The Dodd Frank Act: How Will It Affect the Real Estate Securitization Market

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Submitted to the Program in Real Estate Development
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ABSTRACT

This thesis investigates one of the United States’ most sweeping regulatory responses since the New Deal legislation passed in the 1930’s, the Dodd Frank Act. While the Dodd Frank Act will affect numerous financial markets, this thesis will focus on the implications of this regulation on the real estate securitization market.

To better understand the regulatory response towards real estate securitization, we will clarify some of the key definitions, explain the history of securitization and describe the fundamental issues that led to the real estate securitization boom and subsequent bust as well as its implications on the financial crisis in the late 2000s.

We will then summarize in detail the key provisions in the Dodd Frank Act associated with real estate securitization and describe the framework for which these provisions were formed. In conclusion, we will examine the implications of these provisions and explain our position of how the Dodd Frank Act will not achieve its desired effect on the real estate securitization market as drafted.

Thesis Supervisor: David Geltner
Title: Professor of Real Estate Finance, Thesis Supervisor
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Ch. 1 – INTRODUCTION

The structure of our research is to better understand the impact and significance of the Dodd Frank Act with respect to real estate securitization. The Dodd Frank Wall Street Reform and Consumer Protection Act is a federal statute signed into law on July 21, 2010 by President Barack Obama. The Act was born out of the credit crisis and recession of the late 2000s and signifies the single most sweeping piece of regulatory reform of the financial markets since Franklin D. Roosevelt passed the New Deal. The entire Dodd Frank act goes well beyond the scope of our research as we examine only its effect on real estate securitization. Our intent is to provide an overview of the various types of real estate securitized products, a historical overview of real estate securitization and regulation, and an analysis of the events that led to and caused the real estate crash of the late 2000s. Next, we will identify the provisions within Dodd Frank that directly address real estate securitization. In doing so, we will examine the intent of each provision and provide an analysis of the proponents and opponents of the Act as written. Then, our research will highlight the market curtailing factors of the Act and underscore the benefits of various parts of the Act. Lastly, we will conclude with a hypothesis of how Dodd Frank will eventually be written into law by regulators.
Ch. 2 – SECURITIZATION

In this chapter we will provide an overview of the various products that make up the real estate securitization market, a brief history of the evolution of real estate securitization and regulatory guidelines, and the timeline and events that caused the response of Dodd Frank. Our goal is to orient the reader with the key actors, actions, and products that assisted the market in arriving to its current state.

Ch. 2.1 – Definitions

Passthroughs

To understand how real estate securitization works, it is important to understand the products that make up the market. We will first examine passthroughs as they are a vanilla real estate product and provide the backbone to the understanding of the other various products.

Simply, a mortgage passthrough is a security made up of a pool of mortgage loans that distribute principal and interest payments to the investor(s) on a pro rata basis. To illustrate how this product works, we will break down the components. In an effort to keep things simple, let’s assume a group of 750 30-year mortgage loans at 7% interest rate with a principal value of $100,000 each, comprises the pool of mortgages with an aggregate value of $75 million. The monthly cash flows are made up of three parts: 1) interest, 2) scheduled principal, and 3) payments over and above scheduled principal also known as prepayment. If an investor to purchase one of the 750 loans, he would be highly exposed to prepayment risk because the investor is not certain of the behavior of the respective homeowner. However, if the investor were to buy all 750 mortgages, his prepayment risk would be mitigated over a group of individual loans and not concentrated on a single mortgage position. Intuitively, the more loans in the group, the more likely the investor is exposed to prepayment risk at some level, however, the likelihood of the entire pool being prepaid is low. On
the flip side, the more loans in the group make the security more expensive and probably cost-prohibitive for many investors. Back to the 750 loans, let’s assume for a moment that an entity purchases the 750 loans separately and pools them together to sell to several investors. The entity decides to take the pool and split it into 7,500 shares of $10,000 each. Investors may purchase any number of the shares of the pool, up to 7,500 of course. If an investor were to buy 300 shares, he would be entitled to 1/25th of the respective cash flow of the aggregate pool of mortgages. This simple structure represents a mortgage passthrough security. The representative mortgages that comprised the passthrough have been securitized.1

As we have identified prepayment risk in reference to passthroughs, it is important to note the other inherent risks in the security. The underlying pool of mortgages contains only 30-year loans and the average investor is not likely to tie up their capital throughout the duration of a 30-year bond; and the longer the duration of the bond, the more sensitive the price of the bond is to interest rates. Since interest rates and bond prices move inversely, if interest rates were to shoot up the price of the bonds would decrease significantly leaving the investor with interest rate risk. Due to their nature of scheduled payments over time, passthroughs are similar to traditional bonds. However, with traditional bonds, regular interest payments are made to the investor while the principal is paid back at maturity. Passthroughs are similar in that they distribute regular interest payments but different because the principal is amortized and distributed over the life of the investment. The investor is forced to plow his passthrough distributions of principal into securities under potentially less favorable yields – this is known as reinvestment risk. Lastly, on loans not guaranteed by the agencies investors are subject to homeowner delinquencies and subsequent

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1 Fabozzi & Modigliani 1992, p. 4-9. Mortgage and Mortgage-Backed Securities Markets
foreclosures. In this scenario, regular principal and interest payments are not being made by the homeowner and distributed to the investor – this is known as default risk.

**Collateralized Mortgage Obligation - CMO**

Staying with the example of passthroughs, let’s examine the exact same pool of mortgages but, in this instance, payments are not distributed to the investor on a pro rata basis but instead, principal payments are distributed on a prioritized basis. Let’s split the investors into three classes, Class A, Class B, and Class C. In this scenario, Class A will have priority over claims or be more senior than Class B and Class C. The sum of the par value of the two classes is still $75 million. However, each of the three classes represents $25 million par value. As principal payments come into the pool, Class A will receive all of the distributions of principal until its par value of $25 million has been paid. At that point, Class B will receive distributions of principal until its par value of $25 million has been paid. All remaining principal payments then go to pay Class C. Interest payments, as they come into the pool, are distributed based on the par value of each class. This prioritization of payments creates a collateralized mortgage obligation (CMO).²

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To understand the rationale for creating this security, we'll dig deeper. CMOs were also created as an effort to mitigate the various risks of investing in passthroughs. By splitting the mortgages into three classes, we have created three separate maturities, as referenced in the diagram. Although the aggregate pool of mortgages has the same prepayment risk as in the passthrough example, this CMO creates layers of prioritization for investors. As illustrated, Class A receives principal before Class B and Class C; therefore Class A will have a security with a shorter duration. This shorter duration hedges the potential prepayment risks associated with these loans. Next, by splitting the mortgages into three classes with prioritization, any losses experienced in the pool would hit Class C first, then
to Class B and finally it would hit Class A. The Class C position is also referred to as first-loss. Likewise, as principal payments came into the pool, Class A would have senior claims on the principal payments giving them more security in having their par value repaid. It makes sense that Class A should receive a lower interest rate on their bond than Class B & C because it is a much safer investment. An investor has the ability to choose the appropriate Class of bond given their respective risk tolerance profile. This ability helps shield against interest rate risk. Hopefully, it’s clear that the same risks apply in CMOs as they do in passthroughs, the difference is the structure of the CMO allows to reallocate the risks depending on the risk profile of the market.³

**Stripped Mortgage-Backed Security - SMBS**

SMBS are a form of derivative products that assign the cash flow from the underlying pool of mortgages to the security holders based on unequal distributions. The result of this structure is a security that performs differently from a price/yield standpoint than the price/yield performance of the underlying mortgage pool. There are three forms of SMBS but for the purpose of this thesis, we will only examine IO/PO strips. The mortgages could be split into Principal Only (PO) and Interest Only (IO) bonds. The PO bonds would receive principal payments only. The investor would purchase the bond at a deep discount, receive no regular payments, and receive a one-time par value payment at maturity. PO bonds would have short-term maturities and would be less sensitive to changes in interest rates. Alternatively, the IO bonds would receive the collective interest payments from the underlying pool of mortgages. The IO bonds would be highly sensitive to fluctuations in interest rates and prepayments. These products allow the investor to determine their tolerance for interest-rate fluctuations and when they expect to receive cash flows from the bonds.⁴

⁴ Fabozzi & Modigliani 1992, p. 244-245. Mortgage and Mortgage-Backed Securities Markets
Asset-Backed Security – ABS

“An asset-backed security (ABS) is a fixed income instrument structured as a securitized interest in a pool of assets. The 2010 Dodd-Frank financial reform act broadly defined ABSs to encompass all securitizations:

... a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including (i) a collateralized mortgage obligation; (ii) a collateralized debt obligation; (iii) a collateralized bond obligation; (iv) a collateralized debt obligation of asset-backed securities; (v) a collateralized debt obligation of collateralized debt obligations; and (vi) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section.”

Although the recently defined term of ABS in Dodd Frank includes real estate securitizations, finance professionals have typically referred to ABS in reference to credit card receivables, student loans, auto loans, and home equity lines of credit. Important to note here that ABS is an umbrella term that covers most of the terms we seek to define and explain for the purpose of our thesis.

Exhibit 2

http://people.stern.nyu.edu/igiddy/ABS/absflows.htm

5 http://www.riskglossary.com/link/asset_backed_security.htm last accessed on 6/12/12
Residential Mortgage-Backed Security – RMBS

Residential Mortgage-Backed Securities are a type of debt instrument, or bond, that are backed by mortgages on residential real estate – either single-family homes or 2-4 family buildings. The mortgages of the residential real estate are pooled and packaged to form a bond or group of bonds to sell to investors. As principal and interest payments come into the pool, they are distributed out to the investors based on their respective positions in the RMBS. RMBS are effectively residential mortgage passthroughs but the key difference is that RMBS distinctively separate classes of investors where mortgage passthroughs are known as single-class MBS. RMBS are further spilt into two groups, agency issues and private label issues. Agency issues are those issued by government-sponsored entities - Fannie Mae, Freddie Mac, and Ginnie Mae - where private label are securities backed by non-conforming loans (subprime, Alt-A, Jumbo) relative to the standards set by the GSEs.6

Exhibit 3

http://securitization.weebly.com/private-label-mbs.html

Commercial Mortgage-Backed Security – CMBS

Commercial Mortgage-Backed Securities are similar to RMBS but are, instead, backed by commercial real estate mortgage debt – loans on office, retail, large apartment complexes, hotel, and industrial structures. Another differentiating factor is the mortgagor of the real estate asset. RMBS mortgagors are, for the most part, owner-occupants of the asset being mortgaged; whereas CMBS mortgagors can be institutions, investors, and even individuals owning income-producing real estate. The motivations of the separate mortgagors in RMBS and CMBS differs, therefore these two products are cut out of the MBS cloth. This debt is broken down into two categories: 1) loans to be securitized (CMBS loans) and 2) portfolio loans, loans originated by the lender and subsequently held on the lender’s balance sheet through maturity. Relative uniformity in CMBS is much more difficult to replicate compared to RMBS transactions. In CMBS transactions, mortgage loans of varying property type and size are pooled and transferred to a trust. The trust then issues bonds with tranches that represent prices and yield representative of the underlying mortgages being securitized. The tranches in CMBS follow a similar sequential-pay structure as we discussed in the CMO. Investors decide, based on their tolerance for risk, which tranche to invest in and as interest and principal payments come into the pool, they are distributed down through the tranches on to the investor based on the priorities of the tranches.

A feature of CMBS that is unique is the inherent call protection. Call protection is a risk mitigating characteristic that compensates the investor in principal prepayment scenarios. Two features of the call protection of CMBS are: 1) prepayment penalties and 2) defeasance. CMBS loans have a lock-out feature which is intended to discourage the mortgagors, or borrowers, from prepaying the principal, either by a refinance or recapitalization. Let’s assume that interest rates

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drop considerably and the mortgagor decides to refinance its CMBS loan although the loan is still in the lock-out period. The mortgagor would be subject to a prepayment penalty, often referred to as yield maintenance, to compensate the bond investor for the prepayment of principal. The reason this is the case is that a bond investor makes a decision, based on his risk tolerance and investment time horizon, to invest in a bond with a specific maturity. The investor expects that, over time, the bond will perform to the risk and maturity associated with the pool of mortgages. In the event of a sudden principal prepayment, the investor is now in the conundrum of having to source and reinvest the proceeds in another asset to replicate the original. By having an early repayment of principal on the initial investment, the investor is compensated in the form of a prepayment penalty paid by the borrower. The second feature of CMBS – defeasance – works much differently. A borrower may obtain a release from the trust to substitute its collateral, the commercial real estate structure, with government securities, as long as the securities pledged are enough to generate the principal and interest cash flow equal to how the real estate asset would have performed. What this does is allow a borrower to swap out its obligation to the bondholders with government backed securities. REMIC structures are prohibited from substituting collateral for the initial two years following the securitization, which effectively works as a hard defeasance lock-out period.

**Collateralized Debt Obligation – CDO**

Think back to the way a CMO is structured by creating tranches of priority. Instead of conventional mortgages, now consider a pool of subprime mortgages. If an issuer were to package these subprime mortgages in a passthrough, the investor would expect to be investing in mortgages with a high risk of default which would warrant a risky rating – a BBB in this case. The problem with a BBB security is that it priced lower than higher rated bonds, which means less profitability for the dealer. In the same way that a group of mortgages were able to mitigate the prepayment risk of
a single mortgage, a group of mortgages are able to mitigate the default risk of a single mortgage. Similarly structured as the CMO, a CDO takes a pool of subprime mortgages and assigns priority to classes of investors of the CDO. These classes invest in credit-rated tranches created under the structure. For example, investors in the AAA CDO tranche will receive payment first and before the lower tranches. The corresponding risk a BBB investor will take on is made up for in lower bond price and higher yield. Conversely, the AAA investor will receive a lower yield and pay more for the debt instrument. Although, all the mortgages in the underlying pool are high-risk, the purpose of the CDO was to reallocate the risk among the tranches. During the subprime boom in the mid-to-late 2000s, another CDO was born – the CDO-squared – which was a resecuritization of a tranche of the original CDO. In both products, statistically, the assumption was that the underlying mortgages weren’t strongly correlated, therefore, to further assume that not all the mortgages would default was reasonable. Unfortunately, and as we’ll come to find out, this assumption was unfounded.\(^8\) It is clear that CMOs and CDOs are very similar in structure the key difference in why each product was created is that CMOs are designed to reallocate prepayment risk while CDOs are designed to reallocated default risk.

\(^8\) Durbin, Michael 2011, p. 206-208. All About Derivatives 2nd Edition
Credit Default Swap – CDS

Credit Default Swaps are a financial instrument designed to compensate the buyer in the event of a credit event. The CDS buyer makes period payments (spread) to the seller in return for the protection against a loan default. It is similar, in structure, to auto insurance. A car owner will make period payments to the car insurer to hedge the risk of paying for the damages in the case of an accident. CDS works in the same way, only instead of a car and potential car accident, it is made up of a loan and potential loan default. A CDS buyer will make premium payments to the CDS seller based to protect against or speculate that the underlying bond issuer will default. Intuitively, the higher the risk – increased likelihood of default - of the underlying bond issuer, the more the CDS will cost the buyer. This is an important concept that we will revisit in the history section.
Exhibit 5

Ch. 2.2 – History of Securitization

Earliest Phase – 1920s – 1960s

Real estate securitization in the United States, in its earliest forms, dates back to the 1920’s. Fueled by massive speculation and healthy development in both the residential and commercial real estate, capital intensive pressures were put on the sector to increase their financing capacity to meet demand and remain solvent. In the period of 1918 to 1926, U.S. nonfarm dwelling values are estimated to have increased in excess of 400%.  

Exhibit 6

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In response to the rapid expansion of development at the time, “real estate organizations have taken the public into partnership with them by adopting the corporate form, and by issuing shares as well as bonds.” The earliest issuances of public securities backed by real property, both residential and commercial, were pass-through securities. The characteristics of the early bonds were different with respect to present-day applications. “Most coupon payments were disbursed in gold coin, preserving the inflation hedge desired by many real asset investors. Terms varied widely from 2 to 47 years, but large amounts of principal were often scheduled to mature at intermediate dates prior to final maturity. This feature was likely included to appeal to large investors with varying duration targets. Nearly every bond in the sample was redeemable (callable) at any time by the issuing property developer with very little penalty.” The rampant supply of securitized real estate products in the 1920’s was satiated by the appetite of both the retail investor and the institutional investor. From a retail investor’s standpoint, real estate pass-through securities served as inflation hedges with an opportunity to diversify. On an institutional level, these securities represented the opportunity for speculative real estate investment. Statutory law dictated the illegality “for corporations to own real property beyond that needed in the transaction of their corporate business”. Therefore, the demand for corporations to invest in real estate securities was robust to offset their inability to own income-producing property.

Under the Franklin D. Roosevelt administration, a series of economic programs – known as the New Deal – were created and implemented in response to the Great Depression. As part of the New Deal, the National Housing Act of 1934 or Capehart Act, was passed and the Federal Housing Authority (FHA) was created to establish and maintain affordability in the housing market in both

real asset prices and also financing by regulating the rates and terms of mortgages. One of the principal functions of the FHA was to insure private lenders against the risk of mortgage defaults. A key innovation of the times was the FHA’s role in development and standardization of the self-amortizing fixed rate mortgage. Prior to this, the only mortgage product available was a balloon mortgage – which was a 5-10 year interest-only loan that did not require principal pay down. There were two ways the borrower could meet the loan obligations at the time of maturity: a) come up with the full amount of the mortgage – an unlikely scenario or b) use the proceeds of another mortgage loan. As a result, balloon mortgages had a higher probability of default because the borrower may not have sourced the funding at the time of maturity.

Another spawn of the New Deal was the Federal National Mortgage Association (FNMA) – known as Fannie Mae – which was established in 1938 through amendments to the National Housing Act. The primary function of Fannie Mae was to provide federal capital to community banks in order to increase the rate of home ownership and make mortgage capital more available to the broad market – effectively a nationalized Savings & Loan. As the need for capital increased, the secondary mortgage market was created. Fannie Mae raised money from foreign investors at low interest rates piggybacking on the credit quality of the U.S. Government. Fannie Mae then engaged in interest rate arbitrage – by lending the money at a higher rate to home buyers – and capturing the credit spread as profit. From its inception in 1938, Fannie Mae had a monopoly on the secondary mortgage market for thirty years. However, “despite periods of tight money, Fannie Mae could do little to mitigate the problem because of the continued reliance on depository institutions to originate mortgage loans.”

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**Early Phase**

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Further demand for a broader mortgage capital base elicited changes in the markets. “At that time, banks, depository institutions as well as savings and loans (S&Ls), held their mortgage loans from initiation to maturity. Mortgages were difficult to sell to outside investors because they were not standardized and it was difficult to mitigate repayment risks. The lending institutions raised capital primarily from deposits and secondarily from equity and debt offerings. Since regulations capped the amount of bank debt and banks were only permitted to draw customers from defined geographic areas, funds for mortgage loans were limited.”

Enacted by Congress during the Lyndon Johnson administration was the Housing and Urban Development Act of 1968 which split Fannie Mae into two separate entities: Fannie Mae – which continued to function as a purchaser of conventional mortgage, and; Ginnie Mae – which “was created within HUD to provide the full faith and credit guaranty of the U.S. Government for the timely payment of principal and interest on MBS, secured by pools of government loans. These loans are insured or otherwise guaranteed by FHA, HUD’s Office of Public and Indian Housing. (PIH), the U.S. Department of Veterans Affairs’ (VA) Home Loan Program for Veterans, and the U.S. Department of Agriculture’s Rural Development Housing and Community Facilities Programs and Rural Development Guaranteed Rural Rental Housing Program (Rural Development).”

In 1970, Congress authorized Fannie Mae to purchase private conventional mortgages and, at the same time, created the Federal Home Loan Mortgage Corporation (FHLMC) – known as Freddie Mac – to provide a similar function as Fannie Mae but Freddie Mac supported both private conventional mortgages and the fully-insured FHA, VA, and FmHA mortgages. With respect to their organizational structures, Fannie Mae and Freddie Mac are known throughout the industry as “agencies” of the U.S. Government or government-sponsored entities (GSEs); however, they are

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16 Ginnie Mae, Annual Report 2009, pg. 9.
Agency Securities

In 1968, the first mortgage-backed securities of Ginnie Mae were issued. These plain vanilla passthroughs – guaranteed but not issued by Ginnie Mae – represented the primary function of Ginnie Mae, to “permit these lenders to convert illiquid individual mortgages into liquid securities backed by the U.S. Government.”

In 1971, Freddie Mac got involved and issued its first mortgage passthrough – Participation Certificates – which were pools of private conventional mortgages. Freddie Mac established two programs for PCs: “the Cash Program and the Guarantor/Swap Program. In the former program the individual mortgages that back the PC are those purchased from mortgage originators, then pooled by Freddie Mac and sold in the market or in daily auctions through its dealer network. Under the Conventional Guarantor/Swap Program, Freddie Mac allows originators to swap pooled mortgages for PCs in those same pools. For example, a thrift may have $50 million of mortgages. It can swap these mortgages for Freddie Mac PC in which the underlying mortgage pool is the same

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$50 million in mortgage loans the thrift swapped for the PC.”19 It is important to note, that Fannie Mae also had a swap program which provided liquidity to the loan originators.

In 1981, Fannie Mae issued its first mortgage passthrough, a Mortgage Backed Security. In 1983, Freddie Mac issued the first CMO, which was designed to appeal to institutional investors with different appetites for risk. In 1984, Fannie Mae created a passthrough collateralized by multifamily mortgages through the swap program. Months later, Freddie Mac issued a passthrough collateralized by a pool of multifamily mortgages through its respective swap program. Late 1984, Fannie Mae issued a passthrough backed by a pool of adjustable-rate mortgages (ARMs).

Private Label Securities

Private label passthroughs were initially offered in 1977 by Bank of America but the supply was met with a lack of demand. Three inherent issues of the private sector market were limiting its ability to thrive: 1) private label passthroughs were crowded out by the agency issues, 2) private issuers were subject to state and federal regulations that either diminished demand or required security structures that were too costly, and 3) private issues were not standardized which severely limited liquidity.

As a result of the Presidential Commission on Housing’s recommendations for the enhancement of the private label MBS market, several regulatory changes took place. First, the Secondary Mortgage Market Enhancement Act of 1984 (SMMEA) was passed “to improve the marketability of mortgage-related securities earning a double-A quality rating or better from one of

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the nationally recognized commercial rating companies.”

Further, the Department of Labor approved private label pass-throughs in pension fund investments.

Issuers, at the time, had difficulty complying with SEC registration requirements. SEC required issuers to provide full disclosure of the underlying mortgage pool in investment prospectuses. However, issuers aggregate pools of mortgages over time and don’t necessarily have all the information to disclose – these are referred to as blind pools and the SEC prohibited these securities to be issued on a shelf-registration basis. On top of registration requirements, issuers had to contend with the arduous process of periodic reporting. Conversely, agency MBS were exempt from SEC registration requirements. The cost disparity of doing business between agency MBS and private-label discouraged the widespread acceptance of banks to get into the issuance business. Understanding that private-label MBS would increase demand and liquidity for agency MBS, the SEC stepped in to modified the requirements of private-label pass-throughs. The SEC permitted the registration of blind pools as long as the issuer committed to obtaining a pre-determined credit quality rating and provide investors with sufficient information of the potential mortgage pool. In addition to blind pool registration, the SEC also permitted private label MBS to qualify for shelf registration.

Entities that issue MBS are essentially conduits passing payments received from homeowners through to the security holders. Common sense dictates that the legal structure of such entity would not benefit from being a taxable corporation; moreover, the possibility of taxation would dilute the returns to the investors and, likely, exhibit issues with liquidity. The Tax Reform Act of 1986 allowed for the creation of a special purpose vehicle (SPV) that allowed for the distribution of cash flow to be exempt from entity-level taxation. Specifically, the instrument to

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20 Fabozzi & Modigliani 1992, p. 32. Mortgage and Mortgage-Backed Securities Markets
allow MBS with multiple classes of bondholders to be issued without tax consequences at the trust level was called a Real Estate Investment Conduit (REMIC). As this regulation in the real estate securitization market was taking form, a looming issue began to rear its ugly head. In 1980, U.S. President Jimmy Carter signed the Depository Institutions Deregulation and Monetary Control Act of 1980 into law. Effectively, this Act gave Savings & Loans (S&Ls) the same capabilities of banks without the regulation.

“Title IV - Powers of Thrift Institutions and Miscellaneous Provisions

- Authorizes S&Ls to invest up to 20 percent of assets in consumer loans, commercial paper and corporate debt securities.

- Permits S&Ls to invest in shares or certificates of open-end investment companies registered with the SEC (e.g., money market funds) if the portfolio of the fund is restricted to investments that S&Ls may make directly.

- Expands the authority of S&Ls to make real estate loans by removing the geographic area restriction on lending, substituting a 90 percent loan-to-value limit in place of the existing $75,000 limit, and removing the first lien restriction on residential real estate loans. Also, expands the authority of S&Ls to make acquisition, development and construction loans.

- Authorizes S&Ls to issue credit cards, extend credit in connection with credit cards and engage in credit card operations.

- Authorizes S&Ls to exercise trust and fiduciary powers under restrictions and protections similar to national banks.
• Authorizes a State stock S&L to convert to a Federal stock charter provided that it existed in stock form for not less than the 4 years preceding the date of enactment of this Act.

• Permits S&Ls to include shares of open-end management investment companies among the assets eligible to satisfy liquidity requirements.

Study of Mortgage Portfolios

o Requires the President to convene an interagency task force consisting of Treasury, HUD, the FHLBB, the Federal Reserve, the FDIC, the Comptroller of the Currency and the NCUAB to conduct a study and make recommendations within three months regarding the options available:
  ▪ to provide balance to the asset-liability management problems inherent in the thrift portfolio structure;

  ▪ to increase the ability of thrift institutions to pay market rates of interest in periods of rapid inflation and high interest rates;

  ▪ to assist thrifts in times of economic difficulties.”

Savings and Loans were given the green light to loosen lending standards, and in many cases, had to do so to compete. This period, marked by high interest rates and loose lending standards, was marked by a boom in commercial and residential real estate. Outstanding mortgages nearly doubled

from $700 billion in 1976 to $1.2 trillion in 1980. Coupled with high interest rates, S&Ls engaged in lending on riskier assets in order to maintain liquidity.

“The banking problems of the 80s and 90s came primarily, but not exclusively, from unsound real estate lending. It is instructive to note that the real estate boom and lending fiasco appears to have started in the United States. U.S. banks had been prevented from following their customers’ desires to borrow with money-market instruments because of the U.S.’s Glass-Steagall prohibitions. This law allowed investment bankers to dominate the field. Our U.S. banks were losing the business of the larger borrowing companies.

As a result, in looking around for other kinds of loans to make, and seeking ways to maintain growth, the larger U.S. banks tried leveraged buyouts (LBOs) and Latin American loans. But the largest growth in lending was in new loans for commercial real estate. Previously, banks had done only short-term lending on commercial real estate construction. For example, by law, they could lend on a new office building solely for the construction period and were required to have a follow-on “take out” by a long-term lender, primarily insurance companies, as a part of the required package. When this requirement was repealed, many banks, large and small, began to make loans without “take outs” and real estate lending became the fastest-growing area in the banking business. The change was sudden and dramatic. Prior to the 80s, U.S. banks, real estate loans were less than 10 percent of the portfolio. By the mid-80s, some banks had 50 to 60 percent of their loans in real estate. Real estate was “where the action was.” Of course, this change and increase in availability in and of itself provided fuel for funding a new commercial building boom. “A builder will build if a financer will finance.” Prices soared, construction skyrocketed and banks seemed prosperous. Inflation in the 70s had made real estate a very attractive option as it enhanced nominal value. The

generous bank lending and inflationary pricing set off the real estate construction mania. Soon this same disease was affecting most of the developed world.

Excess real estate lending, powered by rapidly rising rents and prices, rapidly occurred worldwide. But more than anything else, real estate lending became the fashion, the “new” banking idea of the times." \(^\text{23}\)

The S&L crisis was a function of the deregulation of thrifts and perceived backstop of the U.S. Government and the thrifts were hit hard. “…total (housing) starts fell perceptibly after the 1.8 million units recorded in 1986; by 1991, only about 1 million new homes were started, the lowest rate of construction since the end of World War II.” \(^\text{24}\) “The most important trend has been the significant continuing decline in market share of savings and loan institutions, from a high of about 53 percent in 1975 to about 30 percent in 1990.” \(^\text{25}\)

“Many banks and thrifts moved aggressively into commercial real estate lending. During the 1980s, when total real estate loans of banks more than tripled, commercial real estate loans nearly quadrupled. As a percentage of total bank assets, total real estate loans rose from 18 to 27 percent between 1980 and 1990, while the ratio for nonresidential and construction loans nearly doubled, from 6 to 11 percent. A pervasive relaxation of underwriting standards took place, unchecked either by the real estate appraisal system or by supervisory restraints. Overly optimistic appraisals, together with the relaxation of debt coverage, of maximum loan-to-value ratios, and of other underwriting


constraints, meant that borrowers frequently had no equity at stake, and lenders bore all of the risk.”

Even as the early period of real estate securitization was marked by regulatory reform, issuances saw increases in volume, particularly in the mid to late 1980s. Additionally, it is during this time that the secondary market began to flourish. The increased availability of mortgage capital and the relaxed lending standards allowed for the residential mortgage loan originations to soar from a $230 million market in 1984 to a $485 million market in 1990. As the market for securitization began to grow, concentration in specific assets that were collateralized did as well. Here is an excerpt:

“However, their efforts were muted when the market softened in the late 1980s and early 1990s, resulting in credit losses. By the end of 1989, 13 percent of multifamily debt was held in portfolio by Freddie Mac and Fannie Mae or had been securitized, compared with 41 percent of single-family debt. The limited scope of those early efforts reflected the nature of the underlying multifamily loans: Mortgage contracts were not standardized, the collateral rental properties were heterogeneous, and the geographic concentration of properties made multifamily lending a more risky undertaking.”


Established Phase – 1990s

Born out of the S&L crisis was the Resolution Trust Corporation (RTC) which was charged with liquidating the assets of the savings and loans the U.S. Government was inheriting and closing. “The RTC provided two functions. It shuttered many of the failing institutions, which wound up totaling 747. The total amount of assets equaled $394 billion. It then liquidated those assets over a period of time until it was folded back into another federal agency -- the Federal Deposit Insurance Corporation (FDIC).” The RTC, tasked with unwinding billions of dollars of assets from the failed S&Ls, pioneered the CMBS market. “Up until the RTC, CMBS had been little used, only accounting for a few billion dollars of loans in the late 1980s, as issuers hadn’t yet figured out how to fully assuage investor concerns over issues of transparency and how troubled loans would be worked out. But by assuming some of the risk and altering the structure to address some concerns, the sector blossomed under the RTC starting in 1992, and by the late 1990s, private firms were issuing tens of billions in loans via securities. “The successful performance of the RTC securities was a significant factor in the further development and standardization of this market,” the FDIC writes on its website.”

29 Brown, Eliot, Wall Street Journal April 20, 2011. FDIC Gets Back to its CMBS Roots
Exhibit 7

Commercial Mortgage-Backed Security Issuance
1990-2009

$billions

CMBS Annual Volume


Low yields, a sputtering junk bond market, and investor appetite for riskier high-yielding investments turned investors to CMBS. “CMBS, because of their novelty, feeble information flow, and perceived risk, initially traded at enormous spreads, thereby filling this gap” 30

As a result, CMBS issuance increased almost four-fold from 1990 to 1994. The unwinding of the assets taken on by RTC pushed the real estate securitization market to establish standardized criteria which further contributed to growth in securitizing commercial mortgages. Much of the maturation and structural quality the private-label RMBS market provided was applied to the CMBS in the 1990s. These advancements had primed the market for CMBS issuances. 31 The established period is marked less by regulation and more by widespread acceptance and standardization. The S&L crisis exposed a defect in the commercial mortgage markets. Commercial real estate lending, in

the 1970s and 1980s, was provided by portfolio lenders and held on the books as a liability until maturity.
Ch. 2.3 – What Went Wrong

There are numerous factors and forces that played a role in what has been deemed the greatest recession since the Great Depression in the 1930s; however the role of the securitization market was one of the largest contributing factors. The New Deal legislation passed in the 1930’s created regulation that limited the magnitude of several downturns and prevented any major crises for about 50 years, until the savings and loan catastrophe in the 1980’s. The Dodd Frank Act is hoping to replicate that level of stability in the markets for another 50 years.

Within the securitization market there were numerous components that enabled and augmented the market to not only become so prevalent but also so dangerous; however in this paper will attempt to address just a few of these characteristics.

Outside of the pure real estate oriented aspects of the crash, the exuberance of wealth that many countries throughout the world experienced between 2002 and 2007 played a major role in the amount of capital looking for returns. “While assets under investment over the decades had grown to $37 trillion by 2002, these assets basically doubled between 2002 and 2007 to $73 trillion. The United States has historically been attractive to both domestic and foreign investment. But treasury bonds, from 2003 to 2005, ranged from a little over 1% to a little over 4%, depending upon the date and maturity. Investors, seeking a better but safe return, turned to real estate securities which, historically, had a relatively low default rate”\(^{32}\). This incredible amount of wealth resulted in a surge of demand for higher returns and subsequently higher prices, which also typically meant finding investments with greater returns and risks, or ideally less or the same amount of risk given the same anticipated returns – but in many cases, as we know now, the chase for returns didn’t really take into account the actual risks involved.

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\(^{32}\) The Dodd-Frank Wall Street Reform and Consumer Protection Act: What Caused the Financial Crisis and Will Dodd-Frank Succeed in Preventing Future Crises? By Charles W. Murdock, February 2011, pg. 8
This demand is one of the integral factors that led to the surge in subprime mortgage originations. The demand for riskier investments yielding greater returns is epitomized in the percentage of adjustable rate mortgages compared to fixed rate mortgages in the subprime market. Fixed rate subprime mortgages accounted for approximately 33% of subprime mortgages from 2000 to 2003, and had been fairly constant across time. Additionally, adjustable rate mortgages (ARMs), which contained typically low, “teaser” rates, would reset to higher interest rates a few years later accounted for approximately 60% of the subprime mortgage market during that same time frame. These loans, sometimes referred to as “2/28” or “3/27”, contained low, teaser rates that would stay that way for two to three years and then the mortgage would reset to a much higher interest, typically leading to defaults. The percentage of fixed rate mortgages originated from 2004 to 2006 dropped significantly to about 25% of the market, while during the same time period adjustable rate mortgages increased to over 70%. “While the percentage change moved only modestly toward riskier investments, from a volume perspective, the dollar volume of subprime mortgages increased from $100 billion in 2000 to $600 billion in 2006, a 600% increase”. The preceding data emphasizes the point that there was a tremendous surge of risky loans, primarily subprimes, which were growing riskier over time and there was enough demand for this investment that would continue the development of more risky loans and investments in the future.

34 The Dodd-Frank Wall Street Reform and Consumer Protection Act: What Caused the Financial Crisis and Will Dodd-Frank Succeed in Preventing Future Crises? By Charles W. Murdock, February 2011, pg. 10
Similar to the above story regarding the markets to more adjustable rate subprime mortgages, the growth of Alt-A loans was particularly indicative of problems to come. Alt-A loans typically contained limited documentation and were originally created for individuals who could not meet the standard underwriting standards, potentially because they were self-employed or did not have a full-time contract with an employer. However, these Alt-A loans morphed into liar loans where as long as the borrower had “stated assets” that met the requirements of the lender, the borrower never had to demonstrate proof of income or assets. “The dollar volume of Alt-A loans was only $25 billion in 2000 but increased to $400 billion in 2006, an increase of 1,600%. Sparking this rise was a loosening of underwriting standards. From 2000 to 2003, the percentage of fixed rate
Alt-A loans slowly dropped from 85% to 71%. However, from 2004 to 2006, the percentage of fixed rate loans dropped markedly and was steady at about 38%”. The development and surge of teaser rate and Alt-A mortgages were examples reflective of the mortgage market as a whole with loosening underwriting standards and excess availability of credit to not financially stable borrowers. While the borrower is portrayed as being a dishonest opportunist, the role of the mortgage broker really drove many borrowers into subprime loans. Mortgage brokers were effectively incentivized to make riskier loans because they were incentivized through commissions to not only originate the loans but also to place the higher interest rates on the loan to the borrower. Many of the subprime mortgage brokers received a kickback from the lender in the form of a yield spread premium, which provides a broker a point or two as a commission fee. The lender offers a wholesale rate and the broker quotes a retail rate with a built in premium to the borrower. The spread between the wholesale and retail rate is the yield spread premium that the broker gets to collect as a commission, which can make the loan much more risky for the borrower but quite a lucrative deal for the broker – effectively the yield spread is a one-time fee compensated to the broker from the lender for a rate increase to the borrower.

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The most reprehensible of all the players in the subprime crisis was the role of the credit rating agencies, who, different from many of the other culprits, were supposedly acting for the benefit of the public. They were relied on by institutions and investors impartial and unbiased investigation and judgment, as well as analysis on the MBSs and CDOs, which were incredibly complex instruments to understand.

“The Securities and Exchange Commission has observed: Some investors use the credit ratings to assess the risk of the debt instruments. In part, this may be due to the large number of debt instruments in the market and their complexity. Other investors use credit ratings to satisfy client investment mandates regarding the types of securities they can invest in or to satisfy regulatory requirements based on certain levels of credit ratings, or a combination of these conditions. Moreover, investors typically only have looked to ratings issued by Fitch, Moody’s, and S&P, which causes the arrangers of the subprime RMBS and CDOs to use these three NRSROs to obtain credit ratings for the tranche securities they brought to market”.37

The period from 2004 to 2007 was in particular where most of the deterioration in quality underwriting criteria and mortgages occurred, which non-coincidently was the period where

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Moody’s, Standard & Poor’s, and Fitch eased their rating standards directly under pressure from Wall Street to rate more and more securities as AAA. Without going into too much detail, basically the rating agencies were bought off by the investment bankers. To win the business from the investment banks the rating agencies had to rate the securities the way that the investment bankers wanted them to, otherwise the investment bankers would simply go to a competing rating agency. It was particularly lucrative for the rating agencies to win this business and with no direct equity to risk it was a win-win situation as long as the securities performed. However, “by August 2008, Moody's had downgraded 90% of all asset-backed CDO investments issued in 2006 and 2007, and Standard & Poor's had downgraded 84% of the CDO tranches it rated”.  

“As one former Moody’s analyst stated: When I joined Moody’s in late 1997, an analyst’s worst fear was that he would contribute to the assignment of a rating that was wrong, damage Moody’s reputation for getting the answer right and lose his job as a result. When I left Moody’s, an analyst’s worst fear was that he would do something that would allow him to be singled out for jeopardizing Moody’s market share, for impairing Moody’s revenue or for damaging Moody’s relationships with its clients and lose his job as a result”.  

Overall the financial crisis would never have occurred or at least not to the magnitude without the irresponsibility, incompetence, and greed of the rating agencies. While these were just a few examples of the characteristics or problems with the mortgage market in the 2000s, the mortgage market morphed significantly over the years.

While securitization was initial established as a way to bring liquidity to the capital markets and to provide a lower cost of capital to borrowers, the market grew into something much more. The residential mortgage-backed securities (“RMBS”) market was created by Ginnie Mae and Freddie Mac in the 1970s as a pass-through product for pooling residential mortgages into special-

39 Mark Froeba, Testimony before The Financial Crisis Inquiry Commission, June 2, 2010
purpose vehicles. This was established in part to provide a source of liquidity to the government sponsored entities (GSEs) so they in turn could provide liquidity to bank and mortgage origination companies who originated single-family loans. These securitization vehicles were based on an originate-to-distribute model opposed to more asset-centric portfolio lending model. However, different than what the market would eventually become, initially these loans were effectively guaranteed or backed by the full faith and credit of the United States, therefore indicating that the US government had “skin in the game” and they were acting in a sense as portfolio lenders. Also, the government required fairly strict underwriting criteria for these loans to qualify for the guaranty. Additionally, the seller-servicers, the mortgage lenders who were approved by the GSEs to sell mortgages in the secondary market, were obligated to maintain specific representations and warranties as to certain characteristics of the loans, which provided an additional layer of credit support and indirectly increased underwriting standards.

The commercial mortgage backed securities (“CMBS”) market was the next major development in the mortgage securitization market in response to the savings and loan industry in the 1980s. When the Resolution Trust Corporation was established by the US government they turned to securitization to help establish liquidity in the market so to resolve the billions of dollars of real estate assets that were on the balance sheets of many failed savings and loan associations and to mitigate the losses to the federal insurance system\(^4\). While the commercial real estate loans did not have the standardization and documentation that the residential real estate contained, CMBS truly emerged as banks and mortgage originators recognized the ability to securitize their loan originations, which provided additional liquidity for new loan originations and a means of lessening the loan held on lenders’ balance sheets. The next step in the CMBS evolution created a way for lenders to not only juice origination fees and spreads but to create securities that for accounting

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\(^4\) Belling the Cat: Taming the Securitization Beast Without Killing It, by Ronald S. Borod, pg. 4
purposes were considered off-balance sheet items, this process enabled CMBS lenders to originate these loans through a special purpose subsidiary called a conduit. With the establishment of conduits, the loan originators were able issue securities at much lower yields than the underlying loans themselves, thereby allowing the remaining spread to be taken by the securitizers themselves. Very similarly to the RMBS market, the CMBS market quickly established the originate-to-distribute model but the one of the major differences was that the CMBS issuances did not contain a US government guarantee providing “skin in the game”. However, the CMBS market had B pieces in the capital structure which provided additional credit support and a certain degree of “skin in the game”. The B pieces were typically held by sophisticated investors and allowed the CMBS securities to be more marketable as well as provided attractive rates to the borrower. Along with the B piece requirement, the loans initially originated by the conduits were loans where the commercial real estate owners already had significant equity invested below the debt on the capital stack, which provided fairly conservative and well underwritten loans.

In both the RMBS and CMBS market, the basic structure of transferring the securitized assets into a special-purpose vehicle (“SPV”) was specifically designed to meet the requirements for a “true sale” opinion from a law firm.\textsuperscript{41} “The true sale opinion was to the effect that that the transfer was a completed transfer for full consideration that would be respected as such in the event that the transferor is the subject of a bankruptcy proceeding. When this result obtains, then the transfer achieves ‘bankruptcy-remoteness’: the bankruptcy of the originator will not disrupt the operations or most importantly, the collection and disbursement of revenue at the level of the SPV, and the investors in the securities issued by the SPV would be insulated from the risk of the bankruptcy of

\textsuperscript{41}Belling the Cat: Taming the Securitization Beast Without Killing It, by Ronald S. Borod. pg.5
the originator”⁴². Then to protect the SPVs from potential losses several safeguards were put in place regarding the securitization structures.

“They include: (i) rating agencies charged with severely stressing the assets and structures to test their sustainability against extreme adverse financial scenarios; (ii) monoline guarantors running their own independent stress tests before agreeing to issue financial guarantees of the senior tranches of their securitization structures; (iii) bank originators and underwriters with robust risk management offices, and C-suite managers assigned to the responsibility of protecting shareholder values against undue risk; (iv) sophisticated institutional investors with resources to vet the securities thoroughly and reject those with unacceptable risk; (v) securities and bank regulators that oversaw the market and had the tools and power to quickly impose sanctions on players engaged in bad practices; (vi) lawyers – both transactional lawyers that assisted in the due diligence, structuring, disclosing and documenting of the deals as well as the plaintiff’s lawyers, whose contingent fees created an incentive to pounce on bad actors for defective disclosure and fraud; and (vi) the securitization paradigm itself, in which the assets collateralizing the securities were safely ensconced in (supposedly) bankruptcy-remote SPVs. This system of redundancies gave the market participants a feeling of security and even immunity against major market abuses and large-scale defaults, as well as economic recessions”⁴³.

With all these protections and safeguards in place the securitization market remained did not have any major catastrophes or disruptions for over 30 years.

While the major disasters erupted between 2008 and 2010, the securitization market had been drastically changing between 2000 and 2006. While the securitization market took off in nearly all subsectors, the non-GSE RMBS, CMBS, and ABS sectors maintained a fairly consistent growth trajectory compared to the issuance of subprime RMBS and CDOs which far exceed the rate of expansion in the other securitization markets. “By 2006, the total annual aggregate U.S. issuance volume of subprime RMBS and CDOs was approximately $850 billion, compared to $1.2 trillion for the entire U.S. ABS market (including subprime RMBS and CDOs) and only $350 billion for the more traditional forms of ABS. In other words, aggregate subprime and CDO issuance exceeded

⁴² Belling the Cat: Taming the Securitization Beast Without Killing It by Ronald S. Borod, pg. 5
⁴³ Belling the Cat: Taming the Securitization Beast Without Killing It by Ronald S. Borod, pg. 5-6
seventy percent of the issuance volume of the entire ABS market in this high-watermark year. By contrast, in 2001, the total issuance volume of all ABS in the U.S. was slightly less than $300 billion – CDOs did not have sufficient volume to be separately broken out, and were instead grouped under the category of “Other”, collectively at under $50 million”44. There are an abundance of stories about the incredible rise and fall of the subprime and CDO markets and in particular their effect on the U.S. economy, but all narratives conclude that these instruments become tools of mass destruction that ran right over any regulations and safeguards in place to protect the securitization and overall financial market.

Exhibit 10

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44 Belling the Cat: Taming the Securitization Beast Without Killing It by Ronald S. Borod, pg. 6
There was a distinguishing characteristic that made subprime RMBS and CDOs so toxic compared to agency RMBS, CMBS, and ABS, which was that these vehicles contained single family mortgage loans underwritten and sold to borrowers who were never going to be able to pay the loans back, nearly under any circumstances. Many of these loans contained a “teaser rate” which was just low enough to provide somewhat conservative loan standards but would reset not long after the loan was originated. The new or reset rate would create a serious debt service requirement issue for the borrower, who not only would be unable to afford the monthly payment in the best of times and clearly would not be able to afford the payments if unforeseen economic turmoil hit such as losing a job or health issues. Despite this, the subprime mortgage market continued to grow and the
underwriting standards continued to deteriorate. Eventually, borrowers were able to qualify for loans with no or nominal down payments without any documentation proving financial wherewithal or potential earnings. Just as quickly as the loans were originated to the banks they were sold and securitized.

Very similar to the other forms of securitization, the securities were structured as a series of tranches with the lower tranches receiving lower ratings which once sold to investors paid out higher interest rates, but were in a subordinated position to the senior tranches and also contained greater risk. A key goal of the banks in the securitization process was to make the senior tranches, which the highest rating and lower interest rate, as large as possible and reduce the size of the subordinated tranches. This attribute was imperative to the subprime securitization process because “the process of securitizing subprime mortgages was designed to create large differentials, or spreads, between the prices at which the subprime mortgages were purchases from the originating mortgage brokers and the prices at which they could be sold to investors. The process of origination (by brokers), sale (to banks) and securitization (to investors) was like a child’s game of hot potato, with the potato ending up in the hands of the investors, which purchased various tranches based on their risk tolerance and yield objectives”\footnote{Belling the Cat: Taming the Securitization Beast Without Killing It by Ronald S. Borod, pg. 7}. While the market remained hot, this process was a win-win situation for all parties involved; the brokers earned brokers’ fees on each transaction, the banks earned their spread, and the investors collected the yields on the bonds that they had purchased. Additionally, rating agencies and lawyers were collecting fees for the documentation process during each transaction. This model was able to pump serious profits into the US economy for several years, but unfortunately the subprime market incentives were inherently problematic. Very few players in the entire securitization and origination process every had skin in the game, and people were actually incentivized to produce lower quality loans. These lower quality loans paid more to the
brokers who sold them to the banks, who in turn were able to receive a greater spread given the number of low quality loans put into the pools which increased the fees to the lawyers as well as the rating agencies. The rating agencies had even additional incentives to play along with all the originators and securitizers because the issuers and banks were the ones that hired and paid their fees.

Outside of the securitization technology aspect and lack of regulations in place there was a general misconception regarding residential real estate among investors that because there had never been a nationwide collapse in the residential real estate market, that through the securitization process the diversification of assets would reduce the overall risk of the security. While there had clearly been localized downturns in residential real estate there never had truly been a catastrophe across the entire US, thereby these subprime pools of securitized mortgages would create protection and diversification for the investment as a whole. On top of this diversification effect, many felt that values for real estate would continue to increase even despite a potential economic downturn, therefore even if homeowners were not able to currently pay their debt service when teaser rates converted to higher interest rates that through a refinance or sale of the property the homeowners would be able to handle the increase in rates. “What was never contemplated was what actually happened: a massive devaluation of the residential real estate market in virtually all zip codes, leading to massive default devaluation of the residential real estate markets in virtually all zip codes, leading to massive default rates (over thirty-three percent) in mortgage portfolios, and ending in massive defaults and downgrades of both junior and senior tranche securities”46.

While the RMBS market was expanding an even more toxic market was growing, the subprime CDO market. CDO’s have a very similar structure as RMBS but one of the major differences is that a CDO contains subordinated tranches of RMBS deals, whole subprime loans, as

46 Belling the Cat: Taming the Securitization Beast Without Killing It, by Ronald S. Borod, p.8
well as subordinated interests in CMBS pools. The process of actually rating these CDOs was particularly challenging because the underlying assets that were providing the actual cash flow were several layers below the securities held by the CDO issuers, which typically contained tranches rated below investment grade. However, rating agencies continued to rate senior tranches of CDOs AAA/Aaa.

“Without the ability to bundle large pools of assets into securities, the false sense of security provided by the Fortress of Redundancies, and the added ability to expand issuance volume even further through the use of credit default swaps, it is inconceivable that the subprime and CDO securities could have been issued on such a scale”. 47 Once the dust settled on the most catastrophic mortgage disaster the US has ever seen, the regulators needed to come up with a response that would prevent such a disaster from occurring again.

47 Belling the Cat: Taming the Securitization Beast Without Killing It, by Ronald S. Borod, p.10
Ch. 3 – REGULATORY RESPONSE

With real estate markets in shambles, there was great need for reform. Using input from various sources, Dodd Frank was written. In this chapter, we will provide a specific real estate securitization focused overview of the massive piece of legislation. In doing so, we aim to identify the key provisions and sections that specifically relate to the response of regulators to the numerous events that caused the mortgage and credit crisis.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”) of 2010 is a federal statute in the United States that was signed into law on July 21, 2010. The Act was passed as a response to the late-2000s recession and represents the most comprehensive financial regulatory reform measure taken since the Great Depression. Among other things, the Act implements changes that will affect “the oversight and supervision of financial institutions, provides for a new resolution procedure for large financial companies, creates a new agency responsible for implementing and enforcing compliance with consumer financial laws, introduces more stringent regulatory capital requirements, effects significant changes in the regulation of over the counter derivatives, reforms the regulation of credit rating agencies, implements changes to corporate governance and executive compensation practices, incorporates the Volcker Rule, requires registration of advisers to certain private funds, and effects significant changes in the securitization market” (pg. 3). While clearly the Act serves to place much greater regulation on the entire financial industry, we will be focusing on the effects the Dodd Frank bill will have on the real estate securitization market.

48 The Dodd-Frank Act: a cheat sheet by Morrison & Foerster, 2010, pg. 3
The Dodd-Frank Act: a cheat sheet by Morrison & Foerster, 2010

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<thead>
<tr>
<th>Resolution Authority (Title II)</th>
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<tr>
<td>Regulators may seize and break up troubled financial firms whose collapse might cause widespread damage; regulators would recoup losses via fees on firms with more than $50b in assets.</td>
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<tr>
<td>Sets up liquidation process run by FDIC.</td>
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<tr>
<td>Establishes Financial Stability Oversight Council to, among other things, monitor and address risks to financial stability.</td>
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<tr>
<th>The Fed (Titles I, II &amp; III)</th>
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<tr>
<td>Limits the Fed's emergency lending authority and mandates a one-time audit of Fed's emergency lending programs.</td>
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<td>Eliminates role of banks in picking presidents at the Fed's 12 regional banks.</td>
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<th>Oversight Changes (Title III)</th>
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<tr>
<td>Eliminates Office of Thrift Supervision.</td>
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<tr>
<td>Creates Financial Stability Oversight Council.</td>
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<tr>
<td>Fed retains oversight of community banks and supervises the most complex financial companies.</td>
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<td>OCC will regulate national banks and thrifts.</td>
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<td>FDIC will regulate state thrifts.</td>
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<th>Consumer Agency (Title X)</th>
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<tr>
<td>Creates Consumer Financial Protection Bureau within Federal Reserve, with rulemaking and some enforcement power over banks and other financial companies.</td>
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<td>Grants authority to examine and enforce regulations for all mortgage-related businesses; banks and credit unions with assets of more than $10b; payday lenders, check cashers and other non-bank financial firms.</td>
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<td>Allows states to impose stricter consumer protection laws on national banks, compared with the federal standard.</td>
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<td>State attorneys-general get power to enforce certain rules issued by the new consumer bureau.</td>
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<th>Deposit Insurance</th>
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<td>Permanently increases level of federal deposit insurance for banks, thrifts and credit unions to $250,000.</td>
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<th>Mortgages</th>
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<tr>
<td>Lenders are required to ensure a borrower can repay a home loan by verifying income, credit history and job status.</td>
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<td>Banks payments to brokers for steering borrowers to high-priced loans.</td>
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<th>Investment Advice (Title IX)</th>
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<tr>
<td>Requires banks that packaged loans to keep 5% of credit risk on their balance sheets. Directs regulators to exempt low-risk mortgages that meet certain minimum standards.</td>
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<th>Credit-Rating Agencies (Title IX)</th>
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<td>Allows investors to sue credit rating agencies (CRA) for &quot;knowing or reckless&quot; failure; establishes oversight office within the SEC with ability to examine and fine CRAs, and empowers the SEC to deregister a CRA that fails to provide accurate ratings over a period of time; imposes internal control, governance, conflict of interest, disclosure and other requirements on CRAs.</td>
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<tr>
<th>Corporate Governance (Title IX)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gives shareholders nonbinding vote on executive pay and &quot;golden parachutes,&quot; and gives SEC authority to grant shareholders the ability to nominate their own directors.</td>
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<thead>
<tr>
<th>Insurance (Title V)</th>
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<tbody>
<tr>
<td>Creates office within Treasury Department to monitor insurance industry.</td>
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<tr>
<th>Volcker Rule Provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Imposes restrictions on activities of banking entities and on nonbank financial companies (supervised by Fed).</td>
</tr>
<tr>
<td>Banks can make de minimis investments in hedge and private-equity funds that they organize/manage—limited to 3% or less of a bank's Tier 1 capital and 3% of a single fund's capital.</td>
</tr>
<tr>
<td>Banking entities prohibited from engaging in proprietary trading, but may engage in specified &quot;permitted activities,&quot; no outright prohibition for nonbank financial companies.</td>
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</tbody>
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<tr>
<th>Derivatives (Title VII)</th>
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<tbody>
<tr>
<td>Requires a swap to be cleared if the CFTC or SEC, as applicable, determines that it is required to be cleared and a clearinghouse accepts it for clearing, subject to an exception for commercial hedges.</td>
</tr>
<tr>
<td>Swaps subject to the clearing requirement must be executed on an exchange or swap execution facility.</td>
</tr>
<tr>
<td>Imposes registration, minimum capital, initial and variation margin, reporting, recordkeeping, and business conduct requirements on firms that deal in derivatives or are major participants in those markets.</td>
</tr>
<tr>
<td>Effectively requires banks to &quot;push out&quot; certain swaps activities to affiliates; however, banks can retain swaps activities that are for hedging purposes or relate to traditional bank investment categories (e.g., interest rates, FX, and bullion, among others, and CDS so long as it's cleared).</td>
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<tr>
<th>Capital Provisions</th>
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<tr>
<td>Generally imposes more stringent regulatory capital requirements.</td>
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<tr>
<td>Maximum 15-to-1 leverage ratio.</td>
</tr>
<tr>
<td>Federal banking agencies to establish minimum leverage and risk-based capital requirements.</td>
</tr>
<tr>
<td>Applies &quot;prompt corrective action&quot; standards to bank holding companies (effectively limits inclusion of trust prefaces and hybrids in Tier 1).</td>
</tr>
<tr>
<td>Grandfathering of trust prefaces issued prior to 5/19/10, subject to phase-in.</td>
</tr>
<tr>
<td>Expects banks and thrifts under $15b in assets from capital changes.</td>
</tr>
<tr>
<td>Phase-in from 2013 to 2016 for large bank holding companies over $10b in assets.</td>
</tr>
</tbody>
</table>

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40 The Dodd-Frank Act: a cheat sheet by Morrison & Foerster, 2010
Ch. 3.1 – Risk Retention

This provision was intended to address one of the core deficiencies in the securitization market during the Great Recession – lack of skin in the game or, as another term suggests, moral hazard.50 “Section 941(b) of the Dodd-Frank Act, codified as new Section 15G to the Securities Exchange Act of 1934, requires six Federal agencies—the U.S. Department of the Treasury, Federal Reserve Board, Federal Deposit Insurance Corporation, U.S. Securities and Exchange Commission, Federal Housing Finance Agency, and Department of Housing and Urban Development — jointly to prescribe regulations requiring increased credit risk retention for securitizers of asset-backed securities and limiting the hedging or transferring of securitizers’ retained risk”.51 Overall this provision requires securitizers of ABS to hold onto or retain an unhedged 5% interest directly in the credit or capital stack of the securitized assets. However, there are several exceptions that allow securitizers to be exempt from these requirements including an exemption for securities collateralized by qualified residential mortgages as well as certain other asset classes. This rule, as proposed, will have profound implications for the mortgage origination business and will require significant changes to many established securitization practices. Section 941 has been structured based on the concern that during the period leading up to the financial crisis mortgage originators “retained little or no continuing exposure to loans they originated for securitization”.52 Additionally, the proposed rule seeks to realign market incentives and instill much greater discipline by ensuring that the participants maintain a level of “skin in the game”. According to Timothy Geitner, the current United States Secretary of the Treasury and Chairman of the Financial Stability Oversight

50 A party taking risk because it does not bear the consequences of taking the risk.
52 Memorandum from Michael H. Krimminger to the Board of Directors, FDIC, Notice of Proposed Rulemaking to Implement Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, March 21, 2011
Council, in his paper named “Macroeconomic Effects of Risk Retention Requirements”, outlined the definition of credit risk retention as it “refers to the meaningful exposure to the credit risk of a securitization’s underlying assets that cannot be removed, sold, or hedged for a specified period of time. This definition of risk retention does not include representations and warranties…By aligning the incentive structure to reflect the incentives of traditional portfolio lending more closely, risk retention may help ensure that securitizers and originators are making prudent loans that are priced appropriately, as securitizers of these assets will want to be compensated for the risks they now must hold”.53 This rule is attempting to solve the asymmetric information issue associated with non-portfolio lending as well as to allow lenders to properly screen and monitor borrowers. Additionally, by requiring a form of credit risk retention in the securitization process, the rule aims to increase an originators incentive to properly underwrite the borrower and the collateral. The framework for the Section 941 was designed to balance the benefits of risk retention against the potential costs, thereby creating market that properly incentivizes originators and securitizers to full understand and adequately recognize the risk of the underlying assets that are being originated while not creating costs that make the process uneconomic. “Any framework should serve to mitigate the misalignment of incentives, asymmetric information, and macroeconomic risks associated with securitization, and simultaneously promote a robust securitization market that can continue to provide credit to businesses, consumers and homeowners in the United States”.54 Timothy Geithner explains that the framework of the risk retention requirement should achieve the following:

- **“Align incentives.”** Asset-backed securitization developed because it provides specific risk transfer benefits and lowers the cost of credit, in addition to being a source of term funding. By reducing risk and better aligning incentives, risk retention can improve loan quality and underwriting standards, but preserve the benefits of risk and capital transfer.

53 Macroeconomic Effects of Risk Retention Requirements by Timothy F. Geithner, Chairman Financial Stability Oversight Council, completed January 2011, pg.16
54 Macroeconomic Effects of Risk Retention Requirements by Timothy F. Geithner, Chairman Financial Stability Oversight Council, completed January 2011, pg.18
• **Provide greater certainty and confidence among market participants.** A risk retention framework that provides clear rules can help market participants accurately price risk.

• **Promote efficiency of capital allocation.** Risk retention can promote more efficient allocation of capital across the economy because it can help prevent excess credit flows at excessively low interest rates that do not accurately reflect the risks of assets.

• **Preserve flexibility as markets and circumstances evolve.** The framework can take into account the changing nature of markets and future innovations.

• **Allow a broad range of participants to continue to engage in lending activities, while doing so in a safe and sound manner.** Implementation that takes into account unique aspects of smaller originators and securitizers can preserve a robust and competitive securitization market”.

Additionally, he highlights the factors that are considered when evaluating how to properly implement a risk retention rule. The options include the following:

• **“Form of risk retention.** There are several different forms of risk retention that one could consider in developing a framework. While there are many variations, the general forms include: a vertical slice (a pro rata piece of every tranche), a horizontal slice (a first loss interest in the securitization structure), or an equivalent exposure of the securitized pool (retaining a random selection of assets from the pool).

• **Allocation of risk retention.** The point along the securitization chain where risk retention is held also affects the outcome of the risk retention requirements. Section 941 places the primary responsibility for retaining risk on the securitizer, but the originator, and in some cases other participants, could be permitted to hold this exposure. Whether the exposure is held or shared among different entities can also drive different incentives.

• **Amount of risk retention.** A framework could employ a static amount of risk retention, whereby the amount of exposure does not vary across asset classes, asset quality or economic cycle. Alternatively, the framework could allow for variations. Thus, the amount of risk retention could be a function of time and / or a function of asset characteristics.

• **Hedging, prevention of arbitrage, and allowance for risk management.** Specific hedging of the risk retention required by Section 941 is prohibited by the Dodd-Frank Act, and any framework should seek to minimize arbitrage opportunities. However, it is also important for financial institutions to manage their other risks for safety and soundness purposes. Therefore, the framework should seek to prohibit the transfer or hedging of the specific credit risk required to be retained, but allow firms to manage other risks, such as interest rate, foreign exchange, and macroeconomic risks.

• **Exemptions from risk retention.** A risk retention framework could include the ability to exempt higher quality assets meeting rigorous underwriting standards.

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55 Macroeconomic Effects of Risk Retention Requirements by Timothy F. Geithner, Chairman Financial Stability Oversight Council, completed January 2011, pg.18
addition to the required exemptions for the QRM and other asset classes, the framework could exempt securitizers from holding the credit risk of higher quality assets that meet additional product, underwriting, and other standards that tend to decrease credit risk.”

In adopting Section 15G of the Dodd Frank Act, Congress was trying to address several issues of the securitization market that led to the financial crisis, in particularly the masking of credit risks and financial engineering tricks attempting to complicate actions designed to mitigate losses and reduce loan defaults. Primarily, Congress was looking to eliminate the “originate to distribute” model, in which loans were originated for the purpose of selling them into a securitization pool without the underwriter or originator retaining any risk on the assets. That model also unfairly rewarded volume issuance over asset and underwriting quality which led to the relaxed credit and underwriting standards. Under the proposed rules a sponsor or securitizer of “asset-backed securities” is required to retain at least 5% of the credit risk related to the underlying assets and is not allowed to hedge or transfer that credit risk. An asset-backed security is defined as “a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset”.

A securitizer is defined as “an issuer of an asset-backed security; or a person who organizes and initiates an asset backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer”.

Securitizers have a menu of options to select from regarding compliance with the 5% risk retention requirement.

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56 Macroeconomic Effects of Risk Retention Requirements by Timothy F. Geithner, Chairman Financial Stability Oversight Council, completed January 2011, pg.19
57 See Appendix 1: Dodd Frank Act Section 941
58 See Appendix 1: Dodd Frank Act Section 941
There are five acceptable options for securitizers to satisfy the credit risk retention requirement:

1. **Vertical (Pro Rata) Risk Retention**

Exhibit 13

![Diagram](image)

The vertical risk retention requires the retention of a pro rata economic interest in the credit risk of the securitization, which would be equivalent to retaining a pro rata share of each tranche regardless of the nature of the class of interests and whether the class of interests has a par value was issued in certificated form or was sold to unaffiliated investors. Therefore, in the below example, if there was a three-tranche securitization comprised of a 94% senior tranche, a 5% percent subordinated tranche and a 1% percent equity tranche the total retention required would be 5%. The 5% risk retention would contain 5% of the 94% senior tranche (or 4.70% of the total securitization from the senior tranche), 5% of the 5% subordinated tranche (or 0.25% of the total securitization from the subordinated tranche), and 5% of the 1% equity tranche (or 0.05% of the total securitization from the equity tranche).

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59 Figure from Macroeconomic Effects of Risk Retention Requirements by Timothy F. Geithner, Chairman Financial Stability Oversight Council, completed January 2011, pg.20
subordinated tranche), and 5% of the 1% equity tranche (or 0.05% of the total securitization from the equity tranche). As demonstrated by the above graph, the vertical risk retention option allocates the risk of loss through the entire securitization.

2. **Horizontal (First Loss) Risk Retention**

Under this option the securitizer would be in a 5% first loss position being exposed to the credit risk of the entire pool of securitized assets. Until all other interests in the ownership entity are paid back in full, the securitizer’s interest would not receive any payments of principal made on a securitized asset. In the above graph, a securitizer with a 5% horizontal risk retention requirement would hold this horizontal piece as a subordinated tranche to all other interests.

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60 Figure from Macroeconomic Effects of Risk Retention Requirements by Timothy F. Geithner, Chairman Financial Stability Oversight Council, completed January 2011, pg.21
3. **L-Shaped Risk Retention**

The L-shaped risk retention hybrid option is simply that a securitizer would retain 50% of its required risk retention in the form of a vertical slice and 50% in the form of a horizontal position, as long as certain conditions were met. The 50/50 split is required to ensure that each component is adequate enough to affect the securitizer’s incentives.

4. **Representative Sample Risk Retention**

For a securitizer to satisfy the 5% risk retention under this option, the securitizer must retain a randomly selected representative sample of the assets in the securitization. The randomly selected assets must be equivalent in all material respects to the securitized pool as a whole. There is a very particular process and a series of requirements that the securitizer must use in determining the representative sample. “Among these requirements, a sponsor would have to (i) draw from a pool of at least 1,000 separate assets designated for securitization, (ii) use a random selection process to identify the loans from this pool that will be included in the representative sample (taking into account no other characteristic of the assets other than their unpaid principal balance), (iii) test the representative sample for statistical bias and (iv) ensure the similarity of the sample and the securitized assets within a specified confidence level. In addition, a sponsor would be required to obtain a report from an independent public accounting firm addressing the policies and procedures used in selecting the representative sample”.

5. **Revolving Asset Master Trusts (Seller’s Interest)**

This option would allow sponsors of securitizations backed by revolving lines of credit to satisfy their 5% risk retention obligations by holding a separate “seller’s interest”, which would be a direct,

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61 Securitization After Dodd Frank: A Look at the Proposed Risk Retention Rules, Simpson Thacher, April 7, 2011, pg. 3
shared interest with all of the other investors in the performance of the underlying assets or receivables. The securitizer or sponsor would retain an interest of 5% of the unpaid principal balance of all assets held in securitizations collateralized by assets held in a revolving asset master trust.

Additionally, the Agencies recognized that in the market for CMBS it is common to contain a B-piece, which is already in a first-loss position regarding priority in the capital stack. The B-piece or owner of a subordinated tranche is typically a commercial real estate specialist who is more asset level focused and is involved in the selection of the pool of assets, the due diligence on those assets, and commonly are the special servicers, who are tasked with managing loans that have become troubled or contain other non-payment issues. The B-piece owner will have conducted due diligence on individual loans as well as the assets secured by the loans and will typically have more information that other investors about the quality of the underlying pool of assets. Recognizing this market practice, the proposed rule allows a securitizer to satisfy the risk retention requirement if:

“(i) the B-piece buyer retains a first-loss position in the same form, amount and manner as would be required of the sponsor under the horizontal risk retention option (discussed above); (ii) the B-piece buyer pays for the first-loss position in cash at the closing of the securitization without financing; (iii) the B-piece buyer has performed a detailed review of the credit risk of each asset in the pool prior to the sale of the asset-back securities by examining, at a minimum, the underwriting standards, collateral and expected cash flows of each commercial loan in the pool; (iv) the B-piece buyer is not affiliated with any party to the securitization transaction (other than investors) and does not have control rights in the securitization (including servicing) that are not collectively shared by all other investors in the securitization (unless the transaction provides for an independent operating advisor); (v) the sponsor makes certain required disclosures to potential investors regarding the B-piece purchaser (e.g., identifying information, description of experience in CMBS transactions) and other material information on the transaction; and (vi) the compliance by the B-piece purchaser with the proposed rules’ restrictions relating to the hedging and transferring of retained interests”.

62 Securitization After Dodd Frank: A Look at the Proposed Risk Retention Rules, Simpson Thacher, April 7, 2011, pg. 4
Exhibit 15

CMBS Investments

Property Value

Real Estate Asset

Properties

Loans

Debt

Equity

Securities

Investment Grade CMBS

Non-Investment Grade CMBS

Payment Priority

AAA

AA

A

B

C

D

M当事人

Ch. 3.1 (a) – Premium Cash Capture Reserve Account

In addition to the requirements set forth regarding risk retention, the Dodd Frank Act proposes a requirement that any premium or purchase price received by a sponsor with respect to its sale of any premium ABS interest or interest-only ABS interest (or the value of an interest-only strip, even if not monetized) be captured in a separate, subordinated account that will be available to cover losses on the underlying assets until the related ABS interests are paid in full. Frequently included at the closing of a securitization there are one or more interest-only tranches, which are sold at a premium in excess of their par value. The process of selling premium or interest-only tranches allows the securitizer to monetize the excess spread generated by the securitized assets at closing.

“The Agencies suggest that by monetizing the excess spread before the performance of the securitized assets could be observed and unexpected losses realized, sponsors could reduce the impact of any retained interest. The Agencies further suggest that this creates incentives to maximize securitization scale and complexity, and encourage aggressive underwriting”. 63 Therefore, this proposed rule will “capture” the excess spread at closing and require the securitizer to place the proceeds into a separate premium capture cash reserve account, which would be held in addition to any other risk retention requirements. The intention of this provision is to prevent the securitizer from contradicting the intended alignment of interests with investors by extracting value from the transaction at closing. Specifically the proposal states:

1. “A sponsor retaining credit risk under the vertical, horizontal, L-shaped, or revolving asset master trust options will be required to establish and fund (in cash) at closing a premium capture cash reserve account in an amount equal to the difference (if a positive amount) between:
   i. the gross proceeds received by the issuing entity from the sale of the ABS interests in the issuing entity to persons other than the sponsor (net of closing costs paid by a sponsor or the issuing entity to unaffiliated parties); and
   ii. 95% of the par value of all the ABS interests in the issuing entity issued as part of the transaction. The 95% of the par value amount is

63 Understanding The Proposed U.S. Risk Retention Regime by Allen & Overy LLP, April 2011, pg.12
designed to take into account the 5% interest that the sponsor is required to retain in the issuing entity under each of these options.

2. A sponsor retaining risk using a representative sample, or the ABCP or CMBS B-Piece options of the proposed rules, would have to fund (in cash) at closing a premium capture cash reserve account in an amount equal to the difference (if a positive amount) between:
   i. the gross proceeds received by the issuing entity from the sale of the ABS interests to persons other than the sponsor (net of the closing costs described above); and
   ii. 100% of the par value of the ABS interests in the issuing entity issued as part of the transaction. In these cases, the proposal uses 100% (rather than 95%) of the par value of the ABS interests issued because the relevant menu options do not require that the sponsor itself retains any of the ABS interests issued in the transaction and, accordingly, potentially all of such interests could be sold to third parties.”

Overall this provision is intended to prohibit institutions from monetizing excess spread before the performance of the securitized assets can be observed and unexpected losses realized.

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64 Understanding The Proposed U.S. Risk Retention Regime by Allen & Overy LLP, April 2011, pg.13
Ch. 3.1 (b) – Qualified Residential Mortgage (QRM) – Section 941b

As previously discussed, the NPR requires issuers of securitized products to retain credit risk of 5% in each securitization – also known as Risk Retention. A principally effective segment of the Dodd Frank Act is the inclusion of the Qualified Residential Mortgage exemption from risk retention requirements. The exemption is written to allow the securitizer to not retain the credit risk of the issuance if the issuance is collateralized by, and only by, QRM’s. Five terms and conditions govern the QRM risk retention exemption:\(^{65}\)

1. **Basic Eligibility Criteria**

Qualified Residential Mortgages must be first-lien, unsubordinated mortgages to purchase or refinance either a single family residence (SFR) or a 2-4 unit multifamily building in which one unit serves as the borrower’s primary residence. Maturity for the loan cannot exceed 30 years and construction loans are not eligible for exemption. The borrower is also required to check a box on the Uniform Residential Loan Application (1003) to acknowledge the information given to the loan originator in consideration for the mortgage loan is accurate.

2. **Satisfaction of Underwriting Standards**

To ensure the quality of the mortgages, the rule proposes specific underwriting criteria for lenders to adhere to:

- “Maximum Debt-to-Income Ratios”—A borrower’s debt-to-income (“DTI”) ratio for housing debt (the so-called “front-end” DTI ratio) must not exceed 28% percent, and the DTI ratio for a borrower’s total debt (the so-called “back-end” DTI ratio) must not exceed 36%. These calculations would be based on monthly debt and monthly gross income figures and would be assessed as of

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\(^{65}\) Simpson Thatcher, Memorandum April 7, 2011. Securitization After Dodd-Frank: A Look at the Proposed Risk Retention Rules
a date that is no more than 60 days prior to the closing of a particular mortgage transaction.

- **Maximum Loan-to-Value Ratios**—A borrower’s maximum loan-to-value (“LTV”) ratio must not exceed 80% in the case of a home purchase transaction, 75% in the case of a rate-and-term refinancing and 70% in the case of a cash-out refinancing. LTV ratios must not include mortgage insurance in calculations.

- **Minimum Down Payment**—If a mortgage transaction is for the purchase of a one-to four-family property, then a borrower will need to provide a cash down payment in an amount equal to the sum of: (i) all closing costs payable by the borrower; (ii) 20% of the lesser of either the estimated market value of the appraised property or the purchase price; and (iii) any amount by which the purchase price exceeds the estimated market value of the appraised property. Consistent with existing guidance by the Department of Housing and Urban Development, the acceptable sources of “borrower funds” for the down payment would be savings and checking accounts, cash, stocks and bonds, gifts and funds from eligible down payment assistance programs. The proposed rules do not count toward this minimum down payment amount any funds that are subject to a contractual obligation by the borrower to repay or any funds obtained from a person (other than the borrower) that has an interest in the sale of the property.66

3. **Lack of Disqualifying Product Features**

66 Simpson Thatcher, Memorandum April 7, 2011. Securitization After Dodd-Frank: A Look at the Proposed Risk Retention Rules
As the residential real estate market heated up, banks responded with innovative and risky products to meet the extreme demand for mortgage capital. Myopically, these very products are viewed as the contributors to the high default rates throughout the financial crisis. The proposed rules for QRMs set out to prohibit certain mortgages that fall into this innovative category. First, QRMs are prohibited from requiring balloon payments and prepayment penalties. As written, the rule currently allows both fixed-rate and adjustable-rate mortgages (ARMs) however, with respect to ARMs, there is a proposed cap to the interest rate and subsequent payment shock that accompanies variable rate products. The proposal will limit the interest rate caps of 2% in a 12-month period and a maximum of 6% over the life of the loan. This segment of the rule also caps the transactions fees and points paid by the borrower at 3% of the loan amount.

4. Lack of Disqualifying “Derogatory Factors” Relating to Borrowers

Qualified Residential Mortgages, to qualify, must be devoid of a set of derogatory factors relating to the borrower. A borrower must not have been delinquent or have defaulted on previous debt, the borrower must not have gone through Chapter 7 or Chapter 13 bankruptcy, and the borrower must not have a previous foreclosure or any asset repossessions. More specifically, the originator must document:

- “the borrower is not currently 30 or more days past due, in whole or in part, on any debt obligation;
- the borrower has not been 60 or more days past due, in whole or in part, on any debt obligation within the preceding 24 months; and
- the borrower has not, within the preceding 36 months, been a debtor in a bankruptcy proceeding, had property repossessed or foreclosed upon, engaged in a
short sale or deed-in-lieu of foreclosure or been subject to a judgment for collection of any unpaid debt.”

Additionally, the loan originator must obtain credit reports and scores from two of the three consumer credit rating agencies, Experian, Equifax, and TransUnion.

5. **Other Requirements**

There are a number of other requirements that must be met for a residential mortgage to qualify as a QRM. The proposed rules provide for a limited set of servicing requirements that are designed to mitigate the risk of default on residential mortgages. An originator of a QRM must include terms in the mortgage transaction documents under which the creditor commits to have specified servicing policies and procedures for the loan, including requirements regarding loss mitigation workouts, procedures to address subordinate liens on the same property securing other loans held by the same creditor (or any of its affiliates) and responsibility for the assumption of these requirements if servicing rights with respect to a QRM are sold or transferred. Such policies and procedures would have to be disclosed to a borrower at or prior to a mortgage closing.

Specifically, these policies and procedures must require the initiation, within 90 days after a mortgage has become delinquent, of loss mitigation activities or programs, such as loan modification, where the net present value of such action or program exceeds the net present value of the recovery through a foreclosure proceeding. The loss mitigation policies and procedures must also take into account a delinquent borrower’s ability to repay and “other appropriate underwriting criteria” that the Agencies do not specifically identify. In addition, these policies and procedures must obligate the creditor to implement or maintain servicing compensation arrangements that are consistent with the creditor’s commitment to engage in loss mitigation activities. The policies and procedures prescribed under the proposed rules also require that the creditor’s procedures with

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67 Simpson Thatcher, Memorandum April 7, 2011. Securitization After Dodd-Frank: A Look at the Proposed Risk Retention Rules
respect to subordinate liens held by such creditor (or any of its affiliates) on the mortgaged property
be disclosed to potential investors if the creditor subsequently collateralizes the QRM.»68

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68 Simpson Thatcher, Memorandum April 7, 2011. Securitization After Dodd-Frank: A Look at the Proposed Risk Retention Rules
Section 941 specifically identifies commercial real estate mortgages as a separate asset class. However, it is important to note here that the definition of CRE loans excludes loans made to real estate investment trusts (REIT) – including (according to speculation from Morgan Stanley) the specific exclusion of loans securing REIT-owned real estate reflects the nature of the Fed’s experience with bonds holding loans secured by General Growth Properties. Under the QLE provision, there are two options in which the issuer may be exempt from the risk retention requirements. The first option is the ability of the sponsor to transfer the retained interest to a qualified B-piece buyer who meets the following qualifications:

1. First, the B-piece buyer must retain an eligible horizontal residual interest in the securitization in the same form, amount, and manner as would be required of the sponsor under the horizontal risk retention option. Accordingly, the interest acquired by the third-party purchaser must be the most junior interest in the issuing entity, and must be subject to the same limits on payments as would apply if the eligible horizontal residual interest were held by the sponsor pursuant to the horizontal risk retention option.

2. Second, the B-piece buyer must pay for the first-loss subordinated interest in cash at the closing of the securitization without financing being provided, directly or indirectly, from any other person that is a party to the CMBS transaction (including, but not limited to, the sponsor, depositor, or an unaffiliated servicer), other than a person that is a party solely by reason of being an investor.

3. Third, the B-piece buyer must perform a review of the credit risk of each CRE loan in the pool prior to the sale of the CMBS. This review must include, at a minimum, a review of the underwriting standards, collateral, and expected cash flows of each CRE loan in the pool.

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69 Morgan Stanley Research, April 12, 2011. CMBS Market Insights: The Dodd-Frank NPR: Implications for CMBS
70 Willkie Farr & Gallagher LLP White Paper: Proposed Risk Retention and Excess Spread Reserve Account Requirements for Securitized Commercial Mortgages
4. Fourth, the B-piece buyer must be prohibited from (i) being affiliated with any other party to the CMBS transaction (other than investors); and (ii) having control rights in the securitization (including, but not limited to, acting as servicer or special servicer) that are not collectively shared by all other investors in the securitization. The proposed prohibition of control rights related to servicing would be subject to an exception, however, if the underlying CMBS documents provide for the appointment of an independent operating advisor with certain powers and responsibilities. (See “Operating Advisor Requirements,” below.)

5. Fifth, the sponsor must provide, or cause to be provided, to potential purchasers certain information concerning the B-piece buyer and other information concerning the CMBS transaction. (See “B-Piece Buyer Disclosure Requirements,” below.)

6. Sixth, any B-piece buyer acquiring an eligible horizontal residual interest under this option must comply with the hedging, transfer and other restrictions applicable to such interest under the Proposed Rules as if the B-piece buyer were a sponsor who had acquired the interest under the horizontal risk retention option.

The second option for CRE mortgage issuers to qualify for exemption from risk retention requires the collateral pool adhere to particularly conservative underwriting standards. Currently, there are roughly thirty underwriting criteria that must be met in order for the commercial mortgage pool to qualify for exemption from risk retention.

Key Requirements:

- LTV: Max of 65% (or 60% if appraisal cap rate is less than or equal to 10yr swap plus 300bp).
- DSCR: Min of 1.7x (or 1.5x for stabilized, “qualifying” NOI).
- Term and Amortization: minimum term of 10 years, maximum amortization schedule of 20 years
- Loan documents must include covenants that restrict the ability to create additional security interests in the property.

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71 Morgan Stanley Research, April 12, 2011. CMBS Market Insights: The Dodd-Frank NPR: Implications for CMBS
Summary Table of Risk Retention Requirements

<table>
<thead>
<tr>
<th>Option</th>
<th>Summary of Provision</th>
</tr>
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<tbody>
<tr>
<td>Vertical Slice Option</td>
<td>Sponsor would satisfy its risk retention requirement by holding at least a 5% interest in each class of ABS interests in the issuing entity issued as part of the securitization transaction.</td>
</tr>
<tr>
<td>Horizontal Slice Option</td>
<td>The sponsor would satisfy its risk retention requirement by holding an eligible horizontal residual interest in the issuer that provides the sponsor with first-loss exposure to all ABS issuing entity issued as part of the securitization.</td>
</tr>
</tbody>
</table>
| L-Shaped Option                       | The L-Shaped option combines the Vertical Slice and Horizontal Slice options discussed above. Under this option, the sponsor must retain both of the following:  
  • Vertical Component: At least 2.5% of each class of ABS interests in the issuing entity.  
  • Horizontal Component. An eligible horizontal residual interest equal to at least 2.564% of the par value of all ABS interests in the issuing entity, other than those interests required to be retained as part of the vertical component. |
| Representative Sample Option          | Sponsor may satisfy its risk retention requirement by retaining a randomly selected representative sample of assets: that is equivalent, in all material respects, to the securitized assets; and having a total unpaid principal balance at least equal to 5% of the designated pool (based on the unpaid principal balance of all assets initially identified for inclusion in the pool). |
| Revolving Asset Master Trusts (Seller's Interest) | Solely with respect to securitizations involving lines of credit, a sponsor of a revolving asset master trust could satisfy the risk retention requirement by holding a seller's interest in an amount equal to at least 5% of the unpaid principal balance of all assets held by the issuing entity. |
| B-Piece Buyer of Commercial Mortgage Backed Securities (CMBS) | Sponsor of CMBS, where at least 95% of the total unpaid principal balance of the securitized assets in the securitization are commercial real estate loans, may satisfy its risk retention requirements if a third-party purchaser (the B-Piece Buyer) acquires an eligible horizontal residual interest. |
| Premium Cash Capture Reserve Account | Sponsor retaining credit risk under the Vertical Slice, Horizontal Slice, L-Shaped, or Revolving Asset Master Trust options must establish and fund at closing a premium capture cash reserve account equal to any positive difference between: the gross proceeds received by the issuing entity from the sale of ABS interests to persons other than the sponsor (net of closing costs paid by a sponsor or the issuer to unaffiliated parties); and 95% of the par value of all ABS interests issued as part of the securitization. |

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72 Understanding The Proposed U.S. Risk Retention Regime by Allen & Overy LLP, April 2011, pg.12
Ch. 3.2 – Qualified Mortgage (QM) – Section 1412

The Qualified Mortgage provision is an effort to place a set of underwriting and lender standards around mortgage products in order for the originators to presume safe harbor from regulatory – specifically the Dodd Frank Ability to Repay mandate – and litigation risks. The option for the lender to originate loans which are devoid of these risks is an encouragement to participate in a more standardized lending environment in which vanilla products are made and funded. This provision is intended to be the sharp elbows that box out the loan products that fueled the subprime mortgage boom. Qualified Mortgages must meet nine standards in order to pass the test:

1. “Where regular periodic payments do not result in increase in principal and, except for balloon loans under specified circumstances, does not allow borrower to defer principal;
2. Except for balloon loans under specified circumstances, does not include balloon payment that is twice as large as average of earlier scheduled payments;
3. For which income and financial resources of consumer are verified and documented;
4. For fixed rate loan, underwriting based on payment schedule fully amortizing loan over loan term and taking into account all applicable taxes, insurance, and assessments;
5. For adjustable rate loan, underwriting based on maximum rate permitted under loan during first 5 years, payment schedule that fully amortizes loan over loan term and takes into account all applicable taxes, insurance, and assessments;
6. Complies with guidelines or regulations established by CFPB relating to ratios of total monthly debt to monthly income or alternative measures of ability to pay regular expenses after payment of total monthly debt, taking into account income of borrower and such other factors CFPB determines relevant and consistent with purposes;
7. For which total points and fees payable in connection with loan do not exceed 3 percent of total loan amount;
8. For which loan term does not exceed 30 years, except as such term may be extended by CFPB such as in high-cost areas; and

9. In case of a reverse mortgage (except for purposes of subsection 9 (a) of section 129C, to extent that such mortgages are exempt altogether from those requirements), a reverse mortgage which meets standards for a qualified mortgage, as set by CFPB.”73

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The ability to repay (ATR) provision applies to residential mortgage loans and prohibits lenders from funding a mortgage loan unless the originator can make a good faith determination, based on documented and verified information supporting the 1003, the borrower will be able to repay the mortgage loan and service any other mortgage-related debt obligations. This provision is another response to the widespread use and implementation of no-doc loans – loans that were made available to borrowers based on credit scoring and stated income and assets but not on their verifiable ability to repay the debts as they came due. ATR puts the onus on the lender to review IRS Form W-2, IRS Form 1040, payroll receipts, statements of accounts where liquid assets are held, or any other documentation to support the loan application of the borrower. There are four proposed ways in which the lender can comply with the Ability to Repay provision:

1. “Originating mortgage loan after considering and verifying eight statutory factors including: (i) consumer’s current or reasonably expected income; (ii) if creditor relies on income from consumer’s employment, status; (iii) monthly payment on mortgage based on fully indexed rate and amortizing payments that are substantially equal; (iv) consumer’s monthly payment on any simultaneous loan creditor knows or has reason to know will be made; (v) consumer’s monthly payment for mortgage-related obligations; (vi) consumer’s current debt obligations; (vii) consumer’s monthly debt-to-income ratio, or residual income; and (viii) consumer’s credit history.

2. Originating Qualified Mortgage (QM) proposes alternative definitions of QM with different degrees of protection from liability.

a. **Alternative 1-Legal safe harbor that ability to repay requirements met.**

QM defined as: (1) Not including negative amortization, interest-only payments, or balloon payments, or loan term exceeding 30 years; (2) having total points and fees not exceeding 3% of loan amount (with alternative thresholds proposed for smaller loans); (3) income or assets of borrower considered and verified; and (4) where underwriting: (a) is based on maximum interest rate in the first five years, (b) uses a payment schedule that fully amortizes the loan over loan term, and (c) takes into account any mortgage-related obligations.

b. **Alternative 2-Rebuttable presumption of compliance** – QM defined as meeting requirements in Alternative 1 and also meeting additional underwriting requirements in considering and verifying (i) the consumer’s employment status, (ii) monthly payment for any simultaneous mortgage, (iii) consumer’s current debt obligations, (iv) monthly debt-to-income ratio or residual income, and (v) consumer’s credit history.

3. **Originating a Balloon Payment Qualified Mortgage by a small creditor operating predominantly in a rural or underserved area** - Creditor and balloon mortgage must meet requirements in proposal including all requirements for qualified mortgage (except balloon payment allowed).

4. **Refinancing a non-standard mortgage into a standard mortgage** - Intended to provide exception to ability to repay requirements to provide flexibility for certain streamlined refinancing—no-or low-documentation loans—in order to quickly refinance a consumer from a non-standard to a standard product. Would define —non-standard mortgage as (1) an adjustable-rate mortgage with an introductory
fixed interest rate for a period of years, (2) an interest-only loan, and (3) a negative amortization loan. Would define —standard mortgage, as not containing negative amortization, interest-only payments, or balloon payments; and would be subject to limits on points and fees and other restrictions. Would provide specific payment calculations for purposes of determining whether the refinancing reduces the consumer’s monthly mortgage payment, and for determining whether the consumer has the ability to repay standard mortgage.”
Section 619 of the Dodd Frank Act added a section 13 to the Bank Holding Company Act of 1956 to prohibit banks from engaging in proprietary trading and from sponsoring and investing in hedge fund and/or a private equity fund (“Covered Funds”). However, under the rule certain transactions are exempt from the Volcker Rule:75

Proprietary Trading

1. in U.S. Government, state, and municipal obligations;
2. in connection with underwriting or market-making activities;
3. in connection with risk-mitigating activities; and
4. of securities on behalf of their customers.

Covered Funds

1. the banking entity owns no more than 3% of the fund;
2. an overall limit of 3% of the banking entity’s Tier 1 capital invested in private funds; and
3. other limitations, including as to the name of the fund, and affiliate transactions.

The Volcker Rule reaches further into the banking system as it directs the Federal Reserve (Fed) to instill a greater effort of scrutiny to limit banks’ systemic risk. Effectively, the Volcker Rule provides the safety net of banking activities. The intention is to prohibit and discourage banks from the notion of being “too connected to fail” – what this means is that banks typically have built-in protections to keep them flourishing, such as federal deposit insurance (FDIC) and access to the Federal Reserve’s discount borrowing window and regulators are looking to adjust the dial to limit banks’ ability to engage in risky activities with the ability of a bail out on the losing side of a bad trade. Under a strong Volcker Rule, any securities market activities would have focused on serving

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75 See generally Chadbourne & Parke LLP, Client Alert July 29, 2010. Summary and Analysis of the Volcker Rule in the Dodd-Frank Act - Prohibiting Bank Proprietary Trading and Investing in Hedge Funds, Private Equity Funds and Other Private Funds - It Affects More Than Just Funds
the needs of customers and not designed for taking risks and making bets to boost the bank’s profits. Prop trading is a common discipline of many large financial institutions, some of which were bailed out during the 2008 financial crisis. These large, systemically risky firms typically have hedge fund and private equity operations as well. The Volcker Rule helps mitigate conflicts of interest between banks and their clients as well as it provides for the stability of the economy as a whole. “The financial system has the ability to disrupt a huge part of the economy in a panic. The Volcker Rule, by removing the “casino” part of the financial system from the core banking parts, will make panics less likely and more manageable when they do.”

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76 Konczal, Mike. The Nation February 28, 2012. Explainer: Why Do We Need a Volcker Rule?
Ch. 3.5 – Ratings Process Integrity – Rule 17g-5

Rule 17g-5 requires ABS and MBS issuers to provide the same disclosure and information they provide to their selected hire rating agencies to agencies that have not been hired. This process is to enable unsolicited rating agencies to rate ABS and MBS in an effort to provide full transparency and make unbiased recommendations based on the information of the security and not based on the relationship of the issuer and the rating agency. As stated in the rule: “A hired NRSRO also will have to obtain from the issuer, sponsor or underwriter of a structured finance product with an issuer-pay conflict a written representation that can reasonably be relied upon that the issuer, sponsor or underwriter:

- will maintain an identified password-protected internet website that includes all information an arranger provides to the hired NRSRO, or contracts with a third party to provide, for the purpose of determining the initial credit rating and for undertaking credit rating surveillance for the structured finance product, in each case at the same time the information is provided to the hired NRSRO; and

- will provide access to the website to any NRSRO that provides a 17g-5(e) certification.”\(^{77}\)

Ch. 3.6 – Sponsor and Originator Integrity (Conflicts of Interest) – Rule 127B

Rule 127B is written into Dodd Frank to prohibit material conflicts of interest between those who create and distribute ABS and those who purchase ABS. It would institute a lock-out period of one year for an entity to engage in a material conflict of interest to an investor of an ABS that was structured, created, or distributed by the entity. For application of the rule, a transaction must involve the following elements: covered persons, covered products, covered timeframe, a covered conflict, and a material conflict of interest. Covered persons are defined as underwriters, placement agents, sponsors of the ABS, and initial purchasers. Covered products apply to any ABS and the covered timeframe is limited to transactions within one year of the issuance of the ABS. A “covered conflict” under Proposed Rule 127B would be a material conflict of interest between an entity that is a securitization participant with respect to an ABS and an investor in such ABS (whether or not such investor purchased the ABS from the securitization participant) that arises as a result of or in connection with such ABS transaction. The SEC expressly excludes from the scope of “covered conflict” any conflict of interest that: (1) arose exclusively between securitization participants or exclusively between investors; (2) did not arise as a result of or in connection with the related ABS transaction; or (3) did not arise as a result of or in connection with “engag[ing] in any transaction.” Examples of activities that would constitute “engag[ing] in any transaction” are selecting assets for the underlying asset pool and selling those assets to the issuing entity, or effecting a short sale of, or purchasing CDS protection on, securities offered in the ABS transaction or its underlying assets. An example of an activity by a securitization participant that would not constitute “engag[ing] in any transaction” for purposes of Proposed Rule 127B is the issuance of investment

research by a securitization participant. The SEC requests comments on other activities that should be similarly excluded from the scope of “engag[ing] in any transaction.”

The SEC proposed a test to determine the materiality of the conflict; it must meet: “(1) Either— (A) a securitization participant would benefit directly or indirectly from the actual, anticipated or potential (i) adverse performance of the asset pool supporting or referenced by the relevant ABS, (ii) loss of principal, monetary default or early amortization event on the ABS, or (iii) decline in the market value of the relevant ABS (a “short transaction”); or (B) a securitization participant, who directly or indirectly controls the structure of the relevant ABS or the selection of assets underlying the ABS, would benefit directly or indirectly from fees or other forms of remuneration, or the promise of future business, fees, or other forms of remuneration, as a result of allowing a third party, directly or indirectly, to structure the relevant ABS or select assets underlying the ABS in a way that facilitates or creates an opportunity for that third party to benefit from a short transaction as described above; and (2) there is a “substantial likelihood” that a “reasonable” investor would consider the resulting conflict important to his or her investment decision (including a decision to retain the security or not).”

Provided, however, that Rule 127B is an effective means to control conflicts between parties, the primary goals of financial institutions are to create and maintain profitability while they mitigate risk. Therefore, Rule 127B provides exemptions to the rule for “(i) risk-mitigating hedging activities, (ii) liquidity commitments, and (iii) bona fide market-making.”

Risk-Mitigating Hedging Activities:

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The SEC is allowing entities to hedge their positions in ABS as long as those positions have significant risk in holding the respective securities. This exemption is in no way intended to allow a safe harbor for speculative trading and the SEC is at task to remain watchful over hedging activities that produce significant profits to the entity.

Liquidity Commitments:

This exemption proposal would allow market participants to purchase and sell the ABS in order to provide liquidity for the security. This exemption has not been broadened to include credit enhancement for ABS or repo agreements.

Bona Fide Market-Making Exemption:

This exemption allows for market makers who are also the respective entity in the ABS offering to engage in market making activities as the market is typically OTC with few participants who transact. The SEC recognizes the constraints of the market and bona fide market-making activities are necessary to maintain liquidity in ABS.

“This rule was designed in response to the fact pattern exemplified by the controversy surrounding Goldman Sachs in connection with the synthetic CDO known as Abacus 2007-AC1. According to allegations by the SEC in its fraud complaint against Goldman Sachs, the investors in the synthetic CDO were not informed that the subprime securities selected as ‘reference securities’ for the transaction were actually selected by Paulson & Co., the hedge fund that made billions betting against the subprime market, and that the same hedge fund, a client of Goldman Sachs, bet against the same reference securities.”

82 Borod, Ronald. Belling the Cat: Taming the Securitization Beast Without Killing It, pages 13,14.
Ch. 3.7 – Issuer Review Rule – Rule 193, Section 945

Rule 193 is intended to require the issuers of ABS or an independent third party – who must be named in the registration statement and consents to being named an expert as defined by Section 7 Rule 436 of the Securities Act – to perform a review of the assets underlying registered ABS offerings. As it stands, the depth of review will vary depending on the circumstances of the underlying assets being securitized. However, the results of any review are required to be disclosed in the investment prospectus. The SEC will allow large pools of assets to be reviewed by sampling; if used, the issuer needs to disclose the size of the sample, the methodology for choosing the sample, and whether or not the assets reviewed in the sample have material differences from the underwriting criteria disclosed in the prospectus.

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Rule 17g-7 is intended to enforce and prescribe regulations on the use of representations and warranties in the ABS market. “In the transaction agreements that govern a securitization, ABS issuers or originators of those loans typically make “representations and warranties” about the characteristics and the quality of those loans. If a loan does not comply with the representation or warranty, an ABS issuer or lender can be required to repurchase the loan from the pool or replace it with a substitute asset.

Since the financial crisis, many investors and other transaction parties have questioned whether the loans in the bundle meet the characteristics specified by the representations and warranties in transaction agreements, and have been seeking to enforce repurchase provisions. The Dodd-Frank Act imposes new disclosure obligations so that investors receive information about the representations and warranties and repurchase history so they may identify originators with clear underwriting deficiencies.”

Effectively, the rule would have two components: 1) issuer requirement to disclose loan repurchase history, 2) Nationally Recognized Statistical Rating Organizations (NRSROs) requirement for disclosure in reports accompanying credit ratings. The first part would require the issuer to disclose repurchase history of the 5 years prior to a new offering. On an ongoing basis, the issuer must provide repurchase history for all outstanding ABS including a history of all unfulfilled repurchase requests. The second part relates to ABS offering symmetry. NRSROs have access to and underwrite the credit of offerings put out by many issuers. Rule 17g-7 is intended to create a level of parity in the offerings by forcing the NRSROs to disclose reps, warranties, and enforcement mechanisms of similar ABS for easier comparison by investors.

Ch. 4 – IMPLICATIONS

Now that we understand the response of Dodd Frank, it’s important to absorb the potential implications of the Act. In this chapter, we will thoroughly examine the motivations of the players with respect to selected provisions. We, then, will begin to hypothesize the outcome of the specific provisions and determine whether or not it will achieve its intended consequence.

Ch. 4.1 – Implications of Real Estate Securitization Focused Provisions

Risk Retention

Recall that the primary objective of Section 941 of the Dodd Frank Act was to address a deficiency that was at the core of the real estate securitization market, which was lack of skin in the game from the securitizers and issuers of these securities. Section 941 requires a securitizer to retain a portion of the credit risk on assets that it securitizes, which is aimed at providing direct financial disincentives against packaging loans that are underwritten poorly. Congress sought to reform the originate-to-distribute model for securitization and realign the interests in structured finance.86 “The first problem with securitization identified in the portion of the Senate report on the Dodd-Frank Act that dealt with Section 941 was the divergence of the economic interests of securitizers in originate-to-distribute securitizations with those of the third party investors in such securitizations…Concern exists that the originate-to-distribute model is susceptible to moral hazard or adverse selection because the company that originated the securitization asset, once it securitizes that asset, no longer has any capital at risk in that asset… The legislative history of Section 941 of the Dodd-Frank Act, as well as, studies on risk retention released by various agencies mandated to do so under the Dodd-Frank Act, each concluded that the risk in originate-to-distribute models is that originators receive significant compensation upfront without retaining a material ongoing economic interest in the performance of the loan. This reduces the economic incentive of

86 SEC Comments on Credit Risk Retention, July 20, 2011, pg. 2
originators and securitizers to evaluate the credit quality of the underlying loans carefully”.

In developing the risk retention rules, the Agencies recognized that a “one size fits all” approach would not work appropriately for the several different forms of securitization, so offered a menu approach with several options for meeting the risk retention requirements without stifling the re-emergence of a sound securitization market. As described in the testimony of Julie Williams, the First Senior Deputy Controller and Chief Counsel Office of the Controller of the Currency, “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”.

While the risk retention requirements are designed to reshape the real estate securitization market and prevent another financial crisis, the Agencies also recognize that “when done correctly securitization contributes to sustainable growth by improving market liquidity and credit availability”. However, alongside the numerous benefits of securitization, there are certain fundamental weaknesses, particularly the informational and incentive asymmetries that can develop. “If incentives are not well-aligned, then information asymmetries may lead one party to maximize its return at the expense of other parties, particularly borrowers and investors”. Typically, the

87 SEC Comments on Credit Risk Retention, July 20, 2011, pg. 2-3
88 Office of the Comptroller of the Currency (Department of the Treasury), the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the U.S. Securities and Exchange Commission, the Federal Housing Finance Agency and the Department of Housing and Urban Development
89 Testimony of Julie Williams First Senior Deputy Comptroller and Chief Counsel Office of the Comptroller of the Currency, April 14, 2011, pg.18
90 Testimony of Julie Williams First Senior Deputy Comptroller and Chief Counsel Office of the Comptroller of the Currency, April 14, 2011, pg.18
91 Macroeconomic Effects of Risk Retention Requirements by Timothy F. Geithner, Chairman Financial Stability Oversight Council, completed January 2011, pg.9
originator has more information about the asset being underwritten as well as the true understanding about the borrower’s ability to repay the loan than the investor in the security. Not only is the investor several degrees of separation removed from the borrower, but all the information that is given to the investor may not be sufficient information to determine the true quality of the underlying assets that back the security.

While taking all this into consideration, when shaping the risk retention framework the Agencies set out particular objectives. Tim Geithner summarizes that “such a framework should seek to meet the following objectives: (i) align incentives without changing the basic structure and objectives of securitization transactions; (ii) provide for greater certainty and confidence among market participants; (iii) promote efficiency of capital allocation; (iv) preserve flexibility as markets and circumstances evolve; and (v) allow a broad range of participants to continue to engage in lending activities, while doing so in a safe and sound manner”. The framework is designed to help align and improve underwriting standards, strengthen the quality of the assets underlying the security, and help reduce the pro-cyclical effects that securitization can have on the economy as a whole. According to Tim Geithner, “Risk retention can help align the interests of the participants in the securitization chain, reduce the risks inherent in securitization, and promote the stable formation of credit and efficient allocation of capital in the United States”. Overall, the Agencies wanted to put regulation in place that would address their reform objectives, while not restricting the formation of liquidity and credit in the markets that could have an adverse impact on economic growth as well as designing a risk retention framework that maximizes the benefits of securitization while minimizing the costs.

92 Macroeconomic Effects of Risk Retention Requirements by Timothy F. Geithner, Chairman Financial Stability Oversight Council, completed January 2011, pg.3
93 Macroeconomic Effects of Risk Retention Requirements by Timothy F. Geithner, Chairman Financial Stability Oversight Council, completed January 2011, pg.4
While many agree that the concept of risk retention is an appropriate requirement for regulators to focus on, the desired effects of the risk retention framework will not be achieved by the current proposed rules. Overall, the proposed “choose your own” or “menu” approach to risk retention is likely to result in sponsors or securitizers choosing the least effect form of risk retention which permits them to minimize the amount of capital in the intermediation process and will have little bearing on the incentive issues. Opponents of these rules believe, among other things, that the proposed regulations will have many unintended consequences that will be detrimental to the credit markets, the consumers and the overall fragile state of the economy.

Concerns:

- **Higher borrowing costs** - these proposals will impose increased costs that will make many securitizations economically unfeasible and costs will be passed onto borrowers in the form of higher borrowing costs
  - The proposals incentivize originators to impose higher points and fees on borrowers under non-QRM loans, instead of recovering costs of origination through securitization

- **Negatively impact affordability** - Any increase in borrowing cost would ultimately be borne by the consumer and would negatively impact affordability and as a result, housing prices

- **Decrease credit availability** - negatively impact the housing market’s recovery by significantly decreasing credit availability and home ownership opportunities

- **Proposals go beyond the legislative intent of Dodd-Frank** - by taking a mandate for 5% risk retention, and adding on to that (in most cases) the entire value of the interests issued in the securitization over par, through the premium capture cash reserve account
- the proposals use risk retention not just to ensure quality of underwriting within the “originate to distribute” model, but also eliminate viable business models for originating or purchasing loans for resale into the capital markets

- **Will create a much smaller private securitization market** - which will put that much more pressure on the government to regarding establishment of a viable and liquid credit market

- **Regulation will not keep up with the market** - If the regulatory response is not iterative and constantly adapting, loopholes will be found and negative unintended consequences

The Financial Services Roundtable - “The Roundtable believes that the proposals would have an adverse impact on capital maintenance levels for some ABS originators. For example, the transaction sponsor must have capital to support the risk it retains in ABS transactions, and must consider the effect of committing capital on a long-term basis, the rate of return on that capital, and whether the retained interest is consistent with the sponsor’s overall risk management. If the proposed risk retention requirements were adopted, we believe the economics of securitization transactions would change in an adverse manner, because the risk retention requirements would constrain significantly new loan originations, new securitizations, or both”.

American Securitization Forum - “We believe that the Proposed Regulations missed the mark in many key areas and failed to achieve the recommendations of the risk retention studies mandated by Dodd-Frank. As set forth in this letter,

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94 THE FINANCIAL SERVICES ROUNDTABLE, “Comments on Credit Risk Retention under Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act”, Aug. 1, 2011, pg. 10
we believe that the Proposed Regulations will need to be substantially revised to promote a healthy securitization market. While we appreciate the Joint Regulators provision of an extended comment period for the Proposed Regulations, given the complexity of the various sectors of the securitization market, the highly detailed fixes outlined in this letter, the material nature of the proposed changes and controversies surrounding them, we continue to believe that a re-proposal is necessary to ensure that the Joint Regulators get the final risk retention rules right".  

Amherst’ Securities Group - “The idea of risk retention is intellectually appealing—it gives the sponsor of the securitization some skin in the game. However, it is not clear that risk retention produces any net benefit, as it fails to really address the conflicts of interest in the securitization process”.  

Specifically with the vertical risk retention option, this option provides some disincentive for issuers to underwrite more conservatively. Without the premium reserve cash capture account rule in place this option will have little impact. If an issuer still receives some upfront premium price above the unpaid principal balance of an originated loan and bears but a mere fraction of the marginal losses on the pool the incentive to securitize and underwrite aggressively is still very abundant. As illustrated in the below graph:

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95 ASF Risk Retention Letter to Joint Regulators, June 10, 2011, pg.2
96 Comments on Credit Risk Retention, Amherst’ Securities Group LP, June 2nd, 2011, pg.2
97 Federal Reserve Bank of New York Staff Reports, “Shadow Banking Regulation” by Tobias Adrian and Adam Ashcraft, April 2012, pg. 51
According to Adam Ashcraft, of the Federal Reserve Bank of New York, “While the vertical slice does reduce the incentive of the issuer to underwrite aggressively, by forcing them to bear a fraction of the marginal pool losses, the change in incentives is small relative to the marginal benefit of being able to sell the entire loan pool at a premium price. Unless a vertical slice is quite large, it is an ineffective mechanism to mitigate the problems created by risk-insensitive funding”.

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98 Federal Reserve Bank of New York Staff Reports, “Shadow Banking Regulation” by Tobias Adrian and Adam Ashcraft, April 2012, pg. 60-62
Exhibit 18

Figure x2: Risk Choice of Originate-to-Distribute Lender

Marginal cost of securitizer:
More aggressive underwriting leads to higher losses, but these are shifted completely onto investors

Risk choice:
Ability to shift risk to investors leads to more aggressive underwriting

Result depends on other parts in the securitization chain not working adequately:
• market discipline by investors and credit rating agencies
• need for future access to securitization markets to protect issuer franchise value
Exhibit 19

Marginal cost with large horizontal slice:
Lender incurs every dollar of incremental loss to point above standard chosen by balance sheet lender

Risk choice:
Large horizontal slice aligns incentives of issuer with those of a balance sheet lender

Figure 14: Risk Choice of Originate-to-Distribute Lender with Horizontal Risk Retention
**Premium Cash Capture Reserve Account**

As described in Chapter 3, the proposed rules call for a Premium Cash Capture Reserve Account with the intention to prohibit a securitizer from monetizing excess spread at the offset of the securitization process before the performance of the securitized assets would be observed and any unexpected losses realized. The rules require that any premium received by a sponsor with respect to its sale of any premium asset-backed security or interest-only asset-backed security interest (or the value of an interest-only strip, even if not monetized) be held or “captured” in a subordinated account that will not be available until all other interests are paid in full. The Agencies are proposing this account to adjust the appropriate risk retention required for any excess spread that is being monetized at the closing of the transaction. This rule is intended to keep securitizers from dodging the intended implications of the 5% risk retention rules by allowing for profits to be realized before the performance of the securitization is realized. Without the acceptance of this rule, the Agencies believe that a sponsor could effectively negate or reduce the economic exposure it is required to retain under the proposed rules.

While the intentions of the Premium Cash Capture Reserve Account (PCCRA) are clear, opponents of this rule feel that it is outside of the intended scope of the risk retention rules and will less likely accomplish its goal than to increase borrowing costs and restrict mortgage credit. In addition to covering the costs of origination and servicing the mortgages, this spread helps covers the securitizers’ costs, provides them with a small upfront return, and gives them the option to build a reserve against future loan defaults. While the spread is collected over the life of the loans, securitizers have historically been able to collect the full discounted stream of income upfront by selling an interest-only bond backed by the spread. However, the PCCRA would make this prohibitively expensive and force the securitizers to wait until the loans backing the bond have been exhausted and the other bondholders are paid in full before collecting their fees, which typically pay
off or fail within 10 years depending on the maturity duration. Additionally, “The Proposed Rules would prohibit sponsors from recouping the costs of loan origination, requiring, in effect, that sponsors or originators retain the risk relating to such amounts in addition to the 5% base risk retention requirement. As a result, originators will be faced with the choice of either passing origination costs on to borrowers or incurring such expenses without any opportunity to recoup such amounts until most of the loans are paid in full. It can be expected that such restrictions will, in any event, increase the cost of borrowing and inhibit the recovery of the primary lending market”.

On top of potential increased borrowing costs, such as interest rate increases, the securitizers run the risk of receiving a smaller or no payment because their proceeds be hit by any loan losses before the bond investors lost their principal. These circumstances change the entire securitizer’s business model; instead of being paid for underwriting services, they would effectively become subordinate debt investors.

According to Moody’s 2011 report *A Clarification on Risk Retention*, “The problem here is the fundamental disconnect between a bond’s face value and its economic value once credit risks are taken into account. As a result of the way the premium capture rule is stated, the mortgage rate impact to borrowers would be significant—on the order of an increase of 1 to 4 percentage points depending on the parameters of the mortgages being originated and the discount rates applied”.

Selected excerpts from J.P. Morgan’s February 2012 Report on risk retention:

- “Significantly increase interest rates for borrowers and adversely impact the struggling mortgage market in particular
- Impact borrower affordability
- To match current securitization economics, originators will have to raise mortgage interest rates by approximately 2 percentage points, and more for lower credit borrowers

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99 SEC Comments_PCCRA, pg.56-57
100 Moody’s Analystics, Special Report: A Clarification on Risk Retention, September 20, 2011, pg.2
• Any increase in borrowing cost would ultimately be borne by the consumer through higher mortgage rates and would negatively impact affordability and as a result, housing prices
• PCCRA would raise hedging costs significantly, also leading to higher mortgage rates”

Additionally, there is major concern about the negative effects the PCCRA rule may have on the CMBS industry. “MBA (Mortgage Banker’s Association) expresses strong objections to the PCCRA and recommends its elimination. As proposed, we believe that it would be exceedingly disruptive to the CMBS market (which relies on the Interest Only tranche for expense recovery and a return on capital), and effectively would remove the financial incentive to issue CMBS, potentially eliminating CMBS as a potential source of permanent mortgage capital for commercial/multifamily real estate borrowers”

While the intentions of the PCCRA rule are appropriate, the implementation of this rule would have unintended consequences that could impede the successful return of the private securitization markets, particularly by increasing costs onto borrowers and decreasing credit availability.

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101 JP Morgan Risk Retention report
102 MBA Commercial/Multifamily Mortgage Finance Letter To Federal Agencies on Proposed Risk Retention Rule, July 11, 2011, pg.3
Qualified Residential Mortgages (QRM)

The exemption for Qualified Residential Mortgages was included in risk retention in order to encourage the lenders to consciously lend under conservative underwriting guidelines. The exemption is to provide an out for lenders to retain interest in the securitization by making loans that have a high probability of performing. In essence, this is a response to prevent lenders from engaging in the high-risk subprime and Alt-A lending that swept through the markets in the mid-2000s or, at the least, to impose a cost to lenders who underwrite loans outside the QRM criteria. Since this exemption lies within Section 941 – Risk Retention it is clearly part of the hotly contested debate regarding Dodd Frank and it’s proposed effect on real estate securitization. Proponents believe the rule is necessary to prevent a repeat of the mid-2000s. “The group includes strong proponents of the 20% rule who contend that the "qualified residential mortgage" language adopted by Congress in its 2010 Wall Street financial reform legislation requires them to devise a national standard for safe, low-risk home mortgages based on historical data on default and foreclosure risk. One of the statistical indicators of risk, based on studies of Fannie Mae and Freddie Mac mortgages, they maintain, is the amount of equity a borrower has in the property — the higher the initial equity, the lower the probability of foreclosure. Any standard that does not include down payments, proponents insist, will be deficient.” 103

Strong opposition to QRM has been indicated by various industry groups. The general sentiment is that the narrowly defined criteria to qualify for the QRM exemption coupled with risk retention will make the lending landscape more expensive and less flush with capital. Additionally, an unfair advantage has been given to the GSEs as all their loans are exempt from Risk Retention. That alone will make private-label RMBS loans much more expensive for all participants. Further, the, perhaps unintended, consequences will be a heavy hand of the government entrenched in

103 Harney, Kenneth Los Angeles Times, September 25, 2011. Federal Agencies’ 20% Down Payment Plan Faces Political Hurdles
housing. This governmental involvement will ultimately put the risk on the taxpayer’s shoulders. “The highly conservative nature of the QRM definition will likely limit the availability, and increase the cost, of mortgage credit to consumers, particularly to those with low to moderate incomes. In light of the risk retention requirements that will exist upon the securitization of non-QRM loans, these loans will certainly feature higher interest rates, more points and fees and more onerous terms than QRM loans. The Proposing Release indicates that approximately 19.79% of all loans purchased or securitized by the GSEs during the period 1997 - 2009, and approximately 30.52% of loans in 2009 alone, would have met the QRM criteria.”

At the time of writing, a final rule had not been issued – the final rule was due by April 15, 2011, which underscores the debate involved with respect to Section 941.

**Qualified Loan Exemption (QLE)**

The Qualified Loan Exemption is intended to provide a mechanism for CMBS issuers to be exempt from the risk retention requirements proposed in Section 941 of Dodd Frank. Within the exemption are two options in which the issuer can qualify: 1) by transferring the b-piece to a qualified buyer or 2) require the loans in the pool to be underwritten using specific underwriting criteria.

The first exemption option is written to force the B-piece buyer to satisfy the risk retention requirement of issuer. This exemption is effectively just a reallocation of the risk retention from the issuer to the B-piece buyer because the B-piece buyer is stepping into the shoes of the issuer. However, as the rule is written the B-piece buyer has to retain the risk on their books. A B-piece buyer now has to potentially change their core business model which could have been packaging the b-piece into a CDO immediately and selling it out the back door. The implication is that B-piece buyers have liquidity risk associated with their investment because the potential purchasers of the CDO and CDO-squared are limited to the requirements of B-piece buyers. This exemption is intended to discourage and nearly prohibit the game of hot potato associated with CDO and CDO-squared of B-pieces. However, most B-piece buyers are yield investors and with this requirement, as written, they will have to go construct or generate alternative investment sources to get the yield they desire.

The second exemption option is promoted to encourage lenders of CMBS loans to make loans with high a probability of performing. Proponents to this exemption point to the frothiness of the commercial real estate markets prior to the financial crisis of the late 2000s. Underwriting standards had relaxed and risky loans were being originated. The new standards aim to prevent and limit the abuse of lenders to make risky commercial real estate mortgages. However, opponents to
the exemption claim the language and criteria is far too narrow for CMBS loans. “Specifically, there are approximately thirty underwriting requirements that must be satisfied in order for a commercial mortgage pool to be exempt from risk retention. We estimate that if just three of these requirements are applied (LTV of 65% or less, DSCR of 1.7x or higher and an amortization period of 20 years or less at securitization), approximately 0.4% ($2.9 billion) of the $671 billion conduit loans that have been securitized since the beginning of the CMBS market would have qualified. If the rules were loosened to 1.5x DSCR, 70% LTV and 25-year amortization, 3% ($17.5 billion) of the loans would have qualified.”

A rebuttal proposal to the requirements has been recommended to replace the DSCR requirement with a minimum debt yield of 12%, a beginning LTV of 65% or less and an ending LTV of 55% or less and to eliminate the CLTV requirement altogether. These proposed changes to the rule would allow more lenders to originate loans that would fall under the QLE.

As Morgan Stanley points out, two issues of the QLE are particularly curious. The first is the requirement of originators to verify that borrowers are able to service their debt. However, CMBS loans are non-recourse and borrowers “effectively purchase the option to default, and it is assumed by market participants that they will exercise their default option optimally.” The second is the blanket carve out of the ability of loans to REITs to qualify for the exemption. It’s assumed that this exclusion of REIT loans “illustrates concern regarding a REIT’s relatively greater ability to successfully put properties into bankruptcy.” With REIT loans unable to qualify for the exemption it “would inappropriately penalize a REIT seeking to finance its property by unnecessarily increasing its borrowing costs compared to other non-REIT property owners. There

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106 Morgan Stanley Research, April 12, 2011. CMBS Market Insights: The Dodd-Frank NPR: Implications for CMBS
108 Morgan Stanley Research, April 12, 2011. CMBS Market Insights: The Dodd-Frank NPR: Implications for CMBS
109 Morgan Stanley Research, April 12, 2011. CMBS Market Insights: The Dodd-Frank NPR: Implications for CMBS
is absolutely no apparent policy rationale to be made that loans to REITs are inherently riskier than loans to other commercial real estate borrowers. An entity’s status as a REIT is simply the result of a tax election.\textsuperscript{110}

**Volcker Rule**

The Volcker Rule was written in order to regulate and limit banks’ activities in proprietary trading and with investing or operating hedge funds and private equity funds. The purpose, in scope, was not to provide regulation to securitization. The rule is generally to align the banks objectives with their customers and the aforementioned activities do not fall in line with banks serving the needs of their clients.¹¹¹ Heavy opposition has been targeted at the Volcker Rule for many reasons, but with regard to securitization, some people believe exemptions should be added to augment the restrictions set forth in banks inability to invest in and operate covered funds.

“Without utilizing the flexibility we believe is contained in the definition in the Volcker Rule, the broad regulatory definition of a “hedge fund” and “private equity fund” in the Proposed Regulations (encompassed in the definition of “covered fund”) would restrict a banking entity from engaging in any securitization transaction with a securitization entity acting as a depositor or issuer in which that banking entity has any equity interest or a sponsorship role if that securitization entity relies on the exemptions of Section 3(c)(1) or 3(c)(7) of the Investment Company Act. Due principally to the nature of the assets involved or the particular structure, many securitization issuers currently rely on one of those exemptions… Moreover, because the Volcker Rule and the Proposed Regulations prohibit banking entities from engaging in covered transactions with a “hedge fund” or “private equity fund” that the banking entity sponsors or manages, this regulatory definition of a “hedge fund” and “private equity fund” would prohibit banking entities from providing loans or engaging in other covered transactions with a securitization vehicle that the banking entity sponsors or manages. Without the ability to enter into such transactions with securitization entities, these securitization vehicles could not function properly.”¹¹²

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On the flip side, proponents of the Volcker Rule point to the massive speculation and trading on prop desks on subprime mortgages. The proponents are less concerned with the banks relationships with covered funds as they are with proprietary trading. “While broader than just prohibiting the monumental bets that banks placed on the subprime market – as stated above, virtually every major bank’s proprietary trading desk was betting in favor of rather than against the subprime market – the Volcker Rule is clearly needed in some form to prevent a recurrence of the subprime crisis.”

At the time of writing, the Volcker Rule had not met its finalized date of October 18, 2011 although it is still required to take effect July 21, 2012.

113 Belling the Cat: Taming the Securitization Beast Without Killing It, by Ronald S. Borod, pg. 14.
Sponsor and Originator Integrity (Conflicts of Interest)

The Conflicts of Interest rule was written into Dodd Frank and implemented by the SEC to prevent issuers of real estate securitizations to take short positions or purchasing CDS protection against securities they were structuring, creating, or distributing within one year of the issuance. As mentioned previously, this rule was written to prevent scenarios similar to Goldman Sachs (GS) Abacus deal where GS created a synthetic CDO with securities a hedge fund client had targeted as “reference securities” and that very same client cleaned up when the underlying mortgages blew up.\textsuperscript{115} Proponents of this section of the rule point to the information asymmetry with respect to the separate parties in the transaction. The possibility for a massive information disparity is evident in real estate securitizations as it is difficult and timely for an investor to understand exactly what each of the underlying mortgages represent. Those for the rule argue that sponsors and originators should only engage in transaction that they would otherwise invest in themselves. Moreover, proponents believe the exemptions within the rule are sufficient for sponsors and originators to effectively protect themselves from downside risk and to provide liquidity when necessary.\textsuperscript{116}

Opponents to the rule believe the rule is intended to prevent detrimental conduct similar to that in the Abacus deal but it is far too broad in scope. “In formulating the proposed rule, it is evident that the Commission sought to prohibit the specific type of conduct at which Section 621 was aimed without restricting traditional securitization practices. As discussed in greater detail in this letter, however, we believe the Commission’s proposals nevertheless extend beyond the intent of Section 621 and would have unnecessary adverse impacts on the ABS markets.”\textsuperscript{117}

\textsuperscript{115} Belling the Cat: Taming the Securitization Beast Without Killing It, by Ronald S. Borod, pg. 14.
\textsuperscript{116} MorrisonFoerster, News Bulletin, September 29, 2011. SEC Proposes Dodd-Frank Conflict of Interest Rules
\textsuperscript{117} American Securitization Forum, Letter to SEC in response to their call for comments February 13, 2012.
Re: Release No. 34-65355 (File No. S7-38-11)
“This surely means that the answers to future conflicts of interest questions are going to depend heavily on SEC interpretation, which is likely to develop slowly, on a case-by-case basis. It is likely that commenters will focus on this issue in their comments to Proposed Rule 127B, and we expect many commenters to urge the SEC to expand the text of the rule itself to provide a framework on which market participants can rely with greater legal certainty.”

The final rule by the SEC was due on April 15th, 2011, however at the time of writing this deadline had not been met.  

**Issuer Review Rule**

The Issuer Review Rule was written to prohibit issuers from securitizing assets that they don’t understand or have limited information on. During the boom years, issuers in the competitive marketplace were pressed to push issuances out into the market and in doing so securitized assets that they had limited information regarding. Industry participants believe the rule, for the most part, is a good thing. Those for the rule written at face value claim, “it requires that securitization return to the basic principle on which it was founded: know the assets being securitized. Although this rule is limited by its terms to publicly registered securitizations...as least one major bank underwriter...intends to require compliance with the rule even in unregistered deals.”

The American Securitization Forum has advocated for minor changes to the rule but states generally, “Compliance with the new due diligence, disclosure and reporting regime dictated by Rule 193 and Rule 15Ga-2 will require substantial efforts by issuers, underwriters, Third Party Due Diligence Providers and other market participants. Existing processes and procedures will likely need to be adjusted significantly, and new processes and procedures may need to be developed. These efforts will be time consuming, especially since they will require the cooperation of various market participants. Accordingly, we request compliance with Rule 193 and Rule 15Ga-2 be made applicable to transactions issued no earlier than the later of one year following the date of publication of the final rule in the Federal Register and January 1, 2012.”

The SEC issued the final rule on January 20, 2011, which became effective on March 28, 2011 for issuances after December 31, 2011.

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120 Belling the Cat: Taming the Securitization Beast Without Killing It, by Ronald S. Borod, pg. 14.
Reps & Warranties

Section 943 of Dodd Frank, Representations and Warranties Rule, is intended for the SEC to write into effect a law discouraging issuers to make representations with respect to ABS transaction that may be seen as misleading or deceptive. It forces the issuer to make clear and accurate representations regarding the underlying security or face the risk of either replacing the loan from the pool with an asset that meets the representation given or be required to repurchase the loan from the pool. Further, the rule is intended to provide investors with information regarding issuers underwriting and whether deficiencies exist between their actual underwriting and the reps and warranties made on respective issuances and whether or not the issuers have been subject to requests from investors to repurchase loans in ABS within a trailing five-year period. Opponents to the rule argue that the repurchase requests for ABS only be reported if and when they are tied to reps and warranties. The comments point out that repurchase requests can happen for reasons outside of the reps and warranties and therefore should be required to be disclosed.\textsuperscript{123}

“Several commentators noted issues with historical information, such as lack of systems to capture the data, the change in underwriting standards since the housing crisis, misperceptions that may arise from analyzing fragmented data, and the ability to obtain the data from other transaction parties including that certain transaction parties may no longer exist… Most commentators generally supported disclosure of the name of the asset originator.”\textsuperscript{124} Generally speaking, most parties subject to the rule agree that more standardized disclosure is necessary and support market information to be transparent.\textsuperscript{125}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{123} SEC, Rules and Regulations. Federal Register Vol. 76, No. 17. Wednesday, January 26, 2011.
\item \textsuperscript{124} SEC, Rules and Regulations. Federal Register Vol. 76, No. 17. Wednesday, January 26, 2011.
\item \textsuperscript{125} SEC, Rules and Regulations. Federal Register Vol. 76, No. 17. Wednesday, January 26, 2011.
\end{itemize}
\end{footnotesize}
The final rule was issued by the SEC on January 20, 2011 and became effective March 28, 2011.\textsuperscript{126} The SEC took into consideration the feedback on the proposed five-year look back period and reduced it to three years. Although it still appears to be a heavy burden on massive financial institutions that securitized many issuances and raises questions regarding the interpretation of repurchase requests and what exactly is a qualified repurchase request – it will certainly offer investors more transparency regarding ABS issuances.\textsuperscript{127}

\textsuperscript{126} American Securitization Forum, 6/11/12. Timetable of Securitization Related Rulemaking Prescribed by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

\textsuperscript{127} Belling the Cat: Taming the Securitization Beast Without Killing It, by Ronald S. Borod, pg. 14.
Ch. 5 – CONCLUSION

At the writing of this thesis, the eventual outcome of Dodd Frank with respect to real estate securitization is still in flux. Regulators have not issued final rules on every provision and we can merely speculate to where these final rules will land. The rules and regulations that are put in place are designed to guard against future economic disasters. If these regulations had been in place in the early 2000s, the credit crisis that crippled the US mortgage market would have potentially never occurred. Right now markets are appropriately harnessing the major issues that allowed for the absurd behavior that occurred in the real estate securitization boom, but Dodd Frank is being implemented, not as a short term fix but as a long term solution, to protect the US financial markets against the next financial disaster. The Act is being established based on a framework predicated that in future years the regulations in place will not allow for the type of behavior that enabled the abuses that occurred. However, it is important to understand what the Act is actually addressing. Dodd Frank is attempting to deal with the issue of moral hazard – when a party is prone to take undue risks because it does not bear the consequences – of securitizers creating risk but not actually holding the risk. What the Act has done is eliminate moral hazard within the risk retention rules. PCCRA will probably do the best job at truly implementing risk retention and actually requiring skin the game but could increase borrowing costs and limit credit availability. Therefore, regulators have to decide between the two and may not be willing to sacrifice the latter, particularly in the midst of a fragile recovery phase for the economy. Allowable exemption rules in the form of QLE and QRM have been written to narrowly constrict the channel of loans available for exemption of risk retention. As written, these rules will curtail the availability of credit and likely increase the costs to the borrower. QRM would have only accounted for 19.79% of all loans purchased or securitized by the GSEs during the period between 1997 and 2009 and QLE would have been 0.4% of all CMBS loans that have been securitized. Obviously, this rule, as written, is an issue and we believe the
criteria will be loosened to allow for the inclusion of more loans in the exemption process. Clearly, the intention of Dodd Frank is to align the risks and create a level playing field and the Act provides a fair and balanced framework for which the markets can work; however, until the language of risk retention and loan exemptions is modified to allow for a wider availability of affordable mortgage capital we expect the Act to curtail both residential and commercial products.

Types of Bonds: The Various Types of CMOs retrieved on 6/12/12 from http://www.investinginbonds.com/learnmore.asp?catid=5&subcatid=17&id=35


FDIC. “Chapter 1, The Banking Crisis of the 1980s and Early 1990s: Summary and Implications”. An Examination of the Banking Crisis of the 1980s and Early 1990s Volume I.


APPENDICES

Appendix 1: Dodd Frank Act Section 941

Subitle D—Improvements to the Asset-Backed Securitization Process
SEC. 941. REGULATION OF CREDIT RISK RETENTION.
(a) DEFINITION OF ASSET-BACKED SECURITY.—Section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) is amended by adding at the end the following:
“(77) ASSET-BACKED SECURITY.—The term ‘asset-backed security’—
“(A) means a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including—
“(i) a collateralized mortgage obligation;
“(ii) a collateralized debt obligation;
“(iii) a collateralized bond obligation;
“(iv) a collateralized debt obligation of asset-backed securities;
“(v) a collateralized debt obligation of collateralized debt obligations; and
“(vi) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section; and
“(B) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.’’. 
(b) CREDIT RISK RETENTION.—The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by inserting after section 15F, as added by this Act, the following:
“SEC. 15G. CREDIT RISK RETENTION.
“(a) DEFINITIONS.—In this section—
“(1) the term ‘Federal banking agencies’ means the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation;
“(2) the term ‘insured depository institution’ has the same meaning as in section 3(c) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c));
“(3) the term ‘securitizer’ means—
“(A) an issuer of an asset-backed security; or
“(B) a person who organizes and initiates an asset backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer; and
“(4) the term ‘originator’ means a person who—
“(A) through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security; and
“(B) sells an asset directly or indirectly to a securitizer.
“(b) REGULATIONS REQUIRED.—
“(1) IN GENERAL.—Not later than 270 days after the date of enactment of this section, the Federal banking agencies and the Commission shall jointly prescribe regulations to require any securitizer to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party.
“(2) RESIDENTIAL MORTGAGES.—Not later than 270 days after the date of enactment of this section, the Federal banking agencies, the Commission, the Secretary of Housing and Urban Development, and the Federal Housing Finance Agency, shall jointly prescribe regulations to require any securitizer to retain
an economic interest in a portion of the credit risk for any residential mortgage asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party.

“(c) STANDARDS FOR REGULATIONS.—
“(1) STANDARDS.—The regulations prescribed under subsection (b) shall—
“(A) prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain with respect to an asset;
“(B) require a securitizer to retain—“(i) not less than 5 percent of the credit risk for any asset—
“(I) that is not a qualified residential mortgage that is transferred, sold, or conveyed through the issuance of an asset-backed security by the securitizer; or
“(II) that is a qualified residential mortgage that is transferred, sold, or conveyed through the issuance of an asset-backed security by the securitizer, if 1 or more of the assets that collateralize the asset-backed security are not qualified residential mortgages; or
“(ii) less than 5 percent of the credit risk for an asset that is not a qualified residential mortgage that is transferred, sold, or conveyed through the issuance of an asset-backed security by the securitizer, if the originator of the asset meets the underwriting standards prescribed under paragraph (2)(B);
“(C) specify—
“(i) the permissible forms of risk retention for purposes of this section;
“(ii) the minimum duration of the risk retention required under this section; and
“(iii) that a securitizer is not required to retain any part of the credit risk for an asset that is transferred, sold, or conveyed through the issuance of an asset-backed security by the securitizer, if all of the assets that collateralize the asset-backed security are qualified residential mortgages;
“(D) apply, regardless of whether the securitizer is an insured depository institution;
“(E) with respect to a commercial mortgage, specify the permissible types, forms, and amounts of risk retention that would meet the requirements of subparagraph (B), which in the determination of the Federal banking agencies and the Commission may include—
“(i) retention of a specified amount or percentage of the total credit risk of the asset;
“(ii) retention of the first-loss position by third-party purchaser that specifically negotiates for the purchase of such first loss position, holds adequate financial resources to back losses, provides due diligence on all individual assets in the pool before the issuance of the asset-backed securities, and meets the same standards for risk retention as the Federal banking agencies and the Commission require of the securitizer;
“(iii) a determination by the Federal banking agencies and the Commission that the underwriting standards and controls for the asset are adequate; and
“(iv) provision of adequate representations and warranties and related enforcement mechanisms; and
“(F) establish appropriate standards for retention of an economic interest with respect to collateralized debt obligations, securities collateralized by collateralized debt obligations, and similar instruments collateralized by other asset-backed securities; and
“(G) provide for—“(i) a total or partial exemption of any securitization, as may be appropriate in the public interest and for the protection of investors;
“(ii) a total or partial exemption for the securitization of an asset issued or guaranteed by the United States, or an agency of the United States, as the Federal banking agencies and the Commission jointly determine appropriate in the public interest and for the protection of investors, except that, for purposes of this clause, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation are not agencies of the United States;
“(iii) a total or partial exemption for any asset backed security that is a security issued or guaranteed by any State of the United States, or by any political subdivision of a State or territory, or by any public
instrumentality of a State or territory that is exempt from the registration requirements of the Securities Act of 1933 by reason of section 3(a)(2) of that Act (15 U.S.C. 77c(a)(2)), or a security defined as a qualified scholarship funding bond in section 150(d)(2) of the Internal Revenue Code of 1986, as may be appropriate in the public interest and for the protection of investors; and

(iv) the allocation of risk retention obligations between a securitizer and an originator in the case of a securitizer that purchases assets from an originator, as the Federal banking agencies and the Commission jointly determine appropriate.

(2) ASSET CLASSES.—

(A) ASSET CLASSES.—The regulations prescribed under subsection (b) shall establish asset classes with separate rules for securitizers of different classes of assets, including residential mortgages, commercial mortgages, commercial loans, auto loans, and any other class of assets that the Federal banking agencies and the Commission deem appropriate.

(B) CONTENTS.—For each asset class established under subparagraph (A), the regulations prescribed under subsection (b) shall include underwriting standards established by the Federal banking agencies that specify the terms, conditions, and characteristics of a loan within the asset class that indicate a low credit risk with respect to the loan.

(d) ORIGINATORS.—In determining how to allocate risk retention obligations between a securitizer and an originator under subsection (c)(1)(E)(iv), the Federal banking agencies and the Commission shall—

(1) reduce the percentage of risk retention obligations required of the securitizer by the percentage of risk retention obligations required of the originator; and

(2) consider—

(A) whether the assets sold to the securitizer have terms, conditions, and characteristics that reflect low credit risk;

(B) whether the form or volume of transactions in securitization markets creates incentives for imprudent origination of the type of loan or asset to be sold to the securitizer; and

(C) the potential impact of the risk retention obligations on the access of consumers and businesses to credit on reasonable terms, which may not include the transfer of credit risk to a third party.

(e) EXEMPTIONS, EXCEPTIONS, AND ADJUSTMENTS.—

(1) IN GENERAL.—The Federal banking agencies and the Commission may jointly adopt or issue exemptions, exceptions, or adjustments to the rules issued under this section, including exemptions, exceptions, or adjustments for classes of institutions or assets relating to the risk retention requirement and the prohibition on hedging under subsection (c)(1).

(2) APPLICABLE STANDARDS.—Any exemption, exception, or adjustment adopted or issued by the Federal banking agencies and the Commission under this paragraph shall—

(A) help ensure high quality underwriting standards for the securitizers and originators of assets that are securitized or available for securitization; and

(B) encourage appropriate risk management practices by the securitizers and originators of assets, improve the access of consumers and businesses to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors.

(3) CERTAIN INSTITUTIONS AND PROGRAMS EXEMPT.—

(A) FARM CREDIT SYSTEM INSTITUTIONS.—Notwithstanding any other provision of this section, the requirements of this section shall not apply to any loan or other financial asset made, insured, guaranteed, or purchased by any institution that is subject to the supervision of the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation.
“(B) OTHER FEDERAL PROGRAMS.—This section shall not apply to any residential, multifamily, or health care facility mortgage loan asset, or securitization based directly or indirectly on such an asset, which is insured or guaranteed by the United States or an agency of the United States. For purposes of this subsection, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal home loan banks shall not be considered an agency of the United States.

“(4) EXEMPTION FOR QUALIFIED RESIDENTIAL MORTGAGES.—

“(A) IN GENERAL.—The Federal banking agencies, the Commission, the Secretary of Housing and Urban Development, and the Director of the Federal Housing Finance Agency shall jointly issue regulations to exempt qualified residential mortgages from the risk retention requirements of this subsection.

“(B) QUALIFIED RESIDENTIAL MORTGAGE.—The Federal banking agencies, the Commission, the Secretary of Housing and Urban Development, and the Director of the Federal Housing Finance Agency shall jointly define the term ‘qualified residential mortgage’ for purposes of this subsection, taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default, such as— “(i) documentation and verification of the financial resources relied upon to qualify the mortgagor;

“(ii) standards with respect to—

“(I) the residual income of the mortgagor after all monthly obligations;

“(II) the ratio of the housing payments of the mortgagor to the monthly income of the mortgagor;

“(III) the ratio of total monthly installment payments of the mortgagor to the income of the mortgagor;

“(iii) mitigating the potential for payment shock on adjustable rate mortgages through product features and underwriting standards;

“(iv) mortgage guarantee insurance or other types of insurance or credit enhancement obtained at the time of origination, to the extent such insurance or credit enhancement reduces the risk of default; and

“(v) prohibiting or restricting the use of balloon payments, negative amortization, prepayment penalties, interest-only payments, and other features that have been demonstrated to exhibit a higher risk of borrower default.

“(C) LIMITATION ON DEFINITION.—The Federal banking agencies, the Commission, the Secretary of Housing and Urban Development, and the Director of the Federal Housing Finance Agency in defining the term ‘qualified residential mortgage’, as required by subparagraph (B), shall define that term to be no broader than the definition ‘qualified mortgage’ as the term is defined under section 129C(c)(2) of the Truth in Lending Act, as amended by the Consumer Financial Protection Act of 2010, and regulations adopted thereunder.

“(5) CONDITION FOR QUALIFIED RESIDENTIAL MORTGAGE EXEMPTION.—The regulations issued under paragraph (4) shall provide that an asset-backed security that is collateralized by tranches of other asset-backed securities shall not be exempt from the risk retention requirements of this subsection.

“(6) CERTIFICATION.—The Commission shall require an issuer to certify, for each issuance of an asset-backed security collateralized exclusively by qualified residential mortgages, that the issuer has evaluated the effectiveness of the internal supervisory controls of the issuer with respect to the process for ensuring that all assets that collateralize the asset-backed security are qualified residential mortgages.

“(f) ENFORCEMENT.—The regulations issued under this section shall be enforced by—

“(1) the appropriate Federal banking agency, with respect to any securitizer that is an insured depository institution; and

“(2) the Commission, with respect to any securitizer that is not an insured depository institution.

“(g) AUTHORITY OF COMMISSION.—The authority of the Commission under this section shall be in
addition to the authority of the Commission to otherwise enforce the securities laws.
“(h) AUTHORITY TO COORDINATE ON RULEMAKING.—The Chairperson of the Financial Stability Oversight Council shall coordinate all joint rulemaking required under this section.
“(i) EFFECTIVE DATE OF REGULATIONS.—The regulations issued under this section shall become effective—
“(1) with respect to securitizers and originators of asset-backed securities backed by residential mortgages, 1 year after the date on which final rules under this section are published in the Federal Register; and
“(2) with respect to securitizers and originators of all other classes of asset-backed securities, 2 years after the date on which final rules under this section are published in the Federal Register.”.
(c) STUDY ON RISK RETENTION.—
(1) STUDY.—The Board of Governors of the Federal Reserve System, in coordination and consultation with the Comptroller of the Currency, the Director of the Office of Thrift Supervision, the Chairperson of the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission shall conduct a study of the combined impact on each individual class of asset-backed security established under section 15G(c)(2) of the Securities Exchange Act of 1934, as added by subsection (b), of—
(A) the new credit risk retention requirements contained in the amendment made by subsection (b), including the effect credit risk retention requirements have on increasing the market for Federally subsidized loans; and
(B) the Financial Accounting Statements 166 and 167 issued by the Financial Accounting Standards Board.
(2) REPORT.—Not later than 90 days after the date of enactment of this Act, the Board of Governors of the Federal Reserve System shall submit to Congress a report on the study conducted under paragraph (1). Such report shall include statutory and regulatory recommendations for eliminating any negative impacts on the continued viability of the asset-backed securitization markets and on the availability of credit for new lending identified by the study conducted under paragraph (1).
Appendix 2: Dodd Frank Act Section 1411

Subtitle B—Minimum Standards For Mortgages
SEC. 1411. ABILITY TO REPAY.
(a) IN GENERAL.—
(1) RULE OF CONSTRUCTION.—No regulation, order, or guidance issued by the Bureau under this title shall be construed as requiring a depository institution to apply mortgage underwriting standards that do not meet the minimum underwriting standards required by the appropriate prudential regulator of the depository institution.
(2) AMENDMENT TO TRUTH IN LENDING ACT.—Chapter 2 of the Truth in Lending Act (15 U.S.C. 1631 et seq.) is amended by inserting after section 129B (as added by section 1402(a)) the following new section:
“§ 129C. Minimum standards for residential mortgage loans
“(a) ABILITY TO REPAY.—
“(1) IN GENERAL.—In accordance with regulations prescribed by the Board, no creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments.
“(2) MULTIPLE LOANS.—If the creditor knows, or has reason to know, that 1 or more residential mortgage loans secured by the same dwelling will be made to the same consumer, the creditor shall make a reasonable and good faith determination, based on verified and documented information, that the consumer has a reasonable ability to repay the combined payments of all loans on the same dwelling according to the terms of those loans and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments.
“(3) BASIS FOR DETERMINATION.—A determination under this subsection of a consumer’s ability to repay a residential mortgage loan shall include consideration of the consumer’s credit history, current income, expected income the consumer is reasonably assured of receiving, current obligations, debt to- income ratio or the residual income the consumer will have after paying non-mortgage debt and mortgage-related obligations, employment status, and other financial resources other than the consumer’s equity in the dwelling or real property that secures repayment of the loan. A creditor shall determine the ability of the consumer to repay using a payment schedule that fully amortizes the loan over the term of the loan.
“(4) INCOME VERIFICATION.
—A creditor making a residential mortgage loan shall verify amounts of income or assets that such creditor relies on to determine repayment ability, including expected income or assets, by reviewing the consumer’s Internal Revenue Service Form W–2, tax returns, payroll receipts, financial institution records, or other third-party documents that provide reasonably reliable evidence of the consumer’s income or assets. In order to safeguard against fraudulent reporting, any consideration of a consumer’s income history in making a determination under this subsection shall include the verification of such income by the use of—
“(A) Internal Revenue Service transcripts of tax returns; or
“(B) a method that quickly and effectively verifies income documentation by a third party subject to rules prescribed by the Board.
“(5) EXEMPTION.—With respect to loans made, guaranteed, or insured by Federal departments

http://www.dodd-frank-act.us/Dodd_Frank_Act_Text_Section_1411.html
or agencies identified in subsection (b)(3)(B)(ii), such departments or agencies may exempt refinancings under a streamlined refinancing from this income verification requirement as long as the following conditions are met:

“(A) The consumer is not 30 days or more past due on the prior existing residential mortgage loan.

“(B) The refinancing does not increase the principal balance outstanding on the prior existing residential mortgage loan, except to the extent of fees and charges allowed by the department or agency making, guaranteeing, or insuring the refinancing.

“(C) Total points and fees (as defined in section 103(aa)(4), other than bona fide third party charges not retained by the mortgage originator, creditor, or an affiliate of the creditor or mortgage originator) payable in connection with the refinancing do not exceed 3 percent of the total new loan amount.

“(D) The interest rate on the refinanced loan is lower than the interest rate of the original loan, unless the borrower is refinancing from an adjustable rate to a fixed rate loan, under guidelines that the department or agency shall establish for loans they make, guarantee, or issue.

“(E) The refinancing is subject to a payment schedule that will fully amortize the refinancing in accordance with the regulations prescribed by the department or agency making, guaranteeing, or insuring the refinancing.

“(F) The terms of the refinancing do not result in a balloon payment, as defined in subsection (b)(2)(A)(ii).

“(G) Both the residential mortgage loan being refinanced and the refinancing satisfy all requirements of the department or agency making, guaranteeing, or insuring the refinancing.

“(6) NONSTANDARD LOANS.—

“(A) VARIABLE RATE LOANS THAT DEFER REPAYMENT OF ANY PRINCIPAL OR INTEREST.—For purposes of determining, under this subsection, a consumer’s ability to repay a variable rate residential mortgage loan that allows or requires the consumer to defer the repayment of any principal or interest, the creditor shall use a fully amortizing repayment schedule.

“(B) INTEREST-ONLY LOANS.—For purposes of determining, under this subsection, a consumer’s ability to repay a residential mortgage loan that permits or requires the payment of interest only, the creditor shall use the payment amount required to amortize the loan by its final maturity.

“(C) CALCULATION FOR NEGATIVE AMORTIZATION.—In making any determination under this subsection, a creditor shall also take into consideration any balance increase that may accrue from any negative amortization provision.

“(D) CALCULATION PROCESS.—For purposes of making any determination under this subsection, a creditor shall calculate the monthly payment amount for principal and interest on any residential mortgage loan by assuming—

“(i) the loan proceeds are fully disbursed on the date of the consummation of the loan;

“(ii) the loan is to be repaid in substantially equal monthly amortizing payments for principal and interest over the entire term of the loan with no balloon payment, unless the loan contract requires more rapid repayment (including balloon payment), in which case the calculation shall be made (I) in accordance with regulations prescribed by the Board, with respect to any loan which has an annual percentage rate that does not exceed the average prime offer rate for a comparable transaction, as of the date the interest rate is set, by 1.5 or more percentage points for a first lien residential mortgage loan; and by 3.5 or more percentage points for a subordinate lien residential mortgage loan; or

(II) using the contract’s repayment schedule, with respect to a loan which has an annual percentage rate, as of the date the interest rate is set, that is at least 1.5 percentage points above the average prime offer rate for a first lien residential mortgage loan; and 3.5 percentage points above the
average prime offer rate for a subordinate lien residential mortgage loan; and
“(iii) the interest rate over the entire term of the loan is a fixed rate equal to the fully indexed rate at
the time of the loan closing, without considering the introductory rate.
“(E) REFINANCE OF HYBRID LOANS WITH CURRENT LENDER.—In considering any
application for refinancing an existing hybrid loan by the creditor into a standard loan to be made by
the same creditor in any case in which there would be a reduction in monthly payment and the
mortgagor has not been delinquent on any payment on the existing hybrid loan, the creditor may—
“(i) consider the mortgagor’s good standing on the existing mortgage;
“(ii) consider if the extension of new credit would prevent a likely default should the original
mortgage reset and give such concerns a higher priority as an acceptable underwriting practice; and
“(iii) offer rate discounts and other favorable terms to such mortgagor that would be available to
new customers with high credit ratings based on such underwriting practice.
“(7) FULLY-INDEXED RATE DEFINED.—For purposes of this subsection, the term ‘fully
indexed rate’ means the index rate prevailing on a residential mortgage loan at the time the loan is
made plus the margin that will apply after the expiration of any introductory interest rates.
“(8) REVERSE MORTGAGES AND BRIDGE LOANS.—This subsection shall not apply with
respect to any reverse mortgage or temporary or bridge loan with a term of 12 months or less,
including to any loan to purchase a new dwelling where the consumer plans to sell a different
dwelling within 12 months.
“(9) SEASONAL INCOME.—If documented income, including income from a small business, is a
repayment source for a residential mortgage loan, a creditor may consider the seasonality and
irregularity of such income in the underwriting of and scheduling of payments for such credit.”.
(b) CLERICAL AMENDMENT.—The table of sections for chapter 2 of the Truth in Lending Act
is amended by inserting after the item relating to section 129B (as added by section 1402(b)) the
following new item: “129C. Minimum standards for residential mortgage loans.”.
Appendix 3: Dodd Frank Act Section 1412\textsuperscript{129}

SEC. 1412. SAFE HARBOR AND REBUTTABLE PRESUMPTION.
Section 129C of the Truth in Lending Act is amended by inserting after subsection (a) (as added by section 1411) the following new subsection:

“(b) PRESUMPTION OF ABILITY TO REPAY.—
“(1) IN GENERAL.—Any creditor with respect to any residential mortgage loan, and any assignee of such loan subject to liability under this title, may presume that the loan has met the requirements of subsection (a), if the loan is a qualified mortgage.
“(2) DEFINITIONS.—For purposes of this subsection, the following definitions shall apply:
“(A) QUALIFIED MORTGAGE.—The term ‘qualified mortgage’ means any residential mortgage loan—
“(i) for which the regular periodic payments for the loan may not—
“(I) result in an increase of the principal balance; or
“(II) except as provided in subparagraph (E), allow the consumer to defer repayment of principal;
“(ii) except as provided in subparagraph (E), the terms of which do not result in a balloon payment, where a ‘balloon payment’ is a scheduled payment that is more than twice as large as the average of earlier scheduled payments;
“(iii) for which the income and financial resources relied upon to qualify the obligors on the loan are verified and documented;
“(iv) in the case of a fixed rate loan, for which the underwriting process is based on a payment schedule that fully amortizes the loan over the loan term and takes into account all applicable taxes, insurance, and assessments;
“(v) in the case of an adjustable rate loan, for which the underwriting is based on the maximum rate permitted under the loan during the first 5 years, and a payment schedule that fully amortizes the loan over the loan term and takes into account all applicable taxes, insurance, and assessments;
“(vi) that complies with any guidelines or regulations established by the Board relating to ratios of total monthly debt to monthly income or alternative measures of ability to pay regular expenses after payment of total monthly debt, taking into account the income levels of the borrower and such other factors as the Board may determine relevant and consistent with the purposes described in paragraph (3)(B)(i);
“(vii) for which the total points and fees (as defined in subparagraph (C)) payable in connection with the loan do not exceed 3 percent of the total loan amount;
“(viii) for which the term of the loan does not exceed 30 years, except as such term may be extended under paragraph (3), such as in high-cost areas; and
“(ix) in the case of a reverse mortgage (except for the purposes of subsection (a) of section 129C, to the extent that such mortgages are exempt altogether from those requirements), a reverse mortgage which meets the standards for a qualified mortgage, as set by the Board in rules that are consistent with the purposes of this subsection.
“(B) AVERAGE PRIME OFFER RATE.—The term ‘average prime offer rate’ means the average

\textsuperscript{129} http://www.dodd-frank-act.us/Dodd_Frank_Act_Text_Section_1412.html
prime offer rate for a comparable transaction as of the date on which the interest rate for the transaction is set, as published by the Board.

“(C) POINTS AND FEES.—

“(i) IN GENERAL.—For purposes of subparagraph (A), the term ‘points and fees’ means points and fees as defined by section 103(aa)(4) (other than bona fide third party charges not retained by the mortgage originator, creditor, or an affiliate of the creditor or mortgage originator).

“(ii) COMPUTATION.—For purposes of computing the total points and fees under this subparagraph, the total points and fees shall exclude either of the amounts described in the following subclauses, but not both:

“(I) Up to and including 2 bona fide discount points payable by the consumer in connection with the mortgage, but only if the interest rate from which the mortgage’s interest rate will be discounted does not exceed by more than 1 percentage point the average prime offer rate.

“(II) Unless 2 bona fide discount points have been excluded under subclause (I), up to and including 1 bona fide discount point payable by the consumer in connection with the mortgage, but only if the interest rate from which the mortgage’s interest rate will be discounted does not exceed by more than 2 percentage points the average prime offer rate.

“(iii) BONA FIDE DISCOUNT POINTS DEFINED.—For purposes of clause (ii), the term ‘bona fide discount points’ means loan discount points which are knowingly paid by the consumer for the purpose of reducing, and which in fact result in a bona fide reduction of, the interest rate or time-price differential applicable to the mortgage.

“(iv) INTEREST RATE REDUCTION.—Subclauses (I) and (II) of clause (ii) shall not apply to discount points used to purchase an interest rate reduction unless the amount of the interest rate reduction purchased is reasonably consistent with established industry norms and practices for secondary mortgage market transactions.

“(D) SMALLER LOANS.—The Board shall prescribe rules adjusting the criteria under subparagraph (A)(vii) in order to permit lenders that extend smaller loans to meet the requirements of the presumption of compliance under paragraph (1).

In prescribing such rules, the Board shall consider the potential impact of such rules on rural areas and other areas where home values are lower.

“(E) BALLOON LOANS.—The Board may, by regulation, provide that the term ‘qualified mortgage’ includes a balloon loan—

“(i) that meets all of the criteria for a qualified mortgage under subparagraph (A) (except clauses (i)(II), (ii), (iv), and (v) of such subparagraph);

“(ii) for which the creditor makes a determination that the consumer is able to make all scheduled payments, except the balloon payment, out of income or assets other than the collateral;

“(iii) for which the underwriting is based on a payment schedule that fully amortizes the loan over a period of not more than 30 years and takes into account all applicable taxes, insurance, and assessments; and

“(iv) that is extended by a creditor that—

“(I) operates predominantly in rural or underserved areas;

“(II) together with all affiliates, has total annual residential mortgage loan originations that do not
exceed a limit set by the Board;
“(III) retains the balloon loans in portfolio; and
“(IV) meets any asset size threshold and any other criteria as the Board may establish, consistent with the purposes of this subtitle.
“(3) REGULATIONS.—
“(A) IN GENERAL.—The Board shall prescribe regulations to carry out the purposes of this subsection.
“(B) REVISION OF SAFE HARBOR CRITERIA.—
“(i) IN GENERAL.—The Board may prescribe regulations that revise, add to, or subtract from the criteria that define a qualified mortgage upon a finding that such regulations are necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers in a manner consistent with the purposes of this section, necessary and appropriate to effectuate the purposes of this section and section 129B, to prevent circumvention or evasion thereof, or to facilitate compliance with such sections.
“(ii) LOAN DEFINITION.—The following agencies shall, in consultation with the Board, prescribe rules defining the types of loans they insure, guarantee, or administer, as the case may be, that are qualified mortgages for purposes of paragraph (2)(A), and such rules may revise, add to, or subtract from the criteria used to define a qualified mortgage under paragraph (2)(A), upon a finding that such rules are consistent with the purposes of this section and section 129B, to prevent circumvention or evasion thereof, or to facilitate compliance with such sections:
“(I) The Department of Housing and Urban Development, with regard to mortgages insured under the National Housing Act (12 U.S.C. 1707 et seq.).
“(II) The Department of Veterans Affairs, with regard to a loan made or guaranteed by the Secretary of Veterans Affairs.
“(III) The Department of Agriculture, with regard to loans guaranteed by the Secretary of Agriculture pursuant to 42 U.S.C. 1472(h).
“(IV) The Rural Housing Service, with regard to loans insured by the Rural Housing Service.”. 
The major elements of securitization reform that have been finalized under the Act are:

**Repurchase Requests, Representations and Warranties**

- Credit rating agencies must explain, in reports accompanying credit ratings, representations, warranties, and enforcement mechanisms available to investors and how they differ from representations, warranties and enforcement mechanisms in similar issuances.
- Issuers of both registered and unregistered Asset-Backed Securities (“ABS”) must disclose (at time of offering and on an on-going basis) fulfilled and unfulfilled repurchase requests across all ABS transactions (required of issuers or organizers of any ABS as such term is defined under the Exchange Act).

**Issuer Review and Disclosure of Review Findings**

- Issuer must perform an asset review in connection with an ABS offering and disclose its findings in the registration statement. An independent third party may conduct the asset review if it either (i) is named in the registration statement and consents to being deemed an “expert” for liability purposes under Section 11 of the Securities Act, or (ii) the issuer adopts the findings and conclusions of the third-party reviewer.
- Review is meant to provide “reasonable assurance” that asset pool disclosure is accurate.

The major elements of securitization reform that are still in the proposal phase under Dodd-Frank are:

**Credit Risk Retention – Proposed Rule Comment Period Ended August 1, 2011; Final Rule Not Yet Released**

- 5 percent to be retained by the securitizer; however, if originator retains some amount of risk, only the remaining risk (up to 5 percent total) will be allocated to securitizer.
- Risk retention can be in the form of “vertical” slice, “horizontal” first-loss position, an “L-shaped interest” hybrid of vertical and horizontal retention, a funded cash reserve account, or ownership of a representative sample.
- Risk retention also to apply to Collateralized Debt Obligation (“CDOs”), securities collateralized by CDOs and similar instruments.
- Excess spread must be set aside in a premium capture reserve account to prevent sponsors from effectively reducing their economic exposure.
- Specific risk retention types and forms for commercial mortgages, Asset-Backed Commercial Paper (“ABCP”) conduits and revolving master trusts.
- Exemptions for qualified residential mortgages, ABS issued or guaranteed by the federal government (including ABS issued by Fannie Mae and Freddie Mac as long as they operate under the conservatorship or receivership of the FHFA), certain single-tranche resecuritizations, and certain qualifying commercial loans and auto loans.
— Foreign transaction safe harbor if certain conditions are met.
— No hedging or transfer of credit risk, unless such activity is not materially related to the credit risk of a particular ABS interest or exposure required to be retained (can hedge general interest rate risk, currency exchange rate risk, and overall market movement risk).
— Regulations relating to credit risk retention requirements will become effective one year from adoption for residential mortgage assets, and two years from adoption for all other asset classes.


— Prohibition on any ABS securitization participant (underwriter, placement agent, initial purchaser, sponsor, or related subsidiaries or affiliates) from engaging in any transaction that involves or results in a material conflict of interest between such securitization participant and an investor in the relevant ABS transaction.
— Applicable only if the ABS transaction involves (i) covered persons; (ii) covered products; (iii) a covered timeframe; (iv) a covered conflict, and (v) a “material conflict of interest.”
— Exceptions for certain risk mitigating hedging activities, purchases and sales to provide liquidity, and bona fide market making.

The major elements of securitization reform that are still in the proposal phase under Regulation AB II are:

Re-Proposed Regulation AB II Required Disclosures

— Revise shelf registration eligibility criteria to include executive officer certification. PSA repurchase provision requirement, and issuer undertaking to not hold any registered securities sold backed by the same pool of assets.
— Asset-level or data-level detail, including data with unique identifiers relating to loan brokers or originators, the nature and extent of the compensation of the broker or originator of the assets backing the security, and the amount of risk retention of the originator or securitizer of such assets.
— Transaction documents must include a provision that requires the issuer to provide a notice in a public filing if an investor requests to communicate with other investors.
— Same level of information must be provided upon investor request for any of the issuer’s ABS and structured product offerings conducted pursuant to Rule 144A or Regulation D.
— Require a preliminary prospectus be filed at least five business days prior to the first sale or, if used earlier, within two business days of first use; the preliminary prospectus would need to be a single prospectus and include all information omitted from the form of prospectus in the registration statement other than pricing information.