Remarks

by

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"Securitization, 'Skin-in-the-Game' Proposals, and Minimum Mortgage Underwriting Standards"

It is a pleasure to be here today to discuss key issues regarding the U.S. securitization market, in my case from a bank regulator's perspective. I don't need to tell this audience how deeply the securitization business has been shaken by the financial crisis, or how fundamentally the business could change from reform measures proposed or already taken by accounting standard setters, regulators, and legislatures – both here and abroad. Indeed, I believe we are at a crossroads: the collective decisions we make in the next year in an effort to reform and revitalize the securitization market will have profound consequences for consumer and business credit in the United States and abroad.

There is no question that changes are needed. Asset securitization played a significant role in the crisis, and nobody should think that we can just wait for the market to stabilize and then go back to business as before. But I hope we also recognize just how important securitization is to our economy. Done correctly, securitization helps consumers and businesses by increasing the availability of credit on terms that might otherwise be unavailable. Investors benefit from the greater variety of investment products and increased secondary market liquidity

that result. And originators are able to transfer some or all of the risks of ownership to parties more willing or able to manage them.

Moreover, the sheer size of the securitization market demonstrates how important this source of credit has been for the economy. For example, data from the Federal Reserve's Flow of Funds statistics show that securitization increased from four percent of credit provision in 1970 to about 30 percent by the end of 2008. However, originations of asset backed securities in the public and 144A markets were about $1 trillion lower in 2009 than they had been just three years earlier, before the financial crisis began. It is not realistic to think that our banking system, with loans of all kinds totaling about $6.5 trillion, could fully replace this decline in credit any time soon – for even during the bank lending boom of 2000 to 2006, the average annual increase in commercial bank loans was only about $350 billion per year.

In short, I believe we need a vibrant, credible securitization market to help fund the real economy going forward.

Regulatory Initiatives Affecting Securitizations

The challenge, therefore, is to revive securitization while guarding against the kinds of abuses that fueled the crisis, such as creating incentives for lax underwriting of underlying assets; opaque and overly complex asset pools; credit rating failures; inadequate risk capture in both accounting standards and regulatory capital; and breakdowns in disclosure. Indeed, I would argue that appropriate changes in these areas are <u>necessary</u> to revive securitizations, because they are necessary to make securitizations more credible to investors, and necessary to make regulators more comfortable about the risks assumed in the securitization process by regulated institutions.

In this context, however, I fully recognize the potential for counterproductive action – for swinging the pendulum too far in the accounting and regulatory response. If we do not appropriately calibrate and coordinate our actions, rather than reviving a healthy securitization market, we risk perpetuating its decline – with significant and long-lasting effects on credit availability.

Striking this balance will not be easy, especially given the number of important changes that have already occurred, and the number of important proposals that are on the table. These include the following, which are especially important for bank-sponsored securitizations:

- **First, changes to off-balance sheet treatment.** Financial Accounting Standards or "FAS" 166 and 167, which have already become effective, will make it more difficult for securitizers to move assets off their balance sheets, and related bank regulatory capital rules will also treat those assets as on-balance sheet – a topic I will return to later.
- **Second, "skin-in-the-game" risk retention proposals.** These are included in the House-passed financial services bill, the Senate Banking Committee's draft bill, and an FDIC proposal applicable to banks, discussed next.
- **Third, possible changes to the FDIC "safe harbor" for bank-sponsored securitizations.** The FDIC's longstanding agreement not to seek to void securitizations as the receiver of a failed bank – its so-called "safe harbor" rule – will only apply to bank-sponsored securitizations that occur before March 31st, unless that date is extended. In the meantime, the FDIC has asked questions and sought public comment in an Advance Notice of Proposed Rulemaking that suggests extending the safe harbor to securitizations that occur after March 31st – but only if they meet a

number of very specific conditions, such as risk retention of five percent; limits on the number of tranches in residential mortgage securitizations; detailed disclosure requirements; and compensation restrictions.

- **Fourth, increases to bank risk-based regulatory capital resulting from last July's changes to the Basel agreement.** These significant increases would apply to re-securitizations, such as collateralized debt obligations or CDOs; securitization positions held in the trading book especially, but also in the banking book; liquidity facilities for asset-backed commercial paper programs; and securitizations where the bank failed to do its own due diligence on external credit quality, relying instead exclusively on credit ratings. Bank regulators hope to implement these changes by rules that would take effect at the beginning of 2011.
- **Fifth, the Basel Committee's fundamental review of the securitization framework for Basel II.** A working group will make recommendations by mid-year as to whether further modifications are warranted.
- **And sixth, new required disclosures.** These are already required in connection with the accounting changes in FAS 166 and 167; others will be required by changes to the Basel agreement last July that will be implemented by rule this year; still others are expected by imminent proposed changes to the SEC's Regulation AB; and finally, legislative proposals included in the financial reform bills would also increase required disclosures.

These and other proposals could have a profound effect on the future of securitizations. As a result, I think it is imperative for all stakeholders in this process to weigh in with thoughtful

comments and constructive suggestions, including people in this room. Important changes are coming, and regulators and policymakers need the benefit of constructive input to act wisely.

Concerns with "Skin-in-the-Game" Proposals

In this spirit – in an effort to help generate some of this constructive input – I would like to discuss in more detail today some concerns I have with the risk retention or "skin-in-the-game" proposals that have received so much recent attention – and I'd like to suggest an alternative that I think would work better.

I certainly agree with the ultimate goal of skin-in-the-game proposals, which is to improve the underwriting quality of the loans being securitized. That is, if a securitizer retains a material risk of loss on securitized loans, then that organization will have a stronger incentive to ensure that the loans are soundly underwritten at origination, therefore better aligning the securitizer's risk with that of the investors purchasing the securitized assets. Few can debate how much the core problem of terribly underwritten loans, especially residential mortgages, critically impaired the securitization market; precipitated the financial crisis; and resulted in the record number of foreclosures that are now working their way through the real economy. Indeed, one critical lesson from the crisis is that not even the most clever financial engineering – from synthetic securitizations to CDOs squared – can compensate for the devastating problems arising from terrible underwriting. Unfortunately, the maxim "garbage in – garbage out" that is often used in the context of IT systems turned out to be just as true for securitizations.

But while lax underwriting is plainly a fundamental problem that needs to be addressed, mandatory risk retention for securitizers is an imprecise and indirect way to do that, and is by no means guaranteed to work. How much retained risk is enough? And what type of retained risk would work best – first loss, vertical slice, or some other kind of structure? More to the point,

there are significant accounting and regulatory capital issues here that arise from the recently issued standards and rules affecting the off-balance sheet treatment of securitized assets.

Let me explain. The accounting issue arises from FAS 166 and 167, which took effect on January 1 for most banks. These new standards eliminated the use of qualifying special purpose entities to achieve "true sales" of assets to move them off a securitizer's balance sheet. As a result, many previously securitized assets moved from off-balance sheet to on-balance sheet as of the beginning of this year. The new standards will also make it considerably more difficult in the future to structure securitization transactions to qualify as true sales to move assets off the balance sheet. Although the "control" test used in the new standards is not exactly the same as a "risk transfer" test, the results are conceptually similar. The assumption is that the more control the securitizer retains over assets after securitization, the greater the likelihood of ongoing exposure to risk of loss in the securitized assets, and the less likely it is that the risk of loss has adequately shifted to purchasers. As a result, the new accounting standards effectively require the books of securitizers to capture more ongoing risk from securitizations than the old standards. In general, we believe that this treatment is appropriate, given the number of times in the crisis that securitizers were effectively forced to bring securitized assets back on their balance sheets when credit quality problems emerged. Structured Investment Vehicles or SIVs and certain sizeable credit card securitizations provided two notable examples.

The related bank regulatory capital issue arises from the changes to the accounting standards. Under recently finalized revisions to capital regulations, the banking agencies will continue to track GAAP, and the recent changes to GAAP, in determining sales treatment for regulatory capital purposes. As a result, the previously securitized assets that return to bank balance sheets for accounting purposes will require risk-based and leverage capital for regulatory

purposes, and so will assets securitized in the future that fail to meet the new standard for leaving the balance sheet. Again, this result follows logically from our experience with securitizations in the financial crisis, in which it became apparent that risk had not been as effectively transferred from bank securitizers to investors as the previous capital rules had envisioned.

The OCC supports these accounting and regulatory capital changes because we believe they more appropriately align securitizations with risk. But they do raise fundamental and difficult questions. How can securitizations be structured in the future under the new rules to result in true sales, true risk-shifting, true off-balance sheet treatment, and appropriately lower regulatory capital charges? Will it be possible to move securitized assets off the balance sheet in a way that works economically for both securitizers and investors? And if not – if securitizations are much more often treated as "financings" rather than true sales – will it be possible to have a truly robust securitization market? There is a great deal of uncertainty about what the new accounting rules really mean in practice, and what particular factors will result in on-balance sheet treatment versus off-balance sheet treatment. Clarification of these rules will be critical going forward.

Let me return, now, to how these accounting and regulatory capital changes create a lurking problem with proposed "skin-in-the-game" requirements. The issue is this: where a securitizer retains a material risk of loss on loans transferred in a securitization, the new accounting and regulatory capital rules may require that <u>all</u> loans in the securitization vehicle be kept on the bank's balance sheet – not just the amount of risk required to be retained. This could significantly increase the regulatory capital charge for such securitizations. I should stress that there are no bright lines here; whether securitized assets will be treated as staying on the balance sheet will be a facts and circumstances judgment, based on a qualitative assessment of "control."

We don't yet know whether the mere fact of retention by itself will constitute such control, but it appears to be a distinct possibility. At a minimum, it appears that it will be a significant factor weighing against off-balance sheet treatment in a given transaction.

To the extent that true sale and off-balance sheet treatment really are important factors for re-starting a vibrant securitization market – and I suspect they are – an on-balance sheet result caused by a mandatory "skin-in-the-game" requirement would certainly be perverse. That is, a requirement intended to improve the securitization market by improving the quality and trustworthiness of underwriting could significantly curtail the number of securitizations that are actually done. And that, of course, could materially reduce the amount of credit available for housing or any of the other sectors that have traditionally benefited from securitization.

Directly Establishing Minimum Underwriting Standards

I think there is a better and more direct way to improve underwriting standards, at least for residential mortgages – and to do so not just for the benefit of securitization markets, but for all mortgages whether held or sold. Instead of going at the underwriting problem indirectly through "skin-in-the-game" requirements, why not attack it directly? If quality underwriting is the goal, then why not, as I've suggested in a previous speech,[1] establish minimum underwriting standards directly by regulation, at least for residential mortgages? Why not apply these standards to all mortgages, whether retained or securitized, so that there is an entirely level playing field? And in the context of securitizations, why not stipulate that if the standards were satisfied, there would be no need for skin-in-the-game requirements that could defeat true sale treatment of securitized assets?

We could do this.

[1] Dugan, John C. *The Need for Minimum Mortgage Underwriting Standards.* Address before the Special Seminar on International Banking and Finance, Tokyo, Japan. November 18, 2009. http://www.occ.gov/ftp/release/2009-143a.pdf

Bank and thrift regulators could establish minimum underwriting standards for all mortgages originated, purchased, or sold by banks, thrifts, and – very importantly – by all of their affiliates. The Federal Housing Finance Agency could ensure similar treatment for all mortgages purchased or accepted as collateral by Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. And the Federal Housing Administration, which already establishes minimum underwriting standards for U.S. government-guaranteed mortgages, could coordinate those actions with the other regulators.

If taken, these regulatory steps would apply to the vast majority of the mortgage market, but not quite all of it. In the context of financial reform, Congress could ensure these steps were taken by directing the different agencies involved to coordinate in setting minimum mortgage underwriting standards. And it could more directly reach the part of the mortgage market not currently subject to direct federal regulation – that is, unregulated mortgage originators and brokers – by subjecting them to the standards set by federal regulators, bolstered by an effective enforcement mechanism. And it could also consider going even further by making it unlawful for any person to sell or transfer a mortgage without representing that such standards were satisfied.

However it is done, it is critically important that comparable minimum standards be established for all loan originators providing similar products to similar classes of customers. It is also critically important that there be truly comparable levels of effective regulatory implementation by the various regulators. This would ensure a level playing field so that no market participant could end-run the regulatory process as happened during the crisis, especially via unregulated loan originators selling loans directly to securitizers.

What types of minimum standards am I suggesting? I would stick to the basic, core standards on which there is the clearest consensus. My list would include:

- Effective verification of income and financial information;
- Meaningful down payments;
- Reasonable debt-to-income ratios; and
- For monthly payments that increase over time, qualifying borrowers based on the higher, later rate, rather than the lower, initial rate.

Other standards could be included as well, but the ones I've listed strike me as crucial, at least in this sense: had they been in place for the last ten years, I am confident that we would have had nowhere near the problems we have had in the residential mortgage market. For example, without robust income verification, so-called stated income mortgages were rampant and allowed borrowers to qualify for loans they simply could not afford to repay unless house prices continued to climb. Requirements for meaningful down payments ensure that borrowers have their own "skin in the game," and will be less likely to put their significant investments at risk by taking on loans that they won't be able to repay. And the same result would be true for the other standards I've mentioned. Taken as a whole, these four standards would go a long way toward ensuring that mortgage loans are sound; likely to be repaid; less likely to lead to housing bubbles; and more likely to attract investors through the securitization process.

Indeed, this is one set of reforms that would be directly responsive to the very problems that precipitated the crisis.

Now, I do not mean to suggest that minimum underwriting standards are a panacea, or even that they would work as well for other asset classes as I think they would for mortgages. Other measures, including more robust disclosures, credit rating reform, and changes in

compensation practices all merit consideration by policymakers, and that process is underway. I do think, however, for the reasons I've discussed, that minimum underwriting standards should be strongly considered as an alternative to rigid skin-in-the-game requirements. Indeed, using such standards as an alternative is expressly contemplated by the skin-in-the-game legislative proposals in the House and Senate. And I want to emphasize that minimum mortgage underwriting standards also accomplish the fundamental consumer protection objective of assuring that borrowers do not take out mortgages that they cannot afford to repay. In sum, I hope this idea is fleshed out in more detail in the days and weeks to come.

Conclusion

Let me again emphasize in closing my firm belief that re-starting a more stable securitization market is very much in the interests of consumers, investors, and market participants. Regulatory changes are a necessary part of this process, and it is important that policymakers have the benefit of a robust public debate to inform their views as they move forward. Members of the American Securitization Forum are uniquely positioned to contribute to this debate, and I strongly encourage you to do so.

Thank you very much.