Market Insight

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Unexpected Jeopardy

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Thankfully, bankruptcies of financial institutions which are also originators of consumer loan or residential mortgage backed securitisation transactions are rare. Why do we say "thankfully"? Aren't securitisations "bankruptcy remote", i.e., structures that can withstand a bankruptcy of the originator? They are indeed. But, in practice, originator bankruptcy has resulted in impairment to the value of noteholders' securities and clear weaknesses have been uncovered in typical securitisation structures and the analysis and thinking that underpinned them. In this Market Insight we look at what lessons can be learned from the bankruptcy of DSB, a small Dutch consumer bank active in securitisation, and how this case might shape the securitisation market in the Netherlands – an active securitisation market post crisis.

A quick recap

DSB, a small Dutch bank engaged in lending to consumers (mortgage loans and unsecured consumer credit) was declared bankrupt in October 2009. Over 70% or EUR 5bln of their balance sheet was securitised. Four of their securitisation transactions remain outstanding; Monastery 2004-I and 2006-I (RMBS) and Chapel 2003-I and 2007 (consumer loans as well as second lien mortgages).

The demise of DSB put to the test, for the first time, many of the structural features devised to protect noteholders, swap counterparties, liquidity facility providers and other counterparties against originator bankruptcy in the Netherlands. Whilst most of the features worked, some have not and others have given rise to unexpected consequences and jeopardies.

Direct debits

Mainstream securitisation credit analysis takes comfort from underlying borrowers servicing their debt via direct debit. It was conventional wisdom that in the event of an originator bankruptcy these payments would continue uninterruptedly. Surprise then, that the DSB case has highlighted that in the Netherlands, if a bankruptcy of a bank occurs, the direct debit mandate is cancelled automatically by the operation of law.

Bang goes the notion that direct debits automatically protect against interruption in payment flows. In the case of DSB, material payment disruptions caused the Issuer to draw on its reserve accounts while remedies were implemented. We understand that each borrower was contacted and requested to re-instate their direct debit mandate but that only 75% of borrowers had done so 3 months after being contacted (approximately 95% pre-bankruptcy).

Lesson 1

We doubt whether such a cessation of authorisations was factored in by rating agencies and/or investors when considering stress scenarios. As can be derived from the drop in direct debits described above for DSB, this is a material risk. Moreover, automatic cancellation of direct debit mandates may increase arrears as borrowers struggle to make up missed instalments. The good news for investors is that in the DSB case the reserve accounts performed as intended. Going forward, though, credit analysts should consider to resize reserve accounts and liquidity facilities taking into account that practical remedies often take considerable time to implement. It is also good to challenge conventional wisdom.

Some of the finest legal brains failed to identify that direct debit mandates were not protected against bankruptcy.

Notification of borrowers and commingling risk

As in many other jurisdictions, Dutch securitisation structures allow originators to securitise their assets and delay disclosing to borrowers that their loans have been sold to an SPV until such a notification is absolutely necessary (required to comply with legal/security requirements). Typically, notification is required upon pre-defined trigger points; a bankruptcy is perceived to be the ultimate last moment because ensuring that borrower (re)payments on the securitised loans are not commingled with the bankruptcy estate is paramount. It appears that many investors in the DSB securitisations were surprised that DSB actually did not notify borrowers immediately upon bankruptcy. Statements on the issuer's website, suggest that reluctance/confusion considerations played a role in this decision.

On the one hand we can understand investor concern but we also can empathise with the stance taken by the SPVs. Against a back drop of considerable press publicity and speculation, as well as extreme uncertainty immediately following the bankruptcy, would concerned borrowers, uninformed of securitisation generally, have been receptive to following a DSB instruction to start paying their repayment instalment to an unknown SPV? Take up on this request could well have been lower than the bankruptcy trustee eventually achieved, given general public resentment towards DSB at the time and the inflammatory reaction DSB may have prompted were they to have adopted a very legalistic "form of notification" as prescribed by the transaction documentation.

Investor reports seem to indicate that the alternative arrangements agreed upon by the Issuers with the bankruptcy trustees, for the purpose of preventing commingling of securitized cash flows, appear to have worked.

Lesson 2

It's all about reaching the goal and not so much the means by which it is achieved. Having said that, one can hardly define such approach to ring-fencing as triple-A proof. What the DSB circumstances do highlight is that no matter how much "smart" thinking and structuring is done, it is unlikely that one structural and theoretical solution will fit all situations. Securitisation bankers, rating agencies and lawyers might wish to think a little more practically going forward. At Bishopsfield Capital Partners we think that the only real answer to the notification/commingling risk issue is to mitigate it from the outset. Making collections the responsibility of ring-fenced Dutch Foundations that would never become part of the bankruptcy estate may be the way forward. Originators would have to address this at the point of granting a loan though and therefore have a future securitisation in mind. Such a set up could also address the direct debit issue raised earlier.

Set-off risk

Most market participants are familiar with the risk of set-off by a borrower of amounts owed to it by the originating bank against amounts it is due to the bank under a loan (or, as the case may be, to an SPV having purchased such loan). This risk is most apparent when a borrower holds material deposits with the same institution. It could also arise from other banking products having been sold to a client such as derivative contracts.

Set-off by borrowers in the manner described above usually is prohibited under the general conditions that banks apply to their retail and personal banking relationships. But, within the securitisation industry there has always been debate as to whether this prohibition would be upheld in court, especially if the counterparty is a bankrupt financial institution. From material made available to investors in the DSB securitisations, we hear that the bankruptcy trustees believe that under Dutch law the set-off prohibition will in effect not be upheld in court, a view confirmed from our conversations among the Dutch legal fraternity.

At first glance this view could have resulted in investors in the DSB securitisations being faced with a massive set-off risk: DSB had EUR 3bln

of deposits against EUR 6bln of loans to materially the same customer base, and EUR 5bln of these loans were securitised. Fortunately for the securitisation investors, the Dutch Central Bank's depositor protection scheme paid out pre-agreed on a gross basis (i.e. without it offsetting its depositor protection amounts against loans that the depositors had with the bankrupted bank). This grand gesture by the Dutch taxpayer clearly mitigated the set-off risk materially.

There is, however, another set-off risk on the horizon for investors; this time unexpected. Many borrowers have claimed that DSB had mis-sold certain products to them when they took out their loans. If these claims are upheld and not paid out in cash – a fair assumption given the bankruptcy – then the SPVs and investors are facing an additional and unexpected set-off risk.

Lesson 3
The multi-tiered and multi-product relationships a bank has with its client can cause unforeseen issues with regard to set-off. Quantitative analysis of this risk deserves greater attention than it has received in the past. In addition, greater scrutiny of the depositor protection schemes and how they work/pay-out in practice is warranted. These schemes may be a significant mitigant against set-off risk (as seen in the DSB case) or may, in practice, offer little protection.

Origination standards and representations & warranties
Inadequate origination standards is a hot topic in the US at the moment following the questions raised by investors about the manner in which institutions such as Countrywide and Bank of America had originated some of the loans they subsequently securitised. The issue is that an originator represents and warrants to investors that the underlying loans have been originated in a certain manner and fit a defined set of parameters. Rating agencies and investors take comfort from the fact that the originator must buy-back any loan which does not comply with the reps and warranties or pay a penalty to the SPV compensating for any loss due to the breach. What value is such a protection if the originator is bankrupt though?

The DSB bankruptcy has served to resurrect an issue which somehow became buried during the boom years of securitisation. To the extent that the claims from consumers about mis-selling are up held (see above) and it is also found that some of the loans do not actually comply with the reps and warranties (not so farfetched upon a review of the reports and presentations related to the DSB securitisations) what recourse will investors have? In practice, an unsecured claim against the bankruptcy estate of DSB… not the quality of protection most market participants had in mind, we would suggest.

Lesson 4
This issue reinforces the fact that notwithstanding the underlying theme of "bankruptcy remoteness" in true sale securitisations it is impossible to completely de-link a transaction from an originator. The creditworthiness of the originator continues to have a direct impact upon the risk profile of any transaction if the originator has given reps and warranties or other undertakings in relation to the underlying loan portfolio or SPV. It could be argued that the rating agencies and investors should expand their analysis to cover and test origination practices more thoroughly but with such granular pools it is questionable whether this would address the inadequate origination issue. It may simply be one of the risks which investors have to bear when investing in asset backed securitisations.

Drain on noteholder resources
There has been much for DSB noteholders to digest since bankruptcy and many decisions to take. One such decision is looming in relation to what we understand are many thousands of duty of care claims which the bankruptcy trustee has received from borrowers. We understand that the bankruptcy trustee has requested noteholders to allow them to settle these claims on a class action basis to avoid the burden of settling individual claims.

Noteholders will be wrestling with whether the courts will uphold the claims in the first place. There are other important issues to consider also. Firstly, part of those borrowers who have lodged claims will have stopped making their monthly

repayments pending the outcome of the claim or may do so in the future. Noteholders need to weigh whether reaching a settlement quickly thereby forcing the borrowers with claims to start repaying again is more attractive than allowing individual claims to come to court which could take years to process with no certainty that the court will reject the claim. The latter has the added downside of borrowers failing to repay for longer. Secondly, the administrative burden of having settle thousands of individual claims over many years does not bear thinking about. Will noteholders have to approve each and every claim? Maybe. As we touched on previously, the note trustee is unlikely to assume such a burden on behalf of the noteholders. Lastly, noteholders will be concerned that they may be giving the bankruptcy trustee carte blanche to reach a settlement without the noteholders having a sense for the extent of the possible losses as a result of the claims. This is undoubtedly a difficult area but they will almost certainly wish to satisfy themselves that the bankruptcy trustee will always operate in such a way as to maximise the size of the bankruptcy estate.

Whether the noteholders grant the bankruptcy trustee approval to settle the duty of care claims will be known in due course. As they ponder this decision though noteholders may want to reflect on the benefits of resolving this particular issue quickly and the ongoing efforts they will need to expend if claims are settled individually.

Lesson 5

As with any bankruptcy, the amount of time and effort that needs to be expended by the creditors is extensive. This is especially true in the case of securitisations where the note trustee will be inclined to seek noteholder approval if there is any whiff of the note trustee being left with some form of liability were it to take unilateral action. Moreover, the issues related to securitisations tend to be complex and although the structures may be seen as relatively standardised, the issues which arise upon bankruptcy tend to be deal specific in practice.

Conclusion

The securitisation market has always acknowledged the crucial ongoing role that an originator plays in any securitisation notwithstanding "bankruptcy remote" structures. What the DSB case serves to highlight is that however well intentioned, theoretical, complex and heavily structured solutions cannot be expected to cater for every situation and may not work, in practice, in the manner intended. Furthermore, it is important for bankers, rating agencies and lawyers to pay greater attention to the practical realities of a bankruptcy where flexibility is required instead of overly prescriptive arrangements. From an investors perspective, the key take-aways are that with structured products it is wise to expect the unexpected and if originator bankruptcy bites expect to spend considerable time and effort managing the asset. Suffice it to say that there is unexpected jeopardy if a securitisation originator is declared bankrupt notwithstanding the "bankruptcy remoteness".

If you agree with our views in this Market Insight, and even if you don't, we would be delighted to hear from you (info@bishopsfieldcapital.com).

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