

VI. *Asset-Backed Securities Regulation under the Dodd-Frank Act*

A. Introduction

The pervasive securitization of financial assets played a central role in provoking the financial crisis in recent years. The precise mechanisms of securitization have become highly complex and widely varied, but the following description illustrates a basic example of how financial assets, such as loans or receivables, are converted into securities. Financial institutions such as investment banks, commercial banks and thrift institutions often accumulate sets of financial assets by extending credit or purchasing assets from a distinct originating entity.¹ After collecting a set of assets, a financial institution usually creates an entity called a special purpose vehicle (“SPV”) and transfers the assets to the SPV.² With the right to receive principal and interest payments made on its assets, the SPV sells classes, or “tranches”, of securities that give investors the right to receive the cash flow from these payments.³ Tranches themselves can be transferred and pooled to collateralize another hierarchy of marketable securities.⁴ These relatively simple securitizations often spawn more complicated financial instruments, the value of which hinges ultimately on the credit quality of underlying assets.⁵

As the housing bubble expanded, securitization provided a number of perceived economic benefits, including increased liquidity and a consequent expansion in lending.⁶ Secondary and tertiary credit markets appeared to dilute high lending risks by dispersing them across a universe of sophisticated investors who were thought to be well equipped to bear them.⁷ Depository institutions in particular benefited by holding tranches of asset-backed securities with high

¹ Issuer Review of Assets in Offerings of Asset-Backed Securities, 75 Fed. Reg. 64182, 64184 (proposed Oct. 19, 2010) (to be codified at 17 C.F.R. pt. 229).

² STAFF OF FINANCIAL CRISIS INQUIRY COMMISSION, 111TH CONG., SECURITIZATION AND THE MORTGAGE CRISIS 5 (2010).

³ *Id.*

⁴ *Id.* at 9.

⁵ *See id.* (illustrating the complexity of some collateralized debt obligations).

⁶ Mary L. Schapiro, Chairman, SEC, Statement at the SEC Open Meeting (Oct. 13, 2010).

⁷ STAFF OF FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 2, at 18.

credit ratings, rather than loans with low credit ratings; doing so allowed them to lower their regulatory capital requirements.⁸

As the housing bubble burst, however, mortgage-backed securitization contributed significantly to the unfolding financial crisis. The moral hazards inherent in securitization likely increased the frequency of mortgage defaults and simultaneously exacerbated market sensitivity to those increases.⁹ When lenders hold the loans they originate, they have strong incentives to responsibly screen borrowers before subjecting themselves to potential financial losses.¹⁰ Yet if lenders fully divest themselves of the assets they originate, the incentive to originate high-quality loans is replaced by an incentive to originate sellable loans without regard for quality.¹¹ The same logic can be applied to issuers of securities backed by high-risk loans. When a secondary purchaser obtains assets only to sell the right to receive payment on those assets, the purchaser has motive to acquire and pool even junk, so long as investors stand ready to purchase the corresponding securities.¹² In such an environment, all credit risk is transferred to the investor, whose perception of the risk attached to his securities may be clouded by complex securitization processes and dubious credit ratings.¹³

This moral hazard and lack of transparency probably hastened the deterioration of loan underwriting practices while accelerating the proliferation of securities collateralized by risky loans.¹⁴ Hence, securitization helped increase the number of mortgage defaults when home values tanked and multiplied the losses suffered by investors as a result of defaults.¹⁵ Provisions of the Dodd-Frank Act (“Act”) aim to mitigate some of the risk associated with asset-backed securitization and thereby prevent similar

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.* at 19.

¹¹ Ryan Bubb & Alex Kaufmann, *Securitization and Moral Hazard: Evidence from a Lender Cutoff Rule*, Federal Reserve Bank of Boston, Public Policy Discussion Paper No. 09-5 (Sept. 23, 2009), available at <http://www.bos.frb.org/economic/ppdp/2009/ppdp0905.pdf>.

¹² See James D. Shilling et al., *Moral Hazard and Adverse Selection for Subprime Lending and Securitization—Priced or Not Priced?* 4 (Feb. 2008) (unpublished manuscript, on file with author).

¹³ STAFF OF FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 2, at 19.

¹⁴ *Id.*

¹⁵ *Id.*

contributions to a future financial crisis.¹⁶ Most prominently, the Act requires originators and “securitizers” to retain a portion of the credit risk associated with assets that collateralize asset-backed securities.¹⁷ The Act supplements credit risk retention rules with asset-level disclosure requirements to prompt better-informed decisions by investors.¹⁸ Proponents expect these measures to minimize the moral hazard faced by lenders and issuers, and illuminate the darkness supposedly wandered in by institutional investors.¹⁹

B. Credit Risk Retention

1. Framework

By April 15, 2011, The Securities and Exchange Commission (“SEC”), in conjunction with the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation (“Federal Banking Agencies”), must prescribe rules requiring issuers of asset-backed securities to retain a percentage of the credit risk for securitized assets.²⁰ The Federal Housing Finance Agency (“FHFA”) and the Secretary of Housing and Urban Development (“Secretary”) will work with the SEC and Federal Banking Agencies to promulgate regulations specific to securitized residential mortgages.²¹ Section 941 of the Act provides a broad framework to guide and limit agency discretion in establishing credit risk retention regulations. The rules must specify the amount, form and duration of risk retention, while prohibiting securitizers from hedging or transferring their share of the risk.²² Specifically, the regulations must compel securitizers to retain at least five percent of the credit risk for any asset sold,

¹⁶ Dustin Hall, *Improvements to the Asset-Backed Securitization Process Under the Dodd-Frank Wall Street Reform Bill*, July 7, 2010, <http://www.bankbryancave.com/improvements-to-the-asset-backed-securitization-process-under-the-dodd-frank-wall-street-reform-bill>.

¹⁷ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 941(b), 124 Stat. 1376 (2010) (to be codified at 15 U.S.C. § 780-11).

¹⁸ *Id.* § 942 (to be codified at 15 U.S.C. § 780).

¹⁹ *See* Hall, *supra* note 16.

²⁰ Dodd-Frank, *supra* note 17, at § 941(b) (to be codified at 15 U.S.C. § 780-11).

²¹ *Id.*

²² *Id.*

transferred, or conveyed to a third party through the issuance of an asset-backed security.²³

Section 941 weaves a rather intricate web of exceptions and qualifications into this general rule, beginning with a total exemption of residential mortgages that exhibit certain low-risk characteristics. The SEC, Federal Banking Agencies, FHFA and Secretary will jointly define the meaning of the term “qualified residential mortgage” by considering data that historically indicates a low probability of default, such as documentation of the borrower’s financial resources and a high ratio of borrower income to debt.²⁴ If an asset-backed security is collateralized only by qualified residential mortgages, then every asset backing that security is wholly exempted from risk retention requirements.²⁵ However, securitizers must retain five percent of the credit risk even for a qualified residential mortgage, if it collateralizes the same security as an asset that is not a qualified residential mortgage.²⁶

Residential mortgages represent just one of at least four asset classes that the SEC and Federal Banking Agencies will regulate under § 941. The SEC and Federal banking Agencies must adopt separate rules for commercial mortgages, commercial loans, auto loans and any other asset class these agencies deem appropriate to establish.²⁷ For each class, the Federal Banking Agencies must delineate underwriting standards for loans within that class that indicate a low risk of default.²⁸ If an asset meets these class-specific standards, the risk retention rate imposed on the securitizer will decrease to some rate below five percent.²⁹ Depending on the precise rates to be established, this decrease will amount to a total or partial exemption for assets that are not qualified residential mortgages, but nevertheless exhibit sufficiently low-risk features to loosen regulators’ collective grip on their securitization. Unlike the exemption provided for qualified residential mortgages, these exemptions are variable, and granted without regard for the attributes of other assets collateralizing the same security.

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

Still broader exemptions are granted for the securitization of financial assets with other characteristics. The rules must allow for a total or partial exemption of any asset guaranteed by the United States or an agency thereof (excluding Fannie Mae and Freddie Mac), or by any State.³⁰ Furthermore, the SEC and Federal Banking Agencies may provide for the exemption of any securitization, “as may be appropriate in the public interest and for the protection of investors.”³¹ Section 941 even permits exceptions or adjustments for entire classes of institutions and assets, with respect to both risk retention and the prohibition on hedging.³² Any such exception must ensure high-quality underwriting standards, encourage risk management, improve access to credit, or otherwise be in the public interest.³³

The Act also addresses the role of lenders in the asset-backed securitization process. When a securitizer purchases an asset from a separate originator, the requisite percentage of risk retention for that asset must be allocated between securitizer and originator.³⁴ For example, a securitizer otherwise required to retain five percent of the credit risk for a mortgage might only be required to retain three percent, while the originator retains the other two percent. In determining how to divide credit risk between securitizers and originators for a given set of assets, the SEC and Federal Banking Agencies will consider: (1) whether the assets sold to the securitizer exhibit low-risk characteristics, (2) whether market conditions incentivize imprudent origination of the given asset type and (3) the potential effects of the risk retention obligations on credit markets.³⁵

2. Study on Credit Risk Retention

By January 17, 2011, the Chairman of the Financial Services Oversight Council (“Chairman”) must conduct a study and submit a report to Congress on the macroeconomic impact of credit risk retention.³⁶ This study will focus on how risk retention requirements might help stabilize real estate markets, and Section 946 of the Act

³⁰ *Id.*

³¹ *Id.*

³² *Id.*

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.* at § 946 (to be codified at 15 U.S.C. § 77g).

provides several suggestions to guide this focus.³⁷ The Chairman's report may include an analysis of how credit risk retention might have limited the economic havoc wrought by plunging home prices in the recent financial crisis.³⁸ It may also speculate on the feasibility of preventing future asset bubbles by preemptively adjusting retention rates according to market conditions, and opine as to what entity should exercise such an adjustment authority.³⁹ Though potentially informative, most findings from this study will remain speculative, as rules for residential mortgages remain ineffective for one year after publication, and rules for all other asset classes remain ineffective for two years after publication.⁴⁰

3. Discretion and Potential Deficiencies

Provisions of the Act governing credit risk retention raise more questions than they provide answers. The SEC and Federal Banking Agencies have great flexibility to shape regulation according to their findings, and the precise impact of regulation will remain unknown until the new rules are implemented. The form and duration of risk retention, the establishment of asset classes and the delineation of qualified residential mortgages and other exemptions will color the Act's fuzzy sketch of the coming regulatory structure.

Exemptions are especially vague under § 941. Depending on the precise data used to label a residential mortgage "qualified," the proportion of residential mortgages wholly exempted from risk retention could be relatively small or large. Similar indeterminacies accompany exemptions in other asset classes. The underwriting standards used to identify commercial mortgages, commercial loans and auto loans as low-risk could substantially influence the results of regulation. Retention of "less than five percent" of the credit risk for these assets could vary anywhere between 0% and 4.99%, according to agency preference. Furthermore, the nature and scope of exemptions "appropriate in the public interest and for the protection of investors" are potentially consequential, particularly if such exemptions apply across entire institutions or asset classes.

Even the broad guidelines the Act provides, however, cast doubt on the effectiveness of ensuing regulations at eliminating the

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.* at § 941(b) (to be codified at 15 U.S.C. § 78o-11).

moral hazard faced by securitizers and originators. Intuitively, five percent seems like a rather small portion. If pooling assets allowed securitizers to offer investors high returns on junk by issuing tranches of securities, it seems plausible that future bubble-prone market conditions for a given asset class might encourage issuers to sell securities at a premium that exceeds their slight risk exposure. While such calculations will depend on a multitude of currently unknown variables, relatively small risk retention rates could prove insufficient to offset securitizers' prospective profits under the right market conditions. Variable risk retention rates could reduce this threat, assuming regulators possess the information, expertise and incentives to respond appropriately to changing market conditions.

The retention rates appear even less potent in light of the mandated allocation of credit risk between securitizers and originators, together with the Act's selective prohibition on hedging. When a bank issues securities backed by high-risk loans originated in-house, that bank will have to retain at least five percent of the credit risk for those loans.⁴¹ Yet if the same bank securitizes loans purchased from a distinct originator, the bank's risk retention rate will automatically be reduced by the percentage imposed on the originator.⁴² Thus, securitizers can cut their risk retention obligations by securitizing assets created exclusively by other institutions. Furthermore, the Act does not prevent originators from hedging against their share of the credit risk.⁴³ Aggregate risk retention could be significantly diluted if securitizers reduce their credit risk by sharing it with originators, and originators evade much of their risk by hedging against it. In theory, the higher the percentage of risk assigned to originators, the less effective retention requirements will be at eliminating the same moral hazards that previously prompted irresponsible lending and the issuance of risky loan-backed securities.

History provides further evidence that credit risk retention rules might fail to curtail loose lending and the proliferation of high-risk securities transactions. Leading up to the financial crisis, many lenders kept some original loans on their books as well as tranches of their own mortgage-backed securities.⁴⁴ Others retained loan servicing rights, which maintained a quantifiable connection between

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.*

⁴⁴ STAFF OF FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 2, at 20.

loan performance and originator revenues.⁴⁵ Many originators and securitizers failed or sustained billions of dollars in losses when loan defaults spiked, suggesting that they in fact retained a substantial amount of credit risk.⁴⁶ If voluntary retention failed to prevent financial disaster before, compulsory retention could prove inadequate going forward, particularly now that the United States has demonstrated a willingness to shovel out rescue dollars when profits turn to losses.⁴⁷

C. Disclosure and Warranties

1. Asset-Level Information

To supplement credit risk retention under § 941, § 942 of the Act instructs the SEC to adopt regulations requiring issuers of asset-backed securities to disclose asset-level data.⁴⁸ This data should allow investors to compare securities collateralized by similar assets, by comparing the characteristics of the underlying assets themselves.⁴⁹ To allow investors to perform such due diligence, the rules will probably require issuers to disclose: (1) unique identifiers corresponding to the originators of assets backing a given security, (2) the compensation received by the originators and (3) the respective amounts of risk retained by the originators and securitizer.⁵⁰

2. Something Old, Something New

History also suggests that disclosure rules could have a limited impact on the decisions of sophisticated institutional investors, who suffered crushing losses when the value of asset-

⁴⁵ *Id.*

⁴⁶ *Id.* See also Richard M. Hynes, *Securitization, Agency Costs, and the Subprime Crisis*, 4 VA. L. & BUS. REV. 231, 243 (2009).

⁴⁷ See James K. Glassman, *The Hazard of Moral Hazard*, COMMENTARY MAGAZINE, Sept. 2009, at 29 (contending that government intervention in financial crises promotes unsafe business practices, as protection from adverse consequences reduces the incentive to avoid excessive risk-taking).

⁴⁸ Dodd-Frank, *supra* note 17, at § 942 (to be codified at 15 U.S.C. § 780).

⁴⁹ *Id.*

⁵⁰ *Id.*

backed securities plummeted in response to credit defaults.⁵¹ Most investors already had ways to assess the risk in purchasing a given asset-backed security.⁵² The use of credit scores in loan underwriting allowed secondary market participants to gauge the risk of default for underlying assets.⁵³ Many investors would not buy a loan-backed security for which the original borrowers' credit scores were unavailable.⁵⁴ Other important risk factors previously available to securitizers and investors include borrower income data and loan-to-value ratios.⁵⁵ Thus, § 942 essentially mandates the disclosure of information to which investors were largely privy prior to the financial crisis.

Market participants also took steps to mitigate the risk posed by low-quality loans, which may show that they understood the incentive problems posed by securitization.⁵⁶ Securitizers sometimes required lenders to provide a random sample of loans on their books, which limited lenders' ability to sell only their riskiest loans.⁵⁷ Moreover, securitizers usually required originators to make representations and warranties regarding their underwriting practices.⁵⁸ Agreements often obliged originators to repurchase loans that breached these warranties or defaulted soon after sale, and such obligations were frequently enforced.⁵⁹ Section 943 of the Act at least appears to enhance these preexisting safeguards by requiring securitizers to disclose all repurchase requests for underlying assets, allowing investors to flag originators that consistently inject bad loans into the market.⁶⁰

⁵¹ See, e.g., Mark Whitehouse, *Number of the Week: \$132 Billion of Lost Synthetic Mortgage Bets*, WALL STREET JOURNAL, May 1, 2010, <http://blogs.wsj.com/economics/2010/05/01/number-of-the-week-132-billion-of-lost-synthetic-mortgage-bets> (chronicling enormous losses suffered by major institutional investors).

⁵² STAFF OF FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 2, at 7.

⁵³ *Id.* at 20.

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ Dodd-Frank, *supra* note 17, at § 943 (to be codified at 15 U.S.C. § 78o-7).

C. Problem Solved?

The Act facilitates the adoption of rules reasonably geared toward addressing some pitfalls of asset-backed securitization that contributed to the recent financial crisis. However, the broad discretion given federal agencies makes it difficult to evaluate the impact forthcoming requirements will have on financial markets. Perhaps analyses from the study conducted pursuant to § 946 will shed some light on this uncertainty.⁶¹ Yet even the Act's very general framework suggests that the new rules might only induce negligible or conditional changes to securitization practices. It remains to be seen whether the regulations will reign in asset-backed securities markets to an extent that will help prevent their contributions to a future crisis.

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⁶¹ *Id.* at § 946 (to be codified at 15 U.S.C. § 77g).

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