Meeting Between Federal Reserve Board Staff
and Professor Adam Levitin
September 30, 2010

Participants: Karen Pence, Kathleen Hanley, Sviatlana Phelan, Andreas Lehnert, Steven Merriett, April Snyder, Sebastian Astrada and Flora Ahn (Federal Reserve Board)

Professor Adam Levitin

Summary: Staff of the Federal Reserve Board met with Professor Levitin to discuss credit risk retention and the Federal Reserve Board's responsibilities under Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Professor Levitin provided Federal Reserve Board Staff with a presentation on his overall views on risk retention. A copy of the handout provided by Professor Levitin at the meeting is attached below. The handout formed the basis for discussions at the meeting and summarizes the issues discussed.

Skin in the Game: Some Notes

Adam J. Levitin

1. Lemons Problems in Securitization
    a. Theory
    b. Evidence on securitization and the lemons problem is mixed.
    c. Personal view: yes, of course, there's a problem. Some studies just aren't looking the right way.
2. There is already SITG in lots of ways:
    a. Early payment defaults
    b. Reps and warranties
        i. Need PSA and securities law reform to make more effective
    c. Servicing Rights (e.g., MSRs)
    d. Explicit retained interests (horizontal slices)
        i. Junior tranche
    e. Explicit retained interests (vertical slices)
        i. Credit card seller's interest (7% minimum by rating agencies, typically higher)
    f. Implicit retained interests (credit enhancements that if not used go back to the residual
        i. Excess spread
        ii. Reserve accounts
        iii. Yield supplement accounts
        iv. Overcollateralization
    g. On-balance sheet treatment under SFAS 166/167
    h. Reputation
        i. Bear Stearns and SIV
        ii. Citi and SIVs
    i. Investment in other deals
    j. Market exposure
3. Is there too much SITG? And does it work?
    a. Maybe—structure finance losses have hit a lot of banks
    b. Hasn't prevented high Credit Card delinquencies
    c. Hasn't prevented high GSE securitization pool delinquencies (100% SITG other than PMI)
    d. Would 95%, rather than 100% risk transfer really fix things?
        i. If not, why bother?
        ii. If so, will it have adverse effects on structured finance deal economics.
4. How to structure SITG?
    a. Who should have it?
        i. Originator?
        ii. Sponsor?
        iii. Servicer?
        iv. Underwriters?

v. Party able to conduct loan-level diligence? (e.g., controlling class shareholder—B piece—in CMBS deals)

b. Pro rata (vertical slice) versus concentrated

i. Concentrated doesn't work once it's out of the money

ii. But many deals had 5% junior retained, so 5% vertical would be .25% of first loss.

c. How to cover resecuritizations and synthetics?

i. Not clear if covered by Dodd-Frank

d. Does SITG prevent reinsurance?

i. That might be good policy for risk alignment, but it is bad policy for financial institution safety-and-soundness.

5. Risk retention is just a type of credit enhancement.

a. Lots of credit enhancements are used simultaneously on most deals.

b. Credit enhancements are largely interchangeable.

i. If market works, then simply go with best execution.

c. SITG mandates a particular type of credit enhancement on the theory that other types are being underpriced (e.g., monolines in a rate war).

d. Problem with SITG is that it will just shift the type of credit enhancement, maybe not efficiently, rather than raise total credit enhancement.

i. We don't know what the optimal level of credit enhancement is, and it is likely deal specific.

ii. Negative impact on monolines and other credit enhancers if there's mandatory skin-in-the-game.

e. It seems that the real concern of Congress is responding to is not the agency problem that is inherent in securitization but that it resulted in investors mispricing their structured finance investments on wide scale.

i. The goal should be trying to fix the mispricing, rather than the agency problem.

ii. Agency problem only matters if there is informational asymmetries and inability to monitor.

iii. We should first look to an information solution.

1. SEC Reg AB revision

a. Too much info

2. Product standardization as information alternative.

6. Two examples

a. Auto deal (Honda Auto Receivables Owner Trust 2007-2)

i.	Retained interest	3.17% of total $ in deal	
ii.	Funded reserve account	.24%	
iii.	Yield supplement account	2.24%	
iv.	Overcollatearlization (none)		
v.	**Total:**	**5.66%**	**Total SITG**

7. Subprime mortgage deal (ABFC 2006-Opt2 Trust)

i.	OC	2.45% (on face 3.45, but it seems that there is a 1% retained interest contemplated)
ii.	Retained interest of	1%
iii.	**Total:**	**3.45% Total SITG**