United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS

WASHINGTON, DC 20510-6250

June 28, 2011

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RE: <u>Credit Risk Retention</u>

Dear Regulators:

The purpose of this letter is to comment on the proposed rule to implement Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).

Section 941 directs regulators to require sponsors of asset-backed securities (ABS) to generally retain at least 5% of the credit risk of "any asset that the securitizer, through the issuance of an [ABS], transfers, sells, or conveys to a third party." The section also authorizes regulators to exempt securitizers from the risk retention requirement if the underlying assets are "qualified residential mortgage[s]" (QRMs). Securitizers are generally prohibited from transferring or hedging their retained credit risk.

This letter will:

(1) describe how the investigative efforts of the Permanent Subcommittee on Investigations support Section 941's risk retention goal;
(2) while supporting the rule's general approach to risk retention, recommend against the horizontal risk retention alternative for residential mortgage backed securities;

(3) recommend applying the risk retention requirement to synthetic ABS;
(4) address issues related to the QRM exemption; and
(5) discuss how the risk retention requirement interacts with the Merkley-Levin provisions (Section 619), which, *inter alia*, restrict proprietary trading by banking entities and others.

Subcommittee Investigation

The U.S. Senate Permanent Subcommittee on Investigations, which I chair, conducted a two-year, bipartisan investigation into key causes of the financial crisis. One focus of the Subcommittee's work relevant to this proposed rulemaking was the role of high risk, poor quality mortgage products that resulted in the creation of high risk, poor quality residential mortgage backed securities (RMBS).

The investigation's first case study was of Washington Mutual Bank (WaMu), a $300 billion thrift that became the largest bank failure in U.S. history. Over a five-year period from 2003 to 2008, WaMu's mortgage portfolio shifted from low to high risk loans in an attempt to maximize bank profits from the sale or securitization of those high risk products. The bank's fixed rate mortgage originations, for example, fell from 64% of its mortgage originations in 2003 to 25% in 2006, while its subprime, Option ARM, and home equity originations jumped from 19% of originations to 55%. At the same time, Washington Mutual engaged in a variety of high risk lending practices which included: accepting loan applications without verifying the borrower's income; using loans with low initial teaser rates that could lead to payment shock when higher rates took effect later on; and promoting interest-only and negatively amortizing loans in which many borrowers increased rather than paid down their debt.

The WaMu case study also showed how the bank sold or securitized its high risk, poor quality loans, contaminating the U.S. mortgage market as a whole and injecting risk into the holdings of many other financial firms. The loans and RMBS issued by WaMu's subprime lender, Long Beach Mortgage Corporation, for example, were widely known as among the most poorly performing in the marketplace, yet the lender was able to sell them domestically and abroad using its own personnel or Wall Street underwriters. When asked about Long Beach, WaMu's chief credit officer testified at a Subcommittee hearing that he thought the bank was less concerned about the quality of those loans because they were routinely sold or securitized and the risk was passed on. The Subcommittee's investigation found that WaMu even securitized mortgages that had been identified by its personnel as containing fraudulent borrower information or indicators of likely default. The bank's shoddy lending and securitization practices not only led to the downfall of Washington Mutual, but were emblematic of the practices at many other mortgage lenders, demonstrating how high risk, poor quality loans contributed to the financial crisis.

The Subcommittee also examined the role of investment banks in the financial crisis, using Goldman Sachs as a case study to take a deeper look at the mortgage related securities they issued and sold, in particular collateralized debt obligations (CDOs). For example, in one synthetic CDO highlighted by the Subcommittee, Anderson Mezzanine Funding 2007-1, Goldman assembled $500 million in credit default swaps referencing mortgages issued by lenders that Goldman knew were issuing high risk, poor quality loans. When investors questioned those assets, in particular mortgages issued by New Century, Goldman attempted to dispel their concerns, while failing to disclose that it had the same negative view of the mortgages, held 40% of the short side of the Anderson CDO, and stood to profit if its assets lost value.

In another example, Abacus 2007-AC1, Goldman represented to investors that an independent party, ACA Management LLC, had selected the assets in the $1 billion CDO, without also disclosing that Paulson & Co., a hedge fund that held 100% of the short side of the CDO and had economic interests directly adverse to the investors, had been significantly involved with selecting the assets to be included in the CDO. The SEC later filed a civil complaint against Goldman in connection with this CDO that Goldman settled by paying $550 million.

In a third example, Hudson Mezzanine Funding 2006-1, Goldman used a mortgage-related CDO to transfer the risk associated with some of its own assets into the CDO, added additional assets, and then secretly took and held 100% of the short side of the CDO, essentially betting that the $2 billion Hudson CDO would lose value. Goldman sold the Hudson securities to clients without disclosing its short position or the origin of the assets. In all three of these transactions, Goldman Sachs did not meaningfully disclose to investors key adverse information, and the investors collectively suffered billions of dollars in losses. In the case of Hudson, Goldman misled customers by representing that Goldman and the potential buyers' incentives were aligned when, in fact, they were 99% in opposition.

In each of the securitizations examined by the Subcommittee, a well-designed risk retention requirement could have better aligned the incentives of the securitizer with those of the ultimate investors. To address this problem, in April 2011, the Subcommittee released a report, WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE, which included bipartisan recommendations that federal regulators issue a "strong risk retention requirement under Section 941," while providing a qualified residential mortgage exemption for mortgages that have "a low risk of delinquency or default."

Risk Retention

As directed by Section 941, the proposed rule generally requires ABS securitizers of various types of securities to retain at least 5% of the credit risk for the securities they issue. The proposal faithfully carries out this statutory direction.

Exemptions. Also in response to Section 941, the proposed rule reflects different risk retention requirements for securitizations of different asset classes, and authorizes a number of exemptions. For example, the proposed rule would require no risk retention for ABS collateralized exclusively by commercial loans, commercial mortgages, or automobile loans that meet certain high-quality underwriting standards. These exemptions are appropriate if the criteria (and thresholds) used to identify high-quality, low risk loans are carefully set and monitored.

With respect to automobile loan securitizations, the rule should consider expanding the term "automobile loan" to include other appropriate types of automobile-related loans, including loans to finance commercial fleet purchasers, loans for motorcycles, and loans for dealer floorplan financing. In addition, the criteria used to exempt automobile loans from the risk retention requirement should reflect the characteristics of that particular securitization market, rather than use criteria that may be more appropriate to mortgage securitizations. For example, the proposed loan-to-value restriction on automobile loans does not appear to take into account that the loan is often for a depreciating asset and may finance taxes, titling fees, and other products and services.

In the mortgage area, the proposed rule effectively exempts Federal National Mortgage Association (Fannie Mae) and the Federal Home Mortgage Loan Corporation (Freddie Mac) loans so long as those entities remain in conservatorship or receivership. Since it is likely that those entities will remain wards of the U.S. government for an extended period of time, this exemption is justified if the U.S. government also takes steps to ensure that Fannie Mae and Freddie Mac loans are only high quality, low risk loans.

Synthetic ABS. Finally, the proposed rule exempts all synthetic securitizations from any risk retention requirement.[1] Although some argue that this exemption is required by the statute, Section 941 applies to all asset-backed securities "collateralized by self-liquidating financial instruments" and could reasonably be interpreted, and should be interpreted, to include synthetic instruments that reference, in whole or in part, self-liquidating financial instruments. Synthetic CDOs in the years leading up to the financial crisis, for example, were routinely collateralized with credit default swaps (CDS) referencing RMBS and derived their value from those referenced assets. Since synthetic securities that reference self-liquidating financial instruments are inherently reliant upon the referenced assets for their value, it is reasonable to include them within the definition of ABS. Moreover, given the multiple abuses involving synthetic CDOs examined by the Subcommittee, including Anderson, Abacus, Hudson, and Timberwolf, in which the CDOs referenced a host of poor-quality, high-risk assets and the securitizer bet or allowed a favored client to bet on the assets losing value over time, the need for risk retention requirements to align the securitizer's incentives with those of the CDO investors is compelling. In addition, an unintended consequence of excluding them from any risk retention requirement could likely be to create a new incentive for securitizers to issue synthetic ABS. For these reasons, the rule should be expanded to apply its risk retention requirements to synthetic ABS with collateral that references, in whole or in part, self-liquidating financial instruments. Those synthetic ABS would then be subject to risk retention in the same manner as their underlying assets.

Risk Retention Alternatives. For ABS subject to risk retention requirements, the proposed rule provides sponsors with the ability to choose among several options for retaining the required risk, including:

- retention of risk by holding at least 5% of each class of ABS issued in a securitization transaction (also known as vertical retention);
- retention of a first-loss residual interest in an amount equal to at least 5% of the par value of all ABS interests issued in a securitization transaction (horizontal retention);
- an equally-divided combination of vertical and horizontal retention;

[1] See footnote 32 in the proposed rule ("Because the term 'asset-backed security' for purposes of section 15G includes only those securities that are collateralized by self-liquidating financial assets, 'synthetic' securitizations are not within the scope of the proposed rules.")

- retention of a representative sample of the assets designated for securitization in an amount equal to at least 5% of the unpaid principal balance of all the designated assets; and
- for commercial mortgage-backed securities, retention of at least a 5% first-loss residual interest by a third party that specifically negotiates for the interest, if certain requirements are met.

While the flexibility contained in the proposed rule makes sense given the wide variety of ABS products sold in U.S. markets, allowing RMBS securitizers to meet their risk retention requirement by retaining a horizontal, first-loss residual interest is troubling. That option would essentially allow RMBS securitizers to retain the equity tranche at the bottom of their securitizations, which is the tranche that is likely the most difficult to sell. Authorizing retention of the equity tranche would, however, replicate the same practice that was prevalent during the run-up to the financial crisis. History has already shown that retaining the equity tranche was not enough to align the securitizer's incentives with those of investors in the securitization's other tranches. In the case of Hudson, the value of the equity tranche held by Goldman was only 0.3% of the short side of the position it held in the CDO.

Given recent history, although retaining a horizontal residual interest tranche may be appropriate in other types of securitizations, it should not be an available option for RMBS. The history of RMBS is in contrast to, for example, automobile-related securitizations (including automobile loans and leases and dealer floorplan financing) with horizontal interests that are:

(1) junior to all investor-held securities in their right to receive payments received on the pool;
(2) structured to be the first ABS interests in the securitization to absorb losses on the pool; and
(3) often structured to increase in size over the life of the transaction as excess collections are directed to the investor-held securities to increase "overcollateralization" rather than pay the residual interests.

These automobile-related securitizations weathered much of the financial crisis, in part because their retained residual interests protected investors from principal and interest losses – even as borrower delinquencies and defaults peaked. The viability of these securitizations in a time of economic stress indicates it may be appropriate to allow automobile-related securitizations to continue to rely on horizontal risk retention.

Hedging. With respect to hedging, the proposed rule would allow sponsors to hedge against the credit risk inherent in their retained securities in general ways, such as through hedges related to overall market movements and hedges tied to securities backed by similar assets originated and securitized by other sponsors. The proposed rule would not, however, allow sponsors to engage in hedges that are materially related to the risk of their *particular* retained interests. This approach reasonably carries out the intent of Section 941, although as a practical matter, firms will need to revise their policies, procedures, and practices to appropriately distinguish between general hedges and specific hedges. To aid firms in developing these distinguishing mechanisms, regulators should provide additional guidance on what constitutes permissible and impermissible hedges, including the development of additional examples in the rule and perhaps the issuance of opinion or no action letters in response to particular inquiries.

Qualified Residential Mortgages

In drafting Section 941, Congress recognized that some types of assets were so inherently safe that a risk retention requirement for an ABS collateralized with those assets was both unnecessary and could potentially hurt consumers' ability to obtain reasonably-priced credit. In the area of ABS backed by residential mortgages, Congress explicitly exempted securitizers from the risk retention requirement if the securitization contained only "Qualified Residential Mortgages" (QRMs). Congress provided some statutory guidance on the criteria used to identify QRMs, but then left it to regulators to further define the term.

Defining QRM in a way that mitigates systemic risk without hurting the ability of families to buy homes requires striking a balance. If the requirements to qualify as a QRM are too strict, only a small number of loans would be exempt from the risk retention requirement. This narrow definition could lead to more expensive mortgages, and leave many creditworthy borrowers without access to affordable credit. On the other hand, if the requirements are too easily met, then the risk retention requirement would become effectively meaningless. The touchstone for striking an appropriate balance should be to ensure that only low risk mortgages can be securitized and sold without any risk retention by the securitizer.

In addition, the credit risk retention requirement does not stand alone – it works in tandem with other parts of the Dodd-Frank Act that are intended to ensure safer mortgages, such as new residential mortgage loan origination standards and restrictions on steering payments for loan sales personnel. Further, the definition of QRM should also be construed in conjunction with the "Qualified Mortgage" safe harbor established under Section 1412 of the Dodd-Frank Act.

As an initial matter, the proposed rule sets forth a system where, in order to qualify as a QRM, a loan would have to pass a series of independent, threshold tests based on distinct criteria. These tests fall into two general categories, those based on loan characteristics and those based on the credit risk of the borrower.

The first set of tests focus on criteria related to characteristics of mortgage products and would exclude interest-only loans, negatively amortizing loans, loans with balloon payments, and loans that allow significant mortgage payment increases that could lead to payment shock.[2] The Subcommittee's work shows that mortgages containing these features are at higher risk of default and provides a factual foundation for excluding loans with these characteristics from falling within the QRM category. A QRM loan should also be supported by a qualified appraisal that conforms to the Uniform Standards of Professional Appraisal Practice and federal requirements, which is another criteria that the Subcommittee's investigation supports.

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[2] The proposed rule would allow adjustment rate mortgages (ARMS), for example, to qualify as a QRM only if a mortgage payment increase would not exceed two percent in any 12 month period or six percent over the life of the mortgage.

The second set of tests, which relate to borrower creditworthiness, are more difficult to address. This set of tests focuses on objective metrics that are commonly used by lenders in underwriting residential mortgages, such as borrower credit histories, loan-to-value ratios, debt-to-income ratios, down payment percentages, and payment terms. Under the proposed rule, failure to meet any one of the specified creditworthiness criteria would disqualify a loan as QRM.

As currently proposed, the primary creditworthiness criteria that would have to be met to qualify a mortgage as a QRM would be: a first-lien property, a loan-to-value (LTV) ratio maximum of 80%, a down payment of at least 20%, a back-end debt-to-income (DTI) ratio maximum of 36%, and the absence of any "derogatory" credit history factors, such as a borrower being 30 days past due currently on any credit obligation, 60 days past due on any debt in the past two years, or having undergone a foreclosure or bankruptcy in the past three years.

This approach, in which each independent metric essentially acts as a tripwire to disqualify a loan as QRM, is inconsistent with Congressional intent and is not reflective of modern underwriting and risk management practices. Today, lenders consider such metrics together as a whole, and routinely and reasonably allow a higher-risk factor to be offset by other lower-risk factors. For example, a borrower with significant liquid assets, a steady job, and a low DTI ratio would likely pose very little risk of default. Allowing this creditworthy borrower to buy a home with a 10% down payment and 90% LTV loan would likely produce a mortgage with a very low risk of default, yet under the proposed rule, it would not qualify as a QRM. Forcing this type of borrower to make a 20% down payment in order for the related loan to qualify as a QRM may result in decreasing the availability of affordable credit without producing noticeably safer mortgages. The proposed rule should allow the creditworthiness metrics to be considered collectively on a per loan basis. In this way, a moderately "riskier" measure on any one of the objective criteria could be mitigated by "safer" measures on other criteria.

The creditworthiness criteria used to define a QRM should also be those that respected research has shown are necessary to accurately determine which mortgages can reasonably be deemed the safest. Congress provided some guidance in the statute, but did not provide an exhaustive list of what creditworthiness metrics should be used. While the proposed rule identifies metrics that research has shown to be good risk indicators, some of the criteria should be revised to reflect their relative impact on credit risk.

First, the creditworthiness criteria that would exclude borrowers who experienced a 30 or 60-day late payment over the previous 24 months, if included in the final rule, should be revised to require a degree of materiality with respect to the late payment. Being 30 days late on an objectively small debt payment should not disqualify an otherwise qualified borrower from obtaining a QRM loan.

Second, while LTV and down payment criteria may be appropriate risk indicators, imposing an 80% LTV threshold and a 20% down payment requirement would be overly strict. Research has shown that mortgages with down payments of significantly less than 20% may not be significantly more likely to default than loans with a 20% down payment, if other metrics reflecting a low risk loan are present. That is why LTV and down payment criteria should, as suggested earlier, be considered in combination with other creditworthiness criteria on a per loan basis.

Third, as with the LTV and down payment criteria, DTI ratios may be an appropriate risk indicator for residential mortgages, but should not be viewed in isolation. Imposing a DTI threshold of 36%, as indicated in the proposed rule, seems overly severe in light of research showing that higher DTI ratios may produce loans with very low default rates, so long as other creditworthiness metrics and loan characteristics reflecting a low risk loan are present. The DTI criteria should not be set at a level that precludes creditworthy borrowers from home ownership.

Fourth, the proposed rule currently makes no mention of mortgage insurance as a risk-reducing factor that could mitigate, for example, higher LTV or DTI ratios. As the Subcommittee pointed out in its report,[3] federal interagency guidance dating back to 1993 has accounted for the use of mortgage insurance to offset the risk of higher LTV loans.[4] The QRM exemption should consider the role of mortgage insurance as a longstanding tool used to mitigate risk in some loans.

Interaction with Merkley-Levin Provisions

Section 941, which requires securitizers to retain portions of the securities they issue, must also be interpreted in relation to Section 619, which, *inter alia*, restricts banking entities from engaging in proprietary trading. The risk-retention requirement could, at first blush, be viewed as potentially inconsistent with the Merkley-Levin restrictions, which generally prohibit firms from keeping proprietary holdings in their "trading account, or any such other account." These two provisions can, however, be construed in a way to achieve their mutually consistent goals of minimizing institutional and systemic risk.

First, if a banking entity is truly acting as a market maker or underwriter of ABS, retaining the regulatorily-mandated slice of credit risk in its long-term investment book—as opposed to its short-term trading book—would be consistent with the Merkley-Levin provisions. On the other hand, if the bank is intentionally engaging in securitizations ***for the purpose of retaining the risk*** – in other words, the banking entity is seeking to build up and retain a long mortgage exposure, then its actions may run afoul of the Merkley-Levin provisions. In addition, if the bank is intentionally or negligently retaining certain portions of the securitization to facilitate the sale of other portions of the securitization, then such actions may also run afoul of the Merkley-Levin provisions for failing to meet the requirement that the market-making and underwriting not exceed the reasonably expected demands of clients.

[3] Subcommittee Report, Vol. 5 of 5 Part I, at p. 119 and fn. 299.

[4] 10/8/1999, "Interagency Guidance on High LTV Residential Real Estate Lending," http://www.federalreserve.gov/boarddocs/srletters/1993/SR9301.htm ("[F]or any [ ] loan with a loan-to-value ratio that equals or exceeds 90% at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.").

In order to make the distinction between permitted underwriting and market making and impermissible proprietary trading, regulators should require covered firms, among other measures, to:

- identify at the time a portion of an ABS is retained, why the ABS is being retained, including whether the action was taken to meet a risk retention requirement;
- identify where within the firm the decision to retain the portion of the ABS was made;
- indicate how the retained portion of an ABS will be reflected on the firm's books, such as whether it will be included in the firm's long term investment book or short-term trading book;
- if a portion of an ABS was retained to meet a risk retention requirement, identify what efforts would be made to mitigate the risk over time, including where within the firm the retained risk would be monitored and what hedges would be allowed;
- implement policies and procedures to classify and monitor retained ABS risks to prevent proprietary trading; and
- develop compensation policies and practices that do not reward proprietary trading, such as by rewarding profits earned from a retained ABS.

Regulators examining compliance with the Merkley-Levin provisions could then periodically review a firm's information on its ABS holdings and related hedges, as well as its policies and procedures, to ensure that the banking entity is not accumulating a proprietary position in its own ABS.

Enforcement Mechanism

Finally, the federal agencies charged with implementing Section 941 should amend their routine oversight procedures to include monitoring and enforcing compliance with the new rule, including by adding new provisions and checklists to the examination standards for reviewing an entity's securitizations. All securitization sponsors should be held to the same examination standards to ensure that others do not gain a competitive edge by shirking the requirements of the rule.

Thank you for the opportunity to comment on this proposed rule.

Sincerely,

Carl Levin

Carl Levin
Chairman
Permanent Subcommittee on Investigations