Dissenting Statement of Commissioner Daniel M. Gallagher Concerning Adoption of Rules Implementing the Credit Risk Retention Provisions of the Dodd-Frank Act

Commissioner Daniel M. Gallagher

Oct. 22, 2014

Thank you, Chair White. Before I begin, I'd like to extend my thanks to the staff from the Commission's various divisions and offices that worked so diligently on today's release.

Today could have been the day when the Commission and its regulatory partners in this Dodd-Frank Act-mandated rulemaking stood strong, resisted political and special interest group pressure, and courageously seized this golden opportunity to address the failed federal housing policy that was one of the central causes of the financial crisis by creating a meaningful, robust standard for "qualified residential mortgage," or QRM.[1]

Regulators are often pilloried for fighting the last war instead of planning for the next. Today's rulemaking takes the untenable housing policy that injected irrational exuberance into mortgage lending and, as a result, caused a catastrophic financial crisis and chisels that failed policy into the stone tablets of the Code of Federal Regulations. In other words, it manages to take the policies that *lost* the last war and adopt them as the government's preparation to win the next.

The Dodd-Frank Act very rarely provides the SEC with an opportunity to deal with the actual causes of the financial crisis.[2] As I made clear in my dissent to last year's re-proposing release for this rulemaking, I do not believe that the federal government should be dictating prescriptive risk management standards, as the rules adopted today will do for mortgage securitizers.[3] Despite these misgivings, if it prevented adoption of the QRM standard being approved today, I would have voted to adopt the *original* 2011 proposing release with its firm, thoughtful definition of "qualified residential mortgage" or, in fact, the 2012 re-proposal had the agencies chosen to adopt the strong and meaningful *alternative* definition of qualified residential mortgage it set forth. The definition of QRM, which the agencies have disgracefully abdicated to the Consumer Financial Protection Bureau by linking it to their definition of "qualified mortgage," is sure to become the key standard by which federal housing policy will be shaped for as long as today's unfortunate final rule stands. Had it instead been defined in a manner which would have restored the sanity that has long been absent from federal housing policy, it would have been so great a victory for American taxpayers that I would have been willing to look past my natural objections to the rulemaking mandate and cast an affirmative vote. Needless to say, it was not so defined, and my vote is an unconditional no. Of the many dissenting votes I have had to cast over the last three years, this one hurts the most given the dire consequences that I believe will result from today's vote.

The Commission rightfully joined the other agencies in voting to issue the 2011 proposing release and its meaningful standards for QRMs. As with any proposal to substantively reform a fundamentally cronyistic system, however, the blowback was fierce. All regulatory agencies, of course, should always take great care to review and address the comments that we request in any rulemaking, making changes to proposed rules based on the new information and perspectives that the comment letters provide.[4] We should also, however, have the wisdom and courage to take into account the nature and motives of the commenters and the special interests that some of them represent. In other words, regulators working to adopt a final

version of a proposed Henhouse Protection Rule should not abandon their independent judgment by capitulating to the views imposed upon them by a barrage of letters sent in by the Feed the Foxes Foundation and their allies, no matter how many copied, form "comment" letters they receive.[5]

* * *

The Commission has often been accused in this new era of Dodd-Frank regulation of failing to adopt systemic risk as our mandate, an accusation tempered neither by the fact that we already have a tripartite mandate we are obligated to pursue nor by the fact, as I recently noted, that fulfilling our mandate to maintain fair, orderly, and efficient markets, facilitate capital formation, and protect investors is by far the best manner by which the SEC can contribute to the reduction of systemic risk.[6]

Today's rulemaking on "risk" reinforces the conclusion that the SEC should not succumb to political pressure by refocusing its mandate on systemic risk. Systemic risk regulation, in practice, seems to consistently involve making private markets suffer in favor of constantly enhancing government authority and intervention. The present rulemaking, consistent with that interpretation, will ensure that the currently suffocating private mortgage market will continue to be stagnant or finally die off in favor of ensuring that the overwhelming majority of mortgages will be owned or guaranteed by the same federal housing agencies that led the country down the path to destruction over the past several decades. The awfulness of today's rulemaking makes the oft-discussed issue of GSE reform all the more important, and I for one hope that legislation such as Chairman Jeb Hensarling's PATH Act[7] will make it to the President's desk in the next Congress.

It is time for this Commission to declare that it is no longer willing to play the frog to the prudential regulators' scorpion. We are increasingly called upon to cross the river with them on our back by going along with their ideas, only to have them sting us halfway to the opposite shore, drowning us both. The Volcker Rule, for example, is yet another terrible idea implemented through a torturous joint rulemaking process, already causing chaos in the financial world despite the compliance date being nine months away while doing nothing to make our financial system safer. Today's rule, in some ways, is even worse, given that we had in place a 2011 proposing release that would have implemented an unfortunate Dodd-Frank mandate in a manner that would at least establish some level of sanity in our mortgage markets by adding a QRM label that had meaningful requirements and would set a new standard for mortgage lending.

Instead, we are not only reverting to the meaningless standards of the past but also placing a new government imprimatur on mortgages that meet those low standards. By applying the government's QRM label—with its unambiguous declaration that a loan is "qualified"—to virtually any residential mortgage, we render the new standard meaningless at best, deleterious at worst.[8] It was securitizations of what we called subprime RMBS carrying triple-A ratings from credit rating agencies implicitly endorsed by the government as "nationally recognized statistical rating organizations" that played a major role in the last crisis. For the next, there won't even be the "subprime" moniker to dissuade investors from purchasing securitizations of low-quality loans. Instead, residential mortgages with zero percent down and weak loan-to-value ratios that in the past would have been called subprime will now carry the same "quality" endorsement from the government as solid mortgages with significant down payments and strong LTV ratios. When every mortgage is labeled as "qualified," investors should assume none really will be.

I have been severely disappointed with the process for this joint rulemaking, which minimized almost to the point of eradication the ability of individual Commissioners to have their voices heard. It's fitting, then, that the failures of this process continued right up to the present voting stage. I note, in particular, the impropriety of one of the rulemaking agencies releasing a full public copy of the adopting release before any of the other agencies had voted on the rule.

There isn't much more to say that I haven't already said in my dissent to the re-proposing release or in public fora over the past year.[9] I note that the final rule includes a new provision mandating periodic review of the QRM definition, inserted at the insistence of this agency. While I appreciate this effort to at least partially address the disastrous consequences that could arise from the sheer folly of abdicating the definition of QRM to the CFPB for perpetuity, the history of this rulemaking does not give cause for

optimism. The alternative definition of QRM set forth in the re-proposing release appears now to have been nothing more than a fig leaf reluctantly introduced as a concession to the SEC by its fellow participants in the joint rulemaking. As far as I was able to discern in my limited capacity as a mere Presidentially-appointed voting member of one of the agencies party to this rulemaking—which is admittedly not much, given the extremely opaque nature of the negotiations that allowed individual Commission members no voice or even access to the deliberations—at no point was that alternative definition seriously considered for the final rule. Similarly, it would be downright Pollyannaish to expect the agencies that had to be persuaded to even include the review mechanism in the final rule to take the requirement seriously. Certainly nothing over the course of this or indeed of any of the mandated joint Dodd-Frank rulemakings leads to optimism on that front.

This rulemaking process marked a crossroads in our long, ongoing Dodd-Frank implementation process, a rare opportunity to address a genuine cause of the last financial crisis and perhaps set the tone for the implementing rulemakings still to come. When two roads diverged in a wood, one representing the standard, well-trodden path of kowtowing to special interest groups and politics, the other a courageous, rarely taken path of doing the right thing despite the pressure to fall in line with the loudest lobbyists, the agencies, including the Commission, took the one far, far more travelled by. And when the histories of the next financial crisis are written, that, I'm afraid, will prove to have made all the difference.[10]

With sadness but no longer any surprise, I dissent.

[1] This could have been an historic moment in which a group of federal agencies banded together to do what was right for the American people and our economy regardless of outside pressure. Instead, to put today's rulemaking in context, imagine that the Second Continental Congress had chosen to put a draft Declaration of Independence — which we can think of as a sort of inter-colony joint rulemaking — out for notice and comment only to be denounced by the Loyalist lobby, which throughout the summer of 1776 attacked the document and the Congress for their QRM, that is, "quixotic revolutionary movement," policy. Imagine further that the Congress, cowed into submission by the shocking realization that an entrenched pro-English special interest group disagreed with its pro-independence policy, reversed its stance and re-proposed, and ultimately adopted, a re-titled Declaration of Some Minor Concerns of the Colonists centered on a new QRM policy, in this case, "quiescent Redcoat mollification."

[2] For an excellent discussion of the false narratives of the crisis as well as a keen analysis of the factors that actually did lead to the crisis, *see* Wallison, Peter, *Bad History, Worse Policy: How a False Narrative about the Financial Crisis Led to the Dodd-Frank Act* (2013).

[3] Commissioner Daniel M. Gallagher, "Dissenting Statement of Commissioner Daniel M. Gallagher Concerning Re-Proposal of Rules Implementing the Credit Risk Retention Provisions of the Dodd-Frank Act" (Aug. 28, 2013), available at http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370539792762.

[4] It is worth noting that contrary to the Commission's standard practice, the adopting release fails to cite to any specific comment letters, instead consistently attributing a view to a "commenter" or "commenters" without citations. This practice exponentially increases the difficulty of attributing comments referenced in the release to individual commenters, in many cases making the task impossible. This, of course, makes it prohibitively difficult (or impossible) for readers to determine whether individual comments have in fact been addressed. This is, quite simply, an act of bad government.

[5] In contrast, the agencies chose *not* to make a number of reasonable, burden-reducing measures urged by commenters who did not distribute form letters to other market participants. For example, the Loan Syndications and Trading Association (LSTA), Secured Finance Industry Group (SFIG), and the Securities Industry and Financial Markets Association (SIFMA) submitted a joint letter in January 2014 (with LSTA submitting two follow-up letters in June and August 2014) detailing the ruinous effect the re-proposed rule would have on Open Market CLOs and proposing a new definition and exemption for "qualified CLOs" to mitigate the anticipated dramatic decrease in such CLOs. This suggested exemption would have applied to Open Market CLOs whose managers retained five percent of the CLO's equity and maintained a

subordinated compensation structure, among other meaningful requirements. *See* letter from the LSTA, SFIG, and SIFMA dated January 10, 2014; letter from the LSTA dated June 25, 2014; and letter from the LSTA dated August 27, 2014. This "squeaky wheel" approach to evaluating and addressing comment letters (*i.e.*, rewarding commenters for using individuals to bombard the agencies with a mountain of form letters, in this case over 10,000) distorts the rulemaking process and sets a terrible precedent for future rulemakings.

[6] *See* Commissioner Daniel M. Gallagher, "The Securities and Exchange Commission—The Next 80 Years: The 15th Annual A.A. Sommer Jr. Lecture on Corporate, Securities and Financial Law" (Oct. 16, 2014), available at http://www.sec.gov/News/Speech/Detail/Speech/1370543190122.

[7] Protecting American Taxpayers and Homeowners Act of 2013, H.R. 2767, 113th Cong. (2913).

[8] To quote the evil supervillain in *The Incredibles*, "*Everyone* can be super! And when everyone's super..." The supervillain chuckles evilly, before concluding, "*No one* will be." *The Incredibles* (Walt Disney Pictures/Pixar Animation Studios, 2004).

[9] *See, e.g.,* Daniel M. Gallagher and Michael S. Piwowar, Letter to the Editor, *Government Punts on Meaningful Mortgage Standards*, Wall St. J., Jun. 27, 2014 at A12. *See also* Alan Zibel and Andrew Ackerman, *Softened Mortgage Rule Advances*, Wall St. J., Jun. 11, 2014 at C2.

[10] *See* Frost, Robert, "The Road Not Taken," *Mountain Interval* (1916).

Last modified: Oct. 22, 2014