



Testimony of Richard A. Johns

On Behalf of the Structured Finance Industry Group

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Subcommittee on Capital Markets and Government Sponsored Enterprises

Hearing Entitled

**The Impact of the Dodd-Frank Act and Basel III on the Fixed Income Market
and Securitizations**

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Introduction

Chairman Garrett, Ranking Member Maloney and members of the Subcommittee on Capital Markets and Government Sponsored Enterprises: I want to thank you for holding this morning's hearing on *The Impact of the Dodd-Frank Act and Basel III on the Fixed Income Market and Securitizations*. My name is Richard Johns and I am here to testify on behalf of the members of the Structured Finance Industry Group ("SFIG").

Founded in March 2013, SFIG is a member-based, trade industry advocacy group focused on improving and strengthening the broader structured finance and securitization market. SFIG provides an inclusive network for securitization professionals to collaborate and, as industry leaders, drive necessary changes, be advocates for the securitization community, share best practices and innovative ideas, and educate industry members through conferences and other programs. With approximately 350 institutional members, SFIG's membership represents all sectors of the securitization market including investors, issuers, financial intermediaries, law firms, accounting firms, technology firms, rating agencies, servicers and trustees.

SFIG's membership believes that securitization is an essential source of funding for the real economy, representing \$1.6 trillion, or nearly 30% of America's roughly \$6 trillion of annual bond issuance.¹ Securitization connects investors with desired investments and provides consumers and businesses with access to funding and capital. Securitization provides economic benefits that can increase the availability and lower the cost of credit to your constituents' households and businesses.

Although most financial regulation inevitably has some effect on liquidity, as an organization covering the entirety of the structured finance market, I'd like to devote the majority of my time today to discussing a few global rules that affect all asset classes, including: (1) the new liquidity-specific rules that U.S. regulators implemented late in 2014, also known as the Liquidity Ratio ("LCR") rules, (2) European and International regulatory efforts to create standards for high-quality securitizations ("HQS") that would receive preferential capital treatment if certain conditions are met, and (3) the new Basel III capital rules that were adopted by the Basel Committee on Banking Supervision ("Basel") that increase capital standards for bank balance sheets, (4) the new Fundamental Review of the Trading Book ("FRTB") rules that increase capital for the trading book that Basel finalized in January of this year. All of these rules, particularly when combined, pose a serious threat to securitization as a critical source of funding for the real economy.

We believe that the new LCR rules are misguided, and cause concern in several respects. First, and most concerning, LCR does not treat any tranche of any class of asset-backed securities

¹ Securitization Provides Meaningful Funding to the Real Economy, Moody's, March 11, 2015, at https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBS_1003586



("ABS") as High Quality Liquid Assets ("HQLA"). Essentially, regulators have deemed all ABS products illiquid.

According to available evidence, this blanket exclusion is unwarranted. High quality ABS are, by any measure, among the most liquid assets that a bank can hold. In fact, investment-grade credit card and automotive ABS generally performed better than investment-grade corporate debt during the crisis, which was granted HQLA status by U.S. regulators. Second, since the crisis, the implementation of various Dodd-Frank requirements, such as implementation of risk retention requirements, disclosure changes under Regulation AB II, or changes to Rating Agency protocols, has created significant changes across practices of the entire securitization industry. If these changes have any value at all, then how can an ABS security previously deemed to have zero liquidity value, still be deemed to have zero value after the implementation of Dodd-Frank. Effectively we are being told that "zero plus something of value = zero." Essentially Basel - and indeed our own regulators - are saying that post-crisis changes enacted under Dodd-Frank are worthless for capital and liquidity purposes. And third, under some circumstances, LCR treats committed liquidity and credit lines as more detrimental to a bank's liquidity than justified.

The Basel III Securitization Framework is also troubling. The final rule requires higher levels of capitalization than is warranted based on performance history, particularly when compared to competing forms of financing such as secured lending or covered bonds.

In addition, the recently finalized Basel FRTB rules applicable to all market-making activity, including securitization, may compound the effect on bank investment and capital levels if they are adopted by U.S. regulators in their current form.

In contrast, the European Union ("EU") and European Central Bank ("ECB") have recognized, through analysis, that both regulatory and structural impediments are inhibiting the return of the European ABS market.² In reaction, European policymakers have designed criteria for "high-quality securitizations," that would receive more appropriate capital requirements. Basel, and the International Organization of Securities Commissions ("IOSCO") have also undertaken a review of their securitization rules, and are proposing similar high-quality criteria for adoption internationally. At the same time, it does not appear that U.S. regulators will implement a similar capital plan for high quality securitizations. This would not only cause a bifurcated global ABS market, but it could also paradoxically cause the most liquid ABS market in the world to also have the highest capital charges.

² The Bank of England & European Central Bank, *The case for a better functioning securitization market in the European Union*, May, 2014, at, https://www.ecb.europa.eu/pub/pdf/other/ecb-boe_case_better_functioning_securitisation_market.en.pdf

I will also address two of the three bills before the committee that attempt to provide surgical fixes to two asset class-specific issues, including:³

1. H.R. 4166, *the Expanding Proven Financing for American Employer's Act*. H.R. 4166 is an SFIG-supported (see appendix) bi-partisan bill co-sponsored by Congressmen Barr and Scott that creates a “qualified collateralized loan obligation (“QCLO”) risk retention option for CLO’s, and
2. A “discussion draft” bill sponsored by Congressman Hill that would create an exemption from the risk retention requirements for certain commercial real estate loans.

Returning to liquidity and capital, it is important to understand that the cumulative effect of these rules, if they remain unchanged, may be dramatic. As a result, securitization may become a less attractive form of finance than it should be, resulting in less available financing for the real economy.

We are already seeing that the new liquidity and capital rules have negatively impacted the market and reduced liquidity. There is a very real danger that these rules will restrict the supply of funding to an extent that could cause harm to important sectors of the real economy.

To support my conclusions, I will define liquidity, and I will explore how financial institutions manage liquidity, particularly in times of stress. I will then discuss the liquidity situation since the crisis and the effect on liquidity of some forms of regulation. Next I will compare the U.S. situation to developments in Europe, and I will follow that with a discussion of the likely effects of the Basel III Securitization Framework, the FRTB rules, and the liquidity consequences of the current accounting regime, when combined with economic stress. I will conclude by recommending specific reforms to promote liquidity.

What is liquidity?

Before going into detail about the impact of regulation on liquidity, I’d like to explain what I mean when I refer to “liquidity.”

Generally speaking, a liquid asset is one which can be quickly bought and sold, in large quantities, usually with low transaction costs, without causing a significant shift in the price of the asset. An illiquid asset, by contrast, is an asset that is more difficult to buy or sell, connecting buyers and sellers takes more time and effort, and the final sale price of the asset is more difficult to predict. Because liquidity is desirable, liquid assets tend to command a higher price, thereby producing a lower overall return than less liquid assets of similar credit quality.

A liquid *entity* - as opposed to a liquid *asset* - is an entity that has enough liquid assets that it can absorb a short-term (or indeed long term) financial shock without becoming insolvent or

³ SFIG does not have a position on H.R. 4096, as it does not directly affect the securitization industry.



unable to honor its outstanding obligations. By contrast, an entity with low level of liquid assets might have substantial total capital, but may be unable to raise money quickly to meet continuing obligations. Entities attempt to manage their liquidity by balancing competing demands: They must have enough liquidity to ensure the ability to meet outstanding obligations, expected and unexpected, but they do not want so much liquidity that they forego the relatively higher financial returns that are available from investing that liquidity in less liquid assets. Additionally, when financial entities invest too heavily in liquid assets, relative to longer term investment in other commercial and retail products, the supply of funding to the market from financial entities shrinks, thereby slowing growth in the economy.

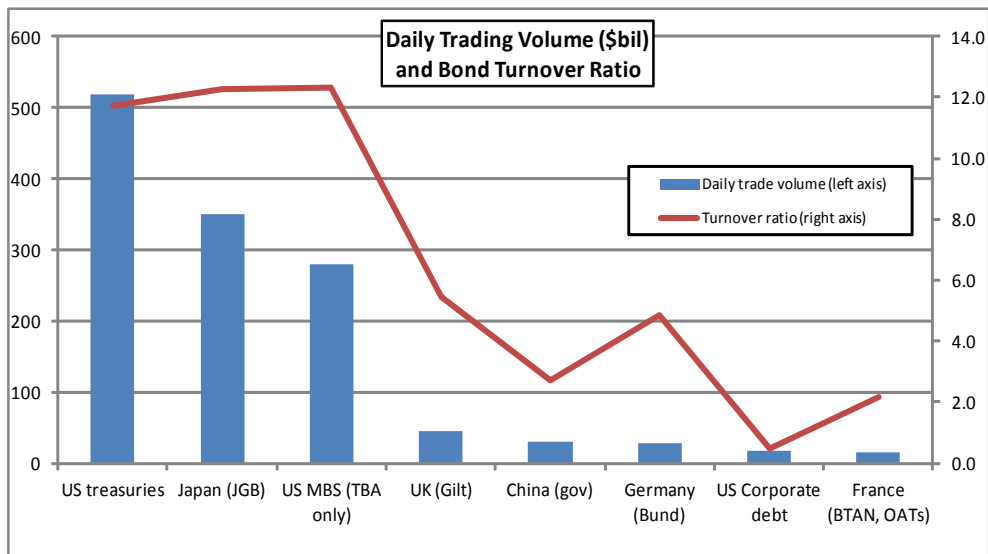
Liquidity is distinct from the concepts of funding and capital. Although all three concepts may relate to the solvency of an institution and its ability to deliver funding to the real economy, liquidity is primarily concerned with timing and price stability - how quickly, and how reliably, can an entity raise money if it needs to?

How do Financial Institutions Manage Liquidity?

Financial institutions manage their liquidity by a variety of means, including securitization. Cash is, by its very nature, the most liquid asset of all. Institutions acquire cash either by raising more funding than is needed to support their assets or by retaining surplus cash generated from operations. Based on cash flow forecasts and contingency planning, institutions may determine that some minimum amount of cash should be kept on hand.

Institutions also invest in liquid securities, which earn better returns than cash, but which are also fairly easy to convert back to cash should the need arise. The level of liquidity provided by these securities may vary. For instance, if cash is invested in US Treasury Notes—the most liquid security in the world with an effective cash equivalent amounting to 100 percent of par value - it is difficult to imagine that an investor is not going to be able to convert that security into cash on an almost immediate basis. If, however, the investor were to invest in government-sponsored enterprise (“Agency”) debt, the third most liquid security in the world, the potential for immediate cash realization would be a fractionally lower amount. This sliding scale continues (with some overlap) through high quality municipal bonds, AAA-rated asset backed securities, high-grade corporate debt, lower-rated but still investment-grade ABS securities, investment-grade corporate debt, and ultimately equity investments.

Agency and Government Bond Trading Volumes



Sources: SIFMA, UK Debt Management Office, FRG Finance Agency, Japan Securities Dealers Association, AsianBondsOnline.com, Agence France Trésor Monthly Bulletin

If institutions do not have enough liquidity from cash and liquid securities, then they may borrow to increase their liquidity. But rather than raise expensive debt and suffer a low return from reinvestment of that debt in a liquid security, institutions may alternatively seek to avoid that “cost of carry” by establishing a committed line of credit from another financial institution. Because there may never be a need to draw on these lines of credit, they can often be far more cost-effective than incurring debt and reinvesting its proceeds.

Institutions also consider certain ordinary-course cash inflows to be an element of liquidity. Such cash inflows might include, for example, coupon payments on securities or installment payments on consumer or corporate loans that they made.

Institutions may also rely upon other forms of liquidity. For example, assets such as credit card loans or auto loans might be structured into AAA-rated securities ready to be sold to the market (Once securitized, those securities become highly liquid.). Or an institution might pledge assets or turn to a reserve bank/central bank line. While these sources of liquidity would never be considered “hard-dollar” liquidity, they are still rightly considered part of the total mix of *potential* liquidity for risk assessment purposes.

If we look to the behavior of financial institutions who managed their liquidity well through the financial crisis and look at what worked well to maintain bank liquidity, it is important to ensure that new regulation does not prevent these “tested tools” from working effectively again. In general, these financial institutions tended to manage their liquidity with a robust combination of liquid products, notably:

- Cash
- Treasuries



- Agency Debt
- Senior rated ABS
- Prime MBS
- Committed lines of credit

We recognize that during the crisis some financial institutions failed and were not able to fulfill their obligations to fund on their committed lines. Similarly, we recognize that lower rated and even some senior rated prime RMBS became illiquid as the housing market suffered, thereby impacting their liquidity value. However, provided that institutions managed liquidity on a prudent and diversified basis, all these categories of liquid assets provided strong defense against the kinds of insolvencies that we witnessed during the crisis. Most banks and financial institutions maintained robust liquidity policies prior to the last financial crisis, and most institutions responded to the crisis by further strengthening liquidity.

The financial sector's emphasis on liquidity dovetailed with the rational behavior of the US consumer - as the recession began, lower consumer confidence led to lower consumer spending and greater saving. This created a growth in deposit balances, and simultaneously there was reduced demand for loans as credit card, auto and mortgage spending reduced. The reduction of assets, coupled with growth in deposits allowed banks to build surplus liquidity as a basis for protecting themselves through an extended recessionary period. So notwithstanding the failure of significant financial institutions, which caused "ripple effects" reducing liquidity throughout the financial system, well-managed banks ultimately *increased* their liquidity and to a large extent became hoarders of cash.

When we look to future regulation it is important to recognize the stimulants that allowed banks to build liquidity in this fashion and appropriately "reward" those practices with regulatory treatment that continues to incentivize such behavior.

Bank Liquidity Post Crisis

In a perfect world, banks would maintain robust liquidity at all times and increase such liquidity during stress or recessionary scenarios. At the peak of the recession we would then hope that banks would begin to release that liquidity back into the system, enabling consumers and businesses to spend, rebuild confidence, and return the economy to a growth trend. In fact, from a profitability model, this ebb and flow of liquidity should fit a bank's business model very well. As the risk of defaults increases during a recessionary period, prior to its peak, one might expect banks to reduce their exposure to loans in favor of higher yielding low credit risk securities, essentially changing the mix of their assets from loans to securities, which in turn builds liquidity. Once the recession reaches its peak and starts to reverse, then default risk on loans starts to decrease in

parallel with credit spreads and yields on securities. At that point, a bank should want to readjust its risk position back towards the now more profitable loans by realizing the cash on those securities and lending it back to its customers, thus fueling a recovery. However, that anticipated release of liquidity did not happen during the most recent crisis to the same extent as it has in the past.

I submit that there are three primary reasons that banks were hesitant about releasing liquidity and expanding their loan portfolios:

1) Pending liquidity regulation:

In November 2009, the Basel Committee issued a consultation paper proposing more stringent liquidity requirements. The proposal would also have reduced banks' ability to rely, for liquidity, on many of the categories of investments that they had previously utilized so effectively, notably Agency securities, senior rated ABS and prime RMBS, and committed lines of credit. Finally, the proposal called for more strict regulatory supervision in the form of liquidity stress testing. The proposal created a great deal of uncertainty as to what would ultimately qualify as liquid investments and how liquidity would be assessed under a crisis. In the face of such uncertainty, banks remained cautious about releasing liquidity into the market.

2) Uncertainty relating to bank regulation more generally:

Irrespective of the specific rules relating to liquidity, since 2009 and continuing to this day, banks have faced an uncertain landscape in terms of where proposed regulation may end, creating a "moving goalpost" scenario for their lending strategies. The decisions that a bank makes today could have regulatory consequences under a future regime that has yet to be announced or even specifically contemplated. For example, changes to off-balance sheet accounting, risk retention, disclosure rules, implementation of the Volcker Rule, and potential changes to the regulatory capital regime, have all contributed to this landscape of uncertainty.

3) Capital requirements:

While much focus has appropriately been applied to capital standards, duplicative or unnecessary capital is not necessarily a good thing. The ability of an organization to release its liquidity back to the real economy, to stimulate lending, is dependent upon that organization's having sufficient capital to withstand the balance sheet's expansion with loan assets, which carry a higher risk-weighting than cash, treasuries or Agency securities. To the extent a capital regulation is burdensome without good reason, it keeps surplus capital on the balance sheet, preventing its use to support the return of that liquidity.



Further, in order to facilitate loan growth, there needs to be a balance of both capital (to support risk) and liquidity (to permit funding). Too much capital without surplus liquidity means financial institutions hold capital that is not able to earn a return. Too much liquidity without surplus capital and institutions end up with liquidity that cannot be used and has to sit on a balance sheet in zero risk assets, causing a carry cost to the bank. Neither of these situations is supportive of stimulating bank lending to help support and grow the real economy.

It is critically important that the cumulative effect of capital and liquidity regulations do not create such a capital shortfall that it prevents banks from supporting consumer lending through their balance sheets. So when we evaluate the impact of regulation on liquidity, it is important to recognize that even regulations that do not *specifically* address liquidity can nonetheless have a substantial *effect* on liquidity. As such, we must pay particular attention to capital regulations.

Liquidity Regulation

While much regulation affects liquidity to some degree, many of these impacts are indirect. For instance, risk retention requirements: the need to retain risk increases the amount of economic capital and possibly the amount of regulatory capital that an organization may be required to hold, which in turn increases the aggregate cost of issuance, potentially making issuance less attractive, and ultimately causing a reduction in supply. Yet investors are likely to be more confident purchasing a security from an issuer that retains some risk or “skin in the game,” so demand for these securities is likely to increase.

This dynamic is common. We often see regulations that are intended to increase investor confidence, but they do so at some expense to the issuer. So regulations can have the effect of decreasing one driver of market liquidity while increasing another. The net effect will often be difficult to predict. These counterbalancing effects may very well be justified in ensuring we do not see markets overheat and become irrational, similar to pre-crisis markets, but that issue is open to reasonable debate with regard to each particular regulation.

There are no such tradeoffs, however, regarding one of the most significant U.S. regulations since the financial crisis - the implementation in the U.S. of the Basel III LCR. The LCR rule has reduced market liquidity, reduced investor interest in ABS, created additional liquidity in the system, and cut off a significant supply of committed credit to consumers and small businesses.

LCR was introduced initially as a response to the perceived need to improve short-term resilience in the liquidity risk profiles of banking organizations. To address this need, the Basel Committee on Banking Supervision first produced a consultation paper in 2009 and subsequently

published revised international liquidity coverage ratio standards as part of the Basel III reform package in 2013.

The goal of the rule is to make sure that banking entities retain enough “high quality liquid assets” in their portfolios to sustain a 30-day period of stress. The regulation specifies what assets may count as HQLA and sets different levels of liquidity credit for different types of assets (see exhibit below). For example, while cash is treated as 100% liquid, investment grade corporate debt is only counted at 50% of its face value, which reflects the regulators’ assumption that corporate debt would be more difficult to monetize during a period of financial stress.

HOLA Designations Under the Final U.S. LCR Rule⁴

Type of Liquid Asset	Description	Haircut	Cap
Level 1	Highest quality and most liquid assets <i>Example: U.S. Treasury Securities</i>	No haircut	No cap
Level 2A	Relative price stability with significant liquidity <i>Example: GSE Securities</i>	15%	When combined with Level 2B liquid assets, cannot exceed 40% of total HQLA
Level 2B	More price volatility and less liquidity <i>Example: Investment grade corporate debt and exchange traded corporate equity securities</i>	50%	Cannot exceed 15% of total HQLA

U.S. prudential regulators finalized implementation of the LCR last year. The regulation has at least two major flaws:

1) Treatment of ABS and MBS as “non-liquid” under the regulation

The U.S. implementation of LCR treats asset-backed securities (ABS) as *categorically* non-HQLA, regardless of performance and trading volume. This includes securities backed by prime-auto loans, prime credit card debt, student loans, and qualified (“QM”) mortgages. So regardless of how much ABS a bank holds, and regardless of how safe or marketable those assets are rated, they count for nothing in the eyes of the regulators.

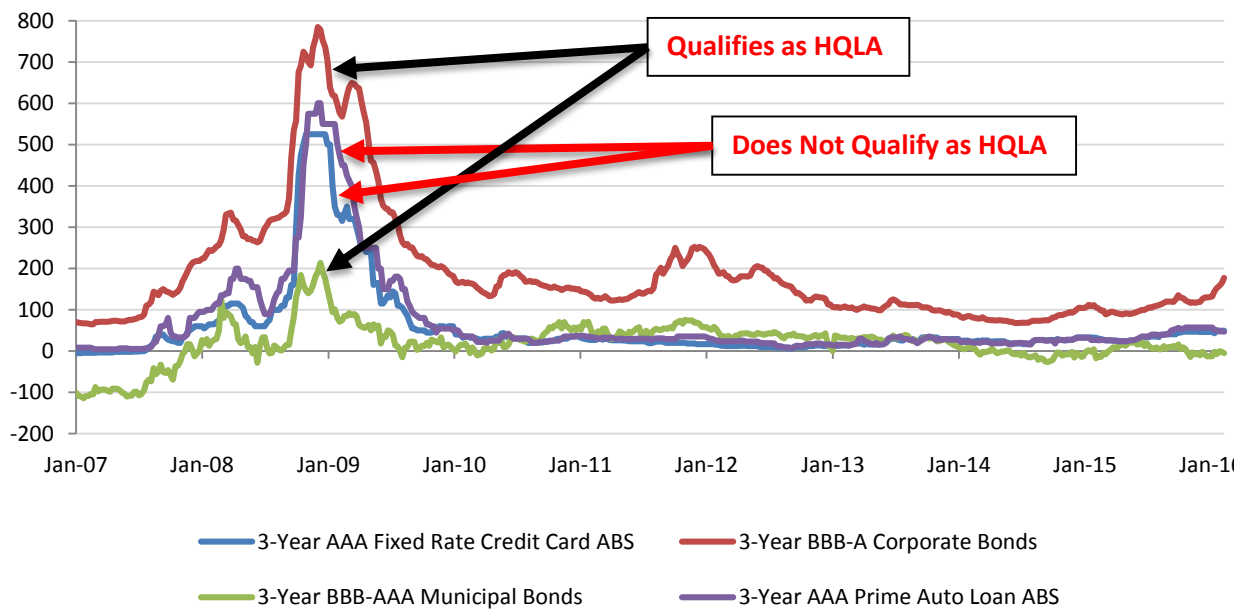
In determining which assets could be considered HQLA and how those assets would have to be discounted, it does not appear that the liquidity treatment was determined based upon the actual performance of each asset class during the crisis. The treatment of ABS - as non-liquid - is particularly striking when compared to that of corporate debt. As I noted above, investment grade

⁴ SFIG’s LCR Briefing Book, at: http://www.sfindustry.org/images/uploads/pdfs/SFIG_Briefing_Book_LCR.pdf



corporate bonds are considered high quality liquid assets for purposes of LCR compliance, though they are subject to a 50% haircut for assumed loss of value in the case of a crisis. Yet AAA rated “plain vanilla” ABS are considered non-liquid, notwithstanding that such assets have historically performed *as well as or better* than most investment grade corporate debt (as demonstrated by the chart below). Indeed, investors commonly refer to AAA-rated prime auto ABS as “treasury surrogates,” or “cash equivalents.”

Comparison of Card and Auto ABS Spreads to Corporate and Municipal Bond Spreads (2007-2016)



Source: Aggregated SFIG Member Data

For example, during the crisis, corporate investment grade debt experienced an 18% price decline at peak, compared to just a 13% decline in AAA automotive loan-backed securities and a 16% decline in AAA credit-card debt-backed securities. So while a 50% discount for investment-grade corporate debt may be extraordinarily conservative, there is simply no rationale for treating ABS as illiquid. Even during the recent financial crisis, ABS *as a category* retained a high degree of liquidity. Plain vanilla ABS generally maintained its ability to access markets, albeit at wider spreads, and many issuers had no need for government intervention programs (i.e. TALF) to maintain liquidity. At the very least, plain vanilla ABS should be entitled to the same 50% discount treatment as investment grade corporate debt. Clear evidence shows that even in a deep recession, price declines for AAA-rated ABS should not come close to 50%.

The regulation’s treatment of all types of private label residential mortgage backed securities (“RMBS”) is also inexplicable. Like all other ABS, RMBS are treated as illiquid, regardless of whether they contain QM loans that are considered so safe that the related sponsor is

exempted from all credit retention requirements under the newly adopted Credit Risk Retention Rule required by Dodd-Frank. The market considers such high quality, resilient mortgages highly liquid. Yet, in contradiction to the Credit Risk Retention Rule, from the perspective of the regulators, the inclusion of such loans in a security has no bearing on the liquidity of that security. We do not agree with this rationale – if an asset-class were deemed worth nothing from a liquidity perspective and subsequently improves its status by implementing Dodd-Frank requirements such as the inclusion of QM collateral, then how can “nothing” plus “something” still equal “nothing”? Regardless of whether or not one supports Dodd-Frank, it would seem that rules required by this law would have an intrinsic value from a liquidity perspective.

This inconsistent treatment of ABS has real consequences for the economy, and to the provision of funding to consumers and small businesses. ABS products are essential to support financing in many important sectors of the real economy. Historically, U.S. banks have been major investors in ABS, holding, for example, 25% of automotive loan-backed securities and 23% of credit card debt-backed securities (See chart in Appendix A). By treating ABS as illiquid, U.S. regulators have increased the risk that financing in these sectors may shrink significantly, creating a risk that automotive and other manufacturers slow growth or even decrease production, which could ultimately lead to higher unemployment.

I would also like to note, without going into too much detail, that the LCR is not the only problematic U.S. liquidity regulation. The net stable funding ratio (“NSFR”), a rule that addresses liquidity over a longer time horizon, is susceptible of the same criticisms because ABS and MBS are treated similarly to their treatment in the LCR. U.S. regulators have not, to date, finalized the NSFR for U.S. bank implementation. The NSFR could have a detrimental long-term effect on ABS liquidity if it is not calibrated to reflect the liquidity of the U.S. marketplace.

2) Treatment of committed lines under the LCR

The LCR rules’ treatment of committed liquidity or credit lines to certain Special Purpose Entities (“SPE”) is also problematic. As I noted earlier, one way that banks maintain liquidity is by maintaining committed lines of credit with other institutions. These lines can be drawn upon when the bank is stressed and needs short term cash to meet its obligations. But banks also extend such lines of credit to other banks, which can decrease their liquidity when drawn.

As demonstrated in the following table, the LCR uses different outflow rate assumptions for committed lines depending on the type of borrower and whether the line is for credit or liquidity.

Customer & Commitment Type	Outflow Amounts for Undrawn Commitments
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Committed credit facilities to: <ul style="list-style-type: none"> • Wholesale customers and counterparties • SPEs that are consolidated subsidiaries of wholesale customers and counterparties that do not issue commercial paper or securities 	10%
Committed liquidity facilities to: <ul style="list-style-type: none"> • Wholesale customers and counterparties • SPEs that are consolidated subsidiaries of wholesale customers and counterparties that do not issue commercial paper or securities 	30%
Committed credit facilities to: <ul style="list-style-type: none"> • Financial sector entities (excluding depository institutions, depository institution holding companies and foreign banks) • SPEs that are consolidated subsidiaries of financial sector entities that do not issue commercial paper or securities 	40%
Committed liquidity facilities to: <ul style="list-style-type: none"> • Financial sector entities • SPEs that are consolidated subsidiaries of financial sector entities 	100%
Committed credit and liquidity facilities to all other SPEs	100%

Banks are exposed to a “double whammy” with respect to the treatment of committed liquidity facilities. Banks must assume a 100% draw on liquidity lines to financial sector entities or their consolidated SPEs. However, they are not allowed to assume ANY inflow from any credit of liquidity facility extended to it. We believe this outcome to be excessively punitive.

These concerns are exacerbated in the context of securitizations. In the original LCR proposal, a credit commitment to any SPE attracted a 100% outflow rate. We appreciate that the prudential regulators took into account our “look through” argument (i.e., that an SPE should attract the same outflow rate as its underlying assets) and, in the final rule, assigned a 40% rate to SPEs that are consolidated subsidiaries of financial sector entities. However, we do not believe that the caveat that such SPEs not issue CP or securities is at all appropriate. While we appreciate that the financial crisis experience with SIVs might have informed this decision, it has unnecessarily complicated the structuring of safe funding vehicles such as master trusts (used often for credit card and dealer floorplan securitizations).

In conclusion, the LCR rules represent a substantial and obviously intentional effort to reduce securitization as a form of funding, regardless of whether it be via committed lines of credit or via publicly placed debt of the highest caliber that historically have stood up well to recessionary factors. We can already see in the field of committed lines of credit, these regulations have nearly eliminated parts of that once vibrant market as a source of any liquidity. And we are seeing signs that the contraction of the ABS market will start to have an effect on important sectors of the real economy. To be clear, these are not unintended consequences—the market has provided clear warnings about the potential consequences of these regulations on multiple occasions. Rather, LCR is a deliberate attempt to contract the ABS and RMBS securities markets.

Changes to LCR in Europe and Adoption of the “Simple, Standard, and Transparent” Standard⁵

In stark contrast to the approach taken by U.S. regulators, European politicians have clearly begun to realize that the wrong kind of regulation or indeed an over-accumulation of any type of regulation can be counterproductive. They are actively pursuing ways to reinvigorate European securities markets, recognizing that the funding that these markets provide is crucial to their economies, including both small businesses and consumers. Both the European Central Bank and the Bank of England believe that securitization is a vital source of funding for the real economy.⁶ These same regulators have also recognized that there are impediments – both structural and regulatory – that are currently constraining the return of the securitization market in Europe.

Basel, IOSCO, and EU policymakers understand that not all securitization is identical, and that many asset classes performed well and were in no way attributable or responsible for the financial crisis. There is a clear recognition that responsible lending and transaction standards have existed for several asset classes and product types since the securitization markets began in Europe, and accordingly, they have proposed criteria to designate such ABS under a “high-quality” banner categorized as “Simple, Standard, and Transparent” (“SST”). They believe that establishing this criteria, together with less onerous regulatory treatment of transactions meeting the criteria, could help stimulate a return of liquidity to the EU ABS market. In particular, the European Commission on Banking and Finance has proposed that capital requirements for SST qualifying ABS be less onerous, which should theoretically promote liquidity. This proposal is now before the European Parliament, and at some point, is expected to be adopted.

In essence, this SST concept seeks to address comments that have been made globally in a plethora of regulatory comment letters. Industry participants have argued that a “one size fits all” approach was inappropriate and that well-performing and liquid asset classes should not be unduly burdened as a consequence of issues associated with other asset classes. In other words, having

⁵ SFIG has generally used the term high-quality securitization (“HQS”), throughout this testimony. International regulators also refer to HQS as simple, standard and transparent (“SST”), and simple, transparent and comparable (“STC”).

⁶The Bank of England & European Central Bank, *The case for a better functioning securitization market in the European Union*, May, 2014, at, https://www.ecb.europa.eu/pub/pdf/other/ecb-boe_case_better_functioning_securitisation_market.en.pdf



thrown out the baby (or in this case, several babies) with the bathwater, European policymakers are now trying to correct those actions.

The European proposals are admittedly not perfect.⁷ Nevertheless, the principle behind SST—identifying a class of high quality securities and subjecting them to a more appropriate regulatory treatment—is sound.

Additionally, recent consultative papers have contemplated capital relief for those EU ABS that meet the SST designation, which would thereby increase the return on capital for banks investing in EU ABS. And on a similar basis the EC (under the Capital Requirements Regulation) has afforded certain EU ABS the HQLA status with applicable caps and haircuts for ABS that meet similar criteria. These are just a few examples of the striking disparity between the European and U.S. regulatory approaches on this issue.

At present, banks are subject to a patchwork of inconsistent regulations around the world, which is not a sustainable situation over the long term. However, with Basel and IOSCO taking a similar approach of identifying SST transactions in their own project, there is growing momentum for these initiatives to eventually become global, and at the very least, a consistent European (and likely global) approach may be emerging, with the U.S. alienated from this process by virtue of its non-adoption.

Of extreme importance, the proposal currently working its way through the European Parliament does not allow for U.S. collateral to qualify for use under their SST approach, thus only European banks buying European collateral will be able to take advantage of the designation and reduce the capital held against these liquid, high quality ABS.

European banks will be able to purchase high-quality European ABS with lower capital requirements, whereas U.S. banks will likely remain invested in U.S. products with higher capital requirements, and consequently a significantly lower return on capital. Faced with a clear differentiation where European collateral has a regulatory embedded advantage in its return on capital, it is inevitable that liquidity will be attracted to the higher returning assets, essentially draining some element of liquidity from the U.S. market. Similarly, in order to provide U.S. bank investors with the same return on capital as European banks, then U.S. issuance spreads will need to be wider than European levels, thus creating a cost burden that inevitably may cause a higher funding cost for the consumer or small business.

⁷ The complexity and ambiguity of the SST definition seriously limits its utility. Moreover, some of the criteria used are not necessarily relevant. The real goal of establishing a “qualifying” security should be to identify securities with a high credit quality. But the SST definition, as currently proposed, would be both over and under-inclusive of that goal. In particular, neither “simplicity” nor “standardization” necessarily imply credit quality.

As mentioned above, this divergence in regulatory standards may be further compounded at the international level. Basel and IOSCO's framework for securitizations that may be adopted by any participating company. Unlike the European proposal, the Basel/IOSCO proposal does not limit qualifying collateral to local jurisdictions, therefore allowing U.S. ABS to qualify. Should the recommendation be adopted by participating countries (i.e. China, Australia, and Japan) and not by U.S. regulators, then we are likely to see capital investment incentives for U.S. issued securities that favor foreign bank investment over U.S. bank investment. The failure of the U.S. to adopt regulations that may be accepted globally can create a division in the markets, whereby U.S. banks are incentivized to invest in higher yielding assets, while other investors may achieve the same return on capital by investing in safer lower yielding securities. Simply put, splitting a market reduces that market's liquidity.

Compare this outcome with what the U.S. is doing with Agency securities and the development of the Common Securitization Platform ("CSP"). Agency securities are the third most liquid security in the world, behind Japanese bonds and U.S. Treasuries. However, in lieu of two liquid securities, we are creating a single-security that, if implemented correctly, will be even more liquid and create a deeper marketplace. The United States' outlier status in the LCR and SST processes is likely to cause a fragmented global ABS marketplace.

We would strongly caution against the risk of creating a bi-furcated market with foreign investment being incentivized toward low risk U.S. assets. Not only does this create a reduction in liquidity due to the bifurcation of the market, but one must question from the perspective of the U.S. economy whether it is advisable to be creating an economy that relies on a significant part of its funding from foreign banks. We have already seen following the most recent financial crisis that foreign bailout funds would likely be contingent upon extended funds being invested at home. If the U.S. were to become over-reliant on foreign investment, then we would likely feel a deeper crisis as foreign investment funds are reduced.

If any of these contingencies come to pass, it would be a self-inflicted wound. The U.S. ABS marketplace is the most liquid ABS marketplace in the world, and it provides significant funding to the real economy (*e.g.* automobiles, credit cards, small businesses, capital equipment, solar power generation, housing, etc.)⁸. But the US LCR rules—in conjunction with less conservative rules for LCR in Europe and recent high quality initiatives—will inevitably create a situation where the far less liquid EU ABS market paradoxically becomes a better investment option than the liquid U.S. market. That would represent a serious regulatory failure.

In short, US markets are becoming less liquid, and some of that lost liquidity is being transferred to Europe. It seems unimaginable that the most liquid capital markets in the world may

⁸ Securitization Provides Meaningful Funding to the Real Economy, Moody's, March 11, 2015. https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBS_1003586



lose liquidity to a market that is significantly less liquid, simply because U.S. regulators have concluded - contrary to the evidence - that our market is not sufficiently liquid.

At the very least, U.S. regulators should cooperate with the Europeans in developing a standardized regulatory approach to SST, both with regard to the definition of SST and with regard to less onerous requirements. They should do so for three reasons. First, and most importantly, a lower capital requirement for SST is good policy that will support liquidity in the securitization market. Although the definition of SST requires revision, the SST approach is a step in the right direction. Second, a global approach will reduce transaction costs and allow financing to flow more freely. And finally, if the U.S. waits to adopt these rules, they will already be well established around the world, and it will be too late to have any influence on their precise formulation. The expertise of U.S. regulators could be invaluable in ensuring that the SST approach is successful in protecting liquidity.

Capital Regulation

Even though capital regulation does not specifically target liquidity, it nonetheless has a substantial effect on liquidity. Consequently, it is worthwhile to understand the difference between capital and liquidity. While both affect the solvency of an institution, they are not the same thing.⁹

Capital is a measure of equity that an organization can use to protect it from future losses. It is primarily a credit risk tool. If an organization takes on business that exposes it to the risk of future losses, it should ensure it can protect itself from such potential losses should they ultimately manifest themselves. Such capital can be derived either externally, via capital markets via equity issuance or other capital markets products such as preferred stock, or internally/organically by the generation and retention of profit.

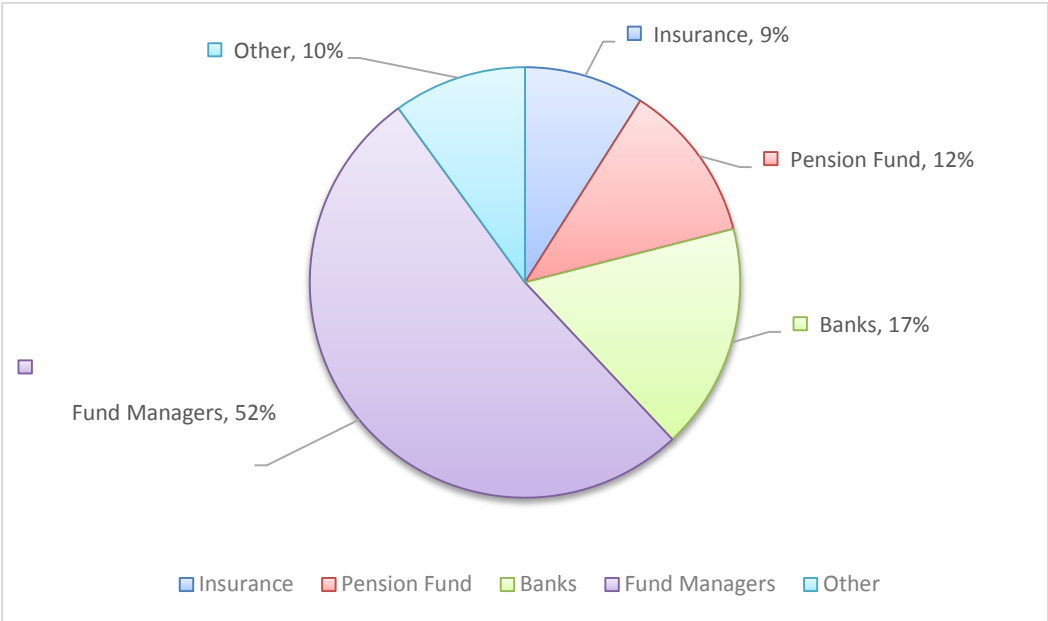
It should be very clearly noted that **capital is held primarily to protect an organization from unexpected losses**. This is very different from “accounting reserves” which may also be created by an organization as a future losses safeguard. However **accounting reserves are calculated based on expected losses**. They are created by writing down an allowance against future income and therefore create a deduction from profits which in turn flows to retained equity – however the creation of that allowance only occurs when you specifically see the loss likely to manifest itself on the horizon.

⁹ It is worth noting that bank funding is also different from capital and liquidity. Funding has a very deliberate cash association. A financial institution may fund itself through a variety of means which may include sales of products for cash, issuance into capital or debt markets, loans from other institutions and deposits from consumer and corporate customers.

As I noted earlier, liquidity is a little less tangible. It may be derived from the issuance of capital products or other funding initiatives, but not every dollar funded creates a dollar of liquidity. Liquidity is more related to an organization’s ability to raise cash at a time when it is needed. For instance, if a company were to raise a million dollars by issuing equity of \$100,000 and taking a bank loan for \$900,000, that would only translate into a million dollars of liquidity if it was maintained in cash or something easily converted to cash such as a US Treasury note. Were the million dollars to be invested in say plant and machinery, it would no longer be liquid and despite the fact that a million dollars had been raised, liquidity would effectively remain at zero.

Therefore, if capital rules require banks to hold increased capital against securitization positions, they will not be able to invest in as much ABS as before. As a result, there will be less liquidity in the marketplace. Although banks are not the only investors in ABS (see chart below), they make up enough of the market that the effect of capital regulation could be to significantly reduce liquidity. This effect may be exacerbated if the increase in capital for ABS and MBS is disproportionately large compared to the capital required for other comparable forms of finance such as secured lending or covered bonds. If the ABS or MBS markets are more limited because of the increased capital requirements applicable to some investors, then such businesses at worst may not be able to fulfill their financing needs, or at best be able to do so only at much higher costs.

U.S. ABS Investor Composition by Type: 2015



Source: Aggregated SFIG Member Data

The Basel III Securitization Framework, released late last year, is problematic in several regards. The details of the rules are complicated, but I would like to highlight a few features. First, Basel III requires banks to have extremely high levels of capital—far more than was required under



the previous Basel II framework. In some cases, for securitization positions, the capital required has increased by multiples of previous requirements.¹⁰ The historical performance of ABS, particularly high quality ABS, does not justify such stringent requirements.

Another serious problem with the new rules is that they require banks to hold much more capital against ABS than they would be required to hold against the underlying assets. In other words, the rules discriminate against securitization. This is particularly striking because securitization is a way of *decreasing* risk through diversification and higher liquidity. As with the liquidity rules, it is hard to see this treatment as anything other than a conscious effort to contract the ABS securities market.

Whether Basel II capital requirements were too loose is a debatable question. But there can be little doubt that the Basel III Securitization Framework has gone too far. Previous capitalization requirements have been adequate to cover all losses, through the history of securitizations, with only one exception - U.S. subprime mortgages and some related and exotic resecuritization vehicles. But rather than revising Basel II to target those particular kinds of assets, Basel III represents a wholesale attack on securitization itself. The result will inevitably be less financing and less growth.

Fundamental Review of the Trading Book

Basel has also recently finalized Fundamental Review of the Trading Book (FRTB) rules that, if adopted, would pose a major threat to securitization in the United States. Although the likely impact of the rules is not yet precisely clear, it is clear that the FRTB rules would require broker-dealers to maintain far higher levels of capital in connection with their ABS market-making activities than they are required to under the current regulatory regime—perhaps more than twice as high. There is no evidence supporting the need for such high capital requirements. Moreover, there is no indication that the design of the FRTB rules took account of the cumulative effect of other regulations that increase capital requirements, such as Dodd-Frank and Basel III.

This rule is particularly troubling for the U.S. ABS market. One essential element of the U.S. ABS market is its use of the capital markets for *market-making*, or simply put, to buy, sell and trade ABS securities. Market-making by bank broker-dealers allows investors to have confidence that they can buy and sell securities as needed. However, if the FRTB rules are implemented in the U.S. in their current form, it may be unlikely that dealers and underwriters would be willing or able to carry the capital required by the rules. A more likely outcome would be that they would sharply curtail their trading of ABS or simply stop trading altogether. This

¹⁰ Results of the Comprehensive Quantitative Impact Study, Basel Committee on Banking Supervision, December 8, 2010, at, <http://www.bis.org/publ/bcbs186.pdf>.

contraction in the secondary market would drastically reduce the liquidity of ABS. Historically, one of the most important characteristics of ABS has been their high liquidity, and the removal of this confidence factor would surely decrease demand for these securities, leading to less issuance, higher cost for the consumer, and ultimately less financing for the real economy.

Securitization Accounting's Effect on Capital: FAS 166/167

While much of the negative impact from regulation is specific to the actual risk based capital regulations, one key change occurred under accounting standards through the post-crisis adoption of FAS 166 (true sale accounting rule) & 167 (consolidation for SPEs accounting rule).

FAS 166 & 167 standards require banks to record—on the face of a bank's balance sheet—existing and future transactions that were previously “off balance sheet,” a process called “reconsolidation.”

The essential test for reconsolidation under FAS 166 & 167 is whether the bank maintained control or management of the financial assets while also having a potentially significant financial interest in their performance. There was a great deal of debate about the decision to reconsolidate these assets, but it is fair to say that the majority of market participants supported transparency and the open disclosure of these assets on a sponsor's balance sheet. The bigger problem is that these standards have impacted bank leverage ratios and accounting reserves, ultimately creating redundant capital in the system. This has had a massive, unintended effect on the ability of banks to release liquidity.

Before explaining the redundancy in question, I want to emphasize that many of the transactions that were affected by this change in accounting were “plain vanilla” securitizations backed by credit card debt, prime auto loans, student loans, and prime mortgages, which included contractual obligations for institutional investors to absorb shortfalls in cash-flows by writing down the value of their investments. These are the same investors who took significant losses during the crisis, as we are all aware. The allocation of potential losses from these transactions was very clearly documented: usually the sponsor retained a small piece of risk, and after that retention was exhausted, losses would be allocated and absorbed by investors according to very deliberate contractual terms. Even though the sponsor was legally liable for a small portion of the risk on the whole portfolio, its reserves were calculated based on the entire portfolio.

It is certainly possible that some issuers might be tempted to support the cash flows of their transactions in order to protect investors from loss, which could help those issuers to maintain continued access to the capital markets throughout a recessionary environment. Such support would be beyond the contractual requirements or expectations of the markets – such as an unexpected loss - and it may perhaps have been appropriate for the joint regulators to assume *some* amount of regulatory capital would be useful to protect issuer reserves in instances where such a non-contractual action were to be taken.



Nevertheless, by bringing these assets back onto the face of the balance sheet—despite the need to make accounting reserves only for **losses that are expected**—the reserves were instead based on the amount of assets artificially disclosed as “owned” by the issuer.

Take for example a well-capitalized credit card issuer: at the height of the recession, when consumer credit card losses were largely tracking unemployment, you might expect to see a loss reserve approaching 10% of assets. The creation of that loss reserve requires a direct reduction of capital, as the reserve has to be funded by retained profit. Simultaneously, as the joint agencies required an additional 10% of risk based capital for a well-capitalized bank, the total net impact to capital from the consolidation of those assets amounts to over 20%. In other words, the amount of capital that is required, through the combination of accounting reserves and regulatory capital, reflects the assumption that over one in every five consumers will be completely unable to pay his credit card obligations, losing credit status and the ability to use credit.

There are two reasons that this level of retained capital is redundant:

1. It assumes that issuers will break contracts and provide 100% transactional support to their deals. Not only does the assumption that hundreds and thousands of incredibly precise documents will be broken run contrary to every other accounting treatment in the book, but;
2. It is also totally unrealistic from the perspective of an institution’s fiduciary duty to its shareholders. In the unlikely event that losses were to approach 20%, which would threaten the capital adequacy of *any* issuer, it is unfathomable that issuers would still prioritize liquidity over the solvency of their institutions.

Although debate will doubtless continue over the specific details of risk based capital regulation, the industry would ask Congress to investigate this application of FAS 166 and 167 to loan loss accounting. A more simple adjustment to loan loss accounting rules could cause a major shift in overall issuance, which might return tens of billions of dollars of redundant capital back into the economy and stimulate *hundreds of billions* of dollars of new lending.

Basel’s Framework for Step-In Risk

I would also like to briefly address Basel’s recently proposed framework for dealing with step-in risk, which it defines as the “risk that banks would provide financial support to certain shadow banking or other non-bank financial entities in times of market stress, beyond or in the absence of any contractual obligations to do so.” Basel clearly states that the proposal would apply to only unconsolidated entities; i.e., those entities outside the scope of regulatory consolidation. The proposal does not address how step-in risk would be incorporated into the current Basel

framework, including whether they would fall within Pillar 1 and/or Pillar 2, but we would presume that it would be addressed by additional capital requirements.

While we appreciate the need for appropriate capital requirements, we are concerned that any potential step-in requirements would not reflect the many changes that have been made to accounting rules and regulations in response to the financial crisis. For example, within the framework of FAS 167 consolidation decisions, the sponsor of a securitization must consider whether it has a significant implicit financial responsibility to ensure that a variable interest entity operates as designed. This determination must take into account the sponsor's concern regarding reputation risk if the variable interest entity does not operate as designed. Therefore, FASB rules already require that a sponsor of the securitization analyze "implicit" risk, including any potential reputational risk, when making consolidation decisions. If, through this analysis, entities are consolidated on balance sheet, banks would have to hold appropriately robust levels of capital as required by Basel III. We believe, therefore, that the combination of post-crisis accounting and regulatory reform renders additional capital requirements redundant and unnecessary for the unconsolidated entities that Basel is targeting.

The Cumulative Effect of Layered Regulations

Many of the regulations I've discussed today would be a concern in isolation. But the cumulative effect of all of these rules could have a detrimental effect to the \$1.6 trillion in annual financing that securitization provides the U.S. economy. It is worth noting that while some reforms have been finalized, there are a number of rules that are still being implemented, and others that are still being proposed (such as the FRTB rule). That said, below are several observations we would highlight.

First, because ABS and MBS are not considered high quality securities, they do not contribute to banks' liquidity ratios, making it far less desirable for banks to hold them. Second, Basel III's capital requirements, outside of subprime RMBS, appear higher than is warranted based on historical evidence. Third, the accounting rules under FAS 167 require banks to hold even more capital against risks for which the banks are not even contractually liable. Fourth, FRTB will require many banks to hold yet more capital—the total amount is not clear, but it is likely to be multiples of what is required under the current regime.

On top of these affects, what is truly difficult to comprehend is the lack of credit given to Dodd-Frank reforms during development of international capital and liquidity standards. One purpose of Dodd-Frank was to shore up holes in the U.S. regulatory framework, and therefore mitigate the fallout from any future crisis.

Many of the Dodd-Frank rules meant to correct the perceived flaws in the ABS market have been finalized, such as disclosures under the SEC's regulation AB II and the joint regulators' risk retention rules, to name just two.



However, the same U.S. regulators who promulgated these rules also sit on the Basel and IOSCO committees that promulgated international capital and liquidity rules. Yet none of these international capital and liquidity rules, when tailored to the U.S. marketplace by our regulators, give credit to the controls installed by Dodd-Frank. Essentially, U.S. capital and liquidity rules ignore the controls installed by Dodd-Frank. Potentially much worse, the U.S. regulators have adopted considerably more stringent approaches to prudential regulations than international standards.

This is precisely why Congress, U.S. regulators and the industry must understand the cumulative effect of regulations. Regulation must strike the right balance between liquidity and a well-regulated U.S. ABS marketplace, or indeed whether we have created an unfair competitive advantage that favors European issuers over U.S. ABS issuers.

Specifically, such a review should be ongoing, examining the interaction of finalized and proposed rules in the same context to understand where the appropriate calibration should be made to balance liquidity and regulation.

European regulators have already undertaken such an analysis and begun to act upon its findings. Unfortunately, without such an analysis in the U.S., it is not hyperbole to say that the combined effects of regulation could be extremely detrimental to the American economy.

Proposed Legislation to Address Asset Class-Specific Regulatory Concerns

H.R. 4166, the Expanding Proven Financing for American Employers Act

The \$285 billion CLO market is a key to a well-functioning commercial loan market which provides significant capital to businesses and fosters economic growth and job creation. By providing substantial credit capacity to the commercial loan market, CLOs generally serve to lower interest rates for corporate borrowers that may not have ready access to alternative capital markets financing. In fact, CLOs represent the largest non-bank segment of the commercial loan market.

As we stated in our December 8, 2015 letter to the Members of this Committee, SFIG supports H.R. 4166, a bipartisan bill introduced by Congressman Barr and Congressman Scott that creates a QCLO option to comply with CLO risk retention requirements. Under the legislation, QCLOs must meet strict criteria across six categories designed to enhance the alignment of interest between CLO managers and investors.

While we appreciate the difficult task that regulators had in promulgating the risk retention rules, SFIG members do not believe that the lead arranger/open market option for CLOs in the

final risk retention rule is a viable solution, and may decrease CLO issuance and increase costs for borrowers.

H.R. 4166 is a common sense solution that will allow the CLO industry to continue supporting real economy growth through investment in local businesses and communities, while also remaining true to the goals of risk retention.

SFIG stands ready to work with the members of this Committee to build the broadest consensus possible to support this approach.

Discussion Draft: To Exempt Certain Commercial Real Estate Loans From Risk Retention Requirements

The \$1.2 trillion commercial real estate market provides significant funding for multifamily housing, office space, grocery stores and hospitals. As of the fourth quarter of 2015, CMBS accounted for roughly \$600 billion in outstanding commercial real estate debt. The discussion draft creates an exemption for single-asset/single-borrower CMBS transactions, and modifies the b-piece risk retention option to allow the risk to be shared amongst two purchasers on a pari-passu basis.

As with any good law or regulation, there needs to be some alignment of interest and skin-in-the-game by issuers in order for investors to feel confident in purchasing an ABS or MBS. The degree of that alignment of interest is subject to debate.

Issuers, on the whole, would prefer the lowest cost and most efficient requirements in order to earn the best returns possible for their stockholders. Investors, in general, would prefer more protections in order to feel confident in their purchase, while at the same also earning an appropriate return on their investment.

While it is too early to give a definitive reaction to the bill, early indicators from SFIG's membership suggest that while our issuers are unanimously supportive of the bill, a majority of our investors are not.

Therefore, SFIG would recommend that a forum be established to create a consensus path forward for the industry on this discussion draft.

Conclusion: Recommendations to Responsibly Create Liquidity in the Financial Market

Based on the foregoing discussion, we request the following:

1. U.S. Regulators should be required to continuously review the effects of current and anticipated regulation on the securitization market. Regulators should also be required to publicly provide any analysis on the effects on the availability or cost of credit to consumers and borrowers. Specifically, U.S. regulators should be required to examine the Basel III Securitization



Framework, the FRTB, current U.S. Risk Based Capital Rules, take into account the rules established under Dodd-Frank, and adjust capital requirements to appropriate levels. A formal review mechanism should be created to conduct such a review and to consider ways in which rules should be calibrated to achieve regulatory goals, while limiting the impacts on market liquidity, consumers and business end users.

2. As was the case with municipal bonds, the definition of High Quality Liquid Assets, as used in the LCR rules, should be reexamined by U.S. regulators to give highly rated ABS and RMBS, a status at least equivalent to that of investment grade corporate bonds. We cannot emphasize this enough. Failing to respect the highly liquid nature of these securities would have severe detrimental effects on both liquidity and the real economy.

3. Committed lines of credit to security-issuing SPEs should not be categorically treated as 100% outflows for LCR purposes. Such treatment should be reserved for lines of credit committed to only the types of SPEs that are most vulnerable to market disruptions.

4. U.S. regulators should work with E.U. regulators to develop an internationally consistent and fully operable standard for “qualifying” securitizations. Consequently, the capital requirements for the related ABS and MBS (for both the trading and banking books) should be reduced to appropriate levels.

5. FAS 166/167 should be reexamined to ensure that capital is being held against contractual obligations, and it should be examined in the face of the additional capital that may be required under Basel’s proposed Step-In risk rule. It is critically important that capital treatment reflects real economic risk.

6. Support H.R. 4166, as it creates a workable option for CLO risk retention. SFIG stands ready to help build the broadest possible consensus for this bipartisan bill.

7. Continue the dialogue on the discussion draft for CRE loans.

8. Congress should continue to monitor liquidity across the various market segments through additional hearings as Dodd-Frank, Basel and other rules are proposed and later enacted.

Thank you for the opportunity to testify before you today. SFIG stands ready to work with all Members of this Committee to find economic solutions that balance appropriate regulation with a liquid securitization marketplace.

Appendix

December 8, 2015

The Honorable Andy Barr
Congressman
1432 Longworth House Office Building
U.S. House of Representatives
Washington, DC 20515

The Honorable David Scott
Congressman
225 Cannon House Office Building
U.S. House of Representatives
Washington, DC 20515

Dear Congressmen Barr and Scott:

The Structured Finance Industry Group, Inc. ("SFIG") is a member-based trade industry group focused on improving and strengthening the broader structured finance and securitization market. Members of SFIG represent all sectors of the securitization market including issuers, investors, financial intermediaries, law firms, accounting firms, technology firms, rating agencies, servicers and trustees.

SFIG urges House support H.R. 4166, the *Expanding Proven Financing for American Employers Act* ("Act"), a bipartisan bill that creates a workable risk retention regime for collateralized loan obligations ("CLOs").

The \$285 billion CLO market is key to a well-functioning commercial loan market which provides significant capital to businesses and fosters economic growth and job creation. By providing substantial credit capacity to the commercial loan market, CLOs generally serve to lower interest rates for corporate borrowers that may not have ready access to alternative capital markets financing. In fact, CLOs represent the largest non-bank segment of the commercial loan market.

While we appreciate the efforts of the regulators, SFIG members do not believe that the lead arranger/open market option for CLOs in the final risk retention rule is a viable solution, and may decrease CLO issuance and increase costs for borrowers.

H.R. 4166 creates a risk retention requirement that applies to "qualified" CLOs ("QCLOs") that meet strict criteria across six categories designed to enhance the alignment of interest between CLO managers and investors. The Act is a common sense solution that will allow the CLO industry to continue supporting real economy growth through investment in local businesses and communities, while also remaining true to the goals of risk retention.

We look forward to working alongside Congressmen Barr and Scott to move H.R. 4166 forward.

Sincerely,



Richard Johns
Executive Director

cc: Members of the House Financial Services Committee