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THE STATE OF SECURITIZATION MARKETS

HEARING

BEFORE THE

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SECURITIES, INSURANCE, AND INVESTMENT

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
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ON

EXAMINING THE STATE OF SECURITIZATION MARKETS

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C O N T E N T S

WEDNESDAY, MAY 18, 2011

WITNESSES

THE STATE OF SECURITIZATION MARKETS

WEDNESDAY, MAY 18, 2011

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 9:35 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Jack Reed, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN JACK REED

Chairman REED. Good morning. Let me call the hearing to order and welcome all of our witnesses. This is an opportunity to talk about the state of the securitization markets, which is a critical issue to our economy and to the Nation.

Securitization is the bundling of individual loans or other debt instruments into marketable securities to be purchased by investors. Securitizations have touched nearly every American. These financial products operate behind the scenes in our economy. They provide lower-cost loans for homes and automobiles. They provide students with low-rate loans. They provide businesses with capital to purchase equipment. They are used to finance apartments and neighborhood malls. And because they are so prevalent in our economy, they can also cause a lot of trouble when they do not function properly.

Securitization has been a powerful tool providing significant economic benefits, including lowering the cost of credit to households and businesses and helping investors better match their return to their appetite for risk. Securitization has also allowed lenders to transfer credit risk and free up capital for additional lending. This in turn provides greater availability and lower-cost loans to consumers and businesses.

Securitization, when executed correctly, can be an important part of our financial system, helping to create jobs by providing the financing and liquidity necessary to build our infrastructure and help our businesses grow and innovate. However, most market participants and policy makers agree that the financial crisis revealed a troubling aspect to an increasingly Byzantine and opaque securitization process which has had a devastating effect on our economy.

The way securitization was implemented in the years leading up to the financial crisis created perverse incentives, often emphasizing volume over quality, easy fees over the long-term viability of

the loans, and speed over diligence. We only need to look at the residential mortgage market to see how badly things can go if securitization is not executed carefully.

Indeed, the mad rush to cut corners led to an eventual freezing of the securitization markets as investors lost confidence and drastic Government intervention was necessary to prevent the evaporation of liquidity and allow access to credit to continue for many consumers and businesses.

In short, securitization is not just a fancy Wall Street process. Securitization structures can and have a profound impact on our economy and a unique ability to allocate capital at low cost.

As we examine the state of the securitization markets today, we need to go back to fundamentals. We need to assess the role of securitization on our economy. Should it continue to have a role as it is playing today? Or should that role be different? What is the balance between liquidity and investor confidence? How can we help create a more robust, transparent, liquid, and competitive marketplace?

At the same time, how do we discourage reckless lending, excessive risk taking, and excessive leverage? And, ultimately, how do we sufficiently protect investors? And how do we protect the American economy and public when these processes go wrong?

We do have to ensure that securitization is used properly and effectively for the benefit of all Americans. The answers to these questions have huge implications for our economy and also as we look forward to reforming and changing the Government-sponsored enterprises under the control of the Government today.

I look forward to hearing from all of our witnesses, and at this point I would like to recognize my Ranking Member, Senator Crapo. Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Senator Reed, and I appreciate you holding this hearing. You are right, the implications of how we resolve this issue are going to have huge consequences for our economy, and we have got to get it right. I appreciate our witnesses being here today and the thoughtful assistance that they are giving us in evaluating this.

If we are going to encourage private money that is still sitting on the sidelines to return to security markets, we need to provide the appropriate balance between the strong standards that will align the interests of lenders, issuers, and investors with the ability of the securitization process to work.

Section 941 of the Dodd-Frank Act legislation mandates that our financial regulators craft rules requiring entities involved in the securitization process to retain a certain level of risk of the assets being securitized. The intent is to better align the incentives among the chain of originators, securitizers, and investors. It is important to note that the Federal Reserve's October 2010 study cautioned that risk retention is not a panacea and that if rules are not implemented carefully by asset class, credit availability could be disrupted at a time when it is desperately needed.

This was also the same reason that the Senate made two key changes to the section when deliberating on the Dodd-Frank legislation.

The first that I refer to is the Landrieu-Izakson-Hagan amendment that required regulators to establish a category of well-underwritten single-family loans that would be exempt from the bill's risk retention requirements.

The second was my amendment, which directed regulators to consider risk retention forms and requirements in order to ensure that regulators considered the unique nature of the commercial mortgage-backed securities market.

After months of sometimes very heated interagency debate, the joint risk retention rule proposal was put out for comment on March 31st this year. The proposal is 367 pages and seeks comments on more than 150 different questions. While many experts are still trying to understand all the consequences of the proposed rule to the impact of capital formation in these markets, the early feedback and comments suggest that more work needs to be done in this area, and several of our witnesses argue that a reproposal is warranted.

This rule will have a broad impact, and I am interested in learning from our witnesses today how it is going to impact the securitization market and our economy. If necessary, what changes should regulators consider that will provide the flow of credit and strengthen the underwriting and align the interests of lenders, issuers, and investors?

Ultimately we need rules that are strong enough to protect our economy but that can adapt to changing market conditions and promote credit availability which will spur job growth for millions of Americans.

Thank you, Mr. Chairman, and, again, I appreciate your holding this hearing.

Chairman REED. Thank you very much, Senator Crapo.

I will now introduce all of the panelists and then ask Professor Schwarcz to begin, but let me begin with the introduction of all the panelists.

Steven Schwarcz is the Stanley A. Star Professor of Law and Business at Duke University. Prior to joining the Duke faculty in 1996, he was a partner at the law firm of Shearman & Sterling and then a partner and practice group chairman at Kaye Scholer LLP. Professor Schwarcz's book, "Structured Finance: A Guide to the Principles of Asset Securitization", is one of the most widely used texts in this field. Thank you, Professor.

Tom Deutsch is the executive director of the American Standardized Forum. Mr. Deutsch previously served as an associate in the Capital Markets Department at Cadwalader, Wickersham & Taft, and he represented issuers and underwriters in various structured finance offerings.

Martin Hughes has served as president of Redwood Trust since 2009 and chief executive officer since May 2010. Mr. Hughes has over 18 years of senior management experience in the financial services industry. Thank you.

Lisa Pendergast is president of the CRE Finance Council. She is also a managing director in Jefferies' Fixed Income Division and is

responsible for strategy and risk for CMBS and other structured commercial and multifamily real estate products. Thank you.

Ann Rutledge is the founding principal of R&R Consulting. In addition, Ms. Rutledge is an adjunct assistant professor of asset securitization at the Hong Kong University of Science and Technology and visiting lecturer at the University of California at Irvine.

Chris Katopis serves as the executive director of the Association of Mortgage Investors, AMI. Mr. Katopis has years of experience in Washington in a variety of public policy positions in the private sector and Government.

Thank you all for being here. Professor Schwarcz, would you begin? Turn on your microphone. Two, your statements are all part of the record, so feel free, very free, to summarize your very thoughtful and analytical presentations. And we have got about 5 minutes. Go ahead, Professor.

STATEMENT OF STEVEN L. SCHWARCZ, STANLEY A. STAR PROFESSOR OF LAW AND BUSINESS, DUKE UNIVERSITY SCHOOL OF LAW

Mr. SCHWARCZ. Thank you. My written testimony discusses in more detail securitization's role in the financial crisis. The problem was not securitization *per se,* but a correlation of factors, some of which were not completely foreseeable, including the unprecedented collapse of the housing markets.

The resulting mortgage defaults had localized consequences in traditional securitization transactions. But they had larger, systemic consequences in nontraditional transactions that involved complex and highly leveraged securitizations of asset-backed securities that were already issued in securitizations—effectively "securitizations of securitizations."

I believe that the important question is: Why did the markets believe in these nontraditional securitization transactions? And answering this question helps us to understand how to protect against potential abuses.

Now, in trying to answer this, in addition to the widespread inconceivability of the extent of the housing price collapse, part of the answer may be that securitization's focus on mathematical modeling to simplify complexity fostered an abandonment of common sense. Another part of the answer may be that investors, who seemed as anxious to buy these superficially attractive securities as underwriters were to sell them, were overly complacent and eager to follow the herd of other investors. Other parts of the answer may touch on intra-firm conflicts, which I will discuss, and the failure to internalize costs.

Dodd-Frank addresses at least one of securitization's flaws, and that is the originate-to-distribute model of securitization, which is said to have fostered an undisciplined lending industry, and Dodd-Frank does this by requiring securitizers to keep skin in the game, effectively retaining a minimum risk of loss, in order to help align the incentives of securitizers and investors.

There does remain a question, however, of the extent to which this originate-to-distribute model actually caused mortgage underwriting standards to fall. There are other reasons set forth in my

testimony that at least give suggestions as to why it may have occurred, and one of the more important questions is: Why did the ultimate beneficial owners of the mortgage loans—the investors in the asset-backed securities—not govern their own investments by the same credit standards that they would observe if they were making the loans in the first place?

Now, Dodd-Frank does not directly address the problem of overreliance on mathematical modeling or complexity. To some extent, this should be self-correcting in the short term. But in the long term, I fear that investors will really forget that lesson; they tend to, as *Business Week* once said it, "Go for the gold, look to the yield."

Dodd-Frank does not address the broader complacency question, although I am not sure how regulation can really change human behavior. For example, market participants will probably always engage in herd behavior, there being safety in numbers.

Dodd-Frank focuses on disclosure besides the skin in the game, and among other things, it requires more standardized disclosure of information. In principle, that makes sense. In my experience, though, investors often already get this type of standardized information. And I think the larger problem is not disclosure itself, that it is inadequate in terms of what is provided, but the fact that investors do not always read it, and if they do read it, they do not always understand the information that is already disclosed.

There are several reasons for this. One is complacency. Another reason which I think is very important is a conflict of interest within investing firms themselves. As investments become more complex, conflicts are increasingly driven by short-term management compensation schemes. And this is critical, especially for the technically sophisticated secondary managers who do not always worry about long-term risks because their compensation is on a short-term bonus basis.

Now, this is an intra-firm conflict, very much unlike the traditional focus of scholars and politicians who focus on conflicts between the senior managers and the shareholders. I think that regulation needs to address this intra-firm conflict.

Another reason for disclosure's failure is that financial products, including some securitization products, are becoming so complex that disclosure can never lead to a complete understanding.

Now, let us just briefly look at the larger perspective. Securitization has existed for decades, has worked very well for the most part. Even during the recent crisis, almost all traditional securitization structures protected investors from major losses. But certain of securitization's problems, especially for the nontraditional structures, are typical of problems we must face in any innovative financial market: that increasing complexity, coupled with human complacency, among other factors, will make failures virtually inevitable. And regulation must respond to this reality. It must mitigate the impact of failures when they occur.

And, finally, it is important to provide incentives for financial institutions to try to minimize the impact of failures and to absorb them. This could be done, for example, by requiring at least systemically important market participants to contribute to a risk fund, which could be used as a source of stabilization. Fund con-

tributors then would be motivated not only to better monitor their own behavior, but also to monitor the behavior of other financial institutions whose failures could deplete the fund.

Thank you.

Chairman REED. Thank you very much Mr. Schwarcz.

Mr. Deutsch.

STATEMENT OF TOM DEUTSCH, EXECUTIVE DIRECTOR, AMERICAN SECURITIZATION FORUM

Mr. DEUTSCH. Chairman Reed, Senator Corker, thank you very much for the opportunity to testify here today. My name is Tom Deutsch, and on behalf of the 330 member institutions of the ASF, I appreciate this opportunity to represent the issuer, dealer, and investor interest in the securitization marketplace.

In our 157-page written statement, which I will not try to get into 5 minutes of oral statements, we seek to identify and describe in detail the panoply of key legislative and regulatory initiatives that are currently confronting the securitization markets. The purpose of this deep and critical review of the outstanding legislative and regulatory initiatives is to demonstrate not just the individual aspects that are of concern to the securitization markets but ultimately the cumulative effects of all of these regulatory initiatives occurring simultaneously. And in effect the securitization markets' greatest fear is not to be damaged by one slice of the sword but, in fact, to be destroyed by a death by a thousand cuts.

Many of the industry's current issues arise from regulations prescribed by the Dodd-Frank Act. Some of the key areas of Dodd-Frank that we discuss in our detailed written statement are: one, risk retention; two, rating agency reform; three, orderly liquidation authority for nonbanks; four, derivatives; five, the Volcker rule; and, finally, conflicts of interest.

But the massive regulatory changes in the securitization market are not solely deriving from the Dodd-Frank Act. And, in fact, they come from a number of other areas, including: one, the SEC's Regulation AB proposals that would completely overhaul the registration, disclosure, and reporting requirements for the entire asset-backed securities market; two, the FDIC's securitization safe harbor, which was developed in a unilateral fashion by the FDIC, effectively front-running much of the Dodd-Frank securitization mandate, and has currently sidelined most bank issuers from securitization issuance; and, three, finally, the capital adequacy changes coming in Basel 2.5 and Basel III, as well as the accounting and regulatory capital charges created by FAS 166 and 167, the effects of which are still being absorbed by the market.

Ultimately, these proposals confront the market during a time when certain sectors, such as auto and equipment ABS, are at or near normal levels, and other sectors, such as the commercial mortgage-backed securities market, that are beginning to see signs of life. Particularly a significant number of commercial loans are coming due for refinance.

But, clearly, the future of residential mortgage funding hangs in the balance as the Administration and Members of Congress seek to wind down the GSEs and wean Americans' addiction off of cheap or Government-subsidized mortgage credit. But to reduce Govern-

ment's role in the residential mortgage sector, private sector capital has to return to this market to allow the residential mortgage market to live on its own.

Ultimately, few would dispute that industry and policy changes do not need to occur in the subprime and Alt-A residential mortgage securities marketplace, and the ASF fully supports appropriate changes in that marketplace. But making changes to the entire engine of the securitization machine while at the same time doing it across all asset classes, while driving up a steep economic hill in a down market, is ultimately a recipe for a sputtering car, if not a complete breakdown on the side of the road.

In particular, in the risk retention proposals recently released by the Federal regulators, we are seeing rules drafted precisely for the residential mortgage market, but being applied, somewhat bluntly, to other types of securitizations, like auto loans. As an example, the regulators included an auto ABS exemption from the risk retention rules for certain qualified auto loans. But few, if any, auto loans made in America over the past 30 years would ever actually qualify for such an exemption because the exemption was developed with mortgage underwriting criteria, such as the requirement for a 20-percent down payment. I do not know about you, but I do not know many people who have put 20 percent down on a car loan. It just simply does not happen.

Also, but even within the mortgage sector, there are new concepts, such as the premium cash reserve account, that ultimately is beyond the scope effectively of Dodd-Frank that would ultimately make the securitization business a not-for-profit business, effectively shutting down large swaths of the RMBS and CMBS markets if those rules were to go into effect as written.

The ASF requests ultimately the regulators should specifically articulate that the proposed risk retention rules not apply to certain sections of the highly functioning securitization market, such as the auto loan sector and the asset-backed commercial paper sector that shows no signs of misalignment of incentives during one of the worst economic crises in American history.

Moreover, given the extremely complicated set of rules that are being proposed, over 300 pages and 150-plus questions, ultimately we believe that given the thousands of pages of comments that the regulators are going to receive on June 10th, the regulators should ultimately repropose the rules to ensure that they get it right and make sure that availability of credit is ensured to Americans through the securitization process.

Thank you very much for your time today, and I look forward to answering questions.

Chairman REED. Thank you very much.

Mr. Hughes, please.

STATEMENT OF MARTIN S. HUGHES, PRESIDENT AND CHIEF EXECUTIVE OFFICER, REDWOOD TRUST, INC.

Mr. HUGHES. Good morning, Chairman Reed, Ranking Member Crapo, and Members of the Committee. My name is Marty Hughes. I am the CEO of Redwood Trust, and I sincerely appreciate the opportunity to testify here today.

My testimony is focused on restoring private sector financing for prime residential mortgages. Redwood has a long history in the business of issuing and investing in private label jumbo mortgage-backed securities, or MBS. Since the market freeze 3 years ago, we have completed the only two issuances of fully private MBS of newly originated mortgage loans. We are planning to complete another two transactions by year end.

Based on the success of these transactions and our ongoing conversations with investors and lenders, we believe private capital is ready to step back in and invest in safe, well-structured prime securitizations backed by good mortgages. The speed at which the private market returns will depend on several factors.

Through Fannie Mae, Freddie Mac, and the FHA, the Government currently supports the credit risk in 90 percent of the mortgages in the U.S. without passing on the full cost of the credit risk assumed. Government subsidies must be scaled back on a safe and measured basis to permit the private market to flourish. We note that post-crisis, the asset-backed securities markets for autos, credit cards loans, and now commercial loans are up and running while the private label MBS market remains virtually dormant. The difference is the pervasive below-market Government financing in the mortgage sector that is crowding out traditional private market players.

We can only securitize the small volume of prime quality loans outside the Government's reach. We are ready to purchase and securitize any prime loan and can do it at an affordable rate once the Government creates a level playing field.

I strongly advocate beginning, again, a safe and measured process of testing the private market's ability to replace Government-dependent mortgage financing.

The Administration should follow through on its plan to reduce conforming limits and increase guarantee fees to market rates over time so the Government gradually withdraws from a majority of the market over 5 years. That time frame will enable the private label market to gain standardized practices and procedures and confidence.

In the wake of the Dodd-Frank Act, there are many regulatory requirements and market standards currently out for comment. The resulting uncertainty keeps many participants out of the market. Once the final rules of the road are known, market participants can adjust their policies, practices, and operations.

Another issue to restoring investor confidence and increasing the velocity of private label issuance is the standardization of sponsor and servicer best practices. In recently issuing two private label MBS transactions, we worked closely with those who invest in high-quality AAA securities—insurance companies, banks, and money managers, and with lenders, borrowers, and industry groups. Each transaction was well oversubscribed. This did not happen by accident. Sponsors need to meet the new requirements of AAA investors. These include enhanced disclosures, strong and enforceable representations and warranties, safer and simpler structures, and meaningful sponsor skin in the game.

It is also critical that servicers regain the confidence of investors. Uniform standards need to be established governing servicer responsibilities, performance, and conflicts of interest.

In my opinion, the one gaping hole to restoring private investor confidence is the unresolved threat from second mortgages—a significant factor that contributed to the mortgage and housing crisis. The first and most important level of skin in the game is at the borrower level. If a borrower can effectively withdraw his or her skin out of the game through a second mortgage, the likelihood of default on the first significantly increases. Left unchecked, this would be a very, very disappointing result for private investors.

Regarding mortgage rates, it is reasonable to expect rates to rise somewhat when the Government withdraws. We believe rates will only rise modestly, perhaps by 50 basis points. And we note that in our most recent deal, the average mortgage interest rate for 30-year fixed rate loans underlying that securitization was 46 basis points above the Government-guaranteed rate.

Done correctly, we believe a gradual wind-down of the Government's role in the mortgage market can be replaced by a smarter, less risky private label MBS market. Thank you for the opportunity to allow me to testify. I would be happy to answer your questions when the time comes up.

Chairman REED. Thank you very much, Mr. Hughes.

Ms. Pendergast.

STATEMENT OF LISA PENDERGAST, PRESIDENT, COMMERCIAL REAL ESTATE FINANCE COUNCIL

Ms. PENDERGAST. Good morning, Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee. My name is Lisa Pendergast, and I am a managing director at Jefferies & Company. I am testifying today a president of the CRE Finance Council, or CREFC. CREFC is a trade association that represents all constituents of CRE real estate finance, including bank, life company, private equity, and CMBS lenders, as well as investors in CRE debt, loan servicers, and other third-party providers.

First, I would like to frame the critical role that the securitized debt occupies in commercial real estate and the economy at large. There is approximately $7 trillion in commercial real estate outstanding in the United States today, and between now and 2014, more than $1 trillion of CRE loans will mature and will require refinancing.

Prior to the economic crisis, the commercial mortgage-backed securities, the CMBS market, provided as much as 50 percent of debt capital for commercial real estate annually. In 2007, CMBS issuance peaked at $240 billion. In 2009, that number plummeted to just over $1 billion, including the help provided by TALF.

As the markets begin to stabilize and recover, so do CMBS. In 2010, CMBS issuance rose to about $12 billion, and in 2011, it is projected that we will issue some $35 to $40 billion in new issue supply.

This is a good start, but it is not nearly enough to address the upcoming refinancing wave. Without a fully functional CMBS market, there simply is not enough capital to address this refinancing wave.

It is for that reason that Treasury Secretary Geithner and other policy makers agree that no economic recovery will be successful unless the securitization markets are revived and healthy. And make no mistake. Getting the Dodd-Frank mandated securitization retention rules right is essential to healthy securitization markets. There are lenders who are withholding judgment today on whether they will reenter the market until they can be sure that the final rules will work. The proposed rules are complicated, controversial, and they create as much uncertainty as they provide answers.

CREFC supports the basic framework for CMBS within the proposed rules. However, there are fundamental aspects within the rules that have the potential to render the CRE securitization market unviable. Given the complexity, the rulemaking process must be an iterative one rather than a one-and-done proposition. For this reason, we are asking that you provide the regulators with the latitude they need to get the rules right.

Specifically, our request today is twofold: first, extend the current June 10, 2011, rulemaking response date to allow for additional debate and clarification via roundtable discussions with regulators; second, encourage a reproposal of the draft rule that incorporates a response to the extensive industry feedback and dialog that will occur between regulators and the markets.

Let me provide you with a sense of some of the issues that we are grappling with as it relates to the rules.

First, the proposal includes a new concept called the premium capture cash reserve account that was not contemplated in the statute. Based on our reading, the reserve account substantially reduces the economic incentive for issuers to undertake securitization transactions. At a minimum, the reserve account will dramatically change CMBS transactions economics and likely result in fewer loans originated by CMBS lenders. Ultimately, this is likely to drive up the cost of CRE debt.

Second, and specifically for CMBS, we appreciate that regulators created a special B-piece buyer retention option, as directed by Dodd-Frank and championed by Senator Crapo. The B-piece of the first loss position buyer is often also the special servicer charged with working out troubled loans, and that raises conflict-of-interest concerns for some of our constituents.

To address that, the proposed rules incorporate a market-developed operating adviser construct that would require an independent ombudsman to participate in any transaction in which the B-piece buyer had special servicing rights. This provision in the rules, however, creates a broad set of its own potential problems as it goes well beyond the market-created operating adviser provisions in recent CMBS transactions.

Third, the proposal requires permanent retention buyer sponsor or B-piece buyer. Such a permanent investment constraint is unprecedented in the financial markets and could severely limit the universe of institutions that would be willing to function as retainers.

Fourth, the proposed regulations include a CRE specific retention exemption for loan pools compromised exclusively of low-risk qualifying CRE loans. It does not appear that any CRE loans would satisfy these requirements, and we are also concerned that the rules

do not properly consider entire segments of the commercial real estate market and the CMBS market, such as large floating-rate loans and single borrower transactions.

The Dodd-Frank risk retention framework is the most significant threat to sustaining a commercial real estate recovery. This statutorily imposed Dodd-Frank rulemaking schedule creates needless time pressure on regulators, especially given that the rules will not go into effect until sometime in 2013. We are concerned that this will result in the issuance of poorly designed final rules. It is critical that you make clear to the six agencies charged with implementing the CMBS components of the retention framework that they take the time necessary to get the rules right. A one-and-done approach for discussion of this high-stakes issue benefits no one.

Thank you for your time, and I look forward to questions.

Chairman REED. Thank you very much.

Ms. Rutledge.

STATEMENT OF ANN ELAINE RUTLEDGE, FOUNDING PRINCIPAL, R&R CONSULTING

Ms. RUTLEDGE. Chairman Reed, Ranking Member Crapo, Senators Corker and Hagan, my name is Ann Rutledge, and I am very grateful for the opportunity to testify this morning.

I have a very simple point to make. As was mentioned, I do lecture and I talk for 8 hours on end and it is impossible for me to read from a speech, so let me tell you what I do when I do not lecture. My business partner, Sylvain Raynes, and I started R&R Consulting 11 years ago. We left Moody's Investors Service because we believed that there was a fatal flaw in the rating product and process. The business model that we created was intended to address that fatal flaw, and let me tell you what that flaw is because it has a lot of relevance today.

The flaw is that it created a market that was too good to be true. That is because the valuation and credit analysis that was done at closing was only related to the conditions at closing. What happens with ABS and RMBS, in particular, but all securitizations in theory, is they may actually improve over time, like good wine. But there is not a rating agency around to take a second look or a periodic look. There is never an apples to apples comparison between the analysis done initially and after the fact.

Now, that was a great situation for investors for 20 or 25 years because it meant that they were holding securities that, on average, were better than the ratings suggested. That was a good situation for investors; but the sellers were happy as well, because securitization is much more flexible and offers a sort of corporate rating arbitrage. But unfortunately the sellers could have done even better.

And so we had a situation in the beginning—at least after 1998, we had a situation where there was an opportunity to repackage securities in CDOs, in particular, RMBS CDOs. And now we have just said that the rating is not a valid credit measure after origination. It either understates or it overstates credit quality. Now we have created a perverse incentive to put securities into the market that are not well structured, that will not improve, that will actually deteriorate, and we can repackage them in CDOs without the

ultimate investors realizing what is happening until it is too late because the rating system does not reflect current credit quality.

What is the source of the flaw? Because ABS and RMBS are measured—the credit quality is measured based upon empirical data. For CDOs, ABCP, and SIVs, the credit measure is a rating. It is not empirical data. And if the rating is stale, then the assessment is wrong.

So my point of view, my recommendation today is the same as 11 years ago, but as Benjamin Franklin said, "Tell me and I forget. Teach me and I learn. Involve me and I understand." We are all involved in this now, so I hope that the next recommendations that I make will have some resonance.

The most important things that we need to have to motivate better behavior is not to regulate behavior, but to create clear standards and enforce them. The standards that need to be set are particularly with respect to disclosure on the securities and with respect to the standard at which the securities are rated. What is the rating scale that allows a AAA security to go out as a AAA or allows a CCC security to go out as a AAA? We all need to know this.

The rating scale issue has not aired publicly. I know from working at Moody's Investors Service that we all benchmarked our ratings according to a fixed-point scale; and in 1994 Moody's analysts actually showed the investor public how it worked. The scale needs to be taken out of the hands of rating agencies, because with it, they have created a discount window for corporations to go to the market with their collateral and get cash, and that is a great idea, but it is something that affects the economy as a whole. The rating scale needs to be determined by the regulators and probably the Administration and Congress, and then it needs to be published so that the whole market can actually monitor credit quality, so that the determination of current credit quality is not in the hands of a few people.

Chairman REED. Thank you very much.

Sir?

STATEMENT OF CHRIS J. KATOPIS, EXECUTIVE DIRECTOR, ASSOCIATION OF MORTGAGE INVESTORS

Mr. KATOPIS. Good morning, Chairman Reed, Ranking Member Crapo, distinguished members of the panel. Thank you for the opportunity for the Association of Mortgage Investors to testify on the state of securitization markets and housing finance in general.

The U.S. mortgage market is awesome, $11 trillion in outstanding mortgages derived from three sources: Bank balance sheets, and critics argue that the bank balance sheets are full and stressed; the GSEs, and there is a vigorous debate about the potential liability on the taxpayers and Uncle Sam resulting from the enterprises; and securitization. Mortgage investors bring private capital to the market. At the height, we have financed $1 trillion in first lien mortgages, and at the height, 60 percent of all first lien mortgages were financed through securitization, not the banks.

But today, securitization is shut down. Senator Corker goes around Tennessee saying mortgage investors are on strike. This is not our choice. We have private capital to invest in the markets.

Capital craves yield. But unfortunately, the current legal and regulatory environment is not conducive to those yields.

So this has two sets of consequences. First is a macroconsequence on the U.S. economy, our capital markets, U.S. global competitiveness. But the second set of consequences squarely impact Main Street, because it impacts the ability to get housing, the price of credit, as well, the pension funds, retirement systems, and unions that have traditionally invested in RMBS because for decades it was the safest, most secure form of investment for long-term returns.

So who is AMI? AMI are a number of private investors that came together to identify obstacles and hurdles to securitization in the market and identify public policy solutions. We, along with the insurance industry, public institutions such as State pension funds, retirement systems, universities, charitable endowments, are trying to identify ways that the Government can develop better systems, structures, and standards to, one, restart securitization in this country, as well as deal with issues surrounding the legacy of investments that impact all stakeholders.

So with my testimony, my oral statement today, I would like to briefly summarize six broad-brush areas of concern, obstacles to RMBS securitization, and also try to touch on 10 public policy recommendations which we outline in our written statement and we outlined in our March 2010 white paper about restarting securitization.

First, the market suffers because of opacity, asymmetries of information, and a thorough lack of transparency. Our investors are very good at pricing risk, but they cannot price the unknown. When have you ever heard of an investor wanting less information? They have fiduciary responsibilities. They want as much information as they can obtain.

Second, there is a lack of standardization and uniformity surrounding very basic transaction documents and papers. Certainly, we strive for a model pooling and servicing agreement. And to give you a flavor of some of the problems that exist in this space, very basic contractual terms, such as delinquency and default, have no standardized industry meaning. So you can imagine the vagueness and ambiguity that flow from these contracts and some of the problems that exist in the space.

Mortgage investors are very concerned about poor underwriting standards. Further, we have a number of concerns about conflicts of interest among servicers and their affiliates. Many services are conflicted. Hence, they are not servicing mortgages properly. Accordingly, AMI finds it aligns with consumers in many instances concerning these issues.

Originators and issuers are not honoring their contractual obligations through representations and warranties. Contracts have these representation and warranty clauses. And to give you an analogy, you buy anything in America, you buy a car, you buy an iPod, you get a warranty. And if you bring it home and it is a four-cylinder car, not an eight-cylinder car, you can have a cure. Maybe the cure is you swap it for what you intended. We find that in a number of instances, these representations and warranties are not being honored and our members are left without recourse.

In general, the market lacks sufficient tools for first lien mortgage holders. And then, again, the effect of enforcement.

So in closing, I would say that we would like to work with the Committee on its continued oversight and legislation regarding this area. There are a number of people that are working on solutions. There seems to be a sense of having a global, elegant, universal solution affecting securitization and all asset classes. We would argue that RMBS is very important for the housing sector, a very basic need, shelter. And if you can just fix MBS this year, that would be a great start. The enemy should not be the perfect of the good. I mean, sorry, the perfect should not be the enemy of the necessary.

So we thank you for your oversight and we would like to be a resource for the Committee.

Chairman REED. Well, thank you very much. I want to thank all the panelists for very detailed and very thoughtful and insightful testimony about very difficult issues that the agencies are confronting today. They have not yet published a final rule, so there is still opportunity. I am sure they are reflecting on everything you have said. I hope they are and expect they will.

Let me begin with Mr. Hughes, because you have just successfully brought issues to the market and many of the points you have made, I think, echo a lot of what has been said before. But let me begin with a point which I think several people have reflected.

If we had good underwriting, we would not have a lot of these problems. In some respects, a lot of what, from my view, Dodd-Frank is trying to do with "skin in the game," *et cetera*, is just forcing good underwriting. So if you could just address from your perspective that issue, and anyone else who has a point about that. You know, there is one view that perhaps we are creating this elaborate structure to force good underwriting where we could do something more specific, more direct, or the market eventually with other sanctions would be doing better underwriting. But, Mr. Hughes, please.

Mr. HUGHES. Yes. I believe everything starts with the borrower and obviously walks through the chain. I think, not to oversimplify, I think, actually, the problem is not as complicated as all the regulations and everything we are going through. If we start with a process where the borrower has a down payment, the borrower can clearly afford the loan from day one, we do not create mortgage products, neg-ams and stuff that would extend the reach of that borrower. There is responsibility in communicating with that borrower between the lender, and then to the extent the next step is when the lender, if it does go to securitize, there is total transparency. They have skin in the game.

I think you can go back—we went 20 years at ten, 15 basis points, a loss in the prime. It is just to reflect on what changed, and to me, the one thing that changed all the way up from borrower down payments, no terrible underwriting, you know, and all the things that have been well documented. From our standpoint, the one thing that is missing here is seconds, and we have been talking about it. I do not know how it—I have heard about St. Germain and this law and why it cannot get changed, but that is a big thing from a borrower standpoint that is still out there.

Chairman REED. Let me just follow up with one question. I read your testimony that you basically—you insist on sort of skin in the game, taking it yourself as a way, I guess, to assure your fellow investors. So you have no problem with at least the concept under Dodd-Frank of making——

Mr. HUGHES. Correct.

Chairman REED. —of the person taking skin in the game.

Mr. HUGHES. Yes. As part of our business model, and again, we are on the prime jumbo space, we think the most significant and best way to provide skin in the game is to hold the horizontal slice. I know there is a lot of confusion between subprime structures and prime. But what our sales pitch says to you is that we put this deal together. We are selling you securities. And then we will hold 5 percent of the securities underneath you, and to the extent that something goes wrong, 100 percent of that is on our checkbook, our buying. It is not vertical where we get 5 percent.

I think that, along with the disclosures in the transactions we did, it was not—you know, the first one was six times oversubscribed. So to me, it goes to show it cannot be subprime, but if you meet what investors are looking for, the borrower has skin in the game and throughout the chain, I do not think it is as difficult as all this, at least on the prime side.

Chairman REED. Thank you.

Professor Schwarcz, in your testimony, you talked about many different factors and some which are intra-company, which are not being dealt with directly today by us, obviously. But one issue, I think, that comes—again, it resonates throughout all the testimony—is the complexity. The market went from pretty simple stuff to CDO-squared and CDO-cubed, where you would take the lowest tranches of a mortgage-backed security and then combine it into something else or actually come up with another security that had at least a component that was AAA rated.

I guess, and I think what Mr. Katopis said, too, if it is standardized, if it is simple, it will work. Should we be spending more time—will the market—let me put it this way. Will the market permanently reject this complexity? Has it learned the lesson that, you know, keep it simple, stupid? That is what I learned at Fort Benning. Or are we going to see, if we do not have some of these very elaborate rules promulgated by the agencies, a quick return to super-complex and issues that cannot be understood?

Mr. SCHWARCZ. That is a very good question, and I think that certainly in the short term, the market is going to reject the complexity. I fear that in the long term, as yields go higher in very complex products, the market may find them very attractive. In my written testimony, I talk about how the intra-firm conflicts, like issues of VaR, can facilitate this.

One thing that—just a couple of thoughts here quickly. One thing is that because complexity will be inevitable, I think that failures will be inevitable. I have a paper that is cited in these materials, "Regulating Complexity in Financial Markets", where I develop this at great length and I compare it to chaos theory in complex engineering systems, where failures are also inevitable.

So the question is how to address this. You address this, in part, by trying to prevent the failures, but also you address it, in part,

by trying to mitigate the consequences of the failures when they occur. This is something I think we need to do.

A couple of other thoughts. In a perfect market, the investors themselves would be understanding what they are buying, would be insisting, in fact, that the originators, the underwriters, really retain skin in the game. In my experience, for example, in many loan sale markets, you could not sell a bank participation in a loan unless the seller of the participation retained at least 5, 10 percent interest in that loan.

And so one of the questions I think we need to fully understand is why did the system break down here, and I think part of the answer is that things, again, have gotten too complex and that disclosure is an insufficient solution. Another part of the answer is that risk has been almost marginalized. This is interesting. Most of the investors are the hugest investors. Many of them are QIBs, Qualified Institutional Buyers, who are freely allowed to buy and sell securities under the SEC rules. And so it is something we need to look at.

A final thing is that I have thought a lot about whether we should try to standardize these complex deals. And, in fact, one of the speakers talked about standardizing in the RMBS field issues of the pooling and servicing agreement and so forth. Standardization certainly can help in the very short term, but I fear that in the long term, requiring standardization would really stymie the ability of our financial markets to innovate and grow. Thank you.

Chairman REED. Thank you very much.

I am going to recognize Senator Crapo and my colleagues, but we will have a second round if you want it, also. So Senator Crapo?

Senator CRAPO. Thank you, Mr. Chairman.

I want to start out on commercial real estate, so Ms. Pendergast, I will direct my first question to you. As you indicated and as I indicated, frankly, in my statement, during the deliberation on Dodd-Frank, I was successful in getting an amendment adopted that would focus on commercial real estate to give the rule makers more flexibility, frankly, to recognize the unique nature of commercial real estate and help us to deal with the risk retention issue in a more flexible way.

From your written testimony and your testimony here today, it is my understanding that you feel that that flexibility was not effectively achieved, or that much more could be done to more effectively create a rule that helps to facilitate commercial real estate mortgage activity and still aligning the interests of lenders, issuers, and investors. Could you elaborate on that a little bit?

Ms. PENDERGAST. Sure. First, I would like to thank you and the regulators for incorporating that B-piece buyer retention option into the rules. It is extremely beneficial and suits the structure of the CMBS market.

As to the second issue, in terms of other forms of risk retention, you know, first and foremost, I am a research analyst by trade and one of the things that you look to is the performance of bank portfolios, those portfolio lenders who kept these loans on their balance sheets. If you look at the data currently via the FDIC, you will find that they have some of the highest commercial real estate default delinquency rates out there.

So certainly, I do not necessarily view risk retention as a panacea. I do think the market has embraced it and that is to the good. But having said that, there are other options for risk alignment, and that would include things like the best practices reps and warranties package that was issued by the Commercial Real Estate Finance Council. Those certainly will go a long way toward better risk alignment if incorporated into current documents and required by the regulators.

In addition to that, there are transparency and disclosure issues that I think permeate the entire securitization market. I like to think that the CMBS market, by very nature of the asset class, such that we have 200 or 300 loans in a deal as opposed to the RMBS market where there are 3,000 to 5,000 loans in the deal, the smaller number of loans allows us to do far more due diligence and provide that information to investors, not only at issuance, but on an ongoing basis.

So one thing we would like to see is the incorporation of some of these best practices that have been put forth by CREFC into the regulations such that perhaps there is a combination of risk retention and the employment of some of these best practices that are out there.

Senator CRAPO. And I assume from that that you believe that a reproposal is warranted.

Ms. PENDERGAST. No question. One of the key things that we saw with the SEC is they held some roundtables when they were doing their Reg AB rulemaking, and it was vital, I think, and it is vital today for we to better understand what some of these proposals are. There is still a lack of clarity regarding the premium capture cash reserves account and many other rules that are out there. So a give and take between the industry and the regulators as to what their intent is and how we can best meet those goals, I think, would be important, and that really would require that we prolong the comment period and then incorporate the results of these roundtables into a reproposal of the regulations.

Senator CRAPO. If we do not take another look at this and get the kind of flexibility that you are talking about, do you believe that we will see an unnecessary restriction of consumer activity and lending in the market?

Ms. PENDERGAST. No question. I have spoken to a lot of the nonlarge bank lenders out there and they are quite concerned and, in fact, have started to pull back some of their activity already because they are not comfortable with how these rules will eventually affect them.

One example would be that we have investors in the B-piece security, also, who will not be able to sell this investment at any time during the life of the security. That is really unheard of in the market, and the lack of liquidity could be extremely troublesome, causing many of these B-piece investors to either, one, leave the market entirely, or two, decide that they need higher yields on those securities that they buy. Ultimately, what that does is that it causes the cost of capital to rise for those CRE borrowers that are out in the market.

Senator CRAPO. Thank you. Would any of the other panelists like to comment on this issue? Mr. Deutsch?

Mr. DEUTSCH. I am happy to talk about the reproposal aspect in detail because one of the key concerns about the proposed rules is they affect not just the mortgage market. I think everybody is very much focused on commercial and residential mortgages. But securitization affects, and is included as part of the asset classes, auto ABS, equipment loan ABS, whole business securitizations, asset-backed commercial paper, which is a $300 billion market. These are all areas that have massive impacts on sort of the middle market funding and consumer market funding in the U.S. Without getting a reproposal that makes the exemptions for these other asset classes work and be functional, I think could be pretty devastating to the consumer credit markets.

Senator CRAPO. And I would like to follow up on that with you, Mr. Deutsch, and again, any other member of the panel that would like to respond to this, but it seems to me that what I am hearing from many of you, if not all of you, is that as currently drafted, the rule will ultimately cause a, well, I guess a contraction in consumer activity and commercial lending that is not justified by increased safety and soundness. Mr. Deutsch, could you comment on that, and any other panelist, if you would like to.

Mr. DEUTSCH. Sure. I will take a fresh shot in thinking about, again, outside of the mortgage context. We can talk about subprime and Alt-A mortgages. It is its own separate bailiwick. But take the example of prime auto loans. Those securitizations worked perfectly throughout the crisis. There were very little, if any, losses in those securitizations in the worst economic downturn.

So to me, to have auto finance companies, which are not in the business of holding capital—they do not just have money sort of sitting around, they are in the business of selling cars and then financing the sale of those cars and motorcycles and equipment loans—to create a lot of capital burdens, to make them hold capital just to sit around pulls that credit out of the system and ultimately lowers the availability of credit and makes it at a higher price, and I think that is a pretty critical component, that we have to get these exemptions right, and right now, they clearly are not.

Senator CRAPO. Ms. Rutledge.

Ms. RUTLEDGE. I guess the main point that I would like to say with respect to risk retention and some of the other structural fixes on the market is that the whole reason for the market initially, which came out of this S&L crisis was recognition that receivable asset quality can be better than the firm's own credit quality, and it can finance itself more cheaply by financing itself off-balance sheet, given how our bankruptcy system works.

The whole idea is an economy of capital utilization: capital efficiency. In fact, when Congress decides to do something like mandate risk retention, or any other structural piece, you are in fact structuring these deals.

A simpler way to address systemic risk is to go back to the original definition of credit quality. What are we doing when we securitize? We are finding the boundary between debt and equity, using a judicious amount of leverage that gives buyers and sellers the best possible deal. "Judicious" is determined primarily with reference to the rating scale, and that is why I advocate transparency around the rating scale.

Senator CRAPO. Thank you. Mr. Hughes and then Mr. Schwarcz, and I am probably going to be out of time. I am already out of time. I apologize.

Mr. HUGHES. I am going to try to talk a little bit about the Premium Capture Account and what is it, and I am going to try and oversimplify what we believed happened and particularly on the residential side.

On the residential side, there was basically two different types of structures that were used. On the prime side, basically, your credit protection, you issued $500,000 in mortgages—$500,000 in mortgages went in the pool, $500,000 securities went out. The protection to the top securities were a series of bonds that were underneath that security. In those deals, there was a time where the AAA—the mortgage may be 5 percent and AAA says, if I have all the subordination, all I need is 4 percent. So that different security there was called an IO. That IO is a senior security in the structure, has nothing to do with subordination.

We move over to a subprime structure. Subprime structures, you could have a mortgage rate of seven and you could have the same pass through as four. The structures were designed, well, why do we not capture some of that excess spread and use that to pay down AAA mortgages, and actually what it is, it is subordination. So what happened in some of the subprime deals during the crisis, that subordination left really early. People pulled out the IO. And by the IO leaving early, you pulled the bottom out of the structure. So that was one thing.

What happened was the rules are written that if you have any IO in a deal, and this includes on the commercial side, even though it is not used for credit support, you have to put it down on the bottom of the structure and use it as credit support. It is very, very inefficient in that spot.

Securitization is about maximizing proceeds. You are going to maximize the proceeds for that IO for a buyer that just wants a senior security, that has to worry about prepayment, if asked to work credit, it is worth a lot less. That was one that gets recaptured.

The second one really relates to a concept of, hey, at the time of securitization, the proceeds were 102. The two must be profit. The profit goes down at the bottom and that has to be recaptured. And the basic theory was it was a measurement against the fair value of the securities. What it failed to do, and the conceptual thing is if we bought loans at 100 and spreads tighten, interest rate move, and they are worth 102, all that matters at the time of exchange of the securitization entry, that the fair value of everything is even and we hold 5 percent of 102. If we want to say, you cannot make any profits, you know, it is the American way. If there is no profit incentive for this, there is not going to be an opportunity to securitize.

What is really, really, really important is at the time we securitize, what I would say, the pot is right. We brought over loans worth 102. Securities went out that was 102. We held 5 percent. I think if you did it on that basis and said, for a prime side, take out premium recapture for the IO, did it on a fair value basis, I think on the prime side, the problems go away.

Senator CRAPO. Thank you.

And Professor, I am way over time, so maybe——

Mr. SCHWARCZ. Ten seconds, if I may?

Chairman REED. Ten seconds.

Mr. SCHWARCZ. OK. I just wanted to point out very briefly that even if we had perfect levels of risk retention, it would not be a panacea. There would still be a mutual misinformation potential. For example, in the recent crisis, firms like Citi, Merrill, took huge amounts of the lowest rated securities on their books in underwriting because they felt these would be very profitable. This can potentially mislead senior investors into investing. So we just need to have that caution. Thank you.

Senator CRAPO. Thank you.

Chairman REED. Thank you.

Let me recognize Senator Hagan.

Senator HAGAN. Thank you, Mr. Chairman.

Mr. Hughes, I wanted to follow up on Senator Reed's earlier question having to do with the good underwriting question. Can you explain in more detail what you mean when you say seconds and why are these such a big problem?

Mr. HUGHES. Yes. So when a—in a securitization entity, you will buy the underlying loans based on the information that you have at that point in time. So you will evaluate, there is 20 percent down. That goes into your modeling. And from that, you can evaluate a risk of loss.

To the extent that after the fact a borrower can go out the next day and get a second from a different lender and take out 15 percent or 20 percent, which is what happened in the crisis, and basically day two, you have no money in the deal, the risk to me as the initial acquirer when I thought it was 80, the risk profile of that borrower has changed.

So what we think is there should be something to check to—we have a couple different ways it could happen—so that the borrower retains whatever the level is, their skin in the game.

Senator HAGAN. Thank you. Mr. Schwarcz, setting aside the question of the extent to which the originate to distribute model caused mortgage underwriting standards to fall, I wanted to ask you about the incentives in portfolio lending versus securitization. It is my understanding that across-the-board risk retention requirement, one where the securitizers retain a fixed percentage of all pools, may encourage originators who are also portfolio lenders to adversely select loans for securitization.

My question is, if an originator makes a marginal loan and has a choice to put it into a securitization with a 5-percent risk retention or hold it with a 100-percent risk retention, what is the lender likely to do? It would seem to me that the loan would go into the securitization.

Mr. SCHWARCZ. On those facts, I would agree with you entirely, and I think that, you know, that is another potential reason that risk retention is not a panacea. We need to really better enable the investors to understand what it is they are buying and to resist the impulse to buy because others are buying, and I am not sure that the answers to do that are easy. And at the end of the day, I think it is going to be imperfect.

We are never going to be able to set up a precise system, and that, I think, is part of the reason why I would argue that in addition to trying to regulate on an *ex ante* basis, that is, to prevent failures from happening, which is very important, we need to also be aware that there will be failures and we need to try to understand how to address them.

Senator HAGAN. Well, in the case of across-the-board risk retention standard, would you expect participants to originate to one standard for their portfolio loans and then another standard for the securitization?

Mr. SCHWARCZ. If you have across-the-board, you mean across-the-board in securitization?

Senator HAGAN. Mm-hmm.

Mr. SCHWARCZ. I think that depends on what the market will require. It is hard to say. I think it depends on the facts. I could not answer that in the vacuum.

Senator HAGAN. Does the QRM standard create incentives to originate to a higher standard, and if a loan could be securitized with a 5-percent risk retention or a zero-percent risk retention, it seems that the exempt loan would be the preference.

Mr. SCHWARCZ. Well, yes, I agree with that. The Qualified Residential Mortgage standard, of course, is not yet worked out as to exactly what it would be, so I am not sure I—I am not sure I could fully answer that question. I would maybe defer that to some of my other colleagues on the panel.

Ms. PENDERGAST. If I may answer the question regarding portfolio lending versus securitization lending, for example, in the commercial real estate market, traditionally, the components are life companies, banks, and CMBS lenders. Traditionally, the portfolio lenders would take, particularly the life companies would focus on the larger assets and the larger markets, leaving the smaller loans, smaller markets to the securitization business.

Just because you have a market that is not sort of the top ten in the country, you still can underwrite a loan that makes sense, and I think that has always been the way in which the CMBS market has worked initially. The average loan size for CMBS is $8 million, whereas I think if you were to look at a life company portfolio, that average loan size is somewhere, you know, $50, $60, $75 million and upward. So there is a distinction between the two.

The one thing, also, I would say about the qualifying mortgage, within CRE, it seems to me there are 33 criteria for becoming a qualified mortgage, and, frankly, some of the criteria are things that have never been seen in the commercial real estate lending world. So we calculate at about a half of 1 percent of the loans that are outstanding currently in the CRE universe would qualify for an exemption. And what is ironic to me is that I hear from my colleagues that in the residential space, that that number is closer to 10 to 20 percent. And when you look at the delinquency rates between the two markets, that is just nonsensical.

Mr. DEUTSCH. Senator Hagan, if I could come back to your question about the QRM and its current definition, the way it is proposed right now is—and the regulators were very clear about this in their proposal—is that, currently, only approximately 19 percent of the loans that Fannie and Freddie guarantee right now would

be eligible for the QRM. So if you are a portfolio lender and you originate, or if you are a bank and you originate a loan right now that would be eligible for the proposed QRM standard, you would sell that immediately to the GSEs. So the QRM standard, an exemption, right now would never, ever be used because those loans will be passed along to Fannie and Freddie.

So a core question as part of this debate is as long as we have this QRM that is much, much smaller than the definition of a conforming loan that you can sell to the GSEs, we are not going to use this exemption. All those loans will just go to Fannie and Freddie and it will continue, I think, as Marty indicated, an inability for the private sector to get into the market and to be able to securitize these loans and bring credit back because the GSEs effectively hog the space.

Senator HAGAN. I was up with Senator Isakson and Senator Landrieu to try to craft the QRM so that it was available to more, to be sure that we did not subject so many people not to have the opportunity to go out and get that first home.

Thank you, Mr. Chairman.

Chairman REED. Thank you.

Senator Corker.

Senator CORKER. Thank you, Mr. Chairman. It has been a great hearing and great witnesses, and I thank all of you for being here.

Mr. Hughes, on the second mortgage issue, it has been a fascinating issue, I think, throughout this whole process. And I guess in many cases a second mortgage holder is actually the servicer of the loan, too. Is that correct?

Mr. HUGHES. Certainly over the last few years they have been the primary——

Senator CORKER. And so what you have is you have the primary lender and you have the investors out there, and then you have the servicer who is benefiting from servicing the loan who makes this second mortgage, and so there is a conflict that is created there. Is that correct?

Mr. HUGHES. Correct.

Senator CORKER. And then I guess the way our laws are now written on bankruptcy and that type of thing, they have the ability to continue to have their second mortgage, which is of lower priority, continue to be paid while the first mortgage is not being paid. Is that correct?

Mr. HUGHES. Correct.

Senator CORKER. Would it be reasonable to say that we ought to revisit that whole priority situation and have that corrected?

Mr. HUGHES. I think revisiting seconds and priorities needs work.

Senator CORKER. And you would actually advocate changing bankruptcy laws to allow for a different type of seniority. Is that correct?

Mr. HUGHES. What we would recommend is just putting controls up front from—allowing borrowers to take them out but have the amount that you go out set to a limit. You could either have—in other forms of lending, two things happen when you take out a second, if you are in corporate, if you are in commercial, whatever,

that basically the first says I feel OK, you can take out a second. That is probably unreasonable in a residential situation.

A second thing—we will go back to our example. We started out with an 80-percent loan to value that potentially you can get to a point in time where, based on a new appraisal, 80 has come down to 70, that you can go back to 80 percent.

Senator CORKER. Let me ask you this. You know, during the risk retention debate, there was a lot of concern about the fact that with risk retention at 5 percent, or whatever the number was going to be, it was basically going to shut the market down, that there were not people out there that had the ability to reserve or keep that risk, and in essence securitization, which is, you know, to efficiently allocate capital and to spread it around, was going to shut down. And yet you found a way for that not to be the case.

What do you do as it relates to your balance sheet and reserving that 5-percent risk?

Mr. HUGHES. Basically, we are agnostic to consolidating, so we are not a bank, so we are not subject to capital requirements, so we just put it on the balance sheet and show the assets and liabilities.

Furthermore, I mean, we are——

Senator CORKER. So you do not really—you just keep it——

Mr. HUGHES. We just keep it.

Senator CORKER. But you do not really have to reserve.

Mr. HUGHES. No.

Senator CORKER. So really——

Mr. HUGHES. So what we would have to do is reserve for the loans over time since we have both—the reserve.

Senator CORKER. So when an investor is buying these bonds and you have kept 5 percent, what are they really getting from you?

Mr. HUGHES. From us in the way we hold it, which is horizontal, if——

Senator CORKER. And walk through the horizontal versus vertical. I think that would be enlightening for everybody.

Mr. HUGHES. OK. And I am going to make a—just to make the math easy, if you had 100 million of loans and the subordination level below AAA was 10 percent, 90 percent was AAA. To the extent that you held vertical, and let us say on that pool, what you would be holding, you would be holding—of your skin in the game, 1 percent effectively would be in that bottom tier, and the top would be—the balance would be sitting in the top, such that if there was, you know, in that pool there was 5 percent of losses or $5 million, you would only share in 5 percent of the $5 million. So there is very little teeth when you hold it in terms of actual loss that you would sustain.

To the extent that you held it horizontally, 5 percent on the bottom, and that same pool had $5 million of losses, all $5 million losses would be borne by someone like Redwood Trust or a sponsor on the bottom holding horizontal.

Senator CORKER. And you are holding horizontal.

Mr. HUGHES. We are holding horizontal. It is part of our——

Senator CORKER. You are really keeping the risk.

Mr. HUGHES. We are keeping the risk because it is part of our business model to sell to you on the top so that you would—the

reason you should feel comfortable about buying our deal is because we are down below you. Right on the bleeding edge is where we are going to have it.

Senator CORKER. And so, but the person who is buying the bonds does not really know that you have reserved against it. I mean, they are just hoping Redwood has the ability to step up in the event that occurs. Is that correct?

Mr. HUGHES. Well, what we are doing, remember, at closing, you know, in our deals, we are essentially completely funding those deals day one, so there is no insurance, there is nothing to come later on. So we will, again, back to that $100 million, we will buy those bonds on the bottom, so they will be completely funded—we contributed by putting $100 million of loans in the deal.

Senator CORKER. Interesting.

Mr. HUGHES. And we are going to leave 5 percent——

Senator CORKER. Interesting. Yes, that is good.

So let me ask you this—that actually is very interesting. Walk me through how we get from where we are with the GSEs and, you know, you transition over from them to the private market. I mean, there are several—there is, you know, three different models we have heard about. One is, you know, basically you start tranching down the upper limit of loans to get down to a level where basically the private sector is coming back on the jumbo side in the beginning and then walking down. The other piece is basically going from 100-percent guarantee to 90, to 80, to 70. And another piece is basically letting the very best loans today go out into the private market and start working it that way.

What is the best way to transition, in your opinion, from where we are today at 90 percent Government-guarantees loans to 100-percent private sector loans? How do we do that?

Mr. HUGHES. I think probably the best first step is to allow the loan limits to come down and to test to see what happens, because I think if we wait—I think one of the things they are waiting for——

Senator CORKER. So the guys like you would come in behind as those loan limits come down.

Mr. HUGHES. We will come—I think the gap will get filled. I know many think it is going to be if you go down to 625, there is going to be this breach, and it is going to go way down. Who is going to step in that breach? It is going to be the same people that are doing 729. The banks. They are just going to move down, and pricing today, you know, in that sector is probably 30 to 40 basis points higher than it is. So I would think the first logical test would be to bring that down.

The second logical test would be why don't we bring up guarantee fees to more of a market rate to allow the private sector to do it. Then you can slowly and gradually measure to figure out is it there. But, I mean, we keep running into this scare-mongering, it cannot happen. This thing, it is going to be 300 basis points. Test it on a safe basis to see where we come out.

I would think waiting until we have co-ops together and all other stuff is years off in trying to do that. So find ways through private capital to begin the process of bringing private capital in and moving back, you know, the Government to more of a reinsurance posi-

tion. And I believe private capital will come in to take that position.

Senator CORKER. Ms. Pendergast, as the CMBS market is kind of is where it is and you have got all these rulemakings that are taking place, what do you do today when you are actually doing a CMBS? I mean, how do you know what the rules are going to be? Do you do it based on the rules as they exist today? How does one go out and actually do a securitization today when the rules are changing?

Ms. PENDERGAST. Carefully. It is a time when those who are lending, I think to the good, the CMBS secondary market has stabilized, so you have a sense of where bonds will clear in the market, and that is important, and that is testament to the fact that there has been some significant recovery in our sector.

As far as, though, the large banks I think are out there lending, and that is a good thing. However, this is a market that is going to need more than just the five or six largest banks in the country focused on CMBS lending. So the smaller banks, those that are nonbank institutions that are lending, I think are quite concerned about how you originate a loan today, not knowing exactly how that execution is going to take place, you know, between now and 2013 when the rules actually take effect.

That is certainly a concern that I have, this sort of lag period between we are now, you know, formulating the rules but, in fact, they do not take effect until 2013. How do you originate during that time period? So it is important that as soon as possible we get—you know, there is clarity as to how these rules are going to work for the CMBS market and for other securitization markets as well.

Mr. DEUTSCH. Senator Corker, if I could add, I think one of the key concerns of the market right now is they are looking toward complying with these future rules. The banks right now, insured depository institutions, are being asked to comply with a different set of rules from the FDIC's securitization safe harbor. So areas around risk retention, they now have to comply with those FDIC safe harbor rules, which those rules right now that the FDIC just implemented last year, are very different than what the current proposals are right now. And I think that is creating a real challenge for banks to try to have to create one system now, but then have to totally overhaul that system once they know what these new final rules are.

Senator CORKER. I would like to keep going, but I know I am overstepping, so I will let you go ahead and then I will come back.

Chairman REED. Thank you very much.

One of the issues that Senator Corker's line of questioning raised was we have seen the asset-backed securities markets in automobiles and other areas come back rather—if not robustly, at least come back. We have not seen that in housing, and the implication, at least—and I think it should be made explicit—is that a lot of this is not—some of it is related to the uncertainty with respect to these rules, but a lot of it is related to the role the GSEs are playing in terms of their guaranteeing fees, below market rate, as you suggest, the fact that they can insure or guarantee to a significant amount now that is going to come down. And I wondered, Mr.

Hughes, your estimate of—is that really what is holding back the private market now? Or is it more this issue of what will the rules be in 2013?

Mr. HUGHES. Yes. So if you were to look at the market in 2010 in terms of, you know, the pieces of it, and actually the amount of loans under 417, the old GSE rate, is 90 percent. So if you went down to—rolled it back to 417, it would be 90 percent. So they are financing now—the additional amount between 417 and 729 is another 5 percent. So the amount that is really only available for people like Redwood is the top 5, and it is even less than that. And the reason it is even less than that for an outside securitizer is if you look at the executions, you know, for a bank today, if you are awash in liquidity you can sell 90 percent into a Government bid. You are sitting on excess cash. You know, a 4- or 5-percent mortgage sounds pretty good, then trading it over for, you know, 25 basis points or something else, so they are retaining it.

So there really is not any financial incentive in the system to get it going. So that, you know, investors, there is really nothing to kind of put together.

Chairman REED. But let me follow—when we begin this process—you suggested, I think, the first step obviously is lowering the maximum amount that can be guaranteed. When we start doing that, you expect the private market to come in. And I guess the question that is before us today, we have got to get these rules right. But the biggest thing at the moment, macroissue, is just the sheer presence of GSEs in the marketplace.

Mr. HUGHES. Correct. And even if it did come back to 629, I think the amount that it would probably add out there, about 3 percent is all I think it would come down to, when you come down, because 5 percent was 417 to 729, so for all the—again, the fear if we go down you are going to take away what is outside the GSEs' reach, about 2 percent.

Chairman REED. Ms. Pendergast, the issue of reproposal presumes that very little of your—you do not feel that your comments will be adhered to, because I presume you have made numerous comments in this process. Not you personally but the industry. But can you just give me an idea of why a reproposal in your view is necessary since the final rules have not been proposed, as I presume, that you will also have a situation where the implementation will not be until 2013, so that seems to suggest that there will be a time even to adjust the rules if they are proposed.

Ms. PENDERGAST. Yes, I think——

Chairman REED. Could you put it on, please?

Ms. PENDERGAST. I think the concern is that there is a lack of clarity as to what some of the proposed rules are suggesting, and I think that is one of the things that, yes, we can comment on the rules as they stand today, but we are not sure exactly what we are commenting on.

For example, the premium capture cash reserve account, the reserve account, is something that we have been discussing with regulators, and yet it is still not clear specifically what the intent was of that particular provision. What we do know is that, as written, it does take substantially all of the economic incentives to be involved in this sector out of the market. But in conversations what

we have learned is that we think that it is much more akin to wanting 5 percent of the proceeds, not 5 percent of par value. So real 5 percent skin in the game.

Chairman REED. But you have made that point—as you are making it today very well, that is why I think this hearing is very useful and very important. You have made that point as clear as you can to the bill writers.

Ms. PENDERGAST. Correct, but it is not 100 percent clear to us that that is the only component of the premium capture cash reserve account.

Chairman REED. Thank you.

Mr. Katopis, you have made some interesting comments with respect to the investors about standardization, transparency, and also the need for servicers—and I think Mr. Hughes made similar comments—to be much more flexible in terms of dealing with mortgages. Can you elaborate on that? Because, frankly, from our different perspectives, that is, trying to get a bottom under this foreclosure problem, we have been at least figuratively banging our heads against the issue of services, their incentives, their relationships, as you alluded to, to some of their affiliates, *et cetera*. So I would benefit from your comments.

Mr. KATOPIS. Thank you, Senator. I could go on for a long time about this, but in brief——

Chairman REED. You have 1.2 minutes.

[Laughter.]

Mr. KATOPIS. I will do my best to explain again and refer you to the written statement that we share the frustration that many consumers have regarding servicers, improper servicing standards. The servicing model was not designed for the default rates we have today. We urge you to take a look at the potential conflicts of interest. When servicers own seconds, stand in the way of modifications, and one of the things I do is try to debunk the urban myth that mortgage investors, as first lien holders, try to block modifications, just go on the record again, we would like to see responsible although distressed homeowners stay in their homes. We would like to work with them on the modification process. We think there are benefits for the homeowners, for investors, and communities through that. And I refer you again to our written statement and our ten points in the white paper.

Chairman REED. Have you communicated these concerns particularly about servicers to the Federal Reserve and the OCC who regulate most of the servicers?

Mr. KATOPIS. In December, we reached out to regulators in support of national servicing standards, and we have also communicated our concerns to the CFPB and the State Attorneys General.

Chairman REED. And have you gotten any feedback or any sense of your getting traction or not?

Mr. KATOPIS. I think there is widespread acknowledgment of some of the defects of the current servicing model and the abuses that are going on. We await further action on that.

Chairman REED. I am similarly positioned.

Senator Corker, do you want to——

Senator CORKER. Thank you, Mr. Chairman. We happen to be crafting some legislation to deal with much of what Chris just

talked about, and maybe we could join together to do that. Talk to us a little bit, Chris, about what the HAMP program actually did as it relates to mortgage investors and their levels of trust, if you will.

Mr. KATOPIS. Well, thank you, Senator, for your question. I will say that we believe that HAMP was very well intentioned as a remedial tool. Certainly it is the view of mortgage investors that if there is a way to properly construct a modification and keep people in their home, paying a mortgage on a monthly basis, where they had the ability and the willingness, this would be a good thing.

We have commented and shared our comments with the Administration that we think there were some defects to some of the structures regarding HAMP, and, therefore, it was not as successful as originally intended, and the evidence bears this out.

I think the most important thing to remember about this or any other proprietary modification program is what is in the borrower's best interest. And certainly the prompt resolution of their distressed situation is very important. If you keep someone in the home for 400 or 500 more days, their situation will deteriorate, their credit will deteriorate. There are a lot of problems. So we think there were concrete observations we had about the defects of the HAMP program. They were not necessarily acted upon, and we hope that remedial programs will try to speed a distressed homeowner to a better solution, whether it is a rental situation or a modification, as quickly as possible.

Senator CORKER. Mr. Hughes, on the risk retention piece, you talked about how you all are handling that. Are there stipulations right now by regulators as to whether that risk has to be vertical or horizontal? Or is that just something you have chosen to do?

Mr. HUGHES. There are actually four options right now, and it is just the risk—the way we have chosen it as part of our business model, and we have been trying to convince—and what we have been battling against has been in a subprime structure where we talked before, there was—down the bottom there was interest, principal, and other than as opposed to prime you had straight bonds. You cannot make more than the face amount of bonds. On the subprime you could make a lot of money.

So in addition, when they wrote risk retention—so we have been pounding the table to at least have the option for horizontal and let others decide what they want to do—is when it was written for horizontal is we cannot get any of our money out until the end of the deal, so 10 years down the road. So even if tests are made, even if your cash is flowing, even those the bonds are paying down, they want to totally block it out. So, unfortunately, what we would do today, if the rules were adopted, because it is to penal for doing that, and it is really not penal to all that hold vertical, we would hold vertical to check the box and say, OK, we did it, and then we will just hold the bottom and not have the restrictions against allowing us to cash-flow in a proper way on the bottom of the structure.

So I am hopeful that maybe, you know, our conversations as well with regulators, that when it gets out, if it is the best forum, is that it is not as penal as it is laid out today.

Mr. DEUTSCH. Senator Corker, if I could add about a bank structure versus a REIT structure, I think Marty's structure has a certain—the corporate structure has a certain availability to be able to withstand that risk, but not have the accounting and regulatory capital implications associated with it.

One challenge with the horizontal risk retention proposal—and certainly I think for an institution like Redwood Trust, it makes a lot of sense and there is a lot of strong arguments why that can better align retention and incentives. One of the core issues, though, is that for a bank that would also service these loans, if they hold a horizontal risk retention and they service the loans, they will have to consolidate that transaction under FAS 166 and 167. The regulatory capital——

Senator CORKER. The entire face value of——

Mr. DEUTSCH. The entire face value. So they are only holding 5 percent of the——

Senator CORKER. That cannot last very long, can it?

Mr. DEUTSCH. It will mean no bank will securitize, because you cannot hold 5 percent of the risk but then hold regulatory capital for 100 percent of the transaction. It is a quixotic outcome of the new FAS 166 and 167 rules and the regulatory capital rules. We have long been very concerned about how those regulatory capital rules were developed. But that is—unless you can get the regulators or FASB to change those rules, we have to take that as a given. And if the regulators would only require a horizontal risk retention, banks would not have an ability to securitize because of those rules.

Senator CORKER. And is there a sense that that issue is being resolved?

Mr. DEUTSCH. I think the proposals that allow both—either a vertical or horizontal or even a L-shaped form would allow banks to hold a vertical slice and also service. The complicating factor, though, now is this premium cash capture reserve account that effectively is additional risk retention, which could also trigger—even if you are holding a vertical slice, could also trigger a consolidation. And there was no accounting or discussion within the proposed rules about what the accounting considerations would be.

So that is, again, another reason to make sure that we get these rules right in a reproposal to know and fully understand the accounting implications.

Senator CORKER. On the residential mortgage end, you know, we talked—I think all of us were shocked, really, when the crisis hit to find out that recourse loans almost did not exist anymore. I foolishly, when they used to have those kind of things, had recourse loans and I did not realize that was not the standard. How much does the borrower being recourse against the debt matter anymore in America? Is that something that people care about anymore? I will ask you, Mr. Hughes, since you securitize them.

Mr. HUGHES. It matters to investors, so from our standpoint—and we put a whole book together on what we think best practices are. You know, we think borrowers should absolutely, positively be protected, but they also need—we need to be protected from actions that they would do. I mean——

Senator CORKER. So in the loans that you make, the borrowers are, in fact, fully recourse?

Mr. HUGHES. In the loans that we have here?

Senator CORKER. Yes.

Mr. HUGHES. Well, it depends State by State on what actual actions you can do and where it goes back to. But, yes, I think one of the things that we had recommended at some point in time, to the extent that strategic defaults need to be addressed, and one way to address strategic defaults is through deficiency judgments after the fact, as well as looking at seconds. So we are not looking to do anything harmful to borrowers. All we want to do is just get to a point where you cannot just either change—significantly change your risk profile from when a securitizer—from when an investor bought your loan, or you cannot just throw the keys on the table and say, you know, I signed something, I am not happy with what I signed.

Senator CORKER. Chris.

Mr. KATOPIS. Just very briefly, I would point out that whereas there has not been an RMBS securitization with the exception of the Redwood Trust's over the last few years, the Redwood Trust loans, from what I understand, are immaculate. And, you know, in the absence of having these immaculate loans, we would point out the things that we identify in our testimony. You need certainty, transparency, recourse, removing conflicts of interest. Those are the things that will bring private capital back into the market. It is not simply pulling a switch on the GSEs, but the things that we enumerate in our testimony.

Senator CORKER. Mr. Chairman, it has been a good hearing. I do not want to sour grape—yes, I am sorry. Thank you.

Ms. RUTLEDGE. After listening to the complexity of your world——

Chairman REED. Can you turn on your microphone? [dropped.]

Ms. RUTLEDGE. Sorry. After listening to the complexity of your world, I think our quantitative world is rather simple, and I would like to just comment a little bit on what Mr. Hughes said about the vertical slice versus the horizontal slice.

In the 1980s, the way that we looked at securitization was, simplistically, if an investor in the senior tranche has five times coverage over the expected loss, that defines AAA. We have moved on from that standard, but let us use it for the moment. Suppose that the vertical slice—sorry, the horizontal slide is 5 percent, which Redwood Trust is holding at the bottom of the capital structure, and the expected loss is 50 basis points, that is ten times coverage.

Now, what happens is as those 50 basis points of expected loss materialize (if loss is indeed 50 bps) and the loss amortizes: Redwood takes the loss. And as that extra is applied against the loss, the rating factor goes from 10 to 20 times, 100 times, an infinite number of times. The securities at the top of the capital structure become so safe, they are bulletproof.

What I have just described is the model that worked for 20 years. I am not advocating a five times coverage scale but pointing out two things. First, a vertical slice does not absorb risk. A horizontal slice does. That is risk retention. The second thing is that if you mandate a 5-percent risk retention, you are inviting the industry

to originate loans with a 5-percent loss because that is economically efficient.

The market risk solution cannot be structural solutions *per se*. There has to be an ability to monitor how the losses are performing and how the securities are performing. And if you have that transparency, you will motivate proper behavior. That is a much simpler model.

Senator CORKER. I would like to follow up. IF I could say just one thing, when this bill was passed, about a week later the Financial Times had an analysis, and basically it said so many pages, so little content. And I think there is something for us to learn. You know, basically we punted to regulators at a time when we wanted clarity in the markets. We kept saying we needed to pass a bill for clarity in the markets, and from what I can tell, we have created years of lack of clarity, and basically all of us up here which create laws hoping—hoping the regulators will do the right thing under time frames that are unrealistic. I think everybody who has been in here in the industry believes that rulemaking time frames are unrealistic, and a lot of rules are being made that are inappropriate.

Anyway, I have learned a lot from this, and I appreciate very much you having the hearing, and certainly all the witnesses being here.

Chairman REED. Well, thank you, Senator Corker, and I think we have all learned a great deal from this, and I think it is an ongoing education. So I will just make everyone aware that some of my colleagues might have questions which they will formally submit to you, and I would ask that all those questions be in by Friday, and that you would respond as quickly as possible, hopefully within 2 weeks or less.

But thank you. It has been a very thoughtful, insightful hearing on a very complicated topic. I was thinking, as Senator Corker talked, about the process of making legislation. I do not think I would have wanted to be at 4 o'clock in the morning trying to figure out the retained risk premium issue to the specificity that the Federal Reserve must—hopefully they will do it at least in the middle of the day with a much more sort of tranquil environment.

Senator CORKER. Yes, I think we could have given, though, a lot more direction, and I do not think we delved into the issues of horizontal versus vertical.

Chairman REED. You are absolutely right.

Senator CORKER. Risk retention sounded like it as an idea that kind of, oh, boy, let us have risk retention, that will make it all work. And it was more of an idea than a well thought through concept, and I think that is why we are having these problems.

Chairman REED. Well, in addition to that, it was an idea which, you know, had many fathers and mothers. I know there were amendments made, *et cetera,* the nature of the process. Some of them have been improvements, I think Senator Crapo's amendment. I think what Senator Hagan did was very, very helpful in terms of qualifying it. But now we are at the point the reality is that this is something that the regulators have to address thoughtfully, thoroughly, and the point I hope is that they have listened carefully to what you have said, as we have, because you have

made some excellent points about how we create a better system that is more transparent, more predictable, and less prone to collapse.

So thank you all very much. Thank you, Senator Corker. The hearing is adjourned.

[Whereupon, at 11:16 a.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF STEVEN L. SCHWARCZ

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MAY 18, 2011

Introduction

The securitization markets are very weak, as I'm sure the others testifying will report. This is unfortunate because securitization can be a major source of capital formation, yielding critical economic benefits.

For example, securitization can significantly decrease the cost of corporate credit. By raising funds without having to borrow from a bank or other financial intermediary, companies avoid the intermediary's profit mark-up. Furthermore, the interest rate paid by the company is ordinarily lower than the interest rate payable on corporate securities issued directly by the company. This interest-rate savings reflects that the mortgage loans and other "financial assets" being securitized are usually more creditworthy, and almost always easier to understand and value, than the company itself. For these reasons, securitization has become an important way for companies of all types to raise low-cost financing.

Securitization is also the principal means by which banks and other lenders turn their loans into cash, thereby enabling them to continue making new loans. Securitization of residential mortgage loans, for example, has facilitated the expansion of home ownership by enabling banks to continue to lend money to homeowners. Many other forms of consumer and business credit are also securitized, including automobile loans, student loans, credit card balances, and equipment loans.

Securitization can also reduce consumer costs. By expanding the "secondary" (*i.e.*, trading) market in consumer loans, securitization lowers the interest rate that lenders charge on those loans.[2]

By 1992, securitization had become so important to the American economy that the Securities and Exchange Commission observed that it was "becoming one of the dominant means of capital formation in the United States."[3] Securitization continued its strong growth until the recent financial crisis, rising from $2.9 trillion in 1996 to $11.8 trillion in 2008.[4] Even during the crisis, the Federal Reserve implemented a $200 billion Term Asset-Backed Securities Loan Facility (known as "TALF") in order to keep the securitization markets running. This helped to assure "the availability of credit to households and businesses of all sizes."[5]

Securitization's Role in the Recent Financial Crisis

The securitization of subprime mortgage loans—essentially mortgage loans made to risky borrowers—is widely viewed as a root cause of the financial crisis. The evil, however, was not securitization *per se* but a correlation of factors, some of which were not completely foreseeable.

Securitization transactions were sometimes backed, at least in part, by subprime loans. Because home prices had generally been increasing in the United States since the Great Depression, the expectation was that continuing home-price appreciation would enable even risky borrowers to repay their loans by refinancing their houses. At the worst, many thought, the steep rise in housing prices might level out for some period of time, although at least one rating agency's model assumed that prices could drop as much as 10 percent. Few predicted the complete collapse of housing prices.

Many argue that the "originate-to-distribute" model of securitization, enabling mortgage lenders to sell off loans as they're made, led to overreliance on the expectation of repayment through home-price appreciation. According to this argument, the originate-to-distribute model created moral hazard because lenders did not have

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[2] *Cf.* Patric H. Hendershott and James D. Shilling, "The Impact of the Agencies on Conventional Fixed-Rate Mortgage Yields", 2 *J. Real Estate Fin. & Econ.* 101 (1989) (finding that securitization of conforming fixed-rate mortgage loans significantly lowered interest rates on mortgage loans relative to what they would otherwise have been); C.F. Sirmans and John D. Benjamin, "Pricing Fixed Rate Mortgages: Some Empirical Evidence", 4 *J. Fin. Services Research* 191 (1990) (finding significantly lower interest rates on fixed rate mortgages that can be sold in the secondary market versus those that cannot).

[3] Investment Company Act, Release No. 19105, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 85,062, at 83,500 (Nov. 19, 1992) (provided in connection with the issuance of Rule 3a-7 under the Investment Company Act of 1940).

[4] These figures are drawn from *http://www.sifma.org/*.

[5] *See, e.g., http://www.ny.frb.org/markets/talf_faq.html; http://www.federalreserve.gov/newsevents/monetary20081125a1.pdf.*

to live with the credit consequences of their loans. Loan origination standards therefore fell.

There are other possible explanations of why subprime loans were made and securitized.[6] But whatever the explanation, the fall in home prices meant that subprime borrowers, who were relying on refinancing for loan repayment, could not refinance and began defaulting. The defaults had mostly localized consequences in traditional securitization transactions. But they had larger, systemic consequences in nontraditional transactions that involved complex and highly leveraged securitizations of asset-backed securities already issued in prior securitizations—effectively "securitizations of securitizations." The resulting leverage caused relatively small errors in cash flow projections—due to the unexpectedly high default rates on underlying subprime loans—to create defaults on substantial amounts of "investment grade" rated subordinated classes of these securities, and to cause even the most highly rated classes of these securities to be downgraded.

The important question is why those nontraditional securitization transactions were structured in a way that even relatively small errors in cash flow projections could cause defaults and downgradings. Although one answer is the widespread inconceivability of a housing-price collapse that could cause those errors, the full answer goes beyond that. Part of the answer may be that securitization's focus on mathematical modeling to statistically predict the payments on financial assets underlying these complex securities fostered an overreliance on modeling and an abandonment of common sense. Yet another part of the answer may be that investors, who seemed as anxious to buy these superficially attractive securities as underwriters were to sell them, were overly complacent and eager to follow the herd of other investors.

Whatever the reasons, these defaults and downgradings panicked investors, who believed that a "AAA" rating meant iron-clad safety and that an "investment grade" rating meant relative freedom from default. Investors started losing confidence in ratings and avoiding the debt markets. Fewer investors meant that the price of debt securities began falling. Falling prices meant that firms using debt securities as collateral had to mark them to market and put up cash, requiring the sale of more securities, which caused market prices to plummet further downward in a death spiral. With the failure of Lehman Brothers, investors lost all confidence in the debt markets. The lack of debt financing meant that companies could no longer grow and, in some cases, even survive. That affected the real economy and, at least in part, contributed to the financial crisis.

The crisis was also arguably exacerbated by the fact that securitization made it difficult to work out problems with securitized mortgage loans. The beneficial owners of the loans were no longer the mortgage lenders, but a broad universe of investors in securities backed by these loans. Although servicers were tasked with the responsibility to restructure the underlying loans "in the best interests" of those investors, they were often reluctant to engage in restructurings when there was uncertainty that their costs would be reimbursed. Foreclosure costs, in contrast, were relatively minimal. Servicers also preferred foreclosure over restructuring because foreclosure was more ministerial and thus had lower litigation risk. As a result, foreclosure was artificially favored, forcing many homeowners from their homes and further driving down property values.

Dodd-Frank's Response

The Dodd-Frank Act addresses securitization by focusing, essentially, on three issues: (i) adequacy of disclosure, (ii) conflicts between "securitizers"[7] and investors, and (iii) rating agency information.

(i) Adequacy of Disclosure: The Dodd-Frank Act directs the SEC to require more standardized disclosure of information regarding the underlying financial assets, including information on the assets underlying each class of asset-backed securities. This disclosure requirement is intended to facilitate an easier comparison of classes. The Act also directs the SEC to require securitizers to engage in a due-diligence review of the underlying financial assets and to disclose to investors the nature of the review.

(ii) Conflicts between Securitizers and Investors: The Act attempts to limit conflicts of interest between securitizers and investors by requiring securitizers, in trans-

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[6] These other explanations are bound up with the more important question, discussed in the next paragraph, of why nontraditional securitization transactions were structured in a way that even relatively small errors in cash flow projections could cause defaults and downgradings.

[7] In most cases, the "securitizer" is the company itself or a financial institution that pools financial assets for eventual issuance of asset-backed securities.

actions that are not backed entirely by "qualified residential mortgage" loans,[8] to retain an unhedged economic interest in the credit risk of each class of asset-backed securities.[9] This is colloquially known as keeping "skin in the game." The minimum retained interest is generally five percent, although it may be less if the financial assets meet quality standards to be announced by Government agencies.

(iii) Rating Agency Information: Dodd-Frank also mandates the SEC to adopt regulations requiring rating agencies to explain, in any report accompanying an asset-backed securities credit rating, the representations, warranties, and other enforcement rights available to investors, including a comparison of how these rights differ from rights in similar transactions.

Dodd-Frank Inadequately Addresses Securitization's Flaws

I believe that Dodd-Frank inadequately addresses securitization's flaws. Although it addresses one of the flaws (or, at least, alleged flaws), it underregulates or fails to regulate other flaws and it overregulates by addressing aspects of securitization that are not flawed.

A. Dodd-Frank Addresses One of Securitization's Flaws

Dodd-Frank addresses one of securitization's flaws—or at least one of its alleged flaws. I mentioned that the originate-to-distribute model of securitization is believed to have fostered an undisciplined mortgage lending industry, including the making of subprime loans. The Dodd-Frank Act, as discussed, addresses the originate-to-distribute model by requiring securitizers to retain skin in the game, *i.e.,* retaining a minimum risk of loss. The theory is that by aligning the incentives of securitizers and investors, the lending industry will become more disciplined.

There remains a question, though, of the extent to which the originate-to-distribute model actually caused mortgage underwriting standards to fall. Some argue that standards fell because of Federal governmental pressure on banks and other mortgage lenders to make and securitize subprime mortgage loans to expand homeownership.[10] The fall in standards also may reflect distortions caused by the liquidity glut of that time, in which lenders competed aggressively for business; or it may also reflect conflicts of interest between lending firms and their employees in charge of setting lending standards, such as employees being paid for booking loans regardless of the loans' long-term performance. Blaming the originate-to-distribute model for lower mortgage underwriting standards also does not explain why standards were not similarly lowered for originating nonmortgage financial assets used in other types of securitization transactions. Nor does it explain why the ultimate beneficial owners of the mortgage loans—the investors in the asset-backed securities—did not govern their investments by the same strict credit standards that they would observe but for the separation of origination and ownership.[11]

The extent to which the originate-to-distribute model actually contributed to the financial crisis may never be known. If that model was not a significant causal factor, Dodd-Frank's skin-in-the-game requirement may well constitute overregulation. This requirement also might, ironically, lull some investors into a false sense of security. In the financial crisis, for example, there is some evidence that investors purchased senior classes of asset-backed securities because underwriters retained the most subordinated interests—effectively creating a "mutual misinformation" problem.[12]

B. Dodd-Frank Underregulates and Fails To Regulate Other Flaws

Dodd-Frank underregulates, and in some cases fails to regulate, other flaws of securitization. The Act does not, for example, directly address the problem of overreliance on mathematical modeling. Mathematical models are not inherently problematic. If the model is realistic and the inputted data are reliable, models can yield accurate predictions of real events. But if the model is unrealistic or the inputted data are unreliable—as occurred when unexpectedly high default rates due to the

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[8] The SEC and other governmental agencies are directed to collectively define what constitutes qualified residential mortgage loans, taking into account mortgage risk factors. Dodd-Frank Act §941(b).

[9] Dodd-Frank Act §941.

[10] *Cf.* Peter J. Wallison, "The Lost Cause: The Failure of the Financial Crisis Inquiry Commission" (2011) (making that argument), *http://www.aei.org/docLib/FSO-2011-02-g.pdf.*

[11] For one explanation of why the ultimate beneficial owners did not observe those standards, *see* Steven L. Schwarcz, "Marginalizing Risk", 89 *Washington University Law Review,* forthcoming issue no. 3 (2012), available at *http://ssrn.com/abstract=1721606.*

[12] Dodd-Frank does mandate the Financial Services Oversight Council, however, to study and submit a report to Congress on the macroeconomic effects of the skin-in-the-game requirements, including possibly proactively regulating mortgage origination as an alternative or supplement. Dodd-Frank Act §946.

housing collapse undermined the value of some asset-backed securities—models can be misleading.

To some extent this overreliance on mathematical models should be self-correcting because the financial crisis has shaken faith in the market's ability to analyze and measure risk through models. In the long term, however, I fear that—as market experience has often shown—investor memories will shorten.

Dodd-Frank also fails to address the complacency problem. I'm not sure, though, how effective regulation can be in changing human behavior. Market participants will probably always engage in herd behavior, for example, there being safety in numbers. And people will probably always invest in high-yielding securities they can't understand if others are doing it.

Dodd-Frank also does not address the servicing problem, but I find that less troublesome. Parties can—and in light of recent experience, should have incentives to—write underlying deal documentation that sets clearer and more flexible guidelines and more certain reimbursement procedures for loan restructuring, especially when restructuring appears to be superior to foreclosure. Parties can also minimize allocating cash flows to investors in ways that create conflicts. Furthermore, parties can agree, when appropriate, to subject servicers to—and regulation could also require—more realistic performance standards, perhaps akin to a business judgment rule that allows them to restructure loans in good faith without being exposed to liability. [13]

C. Dodd-Frank Overregulates by Addressing Aspects of Securitization That Are Not Flawed

Dodd-Frank overregulates by addressing some aspects of securitization that are not flawed. I have already indicated that the skin-in-the-game requirement might constitute overregulation. Dodd-Frank also requires securitizers to engage in a due-diligence review of the underlying financial assets; but in my experience, that is already routinely done.

Dodd-Frank also may overregulate in its requirements for more standardized disclosure of information. In principle it should be helpful for investors to get this information. My experience, however, is that prospectuses usually already provide much of this information, and that *the larger problem is not absence of disclosure but the fact that investors don't always read and understand the information already disclosed.*

There are at least two reasons for this failure. One reason is complacency, discussed above. The second reason is a conflict of interest within investing firms themselves. As investments become more complex, conflicts of interest are increasingly driven by short-term management compensation schemes, especially for technically sophisticated secondary managers. [14]

For example, as the VaR, or value-at-risk, model for measuring investment-portfolio risk became more accepted, financial firms began compensating secondary managers not only for generating profits but also for generating profits with low risks, as measured by VaR. Secondary managers therefore turned to investment products with low VaR risk profile, like credit-defaults swaps that generate small gains but only rarely have losses. The managers knew, but did not always explain to their seniors, that any losses that might eventually occur could be huge.

This is an *intra-firm conflict*, quite unlike the traditional focus of scholars and politicians on conflicts between managers and shareholders. Dodd-Frank attempts to fix the traditional type of conflict but completely ignores the problem of secondary-management conflicts. Regulation should also require that managers, *including secondary managers*, of financial institutions be compensated based more on long-term firm performance. [15]

Dodd-Frank's focus on disclosure may also be inherently insufficient. I have mentioned that investors don't always read and understand the disclosure. Financial products, including some securitization products, are becoming so complex, however,

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[13] *Cf.* Steven L. Schwarcz and Gregory M. Sergi, "Bond Defaults and the Dilemma of the Indenture Trustee", 59 *Alabama Law Review* 1037 (2008) (arguing that this standard should apply to indenture trustee duties after default).

[14] *See,* Steven L. Schwarcz, "Conflicts and Financial Collapse: The Problem of Secondary-Management Agency Costs", 26 *Yale Journal on Regulation* 457 (2009), available at *http://ssrn.com/abstract__id=1322536*; Steven L. Schwarcz, "Regulating Complexity in Financial Markets", 87 *Washington University Law Review* 211, 261–262 (2009/2010), available at *http://ssrn.com/abstract–id=1240863.*

[15] *See* "Conflicts and Financial Collapse", *supra* note 14, at 468–469 (observing that regulation is needed because there is a collective-action problem).

that disclosure can never lead to complete understanding.[16] On the other hand, it may well be counterproductive to try to limit complexity, such as requiring more standardization of financial products. Standardization can interfere with the ability of parties to achieve the efficiencies that arise when firms issue securities tailored to particular needs of investors.[17]

Conclusions

I have suggested certain regulatory responses to improve securitization, including the need to fix the intra-firm problem of secondary-management conflicts. Overall, however, there are no perfect regulatory solutions to the problems of securitization; and indeed those problems are not atypical of problems we will face in any innovative financial market—that increasing complexity coupled with human complacency, among other factors, will make failures virtually inevitable. Regulation must respond to this reality.

To that end, it is important to put into place, before these failures occur, regulatory *responses to failures* that supplement regulatory restrictions intended to prevent failures.[18] The financial crisis has shown the increasing importance, for example, of financial (*e.g.*, securities) markets and the need to protect them against the potential that investor panic artificially drives down market prices, becoming a self-fulfilling prophecy. A possible regulatory response would be to create financial market stabilizers, such as a market liquidity provider of last resort that could act at the outset of a panic, profitably investing in securities at a deep discount from the market price and still providing a "floor" to how low the market will drop.[19]

It also is important to provide incentives for financial institutions to try to minimize the impact of failures (externalities), and to absorb (*i.e.*, "internalize") the cost when failures occur. This could be done, for example, by regulation requiring at least systemically important market participants to contribute to a risk fund, which could be used as a source of stabilization (such as by funding the financial market stabilizers referenced above).[20] Fund contributors would then be motivated not only to better monitor their own behavior but also to monitor the behavior of other financial institutions whose failures could deplete the fund (requiring contributors to pay in more).[21]

The bill that would become the Dodd-Frank Act originally included the concept of a systemic risk resolution fund, to be sourced by large banks and other systemically important financial institutions and used as a possible bailout mechanism in lieu of taxpayer funds. The concept was dropped after some alleged it would increase moral hazard by institutionalizing bailouts.[22] Ironically, if structured properly, a systemic risk fund should actually have the opposite effect, minimizing moral hazard.

We also need to see the big picture. Securitization has existed for decades and has generally worked well. Even during the recent crisis, almost all traditional securitization structures protected investors from major losses. Additionally, we need to keep in mind what investor protection—one focus of this hearing—means in the securitization context. Investors in securitization transactions are generally large and sophisticated financial institutions. One might question whether regulation should have the goal of protecting these types of investors, except in cases when

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[16] *See, e.g.,* Steven L. Schwarcz, "Disclosure's Failure in the Subprime Mortgage Crisis", 2008 *Utah Law Review* 1109 (arguing that disclosure is a necessary but insufficient response to complexity); Steven L. Schwarcz, "Rethinking the Disclosure Paradigm in a World of Complexity, 2004", *University of Illinois Law Review* 1 (2004) (same).

[17] *See* Iman Anabtawi and Steven L. Schwarcz, "Regulating Systemic Risk", 86, *Notre Dame Law Review,* forthcoming issue no. 4 (Spring 2011), available at *http://ssrn.com/abstract=1670017*. Dodd-Frank's focus on standardizing more derivatives transactions is a special case because the goal is less standardization *per se* (in order to minimize investor due diligence) than to enable more derivatives to be cleared through clearinghouses, which generally require a high degree of standardization in the derivatives they clear.

[18] *See generally* Steven L. Schwarcz, "Ex Ante Versus Ex Post Approaches to Financial Regulation: The Chapman Dialogue Series and The Chapman Law Review Symposium Keynote Address", forthcoming in *Chapman Law Review* 2011 symposium issue on "The Future of Financial Regulation", available at *http://ssrn.com/abstract=1748007*.

[19] *See* Anabtawi & Schwarcz, *supra* note 17 (showing how buying securities at a deep discount will mitigate moral hazard and also make it likely that the market liquidity provider will be repaid).

[20] *See id.; see also Marginalizing Risk, supra* note 11. Ideally, any such fund should be international to avoid anticompetitively "taxing" financial institutions in any given jurisdiction.

[21] *Id.*

[22] Dodd-Frank includes a provision for possible *ex post* funding of a systemic risk fund, but it is doubtful that any such fund could be created quickly enough to be effective. Financial institutions might even have difficulty providing such funding at the time of a systemic crisis.

their failures can harm others, such as by triggering systemic consequences,[23] or when market failures can discourage these types of investors from adequately protecting themselves.[24]

My comments focus primarily on creating an appropriate regulatory framework to help ensure long-term integrity of the securitization markets. I do not address how to quickly return depth and liquidity to securitization markets but trust that others testifying today, who are more intimately connected with the industry, will have proposals to that effect. Whatever the proposals, however, there may be relatively little need for securitization or other means of capital formation so long as lenders and companies sit on mounds of cash, reluctant to make loans and to invest in operations.

Thank you.

My testimony is based in part on the following sources, in addition to those already cited:

The 2011 Diane Sanger Memorial Lecture—Protecting Investors in Securitization Transactions: Does Dodd-Frank Help, or Hurt?, available at Securities and Exchange Commission Historical Society virtual museum and archive, *www.sechistorical.org.*

Identifying and Managing Systemic Risk: An Assessment of Our Progress, 1 *Harvard Business Law Review* Online (2011), forthcoming at *http://hblr.org*, also available at *http://ssrn.com/abstract=1788336* (in its original form as the Keynote Speech at the George Mason University 2011 AGEP Advanced Policy Institute on Financial Services Regulation).

The Conundrum of Covered Bonds, 66 *The Business Lawyer* (forthcoming issue no. 3, May 2011), available at *http://ssrn.com/abstract=1661018.*

The Future of Securitization, 41 *Connecticut Law Review* 1313 (2009) (symposium issue on the subprime crisis), available at *http://ssrn.com/abstract__id=1300928.*

[23] *See generally* Steven L. Schwarcz, "Systemic Risk", 97 *Georgetown Law Journal* 193 (2008).

[24] *See supra* note 15 and accompanying text (observing that in order to resolve the problem of secondary-management conflicts, regulation will be needed to fix a collective-action problem).

PREPARED STATEMENT OF TOM DEUTSCH

EXECUTIVE DIRECTOR, AMERICAN SECURITIZATION FORUM

MAY 18, 2011

Statement of:

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Executive Director
American Securitization Forum

Testimony before the:

Senate Committee on Banking, Housing, & Urban Affairs
Subcommittee on Securities, Insurance, and Investment

Public Hearing on:

The State of the Securitization Markets

May 18, 2011

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I. Introduction

Chairman Reed, Ranking Member Crapo, and Distinguished Members of the Subcommittee, I thank you for this opportunity to testify before you today on behalf of the 330 member institutions of the American Securitization Forum.[1] In the testimony that follows, we seek to address the numerous industry efforts to initiate reforms from within the securitization market as well as the myriad of legislative and regulatory proposals currently facing the securitization market that would fundamentally alter, facilitate or eliminate parts of the securitization market. As you read through this testimony, you will see that many of the topics covered involve common themes, including alignment of incentives, transparency and standardization in securitization as well as an overall increase in government oversight of this market.

Many of the industry's current issues arise from regulations prescribed by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act" or "Dodd-Frank"), such as risk retention, rating agency reform, orderly liquidation authority for nonbanks, derivatives, the Volker rule and conflicts of interest. In addition, the SEC's Regulation AB II proposal would overhaul the registration, disclosure and reporting requirements for the entire asset-backed securities ("ABS") market. Further complicating this impending regulation is the FDIC Safe Harbor, which was developed in a unilateral, piecemeal fashion by the FDIC and has effectively front-run much of Dodd-Frank's securitization mandate.

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[1] The American Securitization Forum is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests on important legal, regulatory and market practice issues. ASF members include over 330 firms, including issuers, investors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and other professional organizations involved in securitization transactions. ASF also provides information, education and training on a range of securitization market issues and topics through industry conferences, seminars and similar initiatives. For more information about ASF, its members and activities, please go to www.americansecuritization.com.

Ultimately, these issues face the market during a time when certain sectors, such as auto and equipment ABS are at or nearing normal levels, and other sectors, such as commercial mortgage-backed securities ("CMBS"), are beginning to see signs of life. Finally, the future of residential mortgage finance hangs in the balance as the Administration and members of Congress seek to wind down the GSEs and bring private capital back to the mortgage market in the form of private label residential mortgage-backed securities ("RMBS") and covered bonds. We begin with the current state of the securitization market by issuance volume.

II. The State of the Securitization Market

As noted by the Board of Governors of the Federal Reserve ("FRB") in its recent study on risk retention, different segments of the ABS and RMBS markets have recovered at varying levels during the 18 months since the "end" of the recession.[2] Auto and auto-related ABS accounted for $53.9 billion in issuance in 2009, which represents 80.7% of the auto and auto-related ABS issuance of $66.8 billion during 2007, just before the downturn.[3] $7.2 billion in equipment ABS was issued during 2009, in contrast with the 2007 issuance of $6.1 billion.[4] Most of the reductions in the Auto and Equipment ABS markets can be explained by the overall decrease in purchases of these products, thereby reducing the financing demands in these markets. In 2009, credit card ABS accounted for $46.6 billion in issuance, down 50.7% from

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[2] Board of Governors of the Federal Reserve System, "Report to the Congress on Risk Retention" (Oct. 2010), p. 2, *available at* http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf.
[3] Data are from Asset Backed Alert, see the Proposing Release, p. 12-13, *available at* http://www.sec.gov/rules/proposed/2011/34-64148.pdf.
[4] *Ibid.*

2007 issuance of $94.5 billion.[5] Most credit card ABS reductions have resulted from the changed capital adequacy changes made as a result of the implementation of FAS 166 and 167, which will be discussed below. Meanwhile, the student loan sector issued $20.8 billion in ABS during 2009, down 64.2% from 2007 issuance of $58.1 billion.[6] Given the elimination of the FFELP program, student loan issuance is expected to be a fundamentally small market, which is limited to securitization of legacy FFELP loans for another couple of years as well as the relatively smaller volumes of private student loan originations. By comparison, on the RMBS side, $48.1 billion of RMBS were issued in 2009, down 92.5% from 2007 issuance of $641.8 billion.[7] In addition to the overall reduction of issuance in the RMBS market, we further note that 97% of RMBS were federally-backed in 2010, as compared with only 64% in 2007 when the private market accounted for a much larger share of RMBS issuance.[8] Simply put, the absence of a properly functioning securitization market, and the funding and liquidity this market has historically provided, adversely impacts consumers, businesses, financial markets and the broader economy. The recovery and restoration of confidence in securitization is therefore a necessary ingredient for economic growth to resume, and for that growth to continue on a sustained basis into the future.[9]

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[5] *Ibid.*
[6] *Ibid.*
[7] *Ibid.*
[8] Analysis by 1010data, based on data from FNMA, GNMA and FHLMC.
[9] For more information on the role of securitization within the financial system and U.S. economy, *see* Appendix A.

III. Risk Retention

ASF supports efforts to align the incentives of issuers and originators with investors of ABS and we believe these incentives should encourage the application of sound underwriting standards by both the originator and securitizer in connection with the assets that are securitized. ASF began the process to better align incentives over three years ago, when we launched our Project on Residential Securitization Transparency and Reporting ("Project RESTART"),[10] which is a broad-based industry-developed initiative to help rebuild investor confidence in mortgage and asset-backed securities. As part of this effort, we have produced Model RMBS Representations and Warranties and are in the process of producing Model RMBS Repurchase Principles, which combine to create a very strong alignment of interests in RMBS transactions. As part of the Dodd-Frank Act, Congress also decided to address alignment of incentives, but opted to employ credit risk retention and tasked various regulators with implementing regulations that will effect "skin in the game," but still permit appropriate access to credit.

While ASF believes that risk retention can aid in achieving an appropriate alignment of incentives, any rules enacted must be carefully calibrated so as to not cause unintended consequences. As further described in this testimony, we believe the currently proposed risk retention rules will prove to be a major impediment to securitization, which will most certainly constrain credit as well as increase its cost. ASF delivered its initial views on the proposals before a hearing of the House Committee on Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises entitled, "Understanding the Implications and

[10] *See* http://www.americansecuritization.com/restart.

Consequences of the Proposed Rule on Risk Retention."[11] This lengthy testimony provides detailed comments regarding risk retention for various asset classes, and is being used as the basis for an even more comprehensive comment letter that will be delivered to the joint regulators on June 10, 2011—the comment deadline for the proposals.

A. Industry Efforts to Align Incentives

During the recent economic crisis, some commentators questioned whether mortgage loan originators sufficiently mitigated or retained sufficient risk in the loans they were making to borrowers, especially when those loans were sold into securitization trusts. These critics pointed to a lack of "skin in the game," which they believe misaligned incentives between originators and investors and failed to ensure the loans underlying RMBS were of adequate credit quality. The risk or "skin in the game" traditionally retained by originators of RMBS is embodied in the representations and warranties that issuers provide with respect to the mortgage loans sold into the securitization trust and the repurchase mechanics that serve to enforce those representations and warranties. Some market participants, including some investors, have indicated that they believe the traditional representations and warranties did not have "teeth" because the repurchase mechanisms included in past transactions haven't effectively provided a means to return or "put back" materially defective mortgage loans to the originator.

Beginning in 2008 as part of ASF Project RESTART, ASF began working with its RMBS originator, issuer, financial guarantor, rating agency, trustee and investor members to identify potential areas of improvement and work toward a model set of representations and

[11] *See* "ASF Risk Retention Testimony Before HFSC," American Securitization Forum (April 14, 2011), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_HFSC_Risk_Retention_Testimony_4-14-11.pdf.

warranties (the "ASF Model Reps") and a set of model repurchase principles (the "ASF Model Repurchase Principles") for future, plain vanilla RMBS transactions. The completed ASF Model Reps are currently available on the ASF website and the ASF Model Repurchase Principles are expected to be released in the next couple of months.

i. Representations and Warranties as Risk Retention

In securitizations, representations and warranties are used to allocate the origination risk of mortgage loans between the issuers of the securities and the investors who purchase them. The allocation of origination risks begins when a mortgage loan is sold by an originator for inclusion in a securitization trust. This sale is accompanied by representations and warranties regarding the mortgage loans being sold, including representations and warranties relating to the mortgaged property securing the loan, the documentation for the loan, the manner in which the loan was originated and its compliance with applicable law. These representations and warranties are important to ensure, among other things, that the securitization trust contains mortgage loans having expected characteristics and terms which can be serviced in accordance with accepted servicing standards. The representations and warranties included within the securitization contracts for an RMBS transaction may vary from transaction to transaction depending on a number of factors, including the type of collateral involved, the specific features of the transaction and the particular circumstances of the parties to the transaction.

Generally, if a loan is found to have breached the representations and warranties and such breach materially and adversely affects the interests of investors in such loan, the loan can be "put back" or returned to the seller who is obligated to repurchase it, effectively a 100% risk

retention. Much like a defective product is returned to the store from which it was sold, a materially defective mortgage loan will be returned to the issuer or other representing party through its removal from a securitization trust for the applicable repurchase price or a qualified substitute loan. Like representations and warranties, the "repurchase" remedy in RMBS transactions are governed by the securitization contracts and may vary from transaction to transaction depending on a number of factors.

Without exception, our originator, issuer and investor members view representations and warranties as risk retention for RMBS transactions. ASF supports a 100% repurchase of a loan where its characteristics do not conform to the stated characteristics set forth by the originator and result in a breach of the representations and warranties that materially and adversely affects the interests of investors in such loan. ASF believes that risk retained through representations and warranties results in an even greater amount of skin in the game than the 5% risk retention requirements set forth in the Dodd-Frank Act. In addition, the principal goal of any risk retention initiative should be to establish and reinforce commercial incentives for originators and issuers to create and fund assets that conform to stated underwriting standards and other securitization eligibility criteria, thereby making those parties economically responsible for the stated attributes and underwriting quality of securitized loans. For this reason, the ASF continues to advocate that "skin in the game" for originators and issuers of RMBS continue to be implemented through the representations and warranties that originators and issuers provide with respect to the mortgage loans sold into the securitization trust coupled with meaningful repurchase mechanisms designed to ensure their enforcement.

ii. ASF Model Reps

The Dodd-Frank Act and recent rules issued by the SEC require each nationally recognized statistical rating organization ("NRSRO") to include in any report accompanying a credit rating a description of (i) the representations, warranties, and enforcement mechanisms available to investors; and (ii) how they differ from the representations, warranties, and enforcement mechanisms in issuances of similar securities. This requirement seeks to achieve the same goal that ASF had originally sought when we began creating the ASF Model Reps over two years ago: a means to provide a transparent comparison between different transactions that would allow investors to decipher between the strength of representations, warranties and repurchase provisions in one transaction versus those in another. However, without a baseline such as the Model Reps to facilitate the comparison, the comparing party under the Dodd-Frank provisions (the NRSROs) would have to analyze all differences in language, including specific phraseology and the use of knowledge qualifiers, to evaluate whether various actions and requirements are included within a particular set of representations and warranties. This is a very difficult task.

Historically, the type and form of representations and warranties included in RMBS transactions varied greatly, and investors often expressed concerns about their inability to compare the representations and warranties provided by different issuers. The ASF Model Reps were developed primarily to express customary market representations and warranties in the same, transparent language across transactions and provide a "baseline" against which investors and rating agencies can measure the representations and warranties contained in a particular transaction. The Model Reps were designed to allow market participants to easily determine

whether departures from the Model Reps have occurred and whether knowledge qualifiers were used, adding transparency to the negotiation process among the parties to a given transaction and enabling issuers and investors to more easily and better assess their willingness or unwillingness to assume origination risks. The Model Reps also provide more significant protections by changing the language of the representations and warranties contained in existing RMBS transactions and including many new provisions which did not previously exist. Among these representations are warranties are ones covering mortgage fraud, verification of income, employment and asset verification, veracity of appraisal process, conformance to underwriting guidelines, occupancy status of property, and early payment default. We also address the use of "knowledge qualifiers," which refers to language in the representations and warranties requiring that the issuer be cognizant of the fact that causes a breach. The ASF Model Reps would clearly specify knowledge qualifiers in an exhibit so that rating agencies and investors can identify knowledge qualifications at a glance for comparison across issuers.

iii. ASF Model Repurchase Principles

Throughout the development of the ASF Model Reps, our members also began to consider changes to the repurchase provisions that serve to enforce the representations and warranties in a transaction. In most existing transactions, securitization contracts call for the trustee or another specified party to demand repurchase when defects have been discovered. However, investors believe that the repurchase process set forth in most securitization contracts does not provide certain parties with an adequate means to pursue a repurchase demand. In addition, the effectiveness of the specific mechanisms to identify breaches or to resolve a question as to whether a breach occurred in the RMBS sector has also been questioned in many

cases.

For future transactions, our members, including issuers, investors and financial guarantors, have agreed to work towards a model set of principles for investigating, resolving and enforcing remedies with respect to representations and warranties in RMBS transactions by, among other things, clearly delineating the roles and responsibilities of transaction parties in the repurchase process and allowing greater access into the mortgage loan files so that breaches can be discovered. The goal of the working group is to create a model framework for remediation in future RMBS securitization transactions while aiding the recovery of the RMBS market.

Although ASF has not yet established final Model Repurchase Principles, our membership has generally agreed that proper governance principles for RMBS would require a robust mechanism for the investigation and resolution of disputes regarding breaches of transaction representations and warranties. The basic elements of a mechanism currently being discussed would involve (i) review of pool assets by an independent third party that is given access to the loan files for compliance with representations and warranties following the occurrence of an agreed-upon "review event" that is centered around objective factors, (ii) recommendation by the independent third party to the securitization trustee of whether or not to demand repurchase of, or substitution for, the pool asset by the representing party and (iii) if the representing party disputes the independent third-party's findings, submission of the dispute to a binding determination by a second independent party. We believe that such a strong third-party mechanism will ensure that representations and warranties in securitizations have "teeth," with the beneficial effect of causing asset originators to exercise caution in underwriting and deterring transfers of substandard assets to securitization vehicles.

We note that the Dodd-Frank Act and recent rules issued by the SEC also address loan repurchases in securitizations and requires any securitizer to disclose fulfilled and unfulfilled repurchase requests across all trusts aggregated by the securitizer, so that investors may identify asset originators with clear underwriting deficiencies. Although the Dodd-Frank Act's requirements for repurchase activity would ensure that some ongoing disclosure is made in securitizations about whether a representing party will repurchase pool assets as to which claims of breach of representations or warranties are asserted, it would not ensure that the repurchase of noncompliant assets is effected, as it is a purely disclosure-based provision. Instead, we believe that securitization participants would be incentivized to adopt better practices if the framework for a third-party mechanism of the type we have described in this testimony were included within RMBS transactions. We believe that a robust third-party mechanism for investigating and resolving breaches will serve the interests of investors and issuers going forward.

B. Risk Retention Proposed Pursuant to Dodd-Frank

i. Overview of Proposal

Section 941 of the Dodd-Frank Act requires the Federal Deposit Insurance Corporation ("FDIC"), the Federal Reserve Board of Governors (the "Board"), the Office of the Comptroller of the Currency ("OCC") and the Securities and Exchange Commission (the "SEC" and collectively, the "Joint Regulators")[12] to jointly implement rules to require any "securitizer" to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an "asset-backed security," transfers, sells, or conveys to a third party.

[12] In the context of the Proposed Risk Retention Regulations concerning residential mortgages, "Joint Regulators" also refers to the Federal Housing Finance Agency ("FHFA") and the Secretary of Housing and Urban Development.

Section 941 amends the Securities Exchange Act of 1934 (the "Exchange Act") to establish an alternative definition of "asset-backed security" (an "Exchange Act ABS") that is broader than the existing definition set forth in Regulation AB of the Securities Act of 1933 (the "Securities Act") and a definition for the term "securitizer" which is, generally, an issuer of Exchange Act ABS or a person who organizes and initiates an Exchange Act ABS transaction by transferring assets to the issuer.[13]

The general standards for risk retention are set forth in Section 941, which requires a securitizer to retain "(i) not less than 5 percent of the credit risk for any asset" or "(ii) less than 5 percent of the credit risk for an asset" if the originator of the asset meets underwriting standards to be prescribed by the Joint Regulators. The regulations prescribed under Section 941 must also specify "the permissible forms of risk retention" and "the minimum duration of the risk retention." In addition, the regulations "shall establish asset classes with separate rules for securitizers of different classes of assets, including residential mortgages, commercial mortgages, commercial loans, auto loans, and any other class of assets that the Federal banking agencies and the SEC deem appropriate" and, for each asset class established, the regulations "shall include underwriting standards established by the Federal banking agencies that specify the terms, conditions, and characteristics of a loan within the asset class that indicate a low credit risk with respect to the loan." Additionally, Section 941 specifies that the regulations shall provide for certain exemptions as further described in this testimony.

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[13] In a release of proposed rules relating to Section 943 of the Dodd-Frank Act, the SEC indicates its belief that the definition of Exchange Act ABS includes securities that are typically sold in transactions exempt from registration under the Securities Act and that the definition of securitizer is not specifically limited to entities that undertake transactions that are registered under the Securities Act. *See* Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (75 FR 62718, October 13, 2010), (SEC Release Nos. 33-9148; 34-63029; File No. S7-24-10), p. 62721, *available at* http://www.gpo.gov/fdsys/pkg/FR-2010-10-13/pdf/2010-25361.pdf.

In November and December of 2010, ASF submitted a series of preliminary comment letters to each of the Joint Regulators supporting the proposal of risk retention requirements that are tailored to each major asset class, including (i) our comment letter[14] relating to residential mortgage-backed securities ("RMBS") and the qualified residential mortgage ("QRM") exemption (the "ASF RMBS Risk Retention Letter"), (ii) our comment letter[15] relating to auto ABS (the "ASF Auto Risk Retention Letter"), (iii) our comment letter[16] relating to ABCP (the "ASF ABCP Risk Retention Letter"), (iv) our comment letter[17] relating to credit card ABS (the "ASF Credit Card Risk Retention Letter"), (v) our comment letter[18] relating to student loan ABS (the "ASF Student Loan Risk Retention Letter") and (vi) our comment letter[19] relating to corporate debt repackagings (the "ASF Repack Risk Retention Letter" and collectively, the "ASF Risk Retention Letters"). In these comment letters, our membership sought to highlight the intricacies of each of these asset classes and stress the need for risk retention requirements that permit tailoring of the retention forms to each class of securitized assets.

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[14] *See* "ASF Comment Letter re RMBS Risk Retention & QRM," American Securitization Forum (November 12, 2010), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_RMBS_Risk_Retention_Letter_11.12.10.pdf.

[15] *See* "ASF Comment Letter re Risk Retention for Auto ABS," American Securitization (November 22, 2010), available at http://www.americansecuritization.com/uploadedFiles/ASF_Auto_Risk_Retention_Letter_11.22.10.pdf.

[16] *See* "ASF Comment Letter re Risk Retention for ABCP," American Securitization Forum (November 22, 2010) *available at* http://www.americansecuritization.com/uploadedFiles/ASF_ABCP_Risk_Retention_Comment_Letter_11.22.10.pdf.

[17] *See* "ASF Comment Letter re Risk Retention for Credit and Charge Card ABS," American Securitization Forum (November 23, 2010), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_Credit_Card_Risk_Retention_Letter.pdf.

[18] *See* "ASF Comment Letter re Risk Retention for Student Loan ABS," American Securitization Forum (November 23, 2010), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_Student_Loan_Risk_Retention_Letter.pdf.

[19] *See* "ASF Comment Letter re Corporate Debt Repackaging," American Securitization Forum (December 14, 2010), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_Corporate_Debt_Repackaging_Letter_FINAL_12-14-10.pdf.

The views set forth in the ASF Risk Retention Letters were consistent with the Dodd-Frank Act's directive to implement "separate rules for securitizers of different classes of assets" and reflected the primary recommendation of the Board of Governors of the Federal Reserve System in its October 2010 Report to the Congress on Risk Retention (the "Federal Reserve Study"), in which it stated:

> "Thus, this study concludes that simple credit risk retention rules, applied uniformly across assets of all types, are unlikely to achieve the stated objective of the [Dodd-Frank] Act—namely, to improve the asset-backed securitization process and protect investors from losses associated with poorly underwritten loans. ... Given the degree of heterogeneity in all aspects of securitization, a single approach to credit risk retention could curtail credit availability in certain sectors of the securitization market. A single universal approach would also not adequately take into consideration different forms of credit risk retention, which may differ by asset category. Further, such an approach is unlikely to be effective in achieving the stated aims of the statute across a broad spectrum of asset categories where securitization practices differ markedly. ... In light of the heterogeneity of asset classes and securitization structures, practices and performance, the Board recommends that rulemakers consider crafting credit risk retention requirements that are tailored to each major class of securitized assets."[20]

In addition, the Financial Stability Oversight Council ("FSOC"), chaired by Treasury Secretary Timothy F. Geithner, indicated in its January 2011 study that a risk retention framework should "[a]lign incentives without changing the basic structure and objectives of securitization transactions; [p]reserve flexibility as markets and circumstances evolve; and [a]llow a broad range of participants to continue to engage in lending activities, while doing so in a safe and sound manner."[21]

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[20] The Board of Governors of the Federal Reserve System, Report to Congress on Risk Retention, *available at* http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf, p. 3, 83-84.

[21] Timothy F. Geithner, Chairman, Financial Stability Oversight Counsel, Report to Congress on Macroeconomic Effects of Risk Retention Requirements, *available at*

During the week of March 28, 2011, each of the Joint Regulators approved for release their notice of proposed rulemaking (the "Proposing Release") entitled "Credit Risk Retention" (RIN 1557-AD40; 7100 AD 70; 3064-AD74; 3235-AK96; 2590-AA43),[22] and requested public comment by June 10, 2011 (the "Proposed Risk Retention Regulations"). The Proposed Risk Retention Regulations provide a range of options that securitizers may choose from in meeting the risk retention requirements, including: (i) retention of a "vertical slice" of each class of interest issued in the securitization, (ii) retention of an "eligible horizontal residual interest" in the securitization, (iii) use of "L-Shaped" risk retention, which combines both vertical and horizontal forms, (iv) in the case of revolving asset master trusts, retention of a "seller's interest" that is generally pari passu with the investors' interest in the revolving assets supporting the ABS, (v) retention in its portfolio of a "representative sample" of assets equivalent to the securitized assets; and (vi) other risk retention options that purport to take into account the manner in which risk retention often has occurred in connection with the issuance of asset-backed commercial paper ("ABCP") and CMBS. In addition, the Proposed Risk Retention Regulations set forth various exemptions, including exemptions based on certain "qualified" loans such as the QRM and qualifying automobile loans ("Qualifying Automobile Loans"), as well as hedging restrictions and the premium capture cash reserve account, which would be funded in certain circumstances by excess spread monetized at the time of securitization. In drafting the Proposed Risk Retention Regulations, the Joint Regulators have indicated that they have taken into account the diversity of assets that are securitized, the structures historically used

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http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20%20%28FINAL%29.pdf, p. 3.

[22] *See* http://edocket.access.gpo.gov/2011/pdf/2011-8364.pdf.

in securitizations, and the manner in which securitizers may have retained risk. ASF applauds these efforts to tailor the proposed rules to each asset class.

Within the context of these Proposed Risk Retention Regulations, ASF delivered testimony before a hearing of the House Committee on Financial Services ("HFSC") Subcommittee on Capital Markets and Government Sponsored Enterprises entitled, "Understanding the Implications and Consequences of the Proposed Rule on Risk Retention."[23] Our testimony provides detailed comments regarding risk retention for RMBS, ABS backed by auto loans and leases, credit card receivables, and student loans, ABCP, municipal bond and corporate debt repackagings, and general concerns related to nontraditional or "esoteric" asset classes. In addition, we continue to work on our broad comment letter to be submitted on the Joint Regulators' comment deadline of June 10, 2011, which will cover these same topics, in addition to CLOs, equipment ABS and cross border issues. We believe these comments are of critical importance to the Joint Regulators' goal of prescribing risk retention rules that properly align incentives without inhibiting the return of the securitization market and adversely impacting the availability and cost of credit. Simply put, the absence of a properly functioning securitization market, and the funding and liquidity this market has historically provided, adversely impacts consumers, businesses, financial markets and the broader economy. The recovery and restoration of confidence in securitization is therefore a necessary ingredient for economic growth to resume, and for that growth to continue on a sustained basis into the future.[24]

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[23] *See* "ASF Risk Retention Testimony Before HFSC," American Securitization Forum (April 14, 2011), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_HFSC_Risk_Retention_Testimony_4-14-11.pdf.

[24] For more information on the role of securitization within the financial system and U.S. economy, *see* Appendix A.

ii. Critical Flaws in the Proposal

The ASF has long been supportive of further methods to align the incentives of issuers and investors of mortgage- and asset-backed securities and we very much appreciate the hard work the Joint Regulators have put into developing the Proposed Risk Retention Regulations. In drafting the Proposed Risk Retention Regulations, the Joint Regulators have indicated that they have taken into account the diversity of assets that are securitized, the structures historically used in securitizations, and the manner in which securitizers may have retained risk. We note that a similar effort was not undertaken by the FDIC in unilaterally enacting risk retention rules as part of its securitization safe harbor, which has restricted insured depository institution issuance of asset- and mortgage-backed securities to only one prime auto loan transaction.

Despite the efforts of the Joint Regulators, significant work still needs to be done to evolve the Proposed Risk Retention Regulations into workable solutions. What is at stake is the risk of significant reductions in the availability of car loans, mortgages, student loans, credit cards, and business credit all across America. Given that many engines of the U.S. economy are still sputtering and unemployment remains extremely high, the ASF advocates strongly that these rules not overreach to attempt to "fix" large swaths of the securitization markets that did not see any losses during an extreme economic downturn and instead are now powering economic revival in some sectors of the economy. Attempts to realign incentives in many types of securitization structures, where those incentives have demonstrated through strong performance to be well-aligned between issuer and investor, only serves to risk harm to the American economy, American consumer and to investors.

As such, we believe that the regulators should specifically articulate that the Proposed Risk Retention Regulations would not apply to a number of segments of the securitization market, including appropriately defined prime auto loan pools, government guaranteed student loans and sponsor-supported ABCP that have all demonstrated extraordinary structural resilience in the most stressed of economic circumstances. In other areas such as corporate and municipal bond repackagings, the rules simply should not have the legal authority to apply to these transactions, nor is there any evidence of misaligned incentives in these markets.

In other areas of the securitization markets, such as residential mortgages, we are quite concerned that the rules put the private markets at an enormous disadvantage vis-à-vis the government-backed market, which will ultimately keep the private markets on the sidelines, while American taxpayers continue to bear the risk on 95+% of new mortgages made in America. These rules should be encouraging the return of private capital by allowing for a definition of QRM that would facilitate competition in the relative near-term between government-backed and private label RMBS transactions. Private label offerings and private actors also have a litany of considerations that government offerings, particularly those in conservatorship, do not confront. These include key issues around accounting consolidation under FAS 166 and 167 that can have extraordinary implications for how depository institutions allocate their risk-based capital.

a. Premium Capture

The proposed premium capture rule exceeds the mandate and legislative intent of Dodd Frank by adding on to the 5% risk retention the entire value of ABS issued in a securitization

over par— effectively nullifying the securitizer's entire return on the transaction. While some regulators believe the definition is only meant to ensure that the risk retained by the securitizer is, in fact, worth at least 5% of the fair value of ABS issued, the proposed rule, as written, does not reflect this meaning. The rule as drafted will have pervasive effects on securitization and borrowers, including virtually assuring the accounting consolidation of the securitization onto the balance sheet of the securitizer regardless of the risk retention form employed and higher capital requirements for all institutions, especially banks.

The premium capture rule also not take into account the cost of origination of loans, including out-of-pocket costs such as appraisals and title insurance, as well as the originator's overhead and profit on sale. In addition, the rule would interfere with an originator's or sponsor's ability to use interest rate hedges during the period between origination and securitization, which would likely prevent originators from offering borrowers rate locks for the period between application and funding. Finally, the harsh impacts of the premium capture rules will be most severe for non-prime borrowers, because securitizations of loans to such borrowers create significant amounts of excess spread. This will result in credit being less available to, and more expensive for, low to moderate income mortgage borrowers.

Most disturbing, however, is that the premium capture rule as currently proposed eliminates virtually all incentives to securitize for institutions other than those that securitize purely for financing. Institutions with other sources of funding will move away from securitization altogether, resulting in a constriction of credit and an increased cost of capital. A reduced availability of credit would put negative pressure on home values and, in turn, affect the trillions of dollars of outstanding ABS that investors currently own.

b. Servicing Standards

The inclusion of servicing standards in the QRM definition goes well beyond the legislative intent of Dodd-Frank and its mandate for including criteria relating to underwriting and product features. There is no evidence, either in the legislative history or the language of Dodd-Frank, that Congress intended to include servicing standards as part of risk retention rules. In fact, incorporating servicing standards into the QRM definition would have the peculiar result of regulating the servicing of the highest quality borrowers, those with the least risk of encountering servicing issues or needing loss mitigation, while the bulk of the market, consisting of borrowers with a greater need for loss mitigation, would be left unregulated.

The proposed QRM definition requires the loan documents to include policies and procedures that 1) require commencement of loss mitigation efforts after 90 days delinquency, 2) allow for loan modifications if the resulting net present value would be greater than foreclosure proceeds, 3) address how the lender will service any second lien loan on the same property (when the lender services both the first and the second lien loan) and 4) include servicing compensation arrangements that are consistent with the creditor's commitment to engage in loss mitigation activities. There must also be an undertaking not to transfer servicing to any servicer who does not maintain such policies and procedures. We understand and appreciate the regulatory imperative for national servicing standards that address the above issues and our members are generally supportive of this effort. But, as noted in the Joint Regulators' proposing release, there is a separate interagency effort among certain Federal regulators to develop national servicing standards that will apply to all servicers of residential mortgage loans. We believe that this effort should not be rolled out on a piecemeal basis, and that the QRM definition

is not the right time and place for even a limited preview of these criteria. The key to success for such criteria is that they should be universal. As part of an additional QRM criterion, these standards would not apply to loans that are sold to, or securitized by, the GSEs. Due to the restrictive nature of the QRM criteria, these standards would apply to only a small portion of the non-GSE market, with that segment being the most creditworthy borrowers, who of course are the least likely to need loss mitigation. We frankly believe that it is just not good public policy to apply these nascent and still developing standards to this subset of new originations.

We believe that compliance with the national servicing standards under development should be a matter of regulatory compliance only. We note that this is consistent with the recent efforts undertaken by Congress to regulate the activities of servicers, such as through the establishment of safe harbors for certain loss mitigation practices in the Helping Families Save Their Homes Act of 2009. By placing the requirement to maintain such policies and procedures in the loan documents, this approach invites the borrower to raise as a defense to foreclosure claims that 1) the servicer's policies and procedures did not meet the regulatory requirements as per the covenants in the loan documents, and 2) the servicer failed to comply with its policies and procedures in servicing the mortgage loan. In America's litigious environment, such claims, whether valid or specious, can easily be foreseen. We believe that it would not be good public policy to effectively grant to borrowers a private right of action to enforce these regulatory requirements. The Home Affordable Modification Program as well as other loan modifications were not structured to give the borrower a private right of action. Furthermore, by attaching these potential defenses in foreclosure to QRMs, but not simultaneously to non-QRMs, this aspect of the criteria would actually make QRMs more risky than non-QRMs from the investor's

perspective, which is contrary to the Dodd-Frank mandate. If just one judge in one foreclosure action ruled that the servicer's policies and procedures did not comply with the QRM criteria, the QRM status of all loans serviced by that servicer would be questionable and potentially cause significant losses to institutional investors. The inclusion of servicing standards in the loan documentation also raises the moral hazard of enabling unscrupulous borrowers to better understand the length of time for which they may avoid paying their mortgages without fear of significant consequences.

c. Qualifying Auto Loan

We believe that in preparing the qualifying auto loan definition, the Joint Regulators made a fundamental error in attempting to analogize to the residential mortgage asset class. This inappropriate paralleling is evident in the focus on debt and income verifications at origination, which have traditionally not been required for even the highest quality motor vehicle originations, a required 20% down payment (comprised of cash and/or vehicle trade-in value) in a market where advance rates above 100% are commonplace,[25] and a requirement that the originator or its agent hold the certificate of title on the related loan when one-in-five states require that the consumer, rather than the lender, hold a motor vehicle's certificate of title. Other features, such as the proposed maximum loan terms of 60 months in a market where 72-month lending has been a normal market feature for many years, on both new and used vehicles, simply illustrate a misunderstanding of what constitutes a "standard" product in the motor vehicle marketplace.

[25] Motor vehicle loans in the ordinary course also regularly finance taxes, titling fees, ancillary products, service contracts, insurance policies and/or balances refinanced on trade-in vehicles. The Proposed Risk Retention Regulations not only require a minimum 20% down payment but also demand that the customer pay 100% of the title, tax, registration and dealer-imposed fees.

Furthermore, we believe that the proposed exemption is underinclusive in that it omits many types of consumer transactions that are made using high-quality underwriting standards and that give rise to assets that would be appropriately securitized without prescribed levels of enhancement. For example, in omitting loans to commercial purchasers and to individuals who will use their vehicles for commercial uses by mandating that all loans be made to individuals to secure vehicles used for personal or family use, failing to include motorcycles in the list of permissible "passenger vehicles" and excluding motor vehicle lease transactions, the Proposed Risk Retention Regulations focus on a particular subset of the motor vehicle sector (i.e., loans to individuals for cars) that omits equally creditworthy and low-risk products that should have equivalent access to the exemption.

d. Failure to Incorporate Market Practices

The commentary in the proposing release specifically indicates that the Proposed Risk Retention Regulations for ABCP and credit card ABS are meant to track current market practices. However, there are numerous parts of the Proposed Risk Retention Regulations that are, in fact, not at all consistent and would cause detrimental effects on those markets. Through our comment letter process, ASF is identifying these inconsistencies and recommending specific regulatory changes to resolve them. In addition, there are other examples of market practices, such as in auto ABS, that have proven to withstand extreme economic distress. These market practices should be considered by the Joint Regulators in the forms of risk retention proposed.

e. Competing Regimes

It is important to highlight that securitization transactions in Europe are subject to their own risk retention requirements set forth in the European Union's CRD Article 122a.[26] The structure of the European risk retention regime is fundamentally different than the U.S. rules. While the U.S. rules apply to issuers of ABS, the European rules apply to European Economic Area credit institutions that invest in ABS. Ultimately, this could have the peculiar result of application of both risk retention regimes, which is further confused by the regulations' differing requirements. Harmonization among the two sets of rules will be critical to a functioning and efficient securitization market.

The FDIC's securitization safe harbor (the "FDIC Safe Harbor") for banks also includes a risk retention requirement, but only permits a vertical slice or representative sample. In addition, the FDIC Safe Harbor is currently in effect for bank securitizations, while Dodd-Frank has a mandate of one or two years for its risk retention rules for RMBS and ABS, respectively. While the FDIC Safe Harbor does include an "auto conform" provision that is designed to align it with the rules enacted by the Joint Regulators, the interim effects of the FDIC's inferior rules are not addressed. For example, the FDIC Safe Harbor does not take into account characteristics of different assets and it ignores securitization features such as overcollateralization and seller's interest. Furthermore, the FDIC Safe Harbor's representative sample option is formulated differently than the representative sample option included in the Joint Regulators' Proposed Risk Retention Regulations, and so a bank seeking to avail itself of this option would have to adopt

[26] *See* CRD Directive 2006/48/EC, p. 78, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0048:20100330:EN:PDF.

one set of procedures to comply with the FDIC Safe Harbor in its current form and then a different set of procedures at such time as the auto-conform provision takes effect.

We also note that, by its own admission, the FDIC's recent CMBS transaction did not comply with the FDIC Safe Harbor. The FDIC indicated in the press release for the transaction that "[t]he pilot program is consistent with the [FDIC Safe Harbor], except for certain limited differences necessitated by the origin of the collateral and the absence of information available from the failed banks." While this admission is concerning on its own, we also note that, while certain of the classes contained an FDIC guarantee, the transaction did not comply with either the vertical or representative sample retention requirements of the FDIC Safe Harbor. For more information on this topic, please see "FDIC Safe Harbor Concerns" below.

iii. Impact on GSEs and Housing Finance Reform

a. The Current Policy Debate

On September 7, 2008, FHFA placed Fannie Mae and Freddie Mac (the "GSEs") into conservatorship in order to control their impact on the nation's financial stability during the housing crisis. Since that time, the economic significance of the GSEs has only increased, and they, along with FHA, guarantee 95% of American mortgages, as the private label MBS market continues to lie dormant. Recently, however, policymakers have begun to reconsider the future of these institutions and the broader question of whether the federal government should continue to play a major role in the nation's housing finance market.

On February 11, 2011, the Obama Administration released its plan for reforming America's housing finance market, which called for a winding down of the GSEs and reviewed

measures to encourage the return of private capital to the market, such as reducing conforming loan limits and increasing guarantee fee pricing.[27] The Administration though has not provided any specific long-term solution to the problems facing taxpayer-sponsored housing finance in America, nor has it provided a roadmap for how to move away from today's GSE dependent state.

The Proposed Risk Retention Regulations would impose significant burdens on issuers of private label MBS but provide that the implicit 100% taxpayer guarantee is a suitable form of skin in the game for the GSEs, effectively exempting them from the proposed rules. This has sparked considerable criticism from the House Financial Services Committee Subcommittee on Capital Markets and Government Sponsored Enterprises, which believes the proposed GSE exemption extends well beyond the regulators' mandate under Dodd-Frank. Since the release of the Proposed Risk Retention Regulations, the Subcommittee unanimously passed (34-0) a bipartisan bill that would ensure that MBS issued by the GSEs are treated similarly to private label MBS for purposes of risk retention and held a hearing entitled, "Understanding the Implications and Consequences of the Proposed Rule on Risk Retention," during which the members heavily criticized the regulators' "overreaching." Additionally, a number of other legislative solutions are also in the works, including bills that would require GSE portfolio reduction, increase guarantee fees, revise compensation schemes for executive officers of the GSEs and prohibit the GSEs from offering any new products during the term of conservatorship or receivership.

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[27] *See* "Reforming America's Housing Finance Market," U.S. Department of the Treasury and U.S. Department of Housing and Urban Development (February 11, 2011), *available at* http://www.treasury.gov/initiatives/Documents/Reforming%20America%27s%20Housing%20Finance%20Market.pdf.

Other members of Congress are supportive of a government-backed mortgage. On May 12, 2011, Representatives John Campbell (R-CA) and Gary Peters (D-MI) introduced H.R. 1859, the "Housing Finance Reform Act of 2011," which seeks to replace the GSEs with at least five separate mortgage "guaranty associations" chartered by FHFA. These guaranty associations would operate as private companies, but would be able to issue mortgage-backed securities with explicit federal guarantees.

b. The QRM Definition and Leveling the Playing Field

Regardless of whether the government will play a role, it is clear that most policymakers believe that private capital needs to return to the mortgage market, which makes the Proposed Risk Retention Regulations and, in particular the QRM definition, critically important. As currently contemplated, only the highest quality mortgage loans will qualify as QRMs and therefore QRMs will comprise only a small percentage of the mortgage market. The Joint Regulators' proposing release indicates that approximately 19.79% of all loans purchased or securitized by the GSEs during the period 1997 - 2009, and approximately 30.52% of loans in 2009 alone, would have met the QRM criteria. Currently, highly creditworthy borrowers are continuing to experience difficulties in obtaining mortgage financing, as uncertainty in the world financial markets in general and the mortgage market in particular make obtaining credit difficult. This problem will be substantially exacerbated, and the availability of mortgage credit to consumers will suffer, if the QRM definition is not expanded to include a greater percentage of the mortgage market. The highly conservative nature of the QRM definition will likely limit the availability, and increase the cost, of mortgage credit to consumers, particularly to those with low to moderate incomes. In light of the risk retention requirements that will exist upon the

securitization of non-QRM loans, these loans will certainly feature higher interest rates, more points and fees, and more onerous terms than QRM loans.

We note again that the Proposed Risk Retention Regulations provide a complete exemption from the risk retention requirements (including an exemption from the requirement to establish a premium capture cash reserve account) for RMBS guaranteed by the GSEs for so long as the GSEs operate under the conservatorship or receivership of FHFA. We are concerned that the very conservative terms of the proposed QRM definition, taken together with the risk retention requirements, will provide a significant and undue competitive advantage to the GSEs over private market participants. Securities guaranteed by the GSEs will be able to be securitized free from the risk retention requirements irrespective of whether such securities are QRMs, which will result in the non-QRMs loans backing such securities having lower costs to borrowers and more attractive terms than similar loans offered by private market participants. This will have the effect of increasing the portion of the residential mortgage market dominated by the GSEs, further entrenching the importance of their role in such market. This will make it substantially more difficult for Congress to carry out its efforts to restructure or wind down the GSEs, since a substantial percentage of consumers will be wholly dependent on the GSEs to provide them with affordable mortgage financing.

In our view, the best way to level the playing field and avoid increasing the role of the GSEs in the residential mortgage market is to reduce the impact of the risk retention requirements on private market participants. This could be accomplished in a variety of ways. We urge the Joint Regulators to consider adjusting the criteria for QRMs, such that the vast majority of loans to prime borrowers that meet the product type and LTV criteria in the QRM

definition will qualify as QRMs. Reconciling the QRM criteria with the GSE requirements would enable private market participants to compete on equal terms with the GSEs for most of the mortgage market comprised of loans to prime borrowers. The Joint Regulators could also reduce the adverse impact of the risk retention requirements on private market participants, and thereby enable them to better compete with the GSEs and to serve the borrowing needs of the American homeowner.

iv. Need for Re-Proposal of Proposed Regulations

In preparing the Proposed Risk Retention Regulations, the Joint Regulators undertook the complex task of evaluating the diverse characteristics of securitized assets and the structures historically used in securitizations. We applaud the hard work of the Joint Regulators in developing the Proposed Risk Retention Regulations and their efforts to tailor the proposed rules to each asset class and securitization structure. However, we believe that the time-intensive task of creating risk retention rules that both protect investors and encourage a robust and efficient securitization market is far from complete.

ASF is currently working with our membership to develop a detailed and constructive response to the Joint Regulators' request for comment by the aggressive, but established June 10th deadline. We believe that many other interested parties, including other industry groups, individual market participants, academics, members of Congress and the general public, will submit comment letters as well. Given the diversity and complexity of the securitization market and the highly technical nature of the Proposed Risk Retention Regulations, we believe that revisions made by the Joint Regulators in response to these comments, which will likely number

in thousands of pages, will most certainly justify an opportunity for further review by all securitization market participants prior to adoption. Therefore, we urge the Joint Regulators to revise the Proposed Risk Retention Regulations to address the concerns described in each of our separate comment letters and to re-propose a rule implementing Section 941 of the Act for further consideration and public comment prior to adoption. We strongly believe that this course of action will better enable the Joint Regulators and the securitization industry to collectively ensure that the final regulations achieve the goals of the Dodd-Frank Act while promoting a healthy and vibrant securitization market.

Over the years, securitization has grown in large measure because of the benefits it delivers to transaction participants and to the financial system. However, the efficiency, liquidity and low cost of funding that have long been achieved in the securitization markets are threatened by the risk retention rules set forth in the Proposed Risk Retention Regulations. To ensure the availability of credit for consumers and businesses, it is imperative that the final risk retention rules promote a robust securitization market.

While we support measures to ensure the alignment of the incentives of sponsors and investors in the ABS markets, we believe that the burdens imposed on ABS sponsors by the risk retention rules must be commensurate with the risks associated with investment in ABS. Existing securitization programs have structural features that operate to align the interests of sponsors with those of investors. In fact, in the context of most major sectors of non-mortgage ABS, misalignment of interests has not been identified, and no investor who held those ABS securities to maturity experienced losses during the recent financial crisis. The confidence of issuers and investors in the strength of these structures and the quality of the assets underlying

these non-mortgage ABS is evidenced by the relative speed with which these segments of the market have recovered.

Despite the structural integrity and strong performance record of these ABS segments, the Proposed Risk Retention Regulations would require many sponsors to alter the structures of their securitization programs. While the Proposed Risk Retention Regulations include a number of permissible methods of risk retention, the definitions of and requirements for those methods would not accommodate common methods of risk retention in many asset classes, including auto loans, student loans, credit cards and asset-backed commercial paper. For example, under the Proposed Risk Retention Regulations, in order to qualify as horizontal risk retention an ABS interest must have the most subordinated claim to payments. In some cases, however, the subordinate tranches held by an ABS sponsor may absorb losses before more senior tranches held by third parties are affected, but only after the funds in a reserve account are depleted. Furthermore, even in cases where the Joint Regulators indicated that the proposals were meant to exactly conform to existing market practices, there are significant differences that would create major disruptions in the ABS market.

Altering the structures of ABS programs to conform their risk retention features to the methods permitted under the Proposed Risk Retention Regulations would be very expensive and, in many cases, would render the economics of the programs untenable. If the risk retention rules are not appropriately designed to accommodate existing market practices, we risk an immediate and significant reduction in the availability of auto loans, student loans, credit cards and business credit throughout our country without gaining material improvements to the risk retention measures that protected investors even during the worst of the financial crisis. The risk of

shutting down the securitization markets is not warranted where investors have been protected by existing risk retention methods. Therefore, it is imperative that the provisions of the Proposed Risk Retention Regulations accommodate existing market practices that effectively align the interests of sponsors with those of investors.

Unfortunately, structuring the Proposed Risk Retention Regulations to accommodate existing market practices is easier said than done. Numerous classes of assets are securitized, multiple securitization structures are utilized for each asset class, and each of those structures is extremely complex. The task of ensuring that the sponsors of each asset class and of each existing structure can comply with the Proposed Risk Retention Regulations without substantial additional costs requires an intimate knowledge of the characteristics of each asset class and each securitization structure. As noted previously, the specific credit history factors proposed to be used as a proxy for credit score in the QRM definition have not been established to be predictive of the probability of default. In fact, industry statistics indicate that these proposed delinquency payment requirements could result in the inclusion of a credit score as low as 437 and the exclusion of a score as high as 850. Additionally, the proposed "qualifying auto loan" definition requires a 20% down payment, a figure that is commonplace in the mortgage market but has no relevance in an auto market where advance rates of 100% are commonplace. The complexity of the securitization structures and securitized assets is further demonstrated by the fact that the Joint Regulators included 174 requests for comment in the Proposed Risk Retention Regulations.

We are also concerned that revisions made to the Proposed Risk Retention Regulations to accommodate an existing market practice for one asset class or in one securitization structure may have the unintended consequence of excluding an existing market practice for another asset

class or in a different securitization structure. The potential for these unintended consequences is particularly acute in the context of the portions of the Proposed Risk Retention Regulations that will be the subject of comment from representatives of multiple asset classes, including provisions prescribing the general methods of risk retention that are available to all asset classes. Securitization market participants cannot evaluate the consequences of substantive revisions made by the Joint Regulators in response to comments to the Proposed Risk Retention Regulations unless they are given an opportunity to review those revisions before the final rule is adopted.

In addition to our concerns about the complexity of the subject matter of risk retention rules, we are concerned about the complexity of the process of managing the implementation and interpretation of the final risk retention rules. In the Proposed Risk Retention Regulations, the Joint Regulators indicated that they will jointly approve any written interpretations, written responses to requests for no-action letters and legal opinions, or other written interpretive guidance concerning the scope or terms of the final rules that is intended to be relied on by the public generally. The Joint Regulators further indicated that they will jointly approve any exemptions, exceptions or adjustments to the final rules. The process for seeking corrections to final regulations or interpretive guidance from a single regulator is often onerous and time-consuming. These burdens will be dramatically compounded in the case of the final risk retention rules where the corrections and guidance would need to be approved by multiple regulators. In light of this concern, it is imperative that securitization market participants be granted an opportunity to review the impact of substantive revisions to the proposed risk retention rules before they are adopted.

Given the complexity of adopting risk retention rules that effectively regulate the diverse and dynamic securitization market, the highly technical nature of the Proposed Risk Retention Regulations and the unique difficulty of obtaining future corrections or interpretive guidance on the final risk retention rules, it is imperative that securitization market participants be given a meaningful opportunity to review and provide comment on the risk retention rules before they are adopted. We believe that this course of action will better enable the Joint Regulators and the securitization industry to collectively ensure that the final regulations achieve the goals of the Act while promoting a healthy and vibrant securitization market. Therefore, we strongly urge the Joint Regulators to release a revised version of the Proposed Risk Retention Regulations for additional public comment

IV. Transparency

ASF has been a strong and vocal advocate for targeted securitization market reforms and we continue to work from within the industry to identify and implement them. Through our work on Project RESTART, ASF was an industry leader in promoting transparency through the disclosure and reporting of loan-level information in RMBS transactions. In fact, our work was heavily relied upon by the SEC when it published for comment Release Nos. 33-9117; 34-61858; File No. S7-08-10, dated April 7, 2010 (the "Regulation AB II Proposals"),[28] which proposed rules relating to offering, disclosure and reporting requirements for ABS under the Securities Act

[28] *See* http://edocket.access.gpo.gov/2010/pdf/2010-8282.pdf.

and the Exchange Act. ASF also heavily commented on the Regulation AB II Proposals, submitting four separate letters.[29]

A. Industry Efforts

Through Project RESTART, ASF has identified, designed and implemented numerous industry-driven market standards and practice improvements to rebuild and strengthen the securitization infrastructure and help restore capital flows to the securitization markets. Our work has been recognized by senior policymakers and market participants as a necessary industry initiative to improve the securitization process by developing commonly accepted and detailed standards for disclosure and standardization that each appropriate market participant will be recommended to implement.

The origins of Project RESTART begin in the fall of 2007, when a number of RMBS market participants began meeting to explore market challenges and identify potential areas of improvement. In early 2008 at ASF's annual industry conference, a broad-based group of ASF members comprised of critical transaction parties came together to develop the core concepts and objectives of the Project. Subsequently, in its March 2008 Policy Statement on Financial Market Developments, the President's Working Group (the "PWG") on the Financial Markets recommended that the ASF develop templates for disclosure in securitization that support efforts

[29] *See* "ASF SEC Regulation AB II Comment Letter," American Securitization Forum (August 2, 2010), *available at* http://www.americansecuritization.com/uploadedFiles/ASFRegABIICommentLetter8.2.10.pdf; *See* "ASF ABCP Comment Letter re SEC Regulation AB II," American Securitization Forum (August 2, 2010), *available at* http://www.americanssecuritization.com/uploadedFiles/ASFRegABIIABCPCommentLetter8.2.10.pdf; *See* "ASF Auto Comment Letter re Regulation AB II," American Securitization Forum (August 31, 2010), *available at* http://asf.informz.net/ASF/data/images/emailattachments/advocacy/asf_reg_ab_ii_auto_abs_comment_letter_8.31.10.pdf; and *See* "ASF Waterfall Program Comment Letter re Regulation AB II," American Securitization Forum (August 31, 2010), *available at* http://asf.informz.net/ASF/data/images/emailattachments/advocacy/asf_reg_ab_ii_waterfall_comment_letter_8.31.10.pdf.

to improve market discipline.[30] The Project's objectives were further accelerated by and are directly responsive to the PWG's request. On June 24, 2008, Acting Under Secretary for Domestic Finance Anthony W. Ryan announced that the PWG had engaged the ASF as the private sector group to develop best practices regarding disclosure to investors in securitized credits.[31]

On July 15, 2009, the ASF released final versions of the first two deliverables of the Project, a disclosure package of loan-level information to be provided by issuers prior to the sale of private-label RMBS transactions (the "Disclosure Package") and a reporting package of loan-level information to be updated on a monthly basis by RMBS servicers throughout the life of an RMBS transaction (the "Reporting Package").[32] Both of these packages increase and standardize critical data at issuance and throughout the life of a transaction, which will enable investors to better perform deal and loan-level analysis on the basis of the credit quality of the underlying mortgage loans. By increasing and standardizing critical data, investors can better perform necessary and sufficient deal and loan-level analysis in order to evaluate RMBS transactions on the basis of the credit quality of the underlying mortgage loans.

The release of the Disclosure and Reporting Packages was timely given the Administration's proposals for regulating financial markets. On June 17, 2009, the Treasury Department released a proposal titled "Financial Regulatory Reform," which states that the "SEC

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[30] *See* "Policy Statement on Financial Market Developments," The President's Working Group on Financial Markets (March 2008), page 13, *available at* www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf.

[31] Assistant Secretary Anthony W. Ryan, Remarks at Euromoney's Global Borrowers Investors Forum (June 24, 2008). *See* www.treas.gov/press/releases/hp1053.htm.

[32] For more information on the Disclosure and Reporting Packages, *see* www.americansecuritization.com/uploadedFiles/ASF_Project_RESTART_Final_Release_7_15_09.pdf.

should continue its efforts to increase the transparency and standardization of securitization markets and be given clear authority to require robust reporting by issuers of asset backed securities (ABS)" and that "[i]nvestors and credit rating agencies should have access to the information necessary to assess the credit quality of the assets underlying a securitization transaction at inception and over the life of the transaction, as well as the information necessary to assess the credit, market, liquidity, and other risks of ABS."[33] About a month later, the Administration followed its Financial Regulatory Reform proposal with proposed legislation that sought to implement the recommendations contained in the broader proposal.[34] In the year that followed, the U.S. House of Representatives and Senate considered various iterations of this legislation until, on July 21, 2010, the Administration's proposals for data disclosure and reporting were ultimately codified into law in the Dodd-Frank Act. The Dodd-Frank Act specifically calls for issuers of ABS to disclose "asset-level or loan-level data, if such data are necessary for investors to independently perform due diligence."[35] Not long before the passage of the Dodd-Frank Act, the SEC issued the Regulation AB II Proposals, which include loan-level RMBS disclosure and reporting proposals as originally contemplated by Project RESTART. The ASF appreciates that the SEC considered the great work of our members when putting its template together and we hope that the SEC will also consider the comments that we provided in our broad comment letter to that template.[36]

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[33] *See* "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Regulation and Supervision," U.S. Department of the Treasury, pages 44-45, *available at* www.financialstability.gov/docs/regs/FinalReport_web.pdf.
[34] The provisions of the proposed legislation can be found at www.treasury.gov/press/releases/reports/title%20ix%20subt%20e%20securitization%207222009%20fnl.pdf.
[35] *See* Title IX, Subtitle D "Improvements to the Asset-Backed Securitization Process," *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf.
[36] *See* "ASF SEC Regulation AB II Comment Letter," American Securitization Forum (August 2, 2010), *available at* http://www.americansecuritization.com/uploadedFiles/ASFRegABIICommentLetter8.2.10.pdf.

In connection with the development of the Disclosure and Reporting Packages, the ASF also created a unique loan identification number, known as the ASF LINC™, for securitization reporting purposes to facilitate the monitoring of assets from origination through the securitization process. One of the problems in the securitization market has been the inconsistent fashion in which assets have been identified. In a typical mortgage securitization, the originator, primary servicer, master servicer and trustee could all assign different numbers to identify the loan on each particular system. Implementation of the ASF LINC™ remedies this problem by assigning numbers that will be standard across the entire industry, enabling market participants to track an asset throughout its life regardless of who holds legal title to or services it at any particular time. The ASF LINC™ would enable market participants from across the globe to access information about assets, regardless of where or when they were securitized.

B. Regulation AB II Proposals

As mentioned above, the Regulation AB II Proposals were released by the SEC on April 7, 2010 to overhaul the registration, disclosure and reporting requirements of ABS issuers. As part of the industry's efforts to comment on these proposals, ASF assembled the ASF Reg AB II Taskforce (the "Taskforce") consisting of current members of ASF, including issuers and investors for various asset sectors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and data and analytics firms. In all, nearly 600 individuals directly participated in the comment process as part of the Taskforce. Members of the Taskforce took considerable time out of their daily schedules to participate in more than 125 conference calls and collectively devoted thousands of hours to develop, draft and review our

comment letters. We include as part of this testimony our comments on some of the key proposals that will have a major impact on the securitization market.

i. Securities Act Registration

The SEC proposed to require an ABS issuer using a shelf registration statement to file a preliminary prospectus containing all material information at least five business days in advance of the first sale of ABS in the offering. We appreciate and support the SEC's goal of providing investors with adequate information and time to make an informed investment decision, as well as the SEC's sensitivity to balancing the needs of investors with the interests of ABS issuers in timely access to the capital markets. Our members agreed, however, that a mandatory five-day waiting period between the proposed Rule 424(h) filing and the first sale of ABS is too long. We recommended a two business-day waiting period and, in cases where there has been a subsequent material change in the legal structure, terms of the ABS or composition of the asset pool, a one business-day waiting period.

The SEC also proposed to replace the investment grade ratings requirement in the ABS shelf eligibility conditions with four new requirements, although two have been rendered moot by other proposals per the provisions of Dodd-Frank. The first such requirement was risk retention, which has been taken over by the Joint Regulators' efforts to finalize risk retention proposals, and the second was on-going periodic reporting, which has been obviated by Dodd-Frank and a related SEC proposal.

The third SEC proposal required that the pooling and servicing agreement for the securitization contain a provision requiring the party that is making representations and

warranties relating to the pool assets to furnish a quarterly opinion of a third party to the trustee to the effect that any pool asset as to which the trustee asserted a breach of a representation or warranty and which was not repurchased or replaced by the obligated party, did not violate a representation and warranty contained in the agreement. Although the SEC's proposed shelf eligibility criterion would ensure that some ongoing disclosure is made in shelf offerings about the propriety of a representing party's decision not to repurchase pool assets, it would not ensure that the repurchase of noncompliant assets is effected, as it is a purely disclosure-based mechanism. In the alternative, we requested that the SEC consider including a more robust mechanism for the investigation and resolution of disputes relating to breaches of representations and warranties (similar to our Project RESTART work related to Model Repurchase Principles described earlier in this testimony).

The fourth SEC proposal required that the issuer provide a certification of its chief executive officer regarding the assets underlying the securities for each transaction. The certification would indicate that the officer has reviewed the prospectus and other necessary documents and state that to the officer's knowledge "the securitized assets backing the issue have characteristics that provide a reasonable basis to believe that they will produce, taking into account internal credit enhancements, cash flows at times and in amounts necessary to service any payments on the securities as described in the prospectus." Our issuer members are very concerned that the proposed certification is tantamount to a guarantee by the chief executive officer as to the future performance of the assets underlying the ABS, which would be impossible to provide. Instead, we requested that the SEC adopt an alternative certification requirement that focuses on the sufficiency of the disclosure in the offering documents.

ii. Disclosure Requirements

a) RMBS

The SEC's proposed rules with respect to loan-level disclosure for private-label RMBS transactions substantially incorporate the spirit and substance of the asset-level disclosure and reporting packages that had gained industry-wide consensus through ASF's Project RESTART initiative. We generally agreed with both the substance and the format of the SEC's proposed rules regarding disclosure of asset-level information for RMBS transactions and proposed only a small number of specific modifications to those proposed rules.

b) Credit Card ABS

Through Project RESTART, ASF had begun discussions among credit card ABS market participants to review current disclosure practices. However, this review was not completed by the time the SEC released its disclosure requirements for credit card ABS as part of its Regulation AB II Proposals. The SEC proposed to exclude credit and charge card ABS from the requirement to provide asset-level data. Because many credit and charge card pools contain as many as 20 to 45 million accounts, we agree that asset-level data for credit and charge card ABS would result in issuers providing an overwhelming volume of data that would not be useful to investors. To address this concern, the SEC proposes to require that issuers of credit and charge card ABS provide "grouped account data." However, under the SEC's grouped account data proposal, credit and charge card ABS issuers would be required to disclose commercially-sensitive proprietary information about origination, underwriting and pricing models that are critical to the viability of their businesses. Investors and issuers alike are concerned that this

would drive issuers away from the securitization markets, resulting in a significant decrease in the amount of high quality credit and charge card ABS. In light of these concerns, we leveraged our prior work through Project RESTART and proposed an alternative disclosure and reporting package that builds upon the SEC's proposal with important modifications designed to provide extensive metrics on collateral performance without disclosing proprietary information.

c) Auto Floorplan

The SEC proposes to require auto floorplan issuers to disclose loan-level data for each floorplan receivable in a pool both in the prospectus at the time of offering and in subsequently filed Exchange Act reports. Both issuers and investors recognize and agree that the loan-level disclosure requirements contained in the SEC's proposal would require significant changes from current disclosure standards in the auto floorplan ABS market and that, if the SEC adopts its proposed disclosure requirements without modifications, unintended consequences have the potential to significantly hamper or even dismantle the auto floorplan ABS market. Floorplan sponsors are either owned by, or have significant commercial ties to, auto manufacturers, and the manufacturers are dependent on the ability of the sponsors to provide floorplan financing to dealers. As a result, the ability to issue floorplan ABS is critical to the auto industry and, in turn, is important to the economy as a whole. Under the SEC's loan-level disclosure proposal, auto floorplan issuers would be required to disclose commercially-sensitive proprietary information about origination, underwriting and pricing models that are critical to the viability of their businesses. Like originators and servicers of auto loans and leases, each originator and servicer of floorplan accounts has devoted an enormous amount of time and resources to develop its own models and strategies for underwriting, pricing and servicing. We are concerned that

competitors would be able to derive critical components of these models and strategies from the loan-level data proposed to be required by the SEC. ASF developed an alternative disclosure and reporting proposal for auto floorplan ABS – mutually agreed upon by floorplan sponsors and investors – that we believe will be both beneficial to investors and feasible and appropriate for issuers to provide.

d) Auto Loans and Leases

The SEC proposes to require issuers of ABS backed by auto loans or leases to disclose loan-level data regarding each auto loan or lease in a pool both in the prospectus at the time of offering and in subsequently-filed Exchange Act reports. While our issuer and investor members agree with the SEC that an investor's access to robust information concerning the pool assets is important to enable informed investment decisions, we were unable to reach a consensus ASF view on a disclosure and reporting package for the auto loan and auto lease markets.

Our issuer members are uniformly concerned that, if the SEC adopts its proposed disclosure requirements for ABS backed by auto loans and leases without modification, there could be significant unintended consequences as issuers are faced with the potential trade-off between protecting their business model and continuing to securitize their assets. Ultimately, this has the potential to significantly reduce issuance in the auto loan and lease ABS markets. Our investor members have differing views on the SEC's proposal. All of our issuer members and many of our investor members (we refer to such investors as "grouped-asset investors") believe that their concerns are best addressed through an alternative disclosure and reporting package for auto loan and lease ABS that is based on the grouped account data model outlined

by the SEC for the credit and charge card sector. Many of our other investor members (we refer to such investors as "loan-level investors") believe that the SEC should require loan-level data for auto loan and lease ABS, but propose modifications to the list of loan-level data points for those asset sectors proposed by the SEC.

iii. Waterfall Computer Program

The SEC proposes to require that most ABS issuers file a computer program on EDGAR, in the form of downloadable source code in the Python programming language that gives effect to the flow of funds, or "waterfall," provisions of each ABS transaction. The computer program must (i) give effect to the priority of payment provisions in the transaction agreements; (ii) provide the user with the ability to programmatically input (A) the user's own assumptions regarding the future performance and cash flows from the pool assets, and (B) the current state and performance of the pool assets by uploading the proposed asset-level data file that is to be filed at the time of the offering and on a periodic basis thereafter; and (iii) produces a programmatic output, in machine-readable form, of all resulting cash flows associated with the ABS, including the amount and timing of principal and interest payments payable or distributable to a holder of each class of securities. While our issuer and investor members disagreed in their views on the waterfall program, they both agreed that the SEC's proposal was particularly unclear. It was difficult to determine exactly what the SEC had in mind, and the level of sophistication required in the program.

Our issuer members have a number of significant concerns with the SEC's proposed waterfall computer program, including that it is predictive and would place the ABS issuer in the

unprecedented and extraordinarily precarious position of providing investors with tools to speculate on the future performance of ABS, seemingly without the ability to incorporate standard assumptions into the model. As a result, issuers are deeply troubled by, and fervently object to, the waterfall program as proposed, which would significantly and inappropriately extend an issuer's liability under the federal securities laws by making the issuer responsible not only for the accuracy of the transaction structure but also for the integrity of a waterfall computer program that purports to predict future cash flows based on a limitless series of hypothetical future events and scenarios. Finally, predictive waterfall programs, despite the SEC's indications to the contrary, do not currently exist, even in the third party modeling space.

Our investor members support the SEC's proposed waterfall computer program and believe it would promote transparency in the offering process and enable market participants to better evaluate ABS. Investors believe that the waterfall computer program should be capable of modeling virtually all cash flow scenarios and should only be subject to a very limited number of assumptions. Investors believe that the waterfall provisions in almost all transaction agreements are static and should remain accurate for the life of a deal. For this reason, the waterfall program should only be subject to a few basic assumptions, such as an assumption that there will be no changes in law that would have an impact on the distribution of cash flows.

iv. Privately-Issued Structured Finance Products

The SEC proposes to condition the availability of the safe harbors for privately-issued structured finance products on an issuer's undertaking to provide to investors, in connection with initial offers or sales and on an ongoing basis, the same information as would be required in a

registered transaction. These new disclosure requirements are intended to address concerns about the amount and quality of information available to sophisticated investors about structured finance products purchased in these private transactions.

Although we support the SEC's goal of ensuring that sophisticated investors are able to consider and understand the risks of their investments, we believe that the more appropriate course of action to achieve that goal – a course that is consistent with the historical treatment of institutions and institutional sales under the federal securities laws – is to base the availability of the safe harbors on private transactions with a class of institutional investors ("qualified institutional buyers of structured finance products" or "SQIBs") that possess a level of knowledge and experience in the purchase and surveillance of structured finance products such that they are able to identify and request the information that they need to make informed investment decisions relating to those products without the protections mandated by the registration provisions of the Securities Act.

Our issuer members operate in the private placement market for a number of valid and important reasons. An issuer may not have access to all of the information required for a registered transaction or the underlying assets or transaction structure may not lend themselves to the delivery of the information required for registered transactions, or the issuer's issuances may not be on a sufficient scale or the market for a particular product may be sufficiently limited that the costs and difficulties of compliance with the disclosure standards for a registered transaction make the private placement market the only viable alternative. In each of these cases, the private placement market is a vital source of capital, and the private placement safe harbors should be available to issuers without prescribed disclosure requirements as long as the issuer is offering its

securities to investors that possess a level of knowledge and experience in the purchase and surveillance of structured finance products such that they are able to identify and request the information that they need to make informed investment decisions relating to those products without the protections mandated by the registration provisions of the Securities Act.

Our investor members are supportive of the SQIB concept, but they question whether it will adequately address their concern that issuers might seek to arbitrage the differing information delivery standards between the registered and private markets and thereby undercut the effectiveness of the SEC's proposals for enhanced disclosure and reporting in the registered market.

V. FDIC Safe Harbor Concerns

On September 27, 2010, the FDIC issued its final rule relating to the treatment by the FDIC as conservator or receiver of financial assets transferred by an insured depository institution (a "Bank") in connection with a securitization or participation transaction. Throughout the comment process for this rule, ASF adamantly opposed the vague "conditions" that were included as part of an issuers' compliance with the FDIC Safe Harbor. We stressed that an effective safe harbor should have clearly defined conditions comprised of bright line tests that, if met, provide defined benefits. The conditions of the safe harbor should be ones that can be assessed by all of the participants in the transaction and, if met at the time of the issuance of the relevant securities, should provide benefits that continue for the life of the securities. It should allow an investor to conclude that the conditions have been met or allow a clear

determination that the conditions have not been met so that risks can be appropriately assessed and a transaction can be efficiently priced. A safe harbor becomes ineffective if the conditions are vague, if there are too many conditions or if the conditions are specific but cannot be measured or met.

ASF and its membership continue to strongly oppose linking a determination of whether financial assets have been legally isolated in the case of receivership to preconditions addressing capital structure, disclosure, documentation, origination and compensation. Under the FDIC Safe Harbor, investors will bear the burden of the loss of the safe harbor if any of the securitization preconditions are not satisfied by the issuer or sponsor. Investors in securitization should bear risks associated with the assets underlying a securitization but not risks associated with the originator of those assets. For these reasons, we continue to believe that the FDIC's enactment of the FDIC Safe Harbor will harm a Bank's ability to sponsor a new securitization and, therefore, will create an uneven playing field, pushing securitization activity to unregulated non-bank organizations. This will clearly hurt liquidity but will also mean that future securitizations may take place outside of a regulated structure posing new risks to the system instead of eliminating them.

ASF, along with most other commentators, called for a coordinated approach to securitization reform in its response to the FDIC's Advanced Notice of Proposed Rulemaking and its Notice of Proposed Rulemaking with respect to the FDIC Safe Harbor, as it is our belief that regulators and policymakers have to work together so they do not inadvertently stifle securitization. ASF remains particularly concerned that the FDIC, through its enactment of the FDIC Safe Harbor, has acted ahead of other regulators in an uncoordinated manner.

While the FDIC Safe Harbor contains disclosure standards for securitization transactions that are different from the SEC's Regulation AB II Proposals and documentation and servicing requirements that overlap with provisions of Dodd-Frank and related implementing regulations, the clearest example of the FDIC's unilateral approach to regulation is risk retention. At the time Dodd-Frank was adopted by Congress and signed into law by the President, rule proposals with independent risk retention provisions were put forth for public comment by (i) the FDIC Safe Harbor and (ii) the SEC's Regulation AB II Proposals.[37] ASF submitted extensive comment letters to each of the FDIC and the SEC noting that their respective risk retention proposals overlapped significantly with the risk retention requirements in Dodd-Frank and that the regulatory processes to implement the Dodd-Frank risk retention requirements were moving forward rapidly. ASF urged the FDIC and the SEC, therefore, to impose risk retention requirements only on a coordinated basis, in accordance with the legislative mandate that such regulations be developed on an interagency basis, as informed by the findings and recommendations presented to Congress in several risk retention reports mandated under Dodd-Frank. ASF also cautioned that unilateral rulemaking would introduce multiple layers of regulation addressing the same core issues, which would be extremely detrimental to the recovery of the fragile securitization markets. While the SEC appears to have deferred action on its risk retention rule proposals until the regulatory processes relating to the Dodd-Frank risk retention requirements are completed, the FDIC has brashly moved forward to adopt its FDIC Safe Harbor that effectively preempted Congress' mandate to develop risk retention regulations on an interagency basis.

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[37] Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010); Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation After September 30, 2010 (75 FR 27471, May 17, 2010); Asset-Backed Securities (75 FR 23328, May 3, 2010).

The FDIC Safe Harbor included a requirement that the sponsor must retain at least five percent of the credit risk of the financial assets in one of two ways – (i) through retention of a "vertical slice" of at least five percent of each tranche transferred to investors or (ii) by retaining in its portfolio a "representative sample" in an amount equal to at least five percent of the securitized assets.[38] The FDIC Safe Harbor does contain an "auto-conform" provision that will replace the credit risk retention requirements described above with those implemented under Dodd-Frank when they become effective. As discussed below, however, the FDIC's risk retention requirements that are now in place are too rigid and narrowly drawn and the Dodd-Frank risk retention regulations have only recently been proposed, and so their effective date is still over a year from now in the case of RMBS and over two years from now in the case of all other classes of ABS. In addition, as discussed further below, Banks that sponsor revolving asset master trust securitization transactions could face more unique transition issues under the FDIC's auto-conform provision.

Both the language and legislative history of Section 941 indicate that Congress expected the Joint Regulators, in formulating risk retention rules, to be mindful of the heterogeneity of securitization markets and to give due consideration to the findings and recommendations presented to Congress in certain risk retention studies and reports mandated by Section 941.[39] Consistent with this Congressional mandate, the Joint Regulators have taken into account the

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[38] In contrast, the SEC appears to have deferred action on its risk retention rule proposals until the regulatory processes relating to the Dodd-Frank risk retention requirements are completed.

[39] *See, e.g.*, 15 U.S.C. § 78o-11(c)(1)(E), (c)(2), (e); S. Rep. no. 111-76, at 130 (2010) ("The Committee believes that implementation of risk retention obligations should recognize the differences in securitization practices for various asset classes."). Section 941 of Dodd-Frank directed each of the Board and the Financial Services Oversight Counsel to study certain effects of the risk retention requirements and promptly report their findings to Congress. *See generally* Report to the Congress on Risk Retention, Board of Governors of the Federal Reserve System (October 2010); *see also* Macroeconomic Effects of Risk Retention Requirements, Chairman of the Financial Stability Oversight Counsel (January 2011).

diversity of assets that are securitized, the structures historically used in securitizations, and the manner in which securitizers may have retained exposure to the credit risk of the assets they securitize. As a result, unlike the FDIC Safe Harbor, the Proposed Risk Retention Regulations under Dodd-Frank provide a range of options that securitizers may choose from in meeting the risk retention requirements, including: (i) retention of a "vertical slice" of each class of interest issued in the securitization, (ii) retention of an "eligible horizontal residual interest" in the securitization, (iii) use of "L-Shaped" risk retention, which combines both vertical and horizontal forms, (iv) in the case of revolving asset master trusts, retention of a "seller's interest" that is generally *pari passu* with the investors' interest in the revolving assets supporting the ABS, (v) retention in its portfolio of a "representative sample" of assets equivalent to the securitized assets; and (vi) other risk retention options that purport to take into account the manner in which risk retention often has occurred in connection with the issuance of ABCP and in commercial mortgage-backed securitization transactions.[40] Moreover, as directed by Congress, the Joint Regulators' Proposed Risk Retention Regulations purport to calibrate risk retention with asset quality by exempting ABS supported by QRMs and ABS supported by other high quality assets from any risk retention requirement.

By contrast, the risk retention requirements in the FDIC Safe Harbor embrace a blanket one-size-fits-all retention requirement that is arbitrary in its application to any particular asset type because it does not account for important differences in the expected credit and performance characteristics of one asset type as compared with another asset type. Nor does it account for the

[40] Notably, as to each proposed form of eligible risk retention, the Joint Regulators have also set forth a host of questions for which public comment is sought – questions that evidence both the complexity of the rule-making initiative and the care that is required to produce regulations that appropriately balance the competing objectives of aligning economic interests while preserving securitization as a viable and economical alternative relative to other funding options.

diversity of assets that are securitized, the structures historically used in securitizations, or the manner in which securitizers may have retained exposure to the credit risk of the assets they securitize. Many sponsors already have significant equity and other investments in the capital structure of their securitization transactions in the form of seller's interests, subordinated and first-loss positions, excess spread that represents an interest in excess finance charge collections, overcollateralization, reserve accounts and the like. Adding a vertical slice component as contemplated by the FDIC Safe Harbor will almost certainly add too much incremental cost and render securitization transactions uneconomical relative to other funding options available to the sponsor.

As an alternative to a vertical slice, the FDIC Safe Harbor does contemplate retention of a representative sample as a means of risk retention, but the FDIC's version of this option is formulated differently than the representative sample option included in the Joint Regulators' Proposed Risk Retention Regulations, and so a Bank seeking to avail itself of this option would have to adopt one set of procedures to comply with the FDIC Safe Harbor in its current form and then a different set of procedures at such time as the auto-conform provision takes effect.

Banks that sponsor revolving asset master trust securitization transactions could face more unique transition issues under the FDIC's auto-conform provision. Master trusts allow sponsors to employ a single issuing vehicle to issue multiple issuances of ABS over time. Each issuance provides for the conveyance of additional pool assets in contemplation of future issuances of ABS backed by the same revolving asset pool. Master trusts represent a more integrated form of structuring technology, where each issuance forms a part of the more complete structure of the issuance platform. It is of paramount importance, therefore, that the

sponsor of a master trust securitization platform have the option (but not the requirement) to select and maintain the same form of risk retention over the life of the master trust. If a Bank were to sponsor a revolving asset master trust securitization transaction in conformity with the more limited risk retention options currently available under the FDIC Safe Harbor, the sponsor could effectively be relegated to that form of risk retention for all of the master trust's future ABS issuances, even if a broader (and potentially more efficient) range of options becomes available at such time as the auto-conform provision of the FDIC safe harbor takes effect.[41]

We recognize that legislators and regulators have an interest in fashioning effective regulations to enhance practices of issuers and confidence of investors, but it is critical that legislators and regulators work in concert with, and not in opposition to, one another. Simply stated, by imposing rigid and narrowly-drawn risk retention requirements on Banks that sponsor securitization transactions before the regulatory processes relating to risk retention have been completed, the FDIC has impeded the recovery of the securitization markets by needlessly deterring Banks from the use of securitization. Accordingly, ASF requests that Congress pass legislation providing that, except as set forth in Section 15G of the Exchange Act, no governmental agency shall promulgate risk retention regulations, and that any such regulations

[41] The FDIC's prior securitization safe harbor, adopted a rule in 2000, provided that the FDIC, as conservator or receiver of a Bank, would not use its statutory authority to disaffirm or repudiate contracts in order to reclaim financial assets transferred by a Bank in connection with a securitization or participation if the transfer met all conditions for sale accounting treatment under GAAP. On June 12, 2009, the Financial Accounting Standards Board ("FASB") modified GAAP through FAS 166 and FAS 167, which represent accounting standards that make it more difficult for a transferor of assets in a securitization to meet the conditions for sale accounting treatment. These modifications became effective for annual financial statement reporting periods that began after November 15, 2009.
The FDIC's new securitization safe harbor contains a grandfathering provision that makes the safe harbor available for securitization transactions by revolving or master trusts *at any time*, as long as the trust had issued ABS prior to September 27, 2010 and transfers of pool assets in connection with issuances of ABS backed by the same, revolving pool satisfy the GAAP conditions for sale accounting treatment as in effect prior to November 15, 2009.
This grandfathering provision is *not*, however, available for revolving or master trusts that initially issue ABS only on or after September 27, 2010 or that transfer pool assets in connection with issuances of ABS backed by the same, revolving pool in a manner that does not satisfy those prior GAAP conditions for sale accounting treatment.

previously promulgated are repealed by the terms of such legislation and without need of further action by any such agency.

VI. Orderly Liquidation Authority

In December 2010, two other issues emerged under Dodd-Frank that threatened the viability of the non-bank sectors of the securitization market. Title II of Dodd-Frank sets forth the Orderly Liquidation Authority ("OLA") of the FDIC through which the FDIC can exercise certain powers in the event that a "covered financial company" (a "Covered Financial Company")[42] enters receivership. A Covered Financial Company is a nonbank that is primarily engaged in financial activity and upon its failure would have serious adverse effects on the financial stability of the United States.

The Dodd-Frank Act requires the FDIC to implement OLA and, to the extent possible, to harmonize its rules with the insolvency laws that would otherwise apply. To date, two separate issues have been identified and pursued by market participants and each required immediate attention by the FDIC to prevent further damage to the already fragile securitization markets. The first issue involves securitizations of Covered Financial Companies where the perfection of the security interest on the underlying paper was accomplished by a Uniform Commercial Code

[42] The Orderly Liquidation Authority ("OLA") provisions of Dodd-Frank allow for the FDIC to be appointed as the liquidating receiver of a "covered financial company." A "covered financial company" subject to these provisions:

- is not an insured depository institution,
- is primarily engaged in activities that are financial in nature and the consolidated revenues of such company from such activities are 85% or more of its consolidated revenues; and
- is in default or in danger of being in default, and, among other things, "the failure of the financial company and its resolution under otherwise applicable Federal or State law would have serious adverse effects on financial stability in the United States" (a "Systemic Risk Determination").

(the "UCC") filing, which generally occurs for auto and student loan securitizations, rather than by possession. In such a case, the FDIC under OLA could arguably trump the securitization's lien on the underlying auto or student loans and leave the investors in the securitization unsecured. The second issue involves the scope of the repudiation power that could be exercised by the FDIC as receiver for a Covered Financial Company under OLA. Our membership very much appreciated the FDIC's General Counsel taking immediate steps to "patch up" these issues in part, although considerable uncertainty remains without a legislative solution.

Congress has required through Dodd-Frank that the FDIC harmonize applicable rules and regulations promulgated under OLA with the insolvency and bankruptcy laws that would otherwise apply. Despite clarity in the legislative intent, ambiguity in the statutory language of Title II has caused substantial consternation and uncertainty in the securitization markets and has required prompt interpretive actions from the FDIC, at a time when the FDIC is already inundated with the task of undertaking the numerous large-scale rulemakings required by Dodd-Frank. For these reasons, market participants may be forced to plan transactions based on two different insolvency regimes given that they would not know, at the time of extending credit, whether OLA rules or bankruptcy rules would ultimately apply. To provide much needed certainty, and to ensure that the intent of the OLA provisions under Dodd-Frank are carried out, we believe that a legislative solution is necessary and we stand ready to endorse a bill that requires the OLA provisions to be exercised consistent with the U.S. Bankruptcy Code or other applicable insolvency laws, including bankruptcy- and State-law principles governing legal isolation.

A. Intent to Harmonize Dodd-Frank with the Bankruptcy Code

In enacting OLA, Congress intended to create a new statutory regime for the orderly liquidation of Covered Financial Companies. However, several sources, including the Dodd-Frank Act itself, suggest that Congress also intended for the resulting statutory regime to operate in such a way as to minimize the likelihood of different results to creditors of such potential Covered Financial Companies from those results arising under Title 11 of the United States Code (the "Bankruptcy Code").

Sections 210(a)(7)(B) and (d)(2)(B) of the Dodd-Frank Act, provide that, in the context of OLA liquidation, "a creditor shall, in no event, receive less than the amount that creditor is entitled to receive" if the FDIC "had not been appointed receiver with respect to [a] covered financial company; and the covered financial company had been liquidated under chapter 7 of the Bankruptcy Code." Furthermore, Section 209 of the Dodd-Frank Act mandates that the FDIC "seek to harmonize applicable rules and regulations promulgated under [OLA] with the insolvency laws that would otherwise apply to a covered financial company." In the Notice of Proposed Rulemaking issued by the FDIC with respect to OLA[43], the FDIC states that "[t]he liquidation rules of [OLA] are designed to create parity in the treatment of creditors with the Bankruptcy Code" and that "the provisions that empower the FDIC to avoid and recover fraudulent transfers, preferential transfers and unauthorized transfers of property by the covered financial company are drawn from Bankruptcy Code provisions."

The underlying policy rationale behind this desire for harmonization is likely that Congress wanted to avoid requiring parties extending credit to potential Covered Financial

[43] *See* http://edocket.access.gpo.gov/2010/pdf/2010-26049.pdf.

Companies to be forced to plan transactions based on two different insolvency regimes given that they would not know, at the time of extending credit, which regime would ultimately apply as what constitutes a Covered Financial Company is, at least at this point, a moving target that is determined at the time of receivership. And even if "covered financial company" is strictly defined, companies may still never be able to feel comfortable making a predetermination as to their status with respect to a potential future receivership.

If a creditor faces the possibility of two different insolvency regimes, it will have to structure transactions to comply with both. Doing so will raise transaction costs and ultimately raise the costs and lower the availability of credit. Raising the costs and reducing the availability of credit are especially problematic if the rules under OLA producing a different outcome than under bankruptcy law cannot be justified on the grounds that they provide important benefits in controlling systemic risk. In other words, a company may have to plan on being considered a Covered Financial Company even though they may ultimately not be determined to be systemically important. Moreover, a small company that has no reasonable basis for concluding it is a Covered Financial Company may ultimately be acquired by a Covered Financial Company and become subject to OLA.

B. Preferential Transfer Issue

This past December, ASF became aware of an interpretive issue under Section 210(a)(11) of the Dodd-Frank Act relating to the power of the FDIC to avoid preferential transfers. The issue primarily affects the U.S. consumer finance and commercial credit industries and relates to the interpretation of several inconsistent provisions of the Dodd-Frank Act, although the

legislative intent of these provisions appears to be clear. Generally, OLA could be interpreted to give the FDIC, as receiver for a Covered Financial Company, broader powers to avoid certain previously perfected security interests than a trustee (a "Bankruptcy Trustee") under the Bankruptcy Code would have upon a Chapter 7 liquidation of the same Covered Financial Company. As an example, if a Covered Financial Company securitized chattel paper, such as auto loans, and did not deliver the paper to a custodian for the securitization but instead relied on UCC filings for perfection, the FDIC could potentially trump the securitization's lien on the underlying paper and leave the investors in the securitization unsecured. This result would not occur under the Bankruptcy Code. To eliminate the ambiguity in a manner consistent with the legislative intent, ASF suggested in a December 13th letter to the FDIC that these "preference provisions" would benefit from additional rulemaking by the FDIC, or by the issuance of further guidance in the form of a "policy statement" or other release on which the affected industries could rely.[44]

In the letter, we identified an inconsistency in the drafting of the preference provisions of Section 210(a)(11) of the Dodd-Frank Act, which, if read in a certain way, would create a disparity between the treatment of creditors of potential Covered Financial Companies under the Bankruptcy Code and under OLA. Specifically, defining when a "transfer" is "made" by reference to when the rights of a "bona fide purchaser" are superior to the rights of a holder of a previously perfected security interest is a concept which, under the Bankruptcy Code is applied only in the context of fraudulent transfers and of preferential transfers of real property other than fixtures. Under OLA this concept is applied in the context of not only fraudulent transfers

[44] *See* "ASF FDIC Request re OLA," American Securitization Forum (December 13, 2011), *available at* http://asf.informz.net/ASF/data/images/emailattachments/advocacy/asf_orderly_liquidation_letter_to_the_fdic_12_13_10.pdf.

(Section 210(a)(11)(A) of the Dodd-Frank Act) and preferential transfers of real property other than fixtures but also to preferential transfers of personal property and fixtures (Section 210(a)(11)(B) of the Dodd-Frank Act). The result is that the FDIC as receiver for a Covered Financial Company under OLA may have broader powers than does a Bankruptcy Trustee under the Bankruptcy Code to avoid, as preferential transfers, certain previously perfected security interests in personal property and fixtures, even though the transfers are inherently non-preferential.

We requested in the letter that the FDIC issue guidance resolving the ambiguity, and providing that, (1) consistent with the Bankruptcy Code, the "bona fide purchaser" standard for defining when a transfer is "made" will be applied under OLA only with respect to fraudulent transfers and to preferential transfers of real property other than fixtures; (2) the standard found in Section 547(e)(1)(B) of the Bankruptcy Code be applied to determine the timing of transfers of personal property and fixtures and (3) the 30-day grace period to perfect a transfer, found in Section 547(e)(2) of the Bankruptcy Code be applied to preferences under Section 210(11)(B) of the Dodd-Frank Act. Although the statute's drafting inconsistency is a narrow and technical one, we believed, and continue to believe, that the resulting ambiguity is of considerable practical importance to the consumer and commercial credit industries, as many standard practices in these industries have been established and have evolved, in response to, and in reliance on, the well established Bankruptcy Code provisions.

i. Consequences of the Inconsistency for Consumer and Commercial Credit Industries

The ambiguity described above could potentially impact all lending secured by personal property, securitizations of personal property and even sales involving non-possessory interests in personal property where perfection of transfers of such property by possession or other means could trump perfection by filing a financing statement under the UCC[45] or other similar filings or actions under other applicable law. The issue arises most prominently with respect to consumer and commercial credit transactions in which the subject property is characterized under the UCC either as "chattel paper" or as an "instrument." In the securitization industry, this could affect many different asset classes, but would predominantly affect auto and student loans. Specifically, the ambiguity could affect sales[46] of chattel paper or instruments, as well as transactions in which chattel paper or instruments serve as collateral securing a party's obligations if, in either case, the transfer has been properly perfected by filing a financing statement, as permitted under the UCC, and not through possession (which is not required for such proper perfection if perfection has been obtained by filing).

Section 9-102(a)(11) of the UCC defines "chattel paper" to include "a record or records that evidence both a monetary obligation, and a security interest in specific goods ... or a lease of specific goods." Section 9-102(a)(47) of the UCC defines an "instrument" as "a negotiable instrument or any other writing that evidences a right to the payment of a monetary obligation, is not itself a security agreement or lease, and is of a type that in ordinary course of business is

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[45] *See e.g.*, UCC Section 9-330.
[46] Under Section 1-201(37) of the UCC, the term "security interest" includes "any interest of.....a buyer...of chattel paper."

transferred by delivery with any necessary endorsement or assignment." Under the UCC, a security interest in chattel paper or instruments may be properly perfected by filing a financing statement, among other means.

Under the UCC, while the filing of a financing statement would properly perfect a security interest in chattel paper or instruments, such that a "hypothetical lien creditor" could not acquire a security interest in the chattel paper or instrument that is superior to that of the secured party, the filing of a financing statement alone would not prevent a "bona fide purchaser" from acquiring a security interest in the chattel paper or instrument that is superior to that of the secured party.[47] Therefore, while the Bankruptcy Trustee under the Bankruptcy Code *would not* be able to avoid as a preferential transfer a security interest in chattel paper or instruments granted and perfected by means of filing a financing statement at closing or within 30 days of closing, the FDIC under OLA *would* potentially be able to avoid as a preferential transfer that very same security interest.

Upon the avoidance of such transfer, the claim otherwise secured by a properly perfected security interest would become an unsecured claim in the FDIC receivership. As a result, the creditor would receive less than it would have received in a Chapter 7 Bankruptcy Code liquidation of the same company.

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[47] This is a consequence, for chattel paper, of the rule found in Section 9-330(b) of the UCC: "A purchaser of chattel paper has priority over a security interest in the chattel paper which is claimed other than merely as proceeds of inventory subject to a security interest if the purchaser gives new value and takes possession of the chattel paper or obtains control of the chattel paper under Section 9-105 in good faith, in the ordinary course of the purchaser's business, and without knowledge that the purchase violates the rights of the secured party." A good faith purchaser of an instrument who takes possession of it is likewise given priority under Section 9-330(d) of the UCC and, in the case of a negotiable instrument, a holder in due course of the negotiable instrument obtains priority under Section 9-331 of the UCC. None of these purchasers, who rely upon possession of the chattel paper or instrument, have an obligation to conduct UCC searches to discover any filed financing statements in order to obtain priority.

The consequences to the consumer and commercial credit industries – and their creditor counterparties – are further, and indeed greatly, exacerbated by the absence of a "transition rule" for OLA. Many credit facilities, securitizations and sales date prior to the enactment of the Dodd-Frank Act, and were structured in reliance on the certainty of the provisions of the Bankruptcy Code. The documentation, policies and procedures of both the financial companies and their creditors, and the overall architecture of these transactions and programs, depended on the proper and effective perfection achieved by the filing of a UCC financing statement. Although in some instances these existing transactions and programs could now be re-engineered to comply with the "bona fide purchaser" construct applicable to fraudulent transfers and preferential transfers of real property other than fixtures, that is only a partial solution, and one which will be time consuming, difficult and expensive to implement. The delays needed for such implementation would also be expected to adversely affect the liquidity of the affected financed company during the delay, as it will be difficult, if not impossible during the period of delay to enter into new financing facilities, or portfolio sales, which rely on the existing practices.

With respect to programs currently in place, the re-engineering is in any event only a "partial solution." This is due to the look-back provisions of the preference rules. These rules, which provide that a solution, once implemented, is itself a transfer of property of the debtor to or for the account of a creditor on account of an antecedent debt. As a result, the implementation of the solution would not eliminate the creditor's preference risk until the preference period, commencing on the implementation of the solution has past. The general preference look-back period is 90 days, but for transfers among affiliated companies, the look-back period is a year.

Since many consumer and commercial finance companies structure their financing, securitization and secondary-market activities through transfers to subsidiaries, the look-back period arguably could be a year. Accordingly, creditor counterparties will severely discount the efficacy of any proposed solution.

Further, while some types of consumer and commercial credit transactions are documented by "chattel paper" and "instruments", others are not (such others being characterized under the UCC as, for example, "accounts" or "general intangibles"). Sometimes these are different products of the same finance company (for example, certain types of inventory financings), while in other instances they may be the identical product, simply documented in a different way (this is the case in the student loan industry). Under OLA, in some cases a properly perfected security interest could be attacked as a preferential transfer which another very similar transaction could not be. Thus, the effects and the uncertainty to financial companies' creditor counterparties are further magnified

ii. FDIC's General Counsel's Letter I

On December 29, 2010, the FDIC issued a General Counsel's Letter to the ASF in which it provided an interpretation of the OLA provisions of the Dodd-Frank Act that effectively alleviated the concerns outlined in our December 13th letter.[48] The letter acknowledged the inconsistencies between the OLA provisions and the Bankruptcy Code that were highlighted in ASF's letter and concluded that the treatment of preferential and fraudulent transfers under the OLA provisions was intended to be consistent with the related provisions under the Bankruptcy Code. In addition to providing an interpretation, the letter indicated that FDIC staff would

[48] *See* http://www.americansecuritization.com/uploadedFiles/FDICGeneralCounselLetterreOLA-12-29-10.pdf.

recommend to the FDIC Board of Directors that the Board adopt a regulation to the same effect, in consultation with the Financial Stability Oversight Council. At the March 15, 2011 Board Meeting, the FDIC issued a "Notice of Proposed Rulemaking Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act"[49] that, among other things, purports to "ensure that the preferential and fraudulent transfer provisions of the Dodd-Frank Act are implemented consistently with the corresponding provisions of the Bankruptcy Code" and [conform OLA] "to the interpretation provided by the FDIC General Counsel in December 2010."[50] ASF applauds the FDIC for taking action on this critically important issue and attempting to resolve the ambiguity in Title II.

C. Repudiation Power Issue

This past December, ASF became aware of another issue relating to the authority of the FDIC to repudiate contracts under Section 210(c)(1) of the Dodd-Frank Act and the scope of the temporary automatic stay under Section 210(c)(13) of the Dodd-Frank Act. These provisions raise concerns regarding two issues that are crucial not only to the securitization market but to all parties that have financial dealings with a Covered Financial Company or a covered subsidiary thereof: (1) whether a transfer of property by the Covered Financial Company or a covered subsidiary thereof would constitute an absolute sale or a secured borrowing and (2) whether the separate existence of another person or entity would be respected and its assets and liabilities not substantively consolidated with the assets and liabilities of the Covered Financial Company or of any covered financial subsidiary thereof.

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[49] *See* NPR at http://edocket.access.gpo.gov/2011/pdf/2011-6705.pdf.
[50] *See* FDIC Press Release issued March 15, 2011 at http://www.fdic.gov/news/news/press/2011/pr11056.html.

The insolvency laws that would apply to Covered Financial Companies in the absence of OLA are rather clear on these legal-isolation issues, and supply well-established principles for resolving them. Most notable are the decades of precedent that exist under the Bankruptcy Code and in judicial decisions under the Bankruptcy Code. Financial-market participants have relied on these principles and this precedent when transacting business with financial companies that, under the Dodd-Frank Act, may be designated as Covered Financial Companies and subjected to liquidation under OLA. The concern that has emerged is whether the Dodd-Frank Act required that the FDIC, as receiver for a Covered Financial Company or a covered subsidiary thereof, respect and follow these legal authorities as well.

The resolution of this concern, in our view, is clear. As noted previously, under Section 209 of the Dodd-Frank Act, Congress has directed the FDIC to harmonize its rules implementing OLA "with the insolvency laws that would otherwise apply to a covered financial company." The underlying policy rationale behind this desire for harmonization is that Congress wanted to avoid requiring parties engaging in transactions with financial companies and their subsidiaries to be forced to plan transactions based on two different insolvency regimes given that they would not know, at the time of executing the transaction, which regime would ultimately apply. This holds even more true for transactions that were executed before the Dodd-Frank Act was signed into law and that, due to the absence of any transition provision in OLA, could be affected by such a liquidation. We note further in this context that the Senate Report on the Dodd-Frank Act, in its Section on OLA, observes that "the use of this [OLA] authority [is expected to be] very rare. There is a strong presumption that the Bankruptcy Code will continue to apply to most failing financial companies...including large financial companies." Senate Report at 58. Our

concern with respect to the Section 210(c) repudiation authority goes to precisely this point: there are long-standing Bankruptcy Code doctrines which financial companies have been careful to follow in their sale, securitization and other commercial transactions and programs. For those companies to now try to structure transactions to an unknown target, just in case this "very rare" authority may be invoked in the future, appears to us to be costly and unnecessary.

Because of the mandate in Section 209, we believe that the FDIC would be required to respect and follow "the insolvency laws that would otherwise apply to a covered financial company" when addressing any legal-isolation issue under OLA, including in the context of its repudiation power under Section 210(c)(1) of the Dodd-Frank Act and the temporary automatic stay under Section 210(c)(13) of the Dodd-Frank Act.

*i. **FDIC's General Counsel's Letter II***

On January 14th, ASF submitted a letter to the FDIC requesting that the FDIC issue, as promptly as practicable, a letter from the Acting General Counsel to the effect that:

(a) The FDIC as receiver for a covered financial company shall not, in the exercise of its statutory authority to disaffirm or repudiate contracts, reclaim, recover, or re-characterize as property of the covered financial company or the receivership financial assets transferred by the covered financial company, provided that such transfer satisfies the conditions for a legal true sale as applied in the law defining property of the estate under the Bankruptcy Code.

(b) The Act does not itself contain any provision which would mandate a different approach or analysis regarding the factors or circumstances under which

> the separate existence of one or more legal entities would properly be disregarded than the existing approach or analysis under the Bankruptcy Code.[51]

In response to ASF's Request, the FDIC issued a General Counsel's Letter on January 14th addressing the concerns raised in ASF's request.[52] In the letter, the FDIC clarified that its repudiation power under the OLA provisions of the Dodd-Frank Act would be exercised consistent with the U.S. Bankruptcy Code or other applicable insolvency laws, including bankruptcy- and State-law principles governing legal isolation, on an interim basis until 90 days after the FDIC Board of Directors adopts a regulation to formally address the matter, or until at least June 30, 2011. Again, we applaud the FDIC for its quick action to patch this issue that the market so desperately needed. However, we believe that a legislative solution is necessary to achieve certainty in the market once the interim relief expires and stand ready to endorse a bill that requires the OLA provisions to be exercised consistent with the U.S. Bankruptcy Code or other applicable insolvency laws, including bankruptcy- and State-law principles governing legal isolation. Such a bill would be consistent with the legislative intent that (i) "a creditor shall, in no event, receive less than the amount that creditor is entitled to receive" if the FDIC "had not been appointed receiver with respect to [a] covered financial company; and the covered financial company had been liquidated under chapter 7 of the Bankruptcy Code"[53] and (ii) the FDIC "seek to harmonize applicable rules and regulations promulgated under [OLA] with the insolvency laws that would otherwise apply to a covered financial company."[54] Such a bill would also

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[51] *See* http://www.americansecuritization.com/uploadedFiles/ASF_Orderly_Liquidation_Letter_to_the_FDIC_1_14_11.pdf.

[52] *See* http://www.americansecuritization.com/uploadedFiles/GC_Letter_to_ASF_1_14_2011.pdf.

[53] *See* Sections 210(a)(7)(B) and (d)(2)(B) of the Dodd-Frank Act.

[54] *See* Section 209 of the Dodd-Frank Act.

avoid the situation where parties extending credit to potential Covered Financial Companies would be forced to plan transactions based on two different insolvency regimes given that they would not know, at the time of extending credit, which regime would ultimately apply.

Finally, we are also concerned about the potential for the FDIC to reach beyond the clear intent of Dodd-Frank and use its OLA power to implement conditions for non-banks that are similar to the ones prescribed for the FDIC Safe Harbor for Banks. ASF submitted multiple comment letters with respect to the FDIC's Advanced Notice of Proposed Rulemaking and Notice of Proposed Rulemaking regarding the FDIC Safe Harbor. ASF and its membership continue to strongly oppose linking a determination of whether financial assets have been legally isolated in the case of receivership to preconditions addressing capital structure, disclosure, documentation, origination and compensation. Under the FDIC Safe Harbor for banks, investors will bear the burden of the loss of the safe harbor if any of the securitization preconditions are not satisfied by the issuer or sponsor. Investors in securitization should bear risks associated with the assets underlying a securitization but not risks associated with the originator, who may or may not subsequently be deemed to be a Covered Financial Company.

VII. Rating Agency Reform

A. The Repeal of Rule 436(g)

Upon the effective date of Dodd-Frank last summer, Rule 436(g) under the Securities Act was repealed, which caused the complete shutdown of the U.S. public securitization market. ASF immediately began discussions with SEC staff to help alleviate the problem. The market

paralysis was partially mitigated through the grant of temporary no-action relief by the staff of the SEC on July 22, 2010.[55] The no-action letter relief was then extended indefinitely on November 23, 2010.[56] ASF applauds the SEC's decision to issue the no-action letters but believes a permanent, comprehensive solution is needed to ensure the long-term viability of the U.S. public securitization markets.

i. Regulatory and Legislative History of Rule 436(g)

Rule 436(g) of the Securities Act is often referred to as the NRSRO expert exemption because its effect is to exempt NRSROs from liability as experts for their ratings under Section 11 of the Securities Act. Section 939G of the Dodd-Frank Act provides that "Rule 436(g) promulgated by the SEC under the Securities Act, shall have no force or effect" (the "Repeal of Rule 436(g)").

If the ratings of registered ABS are a condition to the issuance or sale of such ABS, Item 1103(a)(9) and Item 1120 of Regulation AB[57] require disclosure in the statutory prospectuses of the minimum rating required and the identity of each rating agency issuing the ratings (regardless of whether the entity is an NRSRO).[58] Currently, investors expect that the ABS they purchase from underwriters will have specific ratings. For most senior investors, their investment guidelines require certain investment grade ratings to be available before that investor may purchase a particular security. For this reason, ABS underwriting agreements (pursuant to which the underwriters commit to purchase the ABS from the issuer (or the depositor)) have, as a

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[55] *See* http://www.americansecuritization.com/uploadedFiles/SEC_NAL_July2010.pdf.
[56] *See* http://sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm.
[57] 17 C.F.R. §§229.1100 - 229.1123.
[58] See Item 1103(a)(9) and Item 1120 of Regulation AB.

closing condition, the receipt of evidence that the rating agencies have assigned specific ratings. As a result, under Regulation AB, ABS issuers must disclose in the statutory prospectus the ratings that are a condition to the issuance or sale of the ABS and the identity of the rating agency issuing the rating. In addition, in response to comments received from SEC staff during the review process, certain issuers using shelf registration statements include a statement to the effect that the ABS must be rated investment grade at the time of issuance.

Rule 436(g) specifically provided that credit ratings issued by NRSROs (but not other credit rating agencies) on debt securities, convertible debt securities and preferred stock were *not* considered part of the registration statement prepared or certified by a person within the meaning of Sections 7 and 11 of the Securities Act. Section 7 of the Securities Act requires any accountant or person whose profession gives authority to a statement made by him (often referred to as an "expert") who is named as having prepared or certified any part of the registration statement, or who is named as having prepared or certified a report for use in connection with the registration, to file a written consent with the registration statement. Because Rule 436(g) specifically provided that ratings issued by NRSROs were not considered part of the registration statement prepared or certified by a person within the meaning of Section 7, prior to the repeal of Rule 436(g), NRSROs were specifically exempt from the Section 7 requirement to file a written consent.

Because NRSROs did not file consents as experts, they were not subject to the strict liability under Section 11 of the Securities Act for the ratings included in a registration statement. Section 11 imposes liability *over and above* that which would apply under common law or under Rule 10b-5 of the Exchange Act on those who are involved in the preparation of the registration

statement. Section 11 of the Securities Act applies to any person that signs the registration statement, directors of the issuer, underwriters and "experts" who have been named in the registration statement as having prepared or certified any part of the registration statement or any report or valuation used in connection with the registration statement that provided their consent for filing with a registration statement. Therefore, although Item 1103(a)(9) and Item 1120 of Regulation AB require disclosure of the ratings that are a condition to the sale or issuance of the ABS and the identity of the rating agency (and, in some cases, the issuer agreed to disclose that the ABS must be rated investment grade at the time of issuance), Rule 436(g) specifically exempted NRSROs from the consent requirement under Section 7 of the Securities Act. This, in turn, meant NRSROs were not subject to Section 11 of the Securities Act, which imposes civil liability on experts providing a consent for filing with a registration statement.

ii. Implications of the Repeal of Rule 436(g) on the Securitization Market

We note that while many believe that registrants would be able to comply with the disclosure requirements of Items 1103(a)(9) and 1120 without triggering the Section 7 consent requirement, from the time of enactment of Dodd-Frank last year, no ABS public market participant was comfortable from a legal standpoint moving forward on this basis until provided with guidance from the SEC in the form of a no-action letter.[59] Given the uncertainty with

[59] Many members of the ASF believe that the disclosure required under Item 1103(a)(9) and Item 1120 of Regulation AB does not trigger a requirement to file a consent, consistent with the SEC's statements in its October 2009 concept release on the proposed rescission of Rule 436(g) (*available at* http://www.sec.gov/rules/concept/2009/33-9071fr.pdf and http://www.sec.gov/rules/concept/2009/33-9071afr.pdf). In that release and the companion release on disclosure of credit ratings (*available at* http://www.sec.gov/rules/proposed/2009/33-9070fr.pdf and http://www.sec.gov/rules/proposed/2009/33-9070afr.pdf) the SEC said that the proposed disclosure requirement and regarding credit ratings "would not be triggered if the only disclosure ... is related to ... the terms of agreements that refer to credit ratings..." and that the SEC "preliminarily believe[d] that a consent would not be required for such disclosure." This statement would

respect to the applicability of the Section 7 consent requirement, with the repeal of Rule 436(g) under the Securities Act, if and when the SEC staff issues guidance contrary to the current 436(g) no-action letter, public issuance of ABS would again shut down unless issuers obtain the consent of the NRSROs rating the securities. Several of the NRSROs continue to study this matter but have expressed concern with the scope and magnitude of Section 11 strict liability attached to their being considered an "expert." Section 11 liability is considered "strict," which would create potential enterprise liability for any NRSRO, given that the damages could be so significant. Moreover, a rating is a forward looking assessment of expected performance that could be construed or litigated as an expert 'prediction' or 'estimation' of performance. In ABS transactions, the Section 11 liability that attaches to issuers and underwriters is grounded in historical information and facts that are verifiable (and hence not 'predictions' of what may occur in the future). This concern is consistent with comments previously made by the NRSROs to the SEC in connection with proposals that would have subjected NRSROs to the consent requirement, and therefore, increased liability.

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appear to cover reference to an underwriting agreement that has a closing condition that the securities receive a minimum rating from an identified rating agency required under Item 1103(a)(9) and Item 1120 of Regulation AB.

Additionally, we note that because the required disclosure only includes the minimum required rating (and in some cases, a statement that the securities must be rated investment grade) and *not* the rating itself, Section 7 of the Securities Act is not implicated under the SEC's own position that "[t]he consent requirement in Securities Act Section 7(a) applies only when a report, valuation or opinion of an expert is *included or summarized* in the registration statement and attributed to the third party and thus becomes 'expertised' disclosure for purposes of Securities Act Section 11(a), with resultant Section 11 liability for the expert...." (emphasis added). See SEC Compliance and Disclosure Interpretations, Question 141.02. The condition to issuance or the ratings requirement is just that, a condition or a requirement, not the inclusion or summary of a report of an expert, not even the attribution of a statement to an "expert."

For the most part, credit ratings perform an invaluable role in our financial system. They allow investors to sort the universe of potential debt investments into categories of relative riskiness and allow a starting point from which investors can more efficiently perform their own level of due diligence. Without ratings, the markets would lose an effective sorting devise, investors would not have a point of origin for their own due diligence, and disorder would likely result. Redundant replication would replace specialization, and impede the efficiency of capital markets operations, which in turn would slow the formation and reduce the flow of credit into our economy. Again, credit ratings should not be the only source of information, but instead should be one of a number of inputs into an overall assessment of value.

In fact, other provisions in Dodd-Frank require investors to be less reliant on the ratings agencies and to engage in greater independent analysis. But this is like requiring a person to wear belts and suspenders, while knowing the very act of requiring both results in there being no pants to wear, as we saw in the disappearance of the offering of ABS in July 2010.

Given these concerns, it appears most, if not all, of the NRSROs would not be in a position to provide the written consent arguably required by Section 7 in the case where the SEC staff were to no longer provide the current 436(g) no-action relief. Additionally, if the SEC staff were to issue guidance to effectively eliminate the current relief, any transition period afforded the NRSROs may not provide the NRSROs sufficient time to adjust to the new environment by creating and implementing policies and procedures relating to their issuance of consents, including the planning and execution of the "reasonable investigation" contemplated by Section 11(b)(3)(B) of the Securities Act or the installation of related internal supervisory controls. Moreover, it is unclear at this time if, regardless of the length of any implementation period, any

NRSRO would agree to provide a written consent for filing with a registration statement given the associated liability of their statements. Instead, one or more NRSROs may elect to cease rating publicly issued ABS. Given the investor demands in the ABS market for ratings on ABS (and the current requirement that the ABS be rated investment grade to be offered on a shelf registration basis), we believe this would likely bring the public ABS markets to a standstill at any moment if the SEC staff were to eliminate the relief provided by the current 436(g) no-action letter. The ASF actively supports the effort to create a sustainable securitization market and believes the intersection of the Repeal of Rule 436(g) and a renewed enforcement of Item 1103(a)(9) and Item 1120 of Regulation AB would result in a market paralysis, similar to the one that occurred in the initial days after passage of the Dodd-Frank Act, that is damaging to market participants, investors and consumers alike.

iii. ASF Proposed Solutions to These Implications

a. Amend Regulation AB to Eliminate Required Ratings Inclusion

One potential permanent solution to this situation is that Item 1103(a)(9) and Item 1120 of Regulation AB could be amended to be accompanied by an instruction that the specific ratings and rating agencies are not required to be disclosed in statutory prospectuses and that no consent of the rating agency is required in these circumstances. In fact, in testimony question and answer on March 10, 2011, before a House Government Oversight and Reform Subcommittee hearing, the Chairman of the SEC, Mary Schapiro, indicated that the SEC "staff is working through a reconsideration of our disclosure requirements [for ABS], and I believe that they will

recommend that we eliminate our pre-existing requirement for including the ratings, and therefore the liability provisions can go forward."

b. Legislation to Repeal the Repeal of Rule 436(g)

Although we endorse amending Regulation AB, we emphasize our membership's continued preference for a legislative fix to repeal the repeal of Rule 436(g) as the best policy for eliminating the unwanted effects of Dodd-Frank Section 939G. If ratings are to be conveyed to investors, issuers should have the ability to convey these ratings to investors as part of the primary, comprehensive offering documents (statutory prospectuses), rather than through assorted ancillary communications such as free writing prospectuses. Moreover, a regulatory fix, such as the foregoing proposal, would impose an additional burden on the SEC to pursue its regulatory authority in order to negate the harmful effects of this Section of the legislation, at a time when the SEC is already inundated with the task of undertaking the large-scale rulemakings required by Dodd-Frank. In contrast, at a critical time for consumers, businesses and the U.S. economy, we believe that an act by Congress to repeal this Section would provide the most straightforward and effective way to remove a key barrier that remains to resuming the normal flow of credit in America. On April 14, 2011, Representative Steve Stivers (R-OH), a member of the House Committee on Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises, introduced the "Asset-Backed Market Stabilization Act of 2011," which would reinstate Rule 436(g) of the Securities Act. The bill was co-sponsored by Representatives Jim Rennaci (R-OH) and Hansen Clarke (D-MI). ASF and our members support this bill.

B. Ratings Alternatives

Section 939A of the Dodd-Frank Act requires the federal agencies within 1 year of enactment to review regulations that (1) require an assessment of the credit-worthiness of a security or money market instrument and (2) contain references to or requirements regarding credit ratings. In addition, the agencies are required to remove such references and requirements and substitute in their place uniform "standards of credit-worthiness," where feasible.

ASF agrees with the goal of reducing overreliance on credit ratings. Such reliance was a factor leading to the financial crisis, and we support sensible efforts to ensure that investors do not use credit ratings to the detriment of their own independent risk review and analyses of the ABS they purchase. However, we share many of the concerns expressed by members of the federal banking agencies, both before and after enactment of the Dodd-Frank Act, as to the wisdom and feasibility of completely eliminating the use of credit ratings in regulations that include capital requirements at this time. We appreciate that the federal banking agencies have permitted for the formulation of comments by interested parties in various proposals in response to a legislative mandate that they did not initiate, and we hope that in implementing Section 939A they will address the issues expressed in our articulated concerns. We acknowledge that devising alternatives to the use of ratings will be challenging and believe that neither the federal agencies nor the industry would be well-served by replacing such ratings as a measure of creditworthiness with an inferior alternative.

i. Ratings Alternatives for Regulatory Capital

a. Overview

On August, 25, 2010, the FDIC, FRB, OCC and OTS released their "Advance Notice of Proposed Rulemaking Regarding Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies" (the "ANPR") to modify their risk-based capital regulations to remove references to credit ratings and substitute other standards of creditworthiness, as mandated by Dodd-Frank Section 939A.[60] On October 25, 2010, ASF submitted a comment letter in response to the agencies' ANPR which was developed by the ASF Ratings Alternatives Taskforce.[61] The ASF Ratings Alternatives Taskforce has continued to develop a proposed new methodology for calculating regulatory capital for securitization exposures and has held ongoing dialogues with the banking regulators regarding this proposal.[62]

The current risk-based capital regulations for U.S. banking organizations consist of multiple approaches depending upon the type of banking organization, the type of exposure and whether the exposure is in the banking or trading book. In contrast to the risk-weighting methodology for non-securitization exposures, *all* of the current approaches for determining

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[60] 75 Fed. Reg. 52283 (Aug. 25, 2010). ASF's viewpoints expressed herein focus on the portion of the ANPR dealing with securitization exposures and are not intended to comment on other aspects of the ANPR.

[61] *See* "ASF Ratings Alternatives ANPR Comment Letter," American Securitization Forum (October 25, 2011), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_Ratings_Alternatives_ANPR_Comment_Letter_10-25-10.pdf.

[62] *See* "ASF Proposal for Calculating Risk-Based Capital for Securitization Exposures: General and Advanced Approach Examples," American Securitization Forum (March 30, 2011), *available at* http://www.americansecuritization.com/uploadedfiles/ASF939AAutoandMortgageExamples032511.pdf; *see* "ASF Proposal for Calculating Risk-Based Capital for Securitization Exposures: Meeting with FDIC and FRB Staff," American Securitization Forum (January 31, 2011), *available at* http://asf.informz.net/ASF/data/images/asf_proposed_approach_re_939a_1.31.11.pdf; *see* ASF letter to FRB Staff (February 16, 2011), *available at* http://www.americansecuritization.com/uploadedFiles/2_16_11_ASF_Response_Letter_re_RatingsAlternatives.pdf.

capital charges for securitization exposures in the banking book either require (in the case of banking organizations that are subject to the Risk-Based Capital Standards: Advanced Capital Adequacy Framework-Basel II; Final Rule) or permit (in the case of other banking organizations) external credit ratings to be used, when available, to assign an appropriate risk-weight to the exposure.[63] Since most securitization exposures that banking organizations invest in are externally rated, external ratings are currently the main determinant of the risk-based capital charge for such exposures.[64] Accordingly, elimination of credit ratings from the federal agencies existing risk-based capital for securitization exposures will have far-reaching effects on banking organization securitizations and on the securitization markets generally.

With the effect of Dodd-Frank 939A, U.S. banking organizations' options to calculate regulatory capital for securitizations under Basel II have been reduced from four to two methodologies.[65] This is significant as the remaining two methodologies are either Supervisory Formula Approach ("SFA") or full capital deduction. As will be described in more detail later, SFA does not work for investors and lenders in securitizations. Therefore, if SFA cannot be used, then regulatory capital required to be held is full deduction. This requirement would lead U.S. banking institutions to exit current and future investments in securitizations.

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[63] Under the Agencies' Basel II rules (and subject to certain conditions) risk weights range from 7% (for AAA-rated senior exposures with underlying granular pools) to 650% (for BB- - rated exposures). *See, e.g.*, 12 C.F.R. Part 3, Appendix C, Table 6. Under the Agencies' general risk-based capital rules (and subject to certain conditions), risk weights range from 20% for AAA-rated exposures to 200% for BB-rated exposures. *See, e.g.* 12 C.F.R. Part 3, Appendix A, Table C.

[64] In addition, the Agencies' general risk-based capital rules and Basel II rules permit banking organizations to determine the risk-based capital charge for certain unrated exposures to asset-backed commercial paper programs by using internal models that are calibrated to external credit ratings (under the general rules) or using publicly available rating agency criteria (pursuant to the so-called internal assessment approach ("IAA") of the Basel II rules). *See, e.g.*, 12 C.F.R. Part 3, Appendix A, Section 4(g); 12 C.F.R. Part 3, Appendix C, Section 44.

[65] See Attachment B for a detailed decision tree.

We agree with the federal bank agencies that the principles that should guide the selection of any measurement of creditworthiness ("Policy Objectives") are promoting risk management, adequately capturing the risks of particular exposures, providing for timely and accurate measurement of changes in creditworthiness and minimizing opportunities for regulatory arbitrage. We have formed the following "guiding principles" that we believe are well-aligned with the Policy Objectives and, accordingly, should be embodied in any alternative creditworthiness standards.

Any alternative should:

- Promote understanding by banking organizations of the risks associated with their securitization exposures;
- Focus on (i) actual performance of assets, which is the primary driver of the performance of an ABS and (ii) the credit support available to a given risk position within an ABS structure after factoring in the assets' performance;
- Function to facilitate dynamic and timely adjustment of capital in a manner that is consistent with and proportionate to changes in asset performance and the resulting risk profile of a given exposure; and
- Be premised on data that is available to all market participants and should otherwise comport with standard market practices so that all participants have the option of performing the necessary calculations.

Although we agree with the federal banking agencies that any alternative should not be overly complex and that results should be replicable across banking organizations, simplicity should not come at the expense of the factors set forth above. Recognizing that approaches that are appropriate for banking organizations with sophisticated internal systems and controls may not be appropriate for smaller, less sophisticated banking organizations, we believe that there should be room for diversity of alternatives based on the size and sophistication of the relevant banking organization. A key focus of all approaches should be to ensure that all banking organizations have sufficient information, and conduct sufficient diligence, to understand the risk of their exposures. Further, banking organizations should not be improperly motivated to make investment decisions based on capital charges that are not consistent with the actual risk of the investment.

We believe that, as an additional Policy Objective, it is critical that any creditworthiness standard avoid putting U.S. banking organizations at a competitive disadvantage relative to their non-U.S. competitors who operate under the Basel II framework. As discussed above, under that framework, banking organizations must use external ratings to establish the capital charge for a securitization exposure if the exposure has an external rating or if one can be inferred.[66] As further discussed below, all of the alternative creditworthiness standards set forth in the ANPR (the "ANPR Alternatives") that the federal banking agencies have described in enough detail to make comparisons possible (the "Quantifiable ANPR Alternatives") will result in risk weights that far exceed those under the Basel II framework, thereby subjecting U.S. banking

[66] One or more ratings are required in the case of investing banks; two or more ratings are required in the case of originating banks.

organizations to significantly higher capital charges for securitization exposures than apply to non-U.S. banking organizations under that framework.

As further discussed below, we are concerned that by basing the calculation of capital charges for securitization exposures on risk-insensitive approaches, the Quantifiable ANPR Alternatives do not achieve, and could actually undermine, the Policy Objectives. Because they disproportionately focus on structure and do not adjust to reflect expected asset performance, they would not adequately capture the risk of particular securitization exposures or provide for timely and accurate measurements of changes in creditworthiness. As a result, the Quantifiable ANPR Alternatives would undermine, rather than enhance, incentives for banking organizations to understand the risk of their ABS investments or exposures. We believe more risk-sensitive approaches are needed to avoid encouraging investment in higher risk assets. Punitive new capital charges resulting from risk-insensitive assessments will also result in U.S. banking organizations foregoing securitization as a funding technique, which will impede their ability to make new loans and decrease the availability of credit in the overall economy at a time when credit remains severely constrained. Further, they will discourage banking organizations from using securitization to manage credit risk and liquidity.

Because credit ratings are so integrated into the current methodology for establishing risk-based capital charges for securitization positions, an abrupt change from credit rating-based capital charges could be extremely disruptive to banking organizations and to the capital markets generally, and runs a high risk of unintended consequences. For example, elimination of credit ratings from the risk-based capital rules could have a significant impact on liquidity in the ABS markets which rely upon the ability of investors to make real-time decisions at the point of initial

offering or subsequent secondary market purchase. While many non-money center banking organizations have the capacity to understand the basis for credit ratings and to perform their own supplemental diligence at that time, they may not have the capacity to perform more extensive real-time analysis. Accordingly, removing credit ratings from the risk-based capital rules may eliminate the ability of a large number of banking organizations to participate in the ABS markets, substantially reducing market liquidity. This could lead to a decline in market values, forced selling, and reduced credit in the overall economy.

Despite recent criticism of rating agencies, ratings continue to provide objective third-party assessments of ABS that are transparent and easily replicable and that banking organizations should be able to use, together with other analysis, in determining the capital charge that will result from an ABS position.[67] The numerous rating agency reforms contained in the Dodd-Frank Act and in SEC regulations, together with those taking place internationally, will continue to improve the ratings process.[68] Rating agencies have also voluntarily taken

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[67] It is therefore not surprising that the Federal Reserve continues to use ratings as a criteria for accepting ABS and other structured finance products at its discount window and used ratings as a criteria for ABS to be eligible for loans under its Term Asset-Backed Loan Facility ("TALF"). See Discount Window and Payment System Risk Collateral Margins Table, *available at* http://www.frbdiscountwindow.org/discountmargins.xls (discount window) and Term Asset-Backed Securities Loan Facility: Terms and Conditions, *available at* http://www.ny.frb.org/markets/talf_terms.html.

[68] The Dodd-Frank Act provides the SEC with greater enforcement and examination authority over rating agencies by, among other things, creating an Office of Credit Ratings ("OCR") within the SEC to promote rating agency accuracy and independence. The OCR will have the power to administer SEC rules with respect to rating agency practices, conduct annual examinations of the rating agencies, and impose fines and other penalties for violations of SEC rules. The Dodd-Frank Act also requires the rating agencies to make extensive disclosures regarding their ratings methodologies and the data relied upon to determine their ratings, as well as information that can be used by investors to better understand credit ratings of each class. Further, by repealing the SEC's Rule 436(g), the Dodd-Frank Act introduces the possibility of exposing the rating agencies to liability as experts with respect to ratings disclosed in prospectuses. Separate and apart from the Dodd-Frank Act, the SEC has issued Rule 17g-5, which requires issuers of structured finance products to provide other interested rating agencies with access to the information they give to the rating agencies hired to rate their product. Steps undertaken in the European Union include mandatory registration of all credit rating agencies and the adoption of a comprehensive set of regulations aimed at ensuring the quality and transparency of ratings and prohibiting rating agency conflicts of interest. The European Commission has also proposed the introduction of centralized oversight of the rating agencies under the new European Securities and Markets Authority (which would have the power to request information, conduct

significant steps to improve such process, particularly for ABS.[69] We believe that all of these factors argue against eliminating ratings as a creditworthiness standard without an alternative that is both practical and achieves the Policy Objectives.

Despite past issues with credit ratings, there is a broad consensus among policymakers, both in the United States and abroad, that the best way to address those issues is to regulate, rather than prohibit, the use of credit ratings for capital and other regulatory purposes and to improve the regulation and supervision of the credit rating agencies themselves.[70]

As Acting Comptroller of the Currency John Walsh recently testified:

> the prohibition against references to ratings in regulations under section 939A goes further than is reasonably necessary to respond to these issues. Rather than disregard credit ratings, it may be more appropriate to assess their strengths and weaknesses and to supplement ratings with additional analysis in appropriate cases. We suggest that section 939A be amended to direct regulators to require that ratings-based determinations be confirmed by additional risk analysis in circumstances where ratings are likely to present an incomplete picture of the risks presented to an

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investigations and perform on-site examinations) and a rule similar to the SEC's Rule 17g-5 that would require disclosure to other interested rating agencies of the information given to a rating agency hired to rate a structured finance product.

[69] *See* International Monetary Fund, The Uses and Abuses of Sovereign Credit Ratings, Global Financial Stability Report, Chpt. 3 (Oct. 2010), *available at* http://www.imf.org/External/Pubs/FT/GFSR/2010/02/pdf/chap3.pdf ("IMF Report").

[70] IMF Report, p 9.

institution, or where those risks are heightened due to concentrations in particular asset classes.[71]

Internationally, regulators continue to permit the use of credit ratings for capital and other regulatory purposes, but have imposed additional requirements on their use and increased credit rating agency regulation. For example, the new Article 122A(a)(4) of the EU Capital Requirements Directive (which implements Basel II in the EU) requires banking organizations to perform their own stress tests appropriate for securitization positions, but provides that they may rely upon models developed by the credit rating agencies if they can demonstrate, when requested, that they took due care prior to investing to validate the relevant models and to understand their methodology, assumptions and results.[72] The rest of the EU Capital Requirements Directive likewise continues to implement Basel II with extensive use of credit ratings from the rating agencies. The Basel Committee's June 2010 revisions to its market risk framework[73] continue to permit banking organizations to use credit ratings, as does its July 2009 paper on increased risk weights for resecuritization exposures[74] (which also adds additional requirements to ensure appropriate diligence in connection with their use). The Basel

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[71] *See* Testimony of John Walsh, Acting Comptroller of the Currency, before the Committee on Banking, Housing and Urban Affairs, United States Senate (September 20, 2010), Attachment A, p. 2-3 *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=45d8ba0b-04b1-41d6-b5b5-2008c0cc72d9&Witness_ID=b6b6249a-799f-44e7-aecd-2fe30fa9b172.

[72] Committee of European Banking Supervisors, Consolation Paper on Guidelines to Article 122a of the Capital Requirements Directive (CP 40), para. 4 at p. 28 (July 1, 2010), *available at* http://www.c-ebs.org/documents/Publications/Consultation-papers/2010/CP40/CP40.aspx. A similar approach has been suggested by others. *See e.g.*, Richardson and White, "Fixing the Rating Agencies," *available at* http://whitepapers.stern.nyu.edu/summaries/ch03.html (urging that, following the removal of ratings from statutes and regulations, "regulated financial institutions [should] be free to take advice from sources they considered most reliable" but should have to be able to justify the choice to their regulators).

[73] Basel Committee on Banking Supervision, Changes to the Revisions to the Basel II Market Risk Framework (June 18, 2010), available at http://www.bis.org/press/p100618/annex.pdf and Revisions to the Basel II Market Risk Framework (July 13, 2009), *available at* http://www.bis.org/publ/bcbs158.pdf.

[74] Basel Committee on Banking Supervision, Enhancements to the Basel II Framework (July 13, 2009), available at http://www.bis.org/publ/bcbs159.htm.

Committee's Basel III proposals also reference credit ratings, although they indicate that the Basel Committee is undertaking a review of the Basel II framework for securitization exposure which may result in revised capital charges and a reconsideration of the requirement to use credit ratings where a credit rating exists.[75] Also under consideration is a requirement for credit rating agencies to comply with the requirements of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies[76] in order for their ratings to be used for Basel II purposes.[77]

b. ASF Proposed Solutions

Given the above considerations, ASF believes that the federal banking agencies should consider a regulatory framework that permits the use of two different approaches for establishing capital charges for securitizations exposures: a "general approach," that would set capital charges based on third-party inputs and, for banks that have more sophisticated credit risk evaluation capabilities, an "advanced approach" which would allow such organizations to use models and internal analyses to establish capital requirements for such exposures, subject to verification and oversight by the banking regulators. Under both approaches, banking organizations would classify securitization exposures into risk categories which would be mapped to appropriate risk weight percentages. Actual risk weights for each risk category may vary between the general and advanced approaches described below.

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[75] Basel Committee on Banking Supervision, Strengthening the Resilience of the Banking Sector, Consultative Document, para 198 at p. 59 (Dec. 2009), *available at* http://www.bis.org/publ/bcbs164.pdf?noframes=1; Basel Committee on Banking Supervision, International Framework for Liquidity Risk Measurement, Standards and Monitoring (Dec. 17, 2009), *available at* http://www.bis.org/publ/bcbs165.pdf.

[76] International Organization of Securities Commissions (IOSCO), Code of Conduct Fundamentals for Credit Rating Agencies (May 2008), *available at* http://iosco.org/.

[77] IMF Report, p. 9.

1. General Approach

Under the general approach, a banking organization would, subject to appropriate due diligence requirements and Agency supervision, be permitted to use inputs derived from or provided by a third party (which could include credit rating agencies) to calculate capital charges for securitization exposures (whether rated or unrated). Such inputs could include expected loss, the level of credit enhancement (whether provided by structural features or the price at which the assets were purchased) and other structural elements which affect the overall risk profile of the exposure. Banking organizations would then map such inputs to a risk category which would be used to determine the risk-based capital charge.

It is important to note that this is not a replication of a ratings-based approach; rather, inputs provided or derived from third parties would form the basis of the assignment to a risk category, and these inputs could be sourced from a variety of third parties. While Section 939A of the Dodd-Frank Act requires the federal banking agencies to remove references to rating agencies in their regulations, we do not read it as prohibiting the agencies from allowing banking organizations to use properly supplemented third-party inputs to establish capital charges.

The federal banking agencies already have in place safety and soundness standards that banking organizations are required to follow before they invest in ABS and other complex instruments or otherwise assume exposure to securitizations.[78] Such standards require banking organizations to conduct appropriate diligence and to be able to demonstrate an adequate understanding of the securitization exposures they invest in or otherwise assume. To the extent

[78] *See, e.g.*, Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities, 63 Fed. Reg. 20191 (May 26, 1998); OCC Bulletin 2009-15.

appropriate, such standards could be enhanced to ensure that banking organizations conduct proper diligence to understand the applicable third-party inputs. Banking organizations that are not able to demonstrate that they have complied with such standards could be subjected to higher capital charges.

2. Advanced Approach

ASF believes that the soundest alternative for many banking organizations, and the one most consistent with the objectives of Section 939A and with the Policy Objectives, would be to allow such organizations to use their own internal systems, subject to Agency approval, oversight and supervision, to assign securitization exposures (whether rated or unrated) to defined risk categories. These categories would be mapped to risk weight percentages that are consistent with international standards for assets with similar risk characteristics. We believe that this consistency is critical to maintaining a competitive landscape between U.S. and foreign banking organizations. Enhancements to risk management systems and controls resulting from Basel II and the agencies' Supervisory Capital Assessment Program ("SCAP"),[79] along with the new requirement in Title I of the Dodd-Frank Act that the Federal Reserve Board, in coordination with the federal banking agencies, perform annual stress tests on systemic banking organizations,[80] all suggest that this should be a viable approach for many institutions and that consistency of results among institutions (a possible issue when internal systems are used) should be addressable. Such an approach would enable banking organizations to model exposures more extensively and would lead to capital charges that better differentiate risk based

[79] *See* Federal Reserve Board, Supervisory Capital Assessment Program Design and Implementation (Apr. 24, 2009), *available at* http://www.federalreserve.gov/bankinforeg/bcreg20090424a1.pdf.
[80] Dodd-Frank Act, Section 165(i).

on differing structures and underlying exposures. It would also provide the federal banking agencies with a better understanding of how similar risk exposures are being assessed across multiple banking organizations, thereby leading to greater transparency with respect to the adequacy of each organization's systems and controls. Such approach could also lessen systemic risk that can result when all banking organizations use identical, simple models for assessing capital (*i.e.*, risk that all such organizations act in the same manner at the same time with respect to such exposures).

A banking organization's internal assessment of its securitization exposures should consider expected losses on the underlying assets according to its own cash flow analyses, amount and type of credit enhancement, seller/servicer risk analysis, priority of exposure in the cash flow waterfall, and other financial and structural parameters.

ASF believes it is important for the new rules to allow for the use of models as part of a robust process to assess the risk of an exposure. Models are a core part of industry methodology and best practices actively employed by the leading risk managers in the industry. ASF's proposed solution defines a robust process that integrates modeling, comparison of outputs, and verification by the agencies in a standardized manner across banking organizations.

Banking organizations using the Advanced Approach could be required to meet certain predefined criteria including that (i) the use be based on a foundation of generally accepted credit risk evaluation metrics, (ii) internal assessments used for purposes of determining capital requirements not differ from assessments used in the organization's risk management process, and (iii) assessments be subject to periodic reevaluation. The federal banking agencies would be

able to review the underlying models with a view to assuring the transparency and consistency of the resulting capital charges across banking organizations. In addition, banking organizations that are unable to demonstrate that they have adequately complied with these criteria on a consistent basis could be required to use the general approach.

Additionally, since November 29, 2001 (the date of the adoption by the federal banking agencies of their so-called "Recourse Rule" for securitization exposures[81]), all U.S. banking organizations have been eligible to use the external ratings-based approach for securitization exposures. That approach was adopted to address the failure of the federal banking agencies' then-existing Basel I Rules, which did not foster prudent risk management, to adequately take account of the different risks presented by various positions in a securitization.

Subsequent changes to the U.S. risk-based capital rules, including the adoption of the Advanced Internal Ratings Based Approach of the Basel II framework for certain banking organizations[82] and the proposal to adopt the Basel II's standardized approach as an option for others, have all been aimed at increasing the risk-sensitivity of the capital rules to better align capital charges with potential economic loss and encourage improvements in risk management.

In the ANPR, the agencies propose a number of alternatives to the use of ratings to establish the risk-based capital charges for securitization exposures. These include (i) a pre-Recourse Rule approach under which all securitization exposures in a transaction would receive the same risk-weight (the "one-size-fits-all approach"); (ii) simple and more complex "gross-up approaches" under which banking organizations would maintain capital based on the

[81] 66 Fed. Reg. 59617 (Nov. 29, 2001).
[82] 72 Fed. Reg. 69287 (Dec. 7, 2007).

securitization position and more senior securitization positions based on the risk-weight of the underlying assets (and, in the case of the more complex gross-up approach, the transaction's overcollateralization ratio, interest coverage and waterfall priority); (iii) a special rule for the most senior exposure, which would base capital charges on the underlying exposure type and the aggregate amount of subordination that provides credit enhancement for the exposure; (iv) the use of a "concentration ratio" to set the capital charge[83] and (v) a simplified Supervisory Formula Approach ("SSFA") that uses specific inputs, including the capital requirements for the underlying exposures, to set the capital charge but fewer inputs than under the Supervisory Formula Approach in the agencies' Basel II capital rules.

Because all of the Quantifiable ANPR Proposals are largely capital structure-based, they represent, to differing degrees, a return to the risk-insensitive Basel I/pre-Recourse rule approach (*i.e.*, the same or similar capital charge for higher and lower risk exposures) that do not encourage banks to fully understand the risks involved in their securitization exposures. Similarly, they do not meet the Policy Objectives of appropriately distinguishing credit risk exposures within asset classes, providing for timely and accurate measurements in credit quality and fostering prudent risk management. As demonstrated in Annex A to this letter, all of the Quantifiable ANPR Alternatives would result in capital charges well in excess of what would be required under the Recourse Rules and the Basel II Advanced Internal Ratings Base Approach, and, if adopted, would place U.S. banking organizations at a significant competitive disadvantage relative to their non-U.S. competitors.

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[83] The "concentration ratio" would be equal to the sum of the notional amounts of all tranches divided by the sum of the notional amounts of the tranches junior to or *pari passu* with the tranche in which the position is held, including the tranche itself.

The impact of this increase and disadvantage will be significantly magnified due to:

- Changes in GAAP accounting rules (FAS 166 and 167) that bring onto the balance sheet most securitizations and therefore result in more securitization positions being subject to risk-weighting;

- The Banking Agencies' December 2009 amendments to their risk-based capital rules relating to FAS 166 and 167, which require banking organizations to retain risk-based capital against all on-balance-sheet securitization exposures regardless of the amount of risk they have transferred though the securitization;[84]

- Increased capital requirements that could result from systemic regulation under Title I of the Dodd-Frank Act, and from implementation of Basel III, which will require substantially more (and higher quality) capital per dollar of risk-weighted exposure;[85] and

- The risk-retention requirements in the final FDIC Safe Harbor and in the Dodd-Frank Act, which will result in banking organizations having to retain some exposure, which will be subject to a capital charge, in connection with most securitizations.[86]

As an additional proposal, the agencies propose the SSFA, which is a simplified version of the current SFA for unrated securitization exposures in the agencies' current Basel II rules.

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[84] 75 Fed. Reg. 4635 (Jan. 28, 2010).
[85] Dodd-Frank Act, Section 165(b); Basel Committee on Banking Supervision, Strengthening the Resilience of the Banking Sector, Consultative Document, para. 198 at p.. 59 (Dec. 2009), *available at* http://www.bis.org/publ/bcbs164.pdf?noframes=1; Basel Committee on Banking Supervision, International Framework for Liquidity Risk Measurement, Standards and Monitoring (Dec. 17, 2009), *available at* http://www.bis.org/publ/bcbs165.pdf.
[86] 75 Fed. Reg. 60287 (Sept. 30, 2010).

The agencies have not detailed what exposure-specific inputs they intend to require or how the SSFA would be adjusted to compensate for reduced inputs, making such proposal difficult to evaluate. However, given that many of the current informational inputs in the SFA may not be generally available and given the SFA's requirement to segment assets into homogenous risk pools, there are substantial questions as to whether an SSFA would be a viable approach for many securitization exposures, especially for banking organizations that are investing in, rather than originating, such exposures and therefore have more limited ability to access and model information. The current SFA also puts severe limitations on the ability to invest in wholesale assets with a maturity greater than a year. Further, given the SFA's complexity, it lacks transparency and therefore could significantly reduce primary and secondary market liquidity for ABS compared to the current ratings-based approach and other alternatives. However, despite the SFA's limitations, an SSFA could nonetheless provide a useful alternative for some banking organizations for certain securitization exposures, provided its inputs are appropriately adjusted to permit the use of market-based data of the type generally available to investors with flexibility on the number of years of historical information and the applicable formula is further calibrated to result in a smoother relationship between capital requirements and risk. In order to counter its rigidity, banking organizations would also likely have to be given the flexibility to make their own adjustments to the SSFA formula, subject to supervisory review. As noted above, with material modifications, SFA may be a viable alternative for sophisticated banks and some segments of the securitization market.

Given the extent to which credit ratings are integrated into the current framework, in adopting the above approaches (or any other approach), we believe that it is critical that there be

adequate phase-in periods and grandfathering to avoid abrupt and potentially destabilizing changes in capital requirements and to provide banking organizations the necessary time to make system changes (and avoid the need for such changes to be made more than once). In addition, we believe that the agencies should consider a delayed effective date to permit systems and other changes that may be required by the revised risk-based capital rules.

ii. Other Ratings Alternatives Proposals

Pursuant to Dodd-Frank Section 939A, a number of proposed rules relating to the regulations of the federal banking agencies have been issued, and we anticipate that more are forthcoming. The ASF Ratings Alternatives Taskforce has been commenting specifically on those proposals which stand to impact regulations directly affecting the securitization markets.

a. OCC ANPR

On August 13, 2010, the OCC released its "Advance Notice of Proposed Rulemaking on Alternatives to the Use of External Credit Ratings in the Regulations of the OCC" (the "OCC ANPR")[87] to modify its regulations to remove references to credit ratings in its regulations and to substitute other standards of creditworthiness, as mandated by Section 939A of the Dodd-Frank Act. On October 25, 2010, ASF submitted a comment letter in response to the OCC ANPR which was developed by the ASF Ratings Alternatives Taskforce.[88] ASF's comments focus primarily on the portion of the OCC ANPR that relates to the legal investment criteria for

[87] 75 Fed. Reg. 49423 (Aug. 13, 2010).
[88] See "ASF OCC Legal Investment Comment Letter," American Securitization Forum (October 25, 2010), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_OCC_Legal_Investment_Comment_Letter_10-25-10.pdf.

investment in ABS and is not intended to comment on other aspects of the ANPR. ASF believes that the OCC should allow banks to use credit ratings, together with other inputs (either third-party or internal) that the bank deems appropriate, to determine whether an ABS is a legal investment under the Investment Securities Regulation. While Dodd-Frank Section 939A requires the OCC to remove references to rating agencies in its regulations, we do not read it as prohibiting the OCC from allowing banking organizations to use third-party inputs (including credit ratings), properly supplemented, to determine whether an investment is a legal investment.

The OCC currently has in place safety and soundness standards that banks are required to follow before they invest in ABS and other complex instruments.[89] Such standards already require national banks to conduct appropriate due diligence and to be able to demonstrate an understanding of the specific types of ABS structures they plan to purchase. They further require national bank investment policies to specifically authorize holdings of such instruments and to establish appropriate limits. To the extent appropriate, these standards could be enhanced to ensure that banks are not inappropriately relying upon ratings in purchasing ABS.

Given the extent to which credit ratings are integrated into the current framework, ASF believes that, whatever alternative is devised, adequate phase-in and grandfathering provisions will need to be provided to avoid disruptions to banking organizations and the securitization markets. Among other things, these should provide that any ABS owned by a bank prior to any new standards becoming effective are grandfathered investments. In addition, we believe that the OCC should consider a delayed effective date to permit banks to make systems and other changes that could be necessitated by any new regulations.

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[89] *See, e.g.*, OCC Bulletin 2009-15; Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities, 63 Fed. Reg. 20191 (May 26, 2998).

C. Structured Finance Ratings and Assignment Process

i. SEC Study on the Standardization of Credit Ratings

On December 17, 2010, the SEC published a request for comment regarding Release No. 34-63573; File No. 4-622 relating to the study the SEC is required to undertake pursuant to Dodd-Frank Section 939(h) (the "Ratings Standardization RFC"). Section 939(h)[90] requires the SEC to undertake a study on whether the standardization of credit rating agency terminology and streamlining of certain quantitative measurements would be feasible and desirable. The SEC is required to submit to Congress a report containing the findings of this study as well as its recommendations, if any, with respect to the study not later than 1 year after the date of enactment of the Dodd-Frank Act.

Consistent with Section 939(h), the Ratings Standardization RFC asks the following four main questions:

1. Is it feasible and desirable to standardize credit ratings terminology, so that all credit rating agencies issue credit ratings using identical terms?

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[90] **SEC. 939. REMOVAL OF STATUTORY REFERENCES TO CREDIT RATINGS.**
(h) STUDY AND REPORT.—
(1) IN GENERAL.—Commission shall undertake a study on the feasibility and desirability of—
(A) standardizing credit ratings terminology, so that all credit rating agencies issue credit ratings using identical terms;
(B) standardizing the market stress conditions under which ratings are evaluated;
(C) requiring a quantitative correspondence between credit ratings and a range of default probabilities and loss expectations under standardized conditions of economic stress; and
(D) standardizing credit rating terminology across asset classes, so that named ratings correspond to a standard range of default probabilities and expected losses independent of asset class and issuing entity.
(2) REPORT.—Not later than 1 year after the date of enactment of this Act, the Commission shall submit to Congress a report containing the findings of the study under paragraph (1) and the recommendations, if any, of the Commission with respect to the study.

2. Is it feasible and desirable to standardize the market stress conditions under which credit ratings are evaluated?

3. Is it feasible and desirable to require a quantitative correspondence between credit ratings and a range of default probabilities and loss expectations under standardized conditions of economic stress?

4. Is it feasible and desirable to standardize credit rating terminology across asset classes, so that named credit ratings correspond to a standard range of default probabilities and expected losses independent of asset class and issuing entity?

ASF submitted a letter in response to the Ratings Standardization RFC on February 4, 2011.[91] As a general proposition, we believe that standardization of methodology and terminology used by credit rating agencies ("CRAs") would not be desirable as users of credit ratings, in particular investors, benefit from a diversity of experience and methodologies. Increased uniformity may have the counterproductive effect of restricting the use of new information and changing economic conditions by CRAs as well as discouraging competition among CRAs. As a result, we believe uniformity would compromise the quality, accuracy and usefulness of credit ratings in the securitization market.[92] Measures required to be adopted in response to Dodd-Frank that foster transparency of methodology used to derive credit ratings for ABS will, in our view, better serve investors by providing qualitative information helpful to

[91] *See* "ASF Credit Rating Standardization Comment Letter," American Securitization Forum (February 4, 2011), available at http://www.americansecuritization.com/uploadedFiles/asf_letter_re_nrsro_standardization-2-4-11.pdf.

[92] In our letter, we did not specifically address the feasibility of standardizing ratings criteria because we do not think such standardization is desirable. However, we believe that the exercise of standardizing ratings criteria for any asset class, across asset classes and for new asset classes is most likely unworkable given the wide variations in the approach to credit ratings by each CRA and differences among performance characteristics of different assets. In addition, the process of ongoing standardization could limit the ability of CRAs to adapt their credit ratings methodology in a timely manner to changing market and economic conditions.

understand the relevant credit ratings.[93] We also believe that greater standardization would not have helped prevent the economic crisis we have just experienced. Even though different views and methodologies for credit ratings may not necessarily prevent a similar crisis in the future, we believe that a diversity of views and methodologies, with appropriate transparency, across a competitive market for credit ratings would be more likely to avert a similar crisis than would a prescribed set of criteria employed by all CRAs.

a. Standardization of Ratings Terminology

Question 1 of the Ratings Standardization RFC asks, "*[i]s it feasible and desirable to standardize credit ratings terminology, so that all credit rating agencies issue credit ratings using identical terms?* [emphasis added]." We believe that different credit ratings terminology appropriately reflects the differences that exist among quantitative models and qualitative assessments among CRAs. The standardization of ratings terminology could suggest to investors that there is a uniformity of views that is neither intended nor desired.[94] We believe that it may also discourage investors from further inquiry. For similar reasons, we do not support changes to the symbols used by CRAs to rate structured finance products.[95] CRAs should be able to use

[93] In particular, *see* Section 932 of Dodd-Frank.

[94] We note that Section 15E(c)(2) of the Exchange Act expressly limits the authority of the Commission to make rules with respect to credit rating procedures and methodologies, as follows: "Notwithstanding any other provision of this section, or any other provision of law, neither the Commission nor any State (or political subdivision thereof) may regulate the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings." Dodd-Frank amended this section, among other reasons, to clarify that other changes to this section affected by Dodd-Frank were not intended to reverse this limitation.

[95] This is not to suggest that changes in symbols used for credit ratings for structured finance products (but not to other securities rated by CRAs) would be desirable. Use of ABS-specific identifiers may suggest that a credit rating is qualitatively different from a corresponding rating in a different ratings sector. ASF has commented on this issue in previous letters to the Commission. In particular, *see* http://www.americansecuritization.com/uploadedFiles/ASF%20CRA%20-%20ratings%20scale.pdf

different credit terminology and unique symbols.[96] Use of standardized symbols may imply a uniformity of underlying ratings criteria that both does not exist and is not desired by investors and other users, and may negatively impact the interpretation of credit ratings assigned to ABS.

b. Standardization of Ratings Methodologies

Question 3 of the Ratings Standardization RFC asks, "*[i]s it feasible and desirable to require a quantitative correspondence between credit ratings and a range of default probabilities and loss expectations under standardized conditions of economic stress?* [emphasis added]." We believe that the standardization of credit ratings methodologies could deprive investors of the ability to consider diverse perspectives provided by multiple CRAs, thus inhibiting independent analysis. We also believe that investors are aware that CRAs employ different criteria in deriving credit ratings and value divergence of practices among CRAs. Different methodologies allow an investor to consider different perspectives on evaluating an investment. The availability of credit ratings based on a loss expectations model and a model measuring a range of default probabilities differences, for example, can help inventors evaluate credit risk in a way that they determine is more appropriate.

Such diversity may also contribute to the quality and accuracy of credit ratings. The process of deriving a credit rating is necessarily qualitative in nature and takes into account

[96] Separately, we note that Section 938(a) of Dodd-Frank requires the Commission to adopt rules that require nationally recognized statistical organizations "to establish, maintain, and enforce written policies and procedures" that, among other things, define and disclose the meaning of credit rating symbols used by CRAs and requires consistent application of such symbols. We note that Section 938(b) of Dodd-Frank expressly states that "[n]othing in [Section 938(b)] shall prohibit a nationally recognized statistical rating organization from using distinct sets of symbols to denote credit ratings for different types of securities or money market instruments."

differences among asset classes that are not readily quantifiable.[97] Similarly, uniformity of market stress conditions under which ratings are evaluated may undermine the value that different CRAs bring to credit ratings through the application of differing economic views and models to differing asset classes or different qualities or characteristics within the same asset class.[98]

The application of different methodologies makes the standardization of quantitative correspondence between credit ratings and a range of default probabilities or loss expectations difficult, if not impossible, and, for the reasons stated in this letter with respect to the benefits of diverse views and encouraging additional inquiry, less desirable.

c. Standardization of Ratings Terminology Across Asset Classes

Question 4 of the Ratings Standardization RFC asks, "*[i]s it feasible and desirable to standardize credit rating terminology across asset classes, so that named credit ratings correspond to a standard range of default probabilities and expected losses independent of asset class and issuing entity?* [emphasis added]." In addition to the considerations set forth above, requiring CRAs to apply a singular risk analysis to different asset classes may ignore or downplay asset-specific credit risks and may compromise the quality and accuracy of credit ratings applicable to an asset class.

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[97] It is questionable whether agreement could be reached on the nature and severity of general risks, and whether if such consensus were reached, it would be desirable.

[98] Formulating product-specific criteria requires qualitative judgments about the nature of the asset class and related products. For example, not only would a CRA apply different criteria to auto ABS than they would RMBS, it may also employ different criteria within RMBS to the extent the collateral was prime, subprime, seasoned, etc.

d. Conclusion

ASF believes that Dodd-Frank appropriately requires a review of the credit ratings process. However, we believe that greater flexibility to incorporate new information and new conditions into credit analysis methodologies, more diversity of views with respect to how such information and conditions are applied, and transparency with respect to the underlying assumptions and methodologies employed by credit rating agencies are of greater benefit to investors than standardization of terminology or methodology. This flexibility is also important to ensure competition among credit rating agencies.[99] The introduction of standardized criteria and streamlined quantitative models would diminish the diversity of practices employed and number of variables considered by CRAs in formulating credit ratings. Standardization would in effect lead to the expression of a single, unified view applied by separate CRAs, thereby limiting the quality and accuracy of credit ratings

ii. SEC Study and Rulemaking on Assigned Credit Ratings

On May 10, 2011, the SEC published a request for comment regarding Release No. 34-64456; File No. 4-629 relating to the study the SEC is required to undertake pursuant to Dodd-Frank Section 939F (the "Ratings Process RFC"). The SEC is required to submit to Congress a report containing the findings of this study as well as its recommendations, if any, with respect to the study not later than 24 months after the date of enactment of Dodd-Frank.

[99] In its adopting release for rules promulgated under the Credit Rating Agency Reform Act of 2006, including Rule 17g-5, the Commission expressed an intention to follow Congress' stated goals of fostering competition and transparency among CRAs in crafting rules. Release No. 34-61050; File No. S7-04-09 (November 23, 2009).

Section 939F requires the SEC to undertake a study on:

i. The credit rating process for structured finance products and the conflicts of interest associated with the issuer-pay and the subscriber-pay models;

ii. The feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns NRSROs to determine credit ratings of structured finance products;

iii. The range of metrics that could be used to determine the accuracy of credit ratings; and

iv. Alternative means for compensating NRSROs that would create incentives for accurate credit ratings.

After submission of the report, "as the [SEC] determines is necessary or appropriate in the public interest or for the protection of investors," the SEC must establish a system for the initial assignment of credit ratings "in a manner that prevents the issuer, sponsor or underwriter of the structured finance product from selecting the nationally recognized statistical rating organization that will determine the initial credit ratings and monitor such credit ratings."

Although we have not formally responded to the Ratings Process RFC, we believe that any proposal to establish a system in which a public or private utility or a self-regulatory organization would assign NRSROs to issue initial credit ratings would be detrimental to the securitization market in a number of ways. Such a system is premised on the assumption that all "qualified" NRSROs are created equal with respect to rating a particular asset class. However, internal investor guidelines restrict the securities in which they can invest based on the NRSRO

that provides the rating and issuers may struggle to market securities that have a rating from a non-approved NRSRO. Furthermore, issuers would have to pay for additional ratings should an NRSRO that does not have sufficient market credibility be selected to issue an initial rating. Finally, the alleged purpose of Section 939F is to examine and eliminate the perceived conflicts associated with the "issuer-pay" ratings model. The SEC has already attempted to address this conflict with its amended Rule 17g-5, which requires issuers to post information provided to hired NRSROs so that non-hired NRSROs can produce unsolicited ratings. While it is unclear at this point whether the SEC's Rule 17g-5 adequately alleviates any perceived conflicts in rating structured finance products, we remain concerned that the assignment of credit ratings would create substantial expense, confusion and burden for the securitization market. ASF will be developing a detailed response to the SEC's Ratings Process RFC with respect to Section 939F in order to fully articulate our views on this important matter.

D. Rule 17g-5

Rule 17g-5(a)(3) ("Rule 17g-5") under the Exchange Act,[100] which became effective on June 2, 2010, sets forth requirements for NRSROs that are hired by issuers, underwriters or sponsors (collectively, "arrangers") to provide credit ratings for ABS/MBS transactions. In addition, the rules require the arranger to post information provided to hired NRSROs on a password-protected website and make it available to non-hired NRSROs. The purported goal of Rule 17g-5 is to promote competition among rating agencies and to increase the number of ratings for structured finance products.

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[100] *See* Exchange Act Release No. 61050 (Nov. 23, 2009), 74 FR 63832 (Dec. 4, 2009) (the "Adopting Release")

Discussions among our issuer member firms since the effective date of Rule 17g-5 have produced credible and specific evidence that few non-hired NRSROs have requested access to the websites that arrangers are required to maintain under the Rule. In fact, in a survey of ASF members, we are aware of only a small handful of transactions in the entire U.S. ABS/MBS marketplace where an arranger's website has been accessed. In the context of the U.S. market, we fully support the SEC's interrelated goals as stated in the Rule 17g-5 adopting release, namely to promote increased competition among rating agencies through issuance of unsolicited ratings, address conflicts of interest in credit ratings and ultimately improve ratings quality.[101] Ultimately, the new requirements of Rule 17g-5 have been responsible for only a handful of ratings produced by non-hired NRSROs that our members are aware of. Despite this fact, arrangers of ABS continue to be burdened by tens of millions of dollars in initial and ongoing compliance costs in connection with Rule 17g-5, at a time when restarting the securitization markets in the U.S. and around the globe is still a critical component of economic recovery.

i. Industry Implementation of Rule 17g-5

Given the burden of compliance with Rule 17g-5 on market participants, ASF has actively worked within the membership and in discussions with the SEC to identify solutions to key issues presented by the rules.

a. Market Guide

After the rules became effective, the ASF began to hold numerous calls of its various subforums and committees to formulate a market-wide set of issues and concerns relating to the

[101] Adopting Release at 63844.

implementation of Rule 17g-5. The ASF has also attended numerous meetings with the SEC regarding Rule 17g-5 to address implementation concerns, including issues that run across all asset classes as well as specific concerns arising in the ABCP market. ASF continues to address concerns as they arise relating to the implementation of Rule 17g-5.

b. Model Confidentiality Agreement

In the adopting release for Rule 17g-5, the SEC indicated that an arranger may employ a "simple process requiring non-hired NRSROs to agree to keep the information they obtain from the arranger confidential, provided that such a process does not operate to preclude, discourage or significantly impede non-hired NRSROs' access to the information, or their ability to issue a credit rating based on the information." The SEC further indicated its expectation that the confidentiality agreement "would contain the same terms as the confidentiality agreement between the arranger and the hired NRSRO." ASF created a working subgroup of arrangers and certain of the ASF's NRSRO members (the "Confidentiality Subgroup") to aid in the process of implementing confidentiality terms between arrangers and both hired and non-hired NRSROs under Rule 17g-5. The Confidentiality Subgroup worked for nearly two months to develop a standard form agreement in an attempt to address both arranger and NRSRO concerns.

ii. Extraterratoriality Request

Our concerns with respect to the effectiveness of Rule 17g-5 are compounded by lingering international uncertainty regarding its potential future applicability to extraterritorial transactions. With respect to non-U.S. offerings, our members believe Rule 17g-5 should not apply to the conduct of NRSROs or arrangers outside the U.S., absent a substantial effect in the

U.S. or on U.S. persons. We believe that permanently defining the scope in this way would advance the SEC's objectives, provide sufficient certainty for market participants and regulators in other jurisdictions and avoid certain unintended consequences which might otherwise arise in the context of rated deals involving non-U.S. arrangers. In addition, while each NRSRO defines the parts of its business that operate under the NRSRO designation (and, in theory, can therefore control the scope of its conduct that is subject to the rule), arrangers have no role in the NRSRO-designation process but incur significant burdens by operation of the rule simply because they engage the NRSRO to assign an initial credit rating. Because the rule operates to regulate the conduct of both NRSROs and arrangers, under general principles of fairness, the rule should not apply to conduct outside the U.S. absent a substantial effect in the U.S. or on U.S. persons.

On October 27, 2010, the ASF and the Australian Securitisation Forum ("AuSF") jointly submitted a letter[102] to the SEC requesting that they make permanent an exemption for extraterritorial ratings, given both the undue negative impact Rule 17g-5 would have on global issuance of ABS, and, more broadly, the poor progress Rule 17g-5 has made in the U.S. toward achieving the stated goals of the SEC since the June 2, 2010 compliance date. On November 23, 2010, the SEC extended a previously issued temporary conditional exemption for NRSROs from complying with Rule 17g-5(a)(3) with respect to covered extraterritorial transactions until December 2, 2011.[103] We continue to support extending the exemption on a permanent basis in order to provide foreign transactions with sufficient market certainty going forward.

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[102] *See* "AuSF & ASF 17g-5 Extraterratoriality Request," American Securitization Forum and Australian Securitisation Forum (October 27, 2010), available at: http://www.americansecuritization.com/uploadedFiles/ASFAuSF_17g5_Extraterritoriality_Request_102710.pdf.

[103] *See* Securities and Exchange Commission Release No. 34-63363; File No. S7-04-09 (Nov. 23, 2010)

In common with other Organisation for Economic Co-operation and Development ("OECD") jurisdictions, the federal securities laws of the United States focus on the regulation of offerings to U.S. persons. This guiding principle of local investor protection is reflected in the preamble to, and the findings set out at the start of, the U.S. Credit Rating Reform Act of 2006 and in the general mandate of the SEC itself. This principle suggests the SEC has a limited interest in regulating securities offered solely outside the U.S. and this is evidenced by certain existing provisions and practices, including the Regulation S safe harbor. Given this background, the application of Rule 17g-5 to all credit ratings provided by an NRSRO or a registered affiliate, regardless of whether the relevant transaction involves a U.S. investor connection (i.e. via a U.S. offering), would be inconsistent from a policy perspective with the wider U.S. legislative and regulatory framework as well as principles of international comity.

As a major, functioning international securitization market, the Australian market stands to be negatively impacted by Rule 17g-5. Three NRSROs currently operate in Australia and assign ratings to ABS issued to both non-U.S. persons and, on occasion, U.S. persons. Since its correspondence with the SEC earlier in the year, the AuSF has established a series of new public disclosure and reporting standards with the Australian Securities & Investment Commission ("ASIC") that are consistent, if not identical, to those implemented in the U.S. and will apply to issuers of Australian RMBS to provide investors and NRSROs with increased and more consistent information and data. These new International Organization of Securities

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In requesting the initial exempting order, which was subsequently extended by the Commission's November 23, 2010 order, the ASF presented a set of talking points in connection with the rule on April 27, 2010 at our meeting with the Commission. *See* "ASF Discussion Points: Meeting with SEC Staff: Questions re Implementation of Amended Exchange Act Rule 17g-5" (April 27, 2010), *available at* http://www.americansecuritization.com/uploadedFiles/ASFDiscussionPoints_ImplementationofAmendedRule17g-5_042710.pdf.

Commissions ("IOSCO")-compliant standards will assist investors and others to form independent views on the creditworthiness of RMBS and aid the ability of non-hired NRSROs to provide ratings within the Australian jurisdiction.

VIII. Other Dodd-Frank Issues

A. Conflicts of Interest in Securitization

Section 621 (Conflicts of Interest) of Dodd-Frank seeks to address conflicts of interest in securitization and generally provides that an underwriter or sponsor (or any affiliate or subsidiary) of an ABS shall not, for one year after closing, engage in any transaction that would result in any material conflict of interest with respect to any investor. While this general statutory mandate is included in Dodd-Frank, there is significant legislative intent that makes clear this provision was meant to eliminate incentives for market participants to intentionally design ABS asset-backed securities to fail. While ASF has expressed its full support of the intent behind the legislation, we remain deeply concerned that overly broad rules could have serious unintended consequences on the secondary market. The SEC has yet to propose rules pursuant to this provision.

ASF strongly supports the intent of Section 621 to eliminate incentives for market participants to intentionally design asset-backed securities to fail or default. An asset-backed security that is created primarily for the purpose of entering into another, more lucrative transaction that will provide a material financial reward upon the failure or default of the same asset-backed security, creates a clear material conflict of interest, and sponsors and financial

institutions that are responsible for the creation and/or distribution of such asset-backed security should be prohibited from entering into those other transactions. Any rules implemented by the SEC for this purpose, however, must be crafted so as to prohibit the situations that result in such material conflicts of interest without causing unnecessary adverse impacts on the markets for asset-backed securities. As further discussed below, we believe this can be achieved by clearly identifying the activities that would constitute a "material conflict of interest" and the parties subject to the restriction.

United States Senators Jeffrey Merkley and Carl Levin introduced what is now Section 621 on May 10, 2010 as an amendment to Dodd-Frank (the "Merkley-Levin Provisions").[104] Section 621 evolved as a result of the findings of the Senate Permanent Subcommittee on Investigations, chaired by Senator Levin, after it conducted four hearings relating to the financial crisis.[105] The Merkley-Levin Provisions were intended to stop what Senator Levin called "one

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[104] The Merkley-Levin Provisions also include what is now Sections 619 and 620 of Dodd-Frank, but for purposes of this letter, we are only addressing Section 621, which relates to material conflicts of interest in securitization transactions. Section 621 of Dodd-Frank ("Section 621") states, in pertinent part:

> (a) IN GENERAL.—An underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security (as such term is defined in section 3 of the Securities and Exchange Act of 1934 (15 U.S.C. 78c), which for the purposes of this section shall include a synthetic asset-backed security), shall not, at any time for a period ending on the date that is one year after the date of the first closing of the sale of the asset-backed security, engage in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity.
> * * * * *
> (c) EXCEPTION.—The prohibitions of subsection (a) shall not apply to—
> (1) risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship of an asset-backed security, provided that such activities are designed to reduce the specific risks to the underwriter, placement agent, initial purchaser, or sponsor associated with positions or holdings arising out of such underwriting, placement, initial purchase, or sponsorship; or
> (2) purchases or sales of asset-backed securities made pursuant to and consistent with—
> (A) commitments of the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, to provide liquidity for the asset-backed security, or
> (B) bona fide market-making in the asset backed security.

[105] *See* 156 *Cong. Rec.* S4058 (May 20, 2010) (statement of Sen. Levin).

of the most dramatic findings of [their] subcommittee hearings, that of firms betting against financial instruments they are assembling and selling."[106] Senator Levin later noted that "sponsors and underwriters of the asset-backed securities are the parties who select and understand the underlying assets, and who are best positioned to design a security to succeed or fail" and stated that the intent of Section 621 is to "prohibit underwriters, sponsors, and others who assemble asset-backed securities, from packaging and selling those securities and profiting from the securities' failures."[107]

Senator Levin also explained what Section 621 is *not* intended to do:

> [Section 621 is] [n]ot intended to limit the ability of an underwriter to support the value of a security in the aftermarket by providing liquidity and a ready two-sided market for it. Nor does it restrict a firm from creating a synthetic asset-backed security, which inherently contains both long and short positions with respect to securities it previously created, so long as the firm does not take the short position.[108]

Senators Levin and Merkley further clarified the intent of Section 621 in a letter to various heads of government agencies charged with implementing Dodd-Frank, including the

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[106] 156 *Cong. Rec.* S3470 (May 10, 2010) (statement of Sen. Levin). *Also see* 156 *Cong. Rec.* S4058 (May 20, 2010) (statement of Sen. Levin) where Levin further reiterated this point that the Senate needed to act to put an end to the conflict of interest that exists when firms sell asset-backed securities to investors and bet against them and considered such action one of the most "dramatic findings" of their subcommittee.

[107] 156 *Cong. Rec.* S5899 (July 15, 2010) (statement of Sen. Levin). Both Senators Merkley and Levin have focused on designing an instrument to fail, likening the practice to someone who sells cars without brakes (or a mechanic servicing a car designed to fail) and then takes out life insurance on the owners. See 156 *Cong. Rec.* S3469 (May 10, 2010) (statement of Sen. Merkley), 156 *Cong. Rec.* S4057 (May 20, 2010) (statement of Sen. Levin) and 156 *Cong. Rec.* S5899 (July 15, 2010) (statement of Sen. Levin).

[108] 156 *Cong. Rec.* S5899 (July 15, 2010) (statement of Sen. Levin).

Chairman of the SEC.[109] The Senators state in their letter that the objective of Section 621 is to "end the conflicts of interest that arise when a financial firm designs an asset-backed security, sells it to customers, and then bets on its failure."[110]

Accordingly, any rules implemented by the SEC should be crafted so as to prohibit the situations that result in the material conflicts of interest identified by the Senators without causing unnecessary adverse impacts on the markets for asset-backed securities. A broad interpretation of "material conflicts of interest" — prohibiting *any* transaction relating to an asset-backed security by which a party might receive a potential profit upon failure or default of the security — would not only be contrary to the intent of Congress but would inhibit many activities currently undertaken by market participants. For example, many underwriters[111] of asset-backed securities or their affiliates provide transaction sponsors with short-term funding facilities such as "warehouse" lines, variable funding notes and asset-backed commercial paper, whereby the underwriter or its affiliate provides financing to the sponsor to fund asset originations or purchases of assets. These facilities provide essential liquidity until the assets can be packaged through a term securitization and sold into the debt capital markets. As the proceeds from the securitization are used to repay the financing, a broad reading of "material conflicts of interest" could prohibit this funding tool, essentially cutting off one of the only available sources of credit in today's constrained market. Similarly, a broad interpretation of "material conflicts of interest" could prohibit servicers of mortgage loans, auto loans, credit card

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[109] *See* Letter from Senator Merkley and Senator Levin dated August 3, 2010 addressed to, *inter alia*, the Honorable Mary Schapiro, Chairman of the Securities and Exchange Commission regarding the Implementation of Merkley-Levin Provisions.

[110] *Id* at page 2.

[111] For ease of reference, we use the term "underwriter" interchangeably with a placement agent and an initial purchaser in a Rule 144A transaction.

receivables and other assets who are affiliated with the sponsor of a transaction from pursuing customary servicing activities. Especially concerning would be a servicer's inability to exercise loss mitigation activities, such as loan modifications under the Home Affordable Modification Program ("HAMP") or the servicer's internal guidelines, or conduct short sales and short refinances under the Federal Housing Administration's Short Refinance Program. This restriction would effectively prohibit sponsors and their affiliates from servicing the loans that they originate, requiring costly servicing transfers that will decrease efficiency and potentially lead to confusion for consumers and disruptions in the servicing of assets.

Additionally, natural conflicts of interest exist between classes of securities that are commonly issued in a single asset-backed securities transaction to accommodate the varying demands of investors and provide the greatest possible liquidity. For example, holders of senior and subordinated classes of securities and interest-only and principal-only classes of securities may have opposing interests with respect to the rate of prepayments in a transaction. Similarly, even though the interests of holders of time-tranched securities may be aligned with respect to the overall credit performance of a pool, such securities may receive distributions at different times and be subject to different risks. An overly broad reading of the Merkley-Levin Provisions could effectively prohibit the issuance of these securities (and numerous others), especially given the requirement contained in Dodd-Frank and other regulatory proposals[112] that a securitizer retain a portion of the securities issued in a transaction. Further, many investors in asset-backed securities seek interest rates or currencies that differ from the underlying assets, which require that the structures employ interest rate or currency swaps. These swaps are standardized and bid

[112] A risk retention requirement is also contained in the Federal Deposit Insurance Corporation's recently published "safe harbor" and the Commission's recent proposed revisions to Regulation AB.

out to various market participants, including affiliates of the underwriter of the asset-backed transaction. An expansive interpretation of "material conflicts of interest" could prohibit an affiliate of the underwriter from providing such a swap, potentially depriving investors of the best possible execution. Such outcomes would be outside the Congressional intent of Section 621, which sought to eliminate the improper incentives to issue asset-backed securities designed to fail, not to prohibit the creation of asset-backed securities that allocate identified and disclosed risks between or among separate parties.[113] A broad reading of Section 621 could effectively lead to a contraction of available credit for consumer finance and small business, where securitization has provided a significant source of funding, including mortgage loans, auto loans and leases, student loans, small business loans and credit cards.

Consistent with the legislative intent, the regulations issued by the SEC should be specifically tailored to prohibit transactions that create a material incentive to intentionally design asset-backed securities to fail or default. Specifically, the terms "underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of such entity, of an asset-backed security" as used in Section 27B of the Securities Act, as amended by Section 621, should be defined by regulation to be workable — able to be implemented and monitored by the regulated entities and monitored by the applicable regulators. We propose that the SEC define these entities as "Restricted Parties" and include only affiliates and subsidiaries that have a material interest in the asset-backed security. Similarly, the definition of "material conflicts of

[113] We note that Senator Levin believes that disclosure alone may not cure material conflicts of interest in all cases, such as in situations where "disclosures cannot be made to the appropriate party or because the disclosure is not sufficiently meaningful." We further note that Senator Levin does not believe that disclosing that the underwriter of an ABS "has or might in the future bet against the security" will cure the conflict of interest arising if the underwriter takes a short position in a synthetic transaction that references the ABS. However, in situations that are clearly not instances of an asset-backed security being designed to fail, ASF believes that effective disclosure would remedy perceived conflicts. *See* 156 *Cong. Rec.* S5899 and S5901 (July 15, 2010).

interest" should prohibit those types of transactions identified by Senators Merkley and Levin that create conflicts of interests by creating intentionally flawed asset-backed securities. Accordingly, we propose the SEC define "material conflicts of interest" as follows:

> "A "material conflict of interest" shall exist if, other than for hedging purposes or as permitted by Section 27B(c) of the Securities Act of 1933, (i) a Restricted Party participates in the issuance of an asset-backed security that is created primarily to enable such Restricted Party to profit from a related or subsequent transaction as a direct consequence of the adverse credit performance of such asset-backed security and (ii) within one year following the issuance of such asset-backed security, the Restricted Party enters into such related or subsequent transaction."

By clearly identifying (i) principles upon which market participants can determine what activities would constitute a "material conflict of interest" under Section 621 and (ii) which parties are subject to such restriction, the SEC can effectively eliminate the practices identified by Senators Merkley and Levin without risking unintended consequences to the efficient functioning of the capital markets. Finally, we note that Section 621 includes exceptions for risk-mitigating hedging activities, bona fide market making, and commitments to provide liquidity and strongly agree with Senators Merkley and Levin that appropriate hedging, market-making and liquidity commitments are necessary and proper for the development of a healthy asset-backed securities market.

B. Regulation of Derivatives

On April 12, 2011, two long-awaited proposed rules on margin and capital requirements for non-cleared swaps were issued, the first jointly by five federal agencies and the second by the Commodity Futures Trading Commission. The proposed rules implement the regulatory framework established by Sections 731 and 764 of the Dodd-Frank Act, which mandate capital and margin requirements for swap dealers and major swap participants in connection with their non-cleared swaps. ASF is currently formulating a detailed comment letter to explain the grave, and likely unintended, consequences that these proposals may have on the securitization markets. In addition, there are numerous other related proposals that may affect securitization, including (i) the SEC's end-user exception to the mandatory clearing of security-based swaps and swap participant definitions, (ii) the CFTC's swap participant definitions and the end-user exception and (iii) business conduct standards for "swap dealers" and "major swap participants" relating to ERISA plans. ASF has submitted comment letters on all of these other proposals.[114]

Title VII of Dodd-Frank creates new categories of regulated security-based swap entities that would be subject to a number of regulatory requirements, including registration, capital and margin, recordkeeping and business conduct standards. ASF believes that structured finance participants should not, standing alone, be considered to be included in any of these new

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[114] *See* "ASF Derivatives End-User Exception Comment Letter to SEC," American Securitization Forum (February 4, 2011), *available at* http://asf.informz.net/ASF/data/images/emailattachments/advocacy/asf_letter_to_sec_re_end-user_exception.pdf; *see* "ASF Derivatives Comment Letter to SEC," American Securitization Forum (February 14, 2011), *available at* http://asf.informz.net/ASF/data/images/emailattachments/advocacy/asf_letter_to_sec_re_derivatives-2-14-11.pdf; *see* "ASF Derivatives Comment Letter to CFTC," American Securitization Forum (February 22, 2011), *available at* http://www.americansecuritization.com/uploadedFiles/2_22_11_ASF_CFTC_letter_re_Derivatives.pdf; and *see* "ASF Title VII Business Conduct Standards Letter," American Securitization Forum (February 22, 2011), *available at* http://www.americansecuritization.com/uploadedFiles/2_22_11_ASF_cftc_comment_letter_re_business_conduct_standards.pdf.

categories and that, in particular, the mandatory clearing, margin and capital requirements should not apply to swaps entered into by structured finance participants.

Structured finance special purpose vehicles ("SPVs") are typically legal entities created by the sponsor or originator by transferring assets to the SPV, to facilitate a specific purpose or defined activity, or a series of such transactions. SPVs have no other purpose than the transactions for which they were created, and the SPV can make no operational decisions; the rules governing them are prescribed in advance and carefully limit their activities. They may be structured to be either off or on the balance sheet of the sponsor or originator.[115] Frequently for these structures the only business or commercial purpose of these vehicles are to enter into the security-based swaps and manage the exposure relating thereto, which management may entail terminating, closing-out or entering into new swaps or security-based swaps. Structured finance participants generally can include originators and/or sellers of assets, servicers and the SPVs, which typically act as the issuer of the debt instruments that back the particular asset pool. Structured finance participants utilize many different types of security-based swaps, including single-name credit default swaps and certain equity derivatives.

Applying any of these requirements may render many structured financings uneconomic as the SPV would be required to post cash and liquid securities which it does not have. The source of repayment for structured financings is generally the cash flow from the assets or receivables which is generated over time. Applying clearing, margin and capital requirements would affect the cash flow analysis for a structured financing and cause adverse effects on the

[115] Typically, off-balance sheet SPVs have the following characteristics: (a) they do not have independent management or employees; (b) their administrative functions are performed by a trustee who follows set rules with regard to the distribution of cash; there are no other decisions; (c) assets held by the SPV are serviced through a servicing agreement; and (d) they are structured so that they are bankruptcy remote.

functioning of this market, including ultimately resulting in a reduction in the available amount of loans or other financing for the assets underlying the structured financing.

The derivatives regulation is highly complex and technical. We suggest reviewing our numerous comments on these issues to facilitate a better understanding of the potential impact on securitization. In addition, ASF is always available for individual meetings to further explain these issues.

C. Volcker Rule

On October 6, 2010, the Financial Stability Oversight Council (the "Council") requested comment (the "Volcker Rule Notice") relating to their Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds (the "Study"). The Council is conducting the Study pursuant to Section 619 of the Dodd-Frank Act. Section 619 adds a new Section 13 to the Bank Holding Company Act of 1956 (the "BHC Act") that generally prohibits banking entities from engaging in proprietary trading and from sponsoring and investing hedge funds and private equity funds. These prohibitions are commonly referred to as the "Volcker Rule". ASF submitted a comment letter that focused on Question 3 of the Volcker Rule Notice, which asked what considerations should be taken into account in making recommendations to the applicable regulatory agencies[116] (the "Agencies") in implementing the provisions of the Volcker Rule that might apply to securitizations.

[116] The Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System (the "Board"), the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC").

In our view, the Volcker Rule seeks to define generally the types of activities in which banking entities and nonbank financial companies[117] are prohibited from engaging by indentifying the central policy objective of the Rule. That objective is to prevent banking entities from engaging in activities that have caused or might reasonably be expected to cause undue risk to the financial system. Recognizing the difficulty (if not, impossibility) of enumerating specific activities that posed this risk profile during the push to pass the sweeping Dodd-Frank Act, Congress delegated to the Agencies responsibility for implementing the policy-based prohibitions of the Volcker Rule through the development and adoption of regulations. The recommendations contained in the Study are meant to form the bases of the Agencies' regulations.

New Section 13(a)(1)(b) of the BHC Act prohibits a banking entity from "acquir[ing] or retain[ing] any equity, partnership, or other ownership interest in or sponsor[ing] a hedge fund or a private equity fund." A "hedge fund" or "private equity fund" is defined very broadly in the Volcker Act (new Section 13(h)(2) of the BHC Act) to be "a company or other entity that would be an investment company under the Investment Company Act of 1940 (the "1940 Act"), but for Section 3(c)(1) or 3(c)(7) of the 1940 Act, or such similar funds as the appropriate Federal banking agencies, the SEC, and the CFTC may determine." Taken literally, and without giving effect to the exceptions contained in the Volcker Act or the recommendations that the Council is required to make to the Agencies, these two provisions could be read to restrict a banking entity from engaging in any securitization transaction with an issuer fund in which that banking entity has any equity interest or a sponsorship role if that fund relies on the private placement

[117] As used in the Volcker Rule, the term "nonbank financial companies" refers to those nonbank financial companies that may be designed by the Council to be supervised by the Board and subject to enhanced prudential standards.

exemptions of Section 3(c)(1) or 3(c)(7). Many securitization issuers currently rely on the tone of those exemptions.

We are confident that Congress did not intend this result. Indeed, in Section 13(g)(2) of the Volcker Rule, drafters provided the Council and the Agencies with compelling evidence that such application was not intended. Section 13(g)(2) provides that the Volcker Rule is not to be "construed to limit or restrict the ability of banking entities or nonbank financial companies ... to sell or securitize loans...." (the "Securitization Exclusion"). By specifically including the Securitization Exclusion in the "Rules of Construction" for Section 13 of the BHC Act in its entirety, Congress made clear that even though some securitization issuers would otherwise fall within the definition of "hedge fund and private equity fund", those issuers and their sponsors were not meant to be included in the prohibited activities. As stated above, the Volcker Rule contains a general description of prohibited activities and does so with very broad provisions. The Agencies are delegated with the responsibility for interpreting and refining those provisions so as to implement the policy underlying the Rule. If the definition of "hedge fund and private equity fund" were repeated in the regulations exactly as included in the Dodd-Frank Act, the application of the definition would dramatically and adversely impact many long-established and sound businesses of banking entities not intended by Congress.

We believe that the definition of "hedge fund and private equity fund" is intended to identify a type of issuer fund commonly referred to in the marketplace as a "hedge fund" or a "private equity fund" or as being engaged in the business of a "hedge fund or private equity fund". The definition was not intended to define the universe of issuer funds with which banking entities and nonbank financial companies are prohibited from engaging in activities solely by

virtue of sharing a characteristic that relates to their exemption from registration as an investment company. We find Congressional support for these views in the Securitization Exclusion.

It is evident that Congress directed the Council to give effect to the Securitization Exclusion in preparing the Study and in making recommendations to the Agencies as to the interpretation of the definition of "hedge fund and private equity fund" and its impact on the prohibited activities described in Section 13(a)(2). The only issuer funds and activities (whether related to securitizations or not) that are properly scoped into the prohibited activities are those activities that have posed a threat to the safety and soundness of the financial system. To state the obvious, not every issuer fund or activity poses the risks to the banking system and the economy that the Volcker Rule is designed to protect against. Further, there is no doubt that prohibiting certain types of relationships between banking entities and issuer funds as defined in Section 13(h)(2) would not produce the intended result of promoting and enhancing the safety and soundness of the financial system and the economy. Rather, it would eliminate or substantially reduce the viability of certain important lines of business historically conducted by banking entities. Specifically, it is clear that the vast majority of securitizations play a vital role in the traditional business of banks and in the economy, providing a cost effective means of financing for U.S. businesses and an important highly liquid product for U.S. investors, including money market funds. It is equally clear that the vast majority of securitization products have performed well during the financial crisis, experiencing no losses when held to maturity. Lastly, for those sectors of the securitization market that did not perform well, the Dodd-Frank Act contains provisions that on their own, or through regulations, are intended to address corrective actions.

Therefore, we urge the Council to recommend to the Agencies that (i) the Securitization Exclusion be clarified to allow banking entities and nonbank financial companies to participate in certain securitization relationships and activities without falling within the scope of the Volcker Rule, (ii) the Volcker Rule recognize that securitization relationships and activities described in the Securitization Exclusion not be prohibited activities under Section 13(a)(2) of the BHC Act and (iii) the definition of "hedge fund and private equity fund" contain appropriate limitations to implement the foregoing modifications[118]. In defining permissible securitization relationships, the Securitization Exclusion must (i) allow banking entities to engage, both directly and indirectly, through affiliates and securitization vehicles which they sponsor, in traditional and sound securitization activities and (ii) recognize the scope and breadth of assets[119] which have been and will continue to be securitized. We firmly believe that in recommending the changes described in this paragraph, the Council will be acting in a manner consistent with Congress' objectives. The Volcker Rule was not enacted to curtail beneficial securitization activities, but rather to provide the Agencies with authority to regulate those issuer funds and activities which have proven overly risky to the financial system. These outcomes are critical to the promotion and protection of a strong and stable banking system and the recovery of the U.S. economy.

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[118] We note that certain additional provisions of the Volcker Rule may require clarification or conforming changes to give effect to the Securitization Exclusion.

[119] In order to avoid what we expect could be an unintended narrow interpretation of the word "loans" used in the Securitization Exclusion, we believe that "loans" should be interpreted in a manner consistent with the concept of "self-liquidating financial assets", a concept commonly used by the SEC and its staff in regulations and interpretations relating to securitizations. As noted by the SEC in the 1992 Release relating to Shelf Registration for Offerings of Investment Grade Asset-Backed Securities, the definition of "financial assets" is intended to be quite broad, including not only loans, but also notes, leases, installment contracts, credit card receivables, accounts receivables and other assets that by their terms convert to cash within a finite period of time. *See* Securities Act Rel. No. 6964 (Oct. 22, 1992).

We are aware that the Council is receiving responses to the Volcker Rule Notice from many interested parties. We expect that most of these responses are focused on the proprietary trading restrictions contained in the Volcker Rule. However, it is critical that the Council give adequate attention to the other prohibitions in the Volcker Rule and their unintended consequences. Our members fully appreciate the need for appropriate regulation of the business relationships that have had a deleterious effect on the banking system and the U.S. economy. We are convinced, however, that the Council would distort the Congressional mandate captured in the Volcker Rule if it applied the prohibitions of that Rule to safe and sound securitization activities.

IX. Capital Adequacy Standards

We have emphasized that, when introducing legislative or regulatory change into a complex adaptive system like the securitization market, several principles must be observed in order for the system to continue functioning during that process:

- The timing and nature of the changes must be coordinated across the entire system.
- System flaws, and not mere symptoms, must be targeted, and needless disruptive changes must be avoided.
- The ripple effects of individual changes must be identified, assessed, and calibrated in advance.
- The strategic plan for change must be flexible enough to accommodate the inevitable consequences of nonlinearities and information constraints.
- Those charged with making the changes must vigilantly keep an eye on the forest as much as, if not more than, the trees.

We also have stressed that the paralysis afflicting much of the securitization market can be traced directly to failures in adhering to these principles.

This is nowhere more evident than in the case of capital adequacy standards. Securitization evolved into one of the most cost-efficient forms of funding because of its capacity to effectively transfer credit risk through the capital markets and to better align the risks of lending with the capital required of lenders. This attribute, which supplies securitization with so much of its value, has already been compromised by some of the more reactionary responses to the financial crisis and is threatened even more by proposals to drastically reshape the regulatory capital charges associated with making loans. The result has been, and if not corrected will continue to be, higher borrowing costs and less available credit for families, businesses, and governments throughout the United States.

Three examples, while by no means complete, illustrate our concern.

Among the most troubling is the liquidity coverage ratio ("LCR") that has been proposed as part of the Basel III reforms. The LCR represents the first hard liquidity buffer ever introduced into global capital adequacy standards and will require financial institutions to prefund their short-term obligations (including unfunded commitments) with unencumbered, high-quality liquid assets. This means for example that, if the highest-rated bank in the United States were to provide an unfunded liquidity facility to the highest-rated corporation, the bank would be required to hold at least an equal amount of government securities or similarly liquid assets to guard against the risk of a draw on that facility. The acquisition of these liquid assets by the bank, moreover, could not be financed through the repo market because they would need to

remain unencumbered at all times. Making the economics even more prohibitive, the bank also would be compelled to hold regulatory capital against both its unfunded commitment and its liquid assets under the leverage ratio contemplated by Basel III.

This simple example just scratches the surface of the many challenges that are presented by the LCR, which is supposed to be a minimum standard but which is premised on a doomsday scenario that is multiple times worse than the recent crisis. While we are reluctant to sound an alarm, the potential for upheaval in the broader economy is becoming all too real. It is not difficult to foresee the commercial-paper market shrinking materially as banks contract their issuance of 30-day-and-under securities and their sponsorship of CP conduits, the money market doing the same because of the lack of available short-term investments, the government and mortgage repo markets following suit because the money-market funds can no longer supply adequate funding, and the cost of financing for governments, homeowners, and commercial real-estate developers skyrocketing. It is equally possible to foresee that, because of incentives in the LCR to build massive stores of retail deposits, global financial institutions will be forced to become more aggressive in competing with money-market funds and community banks for household customers.

A second example is Section 939A of the Dodd-Frank Act, which calls for each federal agency to remove from its regulations any reference to or requirement of reliance on credit ratings. While we have generally supported efforts to improve credit ratings and related process-oriented safeguards, this wholesale eradication of even references to them has left bank regulators and financial institutions in a quandary. The Basel I and II capital adequacy standards, as well as the proposed Basel II.5 and Basel III reforms, are predicated almost entirely on the use

of credit ratings for securitization exposures. There is no straightforward substitute for this conceptual framework, much less one that could ensure a level playing field for institutions in the United States. As a result, supervisory agencies and market participants have been required to redeploy extraordinary resources to develop an alternative that would be sufficiently risk sensitive to meet institutional needs and sufficiently objective to be audited by regulators. Despite months of technical analysis and collaborative dialogue, solutions remain elusive, and concern is growing that the U.S. securitization market could be handicapped for the foreseeable future.

Statements of Financial Accounting Standards Nos. 166 and 167 provide a third example. Prior to 2010, generally accepted accounting principles ("GAAP") incorporated a financial-components approach that recognized the economic consequences of a securitization – that is, the division of assets into credit tranches and the transfer of those tranches to different parties. Under this accounting standard, each transaction participant would take onto its balance sheet the assets allocated to its securitization exposure but not the assets to which other participants would be exposed. Because the financial-components approach resulted in an institution's interest in a securitization being accurately reflected on its books, capital adequacy standards generally designated GAAP as the starting point for determining the institution's risk-based capital requirements. In 2009, however, the Financial Accounting Standards Board reversed course and mandated in FAS 166 and 167 that, in addition to each party recognizing its own exposure to securitized assets, the entity with a potentially significant interest and with the power to direct the activities of the securitization vehicle (almost always the servicer or the collateral manager) consolidate all of those assets for accounting purposes as well. Under this revised standard, for

example, a servicer holding only a 5% subordinated interest in a securitization generally could be required to consolidate onto its balance sheet – and, under the capital adequacy standards which have remain unchanged, hold risk-based capital against – 100% of the securitized assets. Such a disconnect between an institution's risk in a securitization and its risk-based capital requirements has created a perverse incentive, for now, shedding the power to direct activities rather than actual risk is the gauge for reducing capital. Equally if not more important, because the mainstream securitization market is driven by cost-effective funding rather than regulatory capital arbitrage, rationalizing risk-based capital requirements is viewed as crucial to trades clearing at economically sensible levels in bank-sponsored and bank-serviced securitization transactions.

X. RMBS Chain of Title

By way of background, there are approximately 55 million first lien mortgages outstanding in the United States today and an additional 25 million homes that have no mortgage attached to them. The debt outstanding for these 55 million mortgages is nearly $9.75 trillion dollars, of which approximately $7 trillion dollars resides in securitization trusts and are beneficially owned by institutional investors around the world. Approximately $5.5 trillion dollars of these loans are government guaranteed in Ginnie Mae and GSE RMBS, with an additional $1.5 trillion in outstanding private-label RMBS that has no government backstop. An additional $2.75 trillion dollars of mortgage debt is owned in the portfolios of commercial banks, savings institutions and insurance companies. In addition to the $9.75 trillion of outstanding first

lien mortgages, approximately $1 trillion of second liens are currently outstanding in the United States.[120]

Over the last six months, a few commentators have raised a number of legal theories questioning whether securitization trusts, either those created by private financial institutions or those created by government sponsored enterprises, such as Ginnie Mae, Fannie Mae or Freddie Mac, have valid legal title to the seven trillion dollars of mortgage notes in those trusts. In an effort to contribute thorough and well-researched legal analysis to the discussion of these theories, ASF issued a white paper entitled "Transfer and Assignment of Residential Mortgage Loans in the Secondary Mortgage Market" (the "White Paper").[121] The White Paper provides a detailed overview of the legal principles and processes by which mortgage loans are typically held, assigned, transferred and enforced in the secondary mortgage market and in the creation of MBS. These principles and processes have centuries-old origins, and they have continued to be sound and validated since the advent of MBS over forty years ago. Thirteen major U.S. law firms reviewed the White Paper and believe that the Executive Summary contained therein represents a fair summary of the legal principles presented.

While the real property laws of each of the 50 U.S. states and the District of Columbia affect the method of foreclosing on a mortgage loan in default, the legal principles and processes discussed in this White Paper result, if followed, in a valid and enforceable transfer of mortgage notes and the underlying mortgages in each of these jurisdictions. To be thorough, the White

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[120] Data compiled by Amherst Securities, based on information from the Federal Reserve Flow of Funds, Fannie Mae, Freddie Mac, Ginnie Mae and CoreLogic.

[121] *See* "Transfer and Assignment of Residential Mortgage Loans in the Secondary Mortgage Market," American Securitization Forum (November 16, 2010), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_White_Paper_11_16_10.pdf.

Paper undertakes a review of both common law and the Uniform Commercial Code (the "UCC") in each of the 50 U.S. states and the District of Columbia. One of the most critical principles is that when ownership of a mortgage note is transferred in accordance with common securitization processes, ownership of the mortgage is also automatically transferred pursuant to the common law rule that "the mortgage follows the note." The rule that "the mortgage follows the note" dates back centuries and has been codified in the UCC. In essence, this means that the assignment of a mortgage to a trustee does not need to be recorded in real property records in order for it to be a valid and binding transfer.

XI. Covered Bonds

ASF has long been a supporter of the formation of a U.S. covered bond market and believes that a covered bond market could effectively complement, but not replace, the current securitization market. We also believe that an appropriately structured covered bond market could bridge a portion of the gap in mortgage finance should the U.S. government follow through with its plan to phase out the GSEs over time. However, there are current impediments to a liquid covered bond market, including rigid regulatory capital rules and the FDIC's position that it should have first access to a cover pool in the event of a bank's insolvency for the benefit of the Deposit Insurance Fund. ASF's long standing view is that the FDIC's position will largely prevent the development of a significant covered bond market and that a statutory framework, such as the U.S. Covered Bond Act of 2011 introduced by Rep. Scott Garrett (R-NJ), will be necessary to facilitate its growth. On March 11, 2011, ASF testified at a hearing of the HFSC Capital Markets Subcommittee entitled, "Legislative Priorities to Create a Covered Bond Market

in the United States" and indicated our strong support for the United States Covered Bond Act of 2011. That testimony follows.

As many of you may know, the first U.S. insured depository institution ("IDI") covered bond was issued by Washington Mutual ("WaMu") nearly 5 years ago, even without a legislative framework for it. Approximately a year later, Bank of America became the second U.S. bank to issue covered bonds. In the absence of any legislative framework in the United States, these issuances were denominated in Euros and sold predominantly into the European covered bond market as "contractual" covered bonds.

In July 2008, the FDIC published a Final Statement of Policy (the "Final Policy") for the exercise of its receivership and conservatorship authority in respect of covered bond contracts entered into by a U.S. IDI and the U.S. Treasury issued its "Best Practices for Residential Covered Bonds Guidelines"[122] (the "Best Practices Guidelines") for the issuance of contractual U.S. covered bonds in coordination with the FDIC's Final Policy. At the time, Treasury believed a framework defined by policy and regulation[123] would be sufficient to initiate a U.S. covered bond market that could restore the financing that was withdrawing from a declining asset securitization market. This belief was disproved quickly as the financial crisis accelerated into the autumn and culminated with historic emergency measures passed by Congress. Just two months after the Treasury and FDIC frameworks were issued, Washington Mutual was closed by the OTS and the FDIC was appointed receiver. During those two months, secondary market prices of WaMu's Euro-denominated covered bonds fell precipitously as holders of those

[122] Best Practices for Residential Covered Bonds, Department of the Treasury (July 2008).
[123] A framework not defined by specific legislation (a "legislative framework") is herein referred to interchangeably as a regulatory framework, policy framework, or contractual framework.

investments began to focus on the risk that the FDIC's repudiation authority could override contractual protections while the value of the residential mortgages in the covered pool would decline. Historical price data indicate that the WaMu covered bonds traded as low as 75 cents on the dollar, before rallying after the acquisition by J.P. Morgan later that same September in 2008.[124] The 2006 and 2007 issuances by WaMu and Bank of America remain the only U.S. covered bond issues to date. Curiously, no U.S. covered bonds were issued after the FDIC published its Final Policy and the U.S. Treasury published its Best Practices Guidelines.

A. Policy and Regulation Are Insufficient to Support a U.S. Covered Bond Market

The experience of investors in WaMu covered bonds highlighted the weakness in relying on a regulatory, rather than a legislative, framework for U.S. covered bonds. In general, regulatory frameworks are more easily revised than legislative frameworks, which would require an act of sovereign government to change, rather than a regulatory action under the regulator's own control. Consequently, regulatory frameworks are more susceptible to whim or political expediency that can be disruptive of markets and injurious to investors who relied on such frameworks. In particularly good times, investors might be willing to overlook or de-emphasize the risk posed by a regulatory regime, buy the bonds, and accept even an insignificant premium for the incremental risk. This is basically what occurred in the WaMu story. When stress arises, however, at the precise moment that a framework needs to show stability and resilience, markets will focus their attention on the weaknesses and extract a sometimes painful toll for their sheer presence. If we are to start a new and promising financial sector, we can ill-afford to marry it to

[124] "Washington Mutual's Covered Bonds", Harvard Business School, 9-209-0923, Daniel B. Bergstresser, Robin Greenwood, James Quinn, Rev. (Oct. 22, 2009).

a weak legal framework. The centerpiece of any legal framework will be that framework's treatment of covered bonds in the event of an issuer's insolvency.

B. The Need to Curb FDIC Insolvency Resolution Authorities by Passing U.S. Covered Bond Legislation

In a prospective U.S. covered bond market, the FDIC would be the operative regulator for IDIs that choose to issue covered bonds. Our expectation would be for much of the early U.S. covered bonds market to be developed by U.S. banks, given the experience in other countries. As it now stands, the FDIC's authority as receiver or conservator is simply contradictory and counterproductive to the creation of a healthy legal framework for a covered bond market. This is because the FDIC has too much discretion to choose among resolution alternatives that would have varying consequences for covered bondholders, especially including the worst-case outcome that the FDIC could elect to repudiate a covered bond contract, determine the fair market value of the cover pool securing the covered bonds, and pay covered bondholders the lesser of par or cover pool fair market value with interest accrued only through the date of the FDIC's appointment as receiver, and not to the date on which investors are actually repaid.

Even if the FDIC were to promulgate guidance limiting itself to its more investor-friendly bank insolvency resolution alternatives, investors would lack confidence in and be reluctant to rely on such self-governed guidance. This is because the FDIC would have an inherent conflict of interest to take action that minimizes losses to the Depository Insurance Fund ("DIF"), regardless of whether such result came at the expense of secured creditors. Such conflict of

interest was amplified in acts of earlier Congresses requiring the FDIC to use the "least costly" transaction(s) for resolving insolvent IDIs and giving depositors a payment priority over other unsecured creditors of an insolvent bank. This being the case, legislation is required to limit the FDIC's optionality in resolving the covered bond contracts of a bank under the receivership or conservatorship control of the FDIC. Allowing the FDIC to retain its current authority under Section 11(e)(12) of the Federal Deposit Insurance Act ("FDI Act") in respect of an IDI's secured indebtedness for covered bonds would be a grave policy misstep in our view, and would undermine the market before it can be developed. In the opinion of our issuer and investor members, covered bond legislation needs to set a clear and unmistakable set of resolution mechanics that assure investors will receive the economic value of a market-based negotiation of contracts consistent with the principles already in long-standing operation around the globe for this type of indebtedness. Only legislation can create a carve out for covered bonds in order to curb the insolvency authorities the FDIC now has over covered bonds to the extent necessary to establish a U.S. legislative framework that is competitive with the more established programs domiciled elsewhere.

C. Concerns that Covered Bond Legislation Would Increase the Risk of Loss to the Depository Insurance Fund and to the U.S. Taxpayer Are Misplaced

Some fear that an investor-friendly U.S. covered bond legislation would pose greater risks to the FDIC DIF and ultimately to the U.S. taxpayer. We believe any such fears are misplaced, especially since, by the FDIC's own account, Dodd-Frank has "granted the FDIC the ability to achieve goals for [DIF] fund management that it has sought for decades but lacked the

tools to accomplish"[125]. Among other things, Dodd-Frank raised the minimum designated reserve ratio ("DRR"), removed its upper limit, eliminated the requirement that the FDIC dividend amounts when the DRR is between 1.35% and 1.5%, granted the FDIC sole authority to determine dividend policy above a DRR of 1.5%, and set the calculation of insurance premiums against total assets, not total deposits.[126] Accordingly, it would seem more logical for the FDIC to adjust deposit insurance premiums to the asset-liability practices of IDIs, including any covered bond issuance practices, rather than seek to maintain their traditional insolvency authorities which could impede or even prevent a U.S. covered bond market from becoming a feature of our credit system. Perhaps even the FDIC has come to recognize this in a post Dodd-Frank world, as the September 15, 2010 testimony of the FDIC before the Senate Banking Committee includes a sentence whereby the FDIC witness Michael Krimminger, currently the FDIC's General Counsel, states, "[t]he FDIC would support covered bond legislation that clarifies the amount of repudiation damages to be the par value of outstanding bonds plus interest accrued through the date of payment."[127] Such a policy stance would be a significant improvement from the FDIC's Final Policy wherein the FDIC takes the position that repudiation would mean a payment equal to the lesser of par or the fair market value of the cover pool, plus bond interest accrued to the date on which the FDIC was appointed receiver. This Final Policy subjects investors to market-value loss on the cover pool and could additionally cause a period of lost interest payments for investors. While such movement in policy stance is encouraging, it does not go far enough as the FDIC would still retain an option that is exercisable against

[125] 76 Fed. Reg. 10673 (Feb. 25, 2011).
[126] *Ibid.*
[127] Statement of Michael H. Krimminger, Deputy to the Chairman, Federal Deposit Insurance Corporation on Covered Bonds: Potential Uses and Regulatory Issues, Committee on Banking, Housing, and Urban Affairs, U.S. Senate (Sept. 15, 2010).

investors: *if the cover pool were unhealthy*, the FDIC would turn the cover pool over to an estate for the benefit of covered bondholders who would likely encounter a loss and a resulting unsecured deficiency claim against the issuer; *if the cover pool were healthy*, the FDIC would liquidate it, capture the excess collateral value for the insolvent estate, and pay par to investors, exposing them to what could be potentially material re-investment risk. Still, the movement in the FDIC's policy stance is encouraging in that it signals further movement could occur in favor of a globally competitive U.S. covered bond framework.

D. The Global Nature of a Substantial Covered Bond Market

Like so many financial markets today, the covered bond market is a global market, though it remains concentrated in its European geography of origin. Covered bonds date back to 18th century Prussia, when the Pfandbriefe was introduced by the decree of King Frederick the Great to enable the property of nobles to be pledged as collateral to investors in exchange for agricultural credit. The German Mortgage Bank Act of 1900 modernized the original concept by creating a formal legal framework that assured the cover pool would be ring-fenced on an issuer's balance sheet and that investors in covered bonds had recourse to both the cover pool and the issuer in the event of a default[128]. The first issue of French legal covered bonds (Obligations Foncières) was created by decree in 1852 by Crédit Foncier de France under the *société de credit Foncier* statute. The main business of Crédit Foncier de France, founded in 1852, is to grant mortgage-backed real estate loans and local authority loans and to issue bonds to finance these loans.[129]

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[128] *The Conundrum of Covered Bonds*, Steven L. Schwarcz, forthcoming in The Business Lawyer, May 2011.
[129] *Natixis Credit Research*, Cristina Costa and Jennifer Levy (March 2011).

Today, some 29 countries are counted as having covered bond frameworks rooted in regulation, contract law, or legislation. 22 countries now have legislated covered bond market structures, with Australia, Canada, and New Zealand in the process of passing legislation for covered bonds[130]. Germany, Spain, Denmark, France, and the UK represent nearly 80% of the outstanding covered bonds.[131] The Euro is the predominant currency in which covered bonds are issued, and there are between 140 and 150 issuers of Euro-benchmarked covered bonds. [132]

There is a clear preference for legislative (or statutory) covered bond frameworks. Of the estimated €2.5 trillion in outstanding covered bonds, an estimated 92% were issued under legislative frameworks. A central feature of statutory frameworks concerns the legal framework for insolvency of the covered bond issuer. Effective legislative frameworks include a specific legal framework superseding the general insolvency law. The typical legal framework under legislated market structures affords investors dual recourse: recourse to the cover pool as a secured creditor and recourse to the issuer as an unsecured creditor for amounts not repaid by the cover pool. Of additional importance, the insolvency of the issuer does not automatically trigger the acceleration of the covered bond indebtedness and an accompanying liquidation of the cover pool. This last feature mitigates reinvestment risk, or the risk that an issuer's insolvency would trigger a prepayment to covered bond investors that at a given moment could not be reinvested for comparable investment return to that of the prepaid covered bonds.

The economic benefits of a country's covered bond program can be significant. Market research shows that banks issuing covered bonds can save between 20 and 60 basis points per

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[130] European Covered Bond Fact Book, European Covered Bond Council (Sept. 2009).
[131] *Ibid.*
[132] *Natixis Credit Research*, Cristina Costa and Jennifer Levy (March 2011).

year on interest rates when compared to the rates paid on their senior unsecured issues of comparable maturity[133]. Such savings can be transmitted through society in the form of lower rates on the consumer and commercial credit that finances our economy, stimulates growth, and creates jobs. During periods of economic stress, the relative differential between secured and unsecured borrowing costs increases. Over the past year, such differential expanded to over 4% per annum for weaker banks operating in stressed economies.[134] The ability to issue relatively lower-cost financing, which becomes increasingly relative lower-cost financing during periods of worsening economic and financial stress, is a distinguishing benefit of covered bonds.

E. The Barren but Rapidly Changing Landscape for U.S. Covered Bonds and the Investment Market's Need for Highly-Rated Fixed Income Private Sector Investment

Since the U.S. Treasury, in coordination with the FDIC, issued guidelines in support of establishing a U.S. covered bond market, there has been no issuance of a covered bond by a U.S. issuer. Part of this absence may be explained by the limited investor appetite for exposure to U.S. residential mortgage loans not guaranteed by one of the GSEs (residential mortgage loans are, by far, the primary type of collateral in cover pools worldwide). Part of this absence may also be explained by the continuing role of the GSEs and FHA, which have been responsible for 95% of all new residential mortgage loans having been made in the U.S. in these recent years. Part of the absence may also be explained by the repaired balance sheets of U.S. banks, which have shown a limited need for securitization or secured financing in the face of a rising deposit base.

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[133] *Ibid.*
[134] *Ibid.*

But the landscape is changing rapidly. Although there was only one U.S.$ issuance of a covered bond in 2009—which took place outside the United States—2010 saw a huge increase in U.S.$ issuance of covered bonds. 21 covered bond issues were denominated in U.S.$ in 2010, from issuers based in France, Germany, the United Kingdom, Sweden, Norway and the Netherlands. 2010 U.S.$ covered bond issuance aggregated $30 billion, beginning a trend that has been continuing into 2011[135]. Our neighbors to the North, in Canada, issued 9 of these 21 U.S.$ deals in 2010, aggregating half the total 2010 U.S.$ issuance volume. They issued at rates of interest that were materially lower than other U.S.$ issuers, which is attributable to the extremely low risk of the collateral in their cover pools, which consists of Canadian residential mortgage loans that are guaranteed by Canada Mortgage and Housing Corp., the "AAA" rated full faith and credit Canadian Government agency. In short, our U.S.$-based investors have been investing noticeably in U.S.$ covered bonds for over a year now, but they have been buying them from non-U.S. issuers.

When the approach taken by Treasury to implement a policy framework for contractual covered bond issuance by U.S. issuers failed to gain traction, ASF membership was very supportive of your efforts Chairman Garrett for a legislative response. In March 2010, the United States Covered Bond Act of 2010 was introduced, which was the right idea at the right time, as the market has already validated the movement towards U.S. dollar-denominated covered bonds even before U.S. legislation has passed. We can now interpret this movement as an invitation to pass legislation, which could have a positive transformative effect on the U.S. banking and financial system. Asset securitization was the primary manufacturer of "AAA"

[135] *Natixis Credit Research*, Spreads and Credit, Covered Bond (Nov. 2010), Christina Costa, Jennifer Levy, in collaboration with François Le Roy.

rated private-sector investments, but the post-crisis issuance of "AAA" rated securities has dropped to a fraction of its pre-crisis volume. It is clear that non-U.S. issuers are tapping into the U.S. investor demand for high-quality investments like those offered under existing covered bond frameworks. The ASF voices its full support for such an enacting piece of legislation.

F. ASF Recommendations in Support of Effective U.S. Covered Bond Legislation

In contemplating the United States Covered Bond Act of 2011 and in considering the type of legislation that would be most constructive to the emergence of a deep and liquid U.S. covered bond market, the members of the ASF would like to articulate some principles that we believe should be present in the legislation.

In particular, effective legislation in favor of covered bonds should be as investor-friendly as possible. Many institutional investors in the U.S. and abroad are living with the painful memory of recent government-sponsored intervention that has compromised the operation of contracts. Moreover, the attempt by some regulators to exercise expansive authority over the efficacy of certain debt capital markets products also threatens the confidence investors have in government- led market initiatives. A striking recent example of this expansive view is the FDIC Safe Harbor. The FDIC has publicly stated that such rules are intended to protect the investors in future asset-backed securities sponsored by IDIs, but in fact it will be the investors who lose the protection of an insolvency-remote true sale if the affected IDI failed to meet or comply with the requirements of the FDIC Safe Harbor over which investors have no control.

ASF submits the following essential principles that we believe should be present in the legislation, among others:

1. **The legislation should allow for bank and non-bank entrants without discriminating on the basis of size or credit quality.** Investors should be afforded a menu of alternative covered bonds, which includes multiple issuers of varied standing. This would allow a more balanced flow of capital into the credit sector and avoid imbalances and over-investment in a small number of issuers and too few covered bond programs. It also would avoid the pitfall of having legislation pick the "winners" and "losers."

2. **The legislation should allow a wide variety of collateral types to be included in the cover pool.** Such optionality would allow for investor choice and market-based preferences to balance the flow of capital into an emergent U.S. covered bond sector. Collateral types could include residential mortgage loans, loans outstanding under home equity lines of credit, multi-family housing loans, commercial mortgage loans, auto loans, auto leases, student loans, consumer credit card loans, public sector loans, other types of loans deemed appropriate by the supervising authority, and securities backed by any of the foregoing collateral types provided the security is not backed by more than one, homogenous collateral type.

3. **The legislation should not allow different types of collateral to be co-mingled in the same cover pool, but instead require asset type homogeneity within a cover pool.** This will facilitate elegant simplicity and create standardization and enhanced transparency from the investment perspective. As the U.S. emerges from a rather opaque, complex, and non-standard system of mortgage securitization, aspects of a new secured finance system would find greater uptake in biasing themselves to enhanced simplicity, standardization, and the resulting improvement in transparency.

4. **The legislation must allow investors full dual recourse: first, to the cover pool as a primary source of payment for principal and interest on the covered bonds, and second, as unsecured creditors to the issuer in the event the cover pool proceeds are insufficient to repay principal and interest in full on the covered bonds.** A covered bond investor's unsecured claim should rank *pari passu* with the other senior, unsecured claims on the issuer. Dual recourse is, in fact, 100% "skin-in-the-game". The bank is fully liable to repay the covered bonds and the cover pool assets remain on the balance sheet of the issuing bank, leaving no question around the alignment of interest between issuer and investor. For banks and non-banks with high senior unsecured credit ratings, a covered bond issuance should allow them to issue at appreciably lower rates of interest than where they would issue unsecured debt and be competitive to where they would issue securitization debt rated as high as their own rating. In Europe, we see a significant difference between the rates paid by top-tier banks on their unsecured debt versus their covered bond issuances, with covered bond debt yields being appreciably lower than unsecured debt of comparable maturity.

5. **The legislation should stipulate a specific legal framework that supersedes general insolvency law for the absolute protection of covered bond investors, consistent with the principle articulated in number 4 above.** In our view, investor reception of a U.S. covered bond market will be directly determined by the issuer insolvency framework that accompanies it. If investors fear that an issuer's regulator, the FDIC in the case of U.S. IDIs, can interfere with or have a claim upon the assets in a cover pool, then U.S. covered bonds will be relatively unattractive compared to those issued in other jurisdictions where

the priority of claim of bondholders on cover pool assets is a cornerstone of covered bond legislation. Investors would treat them as quasi-secured but price them more like unsecured, which in turn would eliminate the motivation for issuers to issue. If investors fear that an issuer's regulator can force the early liquidation of a covered pool, and leave them under-secured or at risk of reinvesting par proceeds in lower-yielding investments, investors will most likely require a risk premium that would again increase the cost of issuance relative to an issuer's alternatives. Worse still, from a systemic perspective, such a covered bond paradigm would miss a great opportunity to introduce a great stabilizer in the world of bank asset-liability management. The ability to pledge assets under a robust and investor-friendly secured financing framework, like covered bonds, offers banks and non-banks alike a potentially valuable source of financing and simultaneously offers investors a safer investment during periods of credit and liquidity stress in our financial system. This benefit should not be understated and can become of paramount importance and utility during periods of heightened counterparty credit concerns, like the extreme counterparty credit concerns we experienced in the Credit Crisis of 2008. Indeed, it was precisely this potential that motivated the former U.S. Treasury Secretary Henry Paulson to advance a covered bond framework, but the initiative came too late into the crisis and relied on a weaker regulatory approach rather than a stronger legislative approach to have counteracted the overwhelming forces we confronted in an enormous crisis that was accelerating at the time.

6. **The assets in a cover pool should be segregated from the issuer's other assets, or clearly identified as such to avoid any likelihood that cover pool assets would**

become co-mingled with other assets of the issuer or with an issuer's insolvency estate. Covered bond investors should bear no doubt over the proper identification and segregation of assets comprising the cover pool which secures them. One way to assure such treatment would be to require a periodic audit of an issuer's books and records to determine that the asset segregation standard has been satisfied, to report any deficiencies to a responsible party, and to assure an actionable remedy is imposed on a capable party to cure any non-compliance in a timely fashion.

7. **The issuer should maintain a continuing obligation to "cover" the bonds issued under their covered bond program with a sufficient level of collateral and overcollateralization consisting of performing (non-defaulted), self-liquidating financial assets.** This requirement is universally incorporated into covered bond programs around the world and provides assurance to investors that the cover pool would at all times generate sufficient, self-liquidating proceeds from performing financial assets to repay the full amount of principal and interest without their having to rely on the issuer's unsecured credit quality to do so.

8. **The maturity limit applicable to covered bonds (and cover pool assets) should extend to 30 years.** Such a limit is consistent with the FDIC's Final Policy, which was increased from 10 years after consideration of comments received on their Interim Policy Statement and the FDIC's own view that "longer-term covered bonds should not pose a significant, additional risk and may avoid short-term funding volatility."[136] A 30-year term limit would allow issuers to tap into the long-end of the yield curve and better

[136] 73 Fed. Reg. 43756 (July 28, 2008).

maturity-match to longer dated assets, such as 30-year, fixed-rate mortgages. With regard to such a feature, like a maturity limit on cover pool assets, the more flexibility the final legislation affords issuers, the more likely issuance will emerge.

9. **Covered bonds should be allowed to include provisions for additional credit enhancements, liquidity support, interest rate and currency swaps or options.** These types of instruments may prove useful, and even necessary, by the market to create a more stable investment profile for investors and an even better asset-liability match for issuers than they might otherwise be able to achieve if the use of hedge instruments like the ones mentioned here were disallowed or unnecessarily restricted.

G. Other Considerations for the Legislative Process

In promoting the principles set forth above, it may also be worth noting that our members do not necessarily feel that the legislation needs to be overly prescriptive. Certain elements may be best left for the market to discover, or by Treasury as the principal covered bond regulator. One such element may be the level of overcollateralization. Considering that Dodd-Frank is mandating risk retention for asset securitization on the order of 5% generally, it should be a strikingly clear distinction that covered bonds, by definition, have a 100% risk retention associated with them. This being the case, overcollateralization would exist solely for the benefit of global, market-based investors of adequate sophistication to evaluate the appropriateness of overcollateralization requirements vis à vis the collateral comprising a cover pool. As our recommendation is to allow a wide range of collateral to be eligible for inclusion in covered bond programs, it would be natural to let the investor market set corresponding

overcollateralization requirements, especially since we know from experience that different types of assets require different levels of overcollateralization to achieve comparable credit profiles for the liabilities issued against the assets. This would make sense from the regulator's perspective as well, as in theory, regulators would prefer lower overcollateralization requirements so more assets are immediately available to depositors and unsecured creditors than would otherwise be the case if overcollateralization levels were mandated at levels above what was needed in the market.

Other features of an emergent covered bond system may be best decided by legislation if it is likely regulation will only serve to restrain the formation of a deep and liquid market. For example, the FDIC Final Policy restricts covered bond issuance to 4% of an IDI's liabilities. While their reasoning is understandable,[137] a 4% limit would impose a theoretical initial maximum market size for covered bond issuance of $474 billion, assuming the highly improbable outcome that every bank issued to their maximum limit.[138] When banks are already subject to leverage ratios, we question the necessity of requiring an initial market size cap that could merely serve to dissuade issuance by signaling to IDI's that covered bonds will not be allowed to become a sufficiently meaningful asset-liability tool needed to justify the upfront commitment of time, effort, money, and resources to commence an issuance program.

Still, other features are worthy of inclusion in any final legislation, and some may even be necessary for a U.S. covered bond market. For example, it is typical of many European

[137] "The 4 percent limitation under the Policy Statement is designed to permit the FDIC, and other regulators, an opportunity to evaluate the development of the covered bond market within the financial system of the United States, which differs in many respects from that in other countries deploying covered bonds." 73 Fed. Reg. 43756 (July 28, 2008).
[138] Fitch Ratings, U.S. Housing Reform Proposal FAQs: Filling the Void, February 24, 2011.

covered bond frameworks to provide for special supervision of an issuer's obligations in respect of the cover pool, which is supervision specifically for the benefit of covered bondholders, as compared to more general credit institution or markets supervision. Frequently, this kind of supervision is conducted by designated public authorities, which frequently require a covered bond issuer to obtain a license to issue covered bonds. In a number of countries, the public authority is also the banking supervisory authority. In others, the covered bond supervisory authority is the markets regulator. Such public authorities either appoint or approve a cover pool monitor to assure covenant compliance with the terms and conditions of the covered pool legal contracts, and some of these authorities may conduct their own periodic audits of the cover pool programs they supervise. Article 22 (4) of the Directive in Undertakings for Collective Investment in Transferable Securities (the "UCITS Directive"), which is included in other EC directives, affords favorable treatment, such as risk weightings, to covered bonds subject to special public supervision. Calibrating the legislation to afford special treatment for covered bond investments could enlarge the potential for this new market and may also be necessary if U.S. covered bonds are to find as broad and deep an investor base as the covered bonds issued from frameworks in other countries.

Given the extensive history, longevity, and size of the European covered bond market and the remaining need to encourage private sector credit flows in the United States, the ASF is strongly supportive of a legislative framework for U.S. covered bonds. Our support comes despite the potential for covered bond issuance to draw market share from securitization issuance. This is because we believe securitization will re-emerge as a healthy and viable financing, capital-management, and risk-management technology whether or not a covered bond

market is established in the United States. Moreover, covered bonds and securitization can co-exist in a complementary fashion with one another, as they have for some time in Europe. We also believe it is our obligation as professionals to advocate for disciplined, market-based developments that will promote the availability and affordability of consumer credit to all Americans, just as securitization has been doing for many years. We believe that industry, legislators, regulators, and other policymakers can work in an open, democratic fashion to innovate financial solutions for this greater good. We applaud Chairman Garrett, his co-sponsor Congresswoman Maloney, and this Subcommittee for its forward-thinking initiative and persistence to see the dawn of a new financial technology that will establish a more balanced continuum of asset-liability management alternatives for our credit institutions. By offering credit institutions the ability to issue longer-term, secured liabilities, covered bonds will fill a void that exists among existing alternatives, like short-term unsecured debt (eg, demand deposits), short-term secured debt (eg, repos), longer-term unsecured debt (eg, term CDs and MTNs), and securitization. The filling of such a void can lower the cost of financing a credit institution, which in turn can lower the cost of consumer credit while simultaneously expanding its availability. At a time when we need to transfer public sector support for private sector financing back to the private sector to reduce our fiscal deficits and remove our potentially inflationary monetary policies; at a time when we need to find avenues to create and expand credit to drive consumer spending and real GDP growth; at a time when we need to create jobs, this covered bond legislation could not come at a better time for the financial industry or our economy.

XII. Conclusion

ASF has been a strong and vocal advocate for targeted securitization market reforms and we continue to work with regulators to identify and implement them. ASF supports efforts to align the incentives of issuers with securitization investors and we believe these incentives should encourage the application of sound underwriting standards by both the originator and securitizer in connection with the assets that are securitized. In addition, we support efforts to promote appropriate transparency and standardization in securitization disclosure and transaction documents. ASF will continue to work to provide industry comment on all proposals issued by the various regulatory agencies as well as to promulgate best practices for securitization governance in order to restore confidence in this very important market. Where regulators are tasked with implementing reforms, we support uniform implementation across regulators supported by comprehensive industry and public comment, rather than the piecemeal, brash approach that was taken by the FDIC in enacting the FDIC Safe Harbor. The ASF greatly appreciates the invitation to appear before this Subcommittee to share our views related to these critical issues facing the securitization market. I look forward to answering any questions the Subcommittee may have.

Thank you.

ATTACHMENT A

Role of Securitization within the Financial System and U.S. Economy

The Current State of the Market

As the Federal Reserve Board noted in its recent study on risk retention, different segments of the ABS and MBS markets have recovered differently during the 18 months since the recession ended.[139] Auto and auto-related ABS accounted for $53.9 billion in issuance in 2009, which represents 80.7% of the auto and auto-related ABS issuance of $66.8 billion during 2007, just before the downturn.[140] $7.2 billion in equipment ABS was issued during 2009, in contrast with the 2007 issuance of $6.1 billion.[141] In 2009, credit card ABS accounted for $46.6 billion in issuance, down 50.7% from 2007 issuance of $94.5 billion.[142] Meanwhile, the student loan sector issued $20.8 billion in ABS during 2009, down 64.2% from 2007 issuance of $58.1 billion.[143] By comparison, on the RMBS side, $48.1 billion of RMBS were issued in 2009, down 92.5% from 2007 issuance of $641.8 billion.[144] In addition to the overall reduction of issuance in the RMBS market, we further note that 97% of RMBS were federally-backed in 2010, as compared with only 64% in 2007 when the private market accounted for a much larger share of RMBS issuance.[145]

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[139] Board of Governors of the Federal Reserve System, "Report to the Congress on Risk Retention" (Oct. 2010), p. 2., *available at* http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf.
[140] Data are from Asset Backed Alert, *see* the Proposing Release, p. 12-13, *available at* http://www.sec.gov/rules/proposed/2011/34-64148.pdf.
[141] *Ibid.*
[142] *Ibid.*
[143] *Ibid.*
[144] *Ibid.*
[145] Analysis by 1010data, based on data from FNMA, GNMA and FHLMC.

Simply put, the absence of a properly functioning securitization market, and the funding and liquidity this market has historically provided, adversely impacts consumers, businesses, financial markets and the broader economy. The recovery and restoration of confidence in securitization is therefore a necessary ingredient for economic growth to resume, and for that growth to continue on a sustained basis into the future. ASF supports efforts to align the incentives of issuers and originators with securitization investors and believe these incentives should encourage the application of sound underwriting standards by both the originator and securitizer in connection with the assets that are securitized. We believe that risk retention can aid in achieving this goal so long as the requirements are tailored to each class of securitized assets as described in this testimony. We believe that the Joint Regulators must carefully calibrate the risk retention requirements so as to not impede the securitization markets recovery and further constrain the availability of credit.

Why is Securitization Important?

Securitization—generally speaking, the process of pooling and financing consumer and business assets in the capital markets by issuing securities, the payment on which depends primarily on the performance of those underlying assets—plays an essential role in the financial system and the broader U.S. economy. Over the past 40 years, securitization has grown from a relatively small and unknown segment of the financial markets to a mainstream source of credit and financing for individuals and businesses alike.

In recent years, the role that securitization has assumed in providing both consumers and businesses with credit is striking: currently, there is over $11 trillion of outstanding securitized

assets, including RMBS, ABS and ABCP. This represents a market substantially larger than the normal size of all outstanding marketable U.S. Treasury securities—bonds, bills, notes, and TIPS combined.[146] Between 1990 and 2006, issuance of MBS grew at an annually compounded rate of 13%, from $259 billion to $2 trillion a year.[147] In the same time period, issuance of ABS secured by auto loans, credit cards, home equity loans, equipment loans, student loans and other assets, grew from $43 billion to $753 billion. In 2006, just before the downturn, nearly $2.9 trillion in RMBS and ABS were issued. As these data demonstrate, securitization is clearly an important sector of today's financial markets.

The importance of securitization becomes more evident by observing the significant proportion of consumer credit it has financed in the U.S. It is estimated that securitization has funded between 30% and 75% of lending in various markets, including an estimated 64% of outstanding home mortgages.[148] Securitization plays a critical role in non-mortgage consumer credit as well. Historically, banks securitized 50-60% of their credit card assets.[149] Meanwhile, in the auto industry, approximately 91% of auto industry sales are financed through auto ABS.[150] Overall, recent data collected by the Board show that securitization has provided over 25% of

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[146] U.S. Department of the Treasury, "Monthly Statement of the Public Debt of the United States: January 31, 2011," (January 2011), *available at* http://www.treasurydirect.gov/govt/reports/pd/mspd/2011/opds012011.pdf.
[147] National Economic Research Associates, Inc. ("NERA"), "Study of the Impact of Securitization on Consumers, Investors, Financial Institutions and the Capital Markets," p. 16 (June 2009), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_NERA_Report.pdf (the "NERA Study").
[148] Fitch Ratings, "U.S. Housing Reform Proposal FAQs: Filling the Void" p. 1-2 (Feb. 2011), *available at* http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=606315 (registration required).
[149] Citigroup, "Does the World Need Securitization?" p. 10 (Dec. 2008), *available at* http://www.americansecuritization.com/uploadedFiles/Citi121208_restart_securitization.pdf.
[150] *Ibid.*, p. 10.

outstanding U.S. consumer credit.[151] Securitization also provides an important source of commercial mortgage loan financing throughout the U.S., through the issuance of CMBS.

Over the years, securitization has grown in large measure because of the benefits and value it delivers to transaction participants and to the financial system. Among these benefits and value are the following:

A. *Efficiency and Cost of Financing.* By linking financing terms to the performance of a discrete asset or pool of assets, rather than to the future profitability or claims-paying potential of an operating company, securitization often provides a cheaper and more efficient form of financing than other types of equity or debt financing.

B. *Incremental Credit Creation.* By enabling capital to be raised via securitization, lenders can obtain additional funding from the capital markets that can be used to support incremental credit creation. In contrast, loans that are made and held in a financial institution's portfolio occupy that capital until the loans are repaid.

C. *Credit Cost Reduction.* The economic efficiencies and increased liquidity available from securitization can serve to lower the cost of credit to consumers and businesses. Several academic studies have demonstrated this result. A recent study by National Economic Research Associates, Inc., concluded that securitization lowers the cost of consumer

[151] Federal Reserve Board of Governors, "G19: Consumer Credit," (Sept. 2009), *available at* http://www.federalreserve.gov/releases/g19/current/g19.htm.

credit, reducing yield spreads across a range of products including residential mortgages, credit card receivables and automobile loans.[152]

D. *Liquidity Creation.* Securitization often offers issuers an alternative and cheaper form of financing than is available from traditional bank lending, or debt or equity financing. As a result, securitization serves as an alternative and complementary form of liquidity creation within the capital markets and primary lending markets.

E. *Risk Transfer.* Securitization allows entities that originate credit risk to transfer that risk throughout the financial markets to parties willing to assume it, such as institutional investors and hedge funds.[153]

F. *Customized Financing and Investment Products.* Securitization allows for precise and customized creation of financing and investment products tailored to the specific needs of both issuers and investors. For example, issuers can tailor securitization structures to meet their capital needs and preferences and diversify their sources of financing and liquidity. Investors can tailor securitized products to meet their specific credit, duration, diversification and other investment objectives.

Recognizing these and other benefits, policymakers globally have taken steps to help encourage and facilitate the recovery of securitization activity. Discussing the Joint Regulators' risk retention rulemaking, Acting Comptroller of the Currency John Walsh stated, "I think it's vital that we craft a final rule that does not impede the revival of the securitization markets. We

[152] NERA Study, p. 16, *available at* http://www.americansecuritization.com/uploadedFiles/ASF_NERA_Report.pdf.
[153] The vast majority of investors in the securitization market are institutional investors, including banks, insurance companies, mutual funds, money market funds, pension funds, hedge funds and other large pools of capital.

will be hard pressed to fund the needs of American consumers, particularly in the area of housing, without securitization..."[154] The G-7 finance ministers, representing the world's largest economies, declared that "the current situation calls for urgent and exceptional action...to restart the secondary markets for mortgages and other securitized assets."[155] The Department of the Treasury stated in March, 2009, that "while the intricacies of secondary markets and securitization...may be complex, these loans account for almost half of the credit going to Main Street,"[156] underscoring the critical nature of securitization in today's economy. The Chairman of the Board noted that securitization "provides originators much wider sources of funding than they could obtain through conventional sources, such as retail deposits" and also that "it substantially reduces the originator's exposure to interest rate, credit, prepayment, and other risks."[157] Echoing that statement, the Financial Stability Oversight Council in its recent study on *Macroeconomic Effects of Risk Retention Requirements* stated that, "By providing access to the capital markets, securitization has improved the availability and affordability of credit to a diverse group of businesses, consumers, and homeowners in the United States." There is clear recognition in the official sector of the importance of the securitization process and the access to financing that it provides lenders as well as its importance in providing credit that ultimately flows to consumers, businesses and the real economy.

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[154] Walsh, John, "Remarks Before the American Bankers Association Government Relations Summit." *Office of the Comptroller of the Currency* (March 2011), *available at* http://www.occ.treas.gov/news-issuances/speeches/2011/pub-speech-2011-26.pdf.

[155] G-7 Finance Ministers and Central Bank Governors Plan of Action (Oct. 10, 2008), *available at* http://www.treas.gov/press/releases/hp1195.htm.

[156] U.S. Department of the Treasury, "Road to Stability: Consumer & Business Lending Initiative," *available at* http://www.financialstability.gov/roadtostability/lendinginitiative.html.

[157] Bernanke, Ben S., "Speech at the UC Berkeley/UCLA Symposium: The Mortgage Meltdown, the Economy, and Public Policy, Berkeley, California." *Board of Governors of the Federal Reserve System* (Oct. 2008), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20081031a.htm.

Restoration of function and confidence to the securitization markets is a particularly urgent need, in light of capital and liquidity constraints currently confronting financial institutions and markets globally. As mentioned above, at present nearly $11 trillion in U.S. assets are funded via securitization. With the process of bank de-leveraging and balance sheet reduction still underway, and with increased bank capital requirements on the horizon, such as those expected in Basel III, the funding capacity provided by securitization cannot be replaced with deposit-based financing alone in the current or foreseeable economic environment. In fact, the IMF estimated that a financing "gap" of $440 billion existed between total U.S. credit capacity available for the nonfinancial sector and U.S. total credit demand from that sector for the year 2009.[158] Moreover, non-bank finance companies, which have played an important role in providing financing to consumers and small businesses, are particularly reliant on securitization to fund their lending activities, because they do not have access to deposit-based funding. Small businesses, which employ approximately 50% of the nation's workforce, depend on securitization to supply credit that is used to pay employees, finance inventory and investment, and fulfill other business purposes. Furthermore, many jobs are made possible by securitization. For example, a lack of financing for mortgages hampers the housing industry; likewise, constriction of trade receivable financing can adversely affect employment opportunities in the manufacturing sector. To jump start the engine of growth and jobs, securitization is needed to help restore credit availability.

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[158] International Monetary Fund, "The Road to Recovery." *Global Financial Stability Report: Navigating the Financial Challenges Ahead* (Oct. 2009), p. 29, *available at* http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf.

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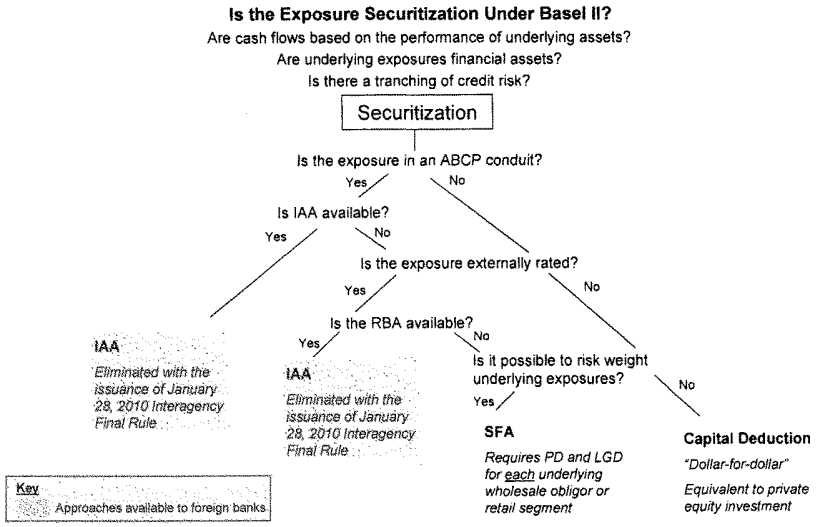
ATTACHMENT B

Basel II Securitization Decision Tree



PREPARED STATEMENT OF MARTIN S. HUGHES

PRESIDENT AND CHIEF EXECUTIVE OFFICER, REDWOOD TRUST, INC.

MAY 18, 2011

Introduction

Good Morning, Chairman Reed, Ranking Member Crapo, and Members of the Committee. My name is Marty Hughes, and I am the CEO of Redwood Trust, Inc., a publicly traded company listed on the New York Stock Exchange. I appreciate the opportunity to testify on the state of the residential mortgage securitization market and look forward to responding to your questions.

Overview

My testimony is focused on restoring a fully functioning private-sector residential mortgage finance market. Currently, about 90 percent of all new mortgage originations rely on Government support.[1] Given the fact that there is $9.6 trillion of outstanding first lien mortgage debt,[2] this level of public subsidization is simply not sustainable. That being said, reducing the current level of governmental support, whether immediately or gradually over time, will have severe consequences for the housing market if the private sector is not prepared to step in with investment capital to replace a diminished level of Government backing.

The consequences of failing to attract sufficient private-sector capital to this market include a contraction in the availability of credit to home buyers, an increase in mortgage rates, and continued decreases in home prices. Furthermore, these problems in the housing market may have broader negative effects on the overall economy.

The main sources of private-sector capital that previously financed residential mortgages include banks, mutual funds, pension funds, and insurance companies. For the nonbanks, the transmission mechanism for providing this financing was through their investments in triple-A rated residential mortgage-backed securities (RMBS). My testimony will recommend how to bring these "triple-A investors" back to this securitization market, thereby enabling the Government to reduce its role in the mortgage market without negative consequences.

Background on Redwood

Redwood commenced operations in 1994 as an investor in residential mortgage credit risk. We are not a direct lender or mortgage servicer. Our primary focus has been on the prime jumbo mortgage market, or that portion of the mortgage market where the loan balances exceed the limits imposed by Fannie Mae and Freddie Mac (the "GSEs") for participation in their programs. Similar to the GSEs, Redwood also provides credit enhancement, but our focus is on the prime jumbo mortgage market. We provide credit enhancement by investing in the subordinated securities of private-label residential mortgage securitizations, which enables the senior securities to obtain triple-A ratings. From 1997 through 2007, Redwood securitized over $35 billion of mortgage loans through 52 securitizations.

Recent Securitization Activity

In April 2010, Redwood was the first company, and is so far the only company, to sponsor a securitization of newly originated residential mortgage loans without any Government support since the market froze in 2008. The size of that first transaction was $238 million. In March 2011, we completed a second securitization of $295 million, and we hope to complete two more securitizations this year.

Completing these transactions required that we address the concerns and interests of triple-A investors who, in the wake of the financial crisis, had lost confidence that their rights and interests would be respected and, consequently, that their investments would be safe and secure. We worked hard to regain their trust by putting together transactions that included even more comprehensive disclosure, better structure, and a new enforcement mechanism for representation and warranty breaches. In addition, Redwood retained meaningful exposure to the transaction's future performance—*i.e.,* through risk retention or "skin-in-the-game"—and, in doing so, aligned our interests with those of investors. Investors responded with significant demand to acquire the triple-A rated securities, as evidenced by the fact that the first offering of those securities was oversubscribed by a factor of six to one. The second securitization was also quickly and fully subscribed.

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[1] *2011 Mortgage Market Statistical Annual,* Volume I , p. 19.

[2] Federal Reserve Flow of Funds of the United States, Fourth Quarter, Tables L.217 and L.218

To be clear, Redwood Trust has a financial interest in the return of private sector securitization for residential mortgages. We hoped that our decision to securitize loans in 2010 would demonstrate to policy makers that private capital would support well-structured securitizations that also have a proper alignment of interests between the sponsor and the triple-A investors. Based in part on the success of our two recent mortgage securitizations and ongoing discussions with triple-A investors, we have confidence that the private market will continue to invest in safe, well-structured, prime securitizations that are backed by "good" mortgage loans. We consider "good" loans as loans on properties where the borrowers have real down payments, capacity to repay, and good credit. We are proud of our history of sponsoring residential mortgage securitizations and our more recent role in helping to restart the private securitization market, and are pleased to have the opportunity to share our insights and observations with the Committee.

The Private Mortgage Securitization Outlook for 2011

The outlook for nongovernment or private-label residential mortgage securitization volume backed by newly originated mortgage loans (new securitizations) in 2011 remains very weak by historical standards. Year-to-date through April 30, 2011, only one new securitization totaling $295 million has been completed, and that was our deal. We hope to complete two more securitizations in 2011 and securitize between $800 million and $1.0 billion for the year, and to build upon that volume in 2012. There are no good industry estimates for new private securitization volume in 2011, as the market is still thawing from its deep freeze. While we would welcome other securitizations in 2011 to provide additional third-party validation of the viability of securitization, the yearly volume will almost certainly be a small fraction of the $180 billion average annual issuance completed from 2002 through 2007, when the market began to shut down.[3]

Major Hurdles to Private Mortgage Securitization Activity

1. Crowding out of private sector

Through the GSEs and the Federal Housing Administration (FHA), the Government has stepped in and taken the credit risk on about 90 percent of the mortgages originated in the U.S., without passing on the full cost of the risk assumed. Government subsidies must be scaled back to permit a private market to flourish. We note that post-crisis, the private asset-backed securities markets for auto loans, credit cards loans, and now commercial real estate loans are up and functioning, while the private-label RMBS market barely has a pulse. The difference is the pervasive below-market Government financing in the residential mortgage sector that is crowding out traditional private market players.

Critics will argue that Redwood's transactions were backed by unusually high quality jumbo mortgage loans and are therefore not representative of the market. In fact, that argument proves the point that the Government is crowding out private label securitizations, by maintaining an abnormally high conforming loan limit and by subsidizing the guarantee fees that the GSEs charge issuers. No private sector securitizer can compete with that—we can only securitize the small volume of prime quality loans beyond the Government's reach. We are ready to purchase and securitize prime mortgage loans of any loan amount, and can do so at an affordable rate once the Government creates a level playing field.

We strongly advocate testing the private market's ability to replace Government-dependent mortgage financing on a safe and measured basis. A first step would be to allow the scheduled reduction in the conforming loan limit in high cost areas from $729,750 to $625,500 to occur as scheduled in September 2011. We believe there is ample liquidity in the banking system to allow banks to step into the breach, while financing through private residential mortgage securitization regains its footing.

Additionally, the Administration should follow through on its plan to increase guarantee fees to market levels over time to eventually level the field between the private market and the GSEs. A gradual Government withdrawal from the mortgage market over a 5-year period will enable time for a safe, attractive, robust private label market to develop.

As the housing market begins to recover, we support further measured reductions on a periodic basis in the conforming loan limit as a means to increase the share of the mortgage market available to the private sector. We note that with housing prices now down in excess of 30 percent from their peak in mid-2006,[4] it would

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[3] *2011 Mortgage Market Statistical Annual*, Volume II, p. 31.

[4] S&P/Case-Shiller Home Price Index press release dated April 26, 2011.

seem logical to consider reducing the conforming loan limit by a similar amount over time.

2. Balance Sheet Capacity of Commercial Banks

The second hurdle to increased private securitization activity is the unprecedented amount of liquidity in the banking system. With $1.5 trillion in excess liquidity and historically low funding costs, there is no financial incentive for bank originators to securitize loans. Instead, banks are eager to retain their non-GSE eligible mortgage loan originations for their balance sheet loan portfolio in order to earn the attractive spread between their low cost of funds and the rate on the loans. To the extent that banks are selling nonagency loans, they are generally selling longer duration mortgages to reduce their interest rate risk. We expect this issue to resolve itself when the Fed eventually withdraws the excess liquidity from the banking system.

3. Regulatory

In the wake of the Dodd Frank Act, there are many new regulatory requirements and market standards out for comment, but they are not yet finalized. The resulting uncertainty keeps many market participants out of the market. Once the rules of the road are known, market participants can begin to adjust their policies, practices, and operations.

A. Dodd-Frank Act Implementation Overview

We recognize joint regulators had a very difficult task in establishing, writing, and implementing the new rules as required by the Dodd-Frank Act. Before I go through specifics, we offer some high level observations on the joint regulators' notice of proposed rulemaking on risk retention (NPR).

The NPR as written has some technical definitional and mechanical issues that need to be fixed. In particular, how the premium capture account works. This issue has been the source of much debate and ire by market participants. We are hopeful that appropriate corrections will be made after all comment letters are received.

We would also note that regulators took a well-intentioned approach to craft a new set of risk retention rules to cover the entire mortgage securitization market which, in theory, should be a more expedient method for restarting securitization. However, there are complex differences between the prime and subprime markets and their unique securitization structures that make it very difficult to apply a one-size-fits-all set of new rules.

The details are far too complex for this testimony, but to oversimplify, the proposed rules are effectively subprime-centric. While the rules do a good job of addressing and deterring abuses of subprime securitization structures, they are overly and unnecessarily harsh when applied to prime securitization structures. This is meaningful since prime loans are likely near 90 percent of the overall market. If the proposed rules are adopted as written, prime borrowers whose loans are financed through private securitization will face unnecessarily higher mortgage rates.

In Redwood's comment letter to the NPR, we intend to offer a more refined approach that would keep intact the necessary safety protections, but eliminate the unnecessary structural inefficiencies that would lead to higher prime mortgage rates.

We believe that restoring the prime segment of the market in a safe yet efficient manner would bring the greatest benefit to the largest number of stakeholders (borrowers, lenders, investors, and taxpayers) and would become more effective and productive than attempting to craft one all encompassing regulatory solution.

B. Form of Risk Retention

We are strong advocates of requiring securitization sponsors to retain risk in order to properly align their interests with those of investors. We support the intent of the joint regulators' NPR on this issue. In fact, it has always been Redwood's operating model to retain the first-loss risk in our securitizations.

The NPR proposes four forms of risk retention: (1) a horizontal slice consisting of the most subordinate class or classes; (2) a vertical slice with *pro-rata* exposure to each class; (3) a combination of horizontal and vertical slices; and (4) a randomly selected sample of loans.

Redwood believes the most effective form of risk retention is the horizontal slice and that other forms are much less effective. The horizontal slice requires the sponsor to retain all of the first-loss securities and places the sponsor's entire investment at risk. Only that approach will provide the required incentive for a sponsor to ensure that the senior securities are backed by safe and sound loans, which will benefit borrowers as well as investors.

The other forms of risk retention result in substantially less of the sponsor's investment in the first risk position, which reduces the incentive to sponsor quality

securitizations. Over time, we believe investors will vote on the best form of risk retention and reward sponsors that retain horizontal "skin in the game."

C. Qualified Residential Mortgages

We support the intention of the proposed definition of a qualified residential mortgage (QRM), but we believe it is a bit too restrictive. We support the concept of "common sense" underwriting, similar to the standards used by the GSEs for so many years prior to the period leading up to the credit bubble that resulted in low credit losses for many years. We note there is nothing in the NPR that prohibits lenders from making loans that do not meet the QRM standards.

D. Servicer Functions and Responsibilities

We believe that the well-publicized mortgage servicing issues are an impediment to broadly restarting private residential mortgage securitization. Beyond the issue of lost documents and foreclosure practices, servicers have been on the front lines throughout the recent crisis. Focusing more narrowly on their role in the securitization structure, they have sometimes been placed in the position of having to interpret vague contractual language, ambiguous requirements, and conflicting direction. In their role, they are required to operate in the best interest of the securitization and not in the interest of any particular bond holder. In practice, without any clear guidance or requirements, they invariably anger one party or another when there are disagreements over what is and is not allowed—with the result of discouraging some triple-A investors from further investment in RMBS. We propose that uniform standards governing servicer responsibilities and conflicts of interest be established and that a credit risk manager be established to monitor servicer performance and actions. We have discussed this servicing issue in greater detail and have proposed recommendations in our "Guide to Restoring the Private-Sector Residential Mortgage Securitization", which is available on our Web site.

Other Hurdles to Private Mortgage Securitization

While the focus of this hearing is on the state of the securitization markets and we believe we are moving in the right direction and addressing the securitization issues we need to address, we also need to broaden the focus beyond lenders and Wall Street. If we really want to restore a safe securitization market, we should also address second liens. One of the significant factors that contributed to the mortgage and housing crisis was the easy availability of home equity loans. Plain and simple, the more equity that a borrower has in his or her home, the more likely that borrower will continue to make mortgage payments.

Although the proposed QRM standard will encourage lenders to originate loans to borrowers who have a minimum 20 percent down payment, there is no prohibition against the borrower immediately obtaining a second lien to borrow back the full amount of that down payment. The addition of a second lien mortgage that substantially erodes the borrower's equity and/or substantially increases a borrower's monthly debt payments increases the likelihood of default on the first mortgage. Many of the current regulatory reform efforts are centered on creating an alignment of interests between sponsors and investors through risk retention or "skin-in-the-game." However, the first and most important line of defense is at the borrower level. If the borrower can take his or her own "skin" out of the game through a second mortgage, what have we really accomplished? The answer is very little. We believe this result will be very discouraging to private-label RMBS investors.

To prevent the layering of additional leverage and risk, it is common in other forms of secured lending (including commercial and corporate lending) to require either the consent of the first lien holder to any additional leverage or to limit the new borrowing based on a prescribed formula approved by the first lien holder. We recommend extending this concept to residential mortgages.

Specifically, we recommend enactment of a Federal law that would prohibit any second lien mortgage on a residential property, unless the first lien mortgage holder gives its consent. Alternatively, a second mortgage could be subject to a formula whereby the new combined loan-to-value (based on a new appraisal) does not exceed 80 percent.

Impact on Mortgage Rates

Some market participants have been very vocal about the potential negative impact on mortgage rates as a result of the proposed definition of a QRM and/or the phase out of the GSEs. Recent news articles have speculated that mortgage rates will rise dramatically, by as much as 300 basis points. We don't agree.

We do believe residential mortgage rates could rise modestly—by perhaps 50 basis points—as the Government withdraws from the market. The Government support effectively subsidizes borrowing rates and it is reasonable to expect these rates to

rise somewhat as the subsidy is withdrawn. We nevertheless expect borrowing rates to remain attractive.

For context, in our most recent deal, the average mortgage interest rate for 30-year fixed rate loans backing the securitization was 0.46 percent above the Government-guaranteed rate. As the number and diversity of loans available for private label securitization increases, thereby lowering risk, it is possible that residential mortgage rates could rise by less than 50 basis points relative to Government rates.

Another reason we do not believe that mortgage interest rates will increase substantially is the sheer amount of global investment capital looking for ways to generate returns, from bank balance sheets, insurance companies, and mutual funds to non-U.S. financial institutions, hedge funds, and even residential investment trusts. The competition for returns is too great to allow such a rise in mortgage rates, assuming well underwritten loans with proper disclosure and alignment of interests.

Conclusion

When I look ahead—and admittedly you need to jump pretty high—I see a number of positives emerging: safer mortgages that borrowers can afford, the return of loan loss rates to historically low norms for newly originated prime loans, and private capital willing to fund residential mortgages at affordable rate for borrowers through responsible, safe securitization. The first step is to give the private sector a chance by following through on the Administration's plan to reduce the conforming loan limits and increase the GSE's guarantee fees to market rates at a safe and measured pace.

Thank you for the opportunity to testify before the Subcommittee today. I would be happy to answer your questions.

PREPARED STATEMENT OF LISA PENDERGAST

PRESIDENT, COMMERCIAL REAL ESTATE FINANCE COUNCIL

MAY 18, 2011

The Commercial Real Estate (CRE) Finance Council is grateful to Chairman Reed, Ranking Member Crapo, and the Members of the Subcommittee for holding this hearing to examine the state of the securitization market. Commercial real estate is the backbone of the American economy. Commercial real estate houses the space where everyone in your States goes to work and, in the case of multifamily, live. Specifically, commercial real estate comprises the office buildings where employees work; the strip malls, grocery stores and other retail establishments where goods are sold and food purchased; the small business spaces on main street that drive local economies; the industrial complexes that produce steel, build cars, and create jobs; the hospitals where doctors tend to the sick; and the hotels where relatives, vacationers and business executives stay.

The CRE Finance Council represents all constituencies in the broader CRE finance market that provides the money to finance these businesses, and we appreciate the opportunity to share our views on the current state of the Commercial Mortgage-Backed Securities (CMBS) sector of the securitization markets. As explained in detail below, the CMBS market is in the early stages of what we hope will be a robust recovery. At this moment, the securitization risk retention framework mandated by Dodd-Frank is the biggest threat to sustaining that recovery. While we are thankful to both Senator Crapo for his amendment to Dodd-Frank that created specific a CMBS retention framework, and to the regulators for considering that framework in their deliberations, we have serious concerns with the proposed rules. Specifically, there are three areas under the rules that could negatively affect the industry if implemented as proposed, including the: (1) Premium Cash Capture Reserve Account; (2) Conditions for a third party to purchase the risk; and (3) the exemption for qualified commercial loans. Under the terms of the statute, those rules will not go into effect until 2013. It is critical that the six agencies that are charged with implementing the CMBS components of that securitization risk retention framework take whatever time they need now to get the rules right. We therefore ask you to communicate with the regulators and urge them to take their time finalizing this important set of rules by extending the current June 10th rulemaking response date and by then reproposing the draft rule which—hopefully—will incorporate and respond to the extensive industry feedback that they will receive.

Introduction and Overview

The $7 trillion commercial real estate market in the United States is just emerging from a period of serious duress brought on by the severe economic downturn, and significant hurdles remain to recovery in the near term. The challenges posed

by the distress the CRE market has experienced will continue to have an impact on U.S. businesses that provide jobs and services, as well as on millions of Americans who live in multifamily housing. Since 2009, the CRE problem shifted from a crisis of confidence and liquidity to a crisis of deteriorating commercial property fundamentals, plummeting property values and rising defaults. Through 2017, approximately $600 million of CMBS loans and over $1.2 trillion in outstanding commercial mortgages will mature, many of which are secured by smaller CRE properties; borrower demand to refinance those obligations will be at an all-time high. [1]

Prior to the onset of the economic crisis, commercial mortgage-backed securities (CMBS) were the source of approximately half of all CRE lending, providing approximately $240 billion in capital to the CRE finance market in 2007 alone. After plummeting to a mere $2 billion in 2009 at the height of the crisis, the CMBS market began to see signs of life in 2010 with $12.3 billion in issuance. Thus far in 2011, just under $10 billion CMBS have been issued, with projections for full-year volume ranging from $30 to $50 billion. Furthermore, the total CMBS issuance for 2011 is expected to range from $30 to $50B, depending on a number of factors including economic conditions and the manner in which regulatory and accounting changes are implemented.

One of the overarching questions faced at this juncture is whether CMBS will be able to satisfy the impending capital needs posed by the refinancing obligations that are coming due. Without CMBS, there simply is not enough balance sheet capacity available through traditional portfolio lenders such as banks and life insurers to satisfy these demands. It is for this reason that Treasury Secretary Geithner noted 2 years ago that "no financial recovery plan will be successful unless it helps restart securitization markets for sound loans made to businesses—large and small." [2] Similarly, then-Comptroller of the Currency John C. Dugan noted that, "[i]f we do not appropriately calibrate and coordinate our actions, rather than reviving a healthy securitization market, we risk perpetuating its decline—with significant and long-lasting effects on credit availability." [3]

Against this backdrop, Congress adopted a credit risk retention framework for asset-backed securities in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). [4] At the same time, the CRE finance industry has taken direct steps to strengthen the CMBS market and to foster investor confidence through the completion of "market standards" in the areas of representations and warranties; underwriting principles; and initial disclosures. Scores of members of the CRE Finance Council across all of the CMBS constituencies worked diligently on these market reforms for over a year. We anticipate that new market standards, coupled with the unparalleled disclosure regime already in place in the CMBS market, will create increased transparency and disclosure in underwriting and improved and enforceable industry representations and warranties, all of which we believe will go a long way toward meeting both investor demands and the Dodd-Frank risk retention objectives.

We are thankful to Senator Crapo, who added a provision to Dodd-Frank requiring the regulators to specifically address some of the unique issues and opportunities posed by the CMBS asset class in crafting the risk retention rules for CMBS. And we are grateful to the regulators who have abided by this mandate in issuing their initial set of proposed risk retention rules for comment.

That said, the proposed rule is long and complicated, containing over 300 pages of analysis and roughly 170 questions open for comment. As explained in detail below, several facets of the proposal are controversial. Indeed, as the regulatory process moves forward, many will argue that implementing certain requirements—or the failure to implement certain requirements—will be a death knell for the market. The more likely outcome is that the failure to get the details right will restrict the overall amount of capital that is available through the securitization finance markets. The proposed rules impose additional costs on and will—in some cases—disincentivize issuers and disrupt the efficient execution of capital structures that securitization provides.

If not properly constructed, the risk retention rules could potentially result in a significantly smaller secondary market, less credit availability, and increased cost

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[1] The Dodd-Frank NPR: Implications for CMBS, April 12, 2011, Morgan Stanley at 1.

[2] Remarks by Treasury Secretary Timothy Geithner Introducing the Financial Stability Plan (Feb. 10, 2009) available at *http://www.ustreas.gov/press/releases/tg18.htm.*

[3] Remarks by John C. Dugan, Comptroller of the Currency, before the American Securitization Forum (Feb. 2, 2010), at 2 (available at *http://www.crefc.org/uploadFiles/CMSA__Site__Home/Government__Relations/CMBS__Issues/TALF__Treasury__Plans/DuganRemarksatASF201.pdf.*).

[4] Pub. L. No. 111-203.

of capital for CRE borrowers. This may result in balance sheet lending (*i.e.*, portfolio lending) at more competitive rates (which would be counter to historical experience), thus attracting the safest risks to the portfolio space and leaving the smaller and/or riskier loans for the CMBS where borrowers will have to pay higher rates. Further, small borrowers—those that are not concentrated in the major urban areas and that need loans in the sub-$10 million space—would be the primary victims of these changes. For these reasons, 23 separate trade organizations, representing many different types of borrower constituencies, as well as lenders and investors in different asset classes, jointly signed a letter last year urging careful consideration of the entirety of the reforms to ensure that there is no disruption or shrinkage of the securitization markets. [5]

As our members continue to work through the proposed rule to better crystallize our views, we cannot overstate the stakes, given that this rule will directly impact credit availability and the overall economic recovery. The agencies need to satisfy the somewhat arbitrarily imposed Congressionally mandated rule promulgation schedule, and we are concerned that the ultimate judgments they reach may not be as soundly thought through as a more generous schedule would allow. We therefore ask that you consider extending those deadlines; this may be especially appropriate given the fact that under the Dodd-Frank provisions the rules for nonresidential asset-backed securities would not go into effect for an additional 2 years and our industry could still abide by that final effective date even if more time were allotted prior to finalizing the actual rules.

We also ask that you urge the regulators to take advantage of such an extended rule promulgation schedule by both (a) holding public roundtables to ensure that the public understands the intent behind each proposed provision, and (b) reproposes the rules for further comment after initial comments are received on June 10th. As one prominent commentator has noted:

> Still, that there appeared to be such a wide gap between regulators' intentions and the market's interpretation for the proposal's language suggests that a single round of formal market feedback, after which the regulators finalize the rules, may not be enough. This would especially be the case if the final rules indeed contained substantial revisions to key provisions, such as the premium capture account. Such revisions could introduce fresh confusion or misrepresentation of the regulators' intentions. [6]

As noted, such a deliberate approach and a reproposal of the rules need not alter the effective implementation date for the industry, given that the statute does not dictate that the rules be effective until 2013 and the CMBS industry does not need 2 years to effectuate the new retention requirements.

The balance of our testimony will focus on six key areas:

1. A description of the CRE Finance Council and its unique role;
2. The current state of CRE finance, including the challenges that loom for the $3.5 trillion in outstanding CRE loans;
3. A framework for a recovery, including the unique structure of the commercial market and the importance of having customized regulatory reforms;
4. The CRE Finance Council's market standards initiatives, which have been designed to build on existing safeguards in our industry, to promote certainty and confidence that will support a timely resurgence of the CRE finance market in the short term, and a sound and sustainable market in the long term;
5. The CRE Finance Council's general reactions to the recently proposed regulation to implement Dodd-Frank's risk retention requirement; and
6. Actions that can be taken to ensure that the CMBS securitization market continues to heal and recover.

Discussion

1. The CRE Finance Council

The CRE Finance Council is the collective voice of the entire $3.5 trillion commercial real estate finance market, including portfolio, multifamily, and CMBS lenders; issuers of CMBS; loan and bond investors such as insurance companies, pension funds, and money managers; servicers; rating agencies; accounting firms; law firms; and other service providers.

Our principal missions include setting market standards, facilitating market information, and education at all levels, particularly related to securitization, which

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[5] A copy of the March 25, 2010, letter is attached.

[6] Citigroup Global Markets CMBS Weekly at 10 (April 29, 2011).

has been a crucial and necessary tool for growth and success in commercial real estate finance. To this end, we have worked closely with policy makers in an effort to ensure that legislative and regulatory actions do not negate or counteract economic recovery efforts in the CRE market. We will continue to work with policy makers on this effort, as well as our ongoing work with market participants and policy makers to build on the unparalleled level of disclosure and other safeguards that exist in the CMBS market, prime examples of which are our "Annex A" initial disclosure package, and our Investor Reporting Package™ (IRP) for ongoing disclosures.

While the CMBS market is very different from other asset classes and is already seeing positive developments, the CRE Finance Council is committed to building on existing safeguards, to promote certainty and confidence that will support a timely resurgence in the short term and a sound and sustainable market in the long term. In this regard, we have worked with market participants to develop mutually agreed upon improvements needed in the CRE finance arena that will provide an important foundation for industry standards. Prime examples of our work include both the CRE Finance Council's "Annex A" initial disclosure package and the Investor Reporting Package™ for ongoing disclosures.

Furthermore, our members across all constituencies have devoted an extraordinary amount of time over the past year to working collaboratively and diligently on the completion of market standards for: (1) Model Representations and Warranties; (2) Underwriting Principles; and (3) Annex A revisions, all of which we previously have shared with the regulators charged with implementing the Dodd-Frank risk retention rules: the Securities and Exchange Commission, Federal Reserve Board, Federal Deposit Insurance Corporation, Department of the Treasury, and the Office of the Comptroller of the Currency. We anticipate that these three new market standards initiatives, along with the unparalleled ongoing disclosure offered by our existing IRP, will create increased transparency and disclosure in underwriting and improved industry representations and warranties and enforcement, which we believe will go a long way toward meeting both investor demands and Dodd-Frank objectives.

2. The Current State of CRE Finance

CRE is a lagging indicator that is greatly impacted by microeconomic conditions, and as such, began to be affected by the prolonged economic recession relatively late in the overall economy's downward cycle. What started as a "housing-driven" recession due to turmoil in the residential/subprime markets (in which credit tightened severely) quickly turned into a "consumer-driven" recession, impacting businesses and the overall economy. Not surprisingly, CRE has come under strain in light of the economic fundamentals today and over the last three years, including poor consumer confidence and business performance, high unemployment and property depreciation. Unlike previous downturns, the stress placed on the CRE sector today is generated by a "perfect storm" of several interconnected challenges that compound each other and that, when taken together, has exacerbated the capital crisis and will prolong a recovery:

- *Severe U.S. Recession*—There is not greater effect on CRE than jobs and a healthy economy. With a prolonged recession and an unemployment rate at or above 8.8 percent for the last 24 months, commercial and multifamily occupancy rates, rental income, and property values have subsequently been negatively impacted, thus perpetuating the economic downturn. Those impacts persist even as the recession has abated.
- *"Equity Gap"*—During the worst of the economic crisis, our industry saw CRE assets depreciate in value by 30 percent to 50 percent from peak 2007 levels, creating an "equity gap" between the outstanding loan amount and the current value of the CRE property, thus requiring additional equity to extend or refinance a loan. This dynamic affects even "performing" properties that continue to support the payment of monthly principal and interest on the underlying loans. While there has been some lessening of the equity gap in the past year as the slide in property values slowed, the market is at a sensitive point on the climb toward recovery and a shortage of capital at this stage could cause a resurgence of the equity gap problem.
- *Significant Loan Maturities*—Approximately $1.2 trillion in CRE loans mature over the next several years. Perhaps most significant is that many of those loans will require additional "equity" to refinance given the decline in CRE asset values.
- *CMBS Restarting—Slowly*—Even in normal economic conditions, the primary banking sector lacked the capacity to meet CRE borrower demand. That gap

has been filled over the course of the last two decades by securitization (specifically, CMBS) which utilizes sophisticated private investors—pension funds, mutual funds, life insurance companies, and endowments, among others—who bring their own capital to the table and fuel lending. CMBS accounts, on average, for approximately 25 percent of all outstanding CRE debt, and as much as 50 percent at the peak, while readily identifiable properties funded by CMBS exist in every State and Congressional district. However, a prolonged liquidity crisis caused the volume of new CRE loan originations and thus new CMBS to plummet from $240 billion in 2007 (when CMBS accounted for half of all CRE lending) to $12 billion in 2008 and $2 billion in 2009. In 2010, the CMBS market began to see signs of life with $12.3 billion in issuance, while issuance is expected to range between $30 and $50 billion in 2011, depending upon a number of economic conditions and uncertainty related to regulatory and accounting changes. While there is revitalized activity in the CMBS space, there is a mismatch between the types of loans that investors are willing to finance and the refinancing that existing borrowers are looking for to extend their current loans.

While the market has evolved from the initial liquidity crisis, there is still an unfortunate combination of circumstances that leave the broader CRE sector and the CMBS market with three primary problems: (1) the "equity gap" (again, the difference between the current market value of commercial properties and the debt owed on them, which will be extremely difficult to refinance as current loans mature); (2) a hesitancy of lenders and issuers to take the risk of "originating" or "aggregating" loans for securitization, given the uncertainty related to investor demand to buy such bonds (this 3–6 month "pre-issuance" phase is known as the "aggregation" or "warehousing" period); and (3) the tremendous uncertainty created by the multitude of required financial regulatory changes, which serve as an impediment to private lending and investing, as the markets attempt to anticipate the impact these developments may have on capital and liquidity. Indeed, market analysts have concluded that regulatory uncertainty will likely delay recovery of the securitization markets, including one observer that recently concluded that the delay would be for at least another 12 months. [7]

The importance of the securitized credit market to economic recovery has been widely recognized. Both the previous and current Administrations share the view that "no financial recovery plan will be successful unless it helps restart securitization markets for sound loans made to consumers and businesses—large and small." [8] The importance of restoring the securitization markets is recognized globally as well, with the International Monetary Fund noting in a Global Financial Stability Report last year that "restarting private-label securitization markets, especially in the United States, is critical to limiting the fallout from the credit crisis and to the withdrawal of central bank and Government interventions." [9]

Current State of Small Business Lending Finance

Significantly, it is also important to be aware of the importance of securitization to smaller businesses that seek real estate financing. The average CMBS securitized loan is $8 million. As of July 2010, there were more than 40,000 CMBS loans less than $10 million in size with a combined outstanding balance of $158 billion, which makes CMBS a significant source of capital for lending to small businesses. Therefore, when evaluating securitization reforms like the proposed risk retention rules, policy makers should be mindful that changes that could halt or severely restrict securitization of CRE loans will have a disparate adverse impact on small businesses, and on capital and liquidity in CRE markets in smaller cities where smaller CRE loans are more likely to be originated.

As many independent research analysts have noted, while the overall CRE market will experience serious strain (driven by poor consumer confidence and business performance, high unemployment and property depreciation), it is the nonsecuritized debt on the books of small and regional banks that will be most problematic on a relative basis, as the projected default rates for such unsecuritized com-

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[7] *See,* "A Guide to Global Structured Finance Regulatory Initiatives and Their Potential Impact", Fitch Ratings (Apr. 4, 2011), at 1 (available at *http://www.fitchratings.com/creditdest/reports/report_frame.cfm?rpt_id=571646*).

[8] Remarks by Treasury Secretary Timothy Geithner Introducing the Financial Stability Plan (Feb. 10, 2009) available at *http://www.ustreas.gov/press/releases/tg18.htm.*

[9] International Monetary Fund, "Restarting Securitization Markets: Policy Proposals and Pitfalls," Chapter 2, Global Financial Stability Report: Navigating the Financial Challenges Ahead (October 2009), at 33 ("Conclusions and Policy Recommendations" section) available at *http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf.*

mercial debt have been, and are expected to continue to be, significantly higher than CMBS loan default rates.

3. A Framework for Recovery—Customized Reforms That Take Into Account the Unique Characteristics of the CMBS

The private investors who purchase CMBS, and thereby provide the capital that supports the origination of loans for CMBS, are absolutely critical to restarting commercial mortgage lending in the capital markets that are critical to a CRE recovery. Accordingly, Government initiatives and other reforms must support private investors—who bring their own capital to the table—in a way that gives them certainty and confidence to return to the capital markets. This type of support can and will vary by asset class. The Board of Governors of the Federal Reserve issued a "Report to the Congress on Risk Retention" as required under the Dodd-Frank mandate, concluding just that:

> simple credit risk retention rules, applied uniformly across assets of all types, are unlikely to achieve the stated objective of the Act—namely, to improve the asset-backed securitization process and protect investors from losses associated with poorly underwritten loans . . . the Board recommends that rule makers consider crafting credit risk retention requirements that are tailored to each major class of securitized assets. Such an approach could recognize differences in market practices and conventions, which in many instances exist for sound reasons related to the inherent nature of the type of asset being securitized. Asset class-specific requirements could also more directly address differences in the fundamental incentive problems characteristic of securitizations of each asset type, some of which became evident only during the crisis. [10]

CMBS has innate characteristics that minimize the risky securitization practices that policy makers sought to address in Dodd-Frank. More specifically, the unique characteristics that set CMBS apart from other types of assets relate not only to the type and sophistication of the borrowers, but to the structure of securities, the underlying collateral, and the existing level of transparency in CMBS deals, each of which are briefly described here:

- *Commercial Borrowers*: Part of the difficulty for securitization as an industry arose from practices in the residential sector, for example, where loans were underwritten in the subprime category for borrowers who may not have been able to document their income, or who may not have understood the effects of factors like floating interest rates and balloon payments on their mortgage's affordability. In contrast, commercial borrowers are highly sophisticated businesses with cash flows based on business operations and/or tenants under leases (*i.e.,* "income-producing" properties). Additionally, securitized commercial mortgages have different terms (generally 5–10 year "balloon" loans), and they are, in the vast majority of cases, "nonrecourse" loans that allow the lender to seize the collateral in the event of default.
- *Structure of CMBS:* There are multiple levels of review and diligence concerning the collateral underlying CMBS, which help ensure that investors have a well

[10] Board of Governors of the Federal Reserve System, Report to Congress on Risk Retention (October 2010), at 3 (available at *http://federalerserve.gov/boarddocs/rtpcongress/securitization/riskretention.pdf*). *See also* Daniel Tarullo, Federal Reserve Governor, Statement Before The House Committee on Financial Services (Oct. 26, 2009) ("A credit exposure retention requirement may thus need to be implemented somewhat differently across the full spectrum of securitizations in order to properly align the interests of originators, securitizers, and investors without unduly restricting the availability of credit or threatening the safety and soundness of financial institutions."); John C. Dugan, Comptroller of the Currency, Statement on the Federal Deposit Insurance Corporation's Advance Notice of Proposed Rulemaking on Securitizations (Dec. 15, 2009), at 1-3 ("[R]ecent studies note that a policy of requiring a rigid minimum retention requirement risks closing down parts of securitization markets if poorly designed and implemented. Before proposing and implementing such a requirement for all securitizations, further analysis is needed to ensure an understanding of the potential effects of the different ways in which risk could be retained.").

Similarly, the International Monetary Fund has warned that "[p]roposals for retention requirements should not be imposed uniformly across-the-board, but tailored to the type of securitization and underlying assets to ensure that those forms of securitization that already benefit from skin in the game and operate well are not weakened. The effects induced by interaction with other regulations will require careful consideration." International Monetary Fund, "Restarting Securitization Markets: Policy Proposals and Pitfalls," Chapter 2, Global Financial Stability Report: Navigating the Financial Challenges Ahead (October 2009), at 109 ("Conclusions and Policy Recommendations" section) available at *http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf.*

informed, thorough understanding of the risks involved. Specifically, in-depth property-level disclosure and review are done by credit rating agencies as part of the process of rating CMBS bonds. Moreover, nonstatistical analysis is performed on CMBS pools. This review is possible given that there are far fewer commercial loans in a pool (traditionally, between 100 to 200 loans; while some recent issuances have had between 30 and 40 loans) that support a bond, as opposed, for example, to residential pools, which are typically comprised of between 1,000 and 4,000 loans. The more limited number of loans (and the tangible nature of properties) in the commercial context allows market participants (investors, rating agencies, *etc.*) to gather detailed information about income producing properties and the integrity of their cash flows, the credit quality of tenants, and the experience and integrity of the borrower and its sponsors, and thus conduct independent and extensive due diligence on the underlying collateral supporting their CMBS investments.

- *First-Loss Investor (B-Piece Buyer) Re-Underwrites Risk*: CMBS bond issuances typically include a first-loss, noninvestment grade bond component. The third-party investors that purchase these lowest-rated securities (referred to as "B-piece" or "first-loss" investors) conduct their own extensive due diligence (usually including, for example, site visits to every property that collateralizes a loan in the loan pool) and essentially re-underwrite all of the loans in the proposed pool. Because of this, the B-piece buyers often negotiate the removal of any loans they consider to be unsatisfactory from a credit perspective, and specifically negotiate with bond sponsors or originators to purchase this noninvestment-grade risk component of the bond offering. This third-party investor due diligence and negotiation occurs on every deal before the investment-grade bonds are issued. We also note that certain types of securitized structures are written so conservatively that they do not include a traditional "B-Piece." Such structures, for example, include extremely low loan-to-value, high debt-service-coverage-ratio pools that are tranched only to investment grade.
- *Greater Transparency:* CMBS market participants already have access to a wealth of information through the CRE Finance Council Investor Reporting Package™, which provides access to loan-, property-, and bond-level information at issuance and while securities are outstanding, including updated bond balances, amount of interest and principal received, and bond ratings. Our reporting package has been so successful in the commercial space that it is now serving as a model for the residential mortgage-backed securities market. By way of contrast, in the residential realm, transparency and disclosure are limited not only by servicers, but by privacy laws that limit access to borrowers' identifying information. Importantly, the CRE Finance Council released version "5.1" of the IRP in December, 2010 to make even further improvements. The updated IRP was responsive to investor needs, including disclosures for a new "Loan Modification Template." Also, as referenced above and as discussed in greater detail in Section 5 below, CREFC working groups—comprised of all CMBS constituencies (issuers, investors, *etc.*)—have created standard practices that could be used immediately in the market to enhance disclosure, improve underwriting, and strengthen representations and warranties to ensure alignment of interests between issuers and investors. These consensus standards build on existing safeguards in CMBS and go beyond Dodd-Frank requirements for CRE loans.

4. The CRE Finance Industry's Market Standards

Another way in which the CMBS space is unique is the nature of the engagement of the industry participants. In the wake of the onset of the economic crisis and with an eye toward addressing issues that prompted policy makers to craft risk retention requirements, the CRE Finance Council and its members have been independently working on a series of market reforms with a view toward strengthening the securitization markets and fostering investor confidence. Our members across all constituencies have devoted an extraordinary amount of time over the past year to working collaboratively and diligently on the development of market standards in the areas of representations and warranties and their enforcement; underwriting principles; and initial disclosures, all of which have similar aims of strengthening our market and fostering investor confidence.

We anticipate that the new industry market standards, coupled with the ongoing disclosure regime offered by our existing IRP, will create increased transparency and disclosure in underwriting and improved industry representations and warranties, which we believe will go a long way toward meeting both investor demands and Dodd-Frank objectives. We believe that these standards will be used both (1) in the

marketplace immediately, and (2) by the regulators as they continue to contemplate how to properly construct the final risk retention rules.

Having previously shared these projects with the regulators charged with implementing the Dodd-Frank risk retention rules, the CRE Finance Council also wishes to provide some information to Congress as well about the projects.

Representations and Warranties

Building upon existing customary representations and warranties for CMBS, the CRE Finance Council has created Model Representations and Warranties that represent industry consensus viewpoints. Representations and warranties relate to assertions that lenders make about loan qualities, characteristics, and the lender's due diligence. The CRE Finance Council's model was the result of 200-plus hours of work by our Representations and Warranties Committee over the last 6 months, and represents the input of more than 50 market participants during negotiations to achieve industry consensus.

The Model Representations and Warranties were specifically crafted to meet the needs of CMBS investors in a way that is also acceptable to issuers. Such Model Representations and Warranties for CMBS will be made by the loan seller in the mortgage loan purchase agreement. Issuers are free to provide the representations and warranties of their choosing, and the representations and warranties will necessarily differ from one deal to another because representations and warranties are fact based. However, issuers will be required to present all prospective bond investors with a comparison via black line of the actual representations and warranties they make to the newly created CRE Finance Council Model Representations and Warranties. Additionally, loan-by-loan exceptions to the representations and warranties must be disclosed to all prospective bond investors.

Finally, the CRE Finance Council also has developed market standards for addressing and resolving breach claims in an expedited, reliable and fair fashion by way of mandatory mediation before any lawsuit can be commenced, thereby streamlining resolution and avoiding unnecessary costs.

For many investors, strengthened and new representations and warranties coupled with extensive disclosure are considered a form of risk retention that is much more valuable than having an issuer hold a 5 percent vertical or horizontal strip. The CRE Finance Council believes that its Model Representations and Warranties are a practical and workable point of reference that has been vetted by the industry, and we intend to explore whether industry-standard representations and warranties such as the CRE Finance Council's model could be adopted by regulators to serve as "adequate" representations and warranties as contemplated by the Dodd-Frank menu of options for risk retention for commercial mortgages.

Moreover, industry-standard representations and warranties could be used in at least two other regulatory contexts. First, the conditions on third-party retention in the proposed regulation contemplate securitizer disclosures regarding representations and warranties, and the possible use of blacklines against industry-standard representations and warranties. We are exploring the possibility of suggesting use of the CRE Finance Council's model for this purpose.

In addition, Dodd-Frank Section 943(1) directs the SEC to develop regulations requiring credit rating agencies (CRAs) to include in ratings reports a description of the representations, warranties, and enforcement mechanisms available to investors for the issuance in question, along with a description of how those representations, warranties, and enforcement mechanisms differ from those in "issuances of similar securities." CRAs have played an important role in the CRE Finance Council's development of Model Representations and Warranties, and we believe the Model Representations and Warranties can facilitate CRAs' fulfillment of their new reporting requirements under Dodd-Frank Section 943(1).

Loan Underwriting Principles

Commercial mortgages securitized through CMBS do not easily lend themselves to the development of universally applicable objective criteria that would be indicative of having lower credit risk as envisioned under Dodd-Frank or otherwise. This is because these nonrecourse loans are collateralized by income streams from an incredibly diverse array of commercial property types that cannot be meaningfully categorized in a way that would allow for the practical application of such objective "low credit risk" criteria. For example, it is difficult to meaningfully compare property types such as hotels, malls, and office buildings, and credit risk profiles can also vary by geographic location, so that it would be even more difficult to compare a resort in Hawaii to a shopping mall in Texas or an office building in New York. In short, commercial properties are not homogeneous and do not lend themselves to a "one size fits all" underwriting standard that could be deemed "adequate."

The industry accordingly created a framework of principles and procedures that are characteristic of a comprehensive underwriting process that enables lenders to mitigate the risk of default associated with all loans, and a disclosure regime that requires representations as to the manner in which that underwriting process was performed. The intent of the Underwriting Best Practices is to be responsive to investors and market participants; provide for the characteristics of low-risk loans; and provide for common definitions and computations for the key metrics used by lenders.

Our membership believes that this principles-based underwriting framework can and will generate the underwriting of lower credit risk CMBS loans and, when combined with necessary and appropriate underwriting transparency, will allow investors to make their own independent underwriting evaluation and be in a position to better evaluate the risk profiles of the loans included in the CMBS issuances in which they are considering investing. It is also critical to note that the majority of the underwriting principles and disclosures outlined in our best practices are already standard industry practices, though they had not previously be formally outlined or presented.

The Underwriting Principles were developed with a view toward reducing risk through use of market analysis; property and cash flow analysis; borrower analysis; loan structure and credit enhancements; risk factors such as macro- and property-type risks. With respect to defining numerical underwriting metrics, our project recognized the impossibility of imposing uniform metrics since the characteristics of a "low risk" CRE loan could vary by property type, area of the country, and even by operator, and low risk loan-to-value ratios differ by geographic area.

While we have long maintained that it is not possible or even advisable for regulators to attempt to define uniform underwriting "standards" for CRE loans due to the heterogeneous nature of commercial mortgages underlying CMBS and the dissimilarity of this market to residential, we recognize that regulators have attempted to do just that in the qualified commercial loan provisions of the proposed risk retention regulations. We wish to point out, in any event, that such criteria exclude many low-risk loans from qualifying for the exemption, and should not be viewed as the sole framework for assessing whether a commercial mortgage is low risk.

"Annex A" Initial Disclosures

The CRE Finance Council's "Annex A" has long been a part of the package of materials given to investors as part of CMBS offering materials, and provides detailed information on the securitized mortgage loans. In conjunction with the SEC's Spring 2010 proposal to revise its Regulation AB, our members commenced an initiative to review, update, and standardize Annex A, which has resulted in changes to Annex A incorporating numerous additional data points concerning the assets underlying CMBS. This work was the effort of both issuers and investors.

These changes, together with the information already required by Annex A, closely conform Annex A with the Schedule L asset-level disclosure framework proposed by the Commission under Regulation AB. The CRE Finance Council's newly created standardized Annex A provides numerous additional data points concerning the assets underlying CMBS, including, but not limited to:

- Changes to the Loan Structure Section with regard to Disclosures on supplemental debt. Examples include, but are not limited to, detail of all rake, B-note, subordinated mortgage, mezzanine debt, and preferred equity as well as information regarding the debt owner, coupon, loan type, term, amortization, debt service calculation, debt yield, cumulative DSCR, and LTV calculations through the capital structure.
- Additionally, issuers will now be providing a breakdown of net operating income into revenue and expenses for historic and underwriting basis.
- Added information on the fourth and fifth largest tenants at a property to the tenant information section—most Annex As in the past would contain information on the three largest tenants at a property, that information being square footage leased, percent of overall net rentable square feet, and lease expiration date.

In fact, Annex A provides more information than required under Schedule L and is available to market participants in more expedited fashion. At the same time, the new standardized Annex A is consistent with the existing practices that CMBS market issuers and other participants have developed to provide CMBS investors with clear, timely and useful disclosure and reporting that is specifically tailored for CMBS investors. We believe that such consistency will avoid unnecessary increases in transaction costs while still delivering enhanced clarity and transparency.

It follows that the CRE Finance Council's Annex A is a practical and workable framework that has already been vetted by the industry, and we believe it can be adopted by the SEC to implement the asset-level and loan-level disclosure requirements in Dodd-Frank Section 942(b), and those in Proposed Schedule L to SEC Regulation AB.

5. Preliminary Views on the Proposed Risk Retention Rule

The proposed risk retention regulations, released in late March, do attempt to fulfill the Congressional mandate embodied in the Crapo amendment by offering different options for satisfying the risk retention requirements (*e.g.,* vertical, horizontal, or L-shape retention structures) and by providing asset-class specific options including a set of CMBS-specific provisions to satisfy the retention mandate. As a community, our members appreciate the efforts to create rules by asset class, given the unique nature of the CMBS market.

At the same time, the proposed risk retention regulations are complex, and we are in the process of studying and discussing them with the different CMBS constituencies included under the CRE Finance Council umbrella (including lenders, issuers, servicers, and investors, among others) in order to fully evaluate their potential impact and to provide useful feedback to regulators on their proposal. As the Board of Governors of the Federal Reserve Report cited above also noted, the totality of the regulatory changes that are being put into motion—including the various new disclosure and credit rating agency reform provisions included in Dodd-Frank, the accounting changes that must be effectuated, and the new Basel capital requirements regime—must be considered *in toto* in making this evaluation:

> [R]ulemakings in other areas could affect securitization in a manner that should be considered in the design of credit risk retention requirements. Retention requirements that would, if imposed in isolation, have modest effects on the provision of credit through securitization channels could, in combination with other regulatory initiatives, significantly impede the availability of financing. In other instances, rulemakings under distinct sections of the Act might more efficiently address the same objectives as credit risk retention requirements. [11]

Viewed through this lens, there are elements of the proposed retention regime that raise potential concerns in the market and, overall, the proposal has prompted more questions than it answers. Our preliminary view, however, is that the structural framework of the CMBS-specific provisions could provide a workable foundation for implementing the risk retention rules as Congress envisioned in Dodd-Frank. That said, there are areas where the rule could have unintended adverse consequences for securitization and the broader CRE finance markets. At the same time, the purpose of many important provisions is unclear, and they will likely need to be refined to ensure that they accomplish their intent in the least disruptive manner. Needless to say, the stakes are high with the impact on credit availability weighing in the balance and we look forward to working with Congress and the regulators to ensure a regulatory framework that supports a sound and vibrant securitization market, which is critical to consumers in the U.S. economy.

The Proposed Risk Retention Regulation for Commercial Mortgages

By way of background, the proposed risk retention regulation contains "base" risk retention requirements that generally apply to all asset classes. The base requirements include a number of options for the securitizer to hold the required 5 percent retained interest, such as: a "vertical slice," which involves holding 5 percent of each class of ABS interests issued in the securitization; a horizontal residual interest, which requires that the securitizer retain a first-loss exposure equal to at least 5 percent of the par value of all the ABS interests issued in the transaction; and an "L-shaped" option which involves a combination of the vertical and horizontal options. The CRE Finance Council believes generally that the menu of options for holding the retained interest will be beneficial in that this flexibility will foster more efficient and practical structuring of securitizations than a one-size-fits-all approach, and we commend regulators for the thought and effort they put into developing these options.

The retained risk would be required to be held for the life of the securitization. No sale or transfer of the retained interest would be permitted, except in limited circumstances.

Notably, the base retention regime includes a restriction on the ability of securitizers to monetize excess spread on underlying assets at the inception of the

[11] *Id.* at 84.

securitization transaction, such as through sale of premium or interest-only (IO) tranches. As discussed below in greater detail, this provision, which requires securitizers to establish a "premium capture cash reserve account" where a transaction is structured to monetize excess spread, and to hold this account in a first-loss position even ahead of the retained interest, has generated considerable confusion throughout the market, and the purpose of the provision is unclear. It should be noted that this particular provision is one that is prompting significant concerns about a potential adverse impact on the viability of the CMBS market, as well as questions about whether it can be implemented as a practical matter without shutting down the market for new CMBS issuance.

Hedging of the retained interest is generally prohibited, although the proposed regulation gives securitizers the ability to use tools, such as foreign currency risk hedges, that do not directly involve hedging against the specific credit risk associated with the retained interest. The continued ability to use market risk hedges is a matter the ABS issuer community viewed as critical to the viability of securitization, and we believe that the proposed rule is generally responsive to market's concerns in that regard.

With respect to CMBS specifically, the Crapo Dodd-Frank amendment mandated that the regulators consider several specific alternatives for risk retention to strengthen the CRE market and to support a recovery for commercial mortgages, including:

1. adequate underwriting standards and controls;
2. adequate representations and warranties and related enforcement mechanisms; and/or
3. a percent of the total credit risk of the asset held by the securitizer, originators, or a third-party investor.

The proposal does not address the representations/warranties alternative at all but we are hopeful that the regulators will consider the role of the CRE Finance Council developed market-standards discussed above when it considers revisions to the risk retention regime. In addition to the base risk retention rules, there are two important provisions specific to commercial mortgages that relate to the other statutory alternatives. First, there is an option to have a third-party purchaser hold a 5 percent horizontal first-loss position. The third-party retention option is subject to several conditions, which are being closely examined, but market participants have noted a lack of clarity with respect to some of the conditions, and there are concerns that some of the conditions may create significant disincentives for use of this retention option. An unworkable third-party retention option would render the rule more inflexible, which may run counter to the intent of Congress when it outlined third-party risk retention as one of the options for the CRE market in Dodd-Frank.

Second, there is a commercial mortgage loan exemption that would subject qualified commercial mortgage loans to a 0 percent retention obligation, if several criteria are met. While we understand that regulators intended that only a small subset of "low-risk" loans would qualify for the exemption, our initial examination of the CRE exemption provision reflects that the parameters for qualified commercial mortgages are so narrow that virtually no CRE mortgage could qualify. This stands in contrast to other asset classes, where we understand that proposed exemptions could cover an appreciably larger percentage of the universe of loans.

Three components of the proposed rules have generated the most internal discussion and debate.

Premium Capture Cash Reserve Accounts

First, there is considerable confusion and concern within the CRE finance community about the proposed rule's requirement that securitizers establish a "premium capture cash reserve account" when a transaction is structured to monetize excess spread at the inception of the securitization transaction, such as through an IO tranche. One issue is that the purpose of such a requirement is unclear. The narrative to the proposed rule states that the purpose of the premium capture is to prevent sponsors of the securitization from "reduc[ing] the impact of any economic interest they may have retained in the outcome of the transaction and in the credit quality of the assets they securitized," [12] presumably by extracting all of their profit on the deal at the outset. However, we were informed through preliminary discussions with the regulatory agencies, for example, that the premium capture feature

[12] Risk Retention NPRM at 89.

was designed to ensure that the retained interest, whether held by the sponsor or a third party, represents 5 percent of the transaction proceeds.

The effect of the proposal as drafted would be for all revenue from excess spread (which is virtually all revenue) to be retained for the life of the transaction. An analogy, for example; would be to consider if the rule were applied to your local sandwich shop owner. The owner, for example, spends money up front—say $1,000—to purchase bread, meat, cheese, mustard, and other sandwich making supplies. He then sells all his sandwiches to customers for $3,000, a gross profit of $2,000. He uses that profit to pay his workers; buy more sandwich supplies and to invest in his business. However, under the PCCRA, he can only collect the cost of the sandwich on the day he sells it to his customer. The net profit of $2,000 must go into an escrow account, and cannot be put to use for 10 years. Under this business strategy, it is difficult to imagine that many delis would be left open in the country.

Such a mechanism will inhibit an issuer's ability to pay operating expenses, transaction expenses, and realize profits from the securitization until, typically, 10 years from the date of a securitization. Thus, while the proposed rule's narrative expressed regulators' expectation that the premium capture feature would merely prompt securitization sponsors to stop structuring securitizations to monetize excess spread at closing,[13] the broader impact would be to make the securitization business very unattractive to sponsors, which in turn, would shrink capital availability. For this reason, many in our industry have significant concerns about the premium capture component having an adverse impact on the viability of the CMBS market.

Conditions for Retention by a Third-Party Purchaser

Second, the third-party retention option that was specifically designed for CMBS also has generated substantial discussion. Under the proposal, the option is subject to several conditions. Most notable among the conditions is a requirement that an independent Operating Advisor be appointed where a third-party purchaser retains the risk and also has control rights (itself or through an affiliate) that are not collectively shared with all other classes of bondholders, such as servicing or special servicing rights. The Operating Advisor would have to be consulted on all major servicing decisions, such as loan modifications or foreclosures, and would have the ability to recommend replacement of the servicer or special servicer if it determines that the servicer or special servicer is not acting in the best interests of the investors as a whole. Only a majority vote of each class of bondholder would prevent the servicer or special servicer from being replaced in this instance.

As a preliminary matter, certain aspects of the Operating Advisor provision are not sufficiently fleshed out, and our membership believes that additional clarity will be necessary for an Operating Advisor framework to function efficiently. For example, other than requiring the Operating Advisor to be independent, the proposed rule provides no specifics on qualifications for an entity to serve as an Operating Advisor, such as whether the entity should have expertise in dealing with the class of securities that are the subject of the securitization. CMBS servicing can be a complex and highly fact-specific enterprise and CMBS transaction parties, including B-piece buyers who might hold the retained interest under the proposed rule and who may handle servicing or special servicing, are sophisticated and very experienced in these matters. It is unlikely that such a B-piece buyer would accept the appointment of an Operating Advisor lacking in CMBS expertise to oversee servicing. Nor should this be desirable from the regulators' perspective, since an unqualified Operating Advisor is unlikely to add value, and would only add to transaction costs.

B-piece buyers and issuers also have raised concerns that the Operating Advisor requirement may create other significant disincentives for use of the third party retention option. For example, some question whether it is necessary for an Operating Advisor to have the authority to oversee servicing and have replacement rights from the deal's inception, when a B-piece buyer's capital is at risk in a first-loss position, which gives a B-piece/servicer incentives that are more fully aligned with those of other investors. Moreover, there are concerns that the addition of another administrative layer in the securitization process may make the servicing and workout of securitized loans more difficult from the borrower's perspective.

Some investment-grade investors have expressed interest in the Operating Advisor construct, but there clearly is room to better hone the powers of and the limitations on the requisite Operating Advisor. For example, one suggestion being discussed to address concerns of B-piece buyers and investment-grade investors may be to have the Operating Advisors' recommendations to replace servicers approved by a majority vote of investors, rather than requiring a majority to disapprove as the proposed rule currently contemplates.

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[13] *See id.* at 90.

We note that there is precedent in the market for use of independent Operating Advisors in these circumstances, as the industry has developed a fairly standard Operating Advisor framework with input from B-piece buyers, investors, and issuers in the past few years. The most practical analogue to examine among past transactions are those that only involved an independent Operating Advisor once the B-piece buyer/servicer is "out of the money" and its interests theoretically would not align with those of other bondholders. Such a structure might solve the alignment of interest concern while also addressing B-piece buyers' reluctance to have servicing decisions second-guessed by a third-party when the B-piece buyer's investment is first in line should there be losses.

Exempt Commercial Mortgages

There is a commercial mortgage loan exemption that would subject "qualified" commercial mortgage loan pools to a 0 percent retention obligation, if several criteria are met. Regulators have stated that they only intended for a relatively small percentage of loans, meeting a set of "low-risk" characteristics, to qualify for the exemption. While the CRE Finance Council understands this objective, our initial examination of the CRE exemption provision reflects that the parameters for qualified commercial mortgages are so narrow that virtually no CMBS mortgages could qualify.

The exemption's 20-year maximum amortization requirement, for instance, presents perhaps the most significant hurdle to qualification, since commercial mortgages are amortized on a 30-year basis. Rather than utilizing an amortization period as a criterion, a better metric for assessing the risk characteristics of a loan may be to use the loan-to-value ration at origination and maturity. Also problematic is the requirement that borrowers covenant not to use the property as collateral for any other indebtedness, which appears to effectively prohibit subordinate debt. Currently, borrowers typically are permitted to have subordinate debt upon lender approval (*e.g.,* loans that have subordinate debt funded concurrent with the first mortgage). It follows that an outright prohibition on subordinate debt, regardless of lender approval, may be viewed by borrowers as an undue restriction of their ability to manage their finances.

That said, as part of its market standards initiative, the CRE Finance Council submitted an underwriting principles framework white paper to the regulators during the rulemaking process highlighting the difficulty in creating universally objective metrics that would indicate that a loan is "low risk" in the very heterogeneous commercial mortgage space. Given the proposed rule, however, we are taking a fresh look at these issues and attempting to evaluate whether the "qualified CRE loan" construct could be reworked to be of value for CRE loans. There are loan segments outside of the typical conduit loan structure—like large loan and single borrower securitization deals—that may be more suited for the exemption treatment and we are evaluating what the appropriate "low risk" metrics should be for such deals.

Additionally, a fourth area of concern about the proposed rule that should be highlighted relates to the duration of retention, and a prohibition on sale or transfer of retained interest. As mentioned, the proposed rule contemplates holding the retained interest for the life of the bond, and imposes a permanent prohibition on the sale or transfer of retained risk. Both of these features would restrict the flow of capital into the markets for an unnecessarily long time period, a situation that is even less desirable in light of the $1 trillion in commercial mortgage maturities that will occur in the next few years, at the same time the CMBS market is struggling to recover. We also note that in the third-party retention context, a permanent prohibition on the sale or transfer of retained risk would not be acceptable to many B-piece buyers.

Our members are evaluating the extent to which the proper alignment of risk can be achieved without making the mandated retention permanent. We also believe that it is not necessary to completely restrict any sale or transfer of retained interest to achieve the risk retention regulation's goals. A modification to the proposed rule to, for example, allow transfer of a B-piece buyer's or sponsor's retained interest to a "qualified" transferee, who would have to comply with the obligations imposed on the transferor and meet other criteria, would address this concern.

On all of these issues as well as for the more technical issues that will emerge during the course of our evaluation, we intend to work with regulators on modifications that will facilitate proper alignment of risk without unduly restricting market capital and liquidity.

6. Proactive Measures That Would Encourage a Securitization Market Recovery

Significantly, the many challenges discussed earlier are interconnected and mutually compounding. To address the challenges and to help to facilitate a revitalized securitization market, we suggest the following:

Take a Deliberate Approach to the Proposed Risk Retention Rules

As discussed at length above, with so many questions remaining unanswered, the current proposed rule reads like an advance notice of proposed rulemaking. We are concerned that the 60-day public comment period, which ends June 10, 2011, does not give the industry sufficient time to fully analyze the impact of the proposed rules. Furthermore, given our expectation that we will be asking for significant changes, we believe that it will be appropriate for the regulators to jointly repropose the rules to allow industry a sufficient opportunity to digest and comment on the revised retention framework. The sheer complexity of these markets demands a thoughtful and deliberate approach to rulemaking, and a more iterative process helps achieve this crucial goal. As part of this process, it is critical to evaluate workable counter-proposals that could make the risk retention regime work in a way that will minimize adverse unintended consequences to credit availability and the overall economy while achieving an appropriate alignment of risk as Congress intended.

Furthermore, our members believe it would be extremely helpful to have more interactive discussion between regulators and the public, particularly as the industry seeks to ensure that it correctly understands both the regulatory goals and intent of certain provisions, and to work cooperatively to develop acceptable alternatives. We are aware that the staffs of the Commodity Futures Trading Commission and the Securities and Exchange Commission have planned a two-day joint public roundtable on issues associated with the rules to govern swaps under Dodd-Frank. We believe that a similar opportunity to have a dialog with the relevant agencies to discuss risk retention rules would be beneficial to all, and could even foster a more efficient rulemaking process since the aim would be to inform the agencies' understanding of industry concerns while the agencies are still in the process developing final rules, rather than afterward.

Create a U.S. Covered Bond Market

The CRE Finance Council supports "H.R. 940, the U.S. Covered Bond Act of 2011," (covered bond) that the House Financial Services Capital Markets Subcommittee passed last week by voice vote. The bill, which was reintroduced by Capital Markets Subcommittee Raking Member Garrett and Congresswoman Maloney, would include high-quality CMBS as eligible collateral in a newly created U.S. covered bond market. Covered bonds, which were originated in Europe are securities issued by a financial institution and backed by a specified pool of loans known as the "cover pool." Bondholders have a preferential contractual claim to the pool in the event of the issuer's insolvency. In the United States, a typical covered bond transaction involves an insured depository institution (IDI) selling mortgage bonds, secured by the cover pool, to a trust or similar entity (known as a "special purpose vehicle" or "SPV"). The pledged mortgages remain on the IDI's balance sheet securing the IDI's promise to make payments on the bond, and the SPV sells "covered bonds," secured by the mortgage bonds, to investors. In this fashion, the IDI generates more capital that can be used, in turn, to make more loans or provide financial institutions with a bigger cushion for their regulatory capitalization requirements. In sum, covered bonds are an elegant mechanism for generating more liquidity in the capital markets.

A problem arises, however, if the IDI becomes insolvent and the FDIC assumes control as a receiver or conservator. Once the FDIC takes over, there can be uncertainty about whether the FDIC would continue to pay on the bond obligation according to the bond's terms, or whether it will repudiate the transaction. If the IDI is also in default on the bond, there also can be uncertainty regarding the amount that investors would repaid, or at the very least, delay in allowing investors access to the bond collateral. The transactions can be hedged to alleviate some of these risks, but this increases transaction costs. In the face of such risks, investors were reluctant to invest in covered bonds to any significant degree; the FDIC reported in July 2008 that only two banks had issued covered bonds. The FDIC recognized that covered bonds could be a "useful liquidity tool" for IDIs and the importance of "diversification of sources of liquidity."[14] Therefore, to provide a measure of certainty to encourage investment in covered bonds, the FDIC issued a Policy Statement in 2008 setting forth directives explaining how it would address certain types of covered

[14] Covered Bond Policy Statement, Final Statement of Policy, FDIC, 73 Fed. Reg. 43754, 43754 (July 28, 2008).

bond obligations in cases in which it has assumed control of an IDI. Unfortunately, the FDIC limited the scope of its Policy Statement to covered bonds secured by "eligible assets," and limited the definition of "eligible assets" to residential mortgages. As a result, a market for covered bonds in the CRE mortgage sector has not developed.

Significantly, however, commercial mortgages and CMBS are already permitted in covered bond pools in most European jurisdictions,[15] which also accord the appropriate and necessary regulatory treatment, including capital requirements, with respect to covered bonds to facilitate the market and to better serve consumers and businesses seeking access to credit. It follows that in order to be globally competitive, any U.S. covered bond regime should include commercial mortgages and CMBS, and that the overall regulatory framework should be closely aligned with the approach used by our European counterparts. Such a framework will give U.S. consumers and businesses access to the same sources of credit availability, supporting our overall recovery and we applaud the Committee's passage of the covered bond bill 2 weeks ago.

While covered bonds should not and cannot replace CMBS as a capital source for the CRE mortgage market, facilitating a commercial covered bond market will be additive. Covered bonds can provide yet another source of liquidity for financial institutions to help raise much needed capital to fund CRE loans, and in turn, ease the current CRE credit crisis, which persists despite high borrower demand. Indeed, in the current environment, covered bonds could be a helpful means of raising capital relative to CMBS, particularly today as the cost of capital related to a covered bond deal could be less volatile than for CMBS. Such conditions also could assist financial institutions in aggregating collateral for a covered bond issuance, in contrast with the aggregation difficulties now being experienced in the CMBS market.

Ensure Credit Rating Transparency

Dodd-Frank includes extensive credit rating agency reform provisions, and the CRE Finance Council and its members generally are supportive of any reforms that require CRAs to provide more information about individual ratings and their rating methodologies.

In terms of credit ratings performance, the CRE Finance Council devoted significant resources over the last few years to affirmatively enhance transparency in credit ratings. Such enhancements will be far more effective in providing investors with the information they need to make the most informed decisions than a differentiated ratings structure. Instead of differentiated ratings for structured finance products—a concept that has been debated and rejected by the SEC, what CMBS investors have consistently sought is new, targeted transparency and disclosures about the ratings of structured products, to build on the already robust information CRAs provide in their published methodology, presale reports, and surveillance press releases.[16]

Conclusion

Today, the CMBS market is showing some positive signs that it is slowly moving toward recovery. However, with $1 trillion in commercial mortgage loans maturing in the next few years, it will be critically important that risk retention regulations be implemented in way that does not severely constrict or shut down altogether the securitization markets. The CRE Finance Council appreciates the fact that the general construct of the proposed risk retention rule attempts to customize and provide options for the commercial mortgage asset class. At the same time, our members strongly believe that the proposal needs clarification in many areas. And we also have concerns about the impact of some of the details, including concerns that these aspects could make securitization an untenable prospect for issuers and third-party investors.

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[15] Legislative frameworks for covered bonds in the following countries specifically permit the use of commercial mortgage loans as collateral: Austria, Bulgaria, Denmark, Finland, France, Germany, Hungary, Iceland, Ireland, Italy, Latvia, Luxembourg, the Netherlands, Norway, Poland, Portugal, Romania, Spain, Sweden, and the United Kingdom. In addition, all European jurisdictions that permit the use of residential mortgage-backed securities (RMBS) in cover pools also permit the use of CMBS.

[16] In comments filed with the SEC in July 2008, the CRE Finance Council (filing under its former CMSA name) listed a number of recommendations for enhancements that would serve the investor community, such as publication of more specific information regarding NRSRO policies and procedures related to CMBS valuations; adoption of a standard presale report template with specified information regarding methodology and underwriting assumptions; and adoption of a standard surveillance press release with specified information regarding the ratings. Such information would allow investors to better understand the rating methodology and make their own investment determinations.

The CRE Finance Council believes these concerns can, and should, be addressed in an extended rulemaking process that we hope you will encourage, and we anticipate working with regulators on clarifications and refinements that can achieve an appropriate alignment of risk while also avoiding undue restriction of capital and liquidity in the CRE finance market.

PREPARED STATEMENT OF ANN ELAINE RUTLEDGE

FOUNDING PRINCIPAL, R&R CONSULTING

MAY 18, 2011

Chairman Reed, Ranking Member Crapo, and distinguished Members of the Subcommittee, my name is Ann Rutledge. You have asked about the current conditions in the mortgage and asset-backed securities markets. You want to hear whether today's impediments to capital formation and liquidity are going to resolve themselves based on reforms or best practices in use today—or whether other mechanisms or perhaps policy initiatives need to be added to the mix, to reignite securitization. As an independent consultant and, at times, critic of securitization market practices, I am deeply honored that you have asked me to testify.

You may not have heard of R&R Consulting before now. We are a seven-person structured finance boutique cofounded by me and my partner, Sylvain Raynes. I resigned from Moody's Investors Service's Structured Finance Group at the end of 1999, when it was becoming clear that Moody's was shedding its franchise-defining commitment to research and becoming a ratings factory. It was also clear that this was happening at a moment in the market's development when thought leadership was becoming more important than ever. I saw the mission of R&R as a continuation of the role Moody's was moving away from, thought leadership. Our business vision was to serve the market by refining and unifying the techniques we learned at Moody's into a single framework of analysis that could be used on all asset classes, at all points in time, to obtain consistent, reliable, capital-efficient results.

I believe today that the goal of a unified framework of analysis is where the securitization market still must go if we are going to (a) restore investor trust in the securitization markets and (b) address, head-on, the needs of the real economy for capital. Many people have commented on the need to rebuild investor trust. However, I don't hear nearly enough discussion about how to channel funds into the real economy with securitization.

The assumption seems to be that all will be well once the market comes back. However, as we commented in *Elements of Structured Finance,* [1] structured finance and securitization marshaled unimaginable quantities of money before—but to what end? It is difficult to base a persuasive economic case for securitization on what has been achieved so far. Moreover, we have been too occupied with making money and mourning the loss of the big money machine to acknowledge that the microstructure of the securitization market is badly broken. If we want it to come back, we must be prepared to accept certain changes in the way it works—beginning with the fact that we need to understand how it works. We cannot delegate the work of understanding it to others, any more than we can delegate the work of understanding the foundation of our civil society to others. Once we understand what the market can and cannot do, the changes that need to be made will seem very fundamental and achievable. I would like to talk to you from my reform-oriented perspective about what is precious and worth preserving about this market, where the challenges lie, what reforms are working, and what still needs to be done.

The Good News: Bragging Rights; Thought and Financial Leadership and the Economy Restored

Securitization is a quintessential American innovation, a melding together of financial innovations from our 19th Century railroad crisis experience and our 20th Century savings and loan crisis experience. So, let's pat ourselves on the back before we ask—which innovations? First, the discovery that, in insolvency, the railroad company's capital structure could be restructured to make both the debt and equity investors better off. Second, credit ratings: a key for investors to discern relative value in securities issued from complex structures like railroad bonds (and securitizations). Third, cash flow modeling technologies based on a different set of metrics than those used in options markets, developed by engineers and information

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[1] Rutledge, Ann, and Sylvain Raynes, "Elements of Structured Finance", Oxford University Press, May 2010.

specialists no longer needed for the Cold War effort, and made ubiquitous by the affordable (also quintessentially American) PC and spreadsheet software.

Substantively, securitization enables investors to look beyond public corporate finance disclosures to find additional evidence of value or risk through a close analysis of company financial receivables—private data. Where value can be found, it can be monetized without adding to company or system risk using standard securitization structuring techniques and a feedback loop. Part of the value that is discovered can be returned, to reward the producers who have created the value and help them continue to grow. America's credibility and thought leadership in finance have taken a severe beating as a result of the credit crisis. Nowhere is our fall from grace more apparent than in China, where I taught a securitization course last month. But, an America that can rebuild its economy with sustainable securitization markets while building incentives for producers in the capital-intensive sectors of the economy will, forcibly, continue to lead the world financially too.

Securitization works where traditional corporate finance does not, because it is less stylized and more capable of using a variety of data types. What this means in practical terms is that securitization holds promise as a means of channeling capital towards our SME sector and our social priorities—education, health care and the arts—where traditional corporate finance tools are ill-suited. Securitization also has a beneficial financial impact because it accelerates the speed and accuracy with which capital circulates between lenders and borrowers. Let me illustrate this point with reference to the health care industry. Beyond the question of delivery of basic health care services, there is the funding problem caused by inefficiencies in the cash cycle of hospitals. The establishment of a system of registering title to health care receivables and discounting them using a uniform set of standards could release billions of dollars of much-needed capital to hospitals, particularly if the insurance companies were given incentives to make early claims payment. R&R estimates that *bona fide* health care securitization is a $1.5 trillion dollar a year market.

This vision for securitization as a funding solution for tough sectors may be grand, but in order to carry it out, the market needs to sharpen its proverbial pencil. Historically, securitization has flourished primarily in consumer sectors, where no particular industry or modeling expertise is required for deals to come to market. Overdevelopment of consumer markets is a generalized problem in securitization. In Russia, during 2007, the mortgage securitization markets developed so rapidly that primary mortgage bankers, already in scarce supply, became unaffordable to many banks. Ironically, mortgage lending activities declined as a result. And yet, Russia's real need for capital was in the SME sector, not homes.

The problems of unbalanced growth and the failure to clone securitization to new opportunities have a single, straightforward solution: skill development through training. The U.S. has many MBA programs and finance departments, but securitization is not taught in the vast majority of them—most certainly not by people who have deal experience. This shortage of teaching talent would disappear quickly if the securitization market made skill development more of a priority.

The Bad News: What Reinventing the Corporate Paradigm Does to Banks

Before securitization, banks were the supply chain of capital. They made money by exploiting market discontinuities: small banks earned spread income from borrowers; regional banks earned spread income from small banks; and universal banks earned spread income from regional banks; *etc.*

Securitization knits the funding markets together into a seamless credit supply chain, where the cost of capital is no longer a function of the risk of the balance sheet it happens to be sitting on, but rather a function of the ultimate borrower's payment ability. It makes the borrower's payment ability more transparent, and it expands the market for the borrower's credit. Securitization did not cause the changes—deregulation, financial education, and the Internet caused them—but securitization is a solution to the problem of credit market inefficiency from which banks have benefited so long—as long as there have been banks and corporations. Securitization is an inconvenient reality for banks, because it erodes their information monopoly, so that they can no longer control the price of credit locally. Effectively it turns their core business from dealing to broking, which is much less profitable.

No one, perhaps, saw this paradigm shift for what it was in the first phase of the market, from 1976–1997. Those were very good years, with new asset types coming on stream, new structures, and so much surplus capital being released that had been locked up in the economy, everyone involved in securitization prospered. New consumer companies got startup capital easily; existing companies lowered their funding costs; investors enjoyed unprecedentedly low default rates, far below what

the ratings implied; and at deal origination, professional services firms lined up for a sliver of the expected residual. It was, as Buck Henry tells Teri Garr in Steve Martin's *The Absent-Minded Waiter*, "an incredible experience." (In this comedy-short, Steve Martin as the absent-minded waiter commits every imaginable *faux pas* but then hands Buck nearly $10,000 in change before the bill is paid—precisely what Buck came for.)

In the late 1990s, as the credit risk premium and the surpluses disappeared, the strategy of securitizing banks shifted to exploiting different loopholes, in particular, those built into different rating methods. The endgame of this strategy was the subprime crisis. Although recounting what happened in detail is beyond the scope of this paper, it is not very hard to depict (see the figure below) or explain. The hard part is that once we explain it, we feel compelled to fix it, and there are no easy solutions for the banking industry other than to meet more the rigorous disclosure requirements that are coming into effect now.

But I would remind the Banking Committee that one of the most fertile periods of American financial innovation came in the mid-to-late 1980s, when regulatory tightening brought the trading of financial derivatives into exchanges and the swaps market was born. There is still much room for banks in America to innovate in credit engineering without operating as if credit were a zero sum game. Credit is not a zero sum game. Everybody benefits from responsible lending.

Disclosure Disciplines

If securitization knits the credit markets together into a supply chain, the biggest challenge to securitization is sealing off the leaks as capital circulates through it. I believe there are two key places where the leakages occur. One is the disclosure problem. I believe Regulation AB does an excellent job of addressing the disclosure problem. As a former securitization analyst, I worked with Reg AB even before it was promulgated; and as a consultant, I have come to rely extensively on Reg AB as a workable, well-designed information standard for this market. Reg AB speaks the language of securitization. It requires disclosure of all the material deal data elements needed for valuation.

Reg AB makes it possible for investors to do for themselves what rating agencies do not do: continuous rerating so that a conclusion can be drawn about how the deal worked out. Rerating is important because the composition of risk and value in these deals can shift, sometimes very dramatically. For well-structured transactions, the risk decreases over time, but for improperly structured transactions, the deterioration can be sudden and shocking if one does not know how to continuously monitor and value the exposure.

Reg AB is currently being revised, and the SEC has said it wants to see cash flow model outputs posted as well as raw data elements. I believe that this requirement is an important mechanism by which the market can organize and communicate its thinking about value. Once a deal is structured, there is actually very little flexi-

bility around the interpretation of the value proposition. Analysts may disagree on the path of future cash flows, but there is no reason to disagree about how the deal works, which is what the cash flow model outputs show. This requirement therefore reduces the "mystery of valuation" by one more important dimension.

Discounting Disciplines

There is one more mechanism (or policy item, perhaps) that I believe the securitization market needs if it is going to come back in a sustainable fashion. The rating scale for structured finance needs to be taken away from the rating agencies and it needs to be published, perhaps after discussion and consensus among the G20, so that everyone can know the technical definition of each notch on the rating scale.

The structured finance rating scale is fundamentally different than that for corporate finance. Perhaps you have not thought about securitization this way, but securitization is a kind of "discount window" for corporations to cash in their receivables at some blended rate, which can be expressed as the weighted average interest cost of the transaction in which the receivables are being refinanced.

Each notch on the scale corresponds to a level of asset impairment: AAA signifies impairment in only a very slight degree (when we worked at Moody's, the numerical meaning was an average 0.06 BP loss of yield on the security), whereas AA signifies slightly more, A even more, *etc.*, in exponential increments going down the scale to single-C. Effectively, the rating agencies are setting the levels of risk and leverage of the financial system.

That is a ridiculous situation. It is analogous to leaving the decision of how large an inch or a meter should be to the individual tailor. Government policy makers should be making this decision, not rating agencies. The structured rating scale is the ultimate tool for calibrating the expansion of credit to the rate of economic growth. Although it has never been used that way before, this is a very good time to begin to learn how to synchronize the microstructure of the securitization credit markets with macroeconomic credit policy.

At the same time, the scale (and its revisions) should be made public so that anyone who cares about the health of the securitization markets can do their own analysis of outstanding deals. It is impossible, finally, for anyone including sophisticated investors to form an opinion about whether a structured rating is right without access to technical rating definitions. But, since most people do not rate securitizations, most people do not even realize they have been denied access to this crucial piece of market infrastructure. It is as if the City of New York (or Washington) enforced speed limits for driving in different districts but refused to disclose what the speed limits were. Circulation would not shut down, but considerable road efficiency and resilience would be lost as a result of drivers having to guess, constantly, whether or not they were driving at the legal speed.

PREPARED STATEMENT OF CHRIS J. KATOPIS

EXECUTIVE DIRECTOR, ASSOCIATION OF MORTGAGE INVESTORS

MAY 18, 2011

Introduction

Chairman Reed and Ranking Member Crapo, and distinguished Members of the Subcommittee, thank you for the opportunity for the Association of Mortgage Investors (AMI) to testify and comment on this critically important topic.

The Association of Mortgage Investors (AMI) commends you and your Senate colleagues for your leadership in pursuing responsible and effective oversight and vigilance to enhance the health and effectiveness of the U.S. financial markets, and in particular, the U.S. housing finance system. In summary, currently, mortgage investors suffer from a number of problems in the securitization space including:

- Market opacity, an asymmetry of information, and a thorough a lack of transparency;
- Poor underwriting standards;
- A lack of standardization and uniformity concerning the transaction documents;
- Numerous conflicts-of-interest among servicers and their affiliates;
- Antiquated, defective, and improper mortgage servicing practices; and,
- Investors lack effective legal remedies for violations of RMBS contractual obligations and other rights arising under State and Federal law.

I. Background

The AMI was formed to become the primary trade association representing investors in mortgage-backed securities (MBS), along with life insurance companies, State pension and retirement systems, university endowments, and pension funds. It has developed a set of policy priorities that we believe can contribute to achieving this goal. We were founded to play a primary role in the analysis, development, and implementation of mortgage and housing policy that keep homeowners in their homes and provide a sound framework that promotes continued home purchasing. In practice, only three sources of residential mortgage capital exist in the United States: (1) the bank balance sheets—which are arguably full and stressed; (2) the Government (Fannie Mae, Freddie Mac, FHA); and, finally, (3) securitization, which is effectively shutdown for the reasons described herein.

Today's U.S. mortgage market consists of approximately $11 trillion in outstanding mortgages. Of that $11 trillion, approximately one-half—$5.4 trillion—are held on the books of the GSEs as agency mortgage-backed securities (issued by one of the agencies) or in whole loan form. Another $4.0 trillion are on the bank balance sheets as whole loans or securities in their portfolios, of which $1 trillion are second liens (*i.e.,* home equity loans/lines of credit or closed end second mortgages).[1] Of the $1.1 trillion outstanding second mortgages, only 3.7 percent of the total (or $41 billion) is held by private investors in securitized form. The remaining $1.2 trillion in first lien mortgages reside in private label mortgage-backed securities (MBS). AMI's members hold a significant proportion of these investments; AMI members have approximately $300 billion of assets under management.

The development of enhanced structures, standards, and safeguards will contribute to improving the functioning of capital markets for all investment asset classes, especially those pertaining to a necessity of life, namely housing. Your work will contribute to helping to keep Americans in their homes, making credit available, and the development of effective tools against the foreclosure crisis.

Mortgage investors share your frustration with the slow restoration of the housing market, relief for homeowners, and finally offering the capital markets and homeowners that are truly in need meaningful and permanent relief. In fact, the markets for Residential Mortgage Backed Securities (RMBS) securitization have virtually ground to a halt since the financial crisis for reasons that we will enumerate.[2] We are hopeful that meaningful solutions can be implemented more quickly, and we believe that our interests are aligned with responsible homeowners. As difficult as it may be to believe, many of the most sophisticated investors were as victimized and abused by the servicers and their affiliates as were many consumers. Investors are essential in order to rebuild the private mortgage market. However, investors and

[1] Observers note that while PLS represents approximately 12.8 percent of the first lien market, they represent 40 percent of the loans that are currently 60+ days delinquent.

[2] The exceptions are two recent securitizations by Redwood Trust.

their private capital will only return to a market which is transparent, has nonconflicted stakeholders, and the protection of contract law.

a. The Role of Mortgage Investors in the Marketplace

Mortgage investors, through securitization, have for decades contributed to the affordability of housing, making credit more inexpensive, and making other benefits available to consumers. Today, however, mortgage investors face enormous challenges in the capital markets due to opacity, an asymmetry of information, poor underwriting, conflicts-of-interests by key parties in the securitization process, as well as the inability to enforce rights arising under contracts, securities, and other laws. This list is by no means intended to be exhaustive. Accordingly, investors, average Americans, and the U.S. economy at-large are harmed.

b. The History and Rise of MBS Securitization

It is important to note that securitization as a mortgage finance tool has been instrumental in reducing housing costs and helping citizens achieve the American dream of homeownership. In the 1970s, the mortgage finance industry was in its infancy. In fact, then the market consisted solely of two products—those backed by Ginnie Mae and Freddie Mac. The advent of the mortgage-backed securities market resulted in deregionalizing or nationalizing real estate investment risk, increasing liquidity to mortgage originators, and lowering barriers to home ownership. Securitization was a key factor in improving regional real estate markets. New York State is a case in point. In the 1970s, most New York depositories were flush with cash but had a hard interest rate limit on mortgages. The result was a flow of California mortgages to New York and a flow of dollars to California. New York was an unattractive and noncompetitive local market. With securitization, the New York market, as well as other markets became national markets; and hence, mortgage funds were more readily available. Since the 1970s, mortgage-backed securities have increased lending levels, with even State housing agencies benefiting from the mortgage-backed securities' structuring techniques. The benefits of securitization are widely known. [3]

II. Mortgage Investors' Interests Align With Responsible Borrowers

Mortgage investors are aligned with both homeowners and the Government in our shared goals of keeping responsible Americans in their homes and rebuilding and maintaining a vibrant real estate market. In fact, the maintenance of a healthy securitization market is a vital source of access to private capital for mortgages as well as autos and credit cards. Moreover, an efficient securitization market provides more and cheaper capital to originators, which allows them to issue more loans to additional qualified borrowers. The use of mortgage-backed securities equitably distributes risk in the mortgage finance industry, and prevents a build-up of specific geographic risk. These features, and many others, are those of a market which makes access to capital cheaper and thus spurs more mortgage lending.

Mortgage investors seek effective, long-term sustainable solutions for responsible homeowners seeking to stay in their homes. We are pleased to report that mortgage investors, primarily the first lien holders, do not object to modifications as part of a solution. Unfortunately, mortgage investors are often powerless under the operative Pooling and Servicing Agreements (PSA) to offer such support. We strive for additional remedies to assist homeowners. Likewise, if a borrower speculating in the housing market, engaging in a strategic default or paying only their second lien mortgages, then they should not be eligible for receiving subsidized first lien interest rates. Potential structural changes that should be examined include: full recourse, blockage of interest payments on second lien debt if the first lien is in default, prohibitions on the second lien debt above a specified loan-to-value (LTV).

Those "private label" (non-Federal agency) securities are put together by a variety of entities (*e.g.*, investment banks) that pool the mortgages into a trust. The trust is built around a document called a Pooling and Servicing Agreement (PSA) that provides investors the rights and protections relating to the mortgages that make up the securitization and the terms and duties that are owed to the investors by the trustee of the security and the servicer of the individual mortgages. Within this Agreement, numerous representations and warranties exist regarding the quality of the mortgages that are included in the trust and the lending practices that were followed in the mortgage origination process. It is important to note that, historically, investment in these mortgage products have been attractive, in part, because

[3] *See, e.g.*,"Securitization and Federal Regulation of Mortgages for Safety and Soundness", CRS Report for Congress at 2 (RS-22722, Oct. 21, 2008). ("This securitization of mortgages increased the supply of funds available for mortgage lending").

they are governed by binding contracts that lend the stability and to the predictability investors desire. Like any purchaser, investors expected the sellers of mortgage securities (which were often large banks) to stand behind their promises. Similarly, the GSEs, the Federal Reserve Bank of New York, and others confront the same challenges. Unfortunately, this critical component of mortgage securities market has broken down, harming mortgage investors including State pension and retirement systems.

With a restored, vital, and healthy securities market, we will be able to attract more private capital into mortgage investments and, in turn, provide more affordable mortgages for potential qualified home buyers.

Problems Arising From Improper Servicing

As Congress reviews this area and considers solutions for enhancing securitization, it may wish to review solutions across all asset classes. We wish to highlight that the housing space and MBS have been devastated by the practices and events of the last few years. Accordingly, we urge lawmakers that it is necessary to treat MBS separately from other asset classes in an effort to restore the U.S. housing sector and help American families pursue home ownership. The problems impacting investors by the malfeasance of servicers and their affiliates are numerous. We wish to highlight the following points:

- *Many Servicers Are Conflicted; They May Not Be Servicing Mortgages Properly.* Very often they are harming the interests' of both investors and homeowners' interests. This has a negative impact on private investor demand for mortgages and limits housing opportunities; [4]
- *Originators and Issuers May Not Be Honoring Their Contractual Representations* about what they sold into securitizations. Additionally, the documents are vague, with basic terminology having no definite meaning (*e.g.,* delinquency or default). The past is prologue and there are no assurances that they will not repeat these practices in the future; and,
- *The Market in General Lacks Sufficient Tools for First Lien Mortgage Holders*, such as: recourse to the homeowner on a uniform, national basis (to avoid strategic defaults) and efficient ways to dismiss the 2nd lien (to allow for more effective workouts with the homeowner on the first lien).

III. Solutions Offered by Mortgage Investors

The current legal and regulatory landscape presents numerous obstacles for the MBS securitization, including a lack of the necessary transparency for the effective functioning of capital markets in connection with several fundamental aspects of the system. These problems are varied and numerous in the RMBS context. For example, investors were offered transactions with overly complex legal documentation, obscured salient facts about a deal, and take-it-or-leave-it time frames for acceptances of offers to purchase securities in underwritings. The lack of transparency in this context distorted markets and ultimately proved to impair the health and stability of our housing and mortgage markets. In essence, mortgage investors simply seek the salient facts underlying a transaction. In fact, last week, Mr. Edward DeMarco, Acting Director, Federal Housing Finance Administration (FHFA), testified before a House of Representatives Subcommittee and explained the following:

> FHFA views enhanced, loan-level disclosures as necessary for investors to analyze and assess the potential risks associated with the collateral of asset-backed securities, including mortgages. [5]

Accordingly two sets of consequences have arisen. First, the U.S. private mortgage-backed securities market has ground to a halt. Observers note that with two exceptions, no new RMBS securitizations have occurred since the financial crisis. Second, Americans suffer through reduced credit, more expensive mortgage rates, and fewer housing opportunities. In an effort to solve the problems facing the capital markets and the working class, AMI has offered a number of policy solutions

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[4] An example of this conflict is as follows. Consider the case when the servicer and the master servicer are the same entity. In such a case, a lack of effective oversight exists when the enforcement entity is owned by the same parent as the servicer. For example, in certain deals the Master Servicer has "default oversight" over the servicer therefore certain loss mitigation cannot be accomplished. Hence certain critics observe that when both are owned by the same parent entity, with the identical priorities and culture, no effective oversight is possible.

[5] Hearing on "Transparency as an Alternative to the Federal Government's Regulation of Risk Retention", before the House Oversight and Government Reform Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs, May 11, 2011 (testimony of Acting Director Edward DeMarco).

which are described in its "Reforming the Asset-Backed Securities Market" white paper (March 2010).

We believe that the recommendations below, which are detailed in depth in the attached white paper, support healthy and efficient securitization and mortgage finance markets, with more information made more widely available to participants, regulators, and observers; incentivize positive economic behavior among market participants; reduce information asymmetries that distort markets and are entirely consistent with the Government's traditional roles of standard-setting in capital markets. In sum, the AMI offers the following recommendations to enhance transparency and best securitization practices within capital markets:

- Provide loan-level information that investors, ratings agencies, and regulators can use to evaluate collateral and its expected economic performance, both at pool underwriting and continuously over the life of the securitization.
- Require a "cooling off period" when asset-backed securities are offered so that investors have sufficient time to review and analyze loan-level information before making investment decisions.
- Make deal documents for all asset-backed securities and structured finance securities publicly available to market participants and regulators sufficiently in advance of investor decisions whether to purchase securities offered.
- Develop, for each asset class, standard pooling and servicing agreements with model representations and warranties as a nonwaivable industry minimum standard.
- Develop clear standard definitions for securitization markets.
- Directly address conflicts of interests of servicers that have economic interests adverse to those of investors, by imposing direct fiduciary duties to investors and/or mandatory separation of those economic interests, and standardize servicer accounting and reporting for restructuring, modification, or work-out of collateral assets.
- Just as the Trust Indenture Act of 1939 requires the appointment of a suitably independent and qualified trustee to act for the benefit of holders of corporate debt securities, model securitization agreements must contain substantive provisions to protect asset-backed security holders.
- Asset-backed securities should be explicitly made subject to private right of action provisions of antifraud statutes in securities law and to appropriate Sarbanes-Oxley disclosures and controls.
- Certain asset-backed securities can be simplified and standardized so as to encourage increased trading in the secondary market on venues, such as exchanges, where trading prices are more visible to investors and regulators.
- Ratings agencies need to use loan-level data on their initial ratings and to update their assumptions and ratings as market conditions evolve and collateral performance is reported.

IV. Conclusion

Mortgage investors believe that the vibrancy and effectiveness of the U.S. capital markets can be restored, in part, by enhancing the transparency around fundamental regulatory structures, standards, and systems. Toward this goal, the Government has a role—not through the heavy-hand of big Government, but rather, the light touch of a prudent standard-setter and facilitator. With appropriate standards and rights for the holders of asset-backed securities, securitization would achieve the goals sought by many—the more efficient funding of capital markets, lessening volatility, and the resulting better economic activity. In the absence of transparency, the future of the U.S. housing finance system will remain dark, hurting America's global competitiveness and our domestic health. The results will include less home lending, more expensive credit, and fewer housing options and less opportunity for working class Americans. These are the reasons that we need solutions providing for more transparent systems and restarting our capital markets.

Thank you for the opportunity to share the view of the Association of Mortgage Investors with the Subcommittee. Please do not hesitate to use the AMI as a resource in your continued oversight concerning the many issues under review. We may be reached at 202-327-8100 or by e-mail at katopis@the-ami.org. We welcome any questions that you might have about securitization, representations and warranties, or other mortgage industry topics.

White Paper

Reforming the Asset-Backed Securities Market

Association of Mortgage Investors

March 2010

Introduction

In the two and a half years since the financial crisis began, it has become clear that the continued health of the securitization markets is crucial not just to U.S. economic recovery but to the financial system as a whole. There are three sources of residential and commercial mortgage capital in the United States – bank balance sheets, which are full and stressed; the securitization market, which is effectively shut down; and the government (Fannie Mae, Freddie Mac, FHA, etc.). For other types of debt capital, there are only two sources – banks and the securitization market – as the government does not directly provide capital the way it does for mortgages. Restoring the securitization market is necessary to get more private capital flowing to those who wish to use it, and accordingly to reduce the government's role of providing public capital to, and allocating that capital among, private borrowers.

The structures and mechanisms that have defined the securitization market to date have been constructed by issuers, underwriters, credit rating agencies and asset servicers with minimal disclosure-based, procedural or substantive regulation by Congress, financial regulators or the SEC. Investors provide the capital that make the securitization markets work yet have been ignored in market structure discussions. They have been told by other parties to securitization to "take it or leave it" on disclosures, definitions and structures, in other words - "just buy the securities we offer you". Now that poor credit underwriting, moral hazards, inadequate disclosures, asset servicer conflicts of interest, ratings agency failures, and logistical obstacles to working out bad collateral assets have scared investors away from the securitization markets, it is important for the government to consider the policy recommendations of investors, whose participation and capital are needed for there to be an asset-backed securities market at all. In fact, while issuers suggest otherwise and ideally it would be great if a consensus between issuers and investors could emerge, there need not be a consensus as investors ultimately provide the capital and have the responsibility to define the terms on which they will commit their capital.

We believe that the following recommendations support healthy and efficient markets, with more information made more widely available to participants, regulators and observers; incentivize positive economic behavior among market participants; reduce information asymmetries that distort the spread between price and value and are entirely consistent with the government's traditional roles of standard-setting in emerging capital markets.

1. **Provide loan-level information that investors, ratings agencies and regulators can use to evaluate collateral and its expected economic performance, both at pool underwriting and continuously over the life of a securitization.** Currently loan-level financial and related due diligence information is not required to be publicly disclosed. Issuers, underwriters and asset servicers already have this information and it costs little to make it publicly available on EDGAR or similar systems. Investors in asset-backed securities have both the interest and the ability to analyze such information to help them make better purchase and sale decisions relating to asset-backed securities.

Data should be provided on a daily, or at least monthly, basis in both the primary and secondary markets. To ensure adequate transparency, enhanced disclosure rules should be required both for deals with and without static pool data such as asset-backed commercial paper. Data on the specific underlying collateral in each pool should be made available for a reasonable period – not less than two weeks – before a deal is sold and brought to market. This should be

done to enhance investor due diligence, to foster the development of independent analytical data providers, and to reduce reliance on rating agencies. To ensure the accuracy of the information, loan-level data offered by issuers, underwriters or assets servicers for investors should be accompanied by an auditor attestation verifying that the data has been properly aggregated, calculated and published. The loan-level data should be available in an electronically manageable and industry standardized format. After the deal is sold, all data fields in the pre-issuance disclosures and material information about the loan-level collateral in the pool should be updated and be similarly disclosed on a daily, or at least monthly, basis. The data already exists and the creation of standard data fields and automation of this process would create little regulatory burden.

Capital markets would be less volatile if investors could fully model the expected performance of underlying loan-level collateral before a deal comes to market and, on a regular basis, assess the deviance from expectations. The provision of loan-level performance to investors on a regular basis would allow any degradation of performance to be observable and therefore priced in over incremental periods. By requiring that investors receive early and regular disclosures of all available information about collateral performance, the importance of NRSROs' ratings will be diminished to the level of equity analysts' research notes.

The fact that investors have to pay to subscribe to services such as Loan Performance to get data on collateral underlying asset-backed securities they are offered and may already hold is outrageous in light of the no-cost extensive public disclosure required for corporate securities. Arguments that the amount of loan-level information exceeds the capacity of investors to process and analyze – when issuers, underwriters and asset servicers have no problem processing and analyzing the very same data – are absurd on their face.

2. **Require a "cooling off" period when asset-backed securities are offered so that investors have sufficient time to review and analyze loan-level information before making investment decisions.** Currently investors in primary offerings of asset-backed securities are forced to make decisions as to whether or not they want to purchase immediately after deals come to market. As with existing SEC requirements relating to new issues of equity and debt securities, issuers should have to wait for a reasonable period of time before closing offerings of asset-backed securities. A two-week period would permit investors to properly analyze loan-level collateral and independently determine whether projected performance expectations are adequate.

3. **Make deal documents for all asset-backed securities and structured finance securities publicly available to market participants and regulators.** This will substantially increase market liquidity for such securities after they are sold. In the lead-up to the financial crisis, even primary financial regulators could not analyze or even have access to deal documents of asset-backed and structured finance securities (e.g. CDOs) that their regulated institutions held. The common practice of making fundamental asset-backed and structured finance deal documents proprietary and subject to confidentiality obligations is fundamentally inconsistent with properly functioning capital markets and prudential regulation of financial institutions.

4. **Develop, for each asset class, standard pooling and servicing agreements with model representations and warranties as a non-waivable industry minimum legal standard.** Right now every pooling and servicing agreement for a securitization is custom-written. Representations and warranties vary tremendously from deal to deal, even within the same fundamental asset class (mortgages, credit cards, etc.). This requires investors to spend tremendous amounts of time analyzing the differences between different transactions' legal terms and subjectively weighing the economic meaning of those terms before coming to investment decisions – or alternatively to ignore these differences of legal terms in the interest of time, to the peril of investors when problems develop in the market.

This lack of standardization and the length of the legal documentation effectively created opacity in the securitization market, which substantially contributed to the recent problems experienced by market participants. When collateral pool performance deteriorated, panic set in and investors began to question the value of their securities, they knew that they did not have the time to read all of the different several-hundred-page deal agreements to evaluate their holdings. This reinforced the rush to liquidate positions. What investor wants to be the last one holding a security the terms of which he doesn't fully understand? Potential buyers of these securities in turn would not step into the market without having read the documents themselves, causing the entire fixed-income market worldwide to freeze up.

Standardizing legal documentation gives investors a common framework with which to evaluate their potential and actual holdings of asset-backed and structured finance securities based largely if not solely on collateral pool performance. The asset-backed securities market as a whole would thereby become more homogenous and therefore more liquid. Investors should be able to rely on certain baseline assurances as to the nature of the collateral underlying their securities. Having a single standard set of representations and warranties that must be met or exceeded in every transaction gives investors comfort about the assets in which they have an interest, and reduces the overhead costs of investing in these securities. In addition, standardized representations and warranties would streamline resolution of disputes as to whether representations and warranties are met by individual assets within collateral pools.

Model agreements for the asset-backed securities market should be drafted with the best interests of the investing public, and with clarity of rights and responsibilities, at their cores.

5. **Develop clear standard definitions for securitization markets.** Without a common language and agreement on the meanings of fundamental concepts – such as "delinquency" and "default" – the value of data is diminished, the ability to compare securities across different pools is diminished, and the concepts of relative collateral pool performance and economic value become seriously muddied. There are no such standard definitions currently, and as a result servicers with very similar underlying collateral pools and servicing standards can produce radically different reports of collateral performance. For example, the term "delinquency" can be determined either on a contractual or recency-of-payment basis. Even among firms that would define delinquency on the same basis, each servicing agreement can have different interpretations on reporting of delinquencies – some may report advances that a servicer makes to a pool that could be applied to reduce stated delinquencies, but other servicing agreements may not. When no one agrees on what delinquencies are and how they must be reported, then how do we know what the term "default" means? How can anyone really understand what is happening if there is so much variability deal-to-deal and there are no industry-standard

practices? This is a huge problem that interferes with investors' ability to make investment decisions among various deals and issuers. The lack of clear standard definitions reinforces the complexity from the lack of standard contracts in securitization deals, and also makes it harder for capital markets to function.

Conversely, if everyone is using common language in loan origination and securitization then it becomes very hard to game the system as issuers and servicers have.

6. **Directly address conflicts of interest of servicers that have economic interests adverse to those of investors, by imposing direct fiduciary duties to investors and/or mandatory separation of those economic interests, and standardize servicer accounting and reporting for restructuring, modification or work-out of collateral assets.** Servicers of mortgage or other financial asset pools often have economic interests that differ from those of investors. Simple contracts between servicers and securitization trustees, which themselves are subject to little or no accountability to investors, have not sufficiently aligned the interests of servicers to those of investors over time.

Where servicers are charged with enforcing representation and warranty claims on specific collateral pool assets so they are put back to originator affiliates of the servicers at par, the servicers have a conflict of interest and appear to have been delaying in carrying out such put-backs so as to avoid losses to their affiliates. Where servicers have affiliates that hold second lien or mortgage pool residual interests, they appear to have been carrying out their loss mitigation duties in ways that delay resolution and thereby maximize the option value of such second lien or residual interests, often at the direct expense of the senior tranche holders. Investors in asset-backed securities need to know that servicing is being performed in a way that maximizes the present value of the entire collateral pool without regard to such conflicts, and this can only be done if fiduciary duties flow directly from servicers that are sufficiently kept away from such competing economic interests.

Servicers, securities administrators and trustees must also establish and enforce uniform accounting policies and procedures for loan restructurings. Since the existing securitization contracts did not contemplate the scope and economic impact of the modifications being implemented under today's environment, it is imperative that securitization accounting in the future reflects the actual economic impact of the modified cash flows associated with the restructuring. Where loan modifications involve principal forbearance, there must be recognition of economic losses that affect how cash flows are allocated within securitizations.

7. **Just as the Trust Indenture Act of 1939 requires the appointment of a suitably independent and qualified trustee to act for the benefit of holders of corporate debt securities, model securitization agreements must contain substantive provisions to protect asset-backed security holders**. Right now, trustees of collateral pools play a largely passive role and bear little if any accountability to the holders of securities which they have agreed – and are being compensated – to serve. In practice they do not supervise the servicers of collateral pools, who are often affiliated with the loan originators and therefore have strong incentives not to enforce representation and warranty claims on behalf of investors. Trustees have no practical means of monitoring or reacting to servicer performance, and no incentive to do so.

If one considers that the trustee of a securitization is like the board of directors of a company and the servicer of a collateral pool is functionally like the management, then it must be stated that holders of asset-backed securities are not given the protective rights, relative to those expected to serve them, that shareholders are provided. Securitization legal structures may utilize trustees and holders of asset-backed securities may have their rights shaped by contracts, but these holders are collectively the equity of the trust and they are owed fiduciary duties which must be respected. At least shareholders have the right to find out who their fellow security holders are, the right to an annual meeting, and the right to remove and elect new directors. Holders of asset-backed securities have none of these rights.

Given servicer incentives and conflicts of interest, the only effective way to effectively enforce deal representations and warranties back to the originator or sponsor is to give investors the ability to re-underwrite the loans as per initial collateral guidelines. Current private-market ABS legal structures seriously limit investors' access to data and ability to require put-backs of bad collateral by onerous minimum ownership hurdles and legal procedures. Legal rights to the integrity of pool collateral without a practical means of enforcement are meaningless in practice, both as a deterrent to originators' knowingly dumping bad assets into ABS pools and as a remedy to investors harmed by such practices.

8. **Asset-backed securities should be explicitly made subject to private right of action provisions of anti-fraud statutes in securities law and to appropriate Sarbanes-Oxley disclosures and controls.** Just as these legal provisions extend to equity and debt securities and help to support investor confidence that they are being treated fairly by issuers, they should similarly extend to asset-backed securities.

9. **Certain asset-backed securities could be simplified and standardized so as to encourage increased trading in the secondary market on venues, such as exchanges, where trading prices are more visible to investors and regulators.** This could result in better price discovery, additional market transparency, additional liquidity and reduced bid/ask spreads. In the interim, investors should be strongly encouraged to buy only those financial instruments which they have an understanding of and are able to analyze completely, including the instruments' current market value. All dealers should be required to disclose historical trade prices on these simplified and standardized asset-backed and structured finance securities daily.

10. **Ratings agencies need to use loan-level data in their initial ratings and to update their assumptions and ratings as market conditions evolve and collateral performance is reported.** The poor record of recently issued asset-backed securities, in light of high initial ratings which were infrequently if at all updated as collateral performance came in, shows that we need fundamental change in the ratings process.

Rating agencies should have to base initial ratings on loan-level data with publicly disclosed economic and collateral performance assumptions including a life-loss curve. As time goes on, they should be required to update their models periodically with updated economic assumptions and new monthly remittance data from servicers. There should be regular secondary market re-ratings, frequent and timely enough to be of real use to investors. Each

NRSRO should have an independent office of a chief statistician that would archive and update ratings models firm-wide, and should be paid based on the accuracy of their ratings as collateral performance is reported. Rating agencies should have their liability exemptions carved back, should have minimum industry standards for analyst professional training in structured finance, and should prohibit revolving-door employee moves to issuers and underwriters. (Of course analysts should be able to join investor firms after leaving the rating agencies as there is not the same conflict of interest as with issuers and underwriters.)

We should create financial and reputation-based incentives for rating agencies to utilize a regular loan-level and cash flow approach to re-rating securities on a regular and frequent basis and their income should be specifically tied to the performance of the rated securities over the life of the issue.

Conclusion

Securitization has shifted significant funding for many asset classes away from bank balance sheets and into the hands of capital markets participants. With appropriate standards and rights for the holders of asset-backed securities, securitization would more efficiently fund markets, result in less volatility, and produce a better convergence between the pricing and value of assets in support of economic activity. This is the reason that we must now restart the securitization markets. If these markets are not functioning as an alternative to portfolio lending where economically less expensive, then there is no way to finance an economy that has previously been funded by global capital flows.

Given the problems in the securitization market that have been exposed by the financial crisis, if the fundamental market restructuring steps taken above are not taken then it will be difficult if not impossible for capital market investors to return to funding economic activity to the degree that they did previously.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN REED FROM STEVEN L. SCHWARCZ

Q.1. In your written statement, you make reference to a kind of expectation gap of investors, where a triple-A rating equated to a certification of "iron-clad safety" and "investment-grade" meant "freedom from default." Could you expand upon this concept? Is this expectation gap contributing to a lack of confidence in ratings? Should rating agencies continue to play a role, and if so, how do we deal with this expectation gap?

A.1. *Could you expand upon this concept?*

As you know, ratings are an assessment of the safety of payment on debt securities, with a triple-A rating being the highest and BBB- or higher ratings being historically called "investment grade"—meaning securities so rated are generally viewed as eligible for investment by banks, insurance companies, and savings and loan associations.[1] Rating agencies clearly perform a social good by assessing diverse information and issuing ratings based thereon, achieving an economy of scale. A problem occurs, however, when investors overrely on ratings as a shortcut for their own diligence and analysis. Investors are prone to overrely for two reasons.

First, there is a secondary-manager conflict, which I referenced more generally in my testimony. In the context of rating agencies, this conflict occurs when analysts employed by investors recommend that their firms invest in securities that are highly rated, without the analyst engaging in the analysis and diligence his or her job theoretically requires. This type of conflict can be mitigated by more closely aligning analyst (and other secondary-manager) compensation with the long-term interests of their firms.[2] As my testimony explained, this is an intra-firm conflict, quite unlike the traditional focus of scholars and politicians on conflicts between managers and shareholders. Dodd-Frank attempts to fix the traditional type of conflict but completely ignores the problem of secondary-management conflicts.

Second, in my experience investors do not always bother—or perhaps, because of the conflict referred to above, want—to learn the limitations of ratings. For example, ratings do not technically cover the risk of fraud but, instead, are based on the information received.[3]

Is this expectation gap contributing to a lack of confidence in ratings?

This expectation gap may well be contributing to a lack of confidence in ratings. However, I believe the expectation gap is not caused by ratings *per se* or even by the ratings system as currently constituted. Rather, the gap is caused, as discussed above, by a combination of (i) the secondary-manager conflict and (ii) investor misunderstanding of what ratings provide. This combination of fail-

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[1] "Private Ordering of Public Markets: The Rating Agency Paradox", 2002 *U. Illinois L. Rev.* 1, 7–8.

[2] *See,* "Conflicts and Financial Collapse: The Problem of Secondary-Management Agency Costs", 26 *Yale Journal on Regulation* 457 (2009), available at *http://ssrn.com/abstract_id=1322536.*

[3] "Private Ordering of Public Markets", *supra* note 1, at 6 and 6 n. 33. I do not think it would be practical to require rating agencies themselves to perform the due diligence needed to discern fraud; indeed, no amount of advance due diligence can ever eliminate fraud.

ures leads to variances between what investors "think" they're investing in and what they're actually investing in.

Should rating agencies continue to play a role, and if so, how do we deal with this expectation gap?

I believe that rating agencies should continue to play a role. As mentioned, they perform a social good by assessing diverse information and issuing ratings based thereon, achieving an economy of scale.

We could deal with this expectation gap in two ways:

1. Mitigate the secondary-manager conflict by more closely aligning analyst (and other secondary-manager) compensation with the long-term interests of their firms. Volume 26 of the *Yale Journal on Regulation* examines, at pages 465–469, how to accomplish this.
2. Require investors to educate themselves about the limitations of ratings. As discussed above, the secondary-manager conflict itself undermines this education process; therefore mitigating that conflict is likely to mitigate this education failure.

Q.2. One of the problems you note in your written statement is the "overreliance on mathematical modeling." The SEC has proposed that ABS issuers file a waterfall program that demonstrates the flow of funds in a transaction. What do you think of this proposal?

A.2. I do not think this proposal is needed. The materiality requirement of existing disclosure law already requires an explanation of waterfalls. In my experience, these explanations are generally clear and (insofar as they can be) straightforward.

I fear this proposal could even backfire. A mathematical program demonstrating the flow of funds could aggrandize the waterfall model, giving the model (as discussed in the next paragraph) greater credence than it deserves.

Sophisticated investors do not, in my experience, have a problem understanding waterfalls and funds flows. Rather, their problem is under-appreciation of how easy it can be—especially in nontraditional transactions involving complex and highly leveraged securitizations of asset-backed securities already issued in prior securitizations (what I called in my testimony "securitizations of securitizations")—for relatively small errors in cash flow projections to significantly impact investor recoveries. To correct this under-appreciation, it would be helpful to require some sort of "sensitivity" analysis explaining how the waterfall cash flows would *change based on changes in collections* on the underlying financial assets. [4]

Even a sensitivity analysis, however, is dependent on assessing how likely it is that collections on the underlying financial assets will change. No one can know that for sure, *ex ante;* there are simply too many variables and potentially unknown correlations. This illustrates a larger point: In complex financial markets, disclosure is necessary but almost always will be insufficient. [5] For an anal-

[4] This might be done, for example, through a "Monte Carlo simulation."

[5] *See, e.g.,* "Disclosure's Failure in the Subprime Mortgage Crisis", 2008 *Utah L. Rev.* 1109, available at *http://ssrn.com/abstract_id=1113034*; "Rethinking the Disclosure Paradigm in a

Continued

ysis of how to attempt to respond to this insufficiency, see pages 238–245 of "Regulating Complexity in Financial Markets". [6]

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN REED FROM TOM DEUTSCH

Q.1. A number of panelists described the development of a new model representation and warranties document that would correct structural flaws in the current representation and warranties. What role should a private-standard setting body play in its development and implementation? What role should Government play? What would be the best method for determining whether a particular transaction deviated from the standards?

A.1. Response not provided.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN REED FROM MARTIN S. HUGHES

Q.1. In your statement, you advocate for risk retention that favors a "horizontal slice," which provides for retaining the first-loss securities, rather than a vertical slice. Should risk retention rules prescribe a specific form of risk retention or provide a choice of options for investors to choose from? What are the strengths and weaknesses of such an approach? In the wake of the financial crisis and evidence that some executives internally disparaged the quality of risky loans while publicly exuding confidence, how could investors have confidence that horizontal slices were really the rust-loss securities?

A.1. Response not provided.

Q.2. In your statement, you noted that "mortgage servicing issues are an impediment to broadly restarting private residential mortgage securitization." How important is it that this be corrected quickly? What do you believe are the most critical items that should be part of any solution to restarting the RMBS market? Should this be a regulatory response or should private industry lead the way?

A.2. Response not provided.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN REED FROM LISA PENDERGRAST

Q.1. A number of panelists described the development of a new model representation and warranties document that would correct structural flaws in the current representation and warranties. What role should a private-standard setting body play in its development and implementation? What role should Government play? What would be the best method for determining whether a particular transaction deviated from the standards?

World of Complexity", 2004 *U. Illinois L. Rev.* 1, available at *http://ssrn.com/abstract=336685. See also,* "Regulating Complexity in Financial Markets", 87 Washington U.L. Rev. 211, 221–225 (2009/2010), available at *http://ssrn.com/abstract__id=1240863.*

[6] 87 Washington U.L. Rev. 211, 238–245.

A.1. The Commercial Real Estate (CRE) Finance Council is an association that represents a very broad and diverse constituency within the commercial real estate finance market, including portfolio, multifamily, and commercial mortgage-backed securities (CMBS) lenders; issuers of CMBS; loan and bond investors such as insurance companies, pension funds, and money managers; servicers; rating agencies; accounting firms; law firms; and other service providers. Even before the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), market participants within our industry were aware of a desire within the industry to address concerns that began to emerge at the onset of the economic crisis and that admittedly prompted policy makers to craft risk retention requirements. To address this demand, the CRE Finance Council independently developed a series of market reforms to strengthen the securitization market and foster greater investor confidence. Given our diverse representation and our stake in ensuring that the CMBS market is efficient and sustainable, we believe our private organization is uniquely positioned to create "best practices" initiatives for the CMBS market. And since regulators have been tasked by Congress to consider and implement measures that essentially represent "best practices" for the various classes of asset-backed securities (*e.g.*, the consideration of representations and warranties and of underwriting standards as part of the risk retention framework established in Dodd-Frank Section 941(b)), we believe that the Government should look to industry-developed standards to help form the basis of such regulations, and we have urged the regulators to do this.

One of the CRE Finance Council's initiatives builds upon existing customary representations and warranties for CMBS to create "Model Representations and Warranties" that represent industry consensus viewpoints. The CRE Finance Council's model was the result of 200-plus hours of work by its Representations and Warranties Committee over the course of many months in 2010, and represents the input of more than 50 market participants with diverse views who worked to achieve industry consensus.

The CRE Finance Council Model Representations and Warranties were specifically crafted to meet the needs of CMBS investors in a way that is also acceptable to issuers, and were developed with an emphasis on investor concerns about transparency and disclosure. Such Model Representations and Warranties for CMBS are designed to be made by the loan seller in the Mortgage Loan Purchase Agreements. The CRE Finance Council's model will require issuers to present all prospective bond investors with a comparison via black line of the actual representations and warranties they make to the newly created CRE Finance Council Model Representations and Warranties. And in addition, loan-by-loan exceptions to the representations and warranties must also be disclosed to all prospective bond investors. The Model Representations provide a clear benchmark for comparison, and the need to black line to the Model Representations is a disclosure best-practice that makes any variations from the Model Representations easy for investors to evaluate. Use of the Model Representations as a reporting template is also a disclosure best-practice that helps investors understand what underwriting and documentation practices were applied, and

what was found in the underwriting process. This provides investors with a key tool that enables them to police the quality and completeness of underwriting procedures, and do their part in funding good origination practices while defunding bad practices that generate risks that can damage market sustainability.

In this regard, it is important for policy makers to be aware that, unlike in the residential loan context, it is the normal course for there to be representation and warranty exceptions in CMBS transactions. This is the case because the facts and circumstances of each loan transaction are unique. For example, tenant verifications may vary from loan to loan depending upon the number and size of tenants, or certain environmental concerns may exist with respect to a property and property-specific steps may have been taken by a borrower to remediate those conditions. Disclosure of these differences is normal course and more broadly, properties that have unique features need and should attain financing provided that the loans are properly sized and structured. It would not be good public policy to render large swaths of commercial real estate unfinanceable just because the property has unique elements that would give rise to a representations exception. Investors understand that any large pool of commercial mortgages will generate many representation exceptions. What they seek is a clear disclosure of those exceptions, so that they can assess the quality of the prospective investment in the related bonds, in light of all of the key facts pertaining to the collateral pool.

Finally, as part of the Model Representations and Warranties project, the CRE Finance Council also has developed a framework for addressing and resolving claims for breach of representations and warranties. We believe these enforcement standards will satisfy the Dodd-Frank Act's requirement for "related enforcement mechanisms" when coupled with adequate representations and warranties. The CRE Finance Council resolution standards provide for mandatory mediation before litigation, and represent an industry consensus view on how to resolve disputes in an expedited, reliable, and fair fashion while also avoiding unnecessary costs.

Q.2. In your written testimony, you described the commercial real estate industry's work on the model representation and warranties agreement that you state: "coupled with extensive disclosure are considered a form of risk retention that is more valuable than having an issuer hold a 5 percent vertical or horizontal strip." This appears to be an innovative approach to dealing with risk retention. Would you please expand on this concept? How would this approach be more valuable than retaining of a percentage of the risks of the underlying securities?

A.2. The adoption of the CRE Finance Council Model Representations and Warranties is a step that both strengthens risk retention and empowers investors with a highly useful informational tool that can help them do their part in policing CMBS market practices. Some investors believe that the use of robust, standardized representations and warranties should be the key risk retention feature that regulators endorse because it helps investors actively monitor securitization quality rather than passively delegating that policing role to issuers, B-Piece buyers, rating agencies, or others.

Other investors prefer a regime where robust and standardized representations are a key part of a multifaceted risk retention regime, provided that no portion of the risk retention regime is so inflexible or ill constructed that it threatens to shut down or significantly chill origination and investment activities in the CMBS market, given that the vibrancy of this market is essential to the ongoing health of our economy. But the industry is united behind the need for, and efficacy of, adopting the Model Representations and Warranties as a key element in the solution.

The CRE Finance Council appreciates the Committee's interest in matters of concern to the commercial real estate finance industry, and we stand ready to work with you on these issues. If you have any additional questions, please feel free to contact Michael Flood, Vice President, Legislative and Regulatory Policy, CRE Finance Council, at (202) 429-6739 or mflood@crefc.org.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN REED FROM ANN ELAINE RUTLEDGE

Q.1. You state in your written remarks, "[A]n America that can rebuild its economy with sustainable securitization markets while building incentives for producers in the capital-intensive sectors of the economy will, forcibly, continue to lead the world financially . . . " Could you expand on this? What types of incentives should be created? Who should be championing them? What policy changes should Congress consider?

A.1. First, the phrase "sustainable securitization markets" needs unpacking. It has two underlying ideas—

a. Securitization markets can be sustainable; and
b. This would be desirable, because securitization is a fairer, more sustainable form of finance for rebuilding the economy.

The latter point only sounds controversial. It isn't. Securitization is 35 years old. It was an obscure market until the Credit Crisis. The best evidence that securitization is inherently stable is its 30-year obscurity.

Securitization is a sustainable market form, if the rules are made transparent and enforced.

The fall of Long Term Capital (LTCM) in 1998 was a watershed in securitization history. The culture of the market changed rapidly as derivatives traders, who make profits from small pricing inconsistencies and large amounts of leverage, moved into credit arbitrage using the tools of structured finance. As they poured new capital into the market, its focus shifted from corporate finance, an intrinsically static activity, to dynamic betting. Before, structuring bankers strove to keep up with what rating agency analysts were thinking. After the demise of LTCM, structured analysts struggled to keep up with what the leaders of the banking pack were thinking.

Securitization was not built to handle credit arbitrage trading because the credit rating system, a key input in pricing and valuing structured securities, was static. This defect stimulated the growth of the market after LTCM. That's right: the source of demand for

RMBS, CDOs, SIVs, and other structured products was not fundamental but generated by flawed market machinery and distorted prices. The bank-rush to squeeze as many faulty deals as possible through the system before it collapsed contributed massively to its ultimate collapse.

Securitization is an information game. To bring it back, the information layer needs transparency.

The history lesson should be clear:

Securitization always worked, more or less, when the objective was to raise funds for companies. It only ceased to work when banks, who make more profit from trading than lending, found a way to book underwriting fees and profits from securitization, not just fees. The social lessons should also be clear:

i. We should not delegate the responsibility for enforcing the rules to the banks when self-interest lies in breaking them. "We are conflicted about what we want our institutions to do; we want them to be ethical, but we also want them to make lots of money." *http://bit.ly/m9k3zx.* Banks are natural rent-seekers. If we want them to be profitable, we can't ask them to act like regulators.

ii. Individuals in a market-capitalist economy cannot delegate their responsibility for keeping the market healthy, any more than a democracy can delegate the duty of electing its representatives. The responsibility is ours, collectively.

We can make the securitization market stable again by publishing information that is relevant to dealing, ensure that the structuring rules are carried out, and see that benchmarks of value are enforced. To these ends, Regulation AB is a highly effective disclosure framework that enables the securitization market to govern itself, with or without rating agencies.

In my opinion, the original 2005 ruling would have been a perfectly adequate standard if the market had been sophisticated about securitization. It wasn't, and it isn't, so further revisions have been proposed to make the practice elements come together to form a firmer, fairer market basis.

Three action items are required to make Regulation AB a complete standard. These are mainly outside the jurisdiction and control of the SEC and therefore merit further comment below:

i. More education about structured finance and securitization is needed. These skills are taught in very few finance departments of business schools. The explanation—that the approach is structural rather than empirical, and therefore unorthodox and unpopular—is a little bit outside the scope of my responses. But, the result is that people learn structured finance and securitization in the workplace—and, as you can imagine after the Crisis, in many cases, some of what was learned is wrong.

ii. Numeracy deficits need to be addressed through our educational system. In one of his tweets, Steve Martin says the "hat" key (shift+6) is a wasted space on the keyboard. This is oddly true. The hat key is the operator for exponents in Excel.

If the average mortgagor knew how to work with exponents, they could do loan math. This would be a massive victory for consumers and knowledge workers in America's information society.

iii. The structured finance rating scale should be published (Question ii). To foster a genuine two-way market that can police itself (and legislators and regulators can take a well-deserved break from dealing with securitization issues) the rating scale needs to be a public good, available to everyone and anyone.

Rebuilding the American economy with securitization.

New companies and small companies are not well served by the financial system as it is currently constituted. Moreover, for structural reasons, we can expect things to get worse. In this section, I justify my assertions and explain how securitization is an answer—even though we have rarely seen it used that way in the past.

In corporate finance 101, we learn that growing firms need working capital because sales alone are not enough to finance and build a sustainable scale of operations. The decision to borrow does not signify "living beyond one's means" (as it may for consumers) but rather pride of ownership and an enterprising spirit. Finance theory teaches that equity capital involves loss of some ownership and control and costs more than company debt. But, in the trenches of finance, we discover a paradox: affordable debt is extended mainly to large, mature, well-capitalized firms that don't need the funding.

Moreover, middle market lending today has become a casualty of the capital management system. To get working capital, small and medium sized businesses (SMEs) turn to personal credit cards or unlicensed lenders, or leverage their homes. This condition describes a large set of 27 million firms (96 percent of the American businesses community), which have fewer than 500 employees yet employ 50 percent of the American labor force according to the 2008 U.S. Census. *www.census.gov/econ/smallbusiness.html*. Moreover, the "nonemployer" firms who represent 74 percent of the businesses in America may never build up enough equity to be able to reach equilibrium and do the normal things most business owners long to do—hire employees, provide health care, pay their lenders and suppliers, and give to charities. Debt financing for innovative startups that produce jobs is also scarce. Wind River Systems, founded in 1983, is the prototype of a startup in the engineering/information space that is too sophisticated for the average lender to understand. They make embedded operating systems, employ 1,500 people, and generate over $350 MM in annual revenues. But their business is too sophisticated for the debt market, and in the early days, the working capital amounts they required would have been too small to merit a wholesale lender's attention.

The stark reality is, a small business owner or entrepreneur in America today may never be bankable—no matter how much we trust or like them personally, how much their business enhances our lives or how lifesaving their inventions may turn out to be.

Our economy is severely afflicted by an invisible structural funding gap, and unless the incentives of the financial system are redirected towards putting capital back into the real economy, things are going to get worse. Financial system trends towards deregulation, disintermediation, Basel, consolidation, *etc.,* have created incentives for the large banks to deal in ever-larger, ever more levered packets of capital at razor-thin margins. The efficiency gains are not being redistributed to players in the real economy—the gains are feeding the financial economy.

It does not have to be this way.

Securitization is a fairer, more sustainable form of finance for rebuilding the economy.

Any firm that knows its clients and its business, and runs it professionally, becomes bankable with securitization. That is because the lending decision is based, not on how big the company brand is, but how reliably the receivables perform. With securitization, the more professional, targeted, and responsive to market the firm is, and the better its collections, the greater its access to affordable working capital—if the conditions for market sustainability are met.

Securitization is about putting the value of the capital created by firms back to work faster, so that the firm can realize its economic potential. Sustainable securitization also realigns the incentives along the supply chain of credit so that other institutions in the same sector use their capital efficiently and appropriately. This is due to the influence of informational feedback: firms that securitize and repay according to plan receive lower-cost funding and those that violate expectations must pay more for their capital. Below, three illustrations of how securitization has been or could be used, to revive the American dream:

Practical examples of how securitization can put certain sectors on a more sustainable financing basis.

#1, Live Example: A securitization of stallion stud fees and associated syndicate shares in 2007 allowed a small but skilled thoroughbred farm to raise five times the amount of its equity capital to invest in new stallion syndicate shares. In one go, this breeder farm went from a small player to a substantial player, and at the same time, halved the interest cost of an on-balance sheet loan.

This transaction was shadow-rated and funded in a bank conduit. As the senior creditor, the conduit provided a more affordable cost of capital (instead of the lending specialist's cost) because

i. The investor was not collateralized by individual horses but a senior slice of pooled cash flows from the pledged studding fees and protected by a pledge of syndicate shares;
ii. The structure was well-crafted to defend investors against the biggest risks in the deal (mortality, infertility, sterility leading to declines in cash flow and share value); and
iii. Investors were provided ample high quality information about the risks and sources of value in the investment.

The transaction has performed extremely well through the worst of the Crisis.

#2, extending the Live Example to businesses in your State: There is nothing special about a securitization of stallion stud fees; this financing solution could be applied to other industries in your State—for example, to energize solar energy, film, music, digital media, information technology, aircraft, health care, and companies with commercially viable process patents ranging from toys and games to defense industries, to life sciences.

Start with 2,500 financially viable SMEs that have been around a few years. Suppose that they could each borrow $400,000 at 15 percent per annum. Or, $1 BN pool of their receivables could be securitized off-balance sheet and funded by issuing two tranches (slices) of securities: senior debt and equity. On a blended (weighted average) basis, the funding would be cheaper.

How much capital could be conserved? The blended rate is market-determined, and this is a hypothetical example. But, suppose it turns out to be 7.5 percent. Over 10 years, the amount of interest expense reduction would exceed 50 percent of the initial borrowing, or about $514.8 MM. If a rating agency determined that the senior debt can be investment grade with 4:1 leverage in the capital structure, $5 billion of new working capital could be raised for the businesses. [1] The footnote goes through the numbers.

What about the new capital flows—where does this money go?

Borrowing firms could redeploy the interest savings as additional working capital, reinvestment in the business, or dividends.

As a condition of participating in this SME fund, the firms could be required to earmark a portion of the proceeds to hire and retain the best IT and engineering talent for their businesses. This is one way to reinforce their responsibility to keep their value proposition alive. Their success would be measured by the performance of their receivables. If they underperformed expectations, they would have to exit the fund. Conversely, as the firms grew in size and reputation, like our Wind River Systems example, they could come off the SME Fund and securitize as standalone firms.

Knowledge of structure allows States to help industries design and plan for the future. To illustrate, a small equity slice could be carved out of the capital structure—a "genius tranche"—for reinvestment in numeracy, structured finance education, engineering sciences, policy projects, with conditions attached to bring the value back into the fund, ultimately. Success could be measured in the fund's financial gains.

Using securitization to put our Federal dollars to work more efficiently.

Two months ago, an article came out about the House Small Business Committee cutting $100 MM from a $985 MM Small Business Administration budget. Another way to think about achieving more capital efficiency from the SBA would be through targeted securitizations where the structuring would be goal-directed and results-oriented; administration costs would be reduced

[1] Here is where the numbers come from: a 4:1 leverage ratio implies a debt layer of 80 percent, equity of 20 percent. Therefore, $1 BN/20 percent= $5 BN. If the equity investors demand 17 percent returns and the debt investors require 5.625 percent returns, the weighted average interest cost would be 7.5 percent.

by tying program performance measures to the performance of the transactions; and new money would flow back into the markets.[2]

That is not to say the SBA has not used securitization—they have. But, to reignite the economy, it must be used more effectively, with continuous measurement and reinvestment in what works.

#*3, making Health Care Finance sustainable:* Another example of how securitization could add value at a national and systemic level is by using "true sale" securitizations backed by individual receivables (not blanket liens) to reform health care finance. Wherever health care is treated as a cost center (Germany or Taiwan, for example) the public bears less than a quarter of the expense where health care is considered a revenue center (the U.S.). But a cost-based system does not offer the same range of choice, and the budget for reinvestment in new techniques is not there.

Health care finance securitizations are a sustainable compromise between patient autonomy and system affordability. "True sale" securitization, where the receivables are discounted at their face value (not bundled and blindly pledged) accelerates the turnover of capital inside hospitals. Insurance companies also love it, because health care receivables securitization solves their only real financial challenge: Asset-Liability Management. They do not need capital for this type of securitization; the returns will be very high yet stable. When health care receivables are put to work by using securitization, our communities will be able to have the quality of care they are willing to pay for, affordably.

Only America has the financial know-how to lead economic growth through sustainable securitization.

America may be the land of plenty but it does not hold an infinite reservoir of cash. We must learn how to use the resources we have more efficiently without unthinkable sacrifices. To put our financial assets to work for us, we need securitization. We can create a model for economies to follow, to develop their economies and distribute the benefits of hard work more equitably. This is how America will reestablish its position as a global financial leader.

What types of incentives should be created? Who should be championing them? What policy changes should Congress consider?

I believe we do not need new incentives. We need to redirect the incentives already there in the financial system, to make capital work harder for us. This will require carrots and sticks.

Carrots first: incentives to recognize and reward the value created by knowledge workers outside finance.

Harold Evans' book on American innovation, *They Made America*[3] and the companion PBS series, talk about how promoters and financiers harvest the value built created by inventors, who remain wage slaves.

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[2] "Tough Choices on SBA Budget", Portfolio.com, March 15, 2011.
[3] Evans, Harold, "They Made America", New York: Little, Brown & Company, 2004.

This is a social problem to match the funding problem already discussed. Just as most of the value made in the real economy feeds the financial economy and does not flow back to the real economy, so do knowledge workers follow the money into finance, to partake in rewards and recognitions as bankers. Few ever return to the real economy.

Incentives are needed to reverse this direction and encourage highly trained people in the sciences and engineering to stay there. For this to happen, some of the value created in the real economy has to flow back to the real economy. I have already suggested how securitization does this through example #2. For engineers that prefer to work in finance, they still have a role: putting their deep knowledge of processes and mathematics to work in monetizing value in IP-intensive businesses. The value will circulate much faster with securitization. The lift to the economy, and the job creation flowing from it, would be swift and self-propelling.

As I see it, securitization in its sustainable form may be the only way to systematically realign the incentives to put the economy on a more equitable footing. It cannot be done piecemeal.

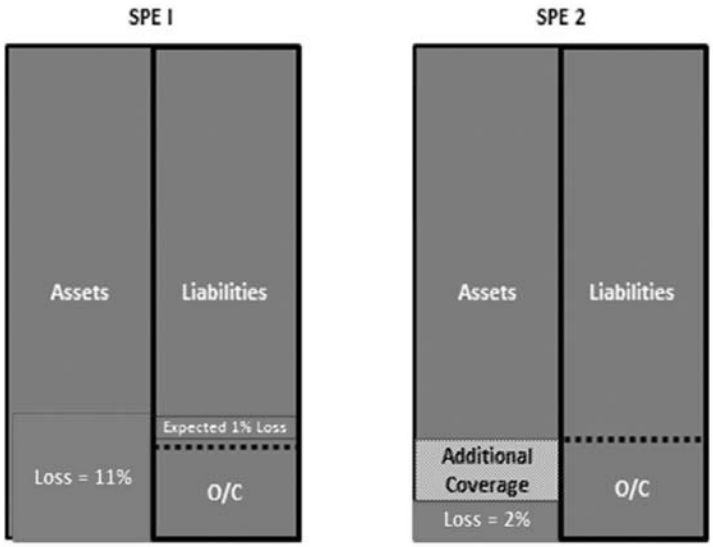
We also need sticks. Better enforcement will not stifle borrowing and lending. It will revive it.

If you know how securitization works, fraud is shockingly easy to commit and get away with. Cheaters should be punished. We already have clear set of rules that facilitate a bright-line determination of material misstatement, but not enough people know how they work. This has to change.

Embracing and enforcing Regulation AB is the key to market sustainability.

The latest version of Reg AB boils down to two styles of regulation: disclosure and risk retention.

I have nothing against risk-retention—in fact, I am in favor of it for shelf-registrations, at least until the Crisis is firmly behind us. But risk retention takes capital out of the system so we have less to work with; and the jury is out on whether it really stops the cheating. There was plenty of risk retention before the Crisis—it just was not disclosed. And the problem with undisclosed risk is just that. No one knows how big the risk actually is. That is why disclosure is a much more effective deterrent. Reference the figure below: if originators are required to hold a 10 percent "horizontal slice" (O/C) then one originator may decide to get around risk-retention by originating and securitizing loans with expected cumulative losses greater than 10 percent while the other follows the rules. Note the differences:



Senior investors in SPE1 are collateralized by a pool where the cumulative loss is 11 percent. They will lose 1 percent of principal (the red sliver above the O/C slice). Senior investors in SPE2 are protected by the additional asset coverage exceeding the 2 percent cumulative loss.

If all we have to rely on is risk-retention, the quality differences between SPEs l and 2 remain invisible. Between tougher disclosure requirements and risk retention, cheaters prefer the latter because they can go on cheating until the deal collapses. Disclosure shines a bright light on cheating for all to see before the deal collapses.

Competition among NRSROs or surrogates is also key.

The prescription for using securitization to finance emerging enterprises and projects only works if a rating agency or other neutral institution is around to vet the financial viability of these transactions in the primary market.

New rating agencies that are not paralyzed with fear of litigation, that can rate securitizations confidently and without fear of liability, are much needed. This is why fostering competition among NRSROs by opening up the field to new entrants, as was proposed under credit rating agency reform initiatives, continues to be so important. [4]

Who else should be championing the[se incentives]?

A financial market is a remarkably agile, resilient source of incentives all by itself. Once we commit to better regulation by infor-

[4] SEC Commissioner Kathleen Casey makes a strong argument for competition in her speech, "In Search of Transparency, Accountability, and Competition: The Regulation of Credit Rating Agencies", February 2009.

mation make the ratings industry more competitive, the market should resurrect itself in due course.

But this could happen a lot faster if President Obama, the Council of Economic Advisors, and certain key OMB staffers were willing to take a fresh look at how securitization can be used to manage the Federal deficit more effectively. Demonstrating that our debt is being used productively to generate future growth and earnings through targeted, well-structured securitizations would not only be good for the dollar, it would be a compelling template for the global financial markets to manage their assets more effectively and democratically.

Q.2. You also describe the need for a structured rating scale for transactions. Would you expand on this concept? How would the rating scale be administered? Should the rules be promulgated by a private standard-setting body, such as the International Organization for Standardization (ISO)? Who would provide the assessments? Where do rating agencies fall short?

A.2. The structured finance rating scale (or structured rating scale) is the set of performance benchmarks against which structured securities are rated. The structured finance scale does not just permit qualitative comparison, like the corporate rating scale, for instance [5]:

Table 3: Long- and short-term ratings for the Majors

	Long-Term Ratings			
	Meaning	**Moody's**	**S&P**	**Fitch**
Investment Grade	*Highest rating, highest quality, lowest expectation of default risk.*	Aaa	AAA	AAA
	Strong capacity to meet financial commitments, high quality, expectations of very low default risk.	Aa1	AA+	AA+
		Aa2	AA	AA
		Aa3	AA-	AA-
	Strong capacity to meet financial commitments but somewhat susceptible to adverse economic conditions; upper-medium grade quality; low default risk expectations.	A1	A+	A+
		A2	A	A
		A3	A-	A-

The structured finance scale is a numerical scale where the output can be a direct factor in valuation and pricing. The output of a corporate finance scale can only be linked to a price through the intermediation of the market. Already, it is something special and powerful, because the intervals are said to have an objective meaning—similar to a temperature scale.

Moreover, each rating agency has its own characterization of the meaning of the rating but all definitions relate to payment certainty and are similar in nature. In structured finance, each rating agency also has its own rating definition, but the differences are anchored on measures: projected portfolio default rate, expected loss of principal or average reduction of yield. (My testimony referred to average reduction of yield scales, so I will stick with it for my numerical illustration in the next section.) Unlike temperature scales, where Fahrenheit can be converted directly to Centi-

[5] Rutledge, Ann, "Study Manual for Paper 10 Credit Rating Services of the Licensing Examination for Securities and Futures Intermediaries", Hong Kong Securities Institute. May 2011, p. 2–11.

grade, and vice versa, the units are not always convertible. This is an incentive for "rating shopping."

The macroeconomic significance of the structured finance rating scale.

The design of the scale (choice of measure, length of intervals) determines how consistently structured securities are rated. Fundamentally, it also determines the credit quality of the securities that bear the rating, not individually but on average across the entire market. In a macroperspective, the structured scale becomes a tool for calibrating the amount of leverage in the economy. During a *bona fide* economic expansion, when good quality receivables are being generated, more *bona fide* AAA/Aaa-rated structured securities can come to market when the financing is needed. During economic contraction, fewer will be produced. This is exactly as it should be.

The rigor of the scale sets the overall tone. One with lax benchmarks increases leverage and lowers credit quality. One with high hurdles contracts leverage and raises credit quality. Rating agencies will always face pressures from issuers to lower their standards and investors will always prefer that the standards be as strict as possible. Giving in will make things worse, since the pressure to lower the standards when credit quality is deteriorating will sink the market further, and vice versa. That is exactly what we don't want to happen to the economy.

That is the rationale for my appeal to separate the roles of setting the structured scale and enforcing the structured scale. Enforcing the scale means reverse-engineering the deal and rerating it. This can be done by rating agencies, as well as by any other skilled person who bothers to get data from the Reg AB Web site. The more opinions, the better! By catching improperly rated or mispriced deals early on, the market can prevent a crisis like the one we just went through—but only if the structured scale is public. Presently no one knows what the structured rating scale is, and this makes arm's-length assessments of ratings impossible, like driving without knowing the speed limit, as I said in my testimony.

Who should set the structured rating scale?

Originally I had thought that President Obama and the head of the Council of Economic Advisors and the Comptroller General of the United States should jointly promulgate the structured scale for the U.S. market, as a matter of national economic priority. They might wish to consult and coordinate with the Federal Reserve and the Treasury—but it should not be decided by the Fed or Treasury due to potential conflicts of interest involving the financial sector.

Since securitization is a global market, it would be advisable for the U.S. to share its rationale for setting the levels of the structured rating scale with the G20. The likely outcome would be for other economies to adopt the same scale—otherwise, rating shopping would occur between countries until the public officials decided to impose uniform standards. You make a good suggestion that the final determination of structured scale could be delivered by the ISO, after a pilot period of review and analysis.

What properties should the scale embody?

The structured rating scale should be designed to be unambiguous. It should be linked to the Average Reduction of Yield scale because it is the only measure that makes sense for structured finance. Public use of the scale will ensure proper calibration between the amount of leverage and certainty of structured debt in the system. The scale I would propose based on 30 years of structuring experience, and the underlying concepts, are explained below:

Rating	Bps
Aaa	0.05
Aa1	0.50
Aa2	1.0
Aa3	2.5
A1	5.0
A2	10
A3	15
Baa1	20
Baa2	25
Baa3	50
Ba1	75
Ba2	100
Ba3	150
B1	200
B2	250
B3	300
Caa	1000
Ca	5000

1. The left column represents the rating. The right column represents the benchmark.
2. To rate a structured transaction, the analyst runs a large series of Monte Carlo scenarios and obtains performance measures on each scenario.
3. In most scenarios, investors receive all the interest and principal they are promised. But under severely stressed scenarios, they will experience yield shortfalls. The arithmetically averaged yield shortfall across all the iterations, or Average Reduction of Yield, is mapped to a rating.
4. So if, through a Monte Carlo simulation, the security loses an average of 0.05 basis points (bps) of yield, other things being equal, the security should merit a Aaa (triple-A) rating because the benchmark is 0.05 bps. A loss of 0.05 bps of yield on a security with (hypothetically) a nominal yield of 4.25 percent at par and an average life of 5 years will have an ex-

pected yield of 4.2495 percent. The 4.25 percent yield comes from looking at the market and finding where Aaa-rated securities with an average life of 5 years are pricing and what they are yielding.

5. But, if the security loses 25 bps of yield, it merits a Baa2 (triple-B flat) rating. A loss of 25 bps of yield on a security with a nominal yield of 6.25 percent will have an expected yield of 6.00 percent, by the same logic as in (4).
6. If, several months later, the same "Baa2" security is reanalyzed in a responsible manner and, on an apples-to-apples basis, produces an average reduction of yield of 5 bps, it is no longer a Baa2 but an A1. If reanalysis produces an average reduction of yield of 200 bps, it is now a B1.

Where do rating agencies fall short?

The rating agencies fall short in two ways: first, competition between the agencies based on the rating scale is likely to exacerbate credit rating arbitrage, or "rating shopping." But, the agencies will not give up their power to make the scale voluntarily. This means a uniform measure is unlikely to emerge, unless the scale is imposed from outside the system—preferably by a body that is independent, unbiased and interested in solving the ages-old dilemmas of calibrating credit extension/curtailment to economic growth/contraction.

The other way credit rating agencies fall short is by failing to rerate structured securities using the original benchmarks for the primary market. As mentioned previously, securitization was not built to handle credit arbitrage trading because the credit rating system, a key input in pricing and valuing structured securities, was static. When all is said and done, lagging ratings in structured finance is the underlying cause of the credit crisis.

Who would provide the assessments?

If the market is held to a consistent set of benchmarks so that AAA always signifies the same risk-return proposition over the life of a structured security—in the same way that a 25-mile an hour speed limit always means the same thing, or a foot is always 12 inches—then it does not matter who provides the assessments. Rating agencies will . . . but others with investments on the line, or ambitions to be recognized for their analytical excellence, will set up to the plate. That is financial democracy in action.

Senator Reed, thank you again for your questions and the opportunity to respond to them.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN REED FROM CHRIS J. KATOPIS

Q.1. In your written statement, you stated: "Mortgage investors seek effective, long-term sustainable solutions for responsible homeowners seeking to stay in their homes . . . [and] mortgage investors, primarily first lien holders, do not object to modifications as part of the solution. Unfortunately, mortgage investors are powerless under the [servicing agreements] to offer such support."

- Why are investors powerless?
- Are there ways to empower investors to ensure that decisions that make financial sense are actually made? In other words, is there a reasonable way to help both homeowners and investors?
- Could you please explain why, from an investor's perspective, a loan modification in some cases can make more financial sense than pursuing foreclosure?

A.1. The business environment and dominant mortgage securitization practices preceding the financial crisis are well-documented. Economist Joshua Rosner has likened this period to a "wild, west" which ultimately proved harmful for consumer, investors, and the Nation-at-large.[1] The legal structure that underlies and controls the residential mortgage-backed securities (RMBS) pools and servicing are governed largely by contracts, such as Pooling and Servicing Agreements (PSAs). These contracts govern the rights and remedies for first-lien holders (*e.g.,* mortgage investors) and consumers.

Investors comprise the "buy-side" of the securities industry, *i.e.,* they purchase and hold securities like RMBS; whereas, bank servicers and their affiliates comprise what is known as the "sell-side," *i.e.*, they create and sell securities like RMBS. The mortgage securitization business has evolved over the past several decades in a manner strongly influenced through the sell-side's control over the structuring and documentation of RMBS and on the *ad hoc* collection of State law that governs real estate ownership, financing and foreclosure.[2] Accordingly, the terms of RMBS securitization are one-sided in favor of the sell-side and against investors in many important respects due to the investors' lack of bargaining power relative to underwriters, including:

- The entities offering RMBS securities have enormous market power and concentration;
- Securities were offered on a take-it-or-leave it basis, providing investors only hours to make a deal decision normally requiring enormous diligence and review;
- The PSAs were very complicated legal documents that varied widely from deal-to-deal (we believe that more than 300 variations of PSAs were in use), written by the sell-side and with little to no input from investors; and,
- The PSAs contained a variety of contractual clauses which favored the rights of originators, servicers, and their affiliates over investors and consumers. One example is that these contracts provide a very high bar for parties to enforce their legal rights and pursue remedies; if RMBS servicers and trustees do not honor their obligations to service mortgages properly and to enforce representations and warranties against the parties that originated the mortgages in the first place, there is little that investors can do. Accordingly, it is extremely difficult for

[1] *http://www.rooseveltinstitute.org/policy-and-ideas/ideas-database/securitization-taming-wild-west*

[2] It is estimated that the five largest servicers control 59 percent of the Nation's residential mortgage servicing.

investors to push for changes in mortgage servicing even if such changes would increase the economic value available to investors while keeping people in their homes through NPV-positive loan modifications.

We believe that it is reasonable for the RMBS securities comprising more than one trillion dollars of U.S. mortgage financing to be governed by documents that are fair to both investors and the sell-side, not the one-sided documents putting the sell-side at the center of every conflict of interest, adverse to investors and consumers, as they were prior to the financial crisis. The Association of Mortgage Investors calls on policy makers to help develop the necessary standards, structures, and systems to ensure a sound securitization system and robust capital markets. These solutions range from enacting legislation analogous to the Trust Indenture Act (which solved problems for corporate bonds revealed by the 1929 financial markets crash similar to the problems that exist for RMBS today), to developing a uniform and standardized Pooling and Servicing Agreement for all widely offered and traded RMBS securities. A properly developed capital market infrastructure will assist both investors (and our affiliated public institutions such as pensions and retirement systems) and consumers enforce their rights and remedies, such getting effective remedies to breaches of representations and warranties in securitizations. Additionally, such reforms, including nationwide servicing standards, would serve to facilitate remedies for distressed borrowers.

The basis for mortgage investors preferring mortgage modifications in many circumstances is founded on a sound business case. First, we believe that a population of distressed borrowers have both the willingness to pay a certain monthly mortgage payment, local taxes, and related expenses and the ability to pay after a modification. In contrast, we concede that not every distressed borrower is an eligible candidate for a mortgage modification, *inter alia,* some may have too much aggregate household debt or may be a victim of long-term unemployment. We believe that a reallocation of one's cash flows, assets, and liabilities is exemplary of sound business judgment. Accordingly, we favor a modification under certain conditions (*e.g.,* the NPV-positive calculation) because a percentage modification is a far superior (business) proposition for investors and our affiliates, such as State pension funds and retirement systems, over a default (a loss arising from a foreclosure).

Q.2. In your written statement, your advocate for the creation of an independent trustee, similar to that created under the Trust Indenture Act of 1939. What benefits would such a proposal provide? What are the weaknesses? Could this same result be achieved under a national pooling and servicing standard? Why or why not?

A.2. AMI raises this point to illustrate a serious problem facing investors, public institutions, and consumers. The current RMBS system is not functioning properly. With no properly independent and incentivized third party looking after the interests of investors in securitizations, there are strong incentives to put bad mortgages into RMBS securitizations and to mismanage them to maximize income to servicers after the mortgages are no longer the economic concern of the originators. As previously explained, the documents

controlling a RMBS securitization, such as Pooling and Servicing Agreement (PSA), provide for a trustee to oversee the pool of collateral underlying the trust (*i.e.*, residential mortgages).

Neither the current servicing model nor trustee model is well-designed for today's economic climate and its default rates. The RMBS pool trustee cannot adequately serve the role of a fiduciary as envisioned for a variety of reasons, including,

1. Being inherently conflicted, as they are employees of the servicer and its affiliates;
2. Failing to provide the necessary financial resources to adequately oversee the trust; and,
3. Insisting on being indemnified by the trust and/or investors for anything short of the basic ministerial functions that the originator and servicer want them to do.

As a consequence, as a general matter trustees have been unresponsive to their investors and reluctant to address problems that have emerged in the mortgage pools which they are nominally charged with overseeing. This may be addressed in several possible manners, including legislation analogous to the Trust Indenture Act of 1939 or the adoption of a national uniform, standardized Pooling and Servicing Agreement that provides for a true third party fiduciary to act on behalf of investors.

The Trust Indenture Act of 1939 (the "TIA") is very instructive on a number of levels. It was enacted following the Great Depression and the 1929 stock market crash. As a result, the corporate bond market and the related legal environment have functioned positively for decades. However, it was enacted against a background where the Nation's bond markets were not functioning effectively and investors lacked sufficient safeguards.

In developing this legislation, the U.S. Senate Banking Committee tasked the Securities and Exchange Commission to study the issue and develop a report. The effort was spearheaded by Abe Fortas and William O. Douglas (both future U.S. Supreme Court justices). The text of the resulting TIA directly speaks to these points of that era, which are equally applicable today:

> Upon the basis of facts disclosed by the reports of the Securities and Exchange Commission made to the Congress . . . it is hereby declared that the national public interest and the interest of investors in notes, bonds, debentures . . . which are offered to the public, are adversely affected—
>
> (1) When the obligor fails to provide a trustee to protect and enforce the rights and to represent the interests of such investors . . .
>
> (2) When the trustee does not have adequate rights and powers, or adequate duties and responsibilities, in connection with matters relating to the protection and enforcement of the rights of such investors . . .
>
> (3) When the trustee does not have resources commensurate with its responsibilities . . .

> (4) When the obligor is not obligated to furnish to the trustee under the indenture and to such investors adequate current information as to its financial condition, and as to the performance of its obligations with respect to the securities outstanding under such indenture . . .
>
> (5) When the indenture contains provisions which are misleading or deceptive, or when full and fair disclosure is not made to prospective investors of the effect of important indenture provisions . . .
>
> Practices of the character above enumerated have existed to such an extent that, unless regulated, the public offering of notes, bond, debentures *[etc.]* is injurious to the capital markets, to investors, and to the general public . . .[3]

The Trust Indenture Act has proven an effective reform for establishing an effective corporate bond structure. It brought reluctant investors back into the bond market, just as the U.S. Government needs to bring reluctant investors back into the private RMBS market. The backdrop for the enactment of the Act is very similar to the circumstances witnessed today. In theory and in the absence of any specific draft legislation, we are not aware of any weaknesses arising from such a legislative remedy. As an alternative to legislation, these defects could also be addressed through regulation or an enhanced set of provisions in a national, standardized, mandatory PSA.

In response to the SEC's 2010 notice and comments for Regulation AB II, the AMI, along with other financial services associations, called for the establishment of a true, independent third-party to review the matters arising pertaining to the rights and remedies of investors. A qualified credit risk manager (CRM) would be independent from other parties to the Asset-Backed Securities (ABS) trust, represent the interests of all certificate-holders in investigations, and, if warranted, pursue claims for breaches of contractual obligations against responsible parties. A CRM should have the independent authority and independent discretion to pursue claims as a fiduciary of the certificate holders or act on behalf of individual certificate holders under special, limited circumstances. Finally, we agree that in discharging its obligations as a compensated third party to the PSA, the CRM, or any equivalent, must have complete access to loan and servicing files in order to conduct a proper examination and effectively pursue resulting claims.

Again, we greatly appreciate the opportunity to respond on the record to the Committee's questions as part of the ongoing inquiry. Please do not hesitate to use us as resource as you continue your review of the state of the U.S.'s securitization markets.

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[3] Trust Indenture Act of 1939, §302, as added Aug. 3, 1939, ch. 411, 53 Stat. 1150.