REALIGNING INCENTIVES: REFORMING THE SECURITIZATION MODEL UNDER DODD-FRANK

CLAYTON BANGSUND*

I. INTRODUCTION

In the aftermath of the 2008 financial crisis, commonly described as the "most severe financial crisis since the Great Depression",[1] there has been a plethora of commentary that identifies, or purports to identify, its origins. Most commentators readily acknowledge that there was no one identifiable cause. Rather, it is widely believed that a number of inextricably linked factors created the "perfect storm" that precipitated the crisis.[2]

Despite the absence of a single "smoking gun", conventional wisdom is that securitization was one of the chief causes of the financial crisis. This notion, though certainly true to an extent, is somewhat misleading. Securitization, *per se,* did not

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[1] THE DEPARTMENT OF THE TREASURY, FINANCIAL REGULATORY REFORM – A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (June 2009), available at <http://www.financialstability.gov/docs/reg/FinalReport_web.pdf> (referred to herein as "A New Foundation") at 2; Also see Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, *The Causes and Current State of the Financial Crisis*, Address Before the Financial Crisis Inquiry Commission (January 14, 2010), available at <http://www.fdic.gov/news/news/speeches/chairman/spjan1410.html> (referred to herein as "Bair Testimony"); Also see FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT (January 2011) (referred to herein as the "Financial Crisis Inquiry Report") at xv.

[2] AMERICAN BAR ASSOCIATION – BANKING LAW COMMITTEE – BUSINESS LAW SECTION, THE FINANCIAL CRISIS OF 2007-2009: CAUSES AND CONTRIBUTING CIRCUMSTANCES (September 2009) (referred to herein as the "ABA Report") at 3. The American Bar Association succinctly describes the interconnectedness of numerous contributing factors to the financial crisis, as follows: "Our report does not seek to assess blame for the crisis. We believe that blame can be laid in many quarters, including financial institution managers who pursued risky business practices with inadequate internal controls, federal supervisors who failed to reign in unsound practices and correct risk management weaknesses, federal and state regulators who failed to adequate regulate nonbank mortgage originators or supervise investment banks, government policies that created moral hazard, homebuyers who unrealistically assumed that housing prices would continue to rise indefinitely and incurred debt they could not realistically repay, credit rating agencies that issued flawed credit ratings, lawmakers who perpetuated public policies that fueled the housing bubble, and investors who took irresponsible risks. Fraud appears to have had its place in the crisis as well."

cause the crisis. Instead, it is more accurate to say that the critical deficiency in the securitization model was the absence of a regulatory framework that properly aligned the interests of loan originators, securitizers and investors. This flawed securitization model, in turn, was a significant contributing cause of the financial crisis. Thus, while securitization may have been used as a means of offloading risk associated with poorly underwritten loans and lining the pockets of a select few financial industry participants, it should not itself be mistaken for the culprit; which is to say that securitization does not inevitably lead to financial disaster.

In the depths of the financial crisis, the U.S. government poured money into a massive bailout of many of Wall Street's most recognizable firms.[3] Although using taxpayer dollars to rescue Wall Street seemed repugnant,[4] the alternative of risking a complete financial system collapse was even more troublesome. Thus, stabilizing the financial system trumped the principled free-market philosophy of "live and let die". The bailout prevented a financial system meltdown and arguably averted disaster. Congress subsequently turned its collective mind to legislative reform designed to prevent the recurrence of a similar crisis in the future. In July 2010, President Barack Obama signed into law the *Dodd-Frank Wall Street Reform and Consumer Protection Act*.[5] The Dodd-Frank Act derives its name from its chief architects, Senator Christopher Dodd and House Representative Barney Frank.

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[3] Financial Crisis Inquiry Report, *supra* note 1 at xvi.

[4] ANDREW ROSS SORKIN, TOO BIG TO FAIL (New York, Penguin Books 2009) (referred to herein as "Too Big to Fail").

[5] Pub. L. No. 111-203, 124 Stat. 176, H.R. 4173 (2010) (referred to herein as the "Dodd-Frank Act").

The Dodd-Frank Act implements financial regulatory reform in an effort to address a wide array of perceived deficiencies in the financial system. One might describe certain aspects of the Dodd-Frank Act as "skeletal" in nature. Although quite expansive in some respects, in others it merely identifies a subject matter, enunciates rules of general application in respect thereof, and directs government agencies to prescribe regulations that give more elaborate content to the general legislative rules. Subtitle D of Title IX, which is aimed at improving the asset-backed securitization process, falls into this latter category of "skeletal legislation". In this paper, I discuss whether, and to what extent, the provisions of Subtitle D will successfully improve the securitization process and help ensure the avoidance of a financial crisis in the future. In order to address these issues, it is necessary to understand why securitization was introduced as a financial tool, and how securitization both evolved and devolved in the years leading up to the financial crisis. The next paragraph sets out a "roadmap" of how this paper addresses the relevant issues.[6]

Part II describes the "originate to hold" lending model traditionally employed by mortgage lenders, and identifies the benefits and drawbacks of such model. Part III describes the "originate to distribute" lending model and, in the same vein as Part II, identifies its potential benefits and drawbacks. In addition, Part III describes the "originate to distribute" model's ascension as a financial industry tool and explains

[6] Although a vast array of assets can be securitized, discussion in this paper tends to focus on the securitization of residential real estate mortgages. This is because mortgage securitization was significantly connected to the housing bubble (and to the ultimate bursting of such bubble), which itself is intimately connected to the 2008 financial crisis. See ABA Report, *supra* note 2 at 6.

how it contributed to the 2008 financial crisis. Part IV describes §941 of Subtitle D, Title IX of the Dodd-Frank Act, and the regulators' proposed rules in respect thereof. In Part V, I critically examine §941 in an effort to determine whether, and to what extent, the amendments introduced thereunder will improve the securitization process and help prevent another major financial crisis from recurring in the future. Part VI sets out my conclusions.

II. THE TRADITIONAL "ORIGINATE TO HOLD" LENDING MODEL

Under the traditional mortgage-lending model, a financial institution (generically referred to herein as a "lender") lends money to a debtor, who in turn grants the lender a mortgage on the property in order to secure repayment of the debt. In the event of debtor default, the lender may force sale of the property through foreclosure proceedings. The proceeds of the sale are applied against the outstanding debt, and the surplus, if any, is paid to the debtor. Under this model, the mortgage debt constitutes an asset that is listed on the lender's balance sheet.[7] The lender's profit is the spread between the interest rate charged on the mortgage loan and the interest rate it pays to fund such loan.

Under the traditional lending model, the lender is highly incentivized to undertake a detailed due diligence process prior to advancing the loan. The due diligence involves a review of various factors, but perhaps the two most important

[7] R.S. CARNELL, J.R. MACEY & G.P. MILLER, THE LAW OF BANKING AND FINANCIAL INSTITUTIONS (New York, Aspen Publishing, 4th ed. 2009) (referred to herein as "The Law of Banking") at 372.

questions the lender is interested in answering are: (i) whether the debtor has the ability to make the stipulated mortgage payments, and (ii) whether the value of the mortgaged property is sufficient to satisfy the debt in the event of debtor default.[8]

The debtor's ability to pay is ascertained by, among other things, reviewing the debtor's credit history, investigating whether the debtor has a stable source of income to facilitate mortgage payments (i.e. a job or steady investment income), and determining the debtor's net worth (i.e. whether the debtor has a large nest-egg that is available to be liquidated and applied against the mortgage debt in the event the debtor's income stream dries up).

Property value is ascertained by reviewing recent sales data in the community and neighborhood in which the property is located, and obtaining an appraisal from a qualified appraiser. Determining the property value is important because most states have anti-deficiency laws that prevent a mortgage lender from pursuing the mortgagor for a deficiency in the event that a foreclosure sale does not generate proceeds sufficient to cover the entire debt outstanding.[9]

Of course, determining property value has its limitations. Indeed, no person holds a "crystal ball" that can accurately predict the future value of real estate. Thus, under the traditional mortgage-lending model, a lender that primarily grants credit

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[8] Financial Crisis Inquiry Report, *supra* note 1 at 67. Tom Putnam, who testified before the Commission, is quoted as saying that mortgage lenders "traditionally lent based on the four C's: credit (quantity, quality, and duration of the borrower's credit obligations), capacity (amount and stability of income), capital (sufficient liquid funds to cover down payments, closing costs, and reserves), and collateral (value and condition of the property)."

[9] ABA Report, *supra* note 2 at 11.

in a particular geographic region is susceptible to incurring crippling losses in the event of a major downturn in the regional economy. Lost jobs create mortgage defaults and increase foreclosure rates. In turn, real estate prices plummet, potentially to the point where homeowners have a financial incentive to "walk away" from their mortgages without fear of being pursued by their lenders due to state anti-deficiency laws. This, in turn, transforms a lender's anticipated profits into realized losses. Simply put, the more regionally concentrated a lender's activities, the riskier its operations. The key to mitigating this risk, in the "originate to hold" model, is undertaking a thorough due diligence process at the loan underwriting stage.

III. THE "ORIGINATE TO DISTRIBUTE" LENDING MODEL

A. DESCRIPTION OF THE "ORIGINATE TO DISTRIBUTE" MODEL

1. "BASIC" MORTGAGE-BACKED SECURITIES

The origination of a mortgage loan, under the "originate to distribute" model (also referred to herein as the "securitization model"), does not differ from origination under the "originate to hold" model; the lender advances funds to the debtor and obtains a mortgage on the property that secures repayment of the loan. The key differences between the models appear after origination of the mortgage loan.

Under the securitization model, rather than holding the mortgage asset on its balance sheet, the originating lender subsequently bundles it with numerous others and sells the bundle to a special purpose vehicle (referred to herein as the "MBS Issuer"). The MBS Issuer, in turn, issues debt securities to its investors. These "mortgage-backed securities" (referred to herein as "MBSs", and more generically referred to as "asset-backed securities" or "ABSs") pay returns to the investors based on the cash flows generated by the underlying mortgage assets.

2. INCREASED COMPLEXITY THROUGH ISSUANCE OF TRANCHES

The preceding paragraph describes the simplest structure of an MBS issuance. In a more complicated structure, the MBS Issuer issues multiple "tranches" of debt securities to investors. The MBS issuer then utilizes a "waterfall" system to prioritize payments from the mortgage assets' cash flows. Using a simple example, imagine that an MBS Issuer issues three tranches of MBSs: Tranche 1, Tranche 2 and Tranche 3. Investors holding Tranche 1 securities are paid before investors holding Tranches 2 and 3. Tranche 2 investors are paid next, and to the extent there is any remaining cash flow after payment to Tranche 1 and 2 investors, Tranche 3 investors are paid the residue.

The tranche system gives investors a "menu" to choose from depending on their expected rate of return (lower tranches fetch a higher interest rate for investors) and their penchant for risk. Tranche 3 investors are at increased risk of losing their investment if there is widespread default among the underlying

mortgage assets. Meanwhile, Tranche 1 investors are reasonably well assured of realizing modest returns on their investment. Of course, MBS issuances, in practice, are much more elaborate and complicated than the basic illustration set out above.[10]

3. Collateralized Debt Obligations & Structured Investment Vehicles

As demonstrated in the preceding paragraphs, MBSs are complicated investment products. But the complexity does not end there. Innovative new structures, known as "collateralized debt obligations" (referred to herein as "CDOs") and "structured investment vehicles" (referred to herein as "SIVs"), are further utilized to "transform" low-level MBS tranches (which do not typically attract strong ratings from credit rating agencies) into low risk, high yield investments.[11] Essentially, both CDO and SIV structures see additional layers of securitization introduced to the investment product that is ultimately purchased by investors.

The notion underlying a collateralized debt obligation is that it further diversifies risk by pooling tranches of MBSs (and other debt securities) into a new special purpose investment vehicle, which subsequently issues long-term debt securities to its investors. The CDO securities pay returns to investors based on the

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[10] See Financial Crisis Inquiry Report, *supra* note 1 at 71. The Commission describes a $947 Million MBS issuance by CMLTI 2006-NC_2, involving the securitization of 4,499 subprime mortgages, divided into 19 tranches, 4 AAA, 3 AA, 3 A, 3 BBB, 2 BB, and 4 unrated; Also see Richard J. Rosen, *The Role of Securitization in Mortgage Lending,* (October 11, 2007) (referred to herein as the "Rosen Article"), available at <http://economistsview.typepad.com/economistsview/2007/10/the-role-of-sec.html> (last visited March 25, 2012). The author describes other features of MBS issuances, including interest rate risk, prepayment risk, subordination features, overcollateralization and excess spread.

[11] Bair Testimony, *supra* note 1; Also see Rosen Article, *id.*

cash flows from the underlying MBSs (which are dependent on the cash flows generated from the underlying mortgage assets). Like MBSs, CDOs are also issued in tranches, again giving investors a risk menu to select from.[12] In some cases, CDOs are securitized with pools of other CDOs, thereby earning the name "CDOs-squared".[13] CDOs are extremely complicated investment products. Indeed, even renowned former Federal Reserve Chairman, Alan Greenspan, has readily admitted that he does not understand them.[14]

Structured investment vehicles are similar to CDOs.[15] Like CDOs, SIVs pool debt securities from a variety of sources, including MBS Issuers. However, SIVs differ from CDOs in the debt securities they issue to their investors. Whereas CDOs typically fund themselves through the issuance of long-term debt securities to investors, SIVs fund themselves through the issuance of short-term and medium-term debt securities, and are thus at a higher risk of defaulting on their debt obligations.[16] Another distinguishing feature between CDOs and SIVs is that CDOs

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[12] Bair Testimony, *id.*; Also see Madlyn G. Primoff & David M. Eskew, *SIVs, CDOs and Structured Products in Distress: Cross-Border and Other Issues for Lenders and Investors*, The Americas Restructuring and Insolvency Guide (2008-2009) (referred to herein as the "Primoff & Eskew Article") at 135.

[13] Bair Testimony, *id*.

[14] Too Big to Fail, *supra* note 4 at 90. Alan Greenspan: "I've got some fairly heavy background in mathematics. But some of the complexities of some of the instruments that were going into CDOs bewilders me. I didn't understand what they were doing or how they actually got the types of returns out of the mezzanines and the various tranches of the CDO that they did. And I figured if I didn't understand it and I had access to a couple hundred PhDs, how the rest of the world is going to understand it sort of bewildered me."

[15] Bair Testimony, *supra* note 1.

[16] Primoff & Eskew Article, *supra* note 12 at 134; Also see Rosen Article, *supra* note 10.

generally retain static investment portfolios, whereas SIVs are more actively engaged in ongoing investment and reinvestment.[17]

B. BENEFITS AND DRAWBACKS OF THE SECURITIZATION MODEL

The securitization model offers various benefits. However, accompanying such benefits are a number of drawbacks. The most pronounced benefits and drawbacks associated with the securitization model are discussed below.

1. INCREASED LIQUIDITY

One key benefit of the securitization model is that it creates increased liquidity for loan originators. Rather than a lender holding a mortgage asset on its balance sheet and awaiting repayment of the loan over an extended period of time, it sells the asset for cash. The lender is then immediately able to put that cash to use by, for example, advancing additional loans to its borrowers. Indeed, securitization generates additional credit availability.[18]

2. SPREADING OF RISK

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[17] Primoff & Eskew Article, *id.* at 136.

[18] Department of the Treasury, Federal Reserve System, Federal Deposit Insurance Corporation, U.S. Securities and Exchange Commission, Federal Housing Financing Agency & Department of Housing and Urban Development, *Proposed rule re: Credit Risk Retention* (March 2011) (referred to herein as the "Proposed §15G Rules") at 13; Also see ABA Report, *supra* note 2 at 7; Also see Peter Went, *Securitization and Its Discontents*, (2011), available at <http://ssrn.com/abstract=1888410> (referred to herein as "Securitization and Its Discontents") at 3.

Another chief benefit of the securitization model is that it spreads risk. There are two distinct aspects to this risk-spreading characteristic. First, since MBSs are issued to numerous investors, a default on the underlying mortgage obligations has less impact on the investors, as a group, than it would have on the loan originator under the "originate to hold" model (who might encounter financial ruin by virtue of default on its mortgage assets). In other words, a large group of investors is better able to absorb a loss than a single entity.

Second, the "pooled" nature of MBSs has an inherent spreading effect. Investors are not investing in one mortgage asset, but rather in a diversified portfolio of mortgage assets. Even if several of the underlying mortgage obligations are in default, any losses associated with such defaults will be largely offset by the vast majority of mortgage obligations that are generating returns as expected. In this sense, securitization performs a quasi-insurance function.

Additionally, as noted above, the tranche system allows investors to make informed decisions about the amount of risk they are willing to incur. A conservative investor will tend toward Tranche 1 securities (which, in theory, will generate a lower, but more stable, rate of return), whereas a more liberal investor may opt to invest in Tranche 3 securities (which will generate a higher, but less stable, rate of return).[19] In summary, under a securitization model, rather than one loan originator bearing the risk of default on one particular mortgage, many

[19] Financial Crisis Inquiry Report, *supra* note 1 at 43.

investors, each of whom can "tailor" their investment to their specific risk tolerance, bear the risk of default on many mortgages.

3. PERVERSE INCENTIVES

One deficiency in an unregulated securitization model is that, to a certain extent, loan originators have less incentive[20] to undertake a thorough due diligence investigation at the loan origination phase. If a lender is aware that it will not hold a particular mortgage asset on its balance sheet, it has less reason to be concerned with whether the debtor has the ability to make stipulated mortgage payments, or whether the value of the home is sufficient to satisfy the debt in the event of debtor default.

An analogy between "secured lending", on one hand, and "home maintenance", on the other, helps illustrate the perverse incentives inherent in an unregulated securitization model. Using "due diligence" (in the lending context) as a proxy for "good maintenance" (of a residential home), one might analogize an "originate to distribute" lender to a residential tenant, and an "originate to hold" lender to a homeowner. Whereas a typical homeowner is motivated to maintain her home in order to preserve and increase its value, a typical tenant has no financial interest in the long-term value of the home and is therefore less likely to fuss over

[20] This point should not be overstated. It is not accurate to say that, under the securitization model, a loan originator has *no incentive* to conduct sound loan underwriting. For example, a loan originator that values its stellar reputation for sound underwriting typically desires to preserve such reputation. As such, it is less likely to devolve into shoddy loan underwriting procedures than a loan originator that is less concerned with its industry reputation.

minor (or major) maintenance. The same notion holds for the "originate to distribute" lender in an unregulated securitization model; the quality of the loan is of less concern to the lender provided it can offload the risk of debtor default onto the ultimate purchasers of the securitized investment product. This is to be contrasted with an "originate to hold" lender, who will have great concern with the quality of the loan. Thus, an "originate to distribute" lender is to a residential tenant what an "originate to hold" lender is to a homeowner.

While the "perverse incentives" problem described in the preceding paragraphs is serious enough, it is further exacerbated when coupled with commission-based compensation incentives for loan officers employed by "originate to distribute" lending institutions. If a loan officer is paid a fixed salary, she will have no incentive to stray from sensible loan underwriting standards.[21] If, however, her level of compensation is derived from the number of loans she originates, she will have less incentive to thoroughly scrutinize her potential borrowers. Sheer quantity of loans, rather than quality of loans, will be of primary importance. Thus, a commission-based compensation model, coupled with an unregulated "originate to distribute" lending model (in which the employer lacks any meaningful incentive to strictly scrutinize its employee's underwriting decisions[22]), is a recipe for disaster.

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[21] Indeed, adhering to strict standards may be her best job security, especially if the bank employs an "originate to hold" lending model. Under such model, her employer will bear the financial risk associated with any dubious loans she approves and issues.

[22] Of course, to the extent that a conscientious employer imposes, and vigilantly oversees and enforces, sensible underwriting guidelines, the "rogue employee" concern is mitigated.

Indeed, this is precisely the recipe that certain financial industry players were cooking with in the years and months leading up to the 2008 financial crisis.

C. THE FINANCIAL CRISIS: SECURITIZATION & OTHER AGGRAVATING FACTORS

The drawbacks of a largely unregulated securitization market, as described above, undoubtedly contributed to the financial crisis. However, certain other factors, closely related to and entangled with the securitization model, amplified securitization's harmful effects on the financial system. Although they are not the primary focus of this paper, several of the more pertinent factors are briefly described below.

1. CREDIT RATING AGENCIES

Credit rating agencies played a major role in the widespread distribution of MBSs and other securitized investment products. In order to attract investors, MBS Issuers sought credit ratings from major institutional credit rating agencies like Standard & Poor's, Moody's and Fitch. To the extent that MBS Issuers could boast strong credit ratings in various tranches of their securities (from AAA down to investment grade), investment advisors could take greater comfort in investing their clients' money in such securities. However, lower level tranches of MBSs were recognized as "risky" investments due to prioritized waterfall payment structures, and credit rating agencies accordingly assigned less favorable ratings to such

tranches, or did not rate them at all. In response to this problem, financial industry players began utilizing CDOs and SIVs to create markets for low-level tranches of MBSs.

In essence, CDOs and SIVs were utilized to "transform" low-level tranches of MBSs into low-risk, high-yield investments.[23] The notion was that pooling a number of low-level tranches of MBS issuances into a CDO (perhaps in combination with some mid-level tranches) would permit the CDO issuer to issue less risky high-level tranches to its investors, who would be at the "top of the waterfall". Credit rating agencies found this logic persuasive,[24] and liberally assigned strong credit ratings to high-level CDO tranches.[25] What the credit rating agencies failed to recognize was that these high-level CDO tranches merely represented the "best of the worst", and that the payment waterfalls associated with them were therefore particularly susceptible to slowing to a mere drip. The favorable credit ratings assigned to such tranches disguised serious flaws in the underlying assets, and induced many investors to spend large sums of money on securities that had little or no value.

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[23] Bobby R. Bean, ENHANCING TRANSPARENCY IN THE STRUCTURED FINANCE MARKET, (2007), available at <http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum08/article01_transparency.html> (referred to herein as "Enhancing Transparency"). Of course, CDOs and SIVs were also promoted, in part, to create additional layers of transaction fees for the various groups of professionals responsible for their development and distribution.

[24] Credit rating agencies were also of the view that credit default swaps enhanced the stability of securitized investment products, and thereby strengthened the case for the delivery of positive credit ratings. Of course, many have pointed to the derivatives industry itself as contributing significantly to the financial crisis. While derivatives are interesting fodder, they fall outside the limited purview of this paper and therefore are not discussed in further depth.

[25] Financial Crisis Inquiry Report, *supra* note 1 at xxv. "From 2000 to 2007, Moody's rated nearly 45,000 mortgage-related securities as triple-A. This compares with six private-sector companies in the United States that carried this coveted rating in early 2010. In 2006 alone, Moody's put its triple-A stamp of approval on 30 mortgage-related securities every working day. The results were disastrous: 83% of the mortgage securities rated triple-A that year ultimately were downgraded."

Ultimately, it appears that the credit rating agencies confused "diversification of risk" with "reduction of risk";[26] this mistake proved enormously costly. In fact, it is arguable that CDOs actually had the effect of magnifying credit risk for investors.[27]

Not surprisingly, credit rating agencies have been the subject of a great deal of scrutiny (although not many changes) in the aftermath of the financial crisis. One common criticism levied at the credit rating agencies is that they receive their compensation from the very companies they are responsible for rating. The conflict of interest is obvious; since they derive their revenue streams from their rating subjects, they are particularly susceptible to succumbing to pressure for favorable ratings from such subjects.[28] As such, not only has the competence of the credit rating industry been called into question; so too has its objectivity and general integrity.

2. CAPITAL REQUIREMENTS

Under the securitization model, banks are still able to hold mortgage assets on their balance sheets, albeit in the modified form of MBSs, CDOs or SIVs (collectively referred to herein as "securitized investment products"). Indeed, it is advantageous for a regulated bank to hold a securitized investment product, rather

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[26] Financial Crisis Inquiry Report, *id.* at 45. The Commission quotes Lawrence Lindsey, former Federal Reserve Governor, as follows: "Securitization was 'diversifying the risk,' said Lindsey, the former Fed governor. 'But it wasn't reducing the risk… You as an individual can diversify your risk. The system as a whole, though, cannot reduce the risk. And that's where the confusion lies.'"

[27] U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE (April 2011) (referred to herein as "Anatomy of a Financial Collapse") at 377.

[28] The Law of Banking, *supra* note 7 at 373.

than a traditional mortgage, on its books because of the far lower capital requirements for highly rated securitized investment products.[29]

Given the capital requirement advantages described above, many banks began acquiring huge quantities of securitized investment products to hold in their investment portfolios.[30] Indeed, they willingly reacquired the same default risk that they may have offloaded at an earlier phase of the securitization process. Andrew Ross Sorkin eloquently describes this puzzling phenomenon as follows:

> But whatever might be said about bankers' behavior during the housing boom, it can't be denied that these institutions "ate their own cooking" – in fact, they gorged on it, buying mountains of mortgage-backed assets from one another.[31]

3. OTHER GOVERNMENT POLICIES

Other government policies, some of which promote home ownership (as opposed to residential tenancy), compounded the problems associated with the securitization model. For example, the federal government sponsors two corporations, the Federal National Mortgage Association (commonly referred to as "Fannie Mae") and the Federal Home Loan Mortgage Corporation (commonly referred to as "Freddie Mac") (Fannie Mae and Freddie Mac are collectively referred

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[29] Bair Testimony, *supra* note 1. "Specifically, capital requirements for securities rated AA or AAA (or equivalent) by a credit rating agency were reduced by 80 percent for securities backed by most types of collateral and by 60 percent for privately issued securities backed by residential mortgages. For these highly rated securities, capital requirements were $1.60 per $100 of exposure, compared to $8 for most loan types and $4 for most residential mortgages."

[30] Dwight M. Jaffee, *Bank Regulation and Mortgage Market Reform*, 8 BERKELEY BUS. L.J. 8 (2011) (referred to herein as the "Jaffee Article") at 13.

[31] Too Big to Fail, *supra* note 4 at 5; Also see ABA Report, *supra* note 2 at 10.

to herein as the "government sponsored entities" or "GSEs").[32] In support of the federal government's policy objective of increasing the level of homeownership, the GSEs bought up huge volumes of mortgages for subsequent securitization, and purchased securitized investment products themselves, thereby creating increased liquidity among loan originators and supporting a "strong secondary market for mortgage loans."[33]

In further support of its desire to increase the level of homeownership across the United States, the federal government provides significant tax incentives to those who purchase homes. Specifically, interest paid on a residential mortgage is deductible against the homeowner's income.[34] An unintended consequence of this government policy is that homeowners are incentivized to expend disproportionate amounts of their income on housing. As a result, many Americans live precariously; a sudden interruption in their income stream can cause them to default on their mortgage obligations, thereby triggering foreclosure of their equity of redemption.

A marked increase in "subprime" lending (i.e. lending to individuals with low credit ratings who do not qualify for low interest rate loans) in the years leading up

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[32] Financial Crisis Inquiry Report, *supra* note 1 at 39. The GSEs are privately owned corporations that are the benefactors of various government benefits. For example, they receive tax exemptions, are able to borrow funds at rates nearly as low as Treasury, and are subject to low capital requirements.

[33] ABA Report, *supra* note 2 at 7, 11; Also see Financial Crisis Inquiry Report, *supra* note 1 at 39. "Fannie and Freddie had dual missions, both public and private: support the mortgage market and maximize returns for shareholders."

[34] In contrast, residential rent is not deductible against income. See Financial Crisis Inquiry Report, *id.* at 67; Also see Nigel Lawson, *Forget Fred and Focus on the Real Banking Scandal*, Financial Times, February 5, 2012, available at <http://www.ft.com/cms/s/0/b1eb10ca-4e65-11e1-aa0b-00144feabdc0.html> (referred to herein as the "Lawson Article"); Also see Bair Testimony, *supra* note 1.

to the financial crisis created an environment in which many non-creditworthy individuals could purchase homes with little or no down payment.[35] These subprime mortgage loans often had onerous terms, which borrowers did not truly understand and/or could not ultimately comply with.[36] Overextended subprime borrowers were more likely than prime borrowers to default on their mortgage obligations. As large numbers of subprime borrowers began defaulting, the cascading effect of widespread foreclosures drove residential real estate prices down considerably.[37] Of course, as real estate prices decreased across the United States, so too did the value of mortgage-backed securities (and CDOs and SIVs collateralized with MBSs).[38]

4. THE PERFECT STORM

Many of the problems associated with securitization were disguised during a prolonged period in which residential real estate prices increased. Conventional wisdom was that residential mortgage assets were "safe", even in the event of debtor default, because the value of underlying collateral remained strong. If necessary, outstanding delinquent debt would be satisfied by virtue of foreclosure proceedings. However, such a model breaks down when the value of the underlying

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[35] Rosen Article, *supra* note 10. "From 1996 to 2006, the share of subprime and Alt-A MBSs rose from 47% to 71% of total private sector MBS issuances."
[36] ABA Report, *supra* note 2 at 8.
[37] Of course, significant drops in real estate prices were not isolated to subprime neighborhoods. All homeowners were affected by the bursting of the real estate bubble.
[38] Enhancing Transparency, *supra* note 23.

collateral decreases (or stops increasing).[39] And this is precisely what happened in the months leading up to the financial crisis. As greater numbers of borrowers defaulted on their loan obligations and triggered foreclosures, the cascading effect systematically decreased the value of residential real estate in neighborhoods and communities across the United States. Simply put, the real estate bubble burst,[40] and those holding securitized investment products[41] discovered that there was little value in the collateral backing their investments.

To summarize, various government policies aimed at promoting increased home ownership, historically low interest rates,[42] a largely unregulated securitization market and various other factors, contributed to the 2008 financial crisis. The difficulty in identifying the "root cause" of the financial crisis is aptly described by the Business Law Section of the Banking Law Committee, American Bar Association, as follows:

> Some experts have blamed the financial crisis on "subprime lending." Yet, absent low interest rates and government policies that subsidized the housing market, the supply and demand for subprime lending and exotic mortgages might have remained on a scale inconsequential to the larger financial system. Absent securitization as a means of selling mortgages to banks and investors, mortgage originators might have applied more prudent credit underwriting standards and not made so many loans dependent on questionable sources of repayment. Absent the ability to sell mortgage-

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[39] Bair Testimony, *supra* note 1.

[40] The Law of Banking, *supra* note 7 at 371, where the authors describe a "bubble" as "sudden price increases unexplained by ordinary economic principles."; Also see Peter J. Wallison, *Dodd-Frank and the Myth of "Interconnectedness"*, The Wall Street Journal, February 9, 2012, <http://online.wsj.com/article/SB10001424052970204468004577164871060718662.html> (referred to herein as the "Wallison Article"), describing the U.S. housing bubble bursting near the end of 2007, triggering massive numbers of defaults on subprime and other risky mortgages.

[41] See Rosen Article, *supra* note 10.

[42] Bair Testimony, *supra* note 1.

> backed securities to investors, securitizers might not have purchased the loans or would have been more cautious in doing so. Absent credit default swaps and triple-A ratings by credit ratings agencies, investors might not have purchased the mortgage-backed securities and the "toxic assets" might not have spread so widely through the financial system. This causal chain of events is oversimplified and incomplete, but illustrates the difficulty of isolating any one cause as the main perpetrator.[43]

It is clear that a largely unregulated securitization model played a prominent role in the 2008 financial crisis. Hence, one's initial inclination might be to prohibit securitization in order to quell its adverse effects. While elegant and simple, flaws in this line of reasoning emerge upon closer examination. As demonstrated above, the securitization model offers various benefits to the financial system and to the general public at large. Therefore, the appropriate solution is not to prohibit securitization, but to implement regulatory reform that properly aligns the interests of originators, securitizers and investors. Indeed, Congress and the various regulatory agencies have adopted this course of action in responding to the financial crisis. Parts IV and V of this paper discuss the federal government's approach to regulatory reform.

IV. THE DODD-FRANK ACT: SUBTITLE D OF TITLE IX

A. BRIEF OVERVIEW OF SUBTITLE D

Subtitle D of the Dodd-Frank Act effects various amendments to both the *Securities Exchange Act of 1934*[44] and the *Securities Act of 1933*,[45] and mandates the

[43] ABA Report, *supra* note 2 at 8.
[44] 15 U.S.C. §78a (referred to herein as the "Securities Exchange Act").
[45] 15 U.S.C. §77a (referred to herein as the "Securities Act").

prescription of various regulations by a number of government agencies including the Office of the Comptroller of the Currency, Treasury (the "OCC"), the Board of Governors of the Federal Reserve System (the "Fed"), the Federal Deposit Insurance Corporation (the "FDIC"), the U.S. Securities and Exchange Commission (the "SEC"), the Federal Housing Finance Agency ("FHFA"), and the Department of Housing and Urban Development ("HUD") (collectively referred to herein as the "regulators").

§941 of the Dodd-Frank Act introduces a new section, §15G, to the Securities Exchange Act. §15G of the Securities Exchange Act generally requires: (i) securitizers to retain an economic interest in a portion of the credit risk for any asset that they transfer to third parties through the issuance of asset-backed securities,[46] and (ii) the regulators to prescribe, within 270 days of the provision's enactment, regulations that elaborate (with additional content) on the substantive rules contained within §15G.[47] On March 30, 2011, the regulators proposed such a set of regulations and invited comments from industry participants and other affected parties respecting the efficacy and fairness of such regulations.[48] The proposed rules[49] (referred to herein as the "Proposed §15G Rules") have received a great deal of feedback since their release, and continue to receive such feedback.[50]

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[46] Securities Exchange Act, *supra* note 44, §15G(c).
[47] *Id.*, §15G(b).
[48] U.S. Securities and Exchange Commission, *Asset-Backed Securities* (December 30, 2011), <http://www.sec.gov/spotlight/dodd-frank/assetbackedsecurities.shtml> (last visited March 26, 2012) (referred to herein as "Asset-Backed Securities").
[49] Proposed §15G Rules, *supra* note 18.
[50] U.S. Securities and Exchange Commission, *Comments on Proposed Rule: Credit Risk Retention* (March 16, 2012) <http://www.sec.gov/comments/s7-14-11/s71411.shtml> (referred to herein as "Comments on Proposed Rule"). The regulators have received feedback respecting the Proposed

As such, the regulators have not yet adopted final rules in connection with §941 of the Dodd-Frank Act. This paper primarily focuses on §941 of the Dodd-Frank Act (i.e. §15G of the Securities Exchange Act), but reference is also made to the other provisions of Subtitle D[51] and the Proposed §15G Rules (even though they do not yet have force of law). For the sake of simplicity, statutory references in the discussion that follows are generally made in respect of §15G of the Securities Exchange Act (rather than §941 of the Dodd-Frank Act) because it is simpler to identify the specific subsections of the operative provisions using this approach.

B. SUMMARY OF §15G OF THE SECURITIES EXCHANGE ACT (§941 OF THE DODD-FRANK ACT)

§15G(c)(1)(A) of the Securities Exchange Act requires regulators to adopt rules that prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that it is required to retain.[52] Thus, securitizers (and each of their affiliates which comprise a consolidated entity) are unable to engage in

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§15G Rules as recently as March 9, 2012, when R. Bram Smith, Executive Director of the Loan Syndications and Trading Association, delivered comments on behalf of his organization.

[51] §942 contains disclosure requirements for issuers of asset-backed securities, §§943-944 require the SEC to prescribe regulations on the use of representations and warranties in the asset-backed securities market, and §945 directs the SEC to adopt rules requiring any issuer of an asset-backed security to perform a review of the assets underlying the asset-backed security and disclose the nature of the review in its disclosure package. §946 directs the Chairman of the Financial Services Oversight Council to carry out a study on the macroeconomic effects of the risk retention requirements under Subtitle D. The Chairman's study was completed in January 2011, and was utilized in preparation of the Proposed §15G Rules.

[52] Securities Exchange Act, *supra* note 44, §15G(c)(1)(A). Note that the prohibition does not extend to hedging on other forms of risk, such as interest rate risk, currency exchange rate risk or home prices, provided they are not "materially related to the credit risk of the ABSs". See Proposed §15G Rules, *supra* note 18 at 58.

derivatives transactions (e.g. credit default swaps) as an alternate method of offloading risk associated with the mortgage loans underlying their MBSs.[53] The theory underlying §15G is that securitizers must keep some "skin in the game".[54] This, in turn, will ensure higher quality underwriting at the loan origination phase and properly align the interests of originators, securitizers and investors.

Pursuant to §15G(c)(1)(B) of the Securities Exchange Act, a securitizer is required to retain not less than 5 percent of the credit risk for any asset that is not a "qualified residential mortgage"[55] transferred, sold, or conveyed through the issuance of an ABS.[56] Moreover, the securitizer is required to retain at least 5 percent of the credit risk for any asset that is a qualified residential mortgage if it is packaged with one or more other assets comprising an ABS.[57] This latter requirement prevents the securitizer from (i) "cherry-picking" good assets, and/or (ii) mixing good assets with bad in an attempt to offload the heightened credit risk associated with the latter.

§15G(c)(1)(B) provides that a securitizer may retain less than 5 percent of the credit risk for an asset that is not a qualified residential mortgage if the

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[53] Proposed §15G Rules, *id.* at 58.

[54] The term "skin in the game" has become a common reference to the risk retention rules set out under §15G. See, for example, Floyd Norris, *Banks to Hold Risk in Rules on Mortgages*, The New York Times, Mar. 29, 2011, at B1; Also see Editorial, *Skin in the Game*, The Wall Street Journal, Mar. 30, 2011, at A18; Also see Ben Protess, *Regulators Propose Rules Requiring Banks to Hold Risk on Mortgages*, The New York Times, Mar. 30, 2011, at B3, Also see Nick Timiraos & Victoria McGrane, *Mortgage Lending Rules are Unveiled*, The Wall Street Journal, Mar. 30, 2011, at C1.

[55] This defined term is discussed in more detail below.

[56] Securities Exchange Act, *supra* note 44, §15G(c)(1)(B)(i)(I).

[57] *Id.*, §15G(c)(1)(B)(i)(II).

originator meets certain underwriting standards specified by the regulators.[58] Finally, §15G(c)(1)(C) provides that a securitizer is not required to retain any part of the credit risk for ABSs that are collateralized exclusively with qualified residential mortgages.[59]

In respect of securitizations backed by commercial mortgages, §15G(c)(1)(E) provides that the rules prescribed by the regulators may provide for retention of the first-loss position by a third-party purchaser that (i) specifically negotiates for the purchase of such position, (ii) holds adequate financial resources to absorb potential losses, and (iii) undertakes due diligence of the assets comprising the securitization pool before the issuance.[60] Thus, in a narrow set of circumstances and under carefully prescribed conditions, a securitizer may circumnavigate the risk retention requirements that would otherwise be imposed by §15G of the Securities Exchange Act.

The rules adopted by the regulators in connection with §15G will apply regardless of whether the securitizer is a depository institution,[61] and will also establish appropriate risk retention standards for CDOs, securities collateralized by CDOs, and similar instruments collateralized by other ABSs.[62]

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[58] *Id.*, §15G(c)(1)(B)(ii).
[59] *Id.*, §15G(c)(1)(C).
[60] Proposed §15G Rules, *supra* note 18 at 43.
[61] Securities Exchange Act, *supra* note 44, §15G(c)(1)(D).
[62] *Id.*, §15G(c)(1)(F).

§15G(c)(1)(G) directs the regulators to (i) provide a variety of partial and full exemptions from the risk retention rules,[63] and (ii) prescribe rules for determining the appropriate method of allocating risk retention as between securitizer (i.e. the entity issuing securities to investors) and originator (i.e. the entity that actually originates the underlying loans).[64] §15G(d)(1) clarifies that the amount of risk to be retained by the securitizer is reduced by the percentage of risk retained by the originator.[65] Pursuant to §15G(d)(2), the regulators shall consider the following factors in allocating risk retention obligations between securitizers and originators:

> (A) whether the assets sold to the securitizer have terms, conditions, and characteristics that reflect low credit risk;
>
> (B) whether the form or volume of transactions in securitization markets creates incentives for imprudent organization of the type of loan or asset to be sold to the securitizer; and
>
> (C) the potential impact of the risk retention obligations on the access of consumers and businesses to credit on reasonable terms, which may not include the transfer of credit risk to a third party.[66]

Thus, in introducing §15G, Congress is clearly mindful that the "skin in the game" rules will reduce credit availability to a certain extent.

As noted above, the regulators have discretion to issue exemptions, exceptions or adjustments to the general securitization rules, including the rules relating to risk retention requirements and the prohibition on hedging.[67] §15G(e)(2)

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[63] *Id.*, §15G(c)(1)(G)(i)-(iii).
[64] *Id.*, §15G(c)(1)(G)(iv).
[65] *Id.*, §15G(d)(1).
[66] *Id.*, §15G(d)(2).
[67] *Id.*, §15G(e)(1).

sets out general guidelines for how such exemptions, exceptions or adjustments may be adopted or issued.

"Qualified residential mortgages" are the most notable exemption class mandated or contemplated by §15G.[68] Although the term "qualified residential mortgage" is left to the regulators to define, §15G offers guidance on how such definition is to be settled upon. Specifically, §15G(e)(4)(B) provides that the regulators, in defining the term "qualified residential mortgage", shall take into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default, such as –

(i) documentation and verification of the financial resources relied upon to qualify the mortgagor;

(ii) standards with respect to –

a. the residual income of the mortgagor after all monthly obligations;

b. the ratio of the housing payments of the mortgagor to the monthly income of the mortgagor;

c. the ratio of total monthly installment payments of the mortgagor to the income of the mortgagor;

(iii) mitigating the potential for payment shock or adjustable rate mortgages through product features and underwriting standards;

(iv) mortgage guarantee insurance or other types of insurance or credit enhancement obtained at the time of origination, to the extent such insurance or credit enhancement reduces the risk of default; and

(v) prohibiting or restricting the use of balloon payments, negative amortization, prepayment penalties, interest-only payments, and other

[68] *Id.*, §15G(e)(4).

> features that have been demonstrated to exhibit a higher risk of borrower default.[69]

Based on the foregoing, it is clear that Congress is of the view that the securitization model, at least with respect to certain "stable" assets, remains an integral feature of the U.S. financial system.

§15G(e)(5) of the Securities Exchange Act clarifies that the "qualified residential mortgage" exemption does not apply to additional layers of securitization. As such, a CDO securitized by various tranches of MBSs (themselves backed by qualified residential mortgages) is not exempt from the "skin in the game" requirements introduced under §15G.

The rules described above, with respect to ABSs backed by residential mortgages, will become effective one year after which they are published in the Federal Register.[70] With respect to other classes of ABSs, the rules will become effective two years after publication.[71]

C. PROPOSED §15G RULES

Pursuant to §15G, the regulators are responsible for defining the term "qualified residential mortgage" and prescribing certain other underwriting standards, exemptions, and permissible forms of risk retention (including the minimum duration of such risk retention). The Proposed §15G Rules, released in

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[69] *Id.*, §15G(e)(4)(B).
[70] *Id.*, §15G(i)(1).
[71] *Id.*, §15G(i)(2).

March 2011, aim to give effect to, or illuminate, §15G of the Securities Exchange Act and fulfill the responsibilities delegated to the regulators by Congress. A brief discussion of the Proposed §15G Rules is set forth below.

1. QUALIFIED RESIDENTIAL MORTGAGE

In the Proposed §15G Rules, the regulators have proposed extensive eligibility criteria for a mortgage to satisfy the definition of "qualified residential mortgage". These criteria include, but are not limited to, the following:

- The mortgage must represent a first lien on the property;[72]
- The originator must demonstrate that it conducted a review of the debtor's credit history;[73]
- The mortgage must not provide for interest-only payments, negative amortization or balloon payments;[74]
- The mortgage must adhere to prescribed criteria respecting adjustable-rate loans;[75]
- The mortgage must not provide for any prepayment penalty;[76]
- The mortgage must satisfy certain loan-to-value ratios (depending on the nature of the transaction) and minimum down payment thresholds;[77] and
- A qualified appraiser must appraise the property.[78]

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[72] Proposed §15G Rules, *supra* note 18 at 68.
[73] *Id.* at 70.
[74] *Id.* at 71-72.
[75] *Id.* at 72.
[76] *Id.* at 72.
[77] *Id.* at 73-76.

In order to be a "qualified residential mortgage", a mortgage loan must satisfy the specified criteria at the time of its origination and be "performing" at the time of the closing of the securitization transaction.[79]

2. OTHER QUALIFYING ASSETS

As noted above, in addition to being tasked with defining the term "qualified residential mortgage", the regulators were also directed, pursuant to §15G(c)(1)(B)(ii), to prescribe certain underwriting standards for residential mortgages, commercial real estate loans, commercial loans, automobile loans and other classes of loans (collectively referred to herein as "qualified assets"), that if satisfied, will permit a securitizer to retain less than 5 percent of the credit risk.[80] Though less stringent than the definition of "qualified residential mortgage", the underwriting standards proposed by the regulators in respect of these other qualified assets remain quite onerous, and are, in many instances, reminiscent of the "qualified residential mortgage" criteria.[81] The regulators have proposed a zero percent risk retention requirement for securitized investment products comprised exclusively of qualified assets, thereby providing a total exemption for such ABS issuances.[82]

3. OTHER EXEMPTIONS

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[78] *Id.* at 77.
[79] *Id.* at 67.
[80] *Id.* at 90.
[81] Morrison & Foerster, *The Dodd-Frank Act: a Cheat Sheet*, (2010) (referred to herein as "Cheat Sheet") at 9, available at <www.mofo.com> (last visited March 25, 2012).
[82] Proposed §15G Rules, *supra* note 18 at 90.

Pursuant to §15G(c)(1)(G) and (e) of the Securities Exchange Act, the regulators must provide a total or partial exemption from risk retention requirements for certain types of asset-backed securities or securitization transactions. In this regard, the regulators have proposed, in addition to the exemptions described above, the following exemptions under the Proposed §15G Rules:

- An exemption for federally insured or guaranteed residential, multifamily, and health care mortgage loan assets;[83] and
- A safe harbor exemption for foreign securitizations where the effects on U.S. interests are sufficiently remote.[84]

4. RETENTION OF RISK

In the Proposed §15G Rules, the regulators have proposed numerous methods by which a sponsor[85] may retain risk in respect of securitized assets, including but not limited to:[86]

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[83] *Id.* at 102-104.
[84] *Id.* at 112.
[85] See Proposed §15G Rules, *id.* at 19. In formulating the risk retention regulations, the regulators adopted the term "sponsor", which is technically a broader term than "securitizer". The term "sponsor" means a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity. In this paper, the terms "sponsor" and "securitizer" are synonymous and are therefore used interchangeably. In addition, the term "securitizer" is occasionally used to encompass the term "originator" within its meaning.
[86] *Id.* at 21-22.

(i) A "vertical" slice of the asset-backed securities, whereby the sponsor retains a minimum *pro rata* percentage of each class of interests issued in the transaction;

(ii) A "horizontal" first-loss position, whereby the sponsor retains a subordinate interest in the issuer that bears losses on the underlying assets before other interests. Under the Proposed §15G Rules, a sponsor would hold an "eligible horizontal residual interest" if it held an interest that is "allocated all losses on the securitized assets until the par value of the class is reduced to zero and has the most subordinated claim to payments of both principal and interest by the issuing entity";[87]

(iii) A "seller's interest" in securitizations structured using a master trust collateralized by revolving assets whereby the sponsor holds a separate interest that is *pari passu* with the investors' interest in the asset pool; or

(iv) A "representative sample", whereby the sponsor retains a randomly selected representative sample of the assets to be securitized that exposes it to credit risk that is equivalent to that of the securitized assets.[88]

In addition to the four methods described above, the sponsor may retain risk through an "L shaped" structure, which essentially reflects a combination of vertical

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[87] *Id.* at 28-29. In lieu of holding an "eligible horizontal residual interest", the Proposed §15G Rules also "allow a sponsor to cause to be established and funded, in cash, a reserve account at closing in an amount equal to at least five percent of the par value of all the ABS interests issued as part of the transaction."

[88] *Id.* at 34.

and horizontal risk retention.[89] In creating flexibility respecting the risk retention standards, regulators have recognized the "heterogeneity of securitization markets and practices," and are aiming to reduce the "potential for the proposed rules to negatively affect the availability and costs of credit to consumers and businesses."[90]

V. A CRITICAL EXAMINATION OF §15G

A. PRELIMINARY COMMENTS

The question arises whether, and to what extent, Subtitle D of the Dodd-Frank Act, and the consequential amendments to the Securities Exchange Act brought about by the introduction of §15G, will successfully improve the securitization process. §15G attempts to strike a delicate balance between ensuring sound loan underwriting, on one hand, and facilitating use of a legitimate financial industry tool for the benefit of the financial system as a whole, on the other. Indeed, both Congress and the regulators recognize that securitization can, and does, serve a useful purpose:

> When properly structured, securitization provides economic benefits that lower the cost of credit to households and businesses. However, when incentives are not properly aligned and there is a lack of discipline in the origination process, securitization can result in harm to investors, consumers, financial institutions, and the financial system. During the financial crisis, securitization displayed significant vulnerabilities to informational and incentive problems among various parties involved in the process.[91]

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[89] *Id.* at 29.
[90] *Id.* at 24.
[91] *Id.* at 13.

To some, §15G may go too far in imposing risk retention requirements on originators and securitizers. Meanwhile, others may believe that §15G does not go far enough in limiting the moral hazard inherent in a securitization model. Subpart B critically examines §15G and, to a certain extent, the Proposed §15G Rules (collectively referred to herein, on occasion, as the "Securitization Reform Provisions"), from both ends of this spectrum.

B. MY TWO CENTS

1. SOUND LOAN UNDERWRITING AS THE PRICE OF SECURITIZATION

In my view, the Securitization Reform Provisions are generally well designed to prevent securitizers from circumventing both the "letter" and the "spirit" of the "skin in the game" principle, and therefore, on the whole, strike an appropriate balance.[92] For example, I think the Securitization Reform Provisions proficiently eliminate the possibility of "cherry-picking" by loan originators and securitizers; that is, retaining risk only in respect of high quality assets while disposing of the risk associated with low quality assets. The Securitization Reform Provisions clarify that only securitized investment products collateralized exclusively with qualified residential mortgages or qualified assets may completely sidestep the risk retention rules. As such, a securitizer cannot offload particularly risky assets by "blending"

[92] As noted above, there has been a plethora of feedback offered by various lobbying groups and other organizations, much of which is focused on the technical definitions of terms like "qualified residential mortgage". For the purposes of brevity, this paper does not attempt to provide an exhaustive technical review of the Proposed §15G Rules.

them into a pool comprised largely of qualified residential mortgages and/or qualified assets. Indeed, the "price" one must pay, to totally circumvent the "skin in the game" requirements, is to populate its securitization pools entirely with loans meeting the prescribed criteria (i.e. loans issued using demonstrably sound underwriting procedures).[93] In my view, this approach reflects a sensible public policy choice that is eminently fair.

2. APPROPRIATE RISK RETENTION METHODS

Of the four chief methods of risk retention proposed by the regulators, the first three methods (i.e. the "vertical slice", "horizontal slice", and the "seller's interest") do not appear easily susceptible to manipulation by clever sponsors insistent on skirting the "skin in the game" principle. The fourth method allows a sponsor to meet its risk retention requirements by retaining a randomly selected representative sample of the underlying assets. At first glance, this risk retention method seems most susceptible to manipulation or abuse. The concern is that a shrewd sponsor could, under the guise of "randomness", retain high quality assets on its balance sheet and dispose of low quality assets into the securitization pool. In such an instance, the sponsor might technically satisfy the risk retention requirements imposed by §15G, but in reality circumvent the provision's underlying "skin in the game" principle.

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[93] *Supra* note 61. As noted above, §15G(c)(1)(D) of the Securities Exchange Act provides that the risk retention requirements apply to all industry participants. Therefore, "shadow banking" entities that were not previously subject to regulatory scrutiny will be subject to the "skin in the game" regulatory regime. In my view, this is positive.

Upon closer examination, however, it appears that the Proposed §15G Rules would adequately mitigate the risk of mischief described in the preceding paragraph. Specifically, the Proposed §15G Rules would mitigate the risk of manipulation or abuse by mandating a rigorous random selection process and requiring that the "servicing of the assets included in the representative sample be conducted by the same entity and under the same contractual standards as the servicing of the securitized assets."[94] In addition, those responsible for servicing the assets must not be able to discern which assets form part of the securitized pool and which form part of the representative sample retained by the sponsor.[95] Thus, in my view, the Securitization Reform Provisions adequately protect the interests of investors while simultaneously providing lenders with the opportunity to securitize mortgage loans and other debt assets in a fair and transparent manner.

3. The Appropriateness of the 5 Percent Minimum Risk Retention Requirement

One question, to which there is no objectively "correct" answer, is whether the general 5 percent risk retention requirement imposed by §15G will be sufficient to properly align the incentives of originators, securitizers and investors, and consequently prevent the recurrence of another financial crisis in the future. Some might argue that a higher percentage risk retention requirement (perhaps in the 10 to 20 percent range) would be more appropriate. Not surprisingly, many financial

[94] *Id.* at 36.
[95] *Id.* at 36.

industry players balk at this notion, and argue instead that higher "skin in the game" requirements would have a negative impact on the financial system by reducing the availability of affordable credit in the secured credit marketplace.

I am of the view that a risk retention requirement in the 5 to 10 percent range is appropriate because it creates a "more-than-trifling" incentive for originators and securitizers to undertake a meaningful due diligence review at the loan origination stage while simultaneously facilitating the disposition of the vast majority (i.e. 90 to 95 percent) of the credit risk. In contrast, a lower risk retention requirement (say in the 1 to 2 percent range) might have a *de minimis* positive impact on the quality of loan underwriting, and therefore fail to achieve the chief objective of Subtitle D. As noted above, there is no objectively "correct" risk retention percentage; reasonable people can disagree on the appropriate minimum percentage threshold. However, on an intuitive level,[96] I believe that the 5 percent risk retention requirement imposed under §15G will be adequate to properly align the incentives of securitizers, originators and investors.

4. THE CASE AGAINST A PURIST APPROACH TO SECURITIZATION

One might argue that the Securitization Reform Provisions impose overly onerous risk retention requirements on lenders, which may ultimately hurt the financial system by driving up the cost of credit and decreasing its availability in the marketplace. For example, "securitization purists" might assert that there is no good

[96] I do not proffer sophisticated economic models in support of my view.

reason why sophisticated commercial parties should be precluded from negotiating the entire transfer of risk from one party to the other free of government meddling.[97] There is legitimacy in this view. However, in my opinion, the Securitization Reform Provisions provide reasonable flexibility to parties interested in negotiating the entire transfer of credit risk associated with securitized investment products. The paragraphs that follow explain my rationale.

First, as noted above, there are no risk retention requirements in respect of securitized investment products collateralized exclusively by qualified residential mortgages or other qualified assets. Thus, provided the parties are dealing in qualified residential mortgages or qualified assets, they are free to negotiate the transfer of the entire credit risk associated with such underlying assets. This is a significant relaxation of the "skin in the game" principle.

Second, §15G(c)(1)(E) of the Securities Exchange Act further expands this flexibility by allowing a third-party purchaser to acquire the entire risk associated with securitized investment products backed by commercial mortgages, provided that the third-party purchaser specifically negotiates for the purchase of such position, holds adequate financial resources to absorb potential losses, and

[97] To purists, the problem lies, not in the securitization model *per se*, but rather in the failure of originators to adhere to sound underwriting policies. Thus, the answer lies in the implementation of and adherence to better quality underwriting standards (i.e. a "pure securitization" model should persist). While I agree that sound underwriting is of the utmost importance, I do not agree that a "pure securitization" model should persist. In my view, a "skin in the game" securitization model promotes implementation of and adherence to sound underwriting standards. Indeed, this is the essence of the "skin in the game" approach – to ensure that securitized investment products are populated with properly underwritten loans.

undertakes due diligence of the commercial mortgage assets comprising the securitization pool before the issuance. Thus, a financially stable investor will be able to purchase, and a securitizer will be able to sell, the entire risk associated with the underlying commercial mortgage assets if the investor sufficiently re-investigates the loan underwriting process (i.e. re-conducts due diligence). This reinforces the notion that careful underwriting is the *sine qua non* of the regulatory exemptions to the "skin in the game" rules.

An argument can be advanced that the "specifically negotiated" exemption, described in the preceding paragraph, should be expanded to include all third-party purchasers (regardless of their financial strength) and all types of securitized products. I respectfully disagree. §15G of the Securities Exchange Act does not currently permit an expansive exemption of this nature, and for good reason. In my view, the Securitization Reform Provisions represent a sensible approach that adequately protects "freedom of contract" while still adhering to the underlying goal of aligning incentives and interests. The restrictive approach proposed by Congress and the regulators will ensure that securitizers do not develop a securitization market in which the "specifically negotiated" exemption becomes the "rule", thereby undermining the foundational purposes of Title IX, Subtitle D of the Dodd-Frank Act. Of course, this restrictive approach[98] will necessarily preclude the completion of a certain range of otherwise *bona fide* transactions. However, I am of the view that the preclusion of such transactions is not so significant that it will have a materially

[98] A certain measure of "restrictiveness" necessarily accompanies rule-based regulations of any sort. Indeed, this is the very essence of rule-based regulations.

adverse effect on the financial system as a whole.[99] Simply put, I do not believe the general 5 percent risk retention requirement is unduly onerous on securitizers and originators.

C. THE CANADIAN EXAMPLE: BRIGHT FUTURE OR PENDING DISASTER?

One wonders why the securitization model has not wreaked havoc on the Canadian housing market specifically, and the Canadian financial system generally. After all, Canadian mortgage lenders have been subject to no more burdensome securitization requirements than their U.S. counterparts.[100] The explanation appears to lie, to a certain extent, in at least three factors. First, securitization is not utilized by Canadian financial system participants to the same degree as their U.S.

[99] It is useful to consider this issue from a slightly different perspective. I believe that the regulators adopted a narrow "specifically negotiated" exemption, in part, because they recognized that it is neither desirable nor feasible for regulators to micro-manage (i) all underwriting activities of commercial lenders, and/or (ii) the compensation packages offered to commercial lenders' loan officers. Indeed, under the Securitization Reform Provisions, lenders are free to issue loans as they see fit (subject to applicable law), and pay their employees as they wish, provided they are (i) comfortable bearing the entire credit risk associated with their loan underwriting under the "originate to hold" model, or (ii) prepared to comply with the risk retention minimums imposed under §15G of the Securities Exchange Act. In other words, though regulators feel that they cannot effectively regulate all loan underwriting directly, they believe that they can regulate the securitization process (i.e. which, in effect, is an indirect "underwriting regulation" with respect to loans intended for distribution in the securitization market, and which therefore have the potential to affect the risk exposure of investors). As such, the regulators are unwilling to give prospective securitizers an overly broad exemption that is not based on readily ascertainable compliance with specified underwriting criteria. I agree with the regulators' general approach. In my view, creating a broad "specifically negotiated" exemption would run the risk of making the "exception" the "rule", and vice versa, and thereby undermine the entire "skin in the game" regulatory regime. As such, I favor a narrow "specifically negotiated" exemption in the nature of that proposed in the Proposed §15G Rules.

[100] Michael Feldman, John Tobin, Jim S. Hong & Simon Williams, *Canada: Securitisation and Structured Finance and Securitisation Handbook, 2011*, (referred to herein as the "Canadian Securitisation Handbook"), available at <http://www.torys.com/Publications/Documents/Publication%20PDFs/AR2011-15.pdf> or <www.practicallaw.com/7-502-7802> (last visited April 23, 2012).

counterparts, which necessarily means that Canadian lenders are not incentivized, to the same extent, to deviate from sound underwriting policies. Secondly, even within the rather small Canadian securitization industry, residential mortgages comprise a relatively low percentage of the asset classes backing securitized investment products.[101] Thirdly, as observed by Paul Volcker, Canada's largest banks, unlike major U.S. banks, are major players in the residential mortgage lending market, and typically utilize the conventional "originate to hold" mortgage lending model.[102]

Perhaps the major banks' strong presence in the Canadian residential mortgage market has promoted sounder lending procedures than those typically employed by U.S. mortgage lenders. Additionally, perhaps the non-deductibility of mortgage interest from a Canadian homeowner's income has not perversely incentivized Canadians to overextend themselves, thereby leading the average Canadian to purchase a more affordable home.[103] But an equally plausible explanation is that mortgage loan underwriting is equally flawed in Canada, and that

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[101] Canadian Securitisation Handbook, *id.* The authors note that residential mortgages comprise only 13.6% of all assets backing securitized investment products in Canada.

[102] Tom Braithwaite, *Volcker Defends His 'Rule' From Critics*, Financial Times, October 26, 2011, available at <http://www.ft.com/intl/cms/s/0/fe44c416-ffe1-11e0-8441-00144feabdc0.html> (referred to herein as the "Braithwaite Article"). Quoting Paul Volcker, the author states: "He (Volcker) notes that Canadian banks, which have performed relatively well in the past few years, have a more traditional model and – unlike the US – are the main players in the mortgage market."; As a personal anecdote, I have a mortgage loan on a home in Edmonton, Alberta, which was originally issued and continues to be held by TD Canada Trust, one of Canada's major banks.

[103] I strongly doubt this is true. Many Canadians, especially young people, exhibit willingness to purchase expensive homes primarily on credit (i.e. with little money down). The United States does not have a monopoly on overindulgence. Massive indebtedness is just as much a Canadian phenomenon as an American one.

other exogenous forces have artificially buoyed the Canadian real estate market (where prices have not declined as drastically as U.S. housing prices) to this point. Indeed, some speculate that a residential real estate market collapse is imminent north of the 49th Parallel.[104] Only time will tell.

VI. CONCLUSION

In the aftermath of the 2008 financial crisis, the U.S. government was forced to make a series of difficult policy decisions. The Dodd-Frank Act represents a comprehensive approach to reform in which each of the perceived financial system deficiencies are addressed in turn. Title IX, Subtitle D of the Dodd-Frank Act is but one little piece of a rather large package of regulatory reform. On the whole, I am of the view that the provisions of Title IX, Subtitle D, along with regulations along the lines set out in the Proposed §15G Rules, will have a meaningful positive effect on the securitization model by bringing the interests of loan originators, securitizers and investors (in securitized investment products) into proper alignment. Whether the Dodd-Frank Act reform package, as a whole, will achieve broader success, is infinitely more complicated.

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[104] David Pye, *Housing Collapse Pending in Canada?*, (March 19, 2012) (referred to herein as the "Pye Article"), available at <http://yourmoney.ca/clearfacts/housing_collapse_pending_in_canada/19296bb0> (last visited April 23, 2012).