69.23
CC	3	0	0	0	0	0	0	0	0	0	66.7	33.3	33.33	66.67
C	0													

SF--Structured finance, ABS--Asset-Backed Securities, CDO--Collateral Debt Obligation, CMBS--Commercial Mortgage-Backed Securities, RMBS--Residential Mortgage-Backed Securities. Note: 'AAA' ratings from the same transaction are not treated as a single rating in the calculation of this table. Full rating categories are used when determining rating transitions such as upgrades and downgrades.

Table 2

Taiwan Ratings' Original-To-Current Structured Finance Rating Transition (%) By Asset Type, 2003 - 2012

Asset type	Beginning no. of ratings	Stable	Upgrade	Downgrade	Default
ABS Commercial Other	1	100.00	0.00	0.00	0.00
ABS Consumer Other	1	100.00	0.00	0.00	0.00
ABS Equipment	6	83.33	16.67	0.00	0.00
CDO Cash Flow CBO	19	42.11	47.37	10.53	0.00
CDO Cash Flow CDO of CDO	9	11.11	0.00	88.89	44.44
CDO Cash Flow CLO	33	21.21	78.79	0.00	0.00
CDO Other	2	100.00	0.00	0.00	0.00
CMBS	6	33.33	66.67	0.00	0.00
RMBS Prime Jumbo	10	70.00	30.00	0.00	0.00
Total	87	39.08	49.43	11.49	4.60

ABS--Asset-Backed Securities, CDO--Collateral Debt Obligation, CMBS--Commercial Mortgage-Backed Securities, RMBS--Residential Mortgage-Backed Securities. Notes: Stable includes withdrawn ratings due to redemptions, for which the rating before withdrawal was the same as the initially assigned. Downgrade rate includes defaults. Rating modifiers (+ and -) are used when determining rating transitions such as upgrades and downgrades. Source: Taiwan Ratings Corp.

Such performance divergence provided important directions to where the market should go in the post-crisis era. In recent years, global regulators and international organizations kicked off a comprehensive review of securitization products, which led to some important insights and there have been many constructive suggestions on the usage of securitization. The market itself has also adapted some of these, and in our opinion, deals initiated after the crisis have largely reflected the lessons learned from past events.

Market Participants Recognize The Benefits Of Securitization

Even with the much criticism on what went wrong with securitization, the market generally acknowledges the benefits it brings to the financial sector and the economy. The International Monetary Fund (IMF) commented on the subject in its paper published shortly after the financial crisis in October 2009 titled, "**Global Financial Stability Report--Navigating the Financial Challenges Ahead.**" In the report, the IMF indicated that given the pivotal role of securitization as an alternative and flexible funding channel, the failure to restart securitization would come at the cost of prolonging funding pressures on banks and a diminution of credit. Recently many regulators have also called for a sound and well-controlled market for securitization as a component of a funding rebalancing strategy, and the need for securitization to create more credit to revive economies upon scarcer bank capital.

To achieve a 'sound and well-controlled market for securitization', there have been many proposals and the actual implementation of new securitization regulations globally. These include the sellers' requirement on risk retention, a minimum level of information disclosure and reporting, changes to accounting rules for securitization, amendments to the capital accord governing securitization transactions, and a securitization-related solvency rule for insurance companies' investments. We anticipate more to come, and that many of these measures will go beyond traditional jurisdictional borders and affect the worldwide securitization market.

Post Crisis Development: Securitization Has Made A Slow But Continued Recovery Worldwide

The Market Has Embraced The Original Ideas Of Securitization And Incorporated New Developments

The aforementioned recognitions and suggestions are based on insight into the origin of securitization itself--providing funding flexibility for the issuers and fostering assets liquidity for the benefit of investors. Market development after the crisis has been consistent with such an expectation, as reflected in the pickup of issuance in asset-backed securities (ABS), prime residential mortgages-backed securities (RMBS), and collateralized loans obligations (CLO). Unlike the many arbitrage, buy-and-sell, and market-betting exercises before the crisis, in the last five years securitization offerings were redirected to support or at least coincide with the economic recovery.

Another distinctive feature of the post-crisis securitization (or Version 2.0, as it is unofficially referred to by market participants) is that investors play more roles in the deal process through more information disclosure on underwriting standards/practices, access to the documentation details, and independent credit reviews. In our observation, investors are now more concerned about the alignment of interests between themselves and the issuers, and could demand more structural protection and decision-making powers when things go wrong during a transaction's life. As investors develop themselves in this way, the information gap and capability disparity between issuers and investors have quickly narrowed.

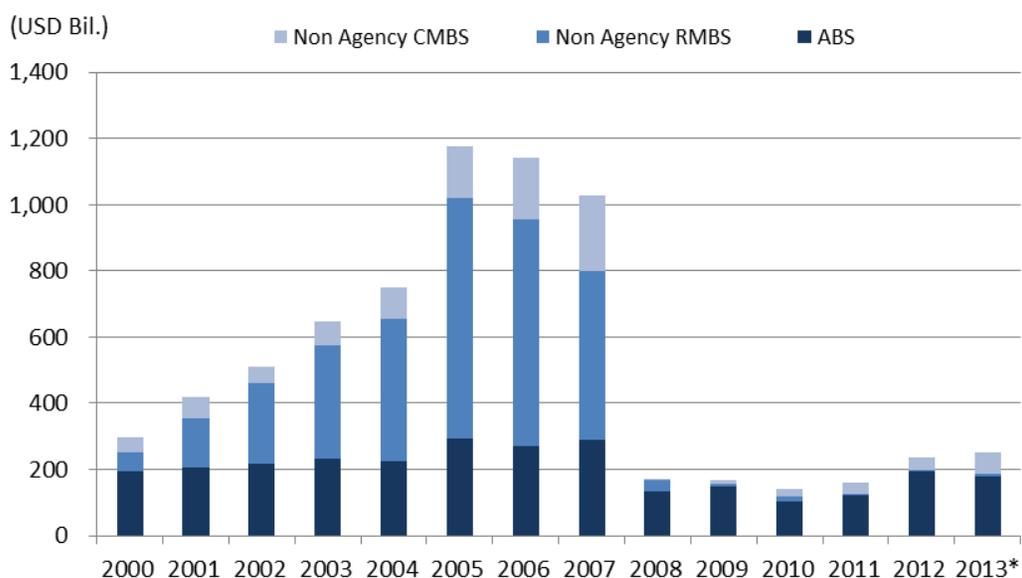
Aside from providing banks with funding flexibility to help them get through the eurozone's recent banking liquidity challenge (before the European Central Bank implemented its long-term refinancing operations), some issuers now also use securitization as a tool for portfolio management. The intention of such securitization includes risk reclassification (from thousands of unrated, small, and individual assets to a single rated note with market liquidity) and duration/liquidity match for the preparation of the new Basel banking capital requirement.

Issuance Volume Has Recovered In New And Established Markets

United States

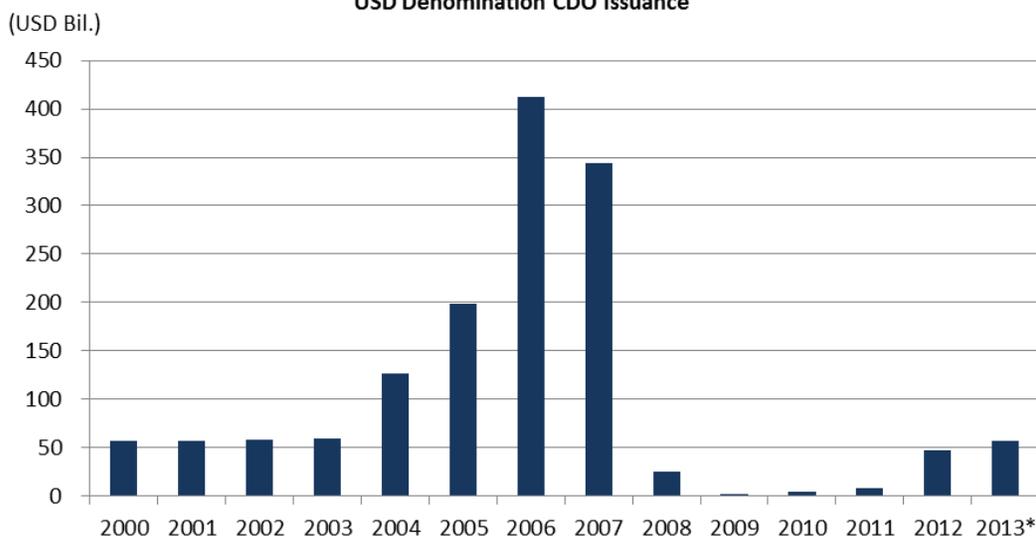
Transactions in their simplest form of repacking a variety of assets, such as the ABS sector with lending to auto purchases, credit cards, and students, are the least affected securitization types after the crisis. The CLO and commercial mortgage backed securities (CMBS) sectors also recovered well due to the demand for financing, stable asset performance, and investors' strong appetite (see charts 1 and 2).

Chart 1
U.S. Securitisation Issuance



*Data as of Nov. 30, 2013. Source: SIFMA.

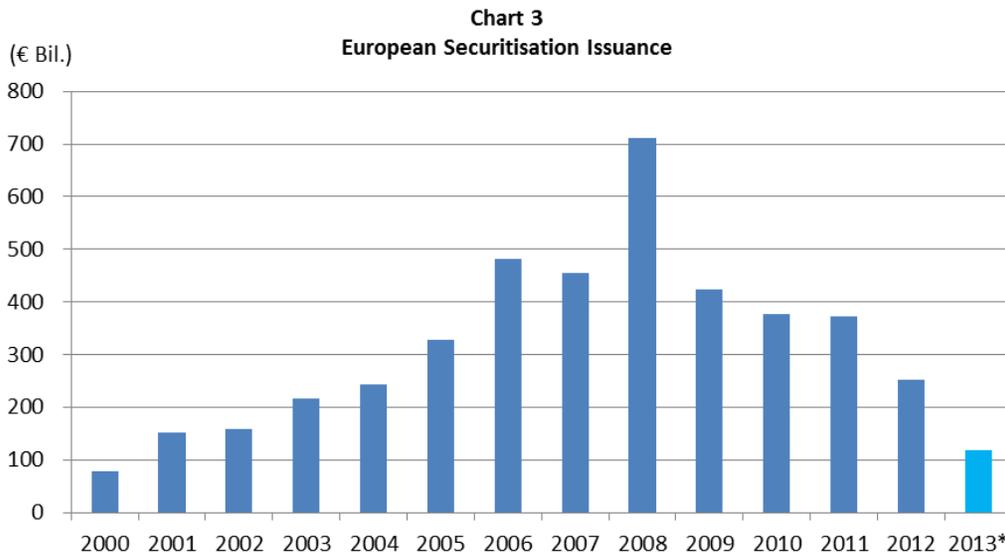
Chart 2
USD Denomination CDO Issuance



*Data as of Sept. 2013. Source: SIFMA.

Europe

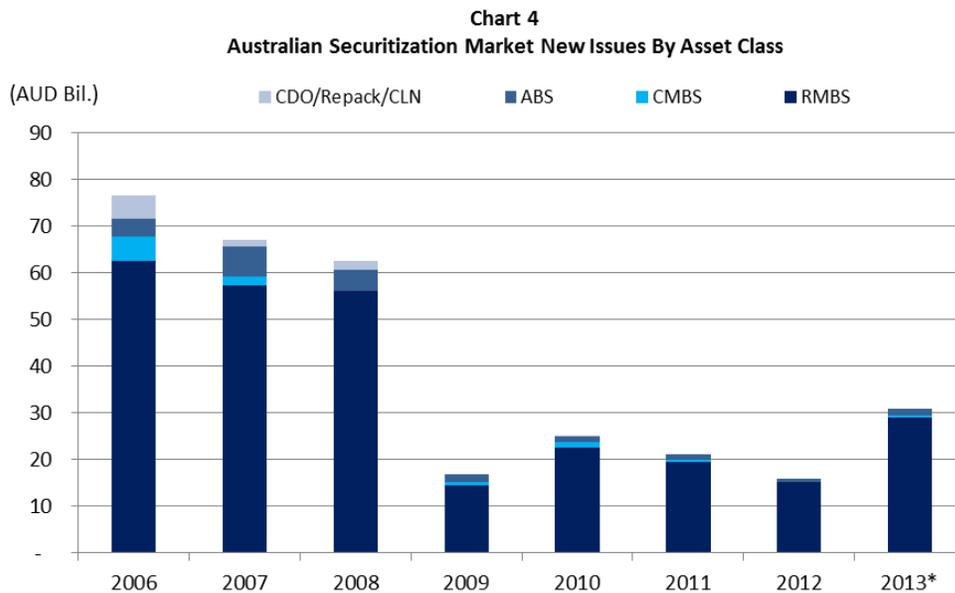
Covered bond issues saw a quick pickup over the past few years to meet the funding gaps of eurozone banks. However, the recovery of other forms of securitization in Europe has been slow due to prolonged concerns over the region’s sovereign debt and economic recession. That being said, the prime RMBS issuance in the United Kingdom and the Netherlands has been resilient to meet the funding demand of the housing sector, and recently there has also been some auto and aircraft ABS issuance (see chart 3).



*Data for January-September 2013. Source: AFME

Australia

Although issuance volume has dropped significantly from the pre-crisis level, Australia has seen stabilized mortgage related issuance in recent years, including prime RMBS and covered bonds (see chart 4).

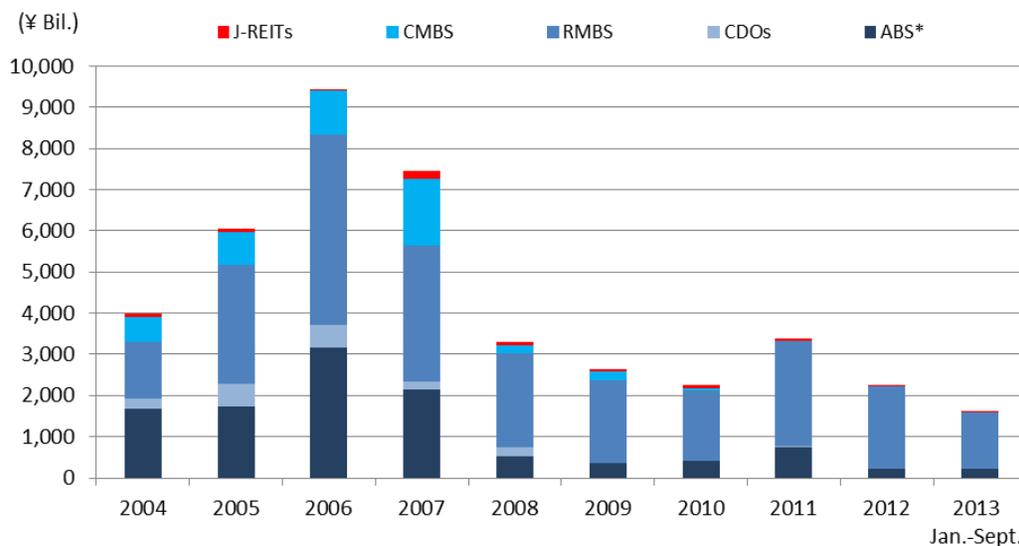


*Data as of Dec. 20, 2013. Source: Standard & Poor's Ratings Services.

Japan

Prime RMBS transactions related to Japan Housing Financing Corp. continue to dominate the new issuance market, and there has been a pickup of ABS transactions recently (see chart 5).

Chart 5
Total Amount Of Rated Structured New Issues In Japan

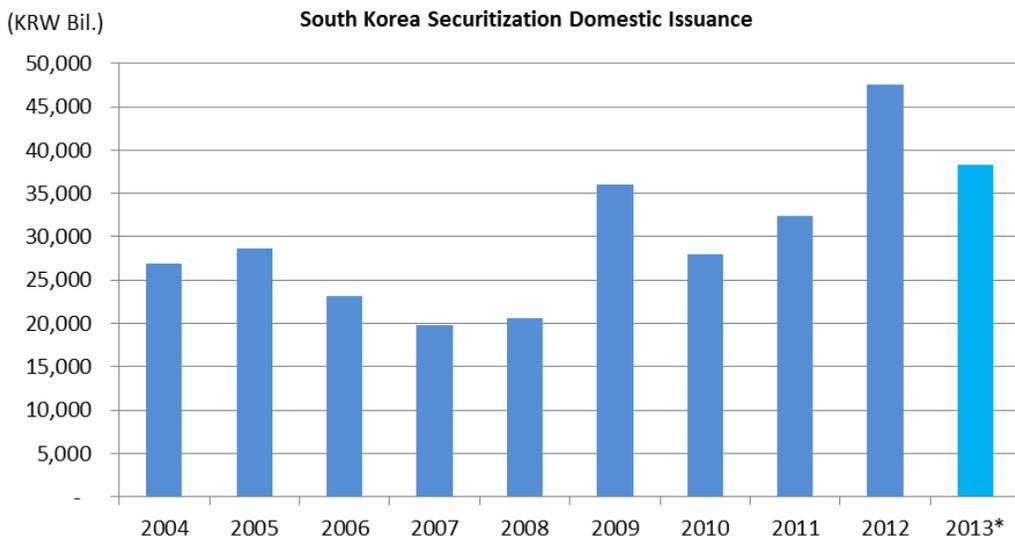


*Includes asset-backed commercial paper and Japanese business securitization transactions. Source: Standard & Poor's Ratings Services.

South Korea

For the year to September 2013, new securitization issuances amounted to KRW 38.2 trillion (equivalent to approx. US\$35 billion) in South Korea (see chart 6). The market is dominated by RMBS, primarily led by government-sponsored entities such as Korea Housing Finance Corp. (KHFC), and consumer debt ABS. In December 2013, the National Assembly in Korea approved the covered bond act, so as to pave the way for private banks to issue covered bonds. The act will come into full force and will become effective three months after the president's promulgation.

Chart 6
South Korea Securitization Domestic Issuance



*Data are for January-September 2013. Source: Korea Financial Supervisory Service.

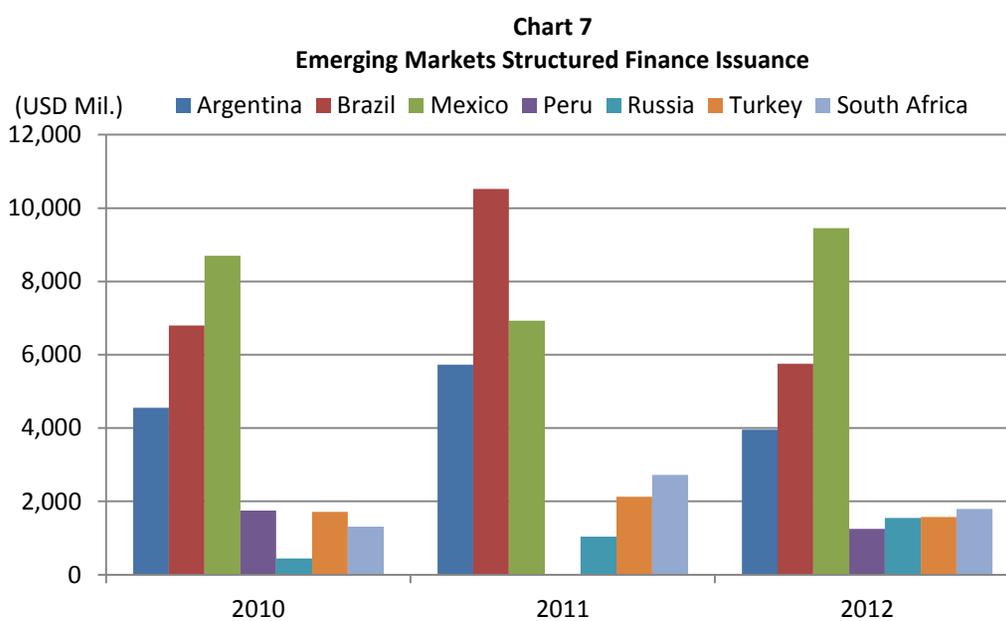
China

There has been increasing deregulation in China's securitization market since 2011, including an expansion of the asset securitization pilot program to more economic sectors, and an increase in the aggregate issuance cap. In 2013, China's State Council announced further plans for the normalization of securitization in China and encouraged financial institutions to actively manage their balance sheets and asset stocks. The recent Third Plenum (of the 18th Central Committee of the Chinese Communist Party) also encouraged the establishment of a securitization market. The overarching policy target, in our view, is to guide the securitization market to support country-level industry development and economic strategy.

China's banking regulators have focused on deals that could facilitate other policy initiatives, such as financing to small and mid-size enterprises (SME), infrastructure developments, local governments, public housing, and the agricultural sector. There were seven transactions launched from 2012 to the end of September 2013, with an aggregate issuance amount of Chinese renminbi (RMB) 24.13 billion. Other China financial industry regulatory arms, such as China Securities Regulatory Commission, also rolled out separate regulatory initiatives sharing the asset segregation and asset backed features of securitization.

Emerging markets

The emerging market structured finance landscape is dominated by Mexico, Brazil, and Argentina in the Latin American region and Russia, South Africa, and Turkey in the East Europe, Middle East and Africa region. In 2012, issuance volumes across markets continued to be trumped by Mexico with regulatory initiatives hamstringing Brazil (see chart 7). In our view, emerging markets have trended towards increased asset and geographic diversification while consumer and corporate credit markets deepen their roots across the globe, but regulatory and opportunity costs will dictate issuers' incentives to securitize.



Observations In Taiwan: Many Factors Constrain The Market's Revival

Taiwan has consistently lagged behind its peers in the securitization market since the end of the global financial crisis--there were only two new transactions launched after 2009. This is despite the fact that the performance of most securitization notes in Taiwan during the financial crisis was relatively good. This inactivity also surprises some market participants as Taiwan is among the pioneers in Asia to start securitization market and had booked many CLO, collateralized bonds obligations (CBO), RMBS, ABS, and real estate securitization transactions since 2003.

We believe this very slow recovery is due to several reasons:

- Banks, the typical securitization originators, have much less incentive to use securitization for financing due to ample and low-cost liquidity in Taiwan;
- The low-interest rate environment and banks' competition contribute to very low loans margins, making asset-backed financing not economical for banks and discouraging potential investors;
- After the crisis, there is a continued misperception that securitization deal structures tend to be complicated and not transparent, and that sellers might take advantage of investors; and
- The experience of investment loss in overseas securitization products during the crisis has kept some investors away from the products completely.

Implications To Taiwan: Global Experience Provides Valuable Guidance For Market Development

Is Securitization A Helpful Instrument Given Its History?

We believe all financial products are neutral and there are no 'helpful' or 'unhelpful' ones by nature. What could go wrong largely rests on how the instruments are used, not what they are.

In our view, the majority of Taiwan securitization transactions aimed to provide market liquidity for assets and alternative funding channels for sellers. In other words, they are designed to serve the fundamental needs of the originators and sellers. Even in the CBO sector that some market participants criticized as the root of the securitization market's troubles, transactions intend to deliver the necessary liquidity for the illiquid structured notes and to manage the associated credit risk with an expanded pool of bonds assets.

Moreover, most transactions in Taiwan have performed well during the global financial crisis and economic recession, particularly the many cash flow CLO, RMBS, and ABS transactions. Taiwan Ratings have upgraded 43 tranches in Taiwan-based transactions since 2003, leaving the ratings on 37 tranches unchanged. In contrast, we've only taken negative rating actions on 12 tranches, all of which are related to corporate credits and residential mortgage-backed securities affected by the adverse global credit cycle in 2008 and 2009. The generally positive rating actions reflected the following:

- A relatively stable local economy and unemployment in Taiwan have helped Taiwan-originated assets to maintain stable creditworthiness;

- Most Taiwan-based transactions employ a sequential-pay structure so that ample credit enhancement could be established from the cash cushion and the pay-down of liabilities, which in turn contributes to rating stability or upgrades; and
- Sellers usually hold the equity pieces and assume the servicer role in Taiwan-based transactions, and could vigorously manage the asset pool to reduce asset default and increase recovery.

What Role Can Securitization Take In Taiwan If The Banking Sector Has No Apparent Funding Needs?

Throughout the years, securitization has evolved not only in its structure, but also in its usage. In some developed markets, providing funding for banks is not the only measure for securitization and other considerations include how the instrument could increase the efficiency of resource allocation, and facilitate capital markets or the whole economy.

In our experience, the securitization market also plays roles in helping fulfill some macroeconomic needs that we believe are also relevant to Taiwan:

- To help alleviate the banking industry's pressure to support the whole economy through the capital market's direct funding, so as to prevent excessive risk accumulation in the banking sector yet still provide important funding to non-bank issuers;
- To offer one alternative funding channel for banks where investors will look at the economic value and risks of its assets rather than depend on the banks' own creditworthiness, which has proven to be extremely important in the case of a liquidity strain in Europe in 2012 when a major macroeconomic downturn drove away demand for banks' senior unsecured bonds;
- To extend liquidity to economic sectors that are sensitive to banks' lending appetites upon adverse changes in the economy, such as the SME and hi-tech sectors;
- To slow down debt accumulation that could be harmful to operations in the future through asset backing (rather than debt raising), such as corporate sector working capital financing, fixed asset management, and public spending in infrastructures; and
- To provide more diversified opportunities for investors and avoid distortion or concentration in their investment portfolio (such as low yields, high currency risk, and clustered investments) due to a limited choice of investment instruments.

Taiwan is also not unique in addressing the many challenges in areas such as portfolio management for capital adequacy and asset-liability risk match, funding long-term fixed-rate assets by short-term variable-rate liabilities, reasonable underwriting and pricing practices, and decent investment behaviors without reliance on external opinions only. In our view, many new developments in securitization after the financial crisis has to some extent offset these risks or contributed to more responsible practices.

Additional Clarification About The Securitization Market's Recovery

Some concern has arisen in Taiwan about the recovery of the securitization market, citing the global prosperity before 2008 that eventually turned into worldwide shock. In our view, Taiwan's securitization market typically features real funding needs due to the regulations in place and

issuers' lower risk appetites. This has effectively prevented exaggerated leverage in transactions that could go wrong upon major market events, and the risk of overall asset deterioration that could spread contagion is limited in Taiwan.

We however like to remind market participants that the securitization market can provide benefits only when it is sound and well managed. As highlighted in the lessons learned, securitization cannot offer a 'risk-free' investment; neither can it address irresponsible underwriting or origination practices. Equally important is that investors must be able to conduct independent and in-depth analysis to achieve issuer-investor parity.

Related Criteria And Research

Related Research

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- **"Australian Securitization News: Issue 576, Week Ended Dec. 20, 2013,"** published on RatingsDirect on the GlobalCreditPortal, Dec. 23, 2013
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