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LEARNING CURVE®

Implementing Transparency

Transparency is rapidly emerging as the solution for restoring trust in pricing and therefore liquidity in the structured finance markets. It is the cure for several ills caused by opacity in the existing deals which has frozen worldwide capital markets. Without it, market participants face an epidemic of worry about potential losses and a loss of confidence in the firms they do business with. The actual performance of the collateral backing each deal must be guessed when valuing and rating each security. And sellers do not know what price to ask for and buyers do not know what price to pay.

But with transparency, market participants can do fundamental data analysis on each structured finance deal and all of the securities that were issued as part of the deal. All relevant knowable facts can be used to value and rate each security. And risk can be managed.

What Is Transparency?

Transparency is presenting data on the underlying collateral performance in such a way that market participants can easily understand what is going on despite the complexity of each structured finance transaction. It is this data and the access to this data that, when combined with TRACE, regulators have focused on in the Presidential Working Group recommendations to restore liquidity in the secondary market.

This is the data former **Federal Reserve Chairman Paul Volker** asked about when he commented about the Fed taking on the mortgages and mortgage-backed securities of questionable pedigree from **Bear Stearns** and wondered how this collateral was "good collateral; tested to the point of no return."

The gold standard for transparency is easily accessible and usable real-time, standardized loan-level detail on the underlying collateral over the life of each structured finance deal. On an ongoing basis, the gold standard brings the loan-by-loan data that is available in the primary issuance market into the secondary market.

Under this standard, collateral performance data is made available to end users so they can use it in the analytic and pricing models of their choice. This data reflects everything that has happened through the close of business yesterday. Data from the close of business yesterday has two advantages. First, it is what was recorded in the audited financials. Second, it avoids settlement cycle issues where payments received by check in the morning might be withdrawn due to insufficient funds in the afternoon.

The data is standardized to maximize its usability. This allows for comparisons across both a single issuer's deals and across multiple Issuers' deals for the same asset type. It also allows securities that involve multiple issuers and asset types such as collateralized debt obligations and CDO squareds and, because their performance is driven by the cash market, synthetic CDOs to be analyzed and compared. Finally, each deal can be monitored and therefore the investment risk managed over the life of the deal.

Transparency's Value To Issuers

By offering transparency, issuers can save themselves the cost of opacity. This cost or opacity premium equals the increase in risk premium and liquidity premium faced by issuers in the primary market since before the credit crisis began. The increased risk premium reflects the perception of a higher probability that the underlying collateral will not perform as expected. The increased liquidity premium reflects the fact that, without transparency, investors will have to hold the asset for the life of the deal because other investors do not know what is backing the deal and therefore are unlikely to buy it. For issuers who cannot tap the capital markets on acceptable terms, the cost of opacity is the ability to access the capital markets. The cost of opacity was calculated from **Deutsche Bank**'s March 2008 Securitization Monthly and is presented below.

ASSET TYPE	ANNUAL COST (in $mln per $1 bln issued)
U.S. Government Insured Student Loans	$5.0
Credit Card Receivables	$6.5
Auto Loans	$11.1
Agency Home Mortgages	$11.4
Commercial Mortgages	$19.0

This cost reduces the issuer's income each year the deal is outstanding.

The rating agencies, particularly **Moody's Investors Service**, are indicating that providing transparency will also factor into the deal rating. They are looking for standardized loan-level detail over the life of each deal and will favor greater transparency.

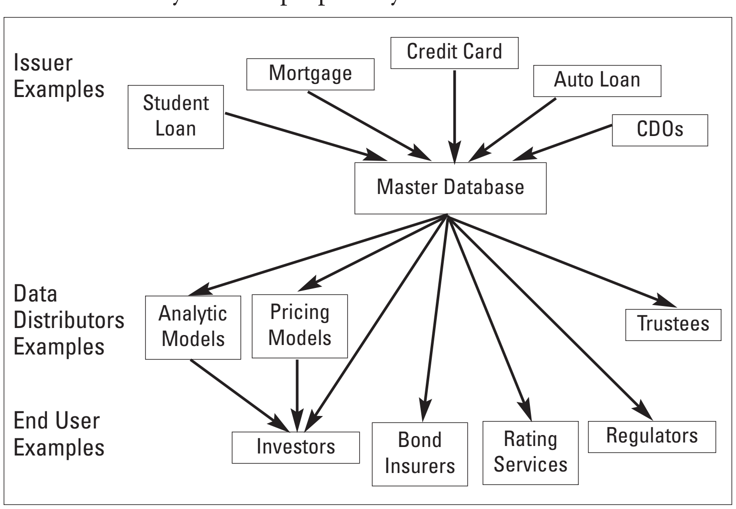
To reduce the cost of opacity and improve the ratings on their deals, issuers are looking for the best transparency solution. The key characteristics of this solution include that it minimizes the cost and burden on the issuer of providing transparency, is administered by a third party to insure data integrity and maximizes the effectiveness of the transparency being provided by making the data available to all market participants.

How Transparency Will Be Offered

While the actual mechanics of providing transparency are very complex, the basic framework is shown in the following flow chart. The collateral performance data will be collected in a master database from every issuer for every deal whether or not the deal was publicly issued or privately placed. The master database is needed so that CDOs and other securities like CDO squareds can be analyzed, valued and monitored. This data will be made available to end users either directly or through data distributors. Potential data distributors include, among others, firms such as **Bloomberg**, **Intex** and **LoanPerformance**.

Along with the actual performance data, these data distributors may provide analytic and/or pricing models. Each end user will be able to get the data that they want. For example, rating agencies might want every field in the data set monthly while investors might want fewer fields in the data set daily.

In addition, because U.S. firms need to comply with Sarbanes-Oxley, the data will be made available to all market participants at the same time each day. Finally, issuers will be able to control who has access to information on privately placed deals. By limiting access, the issuers can maintain the confidentiality of their proprietary deal structures.



Based on its sheer size, the master database is likely to be physically maintained by several large firms that currently provide financial data services to the structured finance industry. Overall coordination of the master database should be by a company whose sole business is overseeing the collection of the data from the issuers' accounting systems, data verification and validation, data standardization, linking data to specific deals, production of summary reports and disseminating the information to data distributors and end users. The role of this company is critical because it bridges the gap between the issuers and the data distributors and end users. It is the company that works with data distributors and end users to be sure that they get the data that they need. This lowers the industry's cost of providing transparency to each end user's desktop while maintaining the highest possible quality standards for the data. This also maximizes the flexibility of the transparency transmission mechanism so that it can meet the evolving needs for transparency into the future.

Ultimately, the transparency data is useless if market participants do not trust it. By definition, the company coordinating the master database must be free of the types of structural conflicts of interest that would be present if the company were a data distributor, an analytic and pricing model vendor, a rating agency or any other participant in securitizations.

The Spread Of Transparency

For the structured finance industry to move forward and grow, transparency must be offered on a global basis. Transparency must take into account differences in regulation. For example, in Europe there are laws protecting borrower privacy. In the U.S., similar privacy laws exist for patient privacy and healthcare receivables transactions have had to comply with this law. By applying the HIPAA standard for patient privacy to U.S. borrowers, the transparency solution also complies with the European privacy laws.

Conclusion

The need for and implementation of the transparency gold standard is the major task facing the structured finance market today. As noted above, every participant in the industry, including regulators, issuers, rating agencies and investors, is demanding transparency. This is a major step forward. Now we need industry leaders to implement the solution and help end the paralysis in the capital markets. By providing real-time, standardized loan-level data to market participants, the fear of owning or buying the unknown is eliminated and the structured finance market can function properly again.

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