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January 25, 2010

The Honorable Barney Frank  
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U.S. House of Representatives  
Washington, DC 20515

The Honorable Christopher Dodd  
Chair, Committee on Banking, Housing  
and Urban Affairs  
United States Senate  
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The Honorable Richard Shelby  
Ranking Member, Committee on Banking,  
Housing and Urban Affairs  
United States Senate  
Washington, DC 20510

Re: Financial Reform Legislation — Asset Securitization Reforms

Gentlemen:

As you and other members of Congress continue to work toward adopting financial regulatory reform measures, we wanted to bring to your attention the enclosed paper, "Securitization in the Post-Crisis Economy: An ABA Business Law Section White Paper" (the "Securitization White Paper"). The views expressed in the Securitization White Paper are presented by the ABA Section of Business Law (the "Section") on behalf of its Committees on Securitization and Structured Finance and Banking Law (the "Committees"). The Securitization White Paper also has been reviewed by the ABA Task Force on Financial Markets Regulatory Reform, which endorses the Section's action in bringing the paper to your attention. The views expressed in the Securitization White Paper have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the policy of the American Bar Association.

Following the Obama Administration's announcement of its proposed securitization reforms and recognizing securitization's critical role both to the availability of consumer credit and to corporate liquidity, in the Fall of 2009 the Committees formed a drafting

committee of lawyers with broad experience in the asset securitization and banking arenas. The Committees believed that a “white paper” describing securitization’s history, structures, economics, and role in the economic crisis, and discussing some of the possible effects of the proposed reforms, could educate readers and assist policymakers in formulating a targeted approach to securitization that would avoid unintended consequences.

In particular, the drafting committee was concerned that a “one size fits all” approach to risk retention and disclosures is unlikely to work for securitization, which is more varied in its structures, assets and economics than most observers realize. Efforts to address issues relating to mortgage-backed securities—which have been the driver of the proposed reforms—may be inappropriate for other asset classes such as credit cards, auto loans and other non-mortgage assets. The Securitization White Paper notes that “Securitization is critical to the availability of consumer credit and corporate liquidity, and any efforts to alter securitization practice need to be narrowly tailored so they do not make securitization so difficult or onerous that it is no longer able to continue its important role in the economy.” (Securitization White Paper at 26.)

The most critical takeaway from the Securitization White Paper is the need for significant regulatory flexibility, especially in the following areas:

- ***Risk retention requirements:*** There is very little empirical information about the effects of risk retention and the appropriate form, levels and seniority of retained risk. Securitizations in most asset classes currently include significant retention of risk, but the form and amount of retained interests depends on the asset class and the overall transaction structure. The Securitization White Paper notes: “Legislative mandates that, intentionally or unintentionally, change the economics of securitization, including those to require a 5% or 10% retained risk exposure to securitized assets, have the greatest risk of unintended consequences, including possible elimination of securitization as a funding source entirely. For instance, these requirements may make it difficult or impossible to conclude that the assets have been transferred in a ‘true sale,’ which is one of the core protections for investors in securitizations.” (*Id.*) If regulators are given sufficient authority, including exemptive authority, to adapt risk retention requirements as needed to support securitization as a funding source for consumer and other credit, there will be less risk that the legislation will unintentionally constrain crucial liquidity.
- ***Disclosure and reporting:*** As the Securitization White Paper notes, “Legislative and regulatory approaches that focus on closing gaps in disclosure that have been identified during the market upheavals may provide meaningful additional transparency and facilitate risk assessment. More disclosure is not always better disclosure, however, and any expansion of disclosure requirements needs to be evaluated in light of the reliability of the requested information, the costs of producing it, whether the information requested is so proprietary that the requirement will cause participants to exit the market rather than disclose such

information, and the value to investors and others that it is expected to bring.” (*Id.* at 39.) For example, the Securitization White Paper discusses the difficulties that requirements for loan level data may create for asset classes, such as credit cards, that involve millions of small assets rather than thousands of large ones; the lack of an appropriate infrastructure in existing deals to expand or extend reporting requirements; and the overall increase in costs that may accompany changes to disclosure regimes that may not provide additional material information. (*Id.* at 27-30.)

The Securitization White Paper also notes that “Industry efforts, such as The American Securitization Forum’s Project RESTART, which contemplates standardized representations and warranties and loan level reporting tailored to specific asset classes, are more likely to provide effective and sustainable market solutions with respect to the fundamental economics terms of securitizations than broad-brush legislative efforts to regulate the substance of these transactions.” (*Id.* at 39.) Regulatory flexibility would allow regulators to work with market participants and industry groups to develop these sustainable solutions.

On behalf of the Section, thank you for your consideration of the Securitization White Paper and the views expressed therein. The Committees and the Section stand ready to provide you with input on specific provisions of the proposed legislation upon request.

Sincerely,



Nathaniel Doliner  
Chair, ABA Section of Business Law

Attachment

cc: The Honorable Paul E. Kanjorski  
The Honorable Scott Garrett  
Members of the House Financial Services Committee  
The Honorable Jose Serrano  
The Honorable Jo Ann Emerson  
The Honorable Jack Reed  
The Honorable Jim Bunning  
Members of the Senate Banking, Housing and Urban Affairs Committee  
The Honorable Richard J. Durbin  
The Honorable Susan M. Collins

January 25, 2010

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Vicki O. Tucker, Chair, Securitization and Structured Finance Committee, ABA  
Section of Business Law

Sally Miller, Chair, Banking Law Committee, ABA Section of Business Law

Ellen L. Marks, Chair, Securitization White Paper Drafting Committee

Members of the Securitization White Paper Drafting Committee

Susan Daly, Director, ABA Section of Business Law

Alpha Brady, Director, ABA Policy Administration

Thomas M. Susman, Director, ABA Governmental Affairs Office

# **SECURITIZATION IN THE POST-CRISIS ECONOMY: AN ABA BUSINESS LAW SECTION WHITE PAPER**

**November 20, 2009**

The Committee on Securitization and Structured Finance and the Committee on Banking Law of the Section of Business Law of the American Bar Association have jointly prepared this paper<sup>1</sup> to help inform policymakers and their advisers about securitization, its role in the financial markets, and the potential effects of the legislation addressing securitization that has been proposed by the Obama Administration and various members of Congress as part of a package of financial system reform proposals. The views expressed in this paper are presented by the ABA Section of Business Law on behalf of the Committee on Securitization and Structured Finance and the Committee on Banking Law. They have not been approved by the House of Delegates or Board of Governors of the American Bar Association, and therefore should not be construed as representing the policy of the ABA.

## **Executive Summary**

Securitization in its most common form is a technique that enables lenders to obtain funding by issuing securities that are supported by and paid out of cash receipts on their financial assets, such as residential mortgage loans, credit card loans, small business loans and auto loans or leases. Securitization is an important funding source for lenders providing consumer and corporate credit, and historically has provided important benefits to lenders, consumers and corporate borrowers alike. Key benefits that should be preserved include:

- Greater availability of mortgage loans, other consumer credit, and small business loans;
- Lower costs of borrowing for consumers and small businesses and for manufacturers of goods who use securitization to fund short-term customer invoices for their products;
- Lower costs of funding, enhanced liquidity, and diversified sources of funding for consumer and small business lenders;

For over thirty years, securitization investments were among the safest and most liquid securities that could be purchased, with elaborate structural and other safeguards that were carefully developed to support their high credit ratings. Legislative and regulatory reform should be targeted at addressing weaknesses revealed by recent performance issues, but there is no reason to believe that securitization or its structures are inherently flawed.

Legislative proposals have suggested mandating a 5% or 10% retention of risk by asset originators as part of the securitization process, based on the belief that this will align the interests of originators with the interests of investors and ensure less risky originations. Significant retention of risk and alignments of interest already exist in many transactions and asset classes, as we discuss in Appendix A. Moreover, although there are a handful of recent

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<sup>1</sup> A list of drafting committee members who prepared this paper for the Committee on Securitization and Structured Finance and the Committee on Banking Law is provided at the end of this paper.

studies, discussed elsewhere in this paper, that attempt to determine whether likelihood of securitization affects loan quality, we do not believe there is currently meaningful empirical evidence that either supports the risk retention proposals or predicts whether those proposals will improve securitization or merely eliminate it as a funding source for many institutions.

The following are some of the key observations discussed in this paper regarding legislative or regulatory changes to the securitization markets:

- Securitization is critical to the availability of consumer credit and corporate liquidity, and any efforts to alter securitization practice need to be narrowly tailored so they do not make securitization so difficult or onerous that it is no longer able to continue its important role in the economy. To date, the effects of fewer private investors in the securitization markets have been partially offset through government programs that purchase or provide financing for the purchase of asset-backed securities, or ABS, thereby replacing the liquidity of the market. These government programs are not an effective or desired long-term solution. We do, however, believe the programs demonstrate the government's endorsement of securitization as an integral and necessary component of the modern financial market.
- Legislative mandates that, intentionally or unintentionally, change the economics of securitization, including those to require a 5% or 10% retained risk exposure to securitized assets, have the greatest risk of unintended consequences, including possible elimination of securitization as a funding source entirely. For instance, these requirement may make it difficult or impossible to conclude that the assets have been transferred in a "true sale," which is one of the core protections for investors in securitizations. To the extent that the credit crunch in the U.S. has been exacerbated by the loss of access to the securitization markets, the continued loss of access to those markets as funding sources likely will result in significant liquidity issues for financial institutions and borrowers alike.
- If any form of mandatory risk retention is adopted, legislators and regulators should closely examine the existing substantial risk retention in various securitization models and define mandatory retentions in a way that gives credit for the existing retentions. In addition, legislators and regulators should consider whether the existing models of risk retention from other asset classes, such as auto loans, may provide useful approaches for risk retention in mortgage loan securitizations, as these existing models that have already been proven to be a sustainable part of a securitization program. We set out some of the aspects of existing risk retention in Appendix A.
- More empirical studies, especially studies that compare losses within securitizations that had significant risk retention by originators to losses within securitizations that did not have meaningful retained interests, should be conducted before Congress mandates specified levels of risk retention.
- A "one size fits all" approach to risk retention and disclosures is unlikely to work for securitization, which is more varied in its structures, assets and economics than most

observers realize. Most importantly, efforts to address issues relating to one asset class, such as mortgage-backed securities, may be inappropriate for other asset classes such as credit cards, auto loans, and other non-mortgage assets.

- Legislative and regulatory approaches that focus on closing gaps in disclosure that have been identified during the market upheavals may provide meaningful additional transparency and facilitate risk assessment. More disclosure is not always better disclosure, however, and any expansion of disclosure requirements needs to be evaluated in light of the reliability of the requested information, the costs of producing it, whether the information requested is so proprietary that the requirement will cause participants to exit the market rather than disclose such information, and the value to investors and others that it is expected to bring.
- The concept of an efficient market has been cast in serious doubt by events of the last two years. Altering securitization practices in an effort to improve origination practices for consumer loans is, at best, an indirect approach that may place the obligation of oversight on those who are too removed from the origination process to fulfill it effectively. A better approach, and one that is already part of some of the legislative proposals, may be to modernize regulatory oversight of the origination of consumer loans.
- Asset originators, and their regulators, should carefully assess the ways in which asset origination is rewarded within the organization; whether quantity is favored over quality; what cost and other constraints limit the loan diligence process and whether those have been shown to reflect an appropriate balance; and what systems, if any, are in place to evaluate and manage the risk of each individual asset origination in light of the risk profile of the organization as a whole.
- Investors in complex financial products, including securitizations and credit derivatives, should evaluate their aggregate counterparty credit risk, whether they can effectively unbundle such risk, and whether hedging strategies can effectively mitigate those risks.
- Industry efforts, such as Project RESTART from The American Securitization Forum (“ASF”), which bring together a wide range of participants in the market with deep knowledge of the related products, are more likely to provide effective and sustainable market solutions with respect to the fundamental economic terms of securitizations than broad-brush legislative efforts to regulate the substance of these transactions.

### **Introduction**<sup>2</sup>

Much of the recent debate about the future of securitization has focused on the events of the last two years and the role securitization has played in those events. It is particularly easy to

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<sup>2</sup> For purposes of this paper, we have focused only on proposals specifically addressed at securitization. We note, however, that a broad array of other proposals, including those relating to credit rating agencies, the banking system, and derivatives, potentially will also have a material effect on securitization, and consideration should be given to the aggregate effect of all such reforms.

assign blame to securitization because so few people really understand what it is, how it works, and why it is so important to the economy as a whole. Securitization is not new. Securitization transactions, which were developed by certain government-sponsored entities, or GSEs, demonstrated safe, stable performance for more than 30 years.<sup>3</sup> Only in the last 2 years have broad volatility and investor losses arisen in this sector.<sup>4</sup> Securitization provided crucial liquidity that first increased the availability of mortgage loans in this country, and later increased the availability of a broader array of consumer assets and corporate loans. It enabled lenders to diversify their sources of funding at a lower cost than had been previously available, and it led to lower borrowing costs for consumers.<sup>5</sup> Securitization is a crucial driver of the US economy, and essential to the reestablishment of robust economic growth.

Securitization was initially developed for first-lien consumer mortgages loans, and indeed represents a government-sponsored effort to increase homeownership by increasing liquidity, and facilitating lending in the housing market. There was little secondary market in mortgage loans, which were not attractive to most investors.<sup>6</sup> Savings and loan associations, or thrifts, depended on funds from their local branch deposits to finance local housing demand.<sup>7</sup> The Great Depression highlighted some of the systemic vulnerabilities relating to mortgage loans,<sup>8</sup> and in response, Congress enacted the National Housing Act of 1934, which was intended in part to

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<sup>3</sup> For example, Fitch Ratings reports that for the period between 1991 and 2007, the average annual rate of default for all structured bonds rated investment grade (not merely AAA) by Fitch was 0.17%. Fitch Ratings 1991-2007 Global Structured Finance Transition and Default Study, March 18, 2008, available at [http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=383102](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=383102) Similarly, according to Moody's research reports, between 1994 and 1997 *no* asset-backed securities, excluding mortgage-related losses, suffered any impairment. For all Aaa-rated securities, Moody's showed a lifetime impairment of 0.08% through 2006. Moody's Rating Service, Special Comment, Default and Loss Rates of Structured Finance Securities, 1993-2006.

<sup>4</sup> See Moody's Rating Service, Special Comment, Default and Loss Rates of Structured Finance Securities, 1993-2008.

<sup>5</sup> See, e.g., Faten Sabry & Chudozie Okongwu, Study of the Impact of Securitization on Consumers, Investors, Financial Institutions and the Capital Markets 119, NERA Economic Consulting, June 17, 2009, available at [http://www.nera.com/publication.asp?p\\_ID=3859](http://www.nera.com/publication.asp?p_ID=3859); Randall S. Kroszner, Governor, Improving the Infrastructure for Non-Agency Mortgage-Backed Securities, Address at the Federal Reserve System Conference on Housing and Mortgage Markets, Washington, D.C. (Dec. 4, 2008) (transcript available at <http://www.federalreserve.gov/newsevents/speech/kroszner20081204a.htm>) (regarding limits of model-based risk management practices and "knock on" effects).

<sup>6</sup> Sabry, *supra* note 5, at 21.

<sup>7</sup> Steven L. Schwarcz, Structured Finance: A Guide to the Principles of Asset Securitization 1:2 (Practising Law Institute, 3rd ed. 2008).

<sup>8</sup> See, e.g., Peter M. Carrozzo, A New Deal for the American Mortgage: the Home Owners' Loan Corporation, the National Housing Act and the Birth of the National Mortgage Market, 17 U. MIAMI BUS. L. REV. 1, 7 (2008) (quoting National Housing Act: Hearing on S. 3603 Before the Senate Comm. on Banking and Currency, 73d Cong. 2, 50 (1934)); Richard E. Mendales, Collateralized Explosive Devices: Why Securities Regulations Failed to Prevent the CDO Meltdown, and How to Fix It, 2009 U. ILL. L. REV. 1359, 1365 (2009) (stating that the drafters of the National Housing Act were trying to create a secondary mortgage market, which had collapsed during the Great Depression); Silver Homes, Inc. v. Marx & Bensdorf, Inc., 206 Tenn. 361, 365 (1960) (noting that congressional concern about the number of people who could not qualify for mortgage loans motivated passage of the National Housing Act).

create a secondary mortgage market.<sup>9</sup> The National Housing Act created the Federal Housing Administration, or FHA, which in turn organized the Federal National Mortgage Association, or FNMA, in 1938, to provide liquidity to the primary mortgage market.<sup>10</sup> FNMA, as a government-sponsored enterprise or GSE, purchased mortgage loans from some institutions and sold them to others.<sup>11</sup> By purchasing whole loans from mortgage lenders, FNMA provided a means for lenders to obtain more cash so that they could make more loans, thereby increasing liquidity in the mortgage market.<sup>12</sup> FNMA bought and sold mortgage loans nationwide. Therefore, thrifts were able to limit their reliance on local deposits and increase their access to funding.<sup>13</sup>

In 1968, Congress divided FNMA into two entities: FNMA (which later changed its name to Fannie Mae), a federally chartered but privately owned corporation which continued to serve its original role, and the Government National Mortgage Association, or Ginnie Mae,<sup>14</sup> which is a wholly owned corporate instrumentality of the U.S. government within the U.S. Department of Housing and Urban Development. Ginnie Mae is authorized “to purchase, service, sell or otherwise deal in any mortgages” that are guaranteed by the FHA or the VA, the U.S. Department of Veteran Affairs.<sup>15</sup> Ginnie Mae created the first mortgage pass-through security in 1970, pooling mortgage loans with similar quality, terms and interest rates in a trust and selling certificates of ownership to investors that represented fractional undivided interests in the pool of mortgage loans. Investors received a pro rata share of the interest income and principal payments generated by the mortgage loans in the pool, and likewise bore a proportionate share of the credit risk of the loans.<sup>16</sup> The fundamental premise behind this type of structure was simple and powerful: rather than bear the risk of investing in individual loans, capital markets investors could invest in a diversified pool in which their exposure to any one loan was relatively small, and they could judge their overall risk by looking to the risk characteristics of the pool as a whole.

Congress also created, in 1968, the Federal Home Loan Mortgage Corporation, or Freddie Mac (also a GSE), to further expand mortgage liquidity. In 1983, Freddie Mac issued the first collateralized mortgage obligation, or CMO,<sup>17</sup> a structure that directs payments to certain classes of debt securities in a specified order, allowing for different interest rates, payment schedules, and maturity dates.<sup>18</sup> The Tax Reform Act of 1986 created the real estate

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<sup>9</sup> National Housing Act of 1934, 12 U.S.C. §1716 et seq. (2006).

<sup>10</sup> Federal National Mortgage Association Charter Act, 12 U.S.C. § 1716 et seq. (2006).

<sup>11</sup> See Gary J. Silversmith, et al., *Mortgage-Backed Securities: Developments and Trends in the Secondary Mortgage Market* 21 (Thomson-West Editorial Staff, 2008-2009 ed.); Gary J. Silversmith, *TAX Management Portfolios: REMICs, FASITs and Other Mortgage-Backed Securities A-1* (1999), (hereinafter referred to as “TMP”).

<sup>12</sup> Sabry, *supra* note 5, at 22.

<sup>13</sup> The geographic benefits of this arrangement are discussed below.

<sup>14</sup> 12 U.S.C. § 1717(a)(2)(A) (2006).

<sup>15</sup> See *id.* at §1717(b)(1).

<sup>16</sup> Schwarcz, *supra* note 7, at § 1:2.

<sup>17</sup> Silversmith, *supra* note 11, at 85.

<sup>18</sup> See *id.*

mortgage investment conduit, or REMIC, as a new means of facilitating the issuance of multi-class mortgage-backed securities, also referred to as MBS, without adverse tax consequences.<sup>19</sup> These new types of structures, which originally focused on mitigating, for some investors, the risk that a loan would prepay as a result of a sale or refinancing of the property, enabled “tranching” of risks (i.e., by dividing the securitization into different classes) and moved these transactions away from the more straightforward pass-through structures of the original deals. Investors could choose the level of risk they were willing to accept by trading off yield, so that a senior tranche would have a high rating but a low interest rate, and a subordinate tranche, bearing more of the credit risk of the pool, would have a lower rating or no rating but a significantly higher interest rate.

Since their inception, Fannie Mae, Freddie Mac and Ginnie Mae have focused on purchasing and securitizing loans that conform to certain standards of credit quality and loan size.<sup>20</sup> In 1977, Bank of America issued the first rated, Securities and Exchange Commission (“SEC”)-registered secondary market private-label (i.e., non-agency) MBS.<sup>21</sup> Other private label issuances of residential mortgage-backed securities, also known as RMBS, soon followed. As the securitization market expanded and focused more and more on achieving high-level ratings for the senior-most tranches, including ratings significantly higher than those of the entity originating or transferring the assets, it became critical to ensure that the assets were held separate from the originator or transferor and would not be subject to the originator’s or transferor’s insolvency risk. This separation, referred to as “legal isolation,” became one of the core elements of securitizations. Over time, triple-A rated RMBS came to be perceived as among the safest and most liquid investments.

The real estate securitization sector expanded over time to include commercial mortgage-backed securities, or CMBS, and securitizations of home equity lines of credit, also known as HELOCs. The initial impetus for the growth of the commercial MBS market was the Resolution Trust Corporation (the “RTC”), which Congress created in 1989 in connection with the bailout of the savings and loan industry. The RTC was responsible for overseeing the disposal of the billions of dollars of assets acquired by the U.S. Government from failed savings and loan associations and thrifts. Much of these assets consisted of undesirable real estate and troubled commercial mortgage loans and ventures. The RTC developed a variety of strategies to dispose of these assets, including auctions of pools of the assets and securitization. By the time the RTC shut down at the end of 1995, it had accounted for nearly \$50 billion of single-family, multifamily and commercial mortgage-backed securities, and was the most active “private-label” MBS issuer in 1991 and the second most active in 1992.<sup>22</sup>

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<sup>19</sup> Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986); *see also* TMP, *supra* note 11, at A-36.

<sup>20</sup> Sabry, *supra* note 5, at 24. In 1980, Fannie Mae and Freddie Mac securitized approximately \$78 billion of residential mortgage loans in the aggregate. In contrast, from January through July of 2009, the three GSEs (Fannie Mae, Freddie Mac, and Ginnie Mae) have issued \$1.197 trillion in mortgage-backed securities. *Id.*

<sup>21</sup> *See id.* at 27.

<sup>22</sup> Kenneth G. Lore, MORTGAGE-BACKED SECURITIES § 2:23 (2009).

Between 1990 and 2006, annual issuance of MBS increased from \$259 billion to \$2,018 billion.<sup>23</sup> What fueled this explosive growth? The early decades of growth of the MBS market were shaped by a number of factors, including the pressure of a consistent demand for housing credit; cash rich pension and mutual funds; the availability of foreign credit; the continuous need of investors to increase diversification and reduce risk; the improved federal climate in tax and securities regulation, including tax reform; the continuous need to increase the efficiency of pricing and trading real estate related securities; and the evolving capital requirements motivating insurance companies to invest in MBS and financial institutions to reduce balance sheet assets, thereby reducing capital levels.

From its initial development as a tool to finance real estate based loans, securitization issuances have expanded to include a broad range of issuers and asset classes. In 1985, Sperry Lease Finance Corporation created and issued securities backed by its computer equipment leases.<sup>24</sup> The following year, General Motors Acceptance Corporation issued approximately \$4 billion in securities backed by General Motors loans. These were the first issuances of non-mortgage asset-backed securities, also known as ABS.<sup>25</sup> ABS came to include securities comprised of bundles of auto loans, credit card receivables, student loans, equipment loans, premium finance loans, and leases, among other assets.<sup>26</sup> ABS issuance grew from \$43.6 billion issued in 1990 to approximately \$753.9 billion issued in 2006.<sup>27</sup> As the private secondary market ground to a halt in mid-2007, the U.S. government sought to support the housing industry by increasing the role of the three GSEs. As noted in footnote 20, in 2009 the three GSEs issued more than \$1 trillion in MBS.<sup>28</sup>

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<sup>23</sup> Sabry, *supra* note 5, at 16 (referencing data taken from The 2007 Mortgage Market Statistical Annual, Vol. II, pp. 3-7).

<sup>24</sup> *Joint Hearing entitled "Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit"*, 108th Cong. 3 (2003) (statement of Mr. Cameron L. Cowan, Esq., Chair, Legislative and Judicial Subcommittee, American Securitization Forum) (hereinafter referred to as "Cowan").

<sup>25</sup> Silversmith, *supra* note 11, at 68.

<sup>26</sup> Cowan, *supra* note 24, at 3-4.

<sup>27</sup> See Securities Industry and Financial Markets Association Research and Statistics, *General Statistics, US Key Stats*, data through Oct. 2009, available at [http://www.sifma.org/uploadedFiles/Research/Statistics/SIFMA\\_USKeyStats.xls](http://www.sifma.org/uploadedFiles/Research/Statistics/SIFMA_USKeyStats.xls).

<sup>28</sup> Other types of transactions have developed that fall under the term "securitization," which at its core involves transforming one or more financial assets into securities. For instance, some securitizations involve buying publicly registered debt securities in the open market and repackaging them so that retail investors can buy interests in them in increments smaller than the minimum denomination (*e.g.*, \$25 instead of \$1,000). Similarly, although some structures for collateralized loan obligations, or CLOs, may involve a company raising money by selling interests in assets selected from its loan portfolio, in others a collateral manager may purchase a pool of corporate loans in the secondary markets specifically to serve as collateral for the securitization. Multi-seller asset-backed commercial paper conduits purchase a variety of assets from a range of originators and issue commercial paper supported by these diverse assets. Structured investment vehicles, or SIVs, issued short-term obligations backed by highly rated long-term obligations to capture the arbitrage from the maturity spread. Collateralized debt obligations, or CDOs, also became common, often using as collateral the lower-rated tranches of MBS transactions or even other CDOs. And synthetic versions of these structures, in which the issuer held a total return swap rather than a loan portfolio, also fell within this category. For purposes of this paper, we have focused on the more traditional asset classes and structures on which the securitization industry was based. Although we discuss some of

## ***Benefits of Securitization***

Originators and sponsors of securitizations, and consumers and other borrowers each receive important benefits from securitization transactions.

*Consumers.* Although securitizations have been criticized over the last two years for failing to permit easy modification of mortgage loans, the resulting belief that securitizations do not benefit borrowers is incorrect. For instance, securitization is a key driver of liquidity in the mortgage market, making mortgages more widely available. Quite simply, lenders have more funds available to make new loans if such lenders can sell off their old loans rather than waiting for them to mature. In addition, data collected before the current financial crisis regarding ABS and MBS markets have shown that lower financing costs for issuers have flowed down to consumers, generally in the form of lower interest rates.<sup>29</sup> A report released in 2006 showed that Fannie Mae and Freddie Mac generated interest-cost savings for American home buyers ranging between \$18.8 billion and \$26.92 billion per year.<sup>30</sup> In addition, geographic disparities have declined as securitization has created a more cohesive national secondary mortgage market, in particular increasing the availability of mortgages in underserved areas.<sup>31</sup>

*Small businesses.* Securitization has been an important factor in the availability of credit for small business by providing funding sources to lenders to small businesses. Restoration of the securitization markets will be essential to reestablishing credit opportunities for small businesses.

*Originators.* Originators of financial assets are much better able to finance the origination of those assets—and thus to provide liquidity to the markets as a whole—when they have access to the securitization markets.

- *Lower cost funding.* As we discuss in more detail under “Securitization Basics,” below, the legal isolation of financial assets from a sponsor’s estate in a securitization transaction enables the ABS to receive a credit rating higher than the unsecured debt rating of the sponsor. Investors rely on the cash flow created by the assets and not on the payment promise of the company. The result is cheaper funding for the sponsor.
- *Diversified funding.* Securitization investors are generally different from corporate debt investors, and a securitization program therefore allows lenders to diversity their sources of funding.
- *Liquidity* – Securitization enables lending institutions to use the proceeds from the sale of securitized assets to make additional loans. In the absence of an established process for selling loans it is currently holding, an institution would be dependent on deposits and

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these other types of transactions elsewhere in this paper to a limited degree, our primary focus is on the use of securitization to provide liquidity for companies holding various types of debt obligations.

<sup>29</sup> Sabry, *supra* note 5, at 119-120; *see also* Cowan, *supra* note 24, at 6-7.

<sup>30</sup> James Miller & James Pearce, *Revisiting the Net Benefits of Freddie Mac and Fannie Mae*, available at <http://www.freddie.com/corporate/reports/>.

<sup>31</sup> Silversmith, *supra* note 11, at 2-3.

bank borrowings, and on the proceeds from repayments on existing loans, to make new loans.

Historically, originators also have benefited from lower regulatory capital requirements by accounting for their transfers of securitized assets as sales. Although sale accounting treatment may no longer be achievable for many traditionally structured securitizations as a result of the recent adoption of Statements of Financial Accounting Standards Nos. 166 and 167,<sup>32</sup> which take effect later this year, we believe the other benefits of securitization will continue to be substantial.

### **Securitization Basics**

Securitization is primarily a financing technique in which companies raise money by transferring interests in their financial assets to capital market investors.<sup>33</sup> The following are some of the fundamental characteristics that cause a financing transaction to be described as a securitization rather than a secured financing:

1. *Investors invest only in assets, not in an operating company.* One of the primary goals of a securitization is to allow the investors to invest only in the assets of a company, and not in the enterprise as a whole. Securitization investors provide funding supported by a company's financial assets—trade, loan or lease receivables that obligate the company's customers to make cash payments to the company over time. Investors expect to be paid out of the cash flows on the assets, assume the credit risk of the obligors on the assets, and do not generally have the right to look to the seller of those assets if the cash flows are insufficient to repay the investors in full. Because the source of payment in a securitization is primarily the cash flow generated from the securitized assets, investors consider the nature and credit quality of the assets and not, in general, the sponsor's financial condition, rating or performance. Investors are generally protected against risks to the cash flows through various forms of credit enhancement<sup>34</sup> that are structured to absorb potential losses. Investors assume the risk that those assets will not pay out as they are supposed to because the obligors on the receivables default—but to the greatest extent possible they do not take on the risk that the company originating those receivables will itself encounter financial difficulty that will constrain its ability to repay its financing. It is not always possible to eliminate all enterprise risk in a securitization, but many of the structuring aspects of these transactions, as described below and in Appendix A, are designed to support that goal.

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<sup>32</sup> See Financial Accounting Series: Statement of Financial Accounting Standards No. 166, Financial Accounting Standard Board, June 2009; Financial Accounting Series: Statement of Financial Accounting Standards No. 167, Financial Accounting Standard Board, June 2009.

<sup>33</sup> See *supra* note 28.

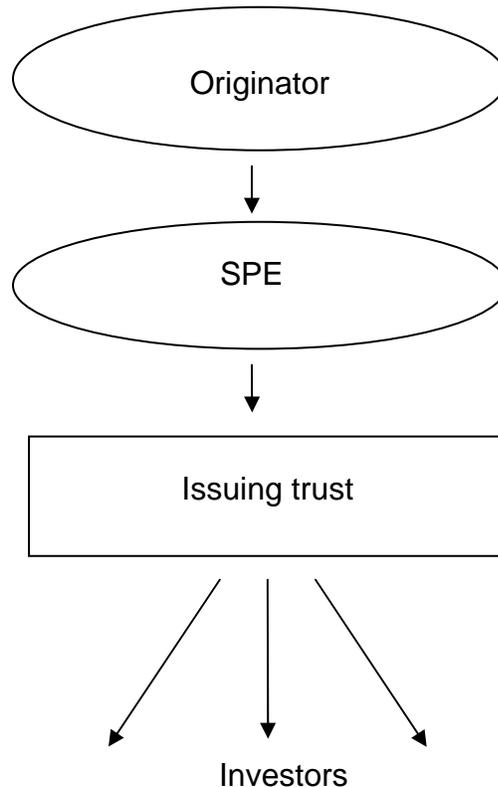
<sup>34</sup> "Credit enhancement" protects investors from the risk that assets will default and is generally included in the securitization transaction at the time it is established. Examples are cash accounts, a letter of credit or a financial guaranty. A senior class may also be "credit enhanced" by a subordinated class that bears loss on the assets before the senior class. We discuss credit enhancement in more detail in item 8 below.

In its simplest version, a securitization structure might look like the following diagram:

Originator transfers receivables to SPE for cash, debt and equity

SPE transfers receivables to issuing trust for cash

Issuing trust issues securities to investors for cash



However, a wide variety of possible structures and entities can be used in a securitization, and some structures may vary from this one quite substantially.

2. *The financial assets are separated, to the greatest degree possible, from the company that is securitizing them.* The first thing that typically happens in a securitization is the transfer of the financial assets to a legal entity, such as a limited liability company or a trust with an independent trustee, that is separate from the company sponsoring the securitization. As noted above, market participants often refer to this as the “legal isolation” of the assets. If the transferring company is subject to the U.S. Bankruptcy Code, this transfer will typically take the form of a true sale of the assets to the new entity, a true contribution of the assets to the new entity’s capital, or both. True sale and true contribution are concepts under both the Bankruptcy Code and state law, and are designed to ensure that the assets are transferred in such a way that they should no longer be considered property of the transferring company. Generally, this means that the assets have been sold for fair or reasonably equivalent value, there has been no attempt to defraud the creditors of the transferring company, the transferring company does not commit to cover losses on the transferred assets or retain the right to receive the income on those assets, and the parties agree that they intend the transaction to transfer all right, title and interest in the assets to the new entity. These transfers are usually coupled with a “backup security interest” to protect investors against the possibility that the transaction would be recharacterized as a secured financing or that the organizational separateness of the transferee would be breached.

Typically a true sale or true contribution is paired with a series of commitments by both the transferor and the transferee to keep the transferee separate from the transferor. While these are referred to as “separateness covenants” in securitizations, and securitization lawyers discuss being able to give an opinion that the assets of the transferee would not be substantively consolidated with the assets of the transferor in insolvency proceedings, many of the fundamentals of maintaining effective separation resemble those necessary to defeat efforts to pierce the corporate veil. Among other things, the new entity needs to maintain its corporate formalities, take actions in its own name, not hold itself out as liable for debts of the transferor, not commingle its assets with those of the transferor, and maintain separate books and records.

For entities that are not subject to the Bankruptcy Code, the form of transfer may be somewhat different. Insured depository institutions, such as banks, for instance, will typically be placed in receivership or conservatorship by the Federal Deposit Insurance Corporation, or FDIC, if they become insolvent, rather than commencing bankruptcy proceedings. Legal isolation for assets transferred by an insured depository institution therefore needs to consider how the FDIC would treat these assets, and does not depend on bankruptcy law. In 2000, the FDIC adopted a rule that provides that if the FDIC is acting as receiver or conservator for a failed insured depository institution, it will not seek to recover, reclaim or recharacterize as assets of the failed institution any assets that have been transferred in a securitization meeting certain criteria. That rule currently depends on the transfer being treated as a sale for financial accounting purposes. To achieve legal isolation, insured depository institutions will need to make sure their asset transfers comply with the FDIC rule but may not need to effect a true sale or true contribution of the assets under bankruptcy or state law standards.<sup>35</sup>

3. *The new entity receiving ownership of the assets is a special or limited purpose entity.* Because one of the goals of a securitization is to allow investors to invest in assets rather than enterprises, securitization transactions are typically structured so that the entities to which the assets are transferred do not themselves present operating risk. The types of entities that are used are generally referred to as special purpose entities, or SPEs, but a more accurate name would be “limited purpose entities.” The distinguishing characteristic of these entities is that, by the terms of their organizational documents (e.g., their corporate charter, limited liability company agreement or trust agreement) they cannot engage in the full range of activities in which a corporation or other entity would normally be permitted legally to engage. An SPE used in a securitization would typically be limited to holding financial assets, investing proceeds of those assets, and either further transferring the assets or issuing equity interests in those assets or debt secured by them.<sup>36</sup> The SPE would be prohibited from incurring debt that was not part of or contemplated by the securitization transaction, and it would likely have either a trustee or one

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<sup>35</sup> The FDIC is currently considering the effect of recent accounting changes on the rule and whether to promulgate a new standard to support legal isolation. In the meantime, the FDIC on November 12, 2009 adopted an interim final rule that clarifies that securitizations issued prior to the accounting change and in some circumstances until March 31, 2010, will continue to receive the benefits of the current legal isolation rule for the full term of the transaction. See Amendments to 12 C.F.R. § 360.6. Defining Safe Harbor Protection for Treatment by the Federal Deposit or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connections with a Securitization or Participation, 74 Fed. Reg. 59066 (Nov. 17, 2009) (interim rule amending 12 C.F.R. pt. 360), available at <http://www.fdic.gov/news/board/2009nov12no6.pdf> (“FDIC Interim Rule”).

<sup>36</sup> Some entities might issue both debt securities and equity securities.

or more independent directors whose vote would be required to put the SPE into insolvency proceedings or to change the entity's limited purposes. These characteristics are designed to keep the entity "clean"—in other words, to protect the investors from taking on the broader risk of an operating company—and to prevent other creditors<sup>37</sup> or shareholders from attempting to reach the assets supporting the securitization by forcing the SPE into bankruptcy. As a result, these entities are often described as "bankruptcy-remote SPEs."

Except for transfers by insured depository institutions that meet the conditions of the FDIC rule described above, most securitizations are structured as "two step" transfers, with the first transfer being the one that meets the requirements of a true sale or true contribution. The second transfer is to a trust or other entity that issues the securities, backed by the pool of financial assets, that are sold to capital markets investors. This second transfer often would not meet true sale or true contribution requirements, largely because the transferring SPE retains both a portion of the risk on the assets and a portion of the benefit of the upside potential. For one-step transfers under the FDIC rule, the insured depository institution itself may retain both risk and upside, with the legal isolation determined based on sale accounting treatment rather than bankruptcy concepts of true sale.<sup>38</sup>

4. *SPEs generally are structured so that they do not incur entity-level taxation.* When sponsors structure securitizations, they are very careful to make sure that the structure does not cause the assets to incur a significantly greater degree of taxation than if they were retained by the sponsor. For mortgage loan securitizations, tax structuring was facilitated by the creation by Congress of the real estate mortgage investment conduit, or REMIC, a special tax structure created to support these transactions. Other securitizations may use LLC or partnership structures, grantor trusts, or other entities such that the entity issuing the securities would be disregarded for tax purposes.

5. *The representations and warranties made at transfer are intended to ensure that the transferred assets have the characteristics such assts are purported to have.* Because of the desire to achieve legal isolation, securitization structures generally have very limited or no *credit* recourse—if a borrower encounters financial trouble and cannot pay, that risk is borne by the investors, subject to any credit enhancement that protects them from those losses. On the other hand, originators generally do stand behind their representations as to the nature and credit characteristics of the assets and legal aspects of the transfer, such as first priority, perfected liens. Some of the representations and warranties are mandated by the credit rating agencies to support their ratings, and some are negotiated with the investors or with underwriters for the transaction to ensure that the representations and warranties are consistent with market standards and investor expectations and allocate risks appropriately. These representations and warranties historically have been an important but limited safeguard, intended to ensure that investors receive the legal interests they expected in the assets that were described to them. The representations and warranties generally have not been intended to guarantee the credit performance of the assets.

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<sup>37</sup> The restrictions on incurring debt are intended to make sure that no other creditors exist. To the extent there *are* other creditors, they would be asked to agree that they would not attempt to put the SPE into bankruptcy until the securitization had paid in full and any applicable preference period had run.

<sup>38</sup> See FDIC Interim Rule, *supra* note 35.

6. *Servicing arrangements are designed to facilitate collections of the assets in accordance with their terms.* Financial assets generally consist primarily of obligations to make cash payments, which require attendant processes of billing the obligors, recording collections, addressing delinquencies, negotiating with obligors to mitigate losses, conducting foreclosures (if applicable) and otherwise managing the collection process that needs to be performed for every securitized pool.<sup>39</sup> This is referred to as servicing the assets. The servicer has contractual rights and obligations with respect to the assets, including rights to modify the assets under certain circumstances. Constraints on loan modifications are intended to limit the ability to make deals with obligors on the assets that would relieve the obligors from their obligations, especially where there is an ongoing business relationship between the servicer and the obligor, but servicers can generally modify loan terms where the loans are in default or default is likely and the servicers believe that modification will increase recoveries. The servicer generally can be replaced if it defaults in the performance of its servicing obligations. The servicer is paid a servicing fee from the cash flows on the securitized assets, and the fee is generally based on the aggregate principal balance of the assets being serviced. The servicer also may be entitled to the “float” (*i.e.*, the investment income) on cash collections during the period before the collections have to be paid over to investors.

7. *Securitizations structure risk among different categories of investors by adjusting the priority of payments of cash collections, allowing securities to be tailored to the risk appetite of particular investors.* The simplest structure for an asset-backed security is a pass-through certificate in which each investor has an undivided beneficial ownership interest in each asset, and the investor’s right to collections from and risk exposure to the assets is pro rata based on the amount invested. For a diversified pool of assets that bear interest at rates that properly reflect the risk of loss, investors would expect to absorb some losses but to be compensated for those losses through a higher yield on the pool as a whole. If losses prove to be higher than anticipated, then investors may have losses that are not fully offset by interest payments. On the other hand, if losses are lower than expected, the investors will receive the benefit.

Some investors, though, would prefer to trade off some of their yield in order to be protected against losses, while other investors are willing to take more risk but demand a higher yield for doing so. This desire to meet the needs of particular investors by tranching risk, and in some cases other aspects of the cash flow allocations from the pool, has become an important part of the securitization markets. Asset-backed securities are frequently divided into two or more classes, or “tranches,” with different levels of seniority. As the issuer receives collections of the cash flows on the assets, it divides them among investors based on that seniority and any other contractual agreements about how funds will be allocated. Losses resulting from payment defaults on the assets also are typically borne by each class in reverse order of seniority. The set of cash-flow provisions that dictate the priority of payments to the various classes in a

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<sup>39</sup> In some transactions, the servicer also agrees to make advances to the securitization in the amount of any delinquent payment obligations on the loans so that investors can receive a more predictable schedule of payments. These advances are repayable out of cash flows on a priority basis, and are made to address problems with the timing of payments rather than with the credit of the obligors.

securitization is sometimes referred to as the “waterfall” because the provisions are set forth in the relevant agreement as a series of cascading clauses.<sup>40</sup>

8. *Credit ratings are based on legal and structural features, credit enhancement and an analysis of historical data involving the same or similar assets.* By legally isolating the assets in a securitization, companies using securitization to fund their receivables often are able to obtain credit ratings that are significantly higher than their corporate debt ratings and, therefore, to achieve a cost of funding that is significantly lower than they would otherwise have been able to obtain.<sup>41</sup> Ratings models look at many aspects of the transaction, including the asset pool itself, the strength and experience of the servicer or servicers, the priority of payments under the documentation, and data about how assets in a particular asset class, with the same originator or servicer, historically have performed over time. Typically this involves stressing the historical data to create what is believed to be a worst-case scenario—for instance, defaults projected at a multiple of the historic maximum, and recoveries reduced by a significant percentage from historic lows. Securities in the most highly rated tranches are evaluated using the most severe stressors, while lower-rated tranches would reflect more moderate stress levels. On this basis, the amount of credit enhancement necessary to achieve the desired ratings would be determined. Credit enhancement typically would be provided in the form of insurance or guarantees, subordination of junior tranches, overcollateralization of the issuance vehicle, letters of credit, cash collateral accounts,<sup>42</sup> or some combination of these. Credit enhancement levels vary from transaction to transaction, but, in general, a riskier asset pool would be expected to have more credit enhancement than a less risky pool. In our experience, prior to the events of the last two years, market participants generally trusted the rating agency models and believed that securitization transactions were as safe as their credit ratings indicated.

### **Causes of the Current Financial Crisis**

The analysis of what triggered the economic crisis is still being conducted by economists, academics, government agencies and others, and it is premature to say at this point that the causes are fully understood. Securitization did play a role, but we do not believe it was a principal catalyst of the crisis. As we will discuss, by enhancing liquidity in the consumer lending markets, securitization indirectly allowed lenders to fund lower-quality loans, but there is

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<sup>40</sup> One of the aspects of asset-backed securities that makes them so versatile is the ability to structure classes to meet the needs of a particular investor by creating very complicated waterfall provisions. Classes with the same rating might have different expected maturities, average lives, interest rates, liquidity support and credit enhancement. The trade-off for this flexibility is the related complexity, where investors in certain asset classes, such as mortgages, will have to decipher a different, nuanced waterfall for each issue of ABS. Other securitizations, such as credit card transactions using a master trust, may have a waterfall for the entire securitization structure that generally remains consistent across issuances for a particular sponsor. In these structures, the waterfall typically provides a framework that supports the ability to issue additional classes or tranches of securities backed by the same pool of assets, but with different interest rates, maturities and other economic terms.

<sup>41</sup> The lower corporate ratings of the originators are, in fact, an additional reason that deal structures limit their reliance on originator representations and warranties—if a significant portion of the deal cash flows were expected to come from an originator with a corporate debt rating below that of the securities, that would put significant pressure on the ratings analysis.

<sup>42</sup> Cash collateral accounts would also include “spread accounts” that are funded over time out of excess cash flows from the assets. These are discussed in more detail in Appendix A.

little evidence that securitization factored directly into lending standards or loan diligence, or that “skin in the game” for securitizations affected originators’ lending standards.

It is easier to describe what happened than why it happened. For purposes of this paper, we have described key aspects of the crisis<sup>43</sup> that we believe are relevant to a discussion of the role securitization may have played:

- Lending standards for mortgage loans, especially for mortgage loans considered to be “sub-prime,” declined dramatically, most likely beginning around 2005.
- U.S. housing values had become inflated over time, in part as a result of the easy availability of mortgage credit. The continual increase in home values skewed perceptions of borrowing capacity because borrowers and lenders both believed that the ability to refinance at lower rates or sell the home at a profit provided a safety net.
- Interest rate increases beginning in 2007 put pressure on both borrowers and home prices, which meant that at the same time borrowers began to have difficulty making mortgage loan payments, the safety net of rising housing values disappeared. As a result, mortgage loans defaults began to climb.
- The increase in mortgage loan defaults began to ripple through the capital markets, initially affecting RMBS and securities that were supported by RMBS, such as leveraged pools of RMBS known as collateralized debt obligations, or CDOs. Triple-A rated RMBS suffered ratings downgrades as the default assumptions on which their ratings were based came into question, and junior tranches began experiencing losses as well as downgrades. Leveraged vehicles that had invested heavily in junior tranches of RMBS transactions because of the higher yield began experiencing magnified losses. And monoline insurers, which had guaranteed payments of principal and interest on a large number of senior tranches of RMBS, were themselves downgraded as losses exceeded projections. These downgrades of the monoline insurers pulled down the ratings of vast amounts of RMBS and other securities that had depended on the monolines’ ratings.
- Lack of confidence in ratings, especially for structured products, significantly constrained the liquidity of a wide range of securities and the entities that depended on their ability to issue them. These issues further tightened the availability of credit and exacerbated problems in the housing market.
- Market values of securities declined, forcing entities that were required to mark their holdings to market to take significant writedowns. Commenters alternately decried fair value accounting for requiring institutions to take paper losses and criticized fair value accounting for failing to address all assets, such as loans held to maturity, that were likely

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<sup>43</sup> We have not attempted to provide a comprehensive list of all the key events and circumstances that comprise the crisis, which is beyond the scope of this paper. For a very efficient timeline of events, see *Timeliness of Policy Responses to the Global Financial Crisis: Domestic Timeline*, Federal Reserve Bank of New York, available at [http://www.newyorkfed.org/research/global\\_economy/Crisis\\_Timeline.pdf](http://www.newyorkfed.org/research/global_economy/Crisis_Timeline.pdf).

impaired. Companies with no obvious connection to mortgage loans, such as pharmaceutical companies, took significant writedowns on holdings of MBS.

- Market participants began to appreciate the broad range of ways in which financial institutions and other companies were exposed to the housing sector, including through a variety of structured products, repurchase agreements, securities lending arrangements, credit default swaps and other over-the-counter derivatives. Market participants also began to appreciate the extent to which high degrees of leverage, in the products and the institutions, were magnifying those exposures. Concerned about hidden risks, financial institutions stopped lending to each other, leading to unprecedented levels of government intervention and support to stabilize the global financial system.

*Decline in Lending Standards.* A number of important questions have been asked in light of these events: Why did lending standards for mortgage loans decline so precipitously across the industry? Were there short-term incentives that encouraged lending without consideration of long-term risks? What were the flaws in securitization ratings and ratings models, such that loss levels on securitized pools exceeded estimates and led to massive ratings downgrades? Why were even the most sophisticated financial institutions, many of which had structured the products in which they were experiencing losses, apparently unaware of the degree of risk to which they were exposed?

Because market problems first manifested themselves at a large scale in securitizations of subprime mortgages, it is natural to consider whether and to what degree securitization played a role. To some extent, however, this is like blaming a seriously ill patient for causing the flu. That is not to say that there are not a number of things that could have been done differently in the securitization markets that would have minimized the spread of contagion. But we believe the fundamental premise on which legislative proposals for risk realignment are based—that securitization provided too liquid a market for mortgage loans and by doing so was a proximate cause of the decline in lending standards—is flawed.

The availability of easy credit was global and spanned many market sectors. In a speech in April 2008, Malcolm D. Knight, then the General Manager of the Bank for International Settlements, described “unusually accommodative global credit conditions” —including record low levels of risk spreads on emerging market sovereign debt, high yield corporate debt and other risky assets and a “spectacular” rise in equity values in many emerging markets—which he ascribed to “the interaction of monetary policy, the choice of exchange rate regime in a number of countries (particularly developing countries with a large labor surplus), and important changes within the global financial system itself.”<sup>44</sup> Securitization was absolutely part of this easy credit environment, but securitization transactions were being conducted in an environment in which diligence levels and risk premiums for *all* financial products had declined dramatically.

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<sup>44</sup> Malcolm D. Knight, General Manager of the Bank for International Settlements, Some reflections on the future of the originate-to-distribute model in the context of the current financial turmoil, Speech at the Euro 50 Group Roundtable, London, England (Apr. 21, 2008) (transcript available at <http://www.bis.org/speeches/sp080423.htm>).

At the same time, significant changes were taking place in the financial sector that led to increased leverage and more exposure to mortgage loans. In the U.S., the barrier between traditional banks and investment banks was removed by the Gramm-Leach-Bliley Act of 1999, which repealed the Depression-era Glass-Steagall Act of 1933. As these institutions began to integrate, they also developed more complex risk structures that were regulated through fragmented regulatory structures. Moreover, the removal of this barrier changed the competitive landscape and may have caused traditional banks to engage in more aggressive and riskier lending and trading practices in order to compete with investment banks.<sup>45</sup> Researchers from the Organisation for Economic Co-operation and Development suggest that other changes in the regulatory and political environment in the years before the crisis also may have caused banks to take on more risk in hopes of increasing revenues and share price. They point to four changes in particular: a government policy that encouraged low-income families to obtain zero equity mortgage loans; greater capital requirements and balance sheet controls imposed on Fannie Mae and Freddie Mac, which resulted in banks assuming more of the role historically played by the government-sponsored enterprises; the publication of the Basel II accord,<sup>46</sup> which informed banks that the new accord would reduce the amount of capital they would need to hold against mortgage loans and cause them to change their practices around mortgage loans in anticipation of the new standards; and the SEC's adoption of revised net capital rules that allowed investment banks to increase leverage ratios.<sup>47</sup>

Those analyzing the crisis also have considered the role of misinformation, incorrect risk assumptions and a lack of incentives for market participants to act prudently. For instance, researchers at The Brookings Institution have cited the prevalent but mistaken belief that real estate prices would continue to rise, the exploitation of the financial system by financial institutions, and the failure of regulators and lawmakers to police that exploitation and adapt financial rules to prevent it.<sup>48</sup> Moreover, certain risks were not considered to be risks at all. One example of this was the requirement in many swap contracts that they be collateralized if the rating of the swap counterparty fell below a specified level, without the end users of these contracts realizing that the sudden obligation to collateralize an entire portfolio of swap contracts could itself cause the swap counterparty with which they had contracted to fail. A broad range of market participants, including sophisticated financial institutions and rating agencies, seems to have underestimated counterparty risk generally,<sup>49</sup> as well as risks related to the custody of

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<sup>45</sup> Matthew Benjamin & Christine Harper, *Glass-Steagall's Specter Returns To Haunt Wall Street*, BLOOMBERG.COM, Mar. 10, 2009, available at: [http://www.bloomberg.com/apps/news?pid=20601208&sid=ad\\_KRWTbPsJw&refer=finance](http://www.bloomberg.com/apps/news?pid=20601208&sid=ad_KRWTbPsJw&refer=finance).

<sup>46</sup> Basel II is a recommendation of banking laws and regulations issued by an international banking committee, the Basel Committee on Banking Supervision of the Bank for International Settlements. The Basel Committee approved a package of enhancements to the Basel II capital requirements in July 2009, available at <http://www.bis.org/publ/bcbsca.htm>.

<sup>47</sup> Adrian Blundell-Wignall, Paul Atkinson & Se Hoon Le, *THE CURRENT FINANCIAL CRISIS: CAUSES AND POLICY ISSUES 3-4* (Organisation for Economic Co-operation and Development 2008).

<sup>48</sup> Robert E. Litan & Martin N. Baily, *FIXING FINANCE: A ROADMAP FOR REFORM* 10, 39 (Initiative on Business and Public Policy at Brookings 2009), available at [http://www.brookings.edu/papers/2009/0217\\_finance\\_baily\\_litan.aspx](http://www.brookings.edu/papers/2009/0217_finance_baily_litan.aspx).

<sup>49</sup> Cf. Randall S. Kroszner, Governor, Address at the Risk Management Association Annual Risk Management Conference, Baltimore, Maryland (Oct. 20, 2008) (transcript available at

assets, risks that transactions would not be fully or clearly documented, risks related to financial intermediaries, and risks that insurance or guarantees would turn into a source of weakness rather than strength when the ratings of the insurers fell.

Some commentators have pointed to the prevalence of nontraditional mortgage loan products and high-risk lending practices and have suggested that the misalignment of interests between originators and investors in asset-backed securities played a central role in encouraging such practices.<sup>50</sup> The basis for this suggestion is the “originate-to-distribute” model, which assumes that certain lenders make loans for the sole purpose of selling the loans to investors in the capital markets via securitization, rather than hold them to maturity.<sup>51</sup> A recent study by the Federal Reserve Bank of Philadelphia, which has been cited as empirical evidence of this effect, shows that *prime* loans that were securitized had a higher likelihood of default than nonsecuritized loans, but found no correlation between securitization and default rate for subprime loans.<sup>52</sup> The study does not, however, analyze whether the loan originators had significant retained interests in the securitization pool, whether the level of credit enhancement for the securitized loan pool appropriately reflected the risks of those loans, or whether the higher default rates for securitized versus nonsecuritized loans held true for particular originators. Indeed, the Philadelphia study references a study of 700,000 loans originated by a single originator showing that low-doc securitized loans were *less* likely to default, and explains this as relating to greater investor scrutiny. Securitization of residential mortgage loans, like other businesses, was a very diverse process with many different participants and a broad range of factors that determined what loans would be securitized, how they would be securitized, how they would be credit-enhanced, and whether the lender retained some or a significant portion of the loss risk and upside potential. In our view, the Philadelphia study, while interesting, does not control enough of the relevant variables to address the critical questions relating to retained risk and the “originate-to-distribute” model.

One economist who disagrees with the assumption that lenders make loans only to sell them has referred to it as the “‘hot potato’ hypothesis,” the idea being that lenders simply sell them down a chain until the last unlucky investor is left holding them.<sup>53</sup> In theory, this model would increase profitability for lenders by increasing fee generation, decrease the risk to which lenders are exposed because they can distribute risk throughout the market, and reduce the interest rate and fees charged to borrowers as a result of that risk distribution. Lenders would have significant incentives to generate a high volume of loans to increase origination and

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<http://www.federalreserve.gov/newsevents/speech/kroszner20081020a.htm>) (regarding limits of model-based risk management practices and “knock on” effects).

<sup>50</sup> Committee on Capital Markets Regulation, *The Global Financial Crisis: A Plan for Regulatory Reform*, May 2009, at 129, available at [http://www.capmktreg.org/pdfs/TGFC-CCMR\\_Report\\_\(5-26-09\).pdf](http://www.capmktreg.org/pdfs/TGFC-CCMR_Report_(5-26-09).pdf).

<sup>51</sup> *Id.*; see also Douglas W. Arner, *The Global Credit Crisis of 2008: Causes and Consequences*, 43 INT’L LAW. 91 (2009), at 11.

<sup>52</sup> Ronel Elul, *Securitization and Mortgage Default: Reputation vs. Adverse Selection 3* (Federal Reserve Bank of Philadelphia, Working Paper No. 09-21, 2009).

<sup>53</sup> Hyun Song Shin, *Securitisations and Financial Stability*, THE ECONOMIC JOURNAL, March 2009, at 312, available at <http://www.res.org.uk/economic/freearticles/2009/March09.PDF> (last visited November 11, 2009).

servicing fees, but few incentives to ensure loan quality or to discourage consumers from borrowing beyond their means.<sup>54</sup>

The problem with the “hot potato” hypothesis, says Hyun Song Shin, is that it ignores the fact that credit supply is driven by factors within the financial system. In particular, leverage is a key element of return on equity for financial institutions, and they will seek to achieve the maximum leverage possible, generally by expanding their balance sheets. Shin goes on to note that “[a]s balance sheets expand, new borrowers must be found. When all prime borrowers have a mortgage but balance sheets still need to expand, then banks have to lower their lending standards in order to lend to subprime borrowers. The seeds of the subsequent downturn in the credit cycle are thus sown.”<sup>55</sup> In other words, lower quality loans aren’t being originated because they can be passed off like hot potatoes but because their origination is part of a large-scale expansion of leverage in the financial sector.

Moreover, the originate-to-distribute model does not explain why many originators, securitization structurers, and underwriters went bankrupt during the current financial crisis. Contrary to the belief that lenders passed all risk of nonperformance to unknowing investors, lenders typically did in fact retain risk. For instance, the Committee on Capital Markets Regulation points out that the failure of originators and other financial institutions was a result of their direct and indirect exposure to catastrophic levels of asset underperformance.<sup>56</sup> Other experts note that lenders faced a warehousing risk, whereby the lenders had to hold mortgage loans until they had accumulated a sufficient volume of loans to securitize.<sup>57</sup> If at any point the lenders could no longer securitize—a real risk if the assets they originated were perceived as being unusually risky—not only would they face the warehousing risk but their whole business model would be in jeopardy. In addition, mortgage lenders held residual risks in securitized loans through their interests in loan servicing fees and in junior tranches of the securitization, which were often the most difficult to sell, and the lenders were exposed to the risk of repurchase claims for any breaches of their representations and warranties.

Finally, the originate-to-distribute model does not explain why a sudden, system-wide shift in the quality of loan originations would have occurred. At the time of the crisis, securitization had been a significant and stable source of liquidity for mortgage loans for more than three decades.

Malcolm D. Knight has stated that he believes that when the originate-to-distribute model, when it functions correctly, it has the capacity to distribute risk and diversify revenue streams for banks.<sup>58</sup> He notes, nevertheless, that as the model became widely implemented, three key problems related to its implementation contributed to the current financial crisis. First,

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<sup>54</sup> Éric Tymoigne, *Securitization, Deregulation, Economic Stability, and Financial Crisis, Part I: The Evolution of Securitization* 22 (The Levy Economics Institute, Working Paper No. 573.1, 2009).

<sup>55</sup> Shin, *supra* note 53, at 310.

<sup>56</sup> Committee on Capital Markets Regulation, *supra* note 50, at 130.

<sup>57</sup> John D. Martin, *A Primer on the Role of Securitization in the Credit Market Crisis of 2007* 9 (2009), available at <http://ssrn.com/abstract=1324349>.

<sup>58</sup> Knight, *supra* note 44.

there was a decline in due diligence procedures, not only by those making the loans, but also, by the banks and other financial institutions at each stage of the securitization process, that placed too much trust in rating agencies and other institutions in the securitization process. Second, investors placed too much weight on credit ratings and were shocked by downgrades in the ratings of asset-backed securities, which meant that investors were exposed to losses much larger than they thought possible when they purchased the securities. Third, there was too much uncertainty associated with the originate-to-distribute model because investors did not understand where risks were concentrated; when the market declined, that uncertainty resulted in a lack of liquidity in the credit markets.

In our view, problems with the originate-to-distribute model do not sufficiently explain the deterioration in credit quality of securitized assets. For instance, large swaths of the asset origination sector—especially those originating revolving assets, such as credit cards, that involve continuing repayment and reborrowing—did not rely on an “originate to distribute” model, but instead used the more conventional approach, which we might refer to as a “distribute to originate” model, in which the distribution continued to be a critical funding source that allowed growth of managed pools of assets. It is possible that some originators may have incorrectly felt they did not have to worry about credit quality since they would be laying off all risks to the market, but our experience suggests that most originators were acutely aware of their ongoing exposure to their assets’ performance notwithstanding securitization. As Shin suggests, a more generous explanation for the deterioration in credit quality may have been what we would call the “originate to originate” model, under which lenders felt continuous pressure to grow their business, and performance and profits were measured by the scale of generation of new assets. At some point, when the pool of creditworthy borrowers had been fully tapped, growth began to be fueled through loans to less creditworthy borrowers, because the alternative—allowing the business to level off—was viewed as untenable.

*Problems with the rating process.* Numerous materials, including an important SEC study,<sup>59</sup> have suggested that conflicts of interest in rating agencies—where the sponsors of the rated deals were also the rating agencies’ largest customers and an important profit source for them—may have contributed to “grade inflation” for some securitized transactions. These materials also suggest that given the quantity of such deals and the speed with which they were being brought to market, ratings analysts simply did not have time to evaluate transactions fully—but rated them nonetheless.<sup>60</sup>

While there have been numerous discussions of conflict problems at rating agencies, and several recent SEC actions to limit the effects of those conflicts,<sup>61</sup> there also appear to have been

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<sup>59</sup>Summary Report of Issues Identified in the Commission Staff’s Examinations of Select Credit Rating Agencies, Staff of the Office of Compliance Inspections and Examinations Division of Trading and Markets and Office of Economic Analysis (July 2008), available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>.

<sup>60</sup> See *id.* at 10-12.

<sup>61</sup> See, e.g., Credit Ratings Disclosure, Securities Act Release No. 33-9070A, Exchange Act Release No. 34-60797A, 74 Fed. Reg. 53086 (Oct. 15, 2009), as amended by Securities Act Release No. 33-9070A, Exchange Act Release No. 34-60797A, 74 Fed. Reg. 55162 (Oct. 27, 2009).

problems with the rating models themselves. It is easy to assert, in retrospect, that a triple-A rating for ABS is very different from a triple-A rating for corporate or government debt and reflects broader systemic risk.<sup>62</sup> Certainly the securities are very different, but historically there was a belief that a triple-A rating for a securitization would be *less* volatile and *less* subject to systemic risk than a similarly rated corporate bond. In the world of RMBS, not only was there a diverse pool of obligors on the loans, but the loans were secured by the borrowers' most precious asset—their homes—and real estate seemed only to appreciate in value. Ratings models relied on historical data, and that data, generated during the housing bubble, suggested very little risk for mortgage loans. The many financial institutions, and others, holding highly rated RMBS in 2007 were understandably sanguine about their investments.

One can point to the deterioration in lending standards and the failure of rating agencies and others to analyze the securities adequately and to conduct appropriate levels of due diligence with respect to the assets as proximate causes of the decline in value of highly rated RMBS, but the ratings models themselves—designed to provide an objective analysis of potential risk—may have had inherent flaws. Economists at The Levy Economics Institute, Bard College, found that rating agencies have been unable to foresee economic problems before they are clearly present and suggest that this hinders the rating agencies' ability to provide a long-term view of credit risk.<sup>63</sup> A deeper problem may have been that the rating agencies were themselves economic actors that altered the environment they were trying to predict: for example, RMBS, and RMBS ratings, not only depended on loss projections for mortgage loans but also affected those projections.

When the ratings on subprime RMBS came under review, investors began to question whether triple-A ratings were flawed with respect to a broader range of securities, and investments in such securities accordingly tapered off. The ratings review based on asset quality in RMBS itself also placed concurrent pressure on the ratings of monoline insurers that had guaranteed RMBS payments and that were therefore unable to support new issuances. With less RMBS issuance providing a ready source of liquidity, mortgage loans became harder and more expensive to obtain even for prime borrowers; this in turn put downward pressure on housing prices. Falling home prices increased losses for defaulted loans and caused more mortgage loans to be “underwater,” meaning that the outstanding amount of the mortgage loans exceeded the value of the related properties. As a result, RMBS became even harder to issue, mortgage loans became even harder to get, and housing values continued to fall.<sup>64</sup> This feedback loop now seems entirely predictable, but there is little reason to believe that the role of RMBS was ever factored into the original ratings models.

*Too many deals and too few skilled personnel.* The growth of the securitization markets likely outpaced the development of the skills and knowledge of the markets' participants and the availability of appropriately skilled personnel at all stages of the securitization process.

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<sup>62</sup> Ricardo J. Caballero & Pablo Kurlat, The “Surprising” Origin and Nature of Financial Crises: A Macroeconomic Policy Proposal 16 (2009).

<sup>63</sup> Tymoigne, *supra* note 54, at 22.

<sup>64</sup> Elizabeth A. Duke, Governor, Address at the Global Association of Risk Professionals' Risk Management Convention, New York, New York (Feb. 11, 2009).

Securitization transactions are complex and nuanced, and the number of deals grew exponentially in a relatively short period of time. This rapid growth meant that those experienced in structuring, rating and investing in securitizations had less time to devote to each transaction and had to rely increasingly on the assistance of those with less expertise. As noted above, rating agencies may have been swayed by conflicts of interest and may have had flawed ratings models, but they were also affected by substantial turnovers in personnel as top performers were lured away by investment banks. Some investors may have relied too much on ratings because they did not have time to perform independent detailed analyses of the structures or did not have enough experienced personnel to conduct those analyses for all products coming to market.

*Structures that relied on short-term debt to fund long-term assets created downward pressure on asset prices when the structures began to fail.* One of the early and catastrophic casualties of the economic downturn was a type of securitization referred to as a structured investment vehicle, or SIV. SIVs generally used short-term debt, such as highly-rated commercial paper, to fund long-term assets, such as RMBS. Because cash flows on assets were generally insufficient to repay maturing commercial paper, these structures relied on the ability to roll over the commercial paper, or CP, by issuing new commercial paper, and on liquidity facilities to cover temporary disruptions in the CP markets. If a more severe problem developed, these vehicles typically did not have enough liquidity to repay all maturing CP, but had only enough to provide breathing room for the vehicle to conduct an orderly liquidation of its assets. The ratings presumed—incorrectly—that the assets held by the vehicle could be liquidated quickly at prices at or near par. Single-seller asset-backed commercial paper programs supported by mortgage loans had similar risks and outcomes.

What in fact happened to the SIVs and other short-term funding vehicles was that many of them ran into difficulty renewing their short-term funding at the same time, did not have sufficient liquidity, and began trying to sell assets to cover upcoming maturities. However, none of these vehicles could sell its assets at sufficient prices, and so each asset sale pushed it closer to the triggers that would cause the entire vehicle to liquidate. Buyers understood that the vehicles were under pressure to sell, and so the prices the buyers offered were more accurately characterized as “fire sale” prices than those that reflected true market values. Because numerous vehicles with multi-billion dollar portfolios all found themselves trying to sell their assets at the same time, into a falling market, the resulting supply glut further depressed prices and exacerbated the problem.

*The complexity of securitization structures, derivative structures and other financial arrangements altered investors’ risk exposures in ways that even the most sophisticated investors failed to appreciate.* Asset-backed securities can be highly complex, sometimes involving many layers of subordination, obscure or convoluted cash flow waterfalls, high leverage, and embedded credit default obligations or other financial instruments. Even the most sophisticated investors, and the rating agencies themselves, had trouble fully appreciating the risks inherent in certain asset-backed securities,<sup>65</sup> the broader risks represented across their portfolios of these

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<sup>65</sup> John B. Taylor, *How Government Created the Financial Crisis*, WALL ST. J., Feb. 9, 2009, at A19.

securities, or the ways in which the slicing and dicing of risk made it harder to hedge that risk effectively.

### **Risk Retention, Alignment of Interests and Securitization Economics**

As we discussed above, there is a strong popular belief that the current economic crisis originated, at least in part, because loan originators did not have ongoing exposure to the performance of those loans as a result of securitization and therefore had no incentive to maintain robust lending standards. Legislative responses to the crisis have therefore looked to mandate risk retention by originators or sponsors as a key element of reforming securitization. The European Union has already adopted a directive that will require 5% risk retention in some circumstances,<sup>66</sup> and proposals from the Obama Administration and Congressional leaders have proposed mandated risk retention of 5% or 10% for all securitizations. The idea that a misalignment of risk led to poor quality loan origination has been described as “common sense,”<sup>67</sup> but given the complexities of the financial industry we do not think it is that simple.

We understand that there may be rhetorical appeal and a degree of political momentum behind this approach, due in part to the popular belief that the “originate to distribute” model has played a major role in the economic crisis. In light of that, we began our review with a focus on the more technical details, such as how the 5% or 10% minimum would be defined, but ultimately we returned to the more fundamental questions we had not addressed: To what extent was the lack of “skin in the game” a factor in the crisis? What collateral effects might the proposed legislation have on our financial system? And the core question: is the assumption that there is no significant risk retention in securitization structures correct, not in isolated transactions (or types of transactions), but broadly across the industry?

In general, the world of asset securitization is broken into three main categories: static pool transactions (such as MBS and auto loan transactions), revolving transactions (such as credit card, trade receivables and home equity line securitizations) and managed transactions (such as CDOs). Many features of securitization structures reflect the characteristics of the underlying assets. In static pool deals, the loans generally consist of a fixed pool identified at the beginning of the transaction, and the cash flows primarily reflect the self-liquidation of the pool over time. As money comes in, whether as interest or as principal, it is distributed to investors instead of being reinvested in new assets. This in turn can have significant effects on the value of the securities. For instance, one of the key issues for RMBS historically has been prepayment speed, which is the rate at which mortgage loan borrowers pay off their loans ahead of their scheduled amortization. Primary drivers of prepayment in a normal market are the rate of refinancing and the rate of sales of the property, both of which would normally increase in a low-interest-rate environment. Prepayment risk means that the investor does not know when it will

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<sup>66</sup> The new directive amends the Capital Requirements Directive, in part to add article 122a, which contains the 5% minimum “skin in the game” requirement. Directive of the European Parliament and of the Council amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC, available at <http://register.consilium.europa.eu/pdf/en/09/st03/st03670.en09.pdf>.

<sup>67</sup> See, e.g., Dr. William Irving, Portfolio Manager, Fidelity Investments, Testimony Concerning “Securitization of Assets: Problems and Solutions,” Testimony Before the Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Securities, Insurance and Investment, October 7, 2009, at 4.

receive its invested principal, and that in turn affects other characteristics of the investment, such as average life and estimated yield. It also means that there may be a risk that the higher yielding loans may pay down earlier than anticipated while the lower yielding loans remain in the pool. Many structural features in RMBS and other static pool deals relate to providing greater certainty around these issues.

In contrast, in securitizations of pools of revolving assets, where the assets themselves reflect frequent payments and new borrowings, like credit card and trade receivables, principal collections may be reinvested in new receivables on a monthly basis for several years instead of being paid to investors. This type of securitization typically has a trigger, called an early amortization event or payout event, that cuts off reinvestment and allows principal to flow to investors if pool performance deteriorates below a specified level or if certain other adverse events occur for the pool or the SPE. There is no corollary in the world of static pool securitizations, such as mortgage loans, where the investors provide permanent funding for the assets with no performance out.

Credit card securitizations are one of the primary examples of a revolving structure, reflecting the nature of the underlying asset. Cardholders make purchases, increasing the balance of the principal receivables owed on their cards; then make payments, reducing the balance of those principal receivables; and then make additional purchases, again increasing the principal receivables balances. The overall size of the receivables pool remains relatively stable (though there may be effects of seasonality, such as holiday spending, or special promotions) but the composition of the pool changes every day. Unlike some of the structures that have been implicated in the credit crisis because they relied on short-term funding to fund long-term assets, revolving securitizations use long-term funding to fund short-term assets, providing stable liquidity for the generation of new receivables so long as the deal continues to meet minimum performance thresholds. The fundamental characteristics of these receivables—including high payment rates and the ability to manipulate reinvestment or payment of cash proceeds to create term securities with a single, reasonably certain maturity date—have driven the development of securitization structures that look very different from those in static pool deals.

Revolving securitizations more closely resemble traditional secured financings than do other types of securitizations. These transactions tend to be built around long-term relationships between the originator and its customers and, as a result reflect, a strong alignment of economic interests between the originator and the investors. Although the investors are relying on the transferred assets for repayment, the quality and collectability of those assets depends on the originator's continued effective management of its account relationships. The originator needs to maintain the strength of the asset pool in order to prevent an early amortization of the transaction and a concomitant loss of funding. In addition, the originator's overall economic success may be closely tied to the performance of the securitization.<sup>68</sup>

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<sup>68</sup> Credit card originators also usually keep substantial amounts of extra receivables in their master trusts, typically ranging from 10% to 20% of the total pool assets, which protect against seasonal fluctuations and dilution and which also ensure future issuance capacity. The amount of these extra receivables is referred to as the “seller’s interest” or the “transferor’s interest.” Because all interests in a credit card master trust, including the seller’s interest and the interests held by third-party investors, represent fractional undivided interests in all of the receivables in the pool, the seller’s interest represents a share of the risk exposure to every receivable in the pool.

Actively managed deals can have some characteristics of each of these structures. They may include a reinvestment period in which principal payments or sale proceeds are reinvested in new assets. They may also include periods in which little or no change in portfolio composition occurs, other than through self-liquidation of the assets, and all proceeds are paid to investors on receipt. These transactions rely on the skill of a collateral manager both to select assets consistent with a set of parameters that supports the ratings of the securities and to dispose of assets when their credit profile changes or they are otherwise no longer appropriate for the pool as a whole. The structures used in these transactions are generally designed to permit active management while still establishing risk guidelines and a relatively limited window for return of principal, unlike securitizations sponsored by the entity originating the assets. The most critical alignment of interests in actively managed securitizations is between the collateral manager and the investors. This alignment may be established through manager investment in the junior-most (or “equity”) tranche, by subordinating a portion of management fees to returns on senior interests, or by providing incentive fees tied to performance over the life of the transaction.<sup>69</sup>

One other difference between the residential mortgage loan securitization model and other securitization models—even other static pool models—is worth noting. In the residential mortgage loan securitization model, the mortgage loan is often immediately sold after origination (referred to as a “whole loan sale”). The mortgage loan may be sold several times in different whole loan sales before it is ultimately securitized. Each whole loan sale is done at a profit to the seller, resulting in the originator and each subsequent seller “cashing out” by realizing all of their profit in the related whole loan sale. Other securitizations models do not rely on whole loan sales. Instead, profits to the originator are realized in other securitization models only when the pool of loans in the related securitization is paid in full, the bonds and/or certificates issued in the securitization are paid in full, and any remaining collections on the pool of loans are received by the originator (those remaining collections are referred to as the “residuals”). Thus, in all securitization models other than the residential mortgage loan securitization model, the originator’s profit comes at the end of the transaction. In contrast, in the residential securitization model, the profit is often realized at the beginning through one or more whole loan sales.

In Appendix A, we discuss some of the structural features, economics and risk retention aspects of “typical” structures within asset classes, though we note that there can be wide structural variation. As explained in Appendix A, we believe that securitizations of most asset classes using common structures already reflect significant risk retention by the originator or sponsor of the securitization and that the risk retention is already structured to create a strong alignment of interests between the originator and third-party investors. If any form of mandatory risk retention is adopted, legislators and regulators should closely examine the existing substantial risk retention in various securitization models and define mandatory retentions in a

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<sup>69</sup> To the extent these managed transactions involve the acquisition of assets in the secondary market, instead of direct origination of those assets, they have no direct effect on the credit quality of assets at origination. However, some commentators have speculated that the ready liquidity provided by these structures may have allowed originators to lower their own quality standards in order to originate assets and realize profits more quickly.

way that gives credit for those retentions. We are concerned that an effort to alter securitization economics for those asset classes that already have a strong alignment of interests will put undue pressure on financial institutions by increasing the costs of these transactions and limit the availability of securitization for consumer lending in areas where there is little reason to believe that such economics have created risk. In addition, legislators and regulators should consider whether existing models of risk retention from other asset classes, such as auto loans, may provide useful approaches for risk retention in mortgage loan securitizations that have already been proven to be a sustainable part of a securitization program.

We note, too, that risk retention may undercut the ability of legal practitioners to render the true sale opinions for securitizations that are essential to their ratings and market acceptance. Even in circumstances where risk retention is not likely to raise true sale issues, the size of losses expected on a pool of securitized loans will still figure in to an analysis of the size and form of interest to be retained by the sponsor. In this regard, a recent study highlights the difficulty in determining the appropriate type and level of risk retention. On the basis of modeling results, the study's authors conclude that under unfavorable economic conditions, heavy loan losses are likely to render the most subordinate (or "equity") class worthless. Consequently, its retention may not lead to better screening efforts. Increasing the size of the retained interest, on the other hand, may significantly raise the costs of securitization. Compelling sponsors to disclose information about the type and level of retained risk may be an alternative, the authors suggest, to a substantive risk retention requirement.<sup>70</sup>

As with any type of surgical intervention, we believe securitization legislation should be approached with great care and not do more harm than good. Securitization is critical to the availability of consumer credit and corporate liquidity, and any efforts to alter securitization practice need to be narrowly tailored so they do not make securitization so difficult or onerous that it is no longer able to continue its important role in the economy. To date, the effects of the constriction in the securitization markets have been partially offset through government programs that are replacing that liquidity. We do not believe such programs are an effective or desired long-term solution. In addition, we make the following observations:

- Altering securitization practices in an effort to improve the quality of the underwriting standards and appropriateness of consumer loans is, at best, an indirect approach that may place the obligation of oversight on those who are too removed from the process to fulfill it effectively. A better approach, and one that is already part of legislative proposals, may be to modernize regulatory oversight of the origination of consumer loans.
- Legislative mandates that, intentionally or unintentionally, change the economics of securitization, including those to require a 5% or 10% retained risk exposure to securitized assets, have the greatest risk of unintended consequences, including possible elimination of securitization as a funding source entirely. For instance, these requirement may make it difficult or impossible to conclude that the assets have been transferred in a "true sale," which is one of the core protections for investors in securitizations. To the extent that the credit crunch in the U.S. can has been exacerbated by the loss of access to

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<sup>70</sup> Ingo Fender & Janet Mitchell, "The Future of Securitisation: How to Align Incentives?" BIS Quarterly Review (September 2009), 27, 42.

the securitization markets, the continued loss of access to those markets as funding sources likely will result in significant liquidity issues for financial institutions and borrowers alike.

- More empirical studies, especially studies that compare losses within securitizations that had significant risk retention by originators to losses within securitizations that did not have meaningful retained interests, should be conducted before Congress mandates specified levels or forms of risk retention. Each of us has extensive anecdotal evidence of securitizations with significant risk retention that nonetheless have performed poorly in the economic downturn, especially as problems became pervasive across whole classes of assets. We believe it is important for lawmakers and regulators to understand how risk retention affected securitization performance, loan due diligence and loan origination standards before they impose new requirements that may have unintended consequences.
- As we indicate above and discuss in more detail in Appendix A, a “one size fits all” approach is unlikely to work for securitization, which is more varied in its structures, assets and economics than most observers realize.<sup>71</sup> Most importantly, efforts to address issues relating to mortgage-backed securities may be inappropriate for different asset classes such as credit cards, auto loans, and other non-mortgage loan assets.
- Under the proper circumstances, alignment of the interests of originators and sponsors with the interests of investors in a securitization can be accomplished without requiring the sponsors to retain an interest in the securitized loans. For certain asset classes (notably commercial mortgage loans) as to which sponsors retain no continuing interest in the related securitizations, the diligence function that risk retention is designed to promote is effectively performed by firms that specialize in investing in the junior (or “first loss”) classes. Because the most junior class in these securitizations is diminished in value, roughly dollar for dollar, for every loss in the loan portfolio, the purchasers of sufficiently large junior classes are motivated to acquire all relevant information about the underlying loans and, where feasible, to demand that sponsors remove unacceptable loans before they are securitized. The fact that the price of the junior classes is heavily negotiated by the investors serves as an inducement to the sponsor to conduct its own thorough assessment of the underlying loans’ value and to cooperate with the investors to meet their demands for information and input. Investors of all classes benefit from the loan review conducted by the junior class investors.

### **Increasing Disclosure, Loan Level Data and Reporting Requirements**

In December 2004, following an extended period of commentary from issuers, investors, accountants and other participants in the securitization process, the SEC adopted specific line-

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<sup>71</sup> We note that the principal existing legislative proposals concerning improvements to securitization practices appear to rely on an analytical foundation focused on consumer mortgage securitization, and quite less so on other important asset types, such as consumer credit card and commercial mortgage securitization. We arrive at this belief due to, among other things, the proposals’ focus on broker and originator compensation, detailed loan-level disclosure, originator repurchase experience, and Securities Act Section 4(5)—all of which seem to derive from consumer mortgage loan securitizations.

item requirements for disclosure and reporting for publicly issued asset-backed securities.<sup>72</sup> New issuances were generally required to satisfy the requirements of Regulation AB beginning in early 2006. As a result, sponsors had very little experience issuing ABS under the new rules at the time the market disruptions began. We believe, however, there is little reason to expect that a significant expansion of disclosure over that required under Regulation AB, which was developed as a result of a very thoughtful and inclusive process, would be important outside RMBS transactions.

The subprime crisis has identified gaps in the disclosure needed to evaluate RMBS at times of severe market disruption and has fundamentally changed the way in which investors will look at RMBS disclosures going forward. Investors and issuers are examining disclosure practices for public securitizations of other classes of assets, but there is less consensus that there are gaps in existing disclosure standards for these other asset classes or that additional disclosure would add meaningful additional information for these classes. Other securitization structures that have been criticized for a lack of transparency, such as CDOs, are typically issued privately and thus not subject to the SEC's reporting regime. It is unclear how changes in reporting requirements would affect such structures.

In general, we favor disclosure solutions that address real gaps in information and require information that is reliable, verifiable, and can be obtained and disclosed at a reasonable cost. We would be concerned, however, about changing disclosure requirements in ways that do not meet those criteria.

### ***Loan Level Reporting and Additional Disclosures***

Proposals with respect to changing the disclosure standards seem to reflect a belief that RMBS is representative of all securitizations. For instance, proposed legislation would require the SEC to adopt rules requiring each issuer of ABS to disclose information regarding the assets backing the ABS, including at a minimum, loan-level data, the nature and extent of the compensation of the broker or originator of the assets backing the ABS and the risk retention of the originator in those assets. We recognize that the Administration and the Congress believe that more transparency is needed in ABS transactions. However, we believe these proposals have little relevance outside the residential mortgage industry.

There appears to be broad agreement among market participants that market practice in RMBS will have to change to include significant and ongoing disclosures of loan-level data. ASF, a securitization trade group comprised of issuers, investors, underwriters, trustees, servicers, rating agencies, outside counsel, accountants and other securitization participants throughout the industry, developed a standardized loan level data reporting package for RMBS transactions which it released in July 2009<sup>73</sup> as part of its Project RESTART. In addition, rating

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<sup>72</sup> Asset-Backed Securities, Securities Act Release No. 33-8518, Exchange Act Release No. 34-50905, 70 Fed. Reg. 1506, 1508 (Jan. 7, 2005).

<sup>73</sup> ASF RMBS Disclosure and Reporting Packages, Final Release, July 15, 2009, *available at* [http://www.americansecuritization.com/uploadedFiles/ASF\\_Project\\_RESTART\\_Final\\_Release\\_7\\_15\\_09.pdf](http://www.americansecuritization.com/uploadedFiles/ASF_Project_RESTART_Final_Release_7_15_09.pdf) ("ASF Report"). We emphasize, however, that the ASF's reporting package is entirely voluntary and will take some time to implement.

agencies, which historically received loan level data only prior to the close of the transaction and thereafter received the same summary distribution reports that the ABS investors received, have begun requesting increasing amounts of loan level data over the term of the transaction to better monitor the performance of RMBS (the requirement to provide such continuing data being a condition to the rating agency's agreement to issue its initial ratings on the RMBS).<sup>74</sup>

It is worth noting that the Project RESTART developments were generally intended to constitute guidelines rather than mandates and that not all issuers will be able to make all recommended disclosures. Any effort to codify those requirements should consider financial and other constraints that may affect the availability of information. For instance, in its report accompanying the reporting package, the ASF noted that servicers and major software providers would incur substantial fixed costs in upgrading their systems for reporting the data.<sup>75</sup>

Nor should the work on Project RESTART be viewed as an acceptable substitute for the broad solicitation of views on any mandated new loan-level or other disclosures. We would hope that any new regulations adopted by the SEC would follow the basic principles embodied in Regulation AB; that is, principles-based disclosure requirements that can be adapted to particular asset classes and are flexible enough to allow the development of new asset classes and new structures.

As we discuss elsewhere, RMBS involves a static pool of assets, established at the beginning of the transaction, to which new assets are generally not added. A typical mortgage loan securitization would have between a few hundred and a few thousand loans in the pool, each with a large outstanding balance. As a result, the provision of loan level data is manageable and verifiable and can be readily used by investors. Public securitizations of other asset classes generally involve larger numbers of loans with smaller balances per loan. For instance, auto loan securitizations would typically have assets that numbered in the tens of thousands. Credit card securitizations, which usually have all securities in a sponsor's program supported by a single asset pool, would have literally tens of millions of accounts in the trust, the characteristics of which change daily. As a general rule, the larger the asset pool is, the less meaningful loan level data is relative to aggregate data and the more expensive and harder it is to produce loan level data. Our understanding from investors is that they do not want and cannot use loan level data for credit card deals, and for issuers it may well be impossible to provide. We believe that requiring loan level data as a condition for credit card securitization, in a one-size-fits-all model

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<sup>74</sup> See, e.g., Kathryn Kelbaugh, Moody's Proposed Enhancements to U.S. Residential Mortgage Securitizations: Call for Comments (March 25, 2008), available at [http://www.americansecuritization.com/uploadedFiles/Moody%27s\\_Proposed\\_Changes\\_RMBS\\_3%2026%2008%20%282%29.pdf](http://www.americansecuritization.com/uploadedFiles/Moody%27s_Proposed_Changes_RMBS_3%2026%2008%20%282%29.pdf).

<sup>75</sup> ASF Report at 6. ASF anticipated that servicers would make system changes in order to provide such data for new issuances of RMBS and expressed hope that servicers also would provide such data on existing RMBS transactions. We note, however, that loan level data likely cannot be provided for existing ABS transactions because no infrastructure for that type of disclosure would have been provided. Moreover, the cost of entering the necessary information into servicers' systems (information in some cases going back many years) on thousands, if not millions, of assets, in order to generate current loan level data would be enormous. We would, accordingly, urge that any regulations adopted by the SEC apply only to ABS issued after the effective date of any such regulations, which we hope would include an appropriate period for servicers, software providers and other participants to develop and implement enhanced reporting systems.

of securitization reform, has the potential to eliminate the use of securitization as a funding source for credit card issuers—a particularly ironic result, given that credit card securitizations have generally retained their ratings and continued to pay in full notwithstanding the economic crisis, in many cases with post-deal support from their issuers.

In addition to tailoring new disclosure requirements to each asset class, it is important for Congress and the SEC to recognize the cost of developing and implementing comprehensive changes to servicers' data collection and reporting systems and in particular for the SEC to work with and solicit input from industry participants as to the types of data that can and should be collected for each asset class, as well as the time frame needed by the industry to put in place the system changes necessary to comply with the SEC's regulations.<sup>76</sup>

### ***Periodic Reporting***

Every issuer of securities pursuant to a registration statement under the Securities Act is required under Section 15(d) of the Exchange Act, and related regulations of the SEC, to comply with the Exchange Act's reporting requirements.<sup>77</sup> For operating companies, the Exchange Act periodic and ongoing reporting obligations generally consist of the obligation to file annual reports on Form 10-K and quarterly reports on Form 10-Q, which are then supplemented as needed by current reports on Form 8-K after the occurrence of certain specified events, such as bankruptcy, change in control, a change in auditors and other unusual material changes. The focus of the periodic reporting is on the financial statements of the company, management's discussion and analysis of the company's results of operations, and the company's current operational risks and challenges.

There are significant differences between ABS and corporate securities and between ABS issuers and operating companies that make this reporting system inapplicable in many ways to ABS reporting. In an ABS offering, financial statements and operating risks do not have particular significance; instead, investors want to understand the transaction structure, the characteristics and quality of the asset pool and the servicing arrangements for the pool. Under modified reporting rules codified in the SEC's Regulation AB,<sup>78</sup> ABS issuers are required to file annual reports on Form 10-K that include detailed disclosure focused on the servicing of the

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<sup>76</sup> We note that the ASF has also recently launched Project RESTART evaluations of the disclosures in credit card and auto securitizations. Given the focus on mortgages, those projects are only now getting underway.

<sup>77</sup> 15 U.S.C. § 78o(d) (2006). Section 13 of the Exchange Act also requires any issuer of securities registered under the Exchange Act (such as securities listed on a national securities exchange) to comply with the Exchange Act's periodic reporting requirements. 15 U.S.C. § 78m(a) (2006). Section 13 rarely applies to ABS, which are not customarily listed on an exchange.

<sup>78</sup> For many years, the SEC worked with issuers to shoehorn ABS reporting into the larger Exchange Act reporting regime, first through a series of exemptive orders and then primarily through the issuance of scores of no-action letters and other interpretive advice, through which a modified reporting regime for ABS and ABS issuers gradually took form. While the SEC largely intended to codify the existing modified reporting for ABS issuers, Regulation AB imposed more comprehensive and detailed Exchange Act reporting requirements on ABS issuers than had existed previously, with disclosure more precisely tailored to meet the needs of ABS investors. Asset-Backed Securities, Securities Act Release No. 33-8518, Exchange Act Release No. 34-50905, 70 Fed. Reg. 1506, 1508 (Jan. 7, 2005) (the "Issuing Release").

assets backing the ABS. Under Regulation AB, an ABS issuer's 10-K must be accompanied by assessments of compliance with the "servicing criteria" specified in Item 1122 of Regulation AB. These servicing criteria not only cover billing and collection activity, but also such items as custodial arrangements, recordkeeping, investor reporting and payments, reconciliation, and application of funds and in some cases establish specified servicing standards. Independent accountants' attestations relating to such assessments of compliance are also required. The assessments of compliance and related accountants' attestations must be provided by each servicer of 5% or more of the asset pool, as well as certain other transaction parties, such as document custodians and entities that hold collections on the assets and calculate and distribute payments to investors. In addition to annual reports on Form 10-K, a copy of each periodic distribution report to investors is required to be filed with the SEC on Form 10-D within 15 days following the delivery of the distribution report to investors. Form 10-D also contains additional line item reporting requirements intended to provide regular updates on asset performance and pool characteristics. Finally, ABS issuers are required to report promptly (usually within specified time periods) certain extraordinary events tailored to securitization transactions, such as the termination of a servicer, removal of a trustee, or the occurrence of an event of default under the transaction documents, using Form 8-K.

The reporting regime established by the SEC through Regulation AB was intended to increase transparency for publicly registered ABS. However, with the notable exception of credit card issuers (which usually continue Exchange Act reporting for the full term of their transactions), most ABS issuers file Exchange Act reports for only a very limited period of time — taking advantage of an Exchange Act provision that permits corporate and ABS issuers with small numbers of investors to suspend Exchange Act reporting. Section 15(d) of the Exchange Act provides that an issuer's obligation to file reports is suspended automatically at the beginning of the first fiscal year following the year of issuance in which such securities are held "of record" by fewer than 300 persons.<sup>79</sup> Because ABS typically is not widely held, being instead concentrated in the hands of a small number of institutional investors, the reporting obligations for a significant portion of ABS issuers, including most RMBS issuers, is automatically suspended in the first year after issuance. As a result, most ABS issuers file distribution reports on Form 10-D and current reports on Form 8-K only during the year in which the ABS is issued, and file a single Form 10-K after the end of that year.<sup>80</sup>

It should be noted that the suspension of the obligation to file reports with the SEC under the Exchange Act does not mean that investors receive no information about the performance of the assets backing their securities. Existing ABS transactions generally require that investors receive a report that accompanies each distribution to investors and contains information about cash flow sources, such as collections on the underlying assets, liquidation proceeds following default, realization on the collateral securing the loans, bond insurance payments and the like,

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<sup>79</sup> 15 U.S.C. § 78o(d) (2006).

<sup>80</sup> The Committee on Capital Markets Regulation, in its report entitled *The Global Financial Crisis, A Plan for Regulatory Reform* (May 2009), available at [http://www.capmktreg.org/pdfs/TGFC-CCMR\\_Report\\_\(5-26-09\).pdf](http://www.capmktreg.org/pdfs/TGFC-CCMR_Report_(5-26-09).pdf), reported that a "rudimentary search" of SEC filings revealed that during the period 2004-07 all but a few RMBS issues each year suspended their Exchange Act reporting. *Id.* at 153 n.349. In adopting Regulation AB, the SEC chose not to address the definition of "held of record" in the Exchange Act Rules. The Issuing Release, at 1561 n. 432.

and how those cash flows have been applied. These reports would reflect payment of fees to servicers, the trustee, bond insurers and other service providers, reimbursement of certain expenses of service providers, and the amount of cash to be distributed in respect of each class of ABS. The reports also would generally provide information on losses, how those losses have been allocated, and what effect the allocation of losses has on credit enhancement for the structure. Some transaction documents also require certain other information to be reported to investors, such as changes in servicers or trustees and certain events of default. This information is provided over the term of the transaction, even where the securitization is issued privately or discontinues public reporting in accordance with Section 15(d) of the Exchange Act. Admittedly, after the Exchange Act reporting is suspended, ongoing disclosure of information is dictated solely by the specific requirements of transaction documents, and the information required to be provided to investors after the suspension of reporting does not necessarily include all of the disclosure detailed in the Exchange Act reports. However, we believe that significant ongoing information is disclosed for nearly all securitizations whether or not they continue public reporting.

In the proposed securitization reform legislation, the Administration has proposed to amend Section 15 of the Exchange Act to continue the application of the periodic reporting requirements of that Act to ABS even if the number of holders of the ABS falls below 300 (although it authorizes the SEC to adopt rules providing for the termination or suspension of such reporting under appropriate circumstances). We are not surprised that the Administration and Congress now seek to make Section 15(d)'s suspension provisions unavailable to ABS issuers. In its initial proposal for Regulation AB, the SEC solicited comment on whether the ability to suspend Exchange Act reporting under Section 15(d) should be revisited and received comments both in favor of and against eliminating automatic suspension for ABS. Ultimately, however, the SEC decided not to revisit the statutory framework, stating that to do so "would raise broad issues regarding the treatment of other non-ABS issuers that do not have public common equity."<sup>81</sup>

We recognize the importance of post-issuance information regarding ABS transactions to an understanding of the performance of the related assets and, accordingly, investment decisions regarding the ABS and generally are supportive of increased transparency in ABS transactions. Undoubtedly, continued Exchange Act reporting would appear to promote transparency by enhancing the amount of information about ABS transactions in the secondary market and facilitate secondary market transactions and SEC oversight. Moreover, we agree that if Section 15(d) is to be made unavailable to ABS issuers, since the provision relating to automatic suspension is statutory, legislative action is required to modify it. However, we have some reservations about this legislative change. First, as the SEC noted in its release adopting Regulation AB, making Section 15(d)'s suspension provision inapplicable to ABS investors does create an issue of disparate treatment of different classes of issuers. Corporate issuers with small numbers of investors will not be subject to continuing Exchange Act reporting requirements, while (depending on any exemptive authority authorized to the SEC and exercised by it) similarly situated ABS issuers would be obligated to continue Exchange Act reporting for the life of the transaction (which, in the case of RMBS could continue for 30 to 40 years, depending on

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<sup>81</sup> Issuing Release at 1563.

the terms of the mortgage loans included in the asset pool). Requiring ABS issuers to continue to file Exchange Act reports through the life of the transaction<sup>82</sup> will not only significantly change current market practice, but will also increase (perhaps significantly) the cost and ongoing expense of securitizations.<sup>83</sup> Moreover, while we understand that many investors in some types of ABS, particularly investors of RMBS, are seeking additional reporting about the performance of the pool assets backing their securities, we are not convinced that investors are expecting or even requesting that such information be publicly filed with the SEC pursuant to the Exchange Act. Rather, we believe that such investors simply want such information to be made available directly to them. In addition, we assume that, in the industry's efforts to facilitate the restart of the private-label securitization market, investor desires for additional reporting will be addressed, as discussed in the section below regarding loan level reporting and additional disclosure requirements. Thus, we have some concern that the cost of providing Exchange Act reports through the life of an ABS transaction will outweigh the benefits to investors. Nonetheless, we recognize that the Congress may well accede to the Administration's desire to mandate continuing Exchange Act reporting for ABS transactions. In doing so, we strongly urge the Congress to make any such change applicable only to new ABS transactions.

We recognize that nothing in the Administration's or Congress's proposal indicates an intention to apply this change retroactively, but we feel it is worth explaining why any legislative change extending the period for Exchange Act reporting should apply only to new transactions. When Regulation AB was adopted, the securitization industry, including sponsors, issuers,

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<sup>82</sup> We note that RMBS transactions generally include an early termination option that permits the servicer or some other participant in the transaction (such as a trustee or master servicer) to purchase all of the underlying mortgage loans at such time as the outstanding principal balance of the loans equals less than a specified percentage (usually 5% or 10%) of the original principal balance of the loans at the closing of the transactions, with the purchase price for the loans being used to pay and retire the related ABS. This feature generally enabled the transaction to be terminated at a time when the costs of maintaining the transaction (such as the expenses associated with servicing the assets, preparing distribution reports and making payments to investors) were thought to exceed the value of the servicing, trustee and other fees paid in connection with the transaction. That feature is of limited utility in existing RMBS transactions, however, because the purchase price required to be paid to exercise the option, generally the outstanding principal balance of the loan pool (plus accrued interest due to investors and all expenses and other amounts to be reimbursed to service providers), in today's market generally exceeds the current value of the assets.

<sup>83</sup> For example, current RMBS transaction documents contemplate that Exchange Act reporting generally will be suspended in the year following issuance of the ABS, and the fees charged by the trustee or other party contractually undertaking the obligation to prepare and file the Exchange Act reports takes the suspension of the reporting obligation into consideration in setting its fee for such reporting. We note, in this regard, that preparing an annual Report on Form 10-K can be extremely time-consuming and expensive for the preparer. For example, for an RMBS transaction in which there are multiple servicers, custodians and other participants who must provide assessments and attestations as to compliance with servicing criteria, the preparer must collect all of the assessments and attestations, review them to assure that they are correct and complete and to determine if they report any material instance of non-compliance, draft the 10-K (which must specifically disclose any material instance of non-compliance in the text of the 10-K even though the assessments and attestations are included as exhibits to the 10-K), circulate it to the issuer or sponsor or other entity that is signing the 10-K for review, arrange for the 10-K to be signed and file it with the SEC. In addition, the preparer usually also must respond to comments on the 10-K provided by SEC staff if the 10-K is selected for review by the staff. Once the comments are resolved to the satisfaction of the SEC staff, then a revised 10-K must be prepared, reviewed, signed and filed with the SEC. Those fees undoubtedly will increase if reporting is not to be suspended, and we may well see that an annual fee will be charged for preparing and filing the reports.

underwriters, servicers, trustees and document custodians, devoted an enormous amount of time and money to develop and implement systems, procedures and processes designed to enable each participant to comply with the reporting obligations imposed by Regulation AB, and extensive and detailed contract provisions are used to ensure that each participant timely reports to the issuer (or the entity preparing the issuer's Exchange Act reports) the information needed to prepare the periodic and ongoing reports and file them timely with the SEC. However, even securitizations issued after the effective date of Regulation AB generally did not provide for Exchange Act reporting, either through contractual obligations or service fees, to continue beyond the first year of the transaction. The relevant parties to the transaction would potentially have no obligation to provide supporting certifications and other materials. The cost of amending transaction documents to reinstate such reporting obligations would be prohibitive. Moreover, for ABS transactions that closed prior to January 1, 2006,<sup>84</sup> the contractual obligations of the servicers and other participants to provide information would not conform to the requirements of Regulation AB. Just as the SEC recognized that imposing Regulation AB's enhanced reporting requirements on existing ABS transactions was impracticable, the Administration and the Congress must equally recognize the enormous difficulties and prohibitive expense of applying this legislative change retroactively. In addition, we note that there is no mechanism in the SEC's rules for resumption of reporting. Accordingly, for outstanding transactions, we do not believe it is practicable, or even feasible, to require the resumption of reporting.

### **Representations and Warranties**

In a typical ABS transaction, the documentation under which the assets are transferred or debt backed by them is issued generally contains representations and warranties regarding the underlying loans or receivables, and specifies who is entitled to enforce those representations and warranties and under what circumstances. These representations and warranties address loan or lease documentation, the property underlying mortgages or leases, origination procedures, and various characteristics of the transferred assets. As we discuss above, the representations and warranties are meant to ensure that the transferred assets have the characteristics such assets were purported to have and that the risk of nonpayment is fairly allocated between the investors and other transaction parties who are in a better position to identify problems or discrepancies. As a general rule, the representations and warranties do not, and are not intended to, provide credit recourse—the transferor is assuming liability if the terms of the assets are not as presented, but not if the obligor fails to pay in accordance with accurately articulated terms. To a large extent this convention is driven by the legal structure of the transaction—credit recourse, beyond de minimis amounts, is inconsistent with a “true sale” of the assets, and thus would compromise the ability to achieve the legal isolation that is one of the defining aspects of a securitization.

Representations and warranties can be viewed either as a means of describing the asset pool with as much specificity as possible—in which case carve-outs for information that the seller cannot reasonably obtain or verify are appropriate and should be reflected in the price the buyer is willing to pay—or as a means of allocating risk, in which case buyers may ask for

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<sup>84</sup> Regulation AB's enhanced reporting obligations became fully effective for ABS issued and sold on or after January 1, 2006.

representations even as to matters such buyers know are not verifiable by the seller. But the latter type of representation is arguably inappropriate where the ultimate investor in the assets—who may not wish to assume any exposure to financial risk of the seller—does not have full information about whether the representations and warranties were believed to be accurate or whether they were instead structured to allocate risk. Entities, their officers and their legal counsel, may also be justifiably uncomfortable providing representations as to matters that they have not been able to verify. This may be particularly true for regulated entities such as banks, which may have difficulty concluding that making representations without reasonable support is consistent with prudent management.

The ASF, through Project RESTART, has issued for comment a set of model representations and warranties for residential MBS that reflects more than a year of discussion among issuers, investors, servicers, rating agencies and other transaction participants. These model representations and warranties are intended to establish industry standards, but are not intended to be binding upon industry participants. The commentary accompanying the request for comments addresses some of the tension described above. A useful example is fraud risk—originators, for instance, are willing to represent to the absence of fraud by them, and are willing to represent that they do not have knowledge of borrower fraud, but are understandably reluctant to represent that others, such as borrowers, have not *committed* fraud that the originators have not yet discovered. Investors, on the other hand, have indicated that they want originators to make an absence of fraud representation without knowledge qualifiers.

Although Regulation AB already requires disclosures of representations and warranties by issuers of a public transaction,<sup>85</sup> the draft securitization legislation proposed by the Obama Administration would require the credit rating agencies to describe the representations and warranties and related enforcement provisions for securitized transactions and to compare those terms in each of the agency’s ratings reports to other similar issuances. The legislation also proposes to require disclosure of fulfilled repurchase requests.

We think it is reasonable to require issuers of ABS to disclose clearly what representations and warranties have been provided, and what exceptions, including knowledge qualifiers, were taken with respect to those warranties. It is likely that MBS investors will require issuers to present that disclosure in such a way that the representations and warranties are easily comparable to the final version of the ASF model provisions. We are concerned, however, that the proposed legislative approach may lead to mandatory requirements for representations and warranties that will force issuers to insure over problems rather than disclose them.

We also are not sure why the requirement to compare representations and warranties to industry standards would be placed with the credit rating agencies rather than with the issuers themselves. The parties involved in the transaction are in the best position to analyze the representations and warranties, repurchase obligations and other remedies for breach, and to explain any deviation from market standard. To the extent disclosure is intended to extend

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<sup>85</sup> Item 1111(e) of Regulation AB requires that issuers “Summarize any representations and warranties made concerning the pool assets by the sponsor, transferor, originator or other party to the transaction, and describe briefly the remedies available if those representations and warranties are breached, such as repurchase obligations.” 17 C.F.R. § 229.1111(e) (2009).

beyond that already required under Regulation AB—and it is not clear, for instance, whether these disclosure requirements would extend to offers and sales issued in transactions exempt from registration under the Securities Act of 1933—we believe that the burden of this disclosure is more fairly and effectively placed with the issuer.

The legislative proposal also requires disclosure “on fulfilled repurchase requests across all trusts aggregated by originator, so that investors may identify asset originators with clear underwriting deficiencies.” This proposal has a number of flaws that would make it unlikely to achieve the stated goals. First, the number of repurchase requests that have been fulfilled by an originator may not be as meaningful a disclosure as the number of repurchase requests that have been made by investors or the related trustees; however, even that number may not be meaningful as it may be skewed by how aggressively investors or trustees assert even tenuous repurchase claims. Second, the number of repurchase requests may not reflect the quality of the underwriting process but rather the quality of recordkeeping by the originator. Repurchase obligations do not reflect payment failures by the obligors, but failure of the securitized assets to have the characteristics they were represented to have. A simple example is a mortgage loan that is reflected in the loan file as having an outstanding balance of \$200,000 when in fact its outstanding balance is \$100,000. The loan may be of tremendously high quality, and may in fact be repaid in full shortly after transfer, but it would still be subject to a repurchase obligation because of the error in the stated amount. Third, a flat number of repurchase requests is not meaningful without knowing the principal balance of the assets transferred. Fourth, because repurchase obligations may vary from transaction to transaction, aggregate repurchase requests may not be comparable across transactions and would likely have to be analyzed as to underlying facts to be informative. Fifth, given the potentially large number of sponsors that may have been involved in securitizations of loans originated by a specific entity, it may be logistically impossible to obtain aggregate data for particular issuers. Sixth, the proposed legislation refers to requests “across trusts,” but there may be numerous transactions that involve comparable representations and warranties that do not involve trusts—including, for instance, sales to Fannie Mae, Freddie Mac and Ginnie Mae.

A more direct way to enable investors to identify originators with underwriting deficiencies would be to direct the SEC to evaluate whether any expansion of historical data regarding asset originators should be required under Regulation AB and whether there are logistical or cost challenges to that approach.

### **Exempted Transactions under the Securities Act of 1933**

We admit to being a bit puzzled by the Administration proposal to amend the Securities Act by striking the exemption from registration provided by Section 4(5). Section 4(5), adopted in 1975, provides a limited offering exemption for real estate notes, or participations in these notes, originated by a banking or banking-type institution subject to federal or state supervision and examination, or by a mortgagee approved by the Secretary of Housing and Urban Development, in each case subject to a minimum purchase price and certain other restrictions.

Subsection (B) of Section 4(5) exempts from registration nonassignable contracts to buy or sell the same types of securities.<sup>86</sup>

The exemption was added to Section 4 by the Securities Acts Amendments of 1975 (the “1975 Amendments”), the genesis of which was a Securities Industry Study Report of the Subcommittee on Securities (S. Doc. No. 93-13, 93d Cong., 1<sup>st</sup> Sess. 1973), which reported the results of an extensive 18-month study and recommended a fundamental reform of the economic and regulatory structure of the securities markets and industry.<sup>87</sup> The 1975 Amendments made sweeping revisions to the Exchange Act, as described in much detail by the Senate Report and the related House Conference Report No. 94-229. No mention of Section 4(5) was found in the Senate Report. The House Conference Report notes in cursory fashion that “the Senate bill provided a limited exemption from the registration provisions of the Securities Act of 1933 for transactions involving the offer or sale of certain mortgages and participation interests in such mortgages. The House amendment contained no comparable provision. The House receded to the Senate.”<sup>88</sup> Other legislative history indicates, however, that Congress’ objective in adopting Section 4(5) and related provisions was to foster broad participation by the private sector in the secondary mortgage markets.<sup>89</sup>

Loss and Seligman note:

The practical consequence of [§4\(5\)](#) is small. Issuers of eligible securities may always seek exemption under [§4\(2\)](#) or [§4\(6\)](#) or [Regulation D](#).<sup>616</sup> They may also register for the shelf under [Rule 415\(a\)\(1\)\(vii\)](#).<sup>617</sup> In part because most issuers did not find the registration process burdensome, Congress in 1983 refused to broaden [§4\(5\)](#) to include such related instruments as “intermediate securities collateralized by first mortgages and second mortgages and loans on cooperative housing,” or to add credit unions, insurance companies, and HUD-approved mortgagees “to the list of institutions that could originate mortgages used as collateral for securities not subject to the registration requirements.”. *(citations omitted)*<sup>90</sup>

It is unclear what effect, if any, on securitizations removal of the exemption will have. Treatises on ABS generally do not mention use of the exemption as an alternative to registration, as they do Section 4(2) and the SEC’s Regulations D and S.<sup>91</sup> However, some securitization practitioners are concerned that repeal of the exemption may have unintended consequences. For example, would mortgage loan repurchase transactions (that is, a transaction in which a pool of mortgage loans is sold to a purchaser with a corresponding obligation of the seller to repurchase the loans at a specified future date) be required to register (or find another suitable exemption)

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<sup>86</sup> 15 U.S.C. 77d(5)(B) (2006).

<sup>87</sup> S. Rep. No. 94-75 (1975), *as reprinted in* 1975 U.S.C.C.A.N. 179, 179 (the “Senate Report”).

<sup>88</sup> H.R. Rep. No. 94-229 (1975) (Conf. Rep.), *as reprinted in* 1975 U.S.C.C.A.N. 321, 341.

<sup>89</sup> Louis Loss, Joel Seligman & Troy Paredes, SECURITIES REGULATION § 7d. (Oct. 2009).

<sup>90</sup> *Id.*

<sup>91</sup> *See, e.g.,* John Arnholz & Edward E. Gainor, Offerings of Asset-Backed Securities § 4 (2009) (discussing exempt transactions and exempt securities).

under the Securities Act? Furthermore, if the exemption is removed, would trustees of RMBS securitization trusts be deemed underwriters of the securities?

Moreover, practitioners are curious why the Administration seeks to remove an exemption that appears to be so little used (if at all) and where any use of it does not appear to have been the subject of abuse or to have exacerbated the subprime crisis. An understanding of the reasons behind the Administration's proposal is necessary in order to better analyze the consequences of eliminating the exemption.

### **Conclusion**

We wish there were an easy way to correct the problems that have beset the securitization market in recent years. We do not think there is. Nor do we believe that regulating the substance of securitization by legislating economic terms, representations and warranties, forms of documentation or simplicity of structures will have the desired effect. In fact, we fear unintended consequences for the financial sector and the economy as a whole. We can, however, make the following observations:

- The concept of an efficient market has been cast in serious doubt by events of the last two years. Altering securitization practices in an effort to ensure the quality and appropriateness of consumer loans that are originated is, at best, an indirect approach that may place the obligation of oversight on those who are too removed from the process to fulfill it effectively. A better approach, and one that is already part of legislative proposals, may be to modernize regulatory oversight of the origination of consumer loans.
- Asset originators, and their regulators, should be carefully assessing the ways in which asset origination is rewarded within the organization; whether quantity is favored over quality; what costs and other constraints limit the loan diligence process and whether such costs and constraints have been shown to reflect an appropriate balance; and what systems, if any, are in place to evaluate and manage the risk of each individual asset origination in light of the risk profile of the organization as a whole. The need to realign incentives in compensation to account for risk has already been recognized with proposals such as the Federal Reserve Board's recent guidance on incentive compensation.<sup>92</sup> Although we are not here addressing the specific points enumerated in that guidance, we agree that ensuring that employees are not provided with incentives to take excessive risk is an appropriate place to start.
- Investors in complex financial products, including securitizations and credit derivatives, should evaluate whether they can effectively disaggregate the bundled risk represented by such products in order to assess their risk exposures more completely and whether hedging strategies can effectively mitigate those risks.

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<sup>92</sup> Federal Reserve System Proposed Guidance on Sound Incentive Compensation Policies, 74 Fed. Reg. 55,227 (Oct. 27, 2009), available at <http://edocket.access.gpo.gov/2009/pdf/E9-25766.pdf>.

- Industry efforts, such as the ASF's Project RESTART, which bring together a wide range of participants in the market with extensive knowledge of the related products, are more likely to provide effective and sustainable market solutions with respect to fundamental economic terms of securitizations than are broad-brushed legislative efforts to regulate the substance of these transactions.
- Legislative and regulatory approaches that focus on closing gaps in disclosure that have been identified during the market upheavals may provide meaningful additional transparency and facilitate risk assessment; however, more disclosure is not always better disclosure, and any expansion of disclosure requirements needs to be evaluated in light of the reliability of the requested information, the costs of producing it, whether the information requested is so proprietary that the requirement will cause participants to exit the market rather than disclose such information, and the value to investors and others that it is expected to bring.

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## APPENDIX A

### Common Securitization Structures<sup>93</sup>

Asset-backed securities issued in conventional securitization transactions, which are sometimes referred to as “term securitizations,” are generally either undivided beneficial ownership interests in the underlying financial assets or debt obligations secured by the underlying assets. Securities of the first type, beneficial ownership interests in the assets, are generally referred to as “pass-through certificates” or “pass-through securities.” These are considered to be equity securities based on their legal form even though they are typically fixed-income securities and may be considered debt for tax purposes. The second type, which is issued in the form of debt, may also be referred to as “pay-through securities,” though that term is less common today.

Securitizations may also be funded through the issuance of commercial paper,<sup>94</sup> referred to as “asset-backed commercial paper” or ABCP, a type of ABS. The issuer is an SPE, known as a “conduit,” and uses the proceeds of the issuance primarily to obtain interests in various types of assets, either by purchasing them or by providing loans secured by them. The conduit usually has a bank sponsor that performs “due diligence” with respect to the asset pools and arranges the financing transactions with the originators of those assets. The bank sponsor typically also provides a liquidity facility that enables the commercial paper to receive very high short-term ratings. Outstanding asset-backed commercial paper is typically paid out of the issuance proceeds of new commercial paper,<sup>95</sup> the cash flow generated by the assets, or borrowings from the bank liquidity facilities if issuance proceeds or cash flows are not available. Transactions entered into by ABCP conduits frequently represent the acquisition of undivided interests in revolving pools of assets rather than individual asset purchases. For instance, companies outside the financial sector—such as manufacturing companies—often rely on conduit securitizations to fund the trade receivables they generate every time they invoice their customers for the products they sell. As some trade receivables are paid, new ones are generated, and the payments are “reinvested” in interests in the new receivables to continue the financing. This is what we refer to as a “revolving pool” securitization; other examples, which we will discuss later, are credit-card receivables and home equity loans.

The assets underlying asset-backed securities are typically loans, receivables or leases, but the broadest sense of the term “asset-backed security” also encompasses interests in bonds, government securities or, in the case of some CDOs, other asset-backed securities. A list of all asset classes securitized to date would be quite lengthy. Common securitization asset classes include residential mortgage loans; commercial mortgage loans; credit card receivables; auto

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<sup>93</sup> In this Appendix, we have not attempted to describe every type of structure or asset class that has been commonly used in securitization. Instead, we wanted to provide a sampling of the diversity of structures and varied economics that characterize the standard structures that fall under the rubric “securitization.”

<sup>94</sup> Commercial paper is a short-term debt obligation with a typical maturity between 1 day and 270 days (or, for some programs, 364 days).

<sup>95</sup> This is known as “rolling over” the commercial paper and is the same process as that used in the corporate commercial paper markets.

loans and leases; student loans; equipment loans and leases; trade receivables; home equity loans; small business loans; and retail installment contracts. Assets commonly financed through ABCP conduits include trade receivables, consumer debt receivables, auto and equipment loans and leases, and CDOs. Conduits may also invest in securities, including asset- and mortgaged-backed securities, corporate and government bonds, and commercial paper issued by other entities.<sup>96</sup>

Securitized assets may carry fixed or floating interest rates (for example, mortgage loans) or no interest rates (for example, trade receivables). They may have long or short maturities, and they may or may not pay their principal over time in installments (also referred to as “amortizing” assets). Securitizations are almost always backed by multiple assets, but occasionally a securitization is backed by a single asset. For example, some commercial mortgage-backed securities transactions have been supported by a single, very large loan. Residual classes that represent the remaining value in a securitization after the payment in full of all other classes sometimes serve as single assets in what are known as re-securitizations (*i.e.*, the securitization of an ABS). Typically, though not always, all the assets in the securitized pool are of the same asset class -- e.g., they are all residential mortgage loans, or all student loans, or all credit card receivables.

The role and identity of the servicer of the assets tends to vary by asset class and by transaction. In trade receivables securitizations, the servicing is typically performed by the company originating those receivables, because that is the entity that has the customer relationship with the obligors. Similarly, in credit card securitizations, where there are continuing advances on the securitized accounts, servicing would typically be performed by the issuer of the cards or an affiliate of the issuer—*i.e.*, by the originator of the assets.

In mortgage loan securitizations, however, there is less likely to be a relationship between the entity originating the loans and the entity servicing them. More than in any other class, individual components of the mortgage securitization process can be isolated. An originator might sell its loans to a third party “servicing released” (meaning that the purchaser acquires the servicing rights) and not know whether they were securitized or how they ultimately performed. A securitization sponsor might pool together loans from a number of different originators with literally dozens of servicers and a master servicer—charged with overseeing the servicers and handling performance reports—that was not involved either in originating the loans or in structuring the securitization. Moreover, servicing might change over the course of the transaction. In most asset classes, the question might be who has the servicing obligations; with respect to mortgage loans, it is more likely to be who has the servicing rights, which are bought and sold separately from the related mortgage loans.

RMBS structures have been criticized in the last two years for limiting the servicers’ ability to modify the securitized loans, but these structures were designed for a normal housing market in which mortgage borrowers could be expected to make payments on their mortgage

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<sup>96</sup> In transactions known as synthetic securitizations (or synthetic CDOs), the investors do not have direct exposure to a portfolio of customary cash-producing financial assets, but rather to a credit default swap that references financial assets. Nevertheless, the term “asset-backed security” is also used to refer to the securities issued in such transactions.

loans in accordance with their contractual terms. In addition, REMIC rules themselves constrained the ability to modify pool assets. If people borrowed too much, or borrowed on too expensive terms, when they bought their homes, that used to be considered an error in their judgment which did not relieve them of their obligations. Only as the problem of inappropriate loans has become widespread has sympathy shifted to the borrowers, backed by a belief that the original lenders may also have been culpable in placing homeowners in unaffordable mortgages. However, RMBS investors believed they were investing in sound mortgages, and the servicing provisions of their deals continued to be designed around the expectation that loan modification would be a rare rather than commonplace remedy.

Typically, re-securitizations of bonds or other ABS do not have a servicer, but they may have an asset manager or administrator with authority to take actions relating to the assets. In securitizations of commercial mortgage loans, the servicing function is divided between a master servicer, which performs normal servicing functions, and a special servicer, which services defaulted or severely delinquent loans.

### *Credit card securitization*

In a typical credit card securitization, the originator of the receivables (generally a bank, which we also refer to as the card issuer) forms a master trust and transfers all of the receivables in designated accounts to that trust. The receivables are the amounts borrowed by a cardholder when that cardholder uses the card to make purchases, obtain cash advances, or transfer balances, along with related finance charges, merchant discount<sup>97</sup> and fees. For any individual cardholder with a designated account, the receivable for every transaction associated with that account will automatically be transferred to the master trust and all payments by the cardholder will be required to be paid into the master trust. If the cardholder eventually defaults, the resulting loss is also allocated through the master trust. However, the account relationship remains with the originating bank, which is the entity that makes each advance when the card is used, and the cardholder can expect to deal with the originating bank—and not the trust—in paying bills, asking for credit line increases, and negotiating payment relief.

The card issuer usually takes back a seller certificate (also referred to as a transferor certificate) that represents the residual interest in the trust and is generally *pari passu* with investor interests, receiving allocations of collections and losses based on the card issuer's proportionate interest in the trust relative to the investors' interests.<sup>98</sup> When the trust is formed, the interest in receivables is represented entirely by the seller certificate and referred to as the seller interest or the transferor interest. For example, if a card issuer transferred \$1 billion of receivables to a master trust, the issuer would initially receive a seller interest that represented that full \$1 billion. When ABS are issued by the securitization trust to investors, a portion of the seller interest is converted into those ABS, the value of the seller certificate declines by the amount of the newly issued investor interests, and the seller receives the cash paid by the

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<sup>97</sup> When a purchase is made using a credit card, the merchant typically receives the purchase price minus a small, negotiated percentage that is divided among the card processor, the card network and the issuing bank. These amounts are referred to as “merchant discount” and “interchange.”

<sup>98</sup> Sometimes the seller interest is held by an intermediary entity that is a wholly-owned subsidiary or another affiliate of the originator.

investors for their interest in the receivables. A \$600 million issuance of securities would reduce the seller interest to \$400 million.<sup>99</sup> The investor certificates and the seller interest each represent fractional undivided interests in the pool of receivables, which means generally that they are *pari passu* exposures to the entire pool. In the example above, 60% of every dollar of collections would be allocated to the investors and 40% of every dollar of collections would be allocated to the seller. Losses would be allocated in the same way. As a result, so long as the card issuer holds the seller interest directly or through an affiliate—and typically it is required to do so, and to maintain it at a specified percentage of investor interests—the card issuer has an ongoing exposure to the risk of the pool that is generally at least equivalent to that of third-party investors.<sup>100</sup>

When looking at the economic health of a credit card securitization, the key measurement is a metric called “excess spread.” Excess spread is calculated by determining portfolio yield on the receivables (finance charge collections, fees, interchange and recoveries of charged-off receivables are common elements of yield) and subtracting from that amount the servicing fee, the charge-offs, credit enhancement or guarantee fees, and the cost of funds. Typically this is then described as an annualized percentage of principal receivables in the trust. For instance, if the portfolio yield is 15%, the charge-off rate is 6%, the servicing fee is 2% and the coupon on the securities is 5%, we would say that the transaction has an excess spread of 2%. This amount—the return on the receivables, minus the cost of financing them and the cost of losses on the portfolio—is essentially a profit measure and flows back to the holder of the seller interest on a monthly basis. If the portfolio becomes more risky, the charge-off rate will go up and the excess spread will go down. If the excess spread goes below 0%, usually as measured on a three-month rolling average basis, the deal will amortize, meaning that principal collections will be distributed to the investors rather than continuing to be reinvested in the business, with the result that the originator will lose an important component of its liquidity and will be trying to finance a pool of receivables that yields less than the cost of funding it. As a result, originators focus intently on the potential effects that any change in card management strategies might have on their excess spread, which is a proxy for the success of the business as a whole.

The excess spread in a credit card securitization is also a form of credit enhancement for investors. Sometimes the spread is used to fund reserve or “spread” accounts, and it also functions as the first line of defense against losses in the portfolio. In the example above, the charge-off rate was 6% on an annualized basis, meaning that 6% of the entire securitized portfolio was charged off as uncollectible over the course of the year. Credit card securitizations assume some level of annual charge-offs and are structured so that those charge-offs are reimbursed out of finance charge collections, recoveries, interchange and other fees, instead of being reflected as a loss to investors. If all other performance statistics were to stay the same, the

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<sup>99</sup> Many structures now include a connected “note issuance trust” as well, that holds a certificate from the master trust and issues true debt securities (as opposed to pass-through certificates, which are technically equity). The economics are generally the same regardless of the form of the security supported by the credit card receivables, but the note issuance vehicles are typically structured to allow more flexible timing on issuances—in particular, junior tranches of notes can be issued ahead of, rather than concurrently with, senior tranches of notes.

<sup>100</sup> Because third-party investors generally receive some form of credit enhancement to support their interests, the unenhanced interest of the originator in the pool generally bears more risk than that assumed by the credit-enhanced investors.

trust portfolio described above could sustain an additional 2% of charge-offs per year before investors would experience a reduction in their credit enhancement—and the seller would bear those charge-offs through a reduction in the value of its interest in the excess spread. Similarly, if excess spread is captured in a spread account, the funds in the spread account are used to cover charge-offs before investors bear a risk of loss. Because funds in the spread account are paid to the originator at the end of the transaction, the originator bears the risk of loss, and the resulting loss in profitability, when charge-offs exceed expected levels and funds in the spread account are used to cover those extra charge-offs. Finally, if excess spread dipped below the early amortization trigger, the master trust would immediately start repaying investors to reduce their exposure to future losses.

Early amortization—the accelerated repayment of investors’ securities as a result of performance or other issues with the pool—is another form of economic protection to investors that is present in revolving structures, such as credit card trusts, but not in static structures such as RMBS trusts. A tranche of interests in a card securitization might be structured with a single maturity date five years after issuance—but the trust might collect 20% of the principal of the receivables supporting that tranche in the first month after issuance.<sup>101</sup> That principal is distributed to the seller for reinvestment in new receivables, rather than being paid to the investors, during the “revolving period.” As an example, for the \$600 million interest described above, perhaps \$120 million in principal collections is received in that first month. That means that the investors would have a \$480 million interest in receivables and a \$120 million interest in cash. The cash is distributed to the seller to compensate for the transfer of another \$120 million interest in receivables, and the investors enter the next month of the transaction with their interest restored to \$600 million. However, if the assets in the trust does not perform well—meaning that increases in default rate are not sufficiently offset by increases in yield—and as a consequence an early amortization event occurs, that cycle will be broken, the cash will be paid out to investors monthly as it comes in, and the investors’ exposure to poorly performing receivables will quickly unwind. As the investors’ interest unwinds, the card issuer’s exposure will increase proportionately. As a result, credit card issuers do not view securitization as a way of offloading credit risk—they view it as a source of liquidity, and they understand that the health of their overall portfolio needs to be maintained to continue to have access to that liquidity.

One other significant aspect of exposure that credit card issuers often, though not always, have is through holding subordinated securities in their securitizations. Achieving a triple-A rating on a senior tranche generally requires one or more subordinated tranches, cash collateral accounts or guarantees to provide additional enhancement to that tranche. Typically only investment grade tranches of junior securities have been issued to third-party investors. As the market for junior tranches has virtually disappeared over the last two years, credit card issuers have retained their subordinated tranches or sold them to affiliates in order to retain senior-level funding capacity.<sup>102</sup> As a result, credit card issuers often retain significant first loss positions for their securitized receivables portfolio.

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<sup>101</sup> This sort of payment rate is inconceivable for a mortgage loan pool, even in a robust housing market with significant ability for homeowners to refinance.

<sup>102</sup> Some issuers had retained the most junior exposures in their credit card securitizations even prior to the market disruptions of the last several years.

Credit card issuers view the performance of their credit card securitizations as a source of reputational risk, as a source of liquidity and as creating diversity of funding sources helpful for maintaining good ratings. Because of the strong relationship between a credit card issuer's profitability and the continued performance of its securitized credit card portfolio, through excess spread generation, the potential for early amortization and the need to maintain a steady source of liquidity, credit card issuers understand that the health of their overall portfolio needs to be maintained.

### *Trade receivables*

Trade receivables securitizations are a source of liquidity for companies that are not in the business of originating debt obligations—but that do originate them as part of the ordinary course operation of their business. Trade receivables represent the obligations invoiced to a company's customers and generally turn over every 30 to 60 days. Typically, they are securitized by transferring the receivables to a wholly-owned SPE subsidiary of the originator in a "true sale" transaction. The SPE then either enters into a secured lending arrangement with a commercial paper conduit or sells the conduit an undivided interest in the pool.<sup>103</sup>

The process of conducting a conduit securitization of trade receivables bears a much stronger resemblance to the structuring of a bank loan secured by receivables than it does to a public term securitization of consumer receivables. The sponsoring bank will conduct "due diligence" with respect to the pool, set "concentration limits" that limit the exposure it is willing to take to individual customers of the originating company or to categories of customers (determined, for instance, by credit rating or by geographic concentration), establish an advance rate with respect to the pool, and set early amortization triggers that will cut off the conduit's obligation to make advances against new receivables originations. The presence of these early amortization triggers tied for instance to delinquency or default rates on the receivables, as a supplement to or a substitute for more stringent financial covenants related to the originator itself, is one of the critical structural differences between a conduit securitization of trade receivables and a bank loan secured by those same receivables.

The originator generally retains significant exposure to the receivables through the advance rate, which establishes a mandatory degree of overcollateralization, through the excess exposures above the concentration limits of the pool and in some transactions through ineligible receivables, which may be included in the pool even though they do not count for purposes of applying the advance rate. The advance rate is the percentage of eligible receivables against which the originator can borrow. A conduit might, for instance, agree to lend only amounts up to 70% of the receivables base, so that, if a company had \$100 million in eligible receivables and \$10 million in ineligible receivables, it could only receive securitization proceeds of \$70 million

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<sup>103</sup> As discussed above, a commercial paper conduit is an SPE that is sponsored by a bank. The conduit buys assets from a variety of different originators (one term used frequently is a "multi-seller conduit") and issues commercial paper supported by those assets, with a liquidity line from the bank to address any timing mismatch between payments on the assets and repayment on the commercial paper. The commercial paper is typically rated in the highest short-term categories by the relevant credit rating agencies, and the conduit passes on to its customers its advantageous short-term borrowing costs, along with a variety of structuring, liquidity and placement fees.

supported by those receivables. But the conduit would have an interest in the full \$110 million, with \$40 million of overcollateralization to absorb losses on the pool. The amount of receivables representing the overcollateralization would typically be contributed to the capital of the SPE by the originator, and any losses would be experienced by the originator as a reduction in equity.

### *Auto Loan Securitization*

Auto loan securitizations are a source of liquidity for companies that provide consumer financing for the purchase of new and used automobiles. Auto loan receivables represent amounts owed by obligors under motor vehicle installment loans and retail installment sales contracts and generally have an average original term between five to six years. As previously mentioned, auto loan securitizations are static pool transactions in that the pool of receivables is designated at the beginning of the transaction and the cash flow of the transaction reflects the amortization of such pool. As such, the receivables in an auto loan securitization amortize as obligors' payments with respect to such receivables are received and the amount of such payments is distributed to the investors in the transaction.

In a typical auto loan securitization, the originator or sponsor of the transaction will form a trust and sell receivables to the trust in a "true sale" transaction. As in credit card transactions and trade receivables transactions, it is rare for the pool supporting auto loan securitizations to consist of loans that the sponsor has not itself originated or that have not been originated for it using the sponsor's credit underwriting guidelines. Unlike residential mortgage loans, there is no active market for whole loan sales of motor vehicle loans.

The trust raises the funds to pay the purchase price for the receivables by issuing and selling the notes to investors. The trust then uses the sale proceeds to purchase the receivables from the sponsor. The notes are obligations of the trust secured by the trust's assets and generally will not be obligations of, or guaranteed by, the sponsor or any of its affiliates or any other person. As such, performance of the notes will be based on the performance of the receivables (*i.e.*, payments by the obligors on the receivables).

In addition to the notes, the trust will issue one or more certificates that represent the entire beneficial interest in the trust. The certificates are non-interest bearing and entitle the holder to the residual cash flow (if any) of the trust after payment of all the notes. In some transactions, the certificates are intended to be transferrable and sold to investors. However, it is rare that such certificates are sold, except to affiliates of the sponsor.

Auto loan securitizations generally are structured to provide some form of credit enhancement for the notes. Credit enhancement provides protection for the notes against losses and delays in payment on the pool of receivables and may consist of (i) excess spread, (ii) overcollateralization, (iii) a reserve account and/or (iv) subordination of certain classes of notes and the certificates.

Excess spread is calculated by determining the finance charge collections on the receivables and other amounts included in yield, and subtracting from those amounts the servicing fee, the charge-offs, credit enhancement and the cost of funds. Finance charge

collections are used on a monthly basis to cover charge-offs arising in that month and other expenses of the securitization, and any remaining amount may then be used either to pay down one or more classes of notes, thereby creating overcollateralization,<sup>104</sup> or to fund a reserve account. Once the overcollateralization amount or the reserve account balance has reached a specified level, the remaining excess spread is paid to the holders of the subordinated notes, if issued, and then to the certificates.

When the principal amount of the receivables owned by the trust exceeds the principal amount of the notes issued by the trust, overcollateralization exists. Overcollateralization may exist when the notes are issued and it may be created or increased after the notes are issued by the use of excess spread, as noted above. Overcollateralization protects investors from losses on the receivables because charge-offs that exceed the monthly amount of excess spread will reduce the overcollateralization, but will not result in a loss to investors (until the overcollateralization is reduced below zero).

Whether overcollateralization exists at issuance or is created or increased after issuance, the overcollateralization represents exposure that the sponsor has to the performance of the receivables. In the case where overcollateralization exists at issuance, the sponsor will have transferred more receivables to the trust than the trust receives in principal amount for the notes, and the sponsor's transfer of the excess receivables to the trust will have been made for no immediate return. Similarly, where overcollateralization is created or increased after issuance, the overcollateralization arises from the payment of excess spread to one or more classes of notes, as a reduction of their principal amount, instead of to the sponsor as holder of the certificates. So in either case, the sponsor foregoes immediate returns in order to provide protections to investors and, as a result, bears risk of future performance on the receivables. Since the sponsor did not profit from the sale of the receivables at the issuance, its profit arises only as excess spread and overcollateralization are paid to the sponsor as holder of the subordinated notes or the certificates.

One other form of credit enhancement used in some auto loan securitizations is subordination of one or more classes of notes and/or certificates. Some trusts issue subordinated notes in addition to a certificate, whereas others issue only senior notes and certificates. In either case, the subordinated notes or the certificates are generally owned by the sponsor or its affiliates. The subordinated notes and the certificates are entitled to receive payments only if the receivables pool is performing within certain specified criteria, including levels of charge-offs, levels of delinquencies, recoveries on repossessed vehicles and similar economic indicia. Because the sponsor or its affiliates hold the subordinated notes or certificates, the sponsor has strong incentives to maintain the performance of the receivables pool.

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<sup>104</sup> Any payment of principal of obligations that uses funds other than principal collections of the assets creates overcollateralization. For example, assume a trust issues \$100 million of loan receivables and \$100 million of notes. In the first year, the trust receives \$20 million of principal collections that it distributes to investors but also generates \$2 million of excess spread that it uses to pay down principal of the notes. Going into the following year, the trust will have \$78 million of notes supported by \$80 million of loan receivables. We would thus describe the effect of the application of the \$2 million excess spread to note principal as having created overcollateralization in the trust.

As in credit card transactions, because the sponsors of auto loan securitizations may lose current and future funds and experience a resulting reduction in profitability, they are quite focused on the potential effects that any change in underwriting criteria of the auto loans might have on their excess spread. Also like credit card issuers, sponsors of auto loan securitizations view the performance of their securitizations as a source of reputational risk, as a source of liquidity and as creating diversity of funding sources helpful for maintaining good ratings. Because of these strong connections between the sponsor's profitability and continued performance of its auto loan pools, through excess spread generation, minimization of charge-offs and the need to maintain a steady source of liquidity, sponsors of auto loan securitizations understand that prudent underwriting criteria for their auto loan business need to be maintained.

### *Auto Lease Securitization*

Auto lease securitizations provide a source of liquidity for auto leasing companies (typically captive auto finance companies and banks). Auto lease receivables represent amounts owed by obligors under motor vehicle leases, which may have terms between one and six years. As previously mentioned, auto lease securitizations are static pool transactions in that the pool of lease receivables is fixed at the beginning of the transaction and the cash flow of the transaction reflects the payments received on such pool. As such, the receivables in an auto lease securitization amortize as obligors' payments under the leases are received and those payments are distributed to the investors in the transaction.

Unlike obligors in an auto loan securitization, the obligor under an auto lease does not own the related motor vehicle. This requires the sponsor of the auto lease securitization to fund the purchase of the related motor vehicle itself and take the risk of loss on the value of the motor vehicle at the end of the related lease. This is referred to as residual risk. For example, if a motor vehicle has a purchase price of \$10,000 and the residual value of the vehicle at the end of the lease is set at 50%, then (i) the sponsor has to fund the full purchase price less any payment received from the obligor (a "cap cost reduction payment") and (ii) at the end of the lease, the sponsor has to sell the vehicle for at least \$5,000 to break even. If the vehicle is sold for less than \$5,000, the sponsor realizes a loss on the residual value. This is a risk that is borne in full by the sponsor, unless it is able to obtain residual risk insurance. Residual risk insurance is difficult to obtain (very few insurers write such policies) and, if it is obtainable, contains many caveats to payment by the insurer in addition to risk retention/first loss retention by the sponsor.

In a typical auto lease securitization, the sponsor of the transaction will form a trust (referred to as the titling trust) to own all of the leases and related vehicles. The titling trust issues two certificates to the sponsor, one representing beneficial ownership of the payments under the leases and the other representing beneficial ownership of the motor vehicles. Typically, the sponsor also enters into a financing arrangement whereby the sponsor lends funds to the titling trust in an amount necessary for the titling trust to purchase the related motor vehicles. The sponsor, as lender, therefore bears the full risk that the obligors on leases related to the motor vehicles will default on the leases and the full risk that the residual values of the motor vehicles will not be less than the amount received upon liquidation of those motor vehicles.

When the sponsor decides to complete a securitization, it will identify a pool of leases for that securitization, obtain a special certificate from the titling trust entitling the owner of that special certificate to payments received on that identified pool of leases (and no others) and sell that special certificate to a second trust (referred to as the issuing trust). In order to purchase the special certificate from the sponsor, the issuing trust issues notes, sells the notes to investors and uses the sale proceeds to purchase the special certificate from the sponsor. The notes are obligations of the issuing trust secured by the issuing trust's assets and will not be obligations of, or guaranteed by, the sponsor or any of its affiliates or any other person. As such, performance of the notes will be based on the performance of the pool of leases related to the special certificate owned by the issuing trust.

In addition to the notes, the issuing trust will issue one or more certificates that represent the entire beneficial interest in the issuing trust. The certificates are non-interest bearing and entitle the holder to the residual cash flow (if any) of the issuing trust after payment of all the notes. In some transactions, the certificates are intended to be transferrable and sold to investors. However, it is rare that such certificates are sold, except to affiliates of the sponsor.

Auto lease securitizations generally are structured to provide some form of credit enhancement for the notes. Credit enhancement provides protection for the notes against losses and delays in payment on the leases and may consist of (i) excess spread, (ii) overcollateralization, (iii) a reserve account and/or (iv) subordination of certain classes of notes and the certificates.

Like the excess spread in an auto loan securitization, excess spread for an auto lease securitization is calculated by determining portfolio yield on the lease receivables (*i.e.*, the excess of the monthly lease payments over a calculated discounted lease amount<sup>105</sup>) and subtracting from that amount the servicing fee, the charge-offs, credit enhancement and the cost of funds. Funds included in portfolio yield are used on a monthly basis to cover charge-offs arising during that month and other expenses of the securitization, and any remaining amount may then be used either to pay down one or more classes of notes to create overcollateralization or to fund a reserve account. Once the overcollateralization amount or the reserve account balance has reached a specified level, the remaining excess spread is paid to the holders of the subordinated notes, if any have been issued, and then to the certificates.

When the principal amount of the discounted lease amounts represented by the special certificate exceeds the principal amount of the notes issued by the issuing trust, overcollateralization exists. As in an auto loan securitization, overcollateralization may exist when the notes are issued, and it may be created or increased after the notes are issued by the use of excess spread, as noted above. Overcollateralization protects investors from losses on the leases because charge-offs that exceed the monthly amount of excess spread will reduce the overcollateralization, but will not result in a loss to investors (until the overcollateralization is reduced below zero).

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<sup>105</sup> Because lease payments do not represent true principal payments, lease securitizations generally consider the adequacy of the amount of collateral in the trust by determining the net present value of the stream of lease payments, discounted at a market rate of interest.

Whether overcollateralization exists at issuance or is created or increased after issuance, the overcollateralization represents exposure that the sponsor has to the performance of the receivables. In the case where overcollateralization exists at issuance, the sponsor will have transferred to the issuing trust more discounted lease balances represented by the special certificate to the issuing trust than the issuing trust receives in principal amount for the notes, and the shortfall will be made up by the sponsors transferring that excess to the issuing trust for no immediate return. Similarly, where overcollateralization is created or increased after issuance, the overcollateralization arises from the payment of excess spread to one or more classes of notes, as a reduction of their principal amount, instead of to the sponsor as holder of the subordinated notes or the certificates. In either case, the sponsor foregoes immediate returns in order to provide protections to investors and, as a result, bears risk of future performance on the leases. Since the sponsor did not profit from the origination of the lease or the sale of the special certificate to the issuing trust, its profit arises only as excess spread and overcollateralization are paid to the sponsor as holder of the subordinated notes or the certificates.

One other form of credit enhancement used in some auto lease securitizations is subordination of one or more classes of notes and/or certificates. Some issuing trusts issue subordinated notes in addition to a certificate, whereas others issue only senior notes and certificates. In either case, the subordinated notes or the certificates are typically owned by the sponsor or its affiliates because the yield that investors would require for such instruments is too high to make the transaction profitable. The subordinated notes and the certificates are entitled to receive payments only if the lease pool is performing within certain specified criteria, including levels of charge-offs, levels of delinquencies, recoveries on repossessed vehicles and vehicles recovered at the end of the leases and similar economic indicia. Because the sponsor or its affiliates hold the subordinated notes or certificates, the sponsor has strong incentives to maintain the performance of the lease pool.

As in credit card transactions and auto loan securitizations, because the sponsor may lose current and future funds and experience a resulting reduction in profitability, they are quite focused on the potential effects that any change in underwriting criteria of the auto leases, including the determination of residual values, might have on their excess spread. Also, like credit card issuers and auto loan securitization sponsors, sponsors of auto lease securitizations view the performance of their auto lease securitizations as a source of reputational risk, as a source of liquidity and as creating diversity of funding sources helpful for maintaining good ratings. Because of the strong connection between the sponsor's profitability and continued performance of its auto lease pools, through excess spread generation, minimization of charge-offs and the need to maintain a steady source of liquidity, sponsors of auto lease securitizations understand that sound underwriting criteria for their auto lease business need to be maintained.

### *Mortgage Loan Securitization*

Mortgage loan securitizations have many structural features in common with auto loan securitizations, discussed above. Mortgage loans are securitized by a sponsor that is either the originator of the loans or a third party that purchases them from one or more originators. The sponsor typically transfers the loans to a trust via one or more transactions that are structured to constitute a "true sale" of the loans by the sponsor -- *i.e.*, a sale that will not be characterized as a pledge of the loans by the sponsor should it enter bankruptcy or a similar insolvency regime. The

trust usually issues multiple classes of securities. However, instead of notes (as in auto loan securitizations), the securities are in the form of certificates representing beneficial ownership interests in the underlying loans. Mortgage loan pools are “static”—*i.e.*, with certain exceptions, new loans are not added to the securitized pool after the date on which securities are issued—and payments of principal on the loans are applied on each monthly distribution date to reduce the principal balance of the securities issued in the securitization. The loan pools in residential mortgage loan securitizations tend to be fairly homogeneous in terms of size and loan characteristics. The loan pools in commercial mortgage loan securitizations typically exhibit significantly more variability.

When the sponsor sells mortgage loans into a securitization, it ultimately receives, as consideration for the transfer of the loans, either all cash (if all classes of the securities issued in the securitization are sold to third parties) or a combination of cash and one or more classes of the issued securities. Classes that represent a portion of the consideration for the transfer of the loans represent the sponsor’s retained interest in the securitization and tend either to be unrated or to have non-investment-grade ratings from the applicable credit rating agencies.

To the extent that the sponsor retains such an interest, as is often the case in residential mortgage loan securitizations, the sponsor generally has incentives as to the loan pool’s performance that are similar to, or the same as, those discussed above with respect to other asset classes. The type and size of the retained interest necessary to induce the sponsor to perform an appropriate level of due diligence with respect to the related loan originators and loan underwriting turn on a number of considerations, principally those that would tend to affect the expected risk of loss on the loan pool.<sup>106</sup> If the securitization is structured so that the sponsor’s retained interest is the most subordinate class of issued securities, and if losses on the loan pool are expected to exceed that class’s principal balance (or, for a class with no principal balance, if the expected loan losses would otherwise render the class worthless) irrespective of the sponsor’s screening efforts, retention of the class is unlikely to influence the sponsor’s diligence incentives. Increasing the size of the retained interest could theoretically increase the sponsor’s incentives; but, as with any other asset class, requiring retention of an interest whose risk of loss exceeds the loan pool’s expected losses could prevent the securitization from ever closing because it jeopardizes achievement of legal isolation (*i.e.*, a true sale) of the transferred loans. In short, whether retaining an interest in a residential mortgage loan securitization is likely to motivate a sponsor to better screen a securitization’s loans and loan originators requires a careful analysis of factors that affect expected losses on the related loan pool. Relatively inflexible requirements as to the nature and size of retained interests may neither serve the intended purpose of increasing the sponsor’s incentives nor promote the continuation of securitization as a financing tool.

In the case of all-cash mortgage loan securitizations, where sponsors retain no continuing interest in the securitized loans, the diligence function that risk retention is designed to promote may effectively be performed not only by the sponsor but also by investors in the classes the

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<sup>106</sup> See, e.g., International Monetary Fund, *Global Financial Stability Report: Navigating the Financial Challenges Ahead* 1, 101 (October 2009) (concluding, on the basis of recent studies, that the optimal size and seniority of the retained class or classes of issued securities depend critically on reasonable assumptions about the loan pool’s credit quality and the economic conditions (*i.e.*, high versus low probability of recession) expected during the life of the securitization).

sponsor would otherwise have retained.<sup>107</sup> Firms that specialize in investing in the junior classes of residential and commercial mortgage loan securitizations are willing to purchase them only because they have developed the expertise to assess the value of these classes. A proper assessment may be made only if the investors have as much information as, or more information than, the sponsor has about the underlying loans. Junior class investors have every incentive to discover this information because, unlike the senior classes, the junior class (as the “first loss” class) is diminished in value, roughly dollar for dollar, for every loss in the loan portfolio. The fact that the purchase price of the junior classes will be heavily negotiated by the investors also serves as an inducement to the sponsor to conduct its own thorough assessment of the underlying loans’ value.

Unlike RMBS transactions, which frequently contemplate the retention of issued classes by the sponsors, CMBS transactions are generally designed to be all-cash securitizations. The junior classes are purchased by highly specialized firms known as “B-piece buyers,” which play a significant role in the securitization process. Among other things, the B-piece buyers re-underwrite the underlying loans and, before the securitization closes, may require sponsors to remove unacceptable mortgage loans from the transaction. Because of the diligence function performed by B-piece buyers in CMBS transactions, it is unclear what additional incentives would be created by requiring the sponsors of these transactions to retain a substantial portion of the related credit risk.

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<sup>107</sup> See, e.g., Ronel Elul, *The Economics of Asset Securitization*, in BUSINESS REVIEW 16, 20 (Federal Reserve Bank of Philadelphia, third quarter 2005) (explaining how tranching a securitization into senior and junior classes encourages sophisticated investors to become as informed as the sponsor about the value of the assets underlying the securitization and how the sponsor need not retain any interest in the securitization when it has no informational advantage over the junior class investors).