Viewpoint: Transparency Precursor to ABS Liquidity

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By Kerry Williams

"Liquidity" is a word we are hearing more often than ever before. From news reports to congressional testimony to casual conversations, there is heightened awareness that liquidity is what the market needs to get the economy back on a path to growth and prosperity.

When the credit markets collapsed, market players did not have the available tools to value whole loans and asset-backed securities. As a result, buyers and sellers became paralyzed, market confidence evaporated and liquidity virtually disappeared.

The Term Asset-Backed Securities Loan Facility and the Public-Private Investment Partnership are designed to revive the securitization markets by supporting new issuance and unclogging toxic assets from bank balance sheets.

The government will assume a substantial share of credit risk for both of these programs in the short term, but liquidity will not return in the long term without the additional transparency required to price and track changes in underlying asset risk.

Though asset-backed securities values depend on the anticipated cash flow from borrowers making payments on underlying loans, until now the market has relied primarily on security-level information and agency ratings for valuation and pricing. Current valuations are not taking into account dynamic consumer information, and the differences among securities can be significant. Two residential mortgage-backed securities with nearly identical market prices can have vastly different loss projections based on the changes in credit behavior of the underlying consumers.

Consumer credit information, including payment history on the underlying asset, delinquencies on nonmortgage obligations and credit card utilization, can be evaluated to help predict prepayment and default probabilities at the aggregated security and pool levels. More importantly, consumer credit data can be applied to securities on a monthly, weekly and even daily basis to provide insights into current values.

For example, Experian took an actual asset-backed security with multiple tranche ratings and linked the underlying assets to consumer data for analysis.

By merely determining the average VantageScore (a credit risk score developed by Experian, Equifax and TransUnion) for consumers paying obligations on the underlying assets and comparing those scores to the security's tranche ratings in the same period (the first quarter of 2005 to the third quarter of 2008), Experian found that a VantageScore decline preceded a decline in ratings by two years.

In addition, the probability of default on the security as measured by a VantageScore analysis of all the underlying consumers worsened by 30% between the first quarter of 2005 and the fourth quarter of that year.

An analysis of underlying consumer behavior would have provided an early warning of significant credit deterioration in the security and given holders the ability to make prudent risk management and hedging decisions in a more timely fashion. Instead, two years later the rating agencies suddenly downgraded this security from investment grade to junk status, creating the type of market disruption that occurs when investors work desperately to sell assets.

Essentially, this reflects a loss of confidence in the markets and the subsequent evaporation of liquidity. If the case for utilizing underlying consumer transparency is compelling, how can the markets begin to incorporate easily accessible, secure and dynamic data into the valuation process?

Initially, the federal government can mandate the use of dynamic consumer credit information in both the Talf and PPIP and establish its use as a market standard. By incorporating consumer data and analytics into the structuring of asset-backed securities, issuers can price them more effectively, the government will be assured greater accountability in the deployment of taxpayer funds, and for the longer term investors will be given the lens they need to make accurate valuations.

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