Skin in the Game: Aligning the Interests of Sponsors and Investors

Commissioner Luis A. Aguilar

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Today, the Commission considers Congressionally-mandated, multi-agency credit risk retention rules that are intended to address a glaring flaw of the asset-backed securities (ABS) market revealed by the financial crisis: the misalignment of interests between the ABS securitizer and the ABS investor.[1]

Historically, banks funded loans through customer deposits and they retained the loans on their balance sheets.[2] Under this traditional "originate-to-hold" model, banks were incentivized to originate high credit quality loans because the banks bore the risk that the loans would not be repaid. The advent of the securitization market and the "pooling" of assets gradually resulted in an "originate-to-distribute" business model in which banks and other lenders could originate loans and quickly sell them into securitization pools.[3] While the "originate-to-distribute" model has the positive effect of allowing lenders to enhance their liquidity and, thus, make credit more widely available,[4] it also results in the lenders' transferring the risk of non-payment to ABS investors.

As we painfully learned, this "originate-to distribute" model often resulted in a decline in loan quality.[5] Simply stated, since the lenders were not going to suffer if the loans were not repaid, they no longer had the incentive of ensuring that the loans would be of appropriate quality.[6] The evidence is clear that, in the years leading up to the financial crisis, mortgage lenders increasingly loosened their underwriting standards, and often disregarded a borrower's ability to pay. This resulted in lenders originating loans with higher risk characteristics, such as loans with low-or-no down payments or interest-only provisions.[7] At the same time, banks and lenders increasingly relied on the "originate-to-distribute" model to sell these riskier loans, including subprime mortgages, into the securitization chain. As a result, these loans were funneled into a pipeline where the risk landed at the feet of the ABS investor.[8] Ultimately, the result was a widespread deterioration in loan credit quality, which resulted in billions of dollars' worth of asset-backed securities collapsing in value.[9]

At its core, today's risk retention rules are intended to align the incentives of sponsors and ABS investors by requiring sponsors to retain a financial interest and maintain skin in the game. In particular, the final rules require that, unless an exemption is available, sponsors must retain at least a 5% economic interest in the credit risk of the securitized assets.[10] Furthermore, today's rules prohibit sponsors (or their affiliates) from diluting the required risk retention by dividing the economic interest among multiple parties, or hedging or transferring the credit risk the sponsor is required to retain.[11]

It should be noted that, as Congress directed, today's rules provide an exemption from the risk retention requirements for those sponsors of asset-backed securities that are fully collateralized by a universe of residential mortgages called "qualified residential mortgages" (or QRMs).[12] In determining how to fulfill this Congressional mandate, and after much deliberation, the staff of the various agencies determined that the goals set forth by Congress would be best accomplished by adopting a definition of QRM that is equal to the definition of "qualified mortgage," as that term is defined by the Consumer Financial Protection Bureau (CFPB) under the Truth in Lending Act.[13]

Admittedly, the CFPB is not among the six federal agencies tasked by Congress with promulgating today's risk retention rules.[14] However, as today's adopting release describes, it is expected that the CFPB's definition will result in mortgages that, as Congress intended, have a lower risk of default than other

mortgages.[15] For example, the CFPB's current "qualified mortgage" definition requires meeting certain minimum underwriting standards,[16] prohibits certain predatory loan features,[17] and provides for a total debt-to-income ratio that does not exceed 43%.[18]

Nonetheless, there are concerns that by deferring to the CFPB's "qualified mortgage" definition, the rule may exempt certain loans that could exhibit other high credit risk characteristics that are not taken into account by the CFPB definition—such as high loan-to-value ratios or loans to borrowers with weaker credit histories.[19] In fact, these concerns are reflected in an analysis made public by the Commission's Division of Economic and Risk Analysis.[20]

An additional concern arises from linking the QRM definition, now and in the future, to the CFPB's "qualified mortgage" definition. As a result of that linkage, the QRM definition will be subject to change over time at the sole discretion of just one agency—the CFPB—and it may not always be reflective of what the particular agencies involved in this rulemaking may deem appropriate.

For these reasons, today's rules mandate a periodic review of the QRM definition—four years after the effective date of this final rule, and every five years thereafter. Additionally, any of the agencies who participated in this rulemaking can request a review of the QRM definition at any time. I view this oversight responsibility as an important check to make sure that the QRM definition will continue to be appropriate in the face of the inevitable changes of financial markets, and other unpredictable and unforeseen developments. It is also important that the SEC, as the only agency involved with the express mission of protecting investors, has the ability to unilaterally request a review of the definition. Accordingly, I expect for the Commission to actively monitor whether subsequent changes in mortgage and securitization practices, or in the CFPB's "qualified mortgage" definition itself, demand a reconsideration of the QRM definition. To that end, I have requested that the SEC staff provide periodic, and at a minimum, annual reports to the Commission regarding whether the QRM definition in force is consistent with the protection of investors and otherwise consistent with the exemption that Congress intended.

Today's risk retention rules represent the culmination of a joint rulemaking involving six different federal agencies with different core missions. Not surprisingly, this has necessarily involved much deliberation and compromise along the way. Rulemaking at the SEC can be challenging enough with five Commissioners, and it becomes even more challenging when there are multiple agencies involved.

These rules are not perfect. I doubt any of my fellow Commissioners are completely satisfied and, as you will shortly hear, some Commissioners strongly object to today's rules. Nonetheless, after much consideration, I will vote to approve the rules being considered. These rules are an important step forward for investor protection and a robust securitization market. I note that it has been over 51 months since the Dodd-Frank Act mandated that the agencies adopt the risk retention rules, and over 41 months since the initial proposal. As a result, the resulting protections for investors and the markets have been unacceptably delayed. It is time to take action.

My support for today's risk retention rules is also informed by the fact that these rules are complimentary to the reforms that the Commission recently adopted to significantly revise the existing registration, disclosure, and reporting requirements for ABS offerings.[21] Those reforms, known as "Reg AB 2," should assist investors in asset-backed securities—whether backed by QRMs, or other assets—by requiring disclosure of key information so that investors have the information they require to assess whether the risk of such an investment is worth the payoff.

Unfortunately, the Commission's work in the ABS area is not complete. While the Commission has also taken action with respect to, among other things, mandating that ABS issuers conduct due diligence reviews on underlying assets, and adopting rules intended to increase the integrity and transparency of credit ratings,[22] it has yet to act on, among others, rules requiring issuers to provide asset-level information across other ABS asset classes, such as equipment loans and leases, student loans, and inventory financings.[23] I look forward to the Commission completing its work in this area.

In closing, I would like to thank the staff from the Division of Corporation Finance, the Division of Economic Research and Analysis, the Office of the General Counsel, and the other agencies, for their hard work on this rulemaking. I appreciate your dedication, and the important work you do to protect investors.

Thank you.

[1] *See* S. Rep. No. 111-176, at 128 (2010), *available at* http://www.gpo.gov/fdsys/pkg/CRPT-111srpt176/pdf/CRPT-111srpt176.pdf. The term "securitizer" refers to both the issuer of the ABS transaction or a person who organizes and initiates an ABS transaction by selling or transferring assets, including through an affiliate or issuer. Accordingly, the securitizer also could encompass what is sometimes referred to as a securitization sponsor or depositor. *See Credit Risk Retention,* SEC Rel. No. 34-73407, File No. S7-14-11 (Oct. 22, 2014), at 30-31 (hereinafter, "Credit Risk Retention Adopting Release"). These rules are mandated by Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), and require that the rules be jointly adopted by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Department of Housing and Urban Development, and the Securities and Exchange Commission.

[2] *See* Thomas M. Hoenig and Charles S. Morris, *Restructuring the Banking System to Improve Safety and Soundness* (Dec. 2012) (describing the "traditional banking model of making loans and holding them to maturity [to] earn profits from loan-deposit rate spreads.")*, available at* https://www.fdic.gov/about/learn/board/restructuring-the-banking-system-05-24-11.pdf. *See also,* Vitaly M. Bord and João A. C. Santos, *The Rise of the Originate-to-Distribute Model and the Role of Banks in Financial Intermediation*, FRBNY Economic Policy Review (July 2012) (noting that banks historically used deposits to fund loans that they held on their balance sheets until maturity), *available at* http://www.newyorkfed.org/research/epr/12v18n2/1207bord.pdf; and Richard J. Rosen, *The impact of the originate-to-distribute model on banks before and during the financial crisis*, Federal Reserve Bank of Chicago (Nov. 2010) (referring to the "traditional model that combines originating a loan with holding it to maturity."), *available at* https://www.chicagofed.org/digital_assets/publications/working_papers/2010/wp2010_20.pdf.

[3] *See id.,* Vitaly M. Bord and João A. C. Santos, *The Rise of the Originate-to-Distribute Model and the Role of Banks in Financial Intermediation* (describing how banks replaced their traditional originate-to-hold model with the originate-to-distribute model, which was critical to the growth of the syndicated loan market)*. See also,* Richard J. Rosen, *The impact of the originate-to-distribute model on banks before and during the financial crisis, supra* note 2 (describing that "with the ['originate-to-distribute' ('OTD')] model, banks originate mortgages and then sell them off to be part of a securitization.").

[4] Securitization enabled lenders to, among other things, free up capital by moving capital intensive assets off their books. In addition, borrowers could benefit from the increasing availability of credit on terms that lenders may not have provided had they kept the loans on their balance sheets. *See Asset Securitization, Comptroller's Handbook*, Comptroller of the Currency (Nov. 1997), at 4, *available at* http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/assetsec.pdf*. See also, Credit Risk Retention Adopting Release, supra* note 1, at 429 (stating that "[a]sset-backed securitizations play an important role in the creation of credit by increasing the amount of capital available for the origination of loans and other receivables through the transfer of those assets—in exchange for new capital—to other market participants.")

[5] *See* S. Rep. No. 111-176, *supra* note 1, at 128 (stating that "under the 'originate to distribute' model, loans were made expressly to be sold into securitization pools, which meant that the lenders did not expect to bear the credit risk of borrower default. This led to significant deterioration in credit and loan underwriting standards, particularly in residential mortgages."). *See also, Credit Risk Retention Adopting Release, supra* note 1, at 430 (stating that "many observers claim that the 'originate-to-distribute' model underlying securitization for some asset classes contributed to the onset of the financial crisis.").

[6] *See id.,* S. Rep. No. 111-176, at 128 (quoting testimony of Dr. William Irving, who stated that "intermediaries found a way to lend money profitably without worrying if the loans were paid back. … So long as there were willing buyers, this situation created enormous incentive to originate mortgage loans solely for the purpose of realizing that up-front intermediation profit.").

[7] *See The Financial Crisis Inquiry Report, The Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, submitted by The Financial Crisis Inquiry Commission (Jan. 2011) (hereinafter, "The Financial Crisis Inquiry Report"), at xxiii-xxiv, *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

[8] *See id., The Financial Crisis Inquiry Report, The Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, at xxiv. *See also,* Sergey Chernenko, Sam Hanson, and Adi Sunderam, *The Rise and Fall of Securitization* (Dec. 2013), *available at* http://www.people.hbs.edu/shanson/ABS_2013-12-19.pdf*;* S. Rep. No. 111-176, at 28, *supra* note 1; João Santos, *The Rise of the Originate-to-Distribute Model and the Role of Banks in Financial Intermediation*, Liberty Street Economics (July 17, 2012), *available at* http://libertystreeteconomics.newyorkfed.org/2012/07/the-rise-of-the-originate-to-distribute-model-and-the-role-of-banks-in-financial-intermediation.html#.VEPu7awpAZ4 *.*

[9] *See* United States Senate, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, Majority and Minority Staff Report, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*, at 5-7, 263-67 (Apr. 13, 2011) ("PSI Report"), *available at* http://www.hsgac.senate.gov//imo/media/doc/Financial_Crisis/FinancialCrisisReport.pdf?attempt=2.

[10] *See Credit Risk Retention Adopting Release, supra* note 1, at 24. In particular, sponsors are permitted to retain credit risk in several flexible forms, including through holding a "horizontal" interest in a "first loss" position, a "vertical" slice of each class of ABS interests of the issuing entity, or a combination of both. *See id.,* at 25.

[11] *Id., Credit Risk Retention Adopting Release,* at 7 and 42.

[12] *See*, 15 U.S.C. § 78o-11(c)(1)(C)(iii), (4)(A) and (B). The statute directs the agencies to define QRM jointly, taking into consideration underwriting and product features that indicate a lower historical risk of default, provided that the definition of QRM shall be "no broader than" the definition of "qualified mortgage" (or QM), as that term is defined by the Consumer Financial Protection Bureau ("CFPB") under the Truth in Lending Act. 15 U.S.C. § 78o-11(c)(1)(C)(iii); § 78o-11(e)(4). Congress directed that these underwriting and product features include, for example, documentation and verification of the financial resources relied upon to qualify the borrower, and prohibiting or restricting the use of balloon payments, negative amortization, prepayment penalties, and interest-only payments, and other features that have been demonstrated to exhibit a higher risk of borrower default. *See id*.

[13] *Credit Risk Retention Adopting Release, supra* note 1, at 23-24, 355-356. These statutory goals and directives include minimizing credit risk, preserving access to affordable credit and reducing compliance burden. *Id.,* at 356. In addition to the QRM exemption, and at Congress' direction, today's rules provide reduced risk retention requirements for certain qualifying commercial real estate loans and commercial or automobile loans, provided, however, that certain disclosures are made and that certain robust underwriting and other eligibility requirements are met. For example, qualifying commercial loans are required to meet specific debt service coverage ratio and leverage ratio thresholds, while qualifying automobile loans are required to have debt-to-income ratios no higher than the designated maximum amount of 36%. *See id.,* at subpart D., section .16 and section .18. These strict underwriting and other eligibility requirements are important for investor protection because they incorporate specific terms that are historically associated with very low credit risk in these asset classes. See *Credit Risk Retention, Proposed Rule*, SEC Rel. No. 34-70277, File No. S7-14-11 (Aug. 28, 2013) ("Credit Risk Retention Re-Proposal"), at 23, *available at* http://www.sec.gov/rules/proposed/2013/34-70277.pdf. Furthermore, to be eligible for these reduced risk retention requirements, sponsors must agree to take steps to ensure that any assets that are found not to

meet the specifically-tailored underwriting requirements subsequently meet such requirements, or otherwise repurchase these assets out of the pool. *See Credit Risk Retention Adopting Release, supra* note 1, at subpart D., sections .16 through.18.

[14] In fact, the CFPB adopted its "qualified mortgage" definition effective earlier this year for a different, albeit worthwhile, purpose: to prescribe underwriting requirements and certain loan features that, if followed, would presume that a lender made a good faith and reasonable determination of a borrower's ability to repay such loans. *See* preamble to *Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act (Regulation Z)*, CFPB-2011-0008; CFPB-2012-0022 (Jan. 10, 2014), at 4-5, *available at* http://files.consumerfinance.gov/f/201301_cfpb_final-rule_ability-to-repay-preamble.pdf. Unfortunately, whether a borrower has the presumed capability to repay his or her loan is not exactly the same as whether that loan has a high likelihood of serious delinquency or default. For example, a borrower at origination may be financially capable of paying off a mortgage, but if the loan requires no down payment and the mortgage secures a second home, the borrower may be less willing to pay down a mortgage if his or her life is unexpectedly interrupted by a medical emergency or job displacement.

[15] *Credit Risk Retention Adopting Release, supra* note 1, at 358 (stating that "[c]onsistent with these statistical models, historical data indicate that borrowers with mortgages that meet the QM criteria have lower probabilities of default than those with mortgages that do not meet the criteria.")

[16] *See,* for example, the QM requirement for lenders to consider and verify consumer's income and assets, including employment status if relied upon, and current debt obligations, mortgage-related obligations, alimony and child support. CFPB *Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z)*, *supra* note 14; *see also, Credit Risk Retention Adoption Release, supra* note 1, at 357.

[17] For example, the QM requirement that a loan have no negative amortization, interest only or balloon features. *See Credit Risk Retention Adoption Release, supra* note 1, at 357. *See also,* the QM requirement that total points and fees may not exceed 3% of the total loan amount (or alternative amounts for small loans up to $100,000). CFBP *Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), supra* note 14.

[18] *See* CFPB *Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z)*, at 32.

[19] *See Credit Risk Retention Adopting Release, supra* note 1, at 357 (noting that "[t]he final definition of QRM does not incorporate either an LTV ratio requirement or standards related to a borrower's credit history, such as those in the alternative QM-plus approach discussed in the reproposal. As the agencies explained in the reproposal, although credit history and LTV ratio are significant factors in determining the probability of mortgage default and are important aspects of prudent underwriting, on balance, the agencies believe policy considerations weigh in favor of aligning QRM with QM at this time."). *See also,* Comment Letter from Dennis M. Kelleher, President & CEO and Stephen W. Hall, Securities Specialist, Better markets, Inc. (Oct. 30, 2013) (stating that "t]he original proposal would have included, among other features, a loan-to-value ratio requirement as well as credit history restrictions, both of which would have substantially reduced the delinquency rate for QRM loans and vastly improved their quality."), *available at* https://www.bettermarkets.com/sites/default/files/FDIC,%20FHFA,%20FRS,%20HUD,%20OCC,%20SEC-%20CL-%20Credit%20Risk%20Retention-%2010-30-2013.pdf. *See also,* Joshua White and Scott Bauguess, Division of Economic and Risk Analysis (DERA), U.S. Securities and Exchange Commission, *Qualified Residential Mortgage: Background Data Analysis on Credit Risk Retention* (August 2013) ("DERA QRM White Paper") (noting that a borrower's FICO score (as a proxy for their credit history) or combined loan-to-value ratios have been shown to have a much stronger correlation to historical loan performance or loan default propensity than debt-to-income ratio, which is a metric used in the CFPB's "qualified mortgage" definition.), *available at* http://www.sec.gov/divisions/riskfin/whitepapers/qrm-analysis-08-2013.pdf.

[20] The Division of Economic and Risk Analysis specifically found in its DERA QRM White Paper that "higher FICO scores and lower [combined loan-to-value ("CLTV")] ratios are associated with significantly lower levels of serious delinquency, both statistically and economically." *See* DERA QRM White Paper, *supra* note 19, at 17. In fact, the DERA analysis also found that "historical performance among loans securitized into private-label RMBS that originated between 1997 and 2009 shows that those meeting the QM standard sustained exceedingly high serious delinquency rates, greater than 30 percent during that period." *See Credit Risk Retention Adopting Release*, *supra* note 1, at 551. In addition, the Credit Risk Retention Adopting Release notes that by aligning the definition of QRM to QM, the agencies allow "for securitizations exempt from the requirement of risk retention that include loans with low down payment and loans without down payment or borrower credit history requirements. … By exempting from the risk retention requirement securitizations comprised of loans with characteristics that historically have been indicators of a higher probability of mortgage default, the same economic incentives for the originate-to-distribute model that existed prior to the onset of the financial crisis may persist." *See id.* at 559.

[21] *See Asset-Backed Securities Disclosure and Registration,* SEC Rel. No. 33-9638 (Sept. 4, 2014), *available at* http://www.sec.gov/rules/final/2014/33-9638.pdf. In fact, the Commission adopted these rules, known as "Reg AB 2," less than two months ago to address a significant structural flaw in the securitization process: the inability of ABS investors to accurately assess the risk of the underlying assets, particularly when those assets were securitized into increasingly complex and opaque instruments. The Reg AB 2 rules provide investors with additional tools to conduct careful due diligence on ABS collateral, primarily by requiring asset-level disclosures. *See id.*

[22] *See Issuer Review of Assets in Offerings of Asset-Backed Securities,* SEC Rel. No. 33-9176 (Jan. 20, 2011), *available at* http://www.sec.gov/rules/final/2011/33-9176.pdf); and *Nationally Recognized Statistical Rating Organizations,* SEC Rel. No. 34-72936 (Aug. 27, 2014), *available at* http://www.sec.gov/rules/final/2014/34-72936.pdf). Additional Commission actions to reform the ABS market include: (i) final rules requiring securitizers to disclose fulfilled and unfulfilled repurchase requests, and requiring nationally recognized statistical rating organizations (NRSROs) to include information on warranties and enforcement mechanisms in ABS credit rating reports (*Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act,* SEC Rel. No. 33-9175 (Jan. 20, 2011), *available at* http://www.sec.gov/rules/final/2011/33-9175.pdf); and (ii) proposed rules to implement Section 621 of the Dodd-Frank Act by prohibiting material conflicts of interest between those who package and sell asset-backed securities and those who invest in them (*Prohibition against Conflicts of Interest in Certain Securitizations*, SEC Rel. No. 34-65355 (Sept. 19, 2011), *available at* http://www.sec.gov/rules/proposed/2011/34-65355.pdf; comment period extended, *Prohibition Against Conflicts of Interest in Certain Securitizations*, SEC Rel. No. 34-66058 (Dec. 23, 2011), *available at* http://www.sec.gov/rules/proposed/2011/34-66058.pdf).

[23] *See Asset-Backed Securities,* SEC Rel. No. 33-9117 (Apr. 7, 2010), at 10, *available at* http://www.sec.gov/rules/proposed/2010/33-9117fr.pdf. In addition, the Commission has other outstanding regulatory proposals in the ABS space, including the following: (i) requiring issuers to provide the same disclosure for ABS issued pursuant to private offerings and resold under Rule 144A, as is required for registered offerings; (ii) requiring the filing of a "waterfall" computer program that models the contractual cash flow provisions of ABS; and (iii) requiring that transaction documents be filed, in substantially final form, by the date the preliminary prospectus is required to be filed. *See id.*

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