Testimony on Understanding the Implications and Consequences of the Proposed Rule on Risk Retention

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Before the Subcommittee on Capital Markets and Government Sponsored Enterprises of the United States House of Representatives Committee on Financial Services

Thursday, April 14, 2011

Chairman Garrett, Ranking Member Waters, and members of the Subcommittee:

My name is Meredith Cross, and I am the Director of the Division of Corporation Finance at the U.S. Securities and Exchange Commission. I am pleased to testify on behalf of the Commission today on the topic of risk retention in securitizations. I appreciate the opportunity to discuss with you the Commission's work in this area.

Background

Securitization generally is a financing technique in which financial assets, in many cases illiquid, are pooled and converted into instruments that are offered and sold in the capital markets as securities. The securities sold through these types of vehicles are called asset-backed securities, or ABS. This financing technique makes it easier for lenders to exchange payment streams coming from the loans for cash. Some of the types of assets that are financed through securitization include residential and commercial mortgages, agricultural equipment leases, automobile loans and leases, student loans and credit card receivables. Often, a bundle of loans is divided into separate securities with different levels of risks and returns. Payments on the loans typically are distributed to the holders of the lower-risk, lower-interest securities first, and then to the holders of the higher-risk securities.

The financial crisis focused attention on the possible misalignment of incentives of participants in the securitization process. Risk retention requirements have been discussed by some market participants as one potential way to improve the quality of asset-backed securities by better aligning the incentives of the sponsors and originators of the pool assets with investors' incentives.

Credit Risk Retention under Section 941(b) of the Dodd-Frank Act

Section 941(b) of Subtitle D of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act, or Act), which is codified as new Section 15G of the Securities Exchange Act of 1934, generally requires the Commission, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and, in the case of the securitization of any "residential mortgage asset," the Federal Housing Finance Agency and Department of Housing and Urban Development, to jointly prescribe regulations that require a securitizer to retain not less than five percent of the credit risk of any asset that the securitizer – through the issuance of an asset-backed security – transfers, sells, or conveys to a third party.[1] Section 15G also provides that the jointly prescribed regulations must prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain.[2]

On March 30, 2011, the Commission joined its fellow regulators in issuing for public comment proposed rules to implement the risk retention requirements of Section

[1] *See* § 78o-11(b)(1) and (2).

[2] *See* § 78o-11(c)(1)(A).

15G.[3] Consistent with the Act, the proposed rules generally would require a sponsor to retain an economic interest equal to at least five percent of the credit risk of the assets collateralizing an issuance of ABS. In developing the proposal, the staffs of the agencies considered the diversity of assets that are securitized, the structures historically used in securitizations, and the manner in which sponsors have historically retained credit risk exposure.

The proposed rules would permit a sponsor to choose from a menu of risk retention options. These options, and the other conditions of the proposal, were designed to provide appropriate flexibility, while also ensuring that the sponsors actually retain risks designed to align incentives. The four options that would generally be available in all securitizations include:

1) A "vertical slice" option whereby the sponsor retains not less than five percent of each class of ABS interests issued in the securitization;

2) A "horizontal slice" option whereby the sponsor retains a first-loss, last-pay residual interest in an amount equal to not less than five percent of the par value of all ABS interests in the securitization. As an alternative to actually retaining a residual interest, this option also allows the sponsor to establish a cash reserve account valued in the same amount and structured to operate as a first-loss position;

3) An "L-shaped" option whereby the sponsor holds half of the five percent retained interest using the vertical slice option and half in the form of the horizontal slice option; and

[3] *See* Release No. 34-64148, *Credit Risk Retention* (March 30, 2011), http://www.sec.gov/rules/proposed/2011/33-64148.pdf.

4) A representative sample option whereby the sponsor retains a randomly-selected, representative sample of the assets designated for securitization in an amount equal to not less than five percent of the unpaid principal balance of all the designated assets.

The proposed rules also include three transaction-specific options related to securitizations involving revolving asset master trusts, asset-backed commercial paper conduits, and commercial mortgage-backed securities. These options were specifically designed to take into account the unique structures historically used in these particular asset classes.

In addition to the risk retention a sponsor would be required to retain under the previously described menu of options, the proposal would also require a sponsor to establish a cash reserve account if the sponsor monetizes excess spread in the transaction by selling an excess spread tranche to a third party, or if the sponsor includes an excess spread tranche senior to other ABS tranches in the contractual cash flow ("waterfall") provisions. Excess spread is generally the difference between the yield on the pool of securitized assets and the coupon paid on the securities, servicing costs, and other trust expenses. The purpose of this additional requirement is to prevent sponsors from effectively negating or reducing the economic exposure they would otherwise be required to retain under the proposed rules.

The proposal would also permit the 100% guarantee of principal and interest provided by Fannie Mae or Freddie Mac to satisfy their risk retention obligations for the mortgage-backed securities they sponsor, but only for the period in which these organizations are operating under conservatorship or receivership with capital support from the United States.

As required by the Act, the proposal provides a complete exemption from the risk retention requirements for ABS that are collateralized solely by "qualified residential mortgages" (or QRMs). The statute requires that the agencies write the definition of QRM "taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default."[4] In developing the proposed definition of a QRM, the staffs of the agencies carefully considered the terms and purposes of Section 15G, public input, and the potential impact of a broad or narrow definition of QRM on the housing and housing finance markets.

Similar to the qualified residential mortgage exemption, the proposal also would not require a sponsor to retain any portion of the credit risk in the securitization if the ABS are collateralized by certain high quality commercial loans, commercial mortgages, or automobile loans that meet underwriting standards prescribed by the Federal banking agencies. While only the Federal banking agencies are responsible for prescribing these additional underwriting standards, the Commission is jointly authorized with its fellow regulators to establish the appropriate level of risk retention applicable to the securitization of loans meeting these prescribed underwriting standards.

The proposal would also implement Section 15G of the Exchange Act by exempting from the risk retention requirements certain other securitizations—for example, those backed by government-insured or guaranteed assets, such as ABS guaranteed by the Government National Mortgage Association (Ginnie Mae), as well as certain residential loan programs offered by the Federal Housing Administration,

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[4] *See* § 78o-11(e)(4).

Department of Veterans Administration, and Farm Credit Administration. There is also an exemption provided in the proposal for most municipal ABS.

The proposal is the product of many months of collaboration and cooperation among cross-disciplinary teams at the Commission and together with staffs from the five other agencies involved in this joint rulemaking effort. Because of the complexity of the issues involved in this rulemaking, the agencies have included a significant number of requests for public comment in the proposal, and we look forward to analyzing the public's comment. In this regard, interested parties are encouraged to submit written comments jointly to all of the agencies by June 10, 2011.

Other ABS Provisions in Dodd-Frank

Other provisions of the Dodd-Frank Act require Commission rulemaking for ABS. Section 943 of the Dodd-Frank Act requires the Commission to adopt rules on the use of representations and warranties in the market for ABS. In January, the Commission adopted final rules[5] to implement this requirement that require securitizers to disclose the history of repurchase requests received for assets that are believed to have violated representations and warranties and repurchases made relating to their outstanding ABS. Securitizers will be required to make their initial filing on February 14, 2012, disclosing the repurchase history for the three years ending December 31, 2011.

Section 945 requires the Commission to issue rules requiring an asset-backed issuer in a Securities Act registered transaction to perform a review of the assets underlying the ABS and disclose the nature of such review. In January, the Commission

[5] *See* Release No. 33-9175, *Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (January 20, 2011), http://www.sec.gov/rules/final/2011/33-9175.pdf.

adopted final rules to implement Section 945.[6] Under the final rules, the type of review conducted may vary, but at a minimum must be designed and effected to provide reasonable assurance that the prospectus disclosure about the assets is accurate in all material respects. The final rule provides a phase-in period to allow market participants to adjust their practices to comply with the new requirements.

Section 942(a) of the Dodd-Frank Act eliminated the automatic suspension of the duty to file reports under Section 15(d) of the Exchange Act for ABS issuers and granted the Commission authority to issue rules providing for the suspension or termination of this duty to file reports. The Commission has proposed rules in connection with this provision of the Act which would permit suspension of the reporting obligations for ABS issuers when there are no longer asset-backed securities of the class sold in a registered transaction held by non-affiliates of the depositor.[7]

Commission April 2010 ABS Proposal

The Commission's actions on ABS have not been limited to Dodd-Frank related rulemaking. In 2009, we undertook a broad review of the regulation of ABS, including the disclosures, offering process, and reporting of asset-backed issuers, with the goal of enhancing investor protection. As a result of that review, on April 7, 2010, the Commission proposed substantial enhancements to Regulation AB and other Commission rules regarding asset-backed securities (the April 2010 ABS proposals).[8]

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[6] *See* Release No. 33-9176, *Issuer Review of Assets in Offerings of Asset-Backed Securities* (January 20, 2011), http://www.sec.gov/rules/final/2011/33-9176.pdf.

[7] *See* Release No. 34-63652, *Suspension of the Duty to File Reports for Classes of Asset-Backed Securities Under Section 15(d) of the Securities Exchange Act of 1934* (January 6, 2011), http://www.sec.gov/rules/proposed/2011/34-63652.pdf.

[8] *See* Release No. 33-9117, *Asset-Backed Securities*, (April 7, 2010), http://www.sec.gov/rules/proposed/2010/33-9117.pdf.

These proposals were designed to improve investor protection and promote more efficient asset-backed securities markets.

The April 2010 ABS proposals sought to address a number of issues – some subsequently referenced in the Dodd-Frank Act, but others not. Among the proposals addressing issues referenced in the Dodd-Frank Act are proposals to repeal the current credit rating references in shelf eligibility[9] criteria for asset-backed issuers and establish four new shelf eligibility criteria, including a requirement that the sponsor of a shelf-eligible offering retain five percent of the risk and an undertaking to continue reporting under the Exchange Act so long as non-affiliates of the depositor hold any securities that were sold in registered transactions backed by the same pool of assets. The Commission also proposed requiring that, with some exceptions, prospectuses for public offerings of ABS and ongoing Exchange Act reports contain specified asset-level information (sometimes referred to as "loan-level data") about each of the assets in the pool.[10] The asset-level information would be provided according to proposed standards and in a tagged data format using eXtensible Markup Language – or XML.

Among the proposals addressing issues not referenced in the Dodd-Frank Act is a proposal to revise filing deadlines for ABS offerings to provide investors with more time to consider transaction-specific information, including information about the pool assets. In addition, the Commission proposed requiring, along with the prospectus filing, the filing of a computer program of the cash flow waterfall provisions. Finally, the

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[9] Shelf is the process under which a sponsor or depositor may register asset-backed securities to be offered on a delayed basis in the future through one or more offerings, or "takedowns," of securities off of the shelf registration statement.

[10] *See also* Section 942(b) of the Dodd-Frank Act, which generally requires the Commission to adopt regulations requiring an issuer of an asset-backed security to disclose, for each tranche or class of security, information regarding the assets backing that security.

Commission proposed new information requirements for the safe harbors for exempt offerings and resales of asset-backed securities and a number of other revisions to our rules applicable to asset-backed securities.

As we continue to work on the ABS rulemaking required under the Dodd-Frank Act, Commission staff is reviewing the comment letters received on these proposals and working to develop recommendations for the Commission that will harmonize these proposals with the regulatory revisions required under the Dodd-Frank Act.

Conclusion

Thank you again for inviting me to appear before you today. I would be happy to answer any questions you may have.