

**SOME THOUGHTS ON FINANCIAL REGULATORY REFORM
ADOPTED IN RESPONSE TO THE FINANCIAL CRISIS OF 2008/9**

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Table of Contents

I.	<i>Introduction</i>	780
II.	<i>A Few Words about Regulation: What Is Good or Bad Regulation? How Does This Analysis Apply to Securitization?</i>	781
	A. Principles vs. Rules.....	781
	B. Activity-Based vs. Segments of an Industry.....	782
	C. Coherent Globally and Macroeconomically	782
	D. Precisely Targeted to Minimize Distortions	782
	E. Designed to Achieve Safety and Soundness.....	783
	F. Flexibility.....	783
	G. Benefits Justify Costs	783
	H. Connecting Measures and Objectives	784
	I. Constant Reevaluation.....	784
III.	<i>The Crisis Generally and Securitization's Role in the Crisis</i>	784
IV.	<i>Risk-Based Capital Rules</i>	789
	A. Summary of the Rule.....	790
	1. Definitions.....	790
	2. Due Diligence and Other Operational Requirements	791
	3. Alternative Approaches to Determine Risk-Weighted Capital	793
	B. Analysis.....	795
V.	<i>Liquidity Coverage Ratio Rule</i>	799
	A. Summary of the Rule.....	799
	1. Numerator	799
	2. The Denominator	800

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	B.	Analysis.....	801
		1. HQLA.....	801
		2. Treatment of Committed Lines	804
VI.		<i>Risk Retention Rules</i>	805
	A.	Summary of the Rule.....	805
		1. Standard Risk Retention Options	805
		2. Specific Asset Class Issues.....	807
		3. Additional Exemptions	809
	B.	Analysis.....	810
VII.		<i>Volcker</i>	815
	A.	Summary of the Rule.....	815
	B.	Analysis.....	817
VIII.		<i>Conclusion</i>	820

I. Introduction

A long time ago, before history was written down, the forces of good were fighting a losing battle with the forces of evil.¹ In a last-ditch effort, the God of Wisdom captured the King of Trolls and insisted that the King reveal the secret to defeating the forces of evil.²

The King of Trolls agreed, but on the condition that the God of Wisdom put out one of his own eyes.³ Being wise, the God sacrificed his eye and then insisted the evil Troll honor his agreement.⁴ Replied the Troll, “The secret is, *Watch with both eyes!*”⁵

Why have we begun this article with the story from John Gardner? The answer is that the God of Wisdom’s predicament matches the predicament in which financial regulators found themselves during the financial crisis of 2008/2009 (the Financial Crisis). The Crisis was so far-reaching in its effects and so difficult to fully analyze that regulators with the best intentions and the most skilled of staff nonetheless found it extraordinarily difficult to craft reforms precisely targeting agreed-on deficiencies in the field of securitization without, at the same time, inhibiting the valuable financial and economic activity that they wished to encourage.

This article begins with a general summary of the principles to which regulators should adhere in order to craft appropriate financial

¹ JOHN GARDNER, ON MORAL FICTION 3 (1978).

² *Id.*

³ *Id.*

⁴ *Id.*

⁵ *Id.*

regulations. Next, it summarizes four of the most important reforms adopted with regard to securitization in response to the crisis in the areas of (1) risk-based capital, (2) liquidity ratios, (3) credit risk retention, and (4) Volcker. This article then proceeds to analyze these rules actually adopted for securitizations in part by testing them against the enumerated principles of good financial regulation.

It concludes that, in many cases, regulators have been overly conservative finding the necessary balance between tight regulation for safety's sake and the freedom to engage in valuable financial activity for the good of the financial system and economy.

II. A Few Words about Regulation: What Is Good or Bad Regulation? How Does This Analysis Apply to Securitization?

In this section, we will review what we think forms the bedrock of “good” regulation. By “good” regulation, we refer to rules that appropriately address key problems without causing new ones. We believe there are nine key characteristics to such regulation for financial institutions.

A. Principles vs. Rules

Principles-based regulation is more effective than an ad-hoc accumulation of rules.⁶ As noted by Stavros Thomadakis, former Chairman of the Public Interest Oversight Board,⁷ principles allow “regulation to respond effectively to evolving conditions without the need for constant amendment.”⁸ Unfortunately, the post-crisis securitization industry is subject to an extensive patchwork of rules, many of which—such as the Volcker Rule⁹ and many aspects of the liquidity¹⁰

⁶ Stavros B. Thomadakis, Chairman, Pub. Interest Oversight Bd., Speech to IFAC Council Seminar: What Makes Good Regulation?, IFAC Council Seminar (Nov. 14, 2007) (available at http://www.ifac.org/system/files/downloads/30th_anniversary_Thomadakis_Pres_Nov_07.pdf) [<https://perma.cc/6FW4-PQ6G>].

⁷ *What Is the PIOB?*, PUB. INTEREST OVERSIGHT BD., <http://www.ipiob.org/index.php/what-is-the-piob> [<https://perma.cc/36UA-9BZ8>] (“The Public Interest Oversight Board is a global independent oversight body that seeks to improve the quality and public interest focus of the international standards.”).

⁸ See Thomadakis, *supra* note 7.

⁹ See *infra* Section V.B.1.

¹⁰ See *infra* Section IV.B.

and capital requirements¹¹—don't address the underlying causes of the crisis.

B. Activity-Based vs. Segments of an Industry

Policymakers must understand the entire breadth of the financial system and develop regulations accordingly. Prior to the crisis, certain segments of the financial system were not effectively regulated or were not under the purview of any particular regulator. Regulations are most effective when they apply to an entire type of activity instead of mere segments of the applicable industry.¹² We therefore applaud the creation of the Financial Stability Oversight Council (FSOC). While one might question FSOC's effectiveness to date, monitoring the activity of the entire financial system is more effective than piecemeal, institution-specific oversight.

C. Coherent Globally and Macroeconomically

Policymakers must have a solid understanding of how financial activities and potential problems are linked across different regions and sectors. Andreas Dombret, a member of the Executive Board of Deutsche Bundesbank, made a persuasive argument for coherence in regulation across borders and sectors to reduce arbitrage risks.¹³ A lack of such coherence also increases costs. The best example of this drawback, as we, shall see are the rules for credit risk retention which are different for the United States on the one hand and the European Union (EU) on the other.¹⁴

D. Precisely Targeted to Minimize Distortions

While it is critical to have a coherent view of the financial system, regulators must be, at the same time, appropriately targeted in their approach. Good regulation must address specific problems and

¹¹ *Id.*

¹² See Andreas Dombret, Member of the Exec. Bd., Deutsche Bundesbank, What is "Good Regulation?": Speech Held at the Bundesbank Symposium on "Banking Supervision in Dialogue" (July 9, 2014) (transcript available at https://www.bundesbank.de/Redaktion/EN/Reden/2014/2014_07_09_dombret.html) [<https://perma.cc/S8MZ-ZKRX>].

¹³ *Id.*

¹⁴ See *infra* Section VI.B.

not try to be all things for everyone. When regulation seeks to solve problems that do not exist (i.e., to fix what is not broken), we face new problems or unintended consequences. A controversial example is the Volcker Rule which arguably attempted, at enormous cost, to correct a problem that was *not* a cause of the Financial Crisis.¹⁵

E. Designed to Achieve Safety and Soundness

The targeted nature of regulation should focus on safety and soundness. Regulation should not try to address or enhance the competitiveness of certain regions or sectors; rather, it should simply seek to ensure the financial system operates within certain parameters that help prevent weaknesses, vulnerabilities, or potential shocks.

F. Flexibility

One of the most important characteristics of good regulation is adaptability. Markets change continually, and innovation is an important constant. Regulators must be able to identify important innovation in financial services and respond accordingly (i.e., without stifling key advances). One may argue, for example, that excessive capital requirements, and inadequate liquidity credit for securitization positions, stifle future innovations in such financings.¹⁶

G. Benefits Justify Costs

A review of several papers that attempt to answer the same question we are addressing here—i.e., “What is good regulation?”—shows that including cost-benefit analysis as one of the key criteria.¹⁷ While U.S. law requires that regulators conduct a cost-benefit analysis before finalizing a new regulation, we believe more stringent analyses would produce better rules and fewer unintended consequences.¹⁸ Again, a more substantive review of the risk-based capital and liquid-

¹⁵ See *infra* Section VII.A.

¹⁶ See *infra* Sections IV.B. & V.B.1.

¹⁷ See e.g., Eric A. Posner & E. Glen Weyl, *Cost-Benefit Analysis of Financial Regulations: A Response to Criticisms*, 124 YALE L.J. F. 246 (2015) (arguing in favor of cost-benefit analysis).

¹⁸ See Bruce Kraus & Connor Raso, *Rational Boundaries for SEC Cost-Benefit Analysis*, 30 YALE J. ON REG. 289, 332 (2013) (“The SEC is using the 2012 Guidance to integrate economic analysis into its rulemaking process.”).

ity ratio rules might show a much greater cost to the economy than the analyses actually provided by regulators.¹⁹

H. Connecting Measures and Objectives

Potential policies should be assessed against the actual objectives sought to be achieved. For example, globally implemented regulations to ensure the banking sector has sufficient liquidity buffers have encouraged banks to increase significantly their investments in sovereign debt and other similarly identified “safe” securities, such as government-sponsored enterprise (GSE) mortgage-backed securities (MBS).²⁰ However, a reasonable concern might be that a lack of diversity in banking books could exacerbate a future financial crisis.

I. Constant Reevaluation

Regulators should conduct rigorous, ongoing assessments of their rulemakings. Only continuous evaluation will allow all market participants to gain a deeper understanding of the financial system, helping to ensure greater stability and innovation moving forward.

III. The Crisis Generally and Securitization’s Role in the Crisis

A key prerequisite to answering the question of how best to regulate the financial markets in the aftermath of the Financial Crisis is obtaining a clear understanding of what events precipitated the crisis. Whether deserved or not, many commentators—and an even larger share of the public—believe actions taken by the securitization industry were the principal catalyst of the crisis.²¹ While the causal chain certainly is more complicated and will be the subject of study and debate for years to come, there is no doubt that securitization—or, more precisely, the manner in which securitization was practiced—had

¹⁹ See *infra* Sections IV.B, V.B.1.

²⁰ See John Carney, *Why Banks Bought So Many Toxic Mortgage Bonds*, BUS. INSIDER (Aug. 7, 2009), <http://www.businessinsider.com/why-banks-bought-so-many-toxic-mortgage-bonds-2009-8> [<http://perma.cc/7S5Q-ADPM>].

²¹ See Steven L. Schwarcz, *Securitization and Post-Crisis Financial Regulation*, 102 CORNELL L. REV. ONLINE 115, 117 (2016) (“It is generally agreed that securitization’s abuses contributed to the global financial crisis . . .”).

a major role in precipitating the crisis.²² Nonetheless, regulators generally acknowledge that, when utilized properly and wisely, securitization is an important source of funding for the so-called “real economy.”²³ Thus, regulators and the industry should be in agreement that the goal of future regulation should be to improve securitization practices without unduly restricting the innovation and responsiveness that have been the hallmarks of securitization since its inception.

The culprit for the credit crisis is usually deemed to be sub-prime²⁴ and Alt-A²⁵ residential mortgage-backed securities (RMBS) in the private-label and GSE markets, along with collateralized debt obligations issued with RMBS as the underlying debt. There also is a debate about whether congressionally mandated targets imposed on the GSEs—for making mortgage credit available to “underserved” portions of the population—actually caused sub-prime underwriting standards to loosen to these targets.²⁶ Regardless, whether poor sub-prime

²² Jason Kravitt, *Securitization: What Happened; Is It Worth Saving; Do We Have the Right Reforms; Where Is It Going?*, in CREDIT MARKET AND SUB-PRIME DISTRESS lvii (Daniel T. Brown & Jon D. Van Gorp eds., 2009).

²³ See Timothy J. Riddiough, *Can Securitization Work? Economic, Structural and Policy Considerations* 14–18 (H.K. Inst. for Monetary Research, Working Paper No. 24/2011, 2011), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1938002 (“Although there clearly have been serious structural and systemic issues associated with securitization, I believe that many positive social benefits can be realized going forward if the markets are properly restructured and regulated.”).

²⁴ THOMAS P. LEMKE ET AL., MORTGAGE-BACKED SECURITIES: DEVELOPMENTS AND TRENDS IN THE SECONDARY MORTGAGE MARKET 25 (2012). Subprime mortgages generally refer to mortgages on loans to borrowers who have significantly higher risks. For example, banking regulators have characterized subprime borrowers as displaying, among other characteristics: (i) a previous record of delinquency, foreclosure, or bankruptcy; (ii) judgment, foreclosure, repossession, or charge-off in the past 24 months; (iii) bankruptcy in the past five years; (iv) a high default probability as evidenced by a low score (e.g., a FICO score of 660 or lower); and/or (v) a debt service-to-home ratio of 50 percent or greater. *Id.*

²⁵ Alt-A mortgages generally include loans to borrowers with good credit but who may not otherwise satisfy various underwriting requirements due to lack of documentation (often due to variable incomes or self-employed cash businesses) or higher leverage. *Id.* at 27.

²⁶ Peter J. Wallinson, *The True Origins of This Financial Crisis*, AM. SPECTATOR (Feb. 6, 2009), https://spectator.org/42211_true-origins-financial-crisis/ (“It was the spreading of these looser standards to the prime loan market that

standards were caused by government targets, private overreaching, or more likely, some combination of both, the lesson to be learned is that it is not a good idea to stretch underwriting standards in order to accomplish social or more prosaic profitability goals. For example, if pushed too far, loosening underwriting standards can have the effect of reducing credit access for poor and moderate-income borrowers.²⁷ Likewise, mandating specific targets is not a reliable way to increase credit access in the long run, because these quotas often are established without taking into account the quality of underwriting necessary to accomplish those goals.²⁸ Knowing where to draw the line regarding these practices can be more art than science.

Although extremely poor underwriting standards likely contributed to the credit crisis and the consequent losses suffered by financial institutions, it is now generally accepted that the impact of these flawed practices would not have been so dramatic had the worldwide financial system not been substantially over-leveraged.²⁹ For example, huge losses were suffered in the “tech bust” that occurred several years before the credit crisis, but nowhere near the dislocation among financial institutions as occurred during the crisis.³⁰ This is because the investments in tech stocks had largely been accomplished without unusually high leverage, whereas financial institutions that invested in sub-prime (and Alt-A) RMBS did so in a highly leveraged fashion.³¹ It is thus not surprising that the primary dealers that failed during the credit crisis, or came close to failing, did so roughly in the order of their leverage—Bear Stearns being the most leveraged and Lehman Brothers being the second most leveraged.³²

vastly increased the availability of credit for mortgages, the speculation in housing, and ultimately the bubble in housing prices.”).

²⁷ *See id.*

²⁸ *See id.*

²⁹ Kravitt, *supra* note 22, at lix (“Interest rates fell to historically low levels and as a result financial institutions and structured vehicles leveraged themselves extensively in order to take advantage of the availability and low cost of credit.”).

³⁰ Gillian Tett, *Wall Street’s Crash Course*, FIN. TIMES (Aug. 26, 2007), <https://www.ft.com/content/f54fd878-5400-11dc-9a6e-0000779fd2ac>.

³¹ *See* CHRISTOPHER L. FOOTE ET AL., RETHINKING THE FINANCIAL CRISIS 139 (Alan S. Blinder et al. eds., 2012) (“Specifically, both Fannie Mae and Freddie Mac indirectly invested heavily in risky mortgages by buying AAA tranches of subprime and Alt-A mortgage-backed securities and holding these securities in their retained portfolios.”).

³² Kravitt, *supra* note 22, at lix.

Another lesson learned from the credit crisis is that the securitization industry and financial markets were highly correlated.³³ Regulators should create rules taking account of this correlation and aim to mitigate its effect.³⁴ In part, this market correlation stemmed from increased interconnectivity.³⁵ Correlation and interconnectivity also caused a classic “domino effect.”³⁶ As defaults in RMBS became worse, special purpose entities (SPEs) and other entities that invested in these securities began to lose value, thus causing other entities exposed to their value to lose value—including “real” financial institutions, such as banks or mortgage originators.³⁷

Generally Accepted Accounting Principles (GAAP) in the United States made this domino effect significantly worse by requiring investments be marked to market in many circumstances.³⁸ This practice failed to account for the fact that, even in the dire environment of the credit crisis, many investors might have intended to continue to hold troubled securities.³⁹ Marking to market also forced many SPEs or financial institutions to record paper losses that forced these entities to sell their investments pursuant to certain contractual covenants.⁴⁰ Those sales glutted the market and drove prices down, which caused all of the securities at risk to lose more value, causing even lower

³³ *Id.* at lvii–lix (“[Securitization] affects other forms of finance as the market uses securitization to provide liquidity to almost all other parts of the financial markets and distributes the resulting securities to many types of investors in many different locations.”).

³⁴ *Id.* at lvii (“We need to better understand . . . the new correlations of risk behavior, and we need to create more and better weapons with which we fight poor credit decisions . . .”).

³⁵ *See generally id.* at lvii–lix (explaining that securitization distributes risk globally, increasing the “correlation between the originators’ and risk bearers’ markets”).

³⁶ *Id.* at lxv.

³⁷ *Id.* at lxiv (noting that as the distressed securities lost value, financial institutions holding the securities began massive write-offs because of mark-to-market accounting rules).

³⁸ Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 396 (2008).

³⁹ *Id.* at 381, 387 (hypothesizing different explanations for investor behavior, such as herd behavior, the fact that home prices had only been rising in recent memory, and overreliance on underwriters/arrangers).

⁴⁰ Kravitt, *supra* note 22, at lxiv.

marks to market and forcing more securities to be sold, and so on.⁴¹ Thus, the financial markets were caught in a textbook vicious cycle.⁴²

The lesson to be taken from this critical point of accounting practice is clear: if investors had been permitted to record the values of investments they had no intention to sell (or only to sell if their prices recovered) at their expected or ultimate realizable value, then tens, if not hundreds, of billions of dollars in equity could have been preserved across the financial system. The potential of U.S. GAAP to turn a systemic deleveraging into a global tailspin is something that has gone unmodified by regulators and legislators alike.⁴³

There also is a debate as to whether a misalignment of interests among the various parties to a securitization—e.g., originators and issuers on the one hand, and investors on the other—contributed to the losses suffered in the credit crisis.⁴⁴ Although complete alignment is unrealistic, the concept of “originate-to-distribute” has been viewed as a major cause of the crisis, generating a great deal of regulatory and legislative support for minimizing the dangers of that practice by better aligning the interests of the parties to a securitization.⁴⁵

In short, there has been, and continues to be, much debate and analysis concerning the events leading to the Crisis. However, what is relevant for these purposes is that regulators believed they needed to re-regulate securitization to mitigate the risks they perceived in practices employed by the industry. This included: improved disclosure in

⁴¹ *Id.* at lxiv–lxv (implying financial institutions sold the distressed securities at low prices given the lack of demand and noting this lead otherwise solvent debtors without access to the “true” value of the assets, causing default and drying up of liquidity, and creating further systemic illiquidity).

⁴² *Id.* at lxiii–lxvii.

⁴³ *But see FASB Finalizes “Market to Market” Accounting*, ABA BANKING J. (Nov. 12, 2015), <https://bankingjournal.aba.com/2015/11/fasb-finalizes-market-to-market-accounting/> [perma.cc/L6S9-STGU] (announcing a new accounting standard that does not require mark to market for loans or debt securities becomes effective in 2018).

⁴⁴ *See, e.g.*, Steven L. Schwarcz, *supra* note 38, at 384 (2008) (acknowledging the conflicts of interest between originators and investors as well as between financial institutions and investment bankers, but arguing that mitigating those conflicts of interest is not the best solution).

⁴⁵ Eric Thompson, *Dodd-Frank and Basel III’s Skin in the Game Divergence and Why It Is Good for the International Banking System*, 2 GLOBAL BUS. L. REV. 159, 166–67 (2012) (discussing the Dodd-Frank Act requirement that originators retain 5 percent of the credit risk in securitized assets and the benefits of this “skin in the game” requirement in aligning interests).

order to make the process fully transparent, or at least as transparent as is practically possible and wise; increasing SPE consolidation to try to improve disclosure of risks inherent in SPEs to their sponsors and requiring appropriate levels of equity to support this risk; attempting to standardize both the documentation of securitization transactions and the securitization process itself as much as is practicable; improving the due diligence process; reforming rating agencies; increasing equity capital and thereby lowering leverage and liquidity ratios; reforming required liquidity ratios to reflect lessons learned on what constitutes liquid assets; and attempting to align the interests between originators and issuers on one hand and investors on the other.

The following sections analyze the regulations that have been adopted or proposed in order to accomplish some of the most important foregoing hoped-for improvements.

IV. Risk-Based Capital Rules

The Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the Agencies) adopted “the Final Rule”⁴⁶ (in the case of the FDIC, an interim Final Rule) to implement the Basel III regulatory capital framework⁴⁷ for banking organizations in the United States.⁴⁸ The Final Rule updates the terminology for the securitization framework “to include a definition of securitization exposure that encompasses a wider range of exposures with similar risk characteristics.”⁴⁹ In addition, the Final Rule incorporates new operational requirements, including due diligence requirements for securitization exposures.⁵⁰

⁴⁶ 12 C.F.R. § 217.20 (2014); Regulatory Capital Rules, 78 Fed. Reg. 55,340 (Sept. 10, 2013); Memorandum from the Office of the Comptroller of the Currency on Regulatory Capital Rules (July 9, 2013) [hereinafter OCC Memo] (available at <http://occ.gov/news-issuances/news-releases/2013/2013-110a.pdf> [perma.cc/TZ43-SP93]).

⁴⁷ See generally *Basel III: International Regulatory Framework for Banks*, BANK FOR INT’L SETTLEMENTS, <http://www.bis.org/bcbs/basel3.htm?q1=1>.

⁴⁸ See generally Legal Update from Mayer Brown LLP, Scott A. Anenberg et al., Bank Regulators Approve Final Rule to Implement Basel III Capital Requirements in the United States (July 15, 2013), <http://www.mayerbrown.com/Bank-Regulators-Approve-Final-Rule-to-Implement-Basel-III-Capital-Requirements-in-the-United-States-07-15-2013/> [perma.cc/46MJ-GQ35].

⁴⁹ OCC Memo, *supra* note 46, at 339.

⁵⁰ *Id.* at 344.

A. Summary of the Rule

1. Definitions

“The final rule defines a securitization exposure as an on- or off-balance sheet credit exposure (including credit-enhancing representations and warranties) that arises from a traditional or synthetic securitization (including a resecuritization), or an exposure that directly or indirectly references a securitization exposure.”⁵¹ Furthermore, the Final Rule retains the power for the primary federal supervisor for a bank to “expand the scope of the securitization framework to include other transactions if doing so is justified by the economics of the transaction.”⁵²

As defined in the Final Rule, securitization requires the credit risk of one or more underlying exposures—which must be financial exposures such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities (ABS), MBS, other debt securities or equity securities—has been transferred to one or more third parties other than through the use of credit derivatives or guarantees, “where the credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority.”⁵³ However, the Final Rule excludes certain exposures that are often indicative of a securitization, such as tranching credit exposures to commercial or industrial companies or associated with non-financial assets.⁵⁴ The Final Rule also excludes an operating company from traditional securitizations, even if substantially all of its assets are financial.⁵⁵ Operating companies such as banking organizations are excluded from the definition of traditional securitization, but investment firms do not qualify for this general exclusion.⁵⁶ Finally, performance of the securitization exposure must depend on the performance of the underlying exposures.⁵⁷ The definition of a synthetic securitization is:

⁵¹ *Id.*

⁵² *Id.* at 344.

⁵³ *Id.* at 340.

⁵⁴ *Id.* at 341.

⁵⁵ *Id.* (“Consistent with the proposal, under the Final Rule, an operating company does not fall under the definition of a traditional securitization.”).

⁵⁶ *Id.* at 341–42.

⁵⁷ *Id.* at 345.

(1) all or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties through the use of one or more credit derivatives or guarantees (other than a guarantee that transfers only the credit risk of an individual retail exposure); (2) the credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority; (3) performance of the securitization exposures depends upon the performance of the underlying exposures; and (4) all or substantially all of the underlying exposures are financial exposures as set out above.⁵⁸

In essence, the principal difference between a synthetic and traditional securitization is the credit risks of the underlying exposure in a synthetic securitization are transferred by means of a guarantee or credit derivative—in a traditional securitization, they are transferred by other means (such as a true sale).

The Final Rule’s definition of “resecuritization” is “an on- or off-balance-sheet exposure to a resecuritization or an exposure that directly or indirectly references a resecuritization exposure.”⁵⁹ In addition, according to the Final Rule, exposure to an asset-backed commercial paper (ABCP) program is not a resecuritization exposure if either:

(1) the program-wide credit enhancement does not meet the definition of a resecuritization exposure; or
(2) the entity sponsoring the program fully supports the commercial paper through the provision of liquidity so that the commercial paper holders effectively are exposed to the default risk of the sponsor instead of the underlying exposures.⁶⁰

2. *Due Diligence and Other Operational Requirements*

Under the Final Rule, banking organizations must satisfy certain operational requirements for securitization exposures.⁶¹ For due

⁵⁸ *Id.*

⁵⁹ *Id.* at 346.

⁶⁰ *Id.*

⁶¹ *Id.* at 349.

diligence, banking organizations are required to evaluate, review, and update their analysis of each securitization's risk characteristics and exposure at least quarterly.⁶² The analysis must include "[s]tructural features . . . that materially impact the performance of the exposure," "information regarding the performance of the underlying credit exposures," market data relating to the securitization, and "performance information on the underlying securitization exposures" for resecuritization exposures.⁶³ For related operational requirements,

a banking organization that transfers exposures it has originated or purchased to SPEs or other third party in connection with a traditional securitization can exclude the underlying exposures from the calculation of risk-weighted assets only if each of the following conditions are met: (1) the exposures are not reported on the banking organization's consolidated balance sheet under GAAP; (2) the banking organization has transferred to one or more third parties credit risk associated with the underlying exposures; and (3) any clean-up calls relating to the securitization are eligible clean-up calls⁶⁴

Furthermore, synthetic securitization operational requirements are more specific to correctly ascertain the originating banking organization has actually transferred credit risk of the underlying exposures to at least one other party.⁶⁵

[A]ny clean-up call associated with a securitization would need to be an eligible clean-up call In the case of a traditional securitization, a clean-up call generally is accomplished by [the Originator] repurchasing the remaining securitization exposures once the amount of underlying exposures or outstanding securitization exposures falls below a specified level. In the case of a synthetic securitization, the clean-up call may take the form of a clause that extinguishes

⁶² *Id.*

⁶³ *Id.* at 349–50.

⁶⁴ *Id.* at 353–54.

⁶⁵ *Id.* at 354.

the credit protection once the amount of underlying exposures has fallen below a specified level.⁶⁶

3. *Alternative Approaches to Determine Risk-Weighted Capital*

The framework for assigning risk-based capital requirements to securitization exposures in the Final Rule generally requires banking organizations to calculate a risk-weighted asset amount for a securitization exposure by applying either the simplified supervisory formula approach (SSFA) or, if the banking organization is a “Standardized Bank”⁶⁷ not subject to the market risk rule, a “gross-up” approach similar to that provided under the general risk-based capital rules. If an “Advanced Bank”⁶⁸ has the required data to do so (which may include loan-level data in some cases), it must instead use the more risk-sensitive supervisory formula approach as in U.S. Basel II, but with changes to the formula yielding a higher capital charge. The Final Rule also provides for an alternative treatment of securitization exposures to ABCP programs and certain gain-on-sale and credit-enhancing interest-only exposures.⁶⁹

The exposure amount for which risk-based capital is required for on-balance sheet positions is generally a bank’s carrying value for the position.⁷⁰ For an off-balance sheet securitization exposure, the exposure amount is generally the notional amount of the exposure.⁷¹

For purposes of calculating the exposure amount of an off-balance-sheet exposure to an ABCP securitization exposure, such as a liquidity facility, under both the “Standardized” and “Advanced” approaches, the notional amount may be reduced to the maximum potential amount the banking organization could be required to fund

⁶⁶ *Id.* at 355–56.

⁶⁷ 12 C.F.R. § 3.30 (2017).

⁶⁸ An “Advanced Bank” includes a national bank or federal savings associations that has, or is a subsidiary of a bank holding company or savings and loan holding company that has, total consolidated assets of \$250 billion or more, total consolidated on-balance sheet foreign exposure of \$10 billion or more, or that has elected to use the Advanced Approaches. 12 C.F.R. § 3.100 (2017).

⁶⁹ OCC Memo, *supra* note 46, at 339.

⁷⁰ *Id.* at 648.

⁷¹ *Id.*

given the ABCP program's current underlying assets (calculated *without* regard to the current credit quality of those assets).⁷²

Under the Final Rule's standardized approach, the exposure amount of an eligible ABCP liquidity facility subject to the SSFA equals the notional amount of the exposure multiplied by a 100 percent credit conversion factor (CCF).⁷³ However, a Standardized Bank can use a 50 percent CCF to calculate the exposure amount of an eligible ABCP liquidity facility not subject to the SSFA.⁷⁴ The exposure amount of a securitization exposure that is a repo-style transaction, an eligible margin loan, an OTC derivative contract (other than a purchased credit derivative), or a derivative that is a cleared transaction (other than a purchased credit derivative) is the exposure amount of the transaction as calculated under section 34 (OTC derivative contracts) or section 37 (collateralized transactions) of the Final Rule, as applicable.⁷⁵

The Final Rule also specifies securitization exposures in the case of a servicer cash advance facility or credit risk mitigation.⁷⁶ For a servicer cash advance facility, a banking organization must apply the SSFA, gross-up approach, or a 1,250 percent risk-weight.⁷⁷ To recognize risk-mitigating effects, the treatment of credit risk mitigation for securitization exposures also differs slightly from treatment for other exposures.⁷⁸

To reduce market uncertainty, the Final Rule requires banking organizations provide the following disclosure regarding securitization-related exposures:

- (i) the nature of the risks inherent in a banking organization's securitized assets; (ii) a description of the policies that monitor changes in the credit and market risk of a banking organization's securitization exposures; (iii) a description of a banking organization's policy regarding the use of credit risk mitigation for securitization exposures; (iv) a list of the SPEs a banking organization uses to securitize expo-

⁷² *Id.* at 648–69.

⁷³ *Id.* at 649.

⁷⁴ *Id.*

⁷⁵ *Id.* at 649.

⁷⁶ *Id.* at 363, 377.

⁷⁷ *Id.* at 363.

⁷⁸ *Id.* at 377.

tures and the affiliated entities that a bank manages or advises and that invest in securitization exposures or the referenced SPEs; and (v) a summary of the banking organization's accounting policies for securitization activities.⁷⁹

There are two aspects of the Final Rule that most drive up the risk-based capital of securitization positions. One of the most controversial is the requirement that a transferor cannot remove assets in a traditional securitization from its regulatory risk-based capital balance sheet, no matter how much real risk has been transferred, unless the transfer is a U.S. GAAP sale.⁸⁰ The second aspect of the Final Rule which most serves to drive up required risk-based capital is how the formulas to calculate such capital work. For Standardized Banks it is the application of the SSFA, and for Advanced Banks it is the content of the required modeling. For example, the SSFA requires a risk weight floor (no matter how much less capital the formula would otherwise require) of 20 percent,⁸¹ penalization of pools with strong credit histories by overweighting the size of the amount of subordination (which of course is higher in the case of pools with less strong credit history),⁸² a so-called "p" factor increasing required capital by 50 percent to take account of the risks of tranching (so the total required capital for all tranches once a pool is securitized is almost always more than if the pool had not been securitized),⁸³ and other similar aspects of the SSFA formula. The modeling formula in the Advanced Approach has analogous factors, such as similar risk weight floors, materially increasing required capital when maturities exceed one year and measuring maturity by legal final maturity dates instead of weighted average maturity dates, and other factors.⁸⁴

B. Analysis

The general purpose of the Final Rule is to ensure the largest and most complex banking organizations possess sufficient capital that is of high enough quality to protect against the risk arising from the

⁷⁹ *Id.* at 461.

⁸⁰ 12 C.F.R. pt. 217.20.

⁸¹ OCC Memo, *supra* note 46, at 660.

⁸² *Id.* at 366.

⁸³ *Id.*

⁸⁴ *Id.* at 408.

scale and complexity of their activities.⁸⁵ Furthermore, the regulation is intended to improve disclosure mechanisms to allow for easier and more accurate evaluation of a bank's capital strength.⁸⁶

When analyzing the quality of capital rules, of course the primary test is not only whether the rules provide for sufficient capital to enable banks to withstand the negative effects of the risks attendant on a bank's relevant businesses, but also whether the rules do not require so much capital that the banks are unable to engage efficiently in the activities for which they are designed to engage in a capitalist economy—chiefly, financing the important business and consumer activities of their customers. Here the activities at issue are the use of different forms of securitization to finance vast swaths of the U.S. economy, encompassing nearly all forms of manufacturing, the provision of services and commercial transactions, and the purchase of the products of such business activity. In this respect as well, one must compare the effects of the required capital on competitiveness with non-U.S. banks and the use of securitization versus other forms of finance such as lending or the issuance of equity.

For purposes of this analysis, we believe the capital rules for securitization enumerated above require excessive amounts of capital and hurt the competitiveness of U.S. banks versus their foreign counterparts, particularly in Europe and Asia.⁸⁷ We also believe such excessive capital often makes securitization less efficient than some competing forms of lending.⁸⁸ This is a serious matter, as excessive

⁸⁵ *Id.* at 35.

⁸⁶ *Id.* at 19.

⁸⁷ See e.g., U.S. DEP'T OF THE TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES—CAPITAL MARKETS 98 (Oct. 6, 2017), www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf [<http://perma.cc/423S-K7HV>] (observing that U.S. banks may be placed at a competitive disadvantage to their European peers since the European Banking Authority has recommended European regulatory bodies lower the minimum capital floor for qualifying senior tranches while U.S. authorities have taken no action).

⁸⁸ See *infra* Schedule A-1. They clearly demonstrate the relative disadvantage that securitization positions suffer in relation to risk based capital for other financial products for banks. The calculations in these charts were derived from information obtained by certain of our client banks through SIFMA and interpreted through published Risk Based Capital Rules. See *infra* Schedule A-2. They clearly demonstrate the relative disadvantage securitization positions of U.S. banks suffer in relation to risk-based capital for the same positions held by EU banks. *Id.*

capital limiting U.S. banks' ability of to finance U.S. business and consumer activity has negative effects on the economy as a whole, including the strength of business activity and employment.⁸⁹

The first material mistake in the Final Rule that jumps out is the requirement that to reduce capital in a traditional securitization, the transaction must qualify as a U.S. GAAP sale to a nonconsolidated purchaser.⁹⁰ It is very difficult to effect a U.S. GAAP sale to a nonconsolidated purchaser.⁹¹ To qualify for such lack of consolidation, the transferor must transfer *control* (and a potentially significant financial interest) over the transferred financial assets to the ultimate purchasers.⁹² Most originators or sponsors will retain control over the transferred pool to insure the quality of the servicing and/or to maintain relations with their customers.⁹³ But this has nothing whatsoever to do with whether the *risk*, or a portion of the risk, of the assets in the pool has in fact been transferred. Therefore, by tying the capital analysis to the transfer of control, rather than to the transfer of risk, the capital rules by definition are no longer "risk-based" and will likely result in too much capital. This too broad requirement also violates the fourth principle of precise targeting. Tying the risk-based capital result to the accounting result was an attempt to be conservative. But tying all traditional securitization transfers to the accounting test clearly was too broad a test to accomplish the goal of maintaining prudent (but not exceeding "prudent") amounts of capital. Excessive amounts of capital are not the same as prudent amounts of capital. Though producing different effects, too much capital may have an equally negative effect as too little capital. Finally, one can argue the accounting test violates the eighth principle of connecting measures to objectives. Tying

⁸⁹ See *id.* at 21 (stating that access to capital allows companies to invest in growth and develop new products and services, leading to increased employment opportunities and wealth creation).

⁹⁰ Regulatory Capital Rules, 70 Fed. Reg. 76,973, 76,979–80 (Dec. 20, 2013) (to be codified at 12 C.F.R. pt. 234).

⁹¹ JASON KRAVITT, SECURITIZATION OF FINANCIAL ASSETS § 19.02[B] (3d ed. 2017).

⁹² FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS No. 167, 151–52 (2009), <http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175820928961&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs> (amending an interpretation requiring an enterprise to perform an analysis to determine whether the enterprise's variable interest or interests gives it a controlling financial interest in a variable interest entity).

⁹³ *Id.*

capital outcomes to accounting outcomes does increase required capital, but it fails to accomplish the larger overall objective of having the correct amount of capital to balance protection from risk with efficiency in financing.

The second major mistake is that even if the U.S. GAAP sale requirement were eliminated, there still would be too much capital required. The above discussion of the modeling formulas explains how the regulators have built excessive conservatism into such formulas. The U.S. Treasury Reports support this assertion.⁹⁴

Do these fundamental mistakes in the Final Rule give rise to additional evidence of violation of any of the nine principles set out earlier in this Article? Most likely they do. First, tying capital relief to an accounting outcome means the capital rules are just a series of rules without a coherent principle against which to measure their appropriateness. Second, by focusing on risks arising from the activity of securitization, but then ignoring mitigating factors such as the effect of other reforms put in place since the Financial Crisis, the capital rules focus on past activity rather than on future activity.

Third, the U.S. Rules deviate from the EU version of the Basel capital rules. As a result banks from the U.S. and EU have different compliance regimes. This is inefficient for banks from each region and may cause unintended advantages and disadvantages for such banks.

One more fault with the present capital rules should be discussed: the dangers of modeling. The Standardized and Advanced Approaches both provide for calculating capital based on elaborate models that themselves use many proxies and assumptions. Every regulator must keep in mind models are at best, *approximations* of reality and at worst, *misleading substitutes* for reality—they are never wholly accurate. When basing capital on models, regulators must step back and ask themselves how logical is the outcome of such models. Is a model producing more capital for triple A securitizations than for Greek national debt a sensible model? Is a model requiring more capital than the entire dollar amount of the securitization position at issue a sensible model? Is a model requiring more capital for a pool with an excellent historical loss record than for a pool with a worse record solely because the second pool has a larger subordinated position a sensible model? These are the types of common sense questions all

⁹⁴ See e.g., *id.* at 99 (concluding the current treatment of securitization exposures along with punitive treatment under bank capital rules have imposed an outsized cost on market makers for securitized products). These assumptions are also based on analyses conveyed to us by bank members of SFIG.

regulators should consider before adopting final regulations. The new capital rules have each of the illogical (and therefore not sensible) outcomes discussed in this paragraph.

One final thought about capital rules and the nine recommended principles: the adoption of the new rules is entirely understandable in view of the Financial Crisis and the weaknesses in securitization as conducted prior to 2008. But the securitization market and the rules that govern it have each changed meaningfully. The ninth principle is constant reevaluation. In view of the analysis in this section, the present circumstances call for just such reevaluation.

V. Liquidity Coverage Ratio Rule

The objective of the liquidity coverage ratio (LCR), introduced and finalized in 2009 and 2013, respectively, by the Basel Committee on Banking Supervision, was to improve the short-term resilience of the banking sector.⁹⁵ The LCR is designed to ensure a covered company has high quality liquid assets (the Numerator) sufficient to meet its total net cash outflows over a prospective 30-day period (the Denominator).⁹⁶ We provide a summary of the rule as implemented by the U.S. regulators, which very closely adheres to the Basel version.

A. Summary of the Rule

1. Numerator

The regulation specifies what assets may count as High Quality Liquid Assets (HQLA) and sets different levels of liquidity credit for different types of assets (see table below).⁹⁷

⁹⁵ Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed. Reg. 61,440, 61,441–48 (Oct. 10, 2014) (to be codified at 12 C.F.R. pt. 329) (“The requirement is designed to promote the short-term resilience of the liquidity risk profile of large and internationally active banking organizations, thereby improving the banking sector’s ability to absorb shocks arising from financial and economic stress, and to further improve the measurement and management of liquidity risk.”).

⁹⁶ Memorandum from the Office of the Comptroller of the Currency, Calculating the Liquidity Coverage Ratio, <https://www.occ.gov/topics/capital-markets/balance-sheet-management/liquidity/Basel-III-LCR-Formulas.pdf>.

⁹⁷ STRUCTURED FIN. INDUS. GRP., REGULATORY BRIEFING BOOK ISSUE III: LIQUIDITY COVERAGE RATIO FINAL RULE (2014), www.sfindustry.org/images/uploads/pdfs/SFIG_Briefing_Book_LCR.pdf.

Type of Liquid Asset	Description	Haircut	Cap
Level 1A	Highest quality and most liquid assets. Example: U.S. Treasury Securities	N/A	N/A
Level 2A	Relative price stability with significant liquidity. Example: GSE Securities	15%	When combined with Level 2B liquid assets, can't exceed 40% of total HQLA
Level 2B	More price volatility and less liquidity. Examples: highly liquid investment grade corporate debt securities; exchange traded corporate equity securities	50%	Can't exceed 15% of total HQLA

2. The Denominator

A bank's total net cash outflow amount is determined by taking amounts the covered company expects to pay out during a calculation period (outflows) and subtracting amounts the company expects to receive during the same calculation period (inflows). The measurements of outflow and inflow set forth in the Final Rule account for the impact of stress events such as the Financial Crisis.⁹⁸

The outflow amount assigned to the undrawn portion of a committed credit or liquidity facility under the LCR is a function of "(1) the type of customer or counterparty to whom the facility is extended, and (2) whether the facility is a credit facility or a liquidity facility."⁹⁹ Below is a table outlining the LCR's outflow amounts for undrawn credit and liquidity commitments particularly relevant to securitization transactions:¹⁰⁰

Customer & Commitment Type	Outflow Amounts for Undrawn Commitments
Committed credit facilities to: <ul style="list-style-type: none"> wholesale customers and counterparties SPEs that are consolidated subsidiaries of wholesale customers and counterparties that do not issue commercial paper or securities 	10%
Committed liquidity facilities to: <ul style="list-style-type: none"> wholesale customers and counterparties 	30%

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ *Id.*

<ul style="list-style-type: none"> • SPEs that are consolidated subsidiaries of wholesale customers and counterparties that do not issue commercial paper or securities 	
Committed credit facilities to: <ul style="list-style-type: none"> • financial sector entities (excluding depository institutions, depository institution holding companies and foreign banks) • SPEs that are consolidated subsidiaries of financial sector entities that do not issue commercial paper or securities 	40%
Committed liquidity facilities to: <ul style="list-style-type: none"> • financial sector entities • SPEs that are consolidated subsidiaries of financial sector entities 	100%
Committed credit and liquidity facilities to all other SPEs	100%

B. Analysis

We believe the regulation has at least two major flaws: (1) treatment of ABS and MBS as “non-HQLA”; and (2) treatment of committed lines.

1. HQLA

The U.S. implementation of LCR treats all ABS as non-HQLA.¹⁰¹ The determination of HQLA vs. non-HQLA assets does not appear to be performance-based. As Richard Johns, Executive Director of the Structured Finance Industry Group, notes:

[t]he treatment of ABS as non-liquid is particularly striking when compared to that of corporate debt. Investment grade corporate bonds are considered high quality liquid assets for purposes of LCR compliance, but AAA rated “plain vanilla” ABS are considered non-liquid, notwithstanding that such assets have historically performed as well as or better than most investment grade corporate debt (as demonstrated by the chart below) For example, during the crisis, corporate investment grade debt experienced an 18%

¹⁰¹ *The Impact of the Dodd-Frank Act and Basel III on the Fixed Income Market and Securitizations: Hearing Before the H. Subcomm. on Capital Mkts. & Gov’t Sponsored Enters.*, 114th Cong. 2 (2016) [hereinafter Johns Testimony] (testimony of Richard A. Johns, Executive Director, Structured Finance Industry Group) (available at <https://financialservices.house.gov/uploadedfiles/hhrg-114-ba16-wstate-rjohns-20160224.pdf>).

price decline at peak, compared to just a 13% decline in AAA automotive loan-backed securities and a 16% decline in AAA credit-card debt-backed securities.¹⁰²

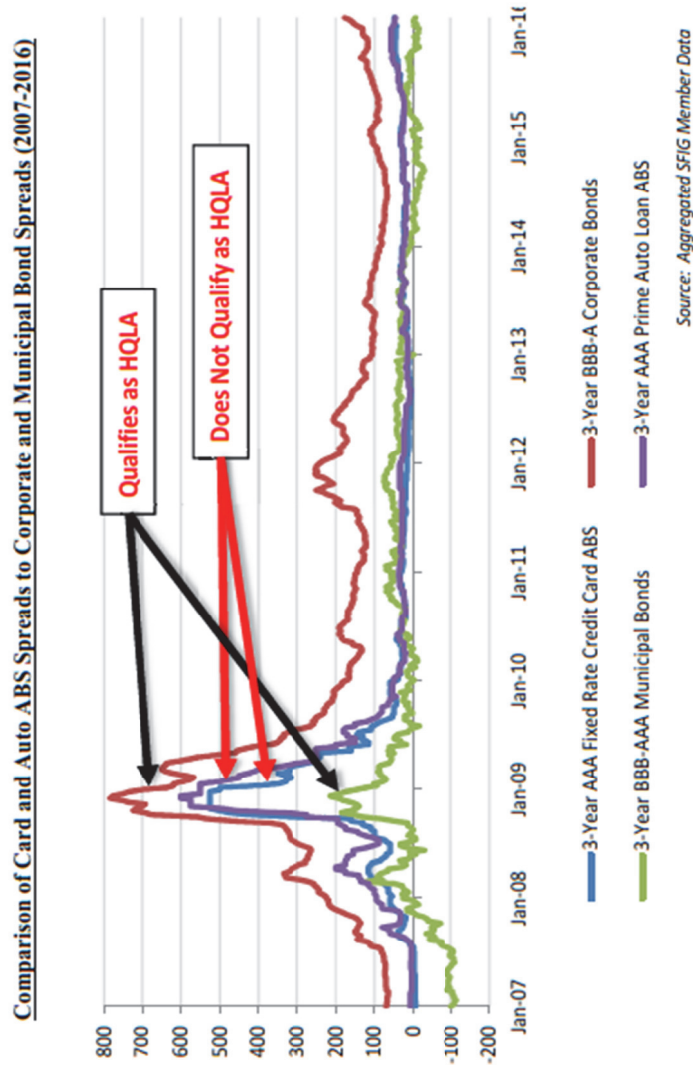


Figure 1¹⁰³

¹⁰² *Id.*

¹⁰³ *Id.* at 11.

Like all other ABS, RMBS are also treated as illiquid, regardless of whether they contain [Qualified Mortgage] QM loans that are considered so safe that the related sponsor is exempted from all credit retention requirements [However,] from the perspective of the regulators, the inclusion of such loans in a security [does not affect the liquidity of that security] [I]f an asset-class were deemed worth nothing from a liquidity perspective and subsequently improves its status by implementing [Section 941 of the] Dodd-Frank requirements such as the inclusion of QM collateral, then how can “nothing” plus “something” still equal “nothing”? Regardless of whether or not one supports Dodd-Frank, it would seem that rules required by this law would have an intrinsic value from a liquidity perspective.¹⁰⁴

If we evaluate the treatment of ABS/RMBS within the “good vs. bad regulation” framework outlined in Section II above, we would likely conclude the balance tilts towards the latter characterization. Given that the rules do not reflect actual asset performance, we do not believe they fulfill the goal of being principles-based, rather than rules-based.¹⁰⁵ Furthermore, with the seemingly arbitrary identification of some assets as liquid versus non-liquid, the LCR fails the “coherence” and “minimize distortions” tests.¹⁰⁶ Similarly, we would question whether the rules “connect[] measures and objectives.”¹⁰⁷ As noted in Section II above, the LCR encourages banks to significantly increase their investments in sovereign debt and other similarly identified “safe” securities, such as GSE MBS.¹⁰⁸ However, the ensuing lack of diversity in banking books could exacerbate a future financial crisis.¹⁰⁹

¹⁰⁴ *Id.* at 11–12.

¹⁰⁵ *Id.* at 10.

¹⁰⁶ Dombret, *supra* note 12.

¹⁰⁷ *See supra* Section II.H.

¹⁰⁸ Johns Testimony, *supra* note 101, at 5 (explaining government-sponsored enterprise debt is highly liquid).

¹⁰⁹ *Id.* at 25.

2. *Treatment of Committed Lines*

We believe the treatment of committed lines under the LCR to certain SPEs is also problematic.¹¹⁰ Banks maintain committed lines of credit with other institutions, and can draw upon them when needed.¹¹¹ But banks also extend such lines of credit to other banks, which can decrease their liquidity when drawn.¹¹² As demonstrated, however, “the LCR uses different outflow rate assumptions for committed lines depending on the type of borrower and whether the line is for credit or liquidity.”¹¹³ Johns also points out:

Banks are exposed to a “double whammy” with respect to the treatment of committed liquidity facilities. Banks must assume a 100% draw on liquidity lines to financial sector entities or their consolidated SPEs. However, they are not allowed to assume ANY inflow from any credit or liquidity facility extended to it. We believe this outcome to be excessively punitive.

These concerns are exacerbated in the context of securitizations. In the original LCR proposal, a credit commitment to any SPE attracted a 100% outflow rate. We appreciate that the prudential regulators took into account [the industry’s] “look through” argument (i.e., that an SPE should attract the same outflow rate as its underlying assets) and, in the final rule, assigned a 40% rate to SPEs that are consolidated subsidiaries of financial sector entities. However, we do not believe that the caveat that such SPEs not issue CP or securities is at all appropriate . . . [I]t has unnecessarily complicated the structuring of safe funding vehicles such as master trusts (used often for credit card and dealer floorplan securitizations).¹¹⁴

Considering the treatment of committed lines in the context of our nine principles framework, we believe it is quite clear that it fails the principles versus rules test and, perhaps most significantly, the

¹¹⁰ *Id.* at 12.

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ *Id.* at 13.

coherence test. It is unnecessarily punitive to ascribe different rates to committed line outflows and inflows. The LCR also contributes to distortions as we've seen certain parts of the committed lines market contract or be eliminated.¹¹⁵ In the case of the LCR in general, both the Numerator and Denominator, we would encourage regulators to reevaluate the more problematic elements on a regular basis and adopt changes as appropriate.

VI. Risk Retention Rules

A. Summary of the Rule

1. Standard Risk Retention Options

On October 22, 2014, six federal agencies, including the SEC, the FRB, the OCC, and the FDIC, jointly approved a Final Rule (Regulation RR) implementing the credit risk retention requirements of Section 15G of the Exchange Act.¹¹⁶ The rule generally requires the sponsor of an ABS transaction to retain at least 5 percent of the credit risk of the assets supporting its securities in accordance with one of the standard risk retention options:¹¹⁷ (i) eligible horizontal residual interest (EHRI);¹¹⁸ (ii) eligible vertical interest (EVI); or (iii) a combination

¹¹⁵ *Id.*

¹¹⁶ Credit Risk Retention, 79 Fed. Reg. 77,602, 77,602 (proposed Dec. 24, 2014) (to be codified at 12 C.F.R. pts. 43, 244, 373, 1234; 17 C.F.R. pt. 246; 24 C.F.R. pt. 267).

¹¹⁷ *Id.* at 77,611.

¹¹⁸ Eligible horizontal residual interest means

an ABS interest in the issuing entity: (1) That is an interest in a single class or multiple classes in the issuing entity, provided that each interest meets, individually or in the aggregate, all of the requirements of this definition; (2) With respect to which, on any payment date or allocation date on which the issuing entity has insufficient funds to satisfy its obligation to pay all contractual interest or principal due, any resulting shortfall will reduce amounts payable to the eligible horizontal residual interest prior to any reduction in the amounts payable to any other ABS interest, whether through loss allocation, operation of the priority of payments, or any other governing contractual provision (until the amount of such ABS interest is reduced to zero); and (3) That, with the exception of any non-economic REMIC resi-

of both an EHRI and an EVI (together with an EHRI and EVI, a Retained Interest).¹¹⁹ Regulation RR generally prohibits a sponsor or any affiliate from hedging or transferring the credit risk the sponsor is required to retain.¹²⁰ In addition, neither a sponsor nor any of its majority owned affiliates may pledge in order to finance such ABS interest the sponsor is required to retain to satisfy its risk retention obligation, unless such obligation is with full recourse to the sponsor or affiliate, respectively.¹²¹

A sponsor may satisfy its risk retention requirement by holding an EHRI, the fair value of which is to be determined using a fair value measurement framework under GAAP as used in the United States.¹²² An EHRI is defined in Regulation RR as an ABS interest in the issuing entity and may be an interest in a single class or multiple classes, provided that each interest meets, individually or in the aggregate, all the requirements of the definition of EHRI.¹²³ EHRI must have the most subordinated claim to both principal and interest in the securitization transaction and therefore shortfalls must reduce amounts paid to the EHRI prior to any other ABS.¹²⁴ These requirements can be achieved by a variety of means including contractual provisions such as the priority of payments.¹²⁵

An EVI can be either (i) a single vertical security or (ii) an interest in each class of ABS (regardless of whether the class of interests has a face or par value, was issued in certificated form, or was sold to unaffiliated investors) issued as part of the securitization transaction constituting the same proportion of each such class.¹²⁶ A single vertical security is defined in Regulation RR as “an ABS interest entitling the sponsor to a specified percentage of the amounts

dual interest, has the most subordinated claim to payments of both principal and interest by the issuing entity.

12 C.F.R. § 1234.2 (2018).

¹¹⁹ Credit Risk Retention, 79 Fed. Reg. at 77,613.

¹²⁰ *Id.* at 77,666.

¹²¹ *Id.*

¹²² *Id.* at 77,611–12.

¹²³ *Id.* at 77,741.

¹²⁴ *Id.*

¹²⁵ *Id.* at 77,614 n.56.

¹²⁶ *Id.* at 77,614, 77,741.

paid on each class of ABS interests in the issuing entity (other than such single vertical security).”¹²⁷

2. *Specific Asset Class Issues*

Regulation RR provides for certain exemptions and/or alternative compliance regimes for certain specific asset classes: RMBS, commercial mortgage-backed securities (CMBS), collateralized loan obligations (CLOs), revolving pool securitizations, asset-backed commercial paper conduits, qualified tender option bonds, certain qualifying assets and blended pools, student loans, as well as Federal National Mortgage Association and Federal Home Loan Mortgage Corporation ABS.¹²⁸ Regulation RR also provides other additional exemptions.¹²⁹

With respect to RMBS, Regulation RR provides an exemption for securitizations of “qualified residential mortgages” (QRMs) meeting several eligibility criteria.¹³⁰ The QRM exemption applies to securitizations if (1) all of the assets that collateralize the ABS are QRMs or servicing assets, (2) none of the assets that collateralize the ABS are ABS, (3) at the closing of the securitization transaction, each QRM collateralizing the ABS is less than thirty days past due, and (4) the depositor has certified to the effectiveness of its internal supervisory controls.¹³¹ Regulation RR aligns with the QRM definition of QM provided by the Consumer Financial Protection Bureau’s (CFPB’s) Qualified Mortgages Rule (QM Rule).¹³²

¹²⁷ See 12 C.F.R. § 1234.2 (2018). Single vertical security means “an ABS interest entitling the sponsor to a specified percentage of the amounts paid on each class of ABS interests in the issuing entity (other than such single vertical security).”

¹²⁸ Credit Risk Retention, 79 Fed. Reg. at 77,740 (indicating exemptions and/or alternative compliance regimes for Federal National Mortgage Association and Federal Home Loan Mortgage, collateralized loan obligation, commercial mortgage-backed securities, qualified residential mortgages, asset-backed securities, and commercial loans).

¹²⁹ *Id.* at 77,763.

¹³⁰ 12 C.F.R. § 244.13(a) (2017).

¹³¹ 253 C.F.R. § 244.13(b) (2017).

¹³² 12 C.F.R. § 1026.43(e)(i) (2017); Memorandum from Paul Hastings LLP, V. Gerard Comizio et al., “QM Equals QRM” . . . CFPB Paves the Way for Key Exemption to Risk Retention Rule (Oct. 27, 2014) [hereinafter Paul Hastings Memo], <https://www.paulhastings.com/publications-items/details/?id=25a3e269-2334-6428-811c-ff00004cbded> [<https://perma.cc/BP8A-A4K6>]. In issuing Regulation RR, “the Agencies [decided] to simplify the scope of

With respect to CMBS transactions, Regulation RR provides for a “B-piece option,” which allows a sponsor to satisfy its risk retention requirement by purchasing an eligible horizontal residual interest through one or two third-party purchasers.¹³³

Under Regulation RR, there are alternative compliance regimes for collateralized loan obligations.¹³⁴ A CLO manager may meet the standard risk retention requirement or, the sole practical alternative, manage a CLO comprised solely of CLO-eligible loan tranches and meeting the other requirements for the “lead arranger” option.¹³⁵

Regulation RR also provides for a risk retention option solely available for sponsors of revolving pool securitizations.¹³⁶ A sponsor of a revolving pool securitization can satisfy its risk retention requirement if, from the closing of the securitization transaction and on a periodic basis (no less than monthly), up until no ABS interest in the issuing entity is outstanding or otherwise held by a person that is not a wholly-owned affiliate, the sponsor (or a wholly-owned affiliate of the sponsor), “maintains a seller’s interest of at least 5 percent of the aggregate unpaid principal balance of outstanding investor ABS interests in the issuing entity.”¹³⁷

With respect to ABCP conduits, Regulation RR permits the sponsor of an “eligible ABCP conduit” to satisfy its risk retention requirement by means of a regular alternative. Alternatively, for each ABS interest acquired by the conduit from an SPE, the SPE’s sponsor holds a retained interest in the credit risk of the underlying assets by using either the standard risk retention option or the revolving pool securitization option.¹³⁸

Meanwhile, Regulation RR assigns a 0 percent risk requirement to commercial loans, CRE loans, and automobile loans that meet

the definition of a QRM to align with the separate but similar definition of QM, which was adopted by the CFPB” Paul Hastings Memo, *supra* note 132.

¹³³ 12 C.F.R. § 244.7(b) (2017); MAYER BROWN LLP, REGULATORY BRIEFING BOOK: CREDIT RISK RETENTION FINAL RULE 12 (2014) https://www.mayerbrown.com/files/Publication/1715e080-7308-4054-a439-628bb43725a5/Presentation/PublicationAttachment/f0c9507b-7b2f-4134-bceb-6397a6a63a14/SFIG-Briefing-Book_Credit-RR-Final-Rule.pdf.

¹³⁴ 12 C.F.R. § 244.9(b) (2017) (listing other risk retention requirements).

¹³⁵ *Id.*; see also Mayer Brown, *supra* note 133, at 13.

¹³⁶ 12 C.F.R. § 246.5(b) (2017).

¹³⁷ *Id.*

¹³⁸ 12 C.F.R. § 244.6(b) (2017); see also Mayer Brown, *supra* note 133, at 19–20.

specified underwriting criteria (qualifying assets), provided certain requirements are met. These requirements include: the securitization transaction is collateralized solely by loans of the same asset class and servicing assets, the securitization transaction does not permit reinvestment periods, and the sponsor provides investors certain specified disclosure regarding the sponsor's determination of the risk retention requirement after including the qualifying assets.¹³⁹

Regulation RR provides for a reduction in the required retention amount for certain student loans.¹⁴⁰ Student loans originated under the Federal Family Education Loan Program (FFELP) enjoy varying degrees of federal guarantees, and their retention requirements are adjusted accordingly. Regulation RR includes a special exemption for RMBS securitization transactions sponsored by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (jointly, the Enterprises). Regulation RR provides that the full guarantee for timely payment of principal and interest by securitization transactions sponsored by the Enterprises would meet risk retention requirements for as long as the Enterprises operated under the conservatorship or receivership of Federal Housing Finance Agency (FHFA) with capital support from the United States.¹⁴¹

3. *Additional Exemptions*

Regulation RR contains a number of general exemptions from the risk retention requirements for the following transactions: certain government-backed mortgage securitizations, certain agricultural loan securitizations, state and municipal securitizations, qualified scholarship funding bonds, certain pass-through resecuritizations, first-pay-class securitizations, seasoned loans, certain public utility securitizations, securitizations of assets issued, insured or guaranteed by the United States and FDIC securitizations.¹⁴² The retention requirements of Regulation RR also do not apply to certain foreign securitization transactions if certain conditions are met.¹⁴³

¹³⁹ 12 C.F.R. § 244.15(a) (2017).

¹⁴⁰ 12 C.F.R. § 244.19(e) (2017).

¹⁴¹ § 244.8(a) (2015).

¹⁴² § 244.19 (2015).

¹⁴³ § 244.20 (2015).

B. Analysis

The purpose of Regulation RR is to address vulnerabilities that stem from the securitization process, namely lack of information transparency and the misalignment of incentives between the parties to a securitization.¹⁴⁴ By mandating that securitizing entities hold a financial interest in the credit risk of the underlying assets being securitized, the regulators intended to encourage the securitizers to verify the quality of the underlying assets on an ongoing basis and align their own interests with those of the investors.¹⁴⁵

Despite its complexity, Regulation RR fails to adequately reflect prevailing market practices and important characteristics of the different kinds of securitization transactions. As a result, Regulation RR at times requires risk retention when not appropriate to do so and is often difficult to comply with efficiently or with certainty.

Any analysis of Regulation RR must begin by examining its underlying assumptions that sponsors and investors did not have their interests aligned prior to these reforms, that the sponsor's retention of 5 percent Retained Interests will align such interests and finally even if each of such assumptions is correct, a uniform Retained Interest is appropriate in all circumstances.¹⁴⁶

First, were sponsors' and investors' interests in fact misaligned?¹⁴⁷ There is no respected academic study supporting this thesis. Further, there is good reason to believe sponsors wanted each securitization they sponsored to work out well for investors.¹⁴⁸ Even if sponsors originated or aggregated assets in order to securitize them and intended to keep no portion of the pool for their own account, if their sponsored deals began to fail, investors would stop investing in them and sponsors businesses (the "originate to distribute" model) would suffer.¹⁴⁹ In the authors' opinions, the actual and operative misalign-

¹⁴⁴ See Credit Risk Retention, 79 Fed. Reg. at 77,603–4 (Dec. 24, 2014) (codified at 12 C.F.R. § 244).

¹⁴⁵ See Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed. Reg. 61,440.

¹⁴⁶ See 12 C.F.R. § 244.1(b) (2015); see generally § 244.4 (a) (2015).

¹⁴⁷ Cf. Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Public Statement: Skin in the Game: Aligning the Interests of Sponsors and Investors (Oct. 22, 2014), <http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1370543250034#.VNH3p LocTml>.

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

ment of interests were between sponsors and their respective employees. In many circumstances, annual bonuses were based on current volume without factoring in the success of a transaction over time or for long-term performance by the relevant employee.¹⁵⁰ Under such a system, a series of failed transactions could nonetheless leave the employee with large bonuses that cannot be clawed back.¹⁵¹

However, many investors believe strongly that Regulation RR is one of the most important reforms to come out of the Financial Crisis, and many sponsors believe they obtain better execution for their transactions where the Regulation applies.¹⁵² Therefore, an efficient, working Regulation RR can be a valuable asset to the securitization market.¹⁵³

In fact, the Regulation has many practical problems.¹⁵⁴ One of the most significant is that it is extremely difficult to calculate the EHRI, as the Regulation does not require retention of the most subordinated interests equal to 5 percent of the nominal dollar account of the securitization, but rather such subordinated interests equal to 5 percent of the *fair value* of the securitization.¹⁵⁵ The calculation is complicated and requires many assumptions, some of which sponsors believe contain proprietary information about their businesses, disclosure of which could lead to competitive disadvantages.¹⁵⁶ The EU rule does not have a similar fair value requirement.¹⁵⁷

Another serious weakness is that, perhaps the most important asset to which Regulation RR applies, RMBS, is based on the CFPB's QM Rule, which itself has various difficulties, not the least of which is

¹⁵⁰ See generally Jonathan C. Lipson et al., *The Pattern in Securitization and Executive Compensation: Evidence and Regulatory Implications*, 20 STAN. J. L. BUS. & FIN. 323, 342 (2015).

¹⁵¹ *Id.*

¹⁵² See generally Jerry Marlatt, Melissa Beck & Kenneth Kohler, *A Closer Look at Newly Adopted U.S. Credit Risk Retention Rules*, 46 UCC L.J. 259 (2015).

¹⁵³ *Id.*

¹⁵⁴ See 12 C.F.R. § 244.4(c)(ii).

¹⁵⁵ *Id.*

¹⁵⁶ See MITCHEL H. KIDER ET AL., REAL ESTATE AND MORTGAGE BANKING: A NEW ERA OF REGULATORY REFORM § 4:44 (2017).

¹⁵⁷ Commission Regulation 2015/35, 2014 O.J. (L 12) 245–57; Commission Regulation 231/2013, 2013 O.J. (L 174) 16; Council Regulation 575/2013, 2013 O.J. (L 176) 1.

that the QM Rule fails to adequately provide for obligors who are self-employed or who otherwise have irregular incomes.¹⁵⁸

Even assuming the idea behind Regulation RR is justified, it may be argued the Regulation does not apply to the portion of the securitization industry that needs it most, and that it should apply stringently to the portion of the securitization industry that needs it least. That is, the Financial Crisis was triggered by the default of hundreds of thousands of subprime and Alt-A residential mortgages.¹⁵⁹ Yet, as exemptions apply to RMBS satisfying the QRM Rule or that are guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae, and similar federal programs, over 90 percent of the current RMBS market need not comply.¹⁶⁰ Conversely, no investor in Multi-Seller ABCP conduits¹⁶¹ during the Crisis lost a penny owing to default on underlying collateral. Yet Regulation RR, in practice (as no safe harbors are workable), applies to 100 percent of the Multi-Seller ABCP market.¹⁶² Surely, if a regulation does not apply to almost all of a market with problems precipitating the regulation's adoption, but it applies to 100 percent of a market with no problems needing regulatory solutions, the regulation is fundamentally problematic.

A fourth major problem with Regulation RR is that most of its safe harbors are intended to allow transactions not in need of the Regulation RR protections and are not practical to apply.¹⁶³ These include intended safe harbors for multi-sellers ABCP Conduits, Auto ABS, CLO transactions, and others.¹⁶⁴

There are other difficulties with Regulation RR, including the fact that its terms are so complicated that most participants in the industry are unclear whether they are actually in compliance in a not-

¹⁵⁸ U.S. GOV'T ACCOUNTABILITY OFF., GAO-11-656, MORTGAGE REFORM: POTENTIAL IMPACTS OF PROVISIONS IN THE DODD-FRANK ACT ON HOME-BUYERS AND THE MORTGAGE MARKET 31 (2011) [hereinafter GAO Mortgage Reform Report], <https://www.gao.gov/new.items/d11656.pdf>.

¹⁵⁹ Kravitt, *supra* note 22, at lvii.

¹⁶⁰ See GAO Mortgage Reform Report, *supra* note 158, at 14–15.

¹⁶¹ In a Multi-Seller ABCP Conduit program, the bank-sponsored conduit purchases assets from a number of sellers and funds its purchases with ABCP. *Asset-Backed Commercial Paper Explained*, FITCH RATINGS: STRUCTURED FIN. (Nov. 8, 1991), <http://people.stern.nyu.edu/igiddy/ABS/fitchabcp.pdf>.

¹⁶² See *id.* at 15.

¹⁶³ See *id.* at 44 (speculating that a non-uniform risk retention requirement “could potentially be difficult to develop and enforce”).

¹⁶⁴ Credit Risk Retention, 79 Fed. Reg. at 77,606.

insubstantial number of circumstances.¹⁶⁵ Further, as six different federal agencies adopted the Regulation, it is extraordinarily difficult to amend in order to fix its problems and equally difficult to obtain helpful, but much needed, interpretations by the adopting agencies.¹⁶⁶ Clearly the combination of these two factors require well-thought out amendments to allow the applicable agencies to fix the Regulation's problems quickly and efficiently.

A final question is whether the 5 percent retention amount should apply to all asset classes. Certainly, a 5 percent test provides for simplicity and consistency. But it cannot be that a 5 percent retained amount for every asset class is just the right amount to align interests. Surely some assets with stellar records require less, while others with difficult performance histories require more. There has been no empirical analysis to answer such question. We do not know if the efficiency of broadly applying the 5 percent test outweighs the value of more precise targeting and attendant complication.

A recent decision of the U.S. Court of Appeals for the District of Columbia illustrates one of the inadequacies of Regulation RR. In the CLO industry, most securitizations are so-called "arbitrage" securitizations, where the collateral manager purchases the loans to be used in the transaction in the open market and by means of tranching makes a profit off the difference between the yield on the loans and the yield to be paid on the securities issued. The manager does not buy and sell the loans, but rather warehouses them in a SPE which eventually transfers them directly or indirectly to the issuer.

In *Loan Syndications and Trading Association v. Securities and Exchange Commission and Board of Government of the Federal Reserve System*,¹⁶⁷ the D.C. Circuit notes the statute itself instructs the agencies to issue regulations "to require any securitizer to retain an economic interest in a portion of the credit risk for any asset that the

¹⁶⁵ Gilbert K.S. Liu, *Risk Retention Issues in Securitization*, KRAMER LEVIN NAFTALIS & FRANKEL LLP, (Sep. 1, 2016), <https://www.kramerlevin.com/en/perspectives-search/risk-retention-issues-in-securitization.html> (lamenting that in order to be compliant under the EHRI option "the sponsor must, among other things, make numerous assumptions, including the rate and timing of defaults, prepayment rates and recovery rates on the underlying assets and coupons and principal balances of the ABS interests issued, and determine a discount rate to calculate the present value of the resulting cash flows to the residual interest").

¹⁶⁶ See GAO Mortgage Reform Report, *supra* note 158, at 15 n.23.

¹⁶⁷ 882 F.3d 220 (D.C. Cir. 2018).

securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party.”¹⁶⁸ Also, Congress defined a “securitizer” as “(A) an issuer of an asset-backed security; or (B) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer”¹⁶⁹

Notwithstanding the clear requirement in the statute that a securitizer must be a transferor, seller, or conveyer, when writing such rules, the agencies wrote them in a manner that swept in CLO managers who never fulfilled such requirements.¹⁷⁰ While one cannot know for certain, Regulation RR appears to be written and interpreted by the agencies in the manner they thought the statute should have been written. This possible intent is understandable, as the rationale for Regulation RR arguably apply to CLO collateral managers. But one can just as easily say it is reasonable to argue that the rationale for Regulation RR does not apply.¹⁷¹ The Loan Syndications and Trading Association (LSTA) argued the agencies had exceeded their authority in Regulation RR under the statute, and the D.C. Circuit should order the district court to vacate Regulation RR insofar as it applies to open-market CLO Managers. It should not be a surprise that the D.C. Circuit reversed the district court and remanded the case to grant summary judgment to the LSTA and to vacate Regulation RR insofar as it applied to open market CLO managers.

It is notable that the D.C. Circuit found the agencies’ statutory interpretation was not reasonable.¹⁷² How coherent can a rule be when an appellate court finds six federal agencies’ interpretation of the statute is not even reasonable? Perhaps the problem lies in the degree of coherence of the statute, but regulatory agencies should not write a rule that is inconsistent with the authorizing statute.

Stepping back, which of the nine principles does Regulation RR violate? One may argue it needs more consistent principles gover-

¹⁶⁸ 15 U.S.C. § 780-11(b)(1) (2012).

¹⁶⁹ *Id.* § 780-11(a)(3).

¹⁷⁰ Credit Risk Retention, 79 Fed. Reg. at 77,651.

¹⁷¹ The argument for application would be that whoever purchases the assets to be securitized, even if they didn’t originate them, should be motivated by retention to do a good job putting the pool together. The contrary argument would be that if an aggregator of the assets did not originate them, it would have adequate motivation to purchase good quality assets without being required to retain a portion of the pool.

¹⁷² *See generally* Chervon, USA, Inc. v. NRDC, 467 U.S. 837 (1984).

ning its rules (LSTA Decision). Its inconsistencies with the EU clearly cause it to fail the global coherence principle.¹⁷³ It is also not precisely targeted to minimize distortions (ABCP vs. RMBS), does not aspire to be adequately flexible (difficulty of amendment and interpretation), and it is unclear if its benefits justify its costs.¹⁷⁴ There is no existing study whether its extensive complication is worth the expense it adds to securitization. One might also inquire whether it adequately connects measures to objectives. Does the Regulation go too far in attempting to align interests in some circumstances while not going far enough in others (once again, compare RMBS with ABCP, autos, the LSTA Decision, etc.)? Considering all of the above, it is time to apply the ninth principle to Regulation RR—regulators should reevaluate the rule and attempt to fix its inadequacies.

VII. Volcker

A. Summary of the Rule

The Volcker Rule is intended to reduce banks' risk exposure by preventing their participation in proprietary trading and limiting investments in covered funds.¹⁷⁵ We will focus on the latter, given the unique issues that arise related to the securitization industry.

The Volcker Rule generally prohibits or restricts a banking entity from investing in, sponsoring, or having certain relationships with, a covered fund.¹⁷⁶ The current approach defines covered funds by reference to whether they would be deemed investment companies under the Investment Company Act but for certain exemptions.¹⁷⁷ To the extent an entity is a covered fund, as defined in the Volcker Rule, and is not covered by an exclusion, the entity cannot acquire or retain a

¹⁷³ See also Commission Regulation 2015/35, 2014 O.J. (L 12) 1; Commission Regulation 648/2012, art. 404–410, 2013 O.J. (L 176) 1.

¹⁷⁴ See GAO Mortgage Reform Report, *supra* note 158, at 13 (reporting, in spite of industry concern, “federal regulators and other industry stakeholders favored relatively restrictive QRM criteria”).

¹⁷⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376 (2010).

¹⁷⁶ *Id.*

¹⁷⁷ The exemptions are found in Sections 3(C)(1) and (7) of the Investment Company Act of 1940. 15 U.S.C.A. § 80a-3 (1977).

principal “ownership interest” in the fund.¹⁷⁸ There are two main considerations: the definition of “ownership interest,” and whether the interest is held as principal. We will focus on ownership interest.¹⁷⁹

Ownership interest is defined as any equity, partnership, or “other similar interest,” which includes having:

- (i) the right to participate in the selection or removal of a general partner, director, investment manager, or similar entity (excluding certain creditor’s rights);
- (ii) the right to receive a share of the fund’s income, gains, or profits;
- (iii) the right to receive underlying assets of the fund after all other interests have been redeemed or paid in full (excluding certain creditors’ rights);
- (iv) the right to receive excess spreads under certain circumstances;
- (v) exposure to certain losses on underlying assets;
- (vi) the right to receive income on a pass-through basis; or
- (vii) a synthetic right to receive rights in the foregoing.¹⁸⁰

As such, while a debt interest would typically not be considered an ownership interest, “to the extent that a debt security or other interest in a covered fund exhibits substantially the same characteristics as an equity or other ownership interest (e.g., certain control rights, or a right, however remote, to receive a portion of the fund’s profits or gains), it would be considered an ownership interest.”¹⁸¹

As indicated above, a covered fund may avail itself of certain exclusions, the Loan Securitization Exclusion (LSE) being one of the most significant for the securitization industry.¹⁸² This exclusion likely derives from the Dodd-Frank Act itself, which states in the section on the Volcker Rule: “[n]othing in this section shall be construed to limit

¹⁷⁸ MAYER BROWN LLP, FINAL REGULATION IMPLEMENTING THE VOLCKER RULE 21 (2013), www.mayerbrown.com/files/Publication/f95121f8-0c01-40f8-b14b-46379c2b118d/Presentation/PublicationAttachment/ddaf0395-d75d-4456-b143-6a026db6be71/Final-Regulation-Implementing-the-Volcker-Rule.pdf [<https://perma.cc/L4KB-37VZ>] (discussing issues relating to the financial regulation promulgated to implement the Volcker Rule).

¹⁷⁹ *Id.*

¹⁸⁰ *Id.*

¹⁸¹ *Id.*

¹⁸² *Id.* at 20.

or restrict the ability of a banking entity or nonbank financial company . . . to sell or securitize loans in a manner otherwise permitted by law.”¹⁸³ However, as discussed more fully below in Section VII.B, the LSE has significant limitations.¹⁸⁴ For example, warehouse facilities would not be able to avail themselves of the LSE given the ABS issuance requirement.¹⁸⁵

B. Analysis

The Volcker Rule currently fails several elements of our “good vs. bad regulation” framework, namely: principles versus rules, distortions, benefits versus costs, and connecting measures and objectives. It is clear Dodd-Frank did not contemplate securitization falling within the mandate of the Volcker Rule.¹⁸⁶ However, the Rule deviates significantly from this principle given the substantial confusion surrounding the “securitization as potential covered fund” analysis. With this confusion comes unnecessary market distortions. As stated in an SFIG letter submitted to the OCC in September 2017:

The time and expense associated with determining the impact of the final rule on securitizations, including obtaining necessary legal opinions, continue to hamper securitization transactions, resulting in inefficient functioning of the securitization markets and reduced market liquidity.¹⁸⁷

Furthermore, as shared by several members of the securitization industry, the costs of the “covered fund determination” process significantly outweigh any potential benefits.¹⁸⁸ From the SFIG letter:

¹⁸³ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376 (2010).

¹⁸⁴ See MAYER BROWN LLP, *supra* note 178 at 20 (stating “most securitizations organized outside the United States that make offers and sales to US investors, typically instead rely on Section 3(c)(1) or (7) under the 1940 Act” instead of the Volcker Rule’s exclusion provision).

¹⁸⁵ *Id.*

¹⁸⁶ Dodd-Frank Wall Street Reform and Consumer Protection Act § 619.

¹⁸⁷ Structured Fin. Indus. Grp., Comment Letter on the Volcker Rule 2 (Sept. 21, 2017) [hereinafter SFIG Comment Letter], http://www.sfindustry.org/images/uploads/pdfs/SFIG_Comment_OCC_Notice_on_Volcker_Rule.pdf.

¹⁸⁸ *Id.*

Moreover, although the entire process required to categorize funds and measure ownership positions in covered funds has resulted in significant investment by banks in compliance support, including annual licensing of external tools (Bloomberg), development of global internal tools, personnel training to categorize funds and other vehicles, controls, annual testing and audit, the actual amount of affected covered fund relationships that were ultimately discovered by most banks during the process has been very small.¹⁸⁹

We share similar concerns regarding the definition of “other similar interests” within the concept of ownership interests.¹⁹⁰ The way “other similar interests” is defined could pull in “plain vanilla” types of securitizations.¹⁹¹ As noted in the SFIG comment letter,

a senior note that includes any right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading advisor of a covered fund (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event) is an “other similar interest”, and this has had significant impacts on CLO markets.¹⁹²

There are other elements in the definition of “other similar interests” that could capture ordinary course securitizations, such as right to receive all or a portion of excess spread.¹⁹³ The general confusion around this aspect of “ownership interests” has also led to distortions (i.e., “abandonment of transactions that were not the intended targets of the Volcker Rule”),¹⁹⁴ violates the principles vs. rules factor, does not fulfill any clearly stated securitization-related objective, and certainly comes down on the wrong side of a cost-benefit analysis.

¹⁸⁹ *Id.*

¹⁹⁰ *Id.* at 3.

¹⁹¹ *Id.* at 5.

¹⁹² *Id.*

¹⁹³ *Id.* at 6.

¹⁹⁴ *Id.* at 5.

Finally, while a properly articulated LSE could have mitigated many of our concerns, it does not do so under the Volcker Rule. Several LSE requirements would ultimately result in the exclusion of plain vanilla facilities.¹⁹⁵ These requirements, which include having to issue ABS, do not meet the principles vs. rules or connecting measures and objectives tests.¹⁹⁶ Dodd-Frank, as discussed, explicitly carves securitization out of the Volcker Rule.¹⁹⁷ We would presume the regulators crafted the LSE to adhere to that principle. However, as implemented, the LSE has several limitations that don't allow a simple, straightforward carve-out for securitization.¹⁹⁸ This further exacerbates our overarching concern with the Volcker Rules—i.e., it is trying to solve a problem that did not contribute to the Crisis.

In conclusion, many facets of the covered fund portion of the Volcker Rule simply do not meet the requirements of our “good vs. bad” regulation framework. The statute states unequivocally that the Volcker Rule should not affect securitization.¹⁹⁹ However, the way the Rule is written results in unintended distortions, does not fulfill any clear objective has unnecessarily high implementation costs, and, last but not least, does not adhere to any overarching principles.²⁰⁰

As SFIG states in its September 2017 comment letter, currently the “net is too broad because, although it is largely successful in catching the private equity and hedge funds intended for regulation, it also catches many securitization issuers that do not engage in the speculative short-term trading activity that was the intended target of the Statute.”²⁰¹

In order to move the Volcker Rule from “bad” to “good”, we agree with the Treasury Department’s June 2017 assessment that “regulators should adopt a simple definition that focuses on the characteristics of hedge funds and private equity funds with appropriate additional exemptions as needed.”²⁰²

¹⁹⁵ *Id.* at 8.

¹⁹⁶ *Id.* at 7–8.

¹⁹⁷ *See supra* Section VII A.

¹⁹⁸ *See* SFIG Comment Letter, *supra* note 187, at 8–9.

¹⁹⁹ 12 U.S.C. §1851(g)(2) (2012).

²⁰⁰ *See generally* SFIG Comment Letter, *supra* note 187.

²⁰¹ *Id.* at 3.

²⁰² U.S. DEP’T OF TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES – BANKS AND CREDIT UNIONS 77 (June 12, 2017), <https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf>.

VIII. Conclusion

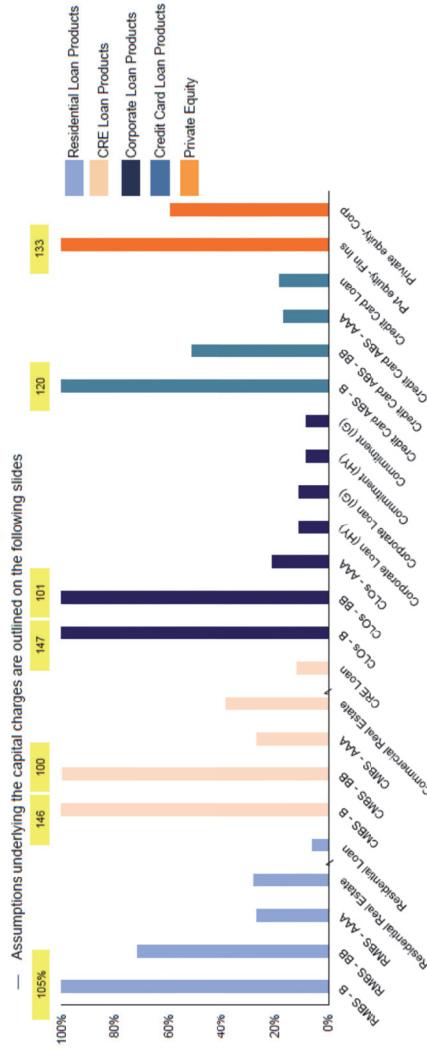
Let us return to John Gardner's parable. We do not believe U.S. regulators need to metaphorically "put out" one of their eyes to improve Financial Crisis-generated regulations for the securitization markets. Nor are they faced with an impossible paradox of "watching with both eyes" when they have only one. The U.S. financial regulators are some of the best in the world—sophisticated, knowledgeable, and able to call on extensive resources. No one doubts their goal is to create prudent rules that do not stifle appropriate financial and economic activity. Nor is it surprising the initial regulatory reaction to the Financial Crisis was to adopt a conservative set of regulations that weren't necessarily coordinated with one another or other global regulations. These regulations may have also leaned too conservatively in finding the difficult balance between protecting the safety of banks, markets and financial activities versus financing appropriate economic activity. The Financial Crisis was unexpectedly severe, and the call for action was intense, loud, and insistent.

But the Financial Crisis ended almost a decade ago. We have had time to reflect and to analyze securitization's strengths and weaknesses more deeply and calmly since then. In many cases, we have much better regulation of, and market practices for, securitization than we have ever had before. Now is the time to build on and refine what has gone before and restore the balance between protecting the safety and soundness on one hand and encouraging desirable financial and economic activity on the other.

Schedule A-1

**Binding Capital Constraints
Minimum Capital Required Across A Range Of Products**

- The chart below compares the capital charges for products held in loan form to their structured product equivalents (e.g., RMBS, CMBS, credit card securitization, CLOs).
- Securitizations are generally classified as Trading Book, held at fair value and subject to a GMS shock under CCAR, while directly held loans are generally classified as Banking Book, held for investment and only subject to the PPNR path (no GMS)¹
- The percentages represent the binding capital required across four rule regimes: Standardized, Supplementary Leverage Ratio (SLR), CCAR Standardized and CCAR SLR



¹ Residential / commercial real estate may attract more capital than a loan for an equivalent product because they are held for sale and follow the asset path for real estate under CCAR

Binding Capital Constraints Constraint Assumptions

- The binding capital constraint equals the highest of spot Standardized, spot SLR, CCAR Standardized, and CCAR SLR:
 - **10% Spot Standardized** = 4.5% CET1 minimum + 2.5% Capital Conservation Buffer + 2.5% G-SIB Buffer + 0.5% Management Buffer
 - **5.5% Spot SLR** = 3% SLR minimum + 2% SLR G-SIB Buffer + 0.5% Management Buffer
- For all CCAR minimums, we assume that Banking Book and Trading Book positions leverage FRB-sourced average loss rates and GMS shocks, respectively
 - **5.0% CCAR Standardized** = 4.5% CET1 minimum + 0.5% Management Buffer
 - **3.5% CCAR SLR** = 3.0% SLR minimum + 0.5% Management Buffer
- The capital charges do not include the impact of future rulemakings, including:
 - Revised Securitization Framework: higher calibration for SSFA
 - Revised Standardized Credit Risk Framework
 - Fundamental Review of the Trading Book ("FRTB"); only incorporates the higher default risk. Credit spread risk assumed to be immaterial
 - CCAR: Inclusion of G-SIB for CCAR minimums for both risk based capital ratio (Standardized Approach) and SLR based on the Stressed Capital Buffer ("SCB") approach
 - Operational Risk

The capital charges do not include impacts from pricing variability, liquidity requirements or Advanced approach requirements.

¹ G-SIB Method 1 represents the firm's G-SIB score under the Basel Committee's methodology which is anticipated to be used under the stressed SLR scenario

Binding Capital Constraints Product-Specific Assumptions

Product	Assumption	Current Approach	Future Approach
■ Residential Loan	■ Prudently Underwritten	■ 50% RW	■ 35%
■ Corporate Loan/Commitment (IG)	■ Rating A	■ Banking Book: 100%/50% ■ Trading Book: 50%/50%	■ /5%
■ Corporate Loan/Commitment (HY)	■ Rating BB	■ Banking Book: 150% ■ Trading Book: 150%	■ 100%/75%
■ Securitization – AAA	■ Vintage: post 2007; Attach/Detach: 30%/100%	■ Based on SSFA with p = .5	■ p increased to 1
■ Securitization - BB	■ Vintage: post 2007; Attach/Detach: 10%/20%	■ Based on SSFA with p = .5	■ p increased to 1
■ Securitization – B	■ Vintage: post 2007; Attach/Detach: 0%/10%	■ Based on SSFA with p = .5	■ p increased to 1
■ Private Equity (Corporate)	■ Private equity investment in non-financial institution counterparty	■ 400% RW	■ 250% RW
■ Private Equity (Financial Institution)	■ Private equity investment in financial institution counterparty	■ 1250% RW	■ 1250% RW

Schedule A-2

Securitization

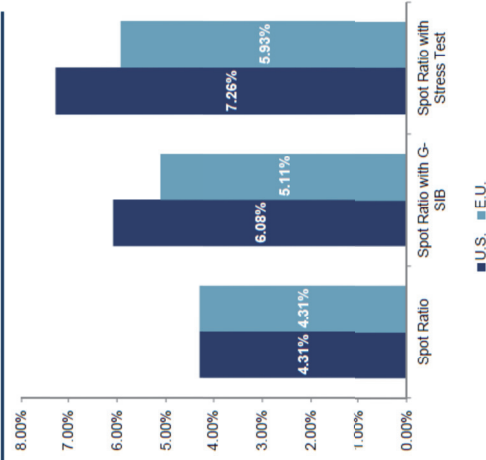
Higher Minimums Disadvantage U.S. Banks

Private & Confidential

Transaction Overview

- The example assumes a full capital stack of a RMBS securitization
- Assumes p=1 for both U.S. and European SSFA

Spread Required: U.S. vs. E.U.¹



Differences in Treatment Between the U.S. and E.U.

- | U.S. | Europe |
|------------|--|
| ■ Exposure | ■ No difference as exposure is the carrying value |
| ■ RWAs | ■ Securitization exposures
■ Securitization exposures floored at 15% RW |
| ■ Minimums | ■ Higher U.S. minimums due to higher G-SIB surcharges and more severe stress test losses |

Pricing Impact

- If the p-factor is calibrated at 1 for both U.S. and Europe, the breakeven pricing for U.S. will be 1.18x of Europe

¹ All ratios assume a 35% tax rate and 20% compensation ratio. Spot Ratio = 7% (4.5% CET1+2.5% Capital Conservation Buffer). Spot Ratio = G-SIB = For U.S. G-SIB: 7% Spot + 2.5% weighted avg. U.S. G-SIB score. For E.U. G-SIB: 7% Spot + 1.5% weighted avg. E.U. G-SIB score. Stress Peak to Trough = For U.S. G-SIB: 4.5% CET1 + 7.5% U.S. Peak to Trough Loss. For E.U. G-SIB: 4.5% CET1 + 3.8% Peak to Trough Loss. Peak to Trough Loss = For U.S. G-SIB: 2.5% weighted avg. U.S. G-SIB score. For E.U. G-SIB: 2.5% weighted avg. E.U. G-SIB score. The capital estimates do not include operational risk RWAs.

Securitization

Break-even analysis between U.S. and Europe

Private & Confidential

Transaction Overview

- The example assumes a full capital stack of a RMBS securitization

Differences in Treatment Between the U.S. and E.U.

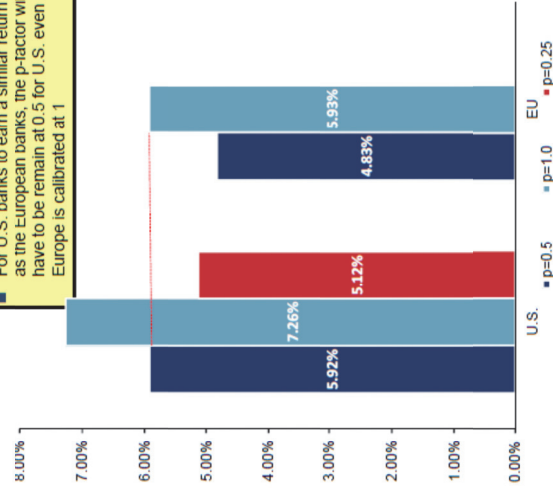
- | | U.S. | Europe |
|----------|--|--|
| Exposure | No difference as exposure is the carrying value | |
| RWAs | Securitization exposures floored at 20% RW | Securitization exposures floored at 15% RW |
| Minimums | Higher U.S. minimums due to more severe stress test losses | |

Pricing Impact

- If the p-factor is calibrated at 0.5 or 1 for both U.S. and Europe, the breakeven pricing for U.S. will be 1.23x of Europe
- In order to maintain a level playing field with EU moving to p=1, in the US, that would mean p=0.5
- The U.S. banks will further disadvantaged with the potential introduction of G-SIB in CCAR

Spread Required: U.S. vs. E.U.¹

For U.S. banks to earn a similar return as the European banks, the p-factor will have to be remain at 0.5 for U.S. even if Europe is calibrated at 1



¹ All ratios assume a 35% tax rate and 50% compensation ratio. Spot Ratio = Stress Peak to Trough = For U.S. G-SIBs: 4.5% CET1 + 7.3% U.S. Peak to Trough Loss, For E.U. G-SIBs: 4.5% CET1 + 3.8% Peak to Trough Loss