Testimony of George P. Miller
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Before the Senate Banking, Housing and Urban Affairs Subcommittee on Securities, Insurance and Investment

"Securitization of Assets: Problems and Solutions"
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On behalf of the American Securitization Forum, I appreciate the opportunity to testify before this Subcommittee as it explores problems and solutions associated with the securitization process.

The American Securitization Forum (ASF) 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 350 firms, including investors, mortgage and consumer credit lenders and securitization issuers, financial intermediaries, legal and accounting firms, and other professional organizations involved in the securitization markets. The ASF also provides information, education and training on a range of securitization market issues and topics through industry conferences, seminars and similar initiatives. ASF is an affiliate of the Securities Industry and Financial Markets Association.[1]

My testimony today will address the following topics:

1) The role and importance of securitization to the financial system and U.S. economy;
2) Current conditions in the securitization market;

[1] For more information on ASF, please visit our website: http://www.americansecuritization.com. For more information on the Securities Industry and Financial Markets Association, please see: http://www.sifma.org.

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3) Limitations and deficiencies in securitization revealed by the recent financial market crisis; and
4) Views on certain securitization policy and market reform initiatives now underway or under consideration

I. THE ROLE AND IMPORTANCE OF SECURITIZATION TO THE FINANCIAL SYSTEM AND U.S. ECONOMY

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 25 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 $12 trillion of outstanding securitized assets,[2] including mortgage-backed securities (MBS), asset-backed securities (ABS), and asset-backed commercial paper. This represents a market nearly double the size of all outstanding marketable U.S. Treasury securities—bonds, bills, notes, and TIPS combined.[3] Between 1990 and 2006, issuance of mortgage-backed securities grew at an annually compounded rate of 13%, from $259 billion to $2 trillion a year.[4] In the same time period, issuance of asset-backed

[2] SIFMA, "Asset-Backed Securities Outstanding." <http://www.sifma.org/uploadedFiles/Research/Statistics/SIFMA_USABSOutstanding.pdf >.
[3] U.S. Department of the Treasury, "Monthly Statement of the Public Debt of the United States: August 31, 2009," (August 2009). < http://www.treasurydirect.gov/govt/reports/pd/mspd/2009/opds082009.pdf>.
[4] National Economic Research Associates, Inc. (NERA), "Study of the Impact of Securitization on Consumers, Investors, Financial Institutions and the Capital Markets," pg. 16 (June 2009). <http://www.americansecuritization.com/uploadedFiles/ASF_NERA_Report.pdf >.

securities secured by auto loans, credit cards, home equity loans, equipment loans, student loans and other assets, grew from $43 billion to $753 billion.[5] In 2006, just before the downturn, nearly $2.9 trillion in mortgage- and asset-backed securities 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 59% of outstanding home mortgages.[6] Securitization plays a critical role in non-mortgage consumer credit as well. Historically, most banks have securitized 50-60% of their credit card assets.[7] Meanwhile, in the auto industry, a substantial portion of automobile sales are financed through auto ABS.[8] Overall, recent data collected by the Federal Reserve Board show that securitization has provided over 25% of outstanding U.S. consumer credit.[9] In the first half of 2009 alone, securitization financed over $9.5 billion in student loans.[10] Securitization also provides an important source of commercial mortgage loan financing throughout the U.S., through the issuance of commercial mortgage-backed securities.

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:

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[5] SIFMA, "U.S. ABS Issuance."
<http://www.sifma.org/uploadedFiles/Research/Statistics/SIFMA_USABSIssuance.pdf>.
[6] Citigroup, "Does the World Need Securitization?" pg. 10-11 (Dec. 2008).
<http://www.americansecuritization.com/uploadedFiles/Citi121208_restart_securitization.pdf>.
[7] Ibid., pg. 10.
[8] Ibid., pg. 10.
[9] Federal Reserve Board of Governors, "G19: Consumer Credit," (September 2009).
<http://www.federalreserve.gov/releases/g19/current/g19.htm>.
[10] SIFMA, "U.S. ABS Issuance."
<http://www.sifma.org/uploadedFiles/Research/Statistics/SIFMA_USABSIssuance.pdf>.

1. *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.

2. *Incremental Credit Creation.* By enabling capital to be recycled 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.

3. *Credit Cost Reduction.* The economic efficiencies and increased liquidity available from securitization can serve to lower the cost of credit to consumers. Several academic studies have demonstrated this result. A recent study by National Economic Research Associates, Inc., concluded that securitization lowers the cost of consumer credit, reducing yield spreads across a range of products including residential mortgages, credit card receivables and automobile loans.[11]

4. *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.

5. *Risk Transfer.* Securitization allows entities that originate credit risk to transfer that risk to other parties throughout the financial markets, thereby allocating that risk to parties willing to assume it.

[11] National Economic Research Associates, Inc. (NERA), "Study of the Impact of Securitization on Consumers, Investors, Financial Institutions and the Capital Markets," (June 2009), pg. 16. <http://www.americansecuritization.com/uploadedFiles/ASF_NERA_Report.pdf>.

6. *Customized Financing and Investment Products.* Securitization technology allows for precise and customized creation of financing and investment products tailored to the specific needs of 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.[12]

Recognizing these and other benefits, policymakers globally have taken steps to help encourage and facilitate the recovery of securitization activity. 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."[13] The Department of the Treasury stated in March 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,"[14] underscoring the critical nature of securitization in today's economy. The Chairman of the Federal Reserve Board recently 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."[15] Echoing that statement, Federal Reserve Board Governor Elizabeth Duke recently stated that the "financial system has become dependent upon

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[12] 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. Although these direct market participants are institutions, many of them—pension funds, mutual funds and insurance companies, in particular—invest on behalf of individuals, in addition to other account holders.

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

[14] U.S. Department of the Treasury, "Road to Stability: Consumer & Business Lending Initiative," (March 2009). <http://www.financialstability.gov/roadtostability/lendinginitiative.html>.

[15] 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). <http://www.federalreserve.gov/newsevents/speech/bernanke20081031a.htm>.

securitization as an important intermediation tool,"[16] and last week the International Monetary Fund (IMF) noted in its *Global Financial Stability Report* that "restarting private-label securitization markets, especially in the United States, is critical to limiting the fallout from the credit crisis and to the withdrawal of central bank and government interventions."[17] There is clear recognition in the official sector of the importance of the securitization process and the access to financing that it provides lenders, and of its importance to the availability of credit that ultimately flows to consumers, businesses and the real economy.

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 $12 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, the funding capacity provided by securitization cannot be replaced with deposit-based financing alone in the current or foreseeable economic environment. Just last week, the IMF estimated that a financing "gap" of $440 billion will exist between total U.S. credit capacity available for the nonfinancial sector and U.S. total credit demand from that sector for the year 2009.[18] Moreover, non-bank finance companies, who have played an important role in providing financing to consumers and small businesses, are particularly reliant on securitization to fund their lending activities, since they do not have access to deposit-based funding. Small businesses, who employ approximately 50% of the nation's workforce, depend on securitization to supply credit that is used to pay employees,

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[16] Duke, Elizabeth A., "Speech at the AICPA National Conference on Banks and Savings Institutions, Washington, D.C." *Board of Governors of the Federal Reserve System* (Sept. 2009). <http://www.federalreserve.gov/newsevents/speech/duke20090914a.htm>.

[17] International Monetary Fund, "Restarting Securitization Markets: Policy Proposals and Pitfalls." *Global Financial Stability Report: Navigating the Financial Challenges Ahead* (Oct. 2009), pg.33. <http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf>.

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

finance inventory and investment, and 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.

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.

II. CURRENT CONDITIONS IN THE SECURITIZATION MARKET

The U.S. securitization markets experienced substantial dislocation during the recent financial market turmoil, with a virtual collapse of both supply and demand in the new-issue market, very substantial reductions in liquidity, widespread declines in securities prices and valuations, and increases in risk premiums throughout the secondary market. While there have been signs of recovery in certain parts of the securitization market throughout the first three calendar quarters of 2009, some market segments—most notably, private-label residential mortgage backed securities—remain dormant, with other securitization asset classes and market sectors remaining significantly challenged.

In the asset-backed securities market, total issuance volume remains at a relatively low level, with 2009 issuance projected to reach $130 billion, roughly in line with the $140 billion issued in

2008 but sharply down from the $750 billion issued in 2006.[19] Although issuance rates in nearly all major asset classes, including credit cards, auto and equipment loans, and student loans, picked up in the second quarter of 2009, a recent ASF survey showed that market participants expect securitization issuance rates to return to only half of their pre-downturn levels over the next two to three years. For residential mortgage-backed securities, 2009 to date has seen over $1.2 trillion in issuance, compared with a yearlong total of $1.3 trillion in 2008 and $2.1 trillion in 2006. However, in 2009, less than 1% of this has been issued without a government or GSE guarantee (i.e., private-label MBS); this is compared with private-label MBS comprising over 23% of all issuance during the time period from 1996 to 2006.[20] Furthermore, private-label MBS transactions that have occurred in 2009 involved pools of seasoned, conforming loans – no major private-label residential mortgage-backed securities deal of which we are aware has directly financed new mortgage loan origination this year.

Part of the reason for this involves a broad retreat from risk by many investors. The events of 2007 and 2008, especially in the RMBS markets, resulted in significant losses for many investors. While it seems unlikely that some types of investors, such as those who purchased securitized instruments issued by structured investment vehicles (SIVs) or certain types of collateralized debt obligations (CDOs), will play a significant role in the future MBS and ABS markets, the number of traditional securitization investors has also diminished, and along with it, the liquidity they have provided to both senior and subordinate parts of the market. Replacing at least a portion of this investor base is a significant challenge faced by participants in today's market.

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[19] SIFMA, "U.S. ABS Issuance."
<http://www.sifma.org/uploadedFiles/Research/Statistics/SIFMA_USABSIssuance.pdf>.
[20] SIFMA, "U.S. Mortgage-Related Issuance."
<http://www.sifma.org/uploadedFiles/Research/Statistics/SIFMA_USMortgageRelatedIssuance.pdf>.

Certain programs sponsored by the federal government—in particular, the TALF program—have been successful in stimulating parts of the new-issue securitization market. President Obama described TALF as the government's "largest effort ever to help provide auto loans, college loans, and small business loans to the consumers and entrepreneurs who keep this economy running,"[21] and in many ways, TALF is among the most successful of the government's efforts to bolster the consumer economy. As of September 2009, TALF has directly financed $46 billion[22] of ABS issuances out of the approximately $80 billion of ABS eligible for TALF that has been issued since March.[23] Due in significant measure to TALF, credit costs on consumer ABS have, across the board, returned to levels more in line with their historical trends than the extremely high levels that were seen in late 2008 and early 2009. For example, 3-year AAA credit card spreads to benchmark rates had ballooned to more than 500 basis points, or 5%, above LIBOR by January 2009, but have retracted to a level less than 1% above LIBOR.[24] While this is not quite back to the spread levels seen over the years leading up to the crisis, it represents a more stable and economical level for issuers that translates into more affordable rates for borrowers. In recent months a number of issuers have been able to sell, at economical levels, transactions without the support of TALF.[25] Clearly there are other factors at play in this recovery, including a generally more benign credit market, but one cannot dismiss the considerable and positive impact of TALF.

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[21] Obama, Barack, "Remarks of President Barack Obama – Address to Joint Session of Congress," (Feb. 24, 2009). <http://www.whitehouse.gov/the_press_office/remarks-of-President-Barack-Obama-address-to-joint-session-of-congress>.
[22] SIFMA, "TALF." <http://www.sifma.org/research/research.aspx?ID=10256#TALF>.
[23] Allison, Herbert M., "Written Testimony: Senate Committee on Banking, Housing and Urban Affairs," (Sept. 2009). <http://www.ustreas.gov/press/releases/tg298.htm>.
[24] JPMorgan Securitized Products Weekly, September 18, 2009, page 22-23.
[25] See, for example: AmeriCredit's $725 million auto ABS transaction, (July 2009) <http://www.reuters.com/article/pressRelease/idUS140529+31-Aug-2009+BW20090831>; JP Morgan's $2.53 billion credit card ABS deal, (Sept. 2009) <http://online.wsj.com/article/SB125311472402316179.html>.

TALF has helped somewhat to bring investors back to the parts of consumer ABS markets that are not directly eligible for the program, although the markets for debt rated lower than AAA are still struggling. For example, 5-year single-A rated credit card ABS, which are not TALF eligible, saw an even more severe spread widening than that of AAA during the height of the disruption in late 2008. By January 2009 spreads had ballooned to more than 15% above LIBOR, but have since come back in to lower levels.[26] The subordinate ABS markets are still relatively dormant, and unless banks are able to finance a greater portion of the capital structure, credit origination via securitization cannot be fully restored.

Notwithstanding the success of the TALF program and the restoration of a modest degree of securitization financing and liquidity in some market segments, significant challenges remain, including establishing a stable, sustainable and broad-based platform for future securitization market issuance and investment activity that is less reliant on direct government support.

III. LIMITATIONS AND DEFICIENCIES IN SECURITIZATION REVEALED BY THE RECENT FINANCIAL MARKET CRISIS

The recent financial market crisis revealed several limitations and weaknesses in securitization market activity. Among the multiple (and, in many cases, interrelated) deficiencies revealed were the following:

1. *Risk management failures, including the excessive or imprudent use of leverage and mismanagement of liquidity risk.* Many market participants—including financial intermediaries, investors and others—established large, leveraged risk positions in securitized instruments. A significant number of these market positions were, in effect,

[26] JPMorgan Securitized Products Weekly, September 18, 2009, page 22-23.

highly-levered triggers which, when tripped by an adverse rating action or downward price movement, caused widespread deleveraging and further price reductions. At the same time, large parts of the securitization market became reliant on cheap, short term liquidity to finance long-term assets. When this liquidity disappeared and financing was either repriced or withdrawn completely, a more systematic deleveraging and unwinding process ensued.

2. *Credit ratings methodologies and assessments that proved to be overly optimistic, and excessive reliance on credit ratings.* Especially in parts of the residential mortgage market, a favorable economic environment and persistent increase in housing prices masked gaps in credit rating agency models and methodologies that did not sufficiently factor in the risk of nationwide housing price declines and a high correlation in the performance of the assets underlying certain mortgage and asset-backed securities. At the same time, market participants became overly reliant on credit ratings, and many failed to perform or to act upon their own assessment of the risks created by certain securitized transaction structures.

3. *Deteriorating underwriting standards and loan quality.* Underwriting standards declined precipitously throughout various segments of the credit markets, including but not limited to subprime mortgages, with housing prices rising steeply and credit and liquidity in plentiful supply. As loan demand and competition among lending institutions intensified, asset quality declined, leaving securitized instruments vulnerable to credit-related performance impairments.

4. *Gaps in data integrity, reliability and standardization.* Especially in parts of the residential mortgage market, a combination of explosive lending growth, operational

weaknesses, the absence of standardized and comparable loan-level data, an increasing prevalence of fraud and other factors caused investors broadly to question the accuracy and integrity of performance data relating to the assets underlying securitizations. This led to a massive loss of confidence and widespread aversion to securitized risk, including asset classes and transaction structures that were far removed from the direct source of these concerns.

5. *A breakdown in checks and balances and lack of shared responsibility for the system as a whole.* While many within the securitization industry were aware of the general deterioration in credit underwriting standards and the other factors outlined above, no single party or group of market participants enforced sufficient discipline across all parts of the interdependent securitization value chain. Weaknesses and deficiencies in one part of the chain thus impaired the function of the chain in its entirety.

It is important to note that the weaknesses outlined above are not inherent in securitization *per se*. Instead, they relate to the manner in which securitization was used in some settings by some market participants. In general, the amount of risk inherent in a securitization is equal to the risk that is embedded in the securitized assets themselves. However, in retrospect it is clear that securitization technology can be used in ways that can reduce and distribute risk (i.e., can be beneficial to the financial system), or that increase and concentrate that risk (i.e., can be detrimental to the financial system). Ancillary practices and strategies employed in some securitization transactions by some market participants—for example, the use of additional leverage; reliance on short-term funding for long-term liabilities; or the absence of effective risk management controls—can amplify and concentrate those risks. This is especially true when such practices and strategies relate to large dollar volumes of transactions and risk positions held by multiple participants throughout the financial system.

It is also important to recognize that many of the deficiencies outlined above were prevalent, or at least more heavily concentrated, in certain securitization market products and sectors, rather than characterizing conditions or practices in the securitization market as a whole. In fact, the most consequential deficiencies were concentrated in portions of the residential mortgage market—and the subprime mortgage market, in particular—and in certain types of CDOs, SIVs and similar securities arbitrage structures. These transactions—many of which relied on high degrees of leverage—generated significant incremental demand for underlying securitization products. However, much of that demand was "artificial," in the sense that production of underlying securitization products (e.g., subordinated risk tranches of subprime RMBS) was driven by demand from CDOs and SIVs, rather than by the financing needs of lenders or borrowing needs of consumers. In other parts of the securitization market, including prime RMBS, credit card, auto and student loan ABS, and asset-backed commercial paper conduits, among others, securitization activity largely remained focused on its historical role of financing the credit extension activities of lenders, and the credit needs of their consumer and business customers.

IV. VIEWS ON SECURITIZATION POLICY AND MARKET REFORM INITIATIVES

Numerous policy and market reforms aimed at the securitization market have been advanced in response to the broader financial market crisis. Global policymaking bodies have proposed a series of securitization reforms as part of their broader response to financial market turmoil, and in the United States, both legislative and regulatory responses are under active consideration. At the same time, industry participants and their representative organizations are moving forward with important reforms to securitization market practices and to retool key parts of the market's operational infrastructure.

Overall, we believe that a targeted combination of thoughtful policy reforms, coupled with industry initiatives to improve the securitization market infrastructure, will help to establish a more stable and lasting platform for future securitization market activity. In general, we believe that these policy and industry reform measures should facilitate the ability to originate and fund of a wide range of consumer and business credit via securitization. However, this activity must be supported by improved data and transparency that enables securitized risk to be evaluated and priced efficiently by market participants, and by enhanced operational controls (including but not limited to asset origination practices, due diligence and quality review practices, standardized and more effective representations and warranties, standardization of key documentation provisions and rating agency methodologies, among others) that provide necessary assurances to investors and other market participants regarding the accuracy, integrity and reliability of securitization data and transaction structures. At the same time, we believe that it is important, as a recent IMF report noted, to consider the individual and combined effects of various reform measures under consideration, to ensure that they do not inadvertently stifle otherwise sound and desirable securitization activity.[27]

In the United States, a primary policy focus is on legislative proposals advanced by the Obama Administration, which in turn reflect many of the reform themes and initiatives under

[27] The exact language used by the IMF in its *Global Financial Stability Report* states: "While most of the current proposals are unambiguously positive for securitization markets and financial stability, some proposals—such as those designed to improve the alignment of securitizer and investor interests and accounting changes that will result in more securitized assets remaining on balance sheets—may be combined in ways that could halt, not restart, securitization, by inadvertently making it too costly for securitizers." See "The Road to Recovery," (Oct. 2009), pg. 29. <http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf>

consideration globally. Together with other reforms being pursued by federal regulatory agencies and accounting standards setters, these securitization reform initiatives may be broadly categorized as follows:

1. *Increased Data Transparency, Disclosure and Standardization, and Improvements to the Securitization Infrastructure.* Initiatives designed to increase the type and amount of information and data (including loan-level data) that is captured and disclosed with respect to securitized instruments, and to improve and standardize that information and data as well as key documentation provisions, market practices and procedures employed in securitization transactions.

2. *Required Risk Retention and Other Incentive Alignment Mechanisms.* Mandated requirements for asset originators and/or securitizers to retain an economic interest in securitization transactions, and other mechanisms designed to produce a closer alignment of economic risks and incentives of originators, securitizers and end investors.

3. *Increased Regulatory Capital Requirements and Limitations on Off-Balance Sheet Accounting.* Increases in regulatory capital required to be held against securitized exposures by regulated financial institutions, as a means of creating an additional safety and soundness buffer against potential losses associated with those exposures, and revisions to generally accepted accounting standards that restrict off-balance sheet accounting for securitized transactions and produce more widespread accounting consolidation of the assets and liabilities of securitization special purpose entities.

4. *Credit Rating Agency Reforms.* Various reforms intended to eliminate or minimize conflicts of interest, and to promote the accuracy, integrity and transparency of

methodologies and processes that credit rating agencies apply to securitization transactions.

A summary of ASF's views on each of these reform directions and initiatives are set forth below.

A. Increased Transparency, Disclosure, Standardization and Improvements to the Securitization Market Infrastructure

ASF supports increased transparency and standardization in the securitization markets, and related improvements to the securitization market infrastructure. We believe that such efforts should be focused on those areas and products where pre-existing practices have been determined to be deficient, and where improvements can help to restore confidence and function to the related market segment(s).

Our principal focus in this area is ASF's Project on Residential Securitization Transparency and Reporting ("Project RESTART"), which is initially directed at addressing transparency and standardization deficiencies in the residential mortgage-backed securities ("RMBS") market. Prior studies and market surveys conducted by ASF have clearly identified the RMBS market as most in need of these types of reform.

Overall, Project RESTART seeks to address transparency and standardization needs in the RMBS market via the substantial injection of new disclosures and reporting by issuers and servicers on new transactions as well as on the trillions of dollars of outstanding private-label RMBS. Project RESTART would create a uniform set of data standards for such disclosure and reporting, including at the loan level. This will create a more level playing field where issuers provide the same information at the initiation of a securitization transaction and on an ongoing basis throughout the life of that transaction. With these standards in place, information provided by different issuers will be more comparable and capable of meaningful evaluation by investors and other market participants. In addition to supporting investment analysis, these data and standardization improvements will also support more robust and reliable rating agency, due diligence, quality review and valuation processes, and other downstream applications that will benefit from more robust, reliable and comparable underlying data.

Project RESTART for RMBS transactions consists of the following phases: (i) the Disclosure Package, which will provide substantially more loan-level data than is currently available to investors, rating agencies and other parties, and standardize the presentation of transaction-level and loan-level data to allow for a more ready comparison of transactions and loans across issuers; (ii) the Reporting Package, which will provide for monthly updating of critical loan-level information that will enable improvements in the ability of investors, rating agencies and other market participants to analyze the performance of outstanding securities; (iii) Model RMBS Representations and Warranties, which will provide assurances to investors in RMBS transactions regarding the allocation and assumption of risk associated with loan origination and underwriting practices; (iv) Model Repurchase Procedures, which will be used to enforce the Model Representations and Warranties and to clearly delineate the roles and responsibilities of transaction parties in the repurchase process; (v) Model Pre-Securitization Due Diligence Standards, which will buttress due diligence and quality review practices relating to mortgage underwriting and origination practices and the data supplied to market participants through the Disclosure Package; and (vi) Model Servicing Provisions for Pooling and Servicing Agreements, which will create more standardized documentation provisions and work rules in key areas, such as loss mitigation procedures that servicers may employ in dealing with delinquent or defaulting loans.

Final versions of the Disclosure and Reporting Packages were released by ASF in July 2009, with industry implementation beginning in 2010. Work continues on the other Project RESTART workstreams identified above, with an immediate focus on the development of Model RMBS Representations and Warranties, which are used to act as a "return policy" to guard against the risk of defective mortgage loans being sold into a securitization trust. Much like a defective product is returned to the store from which it was sold, a defective mortgage loan will be "returned" to the issuer through its removal from a securitization trust for cash. A mortgage loan is "defective" if it materially breaches one of the representations and warranties. Examples of defects range from a general fraud in a loan's origination to a failure to properly verify a borrower's income or employ an independent appraiser. The ASF supports 100% risk retention for defective loans that result from an originator's failure to meet specified underwriting criteria.

Although Project RESTART has initially been focused on the RMBS market, members of the ASF have begun development of the ASF Credit Card ABS Disclosure Package, which seeks to provide increased transparency and standardization to the Credit Card ABS market.

Finally, ASF believes that every mortgage loan should be assigned a unique identification number at origination, which would facilitate the identification and tracking of individual loans as they are sold or financed in the secondary market, including via RMBS securitization. ASF recently selected a vendor who will work with us to provide this unique Loan ID, which is called the ASF LINC™. Implementation of the ASF LINC will enable market participants to access Project RESTART's valuable loan-level information without violating privacy laws by removing personal non-public information and other protected information from the process.

B. Required Risk Retention

ASF supports initiatives to align the economic interests of asset originators and securitization sponsors with investors. As suggested above, we believe that the principal goal of these efforts should be to establish and reinforce commercial incentives for originators and sponsors to create and fund assets that conform to stated underwriting standards and securitization eligibility criteria, thereby making those parties economically responsible for the stated attributes and underwriting quality of securitized loans. The creation and maintenance of effective mechanisms of this type will facilitate responsible lending, as well as a more disciplined and efficient funding of consumer assets via securitization (i.e., where the varying credit and performance risks presented by different types of securitized assets can be properly evaluated and priced in the capital markets).

Securitization risk retention proposals currently under consideration, including legislation advanced by the Obama Administration, call for securitization sponsors and/or asset originators to retain an economic interest in a material portion of the credit risk that the sponsor and/or asset originator conveys to a third party via a securitization transaction.

As noted above, we support the concept of requiring retention of a meaningful economic interest in securitized loans as a means of creating a better alignment of incentives among transaction participants. Many securitizations already embed this concept through various structuring mechanisms, including via the retention of subordinated or equity risk in the securitization, holding portfolio assets bearing credit exposure that is similar or identical to that of securitized assets, and representations and warranties that require originators or sponsors to repurchase assets that fail to meet stated securitization eligibility requirements, among others. However, we do not believe that mandated retention of specific portions of *credit* risk—one such form of economic interest—necessarily constitutes the sole or most effective means of achieving this alignment in all cases.

There are numerous valid and competing policy goals that stand in opposition to requiring the retention of credit risk in securitized assets and exposures. Among others, these include the proper isolation of transferred assets (i.e., meeting legal criteria necessary to effect a "true sale,"); reduction and management of risk on financial institutions' balance sheets; balance sheet management; and the redeployment of capital to enable financial institutions to originate more credit than their limited capital resources would otherwise allow. Balancing these competing and worthwhile policy goals suggests that retention and incentive alignment mechanisms other than universal credit risk retention requirements should be considered. This viewpoint was echoed by the IMF last week in its *Global Financial Stability Report*, which expressed strong concerns about the potential unintended negative consequences of implementing suggested credit risk retention requirements and instead indicated that regulatory authorities "should consider other mechanisms that incentivize due diligence and may be able to produce results comparable to a retention requirement, including, perhaps, representations and warranties."[28]

We believe that 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. These representations and warranties are designed to ensure that the loans are free from undisclosed origination risks, leaving the investor primarily with normal risks of loan ownership, such as the deterioration of the borrower's credit due to loss of employment, disability or other "life events." However, many market participants have

[28] International Monetary Fund, "Restarting Securitization Markets: Policy Proposals and Pitfalls." *Global Financial Stability Report: Navigating the Financial Challenges Ahead* (Oct. 2009), pg. 31. <http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf>.

indicated that the traditional representations and warranties and their related remedy provisions have not sufficiently provided a means to return defective loans to the originator. Because of this, the ASF has sought to enhance and standardize these items through the previously discussed Project RESTART Model RMBS Representations and Warranties and Model Repurchase Provisions.

We therefore believe that to the extent legislation is adopted to require risk retention, regulators should have flexibility to develop and apply alternative retention mechanisms. This flexibility should include the ability for regulators to specify permissible forms and amounts of retention, how retention requirements may be calculated and measured, the duration of retention requirements, whether and to what extent hedging or risk management of retained positions is permissible, and other implementation details.

Finally, we believe that it is imperative to achieve global harmonization and consistency of policy approaches to securitization risk retention. Different approaches are being considered and/or have been adopted in different jurisdictions.[29] Given the global nature of securitization activity and the mobility of global capital among jurisdictions, significant competitive disparities and inefficiencies may be produced by introducing substantively different retention standards throughout the world's financial markets. We believe that is essential for policymakers to coordinate their approaches in this area.

[29] One such approach was adopted by the European Parliament in May 2009. Article 122a to the Capital Requirements Directive prohibits EU banks from investing in securitizations unless the originator retains on an ongoing basis at least 5% of the material net economic interest of the securities securitized. The article proposes four ways the 5% retention requirement may be applied. The article's requirement is scheduled to go into effect on December 31, 2010 for new issues, and December 31, 2014 for existing securitizations where new underlying exposures are added or subtracted after that date. For more information, see: http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P6-TA-2009-0367&language=EN&ring=A6-2009-0139#BKMD-35.

C. Increased Regulatory Capital and Limitations on Off-Balance Sheet Financing

The Obama Administration has advocated that risk-based regulatory capital requirements should appropriately reflect the risk of structured credit products, including the concentrated risk of senior tranches and resecuritizations and the risk of exposures held in highly leveraged off-balance sheet vehicles. Global policymakers have also advocated for minimizing opportunities for financial institutions to use securitization to reduce their regulatory capital requirements without a commensurate reduction in risk.

Consistent with the above views, the Basel Committee on Banking Supervision has amended the Basel II risk-based capital framework to require additional regulatory capital to be held against certain resecuritizations (such as CDOs), on the basis that previous rules underestimated the risks inherent in such structures. In the U.S., the combined bank regulatory agencies recently issued proposals that would continue to link risk-based capital requirements to whether an accounting sale has occurred under U.S. GAAP. Given that recent accounting changes (which will generally take effect in January 2010) will make it very difficult to achieve GAAP sales in many securitizations, including both term asset-backed securities and asset-backed commercial paper vehicles, these proposed rules will likely materially increase the capital that financial institutions will be required to hold in against securitizations, since many securitized assets will remain on or return to those institutions' balance sheets.

ASF supports efforts to addresses weaknesses in the risk-based capital framework that have been revealed in certain securitization products by the recent financial market dislocation, and agrees that regulatory capital levels should adequately reflect the risks of different types of securitization transactions. Furthermore, ASF supports efforts to reduce or eliminate opportunities for regulatory capital arbitrage that are unrelated to differences in the risk profiles of securitization instruments.

We therefore believe that increases in regulatory capital requirements for certain securitizations may be appropriate, based on the conclusion that they present more risk than had been previously understood (for example, because of their use of leverage or where underlying risk positions are more highly correlated than they were assumed to be, as in the case of certain CDOs and SIVs). However, a broader increase in capital requirements for securitization across the board, that is not tied to the differing risk profiles of different transactions, may produce very negative consequences for the economic viability of securitization. In turn, this outcome could unduly constrain the ability of financial institutions to originate and fund consumer and business credit demand, particularly as the broader economy begins to recover.

ASF is particularly concerned that linking risk-based capital requirements to accounting outcomes—particularly when those outcomes are produced by the application of accounting standards that are not themselves risk-based—is an inappropriate policy response. We believe that the resulting increase in regulatory capital required to be held against securitized assets held on financial institutions' balance sheets will grossly misrepresent the actual, incremental risk inherent in those assets. We believe that a more targeted approach to revising the securitization risk-based capital framework is warranted. Last week ASF asked the U.S. bank regulatory agencies for a six-month moratorium relating to any changes in bank regulatory capital requirements resulting from the implementation of FASB's Statements 166 and 167. We believe that this action is necessary to avoid a potentially severe capital and credit shock to the financial system as of January 1st, when the new accounting rules generally take effect. We will be providing detailed input and recommendations to bank regulatory agencies and other policymakers on this important topic by the October 15th deadline.

D. Rating Agency Reforms

ASF supports credit rating reform in the securitization markets, focusing on steps designed to increase the quality, accuracy and integrity of credit ratings and the transparency of the ratings process. Credit ratings have occupied a central role in the securitization markets, providing investors and other market participants with expert views on the credit performance and risks associated with a wide range of securitization products. As an outgrowth of the financial market crisis, confidence in rating agencies and the ratings process for securitization have been significantly impaired. We believe that a restoration of such confidence is a necessary step in restoring broader confidence and function to the securitization markets.

Various credit rating reform measures targeting the securitization markets have been advanced by policymakers, and a number of proposals have been adopted or remain under consideration by the Securities Exchange Commission. Our views on some of the more significant proposals affecting the securitization market are summarized below:[30]

1. *Conflicts of Interest.* We support measures aimed at developing and enhancing strong conflict of interest policies and rules governing the operations of credit rating agencies. We believe that effective management and disclosure of actual and potential conflicts is a necessary component for ensuring transparency and integrity in the rating process.

[30] For more detail on ASF's views on these and other credit rating agency reform proposals, see the series of letters submitted to the SEC by ASF between May and September of 2008. These letters may be found at: http://www.americansecuritization.com/uploadedFiles/ASF%20CRA%20-%20ratings%20scale.pdf (May 2008); http://www.americansecuritization.com/uploadedFiles/Release_34-57967_ASF_Comment_Letter_.pdf (July 2008); and http://www.americansecuritization.com/uploadedFiles/ASF_Final_SEC_CRA_Letter_9_5_08.pdf (Sept. 2008).

2. *Differentiation of Structured Finance Ratings.* ASF supports full and transparent disclosure of the basis for structured finance ratings, so that the risk of securitizations can be understood and differentiated from risks presented by other types of credit instruments. However, we strongly oppose proposals advocating that a special ratings designation or modifier be required for structured finance ratings. We believe that such a designation or modifier would not convey any meaningful information about the rating, and would require significant revisions to private investment guidelines that incorporate ratings requirements.

3. *Ratings Performance Disclosure.* We support the publication in a format reasonably accessible to investors of a record of all ratings actions for securitization instruments for which ratings are published. We believe that publication of these data will enable investors and other market participants to evaluate and compare the performance, stability and quality of ratings judgments over time.

4. *Disclosure of Ratings Methods and Processes.* ASF strongly supports enhanced disclosure of securitization ratings methods and processes, including information relating to the use of ratings models and key assumptions utilized by those models.

5. *Reliance on Ratings.* We believe that investors and other market participants, including regulators, should not place an undue reliance on credit ratings, and should employ other mechanisms for performing an independent credit analysis. However, ASF believes that credit ratings are an important part of existing regulatory regimes, and that steps aimed at reducing or eliminating the use of ratings in regulation should be considered carefully, to avoid undue disruption to market function and efficiency.

V. CONCLUSION

The securitization market is an essential mechanism for supporting credit creation and capital formation throughout the consumer and business economy. Its role is even more important today, when other sources of credit and financing are limited, due to balance sheet, capital and liquidity constraints facing financial institutions. Securitization activity was significantly impaired as a consequence of the financial market crisis. While portions of the securitization market have recovered to some extent throughout 2009, other market segments remain significantly challenged.

The financial market crisis revealed weaknesses in several key areas of securitization market activity. Targeted reforms are needed, and a number are being pursued through both public- and private-sector responses. In pursuing market reforms and redressing these weaknesses, care should be taken to avoid imposing undue impediments to the restoration of securitization activity that could adversely impact credit availability and retard economic recovery and growth.

Thank you for the opportunity to share these views, and I look forward to answering any questions that members of the Subcommittee may have.