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**TESTIMONY OF**  
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**Before the**  
**SUBCOMMITTEE ON CAPITAL MARKETS AND**  
**GOVERNMENT SPONSORED ENTITIES**  
**FINANCIAL SERVICES COMMITTEE**  
**UNITES STATES HOUSE OF REPRESENTATIVES**

**April 14, 2011**

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Chairman Garrett, Ranking Member Waters, and members of the Subcommittee, I appreciate the opportunity to describe the interagency rule proposal on risk retention in asset-backed securitization, required by section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). My testimony describes the proposed rule and discusses key issues on which the agencies are requesting comment.

During the financial crisis, certain factors at work in the securitization markets distorted incentives for market participants in ways that led to broad problems for consumers and the financial markets. Loan originators were able to underwrite low quality or even fraudulent loans for sale through securitization, without any exposure of the originator or securitizer to the future credit risk of the loans. Section 941 of the Dodd-Frank Act<sup>1</sup> was designed to address this aspect of the problem by requiring the securitizer to retain a portion of the credit risk on assets it securitizes, with exceptions from this risk retention requirement available only for loans in asset classes designated by regulators that satisfied underwriting standards that resulted in low credit risk. The goal was to give securitizers direct financial disincentives against packaging loans that are underwritten poorly.<sup>2</sup>

The Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (FRB), Federal Deposit Insurance Corporation (FDIC), and the Securities and Exchange Commission (SEC) are required by section 941 to issue joint

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<sup>1</sup> 12 USC 78o-11 (2010).

<sup>2</sup> Section 941 is but one element of the Dodd-Frank Act's provisions addressing failures in the securitization markets exposed by the financial crisis. Among other things, the Dodd-Frank Act also improves the transparency of credit ratings and strengthens oversight of the ratings agencies, provides registered ABS investors detailed information about the assets underlying the ABS, and provides ABS investors with information about the securitizer's history with regard to asset repurchase activity. See sections 932, 935, 936, 938, 942, and 943.

regulations requiring securitizers of asset-backed securities (ABS) to retain an economic interest in a portion of the credit risk for assets that the securitizer packages into the securitization for sale to others. Where the regulations address the securitization of residential mortgage assets, the Department of Housing and Urban Development (HUD) and the Federal Housing Finance Agency (FHFA) are also part of the joint rulemaking group. The Treasury Secretary, as Chairperson of the Financial Stability Oversight Council, is directed to coordinate the joint rulemaking.<sup>3</sup>

The agencies are required to define the appropriate form and amount of risk retention interests to be held by securitizers, and to consider circumstances in which it might be appropriate to shift the retention obligation to the originator of the securitized assets. The statute also requires the agencies to formulate a number of exemptions from the risk retention requirements. One such exemption is the criteria for loans meeting an exemption for “qualified residential mortgages” (QRMs) with underwriting and product features that historical loan performance data indicate result in a lower risk of default. The statute also requires the agencies to establish underwriting standards indicative of low credit risk for certain other classes of assets used in securitizations -- commercial mortgages, commercial loans, and auto loans -- and to determine how much the risk retention threshold for securitizations of assets meeting those underwriting criteria should be reduced below the five percent minimum generally prescribed by the statute.

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<sup>3</sup> For simplicity’s sake, this statement refers to the joint rulemaking group as “the Agencies,” without distinguishing which members of the group are assigned responsibility for making the various determinations required under section 941.

**I. Proposed Forms of Risk Retention Include Numerous Options Designed to Reflect the Diversity of the Securitization Markets**

As the FRB has noted in its recent study of the securitization markets (also required by section 941 of the Dodd-Frank Act), the securitization markets provide an important mechanism for making credit available for businesses, households, and governments.<sup>4</sup> This liquidity function manifests itself as a remarkably diverse set of securitization channels spanning across at least ten major asset classes, encompassing not only the familiar consumer classes, such as residential mortgage backed securities and credit card and auto securitizations, but also assets such as commercial loans, commercial mortgages, and equipment loans and leases. The securitization markets also rely on different structures, ranging from simple “pass through” securities that ratably distribute principal and interest payments on a pool of underlying mortgages, to tranching securitizations with internal credit enhancements, multi-seller asset-backed commercial paper conduits (ABCPs), revolving asset master trusts, and other specialized structures. In developing the risk retention rules, the Agencies sought to take this diversity into account, based on our concern that a “one size fits all” approach to risk retention would not be workable across the market, and would stifle the re-emergence of sound securitization activity.

As described in Section II of this statement, the proposed rule prescribes underwriting criteria for QRMs and certain other asset classes, and provides that sponsors of securitizations exclusively comprised of these “qualified assets” are not required to retain risk under section 941. However, as is appropriate for an exemption from the risk

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<sup>4</sup> Report to Congress on Risk Retention, Board of Governors of the Federal Reserve System (October 2010).

retention requirement, these underwriting standards are conservative. For other types of loans that do not qualify for exemption from the risk retention requirements, the Agencies have sought to structure the proposed risk retention requirements in a flexible manner that will allow the securitization markets for non-qualified assets to function in a manner that both facilitates the flow of credit to consumers and businesses on economically viable terms and is consistent with the protection of investors.

*A. The “Sponsor” Retains the Risk*

Section 941 creates a new section 15G of the Securities Exchange Act of 1934,<sup>5</sup> requiring the Agencies to issue rules requiring securitizers – the firms that organize and initiate securitization transactions – to retain at least five percent of the credit risk of the securitized assets. The nomenclature of the proposed rule refers to the securitizer as the “sponsor” of the securitization transaction, consistent with the SEC’s disclosure regulation for registered asset-backed securitizations, Regulation AB. Practically speaking, the sponsor is the true decision-maker behind the securitization transaction and determines what assets will be securitized. In light of this, the proposed rule generally requires the sponsor to be the party that retains the five-percent risk interest under section 15G.

*B. Different Ways to Satisfy the Risk Retention Obligation*

Section 15G charges the Agencies with determining the form of the retention interest to be held by the sponsor, and the duration that interest must be held. Consistent with the statute, the proposed rule generally would require a sponsor to retain an

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<sup>5</sup> 15 U.S.C. 780-11.

economic interest equal to at least five percent of the aggregate credit risk of the assets collateralizing an issuance of ABS (the “base” risk retention requirement), for the duration of the securitization.

In designing options for risk retention under rule, the Agencies took into account not only the flexibility that we believe will be necessary to allow sponsors to structure retention interests that will meet investors’ concerns with respect to the alignment of interests between sponsors and investors, but also the structures used by sponsors to satisfy investor demands for risk retention in past and recent markets.

The proposed rule provides several options for the form in which a securitization sponsor may retain risk. These include:

- A five percent “vertical” slice of the ABS interests, whereby the sponsor retains a specified *pro rata* piece of every class of interests issued in the transaction;
- A five percent “horizontal” first-loss position, whereby the sponsor retains a subordinate interest in the issuing entity that bears losses on the assets before any other classes of interests;
- An “L-shaped interest” interest whereby the sponsor holds at least half of the five percent retained interest in the form of a vertical slice and half in the form of a horizontal first-loss position;
- A “seller’s interest” in securitizations structured using a master trust collateralized by revolving assets whereby the sponsor holds a five percent separate interest that is *pari passu* with the investors’ interest in the pool of receivables (unless and until the occurrence of an early amortization event);

- A representative sample, whereby the sponsor retains a five percent representative sample of the assets to be securitized, thereby exposing the sponsor to credit risk that is equivalent to that of the securitized assets; or
- For certain “eligible” single-seller or multi-seller asset-backed commercial paper conduits collateralized by loans and receivables and covered by a 100 percent liquidity guarantee from a regulated bank or holding company, a five percent residual interest is retained by the receivables’ originator-seller.<sup>6</sup>

The proposed rule also provides that Fannie Mae and Freddie Mac (the Enterprises) are deemed to satisfy the five percent risk retention requirement through their guarantees, under which they retain 100 percent of the credit risk of the mortgages backing their securities, as long as the Enterprises continue to operate under the conservatorship or receivership of the FHFA and with direct government support through the Treasury Department’s Senior Preferred Stock Purchase Agreement. The Agencies recognize the importance of reform of the Enterprises, and expect to revisit and appropriately modify this aspect of the rules after the future of the Enterprises becomes clearer. The issues raised by the treatment of the Enterprises in the proposed rule are further discussed in Section II of this statement.

### *C. Prohibitions on Transfer of Risk Retention Interests*

To increase the sponsor’s incentive to monitor the underwriting quality of assets the sponsor selects to back an ABS deal, the proposed rule requires the sponsor to hold the required retention interest for the full life of the securitization transaction. Consistent

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<sup>6</sup> This option would not be available to ABCP programs that operate as SIVs or securities arbitrage programs.

with section 15G, the proposed rule also provides that sponsors cannot sell or transfer the interests they are required to retain under the rule, and cannot hedge the credit risk away. However, to allow sponsors to continue managing the overall credit risk of their operations, portfolio hedging is not prohibited.

The proposed rule would also permit transfer of risk retention in two specific circumstances as contemplated by section 15G:

- The Agencies propose to exempt from the transfer prohibition certain securitizations of commercial mortgage-backed securities (CMBS) for which a form of horizontal risk retention often has been employed, with the horizontal first-loss position initially being held by a third-party purchaser (known in the securitization markets as a “B-piece buyer”) that specifically negotiates for the purchase of the first-loss position and conducts its own credit analysis of each commercial loan backing the CMBS.<sup>7</sup>
- The Agencies also propose to permit a sponsor to allocate a proportional share of the risk retention obligation (through a voluntary contractual agreement) to the originator(s) of the securitized assets, subject to certain conditions, if the originator in question originated at least 20 percent of the assets in the securitization pool. To ensure the originator has “skin in the game,” the proposal requires the originator to pay up front for its share of retention, either in cash or a discount on the price of the loans the originator sells to the pool. The originator must also agree to hold the retention interest subject to the same prohibition against the hedging or transferring of the credit risk that would apply to sponsor.

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<sup>7</sup> If the third-party purchaser also serves as the special servicer of troubled assets in the pool, the proposal also requires appointment of an independent Operating Advisor to oversee servicing.



#### *D. Premium Capture Cash Reserve Account*

In many securitization transactions prior to the financial crisis, the transactions were structured to include a risk retention piece. However, the sponsors were able to sell premium or interest-only tranches to investors for prices that more than offset the sponsors' costs for the amount of the risk retention. These tranches were funded by "excess spread" interest income expected to be generated by securitized assets over time, which reflected the higher credit risk of, and likely losses on, those securitized assets (such as subprime mortgages). This enabled sponsors to obtain up-front payment for that excess spread at the inception of the transaction, before the losses on the securitized assets appeared – which more than compensated for the sponsor's exposure through risk retention. This created incentives for securitizers to issue many complex securitization transactions of high credit-risk, high-yield assets. It also made the risk retention illusory from an incentive standpoint, because the sponsor was paid more for the excess spread than the sponsor's overall cost for the retention interests.

The Agencies propose to address this problem through the proposed rule. If a sponsor structures a securitization to monetize excess spread on the underlying assets – by selling a tranche of the transaction that would be funded by excess spread income – without making an offsetting increase in the risk retention piece, the proposed rule would capture the premium or purchase price received on the sale of the tranches that monetize the excess spread and require that the sponsor place such amounts into a separate "premium capture cash reserve account" in the securitization. The amount placed into the premium capture cash reserve account would be separate from and in addition to the

sponsor's base risk retention requirement, and would be used to cover losses on the underlying assets before such losses were allocated to any other interest or account. The purpose of the account is to keep sponsors from taking an up-front profit on a securitization of high-yield assets that would effectively pay off the sponsor for the risk retention interest it is required to retain, and to keep that excess spread available to cover losses on the assets in the securitization.

#### *E. Exemptions for Low Risk Assets*

As discussed in Section II of this statement, Section 15G provides a complete exemption from the credit risk retention requirements for ABS collateralized solely by QRMs meeting terms and conditions defined by the Agencies in the implementing regulations. In addition, the proposed rule also would not require a securitizer to retain any portion of the credit risk associated with a securitization transaction if the ABS issued are exclusively collateralized by commercial loans, commercial mortgages, or automobile loans that meet underwriting standards included in the proposed rule. As in the case of QRMs, these underwriting standards are designed to be robust and ensure that the loans backing the ABS are of very low credit risk. These standards were developed by the federal banking agencies based upon their supervisory expertise.

However, these underwriting standards do not cover every class of assets that have historically been used to back securitization transactions. Because in some cases securitization transactions involve assets with significant diversity within the transaction, or in other cases assets that by their nature exhibit relatively high credit risk, the Agencies

concluded that it would be extremely difficult as a practical matter to establish workable underwriting standards for them by regulation.

#### *F. Disclosure Requirements*

The proposed rule also includes disclosure requirements specifically tailored to each of the permissible forms of risk retention. The disclosure requirements are designed to provide investors with material information concerning the securitizer's retained interests, such as the amount and form of the interest retained, and the assumptions used in determining the aggregate value of ABS to be issued (which generally affects the amount of risk required to be retained). Further, the disclosures are designed to provide investors and the Agencies with an efficient mechanism to monitor compliance.

## **II. Particular Issues of Note**

#### *A. Criteria for Qualified Residential Mortgages*

Section 15G provides a complete exemption from the credit risk retention requirements for ABS collateralized solely by QRMs. The proposed rule establishes the terms and conditions under which a residential mortgage would qualify as a QRM.

Section 15G requires the Agencies to define QRM, "taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default." A substantial body of evidence, including data analyzed by the Agencies during the rulemaking and academic literature, supports the view that the underwriting criteria in the proposed rule have low credit risk, even in severe economic conditions. The proposed QRM underwriting criteria are also consistent with the premise

that a complete exemption from risk retention should be supported by very high quality mortgage loans.

The proposed rule generally would prohibit QRMs from having product features that contributed significantly to the high levels of delinquencies and foreclosures since 2007—such as failure to document income, “teaser” rates, or terms permitting negative amortization or interest-only payments—and also would establish conservative underwriting standards designed to ensure that QRMs are of high credit quality. As required by the statute, these standards were developed through evaluation of historical loan performance data that are described in the preamble to the proposal. These underwriting standards include, among other things, maximum front-end and back-end debt-to-income ratios of 28 percent and 36 percent, respectively;<sup>8</sup> credit history restrictions, including no 60-day delinquencies within the previous 24 months; a maximum loan-to-value (LTV) ratio of 80 percent in the case of a purchase transaction (with a 75 percent combined LTV for refinance transactions, reduced to 70 percent for cash-out refis); and a 20 percent down payment requirement in the case of a purchase transaction. The Agencies propose to require the LTV to be calculated without taking any mortgage insurance into consideration.

The OCC is interested in the feedback we will receive on this aspect of the proposal. If the Agencies are persuaded that the QRM underwriting criteria are too restrictive on balance, the preamble discusses several possible alternatives. One would be to permit the use of private mortgage insurance obtained at origination of the mortgage for loans with LTVs higher than the 80 percent level specified in the proposed rule. The

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<sup>8</sup> To reduce complexity of the rulemaking, the proposed rule incorporates existing FHA standards for determining and documenting DTI ratios.

guarantee provided by private mortgage insurance, if backed by sufficient capital, lowers the credit risk to investors by covering the unsecured losses attributable to the higher LTV ratio once the borrower defaults and the loan is liquidated. However, to include private mortgage insurance in the QRM criteria, Congress required the Agencies to determine that the presence of private mortgage insurance lowers the risk of default -- not that it reduces the ultimate amount of the loss. The OCC will be interested in the information provided by commenters on this topic, and any data they can provide.

Other alternatives discussed in the proposal are (i) imposing less stringent QRM underwriting criteria, but also imposing more stringent risk retention requirements on non-QRM loan ABS to incentivize origination of the QRM loans and reflect the relatively greater risk of the non-QRM loan market, and (ii) creating an additional residential mortgage loan asset class along side the QRM exemption – like the underwriting asset classes for commercial loans, commercial mortgages, and auto loans under the proposed rule – with less stringent underwriting standards or private mortgage insurance, subject to a risk retention requirement set somewhere between zero and five percent.

*B. Inclusion of Servicing Standards in the QRM Definition; National Mortgage Servicing Standards*

Another issue that has attracted attention in connection with the criteria for a QRM is whether mortgage servicing standards should be part of the QRM requirements. The proposed rule includes a limited set of such requirements that may lower the risk of default on residential mortgages. The requirements focus on establishing a process for

the creditor to take loss mitigation activities that lower the risk of default into account in servicing QRMs, but they do not dictate particular types of actions to be undertaken.

The proposed rule requires inclusion of terms in the mortgage transaction documents under which the creditor commits to have servicing policies and procedures to mitigate risk of default. The policies and procedures must address loss mitigation actions to be taken by the creditor, such as loan modifications or other loss mitigation alternatives, in the event the estimated resulting net present value of the loss mitigation action exceeds the estimated net present value of recovery through foreclosure, without regard to whether the particular loss mitigation action benefits the interests of a particular class of investors in a securitization. The creditor must also implement procedures for addressing any whole loan owned by the creditor (or any of its affiliates) and secured by a subordinate lien on the same property that secures the first mortgage loan if the borrower becomes more than 90 days past due on the first mortgage loan. These procedures could include steps ranging from enhanced loan loss reserves and loss recognition on the loan secured by the subordinate lien, to modification or restructuring of that loan. The procedures must be disclosed to the borrower, and if the creditor transfers servicing rights for the mortgage loan, the transfer agreement must require the transferee to abide by these commitments of the creditor, as if the transferee were the creditor under this section of the proposed rule.

The Agencies have included numerous requests for comment about the servicing standards in the proposed rule, including their feasibility, the authority under section 15G to pursue any servicing alternatives, and the important question whether comprehensive national mortgage servicing standards would be a more effective and transparent

approach. Recent experience and the major enforcement actions just announced by the federal banking agencies highlight the need for uniform standards for mortgage servicing that apply not just to delinquent loans, but to all facets of servicing the loan, from loan closing to payoff or foreclosure. To be meaningful and effective, the OCC believes that mortgage servicing standards should apply uniformly to *all* mortgage servicers and provide the same safeguards for consumers, *regardless* of whether a mortgage has been securitized. Furthermore, a key driver of servicing practices has been and continues to be secondary market requirements. We will not achieve improvements in mortgage servicing without corresponding changes in requirements imposed by the GSEs, and it is also vital that robust and consistent mortgage servicing standards are applicable to – and actually implemented by – nonbank firms engaged in mortgage servicing.

To further this effort and discussion, the OCC developed a framework for comprehensive mortgage servicing standards that we shared with other agencies, and we are now participating in an interagency effort<sup>9</sup> to develop a set of comprehensive, nationally applicable mortgage servicing standards, which take into account numerous servicing issues not addressed in the proposed rule. Our objective is to develop uniform standards that govern processes for:

- Handling borrower payments, including applying payments to principal and interest and taxes and insurance before they are applied to fees, and avoiding payment allocation processes designed primarily to increase fee income;

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<sup>9</sup> Participating agencies in the effort include the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the Federal Housing Finance Agency, the Department of Housing and Urban Development (including the Government National Mortgage Association (Ginnie Mae)), the Consumer Financial Protection Bureau, and the Department of the Treasury.

- Providing adequate borrower notices about their accounts and payment records, including a schedule of fees, periodic and annual statements, and notices of payment history, payoff amount, late payment, delinquency, and loss mitigation;
- Responding promptly to borrower inquiries and complaints, and promptly resolving disputes;
- Providing an avenue for escalation and appeal of unresolved disputes;
- Effective incentives to work with troubled borrowers, including early outreach and counseling;
- Making good faith efforts to engage in loss mitigation and foreclosure prevention for delinquent loans, including modifying loans to provide affordable and sustainable payments for eligible troubled borrowers;
- Implementing procedures to ensure that documents provided by borrowers and third parties are maintained and tracked so that borrowers generally will not be required to resubmit the same documented information;
- Providing an easily accessible single point of contact for borrower inquiries about loss mitigation and loan modifications;
- Notifying borrowers of the reasons for denial of a loan modification, including information on the NPV calculation;
- Implementing strong foreclosure governance processes that ensure compliance with all applicable legal standards and documentation requirements, and oversight and audit of third party vendors;



- Not taking steps to foreclose on a property or conduct a foreclosure sale when the borrower is approved under a trial or permanent modification and is not in default on the modification agreement; and
- Ensuring appropriate levels of trained staff to meet current and projected workloads.

### *C. Risk Retention for Fannie Mae and Freddie Mac*

As discussed in Section I of this statement, the proposal recognizes as a permissible form of risk retention the Enterprises' 100 percent guarantee of principal and interest payments on MBS sponsored by the Enterprises. Through this guarantee, the Enterprises retain 100 percent of the credit risk in the transaction.

Since release of the proposal, some have expressed concerns that this aspect of the proposed rule disadvantages private securitizers, which will incur the funding costs of holding a five percent interest in each ABS they sponsor relative to the Enterprises. The Agencies are very cognizant of the complex issues affecting the treatment of the Enterprises under the proposal and look forward to considering the comments we receive. The approach contained in the proposal reflects several factors: 1) the Enterprises already retain 100 percent of the credit risk in each ABS they sponsor as a result of their guarantees; 2) requiring the Enterprises to retain a five percent interest in each ABS they sponsor would significantly increase their holdings of mortgage-backed securities at a time when there is strong interest in reducing such holdings; 3) the proposed rule's restrictions against hedging or transferring the risk of these interests also would have increased the overall risk of their operations at the time such risks create exposure to U.S.

financial support through the Treasury Department's Senior Preferred Stock Purchase Agreement; and 4) requiring the Enterprises to hold these interests would not have increased the Enterprises' incentives to be vigilant about the credit quality of assets they securitize, since they guarantee 100 percent of that risk already.

More fundamentally, requiring the Enterprises to hold these interests would not create a "level playing field" between the Enterprises and private securitizations. The Enterprises' funding costs to hold these interests are, because of the perception of a government guarantee, lower than the costs their private competitors face to hold the same interests, and the Enterprises enjoy other cost advantages from the scale of their operations, which is generated by investor demand for their fully-guaranteed ABS. These differences translate into the Enterprises' ability to offer mortgage originators better prices for their mortgage loans, even if they were required to retain the additional five percent interest. Even with respect to the retention-exempt QRMs, the Enterprises' QRM securitizations will be more attractive to investors from a credit risk standpoint than a private-label QRM, due to the Enterprises' 100 percent guarantee of their QRM securitizations. These are larger issues that cannot be reached through the risk retention rule. However, Congress has begun to consider fundamental questions about the future structure and role of the Enterprises, and the Agencies have committed to revisit and change the retention approach for the Enterprises as appropriate when those changes occur.

### **III. Conclusion**

The role of securitization in our nation's interlinked facilities for taking on and distributing credit risk is an important one, and when done correctly, securitization

contributes to sustainable growth by improving market liquidity and credit availability. But these goals will falter – as we have seen – if securitization markets are built on a quicksand of shoddy assets. The risk retention proposal is designed to implement the Congressional directive to insure that securitizers have “skin in the game” to incentivize diligence regarding the quality of the loans they securitize. Against that backdrop, the proposal’s exemptions from the risk retention requirements focus on demonstrably high quality loans, and the proposal seeks to provide flexibility for how the risk retention requirement may be satisfied. These are complex issues with multiple public policy implications. Achieving the right balance will be very challenging. The OCC looks forward to the input the Agencies will receive in the comment process to help get that balance right.

I appreciate the opportunity to appear before the Subcommittee this afternoon, and look forward to addressing your questions. Thank you.