Transcript of Open Board Meeting

October 22, 2014

CHAIR YELLEN. Good afternoon. I'd like to welcome our guests to the Federal Reserve today as we, along with five other federal agencies, take another important step in implementing the Dodd-Frank Act. And enhancing stability in the securitization markets. The final rule before the Board would require sponsors of securitizations to retain an economic interest in the assets that they securitize. Often called "skin in the game", risk retention requirements better align the interests of sponsors and investors, by providing an economic incentive for sponsors to monitor the quality of securitized assets. The rule we are considering today was developed on an interagency basis with the SEC, OCC, FDIC, HUD, and FHFA. I look forward to today's discussion, and let me now turn to Scott Alvarez, our general counsel.

SCOTT ALVAREZ. Thank you Chair Yellen. The final rule under consideration today, would implement an important element to the Dodd-Frank Act. Congress included a risk retention requirement in the Dodd- Frank Act to address problems it perceived in the misalignment of interests of investors, and sponsors of securitizations. Under Section 941 of the Dodd Frank Act, the six rule writing agencies that you mentioned, must jointly adopt rules that require securitizers to retain an economic interest in the credit risk of the assets they securitize. In general, this requirement may be no less than 5 percent of the credit risk of the securitized assets. Congress intended this requirement to provide sponsors with an incentive to monitor and ensure the quality of the securitized assets underlying a securitization transaction. And thus help align the interests of the sponsors with the interests of the investors. The statute provides an exemption for qualified residential mortgages, and permits other exemptions from risk retention for assets that meet standards that limit credit risk. The final rule would cover all types of securitizers.

Including those that are not otherwise subject to prudential regulation. Enforcement authority over most securitizers is vested by the statute in the SEC. The Federal Reserve's enforcement responsibilities are focused on securitizers that are state member banks, or uninsured, U.S. state branches of foreign banks. To allow securitizers and the markets, time to adjust to the final rule, the statute delays the effective date of the final rule as it applies to securitization transactions collateralized by residential mortgages until one year after the date in which the final rule was actually published in the Federal Register. For other types of securitization transactions, the final rule does not become effective until two years after the publication date. The final rule we are presenting to you today has benefitted from two rounds of public comment and significant public input. The Board received many thousands of public comments throughout this process, including approximately 250 comments on the revised proposal published in mid-2013. The several of the agencies have approved the rule yesterday, and the remaining rule writing agencies are expected to approve that today. Staff of all the rule writing agencies recommend the adoption of the same final rule. I'll now turn to April Snyder for an overview of the final rule.

APRIL SNYDER. Thank you. In my remarks I will provide a brief overview of the final rule, and highlight key concerns that were raised by commenter's on the proposed rule issued last year. I will then turn to my colleagues, Karen Pence, from the Division of Research and Statistics. And Adam Ashcraft, from the Federal Reserve Bank of New York, to discuss the definition of qualified residential mortgage, application of the rule to collateralize loan applications and the anticipated economic impact of the rule on securitization markets. We three and other members of staff will then help answer questions about details of the final rule following our remarks. Consistent with the Dodd-Frank Act, the final rule would impose a minimum 5 percent risk retention requirement on all securitizers unless there is an applicable exemption. Furthermore, as required by the statute, the final rule would generally prohibit securitizers from hedging or transferring their risk that they would be required to retain under the rule. Securitizers, or sponsors, organize and initiate securitization transactions by directly or indirectly transferring assets to the special purpose entity that issues asset-back securities. Because their decisions -- that is the decisions of the securitizers -- directly affect the quality of the securitized assets, securitizers are identified under the Dodd-Frank Act as the party that typically should be subject to risk retention. The final rule, as in the proposals, would include a menu of options for securitizers to meet their risk retention requirement. A securitizer of any class could satisfy the risk retention requirement by holding a horizontal, residual, or the most subordinated interest in the transaction. That would be measured by fair value. A securitizer could also hold a prorated vertical interest, or a combination of vertical and horizontal risk retention interests. There are also specific options in the menu of options for special types of securitizations, including commercial mortgage securitizations, asset-back commercial paper conduits, and revolving securitizations that use master trust vehicles. Consistent with the statute, the fine rule would provide for a number of exemptions from risk retention. For example, there are exemptions for asset-back securities that are guaranteed by the U.S. government and its agencies. And for state and municipal guaranteed asset-back securities. Also, as Karen will discuss further, the Dodd- Frank Act provides a complete exemption from risk retention for residential mortgages that meet the definition of qualified residential mortgage, or QRN. The definition of QRN was the focus of most of the comments on both the original proposal issued in 2011 and the proposal issued last year. In the revised proposal issued last year, the agencies proposed to align the QRM with the definition of qualified mortgage, or QM, that was adopted by the CFPB in early 2013. This alignment between the QRM and QM was generally supported by commenter's, and is recommended by staff in the final rule. Because of the importance of the QRM definition, staff recommends that the agencies agree to periodically review the QRM definition, and the affect that this definition may have on the residential mortgage market. The final rule would therefore provide that the initial review of the QRM would occur four years after the effective date of the rule, or approximately five years from now, and thereafter occur every five years. This initial review would follow a review of the QM that the CFPB is required to do by statute. The final rule would also exempt commercial loans. Commercial real estate loans. And auto loans from risk retention requirements, if they meet underwriting standards set out in the rule. These underwriting standards have been adjusted in the final ruling in response to comment from the proposals, and they attempt to identify loans in each of these asset categories that indicate low credit risk. In addition, securitizations guaranteed by Fannie Mae and Freddie Mac, as long as these GSC's operate in conservatorship with capital support from the United States, would not be subject to the risk retention requirements. For those securitizations that do not qualify for an exemption, the final rule would include some adjustments to the proposed risk retention requirements, a menu of options, to address commentary concerns. One of these adjustments would provide a more flexible disclosure framework for the fair value calculation for horizontal risk retention. This more flexible disclosure framework should address comments or concerns that were expressed about the proposed disclosure of proprietary information with respect to the fair value calculation. Another significant change would remove proposed restrictions on cash flows to securitizers that hold a horizontal risk retention interest under the rule. The proposed cash flow restrictions would have limited how quickly a securitizer holding residential -- horizontal residential -- residual risk retention could receive payments with respect to the residual interest. These restrictions were intended to ensure that securitizers would not be paid more quickly than more senior investors in the transaction. However, the proposed restrictions tend to be unduly restrictive for some asset classes. Furthermore, the requirement to measure horizontal risk retention using fair value under U.S. gap should ensure that any horizontal risk retention interest is meaningful without the proposed cash flow restrictions, because the fair value calculation already takes into account cash flows -- projected cash flows on the residual interest. A number of commenter's requested that the agency's fully exempt securitizations of leveraged commercial loans -- or CLO's -- that are sponsored by asset managers that are usually not affiliated with the originators of the leveraged loans. These are referred to in the final rule as "open market CLO's". As Adam will discuss further, the final rule does not include a specific exemption for open market CLO's based on structural features, which is what the commenter's requested. Instead, the final rule would implement the option from the 2013 proposal for allocating risk retention to the leader ranger of leveraged loan syndications. Taking into consideration evidence of widespread deterioration and underwriting standards for leveraged loans in recent years, applying the risk retention requirement to open market CLO's, which are covered by the risk retention requirements of the statute would promote disciplined underwriting in the leverage loan markets. And reduce risks that this market may pose to financial stability. It should also meaningfully align the incentives of the sponsors and the investors in CLO transactions, which is key goal of risk retention. As proposed in 2013 and in response to comments on the original 2011 proposal, the final rule would limit the duration of risk retention requirements by allowing the securitizers to hedge or transfer their risk retention interests after the end of the period, when default on the underlying securitized assets is most likely to be associated with low-quality underwriting. In the case of residential mortgages, this limitation on hedging or transfer of the risk retention interest would be lifted after the later of five years from the closing date, or when the original, unpaid principal balance of the collateral pool is reduced to 25 percent. But in no case would the limitation on hedging or transfer last later than seven years after closing. In the case of all other asset classes, the limit on the hedging or transferring by sponsor could occur after the later of two years from closing, or when the original, unpaid principal balance was reduced to 33 percent. This concludes my overview of the final rule. And Karen Pence will now discuss the aspects of the rule related to residential mortgages.

KAREN PENCE. Thank you April. The Dodd-Frank Act requires the agencies in setting the qualified residential mortgage definition to take into account underwriting and project features that historical loan performance data indicate result in a lower risk of default. In addition, by statute, the definition of QRM cannot be any broader than the definition of qualified mortgage, or QM, adopted by the Consumer Financial Protection Bureau, and its ability to repay rules. Staff recommends aligning the QM and QRM definitions in order to fulfill these statutory requirements, and to facilitate mortgage credit availability. Broadly speaking, a qualified mortgage cannot have negative amortization, interest only, or balloon features, or a loan term longer than 30 years. Generally, points or fees must be less than or equal to 3 percent of the loan amount, with adjusted caps for smaller loan amounts. And the total debt-to-income ratio must be 43 percent or less, with full documentation of consumer's debt and income. Some exceptions to these rules are permitted for loans originated by small portfolio lenders insured or guaranteed by the Federal Housing Administration or other government agencies, or eligible for purchase or guarantee by Fannie Mae or Freddie Mac. This last exception, known as the "GSE patch", is in place until January 2021, or the GSE's exit conservatorship; whichever comes first. Historical data suggests that loans that meet the qualified mortgage criteria typically perform better than those that do not. For example, by one calculation, serious delinquency rates for loans originated from 2005 to 2008 that would likely have met the QM criteria, are about half the rates for loans originated at the same time that appear ineligible. This calculation and other supporting analysis are described further in the revised proposal that the agency's issued last August. At the same time, staff evaluated the potential effect of the QRM definition on access to mortgage credit. Mortgage lending conditions remain very tight, especially for borrowers with lower credit scores. Meanwhile, mortgage applications -- as measured by the mortgage banker’s association application indexes -- remain at the lowest level since the 1990s. Staff was concerned that lenders would be reluctant to originate loans that did not meet the QRM criteria, or would charge significantly higher rates or fees for such loans, and that credit availability might thereby tighten further. Many commenter's also focused on the possible effects of the QRM definition on access to credit. In order to facilitate the recovery in the mortgage credit markets, staff thus recommends aligning the QM and QRM definitions. Staff believes that this definition also provides considerable protection for investors. As QM requirements, such as full documentation of income and debts will improve underwriting and increase the information available to investors. However, mortgage and securitization market conditions and practices may change over the next few years. And concerns about access to credit may become less acute. As a result, as April mentioned, staff recommends revisiting the QRM definition in five years, or earlier at the request of any agency. In the interim, staff expects that the effect of the rule on access to mortgage credit will be small. This judgment is based on the fact that the vast majority of current mortgage originations meet the qualified mortgage criteria, and so will be exempt from risk retention. At this time, most non-QM loan originations appear to be jumbo loans with interest only payments or debt-to-income ratios greater than 43 percent. As these loans tend to be originated to borrowers who appear otherwise to be strong credit prospects, staff anticipates that funding for these loans will remain available. The staff also recommends providing an exemption from risk retention for securities collateralized by two types of mortgages that do not qualify, for technical reasons, as qualified mortgages, yet meet similar underwriting criteria, and play a role in providing affordable mortgage credit, or affordable housing. The first type are those originated by state housing finance agencies, community development financial institutions, and other institutions with a focus on building and strengthening at risk communities. The second type are certain mortgages backed by three to four family properties, which are typically pooled in securitizations with mortgages backed by one to two family properties. Under the draft final rule, loans on three to four unit residential properties that otherwise meet all of the QM criteria, including underwriting and product criteria, would be excluded from risk retention requirements and could be combined with QRM in a single security. Staff recommends that the agency's review the exemption for both of these types of mortgages at the same time as the review of the QRM definition. My colleague, Adam Ashcraft, will now discuss the CLO market and the possible effects of the rule on the securitization market.

ADAM ASHCRAFT. Thank you Karen. I first wanted to start by reminding you that there are two segments to the CLO market. There is a balance sheet segment, which is largely used by non-bank finance companies, used for funding loans to middle market companies. The sponsors in this segment generally hold very large, first-loss positions, which we believe are adequate to satisfy the rule. A second, and much larger segment of the CLO market is the open market or arbitrage CLO segment. These CLO's are organized and managed by an asset manager who purchases these loans that are used by private equity funds to fund or refinance mergers and acquisitions. The leader rangers of these loan facilities generally retain a revolving component of those facilities, and sell the term component into the market, about half of which are currently sold to CLO's. Asset managers of these CLO's, while at times hold some of the equity of these transactions, but not always, and generally not enough to satisfy the rule. The proposed rule has two options for the market in order to meet the risk retention requirements. The first of which is it recognizes the sponsor of these transactions as the asset manager. And as the sponsor of the transactions, the asset manager can use any of the options that any sponsor can use in order to satisfy the rule, holding risks vertically, through an L-shaped form, or in a first loss position. The second alternative is that risk retention can be allocated from the CLO manager to the lead arranger, who can make all or part of the term loan that they originate to be CLO eligible by retaining 5 percent of that amount, and abiding by the sales and hedging restrictions that are in the rule. An asset manager who purchases only CLO eligible tranches, would not have an incremental retention requirement, effectively allocating the burden on the lead arranger. The industry has criticized each of these options. First, they've maintained that the statute does not subject CLO managers to risk retention. And have made the observation that some asset managers don't have the balance sheet necessary to raise the funding in order to meet the retention requirement. Second, the industry has suggested that the allocation to lead arranger alternative is not market practice, and believe that it would not work, and it would not be used. Finally, they have alternatively asked for an exemption from the risk retention requirements, based largely on structural features that exist in the current market. Staff have reviewed each of these comments very carefully, and after consideration, recommend proceeding with the two options that were proposed last year in the proposal. The reason for this position is first, that the structural features of CLO's that were being used as a basis for an exemption are commonly found in all types of CDO's -- which we know from our experience during the recent financial crisis, did not provide market discipline or investor protection. Our staff do not believe there is compelling evidence documenting that these features alone promote high-quality underwriting or investor protection. In addition to that, the structural features of CLO's did not mitigate a significant underwriting cycle in leverage loans during the recent financial crisis. We also observe that those structural features are not doing very much to prevent overheating in the current market. A significant fraction of the loans that are purchased by these CLOs are being assigned to criticized rating by bank supervisors. So for these reasons, we recommend going forward with the rule as proposed. I'm going to turn my discussion to some of the other underwriting standards in the rule outside of QRM. The act permits the banking agencies to set underwriting standards which exempt selective commercial loans, commercial real estate loans, and automobile loans from risk retention. Underwriting standards for these other asset classes in the final rule are largely unchanged from what we proposed last year, and are generally narrower than the equivalent of QRM for the following reasons. For auto loans -- auto loan underwriting typically relies heavily on credit scores, and does not typically involve the verification of borrower/debt and income that's required in the proposed exemptions. The market for fully stabilized commercial real estate loans is segmented, with life insurance companies making less risky loans, leaving only the more risky loans for securitization market. Similarly, the market for commercial credit is segmented when more creditworthy firms are using alternative sources of finance, which means that there are only the risky loans are left to be financed by securitization. Given these reasons, the staff support going forward with the underwriting exemptions in the final rule. My final remarks are focused on helping you understand the impact of this rule on securitization markets. In particular, the impact of the rule on sponsor incentives and the cost of credit. Risk retention can have a positive impact on sponsor incentives, by increasing the amount and duration of capital underlying securitization transactions. However, the measured impact of this incremental amount and duration of capital on the cost of credit is generally going to be very small for the following reasons. The first of which is that risk retention is a fairly common feature of the market. Which means that any change in amount of duration is going to be small, if not zero, in many of the market segments that we've studied. In addition to that, financial markets are fairly efficient. What that means is that the differential cost of funding on credit through securitization, as opposed to funding it on balance sheet is not going to be that large. And the combination of those two things means that the cost of credit created by incremental capital is not going to be particularly big. As a specific example, if the amount of incremental retention is the maximum of 5 percent, and a difference in yield between how much it costs to fund a credit on balance sheet as opposed to in a securitization is as large as five percentage points -- which is a very large number -- the cost of incremental retention is only going to be 25 basis points ultimately to the borrower. So for those reasons, we don't think that the impact of this on the cost of credit is going to be particularly large. That being said, we do think the impact is obviously going to be larger in markets where the amount of retention is larger, both due to the positive impact of retention on incentives, as well as the higher cost of credit. We do project that the rule will have the most significant impact on the CLO and CMDS market segments. Which are the two largest asset classes in the current new issue market. Given the limited risk retention that exists in place, as well as the current trends in underwriting which are likely to be changed for more capital. A likely impact on the CLO market will depend in part on the option used by the market. If asset managers hold horizontal risk retention, the cost of funding that equity tranche would likely increase, leading to a small, incremental impact on the cost of credit. Likely between 10 and 20 basis points. If instead lead arrangers exercise the option and the hold risk, we project that it will have a minimal impact on the cost of credit, given the amount of leverage that they can get under capital rules in the range of 0 to 10 basis points. In the CMBA market, current horizontal risk retention of 2.5% in the conduit market would double to 5 percent for the requirement. We estimate this incremental retention would have a small impact on the cost of credit on the order of magnitude of 0 to 10 basis points. However, the having of decreased leverage could significantly improve incentives. And other requirements in the rule could mitigate existing conflicts of interest that exist between the B-piece buyer and senior investors. Obviously, in each of these two market segments, there's some uncertainty about the impact given the magnitude of the change. The estimates outlined are based on reasonably conservative assumptions, but the magnitude is not particularly sensitive to even more conservative assumptions than we used. In other market segments, the impact of the rule is likely to be minimal, as the amount of incremental retention is small to zero. In particular, transactions in the consumer, non-agency mortgage, and esoteric segments typically meet the rule as currently structured. It's possible that the sales and hedging restrictions that are part of the rule, that are not part of the market, will -- that will further improve sponsor incentives, that might increase the cost of equity for the risk retention that's in place. It's also possible that the required disclosures which are part of the rule, will increase the cost of securitization. However, we project that each of these changes will have minimal impact on the cost of credit.

In summary, the rule is likely to have a positive impact on sponsor incentives in the largest market segments, where underwriting is tier rating with a small impact on the cost of credit. While the rule is unlikely to have a significant impact on incentives or cost of credit in other market segments, it will prevent the sale or hedging of risk retention that's already in place. And will provide an important back stop to limit the future dilution of risk retention going forward.

CHAIR YELLEN. Thanks very much. Let me start off with -- I just have one question. I just want to talk a little bit more about CLO's. As you noted, this was an area where there were a lot of comments that we're worried about, market practice in this area, and whether or not the market could adjust to this requirement. On the other hand, as you mentioned and April did as well, we've really seen a marked deterioration of underwriting standards on leverage loans. And so in a way it looks like a prime example of why we would want risk retention. So I guess I just have two parts of a question. One is, do you think that the market has the ability to adjust? It seems as though asset managers aren't structured to have the resources to be able to take on the risk retention. And as you noted, for the lead arrangers, that hasn't been common practice. So, is it your sense from the conversations and research that you've done, that you think the market has the ability to adjust, so we won't see a severe contraction of credit in this area? And I guess the other side of it is, do you think we will see an improvement in underwriting standards in this area as a consequence of this?

ADAM ASHCRAFT. I think the economics are fairly compelling that either the asset manager or the lead arranger could find a way of retaining the retention, and earn a return on their capital that would be attractive and consistent with the risk profile of that exposure. So I think we're fairly confident that the market will find a way to respond. As to whether or not these standards themselves will have an important effect on the underwriting in the leverage loan market, again I think the -- we do believe that that will be the case. I would point out that the rule does not go into effect for two years, so it does depend, in part, on whether or not the market begins to act out of the rule or not.

CHAIR YELLEN. Thanks very much. Vice chair?

VICE CHAIRMAN FISCHER. Thank you Madame Chair. What was the experience with loans in which there was a retention of risk by the original lender during the Great Recession? I mean do we have evidence that 5 percent is -- makes a significant difference?

ADAM ASHCRAFT. Okay, so there is an academic literature that's focused on this, and there certainly is evidence that retention is correlated with performance. I've authored a study focused on the conduit CMBS market. And documented what happened when the B-piece investors, or the first class investors in that market were able to sell their first loss positions into vehicles called CRECDO's and it turns out that if you control for all the information that's available at the issuance of those conduits CMBS transactions, the amount that B-piece investors sell to CRECDO's has an important explanatory power for the adverse performance of those transactions. So there's certainly compelling statistical evidence that the risk retention is correlated with performance.

VICE CHAIRMAN FISCHER. And another question, the -- looking through the proposed rules, which are really very impressive. And look reasonably complicated to those who don't know the field. I assume there's a lot of pressure for relaxing the requirements when this all was being discussed. And how much sort of did you have to insist that this is going to happen. I now see there's a few areas where there are compelling reasons to make the originator not have to retain some of the risk. How big was that?

SCOTT ALVAREZ. I don't know how we size that. The QRM space, the mortgage space, that's a statutory exception. So the pushback there was about how you define QRM versus QM. And there was -- as Karen explained, there was quite a lot of debate and a lot of thought about where exactly to draw that line to ensure that there would still be access to credit while making meaningful risk retention. And the CLO space, I think, was the place where there was the most comment requesting an exception. And for the reasons we explained, we decided to recommend not allowing an exception in the CLO place. I think with the other markets, we actually were pretty comfortably within what is market practice, and what the statute requires, so there's not a lot of -- there wasn't a lot of controversy in the auto loans or the CMBS or the corporate space. Is there any other comments?

VICE CHAIRMAN FISCHER. Thank you Madame Chair.

CHAIR YELLEN. Governor Tarullo.

GOVERNOR TARULLO. Thank you Madame Chair. I think this is probably directed to Karen and Adam. With the contemplation in this reg of a review, within four or five years, what kinds of developments will staffs of the relevant agencies be monitoring? And what would be a potential trigger for an earlier review than the four years that's contemplated in the draft reg?

KAREN PENCE. Of course in the mortgage space, we'll be looking very closely at access to credit. As you know, credit scores of residential mortgages still remain quite high. Much higher than they were pre-crisis. So I think before we started to get concerned, we'd really have to see an extension of credit that it's a little hard to say what normal is, but it certainly wasn't today's market standards. And then within the securitization markets, of course return to some of the risky practices. To date, the mortgage securitization markets are quite muted. I mean there's no signs of pressures there at all. So I think we're still, you know, a few years away from being in a place where red flags would come up for us.

GOVERNOR TARULLO. Is there a contemplated inner agency -- an ongoing inner agency staff process to do this kind of monitoring and discussion?

KAREN PENCE. We certainly talk frequently. Okay [chuckles]

GOVERNOR TARULLO. Thank you Madame Chair.

CHAIR YELLEN. Governor Powell.

GOVERNOR POWELL. Thank you Madame Chair. So has -- is this the sort of global market where we have to think about competitive balance between jurisdictions, and can you -- I don't know which of you this would be addressed to, but what have other jurisdictions done on risk retention for securitization? And is that a consideration for these markets?

TOM BOEMIO. So one of the things that we did take into consideration was the EU risk retention framework that they put into place I believe in 2011. And there's a couple of differences between our framework and the EU framework. First, the EU framework puts the onus on the investors to ensure that the sponsor, or securitizer retains the 5 percent in the transaction. So essentially the investor cannot buy anything where they haven't gotten a warranty if you will, or a piece of paper saying that this sponsor has retained 5 percent. Two, the European framework allows the use of unfunded credit enhancement. Such as letters of credit, or credit derivatives, and that's something that we don't allow under our final rule. As you know, during the crisis there were problems that arose with more than a few institutions with unfunded enhancements where they didn't perform, and then basically you had that knock-off effect. So that's where a potential rub could occur. The -- but many of the risk retention options are similar.

GOVERNOR POWELL. Bottom line, it's a fairly level playing field then Tom.

TOM BOEMIO. Well the -- depends upon if you're a European issuer. You may have problems with coming up with a funded credit enhancement. Or you may have more concern about it because it could cost you more.

APRIL SYNDER. But also under the rule there is a safe harbor for foreign securitizations that have limited connection to the United States. So if the sponsor is not a U.S. person. And a U.S. person does not include the foreign branches or agencies of U.S. banks, but it would include the U.S. branches and agencies of foreign banks. If you're not a U.S. person, you will not have to re-comply with the risk retention requirements of the final rule, as long as a couple of things are satisfied. One is that no more than 10 percent of the value of the securitization can be sold or transferred to U.S. persons. And the other is if the foreign sponsor who's not a U.S. person is 50 percent owned – 50 percent or more owned by an entity that also 50 percent or more owns a U.S. person, the foreign sponsor cannot acquire more than 25 percent of the collateral in the pool that's being securitized abroad from that U.S. person that's in their affiliated group. So that would allow a lot of foreign securitizations to not have to comply with the rule.

Great. Thank you.

SCOTT ALVAREZ. And we did try to address some concerns that foreign securitizers had raised with us, to try and take care of some of the -- or smooth out some of the potential bumps.

GOVERNOR POWELL. That's helpful. Thank you. Just one other question Scott, something you said at the beginning. I want to make sure I understood correctly. Is it the case that the asset managers -- that any party that's not regulated by a prudential regulator now, automatically is regulated by the SEC? Is that what I heard you say?

SCOTT ALVAREZ. Yes. So under -- the statute lays out the jurisdiction for enforcement of compliance with the rule. And the way it's laid out, the federal banking agencies have authority over ensured depository institutions, which does include in the definition, U.S. branches of foreign banks. And everybody else is subject to the SEC. Thank you.

CHAIR YELLEN. Governor Brainard.

GOVERNOR BRAINARD. Thank you Madame Chair. So are you satisfied that the definition of qualified mortgage, which was really a definition that was developed for consumer protection reasons, will -- if as proposed in the rule, it's adopted as the definition of qualified residential mortgages, also satisfy the need for incentive alignment, and for investor protection that's really the thrust of this rule?

KAREN PENCE. Right. And of course you're hitting on the issue that staff spent an awful lot of time and stomach lining trying to figure out. I think, you know, the crucial issue -- the crucial motivation for risk retention is this idea that the investors don't have all the information that the sponsors have. And there's a feature of the QM which is particularly helpful along that respect. Which is the full documentation of income and assets. Which, of course, was not something we knew about when we originally proposed the rule. It's hard to believe that now, but if you look back at the years going up to the run up of the crisis, you know, 40 percent of sub-prime purchase mortgage originations did not have full documentation of income. And if you look at the academic literature, where they've found misaligned incentives and information problems, it's in the low document space. They're not finding it as much in the full documentation space. So we do think those full documentation requirements are going to go quite a bit towards, you know, ameliorating some of the investor concerns. There also have been other changes in securitization markets. For of course the Securities and Exchange Commission released their Regulation AB, which requires a lot more disclosure to investors about what's in the transactions. And crucially requires that disclosure three days in advance of when the securities go for sale. So we do think that, along with some other reforms in the securitization market, some of the changes made by the GSE's in industry for example. Mean that a lot of the information asymmetry that was a big problem before, has partially been addressed by changes. So on balance, we do think this is a reasonable place to end up. Of course we have left open the, you know, the re-review in five years to see if change -- you know, if our judgment should change.

GOVERNOR BRAINARD. Thank you. The second question, if this rule had been in place over the course of the last year or two years, to what extent do you think it would have addressed our concerns about excessive risk-taking and deteriorating underwriting standards in the leveraged loan space? And how do you think terms, volumes, underwriting standards might be different today?

ADAM ASHCRAFT. Understood. So I think it's important to observe that the CLE market only has about a 50 percent market share of the leverage loan market. And in the past few years the CLE market share was actually relatively low, as investors coming through mutual funds were bidding up the prices of leverage loans. So an effective rule on CLO's might have further constrained their market share, but might not have had an overall effect on the leverage loan market. I think the only caveat to that is if the way that lead arrangers decided to implement the rule would have been to choose to retain the risk themselves. That would have protected the broader market from risk insensitive pricing. And could have done a lot more to moderate the underwriting cycle. So I think it depends in part on how the rule is implemented.

CHAIR YELLEN. Well thank you. Before asking for motions, I would like to ask each of my colleagues to state your position on the rule. Maybe we'll start with Vice Chair and ?

VICE CHAIRMAN FISCHER. I'm in favor of agreeing to the rule.

CHAIR YELLEN. Governor Tarullo?

GOVERNOR TARULLO. I as well Madame Chair.

CHAIR YELLEN. Governor Powell?

GOVERNOR POWELL. As do I. I'm happy to support the rule.

CHAIR YELLEN. Governor Brainard?

GOVERNOR BRAINARD. yes

CHAIR YELLEN. And likewise. With that then, I need -- we'll have two motions. The first is as follows. I need a motion to approve the proposed joint final rule, implementing the securitization credit risk retention requirements of Section 941 of the Dodd- Frank Act.

VICE CHAIRMAN FISCHER. So moved Madame Chair.

OTHERS. Second. Second.

CHAIR YELLEN. All in favor?

ALL: Aye. Aye.

CHAIR YELLEN. And second, I need a motion to authorize staff to make technical, non-substantive changes prior to publication in the Federal Register.

VICE CHAIRMAN FISCHER. So moved Madame Chair.

GOVERNOR TARULLO. Second.

CHAIR YELLEN. All in favor?

ALL. Aye. Aye.

CHAIR YELLEN. Okay.

Both motions passed. Thank you everybody for the --. – excellent, excellent work that you've done. And at this point I'd like to call a recess in our meeting for a few minutes.