BETTER MARKETS
TRANSPARENCY · ACCOUNTABILITY · OVERSIGHT

August 1, 2011

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20th Street and Constitution Ave, NW
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Docket No. R-1411

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File No. S7-14-11

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FR-5504-P-01

Re: Credit Risk Retention

Dear Ladies and Gentlemen:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rules (the "Proposed Rules") issued jointly by the Office of the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Securities and Exchange Commission, and the Department of Housing and Urban Development (collectively, the "Agencies"). The Proposed Rules would implement credit risk retention requirements for securitizers of asset-backed securities ("ABS"), as required by Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). The Proposed Rules also would establish exemptions from the risk retention requirements for ABS comprised of certain types of qualifying loans.

[1] Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

INTRODUCTION

If properly structured and regulated, the securitization markets can be an important source of affordable credit for households, businesses, and state and local governments. However, when the securitization process is corrupted through reckless or fraudulent origination of the underlying financial assets, coupled with a lack of transparency and disclosure regarding the nature of those assets, then enormous harm can be inflicted on the entire financial system.

It was precisely this type of broken securitization market that contributed so heavily to the financial crisis. In the years leading up to the crisis, the "originate to distribute" model became pervasive in the residential mortgage market. Loans were originated for the express purpose of being sold into securitization pools, allowing lenders to reap abundant fees without bearing the credit risk of borrower default.[2] This widespread practice ultimately led to the accumulation of massive amounts of high-risk mortgage-backed securities in the hands of financial institutions and investors of all stripes. The situation epitomized the very concept of systemic risk, and when the housing bubble burst, it took a huge toll on markets, investors, and the economy.

Simply put, the securitization process was the conveyor belt that loaded financial institutions and investors up and down the line with toxic securities that continue to cripple the balance sheets of banks (and Government-Sponsored Enterprises) as foreclosures continue at historically high levels.

This horrendous situation was allowed to unfold because the laws and regulations in place before enactment of the Dodd-Frank Act suffered from glaring—and ultimately extremely costly—gaps and deficiencies. To address these problems, and to ensure that the securitization markets would never wreck such havoc again, Congress passed Subtitle D of Title IX of the Dodd-Frank Act, including the risk retention provisions.

Although many commenters have raised legitimate concerns about the impact of risk retention on the ***housing*** market, the Agencies must not lose sight of the Congressional resolve to repair a deeply flawed ***securitization*** market. The Dodd-Frank Act clearly requires that the provisions in Subtitle D, including Section 941, be implemented as set forth and not diluted, changed, or evaded to achieve other social policy goals, no matter how worthy. Those matters can be and must be addressed through other means.

This position is warranted on two grounds. First, legally, the Agencies must adhere to the overriding Congressional policy underlying Title IX of the Dodd-Frank Act, and that policy is reducing systemic risk and increasing investor protection. Second, the same conclusion is compelled by a cost-benefit analysis. If the securitization markets are not repaired properly, and they trigger another financial meltdown, then the resulting harm to all consumers—especially those of modest means who seek mortgage financing—will far outweigh any burdens associated with a narrow qualified residential mortgages exemption in the Proposed Rules.

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[2] Release at 24095.

As a highly respected columnist, Gretchen Morgenson, noted recently, "[w]hile we are discussing societal costs, let's not forget how minority borrowers and first-time homebuyers were the targets of predatory lenders who lured them into toxic loans loaded with fees."[3] Making the devastating impact of the financial crisis on families clear, Ms. Morgenson also discussed a recent Pew Research Center study:

> "A study issued last week on the widening wealth gap between minorities and white Americans points to the costs of predatory lending. Conducted by the Pew Research Center, a nonpartisan organization, the study notes that housing woes were the principal cause of precipitous declines in household net worth among both Hispanics and blacks from 2005 through 2009. The organization found that, adjusted for inflation, the median wealth of Hispanic households fell by two-thirds during that period. The wealth of black households declined 53 percent. The net worth of white households fell only 16 percent."[4]

Given the magnitude of these and other costs inflicted by the financial crisis, weakening critical protections designed to prevent a recurrence is not an option. The law is clearly intended to make the financial system more stable and to eliminate incentives for fraud, predatory behavior, and outright criminal conduct. It must be implemented with these ends foremost in mind.

THE DODD-FRANK ACT

The Dodd-Frank Act includes several important remedies designed to address the current flaws in the securitization market. Subtitle D of Title IX establishes a framework under which securitizers must retain at least 5% of the risk associated with the assets underlying a securitization, subject to exemptions for assets that are by design of high quality and low risk. In addition, securitizers as well as Nationally Recognized Statistical Rating Organizations ("NRSROs") must assume new responsibilities for reviewing assets in a securitization pool, making disclosures regarding those assets, and informing investors about the representations and warranties to which they are entitled in connection with an ABS investment.[5]

The focus of the Proposed Rules is specifically on the risk retention requirement established in the Dodd-Frank Act. The rationale for this requirement is that forcing a securitizer to assume risk exposure will create a strong incentive for that securitizer to monitor and control the quality of the assets being brought into the securitization pool. This incentive helps "align the interests of the sponsor with those of investors in ABS," ultimately resulting in better quality ABS and less systemic risk.[6]

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3 Gretchen Morgenson, *Some Bankers Never Learn*, New York Times, July 31, 2011.

4 *Id.* (citing Rakash Kochhar, Richard Fry & Paul Taylor, *Wealth Gaps Rise to Record Highs Between Whites, Blacks and Hispanics*, Pew Research Center (July 26, 2011)).

5 Sections 945, 942, and 943, respectively, of the Dodd-Frank Act.

6 Release at 24100.

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OVERVIEW OF PROPOSED RULES

The Proposed Rules have essentially three components. First, they establish the basic risk retention requirements by specifying that securitizers must retain a minimum of 5% of the risk associated with the assets underlying an ABS. The risk may be retained in one of several forms, including vertical, horizontal, and other configurations. The securitizer must make certain disclosures to investors regarding the form and amount of the securitizer's retained interest, and the risk retained is subject to restrictions on hedging and transfer.

Second, the Proposed Rules define the universe of mortgages, known as "qualified residential mortgages" or "QRM," that are not subject to any risk retention requirements. To define QRM, the Proposed Rules establish a comprehensive set of criteria relating to the nature of the residential property, the borrower's credit history, the mortgage payment terms, and down payment amounts.

Finally, the Proposed Rules establish the underwriting standards that warrant reduced risk retention requirements for ABS backed by other types of financial assets, including qualifying commercial real estate loans and commercial or automobile loans.

The Release acknowledges the potentially disruptive effects that the risk retention requirements may have on securitization markets and on the "flow or pricing of credit to borrowers and businesses."[7] However, the Release also reflects a belief that a relatively narrow exemption for QRMs is nevertheless appropriate. The Release explains that because QRMs will be totally exempt from the risk retention requirements, the underwriting standards and product features for QRMs should ensure that such residential mortgages are of "a very high quality."[8] In addition, the Release observes that if the QRM definition is too broad, then the supply of non-QRM mortgages will become so small that the securitization market for those mortgages will become illiquid, adversely affecting access to credit for many would-be homeowners.[9]

SUMMARY OF COMMENTS

We offer two types of comments on the Proposed Rules. First, the Proposed Rules need to be strengthened to ensure that the basic risk retention framework achieves its intended purposes. Specifically—

- The Proposed Rules must establish specifically tailored risk retention levels at or above the minimum 5% rate for different classes of ABS, and must further establish an economic rationale for each level.
- Similarly, the Proposed Rules must correlate risk retention levels with each of the permitted forms of risk retention.

[7] Release at 24118.
[8] Release at 24117.
[9] Release at 24118.

- The Proposed Rules must close or narrow the exceptions to the prohibitions against the transfer or hedging of any risks retained, so that those exceptions do not eviscerate the statutory requirements.

- The Proposed Rules must more clearly allocate the risk retention obligations among multiple sponsors.

Second, rather than address the specific provisions dealing with the exemptions from the risk retention requirements, including the definition of QRM, we urge the Agencies to adhere to this **fundamental guiding principle**: The Proposed Rules should be written above all to achieve the risk-mitigation and investor protections goals embodied in the Section 941 of the Dodd-Frank Act, rather than to advance any particular housing policy objectives. To the extent the risk retention requirements and the QRM exemption create impediments to home ownership or otherwise disrupt the housing market in undesirable ways, those issues can and should be addressed through separate, targeted legislative or regulatory measures.

COMMENTS

The Proposed Rules Must Establish Specific Risk Retention Levels at or Above the Minimum 5% Rate for Different Classes of ABS, and Must Further Establish an Economic Rationale for Each Level.

The actual quantum of risk retention imposed on securitizers is at the very core of the risk-mitigating protections that the Dodd-Frank Act establishes. Section 941 requires that the Proposed Rules impose a risk retention requirement of ***not less*** than 5% of the credit risk for any asset that a securitizer conveys through the issuance of an ABS, absent an exemption. The statute thus establishes a floor, and leaves the precise magnitude of risk retention to be set by the Agencies.

However, as a general matter, the Proposed Rules simply incorporate the "not less than 5%" formulation, without regard to the nature of the ABS or the form of the risk retention. Moreover, the Proposed Rules do not offer an economic rationale for the decision to adopt the statutory 5% minimum as the uniform benchmark in the rules. This approach is arbitrary and fails to implement the statute as intended.

The Proposed Rules must adopt a specific, minimum risk retention requirement for each type or class of ABS. Moreover, the levels set must be derived from objective criteria that reflect the particular risks associated with the various types of ABS. Those criteria may include the terms of the assets underlying the ABS; the form in which the risk is to be retained; expected losses based upon historical data and future scenarios; typical underwriting fees; priority of security interests in or other claims on cash flow from the assets being securitized; and additional metrics such as interest rate spreads relative to benchmark indices.

Establishing more carefully tailored risk retention levels will certainly enhance the risk mitigation and investor protection functions intended under Section 941. At the same time, such an approach will help ensure that the credit markets are not *unnecessarily* burdened by the risk retention requirements. More precisely quantified and rationally-based risk retention percentages will serve both goals.

The Proposed Rules Must Correlate Risk Retention Levels with Each of the Permitted Forms of Risk Retention.

The Proposed Rules would allow sponsors to retain risk in a wide variety of forms, including vertical, horizontal, and "L-shaped" (i.e. hybrid) risk retention. As explained in the Release, these options are "designed to take into account the heterogeneity of securitization markets and practices, and to reduce the potential for the Proposed Rules to negatively affect the availability and costs of credit to consumers and businesses." [10]

This accommodation to market practices may be reasonable, but only if the required risk mitigation and investor protection rationale in Section 941 of the Dodd-Frank Act does not suffer. It is not at all clear that this test has been met. For example, the Proposed Rules do not differentiate among the various forms with respect to the required level of risk retention: they are each subject to the "not less than 5%" standard. However, it is exceedingly unlikely that each form of risk retention will prove equally effective in achieving the risk mitigation and investor protection goals underlying Section 941.

For instance, horizontal risk retention is presumptively more effective than the vertical form, since it exposes the securitizer to greater risk, yet the Proposed Rules do not compensate for this disparity by establishing a ***higher*** risk retention requirement for those who elect the vertical form. To account for these differences, the Proposed Rules should set a higher minimum risk retention level where a sponsor elects to retain risk in the vertical form. More generally, the Proposed Rules should carefully evaluate the risk profile for each form of risk retention, and adjust the minimum level of required risk retention accordingly.

The Proposed Rules Must Strengthen the Prohibitions Against the Transfer or Hedging of Any Risks Retained.

The Dodd-Frank Act clearly prohibits a securitizer from "directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain with respect to an asset."[11] This is a profoundly important element of the new risk retention framework and key to making the entire system safer as well as less prone to failure and bailouts. Unless this prohibition is implemented in a robust way, the risk retention requirement will become essentially meaningless, as any securitizer could hedge its retained risk and thereby shed any incentive to ensure that the assets underlying a securitization transaction were of high quality.

The result would be a reversion to the disgraced "originate to distribute" model, which inundated the financial system with toxic time bombs that would inevitably explode but only after the originators had reaped their profits and washed their hands of their originations. That must not be allowed to happen again.

The Proposed Rules do not fully implement this prohibition against the transfer or hedging of retained risk, because they allow too much partial or indirect hedging. For

[10] Release at 24101.
[11] Section 941 of the Dodd-Frank Act.

example, the Proposed Rules would allow a sponsor in a securitization to purchase or sell a related financial instrument, provided that the payments on the financial instrument were not "**materially** related" to the credit risk of one or more particular securitized assets.[12] Therefore, if the relationship between the hedge and the securitized asset is something less than "material"—but potentially still significant—the hedge would be permitted. Moreover, the term "material" is ambiguous, inviting questions that are not addressed in the Proposed Rules. For example, how would "materiality" be measured, by whom, and over what time frame?

The Release itself increases the concerns surrounding this type of weak or partial hedge by describing examples of permitted transactions. They would include "hedges related to overall market movements, such as movements of market interest rates . . . , currency exchange rates, home prices, or of the overall value of a particular broad category of asset-backed security."[13] In addition, and even more troubling, "hedges tied to securities that are backed by similar assets originated and securitized by other sponsors, also would ***not*** be prohibited."[14]

The Proposed Rules include yet another type of permitted hedge that undermines the risk retention requirements. As explained in the Release, the Proposed Rules would allow a sponsor to purchase instruments that are based on an index, even where the index is comprised of a certain percentage of ABS from transactions in which the sponsor is involved.[15] Such hedges would be permitted as long as no single class of ABS from the sponsor's transaction comprised more than 10% of the index, and as long as all classes of ABS from the sponsor's transaction did not comprise more than 20% of the index.

The hedges described above would clearly enable a securitizer to reduce to some degree the risks that it would otherwise be forced to retain under Section 941. They constitute partial or indirect hedges **in direct conflict** with the statutory prohibition. Moreover, techniques could undoubtedly be devised to use the hedging increments allowed under the Proposed Rules to, in effect, negate the entire risk retention exposure.

The law in Section 941 flatly prohibits a securitizer from "directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain."[16] This plain and clear language encompasses any form of hedge, whether full or partial, material or immaterial, or strong or weak. The Proposed Rules must be amended to conform fully to the law and preclude such transactions. Otherwise, the risk retention requirements will be gutted.

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[12] Release at 24116. The Proposed Rules are at least ambiguous on this point. The provision on hedging appears to provide in a separate paragraph that any hedge is prohibited if it "in any way reduces or limits the financial exposure of the sponsor" to its credit risk. Release at 24164. However, this language conflicts with the prohibition against a "material" relationship between retained risk and any hedge, since the materiality test clearly implies that hedges involving non-material but still meaningful relationships would be permitted. Moreover, none of this language negates what are essentially unacceptable loopholes for certain specific types of hedges, as described above in the text, which certainly would reduce the required risk exposure to some degree.

[13] *Id.*

[14] *Id.* (Emphasis added.)

[15] *Id.*

[16] Dodd-Frank Act § 941(b).

The Proposed Rules Must More Clearly Allocate the Risk Retention Obligations Among Multiple Sponsors.

In situations where two or more entities each meet the definition of "sponsor" in connection with a single securitization transaction, the Proposed Rules would simply require that one of the sponsors retain the necessary credit risk, without specifying any standards that would determine which sponsor should bear the risk.[17]

This provision affords too much discretion to the sponsors in a given transaction, which increases the risk of evasion. For example, this approach fails to account for the possibility that a shell entity or an entity with little or no involvement in the securitization process might be designated as the risk-retaining entity. This scenario would undermine the goals of the Dodd-Frank Act, since a sponsor that is in fact controlling the assembly of assets for a securitization might entirely evade the risk retention requirement through the designation mechanism. This in turn would destroy the incentives for ensuring that high quality assets are involved in the securitization, thus undermining the alignment between the interests of securitizers and investors that the Dodd-Frank Act intended to establish.

The Proposed Rules must stipulate how the risk retention obligations will be allocated between or among multiple sponsors. The formula should be designed to maximize the risk-mitigating impact of the risk retention requirements. The most obvious solution is to insist that *each* sponsor be subject to an appropriate risk retention amount (no less than 5%) as to all assets that it contributes to the trust or pool. Alternatively, the rules could require the entity exercising the most control over the securitization to retain the full amount of appropriate risk (again, not less than 5%), subject to controls that would prevent the use of shell entities without significant assets to manage the securitization.

The Proposed Rules Should Be Written to Reduce Systemic Risk and Protect Investors, in Accordance With the Dodd-Frank Act, Not to Achieve Housing or Other Policy Goals.

The Proposed Rules have drawn a great deal of attention from public interest groups, lending institutions, and members of Congress. These commenters have focused largely on the exemption from the risk retention requirements for QRMs and the impact that the terms of the exemption—most notably the 20% down payment requirement—will have on the housing market.

For example, numerous commenters have argued that the down payment requirement for QRM in the Proposed Rules is too restrictive, and unless reduced, will raise the cost of mortgages for those who can least afford such an increase, reduce access to home ownership for creditworthy borrowers, and imperil the nation's fragile housing recovery.

While these are legitimate issues in the context of housing policy, they should not serve as the dominant considerations as the Agencies finalize the Proposed Rules implementing the risk retention requirements. Instead, the ***risk mitigation and investor protection goals*** that underlie the Dodd-Frank Act should determine the framework for risk retention, including the scope of the exemption for QRMs. To the extent that the

[17] Release at 24098-99.

Proposed Rules are suggested to have an unavoidable and undesirable impact on the housing market—a matter of understandable concern—the best way to address that impact is through other legislative or regulatory measures in the housing arena that specifically target those potential problems.

There is no question that Congress's primary aim in enacting the risk retention provisions in Section 941 of the Dodd-Frank Act was to mitigate systemic risk in the securitization markets, not to promote specific housing policies. Section 941 ensures that securitizers retain an economic interest in the credit risk of the assets they securitize. This in turn creates an incentive to increase the quality of those assets. As observed in the legislative history—

> When securitizers retain a material amount of risk, they have "skin in the game," aligning their economic interest with those of investors in asset-backed securities.[18]

Congress's overriding concern with market stability and investor protection, extending well beyond the housing market, is evident from other provisions in the Dodd-Frank Act. For example, the risk retention measures established in Section 941 are not limited to residential mortgage-backed securities. The definition of "asset-backed security" is extremely broad, encompassing "any type of self-liquidating financial asset . . . that allows the holder of the security to receive payments that depend primarily on cash flow from the asset." This covers securities backed not only by residential real estate, but also by commercial real estate, commercial paper, and automobile loans.

In addition, Subtitle D of Title IX of the Dodd-Frank Act includes a number of provisions unrelated to risk retention, which are aimed at improving the integrity of the securitization process. Once implemented in Agency rules, those provisions will require issuers of ABS to disclose asset-level or loan-level data to investors under the securities laws (§ 942); to review the assets underlying the ABS and disclose the nature of that review (§ 945); and to disclose to investors fulfilled and unfulfilled repurchase requests relating to outstanding ABS offerings (§ 943). Further, the Dodd-Frank Act requires NRSROs to include in their credit rating reports the representations and warranties available to investors in connection with ABS offerings (§ 943).[19]

Hence, to the extent there is any conflict between restoring the integrity of the securitization market through risk retention requirements on the one hand, and promoting home ownership or advancing other housing policy objectives on the other, the former must prevail. This was the intent of Congress as reflected in the provisions of Subtitle D of Title IX of the Dodd-Frank Act, and it must be implemented as the Proposed Rules are finalized.

[18] Release at 24096 (quoting S. Rep. No. 111-176, at 128 (2010)).

[19] Section 941 notes that any exemptions from the risk retention requirements must "improve the access of consumers and businesses to credit on reasonable terms." However, this lone reference appears among a litany of other goals, all related to risk mitigation and investor protection, including achieving "high quality underwriting standards," encouraging "appropriate risk management practices," and "the protection of investors."

CONCLUSION

We hope these comments are helpful as you finalize the Proposed Rules.

Sincerely,

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