

## Special Report

# Exposure Draft: Retaining Equity Piece Risk – Enhancing Transparency

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**Summary**

Fitch Ratings is making this exposure draft available to seek market feedback with regard to its plan to invite transaction originators, sponsors and servicers or asset managers (collectively “key transaction parties”) to disclose whether they retain the economic risk of the equity piece (or first loss piece) in Fitch-rated structured finance transactions (i.e. exposure to economic risk of first loss pieces). The initiative would only include equity piece risk held by parties that continue to fulfil these key roles in transactions and would not extend to third party holders of equity piece risk who do not perform such roles. This is an area that has been highlighted by some commentators as lacking in transparency and this initiative seeks to address this issue. For example, the recent report of the European Securities Market Expert Group (ESME) “Role of Credit Rating Agencies” published in June 2008 recommends that credit rating agencies should seek to disclose information regarding an originator or sponsor’s retained interest in the transaction. They recognise that this will require co-operation by key transaction parties, who may be reluctant to disclose such information. Market participants across the industry – including rating agencies – have, however, been urged by regulators to foster greater transparency within the structured finance markets generally, and Fitch’s proposal regarding equity piece risk disclosure is with this in mind.

In issuing this exposure draft, Fitch is not making a case for or against the relative benefits to transaction performance of key transaction parties retaining – or not retaining – exposure to the economic risk of the first loss piece. The agency believes that there are clear risks and conflicts of interest that arise with both retention and non-retention – these issues are outlined in this report. For this reason, Fitch does not currently make specific adjustments in structured finance rating analysis specifically based around whether or not the risk of the first loss piece has been retained by key transaction parties. There is currently no data available to assess whether such retention or non-retention of equity piece risk actually has a greater impact on a transaction’s performance. In the event that Fitch’s proposed initiative saw substantive participation by originators, sponsors and servicers or asset managers, more data might be constructed regarding the relative performance of Fitch-rated structured finance transactions where the risk of the equity tranche is retained and where it is not. Analytical adjustments might then be incorporated into Fitch rating methodology depending on the indications given by such data.

**Market Feedback**

Fitch is publishing the proposed disclosure process in the form of this exposure draft (with a one-month comment period from the date of publication) for the purpose of soliciting market feedback. Fitch will assess industry comments regarding the merits of the proposal and publish a final report after this period. Comments should be sent to Stuart Jennings using the e-mail address shown at left. Fitch is seeking specific feedback on the following questions.

- Would the disclosure of key transaction parties’ retention of equity tranches within structured finance transaction add value to investors and other market participants?

- What views do industry participants hold regarding the importance of first loss piece retention or otherwise to transaction performance? Despite limited data to assess this, do industry participants believe it has an important influence?
- Would investors see this information as useful in their assessment of the merits of structured finance transactions, both at the time of investment and in assessing ongoing performance?
- Is the nature of the information proposed to be requested from key transaction parties sufficient? How could it be amended or refined? Should there be further disclosures, such as retention or otherwise of interest-only strips or other exposures further up the capital structure?
- How often should such information disclosed by key transaction parties be refreshed?
- What difficulties do industry participants see with regard to the practical aspects associated with providing the disclosure, particularly from the perspective of the key transaction parties?
- Do such disclosures belong on rating agency surveillance pages and reports or would they be better disclosed via another forum? If so, what type of forum?

Fitch will also welcome any more general comments from market participants regarding the proposal.

Market participants are asked to provide any comments on Fitch's proposals by 22 July 2008.

## Background

Before the start of the "credit crunch" in summer 2007, investor appetite for structured finance products was considerable. More and more investors were going further down the credit curve, such that a market for unrated equity (or "first loss") pieces developed. This began to change the situation whereby the equity piece was retained by the transaction originator or sponsor. Investors in equity pieces included newly established funds to invest specifically in equity pieces as well as certain hedge funds. There have also been some transactions to repackage equity pieces. Credit protection became available on equity pieces and some have also been used as collateral to obtain funding.

For some mezzanine and senior investors, originator or sponsor ownership of the equity piece was seen as a source of comfort in many areas of global structured finance, since it was seen as having some "skin in the game" by remaining the first party at risk of loss through its retention of the equity piece. Where the originator or sponsor is also the servicer or manager of the securitised assets, ownership of the equity piece can be seen by investors as an incentive to perform well in that role, given the originator's position in suffering the first loss should they fail to perform well. The development of a market in equity pieces therefore began to erode this comfort. To date, there has been little transparency as to which originators still retained the risk associated with the equity piece and which did not.

The onset of the US subprime crisis and its knock-on effect on structured finance CDOs, structured investment vehicles, ABCP conduits and monoline financial guarantors has led to a seizure in investor sentiment and confidence in all structured finance products globally. Lack of transparency in certain areas has been highlighted as a major contributor to the dislocation being experienced in structured finance markets.

This report examines the incentives, advantages and disadvantages for investors associated with key transaction parties retaining or not retaining the economic risk of the first loss equity piece. The incentives involved are found to be more complex than they might initially appear. It also outlines Fitch's proposals to introduce transparency on this subject by inviting key transaction parties to disclose on

Fitch's transaction surveillance pages whether they (i) own or have sold the equity piece; or (ii) have obtained credit protection or not with respect to the economic risk of the equity piece.

Where the key transaction parties opt not to make these disclosures, Fitch proposes that this be stated on the relevant surveillance web pages. It should be noted that the ultimate success of this transparency initiative depends entirely on the degree of co-operation received from such transaction parties.

## **What is the Equity/First Loss Piece?**

The equity piece comprises the "first loss" piece in a tranching structured finance transaction. It is typically unrated and will provide credit enhancement to more senior tranches of the transaction, which will usually have credit ratings assigned. The equity piece will typically consist of a subordinated loan or note tranche. Losses incurred by the transaction would first be borne by the equity piece, before they start being allocated to more senior tranches in the structure. The equity tranche holder receives remuneration on its investment, which will typically involve receiving excess revenue cash flows after senior expenses and senior note interest have been paid in higher positions in a priority of payments. The argument for an originator or sponsor retaining the risk of the equity piece is that it provides an incentive to perform well in terms of originally underwriting or selecting the assets and subsequently servicing or managing the assets to avoid losses being allocated to its equity tranche investment.

## **What is Fitch's View on Retention?**

While incentives exist to perform well when the first loss piece is retained by key transaction parties, there are equally a number of risks and conflicts of interest that might arise with retention. Similarly, while non-retention of a first loss interest may appear to weaken the incentive to perform as a key transaction party, the introduction of third parties may introduce an element of independence and discipline to transactions which counterbalances conflicts of interest associated with retention.

Given these factors, Fitch's view is that the risks, incentives and conflicts of interest associated with retention or non-retention are somewhat balanced. This report gives a synopsis of these factors. It is the agency's opinion that there is not a sufficiently strong argument for or against retention or non-retention to warrant specific analytical adjustments in the rating process in either case. This view is, however, based on a subjective assessment of the risks. The opacity currently surrounding whether a key transaction party retains an interest in the first loss piece makes accumulation of data to support a view problematic. One of the drivers for this proposal is to allow for the potential accumulation of data to assess these risks and their impact on performance. Depending on what such a data set might reveal, Fitch might ultimately add specific adjustments to its structured finance rating analysis, or that of individual asset classes.

## **Retaining the Risk – Investor Advantages**

The advantage to investors that appears immediately apparent in a key transaction party retaining the equity piece risk is the very fact that it has something to lose from poor transaction performance. Not only this, but the key transaction party would incur the first loss prior to investors, since if excess spread is insufficient to absorb losses, then it is the equity piece that will be used next to absorb losses.

In US RMBS, the equity piece is often sold together with the special servicing rights to third parties, such as C-Bass, Ellington and Litton. In this instance, therefore, despite the transfer of the equity piece by the originator, the accompanying transfer of special servicing means that the servicer as holder of the equity piece remains theoretically incentivised to continue following up arrears, such that

recoveries are maximised and losses minimised. There remains an originator incentive to maintain good origination standards to facilitate a sale to these entities on an ongoing basis.

Retention by a key transaction party would therefore appear to give a number of clear incentives for such parties to ensure that the overall transaction performs well, thereby benefiting all investors, as summarised below.

### **Underwriting Quality and Due Diligence**

Originator-retained first loss provides an incentive for the originator to ensure that assets were underwritten and originated to a high quality, thereby maximising the possibility of them performing well and minimising the risk of loss to the equity tranche. Where a pool is revolving, continued retention of equity tranche risks also ensures assets continue to be underwritten and originated to a high quality on an ongoing basis. Conversely, where the originator knows that it will continually sell on the equity piece with no risk retained, then the risk of poor underwriting and origination of products could intensify.

In the run-up to the credit crunch, there was an increasing number of securitised transactions involving a pool of mortgages that had previously been transferred from the originator to another party (often an investment bank) but where the originator remained the servicer. If such purchasers as transaction sponsor retain the risk of the equity piece in the subsequent securitisation, they are incentivised to perform a tight due diligence and loan selection process at the point of purchase to ensure high-quality assets, as well as to enforce representations and warranties vigorously. Therefore from this perspective, there is some comfort to investors that the sponsor has an incentive to perform tight due diligence, perhaps mitigating the potential for weaker underwriting from the originator given the knowledge it will transfer the risk of the assets in full. Similarly, CDO asset managers might be incentivised to perform well in their selection of credits in the event that equity risk is retained.

### **Information and Product Pricing**

By definition, the originator will be one of the parties closest to the assets and with a significant amount of data with respect to historical performance of assets. Where the originator is also the servicer of their transactions, it will be able to accumulate and analyse detailed data on asset performance on an ongoing basis better than any other party. Where the equity piece is retained, this provides the incentive to use this information to make optimal decisions with respect to the assets on an ongoing basis so as to avoid loss to the first loss piece.

For example, there is an incentive for the originator to ensure that the assets are appropriately priced to reflect the inherent risk of default and loss associated with those assets. This thereby maximises the likelihood that excess spread from related transactions will be sufficient to absorb losses before reaching the first loss piece.

### **Servicing Quality**

Where the originator, sponsor or servicer retains the special servicing rights as well as the economic risk of the equity tranche, then an incentive exists to ensure that arrears are followed up promptly and efficiently to maximise recovery and thereby minimise loss to the retained first loss piece.

For a special servicer owning the equity piece, it allows the accumulation of data regarding assets and borrowers most likely to lead to a loss on default, allowing most efficient deployment of resources in following up delinquencies and minimising losses.

Conversely, in the event that the economic risk of the equity piece were transferred to a third party, then in a downturn there may be the incentive to prioritise servicing loans which remain on the originator, sponsor or servicer's

balance sheet over servicing the securitised loans of transactions where the equity risk has been transferred.

### Summary

The incentives for key transaction parties (and the consequent advantages to investors) in retaining an interest in their securitised transactions would therefore seem fairly clear cut. This is not, however, the case. The section below outlines some more involved arguments that contend that transferring the risk of the equity piece may provide its own advantages to other investors compared with retaining the risk, and, as a result, could be the preferred model.

### Transferring the Risk – Investor Advantages

On the surface it might appear that the retention of risk associated with the first loss piece by a key transaction party only presents potential advantages to the investor. This, however, is not the case, as there are other competing incentives which may counteract the advantages outlined above and may actually favour the economic risk of the equity piece being transferred to a third party. Some of these factors are outlined below.

### Removing Conflicts of Interest

Most RMBS transactions have principal deficiency ledgers on which losses are recorded and which in the first instance would be recovered through excess spread and then from reserves funded from the equity tranche. Equally, some structured transactions have arrears, loss and other structural triggers which might halt the amortisation of reserve funds and therefore halt an element of funds being released to the equity tranche holder.

Where the key transaction party holds the equity tranche risk, but is also the special servicer or asset manager, a conflict of interest exists. Where performance starts to deteriorate, there is a potential incentive for the servicer to delay recovery procedures on delinquent and defaulted assets. This could therefore defer a loss being incurred or delay the breach of transaction triggers that would otherwise divert transaction flows away from the first loss piece. Servicers could be incentivised to take other action, such as capitalisation of arrears, when borrower circumstances do not warrant it, thereby massaging down arrears figures. While losses would still ultimately be realised, delaying losses in this way continues to maximise excess spread being released to the equity tranche holder at the bottom of the waterfall and maintains the flow of current cash to the equity holder. There is therefore an incentive for the servicer to act in its own interests rather than in the interests of the more senior bondholders.

If the equity tranche risk is transferred, but with the special servicing rights being retained by the originator, such that the two are separated, this introduces a degree of independence. The originator will then be compensated purely in respect of its performance as a servicer at a senior level, which therefore potentially better aligns the originator's interests with that of investors.

### More Independence

Given the substantial risks involved in holding the equity piece, any third-party holder of an equity tranche is likely to require more intensive granular monitoring information from the servicer or asset manager than might be the case for investors at more senior levels in the transaction structure. The introduction of a third-party equity tranche holder therefore potentially introduces a degree of extra independence and discipline to surveillance information that key transaction parties are required to provide to investors.

### Financial Strength

An originator/servicer that retains the equity piece of its securitised transactions, and which has a significant dependence on securitisation for its funding, would

draw a significant amount of its income during buoyant times from the funds released from transactions through its equity piece ownership. Once there is a general market downturn accompanied by poor asset performance, income from equity ownership could dry up, thereby placing the originator/servicer in a weaker financial position than before. This therefore presents the increased possibility of the demise of the originator/servicer and a transfer of servicing being required at the height of a downturn, when proficient servicing will be most required. The separation of equity piece ownership and servicing, thereby introducing more interested parties into transaction performance, perhaps provides some mitigation to this prospect.

### No System Flagging

For many of the larger mainstream originators, securitisation is only one of their funding sources. They may therefore be servicing assets that remain on balance sheet alongside those that are securitised. Most national regulators require originators not to “cherry-pick” assets for securitisation, such that a securitised portfolio should be representative of the originator’s overall book (that is, securitised assets should be largely non-distinguishable from non-securitised assets). Provided securitised assets are **not** flagged as such on servicing systems and there is sufficient segregation of duties between servicing and other staff, then servicing staff should not be able to distinguish whether they are servicing a balance sheet or securitised asset. In this instance, therefore, the weakening of incentives that may come with transferring the risk of the equity piece would be mitigated as far as servicing the assets is concerned. This mitigant would be stronger the smaller the proportion of securitised assets as a percentage of the overall book.

### Reputational Issues

Where the originator depends on structured finance for its funding and survival, there is an argument that regardless of transferring the equity piece risk, the originator will still have an incentive to keep servicing to a high standard and to maintain a good standard of origination and underwriting for new assets. However, this argument would appear to be unpredictable and case-by-case in nature.

### Thickness of Equity Piece

In the event that the equity piece is somewhat thin, and where cash flows and the equity piece are consumed by increased losses following deteriorating performance, a key transaction party that retained equity piece risk would quickly be in the same position as one that did not. Therefore, for those transactions where excess spread or the equity piece are somewhat thin, there may be less incentive to perform due to equity piece risk retention than where excess spread is greater or the equity piece “thicker” in relative size. In such cases, transferring or retaining the equity piece risk would seem relatively neutral as far as the usual incentive arguments are concerned.

### Other Income Streams

The servicer or asset manager earns other income streams from a transaction: for example, for mortgage assets, a servicing fee at a senior position in the priority of payments. Failure to perform in this capacity – assuming the fee provides ample remuneration for the task undertaken – could see replacement of the servicer or asset manager in accordance with transaction documents. Poor performance could therefore remove a senior income source – a situation the transaction party is likely to be keen to avoid, regardless of its retention of equity piece risk. Such alternative revenue streams could therefore act as a mitigant to any perceived risk to performance from not holding the equity piece risk.

However, in managed CDOs often complex bonus or incentive structures could also influence the incentives of the asset manager adversely. Managers have often not held an interest in the performance of the equity. There may be an incentive to maximise the manager’s financial gain by taking higher-risk credit decisions that are misaligned with the interests of investors.

## Summary

As can be seen, there are a number of arguments that contend that transferring the first loss tranche risk to an independent third party may at worst have limited impact on transaction performance and, in the best case, may actually improve performance. As stated above, Fitch currently does not favour one argument over the other and does not incorporate specific adjustments into its analysis with respect to equity tranche risk retention.

## Fitch Proposals for Disclosure

Due to the interest of some market participants in greater clarity and transparency in this area, Fitch is asking for feedback on a proposed initiative to invite key transaction parties of global structured finance transactions which have notes rated by Fitch to disclose whether the economic risk associated with the equity piece has been transferred to another party. Should the proposal proceed following the feedback period, the agency would approach key transaction parties of global structured finance transactions rated by the agency to propose that this information be disclosed and published on the Fitch web site. The proposal would involve publishing the following information:

1. a report on the non-subscription section of its web site and freely available to download disclosing the equity piece risk retention information gathered on a transaction-by-transaction basis, which Fitch would propose updating this report every six months; and
2. equity piece information for each transaction on the relevant transaction's surveillance pages on the subscription section of Fitch's web site. Fitch proposes that this data would be refreshed every six months in conjunction with the preparation of the report discussed above or through any information submitted by key transaction parties in the period between reports being prepared.

The agency would propose that key transaction parties provide the following information with respect to retention of equity tranche risk:

1. whether the equity piece has been sold to a third party or repackaged either partially or fully;
2. whether the key transaction party has obtained credit protection with respect to the equity piece, either partially or fully, via credit default swap, synthetic repackaging or any other instrument; and
3. the size of equity piece risk exposure retained.

Partial transfer might include the separate transfer of the right to excess transaction cash flows, while retaining the equity piece position itself.

Fitch would also propose that key transaction parties disclose at the time of closing of new transactions whether they propose to retain the risk of the equity piece. This information could then be included in transaction presale reports, where they are published, and refreshed periodically during the surveillance process.

## Appendix 1 – Draft Surveillance Page Disclosure

The following screen shot gives an example of the disclosure that could be given on transaction surveillance pages as they currently stand. Should the proposal proceed, more specific flags and prominence could be designed for the disclosures on surveillance pages.

The example pertains to a notional transaction and is not intended to reflect a currently rated transaction or any actual transaction party.

### Example Disclosure

The screenshot displays the FitchResearch website interface. A table lists various security classes with their respective ratings and financial details. A callout box points to a specific disclosure in the 'Deal Commentary' section.

Class	Rating	Original	Current	Amount	Yield	Currency	Value
Class A2a Detachable Coupon	AAA	AAA	0	0	14.82	USD	64.92
Class A2b	AAA	AAA	0	0		USD	
Class A2b Detachable Coupon	AAA	AAA	0	0		USD	
Class A2c	AAA	AAA	0	108,500,000	14.82	EUR	64.92
Class A2c Detachable Coupon	AAA	AAA	0	0		EUR	
Class M1b	AA	AAA	0	85,000,000	8.77	USD	52.32
Class M1c	AA	AAA	0	11,000,000	8.77	EUR	52.32
Class M2a	A	AA+	0	17,500,000	5.07	GBP	44.61
Class M2b	A	AA+	0	5,000,000	5.07	USD	44.61
Class M2c	A	AA+	0	12,750,000	5.07	EUR	44.61
Class B1a	BBB	AA-	0	10,000,000	2.85	GBP	39.93
Class B1c	BBB	AA-	0	11,500,000	2.85	EUR	39.93
Class C			0	30,250,000		GBP	
Mortgage Early Redemption Certificates (MERCs)	AAA	AAA	0	0		GBP	

**Deal Commentary**

**Fitch Commentary**

19-Jun-2008 xxxxx (closing) - [Originator]/[Servicer] [xxx plc] has confirmed Class [x] unrated equity tranche has been retained by the [Originator]/[Servicer]. "xxxxx (review date) - [Originator]/[Servicer] [xxx plc] has confirmed that Class [x] unrated equity tranche has been sold to a third party OR [Originator]/[Servicer] [xxx plc] has confirmed that it has obtained credit protection with respect to the retained unrated equity tranche"

21-Sep-2005 Additional performance data will be added once the August and September monthly reports have been published.

04-Aug-2005 Previously, collateral information was based on current balances, however, now all calculations are based entirely on the principal outstanding at each determination date. This gives greater consistency across all of the reporting and the principal outstanding being the primary concern rather than the current balance.

22-Jul-2005 Class A1R and A1R DAC affirmed at 'AAA', Class A2a and A2a DAC affirmed at 'AAA', Class A2b and A2b DAC affirmed at 'AAA', Class A2c and A2c DAC affirmed at 'AAA', Class M1b affirmed at 'AA', Class M1c affirmed at 'AA', Class M2a affirmed at 'A', Class M2b affirmed at 'A', Class M2c affirmed at 'A', Class B1a affirmed at 'BBB' and Class B1c affirmed at 'BBB'. MERCs affirmed at 'AAA'. The detachable coupons are extremely sensitive to the rate of prepayments, which Fitch ratings do not address. The rating of the MERCs addresses only the likelihood of receipt by the MERC-holders of mortgage early

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