

Securitized Products, Disclosure, and the Reduction of Systemic Risk

Scott Hendry, Stéphane Lavoie, and Carolyn Wilkins*

INTRODUCTION

Securitization represents an important source of credit to the economy. By converting non-tradable financial assets into tradable instruments, securitization has the potential to expand the supply of credit beyond what would be available solely through banks and other financial intermediaries.¹ The revival and reform of global securitization markets are key elements in supporting future economic growth and, importantly, in limiting the risk that these markets could again be a source of financial instability.

Much has been said about what went wrong with securitized products and what should be done to put securitization markets on a stable footing.² The way forward includes several elements: (i) a better alignment of economic interests in the securitization process;³ (ii) appropriate prudential regulation and accounting standards;⁴ (iii) simplified and standardized structures based on high-quality real-economy

assets;⁵ and (iv) greater standardization of documentation and increased transparency and disclosure to facilitate investors' efforts to understand and manage the risks inherent in securitized products. Enhanced disclosure is only one necessary element of a comprehensive policy and industry response to the recent financial crisis.

This report focuses on issues related to disclosure for asset-backed commercial paper (ABCP) and publicly issued term asset-backed securities (ABS) in Canada. "Disclosure" here refers to the release of product information that is pertinent to investment decisions, including access to that information and the manner in which it is revealed. It does not refer to other important forms of transparency, such as information about bank holdings of securitized products or the publication of pre- or post-trade prices.

The full range of benefits associated with disclosure includes:

- *Enhanced investor protection*—Improved information supports informed investment decisions and a more level playing field for investors.
- *Improved market efficiency*—Improved and more readily available information reduces informational asymmetry, facilitates the valuation process, and supports market efficiency.
- *Reduced systemic risk*—Less uncertainty about asset values translates into greater market confidence; a lower probability of unwarranted price volatility; and a reduced risk of contagion, liquidity spirals,⁶ and market freezes.

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1 See Selody and Woodman (2009) for a discussion of the economic benefits of securitization.

2 The Financial Stability Board (FSB 2009) has made a commitment to have supervisors and regulators undertake the following during 2010: implement the Basel Committee's measures to strengthen the capital treatment of securitization and establish clear rules for banks' management and disclosure; implement IOSCO's proposals to strengthen practices in securitization markets; examine other ways to align the incentives of issuers with those of investors; encourage greater use of the contractual form used in covered bonds, which tie issuers to the instruments; and support the implementation of industry initiatives to standardize terms and structures, reduce complexity, and enhance transparency. See also Selody and Woodman (2009) for an examination of the shortcomings in the securitization process and a range of options for addressing them. One possible area for attention is enhanced risk management by investors.

3 See Paligorova (2009) for a review of the conflicts of interest between participants in the securitization process and potential solutions for ameliorating these agency issues.

4 The Basel Committee on Banking Supervision has identified a number of measures to strengthen the capital treatment of securitization.

5 Real-economy assets refer to claims on consumer or business loans or leases, such as credit card receivables and mortgages.

6 See Brunnermeier (2009) for a discussion of liquidity spirals as they relate to funding liquidity.

The first two benefits are stated explicitly in the mandates of most securities regulators.⁷ Considerations regarding systemic risk or financial stability, which are particularly important for securitized products, are not explicitly part of some mandates, although such considerations are central to regulatory reform initiatives in many jurisdictions.⁸ All three benefits, however, are the stated objectives of the thirty principles of securities regulation, first published in 1998 by the International Organization of Securities Commissions (IOSCO) and updated in 2003 (IOSCO 1998, 2003). While these principles cover a wide range of securities regulations, one of the fundamental messages is that achieving the desired benefits requires that investors have adequate access to information. Any regulatory changes to achieve these benefits should take into account the costs associated with compliance with disclosure requirements.

The first section of this report discusses why the disclosure of information is important, especially in terms of mitigating systemic risk, and particularly with regard to securitized products. The second section reviews the Canadian experience during the recent crisis, as well as the role played by inadequate disclosure of information. The third section summarizes current disclosure requirements and practices for ABCP and ABS issued in Canada, while the fourth section outlines principles of disclosure for securitized products, and discusses areas for potential improvement in Canada.

DISCLOSURE AND SYSTEMIC RISK

Mitigating systemic risk⁹ involves reducing the risk of contagion—that is, the risk that shocks in one institution or market segment are transmitted to other institutions or market segments. One important cause of contagion and financial crisis is the presence of asymmetric information between borrowers and lenders, or between investors in securities and sellers.¹⁰ Increased uncertainty makes it difficult for investors to separate the good assets from the bad and can lead to a sharp decline in confidence and investment. Hence, an important policy response is to make more information available to investors to reduce the probability of a sudden loss of confidence that could trigger a financial crisis. This is especially important for securitized products such as ABS and ABCP. Investors need to have enough information about the product and its inherent risks

to properly assess its underlying value.¹¹ They also need to feel confident that they are not at a significant informational disadvantage relative to other investors or market participants, particularly other entities involved in the securitization chain. While adequate disclosure of information cannot by itself prevent a crisis from occurring, non-disclosure of important information can increase the probability and intensity of a crisis.¹²

Many factors contributed to the recent credit crisis, and no single one can be identified as the main cause. Still, it is clear that inadequate disclosure of information was one of those factors. Gorton (2008a,b) describes how the panic of 2007 largely stemmed from a lack of readily available information about the source and magnitude of the losses due to default. He argues that even sophisticated investors relied too heavily on agency relationships (e.g., bankers, credit-rating agencies) and did not make full use of available information because the AAA-rated tranches of securitized products were viewed as being too far from default to make it worth the cost of more intensive due diligence. Even though all investors may not have read and used the information disclosed about securitized products when making investment decisions prior to the crisis, the fact that the information was not transparent enough when markets became stressed contributed to the market freeze. Gorton (2009) describes how, in normal times, because of the overcollateralization and seniority associated with highly rated tranches of securitized debt, these securities can be perceived to have a very low probability of default and thus be insensitive to information. They can, however, become sensitive to information when shocks create sufficient uncertainty as to the true distance to default. In this case, there is a risk of contagious adverse-selection bias that can feed financial instability, creating a situation where a lack of market confidence leads traders to withdraw from the market because they fear that the only traders still in the market are those with more information and an ability to exploit it.¹³ Financial stability can therefore be enhanced by ensuring that all participants have equal access to sufficient information.¹⁴

THE CANADIAN EXPERIENCE DURING THE CRISIS

During the financial crisis that began in August 2007, ABS issuance in Canada—and abroad—fell dramatically and essentially came to a halt for several months. The amount of

7 For example, see Section 1.1 of the Securities Act (Ontario).

8 See Anand (2010) for a discussion of the securities regulator's mandate and the implications of systemic risk considerations for the regulation of exempt markets, hedge funds, and derivatives trading.

9 While there is no single definition of systemic risk, in this paper, it refers to a risk that is not limited to specific individual institutions but, rather, has the potential to affect the financial system as a whole and to have macroeconomic consequences.

10 See, for example, Mishkin (1991) and Dornbusch, Park, and Claessens (2000).

11 Providing the information does not guarantee that it will be used by investors; but it is a necessary step. Moreover, at times of stress, information is at a premium.

12 Dudley (2009) argues that a lack of transparency contributed to a loss of confidence that intensified the financial crisis.

13 See, for example, Akerlof (1970) and Morris and Shin (2009).

14 It could also potentially be enhanced by other measures, such as the dissemination of the values at which trades take place, although a discussion of the benefits and costs of post-trade price transparency is outside the scope of this report.

ABCP outstanding in Canada also fell from about \$120 billion at its peak¹⁵ to about \$30 billion as of March 2010, which is similar to the amount that was outstanding in 1998, prior to the period of rapid growth that preceded the recent crisis. The panic that originated in the U.S. subprime-mortgage market began affecting associated securitization markets and then spread to other markets, in part because investors had difficulty understanding and managing the risks inherent in the instruments they held, partly because of inadequate disclosure of information.¹⁶

The Canadian third-party ABCP market is a clear example of how insufficient disclosure undermined investor protection, contributed to systemic risk, and left investors and regulators without the necessary information to fully assess the risks inherent in those securities. The information provided voluntarily by some ABCP sponsors was often incomplete, untimely, opaque, and complicated. Thus, for some time, it was not widely understood that some of the riskiest, most highly complex, and leveraged structured finance products in the Canadian market were in the form of ABCP—securities that were seen as very low risk and often bought solely on the basis of their credit rating.¹⁷ The fact that most ABCP originated from banks probably contributed to this perception of low risk, and investors may not have properly differentiated across types of ABCP over time.¹⁸ Thus, when concerns first emerged about U.S. subprime mortgages, the lack of detail on the underlying assets and their performance meant that investors were at first unsure as to how much exposure they had to U.S. subprime mortgages, leading them to try to sell their holdings. Combined with the lack of disclosure and understanding about important contingencies, this situation led to a massive loss of confidence in all ABCP,¹⁹ contributing to the system-wide crisis and to considerable losses for many investors.

Problems with securitized products linked to U.S. subprime mortgages also spilled over to other ABS markets, partly because of the perception that the information necessary to assess the value of these products was insufficient, as well as a general loss of investor confidence and appetite for all securitized products. An additional factor was the uncertainty as to how these structures would perform in a severe economic downturn.

¹⁵ This includes third-party ABCP. The amount of bank-sponsored ABCP has declined from a peak of approximately \$80 billion.

¹⁶ Overreliance on credit ratings, insufficient due diligence by investors, and worries about the ability of issuers to roll over maturing paper were also contributing factors.

¹⁷ See, for example, Kamhi and Tuer (2007a,b) for a discussion of the Canadian ABCP market prior to and during the crisis.

¹⁸ Since ABCP are very short-term securities, less due diligence was done in assessing the associated risk than for investments in longer-term securities, such as ABS.

¹⁹ The opaqueness of the contingencies embedded in some contracts for liquidity provision, many of which included a Canadian-specific clause for a “general market disruption” (see Kamhi and Tuer 2007a), is an example. Also, while the lion’s share of the assets in Canadian bank-sponsored ABCP was unrelated to U.S. subprime mortgages, market participants could not at first be sure of this.

CURRENT REQUIREMENTS AND PRACTICES

Canadian requirements for public market disclosure are based on a materiality standard. That is, reporting issuers must make “full, true, and plain” disclosure of all material facts in primary offering documents and then keep markets abreast of material changes in the business, operations, and capital of the issuer. In practice, the application of this legal threshold is often a question of judgment as to just what information is material at the time disclosure is made. In the case of securitized products, for which timely and detailed information on the assets underlying the securities is most needed, this standard does not necessarily fully support the requirements of investors and regulators for the ongoing up-to-date information essential for risk monitoring and management purposes. Below is a brief description of the current disclosure requirements for ABCP (offered in the exempt market) and ABS (offered in the public market) in Canada, which have not changed since the financial crisis.²⁰

Current practice for ABCP

Currently, in Canada, ABCP can be issued in the exempt market under the short-term debt securities exemption if it receives an “approved credit rating from an approved credit-rating organization,” or under other possible exemptions, including the accredited investor exemption.²¹ This means that sufficiently highly rated ABCP (and commercial paper)²² is exempt from the prospectus and other disclosure requirements (**Table 1**), although the structure of ABCP is generally more complex than that of regular commercial paper.²³ The extensive legal documentation supporting ABCP that is provided to investors on demand is contained in multiple documents, is not fully standardized, and is not typically summarized and made public in a single, concise document.

The exempt securitization market is primarily an institutional investors’ market, and those investors have historically been presumed to know what information they need and to have the negotiating power to get it. However, the recent crisis has demonstrated that this was not always the case. In good times, investors may not obtain or use all the information required to make fully informed investment decisions. Additional disclosure does not guarantee that all investors will make good use of the available information, or that it alone is sufficient to avert a crisis. However, at times of stress, properly designed disclosure will limit contagion.

²⁰ In 2008, securities regulators, under the auspices of the Canadian Securities Administrators (CSA), undertook consultations on proposed policy responses to address the role of ABCP in the financial crisis, including a possible amendment to exclude ABCP from the short-term debt exemption. Subsequently, CSA committees have been assessing and developing regulatory responses for the sale of securitized products.

²¹ National Instrument 45–106.

²² There is no ABCP conduit in Canada with a lower rating than that needed to make use of the exemption, and only a handful of CP issuers.

²³ See Toovey and Kiff (2003) for an earlier discussion of disclosure issues regarding Canadian ABCP.

Table 1: Disclosure requirements for private or exempt issuances of asset-backed commercial paper (ABCP)

	At time of issue	Continuous disclosure
Requirements under securities law	Securities qualify for an exemption (short-term debt exemption or accredited investor exemption). No disclosure to investors required (NI 45-106).	No continuous disclosure required on the securities, which are issued in the exempt market by non-reporting issuers.
Documents	Required form of report for exempt distribution must be filed with securities regulatory authorities if the accredited investor exemption is used (although not if the short-term debt exemption is used).	No continuous disclosure required on the securities, which are issued in the exempt market by non-reporting issuers.
Completeness of information	Not applicable	Not applicable
Clarity of information	Not applicable	Not applicable

Although there is no requirement to regularly report on the performance of the underlying assets or the financial health of parties involved in the transaction, the practice has evolved such that ABCP sponsors in Canada now typically voluntarily release unaudited monthly investor reports with static pool and pool asset information. In addition, detailed monthly reports are released by rating agencies.

Current practice for ABS

Securities regulation in Canada calls for a high level of disclosure by issuers of public ABS, compared with what exists for ABCP, which is issued in the exempt market (Table 2). Full, true, and plain disclosure of all material facts is required at the time of issuance with the filing of a prospectus. Disclosure is also provided during the life of the asset through the Annual Information Form (AIF), which must contain all the information that would likely influence a reasonable investor’s decision on whether to buy, sell, or hold the securities of a particular issuer. The AIF discloses information regarding the underlying pool of assets, factors that may affect the timing or amount of payments or distributions to be made, and any other relevant information. There is also a general requirement applicable to all public securities to reveal all material changes in a timely manner.

Prospectus requirements

In Canada, securities issuers subject to a prospectus requirement have four options: they can use a long-form prospectus, a short-form prospectus, a base-shelf prospectus followed by a prospectus supplement, or they can issue under an exemption. Our focus is on disclosure in the public market and not on the regulatory framework of the exempt market. The main difference between the long- and short-form prospectus is that the latter permits the incorporation of information by referencing other publicly available documents, such as audited financial statements, while the former does not. Because all forms must contain a full, true, and plain disclosure of all material facts, they do not differ materially in terms of the overall information disclosed. Most ABS issuers in Canada use a short-form prospectus, which entails a much more rapid review process.

For ABS, the issuer must provide a description of the material attributes of the securities, including information regarding the parties involved in the transaction, the duration of the obligation and related payments, the nature and composition of underlying assets, and the embedded contingencies. Issuers are also required to summarize contractual arrangements in plain language. This requirement is typically not adhered to, however, perhaps because of concerns that the level of precision required to support clarity in a legal sense would be compromised by the use of plain language. In broad terms, ABS prospectuses contain:

- information on the business of the issuer and the identities of the other key parties involved in the transaction (e.g., servicers);
- statistics on the performance of the issuer’s assets that are of the same type as those backing the ABS being issued;
- descriptive information on the particular pool of assets selected for the ABS being issued (e.g., geographical and interest rate distribution); and
- descriptions of legal documents specific to the creation of the asset pool and issuance of the notes.

The third option—the shelf prospectus—splits the filing of information into two steps: the base shelf and a prospectus

Figure 1: ABS investors require information about the underlying assets and structure

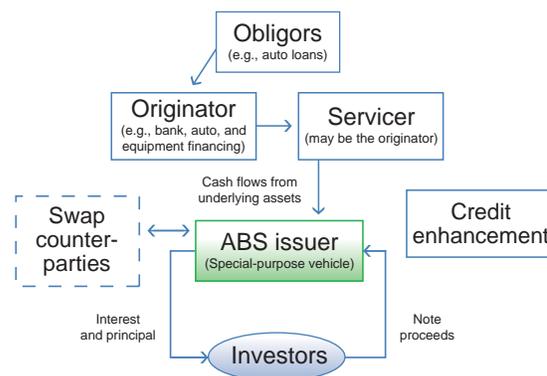


Table 2: Disclosure requirements for public issuance of asset-backed securities (ABS)

	At time of issue	Continuous disclosure
Requirements under securities law	Full, true, and plain disclosure of all material facts that would reasonably be expected to have a significant effect on the market price or value of the securities (e.g., s. 56 Ontario Securities Act (OSA)).	- When a material change (a change in the business, operations, or capital of the issuer) occurs, the issuer must put out a press release, file a Form 51-102F3 Material Change Report with securities regulators, and report to them (e.g., s. 75 OSA, NI 51-102). - Periodic disclosure (NI 51-102)
Documents	Prospectus	- Press release and material change reports - Audited annual and interim financial statements and Management Discussion and Analysis (MD&A) - Annual information forms ^a - No legal requirement for monthly servicer reports
Completeness of information	- Information applicable to all public securities prospectuses plus additional information particular to ABS (NI 41-101 F1s. 5.3). - Extensive information regarding the issuer, parties involved in the transaction, and the underlying assets.	- Information common to all public securities such as audited financial statements and some additional information particular to ABS (NI 51-102F2 s. 5.3) - NI 51-102 sets out requirements for all continuous disclosure - No comprehensive set of disclosure requirements specifically adapted to ABS
Clarity of information	- No standard templates for documents - Plain language guidance (NI 44-101, Companion Policy s. 4.1), but typically not adhered to	- No standard templates for documents - Companion Policy to NI 51-102 states that issuers “should apply plain language principles when [they] prepare their disclosure including: using short sentences, using everyday language, using active voice, avoiding superfluous words, organizing document in clear, concise sections and avoiding jargon.”

a. A “form” in this case is a list of the information that must be revealed; it is not a template that standardizes how the information is reported.

supplement. The base shelf contains information about the issuer, statistics on the performance of similar assets, and a generic description of the standard legal documents used, but no information on the specific pool of assets being securitized or the specific legal documents pertaining to the notes being issued (except for legal documents that will apply to all notes issued under the shelf prospectus). This information is contained in the prospectus supplement, which is typically filed after the deal has been priced.²⁴ Given the nature of ABS and the type of information contained in the documents, the prospectus supplement is more detailed, lengthy, and material than for corporate bonds, so the base-shelf option may be appropriate only for ABS backed by a revolving pool of assets, such as credit card receivables, where multiple series of notes with an ownership interest in the same asset pool are issued.

Continuous disclosure

In addition to filing a prospectus at the time of issue, ABS issuers are subject to a legal requirement for continuous disclosure. Securities law in Canada requires the filing of quarterly financial statements, the annual completion of an AIF,²⁵ and the issuance of a press release and filing of a

material change report if there is a material change in the business, operations, or capital of the issuer. The term “material change” is defined as “a change in the business, operations or capital of the reporting issuer that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the reporting issuer.” However, items that are material for an ABS differ from those for a standard security, such as a corporate bond or equity, owing to the very different nature of the securities (see **Figure 1**). In particular:

- Audited financial statements of an ABS issuer (a trust or special-purpose vehicle) are useful, but are of less value to investors than the financial statements of a corporate bond or equity issuer. This is because the trust’s financial statements can pertain to a number of ABS series and asset pools, not only to the specific assets underlying the securities of interest to the investor. For the same reason, those statements are also of less value to ABS investors than either information on the composition and performance of the actual pool of assets underlying the specific notes they hold, or data on individual loans within the pool.
- The AIF is required to be released on an annual basis only, thus limiting its usefulness to investors looking for timely information on changes in the performance of the assets and expected payouts, particularly in a crisis. It is not required to be audited, potentially reducing at least its perceived reliability in the eyes of investors.

²⁴ A draft supplement is typically distributed to investors during the marketing of the deal, but this draft is not legally binding and could be subject to change prior to the filing, although this would be unusual.

²⁵ Securities law generally does not require the annual completion of an AIF. It is, however, required in order for securities to be eligible for issuance under the short-form prospectus, which is how most ABS are issued.

In addition to the trust's financial statements and an annual form, ABS investors need detailed and timely information on the performance of the underlying assets. Recognizing this, ABS issuers often do release monthly servicer reports with information on the performance of pool assets. The right to view the performance of pool assets is governed by the transaction agreements. While there is no specific legal requirement for them, ABS prospectuses typically include statements to the effect that investors will receive monthly reports from their servicers.²⁶ However, the information that these reports contain is left to the issuer's discretion, and there is no requirement to have them certified or audited.

PRINCIPLES OF DISCLOSURE FOR SECURITIZED PRODUCTS AND AREAS FOR POTENTIAL IMPROVEMENT

Disclosure requirements should be assessed from the point of view of the objectives of the requirement (i.e., investor protection, market efficiency, and reduced systemic risk), as well as what is material to the investor in terms of:

- *Timeliness of the information*—at the time of issue and continuously over the life of the security.
- *Completeness of the information*—all pertinent information to allow pricing and foster market liquidity, including: information about all parties involved; the duration of the obligation, distribution of cash flows, and possible trigger events and consequences; the nature, quality, and performance of the underlying assets; and the embedded contingencies and credit enhancements.
- *Clarity of the information*—standardized terminology and clear language should be used in all reporting.

Fundamentally, the same overarching principle—to disclose in a timely fashion all material facts and material changes—should apply to all securities issued in the public market. As suggested above, securitized products are very different from—and typically more complex than—traditional securities and, as a result, the nature of what constitutes “material information” is also likely to be quite different. This argues in favour of disclosure requirements that are tailored to securitized products, and clear guidance with regard to their application. The minimum requirements should be based on the IOSCO disclosure principles for public offerings of ABS.

These principles, which apply at the time of issuance, include disclosure of:²⁷

1. the identity of parties involved and their responsibilities (e.g., arrangers, sponsors, servicers, trustees);

2. description of the ABS (e.g., types and classes of securities, triggers, overcollateralization, credit rating) and structure of the transaction (e.g., flow of funds, distribution, fees, prepayment considerations);
3. static pool data (i.e., how assets originated at different periods have performed over time);²⁸
4. pool assets (e.g., composition and characteristics of asset pool, as well as delinquency and loss information);
5. significant obligors of assets;
6. credit enhancements and other forms of credit support; and
7. significant derivatives contracts beyond credit support (e.g., identity of interest rate or currency swap counterparties and terms of agreements, financial information of significant counterparties).

While the spirit of securities regulation in Canada is aligned with these principles, and ABS prospectuses do contain much of the information that investors need, there are areas for improvement in terms of the disclosure requirements. For example, more comprehensive disclosure requirements that are tailored to securitized products may be desirable, given significant differences in the nature of those securities compared with traditional corporate debt.²⁹ History and research show that voluntary disclosure is less likely to be forthcoming in complex markets (Fishman and Hagerty 2003). This suggests that more precise guidance for disclosure of information related to securitized products may be helpful, since reliance on voluntary disclosure may not, over time, achieve the optimal level of disclosure.

Initiatives in other countries

In the wake of the financial crisis, jurisdictions around the world are investigating the need to refine their disclosure requirements for securitized products.³⁰ In April 2010, the U.S. Securities and Exchange Commission (SEC) released a broad and detailed list of proposals for the expansion of disclosure and other requirements to support investor protection. In particular, it proposes new requirements for the disclosure of specified data on the underlying assets, characteristics of obligors, new information on originators and sponsors, and underwriting of the asset. The asset-level data are to be provided in a machine-readable standardized format, along with a computer program of the contractual cash-flow provisions to facilitate the review of the data by

²⁸ This can allow investors to detect changes in asset quality and credit standards that may not be as easily or readily detectable with information on pool assets.

²⁹ See, for example, Feldman et al. (2005) for a comparison of U.S. and Canadian disclosure requirements. Note that this comparison was made before the SEC published substantial revisions in April 2010.

³⁰ See FSB (2009) for a brief discussion.

²⁶ A number of sponsors file those reports on the System for Electronic Document Analysis and Retrieval (SEDAR) as open to the public, while some have password-protected websites accessible only to investors.

²⁷ See IOSCO (2010) for a full list of the IOSCO disclosure principles.

investors. The rule changes also establish new criteria for shelf prospectus eligibility. The American Securitization Forum's Project RESTART is a private sector initiative that has delivered voluntary standardized reporting and disclosure packages, starting with residential mortgage-backed securities (RMBS). Similarly, the European Securitization Forum published its disclosure principles. In addition, both the European Central Bank and the Bank of England have released for consultation detailed disclosure requirements (including, in some cases, for loan-level data) that they are considering applying to ABS that are eligible as collateral to their lending facilities.³¹

Potential enhancements for ABS

As stated above, current disclosure requirements for ABS issued in Canada could be enhanced—both at the time of issue and over the life of the security.³² One important element of disclosure is how the information is provided. While ABS prospectuses contain much of the information that investors need, benefits could be achieved, in terms of ease of understanding and enhanced ability to compare across issues, from more standardized documentation. This could include a concise summary that describes, in clear language, all the key elements contained in the prospectus (and some guidance on what those key elements are).³³

There is also room for improvement with regard to the substantive information itself, not simply how it is provided. For example, the IOSCO principles include static pool data that allow for a historical comparison of the performance of assets that are originated at different times, which could allow investors to detect changes in underwriting standards that may not otherwise be evident.³⁴ In addition, there may be a need to disclose loan-level data for certain types of ABS where this information would be pertinent.³⁵ Finally, there may be room for enhancing the level of information provided with respect to the various parties involved in an ABS transaction; for example, financial information on those

parties that could allow investors to judge their ability to fulfill their obligations.

There is also room for improvement in terms of information disclosure over the life of the security, particularly since IOSCO's disclosure principles for ABS do not address the issue of continuous disclosure. Continuous disclosure requirements for ABS should recognize that the issuer's financial statements are less relevant to investors than in the case of traditional corporate securities issuers, given the need for detailed information on the specific assets underlying the securities rather than on the issuer, as was argued earlier, and that frequent reporting on the performance of the underlying assets is important. So, in addition to an AIF, which is released on an annual basis, certified monthly servicer reports are important for both investors and regulators to be able to make appropriate decisions and properly assess, monitor, and manage the risks inherent in securitized products. In support of this, some guidance should be provided as to the minimum material information these reports should contain for the various types of ABS and how that information should be presented in order to facilitate comparison across securities.

Potential enhancements for ABCP

The greater complexity and unique risk characteristics of securitized products, compared with regular commercial paper, raise the question of whether the level of disclosure mandated under the current form of the short-term debt exemption is appropriate for ABCP.³⁶ In developing an appropriate set of standards for disclosure, it may be useful to consider some elements of the Bank of Canada's disclosure requirements regarding the ABCP it accepts as collateral under its Standing Liquidity Facility. These were developed in response to the limited disclosure of information in the structure of ABCP products before the crisis. The Bank of Canada requires a single, concise document that contains all relevant information and is validated by the sponsor.³⁷ These disclosure standards include the identities of the key parties involved; the range of assets that may be held and the manner in which the exposure is gained; the characteristics of asset pools, including performance measures, foreign currency exposures, and hedging methods; the nature of credit enhancements and liquidity facilities; asset-performance triggers and consequences for investors; and flow of funds for the ABCP program. The Bank also requires that this document be accessible to all investors and be updated whenever any significant change occurs.

31 In December 2009, the ECB launched a public consultation process on the establishment of loan-by-loan information requirements for ABS in the Eurosystem collateral framework to increase transparency, allow for more informed risk assessments, and to help restore confidence in securitization markets. The consultation documents include detailed proposed reporting templates for RMBS (see <http://www.ecb.int/press/pr/date/2009/html/pr091223.en.html>). On 17 March 2010, the Bank of England also announced a consultation on enhanced disclosure requirements for the eligibility of ABS collateral in its operations (see <http://www.bankofengland.co.uk/publications/news/2010/031.htm>).

32 This may prompt the Bank of Canada to apply additional transparency requirements, based partly on the IOSCO principles, should it decide to expand its list of eligible collateral to include a subset of ABS. The Bank could set disclosure requirements for the securities it would consider accepting as collateral under its Standing Liquidity Facility both to protect its financial interests and to provide leadership in this area.

33 Many prospectuses already contain a summary, highlighting the value of such a document to investors, but there is no legal requirement for it, and greater standardization would help.

34 Since this information is typically requested by rating agencies, it should not represent a material additional cost for the issuer.

35 Loan-level data would be more appropriate for certain types of securitized products (for example, RMBS) than for others (for example, ABS backed by credit card receivables), given the shorter term of the loans, the much higher turnover of portfolios, and the larger number of loans underlying the latter type of securities.

36 Ontario's Standing Committee on Government Agencies (2010) released a report calling for, among other recommendations, an amendment to the short-term debt exemption rule to make this exemption unavailable for the sale of ABCP, and more generally, for improved disclosure with respect to ABCP. An amendment to the short-term debt exemption to make it unavailable to distributions of ABCP was also proposed in 2008 by the CSA ABCP Working Group, which was formed to consider securities regulatory issues stemming from the credit turmoil and to make recommendations to the chairs of the CSA on appropriate regulatory responses.

37 For details, see <<http://www.bankofcanada.ca/en/financial/securities.pdf>>.

CONCLUSION

This report focuses on issues related to the disclosure requirements for ABCP and ABS in Canada, and argues that enhancements to current disclosure requirements, and their application, should be considered. As illustrated by the recent crisis, inadequate disclosure of information can contribute to financial instability in times of stress. The unique nature of securitized products, compared with traditional corporate securities, suggests that disclosure standards that are better tailored to these products would be desirable. Securitized markets suffered significant stress during the crisis, with many closing down completely. To restore market confidence and ensure the reopening of ABS markets on a solid footing, enhanced disclosure is necessary to provide investors with sufficient information to make informed decisions.

Enhanced disclosure is, however, only one element in a comprehensive policy and industry response to the recent financial crisis. Other initiatives, including steps to reduce conflicts of interest in the securitization chain, the simplification and standardization of structures, and appropriate prudential regulation and accounting standards, are key factors in putting securitization markets on a more stable footing. These initiatives can reinforce each other and, if appropriately implemented, would augment the benefits of more stringent requirements for transparency and disclosure.

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