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Mr. Robert E. Feldman
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Attn: Comments

Comment on Treatment by the Federal Deposit Insurance Corporation as Conservator of Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection With a Securitization or Participation After March 31, 2010

RIN 3064 – AD55 (proposed amendment to 12 C.F.R. pt. 360)

Mr. Feldman:

I appreciate the opportunity to provide thoughts in response to the Federal Deposit Insurance Corporation's ("FDIC") request on its Advanced Notice of Proposed Rulemaking regarding the proposed treatment of assets transferred by an FDIC-insured depository institution ("IDI") related to future securitizations. Securitization has played a critical role in the adverse economic developments of the past two years, placing increasing stress on the FDIC's Deposit Insurance Fund,[1] to say nothing of the US economy as a whole. While reckless securitization does pose a great threat to the economy, we must not lose sight of the valuable liquidity and risk spreading benefits responsible and well-informed securitization may provide to the economy going forward. I believe the FDIC's proposal to impose regulations on the securitization practices of its insured banks will greatly benefit the US economy. The proposal's information-forcing regulations, which incentivize accurate pricing of securitized interests, ought to be preserved and augmented. The attempts to regulate the structure

[1] *See* Federal Deposit Insurance Corporation, FDIC: Failed Bank List (last visited Feb. 10, 2010) http://www.fdic.gov/bank/individual/failed/banklist.html. Thankfully, the rates of bank failures during the current economic crisis, while high, are still significantly lower than during the savings and loan crisis of the 1980s. *See, e.g.*, News N Economics, Failed Bank List Surprises: Consolidation? (last visited Feb. 10, 2010) http://www.newsneconomics.com/2009/04/failed-bank-list-surprises.html (graphically depicting the annual rate of bank failures since 1934.)

of residential mortgage backed securities ("RMBSs") are misguided, however, and ought to be eliminated in the final bill. The information-forcing provisions will already achieve what the structural regulations are intended to, and the double protection may reduce overall efficiency of securitization vehicles in the area.

US law provides the FDIC with significant power over the assets of insured banks in its receivership, even if those assets are pledged as part of a security agreement.[2] It is prudent for the FDIC to promulgate regulations establishing a safe harbor within which the FDIC will permit securitization partners to obtain the insured bank's assets in accordance with their agreement, both to reduce uncertainty for prospective securitization partners and to exert a positive constraining influence on the destructive potential of reckless securitization. Recognizing both the dangers and benefits of securitization, I suggest the FDIC structure its proposed regulations to maximize information available to prospective securitization partners and impose restrictions tying securitization payments to the performance of the underlying assets. These two controls will be sufficient to remedy the principal-agent problems inherent in securitization as we now know it, and the FDIC need not impose additional structural constraints,[3] which would decrease the liquidity provided by securitization while not providing substantially more protection against the risks of continued securitization use.

1. Safe harbor should be confined to those securitizations that tie payout to performance of the underlying assets.

Responsible securitization must provide adequate incentives for the purchasers to independently verify that the underlying assets are priced effectively, rather than trusting the originators or guarantors of tranch payments. Thus, it is prudent to confine the FDIC safe harbor to securitizations free of any external credit support agreements.[4] With guarantees, purchasers would have little incentive to diligently investigate the merits of the underlying securities, leading to many of the same principal-agent problems observed in the past credit crisis. So long as the ultimate purchaser of the tranches has incentives to diligently research the underlying assets, the provisions

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[2] 12 U.S.C. §1821(e)(13)(C) (requiring a counterparty to a securitized agreement with an FDIC insured bank to receive FDIC permission before obtaining possession of the bank's assets) .

[3] *See* Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets . . . With a Securitization, 75 Fed. Reg. 934, 940 (Jan. 7, 2010) (to be codified at 12 C.F.R. pt. 360) (detailing that residential mortgage backed securities will be limited to six credit tranches) (*hereinafter* "ANPRM").

[4] *Id.* at 936 ("sponsors may have greater incentives to participate in securitizations of [well-underwritten] loans if payments of principal and interest on the obligations are primarily dependent on the performance of the financial assets supporting the securitization.").

requiring the originator to retain securitized assets and/or "season" the assets sold[5] are not necessary, and delay may be detrimental if they hamper the originator's ability to diversify its risk. The ban on external financing guarantees, coupled with a strong information-forcing requirement, is sufficient to ensure that securitization agreements are not recklessly written in the future.

2. FDIC ought to require originators to provide a high and ongoing level of information to investors to enable them to prudently price securitized asset tranches.

The FDIC is prudent to impose high information provision requirements on originators to disclose details of both the assets underlying the securitization as well as the structure of the securitization agreement.[6] The originator is the lowest cost provider of this information and it is vital to the accurate pricing of the securitized tranches. Incorporating the information provision cost into the securitization distribution structure seems an efficient way of apportioning the information costs, though this will likely be done whether or not FDIC requires it.[7] In sum, it is desirable that securitization partners are fully informed of the risks they are assuming, even if it entails lower returns, especially as the FDIC's proposed regulations will remove some of the other purchaser protections currently offered.[8]

3. The FDIC ought to require the same transparency across areas. Residential mortgage backed securities are not inherently more risky than other securitizations, and subjecting them to additional structural constraints will simply reduce the benefits of (responsible) securitization.

True securitization interests, purchased by well-informed buyers in arms-length transactions where they assume actual risk, are unambiguously beneficial to the US economy. They allow for risk diversification and provide liquidity. The FDIC proposal suggests heightened restrictions on mortgage-backed securitizations,[9] but there seems

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[5] *Id.* at 941 (describing proposed origination and retention rules, "retained interest may be . . . a representative sample of the securitized financial assets equal to at least five percent of the principal amount").

[6] *Id.* at 940.

[7] *See* TYI, LLC, comment *on* ANPRM, at 16 (Feb. 4, 2010) ("The cost of providing loan-level performance data daily should be built into the flow of funds (the waterfall) for each securitization transaction." Though it also bears mentioning that TYI, LLC stands to gain financially from greater information reporting requirements, and thus cannot be said to be a disinterested commenter in this matter. *See* TYI,LLC, White Paper, http://www.tyillc.com/whitepaper.).

[8] The FDIC proposal will prohibit securitizations with external credit guarantees from falling within its safe harbor, for example. *See* Section 1, *infra*.

[9] ANPRM, *supra* note 3, at 936 (noting that "there is no question that greater difficulties have been demonstrated in residential mortgage-backed securities," yet providing no sources to establish this point.) I would caution against conflating correlation and causation when looking at the role RMBSs played in the economic crisis. The securitization of any pool of risky assets will be prone to the detrimental effects experienced if neither the originator nor the purchasers have the information or

to be no greater economic risk incurred by taking a mortgage-backed security interest, just because the underlying risky asset stream happens to be tied to real-estate-based obligations.[10] The heightened restrictions imposed upon this class of securitized assets, such as the six tranch limitation,[11] inefficiently reduce the liquidity to be gained by securitization in this area. The problem during the credit crisis was a lack of information about the underlying assets (and an overreliance on outside ratings agencies), not risk idiosyncratic to the housing market. The information forcing and incentive alignment regulations contemplated elsewhere in the FDIC's proposal remedy this problem. Constraining the tranches, as proposed rule 12 C.F.R. 360.6(b)(1)(ii)(A) outlines, will simply reduce the flexibility of securitization in this area.

Undoubtedly, the rise of securitization exacerbated America's recent financial troubles. The FDIC is prudent to use its power to curtail the origination of reckless securitization agreements, and wise to refrain from imposing too much of a damper on this useful financial tool. Increasing information and the incentives to accurately price securitized assets, as this ANPRM proposes, will remove a significant and unnecessary risk from the economy. While necessary and generally well-designed, the proposal goes too far in one notable place – when it tries to regulate the structure of securitization. By imposing a command-and-control style regulation on the structure of mortgaged backed securitization agreements, the FDIC loses much of the flexibility that is securitization's strength as a financial instrument. Although this structural regulation is a mistake and ought to be removed, I believe the rest of the bill proposes fair, efficient, and useful constraints which will result in much more prudent use of securitization in the future.

Sincerely,

Timothy H. Shapiro

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incentives to make sure their securitized assets are priced accurately. This would be the case equally regarding the securitization of fruit futures as with mortgages in Phoenix.

[10] The experience of the past two years may suggest a correlation between securitization of mortgages and systemic risk (albeit with a sample size of one), but this is not grounds to infer causation.

[11] *See* ANPRM, *supra* note 3, at 940 (proposing amendments to 12 C.F.R. pt. 360.6(b)(1)(ii)(A) which would limit the capital structure of RMBS securitization "to no more than six credit tranches.").