Statement of:

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The State of the Securitization Markets

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I. Introduction

Chairman Reed, Ranking Member Crapo, and Distinguished Members of the Subcommittee, I thank you for this opportunity to testify before you today on behalf of the 330 member institutions of the American Securitization Forum.[1] In the testimony that follows, we seek to address the numerous industry efforts to initiate reforms from within the securitization market as well as the myriad of legislative and regulatory proposals currently facing the securitization market that would fundamentally alter, facilitate or eliminate parts of the securitization market. As you read through this testimony, you will see that many of the topics covered involve common themes, including alignment of incentives, transparency and standardization in securitization as well as an overall increase in government oversight of this market.

Many of the industry's current issues arise from regulations prescribed by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act" or "Dodd-Frank"), such as risk retention, rating agency reform, orderly liquidation authority for nonbanks, derivatives, the Volker rule and conflicts of interest. In addition, the SEC's Regulation AB II proposal would overhaul the registration, disclosure and reporting requirements for the entire asset-backed securities ("ABS") market. Further complicating this impending regulation is the FDIC Safe Harbor, which was developed in a unilateral, piecemeal fashion by the FDIC and has effectively front-run much of Dodd-Frank's securitization mandate.

[1] The American Securitization Forum is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests on important legal, regulatory and market practice issues. ASF members include over 330 firms, including issuers, investors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and other professional organizations involved in securitization transactions. ASF also provides information, education and training on a range of securitization market issues and topics through industry conferences, seminars and similar initiatives. For more information about ASF, its members and activities, please go to www.americansecuritization.com.

Ultimately, these issues face the market during a time when certain sectors, such as auto and equipment ABS are at or nearing normal levels, and other sectors, such as commercial mortgage-backed securities ("CMBS"), are beginning to see signs of life. Finally, the future of residential mortgage finance hangs in the balance as the Administration and members of Congress seek to wind down the GSEs and bring private capital back to the mortgage market in the form of private label residential mortgage-backed securities ("RMBS") and covered bonds. We begin with the current state of the securitization market by issuance volume.

II. The State of the Securitization Market

As noted by the Board of Governors of the Federal Reserve ("FRB") in its recent study on risk retention, different segments of the ABS and RMBS markets have recovered at varying levels during the 18 months since the "end" of the recession.[2] Auto and auto-related ABS accounted for $53.9 billion in issuance in 2009, which represents 80.7% of the auto and auto-related ABS issuance of $66.8 billion during 2007, just before the downturn.[3] $7.2 billion in equipment ABS was issued during 2009, in contrast with the 2007 issuance of $6.1 billion.[4] Most of the reductions in the Auto and Equipment ABS markets can be explained by the overall decrease in purchases of these products, thereby reducing the financing demands in these markets. In 2009, credit card ABS accounted for $46.6 billion in issuance, down 50.7% from

[2] Board of Governors of the Federal Reserve System, "Report to the Congress on Risk Retention" (Oct. 2010), p. 2, *available at* http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf.
[3] Data are from Asset Backed Alert, see the Proposing Release, p. 12-13, *available at* http://www.sec.gov/rules/proposed/2011/34-64148.pdf.
[4] *Ibid*.

2007 issuance of $94.5 billion.[5] Most credit card ABS reductions have resulted from the changed capital adequacy changes made as a result of the implementation of FAS 166 and 167, which will be discussed below. Meanwhile, the student loan sector issued $20.8 billion in ABS during 2009, down 64.2% from 2007 issuance of $58.1 billion.[6] Given the elimination of the FFELP program, student loan issuance is expected to be a fundamentally small market, which is limited to securitization of legacy FFELP loans for another couple of years as well as the relatively smaller volumes of private student loan originations. By comparison, on the RMBS side, $48.1 billion of RMBS were issued in 2009, down 92.5% from 2007 issuance of $641.8 billion.[7] In addition to the overall reduction of issuance in the RMBS market, we further note that 97% of RMBS were federally-backed in 2010, as compared with only 64% in 2007 when the private market accounted for a much larger share of RMBS issuance.[8] Simply put, the absence of a properly functioning securitization market, and the funding and liquidity this market has historically provided, adversely impacts consumers, businesses, financial markets and the broader economy. The recovery and restoration of confidence in securitization is therefore a necessary ingredient for economic growth to resume, and for that growth to continue on a sustained basis into the future.[9]

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[5] *Ibid*.
[6] *Ibid*.
[7] *Ibid*.
[8] Analysis by 1010data, based on data from FNMA, GNMA and FHLMC.
[9] For more information on the role of securitization within the financial system and U.S. economy, *see* Appendix A.

III. Risk Retention

ASF supports efforts to align the incentives of issuers and originators with investors of ABS and we believe these incentives should encourage the application of sound underwriting standards by both the originator and securitizer in connection with the assets that are securitized. ASF began the process to better align incentives over three years ago, when we launched our Project on Residential Securitization Transparency and Reporting ("Project RESTART"),[10] which is a broad-based industry-developed initiative to help rebuild investor confidence in mortgage and asset-backed securities. As part of this effort, we have produced Model RMBS Representations and Warranties and are in the process of producing Model RMBS Repurchase Principles, which combine to create a very strong alignment of interests in RMBS transactions. As part of the Dodd-Frank Act, Congress also decided to address alignment of incentives, but opted to employ credit risk retention and tasked various regulators with implementing regulations that will effect "skin in the game," but still permit appropriate access to credit.

While ASF believes that risk retention can aid in achieving an appropriate alignment of incentives, any rules enacted must be carefully calibrated so as to not cause unintended consequences. As further described in this testimony, we believe the currently proposed risk retention rules will prove to be a major impediment to securitization, which will most certainly constrain credit as well as increase its cost. ASF delivered its initial views on the proposals before a hearing of the House Committee on Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises entitled, "Understanding the Implications and

[10] *See* http://www.americansecuritization.com/restart.

Consequences of the Proposed Rule on Risk Retention."[11] This lengthy testimony provides detailed comments regarding risk retention for various asset classes, and is being used as the basis for an even more comprehensive comment letter that will be delivered to the joint regulators on June 10, 2011—the comment deadline for the proposals.

A. Industry Efforts to Align Incentives

During the recent economic crisis, some commentators questioned whether mortgage loan originators sufficiently mitigated or retained sufficient risk in the loans they were making to borrowers, especially when those loans were sold into securitization trusts. These critics pointed to a lack of "skin in the game," which they believe misaligned incentives between originators and investors and failed to ensure the loans underlying RMBS were of adequate credit quality. The risk or "skin in the game" traditionally retained by originators of RMBS is embodied in the representations and warranties that issuers provide with respect to the mortgage loans sold into the securitization trust and the repurchase mechanics that serve to enforce those representations and warranties. Some market participants, including some investors, have indicated that they believe the traditional representations and warranties did not have "teeth" because the repurchase mechanisms included in past transactions haven't effectively provided a means to return or "put back" materially defective mortgage loans to the originator.

Beginning in 2008 as part of ASF Project RESTART, ASF began working with its RMBS originator, issuer, financial guarantor, rating agency, trustee and investor members to identify potential areas of improvement and work toward a model set of representations and

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[11] *See* "ASF Risk Retention Testimony Before HFSC," American Securitization Forum (April 14, 2011), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_HFSC_Risk_Retention_Testimony_4-14-11.pdf.

warranties (the "ASF Model Reps") and a set of model repurchase principles (the "ASF Model Repurchase Principles") for future, plain vanilla RMBS transactions. The completed ASF Model Reps are currently available on the ASF website and the ASF Model Repurchase Principles are expected to be released in the next couple of months.

i. Representations and Warranties as Risk Retention

In securitizations, representations and warranties are used to allocate the origination risk of mortgage loans between the issuers of the securities and the investors who purchase them. The allocation of origination risks begins when a mortgage loan is sold by an originator for inclusion in a securitization trust. This sale is accompanied by representations and warranties regarding the mortgage loans being sold, including representations and warranties relating to the mortgaged property securing the loan, the documentation for the loan, the manner in which the loan was originated and its compliance with applicable law. These representations and warranties are important to ensure, among other things, that the securitization trust contains mortgage loans having expected characteristics and terms which can be serviced in accordance with accepted servicing standards. The representations and warranties included within the securitization contracts for an RMBS transaction may vary from transaction to transaction depending on a number of factors, including the type of collateral involved, the specific features of the transaction and the particular circumstances of the parties to the transaction.

Generally, if a loan is found to have breached the representations and warranties and such breach materially and adversely affects the interests of investors in such loan, the loan can be "put back" or returned to the seller who is obligated to repurchase it, effectively a 100% risk retention. Much like a defective product is returned to the store from which it was sold, a materially defective mortgage loan will be returned to the issuer or other representing party through its removal from a securitization trust for the applicable repurchase price or a qualified substitute loan. Like representations and warranties, the "repurchase" remedy in RMBS transactions are governed by the securitization contracts and may vary from transaction to transaction depending on a number of factors.

Without exception, our originator, issuer and investor members view representations and warranties as risk retention for RMBS transactions. ASF supports a 100% repurchase of a loan where its characteristics do not conform to the stated characteristics set forth by the originator and result in a breach of the representations and warranties that materially and adversely affects the interests of investors in such loan. ASF believes that risk retained through representations and warranties results in an even greater amount of skin in the game than the 5% risk retention requirements set forth in the Dodd-Frank Act. In addition, the principal goal of any risk retention initiative should be to establish and reinforce commercial incentives for originators and issuers to create and fund assets that conform to stated underwriting standards and other securitization eligibility criteria, thereby making those parties economically responsible for the stated attributes and underwriting quality of securitized loans. For this reason, the ASF continues to advocate that "skin in the game" for originators and issuers of RMBS continue to be implemented through the representations and warranties that originators and issuers provide with respect to the mortgage loans sold into the securitization trust coupled with meaningful repurchase mechanisms designed to ensure their enforcement.

ii. ASF Model Reps

The Dodd-Frank Act and recent rules issued by the SEC require each nationally recognized statistical rating organization ("NRSRO") to include in any report accompanying a credit rating a description of (i) the representations, warranties, and enforcement mechanisms available to investors; and (ii) how they differ from the representations, warranties, and enforcement mechanisms in issuances of similar securities. This requirement seeks to achieve the same goal that ASF had originally sought when we began creating the ASF Model Reps over two years ago: a means to provide a transparent comparison between different transactions that would allow investors to decipher between the strength of representations, warranties and repurchase provisions in one transaction versus those in another. However, without a baseline such as the Model Reps to facilitate the comparison, the comparing party under the Dodd-Frank provisions (the NRSROs) would have to analyze all differences in language, including specific phraseology and the use of knowledge qualifiers, to evaluate whether various actions and requirements are included within a particular set of representations and warranties. This is a very difficult task.

Historically, the type and form of representations and warranties included in RMBS transactions varied greatly, and investors often expressed concerns about their inability to compare the representations and warranties provided by different issuers. The ASF Model Reps were developed primarily to express customary market representations and warranties in the same, transparent language across transactions and provide a "baseline" against which investors and rating agencies can measure the representations and warranties contained in a particular transaction. The Model Reps were designed to allow market participants to easily determine whether departures from the Model Reps have occurred and whether knowledge qualifiers were used, adding transparency to the negotiation process among the parties to a given transaction and enabling issuers and investors to more easily and better assess their willingness or unwillingness to assume origination risks. The Model Reps also provide more significant protections by changing the language of the representations and warranties contained in existing RMBS transactions and including many new provisions which did not previously exist. Among these representations are warranties are ones covering mortgage fraud, verification of income, employment and asset verification, veracity of appraisal process, conformance to underwriting guidelines, occupancy status of property, and early payment default. We also address the use of "knowledge qualifiers," which refers to language in the representations and warranties requiring that the issuer be cognizant of the fact that causes a breach. The ASF Model Reps would clearly specify knowledge qualifiers in an exhibit so that rating agencies and investors can identify knowledge qualifications at a glance for comparison across issuers.

iii. ASF Model Repurchase Principles

Throughout the development of the ASF Model Reps, our members also began to consider changes to the repurchase provisions that serve to enforce the representations and warranties in a transaction. In most existing transactions, securitization contracts call for the trustee or another specified party to demand repurchase when defects have been discovered. However, investors believe that the repurchase process set forth in most securitization contracts does not provide certain parties with an adequate means to pursue a repurchase demand. In addition, the effectiveness of the specific mechanisms to identify breaches or to resolve a question as to whether a breach occurred in the RMBS sector has also been questioned in many cases.

For future transactions, our members, including issuers, investors and financial guarantors, have agreed to work towards a model set of principles for investigating, resolving and enforcing remedies with respect to representations and warranties in RMBS transactions by, among other things, clearly delineating the roles and responsibilities of transaction parties in the repurchase process and allowing greater access into the mortgage loan files so that breaches can be discovered. The goal of the working group is to create a model framework for remediation in future RMBS securitization transactions while aiding the recovery of the RMBS market.

Although ASF has not yet established final Model Repurchase Principles, our membership has generally agreed that proper governance principles for RMBS would require a robust mechanism for the investigation and resolution of disputes regarding breaches of transaction representations and warranties. The basic elements of a mechanism currently being discussed would involve (i) review of pool assets by an independent third party that is given access to the loan files for compliance with representations and warranties following the occurrence of an agreed-upon “review event” that is centered around objective factors, (ii) recommendation by the independent third party to the securitization trustee of whether or not to demand repurchase of, or substitution for, the pool asset by the representing party and (iii) if the representing party disputes the independent third-party’s findings, submission of the dispute to a binding determination by a second independent party. We believe that such a strong third-party mechanism will ensure that representations and warranties in securitizations have “teeth,” with the beneficial effect of causing asset originators to exercise caution in underwriting and deterring transfers of substandard assets to securitization vehicles.

We note that the Dodd-Frank Act and recent rules issued by the SEC also address loan repurchases in securitizations and requires any securitizer to disclose fulfilled and unfulfilled repurchase requests across all trusts aggregated by the securitizer, so that investors may identify asset originators with clear underwriting deficiencies. Although the Dodd-Frank Act's requirements for repurchase activity would ensure that some ongoing disclosure is made in securitizations about whether a representing party will repurchase pool assets as to which claims of breach of representations or warranties are asserted, it would not ensure that the repurchase of noncompliant assets is effected, as it is a purely disclosure-based provision. Instead, we believe that securitization participants would be incentivized to adopt better practices if the framework for a third-party mechanism of the type we have described in this testimony were included within RMBS transactions. We believe that a robust third-party mechanism for investigating and resolving breaches will serve the interests of investors and issuers going forward.

B. Risk Retention Proposed Pursuant to Dodd-Frank

i. Overview of Proposal

Section 941 of the Dodd-Frank Act requires the Federal Deposit Insurance Corporation ("FDIC"), the Federal Reserve Board of Governors (the "Board"), the Office of the Comptroller of the Currency ("OCC") and the Securities and Exchange Commission (the "SEC" and collectively, the "Joint Regulators")[12] to jointly implement rules to require any "securitizer" to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an "asset-backed security," transfers, sells, or conveys to a third party.

[12] In the context of the Proposed Risk Retention Regulations concerning residential mortgages, "Joint Regulators" also refers to the Federal Housing Finance Agency ("FHFA") and the Secretary of Housing and Urban Development.

Section 941 amends the Securities Exchange Act of 1934 (the "Exchange Act") to establish an alternative definition of "asset-backed security" (an "Exchange Act ABS") that is broader than the existing definition set forth in Regulation AB of the Securities Act of 1933 (the "Securities Act") and a definition for the term "securitizer" which is, generally, an issuer of Exchange Act ABS or a person who organizes and initiates an Exchange Act ABS transaction by transferring assets to the issuer.[13]

The general standards for risk retention are set forth in Section 941, which requires a securitizer to retain "(i) not less than 5 percent of the credit risk for any asset" or "(ii) less than 5 percent of the credit risk for an asset" if the originator of the asset meets underwriting standards to be prescribed by the Joint Regulators. The regulations prescribed under Section 941 must also specify "the permissible forms of risk retention" and "the minimum duration of the risk retention." In addition, the regulations "shall establish asset classes with separate rules for securitizers of different classes of assets, including residential mortgages, commercial mortgages, commercial loans, auto loans, and any other class of assets that the Federal banking agencies and the SEC deem appropriate" and, for each asset class established, the regulations "shall include underwriting standards established by the Federal banking agencies that specify the terms, conditions, and characteristics of a loan within the asset class that indicate a low credit risk with respect to the loan." Additionally, Section 941 specifies that the regulations shall provide for certain exemptions as further described in this testimony.

[13] In a release of proposed rules relating to Section 943 of the Dodd-Frank Act, the SEC indicates its belief that the definition of Exchange Act ABS includes securities that are typically sold in transactions exempt from registration under the Securities Act and that the definition of securitizer is not specifically limited to entities that undertake transactions that are registered under the Securities Act. *See* Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (75 FR 62718, October 13, 2010), (SEC Release Nos. 33-9148; 34-63029; File No. S7-24-10), p. 62721, *available at* http://www.gpo.gov/fdsys/pkg/FR-2010-10-13/pdf/2010-25361.pdf.

In November and December of 2010, ASF submitted a series of preliminary comment letters to each of the Joint Regulators supporting the proposal of risk retention requirements that are tailored to each major asset class, including (i) our comment letter[14] relating to residential mortgage-backed securities ("RMBS") and the qualified residential mortgage ("QRM") exemption (the "ASF RMBS Risk Retention Letter"), (ii) our comment letter[15] relating to auto ABS (the "ASF Auto Risk Retention Letter"), (iii) our comment letter[16] relating to ABCP (the "ASF ABCP Risk Retention Letter"), (iv) our comment letter[17] relating to credit card ABS (the "ASF Credit Card Risk Retention Letter"), (v) our comment letter[18] relating to student loan ABS (the "ASF Student Loan Risk Retention Letter") and (vi) our comment letter[19] relating to corporate debt repackagings (the "ASF Repack Risk Retention Letter" and collectively, the "ASF Risk Retention Letters"). In these comment letters, our membership sought to highlight the intricacies of each of these asset classes and stress the need for risk retention requirements that permit tailoring of the retention forms to each class of securitized assets.

[14] *See* "ASF Comment Letter re RMBS Risk Retention & QRM," American Securitization Forum (November 12, 2010), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_RMBS_Risk_Retention_Letter_11.12.10.pdf.
[15] *See* "ASF Comment Letter re Risk Retention for Auto ABS," American Securitization (November 22, 2010), available at http://www.americansecuritization.com/uploadedFiles/ASF_Auto_Risk_Retention_Letter_11.22.10.pdf.
[16] *See* "ASF Comment Letter re Risk Retention for ABCP," American Securitization Forum (November 22, 2010), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_ABCP_Risk_Retention_Comment_Letter_11.22.10.pdf.
[17] *See* "ASF Comment Letter re Risk Retention for Credit and Charge Card ABS," American Securitization Forum (November 23, 2010), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_Credit_Card_Risk_Retention_Letter.pdf.
[18] *See* "ASF Comment Letter re Risk Retention for Student Loan ABS," American Securitization Forum (November 23, 2010), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_Student_Loan_Risk_Retention_Letter.pdf.
[19] *See* "ASF Comment Letter re Corporate Debt Repackaging," American Securitization Forum (December 14, 2010), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_Corporate_Debt_Repackaging_Letter_FINAL_12-14-10.pdf.

The views set forth in the ASF Risk Retention Letters were consistent with the Dodd-Frank Act's directive to implement "separate rules for securitizers of different classes of assets" and reflected the primary recommendation of the Board of Governors of the Federal Reserve System in its October 2010 Report to the Congress on Risk Retention (the "Federal Reserve Study"), in which it stated:

> "Thus, this study concludes that simple credit risk retention rules, applied uniformly across assets of all types, are unlikely to achieve the stated objective of the [Dodd-Frank] Act—namely, to improve the asset-backed securitization process and protect investors from losses associated with poorly underwritten loans. … Given the degree of heterogeneity in all aspects of securitization, a single approach to credit risk retention could curtail credit availability in certain sectors of the securitization market. A single universal approach would also not adequately take into consideration different forms of credit risk retention, which may differ by asset category. Further, such an approach is unlikely to be effective in achieving the stated aims of the statute across a broad spectrum of asset categories where securitization practices differ markedly. … In light of the heterogeneity of asset classes and securitization structures, practices and performance, the Board recommends that rulemakers consider crafting credit risk retention requirements that are tailored to each major class of securitized assets."[20]

In addition, the Financial Stability Oversight Council ("FSOC"), chaired by Treasury Secretary Timothy F. Geithner, indicated in its January 2011 study that a risk retention framework should "[a]lign incentives without changing the basic structure and objectives of securitization transactions; [p]reserve flexibility as markets and circumstances evolve; and [a]llow a broad range of participants to continue to engage in lending activities, while doing so in a safe and sound manner."[21]

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[20] The Board of Governors of the Federal Reserve System, Report to Congress on Risk Retention, *available at* http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf, p. 3, 83-84.

[21] Timothy F. Geithner, Chairman, Financial Stability Oversight Counsel, Report to Congress on Macroeconomic Effects of Risk Retention Requirements, *available at*

During the week of March 28, 2011, each of the Joint Regulators approved for release their notice of proposed rulemaking (the "Proposing Release") entitled "Credit Risk Retention" (RIN 1557-AD40; 7100 AD 70; 3064-AD74; 3235-AK96; 2590-AA43),[22] and requested public comment by June 10, 2011 (the "Proposed Risk Retention Regulations"). The Proposed Risk Retention Regulations provide a range of options that securitizers may choose from in meeting the risk retention requirements, including: (i) retention of a "vertical slice" of each class of interest issued in the securitization, (ii) retention of an "eligible horizontal residual interest" in the securitization, (iii) use of "L-Shaped" risk retention, which combines both vertical and horizontal forms, (iv) in the case of revolving asset master trusts, retention of a "seller's interest" that is generally pari passu with the investors' interest in the revolving assets supporting the ABS, (v) retention in its portfolio of a "representative sample" of assets equivalent to the securitized assets; and (vi) other risk retention options that purport to take into account the manner in which risk retention often has occurred in connection with the issuance of asset-backed commercial paper ("ABCP") and CMBS. In addition, the Proposed Risk Retention Regulations set forth various exemptions, including exemptions based on certain "qualified" loans such as the QRM and qualifying automobile loans ("Qualifying Automobile Loans"), as well as hedging restrictions and the premium capture cash reserve account, which would be funded in certain circumstances by excess spread monetized at the time of securitization. In drafting the Proposed Risk Retention Regulations, the Joint Regulators have indicated that they have taken into account the diversity of assets that are securitized, the structures historically used

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http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20%20%28FINAL%29.pdf, p. 3.

[22] *See* http://edocket.access.gpo.gov/2011/pdf/2011-8364.pdf.

in securitizations, and the manner in which securitizers may have retained risk. ASF applauds these efforts to tailor the proposed rules to each asset class.

Within the context of these Proposed Risk Retention Regulations, ASF delivered testimony before a hearing of the House Committee on Financial Services ("HFSC") Subcommittee on Capital Markets and Government Sponsored Enterprises entitled, "Understanding the Implications and Consequences of the Proposed Rule on Risk Retention."[23] Our testimony provides detailed comments regarding risk retention for RMBS, ABS backed by auto loans and leases, credit card receivables, and student loans, ABCP, municipal bond and corporate debt repackagings, and general concerns related to nontraditional or "esoteric" asset classes. In addition, we continue to work on our broad comment letter to be submitted on the Joint Regulators' comment deadline of June 10, 2011, which will cover these same topics, in addition to CLOs, equipment ABS and cross border issues. We believe these comments are of critical importance to the Joint Regulators' goal of prescribing risk retention rules that properly align incentives without inhibiting the return of the securitization market and adversely impacting the availability and cost of credit. Simply put, the absence of a properly functioning securitization market, and the funding and liquidity this market has historically provided, adversely impacts consumers, businesses, financial markets and the broader economy. The recovery and restoration of confidence in securitization is therefore a necessary ingredient for economic growth to resume, and for that growth to continue on a sustained basis into the future.[24]

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[23] *See* "ASF Risk Retention Testimony Before HFSC," American Securitization Forum (April 14, 2011), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_HFSC_Risk_Retention_Testimony_4-14-11.pdf.
[24] For more information on the role of securitization within the financial system and U.S. economy, *see* Appendix A.

ii. Critical Flaws in the Proposal

The ASF has long been supportive of further methods to align the incentives of issuers and investors of mortgage- and asset-backed securities and we very much appreciate the hard work the Joint Regulators have put into developing the Proposed Risk Retention Regulations. In drafting the Proposed Risk Retention Regulations, the Joint Regulators have indicated that they have taken into account the diversity of assets that are securitized, the structures historically used in securitizations, and the manner in which securitizers may have retained risk. We note that a similar effort was not undertaken by the FDIC in unilaterally enacting risk retention rules as part of its securitization safe harbor, which has restricted insured depository institution issuance of asset- and mortgage-backed securities to only one prime auto loan transaction.

Despite the efforts of the Joint Regulators, significant work still needs to be done to evolve the Proposed Risk Retention Regulations into workable solutions. What is at stake is the risk of significant reductions in the availability of car loans, mortgages, student loans, credit cards, and business credit all across America. Given that many engines of the U.S. economy are still sputtering and unemployment remains extremely high, the ASF advocates strongly that these rules not overreach to attempt to “fix” large swaths of the securitization markets that did not see any losses during an extreme economic downturn and instead are now powering economic revival in some sectors of the economy. Attempts to realign incentives in many types of securitization structures, where those incentives have demonstrated through strong performance to be well-aligned between issuer and investor, only serves to risk harm to the American economy, American consumer and to investors.

As such, we believe that the regulators should specifically articulate that the Proposed Risk Retention Regulations would not apply to a number of segments of the securitization market, including appropriately defined prime auto loan pools, government guaranteed student loans and sponsor-supported ABCP that have all demonstrated extraordinary structural resilience in the most stressed of economic circumstances. In other areas such as corporate and municipal bond repackagings, the rules simply should not have the legal authority to apply to these transactions, nor is there any evidence of misaligned incentives in these markets.

In other areas of the securitization markets, such as residential mortgages, we are quite concerned that the rules put the private markets at an enormous disadvantage vis-à-vis the government-backed market, which will ultimately keep the private markets on the sidelines, while American taxpayers continue to bear the risk on 95+% of new mortgages made in America. These rules should be encouraging the return of private capital by allowing for a definition of QRM that would facilitate competition in the relative near-term between government-backed and private label RMBS transactions. Private label offerings and private actors also have a litany of considerations that government offerings, particularly those in conservatorship, do not confront. These include key issues around accounting consolidation under FAS 166 and 167 that can have extraordinary implications for how depository institutions allocate their risk-based capital.

a. Premium Capture

The proposed premium capture rule exceeds the mandate and legislative intent of Dodd Frank by adding on to the 5% risk retention the entire value of ABS issued in a securitization over par— effectively nullifying the securitizer's entire return on the transaction. While some regulators believe the definition is only meant to ensure that the risk retained by the securitizer is, in fact, worth at least 5% of the fair value of ABS issued, the proposed rule, as written, does not reflect this meaning. The rule as drafted will have pervasive effects on securitization and borrowers, including virtually assuring the accounting consolidation of the securitization onto the balance sheet of the securitizer regardless of the risk retention form employed and higher capital requirements for all institutions, especially banks.

The premium capture rule also not take into account the cost of origination of loans, including out-of-pocket costs such as appraisals and title insurance, as well as the originator's overhead and profit on sale. In addition, the rule would interfere with an originator's or sponsor's ability to use interest rate hedges during the period between origination and securitization, which would likely prevent originators from offering borrowers rate locks for the period between application and funding. Finally, the harsh impacts of the premium capture rules will be most severe for non-prime borrowers, because securitizations of loans to such borrowers create significant amounts of excess spread. This will result in credit being less available to, and more expensive for, low to moderate income mortgage borrowers.

Most disturbing, however, is that the premium capture rule as currently proposed eliminates virtually all incentives to securitize for institutions other than those that securitize purely for financing. Institutions with other sources of funding will move away from securitization altogether, resulting in a constriction of credit and an increased cost of capital. A reduced availability of credit would put negative pressure on home values and, in turn, affect the trillions of dollars of outstanding ABS that investors currently own.

b. Servicing Standards

The inclusion of servicing standards in the QRM definition goes well beyond the legislative intent of Dodd-Frank and its mandate for including criteria relating to underwriting and product features. There is no evidence, either in the legislative history or the language of Dodd-Frank, that Congress intended to include servicing standards as part of risk retention rules. In fact, incorporating servicing standards into the QRM definition would have the peculiar result of regulating the servicing of the highest quality borrowers, those with the least risk of encountering servicing issues or needing loss mitigation, while the bulk of the market, consisting of borrowers with a greater need for loss mitigation, would be left unregulated.

The proposed QRM definition requires the loan documents to include policies and procedures that 1) require commencement of loss mitigation efforts after 90 days delinquency, 2) allow for loan modifications if the resulting net present value would be greater than foreclosure proceeds, 3) address how the lender will service any second lien loan on the same property (when the lender services both the first and the second lien loan) and 4) include servicing compensation arrangements that are consistent with the creditor's commitment to engage in loss mitigation activities. There must also be an undertaking not to transfer servicing to any servicer who does not maintain such policies and procedures. We understand and appreciate the regulatory imperative for national servicing standards that address the above issues and our members are generally supportive of this effort. But, as noted in the Joint Regulators' proposing release, there is a separate interagency effort among certain Federal regulators to develop national servicing standards that will apply to all servicers of residential mortgage loans. We believe that this effort should not be rolled out on a piecemeal basis, and that the QRM definition is not the right time and place for even a limited preview of these criteria. The key to success for such criteria is that they should be universal. As part of an additional QRM criterion, these standards would not apply to loans that are sold to, or securitized by, the GSEs. Due to the restrictive nature of the QRM criteria, these standards would apply to only a small portion of the non-GSE market, with that segment being the most creditworthy borrowers, who of course are the least likely to need loss mitigation. We frankly believe that it is just not good public policy to apply these nascent and still developing standards to this subset of new originations.

We believe that compliance with the national servicing standards under development should be a matter of regulatory compliance only. We note that this is consistent with the recent efforts undertaken by Congress to regulate the activities of servicers, such as through the establishment of safe harbors for certain loss mitigation practices in the Helping Families Save Their Homes Act of 2009. By placing the requirement to maintain such policies and procedures in the loan documents, this approach invites the borrower to raise as a defense to foreclosure claims that 1) the servicer's policies and procedures did not meet the regulatory requirements as per the covenants in the loan documents, and 2) the servicer failed to comply with its policies and procedures in servicing the mortgage loan. In America's litigious environment, such claims, whether valid or specious, can easily be foreseen. We believe that it would not be good public policy to effectively grant to borrowers a private right of action to enforce these regulatory requirements. The Home Affordable Modification Program as well as other loan modifications were not structured to give the borrower a private right of action. Furthermore, by attaching these potential defenses in foreclosure to QRMs, but not simultaneously to non-QRMs, this aspect of the criteria would actually make QRMs <u>more</u> risky than non-QRMs from the investor's perspective, which is contrary to the Dodd-Frank mandate. If just one judge in one foreclosure action ruled that the servicer's policies and procedures did not comply with the QRM criteria, the QRM status of all loans serviced by that servicer would be questionable and potentially cause significant losses to institutional investors. The inclusion of servicing standards in the loan documentation also raises the moral hazard of enabling unscrupulous borrowers to better understand the length of time for which they may avoid paying their mortgages without fear of significant consequences.

c. Qualifying Auto Loan

We believe that in preparing the qualifying auto loan definition, the Joint Regulators made a fundamental error in attempting to analogize to the residential mortgage asset class. This inappropriate paralleling is evident in the focus on debt and income verifications at origination, which have traditionally not been required for even the highest quality motor vehicle originations, a required 20% down payment (comprised of cash and/or vehicle trade-in value) in a market where advance rates above 100% are commonplace,[25] and a requirement that the originator or its agent hold the certificate of title on the related loan when one-in-five states require that the consumer, rather than the lender, hold a motor vehicle's certificate of title. Other features, such as the proposed maximum loan terms of 60 months in a market where 72-month lending has been a normal market feature for many years, on both new and used vehicles, simply illustrate a misunderstanding of what constitutes a "standard" product in the motor vehicle marketplace.

[25] Motor vehicle loans in the ordinary course also regularly finance taxes, titling fees, ancillary products, service contracts, insurance policies and/or balances refinanced on trade-in vehicles. The Proposed Risk Retention Regulations not only require a minimum 20% down payment but also demand that the customer pay 100% of the title, tax, registration and dealer-imposed fees.

Furthermore, we believe that the proposed exemption is underinclusive in that it omits many types of consumer transactions that are made using high-quality underwriting standards and that give rise to assets that would be appropriately securitized without prescribed levels of enhancement. For example, in omitting loans to commercial purchasers and to individuals who will use their vehicles for commercial uses by mandating that all loans be made to individuals to secure vehicles used for personal or family use, failing to include motorcycles in the list of permissible "passenger vehicles" and excluding motor vehicle lease transactions, the Proposed Risk Retention Regulations focus on a particular subset of the motor vehicle sector (i.e., loans to individuals for cars) that omits equally creditworthy and low-risk products that should have equivalent access to the exemption.

d. Failure to Incorporate Market Practices

The commentary in the proposing release specifically indicates that the Proposed Risk Retention Regulations for ABCP and credit card ABS are meant to track current market practices. However, there are numerous parts of the Proposed Risk Retention Regulations that are, in fact, not at all consistent and would cause detrimental effects on those markets. Through our comment letter process, ASF is identifying these inconsistencies and recommending specific regulatory changes to resolve them. In addition, there are other examples of market practices, such as in auto ABS, that have proven to withstand extreme economic distress. These market practices should be considered by the Joint Regulators in the forms of risk retention proposed.

e. Competing Regimes

It is important to highlight that securitization transactions in Europe are subject to their own risk retention requirements set forth in the European Union's CRD Article 122a.[26] The structure of the European risk retention regime is fundamentally different than the U.S. rules. While the U.S. rules apply to issuers of ABS, the European rules apply to European Economic Area credit institutions that invest in ABS. Ultimately, this could have the peculiar result of application of both risk retention regimes, which is further confused by the regulations' differing requirements. Harmonization among the two sets of rules will be critical to a functioning and efficient securitization market.

The FDIC's securitization safe harbor (the "FDIC Safe Harbor") for banks also includes a risk retention requirement, but only permits a vertical slice or representative sample. In addition, the FDIC Safe Harbor is currently in effect for bank securitizations, while Dodd-Frank has a mandate of one or two years for its risk retention rules for RMBS and ABS, respectively. While the FDIC Safe Harbor does include an "auto conform" provision that is designed to align it with the rules enacted by the Joint Regulators, the interim effects of the FDIC's inferior rules are not addressed. For example, the FDIC Safe Harbor does not take into account characteristics of different assets and it ignores securitization features such as overcollateralization and seller's interest. Furthermore, the FDIC Safe Harbor's representative sample option is formulated differently than the representative sample option included in the Joint Regulators' Proposed Risk Retention Regulations, and so a bank seeking to avail itself of this option would have to adopt

[26] *See* CRD Directive 2006/48/EC, p. 78, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0048:20100330:EN:PDF.

one set of procedures to comply with the FDIC Safe Harbor in its current form and then a different set of procedures at such time as the auto-conform provision takes effect.

We also note that, by its own admission, the FDIC's recent CMBS transaction did not comply with the FDIC Safe Harbor. The FDIC indicated in the press release for the transaction that "[t]he pilot program is consistent with the [FDIC Safe Harbor], except for certain limited differences necessitated by the origin of the collateral and the absence of information available from the failed banks." While this admission is concerning on its own, we also note that, while certain of the classes contained an FDIC guarantee, the transaction did not comply with either the vertical or representative sample retention requirements of the FDIC Safe Harbor. For more information on this topic, please see "FDIC Safe Harbor Concerns" below.

iii. Impact on GSEs and Housing Finance Reform

a. The Current Policy Debate

On September 7, 2008, FHFA placed Fannie Mae and Freddie Mac (the "GSEs") into conservatorship in order to control their impact on the nation's financial stability during the housing crisis. Since that time, the economic significance of the GSEs has only increased, and they, along with FHA, guarantee 95% of American mortgages, as the private label MBS market continues to lie dormant. Recently, however, policymakers have begun to reconsider the future of these institutions and the broader question of whether the federal government should continue to play a major role in the nation's housing finance market.

On February 11, 2011, the Obama Administration released its plan for reforming America's housing finance market, which called for a winding down of the GSEs and reviewed measures to encourage the return of private capital to the market, such as reducing conforming loan limits and increasing guarantee fee pricing.[27] The Administration though has not provided any specific long-term solution to the problems facing taxpayer-sponsored housing finance in America, nor has it provided a roadmap for how to move away from today's GSE dependent state.

The Proposed Risk Retention Regulations would impose significant burdens on issuers of private label MBS but provide that the implicit 100% taxpayer guarantee is a suitable form of skin in the game for the GSEs, effectively exempting them from the proposed rules. This has sparked considerable criticism from the House Financial Services Committee Subcommittee on Capital Markets and Government Sponsored Enterprises, which believes the proposed GSE exemption extends well beyond the regulators' mandate under Dodd-Frank. Since the release of the Proposed Risk Retention Regulations, the Subcommittee unanimously passed (34-0) a bipartisan bill that would ensure that MBS issued by the GSEs are treated similarly to private label MBS for purposes of risk retention and held a hearing entitled, "Understanding the Implications and Consequences of the Proposed Rule on Risk Retention," during which the members heavily criticized the regulators' "overreaching." Additionally, a number of other legislative solutions are also in the works, including bills that would require GSE portfolio reduction, increase guarantee fees, revise compensation schemes for executive officers of the GSEs and prohibit the GSEs from offering any new products during the term of conservatorship or receivership.

[27] *See* "Reforming America's Housing Finance Market," U.S. Department of the Treasury and U.S. Department of Housing and Urban Development (February 11, 2011), *available at* http://www.treasury.gov/initiatives/Documents/Reforming%20America%27s%20Housing%20Finance%20Market.pdf.

Other members of Congress are supportive of a government-backed mortgage. On May 12, 2011, Representatives John Campbell (R-CA) and Gary Peters (D-MI) introduced H.R. 1859, the "Housing Finance Reform Act of 2011," which seeks to replace the GSEs with at least five separate mortgage "guaranty associations" chartered by FHFA. These guaranty associations would operate as private companies, but would be able to issue mortgage-backed securities with explicit federal guarantees.

b. The QRM Definition and Leveling the Playing Field

Regardless of whether the government will play a role, it is clear that most policymakers believe that private capital needs to return to the mortgage market, which makes the Proposed Risk Retention Regulations and, in particular the QRM definition, critically important. As currently contemplated, only the highest quality mortgage loans will qualify as QRMs and therefore QRMs will comprise only a small percentage of the mortgage market. The Joint Regulators' proposing release indicates that approximately 19.79% of all loans purchased or securitized by the GSEs during the period 1997 - 2009, and approximately 30.52% of loans in 2009 alone, would have met the QRM criteria. Currently, highly creditworthy borrowers are continuing to experience difficulties in obtaining mortgage financing, as uncertainty in the world financial markets in general and the mortgage market in particular make obtaining credit difficult. This problem will be substantially exacerbated, and the availability of mortgage credit to consumers will suffer, if the QRM definition is not expanded to include a greater percentage of the mortgage market. The highly conservative nature of the QRM definition will likely limit the availability, and increase the cost, of mortgage credit to consumers, particularly to those with low to moderate incomes. In light of the risk retention requirements that will exist upon the securitization of non-QRM loans, these loans will certainly feature higher interest rates, more points and fees, and more onerous terms than QRM loans.

We note again that the Proposed Risk Retention Regulations provide a complete exemption from the risk retention requirements (including an exemption from the requirement to establish a premium capture cash reserve account) for RMBS guaranteed by the GSEs for so long as the GSEs operate under the conservatorship or receivership of FHFA. We are concerned that the very conservative terms of the proposed QRM definition, taken together with the risk retention requirements, will provide a significant and undue competitive advantage to the GSEs over private market participants. Securities guaranteed by the GSEs will be able to be securitized free from the risk retention requirements irrespective of whether such securities are QRMs, which will result in the non-QRMs loans backing such securities having lower costs to borrowers and more attractive terms than similar loans offered by private market participants. This will have the effect of increasing the portion of the residential mortgage market dominated by the GSEs, further entrenching the importance of their role in such market. This will make it substantially more difficult for Congress to carry out its efforts to restructure or wind down the GSEs, since a substantial percentage of consumers will be wholly dependent on the GSEs to provide them with affordable mortgage financing.

In our view, the best way to level the playing field and avoid increasing the role of the GSEs in the residential mortgage market is to reduce the impact of the risk retention requirements on private market participants. This could be accomplished in a variety of ways. We urge the Joint Regulators to consider adjusting the criteria for QRMs, such that the vast majority of loans to prime borrowers that meet the product type and LTV criteria in the QRM definition will qualify as QRMs. Reconciling the QRM criteria with the GSE requirements would enable private market participants to compete on equal terms with the GSEs for most of the mortgage market comprised of loans to prime borrowers. The Joint Regulators could also reduce the adverse impact of the risk retention requirements on private market participants, and thereby enable them to better compete with the GSEs and to serve the borrowing needs of the American homeowner.

iv. Need for Re-Proposal of Proposed Regulations

In preparing the Proposed Risk Retention Regulations, the Joint Regulators undertook the complex task of evaluating the diverse characteristics of securitized assets and the structures historically used in securitizations. We applaud the hard work of the Joint Regulators in developing the Proposed Risk Retention Regulations and their efforts to tailor the proposed rules to each asset class and securitization structure. However, we believe that the time-intensive task of creating risk retention rules that both protect investors and encourage a robust and efficient securitization market is far from complete.

ASF is currently working with our membership to develop a detailed and constructive response to the Joint Regulators' request for comment by the aggressive, but established June 10th deadline. We believe that many other interested parties, including other industry groups, individual market participants, academics, members of Congress and the general public, will submit comment letters as well. Given the diversity and complexity of the securitization market and the highly technical nature of the Proposed Risk Retention Regulations, we believe that revisions made by the Joint Regulators in response to these comments, which will likely number in thousands of pages, will most certainly justify an opportunity for further review by all securitization market participants prior to adoption. Therefore, we urge the Joint Regulators to revise the Proposed Risk Retention Regulations to address the concerns described in each of our separate comment letters and to re-propose a rule implementing Section 941 of the Act for further consideration and public comment prior to adoption. We strongly believe that this course of action will better enable the Joint Regulators and the securitization industry to collectively ensure that the final regulations achieve the goals of the Dodd-Frank Act while promoting a healthy and vibrant securitization market.

Over the years, securitization has grown in large measure because of the benefits it delivers to transaction participants and to the financial system. However, the efficiency, liquidity and low cost of funding that have long been achieved in the securitization markets are threatened by the risk retention rules set forth in the Proposed Risk Retention Regulations. To ensure the availability of credit for consumers and businesses, it is imperative that the final risk retention rules promote a robust securitization market.

While we support measures to ensure the alignment of the incentives of sponsors and investors in the ABS markets, we believe that the burdens imposed on ABS sponsors by the risk retention rules must be commensurate with the risks associated with investment in ABS. Existing securitization programs have structural features that operate to align the interests of sponsors with those of investors. In fact, in the context of most major sectors of non-mortgage ABS, misalignment of interests has not been identified, and no investor who held those ABS securities to maturity experienced losses during the recent financial crisis. The confidence of issuers and investors in the strength of these structures and the quality of the assets underlying these non-mortgage ABS is evidenced by the relative speed with which these segments of the market have recovered.

Despite the structural integrity and strong performance record of these ABS segments, the Proposed Risk Retention Regulations would require many sponsors to alter the structures of their securitization programs. While the Proposed Risk Retention Regulations include a number of permissible methods of risk retention, the definitions of and requirements for those methods would not accommodate common methods of risk retention in many asset classes, including auto loans, student loans, credit cards and asset-backed commercial paper. For example, under the Proposed Risk Retention Regulations, in order to qualify as horizontal risk retention an ABS interest must have the most subordinated claim to payments. In some cases, however, the subordinate tranches held by an ABS sponsor may absorb losses before more senior tranches held by third parties are affected, but only after the funds in a reserve account are depleted. Furthermore, even in cases where the Joint Regulators indicated that the proposals were meant to exactly conform to existing market practices, there are significant differences that would create major disruptions in the ABS market.

Altering the structures of ABS programs to conform their risk retention features to the methods permitted under the Proposed Risk Retention Regulations would be very expensive and, in many cases, would render the economics of the programs untenable. If the risk retention rules are not appropriately designed to accommodate existing market practices, we risk an immediate and significant reduction in the availability of auto loans, student loans, credit cards and business credit throughout our country without gaining material improvements to the risk retention measures that protected investors even during the worst of the financial crisis. The risk of shutting down the securitization markets is not warranted where investors have been protected by existing risk retention methods. Therefore, it is imperative that the provisions of the Proposed Risk Retention Regulations accommodate existing market practices that effectively align the interests of sponsors with those of investors.

Unfortunately, structuring the Proposed Risk Retention Regulations to accommodate existing market practices is easier said than done. Numerous classes of assets are securitized, multiple securitization structures are utilized for each asset class, and each of those structures is extremely complex. The task of ensuring that the sponsors of each asset class and of each existing structure can comply with the Proposed Risk Retention Regulations without substantial additional costs requires an intimate knowledge of the characteristics of each asset class and each securitization structure. As noted previously, the specific credit history factors proposed to be used as a proxy for credit score in the QRM definition have not been established to be predictive of the probability of default. In fact, industry statistics indicate that these proposed delinquency payment requirements could result in the inclusion of a credit score as low as 437 and the exclusion of a score as high as 850. Additionally, the proposed "qualifying auto loan" definition requires a 20% down payment, a figure that is commonplace in the mortgage market but has no relevance in an auto market where advance rates of 100% are commonplace. The complexity of the securitization structures and securitized assets is further demonstrated by the fact that the Joint Regulators included 174 requests for comment in the Proposed Risk Retention Regulations.

We are also concerned that revisions made to the Proposed Risk Retention Regulations to accommodate an existing market practice for one asset class or in one securitization structure may have the unintended consequence of excluding an existing market practice for another asset class or in a different securitization structure. The potential for these unintended consequences is particularly acute in the context of the portions of the Proposed Risk Retention Regulations that will be the subject of comment from representatives of multiple asset classes, including provisions prescribing the general methods of risk retention that are available to all asset classes. Securitization market participants cannot evaluate the consequences of substantive revisions made by the Joint Regulators in response to comments to the Proposed Risk Retention Regulations unless they are given an opportunity to review those revisions before the final rule is adopted.

In addition to our concerns about the complexity of the subject matter of risk retention rules, we are concerned about the complexity of the process of managing the implementation and interpretation of the final risk retention rules. In the Proposed Risk Retention Regulations, the Joint Regulators indicated that they will jointly approve any written interpretations, written responses to requests for no-action letters and legal opinions, or other written interpretive guidance concerning the scope or terms of the final rules that is intended to be relied on by the public generally. The Joint Regulators further indicated that they will jointly approve any exemptions, exceptions or adjustments to the final rules. The process for seeking corrections to final regulations or interpretive guidance from a single regulator is often onerous and time-consuming. These burdens will be dramatically compounded in the case of the final risk retention rules where the corrections and guidance would need to be approved by multiple regulators. In light of this concern, it is imperative that securitization market participants be granted an opportunity to review the impact of substantive revisions to the proposed risk retention rules before they are adopted.

Given the complexity of adopting risk retention rules that effectively regulate the diverse and dynamic securitization market, the highly technical nature of the Proposed Risk Retention Regulations and the unique difficulty of obtaining future corrections or interpretive guidance on the final risk retention rules, it is imperative that securitization market participants be given a meaningful opportunity to review and provide comment on the risk retention rules before they are adopted. We believe that this course of action will better enable the Joint Regulators and the securitization industry to collectively ensure that the final regulations achieve the goals of the Act while promoting a healthy and vibrant securitization market. Therefore, we strongly urge the Joint Regulators to release a revised version of the Proposed Risk Retention Regulations for additional public comment

IV. Transparency

ASF has been a strong and vocal advocate for targeted securitization market reforms and we continue to work from within the industry to identify and implement them. Through our work on Project RESTART, ASF was an industry leader in promoting transparency through the disclosure and reporting of loan-level information in RMBS transactions. In fact, our work was heavily relied upon by the SEC when it published for comment Release Nos. 33-9117; 34-61858; File No. S7-08-10, dated April 7, 2010 (the "Regulation AB II Proposals"),[28] which proposed rules relating to offering, disclosure and reporting requirements for ABS under the Securities Act

[28] *See* http://edocket.access.gpo.gov/2010/pdf/2010-8282.pdf.

and the Exchange Act. ASF also heavily commented on the Regulation AB II Proposals, submitting four separate letters.[29]

A. Industry Efforts

Through Project RESTART, ASF has identified, designed and implemented numerous industry-driven market standards and practice improvements to rebuild and strengthen the securitization infrastructure and help restore capital flows to the securitization markets. Our work has been recognized by senior policymakers and market participants as a necessary industry initiative to improve the securitization process by developing commonly accepted and detailed standards for disclosure and standardization that each appropriate market participant will be recommended to implement.

The origins of Project RESTART begin in the fall of 2007, when a number of RMBS market participants began meeting to explore market challenges and identify potential areas of improvement. In early 2008 at ASF's annual industry conference, a broad-based group of ASF members comprised of critical transaction parties came together to develop the core concepts and objectives of the Project. Subsequently, in its March 2008 Policy Statement on Financial Market Developments, the President's Working Group (the "PWG") on the Financial Markets recommended that the ASF develop templates for disclosure in securitization that support efforts

[29] *See* "ASF SEC Regulation AB II Comment Letter," American Securitization Forum (August 2, 2010), *available at* http://www.americansecuritization.com/uploadedFiles/ASFRegABIICommentLetter8.2.10.pdf; *See* "ASF ABCP Comment Letter re SEC Regulation AB II," American Securitization Forum (August 2, 2010), *available at* http://www.americansecuritization.com/uploadedFiles/ASFRegABIIABCPCommentLetter8.2.10.pdf; *See* "ASF Auto Comment Letter re Regulation AB II," American Securitization Forum (August 31, 2010), *available at* http://asf.informz.net/ASF/data/images/emailattachments/advocacy/asf_reg_ab_ii_auto_abs_comment_letter_8.31.10.pdf; and *See* "ASF Waterfall Program Comment Letter re Regulation AB II," American Securitization Forum (August 31, 2010), *available at* http://asf.informz.net/ASF/data/images/emailattachments/advocacy/asf_reg_ab_ii_waterfall_comment_letter_8.31.10.pdf.

to improve market discipline.[30] The Project's objectives were further accelerated by and are directly responsive to the PWG's request. On June 24, 2008, Acting Under Secretary for Domestic Finance Anthony W. Ryan announced that the PWG had engaged the ASF as the private sector group to develop best practices regarding disclosure to investors in securitized credits.[31]

On July 15, 2009, the ASF released final versions of the first two deliverables of the Project, a disclosure package of loan-level information to be provided by issuers prior to the sale of private-label RMBS transactions (the "Disclosure Package") and a reporting package of loan-level information to be updated on a monthly basis by RMBS servicers throughout the life of an RMBS transaction (the "Reporting Package").[32] Both of these packages increase and standardize critical data at issuance and throughout the life of a transaction, which will enable investors to better perform deal and loan-level analysis on the basis of the credit quality of the underlying mortgage loans. By increasing and standardizing critical data, investors can better perform necessary and sufficient deal and loan-level analysis in order to evaluate RMBS transactions on the basis of the credit quality of the underlying mortgage loans.

The release of the Disclosure and Reporting Packages was timely given the Administration's proposals for regulating financial markets. On June 17, 2009, the Treasury Department released a proposal titled "Financial Regulatory Reform," which states that the "SEC

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[30] *See* "Policy Statement on Financial Market Developments," The President's Working Group on Financial Markets (March 2008), page 13, *available at* www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf.

[31] Assistant Secretary Anthony W. Ryan, Remarks at Euromoney's Global Borrowers Investors Forum (June 24, 2008). *See* www.treas.gov/press/releases/hp1053.htm.

[32] For more information on the Disclosure and Reporting Packages, *see* www.americansecuritization.com/uploadedFiles/ASF_Project_RESTART_Final_Release_7_15_09.pdf.

should continue its efforts to increase the transparency and standardization of securitization markets and be given clear authority to require robust reporting by issuers of asset backed securities (ABS)" and that "[i]nvestors and credit rating agencies should have access to the information necessary to assess the credit quality of the assets underlying a securitization transaction at inception and over the life of the transaction, as well as the information necessary to assess the credit, market, liquidity, and other risks of ABS."[33] About a month later, the Administration followed its Financial Regulatory Reform proposal with proposed legislation that sought to implement the recommendations contained in the broader proposal.[34] In the year that followed, the U.S. House of Representatives and Senate considered various iterations of this legislation until, on July 21, 2010, the Administration's proposals for data disclosure and reporting were ultimately codified into law in the Dodd-Frank Act. The Dodd-Frank Act specifically calls for issuers of ABS to disclose "asset-level or loan-level data, if such data are necessary for investors to independently perform due diligence."[35] Not long before the passage of the Dodd-Frank Act, the SEC issued the Regulation AB II Proposals, which include loan-level RMBS disclosure and reporting proposals as originally contemplated by Project RESTART. The ASF appreciates that the SEC considered the great work of our members when putting its template together and we hope that the SEC will also consider the comments that we provided in our broad comment letter to that template.[36]

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[33] *See* "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Regulation and Supervision," U.S. Department of the Treasury, pages 44-45, *available at* www.financialstability.gov/docs/regs/FinalReport_web.pdf.

[34] The provisions of the proposed legislation can be found at www.treasury.gov/press/releases/reports/title%20ix%20subt%20e%20securitization%207222009%20fnl.pdf.

[35] *See* Title IX, Subtitle D "Improvements to the Asset-Backed Securitization Process," *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf.

[36] *See* "ASF SEC Regulation AB II Comment Letter," American Securitization Forum (August 2, 2010), *available at* http://www.americansecuritization.com/uploadedFiles/ASFRegABIICommentLetter8.2.10.pdf.

In connection with the development of the Disclosure and Reporting Packages, the ASF also created a unique loan identification number, known as the ASF LINC™, for securitization reporting purposes to facilitate the monitoring of assets from origination through the securitization process. One of the problems in the securitization market has been the inconsistent fashion in which assets have been identified. In a typical mortgage securitization, the originator, primary servicer, master servicer and trustee could all assign different numbers to identify the loan on each particular system. Implementation of the ASF LINC™ remedies this problem by assigning numbers that will be standard across the entire industry, enabling market participants to track an asset throughout its life regardless of who holds legal title to or services it at any particular time. The ASF LINC™ would enable market participants from across the globe to access information about assets, regardless of where or when they were securitized.

B. Regulation AB II Proposals

As mentioned above, the Regulation AB II Proposals were released by the SEC on April 7, 2010 to overhaul the registration, disclosure and reporting requirements of ABS issuers. As part of the industry's efforts to comment on these proposals, ASF assembled the ASF Reg AB II Taskforce (the "Taskforce") consisting of current members of ASF, including issuers and investors for various asset sectors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and data and analytics firms. In all, nearly 600 individuals directly participated in the comment process as part of the Taskforce. Members of the Taskforce took considerable time out of their daily schedules to participate in more than 125 conference calls and collectively devoted thousands of hours to develop, draft and review our comment letters. We include as part of this testimony our comments on some of the key proposals that will have a major impact on the securitization market.

i. Securities Act Registration

The SEC proposed to require an ABS issuer using a shelf registration statement to file a preliminary prospectus containing all material information at least five business days in advance of the first sale of ABS in the offering. We appreciate and support the SEC's goal of providing investors with adequate information and time to make an informed investment decision, as well as the SEC's sensitivity to balancing the needs of investors with the interests of ABS issuers in timely access to the capital markets. Our members agreed, however, that a mandatory five-day waiting period between the proposed Rule 424(h) filing and the first sale of ABS is too long. We recommended a two business-day waiting period and, in cases where there has been a subsequent material change in the legal structure, terms of the ABS or composition of the asset pool, a one business-day waiting period.

The SEC also proposed to replace the investment grade ratings requirement in the ABS shelf eligibility conditions with four new requirements, although two have been rendered moot by other proposals per the provisions of Dodd-Frank. The first such requirement was risk retention, which has been taken over by the Joint Regulators' efforts to finalize risk retention proposals, and the second was on-going periodic reporting, which has been obviated by Dodd-Frank and a related SEC proposal.

The third SEC proposal required that the pooling and servicing agreement for the securitization contain a provision requiring the party that is making representations and warranties relating to the pool assets to furnish a quarterly opinion of a third party to the trustee to the effect that any pool asset as to which the trustee asserted a breach of a representation or warranty and which was not repurchased or replaced by the obligated party, did not violate a representation and warranty contained in the agreement. Although the SEC's proposed shelf eligibility criterion would ensure that some ongoing disclosure is made in shelf offerings about the propriety of a representing party's decision not to repurchase pool assets, it would not ensure that the repurchase of noncompliant assets is effected, as it is a purely disclosure-based mechanism. In the alternative, we requested that the SEC consider including a more robust mechanism for the investigation and resolution of disputes relating to breaches of representations and warranties (similar to our Project RESTART work related to Model Repurchase Principles described earlier in this testimony).

The fourth SEC proposal required that the issuer provide a certification of its chief executive officer regarding the assets underlying the securities for each transaction. The certification would indicate that the officer has reviewed the prospectus and other necessary documents and state that to the officer's knowledge "the securitized assets backing the issue have characteristics that provide a reasonable basis to believe that they will produce, taking into account internal credit enhancements, cash flows at times and in amounts necessary to service any payments on the securities as described in the prospectus." Our issuer members are very concerned that the proposed certification is tantamount to a guarantee by the chief executive officer as to the future performance of the assets underlying the ABS, which would be impossible to provide. Instead, we requested that the SEC adopt an alternative certification requirement that focuses on the sufficiency of the disclosure in the offering documents.

ii. Disclosure Requirements

a) RMBS

The SEC's proposed rules with respect to loan-level disclosure for private-label RMBS transactions substantially incorporate the spirit and substance of the asset-level disclosure and reporting packages that had gained industry-wide consensus through ASF's Project RESTART initiative. We generally agreed with both the substance and the format of the SEC's proposed rules regarding disclosure of asset-level information for RMBS transactions and proposed only a small number of specific modifications to those proposed rules.

b) Credit Card ABS

Through Project RESTART, ASF had begun discussions among credit card ABS market participants to review current disclosure practices. However, this review was not completed by the time the SEC released its disclosure requirements for credit card ABS as part of its Regulation AB II Proposals. The SEC proposed to exclude credit and charge card ABS from the requirement to provide asset-level data. Because many credit and charge card pools contain as many as 20 to 45 million accounts, we agree that asset-level data for credit and charge card ABS would result in issuers providing an overwhelming volume of data that would not be useful to investors. To address this concern, the SEC proposes to require that issuers of credit and charge card ABS provide "grouped account data." However, under the SEC's grouped account data proposal, credit and charge card ABS issuers would be required to disclose commercially-sensitive proprietary information about origination, underwriting and pricing models that are critical to the viability of their businesses. Investors and issuers alike are concerned that this would drive issuers away from the securitization markets, resulting in a significant decrease in the amount of high quality credit and charge card ABS. In light of these concerns, we leveraged our prior work through Project RESTART and proposed an alternative disclosure and reporting package that builds upon the SEC's proposal with important modifications designed to provide extensive metrics on collateral performance without disclosing proprietary information.

c) Auto Floorplan

The SEC proposes to require auto floorplan issuers to disclose loan-level data for each floorplan receivable in a pool both in the prospectus at the time of offering and in subsequently filed Exchange Act reports. Both issuers and investors recognize and agree that the loan-level disclosure requirements contained in the SEC's proposal would require significant changes from current disclosure standards in the auto floorplan ABS market and that, if the SEC adopts its proposed disclosure requirements without modifications, unintended consequences have the potential to significantly hamper or even dismantle the auto floorplan ABS market. Floorplan sponsors are either owned by, or have significant commercial ties to, auto manufacturers, and the manufacturers are dependent on the ability of the sponsors to provide floorplan financing to dealers. As a result, the ability to issue floorplan ABS is critical to the auto industry and, in turn, is important to the economy as a whole. Under the SEC's loan-level disclosure proposal, auto floorplan issuers would be required to disclose commercially-sensitive proprietary information about origination, underwriting and pricing models that are critical to the viability of their businesses. Like originators and servicers of auto loans and leases, each originator and servicer of floorplan accounts has devoted an enormous amount of time and resources to develop its own models and strategies for underwriting, pricing and servicing. We are concerned that competitors would be able to derive critical components of these models and strategies from the loan-level data proposed to be required by the SEC. ASF developed an alternative disclosure and reporting proposal for auto floorplan ABS – mutually agreed upon by floorplan sponsors and investors – that we believe will be both beneficial to investors and feasible and appropriate for issuers to provide.

d) Auto Loans and Leases

The SEC proposes to require issuers of ABS backed by auto loans or leases to disclose loan-level data regarding each auto loan or lease in a pool both in the prospectus at the time of offering and in subsequently-filed Exchange Act reports. While our issuer and investor members agree with the SEC that an investor's access to robust information concerning the pool assets is important to enable informed investment decisions, we were unable to reach a consensus ASF view on a disclosure and reporting package for the auto loan and auto lease markets.

Our issuer members are uniformly concerned that, if the SEC adopts its proposed disclosure requirements for ABS backed by auto loans and leases without modification, there could be significant unintended consequences as issuers are faced with the potential trade-off between protecting their business model and continuing to securitize their assets. Ultimately, this has the potential to significantly reduce issuance in the auto loan and lease ABS markets. Our investor members have differing views on the SEC's proposal. All of our issuer members and many of our investor members (we refer to such investors as "grouped-asset investors") believe that their concerns are best addressed through an alternative disclosure and reporting package for auto loan and lease ABS that is based on the grouped account data model outlined by the SEC for the credit and charge card sector. Many of our other investor members (we refer to such investors as "loan-level investors") believe that the SEC should require loan-level data for auto loan and lease ABS, but propose modifications to the list of loan-level data points for those asset sectors proposed by the SEC.

iii. Waterfall Computer Program

The SEC proposes to require that most ABS issuers file a computer program on EDGAR, in the form of downloadable source code in the Python programming language that gives effect to the flow of funds, or "waterfall," provisions of each ABS transaction. The computer program must (i) give effect to the priority of payment provisions in the transaction agreements; (ii) provide the user with the ability to programmatically input (A) the user's own assumptions regarding the future performance and cash flows from the pool assets, and (B) the current state and performance of the pool assets by uploading the proposed asset-level data file that is to be filed at the time of the offering and on a periodic basis thereafter; and (iii) produces a programmatic output, in machine-readable form, of all resulting cash flows associated with the ABS, including the amount and timing of principal and interest payments payable or distributable to a holder of each class of securities. While our issuer and investor members disagreed in their views on the waterfall program, they both agreed that the SEC's proposal was particularly unclear. It was difficult to determine exactly what the SEC had in mind, and the level of sophistication required in the program.

Our issuer members have a number of significant concerns with the SEC's proposed waterfall computer program, including that it is predictive and would place the ABS issuer in the unprecedented and extraordinarily precarious position of providing investors with tools to speculate on the future performance of ABS, seemingly without the ability to incorporate standard assumptions into the model. As a result, issuers are deeply troubled by, and fervently object to, the waterfall program as proposed, which would significantly and inappropriately extend an issuer's liability under the federal securities laws by making the issuer responsible not only for the accuracy of the transaction structure but also for the integrity of a waterfall computer program that purports to predict future cash flows based on a limitless series of hypothetical future events and scenarios. Finally, predictive waterfall programs, despite the SEC's indications to the contrary, do not currently exist, even in the third party modeling space.

Our investor members support the SEC's proposed waterfall computer program and believe it would promote transparency in the offering process and enable market participants to better evaluate ABS. Investors believe that the waterfall computer program should be capable of modeling virtually all cash flow scenarios and should only be subject to a very limited number of assumptions. Investors believe that the waterfall provisions in almost all transaction agreements are static and should remain accurate for the life of a deal. For this reason, the waterfall program should only be subject to a few basic assumptions, such as an assumption that there will be no changes in law that would have an impact on the distribution of cash flows.

iv. Privately-Issued Structured Finance Products

The SEC proposes to condition the availability of the safe harbors for privately-issued structured finance products on an issuer's undertaking to provide to investors, in connection with initial offers or sales and on an ongoing basis, the same information as would be required in a registered transaction. These new disclosure requirements are intended to address concerns about the amount and quality of information available to sophisticated investors about structured finance products purchased in these private transactions.

Although we support the SEC's goal of ensuring that sophisticated investors are able to consider and understand the risks of their investments, we believe that the more appropriate course of action to achieve that goal – a course that is consistent with the historical treatment of institutions and institutional sales under the federal securities laws – is to base the availability of the safe harbors on private transactions with a class of institutional investors ("qualified institutional buyers of structured finance products" or "SQIBs") that possess a level of knowledge and experience in the purchase and surveillance of structured finance products such that they are able to identify and request the information that they need to make informed investment decisions relating to those products without the protections mandated by the registration provisions of the Securities Act.

Our issuer members operate in the private placement market for a number of valid and important reasons. An issuer may not have access to all of the information required for a registered transaction or the underlying assets or transaction structure may not lend themselves to the delivery of the information required for registered transactions, or the issuer's issuances may not be on a sufficient scale or the market for a particular product may be sufficiently limited that the costs and difficulties of compliance with the disclosure standards for a registered transaction make the private placement market the only viable alternative. In each of these cases, the private placement market is a vital source of capital, and the private placement safe harbors should be available to issuers without prescribed disclosure requirements as long as the issuer is offering its securities to investors that possess a level of knowledge and experience in the purchase and surveillance of structured finance products such that they are able to identify and request the information that they need to make informed investment decisions relating to those products without the protections mandated by the registration provisions of the Securities Act.

Our investor members are supportive of the SQIB concept, but they question whether it will adequately address their concern that issuers might seek to arbitrage the differing information delivery standards between the registered and private markets and thereby undercut the effectiveness of the SEC's proposals for enhanced disclosure and reporting in the registered market.

V. FDIC Safe Harbor Concerns

On September 27, 2010, the FDIC issued its final rule relating to the treatment by the FDIC as conservator or receiver of financial assets transferred by an insured depository institution (a "Bank") in connection with a securitization or participation transaction. Throughout the comment process for this rule, ASF adamantly opposed the vague "conditions" that were included as part of an issuers' compliance with the FDIC Safe Harbor. We stressed that an effective safe harbor should have clearly defined conditions comprised of bright line tests that, if met, provide defined benefits. The conditions of the safe harbor should be ones that can be assessed by all of the participants in the transaction and, if met at the time of the issuance of the relevant securities, should provide benefits that continue for the life of the securities. It should allow an investor to conclude that the conditions have been met or allow a clear determination that the conditions have not been met so that risks can be appropriately assessed and a transaction can be efficiently priced. A safe harbor becomes ineffective if the conditions are vague, if there are too many conditions or if the conditions are specific but cannot be measured or met.

ASF and its membership continue to strongly oppose linking a determination of whether financial assets have been legally isolated in the case of receivership to preconditions addressing capital structure, disclosure, documentation, origination and compensation. Under the FDIC Safe Harbor, investors will bear the burden of the loss of the safe harbor if any of the securitization preconditions are not satisfied by the issuer or sponsor. Investors in securitization should bear risks associated with the assets underlying a securitization but not risks associated with the originator of those assets. For these reasons, we continue to believe that the FDIC's enactment of the FDIC Safe Harbor will harm a Bank's ability to sponsor a new securitization and, therefore, will create an uneven playing field, pushing securitization activity to unregulated non-bank organizations. This will clearly hurt liquidity but will also mean that future securitizations may take place outside of a regulated structure posing new risks to the system instead of eliminating them.

ASF, along with most other commentators, called for a coordinated approach to securitization reform in its response to the FDIC's Advanced Notice of Proposed Rulemaking and its Notice of Proposed Rulemaking with respect to the FDIC Safe Harbor, as it is our belief that regulators and policymakers have to work together so they do not inadvertently stifle securitization. ASF remains particularly concerned that the FDIC, through its enactment of the FDIC Safe Harbor, has acted ahead of other regulators in an uncoordinated manner.

While the FDIC Safe Harbor contains disclosure standards for securitization transactions that are different from the SEC's Regulation AB II Proposals and documentation and servicing requirements that overlap with provisions of Dodd-Frank and related implementing regulations, the clearest example of the FDIC's unilateral approach to regulation is risk retention. At the time Dodd-Frank was adopted by Congress and signed into law by the President, rule proposals with independent risk retention provisions were put forth for public comment by (i) the FDIC Safe Harbor and (ii) the SEC's Regulation AB II Proposals.[37] ASF submitted extensive comment letters to each of the FDIC and the SEC noting that their respective risk retention proposals overlapped significantly with the risk retention requirements in Dodd-Frank and that the regulatory processes to implement the Dodd-Frank risk retention requirements were moving forward rapidly. ASF urged the FDIC and the SEC, therefore, to impose risk retention requirements only on a coordinated basis, in accordance with the legislative mandate that such regulations be developed on an interagency basis, as informed by the findings and recommendations presented to Congress in several risk retention reports mandated under Dodd-Frank. ASF also cautioned that unilateral rulemaking would introduce multiple layers of regulation addressing the same core issues, which would be extremely detrimental to the recovery of the fragile securitization markets. While the SEC appears to have deferred action on its risk retention rule proposals until the regulatory processes relating to the Dodd-Frank risk retention requirements are completed, the FDIC has brashly moved forward to adopt its FDIC Safe Harbor that effectively preempted Congress' mandate to develop risk retention regulations on an interagency basis.

[37] Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010); Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation After September 30, 2010 (75 FR 27471, May 17, 2010); Asset-Backed Securities (75 FR 23328, May 3, 2010).

The FDIC Safe Harbor included a requirement that the sponsor must retain at least five percent of the credit risk of the financial assets in one of two ways – (i) through retention of a "vertical slice" of at least five percent of each tranche transferred to investors or (ii) by retaining in its portfolio a "representative sample" in an amount equal to at least five percent of the securitized assets.[38] The FDIC Safe Harbor does contain an "auto-conform" provision that will replace the credit risk retention requirements described above with those implemented under Dodd-Frank when they become effective. As discussed below, however, the FDIC's risk retention requirements that are now in place are too rigid and narrowly drawn and the Dodd-Frank risk retention regulations have only recently been proposed, and so their effective date is still over a year from now in the case of RMBS and over two years from now in the case of all other classes of ABS. In addition, as discussed further below, Banks that sponsor revolving asset master trust securitization transactions could face more unique transition issues under the FDIC's auto-conform provision.

Both the language and legislative history of Section 941 indicate that Congress expected the Joint Regulators, in formulating risk retention rules, to be mindful of the heterogeneity of securitization markets and to give due consideration to the findings and recommendations presented to Congress in certain risk retention studies and reports mandated by Section 941.[39] Consistent with this Congressional mandate, the Joint Regulators have taken into account the

[38] In contrast, the SEC appears to have deferred action on its risk retention rule proposals until the regulatory processes relating to the Dodd-Frank risk retention requirements are completed.

[39] *See*, *e.g.*, 15 U.S.C. § 78o-11(c)(1)(E), (c)(2), (e); S. Rep. no. 111-76, at 130 (2010) ("The Committee believes that implementation of risk retention obligations should recognize the differences in securitization practices for various asset classes."). Section 941 of Dodd-Frank directed each of the Board and the Financial Services Oversight Counsel to study certain effects of the risk retention requirements and promptly report their findings to Congress. *See generally* Report to the Congress on Risk Retention, Board of Governors of the Federal Reserve System (October 2010); *see also* Macroeconomic Effects of Risk Retention Requirements, Chairman of the Financial Stability Oversight Counsel (January 2011).

diversity of assets that are securitized, the structures historically used in securitizations, and the manner in which securitizers may have retained exposure to the credit risk of the assets they securitize. As a result, unlike the FDIC Safe Harbor, the Proposed Risk Retention Regulations under Dodd-Frank provide a range of options that securitizers may choose from in meeting the risk retention requirements, including: (i) retention of a "vertical slice" of each class of interest issued in the securitization, (ii) retention of an "eligible horizontal residual interest" in the securitization, (iii) use of "L-Shaped" risk retention, which combines both vertical and horizontal forms, (iv) in the case of revolving asset master trusts, retention of a "seller's interest" that is generally *pari passu* with the investors' interest in the revolving assets supporting the ABS, (v) retention in its portfolio of a "representative sample" of assets equivalent to the securitized assets; and (vi) other risk retention options that purport to take into account the manner in which risk retention often has occurred in connection with the issuance of ABCP and in commercial mortgage-backed securitization transactions.[40] Moreover, as directed by Congress, the Joint Regulators' Proposed Risk Retention Regulations purport to calibrate risk retention with asset quality by exempting ABS supported by QRMs and ABS supported by other high quality assets from any risk retention requirement.

By contrast, the risk retention requirements in the FDIC Safe Harbor embrace a blanket one-size-fits-all retention requirement that is arbitrary in its application to any particular asset type because it does not account for important differences in the expected credit and performance characteristics of one asset type as compared with another asset type. Nor does it account for the

[40] Notably, as to each proposed form of eligible risk retention, the Joint Regulators have also set forth a host of questions for which public comment is sought – questions that evidence both the complexity of the rule-making initiative and the care that is required to produce regulations that appropriately balance the competing objectives of aligning economic interests while preserving securitization as a viable and economical alternative relative to other funding options.

diversity of assets that are securitized, the structures historically used in securitizations, or the manner in which securitizers may have retained exposure to the credit risk of the assets they securitize. Many sponsors already have significant equity and other investments in the capital structure of their securitization transactions in the form of seller's interests, subordinated and first-loss positions, excess spread that represents an interest in excess finance charge collections, overcollateralization, reserve accounts and the like. Adding a vertical slice component as contemplated by the FDIC Safe Harbor will almost certainly add too much incremental cost and render securitization transactions uneconomical relative to other funding options available to the sponsor.

As an alternative to a vertical slice, the FDIC Safe Harbor does contemplate retention of a representative sample as a means of risk retention, but the FDIC's version of this option is formulated differently than the representative sample option included in the Joint Regulators' Proposed Risk Retention Regulations, and so a Bank seeking to avail itself of this option would have to adopt one set of procedures to comply with the FDIC Safe Harbor in its current form and then a different set of procedures at such time as the auto-conform provision takes effect.

Banks that sponsor revolving asset master trust securitization transactions could face more unique transition issues under the FDIC's auto-conform provision. Master trusts allow sponsors to employ a single issuing vehicle to issue multiple issuances of ABS over time. Each issuance provides for the conveyance of additional pool assets in contemplation of future issuances of ABS backed by the same revolving asset pool. Master trusts represent a more integrated form of structuring technology, where each issuance forms a part of the more complete structure of the issuance platform. It is of paramount importance, therefore, that the sponsor of a master trust securitization platform have the option (but not the requirement) to select and maintain the same form of risk retention over the life of the master trust. If a Bank were to sponsor a revolving asset master trust securitization transaction in conformity with the more limited risk retention options currently available under the FDIC Safe Harbor, the sponsor could effectively be relegated to that form of risk retention for all of the master trust's future ABS issuances, even if a broader (and potentially more efficient) range of options becomes available at such time as the auto-conform provision of the FDIC safe harbor takes effect.[41]

We recognize that legislators and regulators have an interest in fashioning effective regulations to enhance practices of issuers and confidence of investors, but it is critical that legislators and regulators work in concert with, and not in opposition to, one another. Simply stated, by imposing rigid and narrowly-drawn risk retention requirements on Banks that sponsor securitization transactions before the regulatory processes relating to risk retention have been completed, the FDIC has impeded the recovery of the securitization markets by needlessly deterring Banks from the use of securitization. Accordingly, ASF requests that Congress pass legislation providing that, except as set forth in Section 15G of the Exchange Act, no governmental agency shall promulgate risk retention regulations, and that any such regulations

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[41] The FDIC's prior securitization safe harbor, adopted a rule in 2000, provided that the FDIC, as conservator or receiver of a Bank, would not use its statutory authority to disaffirm or repudiate contracts in order to reclaim financial assets transferred by a Bank in connection with a securitization or participation if the transfer met all conditions for sale accounting treatment under GAAP. On June 12, 2009, the Financial Accounting Standards Board ("FASB") modified GAAP through FAS 166 and FAS 167, which represent accounting standards that make it more difficult for a transferor of assets in a securitization to meet the conditions for sale accounting treatment. These modifications became effective for annual financial statement reporting periods that began after November 15, 2009.
The FDIC's new securitization safe harbor contains a grandfathering provision that makes the safe harbor available for securitization transactions by revolving or master trusts *at any time*, as long as the trust had issued ABS prior to September 27, 2010 and transfers of pool assets in connection with issuances of ABS backed by the same, revolving pool satisfy the GAAP conditions for sale accounting treatment as in effect prior to November 15, 2009.
This grandfathering provision is *not*, however, available for revolving or master trusts that initially issue ABS only on or after September 27, 2010 or that transfer pool assets in connection with issuances of ABS backed by the same, revolving pool in a manner that does not satisfy those prior GAAP conditions for sale accounting treatment.

previously promulgated are repealed by the terms of such legislation and without need of further action by any such agency.

VI. Orderly Liquidation Authority

In December 2010, two other issues emerged under Dodd-Frank that threatened the viability of the non-bank sectors of the securitization market. Title II of Dodd-Frank sets forth the Orderly Liquidation Authority ("OLA") of the FDIC through which the FDIC can exercise certain powers in the event that a "covered financial company" (a "Covered Financial Company")[42] enters receivership. A Covered Financial Company is a nonbank that is primarily engaged in financial activity and upon its failure would have serious adverse effects on the financial stability of the United States.

The Dodd-Frank Act requires the FDIC to implement OLA and, to the extent possible, to harmonize its rules with the insolvency laws that would otherwise apply. To date, two separate issues have been identified and pursued by market participants and each required immediate attention by the FDIC to prevent further damage to the already fragile securitization markets. The first issue involves securitizations of Covered Financial Companies where the perfection of the security interest on the underlying paper was accomplished by a Uniform Commercial Code

[42] The Orderly Liquidation Authority ("OLA") provisions of Dodd-Frank allow for the FDIC to be appointed as the liquidating receiver of a "covered financial company." A "covered financial company" subject to these provisions:

- is not an insured depository institution,
- is primarily engaged in activities that are financial in nature and the consolidated revenues of such company from such activities are 85% or more of its consolidated revenues; and
- is in default or in danger of being in default, and, among other things, "the failure of the financial company and its resolution under otherwise applicable Federal or State law would have serious adverse effects on financial stability in the United States" (a "Systemic Risk Determination").

(the "UCC") filing, which generally occurs for auto and student loan securitizations, rather than by possession. In such a case, the FDIC under OLA could arguably trump the securitization's lien on the underlying auto or student loans and leave the investors in the securitization unsecured. The second issue involves the scope of the repudiation power that could be exercised by the FDIC as receiver for a Covered Financial Company under OLA. Our membership very much appreciated the FDIC's General Counsel taking immediate steps to "patch up" these issues in part, although considerable uncertainty remains without a legislative solution.

Congress has required through Dodd-Frank that the FDIC harmonize applicable rules and regulations promulgated under OLA with the insolvency and bankruptcy laws that would otherwise apply. Despite clarity in the legislative intent, ambiguity in the statutory language of Title II has caused substantial consternation and uncertainty in the securitization markets and has required prompt interpretive actions from the FDIC, at a time when the FDIC is already inundated with the task of undertaking the numerous large-scale rulemakings required by Dodd-Frank. For these reasons, market participants may be forced to plan transactions based on two different insolvency regimes given that they would not know, at the time of extending credit, whether OLA rules or bankruptcy rules would ultimately apply. To provide much needed certainty, and to ensure that the intent of the OLA provisions under Dodd-Frank are carried out, we believe that a legislative solution is necessary and we stand ready to endorse a bill that requires the OLA provisions to be exercised consistent with the U.S. Bankruptcy Code or other applicable insolvency laws, including bankruptcy- and State-law principles governing legal isolation.

A. Intent to Harmonize Dodd-Frank with the Bankruptcy Code

In enacting OLA, Congress intended to create a new statutory regime for the orderly liquidation of Covered Financial Companies. However, several sources, including the Dodd-Frank Act itself, suggest that Congress also intended for the resulting statutory regime to operate in such a way as to minimize the likelihood of different results to creditors of such potential Covered Financial Companies from those results arising under Title 11 of the United States Code (the "Bankruptcy Code").

Sections 210(a)(7)(B) and (d)(2)(B) of the Dodd-Frank Act, provide that, in the context of OLA liquidation, "a creditor shall, in no event, receive less than the amount that creditor is entitled to receive" if the FDIC "had not been appointed receiver with respect to [a] covered financial company; and the covered financial company had been liquidated under chapter 7 of the Bankruptcy Code." Furthermore, Section 209 of the Dodd-Frank Act mandates that the FDIC "seek to harmonize applicable rules and regulations promulgated under [OLA] with the insolvency laws that would otherwise apply to a covered financial company." In the Notice of Proposed Rulemaking issued by the FDIC with respect to OLA[43], the FDIC states that "[t]he liquidation rules of [OLA] are designed to create parity in the treatment of creditors with the Bankruptcy Code" and that "the provisions that empower the FDIC to avoid and recover fraudulent transfers, preferential transfers and unauthorized transfers of property by the covered financial company are drawn from Bankruptcy Code provisions."

The underlying policy rationale behind this desire for harmonization is likely that Congress wanted to avoid requiring parties extending credit to potential Covered Financial

[43] *See* http://edocket.access.gpo.gov/2010/pdf/2010-26049.pdf.

Companies to be forced to plan transactions based on two different insolvency regimes given that they would not know, at the time of extending credit, which regime would ultimately apply as what constitutes a Covered Financial Company is, at least at this point, a moving target that is determined at the time of receivership. And even if "covered financial company" is strictly defined, companies may still never be able to feel comfortable making a predetermination as to their status with respect to a potential future receivership.

If a creditor faces the possibility of two different insolvency regimes, it will have to structure transactions to comply with both. Doing so will raise transaction costs and ultimately raise the costs and lower the availability of credit. Raising the costs and reducing the availability of credit are especially problematic if the rules under OLA producing a different outcome than under bankruptcy law cannot be justified on the grounds that they provide important benefits in controlling systemic risk. In other words, a company may have to plan on being considered a Covered Financial Company even though they may ultimately not be determined to be systemically important. Moreover, a small company that has no reasonable basis for concluding it is a Covered Financial Company may ultimately be acquired by a Covered Financial Company and become subject to OLA.

B. Preferential Transfer Issue

This past December, ASF became aware of an interpretive issue under Section 210(a)(11) of the Dodd-Frank Act relating to the power of the FDIC to avoid preferential transfers. The issue primarily affects the U.S. consumer finance and commercial credit industries and relates to the interpretation of several inconsistent provisions of the Dodd-Frank Act, although the legislative intent of these provisions appears to be clear. Generally, OLA could be interpreted to give the FDIC, as receiver for a Covered Financial Company, broader powers to avoid certain previously perfected security interests than a trustee (a "Bankruptcy Trustee") under the Bankruptcy Code would have upon a Chapter 7 liquidation of the same Covered Financial Company. As an example, if a Covered Financial Company securitized chattel paper, such as auto loans, and did not deliver the paper to a custodian for the securitization but instead relied on UCC filings for perfection, the FDIC could potentially trump the securitization's lien on the underlying paper and leave the investors in the securitization unsecured. This result would not occur under the Bankruptcy Code. To eliminate the ambiguity in a manner consistent with the legislative intent, ASF suggested in a December 13th letter to the FDIC that these "preference provisions" would benefit from additional rulemaking by the FDIC, or by the issuance of further guidance in the form of a "policy statement" or other release on which the affected industries could rely.[44]

In the letter, we identified an inconsistency in the drafting of the preference provisions of Section 210(a)(11) of the Dodd-Frank Act, which, if read in a certain way, would create a disparity between the treatment of creditors of potential Covered Financial Companies under the Bankruptcy Code and under OLA. Specifically, defining when a "transfer" is "made" by reference to when the rights of a "bona fide purchaser" are superior to the rights of a holder of a previously perfected security interest is a concept which, under the Bankruptcy Code is applied only in the context of fraudulent transfers and of preferential transfers of real property other than fixtures. Under OLA this concept is applied in the context of not only fraudulent transfers

[44] *See* "ASF FDIC Request re OLA," American Securitization Forum (December 13, 2011), *available at* http://asf.informz.net/ASF/data/images/emailattachments/advocacy/asf_orderly_liquidation_letter_to_the_fdic_12_13_10.pdf.

(Section 210(a)(11)(A) of the Dodd-Frank Act) and preferential transfers of real property other than fixtures but also to preferential transfers of personal property and fixtures (Section 210(a)(11)(B) of the Dodd-Frank Act). The result is that the FDIC as receiver for a Covered Financial Company under OLA may have broader powers than does a Bankruptcy Trustee under the Bankruptcy Code to avoid, as preferential transfers, certain previously perfected security interests in personal property and fixtures, even though the transfers are inherently non-preferential.

We requested in the letter that the FDIC issue guidance resolving the ambiguity, and providing that, (1) consistent with the Bankruptcy Code, the "bona fide purchaser" standard for defining when a transfer is "made" will be applied under OLA only with respect to fraudulent transfers and to preferential transfers of real property other than fixtures; (2) the standard found in Section 547(e)(1)(B) of the Bankruptcy Code be applied to determine the timing of transfers of personal property and fixtures and (3) the 30-day grace period to perfect a transfer, found in Section 547(e)(2) of the Bankruptcy Code be applied to preferences under Section 210(11)(B) of the Dodd-Frank Act. Although the statute's drafting inconsistency is a narrow and technical one, we believed, and continue to believe, that the resulting ambiguity is of considerable practical importance to the consumer and commercial credit industries, as many standard practices in these industries have been established and have evolved, in response to, and in reliance on, the well established Bankruptcy Code provisions.

i. Consequences of the Inconsistency for Consumer and Commercial Credit Industries

The ambiguity described above could potentially impact all lending secured by personal property, securitizations of personal property and even sales involving non-possessory interests in personal property where perfection of transfers of such property by possession or other means could trump perfection by filing a financing statement under the UCC[45] or other similar filings or actions under other applicable law. The issue arises most prominently with respect to consumer and commercial credit transactions in which the subject property is characterized under the UCC either as "chattel paper" or as an "instrument." In the securitization industry, this could affect many different asset classes, but would predominantly affect auto and student loans. Specifically, the ambiguity could affect sales[46] of chattel paper or instruments, as well as transactions in which chattel paper or instruments serve as collateral securing a party's obligations if, in either case, the transfer has been properly perfected by filing a financing statement, as permitted under the UCC, and not through possession (which is not required for such proper perfection if perfection has been obtained by filing).

Section 9-102(a)(11) of the UCC defines "chattel paper" to include "a record or records that evidence both a monetary obligation, and a security interest in specific goods … or a lease of specific goods." Section 9-102(a)(47) of the UCC defines an "instrument" as "a negotiable instrument or any other writing that evidences a right to the payment of a monetary obligation, is not itself a security agreement or lease, and is of a type that in ordinary course of business is

[45] *See* e.g., UCC Section 9-330.
[46] Under Section 1-201(37) of the UCC, the term "security interest" includes "any interest of.....a buyer...of chattel paper."

transferred by delivery with any necessary endorsement or assignment." Under the UCC, a security interest in chattel paper or instruments may be properly perfected by filing a financing statement, among other means.

Under the UCC, while the filing of a financing statement would properly perfect a security interest in chattel paper or instruments, such that a "hypothetical lien creditor" could not acquire a security interest in the chattel paper or instrument that is superior to that of the secured party, the filing of a financing statement alone would not prevent a "bona fide purchaser" from acquiring a security interest in the chattel paper or instrument that is superior to that of the secured party.[47] Therefore, while the Bankruptcy Trustee under the Bankruptcy Code *would not* be able to avoid as a preferential transfer a security interest in chattel paper or instruments granted and perfected by means of filing a financing statement at closing or within 30 days of closing, the FDIC under OLA *would* potentially be able to avoid as a preferential transfer that very same security interest.

Upon the avoidance of such transfer, the claim otherwise secured by a properly perfected security interest would become an unsecured claim in the FDIC receivership. As a result, the creditor would receive less than it would have received in a Chapter 7 Bankruptcy Code liquidation of the same company.

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[47] This is a consequence, for chattel paper, of the rule found in Section 9-330(b) of the UCC: "A purchaser of chattel paper has priority over a security interest in the chattel paper which is claimed other than merely as proceeds of inventory subject to a security interest if the purchaser gives new value and takes possession of the chattel paper or obtains control of the chattel paper under Section 9-105 in good faith, in the ordinary course of the purchaser's business, and without knowledge that the purchase violates the rights of the secured party." A good faith purchaser of an instrument who takes possession of it is likewise given priority under Section 9-330(d) of the UCC and, in the case of a negotiable instrument, a holder in due course of the negotiable instrument obtains priority under Section 9-331 of the UCC. None of these purchasers, who rely upon possession of the chattel paper or instrument, have an obligation to conduct UCC searches to discover any filed financing statements in order to obtain priority.

The consequences to the consumer and commercial credit industries – and their creditor counterparties – are further, and indeed greatly, exacerbated by the absence of a "transition rule" for OLA. Many credit facilities, securitizations and sales date prior to the enactment of the Dodd-Frank Act, and were structured in reliance on the certainty of the provisions of the Bankruptcy Code. The documentation, policies and procedures of both the financial companies and their creditors, and the overall architecture of these transactions and programs, depended on the proper and effective perfection achieved by the filing of a UCC financing statement. Although in some instances these existing transactions and programs could now be re-engineered to comply with the "bona fide purchaser" construct applicable to fraudulent transfers and preferential transfers of real property other than fixtures, that is only a partial solution, and one which will be time consuming, difficult and expensive to implement. The delays needed for such implementation would also be expected to adversely affect the liquidity of the affected financed company during the delay, as it will be difficult, if not impossible during the period of delay to enter into new financing facilities, or portfolio sales, which rely on the existing practices.

With respect to programs currently in place, the re-engineering is in any event only a "partial solution." This is due to the look-back provisions of the preference rules. These rules, which provide that a solution, once implemented, is itself a transfer of property of the debtor to or for the account of a creditor on account of an antecedent debt. As a result, the implementation of the solution would not eliminate the creditor's preference risk until the preference period, commencing on the implementation of the solution has past. The general preference look-back period is 90 days, but for transfers among affiliated companies, the look-back period is a year.

Since many consumer and commercial finance companies structure their financing, securitization and secondary-market activities through transfers to subsidiaries, the look-back period arguably could be a year. Accordingly, creditor counterparties will severely discount the efficacy of any proposed solution.

Further, while some types of consumer and commercial credit transactions are documented by "chattel paper" and "instruments", others are not (such others being characterized under the UCC as, for example, "accounts" or "general intangibles"). Sometimes these are different products of the same finance company (for example, certain types of inventory financings), while in other instances they may be the identical product, simply documented in a different way (this is the case in the student loan industry). Under OLA, in some cases a properly perfected security interest could be attacked as a preferential transfer which another very similar transaction could not be. Thus, the effects and the uncertainty to financial companies' creditor counterparties are further magnified.

ii. FDIC's General Counsel's Letter I

On December 29, 2010, the FDIC issued a General Counsel's Letter to the ASF in which it provided an interpretation of the OLA provisions of the Dodd-Frank Act that effectively alleviated the concerns outlined in our December 13th letter.[48] The letter acknowledged the inconsistencies between the OLA provisions and the Bankruptcy Code that were highlighted in ASF's letter and concluded that the treatment of preferential and fraudulent transfers under the OLA provisions was intended to be consistent with the related provisions under the Bankruptcy Code. In addition to providing an interpretation, the letter indicated that FDIC staff would

[48] *See* http://www.americansecuritization.com/uploadedFiles/FDICGeneralCounselLetterreOLA-12-29-10.pdf.

recommend to the FDIC Board of Directors that the Board adopt a regulation to the same effect, in consultation with the Financial Stability Oversight Council. At the March 15, 2011 Board Meeting, the FDIC issued a "Notice of Proposed Rulemaking Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act"[49] that, among other things, purports to "ensure that the preferential and fraudulent transfer provisions of the Dodd-Frank Act are implemented consistently with the corresponding provisions of the Bankruptcy Code" and [conform OLA] "to the interpretation provided by the FDIC General Counsel in December 2010."[50] ASF applauds the FDIC for taking action on this critically important issue and attempting to resolve the ambiguity in Title II.

C. Repudiation Power Issue

This past December, ASF became aware of another issue relating to the authority of the FDIC to repudiate contracts under Section 210(c)(1) of the Dodd-Frank Act and the scope of the temporary automatic stay under Section 210(c)(13) of the Dodd-Frank Act. These provisions raise concerns regarding two issues that are crucial not only to the securitization market but to all parties that have financial dealings with a Covered Financial Company or a covered subsidiary thereof: (1) whether a transfer of property by the Covered Financial Company or a covered subsidiary thereof would constitute an absolute sale or a secured borrowing and (2) whether the separate existence of another person or entity would be respected and its assets and liabilities not substantively consolidated with the assets and liabilities of the Covered Financial Company or of any covered financial subsidiary thereof.

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[49] *See* NPR at http://edocket.access.gpo.gov/2011/pdf/2011-6705.pdf.
[50] *See* FDIC Press Release issued March 15, 2011 at http://www.fdic.gov/news/news/press/2011/pr11056.html.

The insolvency laws that would apply to Covered Financial Companies in the absence of OLA are rather clear on these legal-isolation issues, and supply well-established principles for resolving them. Most notable are the decades of precedent that exist under the Bankruptcy Code and in judicial decisions under the Bankruptcy Code. Financial-market participants have relied on these principles and this precedent when transacting business with financial companies that, under the Dodd-Frank Act, may be designated as Covered Financial Companies and subjected to liquidation under OLA. The concern that has emerged is whether the Dodd-Frank Act required that the FDIC, as receiver for a Covered Financial Company or a covered subsidiary thereof, respect and follow these legal authorities as well.

The resolution of this concern, in our view, is clear. As noted previously, under Section 209 of the Dodd-Frank Act, Congress has directed the FDIC to harmonize its rules implementing OLA "with the insolvency laws that would otherwise apply to a covered financial company." The underlying policy rationale behind this desire for harmonization is that Congress wanted to avoid requiring parties engaging in transactions with financial companies and their subsidiaries to be forced to plan transactions based on two different insolvency regimes given that they would not know, at the time of executing the transaction, which regime would ultimately apply. This holds even more true for transactions that were executed before the Dodd-Frank Act was signed into law and that, due to the absence of any transition provision in OLA, could be affected by such a liquidation. We note further in this context that the Senate Report on the Dodd-Frank Act, in its Section on OLA, observes that "the use of this [OLA] authority [is expected to be] very rare. There is a strong presumption that the Bankruptcy Code will continue to apply to most failing financial companies...including large financial companies." <u>Senate Report</u> at 58. Our concern with respect to the Section 210(c) repudiation authority goes to precisely this point: there are long-standing Bankruptcy Code doctrines which financial companies have been careful to follow in their sale, securitization and other commercial transactions and programs. For those companies to now try to structure transactions to an unknown target, just in case this "very rare" authority may be invoked in the future, appears to us to be costly and unnecessary.

Because of the mandate in Section 209, we believe that the FDIC would be required to respect and follow "the insolvency laws that would otherwise apply to a covered financial company" when addressing any legal-isolation issue under OLA, including in the context of its repudiation power under Section 210(c)(1) of the Dodd-Frank Act and the temporary automatic stay under Section 210(c)(13) of the Dodd-Frank Act.

i. FDIC's General Counsel's Letter II

On January 14th, ASF submitted a letter to the FDIC requesting that the FDIC issue, as promptly as practicable, a letter from the Acting General Counsel to the effect that:

(a) The FDIC as receiver for a covered financial company shall not, in the exercise of its statutory authority to disaffirm or repudiate contracts, reclaim, recover, or re-characterize as property of the covered financial company or the receivership financial assets transferred by the covered financial company, provided that such transfer satisfies the conditions for a legal true sale as applied in the law defining property of the estate under the Bankruptcy Code.

(b) The Act does not itself contain any provision which would mandate a different approach or analysis regarding the factors or circumstances under which

> the separate existence of one or more legal entities would properly be disregarded than the existing approach or analysis under the Bankruptcy Code.[51]

In response to ASF's Request, the FDIC issued a General Counsel's Letter on January 14th addressing the concerns raised in ASF's request.[52] In the letter, the FDIC clarified that its repudiation power under the OLA provisions of the Dodd-Frank Act would be exercised consistent with the U.S. Bankruptcy Code or other applicable insolvency laws, including bankruptcy- and State-law principles governing legal isolation, on an interim basis until 90 days after the FDIC Board of Directors adopts a regulation to formally address the matter, or until at least June 30, 2011. Again, we applaud the FDIC for its quick action to patch this issue that the market so desperately needed. However, we believe that a legislative solution is necessary to achieve certainty in the market once the interim relief expires and stand ready to endorse a bill that requires the OLA provisions to be exercised consistent with the U.S. Bankruptcy Code or other applicable insolvency laws, including bankruptcy- and State-law principles governing legal isolation. Such a bill would be consistent with the legislative intent that (i) "a creditor shall, in no event, receive less than the amount that creditor is entitled to receive" if the FDIC "had not been appointed receiver with respect to [a] covered financial company; and the covered financial company had been liquidated under chapter 7 of the Bankruptcy Code"[53] and (ii) the FDIC "seek to harmonize applicable rules and regulations promulgated under [OLA] with the insolvency laws that would otherwise apply to a covered financial company."[54] Such a bill would also

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[51] *See* http://www.americansecuritization.com/uploadedFiles/ASF_Orderly_Liquidation_Letter_to_the_FDIC_1_14_11.pdf.
[52] *See* http://www.americansecuritization.com/uploadedFiles/GC_Letter_to_ASF_1_14_2011.pdf.
[53] *See* Sections 210(a)(7)(B) and (d)(2)(B) of the Dodd-Frank Act.
[54] *See* Section 209 of the Dodd-Frank Act.

avoid the situation where parties extending credit to potential Covered Financial Companies would be forced to plan transactions based on two different insolvency regimes given that they would not know, at the time of extending credit, which regime would ultimately apply.

Finally, we are also concerned about the potential for the FDIC to reach beyond the clear intent of Dodd-Frank and use its OLA power to implement conditions for non-banks that are similar to the ones prescribed for the FDIC Safe Harbor for Banks. ASF submitted multiple comment letters with respect to the FDIC's Advanced Notice of Proposed Rulemaking and Notice of Proposed Rulemaking regarding the FDIC Safe Harbor. ASF and its membership continue to strongly oppose linking a determination of whether financial assets have been legally isolated in the case of receivership to preconditions addressing capital structure, disclosure, documentation, origination and compensation. Under the FDIC Safe Harbor for banks, investors will bear the burden of the loss of the safe harbor if any of the securitization preconditions are not satisfied by the issuer or sponsor. Investors in securitization should bear risks associated with the assets underlying a securitization but not risks associated with the originator, who may or may not subsequently be deemed to be a Covered Financial Company.

VII. Rating Agency Reform

A. The Repeal of Rule 436(g)

Upon the effective date of Dodd-Frank last summer, Rule 436(g) under the Securities Act was repealed, which caused the complete shutdown of the U.S. public securitization market. ASF immediately began discussions with SEC staff to help alleviate the problem. The market paralysis was partially mitigated through the grant of temporary no-action relief by the staff of the SEC on July 22, 2010.[55] The no-action letter relief was then extended indefinitely on November 23, 2010.[56] ASF applauds the SEC's decision to issue the no-action letters but believes a permanent, comprehensive solution is needed to ensure the long-term viability of the U.S. public securitization markets.

i. Regulatory and Legislative History of Rule 436(g)

Rule 436(g) of the Securities Act is often referred to as the NRSRO expert exemption because its effect is to exempt NRSROs from liability as experts for their ratings under Section 11 of the Securities Act. Section 939G of the Dodd-Frank Act provides that "Rule 436(g) promulgated by the SEC under the Securities Act, shall have no force or effect" (the "Repeal of Rule 436(g)").

If the ratings of registered ABS are a condition to the issuance or sale of such ABS, Item 1103(a)(9) and Item 1120 of Regulation AB[57] require disclosure in the statutory prospectuses of the minimum rating required and the identity of each rating agency issuing the ratings (regardless of whether the entity is an NRSRO).[58] Currently, investors expect that the ABS they purchase from underwriters will have specific ratings. For most senior investors, their investment guidelines require certain investment grade ratings to be available before that investor may purchase a particular security. For this reason, ABS underwriting agreements (pursuant to which the underwriters commit to purchase the ABS from the issuer (or the depositor)) have, as a

[55] *See* http://www.americansecuritization.com/uploadedFiles/SEC_NAL_July2010.pdf.
[56] *See* http://sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm.
[57] 17 C.F.R. §§229.1100 - 229.1123.
[58] See Item 1103(a)(9) and Item 1120 of Regulation AB.

closing condition, the receipt of evidence that the rating agencies have assigned specific ratings. As a result, under Regulation AB, ABS issuers must disclose in the statutory prospectus the ratings that are a condition to the issuance or sale of the ABS and the identity of the rating agency issuing the rating. In addition, in response to comments received from SEC staff during the review process, certain issuers using shelf registration statements include a statement to the effect that the ABS must be rated investment grade at the time of issuance.

Rule 436(g) specifically provided that credit ratings issued by NRSROs (but not other credit rating agencies) on debt securities, convertible debt securities and preferred stock were *not* considered part of the registration statement prepared or certified by a person within the meaning of Sections 7 and 11 of the Securities Act. Section 7 of the Securities Act requires any accountant or person whose profession gives authority to a statement made by him (often referred to as an "expert") who is named as having prepared or certified any part of the registration statement, or who is named as having prepared or certified a report for use in connection with the registration, to file a written consent with the registration statement. Because Rule 436(g) specifically provided that ratings issued by NRSROs were not considered part of the registration statement prepared or certified by a person within the meaning of Section 7, prior to the repeal of Rule 436(g), NRSROs were specifically exempt from the Section 7 requirement to file a written consent.

Because NRSROs did not file consents as experts, they were not subject to the strict liability under Section 11 of the Securities Act for the ratings included in a registration statement. Section 11 imposes liability <u>*over and above*</u> that which would apply under common law or under Rule 10b-5 of the Exchange Act on those who are involved in the preparation of the registration statement. Section 11 of the Securities Act applies to any person that signs the registration statement, directors of the issuer, underwriters and "experts" who have been named in the registration statement as having prepared or certified any part of the registration statement or any report or valuation used in connection with the registration statement that provided their consent for filing with a registration statement. Therefore, although Item 1103(a)(9) and Item 1120 of Regulation AB require disclosure of the ratings that are a condition to the sale or issuance of the ABS and the identity of the rating agency (and, in some cases, the issuer agreed to disclose that the ABS must be rated investment grade at the time of issuance), Rule 436(g) specifically exempted NRSROs from the consent requirement under Section 7 of the Securities Act. This, in turn, meant NRSROs were not subject to Section 11 of the Securities Act, which imposes civil liability on experts providing a consent for filing with a registration statement.

ii. Implications of the Repeal of Rule 436(g) on the Securitization Market

We note that while many believe that registrants would be able to comply with the disclosure requirements of Items 1103(a)(9) and 1120 without triggering the Section 7 consent requirement, from the time of enactment of Dodd-Frank last year, no ABS public market participant was comfortable from a legal standpoint moving forward on this basis until provided with guidance from the SEC in the form of a no-action letter.[59] Given the uncertainty with

[59] Many members of the ASF believe that the disclosure required under Item 1103(a)(9) and Item 1120 of Regulation AB does not trigger a requirement to file a consent, consistent with the SEC's statements in its October 2009 concept release on the proposed rescission of Rule 436(g) (*available at* http://www.sec.gov/rules/concept/2009/33-9071fr.pdf and http://www.sec.gov/rules/concept/2009/33-9071afr.pdf). In that release and the companion release on disclosure of credit ratings (*available at* http://www.sec.gov/rules/proposed/2009/33-9070fr.pdf and http://www.sec.gov/rules/proposed/2009/33-9070afr.pdf) the SEC said that the proposed disclosure requirement and regarding credit ratings "would not be triggered if the only disclosure … is related to … the terms of agreements that refer to credit ratings…" and that the SEC "preliminarily believe[d] that a consent would not be required for such disclosure." This statement would

respect to the applicability of the Section 7 consent requirement, with the repeal of Rule 436(g) under the Securities Act, if and when the SEC staff issues guidance contrary to the current 436(g) no-action letter, public issuance of ABS would again shut down unless issuers obtain the consent of the NRSROs rating the securities. Several of the NRSROs continue to study this matter but have expressed concern with the scope and magnitude of Section 11 strict liability attached to their being considered an "expert." Section 11 liability is considered "strict," which would create potential enterprise liability for any NRSRO, given that the damages could be so significant. Moreover, a rating is a forward looking assessment of expected performance that could be construed or litigated as an expert 'prediction' or 'estimation' of performance. In ABS transactions, the Section 11 liability that attaches to issuers and underwriters is grounded in historical information and facts that are verifiable (and hence not 'predictions' of what may occur in the future). This concern is consistent with comments previously made by the NRSROs to the SEC in connection with proposals that would have subjected NRSROs to the consent requirement, and therefore, increased liability.

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appear to cover reference to an underwriting agreement that has a closing condition that the securities receive a minimum rating from an identified rating agency required under Item 1103(a)(9) and Item 1120 of Regulation AB.

Additionally, we note that because the required disclosure only includes the minimum required rating (and in some cases, a statement that the securities must be rated investment grade) and *not* the rating itself, Section 7 of the Securities Act is not implicated under the SEC's own position that "[t]he consent requirement in Securities Act Section 7(a) applies only when a report, valuation or opinion of an expert is *included or summarized* in the registration statement and attributed to the third party and thus becomes 'expertised' disclosure for purposes of Securities Act Section 11(a), with resultant Section 11 liability for the expert…." (emphasis added). See SEC Compliance and Disclosure Interpretations, Question 141.02. The condition to issuance or the ratings requirement is just that, a condition or a requirement, not the inclusion or summary of a report of an expert, not even the attribution of a statement to an "expert."

For the most part, credit ratings perform an invaluable role in our financial system. They allow investors to sort the universe of potential debt investments into categories of relative riskiness and allow a starting point from which investors can more efficiently perform their own level of due diligence. Without ratings, the markets would lose an effective sorting devise, investors would not have a point of origin for their own due diligence, and disorder would likely result. Redundant replication would replace specialization, and impede the efficiency of capital markets operations, which in turn would slow the formation and reduce the flow of credit into our economy. Again, credit ratings should not be the only source of information, but instead should be one of a number of inputs into an overall assessment of value.

In fact, other provisions in Dodd-Frank require investors to be less reliant on the ratings agencies and to engage in greater independent analysis. But this is like requiring a person to wear belts and suspenders, while knowing the very act of requiring both results in there being no pants to wear, as we saw in the disappearance of the offering of ABS in July 2010.

Given these concerns, it appears most, if not all, of the NRSROs would not be in a position to provide the written consent arguably required by Section 7 in the case where the SEC staff were to no longer provide the current 436(g) no-action relief. Additionally, if the SEC staff were to issue guidance to effectively eliminate the current relief, any transition period afforded the NRSROs may not provide the NRSROs sufficient time to adjust to the new environment by creating and implementing policies and procedures relating to their issuance of consents, including the planning and execution of the "reasonable investigation" contemplated by Section 11(b)(3)(B) of the Securities Act or the installation of related internal supervisory controls. Moreover, it is unclear at this time if, regardless of the length of any implementation period, any

NRSRO would agree to provide a written consent for filing with a registration statement given the associated liability of their statements. Instead, one or more NRSROs may elect to cease rating publicly issued ABS. Given the investor demands in the ABS market for ratings on ABS (and the current requirement that the ABS be rated investment grade to be offered on a shelf registration basis), we believe this would likely bring the public ABS markets to a standstill at any moment if the SEC staff were to eliminate the relief provided by the current 436(g) no-action letter. The ASF actively supports the effort to create a sustainable securitization market and believes the intersection of the Repeal of Rule 436(g) and a renewed enforcement of Item 1103(a)(9) and Item 1120 of Regulation AB would result in a market paralysis, similar to the one that occurred in the initial days after passage of the Dodd-Frank Act, that is damaging to market participants, investors and consumers alike.

iii. ASF Proposed Solutions to These Implications

a. Amend Regulation AB to Eliminate Required Ratings Inclusion

One potential permanent solution to this situation is that Item 1103(a)(9) and Item 1120 of Regulation AB could be amended to be accompanied by an instruction that the specific ratings and rating agencies are not required to be disclosed in statutory prospectuses and that no consent of the rating agency is required in these circumstances. In fact, in testimony question and answer on March 10, 2011, before a House Government Oversight and Reform Subcommittee hearing, the Chairman of the SEC, Mary Schapiro, indicated that the SEC "staff is working through a reconsideration of our disclosure requirements [for ABS], and I believe that they will recommend that we eliminate our pre-existing requirement for including the ratings, and therefore the liability provisions can go forward."

b. Legislation to Repeal the Repeal of Rule 436(g)

Although we endorse amending Regulation AB, we emphasize our membership's continued preference for a legislative fix to repeal the repeal of Rule 436(g) as the best policy for eliminating the unwanted effects of Dodd-Frank Section 939G. If ratings are to be conveyed to investors, issuers should have the ability to convey these ratings to investors as part of the primary, comprehensive offering documents (statutory prospectuses), rather than through assorted ancillary communications such as free writing prospectuses. Moreover, a regulatory fix, such as the foregoing proposal, would impose an additional burden on the SEC to pursue its regulatory authority in order to negate the harmful effects of this Section of the legislation, at a time when the SEC is already inundated with the task of undertaking the large-scale rulemakings required by Dodd-Frank. In contrast, at a critical time for consumers, businesses and the U.S. economy, we believe that an act by Congress to repeal this Section would provide the most straightforward and effective way to remove a key barrier that remains to resuming the normal flow of credit in America. On April 14, 2011, Representative Steve Stivers (R-OH), a member of the House Committee on Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises, introduced the "Asset-Backed Market Stabilization Act of 2011," which would reinstate Rule 436(g) of the Securities Act. The bill was co-sponsored by Representatives Jim Rennaci (R-OH) and Hansen Clarke (D-MI). ASF and our members support this bill.

B. Ratings Alternatives

Section 939A of the Dodd-Frank Act requires the federal agencies within 1 year of enactment to review regulations that (1) require an assessment of the credit-worthiness of a security or money market instrument and (2) contain references to or requirements regarding credit ratings. In addition, the agencies are required to remove such references and requirements and substitute in their place uniform "standards of credit-worthiness," where feasible.

ASF agrees with the goal of reducing overreliance on credit ratings. Such reliance was a factor leading to the financial crisis, and we support sensible efforts to ensure that investors do not use credit ratings to the detriment of their own independent risk review and analyses of the ABS they purchase. However, we share many of the concerns expressed by members of the federal banking agencies, both before and after enactment of the Dodd-Frank Act, as to the wisdom and feasibility of completely eliminating the use of credit ratings in regulations that include capital requirements at this time. We appreciate that the federal banking agencies have permitted for the formulation of comments by interested parties in various proposals in response to a legislative mandate that they did not initiate, and we hope that in implementing Section 939A they will address the issues expressed in our articulated concerns. We acknowledge that devising alternatives to the use of ratings will be challenging and believe that neither the federal agencies nor the industry would be well-served by replacing such ratings as a measure of creditworthiness with an inferior alternative.

i. Ratings Alternatives for Regulatory Capital

a. Overview

On August, 25, 2010, the FDIC, FRB, OCC and OTS released their "Advance Notice of Proposed Rulemaking Regarding Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies" (the "ANPR") to modify their risk-based capital regulations to remove references to credit ratings and substitute other standards of creditworthiness, as mandated by Dodd-Frank Section 939A.[60] On October 25, 2010, ASF submitted a comment letter in response to the agencies' ANPR which was developed by the ASF Ratings Alternatives Taskforce.[61] The ASF Ratings Alternatives Taskforce has continued to develop a proposed new methodology for calculating regulatory capital for securitization exposures and has held ongoing dialogues with the banking regulators regarding this proposal.[62]

The current risk-based capital regulations for U.S. banking organizations consist of multiple approaches depending upon the type of banking organization, the type of exposure and whether the exposure is in the banking or trading book. In contrast to the risk-weighting methodology for non-securitization exposures, *all* of the current approaches for determining

[60] 75 Fed. Reg. 52283 (Aug. 25, 2010). ASF's viewpoints expressed herein focus on the portion of the ANPR dealing with securitization exposures and are not intended to comment on other aspects of the ANPR.

[61] *See* "ASF Ratings Alternatives ANPR Comment Letter," American Securitization Forum (October 25, 2011), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_Ratings_Alternatives_ANPR_Comment_Letter_10-25-10.pdf.

[62] *See* "ASF Proposal for Calculating Risk-Based Capital for Securitization Exposures: General and Advanced Approach Examples," American Securitization Forum (March 30, 2011), *available at* http://www.americansecuritization.com/uploadedfiles/ASF939AAutoandMortgageExamples032511.pdf; *see* "ASF Proposal for Calculating Risk-Based Capital for Securitization Exposures: Meeting with FDIC and FRB Staff," American Securitization Forum (January 31, 2011), *available at* http://asf.informz.net/ASF/data/images/asf_proposed_approach_re_939a_1.31.11.pdf; *see* ASF letter to FRB Staff (February 16, 2011), *available at* http://www.americansecuritization.com/uploadedFiles/2_16_11_ASF_Response_Letter_re_RatingsAlternatives.pdf.

capital charges for securitization exposures in the banking book either require (in the case of banking organizations that are subject to the Risk-Based Capital Standards: Advanced Capital Adequacy Framework-Basel II; Final Rule) or permit (in the case of other banking organizations) external credit ratings to be used, when available, to assign an appropriate risk-weight to the exposure.[63] Since most securitization exposures that banking organizations invest in are externally rated, external ratings are currently the main determinant of the risk-based capital charge for such exposures.[64] Accordingly, elimination of credit ratings from the federal agencies existing risk-based capital for securitization exposures will have far-reaching effects on banking organization securitizations and on the securitization markets generally.

With the effect of Dodd-Frank 939A, U.S. banking organizations' options to calculate regulatory capital for securitizations under Basel II have been reduced from four to two methodologies.[65] This is significant as the remaining two methodologies are either Supervisory Formula Approach ("SFA") or full capital deduction. As will be described in more detail later, SFA does not work for investors and lenders in securitizations. Therefore, if SFA cannot be used, then regulatory capital required to be held is full deduction. This requirement would lead U.S. banking institutions to exit current and future investments in securitizations.

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[63] Under the Agencies' Basel II rules (and subject to certain conditions) risk weights range from 7% (for AAA-rated senior exposures with underlying granular pools) to 650% (for BB- - rated exposures). *See, e.g.*, 12 C.F.R. Part 3, Appendix C, Table 6. Under the Agencies' general risk-based capital rules (and subject to certain conditions), risk weights range from 20% for AAA-rated exposures to 200% for BB-rated exposures. *See, e.g.* 12 C.F.R. Part 3, Appendix A, Table C.

[64] In addition, the Agencies' general risk-based capital rules and Basel II rules permit banking organizations to determine the risk-based capital charge for certain unrated exposures to asset-backed commercial paper programs by using internal models that are calibrated to external credit ratings (under the general rules) or using publicly available rating agency criteria (pursuant to the so-called internal assessment approach ("IAA") of the Basel II rules). *See, e.g.*, 12 C.F.R. Part 3, Appendix A, Section 4(g); 12 C.F.R. Part 3, Appendix C, Section 44.

[65] See Attachment B for a detailed decision tree.

We agree with the federal bank agencies that the principles that should guide the selection of any measurement of creditworthiness ("Policy Objectives") are promoting risk management, adequately capturing the risks of particular exposures, providing for timely and accurate measurement of changes in creditworthiness and minimizing opportunities for regulatory arbitrage. We have formed the following "guiding principles" that we believe are well-aligned with the Policy Objectives and, accordingly, should be embodied in any alternative creditworthiness standards.

Any alternative should:

- Promote understanding by banking organizations of the risks associated with their securitization exposures;

- Focus on (i) actual performance of assets, which is the primary driver of the performance of an ABS and (ii) the credit support available to a given risk position within an ABS structure after factoring in the assets' performance;

- Function to facilitate dynamic and timely adjustment of capital in a manner that is consistent with and proportionate to changes in asset performance and the resulting risk profile of a given exposure; and

- Be premised on data that is available to all market participants and should otherwise comport with standard market practices so that all participants have the option of performing the necessary calculations.

Although we agree with the federal banking agencies that any alternative should not be overly complex and that results should be replicable across banking organizations, simplicity should not come at the expense of the factors set forth above. Recognizing that approaches that are appropriate for banking organizations with sophisticated internal systems and controls may not be appropriate for smaller, less sophisticated banking organizations, we believe that there should be room for diversity of alternatives based on the size and sophistication of the relevant banking organization. A key focus of all approaches should be to ensure that all banking organizations have sufficient information, and conduct sufficient diligence, to understand the risk of their exposures. Further, banking organizations should not be improperly motivated to make investment decisions based on capital charges that are not consistent with the actual risk of the investment.

We believe that, as an additional Policy Objective, it is critical that any creditworthiness standard avoid putting U.S. banking organizations at a competitive disadvantage relative to their non-U.S. competitors who operate under the Basel II framework. As discussed above, under that framework, banking organizations must use external ratings to establish the capital charge for a securitization exposure if the exposure has an external rating or if one can be inferred.[66] As further discussed below, all of the alternative creditworthiness standards set forth in the ANPR (the "ANPR Alternatives") that the federal banking agencies have described in enough detail to make comparisons possible (the "Quantifiable ANPR Alternatives") will result in risk weights that far exceed those under the Basel II framework, thereby subjecting U.S. banking

[66] One or more ratings are required in the case of investing banks; two or more ratings are required in the case of originating banks.

organizations to significantly higher capital charges for securitization exposures than apply to non-U.S. banking organizations under that framework.

As further discussed below, we are concerned that by basing the calculation of capital charges for securitization exposures on risk-insensitive approaches, the Quantifiable ANPR Alternatives do not achieve, and could actually undermine, the Policy Objectives. Because they disproportionately focus on structure and do not adjust to reflect expected asset performance, they would not adequately capture the risk of particular securitization exposures or provide for timely and accurate measurements of changes in creditworthiness. As a result, the Quantifiable ANPR Alternatives would undermine, rather than enhance, incentives for banking organizations to understand the risk of their ABS investments or exposures. We believe more risk-sensitive approaches are needed to avoid encouraging investment in higher risk assets. Punitive new capital charges resulting from risk-insensitive assessments will also result in U.S. banking organizations foregoing securitization as a funding technique, which will impede their ability to make new loans and decrease the availability of credit in the overall economy at a time when credit remains severely constrained. Further, they will discourage banking organizations from using securitization to manage credit risk and liquidity.

Because credit ratings are so integrated into the current methodology for establishing risk-based capital charges for securitization positions, an abrupt change from credit rating-based capital charges could be extremely disruptive to banking organizations and to the capital markets generally, and runs a high risk of unintended consequences. For example, elimination of credit ratings from the risk-based capital rules could have a significant impact on liquidity in the ABS markets which rely upon the ability of investors to make real-time decisions at the point of initial offering or subsequent secondary market purchase. While many non-money center banking organizations have the capacity to understand the basis for credit ratings and to perform their own supplemental diligence at that time, they may not have the capacity to perform more extensive real-time analysis. Accordingly, removing credit ratings from the risk-based capital rules may eliminate the ability of a large number of banking organizations to participate in the ABS markets, substantially reducing market liquidity. This could lead to a decline in market values, forced selling, and reduced credit in the overall economy.

Despite recent criticism of rating agencies, ratings continue to provide objective third-party assessments of ABS that are transparent and easily replicable and that banking organizations should be able to use, together with other analysis, in determining the capital charge that will result from an ABS position.[67] The numerous rating agency reforms contained in the Dodd-Frank Act and in SEC regulations, together with those taking place internationally, will continue to improve the ratings process.[68] Rating agencies have also voluntarily taken

[67] It is therefore not surprising that the Federal Reserve continues to use ratings as a criteria for accepting ABS and other structured finance products at its discount window and used ratings as a criteria for ABS to be eligible for loans under its Term Asset-Backed Loan Facility ("TALF"). See Discount Window and Payment System Risk Collateral Margins Table, *available at* http://www.frbdiscountwindow.org/discountmargins.xls (discount window) and Term Asset-Backed Securities Loan Facility: Terms and Conditions, *available at* http://www.ny.frb.org/markets/talf_terms.html.

[68] The Dodd-Frank Act provides the SEC with greater enforcement and examination authority over rating agencies by, among other things, creating an Office of Credit Ratings ("OCR") within the SEC to promote rating agency accuracy and independence. The OCR will have the power to administer SEC rules with respect to rating agency practices, conduct annual examinations of the rating agencies, and impose fines and other penalties for violations of SEC rules. The Dodd-Frank Act also requires the rating agencies to make extensive disclosures regarding their ratings methodologies and the data relied upon to determine their ratings, as well as information that can be used by investors to better understand credit ratings of each class. Further, by repealing the SEC's Rule 436(g), the Dodd-Frank Act introduces the possibility of exposing the rating agencies to liability as experts with respect to ratings disclosed in prospectuses. Separate and apart from the Dodd-Frank Act, the SEC has issued Rule 17g-5, which requires issuers of structured finance products to provide other interested rating agencies with access to the information they give to the rating agencies hired to rate their product. Steps undertaken in the European Union include mandatory registration of all credit rating agencies and the adoption of a comprehensive set of regulations aimed at ensuring the quality and transparency of ratings and prohibiting rating agency conflicts of interest. The European Commission has also proposed the introduction of centralized oversight of the rating agencies under the new European Securities and Markets Authority (which would have the power to request information, conduct

significant steps to improve such process, particularly for ABS.[69] We believe that all of these factors argue against eliminating ratings as a creditworthiness standard without an alternative that is both practical and achieves the Policy Objectives.

Despite past issues with credit ratings, there is a broad consensus among policymakers, both in the United States and abroad, that the best way to address those issues is to regulate, rather than prohibit, the use of credit ratings for capital and other regulatory purposes and to improve the regulation and supervision of the credit rating agencies themselves.[70]

As Acting Comptroller of the Currency John Walsh recently testified:

> the prohibition against references to ratings in regulations under section 939A goes further than is reasonably necessary to respond to these issues. Rather than disregard credit ratings, it may be more appropriate to assess their strengths and weaknesses and to supplement ratings with additional analysis in appropriate cases. We suggest that section 939A be amended to direct regulators to require that ratings-based determinations be confirmed by additional risk analysis in circumstances where ratings are likely to present an incomplete picture of the risks presented to an

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investigations and perform on-site examinations) and a rule similar to the SEC's Rule 17g-5 that would require disclosure to other interested rating agencies of the information given to a rating agency hired to rate a structured finance product.

[69] *See* International Monetary Fund, The Uses and Abuses of Sovereign Credit Ratings, Global Financial Stability Report, Chpt. 3 (Oct. 2010), *available at* http://www.imf.org/External/Pubs/FT/GFSR/2010/02/pdf/chap3.pdf ("IMF Report").

[70] IMF Report, p 9.

> institution, or where those risks are heightened due to concentrations in particular asset classes.[71]

Internationally, regulators continue to permit the use of credit ratings for capital and other regulatory purposes, but have imposed additional requirements on their use and increased credit rating agency regulation. For example, the new Article 122A(a)(4) of the EU Capital Requirements Directive (which implements Basel II in the EU) requires banking organizations to perform their own stress tests appropriate for securitization positions, but provides that they may rely upon models developed by the credit rating agencies if they can demonstrate, when requested, that they took due care prior to investing to validate the relevant models and to understand their methodology, assumptions and results.[72] The rest of the EU Capital Requirements Directive likewise continues to implement Basel II with extensive use of credit ratings from the rating agencies. The Basel Committee's June 2010 revisions to its market risk framework[73] continue to permit banking organizations to use credit ratings, as does its July 2009 paper on increased risk weights for resecuritization exposures[74] (which also adds additional requirements to ensure appropriate diligence in connection with their use). The Basel

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[71] *See* Testimony of John Walsh, Acting Comptroller of the Currency, before the Committee on Banking, Housing and Urban Affairs, United States Senate (September 20, 2010), Attachment A, p. 2-3 *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=45d8ba0b-04b1-41d6-b5b5-2008c0ce72d9&Witness_ID=b6b6249a-799f-44e7-aecd-2fe30fa9b172.

[72] Committee of European Banking Supervisors, Consolation Paper on Guidelines to Article 122a of the Capital Requirements Directive (CP 40), para. 4 at p. 28 (July 1, 2010), *available at* http://www.c-ebs.org/documents/Publications/Consultation-papers/2010/CP40/CP40.aspx. A similar approach has been suggested by others. *See e.g.*, Richardson and White, "Fixing the Rating Agencies," *available at* http://whitepapers.stern.nyu.edu/summaries/ch03.html (urging that, following the removal of ratings from statutes and regulations, "regulated financial institutions [should] be free to take advice from sources they considered most reliable" but should have to be able to justify the choice to their regulators).

[73] Basel Committee on Banking Supervision, Changes to the Revisions to the Basel II Market Risk Framework (June 18, 2010), available at http://www.bis.org/press/p100618/annex.pdf and Revisions to the Basel II Market Risk Framework (July 13, 2009), *available at* http://www.bis.org/publ/bcbs158.pdf.

[74] Basel Committee on Banking Supervision, Enhancements to the Basel II Framework (July 13, 2009), available at http://www.bis.org/publ/bcbs159.htm.

Committee's Basel III proposals also reference credit ratings, although they indicate that the Basel Committee is undertaking a review of the Basel II framework for securitization exposure which may result in revised capital charges and a reconsideration of the requirement to use credit ratings where a credit rating exists.[75] Also under consideration is a requirement for credit rating agencies to comply with the requirements of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies[76] in order for their ratings to be used for Basel II purposes.[77]

b. ASF Proposed Solutions

Given the above considerations, ASF believes that the federal banking agencies should consider a regulatory framework that permits the use of two different approaches for establishing capital charges for securitizations exposures: a "general approach," that would set capital charges based on third-party inputs and, for banks that have more sophisticated credit risk evaluation capabilities, an "advanced approach" which would allow such organizations to use models and internal analyses to establish capital requirements for such exposures, subject to verification and oversight by the banking regulators. Under both approaches, banking organizations would classify securitization exposures into risk categories which would be mapped to appropriate risk weight percentages. Actual risk weights for each risk category may vary between the general and advanced approaches described below.

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[75] Basel Committee on Banking Supervision, Strengthening the Resilience of the Banking Sector, Consultative Document, para 198 at p. 59 (Dec. 2009), *available at* http://www.bis.org/publ/bcbs164.pdf?noframes=1; Basel Committee on Banking Supervision, International Framework for Liquidity Risk Measurement, Standards and Monitoring (Dec. 17, 2009), *available at* http://www.bis.org/publ/bcbs165.pdf.

[76] International Organization of Securities Commissions (IOSCO), Code of Conduct Fundamentals for Credit Rating Agencies (May 2008), *available at* http://iosco.org/.

[77] IMF Report, p. 9.

1. General Approach

Under the general approach, a banking organization would, subject to appropriate due diligence requirements and Agency supervision, be permitted to use inputs derived from or provided by a third party (which could include credit rating agencies) to calculate capital charges for securitization exposures (whether rated or unrated). Such inputs could include expected loss, the level of credit enhancement (whether provided by structural features or the price at which the assets were purchased) and other structural elements which affect the overall risk profile of the exposure. Banking organizations would then map such inputs to a risk category which would be used to determine the risk-based capital charge.

It is important to note that this is not a replication of a ratings-based approach; rather, inputs provided or derived from third parties would form the basis of the assignment to a risk category, and these inputs could be sourced from a variety of third parties. While Section 939A of the Dodd-Frank Act requires the federal banking agencies to remove references to rating agencies in their regulations, we do not read it as prohibiting the agencies from allowing banking organizations to use properly supplemented third-party inputs to establish capital charges.

The federal banking agencies already have in place safety and soundness standards that banking organizations are required to follow before they invest in ABS and other complex instruments or otherwise assume exposure to securitizations.[78] Such standards require banking organizations to conduct appropriate diligence and to be able to demonstrate an adequate understanding of the securitization exposures they invest in or otherwise assume. To the extent

[78] *See, e.g.*, Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities, 63 Fed. Reg. 20191 (May 26, 1998); OCC Bulletin 2009-15.

appropriate, such standards could be enhanced to ensure that banking organizations conduct proper diligence to understand the applicable third-party inputs. Banking organizations that are not able to demonstrate that they have complied with such standards could be subjected to higher capital charges.

2. Advanced Approach

ASF believes that the soundest alternative for many banking organizations, and the one most consistent with the objectives of Section 939A and with the Policy Objectives, would be to allow such organizations to use their own internal systems, subject to Agency approval, oversight and supervision, to assign securitization exposures (whether rated or unrated) to defined risk categories. These categories would be mapped to risk weight percentages that are consistent with international standards for assets with similar risk characteristics. We believe that this consistency is critical to maintaining a competitive landscape between U.S. and foreign banking organizations. Enhancements to risk management systems and controls resulting from Basel II and the agencies' Supervisory Capital Assessment Program ("SCAP"),[79] along with the new requirement in Title I of the Dodd-Frank Act that the Federal Reserve Board, in coordination with the federal banking agencies, perform annual stress tests on systemic banking organizations,[80] all suggest that this should be a viable approach for many institutions and that consistency of results among institutions (a possible issue when internal systems are used) should be addressable. Such an approach would enable banking organizations to model exposures more extensively and would lead to capital charges that better differentiate risk based

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[79] *See* Federal Reserve Board, Supervisory Capital Assessment Program Design and Implementation (Apr. 24, 2009), *available at* http://www.federalreserve.gov/bankinforeg/bcreg20090424a1.pdf.

[80] Dodd-Frank Act, Section 165(i).

on differing structures and underlying exposures. It would also provide the federal banking agencies with a better understanding of how similar risk exposures are being assessed across multiple banking organizations, thereby leading to greater transparency with respect to the adequacy of each organization's systems and controls. Such approach could also lessen systemic risk that can result when all banking organizations use identical, simple models for assessing capital (*i.e.*, risk that all such organizations act in the same manner at the same time with respect to such exposures).

A banking organization's internal assessment of its securitization exposures should consider expected losses on the underlying assets according to its own cash flow analyses, amount and type of credit enhancement, seller/servicer risk analysis, priority of exposure in the cash flow waterfall, and other financial and structural parameters.

ASF believes it is important for the new rules to allow for the use of models as part of a robust process to assess the risk of an exposure. Models are a core part of industry methodology and best practices actively employed by the leading risk managers in the industry. ASF's proposed solution defines a robust process that integrates modeling, comparison of outputs, and verification by the agencies in a standardized manner across banking organizations.

Banking organizations using the Advanced Approach could be required to meet certain predefined criteria including that (i) the use be based on a foundation of generally accepted credit risk evaluation metrics, (ii) internal assessments used for purposes of determining capital requirements not differ from assessments used in the organization's risk management process, and (iii) assessments be subject to periodic reevaluation. The federal banking agencies would be able to review the underlying models with a view to assuring the transparency and consistency of the resulting capital charges across banking organizations. In addition, banking organizations that are unable to demonstrate that they have adequately complied with these criteria on a consistent basis could be required to use the general approach.

Additionally, since November 29, 2001 (the date of the adoption by the federal banking agencies of their so-called "Recourse Rule" for securitization exposures[81]), all U.S. banking organizations have been eligible to use the external ratings-based approach for securitization exposures. That approach was adopted to address the failure of the federal banking agencies' then-existing Basel I Rules, which did not foster prudent risk management, to adequately take account of the different risks presented by various positions in a securitization.

Subsequent changes to the U.S. risk-based capital rules, including the adoption of the Advanced Internal Ratings Based Approach of the Basel II framework for certain banking organizations[82] and the proposal to adopt the Basel II's standardized approach as an option for others, have all been aimed at increasing the risk-sensitivity of the capital rules to better align capital charges with potential economic loss and encourage improvements in risk management.

In the ANPR, the agencies propose a number of alternatives to the use of ratings to establish the risk-based capital charges for securitization exposures. These include (i) a pre-Recourse Rule approach under which all securitization exposures in a transaction would receive the same risk-weight (the "one-size-fits-all approach"); (ii) simple and more complex "gross-up approaches" under which banking organizations would maintain capital based on the

[81] 66 Fed. Reg. 59617 (Nov. 29, 2001).
[82] 72 Fed. Reg. 69287 (Dec. 7, 2007).

securitization position and more senior securitization positions based on the risk-weight of the underlying assets (and, in the case of the more complex gross-up approach, the transaction's overcollateralization ratio, interest coverage and waterfall priority); (iii) a special rule for the most senior exposure, which would base capital charges on the underlying exposure type and the aggregate amount of subordination that provides credit enhancement for the exposure; (iv) the use of a "concentration ratio" to set the capital charge[83] and (v) a simplified Supervisory Formula Approach ("SSFA") that uses specific inputs, including the capital requirements for the underlying exposures, to set the capital charge but fewer inputs than under the Supervisory Formula Approach in the agencies' Basel II capital rules.

Because all of the Quantifiable ANPR Proposals are largely capital structure-based, they represent, to differing degrees, a return to the risk-insensitive Basel I/pre-Recourse rule approach (*i.e.*, the same or similar capital charge for higher and lower risk exposures) that do not encourage banks to fully understand the risks involved in their securitization exposures. Similarly, they do not meet the Policy Objectives of appropriately distinguishing credit risk exposures within asset classes, providing for timely and accurate measurements in credit quality and fostering prudent risk management. As demonstrated in Annex A to this letter, all of the Quantifiable ANPR Alternatives would result in capital charges well in excess of what would be required under the Recourse Rules and the Basel II Advanced Internal Ratings Base Approach, and, if adopted, would place U.S. banking organizations at a significant competitive disadvantage relative to their non-U.S. competitors.

[83] The "concentration ratio" would be equal to the sum of the notional amounts of all tranches divided by the sum of the notional amounts of the tranches junior to or *pari passu* with the tranche in which the position is held, including the tranche itself.

The impact of this increase and disadvantage will be significantly magnified due to:

- Changes in GAAP accounting rules (FAS 166 and 167) that bring onto the balance sheet most securitizations and therefore result in more securitization positions being subject to risk-weighting;

- The Banking Agencies' December 2009 amendments to their risk-based capital rules relating to FAS 166 and 167, which require banking organizations to retain risk-based capital against all on-balance-sheet securitization exposures regardless of the amount of risk they have transferred though the securitization;[84]

- Increased capital requirements that could result from systemic regulation under Title I of the Dodd-Frank Act, and from implementation of Basel III, which will require substantially more (and higher quality) capital per dollar of risk-weighted exposure;[85] and

- The risk-retention requirements in the final FDIC Safe Harbor and in the Dodd-Frank Act, which will result in banking organizations having to retain some exposure, which will be subject to a capital charge, in connection with most securitizations.[86]

As an additional proposal, the agencies propose the SSFA, which is a simplified version of the current SFA for unrated securitization exposures in the agencies' current Basel II rules.

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[84] 75 Fed. Reg. 4635 (Jan. 28, 2010).

[85] Dodd-Frank Act, Section 165(b); Basel Committee on Banking Supervision, Strengthening the Resilience of the Banking Sector, Consultative Document, para. 198 at p.. 59 (Dec. 2009), *available at* http://www.bis.org/publ/bcbs164.pdf?noframes=1; Basel Committee on Banking Supervision, International Framework for Liquidity Risk Measurement, Standards and Monitoring (Dec. 17, 2009), *available at* http://www.bis.org/publ/bcbs165.pdf.

[86] 75 Fed. Reg. 60287 (Sept. 30, 2010).

The agencies have not detailed what exposure-specific inputs they intend to require or how the SSFA would be adjusted to compensate for reduced inputs, making such proposal difficult to evaluate. However, given that many of the current informational inputs in the SFA may not be generally available and given the SFA's requirement to segment assets into homogenous risk pools, there are substantial questions as to whether an SSFA would be a viable approach for many securitization exposures, especially for banking organizations that are investing in, rather than originating, such exposures and therefore have more limited ability to access and model information. The current SFA also puts severe limitations on the ability to invest in wholesale assets with a maturity greater than a year. Further, given the SFA's complexity, it lacks transparency and therefore could significantly reduce primary and secondary market liquidity for ABS compared to the current ratings-based approach and other alternatives. However, despite the SFA's limitations, an SSFA could nonetheless provide a useful alternative for some banking organizations for certain securitization exposures, provided its inputs are appropriately adjusted to permit the use of market-based data of the type generally available to investors with flexibility on the number of years of historical information and the applicable formula is further calibrated to result in a smoother relationship between capital requirements and risk. In order to counter its rigidity, banking organizations would also likely have to be given the flexibility to make their own adjustments to the SSFA formula, subject to supervisory review. As noted above, with material modifications, SFA may be a viable alternative for sophisticated banks and some segments of the securitization market.

Given the extent to which credit ratings are integrated into the current framework, in adopting the above approaches (or any other approach), we believe that it is critical that there be adequate phase-in periods and grandfathering to avoid abrupt and potentially destabilizing changes in capital requirements and to provide banking organizations the necessary time to make system changes (and avoid the need for such changes to be made more than once). In addition, we believe that the agencies should consider a delayed effective date to permit systems and other changes that may be required by the revised risk-based capital rules.

ii. Other Ratings Alternatives Proposals

Pursuant to Dodd-Frank Section 939A, a number of proposed rules relating to the regulations of the federal banking agencies have been issued, and we anticipate that more are forthcoming. The ASF Ratings Alternatives Taskforce has been commenting specifically on those proposals which stand to impact regulations directly affecting the securitization markets.

a. OCC ANPR

On August 13, 2010, the OCC released its "Advance Notice of Proposed Rulemaking on Alternatives to the Use of External Credit Ratings in the Regulations of the OCC" (the "OCC ANPR")[87] to modify its regulations to remove references to credit ratings in its regulations and to substitute other standards of creditworthiness, as mandated by Section 939A of the Dodd-Frank Act. On October 25, 2010, ASF submitted a comment letter in response to the OCC ANPR which was developed by the ASF Ratings Alternatives Taskforce.[88] ASF's comments focus primarily on the portion of the OCC ANPR that relates to the legal investment criteria for

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[87] 75 Fed. Reg. 49423 (Aug. 13, 2010).
[88] See "ASF OCC Legal Investment Comment Letter," American Securitization Forum (October 25, 2010), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_OCC_Legal_Investment_Comment_Letter_10-25-10.pdf.

investment in ABS and is not intended to comment on other aspects of the ANPR. ASF believes that the OCC should allow banks to use credit ratings, together with other inputs (either third-party or internal) that the bank deems appropriate, to determine whether an ABS is a legal investment under the Investment Securities Regulation. While Dodd-Frank Section 939A requires the OCC to remove references to rating agencies in its regulations, we do not read it as prohibiting the OCC from allowing banking organizations to use third-party inputs (including credit ratings), properly supplemented, to determine whether an investment is a legal investment.

The OCC currently has in place safety and soundness standards that banks are required to follow before they invest in ABS and other complex instruments.[89] Such standards already require national banks to conduct appropriate due diligence and to be able to demonstrate an understanding of the specific types of ABS structures they plan to purchase. They further require national bank investment policies to specifically authorize holdings of such instruments and to establish appropriate limits. To the extent appropriate, these standards could be enhanced to ensure that banks are not inappropriately relying upon ratings in purchasing ABS.

Given the extent to which credit ratings are integrated into the current framework, ASF believes that, whatever alternative is devised, adequate phase-in and grandfathering provisions will need to be provided to avoid disruptions to banking organizations and the securitization markets. Among other things, these should provide that any ABS owned by a bank prior to any new standards becoming effective are grandfathered investments. In addition, we believe that the OCC should consider a delayed effective date to permit banks to make systems and other changes that could be necessitated by any new regulations.

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[89] *See*, *e.g.*, OCC Bulletin 2009-15; Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities, 63 Fed. Reg. 20191 (May 26, 2998).

C. Structured Finance Ratings and Assignment Process

i. SEC Study on the Standardization of Credit Ratings

On December 17, 2010, the SEC published a request for comment regarding Release No. 34-63573; File No. 4-622 relating to the study the SEC is required to undertake pursuant to Dodd-Frank Section 939(h) (the "Ratings Standardization RFC"). Section 939(h)[90] requires the SEC to undertake a study on whether the standardization of credit rating agency terminology and streamlining of certain quantitative measurements would be feasible and desirable. The SEC is required to submit to Congress a report containing the findings of this study as well as its recommendations, if any, with respect to the study not later than 1 year after the date of enactment of the Dodd-Frank Act.

Consistent with Section 939(h), the Ratings Standardization RFC asks the following four main questions:

1. Is it feasible and desirable to standardize credit ratings terminology, so that all credit rating agencies issue credit ratings using identical terms?

[90] **SEC. 939. REMOVAL OF STATUTORY REFERENCES TO CREDIT RATINGS.**
(h) STUDY AND REPORT.—
(1) IN GENERAL.—Commission shall undertake a study on the feasibility and desirability of—
(A) standardizing credit ratings terminology, so that all credit rating agencies issue credit ratings using identical terms;
(B) standardizing the market stress conditions under which ratings are evaluated;
(C) requiring a quantitative correspondence between credit ratings and a range of default probabilities and loss expectations under standardized conditions of economic stress; and
(D) standardizing credit rating terminology across asset classes, so that named ratings correspond to a standard range of default probabilities and expected losses independent of asset class and issuing entity.
(2) REPORT.—Not later than 1 year after the date of enactment of this Act, the Commission shall submit to Congress a report containing the findings of the study under paragraph (1) and the recommendations, if any, of the Commission with respect to the study.

2. Is it feasible and desirable to standardize the market stress conditions under which credit ratings are evaluated?

3. Is it feasible and desirable to require a quantitative correspondence between credit ratings and a range of default probabilities and loss expectations under standardized conditions of economic stress?

4. Is it feasible and desirable to standardize credit rating terminology across asset classes, so that named credit ratings correspond to a standard range of default probabilities and expected losses independent of asset class and issuing entity?

ASF submitted a letter in response to the Ratings Standardization RFC on February 4, 2011.[91] As a general proposition, we believe that standardization of methodology and terminology used by credit rating agencies ("CRAs") would not be desirable as users of credit ratings, in particular investors, benefit from a diversity of experience and methodologies. Increased uniformity may have the counterproductive effect of restricting the use of new information and changing economic conditions by CRAs as well as discouraging competition among CRAs. As a result, we believe uniformity would compromise the quality, accuracy and usefulness of credit ratings in the securitization market.[92] Measures required to be adopted in response to Dodd-Frank that foster transparency of methodology used to derive credit ratings for ABS will, in our view, better serve investors by providing qualitative information helpful to

[91] *See* "ASF Credit Rating Standardization Comment Letter," American Securitization Forum (February 4, 2011), available at http://www.americansecuritization.com/uploadedFiles/asf_letter_re_nrsro_standardization-2-4-11.pdf.
[92] In our letter, we did not specifically address the feasibility of standardizing ratings criteria because we do not think such standardization is desirable. However, we believe that the exercise of standardizing ratings criteria for any asset class, across asset classes and for new asset classes is most likely unworkable given the wide variations in the approach to credit ratings by each CRA and differences among performance characteristics of different assets. In addition, the process of ongoing standardization could limit the ability of CRAs to adapt their credit ratings methodology in a timely manner to changing market and economic conditions.

understand the relevant credit ratings.[93] We also believe that greater standardization would not have helped prevent the economic crisis we have just experienced. Even though different views and methodologies for credit ratings may not necessarily prevent a similar crisis in the future, we believe that a diversity of views and methodologies, with appropriate transparency, across a competitive market for credit ratings would be more likely to avert a similar crisis than would a prescribed set of criteria employed by all CRAs.

a. Standardization of Ratings Terminology

Question 1 of the Ratings Standardization RFC asks, "[*i*]*s it feasible and desirable to standardize credit ratings terminology, so that all credit rating agencies issue credit ratings using identical terms?* [emphasis added]*.*" We believe that different credit ratings terminology appropriately reflects the differences that exist among quantitative models and qualitative assessments among CRAs. The standardization of ratings terminology could suggest to investors that there is a uniformity of views that is neither intended nor desired. [94] We believe that it may also discourage investors from further inquiry. For similar reasons, we do not support changes to the symbols used by CRAs to rate structured finance products.[95] CRAs should be able to use

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[93] In particular, *see* Section 932 of Dodd-Frank.

[94] We note that Section 15E(c)(2) of the Exchange Act expressly limits the authority of the Commission to make rules with respect to credit rating procedures and methodologies, as follows: "Notwithstanding any other provision of this section, or any other provision of law, neither the Commission nor any State (or political subdivision thereof) may regulate the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings." Dodd-Frank amended this section, among other reasons, to clarify that other changes to this section affected by Dodd-Frank were not intended to reverse this limitation.

[95] This is not to suggest that changes in symbols used for credit ratings for structured finance products (but not to other securities rated by CRAs) would be desirable. Use of ABS-specific identifiers may suggest that a credit rating is qualitatively different from a corresponding rating in a different ratings sector. ASF has commented on this issue in previous letters to the Commission. In particular, *see* http://www.americansecuritization.com/uploadedFiles/ASF%20CRA%20-%20ratings%20scale.pdf

different credit terminology and unique symbols.[96] Use of standardized symbols may imply a uniformity of underlying ratings criteria that both does not exist and is not desired by investors and other users, and may negatively impact the interpretation of credit ratings assigned to ABS.

b. Standardization of Ratings Methodologies

Question 3 of the Ratings Standardization RFC asks, "*[i]s it feasible and desirable to require a quantitative correspondence between credit ratings and a range of default probabilities and loss expectations under standardized conditions of economic stress?* [emphasis added]." We believe that the standardization of credit ratings methodologies could deprive investors of the ability to consider diverse perspectives provided by multiple CRAs, thus inhibiting independent analysis. We also believe that investors are aware that CRAs employ different criteria in deriving credit ratings and value divergence of practices among CRAs. Different methodologies allow an investor to consider different perspectives on evaluating an investment. The availability of credit ratings based on a loss expectations model and a model measuring a range of default probabilities differences, for example, can help inventors evaluate credit risk in a way that they determine is more appropriate.

Such diversity may also contribute to the quality and accuracy of credit ratings. The process of deriving a credit rating is necessarily qualitative in nature and takes into account

[96] Separately, we note that Section 938(a) of Dodd-Frank requires the Commission to adopt rules that require nationally recognized statistical organizations "to establish, maintain, and enforce written policies and procedures" that, among other things, define and disclose the meaning of credit rating symbols used by CRAs and requires consistent application of such symbols. We note that Section 938(b) of Dodd-Frank expressly states that "[n]othing in [Section 938(b)] shall prohibit a nationally recognized statistical rating organization from using distinct sets of symbols to denote credit ratings for different types of securities or money market instruments."

differences among asset classes that are not readily quantifiable.[97] Similarly, uniformity of market stress conditions under which ratings are evaluated may undermine the value that different CRAs bring to credit ratings through the application of differing economic views and models to differing asset classes or different qualities or characteristics within the same asset class.[98]

The application of different methodologies makes the standardization of quantitative correspondence between credit ratings and a range of default probabilities or loss expectations difficult, if not impossible, and, for the reasons stated in this letter with respect to the benefits of diverse views and encouraging additional inquiry, less desirable.

c. Standardization of Ratings Terminology Across Asset Classes

Question 4 of the Ratings Standardization RFC asks, "*[i]*s *it feasible and desirable to standardize credit rating terminology across asset classes, so that named credit ratings correspond to a standard range of default probabilities and expected losses independent of asset class and issuing entity?* [emphasis added]." In addition to the considerations set forth above, requiring CRAs to apply a singular risk analysis to different asset classes may ignore or downplay asset-specific credit risks and may compromise the quality and accuracy of credit ratings applicable to an asset class.

[97] It is questionable whether agreement could be reached on the nature and severity of general risks, and whether if such consensus were reached, it would be desirable.
[98] Formulating product-specific criteria requires qualitative judgments about the nature of the asset class and related products. For example, not only would a CRA apply different criteria to auto ABS than they would RMBS, it may also employ different criteria within RMBS to the extent the collateral was prime, subprime, seasoned, etc.

d. Conclusion

ASF believes that Dodd-Frank appropriately requires a review of the credit ratings process. However, we believe that greater flexibility to incorporate new information and new conditions into credit analysis methodologies, more diversity of views with respect to how such information and conditions are applied, and transparency with respect to the underlying assumptions and methodologies employed by credit rating agencies are of greater benefit to investors than standardization of terminology or methodology. This flexibility is also important to ensure competition among credit rating agencies.[99] The introduction of standardized criteria and streamlined quantitative models would diminish the diversity of practices employed and number of variables considered by CRAs in formulating credit ratings. Standardization would in effect lead to the expression of a single, unified view applied by separate CRAs, thereby limiting the quality and accuracy of credit ratings

ii. SEC Study and Rulemaking on Assigned Credit Ratings

On May 10, 2011, the SEC published a request for comment regarding Release No. 34-64456; File No. 4-629 relating to the study the SEC is required to undertake pursuant to Dodd-Frank Section 939F (the "Ratings Process RFC"). The SEC is required to submit to Congress a report containing the findings of this study as well as its recommendations, if any, with respect to the study not later than 24 months after the date of enactment of Dodd-Frank.

[99] In its adopting release for rules promulgated under the Credit Rating Agency Reform Act of 2006, including Rule 17g-5, the Commission expressed an intention to follow Congress' stated goals of fostering competition and transparency among CRAs in crafting rules. Release No. 34-61050; File No. S7-04-09 (November 23, 2009).

Section 939F requires the SEC to undertake a study on:

i. The credit rating process for structured finance products and the conflicts of interest associated with the issuer-pay and the subscriber-pay models;

ii. The feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns NRSROs to determine credit ratings of structured finance products;

iii. The range of metrics that could be used to determine the accuracy of credit ratings; and

iv. Alternative means for compensating NRSROs that would create incentives for accurate credit ratings.

After submission of the report, "as the [SEC] determines is necessary or appropriate in the public interest or for the protection of investors," the SEC must establish a system for the initial assignment of credit ratings "in a manner that prevents the issuer, sponsor or underwriter of the structured finance product from selecting the nationally recognized statistical rating organization that will determine the initial credit ratings and monitor such credit ratings."

Although we have not formally responded to the Ratings Process RFC, we believe that any proposal to establish a system in which a public or private utility or a self-regulatory organization would assign NRSROs to issue initial credit ratings would be detrimental to the securitization market in a number of ways. Such a system is premised on the assumption that all "qualified" NRSROs are created equal with respect to rating a particular asset class. However, internal investor guidelines restrict the securities in which they can invest based on the NRSRO that provides the rating and issuers may struggle to market securities that have a rating from a non-approved NRSRO. Furthermore, issuers would have to pay for additional ratings should an NRSRO that does not have sufficient market credibility be selected to issue an initial rating. Finally, the alleged purpose of Section 939F is to examine and eliminate the perceived conflicts associated with the "issuer-pay" ratings model. The SEC has already attempted to address this conflict with its amended Rule 17g-5, which requires issuers to post information provided to hired NRSROs so that non-hired NRSROs can produce unsolicited ratings. While it is unclear at this point whether the SEC's Rule 17g-5 adequately alleviates any perceived conflicts in rating structured finance products, we remain concerned that the assignment of credit ratings would create substantial expense, confusion and burden for the securitization market. ASF will be developing a detailed response to the SEC's Ratings Process RFC with respect to Section 939F in order to fully articulate our views on this important matter.

D. Rule 17g-5

Rule 17g-5(a)(3) ("Rule 17g-5") under the Exchange Act,[100] which became effective on June 2, 2010, sets forth requirements for NRSROs that are hired by issuers, underwriters or sponsors (collectively, "arrangers") to provide credit ratings for ABS/MBS transactions. In addition, the rules require the arranger to post information provided to hired NRSROs on a password-protected website and make it available to non-hired NRSROs. The purported goal of Rule 17g-5 is to promote competition among rating agencies and to increase the number of ratings for structured finance products.

[100] *See* Exchange Act Release No. 61050 (Nov. 23, 2009), 74 FR 63832 (Dec. 4, 2009) (the "Adopting Release")

Discussions among our issuer member firms since the effective date of Rule 17g-5 have produced credible and specific evidence that few non-hired NRSROs have requested access to the websites that arrangers are required to maintain under the Rule. In fact, in a survey of ASF members, we are aware of only a small handful of transactions in the entire U.S. ABS/MBS marketplace where an arranger's website has been accessed. In the context of the U.S. market, we fully support the SEC's interrelated goals as stated in the Rule 17g-5 adopting release, namely to promote increased competition among rating agencies through issuance of unsolicited ratings, address conflicts of interest in credit ratings and ultimately improve ratings quality.[101] Ultimately, the new requirements of Rule 17g-5 have been responsible for only a handful of ratings produced by non-hired NRSROs that our members are aware of. Despite this fact, arrangers of ABS continue to be burdened by tens of millions of dollars in initial and ongoing compliance costs in connection with Rule 17g-5, at a time when restarting the securitization markets in the U.S. and around the globe is still a critical component of economic recovery.

i. Industry Implementation of Rule 17g-5

Given the burden of compliance with Rule 17g-5 on market participants, ASF has actively worked within the membership and in discussions with the SEC to identify solutions to key issues presented by the rules.

a. Market Guide

After the rules became effective, the ASF began to hold numerous calls of its various subforums and committees to formulate a market-wide set of issues and concerns relating to the

[101] Adopting Release at 63844.

implementation of Rule 17g-5. The ASF has also attended numerous meetings with the SEC regarding Rule 17g-5 to address implementation concerns, including issues that run across all asset classes as well as specific concerns arising in the ABCP market. ASF continues to address concerns as they arise relating to the implementation of Rule 17g-5.

b. Model Confidentiality Agreement

In the adopting release for Rule 17g-5, the SEC indicated that an arranger may employ a "simple process requiring non-hired NRSROs to agree to keep the information they obtain from the arranger confidential, provided that such a process does not operate to preclude, discourage or significantly impede non-hired NRSROs' access to the information, or their ability to issue a credit rating based on the information." The SEC further indicated its expectation that the confidentiality agreement "would contain the same terms as the confidentiality agreement between the arranger and the hired NRSRO." ASF created a working subgroup of arrangers and certain of the ASF's NRSRO members (the "Confidentiality Subgroup") to aid in the process of implementing confidentiality terms between arrangers and both hired and non-hired NRSROs under Rule 17g-5. The Confidentiality Subgroup worked for nearly two months to develop a standard form agreement in an attempt to address both arranger and NRSRO concerns.

ii. Extraterratoriality Request

Our concerns with respect to the effectiveness of Rule 17g-5 are compounded by lingering international uncertainty regarding its potential future applicability to extraterritorial transactions. With respect to non-U.S. offerings, our members believe Rule 17g-5 should not apply to the conduct of NRSROs or arrangers outside the U.S., absent a substantial effect in the

U.S. or on U.S. persons. We believe that permanently defining the scope in this way would advance the SEC's objectives, provide sufficient certainty for market participants and regulators in other jurisdictions and avoid certain unintended consequences which might otherwise arise in the context of rated deals involving non-U.S. arrangers. In addition, while each NRSRO defines the parts of its business that operate under the NRSRO designation (and, in theory, can therefore control the scope of its conduct that is subject to the rule), arrangers have no role in the NRSRO-designation process but incur significant burdens by operation of the rule simply because they engage the NRSRO to assign an initial credit rating. Because the rule operates to regulate the conduct of both NRSROs and arrangers, under general principles of fairness, the rule should not apply to conduct outside the U.S. absent a substantial effect in the U.S. or on U.S. persons.

On October 27, 2010, the ASF and the Australian Securitisation Forum ("AuSF") jointly submitted a letter[102] to the SEC requesting that they make permanent an exemption for extraterritorial ratings, given both the undue negative impact Rule 17g-5 would have on global issuance of ABS, and, more broadly, the poor progress Rule 17g-5 has made in the U.S. toward achieving the stated goals of the SEC since the June 2, 2010 compliance date. On November 23, 2010, the SEC extended a previously issued temporary conditional exemption for NRSROs from complying with Rule 17g-5(a)(3) with respect to covered extraterritorial transactions until December 2, 2011.[103] We continue to support extending the exemption on a permanent basis in order to provide foreign transactions with sufficient market certainty going forward.

[102] *See* "AuSF & ASF 17g-5 Extraterratoriality Request," American Securitization Forum and Australian Securitisation Forum (October 27, 2010), available at: http://www.americansecuritization.com/uploadedFiles/ASFAuSF_17g5_Extraterritoriality_Request_102710.pdf.
[103] *See* Securities and Exchange Commission Release No. 34-63363; File No. S7-04-09 (Nov. 23, 2010)

In common with other Organisation for Economic Co-operation and Development ("OECD") jurisdictions, the federal securities laws of the United States focus on the regulation of offerings to U.S. persons. This guiding principle of local investor protection is reflected in the preamble to, and the findings set out at the start of, the U.S. Credit Rating Reform Act of 2006 and in the general mandate of the SEC itself. This principle suggests the SEC has a limited interest in regulating securities offered solely outside the U.S. and this is evidenced by certain existing provisions and practices, including the Regulation S safe harbor. Given this background, the application of Rule 17g-5 to all credit ratings provided by an NRSRO or a registered affiliate, regardless of whether the relevant transaction involves a U.S. investor connection (i.e. via a U.S. offering), would be inconsistent from a policy perspective with the wider U.S. legislative and regulatory framework as well as principles of international comity.

As a major, functioning international securitization market, the Australian market stands to be negatively impacted by Rule 17g-5. Three NRSROs currently operate in Australia and assign ratings to ABS issued to both non-U.S. persons and, on occasion, U.S. persons. Since its correspondence with the SEC earlier in the year, the AuSF has established a series of new public disclosure and reporting standards with the Australian Securities & Investment Commission ("ASIC") that are consistent, if not identical, to those implemented in the U.S. and will apply to issuers of Australian RMBS to provide investors and NRSROs with increased and more consistent information and data. These new International Organization of Securities

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In requesting the initial exempting order, which was subsequently extended by the Commission's November 23, 2010 order, the ASF presented a set of talking points in connection with the rule on April 27, 2010 at our meeting with the Commission. *See* "ASF Discussion Points: Meeting with SEC Staff: Questions re Implementation of Amended Exchange Act Rule 17g-5" (April 27, 2010), *available at* http://www.americansecuritization.com/uploadedFiles/ASFDiscussionPoints_ImplementationofAmendedRule17g-5_042710.pdf.

Commissions ("IOSCO")-compliant standards will assist investors and others to form independent views on the creditworthiness of RMBS and aid the ability of non-hired NRSROs to provide ratings within the Australian jurisdiction.

VIII. Other Dodd-Frank Issues

A. Conflicts of Interest in Securitization

Section 621 (Conflicts of Interest) of Dodd-Frank seeks to address conflicts of interest in securitization and generally provides that an underwriter or sponsor (or any affiliate or subsidiary) of an ABS shall not, for one year after closing, engage in any transaction that would result in any material conflict of interest with respect to any investor. While this general statutory mandate is included in Dodd-Frank, there is significant legislative intent that makes clear this provision was meant to eliminate incentives for market participants to intentionally design ABS asset-backed securities to fail. While ASF has expressed its full support of the intent behind the legislation, we remain deeply concerned that overly broad rules could have serious unintended consequences on the secondary market. The SEC has yet to propose rules pursuant to this provision.

ASF strongly supports the intent of Section 621 to eliminate incentives for market participants to intentionally design asset-backed securities to fail or default. An asset-backed security that is created primarily for the purpose of entering into another, more lucrative transaction that will provide a material financial reward upon the failure or default of the same asset-backed security, creates a clear material conflict of interest, and sponsors and financial institutions that are responsible for the creation and/or distribution of such asset-backed security should be prohibited from entering into those other transactions. Any rules implemented by the SEC for this purpose, however, must be crafted so as to prohibit the situations that result in such material conflicts of interest without causing unnecessary adverse impacts on the markets for asset-backed securities. As further discussed below, we believe this can be achieved by clearly identifying the activities that would constitute a "material conflict of interest" and the parties subject to the restriction.

United States Senators Jeffrey Merkley and Carl Levin introduced what is now Section 621 on May 10, 2010 as an amendment to Dodd-Frank (the "Merkley-Levin Provisions").[104] Section 621 evolved as a result of the findings of the Senate Permanent Subcommittee on Investigations, chaired by Senator Levin, after it conducted four hearings relating to the financial crisis.[105] The Merkley-Levin Provisions were intended to stop what Senator Levin called "one

[104] The Merkley-Levin Provisions also include what is now Sections 619 and 620 of Dodd-Frank, but for purposes of this letter, we are only addressing Section 621, which relates to material conflicts of interest in securitization transactions. Section 621 of Dodd-Frank ("Section 621") states, in pertinent part:

> (a) IN GENERAL.—An underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security (as such term is defined in section 3 of the Securities and Exchange Act of 1934 (15 U.S.C. 78c), which for the purposes of this section shall include a synthetic asset-backed security), shall not, at any time for a period ending on the date that is one year after the date of the first closing of the sale of the asset-backed security, engage in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity.
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> * * * * *
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> (c) EXCEPTION.—The prohibitions of subsection (a) shall not apply to—
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> (1) risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship of an asset-backed security, provided that such activities are designed to reduce the specific risks to the underwriter, placement agent, initial purchaser, or sponsor associated with positions or holdings arising out of such underwriting, placement, initial purchase, or sponsorship; or
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> (2) purchases or sales of asset-backed securities made pursuant to and consistent with—
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> (A) commitments of the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, to provide liquidity for the asset-backed security, or
>
> (B) bona fide market-making in the asset backed security.

[105] *See* 156 *Cong. Rec.* S4058 (May 20, 2010) (statement of Sen. Levin).

of the most dramatic findings of [their] subcommittee hearings, that of firms betting against financial instruments they are assembling and selling."[106] Senator Levin later noted that "sponsors and underwriters of the asset-backed securities are the parties who select and understand the underlying assets, and who are best positioned to design a security to succeed or fail" and stated that the intent of Section 621 is to "prohibit underwriters, sponsors, and others who assemble asset-backed securities, from packaging and selling those securities and profiting from the securities' failures."[107]

Senator Levin also explained what Section 621 is *not* intended to do:

> [Section 621 is] [n]ot intended to limit the ability of an underwriter to support the value of a security in the aftermarket by providing liquidity and a ready two-sided market for it. Nor does it restrict a firm from creating a synthetic asset-backed security, which inherently contains both long and short positions with respect to securities it previously created, so long as the firm does not take the short position.[108]

Senators Levin and Merkley further clarified the intent of Section 621 in a letter to various heads of government agencies charged with implementing Dodd-Frank, including the

[106] 156 *Cong. Rec.* S3470 (May 10, 2010) (statement of Sen. Levin). *Also see* 156 *Cong. Rec.* S4058 (May 20, 2010) (statement of Sen. Levin) where Levin further reiterated this point that the Senate needed to act to put an end to the conflict of interest that exists when firms sell asset-backed securities to investors and bet against them and considered such action one of the most "dramatic findings" of their subcommittee.
[107] 156 *Cong. Rec.* S5899 (July 15, 2010) (statement of Sen. Levin). Both Senators Merkley and Levin have focused on designing an instrument to fail, likening the practice to someone who sells cars without brakes (or a mechanic servicing a car designed to fail) and then takes out life insurance on the owners. See 156 *Cong. Rec.* S3469 (May 10, 2010) (statement of Sen. Merkley), 156 *Cong. Rec.* S4057 (May 20, 2010) (statement of Sen. Levin) and 156 *Cong. Rec.* S5899 (July 15, 2010) (statement of Sen. Levin).
[108] 156 *Cong. Rec.* S5899 (July 15, 2010) (statement of Sen. Levin).

Chairman of the SEC.[109] The Senators state in their letter that the objective of Section 621 is to "end the conflicts of interest that arise when a financial firm designs an asset-backed security, sells it to customers, and then bets on its failure."[110]

Accordingly, any rules implemented by the SEC should be crafted so as to prohibit the situations that result in the material conflicts of interest identified by the Senators without causing unnecessary adverse impacts on the markets for asset-backed securities. A broad interpretation of "material conflicts of interest" — prohibiting *any* transaction relating to an asset-backed security by which a party might receive a potential profit upon failure or default of the security — would not only be contrary to the intent of Congress but would inhibit many activities currently undertaken by market participants. For example, many underwriters[111] of asset-backed securities or their affiliates provide transaction sponsors with short-term funding facilities such as "warehouse" lines, variable funding notes and asset-backed commercial paper, whereby the underwriter or its affiliate provides financing to the sponsor to fund asset originations or purchases of assets. These facilities provide essential liquidity until the assets can be packaged through a term securitization and sold into the debt capital markets. As the proceeds from the securitization are used to repay the financing, a broad reading of "material conflicts of interest" could prohibit this funding tool, essentially cutting off one of the only available sources of credit in today's constrained market. Similarly, a broad interpretation of "material conflicts of interest" could prohibit servicers of mortgage loans, auto loans, credit card

[109] *See* Letter from Senator Merkley and Senator Levin dated August 3, 2010 addressed to, *inter alia*, the Honorable Mary Schapiro, Chairman of the Securities and Exchange Commission regarding the Implementation of Merkley-Levin Provisions.
[110] *Id* at page 2.
[111] For ease of reference, we use the term "underwriter" interchangeably with a placement agent and an initial purchaser in a Rule 144A transaction.

receivables and other assets who are affiliated with the sponsor of a transaction from pursuing customary servicing activities. Especially concerning would be a servicer's inability to exercise loss mitigation activities, such as loan modifications under the Home Affordable Modification Program ("HAMP") or the servicer's internal guidelines, or conduct short sales and short refinances under the Federal Housing Administration's Short Refinance Program. This restriction would effectively prohibit sponsors and their affiliates from servicing the loans that they originate, requiring costly servicing transfers that will decrease efficiency and potentially lead to confusion for consumers and disruptions in the servicing of assets.

Additionally, natural conflicts of interest exist between classes of securities that are commonly issued in a single asset-backed securities transaction to accommodate the varying demands of investors and provide the greatest possible liquidity. For example, holders of senior and subordinated classes of securities and interest-only and principal-only classes of securities may have opposing interests with respect to the rate of prepayments in a transaction. Similarly, even though the interests of holders of time-tranched securities may be aligned with respect to the overall credit performance of a pool, such securities may receive distributions at different times and be subject to different risks. An overly broad reading of the Merkley-Levin Provisions could effectively prohibit the issuance of these securities (and numerous others), especially given the requirement contained in Dodd-Frank and other regulatory proposals[112] that a securitizer retain a portion of the securities issued in a transaction. Further, many investors in asset-backed securities seek interest rates or currencies that differ from the underlying assets, which require that the structures employ interest rate or currency swaps. These swaps are standardized and bid

[112] A risk retention requirement is also contained in the Federal Deposit Insurance Corporation's recently published "safe harbor" and the Commission's recent proposed revisions to Regulation AB.

out to various market participants, including affiliates of the underwriter of the asset-backed transaction. An expansive interpretation of "material conflicts of interest" could prohibit an affiliate of the underwriter from providing such a swap, potentially depriving investors of the best possible execution. Such outcomes would be outside the Congressional intent of Section 621, which sought to eliminate the improper incentives to issue asset-backed securities designed to fail, not to prohibit the creation of asset-backed securities that allocate identified and disclosed risks between or among separate parties.[113] A broad reading of Section 621 could effectively lead to a contraction of available credit for consumer finance and small business, where securitization has provided a significant source of funding, including mortgage loans, auto loans and leases, student loans, small business loans and credit cards.

Consistent with the legislative intent, the regulations issued by the SEC should be specifically tailored to prohibit transactions that create a material incentive to intentionally design asset-backed securities to fail or default. Specifically, the terms "underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of such entity, of an asset-backed security" as used in Section 27B of the Securities Act, as amended by Section 621, should be defined by regulation to be workable — able to be implemented and monitored by the regulated entities and monitored by the applicable regulators. We propose that the SEC define these entities as "Restricted Parties" and include only affiliates and subsidiaries that have a material interest in the asset-backed security. Similarly, the definition of "material conflicts of

[113] We note that Senator Levin believes that disclosure alone may not cure material conflicts of interest in all cases, such as in situations where "disclosures cannot be made to the appropriate party or because the disclosure is not sufficiently meaningful." We further note that Senator Levin does not believe that disclosing that the underwriter of an ABS "has or might in the future bet against the security" will cure the conflict of interest arising if the underwriter takes a short position in a synthetic transaction that references the ABS. However, in situations that are clearly not instances of an asset-backed security being designed to fail, ASF believes that effective disclosure would remedy perceived conflicts. *See* 156 *Cong. Rec.* S5899 and S5901 (July 15, 2010).

interest" should prohibit those types of transactions identified by Senators Merkley and Levin that create conflicts of interests by creating intentionally flawed asset-backed securities. Accordingly, we propose the SEC define "material conflicts of interest" as follows:

> "A "material conflict of interest" shall exist if, other than for hedging purposes or as permitted by Section 27B(c) of the Securities Act of 1933, (i) a Restricted Party participates in the issuance of an asset-backed security that is created primarily to enable such Restricted Party to profit from a related or subsequent transaction as a direct consequence of the adverse credit performance of such asset-backed security and (ii) within one year following the issuance of such asset-backed security, the Restricted Party enters into such related or subsequent transaction."

By clearly identifying (i) principles upon which market participants can determine what activities would constitute a "material conflict of interest" under Section 621 and (ii) which parties are subject to such restriction, the SEC can effectively eliminate the practices identified by Senators Merkley and Levin without risking unintended consequences to the efficient functioning of the capital markets. Finally, we note that Section 621 includes exceptions for risk-mitigating hedging activities, bona fide market making, and commitments to provide liquidity and strongly agree with Senators Merkley and Levin that appropriate hedging, market-making and liquidity commitments are necessary and proper for the development of a healthy asset-backed securities market.

B. Regulation of Derivatives

On April 12, 2011, two long-awaited proposed rules on margin and capital requirements for non-cleared swaps were issued, the first jointly by five federal agencies and the second by the Commodity Futures Trading Commission. The proposed rules implement the regulatory framework established by Sections 731 and 764 of the Dodd-Frank Act, which mandate capital and margin requirements for swap dealers and major swap participants in connection with their non-cleared swaps. ASF is currently formulating a detailed comment letter to explain the grave, and likely unintended, consequences that these proposals may have on the securitization markets. In addition, there are numerous other related proposals that may affect securitization, including (i) the SEC's end-user exception to the mandatory clearing of security-based swaps and swap participant definitions, (ii) the CFTC's swap participant definitions and the end-user exception and (iii) business conduct standards for "swap dealers" and "major swap participants" relating to ERISA plans. ASF has submitted comment letters on all of these other proposals.[114]

Title VII of Dodd-Frank creates new categories of regulated security-based swap entities that would be subject to a number of regulatory requirements, including registration, capital and margin, recordkeeping and business conduct standards. ASF believes that structured finance participants should not, standing alone, be considered to be included in any of these new

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[114] *See* "ASF Derivatives End-User Exception Comment Letter to SEC," American Securitization Forum (February 4, 2011), *available at* http://asf.informz.net/ASF/data/images/emailattachments/advocacy/asf_letter_to_sec_re_end-user_exception.pdf; *see* "ASF Derivatives Comment Letter to SEC," American Securitization Forum (February 14, 2011), *available at* http://asf.informz.net/ASF/data/images/emailattachments/advocacy/asf_letter_to_sec_re_derivatives-2-14-11.pdf; *see* "ASF Derivatives Comment Letter to CFTC," American Securitization Forum (February 22, 2011), *available at* http://www.americansecuritization.com/uploadedFiles/2_22_11_ASF_CFTC_letter_re_Derivatives.pdf; and *see* "ASF Title VII Business Conduct Standards Letter," American Securitization Forum (February 22, 2011), *available at* http://www.americansecuritization.com/uploadedFiles/2_22_11_ASF_cftc_comment_letter_re_business_conduct_standards.pdf.

categories and that, in particular, the mandatory clearing, margin and capital requirements should not apply to swaps entered into by structured finance participants.

Structured finance special purpose vehicles ("SPVs") are typically legal entities created by the sponsor or originator by transferring assets to the SPV, to facilitate a specific purpose or defined activity, or a series of such transactions. SPVs have no other purpose than the transactions for which they were created, and the SPV can make no operational decisions; the rules governing them are prescribed in advance and carefully limit their activities. They may be structured to be either off or on the balance sheet of the sponsor or originator.[115] Frequently for these structures the only business or commercial purpose of these vehicles are to enter into the security-based swaps and manage the exposure relating thereto, which management may entail terminating, closing-out or entering into new swaps or security-based swaps. Structured finance participants generally can include originators and/or sellers of assets, servicers and the SPVs, which typically act as the issuer of the debt instruments that back the particular asset pool. Structured finance participants utilize many different types of security-based swaps, including single-name credit default swaps and certain equity derivatives.

Applying any of these requirements may render many structured financings uneconomic as the SPV would be required to post cash and liquid securities which it does not have. The source of repayment for structured financings is generally the cash flow from the assets or receivables which is generated over time. Applying clearing, margin and capital requirements would affect the cash flow analysis for a structured financing and cause adverse effects on the

[115] Typically, off-balance sheet SPVs have the following characteristics: (a) they do not have independent management or employees; (b) their administrative functions are performed by a trustee who follows set rules with regard to the distribution of cash; there are no other decisions; (c) assets held by the SPV are serviced through a servicing agreement; and (d) they are structured so that they are bankruptcy remote.

functioning of this market, including ultimately resulting in a reduction in the available amount of loans or other financing for the assets underlying the structured financing.

The derivatives regulation is highly complex and technical. We suggest reviewing our numerous comments on these issues to facilitate a better understanding of the potential impact on securitization. In addition, ASF is always available for individual meetings to further explain these issues.

C. Volcker Rule

On October 6, 2010, the Financial Stability Oversight Council (the "Council") requested comment (the "Volcker Rule Notice") relating to their Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds (the "Study"). The Council is conducting the Study pursuant to Section 619 of the Dodd-Frank Act. Section 619 adds a new Section 13 to the Bank Holding Company Act of 1956 (the "BHC Act") that generally prohibits banking entities from engaging in proprietary trading and from sponsoring and investing hedge funds and private equity funds. These prohibitions are commonly referred to as the "Volcker Rule". ASF submitted a comment letter that focused on Question 3 of the Volcker Rule Notice, which asked what considerations should be taken into account in making recommendations to the applicable regulatory agencies[116] (the "Agencies") in implementing the provisions of the Volcker Rule that might apply to securitizations.

[116] The Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System (the "Board"), the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC").

In our view, the Volcker Rule seeks to define generally the types of activities in which banking entities and nonbank financial companies[117] are prohibited from engaging by indentifying the central policy objective of the Rule. That objective is to prevent banking entities from engaging in activities that have caused or might reasonably be expected to cause undue risk to the financial system. Recognizing the difficulty (if not, impossibility) of enumerating specific activities that posed this risk profile during the push to pass the sweeping Dodd-Frank Act, Congress delegated to the Agencies responsibility for implementing the policy-based prohibitions of the Volcker Rule through the development and adoption of regulations. The recommendations contained in the Study are meant to form the bases of the Agencies' regulations.

New Section 13(a)(1)(b) of the BHC Act prohibits a banking entity from "acquir[ing] or retain[ing] any equity, partnership, or other ownership interest in or sponsor[ing] a hedge fund or a private equity fund." A "hedge fund" or "private equity fund" is defined very broadly in the Volcker Act (new Section 13(h)(2) of the BHC Act) to be "a company or other entity that would be an investment company under the Investment Company Act of 1940 (the "1940 Act"), but for Section 3(c)(1) or 3(c)(7) of the 1940 Act, or such similar funds as the appropriate Federal banking agencies, the SEC, and the CFTC may determine." Taken literally, and without giving effect to the exceptions contained in the Volcker Act or the recommendations that the Council is required to make to the Agencies, these two provisions could be read to restrict a banking entity from engaging in any securitization transaction with an issuer fund in which that banking entity has any equity interest or a sponsorship role if that fund relies on the private placement

[117] As used in the Volcker Rule, the term "nonbank financial companies" refers to those nonbank financial companies that may be designed by the Council to be supervised by the Board and subject to enhanced prudential standards.

exemptions of Section 3(c)(1) or 3(c)(7). Many securitization issuers currently rely on the tone of those exemptions.

We are confident that Congress did not intend this result. Indeed, in Section 13(g)(2) of the Volcker Rule, drafters provided the Council and the Agencies with compelling evidence that such application was not intended. Section 13(g)(2) provides that the Volcker Rule is not to be "construed to limit or restrict the ability of banking entities or nonbank financial companies … to sell or securitize loans…." (the "Securitization Exclusion"). By specifically including the Securitization Exclusion in the "Rules of Construction" for Section 13 of the BHC Act in its entirety, Congress made clear that even though some securitization issuers would otherwise fall within the definition of "hedge fund and private equity fund", those issuers and their sponsors were not meant to be included in the prohibited activities. As stated above, the Volcker Rule contains a general description of prohibited activities and does so with very broad provisions. The Agencies are delegated with the responsibility for interpreting and refining those provisions so as to implement the policy underlying the Rule. If the definition of "hedge fund and private equity fund" were repeated in the regulations exactly as included in the Dodd-Frank Act, the application of the definition would dramatically and adversely impact many long-established and sound businesses of banking entities not intended by Congress.

We believe that the definition of "hedge fund and private equity fund" is intended to identify a type of issuer fund commonly referred to in the marketplace as a "hedge fund" or a "private equity fund" or as being engaged in the business of a "hedge fund or private equity fund". The definition was not intended to define the universe of issuer funds with which banking entities and nonbank financial companies are prohibited from engaging in activities solely by virtue of sharing a characteristic that relates to their exemption from registration as an investment company. We find Congressional support for these views in the Securitization Exclusion.

It is evident that Congress directed the Council to give effect to the Securitization Exclusion in preparing the Study and in making recommendations to the Agencies as to the interpretation of the definition of "hedge fund and private equity fund" and its impact on the prohibited activities described in Section 13(a)(2). The only issuer funds and activities (whether related to securitizations or not) that are properly scoped into the prohibited activities are those activities that have posed a threat to the safety and soundness of the financial system. To state the obvious, not every issuer fund or activity poses the risks to the banking system and the economy that the Volcker Rule is designed to protect against. Further, there is no doubt that prohibiting certain types of relationships between banking entities and issuer funds as defined in Section 13(h)(2) would not produce the intended result of promoting and enhancing the safety and soundness of the financial system and the economy. Rather, it would eliminate or substantially reduce the viability of certain important lines of business historically conducted by banking entities. Specifically, it is clear that the vast majority of securitizations play a vital role in the traditional business of banks and in the economy, providing a cost effective means of financing for U.S. businesses and an important highly liquid product for U.S. investors, including money market funds. It is equally clear that the vast majority of securitization products have performed well during the financial crisis, experiencing no losses when held to maturity. Lastly, for those sectors of the securitization market that did not perform well, the Dodd-Frank Act contains provisions that on their own, or through regulations, are intended to address corrective actions.

Therefore, we urge the Council to recommend to the Agencies that (i) the Securitization Exclusion be clarified to allow banking entities and nonbank financial companies to participate in certain securitization relationships and activities without falling within the scope of the Volcker Rule, (ii) the Volcker Rule recognize that securitization relationships and activities described in the Securitization Exclusion not be prohibited activities under Section 13(a)(2) of the BHC Act and (iii) the definition of "hedge fund and private equity fund" contain appropriate limitations to implement the foregoing modifications[118]. In defining permissible securitization relationships, the Securitization Exclusion must (i) allow banking entities to engage, both directly and indirectly, through affiliates and securitization vehicles which they sponsor, in traditional and sound securitization activities and (ii) recognize the scope and breadth of assets[119] which have been and will continue to be securitized. We firmly believe that in recommending the changes described in this paragraph, the Council will be acting in a manner consistent with Congress' objectives. The Volcker Rule was not enacted to curtail beneficial securitization activities, but rather to provide the Agencies with authority to regulate those issuer funds and activities which have proven overly risky to the financial system. These outcomes are critical to the promotion and protection of a strong and stable banking system and the recovery of the U.S. economy.

[118] We note that certain additional provisions of the Volcker Rule may require clarification or conforming changes to give effect to the Securitization Exclusion.

[119] In order to avoid what we expect could be an unintended narrow interpretation of the word "loans" used in the Securitization Exclusion, we believe that "loans" should be interpreted in a manner consistent with the concept of "self-liquidating financial assets", a concept commonly used by the SEC and its staff in regulations and interpretations relating to securitizations. As noted by the SEC in the 1992 Release relating to Shelf Registration for Offerings of Investment Grade Asset-Backed Securities, the definition of "financial assets" is intended to be quite broad, including not only loans, but also notes, leases, installment contracts, credit card receivables, accounts receivables and other assets that by their terms convert to cash within a finite period of time. *See* Securities Act Rel. No. 6964 (Oct. 22, 1992).

We are aware that the Council is receiving responses to the Volcker Rule Notice from many interested parties. We expect that most of these responses are focused on the proprietary trading restrictions contained in the Volcker Rule. However, it is critical that the Council give adequate attention to the other prohibitions in the Volcker Rule and their unintended consequences. Our members fully appreciate the need for appropriate regulation of the business relationships that have had a deleterious effect on the banking system and the U.S. economy. We are convinced, however, that the Council would distort the Congressional mandate captured in the Volcker Rule if it applied the prohibitions of that Rule to safe and sound securitization activities.

IX. Capital Adequacy Standards

We have emphasized that, when introducing legislative or regulatory change into a complex adaptive system like the securitization market, several principles must be observed in order for the system to continue functioning during that process:

- The timing and nature of the changes must be coordinated across the entire system.
- System flaws, and not mere symptoms, must be targeted, and needless disruptive changes must be avoided.
- The ripple effects of individual changes must be identified, assessed, and calibrated in advance.
- The strategic plan for change must be flexible enough to accommodate the inevitable consequences of nonlinearities and information constraints.
- Those charged with making the changes must vigilantly keep an eye on the forest as much as, if not more than, the trees.

We also have stressed that the paralysis afflicting much of the securitization market can be traced directly to failures in adhering to these principles.

This is nowhere more evident than in the case of capital adequacy standards. Securitization evolved into one of the most cost-efficient forms of funding because of its capacity to effectively transfer credit risk through the capital markets and to better align the risks of lending with the capital required of lenders. This attribute, which supplies securitization with so much of its value, has already been compromised by some of the more reactionary responses to the financial crisis and is threatened even more by proposals to drastically reshape the regulatory capital charges associated with making loans. The result has been, and if not corrected will continue to be, higher borrowing costs and less available credit for families, businesses, and governments throughout the United States.

Three examples, while by no means complete, illustrate our concern.

Among the most troubling is the liquidity coverage ratio ("LCR") that has been proposed as part of the Basel III reforms. The LCR represents the first hard liquidity buffer ever introduced into global capital adequacy standards and will require financial institutions to prefund their short-term obligations (including unfunded commitments) with unencumbered, high-quality liquid assets. This means for example that, if the highest-rated bank in the United States were to provide an unfunded liquidity facility to the highest-rated corporation, the bank would be required to hold at least an equal amount of government securities or similarly liquid assets to guard against the risk of a draw on that facility. The acquisition of these liquid assets by the bank, moreover, could not be financed through the repo market because they would need to remain unencumbered at all times. Making the economics even more prohibitive, the bank also would be compelled to hold regulatory capital against both its unfunded commitment and its liquid assets under the leverage ratio contemplated by Basel III.

This simple example just scratches the surface of the many challenges that are presented by the LCR, which is supposed to be a minimum standard but which is premised on a doomsday scenario that is multiple times worse than the recent crisis. While we are reluctant to sound an alarm, the potential for upheaval in the broader economy is becoming all too real. It is not difficult to foresee the commercial-paper market shrinking materially as banks contract their issuance of 30-day-and-under securities and their sponsorship of CP conduits, the money market doing the same because of the lack of available short-term investments, the government and mortgage repo markets following suit because the money-market funds can no longer supply adequate funding, and the cost of financing for governments, homeowners, and commercial real-estate developers skyrocketing. It is equally possible to foresee that, because of incentives in the LCR to build massive stores of retail deposits, global financial institutions will be forced to become more aggressive in competing with money-market funds and community banks for household customers.

A second example is Section 939A of the Dodd-Frank Act, which calls for each federal agency to remove from its regulations any reference to or requirement of reliance on credit ratings. While we have generally supported efforts to improve credit ratings and related process-oriented safeguards, this wholesale eradication of even references to them has left bank regulators and financial institutions in a quandary. The Basel I and II capital adequacy standards, as well as the proposed Basel II.5 and Basel III reforms, are predicated almost entirely on the use of credit ratings for securitization exposures. There is no straightforward substitute for this conceptual framework, much less one that could ensure a level playing field for institutions in the United States. As a result, supervisory agencies and market participants have been required to redeploy extraordinary resources to develop an alternative that would be sufficiently risk sensitive to meet institutional needs and sufficiently objective to be audited by regulators. Despite months of technical analysis and collaborative dialogue, solutions remain elusive, and concern is growing that the U.S. securitization market could be handicapped for the foreseeable future.

Statements of Financial Accounting Standards Nos. 166 and 167 provide a third example. Prior to 2010, generally accepted accounting principles ("GAAP") incorporated a financial-components approach that recognized the economic consequences of a securitization – that is, the division of assets into credit tranches and the transfer of those tranches to different parties. Under this accounting standard, each transaction participant would take onto its balance sheet the assets allocated to its securitization exposure but not the assets to which other participants would be exposed. Because the financial-components approach resulted in an institution's interest in a securitization being accurately reflected on its books, capital adequacy standards generally designated GAAP as the starting point for determining the institution's risk-based capital requirements. In 2009, however, the Financial Accounting Standards Board reversed course and mandated in FAS 166 and 167 that, in addition to each party recognizing its own exposure to securitized assets, the entity with a potentially significant interest and with the power to direct the activities of the securitization vehicle (almost always the servicer or the collateral manager) consolidate all of those assets for accounting purposes as well. Under this revised standard, for example, a servicer holding only a 5% subordinated interest in a securitization generally could be required to consolidate onto its balance sheet – and, under the capital adequacy standards which have remain unchanged, hold risk-based capital against – 100% of the securitized assets. Such a disconnect between an institution's risk in a securitization and its risk-based capital requirements has created a perverse incentive, for now, shedding the power to direct activities rather than actual risk is the gauge for reducing capital. Equally if not more important, because the mainstream securitization market is driven by cost-effective funding rather than regulatory capital arbitrage, rationalizing risk-based capital requirements is viewed as crucial to trades clearing at economically sensible levels in bank-sponsored and bank-serviced securitization transactions.

X. <u>RMBS Chain of Title</u>

By way of background, there are approximately 55 million first lien mortgages outstanding in the United States today and an additional 25 million homes that have no mortgage attached to them. The debt outstanding for these 55 million mortgages is nearly $9.75 trillion dollars, of which approximately $7 trillion dollars resides in securitization trusts and are beneficially owned by institutional investors around the world. Approximately $5.5 trillion dollars of these loans are government guaranteed in Ginnie Mae and GSE RMBS, with an additional $1.5 trillion in outstanding private-label RMBS that has no government backstop. An additional $2.75 trillion dollars of mortgage debt is owned in the portfolios of commercial banks, savings institutions and insurance companies. In addition to the $9.75 trillion of outstanding first lien mortgages, approximately $1 trillion of second liens are currently outstanding in the United States.[120]

Over the last six months, a few commentators have raised a number of legal theories questioning whether securitization trusts, either those created by private financial institutions or those created by government sponsored enterprises, such as Ginnie Mae, Fannie Mae or Freddie Mac, have valid legal title to the seven trillion dollars of mortgage notes in those trusts. In an effort to contribute thorough and well-researched legal analysis to the discussion of these theories, ASF issued a white paper entitled "Transfer and Assignment of Residential Mortgage Loans in the Secondary Mortgage Market" (the "White Paper").[121] The White Paper provides a detailed overview of the legal principles and processes by which mortgage loans are typically held, assigned, transferred and enforced in the secondary mortgage market and in the creation of MBS. These principles and processes have centuries-old origins, and they have continued to be sound and validated since the advent of MBS over forty years ago. Thirteen major U.S. law firms reviewed the White Paper and believe that the Executive Summary contained therein represents a fair summary of the legal principles presented.

While the real property laws of each of the 50 U.S. states and the District of Columbia affect the method of foreclosing on a mortgage loan in default, the legal principles and processes discussed in this White Paper result, if followed, in a valid and enforceable transfer of mortgage notes and the underlying mortgages in each of these jurisdictions. To be thorough, the White

[120] Data compiled by Amherst Securities, based on information from the Federal Reserve Flow of Funds, Fannie Mae, Freddie Mac, Ginnie Mae and CoreLogic.
[121] *See* "Transfer and Assignment of Residential Mortgage Loans in the Secondary Mortgage Market," American Securitization Forum (November 16, 2010), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_White_Paper_11_16_10.pdf.

Paper undertakes a review of both common law and the Uniform Commercial Code (the "UCC") in each of the 50 U.S. states and the District of Columbia. One of the most critical principles is that when ownership of a mortgage note is transferred in accordance with common securitization processes, ownership of the mortgage is also automatically transferred pursuant to the common law rule that "the mortgage follows the note." The rule that "the mortgage follows the note" dates back centuries and has been codified in the UCC. In essence, this means that the assignment of a mortgage to a trustee does not need to be recorded in real property records in order for it to be a valid and binding transfer.

XI. Covered Bonds

ASF has long been a supporter of the formation of a U.S. covered bond market and believes that a covered bond market could effectively complement, but not replace, the current securitization market. We also believe that an appropriately structured covered bond market could bridge a portion of the gap in mortgage finance should the U.S. government follow through with its plan to phase out the GSEs over time. However, there are current impediments to a liquid covered bond market, including rigid regulatory capital rules and the FDIC's position that it should have first access to a cover pool in the event of a bank's insolvency for the benefit of the Deposit Insurance Fund. ASF's long standing view is that the FDIC's position will largely prevent the development of a significant covered bond market and that a statutory framework, such as the U.S. Covered Bond Act of 2011 introduced by Rep. Scott Garrett (R-NJ), will be necessary to facilitate its growth. On March 11, 2011, ASF testified at a hearing of the HFSC Capital Markets Subcommittee entitled, "Legislative Priorities to Create a Covered Bond Market in the United States" and indicated our strong support for the United States Covered Bond Act of 2011. That testimony follows.

As many of you may know, the first U.S. insured depository institution ("IDI") covered bond was issued by Washington Mutual ("WaMu") nearly 5 years ago, even without a legislative framework for it. Approximately a year later, Bank of America became the second U.S. bank to issue covered bonds. In the absence of any legislative framework in the United States, these issuances were denominated in Euros and sold predominantly into the European covered bond market as "contractual" covered bonds.

In July 2008, the FDIC published a Final Statement of Policy (the "Final Policy") for the exercise of its receivership and conservatorship authority in respect of covered bond contracts entered into by a U.S. IDI and the U.S. Treasury issued its "Best Practices for Residential Covered Bonds Guidelines"[122] (the "Best Practices Guidelines") for the issuance of contractual U.S. covered bonds in coordination with the FDIC's Final Policy. At the time, Treasury believed a framework defined by policy and regulation[123] would be sufficient to initiate a U.S. covered bond market that could restore the financing that was withdrawing from a declining asset securitization market. This belief was disproved quickly as the financial crisis accelerated into the autumn and culminated with historic emergency measures passed by Congress. Just two months after the Treasury and FDIC frameworks were issued, Washington Mutual was closed by the OTS and the FDIC was appointed receiver. During those two months, secondary market prices of WaMu's Euro-denominated covered bonds fell precipitously as holders of those

[122] Best Practices for Residential Covered Bonds, Department of the Treasury (July 2008).
[123] A framework not defined by specific legislation (a "legislative framework") is herein referred to interchangeably as a regulatory framework, policy framework, or contractual framework.

investments began to focus on the risk that the FDIC's repudiation authority could override contractual protections while the value of the residential mortgages in the covered pool would decline. Historical price data indicate that the WaMu covered bonds traded as low as 75 cents on the dollar, before rallying after the acquisition by J.P. Morgan later that same September in 2008.[124] The 2006 and 2007 issuances by WaMu and Bank of America remain the only U.S. covered bond issues to date. Curiously, no U.S. covered bonds were issued after the FDIC published its Final Policy and the U.S. Treasury published its Best Practices Guidelines.

A. Policy and Regulation Are Insufficient to Support a U.S. Covered Bond Market

The experience of investors in WaMu covered bonds highlighted the weakness in relying on a regulatory, rather than a legislative, framework for U.S. covered bonds. In general, regulatory frameworks are more easily revised than legislative frameworks, which would require an act of sovereign government to change, rather than a regulatory action under the regulator's own control. Consequently, regulatory frameworks are more susceptible to whim or political expediency that can be disruptive of markets and injurious to investors who relied on such frameworks. In particularly good times, investors might be willing to overlook or de-emphasize the risk posed by a regulatory regime, buy the bonds, and accept even an insignificant premium for the incremental risk. This is basically what occurred in the WaMu story. When stress arises, however, at the precise moment that a framework needs to show stability and resilience, markets will focus their attention on the weaknesses and extract a sometimes painful toll for their sheer presence. If we are to start a new and promising financial sector, we can ill-afford to marry it to

[124] "Washington Mutual's Covered Bonds", Harvard Business School, 9-209-0923, Daniel B. Bergstresser, Robin Greenwood, James Quinn, Rev. (Oct. 22, 2009).

a weak legal framework. The centerpiece of any legal framework will be that framework's treatment of covered bonds in the event of an issuer's insolvency.

B. The Need to Curb FDIC Insolvency Resolution Authorities by Passing U.S. Covered Bond Legislation

In a prospective U.S. covered bond market, the FDIC would be the operative regulator for IDIs that choose to issue covered bonds. Our expectation would be for much of the early U.S. covered bonds market to be developed by U.S. banks, given the experience in other countries. As it now stands, the FDIC's authority as receiver or conservator is simply contradictory and counterproductive to the creation of a healthy legal framework for a covered bond market. This is because the FDIC has too much discretion to choose among resolution alternatives that would have varying consequences for covered bondholders, especially including the worst-case outcome that the FDIC could elect to repudiate a covered bond contract, determine the fair market value of the cover pool securing the covered bonds, and pay covered bondholders the lesser of par or cover pool fair market value with interest accrued only through the date of the FDIC's appointment as receiver, and not to the date on which investors are actually repaid.

Even if the FDIC were to promulgate guidance limiting itself to its more investor-friendly bank insolvency resolution alternatives, investors would lack confidence in and be reluctant to rely on such self-governed guidance. This is because the FDIC would have an inherent conflict of interest to take action that minimizes losses to the Depository Insurance Fund ("DIF"), regardless of whether such result came at the expense of secured creditors. Such conflict of interest was amplified in acts of earlier Congresses requiring the FDIC to use the "least costly" transaction(s) for resolving insolvent IDIs and giving depositors a payment priority over other unsecured creditors of an insolvent bank. This being the case, legislation is required to limit the FDIC's optionality in resolving the covered bond contracts of a bank under the receivership or conservatorship control of the FDIC. Allowing the FDIC to retain its current authority under Section 11(e)(12) of the Federal Deposit Insurance Act ("FDI Act") in respect of an IDI's secured indebtedness for covered bonds would be a grave policy misstep in our view, and would undermine the market before it can be developed. In the opinion of our issuer and investor members, covered bond legislation needs to set a clear and unmistakable set of resolution mechanics that assure investors will receive the economic value of a market-based negotiation of contracts consistent with the principles already in long-standing operation around the globe for this type of indebtedness. Only legislation can create a carve out for covered bonds in order to curb the insolvency authorities the FDIC now has over covered bonds to the extent necessary to establish a U.S. legislative framework that is competitive with the more established programs domiciled elsewhere.

C. Concerns that Covered Bond Legislation Would Increase the Risk of Loss to the Depository Insurance Fund and to the U.S. Taxpayer Are Misplaced

Some fear that an investor-friendly U.S. covered bond legislation would pose greater risks to the FDIC DIF and ultimately to the U.S. taxpayer. We believe any such fears are misplaced, especially since, by the FDIC's own account, Dodd-Frank has "granted the FDIC the ability to achieve goals for [DIF] fund management that it has sought for decades but lacked the tools to accomplish"[125]. Among other things, Dodd-Frank raised the minimum designated reserve ratio ("DRR"), removed its upper limit, eliminated the requirement that the FDIC dividend amounts when the DRR is between 1.35% and 1.5%, granted the FDIC sole authority to determine dividend policy above a DRR of 1.5%, and set the calculation of insurance premiums against total assets, not total deposits.[126] Accordingly, it would seem more logical for the FDIC to adjust deposit insurance premiums to the asset-liability practices of IDIs, including any covered bond issuance practices, rather than seek to maintain their traditional insolvency authorities which could impede or even prevent a U.S. covered bond market from becoming a feature of our credit system. Perhaps even the FDIC has come to recognize this in a post Dodd-Frank world, as the September 15, 2010 testimony of the FDIC before the Senate Banking Committee includes a sentence whereby the FDIC witness Michael Krimminger, currently the FDIC's General Counsel, states, "[t]he FDIC would support covered bond legislation that clarifies the amount of repudiation damages to be the par value of outstanding bonds plus interest accrued through the date of payment."[127] Such a policy stance would be a significant improvement from the FDIC's Final Policy wherein the FDIC takes the position that repudiation would mean a payment equal to the lesser of par or the fair market value of the cover pool, plus bond interest accrued to the date on which the FDIC was appointed receiver. This Final Policy subjects investors to market-value loss on the cover pool and could additionally cause a period of lost interest payments for investors. While such movement in policy stance is encouraging, it does not go far enough as the FDIC would still retain an option that is exercisable against

[125] 76 Fed. Reg. 10673 (Feb. 25, 2011).
[126] *Ibid*.
[127] Statement of Michael H. Krimminger, Deputy to the Chairman, Federal Deposit Insurance Corporation on Covered Bonds: Potential Uses and Regulatory Issues, Committee on Banking, Housing, and Urban Affairs, U.S. Senate (Sept. 15, 2010).

investors: *if the cover pool were unhealthy*, the FDIC would turn the cover pool over to an estate for the benefit of covered bondholders who would likely encounter a loss and a resulting unsecured deficiency claim against the issuer; *if the cover pool were healthy*, the FDIC would liquidate it, capture the excess collateral value for the insolvent estate, and pay par to investors, exposing them to what could be potentially material re-investment risk. Still, the movement in the FDIC's policy stance is encouraging in that it signals further movement could occur in favor of a globally competitive U.S. covered bond framework.

D. The Global Nature of a Substantial Covered Bond Market

Like so many financial markets today, the covered bond market is a global market, though it remains concentrated in its European geography of origin. Covered bonds date back to 18th century Prussia, when the Pfandbriefe was introduced by the decree of King Frederick the Great to enable the property of nobles to be pledged as collateral to investors in exchange for agricultural credit. The German Mortgage Bank Act of 1900 modernized the original concept by creating a formal legal framework that assured the cover pool would be ring-fenced on an issuer's balance sheet and that investors in covered bonds had recourse to both the cover pool and the issuer in the event of a default[128]. The first issue of French legal covered bonds (Obligations Foncières) was created by decree in 1852 by Crédit Foncier de France under the *société de credit Foncier* statute. The main business of Crédit Foncier de France, founded in 1852, is to grant mortgage-backed real estate loans and local authority loans and to issue bonds to finance these loans.[129]

[128] *The Conundrum of Covered Bonds*, Steven L. Schwarcz, forthcoming in The Business Lawyer, May 2011.
[129] *Natixis Credit Research*, Cristina Costa and Jennifer Levy (March 2011).

Today, some 29 countries are counted as having covered bond frameworks rooted in regulation, contract law, or legislation. 22 countries now have legislated covered bond market structures, with Australia, Canada, and New Zealand in the process of passing legislation for covered bonds[130]. Germany, Spain, Denmark, France, and the UK represent nearly 80% of the outstanding covered bonds.[131] The Euro is the predominant currency in which covered bonds are issued, and there are between 140 and 150 issuers of Euro-benchmarked covered bonds. [132]

There is a clear preference for legislative (or statutory) covered bond frameworks. Of the estimated €2.5 trillion in outstanding covered bonds, an estimated 92% were issued under legislative frameworks. A central feature of statutory frameworks concerns the legal framework for insolvency of the covered bond issuer. Effective legislative frameworks include a specific legal framework superseding the general insolvency law. The typical legal framework under legislated market structures affords investors dual recourse: recourse to the cover pool as a secured creditor and recourse to the issuer as an unsecured creditor for amounts not repaid by the cover pool. Of additional importance, the insolvency of the issuer does not automatically trigger the acceleration of the covered bond indebtedness and an accompanying liquidation of the cover pool. This last feature mitigates reinvestment risk, or the risk that an issuer's insolvency would trigger a prepayment to covered bond investors that at a given moment could not be reinvested for comparable investment return to that of the prepaid covered bonds.

The economic benefits of a country's covered bond program can be significant. Market research shows that banks issuing covered bonds can save between 20 and 60 basis points per

[130] European Covered Bond Fact Book, European Covered Bond Council (Sept. 2009).
[131] *Ibid*.
[132] *Natixis Credit Research*, Cristina Costa and Jennifer Levy (March 2011).

year on interest rates when compared to the rates paid on their senior unsecured issues of comparable maturity[133]. Such savings can be transmitted through society in the form of lower rates on the consumer and commercial credit that finances our economy, stimulates growth, and creates jobs. During periods of economic stress, the relative differential between secured and unsecured borrowing costs increases. Over the past year, such differential expanded to over 4% per annum for weaker banks operating in stressed economies.[134] The ability to issue relatively lower-cost financing, which becomes increasingly relative lower-cost financing during periods of worsening economic and financial stress, is a distinguishing benefit of covered bonds.

E. The Barren but Rapidly Changing Landscape for U.S. Covered Bonds and the Investment Market's Need for Highly-Rated Fixed Income Private Sector Investment

Since the U.S. Treasury, in coordination with the FDIC, issued guidelines in support of establishing a U.S. covered bond market, there has been no issuance of a covered bond by a U.S. issuer. Part of this absence may be explained by the limited investor appetite for exposure to U.S. residential mortgage loans not guaranteed by one of the GSEs (residential mortgage loans are, by far, the primary type of collateral in cover pools worldwide). Part of this absence may also be explained by the continuing role of the GSEs and FHA, which have been responsible for 95% of all new residential mortgage loans having been made in the U.S. in these recent years. Part of the absence may also be explained by the repaired balance sheets of U.S. banks, which have shown a limited need for securitization or secured financing in the face of a rising deposit base.

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[133] *Ibid*.
[134] *Ibid*.

But the landscape is changing rapidly. Although there was only one U.S.$ issuance of a covered bond in 2009—which took place outside the United States—2010 saw a huge increase in U.S.$ issuance of covered bonds. 21 covered bond issues were denominated in U.S.$ in 2010, from issuers based in France, Germany, the United Kingdom, Sweden, Norway and the Netherlands. 2010 U.S.$ covered bond issuance aggregated $30 billion, beginning a trend that has been continuing into 2011[135]. Our neighbors to the North, in Canada, issued 9 of these 21 U.S.$ deals in 2010, aggregating half the total 2010 U.S.$ issuance volume. They issued at rates of interest that were materially lower than other U.S.$ issuers, which is attributable to the extremely low risk of the collateral in their cover pools, which consists of Canadian residential mortgage loans that are guaranteed by Canada Mortgage and Housing Corp., the "AAA" rated full faith and credit Canadian Government agency. In short, our U.S.$-based investors have been investing noticeably in U.S.$ covered bonds for over a year now, but they have been buying them from non-U.S. issuers.

When the approach taken by Treasury to implement a policy framework for contractual covered bond issuance by U.S. issuers failed to gain traction, ASF membership was very supportive of your efforts Chairman Garrett for a legislative response. In March 2010, the United States Covered Bond Act of 2010 was introduced, which was the right idea at the right time, as the market has already validated the movement towards U.S. dollar-denominated covered bonds even before U.S. legislation has passed. We can now interpret this movement as an invitation to pass legislation, which could have a positive transformative effect on the U.S. banking and financial system. Asset securitization was the primary manufacturer of "AAA"

[135] *Natixis Credit Research*, Spreads and Credit, Covered Bond (Nov. 2010), Christina Costa, Jennifer Levy, in collaboration with François Le Roy.

rated private-sector investments, but the post-crisis issuance of "AAA" rated securities has dropped to a fraction of its pre-crisis volume. It is clear that non-U.S. issuers are tapping into the U.S. investor demand for high-quality investments like those offered under existing covered bond frameworks. The ASF voices its full support for such an enacting piece of legislation.

F. ASF Recommendations in Support of Effective U.S. Covered Bond Legislation

In contemplating the United States Covered Bond Act of 2011 and in considering the type of legislation that would be most constructive to the emergence of a deep and liquid U.S. covered bond market, the members of the ASF would like to articulate some principles that we believe should be present in the legislation.

In particular, effective legislation in favor of covered bonds should be as investor-friendly as possible. Many institutional investors in the U.S. and abroad are living with the painful memory of recent government-sponsored intervention that has compromised the operation of contracts. Moreover, the attempt by some regulators to exercise expansive authority over the efficacy of certain debt capital markets products also threatens the confidence investors have in government- led market initiatives. A striking recent example of this expansive view is the FDIC Safe Harbor. The FDIC has publicly stated that such rules are intended to protect the investors in future asset-backed securities sponsored by IDIs, but in fact it will be the investors who lose the protection of an insolvency-remote true sale if the affected IDI failed to meet or comply with the requirements of the FDIC Safe Harbor over which investors have no control.

ASF submits the following essential principles that we believe should be present in the legislation, among others:

1. **<u>The legislation should allow for bank and non-bank entrants without discriminating on the basis of size or credit quality.</u>** Investors should be afforded a menu of alternative covered bonds, which includes multiple issuers of varied standing. This would allow a more balanced flow of capital into the credit sector and avoid imbalances and over-investment in a small number of issuers and too few covered bond programs. It also would avoid the pitfall of having legislation pick the "winners" and "losers."

2. **<u>The legislation should allow a wide variety of collateral types to be included in the cover pool.</u>** Such optionality would allow for investor choice and market-based preferences to balance the flow of capital into an emergent U.S. covered bond sector. Collateral types could include residential mortgage loans, loans outstanding under home equity lines of credit, multi-family housing loans, commercial mortgage loans, auto loans, auto leases, student loans, consumer credit card loans, public sector loans, other types of loans deemed appropriate by the supervising authority, and securities backed by any of the foregoing collateral types provided the security is not backed by more than one, homogenous collateral type.

3. **<u>The legislation should not allow different types of collateral to be co-mingled in the same cover pool, but instead require asset type homogeneity within a cover pool.</u>** This will facilitate elegant simplicity and create standardization and enhanced transparency from the investment perspective. As the U.S. emerges from a rather opaque, complex, and non-standard system of mortgage securitization, aspects of a new secured finance system would find greater uptake in biasing themselves to enhanced simplicity, standardization, and the resulting improvement in transparency.

4. **<u>The legislation must allow investors full dual recourse: first, to the cover pool as a primary source of payment for principal and interest on the covered bonds, and second, as unsecured creditors to the issuer in the event the cover pool proceeds are insufficient to repay principal and interest in full on the covered bonds.</u>** A covered bond investor's unsecured claim should rank *pari passu* with the other senior, unsecured claims on the issuer. Dual recourse is, in fact, 100% "skin-in-the-game". The bank is fully liable to repay the covered bonds and the cover pool assets remain on the balance sheet of the issuing bank, leaving no question around the alignment of interest between issuer and investor. For banks and non-banks with high senior unsecured credit ratings, a covered bond issuance should allow them to issue at appreciably lower rates of interest than where they would issue unsecured debt and be competitive to where they would issue securitization debt rated as high as their own rating. In Europe, we see a significant difference between the rates paid by top-tier banks on their unsecured debt versus their covered bond issuances, with covered bond debt yields being appreciably lower than unsecured debt of comparable maturity.

5. **<u>The legislation should stipulate a specific legal framework that supersedes general insolvency law for the absolute protection of covered bond investors, consistent with the principle articulated in number 4 above.</u>** In our view, investor reception of a U.S. covered bond market will be directly determined by the issuer insolvency framework that accompanies it. If investors fear that an issuer's regulator, the FDIC in the case of U.S. IDIs, can interfere with or have a claim upon the assets in a cover pool, then U.S. covered bonds will be relatively unattractive compared to those issued in other jurisdictions where

the priority of claim of bondholders on cover pool assets is a cornerstone of covered bond legislation. Investors would treat them as quasi-secured but price them more like unsecured, which in turn would eliminate the motivation for issuers to issue. If investors fear that an issuer's regulator can force the early liquidation of a covered pool, and leave them under-secured or at risk of reinvesting par proceeds in lower-yielding investments, investors will most likely require a risk premium that would again increase the cost of issuance relative to an issuer's alternatives. Worse still, from a systemic perspective, such a covered bond paradigm would miss a great opportunity to introduce a great stabilizer in the world of bank asset-liability management. The ability to pledge assets under a robust and investor-friendly secured financing framework, like covered bonds, offers banks and non-banks alike a potentially valuable source of financing and simultaneously offers investors a safer investment during periods of credit and liquidity stress in our financial system. This benefit should not be understated and can become of paramount importance and utility during periods of heightened counterparty credit concerns, like the extreme counterparty credit concerns we experienced in the Credit Crisis of 2008. Indeed, it was precisely this potential that motivated the former U.S. Treasury Secretary Henry Paulson to advance a covered bond framework, but the initiative came too late into the crisis and relied on a weaker regulatory approach rather than a stronger legislative approach to have counteracted the overwhelming forces we confronted in an enormous crisis that was accelerating at the time.

6. **The assets in a cover pool should be segregated from the issuer's other assets, or clearly identified as such to avoid any likelihood that cover pool assets would**

<u>become co-mingled with other assets of the issuer or with an issuer's insolvency estate.</u> Covered bond investors should bear no doubt over the proper identification and segregation of assets comprising the cover pool which secures them. One way to assure such treatment would be to require a periodic audit of an issuer's books and records to determine that the asset segregation standard has been satisfied, to report any deficiencies to a responsible party, and to assure an actionable remedy is imposed on a capable party to cure any non-compliance in a timely fashion.

7. **<u>The issuer should maintain a continuing obligation to "cover" the bonds issued under their covered bond program with a sufficient level of collateral and overcollateralization consisting of performing (non-defaulted), self-liquidating financial assets.</u>** This requirement is universally incorporated into covered bond programs around the world and provides assurance to investors that the cover pool would at all times generate sufficient, self-liquidating proceeds from performing financial assets to repay the full amount of principal and interest without their having to rely on the issuer's unsecured credit quality to do so.

8. **<u>The maturity limit applicable to covered bonds (and cover pool assets) should extend to 30 years.</u>** Such a limit is consistent with the FDIC's Final Policy, which was increased from 10 years after consideration of comments received on their Interim Policy Statement and the FDIC's own view that "longer-term covered bonds should not pose a significant, additional risk and may avoid short-term funding volatility."[136] A 30-year term limit would allow issuers to tap into the long-end of the yield curve and better

[136] 73 Fed. Reg. 43756 (July 28, 2008).

maturity-match to longer dated assets, such as 30-year, fixed-rate mortgages. With regard to such a feature, like a maturity limit on cover pool assets, the more flexibility the final legislation affords issuers, the more likely issuance will emerge.

9. **Covered bonds should be allowed to include provisions for additional credit enhancements, liquidity support, interest rate and currency swaps or options.** These types of instruments may prove useful, and even necessary, by the market to create a more stable investment profile for investors and an even better asset-liability match for issuers than they might otherwise be able to achieve if the use of hedge instruments like the ones mentioned here were disallowed or unnecessarily restricted.

G. Other Considerations for the Legislative Process

In promoting the principles set forth above, it may also be worth noting that our members do not necessarily feel that the legislation needs to be overly prescriptive. Certain elements may be best left for the market to discover, or by Treasury as the principal covered bond regulator. One such element may be the level of overcollateralization. Considering that Dodd-Frank is mandating risk retention for asset securitization on the order of 5% generally, it should be a strikingly clear distinction that covered bonds, by definition, have a 100% risk retention associated with them. This being the case, overcollateralization would exist solely for the benefit of global, market-based investors of adequate sophistication to evaluate the appropriateness of overcollateralization requirements vis à vis the collateral comprising a cover pool. As our recommendation is to allow a wide range of collateral to be eligible for inclusion in covered bond programs, it would be natural to let the investor market set corresponding overcollateralization requirements, especially since we know from experience that different types of assets require different levels of overcollateralization to achieve comparable credit profiles for the liabilities issued against the assets. This would make sense from the regulator's perspective as well, as in theory, regulators would prefer lower overcollateralization requirements so more assets are immediately available to depositors and unsecured creditors than would otherwise be the case if overcollateralization levels were mandated at levels above what was needed in the market.

Other features of an emergent covered bond system may be best decided by legislation if it is likely regulation will only serve to restrain the formation of a deep and liquid market. For example, the FDIC Final Policy restricts covered bond issuance to 4% of an IDI's liabilities. While their reasoning is understandable,[137] a 4% limit would impose a theoretical initial maximum market size for covered bond issuance of $474 billion, assuming the highly improbable outcome that every bank issued to their maximum limit.[138] When banks are already subject to leverage ratios, we question the necessity of requiring an initial market size cap that could merely serve to dissuade issuance by signaling to IDI's that covered bonds will not be allowed to become a sufficiently meaningful asset-liability tool needed to justify the upfront commitment of time, effort, money, and resources to commence an issuance program.

Still, other features are worthy of inclusion in any final legislation, and some may even be necessary for a U.S. covered bond market. For example, it is typical of many European

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[137] "The 4 percent limitation under the Policy Statement is designed to permit the FDIC, and other regulators, an opportunity to evaluate the development of the covered bond market within the financial system of the United States, which differs in many respects from that in other countries deploying covered bonds." 73 Fed. Reg. 43756 (July 28, 2008).

[138] Fitch Ratings, U.S. Housing Reform Proposal FAQs: Filling the Void, February 24, 2011.

covered bond frameworks to provide for special supervision of an issuer's obligations in respect of the cover pool, which is supervision specifically for the benefit of covered bondholders, as compared to more general credit institution or markets supervision. Frequently, this kind of supervision is conducted by designated public authorities, which frequently require a covered bond issuer to obtain a license to issue covered bonds. In a number of countries, the public authority is also the banking supervisory authority. In others, the covered bond supervisory authority is the markets regulator. Such public authorities either appoint or approve a cover pool monitor to assure covenant compliance with the terms and conditions of the covered pool legal contracts, and some of these authorities may conduct their own periodic audits of the cover pool programs they supervise. Article 22 (4) of the Directive in Undertakings for Collective Investment in Transferable Securities (the "UCITS Directive"), which is included in other EC directives, affords favorable treatment, such as risk weightings, to covered bonds subject to special public supervision. Calibrating the legislation to afford special treatment for covered bond investments could enlarge the potential for this new market and may also be necessary if U.S. covered bonds are to find as broad and deep an investor base as the covered bonds issued from frameworks in other countries.

Given the extensive history, longevity, and size of the European covered bond market and the remaining need to encourage private sector credit flows in the United States, the ASF is strongly supportive of a legislative framework for U.S. covered bonds. Our support comes despite the potential for covered bond issuance to draw market share from securitization issuance. This is because we believe securitization will re-emerge as a healthy and viable financing, capital-management, and risk-management technology whether or not a covered bond market is established in the United States. Moreover, covered bonds and securitization can co-exist in a complementary fashion with one another, as they have for some time in Europe. We also believe it is our obligation as professionals to advocate for disciplined, market-based developments that will promote the availability and affordability of consumer credit to all Americans, just as securitization has been doing for many years. We believe that industry, legislators, regulators, and other policymakers can work in an open, democratic fashion to innovate financial solutions for this greater good. We applaud Chairman Garrett, his co-sponsor Congresswoman Maloney, and this Subcommittee for its forward-thinking initiative and persistence to see the dawn of a new financial technology that will establish a more balanced continuum of asset-liability management alternatives for our credit institutions. By offering credit institutions the ability to issue longer-term, secured liabilities, covered bonds will fill a void that exists among existing alternatives, like short-term unsecured debt (eg, demand deposits), short-term secured debt (eg, repos), longer-term unsecured debt (eg, term CDs and MTNs), and securitization. The filling of such a void can lower the cost of financing a credit institution, which in turn can lower the cost of consumer credit while simultaneously expanding its availability. At a time when we need to transfer public sector support for private sector financing back to the private sector to reduce our fiscal deficits and remove our potentially inflationary monetary policies; at a time when we need to find avenues to create and expand credit to drive consumer spending and real GDP growth; at a time when we need to create jobs, this covered bond legislation could not come at a better time for the financial industry or our economy.

XII. Conclusion

ASF has been a strong and vocal advocate for targeted securitization market reforms and we continue to work with regulators to identify and implement them. ASF supports efforts to align the incentives of issuers with securitization investors and we believe these incentives should encourage the application of sound underwriting standards by both the originator and securitizer in connection with the assets that are securitized. In addition, we support efforts to promote appropriate transparency and standardization in securitization disclosure and transaction documents. ASF will continue to work to provide industry comment on all proposals issued by the various regulatory agencies as well as to promulgate best practices for securitization governance in order to restore confidence in this very important market. Where regulators are tasked with implementing reforms, we support uniform implementation across regulators supported by comprehensive industry and public comment, rather than the piecemeal, brash approach that was taken by the FDIC in enacting the FDIC Safe Harbor. The ASF greatly appreciates the invitation to appear before this Subcommittee to share our views related to these critical issues facing the securitization market. I look forward to answering any questions the Subcommittee may have.

Thank you.

ATTACHMENT A

Role of Securitization within the Financial System and U.S. Economy

The Current State of the Market

As the Federal Reserve Board noted in its recent study on risk retention, different segments of the ABS and MBS markets have recovered differently during the 18 months since the recession ended.[139] Auto and auto-related ABS accounted for $53.9 billion in issuance in 2009, which represents 80.7% of the auto and auto-related ABS issuance of $66.8 billion during 2007, just before the downturn.[140] $7.2 billion in equipment ABS was issued during 2009, in contrast with the 2007 issuance of $6.1 billion.[141] In 2009, credit card ABS accounted for $46.6 billion in issuance, down 50.7% from 2007 issuance of $94.5 billion.[142] Meanwhile, the student loan sector issued $20.8 billion in ABS during 2009, down 64.2% from 2007 issuance of $58.1 billion.[143] By comparison, on the RMBS side, $48.1 billion of RMBS were issued in 2009, down 92.5% from 2007 issuance of $641.8 billion.[144] In addition to the overall reduction of issuance in the RMBS market, we further note that 97% of RMBS were federally-backed in 2010, as compared with only 64% in 2007 when the private market accounted for a much larger share of RMBS issuance.[145]

[139] Board of Governors of the Federal Reserve System, "Report to the Congress on Risk Retention" (Oct. 2010), p. 2., *available at* http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf.
[140] Data are from Asset Backed Alert, *see* the Proposing Release, p. 12-13, *available at* http://www.sec.gov/rules/proposed/2011/34-64148.pdf.
[141] *Ibid*.
[142] *Ibid*.
[143] *Ibid*.
[144] *Ibid*.
[145] Analysis by 1010data, based on data from FNMA, GNMA and FHLMC.

Simply put, the absence of a properly functioning securitization market, and the funding and liquidity this market has historically provided, adversely impacts consumers, businesses, financial markets and the broader economy. The recovery and restoration of confidence in securitization is therefore a necessary ingredient for economic growth to resume, and for that growth to continue on a sustained basis into the future. ASF supports efforts to align the incentives of issuers and originators with securitization investors and believe these incentives should encourage the application of sound underwriting standards by both the originator and securitizer in connection with the assets that are securitized. We believe that risk retention can aid in achieving this goal so long as the requirements are tailored to each class of securitized assets as described in this testimony. We believe that the Joint Regulators must carefully calibrate the risk retention requirements so as to not impede the securitization markets recovery and further constrain the availability of credit.

Why is Securitization Important?

Securitization—generally speaking, the process of pooling and financing consumer and business assets in the capital markets by issuing securities, the payment on which depends primarily on the performance of those underlying assets—plays an essential role in the financial system and the broader U.S. economy. Over the past 40 years, securitization has grown from a relatively small and unknown segment of the financial markets to a mainstream source of credit and financing for individuals and businesses alike.

In recent years, the role that securitization has assumed in providing both consumers and businesses with credit is striking: currently, there is over $11 trillion of outstanding securitized assets, including RMBS, ABS and ABCP. This represents a market substantially larger than the normal size of all outstanding marketable U.S. Treasury securities—bonds, bills, notes, and TIPS combined.[146] Between 1990 and 2006, issuance of MBS grew at an annually compounded rate of 13%, from $259 billion to $2 trillion a year.[147] In the same time period, issuance of ABS secured by auto loans, credit cards, home equity loans, equipment loans, student loans and other assets, grew from $43 billion to $753 billion. In 2006, just before the downturn, nearly $2.9 trillion in RMBS and ABS were issued. As these data demonstrate, securitization is clearly an important sector of today's financial markets.

The importance of securitization becomes more evident by observing the significant proportion of consumer credit it has financed in the U.S. It is estimated that securitization has funded between 30% and 75% of lending in various markets, including an estimated 64% of outstanding home mortgages.[148] Securitization plays a critical role in non-mortgage consumer credit as well. Historically, banks securitized 50-60% of their credit card assets.[149] Meanwhile, in the auto industry, approximately 91% of auto industry sales are financed through auto ABS.[150] Overall, recent data collected by the Board show that securitization has provided over 25% of

[146] U.S. Department of the Treasury, "Monthly Statement of the Public Debt of the United States: January 31, 2011," (January 2011), *available at* http://www.treasurydirect.gov/govt/reports/pd/mspd/2011/opds012011.pdf.
[147] National Economic Research Associates, Inc. ("NERA"), "Study of the Impact of Securitization on Consumers, Investors, Financial Institutions and the Capital Markets," p. 16 (June 2009), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_NERA_Report.pdf (the "NERA Study").
[148] Fitch Ratings, "U.S. Housing Reform Proposal FAQs: Filling the Void" p. 1-2 (Feb. 2011), *available at* http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=606315 (registration required).
[149] Citigroup, "Does the World Need Securitization?" p. 10 (Dec. 2008), *available at* http://www.americansecuritization.com/uploadedFiles/Citi121208_restart_securitization.pdf.
[150] *Ibid*., p. 10.

outstanding U.S. consumer credit.[151] Securitization also provides an important source of commercial mortgage loan financing throughout the U.S., through the issuance of CMBS.

Over the years, securitization has grown in large measure because of the benefits and value it delivers to transaction participants and to the financial system. Among these benefits and value are the following:

A. *Efficiency and Cost of Financing.* By linking financing terms to the performance of a discrete asset or pool of assets, rather than to the future profitability or claims-paying potential of an operating company, securitization often provides a cheaper and more efficient form of financing than other types of equity or debt financing.

B. *Incremental Credit Creation.* By enabling capital to be raised via securitization, lenders can obtain additional funding from the capital markets that can be used to support incremental credit creation. In contrast, loans that are made and held in a financial institution's portfolio occupy that capital until the loans are repaid.

C. *Credit Cost Reduction.* The economic efficiencies and increased liquidity available from securitization can serve to lower the cost of credit to consumers and businesses. Several academic studies have demonstrated this result. A recent study by National Economic Research Associates, Inc., concluded that securitization lowers the cost of consumer

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[151] Federal Reserve Board of Governors, "G19: Consumer Credit," (Sept. 2009), *available at* http://www.federalreserve.gov/releases/g19/current/g19.htm.

credit, reducing yield spreads across a range of products including residential mortgages, credit card receivables and automobile loans.[152]

D. Liquidity Creation. Securitization often offers issuers an alternative and cheaper form of financing than is available from traditional bank lending, or debt or equity financing. As a result, securitization serves as an alternative and complementary form of liquidity creation within the capital markets and primary lending markets.

E. Risk Transfer. Securitization allows entities that originate credit risk to transfer that risk throughout the financial markets to parties willing to assume it, such as institutional investors and hedge funds.[153]

F. Customized Financing and Investment Products. Securitization allows for precise and customized creation of financing and investment products tailored to the specific needs of both issuers and investors. For example, issuers can tailor securitization structures to meet their capital needs and preferences and diversify their sources of financing and liquidity. Investors can tailor securitized products to meet their specific credit, duration, diversification and other investment objectives.

Recognizing these and other benefits, policymakers globally have taken steps to help encourage and facilitate the recovery of securitization activity. Discussing the Joint Regulators' risk retention rulemaking, Acting Comptroller of the Currency John Walsh stated, "I think it's vital that we craft a final rule that does not impede the revival of the securitization markets. We

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[152] NERA Study, p. 16, *available at* http://www.americansecuritization.com/uploadedFiles/ASF_NERA_Report.pdf.

[153] The vast majority of investors in the securitization market are institutional investors, including banks, insurance companies, mutual funds, money market funds, pension funds, hedge funds and other large pools of capital.

will be hard pressed to fund the needs of American consumers, particularly in the area of housing, without securitization…"[154] The G-7 finance ministers, representing the world's largest economies, declared that "the current situation calls for urgent and exceptional action…to restart the secondary markets for mortgages and other securitized assets."[155] The Department of the Treasury stated in March, 2009, that "while the intricacies of secondary markets and securitization…may be complex, these loans account for almost half of the credit going to Main Street,"[156] underscoring the critical nature of securitization in today's economy. The Chairman of the Board noted that securitization "provides originators much wider sources of funding than they could obtain through conventional sources, such as retail deposits" and also that "it substantially reduces the originator's exposure to interest rate, credit, prepayment, and other risks."[157] Echoing that statement, the Financial Stability Oversight Council in its recent study on *Macroeconomic Effects of Risk Retention Requirements* stated that, "By providing access to the capital markets, securitization has improved the availability and affordability of credit to a diverse group of businesses, consumers, and homeowners in the United States." There is clear recognition in the official sector of the importance of the securitization process and the access to financing that it provides lenders as well as its importance in providing credit that ultimately flows to consumers, businesses and the real economy.

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[154] Walsh, John, "Remarks Before the American Bankers Association Government Relations Summit." *Office of the Comptroller of the Currency* (March 2011), *available at* http://www.occ.treas.gov/news-issuances/speeches/2011/pub-speech-2011-26.pdf.

[155] G-7 Finance Ministers and Central Bank Governors Plan of Action (Oct. 10, 2008), *available at* http://www.treas.gov/press/releases/hp1195.htm.

[156] U.S. Department of the Treasury, "Road to Stability: Consumer & Business Lending Initiative," *available at* http://www.financialstability.gov/roadtostability/lendinginitiative.html.

[157] Bernanke, Ben S., "Speech at the UC Berkeley/UCLA Symposium: The Mortgage Meltdown, the Economy, and Public Policy, Berkeley, California." *Board of Governors of the Federal Reserve System* (Oct. 2008), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20081031a.htm.

Restoration of function and confidence to the securitization markets is a particularly urgent need, in light of capital and liquidity constraints currently confronting financial institutions and markets globally. As mentioned above, at present nearly $11 trillion in U.S. assets are funded via securitization. With the process of bank de-leveraging and balance sheet reduction still underway, and with increased bank capital requirements on the horizon, such as those expected in Basel III, the funding capacity provided by securitization cannot be replaced with deposit-based financing alone in the current or foreseeable economic environment. In fact, the IMF estimated that a financing "gap" of $440 billion existed between total U.S. credit capacity available for the nonfinancial sector and U.S. total credit demand from that sector for the year 2009.[158] Moreover, non-bank finance companies, which have played an important role in providing financing to consumers and small businesses, are particularly reliant on securitization to fund their lending activities, because they do not have access to deposit-based funding. Small businesses, which employ approximately 50% of the nation's workforce, depend on securitization to supply credit that is used to pay employees, finance inventory and investment, and fulfill other business purposes. Furthermore, many jobs are made possible by securitization. For example, a lack of financing for mortgages hampers the housing industry; likewise, constriction of trade receivable financing can adversely affect employment opportunities in the manufacturing sector. To jump start the engine of growth and jobs, securitization is needed to help restore credit availability.

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[158] International Monetary Fund, "The Road to Recovery." *Global Financial Stability Report: Navigating the Financial Challenges Ahead* (Oct. 2009), p. 29, *available at* http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf.

ATTACHMENT B

Basel II Securitization Decision Tree