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## Defending Skin-in-The-Game: How Regulators Should Structure the Final Credit Risk Retention Rules for The Residential Mortgage Market

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# Defending Skin-in-The-Game: How Regulators Should Structure the Final Credit Risk Retention Rules for The Residential Mortgage Market\*

Vishal M. Mahadkar

## Abstract

Relaxed lending standards, lending without retaining residual risk, and financial engineering led to a large expansion of mortgage credit that resulted in the over-origination and over-leveraging of poor quality mortgage securities products in the years leading up to the 2008 financial crisis. The over-origination of these poor quality assets has been attributed to a lack of skin-in-the-game by the parties making lending and structuring decisions in the securitization chain. The proposed credit risk retention rules, promulgated pursuant to Section 941 of the Dodd-Frank Act, attempt to fix the flaws in the residential mortgage securitization process that led to the financial crisis by closely aligning the economic interests of parties in the securitization chain, namely by crafting the Qualified Residential Mortgage (“QRM”) safe-harbor to risk retention narrowly, and by prohibiting a securitizer from profiting off of a securitization pool that ultimately fails by establishing a premium capture cash reserve account. These proposed rules are currently under attack by a variety of commentators who seek to expand the definition of the QRM safe-harbor and ease other restrictions associated with the proposed rulemaking. This Comment examines the proposed credit risk retention rules as they apply to residential mortgages and considers responses to the rules from consumer advocates, politicians, trade groups, and financiers. In spite of the opposition to the proposed rules, this Comment urges regulators to maintain most elements of the proposed rulemaking, including the narrow QRM definition and restrictions on hedging because they attack certain crucial problems that contributed to the recent financial crisis. However, this Comment proposes a modification of the premium capture cash reserve account concept in a manner that would better encourage private label extension of safe credit.

**KEYWORDS:** Regulation, Credit, Mortgage, Markets, Housing

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\*J.D. Candidate, Fordham University School of Law, 2013; B.A., magna cum laude, Economics and History, Boston College, 2010. I thank Professor Susan Block-Lieb for encouraging me to write on this topic and for her feedback on the working drafts of this Comment. I am also grateful to Marc Zelina and Hannah Lee for helpful comments and conversations. I save my highest gratitude for my parents, Rani and Mohan, for all of their support. Any errors are my own.

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*Vishal M. Mahadkar\**

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## INTRODUCTION

On October 19, 2011, the Securities and Exchange Commission (“SEC”) filed a complaint alleging fraud against Citigroup for its role in structuring and marketing a collateralized debt obligation (“CDO”) that derived its value from subprime mortgages.<sup>1</sup> Although investors in the CDO lost hundreds of millions of dollars once the subprime bubble burst, it was alleged that Citigroup realized net profits of at least \$160 million for arranging the CDO.<sup>2</sup> Making matters worse, the complaint alleged that Citigroup selected and marketed \$500 million worth of the assets in the CDO without disclosing to investors that it had entered into short positions on those assets by purchasing credit default swaps (“CDS”), thereby placing its economic interests adverse to those of the investors in the CDO.<sup>3</sup> Citigroup entered into a settlement agreement with the SEC, agreeing to pay a \$285 million fine to squash the complaint, without admitting any wrongdoing.<sup>4</sup>

Similarly, on April 15, 2010, the SEC filed a complaint alleging fraud against Goldman Sachs for its role in marketing a CDO to

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1. Complaint at 1, *SEC v. Citigroup Global Mkts. Inc.*, 827 F. Supp. 2d 328 (S.D.N.Y. 2011) (No. 11 Civ. 7387 (JSR)).

2. *Id.* at 3.

3. *Id.* at 2.

4. *SEC v. Citigroup Global Mkts. Inc.*, 827 F. Supp. 2d 328, 330 (S.D.N.Y. 2011). The settlement agreement was initially rejected by The Honorable Jed Rakoff, United States District Court Judge for the Southern District of New York, “primarily because it included no admission by Citigroup of liability.” *SEC v. Citigroup Global Mkts. Inc.*, 673 F.3d 158, 161(2d Cir. 2012) (citing *SEC v. Citigroup Global Mkts. Inc.*, 827 F. Supp. 2d at 335). The Second Circuit, however, later granted a preliminary injunction, staying the proceedings in the District Court pending the outcome of the appeal on the merits, suggesting that Judge Rakoff erroneously rejected the settlement agreement. *Id.* at 168–69. To this date, the appeal of the District Court order is pending in the Second Circuit.

investors that derived its value from subprime mortgages.<sup>5</sup> Specifically, the complaint alleged that Goldman failed to disclose that a hedge fund with economic interests directly adverse to those of investors in the CDO played a significant role in selecting the assets that collateralized the CDO.<sup>6</sup> Investors in the CDO lost over one billion dollars while the hedge fund's CDS exposure to the CDO yielded a profit of approximately one billion dollars.<sup>7</sup> Goldman, which did not retain an economic interest in the CDO, collected \$15 million from the hedge fund for marketing the CDO to investors.<sup>8</sup> Goldman ended up paying a \$550 million fine to the SEC to settle this complaint without admitting any wrongdoing or liability.<sup>9</sup>

These two proceedings exemplify the flaws in the originate-to-distribute model of mortgage securitization that helped precipitate the 2008 financial crisis ("Financial Crisis"). Because the parties making lending and structuring decisions in the securitization chain were exposed to minimal credit risk on the underlying loans and received fees in proportion to the size of the deals they created, they were incentivized to cut as many deals as possible, which encouraged shady, and even predatory, lending and structuring practices.<sup>10</sup> This model led to the over-origination of trillions of dollars worth of poor quality residential mortgage-backed securities ("RMBS") products,<sup>11</sup> which, through financial engineering, infiltrated the balance sheets of many large financial institutions.<sup>12</sup> Once it became apparent that RMBS products and their derivative offspring, CDOs, were not investment-worthy, investors dumped these products en masse and financial institutions that

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5. Complaint at 1, SEC v. Goldman Sachs & Co., No. 10 Civ. 3229 (S.D.N.Y. Apr. 15, 2010).

6. *Id.* at 2.

7. *Id.* at 3.

8. *Id.*

9. See Consent Judgment at 1, SEC v. Goldman Sachs & Co., No. 10 Civ. 3229 (S.D.N.Y. July 14, 2010), 2010 WL 2779309.

10. TIMOTHY F. GEITHNER, FIN. STABILITY OVERSIGHT COUNCIL, MACROECONOMIC EFFECTS OF RISK RETENTION REQUIREMENTS 3 (2011), available at [http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20\(FINAL\).pdf](http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20(FINAL).pdf); see generally Susan Block-Lieb & Edward Janger, *Demand-Side Gatekeepers in the Market for Home Loans*, 82 TEMP. L. REV. 465, 465–70 (2009).

11. KATHLEEN C. ENGEL & PATRICIA A. MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE AND NEXT STEPS 38 (2011).

12. See, e.g., *id.* at 53–54.

over-invested in them were unable to borrow against them in the repurchase agreement (“repo”) markets, which led to the insolvency of many systemically important financial institutions.<sup>13</sup>

As the Financial Crisis demonstrates, when incentives are not aligned, securitization can cause significant harm to the economy.<sup>14</sup> Although mortgage related lawsuits have become legion in the wake of the Financial Crisis,<sup>15</sup> the fact that they may be settled for civil penalties without any admission of liability on the part of financial institutions,<sup>16</sup> arguably amounting to a slap-on-the-wrist,<sup>17</sup> years after helping to precipitate a financial crisis (of which the world has yet to recover), underscores the importance of taking prophylactic measures to reform the mortgage securitization market.

Requiring that originators or securitizers keep “skin-in-the-game,” and retain an economic interest in the securitization products packaged to investors—thereby aligning the interests of investors and intermediaries—is the focal point of the regulatory reform of securitization in the wake of the Financial Crisis.<sup>18</sup> According to U.S.

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13. See, e.g., Gary B. Gorton & Andrew Metrick, *Securitized Banking and the Run on Repo* (Nat’l Bureau of Econ. Research, Working Paper No. 15,223, 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1454939](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1454939).

14. See GEITHNER, *supra* note 10, at 4.

15. See e.g., Consent Order at 4–5, 14–18, *United States v. Wells Fargo Bank, N.A.*, No. 12 Civ. 1150 (D.D.C. July 12, 2012), available at <http://www.justice.gov/crt/about/hce/documents/wellsfargosettle.pdf> (stipulating that Wells Fargo pay \$175 million to settle complaint alleging discriminatory mortgage lending without admitting any liability or wrongdoing pending court approval); Press Release, Dep’t of Justice, Office of Pub. Affairs, Justice Department Reaches \$335 Million Settlement to Resolve Allegations of Lending Discrimination by Countrywide Financial Corporation (Dec. 21, 2011), available at <http://www.justice.gov/opa/pr/2011/December/11-ag-1694.html>; Jonathan Stempel, *U.S. Sues Bank of America over “Hustle” Mortgage Fraud*, REUTERS (Oct. 24, 2012, 7:15 PM), <http://www.reuters.com/article/2012/10/24/us-bankofamerica-fraud-lawsuit-idUSBRE89N17120121024> (discussing that United States sues Bank of America alleging that it caused taxpayers more than \$1 billion by selling toxic mortgage assets to Fannie and Freddie in a scheme known as the “Hustle”).

16. See *supra* notes 4, 9 and accompanying text.

17. See *SEC v. Citigroup Global Mkts.*, 824 F. Supp. 2d 328, 333–34 (suggesting that a \$285 million settlement agreement, which, after returning profits collected from arranging toxic CDOs, amounts to a \$95 million civil penalty, is “pocket change” that will do little to deter a “recidivist” entity as large as Citigroup).

18. Indeed, Representative Barney Frank considers the risk retention provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act to be the most important portion of the Act, which totals over 2000 pages. See Nicole Duran, *Barney*



Treasury Secretary Timothy Geithner, “[r]isk 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.”<sup>19</sup>

Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act<sup>20</sup> (“Dodd-Frank” or the “Act”) adds a new section 15G to the Securities Exchange Act of 1934, as amended (the “Exchange Act”) that generally requires intermediaries in the securitization chain to retain credit risk of the products they distribute to investors.<sup>21</sup> Specifically, the Act requires securitizers or originators of asset-backed securities (“ABS”) to retain not less than 5% of any asset unless that asset is a Qualified Residential Mortgage (“QRM”) or meets other safe harbor exemptions.<sup>22</sup> The Office of the Comptroller of the Currency (“OCC”), Board of Governors of the Federal Reserve System (“Board”), Federal Deposit Insurance Corporation (“FDIC”), U.S. Securities and Exchange Commission (“Commission”), Federal Housing Finance Agency (“FHFA”) and the Department of Housing and Urban Development (“HUD”) (the OCC, Board, FDIC, Commission, FHFA, and HUD, collectively, the “Agencies”) proposed rules to implement the credit risk retention requirements of Section 15G of the Exchange Act on April 29, 2011 (the “Proposed Rules” or “Proposed Risk Retention Rules”) that were open for public comment until August 1, 2011.<sup>23</sup>

The Agencies’ Proposed Rules prohibit a securitizer from profiting from structuring a RMBS or CDO unless investors in the same are paid

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*Frank Defends his Law*, THE DEAL PIPELINE (July 11, 2011, 5:01 PM), <http://www.thedeal.com/content/real-estate/frank-defends-his-law.php>.

19. GEITHNER, *supra* note 10, at 4.

20. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 941, 124 Stat. 1376, 1890–91 (2010).

21. 15 U.S.C.A. § 78o-11 (West 2012).

22. *Id.* § 78o-11(c)(1)(B)(i)(I), (II).

23. Credit Risk Retention, 76 Fed. Reg. 24,090 (proposed Apr. 29, 2011). The Proposed Rules total 274 pages, and include requests that commentators provide feedback on 174 questions, some of which contain multiple parts. As of this date, Federal Regulators report that the final QRM rules will not arrive until 2013. Justin T. Hilley, *Fed Regulators Confirm QRM Won’t Arrive in 2012*, HOUSING WIRE (June 6, 2012, 12:56 PM), <http://www.housingwire.com/news/fed-regulators-confirm-qrm-will-arrive-after-2012>. The rules will take effect, with respect to residential mortgages, one year after the final rules are published in the Federal Register and, with respect to all other classes of asset backed securities, two years after the final rules are published. *See* 15 U.S.C.A. § 78o-11(i).

off in full first.<sup>24</sup> Additionally, rule makers defined the QRM exemption to risk retention narrowly to ensure that originators or securitizers retain an economic interest in most mortgage loans—the policy makers anticipate that most mortgages would be non-QRM loans.<sup>25</sup> Rule makers believe that this is the best way to encourage safer underwriting standards, boost investor confidence, and restore the private market for mortgage securities products.<sup>26</sup>

The Proposed Rules have been met with opposition from an unlikely combination of financiers, mortgage brokers and consumer advocates who believe that the QRM exemption is too narrowly defined.<sup>27</sup> Generally, these commentators fear that the Proposed Rules ultimately will result in denying home ownership to low and middle income individuals and minorities.<sup>28</sup> Some financial analysts even suggest that the Proposed Rules may scare sponsors away from the mortgage-backed securities market altogether, thereby further freezing the market for private label home loans.<sup>29</sup> Other commentators, however, question whether risk retention does enough to guard against the dangers of securitization that caused the Financial Crisis.<sup>30</sup>

Part I of this Comment provides background on problems in the mortgage securitization chain that caused the Financial Crisis and what Dodd-Frank Act did to correct these flaws through Section 941. Part II examines the proposed credit risk retention rules and the definition of the QRM exemption to risk retention promulgated by the Agencies pursuant to Dodd-Frank Section 941. Part III analyzes the market impact of the Proposed Rules and public responses to the proposed rules from consumer advocates, financiers, and academics. Part IV makes recommendations ahead of final rulemaking. In particular, Part IV urges

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24. See *infra* Part II.A.2.

25. See Credit Risk Retention, 76 Fed. Reg. at 24,118.

26. See, e.g., Press Release, FDIC, Chairman Bair's Statement on Credit Risk Retention Notice of Proposed Rulemaking (Mar. 29, 2011), available at <http://www.fdic.gov/news/news/press/2011/statement03292011.html>.

27. See, e.g., Joe Adler, *Bankers, Consumer Groups Form Rare Alliance to Urge Risk Retention Easing*, AMERICAN BANKER (May 31, 2011), [http://www.americanbanker.com/issues/176\\_104/bankers-consumers-alliance-risk-retention-1038197-1.html?zkPrintable=1&nopagination=1](http://www.americanbanker.com/issues/176_104/bankers-consumers-alliance-risk-retention-1038197-1.html?zkPrintable=1&nopagination=1).

28. See *id.*

29. See, e.g., MARK ZANDI & CRISTIAN DERITIS, MOODY'S ANALYTICS, SPECIAL REPORT: REWORKING RISK RETENTION (2011), available at <http://www.economy.com/mark-zandi/documents/Reworking-Risk-Retention-062011.pdf>.

30. See Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 GEO L.J. 1177, 1256–58 (2012).

regulators to keep vital provisions of the Proposed Rules alive, including the narrow QRM and restrictions on hedging, but suggests a modification of the rule regarding the premium capture cash reserve account (“Premium Capture Account”) that would allow a securitizer to collect fees for arranging a successful securitization transaction more readily. It is hoped that these recommendations will best achieve the optimal balance between two goals: on the one hand, keeping securitization safe by closely aligning the financial incentives of the parties in the securitization chain and on the other, keeping private actors interested in arranging securitization transactions at competitive rates so that credit will be available to borrowers who are actually able to afford homes.

### I. PROBLEMS IN PRE-CRISIS MORTGAGE SECURITIZATION PRACTICE & THE DODD-FRANK RESPONSE

This Part provides a brief overview of the flaws in the mortgage securitization process that contributed to the Financial Crisis. This explanation is not exhaustive but is meant to provide background to help explain why Congress chose skin-in-the-game as a major component of mortgage securitization reform. This Part concludes with a discussion of the new Section 15G of the Exchange Act that Dodd-Frank creates and the rule making authority it vests upon regulatory agencies to enact skin-in-the-game regulations.

#### A. PRE-CRISIS SECURITIZATION: INTERMEDIARIES WIN, BORROWERS AND INVESTORS LOSE

The Senate Committee on Banking, Housing and Urban Affairs’ investigation into the Financial Crisis found that flaws in the securitization process were a major contributor to the crisis.<sup>31</sup> Loans were originated primarily to sell to securitization pools, which meant that underwriters bore little, if any, of the default risk of the loans they made to consumers.<sup>32</sup> Further, “loan originators, warehouse facilitators, security designers, credit raters, and marketing and product placement professionals all received fees for their part in helping to create and

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31. S. REP. NO. 111-176, at 128 (2010).

32. *See id.* at 43.

distribute securities.”<sup>33</sup> These fees were paid prior to the sale of the security to investors and increased in proportion to the size of the securitization.<sup>34</sup> Given the capital market demand for such securities, the originate-to-distribute model created incentives to originate as many mortgage loans as possible to maximize profits from fee collection.<sup>35</sup> Empirical research suggests that the expansion in mortgage credit to subprime borrowers was caused by an outward shift in the supply of mortgage credit by lenders (i.e., lax lending standards, abuses of intermediaries, demand from investors) rather than borrowers demonstrating greater income potential.<sup>36</sup>

Fee collection, without residual risk, ultimately drove mortgage originators to underwrite increasingly risky, and even predatory, mortgage loans.<sup>37</sup> Mortgage originators made suspect loans, such as “liar” loans—where borrowers’ documentation was not reviewed—and “ninja” loans—loans made without information on the borrower’s income, job, or assets.<sup>38</sup> Further, mortgage brokers were rewarded with yield spread premiums and additional fees for steering borrowers towards costlier subprime loans.<sup>39</sup> Originators then sold these loans to

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33. *Securitization of Assets: Problems and Solutions: Hearing Before the Subcomm. on Securities, Insurance and Investment of the S. Comm. on Banking, Hous., and Urban Affairs*, 111th Cong. 70 (2009) (testimony of Dr. William W. Irving, Portfolio Manager, Fidelity Investments).

34. *See id.*

35. *See id.*

36. *See* Atif Mian & Amir Sufi, *The Consequences of Mortgage Credit Expansion: Evidence from the U.S. Mortgage Default Crisis*, 124 Q. J. ECON. 1449, 1477–83 (2009), available at <http://qje.oxfordjournals.org/content/124/4/1449.full.pdf+html>.

37. Increased competition among mortgage originators has been linked to the erosion of underwriting standards that caused the Financial Crisis. Specifically, mortgage originators competed with one another for market share, which led to a race to the bottom in underwriting standards in order to originate as many loans as possible. *See* Michael Simkovic, *Competition and Crisis in Mortgage Securitization*, 88 IND. L.J. (forthcoming 2013), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1924831](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1924831) (arguing that mortgage lending was safer when competition was weaker and securitizers, rather than originators, monitored underwriting standards). *Accord* David Line Batty, *Dodd-Frank’s Requirement of “Skin In the Game” for Asset-Backed Securities May Scalp Corporate Loan Liquidity*, 15 N.C. BANKING INST. 13, 39 (2011) (suggesting that the incredible demand for securities products encouraged very risky lending decisions).

38. *See* Richard E. Mendales, *Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix It*, 2009 U. ILL. L. REV. 1359, 1397 (2009).

39. *See, e.g.*, ENGEL & MCCOY, *supra* note 11, at 21–32.

securitizers, who in turn packaged them to investors all over the world, paying little, if any, attention to the quality of the loans they were distributing.<sup>40</sup>

Without being forced to keep skin-in-the-game, securitizers, looking to satisfy virtually insatiable demand for AAA debt<sup>41</sup> and believing that diversification alone would lessen portfolio risk of such debt,<sup>42</sup> made increasingly complex re-securitization products, such as CDOs, CDO-squared, and CDO-cubed, which enabled them to pass any risk they retained in an ABS to investors.<sup>43</sup> ABS products are broken up into tranches, and tranches are paid sequentially from the most senior tranche to the most subordinate tranche.<sup>44</sup> Prior to the Financial Crisis, more senior tranches would receive the highest rating from ratings agencies whereas mezzanine or subordinate tranches generally received below investment-grade ratings.<sup>45</sup> In practice, securitizers ended up retaining a stake in the more subordinated tranches with below investment-grade ratings because of lack of investor demand for these “riskier” products.<sup>46</sup> This did not incentivize securitizers to monitor loan quality, however. Instead, to avoid retaining exposure to poorly rated subordinated tranches, securitizers would re-securitize the below investment grade tranches into new products, such as CDOs.<sup>47</sup> The CDOs would also pay out sequentially from the most senior to the most subordinate tranche and receive corresponding credit ratings even though the assets underlying the CDO may have been from below

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40. *See id.*

41. *See* Gorton & Metrick, *supra* note 13, at 9 (“[E]ssentially, there is not enough AAA debt in the world to satisfy demand, so the banking system has set out to manufacture the supply.”).

42. *See* Mendales, *supra* note 38, at 1389 (arguing that the CDO bust demonstrated that thousands of bad asset-backed securities pooled together are as toxic as any of them individually).

43. *See e.g.*, Gorton & Metrick, *supra* note 13, at 9–10 (explaining that each level of securitization brought an additional level of opacity with regard to what exactly was behind each tranche).

44. *See, e.g.*, Block-Lieb & Janger, *supra* note 10, at 471–72.

45. *See id.*

46. *See* Gorton & Metrick, *supra* note 13, at 10–11. Institutional investors, such as pension funds or mutual funds, are often only allowed to invest in investment grade securities or higher (typically A or higher). *See* Block-Lieb & Janger, *supra* note 10, at 471.

47. *See, e.g.*, ENGEL & MCCOY, *supra* note 11, at 51–52.

investment grade tranches in the initial ABS.<sup>48</sup> This allowed securitizers to parcel out the risk they retained in the riskiest tranches of an ABS to investors in the form of investment grade securities.<sup>49</sup> If securitizers were again forced to retain exposure on the more poorly rated CDO tranches, the process was repeated to make CDO-squares, and, in turn, repeated again to make CDO-cubes.<sup>50</sup>

The complexities of re-securitizations made it very difficult for investors to understand the quality of the assets they were purchasing.<sup>51</sup> Without originators or securitizers monitoring loan quality, they were reliant on credit ratings agencies to reveal the quality of the assets underlying the securitization products they purchased.<sup>52</sup> The ratings agencies were unable to fulfill this gate-keeping role.<sup>53</sup> Ratings agencies, like the securitizers themselves, had no required exposure to the products they rated and received fees from securitizers for rating products.<sup>54</sup> Contrary to their better judgment, credit ratings agencies gave risky ABS and risky re-securitization products that they knew were prone to high default rates investment grade ratings in order to generate future business from securitizers.<sup>55</sup> Whereas corporate debt rated Baa (the lowest investment grade rating) defaulted at a rate of 2.2% from 1983 to 2005, CDOs with the same credit rating defaulted at a rate of 24% from 1993 to 2005.<sup>56</sup> Such a differential in default rates between bonds of the same credit rating suggests that the pre-crisis securitization market could not regulate itself properly when the parties best able to

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48. *See id.* at 52–53.

49. *See id.*

50. *See id.* This is not to say that securitizers were per se setting up investors to fail. They believed that diversification, rather than monitoring the borrower's ability to repay, would protect investors from suffering systematic losses. This turned out to be false when all of the mortgages underlying these products were of poor quality. *See Mendales, supra* note 38, at 1389 (arguing that Criimi Mae's collapse after investing primarily in junior tranches of CDOs exemplifies that there is a limit to the extent to which diversification can make securitized products safe).

51. S. REP. NO. 111-176, at 128 (2010); *see also* GARY B. GORTON, SLAPPED BY THE INVISIBLE HAND: THE PANIC OF 2007 (2010) (emphasizing how difficult it is to pierce the veil of a CDO and learn exactly what lies beneath each tranche).

52. *See* Block-Lieb & Janger, *supra* note 10, at 472–75.

53. *Id.*

54. *Id.*

55. *See* ENGEL & MCCOY, *supra* note 11, at 51–56.

56. *See* Mendales, *supra* note 38 at 1396.

monitor the underwriting quality of securitization products did not keep skin-in-the-game.<sup>57</sup>

B. SECURITIZATION'S VOLATILE EFFECTS, OVERLEVERAGING AND  
IRRATIONAL ACTORS

The Financial Crisis demonstrated that if securitization is left unregulated, banks are susceptible to collapse because markets are unable to fully internalize the risks securitization can pose to financial and economic activity.<sup>58</sup> The Financial Crisis showed us that a localized real estate bust can threaten the solvency of the banking system due in part to financial interdependence and irrational actors.<sup>59</sup> Some financial economists argue that although the creation of safe securities is desirable, securitization and other financial engineering (dubbed in academic literature as “financial innovation”) expose the financial system to crisis.<sup>60</sup> A recent model of the Financial Crisis suggests that

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57. *Accord* Block-Lieb & Janger, *supra* note 10, at 472-73 (arguing that the RMBS market collapsed because the mortgage lending model shifted from an investment model to a sales model and credit rating agencies failed to value mortgage pools properly).

58. *See* GEITHNER, *supra* note 10, at 14 (“Taken as a whole, these problems illustrate that markets are unable, in certain circumstances, to align the incentives of parties in the securitization chain adequately. Moreover markets may not fully internalize the risks securitization can pose to financial and economic stability. Such weaknesses demonstrate the need for regulatory reforms.”).

59. *See, e.g.*, Block-Lieb & Janger, *supra* note 10, at 478-79 (discussing the cognitive limitations of consumer borrowers to make sound borrowing decisions as it relates to purchasing a home); Nicola Gennaioli et al., *Neglected Risks, Financial Innovation, and Financial Fragility* 29 (Nat’l Bureau of Econ. Research, Working Paper No. 16068, 2010), available at <http://www.nber.org/papers/w16068> (explaining that sophisticated institutions also may irrationally over-invest in a securities product). I do not endeavor to provide the full behavioral finance explanation in this space but a cursory discussion of a few root causes is warranted to put securitization reform into perspective.

60. *See, e.g.*, Gennaioli et al., *supra* note 59, at 39; Josh Lerner & Peter Tufano, *The Consequences of Financial Innovation: A Counterfactual Research Agenda* 5–10 (Nat’l Bureau of Econ. Research, Working Paper No. 16780, 2011), available at <http://www.nber.org/papers/w16780.pdf> (explaining the pros and cons of financial innovation); Jeremy Stein, *Monetary Policy as Financial-Stability Regulation*, (Nat’l Bureau of Econ. Research, Working Paper No. 16883, 2011), available at <http://www.nber.org/papers/w16883> (“This paper . . . defines the fundamental market failure to be addressed, namely that unregulated private money creation can lead to an

the creation of new and complex securities products (such as CDOs and CDSs) to satisfy investor demand creates a boom and bust tendency because investors, even sophisticated ones like financial institutions, are irrational,<sup>61</sup> tending to be initially overly optimistic about the investment prospects of new securities products.<sup>62</sup> This over-optimism manifests itself in both excessive origination of the underlying asset,<sup>63</sup> as well as excessive willingness of financial institutions to borrow and lend against the securitized assets on a short-term basis.<sup>64</sup> Once certain “neglected risks” of these products are realized, the market’s view towards them turns sharply: investors seek to dump these products, new issuance stops and the willingness to lend against these securities products as collateral (i.e., repo financing) deteriorates.<sup>65</sup>

This behavioral model of over-optimism followed by sharp pessimism helps to explain how subprime mortgage securitization precipitated the Financial Crisis. When subprime lending was at its peak, it “helped accelerate price increases in the housing market to unsustainable levels and, therefore, contributed to the ensuing decline in housing prices and the economy.”<sup>66</sup> A problematic feedback loop developed where increases in home prices encouraged greater lending and increases in lending precipitated further increases in home prices.<sup>67</sup> Increases in housing prices led to further investment in mortgage securities products and large financial institutions started to increasingly use these products to collateralize short-term borrowings (i.e., as collateral for repo agreements).<sup>68</sup> Trillions of dollars worth of subprime

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externality in which intermediaries issue too much short-term debt and leave the system excessively vulnerable to costly financial crises”).

61. The use of the term irrational investor in this context is meant as short-hand for the theory of “local thinking,” which describes a scenario where an investor makes investment decisions based on a subset of possible outcomes rather than taking into account all of the information the market has to offer, as the efficient market hypothesis assumes. *See* Gennaioli et al., *supra* note 59, at 5.

62. *See id.*; *see generally* Lerner & Tufano, *supra* note 60.

63. This over-origination is the product of both irrational investment decisions on the part of consumers and the failures of “demand-side gate keepers” to monitor loan quality. *See* Block-Lieb & Janger, *supra* note 10, at 475–83.

64. Gennaioli et al., *supra* note 59, at 2–3.

65. *Id.* at 3.

66. *See* GEITHNER, *supra* note 10, at 12 (citing Mian & Sufi, *supra* note 36, at 1477–83).

67. *See id.*

68. *See* Gorton & Metrick, *supra* note 13, at 1–2, 10–11. Prior to the crisis, investment banks, especially Lehman Brothers, Morgan Stanley, Merrill Lynch, and



securities products were created.<sup>69</sup> Later, when home prices began to decline and subprime mortgages began to default, investors sought to dump mortgage securities products en masse and the value of these securities products plummeted.<sup>70</sup> For banks that over-invested in these products or over-leveraged them, a “bank-run” ensued, whereby investors refused to finance banks’ short term debt by purchasing repo agreements,<sup>71</sup> including repos that were collateralized by safer securities, such as commercial paper.<sup>72</sup> The inability of financial institutions to finance their short-term debt through the repo market was a death sentence for Bear Sterns and Lehman Brothers,<sup>73</sup> and necessitated a government bailout for other Wall Street players through TARP. Further, demand for all securities products screeched to a halt, constricting the general flow of credit available to consumer borrowers.<sup>74</sup>

Left unregulated, securitization can be incredibly volatile. Although subprime defaults were fairly localized in the United States, the local

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Bear Sterns, and even commercial banks, such as Citigroup, J.P. Morgan, and Bank of America, relied heavily on the “repo” market for their short-term liquidity needs. A repo agreement is a two-part transaction that is primarily between a bank and an institutional investor. In the first step, a bank or borrower transfers securities, in exchange for cash, to a depositor or lender. The second step includes a contemporaneous agreement by the bank to repurchase the securities at a premium on a specified future date. The repo market collateralizes banks’ short-term borrowing with securities products and acts as a safe, deposit-like investment, for institutional investors or other entities. *See id.* at 10.

69. *See* ENGEL & MCCOY, *supra* note 11, at 38 and accompanying text.

70. *See* Gennaioli et al., *supra* note 59, at 2–3, 38.

71. *See id.* at 37–38.

72. *See id.*; *see also* Daniel M. Covitz, Nellie Liang, & Gustavo A. Suarez, *The Evolution of a Financial Crisis: Panic in the Asset-Backed Commercial Paper Market*, (Divs. of Res. & Statistics and Monetary Affairs, Fed. Reserve Bd., Working Paper No. 2009-36, 2009), available at <http://www.federalreserve.gov/pubs/feds/2009/200936/200936pap.pdf> (arguing that panic over the solvency of banking institutions led to contraction of demand for asset backed commercial paper securities, severely crippling banks’ ability to finance short-term debt).

73. *See, e.g.*, Gorton & Metric, *supra* note 13, at 1–2, 4, 10–11.

74. *See* GEITHNER, *supra* note 10, at 13 (noting that during the financial crisis the prices of other ABS, such as those backed by auto loans, credit cards, student loans, loans to businesses, and loans secured by heavy equipment, all fell dramatically and simultaneously).

default crises were parceled to investors all over the world.<sup>75</sup> At the time the government took over Fannie Mae and Freddie Mac, which had taken a severe beating by guaranteeing subprime loans, the two government-sponsored enterprises (“GSEs”) held half of the United States’ \$12 trillion residential mortgages.<sup>76</sup> Moreover, investors all over the globe, including foreign governments, held over \$ 5.4 trillion in debt securities backed by the GSEs.<sup>77</sup> Clearly, securitization had serious global macroeconomic consequences.

### C. THE GOVERNMENT’S ROLE

Financiers, mortgage brokers, irrational actors and the inherent volatility of securitization in well-integrated markets are not the only causes of the Financial Crisis. The government’s desire to push for the American (Pipe) Dream of homeownership also fueled the Financial Crisis.<sup>78</sup> The HUD affordable housing initiative under the Federal Housing Enterprises Financial Safety and Soundness Act<sup>79</sup> incentivized both government sponsored institutions, namely Fannie Mae and Freddie Mac, and private lending institutions to increase home ownership.<sup>80</sup> The easiest way of reaching HUD’s goals, especially among distressed communities, was to relax lending standards.<sup>81</sup> As a result, the use of “innovative lending standards to allow for the acceptances of loans of more than 97% [loan to value ratio (“LTV”)], of loans to those with impaired credit, high debt [to income] ratios, and questionable income potential” became more prevalent.<sup>82</sup> The Bush Administration went so far as to embrace subprime loans as the key to growth in homeownership, especially for minority Americans.<sup>83</sup> The initial consequence of the government’s desire to increase affordable housing was the lowering of underwriting standards of commercial

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75. See Mendales, *supra* note 38, at 1359; see also Mian & Sufi, *supra* note 36, at 1 (noting that subprime defaults were concentrated to a handful of zip codes).

76. See Dale A. Oesterle, *The Collapse of Fannie Mae and Freddie Mac: Victims or Villains?*, 5 ENTREPRENEURIAL BUS. L.J. 733, 733 (2010).

77. See *id.* at 734.

78. See, e.g., ENGEL & MCCOY, *supra* note 11, at 20–21; Oesterle, *supra* note 76, at 749–52.

79. 12 U.S.C. § 4501 (2006).

80. See Oesterle, *supra* note 76, at 749–52.

81. *Id.* at 750.

82. *Id.*

83. ENGEL & MCCOY, *supra* note 11, at 21.

mortgages to meet affordable housing goals.<sup>84</sup> However, the government's encouragement of lower underwriting standards eventually extended to all types of home loans.<sup>85</sup> Consequently, well-off borrowers and real estate speculators were able to take out risky high leveraged loans for second homes, retirement homes and vacation homes.<sup>86</sup> In the end, the originate-to-distribute model of lending, supported by the government's desire to increase home ownership, deteriorated underwriting standards for all home loans, and contributed to the Financial Crisis.<sup>87</sup> The government eventually stepped in and took over Fannie Mae and Freddie Mac and the private label mortgage-backed securities market has yet to recover.<sup>88</sup>

#### D. WHAT DODD-FRANK DID; SECTION 941

Through Dodd-Frank, Congress added a new Section 15G to the Exchange Act to correct the flaws in the securitization process discussed above, namely by reforming the originate to distribute model of securitization so as to align the economic interests of investors and intermediaries in the securitization chain.<sup>89</sup> Congress felt that credit risk retention would encourage securitizers to monitor carefully the loans they purchase from originators which, in turn, would, at the very least, create disincentives to risky and predatory lending.<sup>90</sup> In addition, the

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84. See Oesterele, *supra* note 76, at 749–52.

85. “Had the banks and Fannie and Freddie limited the loosening of their underwriting standards to CRA loans, the mortgage crisis would not have been a crisis. However the lowered underwriting standards infected all underwriting standards.” *Id.* at 751 (citing Edward Pinto, *How Did Paul Krugman Get it So Wrong?* (Nov. 9, 2009) (unpublished manuscript), available at <http://www.scribd.com/doc/22327819/Pinto-How-Did-Paul-Krugman-Get-It-So-Wrong-11-9-09>. See also Brent J. Horton, *In Defense of Private-Label Mortgage-Backed Securities*, 61 FLA. L. REV. 827, 881–82 (2009) (arguing that congressional initiatives to expand home ownership are at fault for precipitating the Financial Crisis).

86. See *id.*

87. See ENGEL & MCCOY, *supra* note 11, at 21.

88. Press Release, FDIC, *supra* note 26, at 3 (“[T]he private securitization market, which created more than \$1 trillion in mortgage credit annually in its peak years of 2005 and 2006, has virtually ceased to exist in the wake of the crisis. Issuance in 2009 and 2010 was just 5% of peak levels.”).

89. *Id.* at 1 (“Fundamentally, [Section 15G] is about reforming the ‘originate-to-distribute’ model for securitization, and realigning the interests in structured finance towards long-term, sustainable lending.”). See also S. REP. NO. 111-176, at 129 (2010).

90. See S. REP. NO. 111-176, at 128.

limited empirical research available<sup>91</sup> suggests that RMBS products are less likely to suffer losses when the economic interests of the parties in the securitization chain are aligned.<sup>92</sup>

As it pertains to residential mortgage securitization, Section 15G generally requires securitizers<sup>93</sup> to retain not less than 5% of any ABS unless *all* of the assets that comprise the securitization pool are qualified residential mortgages (QRMs)—that is, even if every mortgage but one in a securitization pool is a QRM, a sponsor would be required to retain at least 5% of an economic interest in the pool.<sup>94</sup> In particular, the legislation specifically prohibits a securitizer or its affiliates from directly or indirectly hedging against its required exposure to the products it securitizes, thereby keeping the interests between investor and intermediary closely aligned.<sup>95</sup> The legislation specifically requires regulators to specify permissible forms of risk retention,<sup>96</sup> define the

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91. See GEITHNER, *supra* note 10, at 17.

92. See Cem Demiroglu & Christopher James, *How Important is Having Skin in the Game? Originator-Sponsor Affiliation and Losses on Mortgage-backed Securities*, 25 REV. FIN. STUD. 3217 (2012), available at <http://rfs.oxfordjournals.org/content/early/2012/09/10/rfs.lhs095.full.pdf> (showing that default rates on securitized mortgages were lower when originators and securitizers were affiliated entities because an originator was less likely to sell poor quality assets to its own affiliate).

93. The legislation defines a “securitizer” as “(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.” 15 U.S.C.A. 78o-11(a)(3) (West 2012).

94. See *id.* § 78o-11(c)(1). Section 15G states that the Agencies must permit securitizers to retain less than 5% of the risk of commercial mortgages, commercial loans, and auto-loans if those loans meet underwriting standards that indicate that they are of low credit risk. *Id.* § 78o-11(c)(1)(B)(ii), (c)(2)(B). In addition, 15G creates an exemption for loans to farming entities, loans backed by the federal government, and loans backed by state governments. *Id.* § 78o-11(c)(G)(iii). The Agencies’ also have the authority to issue other exemptions, exceptions or adjustments for other classes of institutions or assets as appropriate. *Id.* § 78o-11 (e)(1). Enforcement authority under the statute (and related regulations) rests with the appropriate Federal banking regulator (e.g., the Board, OCC, FDIC) if the securitizer is an insured depository institution and the Securities and Exchange Commission if the securitizer is not an insured depository institution. *Id.* § 78o-11 (f).

95. *Id.* § 78o-11(c)(1)(A).

96. *Id.* § 78o-11(c)(1)(C)(i). Cognizant of the fact that different forms of risk retention may be warranted for different asset classes, Dodd-Frank gives the regulatory agencies flexibility in determining the scope and nature of how securitizers are to retain credit risk. S. REP. NO. 111-176, at 130 (2010). Section 15G authorizes regulators to craft risk retention rules and exemptions specifically tailored for asset classes other than residential mortgages, such as commercial mortgages, commercial loans, auto loans and

QRM, create a total or partial exemption for federally-issued or guaranteed ABS, create a total or partial exemption for state-issued or guaranteed ABS, and allow for the allocation of required risk retention to be split between a securitizer and originator.<sup>97</sup> In addition, the legislation gives regulators leeway to craft other safe harbor exemptions if appropriate for the protection of investors.<sup>98</sup>

Although Section 15G delegates defining the QRM to regulators, it is important to note that the ultimate definition of the QRM may be no broader than the definition of the Qualified Mortgage (“QM”), as defined in Title 14 of the Dodd-Frank Act.<sup>99</sup> Title 14 of the Act amends the Truth in Lending Act to empower the Board to set mortgage originating standards that would generally prohibit a lender from extending mortgage credit to a borrower unless the borrower demonstrates the ability to repay the loan.<sup>100</sup> Sections 1411 and 1412 of the Act generally require creditors to make a reasonable determination of a consumer’s ability to repay a residential mortgage loan as well as establish certain protections from liability under this requirement for

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any other asset class that the Board, OCC, FDIC and the SEC deem appropriate. *See* § 780-11(c)(2)(A). Some scholars argue that skin-in-the-game would not necessarily encourage safer underwriting standards for classes of asset-backed securities other than residential mortgages. *See generally* Batty, *supra* note 37 (arguing that skin-in-the-game would not necessarily make the market for collateralized loan obligations any safer); Joseph Philip Forte, *Risk Retention in CMBS Lending—Reality or Illusion*, SS047 ALI-ABA 1255, 1259 (2011) (arguing that risk retention by a securitizer is unnecessary in the market for commercial real estate loans because a third party purchaser of subordinate tranches adequately serves to monitor the loans underlying the CMBS); Adam J. Levitin, *Skin-In-The-Game: Risk Retention Lessons From Credit Card Securitization* (Georgetown University Law Center, Business, Economics and Regulatory Policy Working Paper Series Research Paper No. 11-18, 2011), *available at* [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1898763](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1898763) (arguing that risk retention plays a questionable role at best in incentivizing better underwriting quality in the market for credit card ABS because the market, in effect, polices itself through implicit recourse).

97. *See* 15 U.S.C.A. § 780-11(c)(1)(G)(ii) (West 2012).

98. *See id.* § 780-11 (c)(1)(B)(ii), (c)(2)(B).

99. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1412, 124 Stat. 1376, 2145 (2010).

100. 15 U.S.C.A. § 1639c(a), (b)(1) (West 2012). This section of the Truth in Lending Act was added pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1411, 124 Stat. 1376, 2142 (2010).

home loans that constitute “qualified mortgages.”<sup>101</sup> The Qualified Mortgage (“QM”) is not to be confused with the Qualified Residential Mortgage, the proposed rules for which are discussed at length in this Comment. The QM—the final rules of which were recently adopted—is the exemption that insulates a lender from liability for failing to comply with the ability to pay provisions under Dodd-Frank and regulations promulgated there-under by the Consumer Financial Protection Bureau (“CFPB”).<sup>102</sup> In contrast, the QRM is the exemption that allows sponsors to avoid retaining risk in a securitization transaction where the underlying assets in the pool are residential mortgages.<sup>103</sup> Although full discussion of the QM rules is beyond the scope of this Comment, at a minimum, a QM may not provide for (i) negative amortization, (ii) a balloon payment that is twice the average of earlier payments, (iii) total points and fees of more than 3% of the loan amount, and (iv) a mortgage term of more than thirty years.<sup>104</sup> Additionally, in the case of an adjustable rate mortgage, the underwriting for a QM must be based on the maximum rate for the loan during the first five years and a payment schedule that fully amortizes the loan over the loan term.<sup>105</sup> Because a QRM may not be defined more broadly than a QM, the QRM must, at a minimum, meet the above requirements.<sup>106</sup> The statutory language seems to imply that the QRM is supposed to be more narrowly defined than the QM. It is also interesting to note that the QM (unlike the

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101. *Id.* § 1639c(b)(2); *see also* Consumer Financial Protection Bureau, Press Release, “Ability to Repay and Qualified Mortgage Standards Under the Truth in Lending Act” (Regulation Z), *available at* <http://www.consumerfinance.gov/regulations/ability-to-repay-and-qualified-mortgage-standards-under-the-truth-in-lending-act-regulation-z/#doccontents>.

102. The final QM rules issued by the CFPB create two separate qualified mortgage safe harbors based on the credit risk of a mortgage loan. The lenders who make loans that conform with the safer of the two standards are insulated from liability entirely for making a good faith determination of a borrower’s ability to repay a loan, whereas lenders who make loans that conform to the riskier QM are afforded a rebuttable presumption of compliance with the ability to-repay provisions. *See Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act (Regulation Z)*, 78 Fed. Reg. 6407, 6586–87 (Jan. 30, 2013) (to be codified at 12 C.F.R. 1026.43(e)).

103. 15 U.S.C.A. § 78o-11(c)(1).

104. *See id.* § 1639c(b)(2)(A). There is an exemption for extending the mortgage term past thirty years in high cost areas. *See* § 1639c(b)(2)(A)(vii). Dodd Frank gives the Board the authority to treat a reverse mortgage as a QM and have the borrower’s debt-to-income ratio factor into the QM. *See* § 1639c(b)(2)(A)(vi), (ix).

105. *Id.* § 1639c(b)(2)(A)(v).

106. *Id.* § 1639c(b)(2)(A).

proposed QRM)<sup>107</sup> has no requirement of a down payment on the part of the borrower.<sup>108</sup>

**Table 1: Summary of 15 U.S.C. 78o-11 For  
Residential Mortgage-Backed Securities**

<p>Risk retention: What is set by statute</p>	<ul style="list-style-type: none"> <li>• Securitizer must retain 5% of the credit risk of an ABS unless <i>all</i> of the mortgages collateralizing a securitization pool are QRMs.</li> <li>• Issuer, Sponsor, or Depositor (as applicable) may not directly or indirectly (i.e., an entity affiliated with the issuer, sponsor or depositor may not) hedge against its 5% required interest in an ABS by purchasing CDS or insurance contracts.</li> <li>• QRM must fit within the definition of the QM as defined under Title 14 of Dodd-Frank (which amends the Truth In Lending Act).</li> <li>• No reverse mortgages or interest only payments.</li> <li>• For adjustable rate mortgages, interest rate may not increase by more than 2% in any twelve-month period or by 6% over the life of the transaction.</li> <li>• Total or partial exemption for ABS backed by state or federal government.</li> </ul>
<p>What is left up to regulators to decide</p>	<ul style="list-style-type: none"> <li>• The form risk retention takes (i.e., how does a securitizer retain a 5% stake in an ABS).</li> <li>• The narrowness of the definition of QRM (but no broader than the definition of QM).</li> <li>• The minimum duration of Risk Retention.</li> <li>• Must establish appropriate standard of risk retention for re-securitization products.</li> <li>• Scope of exemption for ABS backed by state or federal government.</li> </ul>

107. See *infra* Part II.B.6.

108. Clea Benson, *Housing Industry Awaits Down-Payment Rule for Mortgages*, BLOOMBERG, (Jan. 18, 2013, 12:01 AM) (noting that the QM fell short of requiring a down payment requirement), available at <http://www.bloomberg.com/news/2013-01-18/housing-industry-awaits-down-payment-rule-for-mortgages.html>.

## II. THE PROPOSED RMBS RISK RETENTION RULES AND QRM SAFE-HARBOR

On April 21, 2011, the Agencies released proposed rules on credit risk retention, as required by Section 15G.<sup>109</sup> This section provides an overview of the risk retention rules, highlights a few important rules that will change economic incentives of sponsors in a securitization transaction, and breaks down the Agencies' proposed definition of the QRM safe-harbor.

### A. RISK RETENTION RULES

Though Dodd-Frank gave the Agencies the authority to require a higher level of risk retention, the Proposed Rules require that a securitizer retain not less than 5% of an interest in an ABS for its entire duration unless certain exemptions are met. The details of three particular parts of the Proposed Rules that apply to the securitization of all asset classes are fundamental to understanding how the securitization market will change: (1) how risk is to be retained, (2) the establishment of a Premium Capture Account, and (3) prohibitions on hedging.

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109. Credit Risk Retention, 76 Fed. Reg. 24,090 (proposed Apr. 29, 2011). In considering how to determine whether a mortgage is of sufficient credit quality to constitute a QRM, the Agencies looked at a mortgage performance dataset that consisted of underwriting and performance information on approximately 8.9 million mortgages. *Id.* at 24,117–18. In addition, the Agencies looked to another dataset that consisted of more than 75 million mortgages that were packaged into ABS. As per the above-described legislation, the Proposed Rules require that sponsors or originators of asset backed securities retain a 5% position in the ABS unless the loans underlying the securitization meet prescribed safe harbors. Importantly, the Proposed Rules do not allow a sponsor to hedge directly or indirectly its interest in the securitization it arranges. This would prevent a sponsor's affiliated entity from purchasing a credit default swap or other insurance contract that would have the net effect of negating the risk retained in the securitization of the sponsor. Consistent with the intent of skin-in-the-game regulatory reform, the prohibition on a sponsor hedging its skin (i.e., purchasing credit default swaps) ensures that a sponsor's incentive to monitor loan quality is not offset by insurance. *See id.* at 24,117.



*I. How Risk May Be Retained*

The Proposed Rules provide a menu of options by which securitizers may structure their risk retention for a given asset class.<sup>110</sup> As it pertains to RMBS transactions, this includes more obvious methods, such as horizontal retention (holding the lowest tranche in an ABS in the amount equal to 5% of the entire ABS), vertical retention (retaining not less than 5% of each tranche in an ABS), L-shaped retention (a combination of horizontal and vertical: holding 2.5% of each tranche in an ABS and holding a portion of the lowest tranche in an ABS equal to 2.564%), and retention by holding a representative sample (holding a random sample of unsecuritized loans that were picked for securitization).<sup>111</sup> A sponsor using these methods must disclose to investors how it is retaining credit risk as well as the material assumptions and methodologies used in determining the aggregate dollar amount of the ABS interests issued to investors in the securitization transactions.<sup>112</sup> Based on custom and practice in the securitization industry, the Proposed Rules also include retention structures suited for particular asset classes, such as revolving lines of credit, asset-backed commercial paper, and commercial mortgage-backed securities.<sup>113</sup>

*2. Premium Capture Cash Reserve Account*

The Proposed Rules require a securitizer to keep any profits collected for arranging a securitization transaction in a Premium Capture Account.<sup>114</sup> The Premium Capture Account is a trust account that serves

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110. See S. REP. NO. 111-76, at 130 (2010).

111. See Credit Risk Retention, §§ \_\_.3, \_\_.6, \_\_.8, 76 Fed. Reg. 24,090, 24,158–59 (proposed Apr. 29, 2011).

112. See *id.* §§ \_\_.4(b), \_\_.5(c), 76 Fed. Reg. at 24,158–59.

113. See *id.* §§ \_\_.7, \_\_.9 – \_\_.10, 76 Fed. Reg. at 24,159–62. The rule also allows for risk retention to be split between originator and securitizer, as an additional means of giving intermediaries flexibility in structuring risk retention. *Id.* § \_\_.13, 76 Fed. Reg. at 24,163. There are safe harbor exemptions in the Proposed Rules for commercial mortgages, commercial loans, and auto-loans. See *id.* §§ \_\_.16 – \_\_.20, 76 Fed. Reg. at 24,167–72. Although rule makers had the authority to adopt safe harbor exemptions for other classes of ABS, such as revolving lines of credit, no such exemptions were adopted. See *id.* § \_\_.7.

114. See *id.* § \_\_.12(a), 76 Fed. Reg. at 24,162. The plain language of the Proposed Rules does not appear to allow a sponsor to be compensated outside of the premium capture cash reserve account as the amount by which the gross proceeds received by a

as a first loss position in an ABS.<sup>115</sup> Meaning, before any losses in an ABS may be realized, funds from the account shall be released to satisfy payments on ABS interests on any date on which there are insufficient funds to satisfy an amount due on an ABS.<sup>116</sup> Put differently, any profits a securitizer earns for arranging a securitization transaction are held in trust to satisfy its payment obligations to investors and may not be collected by the securitizer unless investors in the ABS are paid in full.<sup>117</sup> Furthermore, the amounts in the trust account may only be invested in one-year U.S. Treasuries or in one or more depository institutions that are fully insured by the FDIC.<sup>118</sup> The Premium Capture Account must be established regardless of whether or not an ABS is exempt from risk retention.

### 3. Prohibitions on Hedging

The Proposed Rules prohibit securitizers and their affiliates from directly or indirectly hedging against their required exposure to the products they securitize, thereby keeping the interests between investor and intermediary closely aligned, with a few exceptions.<sup>119</sup> Securitizers may still hedge against interest rate risk, and foreign exchange risk.<sup>120</sup> Importantly however, securitizers cannot simply bet against a securitization pool entirely so that their interests are adverse to that of investors in the ABS, as seen in the years leading up to the Financial Crisis.<sup>121</sup>

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sponsor, net of costs paid out by the sponsor to unaffiliated parties, exceeds the par value of all interests in an ABS must be held in the premium capture cash reserve account. *See id.*

115. *See id.* § \_\_\_.12(b)(1), (3), 76 Fed. Reg. at 24,162.

116. *See id.*

117. *See id.* § \_\_\_.12(b)(3), 76 Fed. Reg. at 24,162.

118. *See id.* § \_\_\_.12(b)(2), 76 Fed. Reg. at 24,162.

119. *See* 76 Fed. Reg. at 24,116 (“The proposal prohibits a sponsor and its consolidated affiliates from purchasing or selling a security or other financial instrument, or entering into an agreement (including an insurance contract) . . . [that] in any way reduces or limits the financial exposure of the sponsor to the credit risk of one or more of the particular ABS interests.”). This rule specifically inhibits issuers from using credit default swaps to limit exposure to any retained interest they may have in an RMBS.

120. *See* Credit Risk Retention, § \_\_\_.14(d)(1), 76 Fed. Reg. at 24,163.

121. *See id.* § \_\_\_.14, 76 Fed. Reg. at 24,163; *see also supra* notes 1–9 and accompanying text.

## B. THE QUALIFIED RESIDENTIAL MORTGAGE

For a securitizer to be exempt from retaining risk in an RMBS, all of the mortgages that collateralize the ABS must be QRMs at the closing of the securitization transaction and each of the QRMs collateralizing the ABS must be currently performing—that is, the borrower must not be more than 30 days past due in whole or in part on the mortgage.<sup>122</sup> In addition, the depositor<sup>123</sup> or sponsor<sup>124</sup> of the ABS (as applicable) must certify that it evaluated the effectiveness of its internal supervisory controls for ensuring that all of the assets that collateralize the ABS are QRMs (as defined below).<sup>125</sup> Finally, the sponsor must provide a copy of the certification described above to potential investors before the sale of the ABS and, upon request, to the Commission and the appropriate Federal banking regulator as applicable.<sup>126</sup> Below is a tabular summary of how the Agencies defined the QRM in the Proposed Rules followed by an analysis of key components of the QRM definition.

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122. See Credit Risk Retention, § \_\_.15(b)(1)–(3), 76 Fed. Reg. at 24,165. The Proposed Rules also include an appendix, which details standards for determining acceptable sources for a borrower’s down payment and standards for verifying a borrower’s income. See *id.* at 24,173–86. Discussion of the specifics of the appendix is not included here, as the standards themselves have not been singled out for controversy.

123. The term “depositor” has three meanings. “Depositor means the person that receives or purchases and transfers or sells the securitized assets to the issuing entity.” Credit Risk Retention, § \_\_.2, 76 Fed. Reg. at 24,156. “[I]n the case of a securitization transaction, where there is not an intermediate transfer of the assets from the sponsor to the issuing entity,” depositor means sponsor. *Id.* Depositor also means “[t]he person that receives or purchases and transfers or sells the securitized assets to the issuing entity in the case of a securitization transaction where the person transferring or selling the securitized assets directly to the issuing entity is itself a trust.” *Id.*

124. The Proposed Rules define a “sponsor” as “a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.” *Id.* § \_\_.2, 76 Fed. Reg. at 24,157.

125. See *id.* § \_\_.15(b)(4)(i)–(iii), 76 Fed. Reg. at 24,165–66.

126. See *id.* § \_\_.15(b)(4)(iii), 76 Fed. Reg. at 24,165–66.

**Table 2: Proposed QRM**

Underwriting Criteria	<ul style="list-style-type: none"> <li>• Closed-end first-lien mortgage to purchase or refinance a one-to-four family property at least one unit of which is a dwelling of a family.</li> <li>• A QRM cannot be a construction loan, reverse mortgage, bridge loan or timeshare.</li> </ul>
Credit History	<ul style="list-style-type: none"> <li>• Borrower must not be 60 days or more past due on any debt obligation in past 24 months.</li> <li>• Borrower must not have been a debtor in bankruptcy within the last three years.</li> </ul>
Ability to Repay	<ul style="list-style-type: none"> <li>• A QRM must fit within the definition of the QM as defined under Title 14 of Dodd-Frank (which amends the Truth In Lending Act).</li> <li>• No reverse mortgages or interest only payments.</li> <li>• For adjustable rate mortgages, the interest rate may not increase by more than 2% in any twelve month period or by 6% over the life of the transaction.</li> </ul>
Loan to Value Ratio	<ul style="list-style-type: none"> <li>• 80% in a purchase transaction, 75% in a refinancing and 70% in cash out refinancing.</li> </ul>
Servicing/Default Mitigation	<ul style="list-style-type: none"> <li>• Provides financial incentives for servicers to consider options other than foreclosure, such as loan modifications.</li> </ul>
Rules Protecting Sponsors and Depositors	<ul style="list-style-type: none"> <li>• The Proposed Rules seek to balance the interest of encouraging sponsors to review the loans collateralizing an ABS transaction against the interest of not deterring sponsors from issuing ABS altogether. Accordingly, a sponsor would not lose the protection of the QRM safe harbor provision if they were to follow the internal review procedures required by the Proposed Rules and take additional measures to remediate any errors.</li> </ul>

### *1. Underwriting Criteria for QRM*

The Proposed Rules limit a QRM to a closed-end first lien mortgage to purchase or refinance a one-to-four family property, at least one unit of which is the principal dwelling of a borrower.<sup>127</sup> A QRM

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127. *Id.* § \_\_.15(c)–(d)(1), 76 Fed. Reg. at 24,166.

may not be a (i) loan to finance the initial construction of a property, (ii) a reverse mortgage, (iii) a bridge loan with a term of twelve months or less, or a (iv) time share.<sup>128</sup>

## 2. Credit History

To qualify as a QRM, a creditor must verify and document that within 90 days prior to the closing of the mortgage, the borrower is not 30 days or more past due, in whole or in part, on the mortgage, and is not 60 or more days past due, in whole or in part, on any debt obligation within the preceding 24 months.<sup>129</sup> Further, within the preceding 36 months, a borrower must not have 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 federal or state judgment for collection of any unpaid debt.<sup>130</sup> The creditor may satisfy these underwriting criteria by obtaining at least two credit reports from consumer reporting agencies that compile and maintain files on consumers on a nationwide basis, indicating that the borrower meets all the requisite underwriting criteria.<sup>131</sup>

## 3. Payment Terms and Assumability

Consistent with the requirements for a qualified mortgage under section 1639(b)(2) of the Truth in Lending Act (“TILA”), the Proposed Rules seek to discourage loan terms that were associated with predatory lending in the years leading up to the crisis.<sup>132</sup> The Proposed Rules exclude QRMs from having payment terms that allow interest-only payments or negative amortization.<sup>133</sup> In addition, the Proposed Rules prohibit balloon payments, “defined . . . as a scheduled payment of principal and interest that is more than twice as large as any earlier scheduled payment of principal and interest.”<sup>134</sup> To protect against the adverse impact of interest rate shocks, for adjustable rate mortgages to

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128. *Id.* § \_\_.15(c), 76 Fed. Reg. at 24,166.

129. *See id.* § \_\_.15(d)(5)(i)(A)–(B), 76 Fed. Reg. at 24,166.

130. *See id.* § \_\_.15(d)(5)(i)(C), 76 Fed. Reg. at 24,166.

131. *See id.* § \_\_.15(d)(5)(ii), 76 Fed. Reg. at 24,166.

132. *See* Press Release, FDIC, *supra* note 26.

133. *See* Credit Risk Retention, § \_\_.15(d)(6), 76 Fed. Reg. at 24,166.

134. 76 Fed. Reg. at 24,122; *see* Credit Risk Retention, § \_\_.15(d)(6)(ii), 76 Fed. Reg. at 24,166.

qualify as QRMs, the Agencies propose that the annual interest rate must not increase by more than (a) 2% in any twelve month period and by (b) 6% over the life of the mortgage transaction.<sup>135</sup> Consistent with TILA, the Proposed Rules prohibit the QRM from having any points and fees in excess of 3% and any pre-payment penalty.<sup>136</sup> Also, a QRM is not assumable by any person who was not a borrower under the original mortgage transaction.<sup>137</sup>

#### 4. Debt to Income Ratios (DTI)/ Ability to Repay

To be a QRM, the Proposed Rules stipulate that the borrower's front-end debt to income ratio ("DTI") must not exceed 28% and that the borrower's back-end DTI must not exceed 36%.<sup>138</sup> The creditor must verify that the DTI ratios are based on the maximum interest rate that is permitted or required under the mortgage terms during the first five years of the transaction and a payment schedule that fully amortizes the mortgage over the term of the mortgage transaction.<sup>139</sup> These proposals are narrower than the requirement of the QM, which imposes a back-end DTI of 43%.<sup>140</sup>

#### 5. Loan to Value Ratio

The Proposed Rules require that QRMs meet one of three loan to value ("LTV") ratios, defined as the value of the loan to the fair market

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135. See *id.* § \_\_.15(d)(6)(iii), 76 Fed. Reg. at 24,166. Predatory adjustable rate mortgages were particularly hurtful to consumers in the years leading up to the financial crisis. Borrowers took out loans with very low initial ("teaser") interest rates only to see the interest rates increase dramatically (a "shock") after a few years, which led to defaults. See ENGEL & MCCOY, *supra* note 11.

136. Credit Risk Retention, § \_\_.15(d)(6)(iv)-(7), 76 Fed. Reg. at 24,166.

137. *Id.* § \_\_.15(d)(12), 76 Fed. Reg. at 24,167.

138. *Id.* § \_\_.15(d)(8)(i), 76 Fed. Reg. at 24,166. A front-end DTI ratio refers to the ratio of a borrower's monthly housing debt to a borrower's monthly gross income whereas a back-end DTI ratio refers to the ratio of a borrower's total monthly debt to the borrower's monthly gross income.

139. See *id.* § \_\_.15(d)(8)(ii)-(iii), 76 Fed. Reg. at 24,166-67. Real estate taxes, hazard insurance, homeowners' and condominium association dues, ground rent or leasehold payments and special assessments must be included, pro rata, as applicable, in computing the requisite DTI ratios. *Id.* § \_\_.15(d)(8)(iii), 76 Fed. Reg. at 24,166-67.

140. See Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 6407, 6587 (Jan. 30, 2013) (to be codified at 12 C.F.R. 1026.43(e)(2)(vi)).

value of the property, depending on the type of mortgage transaction at issue.<sup>141</sup> In a purchase of a one-to-four family property, the LTV ratio at closing must not exceed 80%.<sup>142</sup> In a rate and term refinancing transaction, the LTV ratio at closing must not exceed 75%.<sup>143</sup> Finally, in a cash out refinancing, the combined LTV ratio at closing must not exceed 70%.<sup>144</sup> The theory behind imposing strict LTV ratios is that, historically, loans with LTV ratios of 80% or less perform better and exhibit substantially less default risk than loans with LTV ratios in excess of 80%.<sup>145</sup> As discussed in Part I.C., leading up to the Financial Crisis, however, loans with LTV ratios of 97%-100% dominated residential mortgage lending.<sup>146</sup> The Proposed Rules require borrowers to have sufficient equity in their homes before taking out a mortgage or refinancing an existing mortgage to be QRM eligible.<sup>147</sup>

#### 6. Down Payment

The down payment component of the QRM is not mentioned in Section 15G nor is there a requirement of a down payment on the part of a borrower under the ability to re-pay provisions of Dodd-Frank. Nevertheless, the Agencies propose a strong down payment requirement based on data that borrowers are less likely to default if they have more equity in their homes.<sup>148</sup> In the event that the mortgage transaction is for the purchase of a one to four family property, the Proposed Rules would require the borrower to provide a cash down payment equal to the sum of (i) the closing costs payable by the borrower in connection with the mortgage transaction, (ii) 20% of the lesser of (a) the estimated market value of the one to four family property as determined by a qualifying appraisal<sup>149</sup> and (b) the purchase price of the one-to-four family

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141. Credit Risk Retention, § \_\_\_\_.15(d)(9), 76 Fed. Reg. at 24,167.

142. *Id.* § \_\_\_\_.15(d)(9)(i), 76 Fed. Reg. at 24,167.

143. *Id.* § \_\_\_\_.15(d)(9)(ii), 76 Fed. Reg. at 24,167.

144. *Id.* § \_\_\_\_.15(d)(9)(iii), 76 Fed. Reg. at 24,167.

145. 76 Fed. Reg. at 24,123.

146. *See* Oesterle, *supra* note 76, at 750.

147. *See id.*

148. *See* 76 Fed. Reg. at 24,124 (citing Austin Kelly, *Skin in the Game: Zero Down Payment Mortgage Default*, 19 J. HOUSING RESEARCH 75 (2008)), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1330132](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1330132)—.

149. A QRM must be supported by the written appraisal of an independent third party that conforms to generally accepted appraisal standards. *See id.* § \_\_\_\_.15(d)(11), 76 Fed. Reg. at 24,167.

property, and (iii) if the estimated market value of the one-to-four family property as determined by a qualifying appraisal is less than the purchase price of the property to be paid in connection with the mortgage transaction, the difference between these amounts.<sup>150</sup> By not allowing the borrower to finance closing costs, and by requiring borrowers to pay the difference between purchase price of the home and the market value of the home, the Proposed Rules seek to ensure that the borrower has sufficient equity in the property to minimize risks of default.<sup>151</sup>

### 7. Rules Protecting Sponsors and Depositors

The Proposed Rules seek to balance the interest of encouraging sponsors to review the loans collateralizing an ABS transaction against the interest of not deterring sponsors from issuing an ABS altogether.<sup>152</sup> The Agencies recognize that “despite the use of robust processes and procedures, it is possible that one or more loans included in a QRM securitization transaction may later be determined to have not met the QRM definition due to inadvertent error.”<sup>153</sup> Accordingly, a sponsor would not lose the protection of the QRM safe harbor provision if they were to follow the internal review procedures required by the Proposed Rules and take additional measures to remediate any errors.<sup>154</sup> Specifically, a sponsor that has relied on the QRM exemption with respect to a securitization transaction would not lose the exemption if, after closing the securitization transaction, it is determined that one or more of the mortgages collateralizing the ABS do not meet all of the qualifying criteria, provided that (1) the sponsor/depositor completed the certification requirements set forth in the regulations, (2) the sponsor repurchases the loans determined not to be QRMs from the issuing entity at a price equal to the remaining principal balance and accrued interest on the loans, and (3) the sponsor notifies all investors of the ABS of any loans that are required to be repurchased by the sponsor.<sup>155</sup>

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150. See *id.* § \_\_\_\_.15(d)(10), 76 Fed. Reg. at 24,167.

151. *Id.*

152. *Id.*

153. 76 Fed. Reg. at 24,128.

154. See Credit Risk Retention, § \_\_\_\_.15(e), 76 Fed. Reg. 24,167.

155. *Id.*



## C. RE-SECURITIZATION PRODUCTS

The Proposed Rules do not allow a securitizer to avoid retaining risk by creating re-securitizations that re-tranche the credit risk of the underlying ABS. Two conditions must be met in order for a re-securitization product to be exempt from risk retention.<sup>156</sup> First, the re-securitized assets must be collateralized solely by existing ABS that were structured in compliance with Section 15G.<sup>157</sup> Second, the re-securitization may involve the issuance of only a single class of ABS interests.<sup>158</sup> Consequently, a securitizer would be required to retain at least 5% of the risk of a CDO (a product that re-tranches an ABS), even if all of the assets that underlie the ABS were QRM (or in the case of a non-mortgage transaction, even where all of the underlying assets were exempt from risk retention).<sup>159</sup>

## D. TREATMENT OF GSEs AND GOVERNMENT-RELATED EXEMPTIONS

The Proposed Rules exempt loans owned, insured or guaranteed by Fannie Mae and Freddie Mac from risk retention while under the conservatorship of the FHFA.<sup>160</sup> To the Agencies, the GSEs' guarantee of timely payment coupled with capital support from the Federal Government satisfies the risk retention requirements.<sup>161</sup> The rules with respect to the Premium Capture Account and the prohibitions on hedging also do not apply to the GSEs while under the conservatorship of the FHFA. The Proposed Rules also exempt any security backed by the Federal Government or any state government from risk retention.

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156. See 76 Fed. Reg. at 24,138.

157. See 76 Fed. Reg. at 24,138–39.

158. *Id.* The Agencies describe the types of re-securitized bonds that would meet this exemption, see 76 Fed. Reg. at 24,138–39, but further discussion of re-securitization products is beyond the scope of this paper. The important takeaway is that this particular proposed rule would prohibit the most common and dangerous forms of re-securitization transactions (e.g., the CDO), see *supra* notes 1–9, 41–57 and accompanying text, from being exempt from risk retention.

159. See 76 Fed. Reg. at 24,138; see also Credit Risk Retention, § \_\_\_.21(a)(5), 76 Fed. Reg. at 24,172–73.

160. 76 Fed. Reg. at 24,112.

161. *Id.* The Proposed Rules with respect to the Premium Capture Account, § \_\_\_.12, as well as prohibitions on hedging, § \_\_\_.14(b), (c) and (d), do not apply to the GSEs while in conservatorship.

### III. MARKET IMPLICATIONS OF PROPOSED RISK RETENTION RULES

Part III of this Comment provides a market analysis of the Proposed Rules. The accomplishments of the Proposed Rules in attacking the flaws in the pre-crisis securitization market are discussed followed by a survey of the major concerns that the proposed risk retention framework raises, including concerns raised by consumer advocates, mortgage originators, financiers, lawmakers and academics.

#### A. THE MERITS OF THE PROPOSED RISK RETENTION RULES: HOW THEY ADDRESS KEY PROBLEMS IN THE PRE-CRISIS MORTGAGE SECURITIZATION PROCESS

As they apply to residential mortgages, the Proposed Risk Retention Rules target the incentive misalignment that plagued mortgage securitization in the years leading up to the Financial Crisis by closely aligning the economic interests of securitizers and investors. In doing so, the Agencies define the QRM exemption narrowly, inhibit securitizers from profiting off of arranging an RMBS unless the RMBS pays off all investors in full,<sup>162</sup> and prohibit the type of detrimental hedging activities witnessed in the years leading up to the Financial Crisis.<sup>163</sup> These proposals, working in conjunction with other provisions of Dodd-Frank, address two goals of paramount importance: 1) deterring predatory securitization and excessive liquidity creation that contributed to the Financial Crisis and 2) keeping private label mortgage securitization flexible enough to allow capital to flow to borrowers who pose low default risks but would not meet the QRM exemption.<sup>164</sup>

##### *1. Deterring Predatory Securitization and Excessive Liquidity Creation*

The narrow definition of the QRM is intended to change private label mortgage securitization markets so that most RMBS transactions require risk retention on the part of the securitizer. The Agencies defined the QRM exemption narrowly, because, in the words of Sheila Bair, “the QRM is the exception not the rule.”<sup>165</sup> Moreover, the prohibitions on hedging and the establishment of the Premium Capture Account ensure that incentives are aligned in the securitization chain.

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162. See *supra* notes 114–18 and accompanying text.

163. See *supra* notes 1–9 and accompanying text.

164. See *infra* Part III.A.2.

165. See Press Release, FDIC, *supra* note 26.

By inhibiting sponsors from hedging against their required exposure to an ABS, the Proposed Rules prohibit securitizers from taking positions directly adverse to investors (i.e., by purchasing CDS) in the ABS they arrange.<sup>166</sup> The Premium Capture Account deters imprudent conduct on the part of securitizers by ensuring that securitizers may only profit off of a securitization transaction if investors are first paid off in full.<sup>167</sup> These measures ensure that securitizers have an incentive to arrange only those securitizations that are safe and have a high potential for success.

Had the Citigroup CDO discussed at the beginning of this Comment been arranged in a securitization structure governed by the Proposed Rules, the results would have been far different. Citigroup would have had to retain at least \$25 million in the \$500 million transaction, would not have been able to enter into CDSs against the CDO, and the \$160 million in fees it collected for arranging the CDO would have been held in the Premium Capture Account to serve as a first loss position for the benefit of investors.<sup>168</sup> Given the financial incentives, it is highly unlikely that Citigroup would arrange this deal if it were doomed to failure, as it would suffer a \$25 million loss and would not collect any fees. Prior to the crisis, financial incentives led to originators and securitizers fraudulently passing off subprime mortgages as investment grade to investors because they had the ability to profit off of an ABS or CDO simply by arranging it, or, worse still, by betting against it.<sup>169</sup> Under the new framework, a securitizer's ultimate fate is inextricably tied to that of the investors, which, in turn, should give them an incentive to pay close attention to the behavior and practices of mortgage originators.<sup>170</sup> Forcing securitizers to monitor the loan quality of the assets they securitize should deter excessive mortgage origination on loan terms that borrowers simply cannot afford, as these deals would threaten a securitizer's ability to collect fees.<sup>171</sup>

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166. See *supra* notes 119–21 and accompanying text.

167. See *supra* notes 114–18 and accompanying text.

168. See *supra* notes 92, 110–21 and accompanying text.

169. See *supra* notes 1–9 and accompanying text.

170. Press Release, FDIC, *supra* note 26 (arguing that skin-in-the-game rules will assure that originators and securitizers cannot escape the consequences of their own lending practices).

171. See *supra* notes 114–18 and accompanying text.

## 2. Merits of the Narrowness of the QRM Definition

Other than incentivizing a structure in which most securitization transactions involve risk retention on the part of securitizers, a narrow QRM also provides the private label mortgage securitization market with some needed flexibility. According to Bair, the QRM should become the exception in the mortgage market, while the non-QRM risk retention loan should become the dominant form of mortgage securitization.<sup>172</sup> It is also hoped that a narrow QRM excludes enough high quality home loans such that ABS backed by high quality non-QRMs “may be routinely issued and purchased by a wide variety of investors.”<sup>173</sup> The rule makers explain that their study of mortgage lending strongly suggests that the loans that meet the minimum QRM standards carry low default risk even during adverse economic conditions, such as a period of high unemployment coupled with sharply declining home prices.<sup>174</sup> They note that certain safe mortgage loans will be left out of the QRM definition, thereby making the market for such securities relatively liquid.<sup>175</sup> By contrast, the broader the definition of QRM, the more convoluted the exemption becomes, and the less liquid the market ordinarily would be for residential mortgages falling outside of the QRM definition.<sup>176</sup>

### B. CONCERNS OVER THE PROPOSED RISK RETENTION REGULATORY FRAMEWORK

The Proposed Rules have ironically united mortgage originators, financiers, lawmakers and consumer advocates alike in fierce opposition to the QRM.<sup>177</sup> The arguments generally assume that the additional

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172. Press Release, FDIC, *supra* note 26.

173. Credit Risk Retention, 76 Fed. Reg. 24,090, 24,118 (proposed Apr. 29, 2011).

174. *Id.* at 24,117–18.

175. *Id.* at 24,118. The Agencies explain that “incorporating all of the tradeoffs that may prudently be made as part of a secured underwriting process into a regulation would be very difficult without introducing a level of complexity and cost that could undermine any incentives for sponsors to securitize, and originators to originate, QRMs.” *Id.*

176. *Id.*

177. See, e.g., Adler, *supra* note 27; Josh Silver & Archana Pradhan, Nat’l Cmty. Reinvestment Coal., *The Impact of the Proposed Qualified Residential Mortgage Definition on Home Opportunity in America* (2011), available at [http://www.scribd.com/fullscreen/73355463?access\\_key=key-13t4p3yx457mnaevylg0](http://www.scribd.com/fullscreen/73355463?access_key=key-13t4p3yx457mnaevylg0);

costs of skin-in-the-game in non-QRM loans will ultimately be passed on to consumers.<sup>178</sup> As a result, most commentators suspect that the QRM loan will be the most common loan on the market whereas the non-QRM will be a costly alternative.<sup>179</sup> Consequently, commentators propose that the definition of the QRM be expanded.

Economists speculate<sup>180</sup> that securitizers will require a higher return on the 5% stake they hold than investors usually require, which, in turn, will necessitate higher interest rates on non-QRM loans.<sup>181</sup> It is argued that securitizers will require additional returns primarily due to capital constraints.<sup>182</sup> Commentators fear that risk retention coupled with additional capital constraints will dis-incentivize non-QRM lending, and potentially make non-QRM loans prohibitively expensive, or even put private label mortgage lending out of business altogether.<sup>183</sup> Whereas regulators forecast that the costs of skin-in-the-game will increase the

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Am. Securitization Forum, *ASF Risk Retention Letter to Joint Regulators: Executive Summary* (2011), available at [http://www.americansecuritization.com/uploadedFiles/ASF\\_Risk\\_Retention\\_Comment\\_Letter\\_Executive\\_Summary.pdf](http://www.americansecuritization.com/uploadedFiles/ASF_Risk_Retention_Comment_Letter_Executive_Summary.pdf); Nat'l Ass'n of Realtors, *Letter Regarding Credit Risk Retention Proposed Rule* (2011), available at <http://www.ksefocus.com/billdatabase/clientfiles/172/3/1292.pdf>; Jon Prior, *More Lawmakers Join Major Push to Reduce QRM Down Payment*, HOUSINGWIRE (June 20, 2011, 3:56 pm), <http://www.housingwire.com/2011/06/20/more-lawmakers-join-major-push-to-reduce-qrm-down-payment>; Davis Polk, *Proposed Credit Risk Retention Rules Raise Serious Concerns* (2011), available at <http://www.davispolk.com/files/Publication/fb3d913d-f3b6-45c9-9657-003251fd80cb/Presentation/PublicationAttachment/3e99bb31-2cac-4063a6370b9a4cfa61f3/060111ProposedCreditRisk.pdf>.

178. See, e.g., ZANDI & DERITIS, *supra* note 29, at 5.

179. See, e.g., *id.*

180. It is important to note that any projection on how private label mortgage interest rates will be affected by skin-in-the-game is speculative at best. There is simply not enough hard data to predict, with confidence, how the market will react. See GEITHNER, *supra* note 10, at 6 (suggesting that studies on the implications of risk retention are limited).

181. See ZANDI & DERITIS, *supra* note 29, at 5. Reasoning by analogy, Zandi and DeRitis argue that securitizers will require a significantly higher return than that of investors because mortgage insurers currently require a 15% return for keeping some skin-in-the-game. The economists argue that if the required return for securitizers was 6% higher than that of investors, interest rates would increase by 30 basis points, and if securitizers' required return was 9% higher than that of investors, interest rates would increase by 45 basis points. *Id.*

182. See, e.g., *id.*

183. See, e.g., *id.*; see also Davis Polk, *supra* note 177, at 4 (suggesting that the premium capture reserve account would have a "significant and negative impact" on the volume of private label securitizations).

interest rates on non-QRM loans by 10 to 15 basis points, commentators forecast that interest rates could increase by as much as 100<sup>184</sup> to 185<sup>185</sup> basis points.

The potential for skin-in-the-game to make home loans more expensive creates a concern that homeownership will become very difficult to attain.<sup>186</sup> Consistent with regulatory intent that seeks to make the QRM the exception to the mortgage market, commentators point out that most home loans originated in the last decade were not QRMs.<sup>187</sup> Commentators fear that this phenomenon is particularly concerning for low-income borrowers.<sup>188</sup> Because historical data suggests that minorities and low-income individuals are especially unlikely to qualify for QRM loans today, commentators fear that the Proposed Rules will ultimately make home ownership even more difficult for these groups to attain.<sup>189</sup>

On the structuring side, the American Securitization Forum (“ASF”) is concerned that the Premium Capture Account is “lethal” to the securitization market.<sup>190</sup> According to the ASF, the Premium

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184. ZANDI & DERITIS, *supra* note 29, at 3, 6.

185. See Nat’l Ass’n of Realtors, *supra* note 177, at 19. Of course, doomsday projections from mortgage brokers must be taken with a grain of salt.

186. See, e.g., *id.*

187. See ZANDI & DERITIS, *supra* note 26, at 2–3 (arguing that only one-fifth of mortgage originations between 1997 and 2009 were QRMs and only one-third of originations made in 2009 alone, the year lending standards were tightest, would have met the Proposed Rules definition of a QRM).

188. See, e.g., Silver & Pradhan, *supra* note 174, at 2.

189. The down payment requirement in the Proposed Rules has been singled out for criticism because of its potential disparate effect on low-income groups and minorities. See, e.g., Silver & Pradhan, *supra* note 177, at 2 (arguing that a down payment of 20% reduces QRM ineligibility for many while only marginally having an impact on default rates). Senators sent letters to the Agencies on May 26, 2011, contending that the Proposed Rules go beyond the intent of Dodd-Frank in implementing stringent down payment requirements. See Comment Letter on QRM from 39 Members of the U.S. Senate to the Agencies (May 26, 2011), available at <http://www.hagan.senate.gov/files/images/SenateQRMLetter.pdf>. The National Association of Realtors makes especially troubling predictions about the ability of middle to low-income families, and certain minorities in particular, to obtain QRM loans. See Nat’l Ass’n of Realtors, *supra* note 177, at 15. Similarly, a big law partner suggests that the QRM means the death of the American Dream. See Richard J. Andreano, Jr., *Death of the American Dreams Focus on QRM*, 128 BANKING L.J. 714 (2011).

190. *The Impact of Dodd-Frank on Customers, Credit, and Job Creators: Hearing Before the Subcomm. on Capital Mkts. and Gov’t Sponsored Enters. of the H. Comm.*

Capture Account adds an additional skin-in-the-game requirement on securitizers on top of the 5% requirement that may disincentivize sponsors from structuring securitizations altogether, thereby making homeownership more costly for non-prime borrowers in particular.<sup>191</sup> This concern is well founded. For instance, in a securitization pool where all the mortgages have thirty year terms, the current structure would inhibit a securitizer from collecting fees for three decades until it is certain that investors in an ABS are paid in full.<sup>192</sup> Although this structure would force a securitizer to have its skin-in-the-game for the long-haul, it appears to be impracticable, only leaving an incentive to structure a securitization for financing purposes.<sup>193</sup> Moreover, this fee structure would make it very difficult for the private sector to displace the government's involvement in the mortgage market while the GSEs remain exempt from the risk retention rules while under the conservatorship of the FHFA.<sup>194</sup>

ASF also advocates for a QRM blend exception, which would allow a securitizer to mix non-QRM and QRM loans in an ABS and retain 5% of the risk of the non-QRM loans in the ABS only; a safe-harbor for loans that are securitized well after origination (about one to three years); and a sunset safe harbor provision that allows a securitizer

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*on Fin. Servs.*, 112th Cong. (2012) (statement of Tom Deutsch, Executive Director, American Securitization Forum, at 3), available at <http://financialservices.house.gov/uploadedfiles/hhrg-112-ba16-wstate-tdeutsch-20120710.pdf> (“Some rules like the premium capture cash reserve account are so lethal to the RMBS and CMBS markets that those markets are predicted to become relegated to history books for all of those other than a few niche players serving extremely limited segments of the market, if that rule were to be put into place as proposed.”).

191. *Understanding the Implications and Consequences of the Proposed Rule on Risk Retention: Hearing Before the Subcomm. on Capital Mkts. and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 112th Cong. 15 (2011) (statement of Tom Deutsch, Executive Director, American Securitization Forum), available at [http://www.americansecuritization.com/uploadedFiles/ASF\\_HFSC\\_Risk\\_Retention\\_Teimony\\_4-14-11.pdf](http://www.americansecuritization.com/uploadedFiles/ASF_HFSC_Risk_Retention_Teimony_4-14-11.pdf).

192. See *supra* notes 114–18 and accompanying text.

193. *The Impact of Dodd-Frank on Customers, Credit, and Job Creators*, *supra* note 190, at 8 (statement of Tom Deutsch); but see ZANDI & DERITIS, *supra* note 29, at 4 (acknowledging that securitizers' ability to cover costs upfront under the Proposed Rules is in doubt but predicting that regulators will clarify that securitizers will be able to retain a standardized fee—that is not required to be held in the premium capture cash reserve account—for arranging an ABS).

194. *The Impact of Dodd-Frank on Customers, Credit, and Job Creators*, *supra* note 190, at 9.

to shed its skin-in-the-game if the loans have performed for a reasonable period of time.<sup>195</sup> ASF also requests that the prohibitions on hedging only apply for a specified number of years after the securitization closes so that sponsors are allowed to hedge against their exposures if market conditions change.<sup>196</sup>

In contrast to the critiques above, which find the rulemaking too onerous on securitizers and borrowers, some scholars' criticism cuts in the other direction.<sup>197</sup> These academics are concerned that skin-in-the-game does not inform investors of the credit risk of mortgage securitization products and cannot prevent risky lending from threatening the solvency of the financial system in real-time.<sup>198</sup> These scholars would prohibit securitizing mortgage loans altogether if the mortgages to be securitized do not conform to certain "plain" standardized criteria with low default risk.<sup>199</sup> These scholars note that Section 941 leaves the door open to such standardization by allowing the Agencies to propose risk retention rules onerous enough to deter securitization or origination of non-QRM loans altogether.<sup>200</sup>

#### IV. POLICY RECOMMENDATIONS: WHAT THE FINAL RULES SHOULD LOOK LIKE FOR THE RMBS MARKET

Although private label securities account for only 5% of the secondary mortgage market,<sup>201</sup> there is strong reason to believe that the risk retention rules will have a significant impact on the mortgage

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195. See, e.g., American Securitization Forum, *supra* note 177, at 4.

196. See *Understanding the Implications and Consequences of the Proposed Rule on Risk Retention*, *supra* note 191, at 197 (statement of Tom Deutsch).

197. See Levitin & Wachter, *supra* note 30, at 1256–58 (arguing that niche mortgage loans should not be securitized at all but should remain entirely on bank balance sheets); see also Adam J. Levitin et al., *The Dodd-Frank Act and Housing Finance: Can it Restore Private Risk Capital to the Securitization Market?*, 29 YALE J. ON REG. 155 (2012).

198. Levitin et al., *The Dodd-Frank Act and Housing Finance*, *supra* note 197, at 164.

199. Levitin & Wachter, *supra* note 30, at 1256–57.

200. *Id.* at 1256 n.279.

201. Jon Prior, *Pending Conforming Loan Limit Decrease Puts California on Edge*, HOUSINGWIRE (June 23, 2011, 1:04 PM), <http://www.housingwire.com/news/pending-conforming-loan-limit-decrease-puts-california-edge>. As previously mentioned, RMBS products arranged by the GSEs are exempt from risk retention, restrictions on hedging and premium capture while under the conservatorship of the FHFA. See *supra* Part II.D.



market in the near future. A congressional study on the future of the GSEs reveals that the ability of the GSEs to exit conservatorship will require a return to financial viability, which would require the generation of interest among private investors to hold an equity stake in the GSEs.<sup>202</sup> Whether such investor interest is sufficient to allow the GSEs to stand on their own would in turn depend upon the equity investment appetite for an entity that issues RMBS products.<sup>203</sup> Consequently, the creation of a safe, well-functioning and profitable private label mortgage securitization market under the framework of the final risk retention rules that is able to establish investor confidence in entities that issue RMBS products, may be crucial in determining whether the GSEs will exit conservatorship without further government assistance.<sup>204</sup>

Further, it is worth noting that there has been recent activity in the private label mortgage market that suggests that there is still interest in generating private label RMBS products despite the announcement of the supposedly “onerous” Proposed Rules.<sup>205</sup> Shell Point Financial filed a shelf registration to issue RMBS securities products,<sup>206</sup> Redwood Trust<sup>207</sup> (another private company) recently completed its fifth RMBS transaction of the year, and Residential Capital’s mortgage servicing and origination units were sold in a bankruptcy auction to Ocwen Capital and Walter Investment Management Corp. for \$3 billion.<sup>208</sup> Whether such deals will become increasingly commonplace or be considered an aberration will also depend on the structure and substance of the final risk retention rules.<sup>209</sup>

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202. N. ERIC WEISS, CONG. RESEARCH SERV., RL 34661, FANNIE MAE’S AND FREDDIE MAC’S FINANCIAL PROBLEMS 15 (2012), available at <http://www.fas.org/sgp/crs/misc/RL34661.pdf>.

203. *Id.* at 15.

204. *Id.*

205. *See supra* notes 177–94 and accompanying text.

206. Jacob Gaffney, *Shellpoint Files to Issue Private Mortgage Bonds*, HOUSINGWIRE (Oct. 15, 2012, 3:47 PM), available at <http://www.housingwire.com/news/shellpoint-files-issue-private-mortgage-bonds>.

207. *Id.*

208. Press Release, Ocwen Fin. Corp., Ocwen Loan Servicing, LLC and Walter Investment Management Corp. Awarded Winning Bid for ResCap’s Mortgage Servicing and Origination Platform (Oct. 24, 2012), available at <http://shareholders.ocwen.com/releases.cfm>.

209. *Accord* Press Release, FDIC, *supra* note 26.

This section advocates for final rules that maintain the narrow QRM exemption, require risk to be retained until maturity, and keep the prohibition on hedging and the establishment of a Premium Capture Account in place; however, this section argues that a securitizer should be allowed to collect profits from the Premium Capture Account, at the discretion of a trustee, after three to five years, if an RMBS has performed well, to ensure a financial incentive still remains for securitizers to arrange RMBS transactions. This Comment is written in hopes that these recommendations would best create a safe mortgage securitization market that generates investor confidence in both private label RMBS products and equity investor interest in entities that issue such products, such that credit may flow to borrowers who are actually able to afford homes and that the GSEs have a viable option of leaving conservatorship without further government assistance.

#### A. DEFENDING A NARROW QRM EXEMPTION

The final risk retention rules should maintain the definition of the QRM outlined in the Proposed Rules, including the controversial down payment requirement. Both rule makers and critics admit that borrowers who pose a low default risk will be denied QRM loans under the Proposed Rules.<sup>210</sup> While some critics see this as an outright bar to homeownership for certain groups, it is at least equally plausible that the market will realize that there are non-QRM loans of investment quality, thereby allowing borrowers to take out affordable non-QRM loans at reasonable rates.<sup>211</sup> The economic literature demonstrates that in the years prior to the Financial Crisis, demand for investment-grade quality home loans is what increased credit availability to borrowers.<sup>212</sup> The new risk retention structure in which the QRM is narrowly defined

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210. Joe Adler, *FDIC's Bair Would Rather Eliminate QRM from Risk Retention Rule*, BANK INVESTMENT CONSULTANT (June 10, 2011), available at <http://www.bankinvestmentconsultant.com/news/FDIC-banks-risk-management-QRM-2673729-1.html>. In acknowledgement of the broad pushback against the QRM, Sheila Bair retorted, "If we could just get rid of [QRM] it would be fine with me, just making sure that the [risk retention] is 5% [for all mortgage loans]." *Id.* Bair maintains that the premium on non-QRM loans should only be 10 to 15 basis points and that the non-QRM loan will be the most common loan on the private label market. *Id.* Of course, getting rid of the QRM would require amending Dodd-Frank, which would open up a can of worms that could cause more harm than good. Rule makers should work within the framework given by the legislation.

211. See *supra* notes 172–76 and accompanying text.

212. See *supra* note 36 and accompanying text.

should encourage the origination and securitization of prudently underwritten home loans that will inspire investor confidence in such products and in the entities that issue them.<sup>213</sup>

Of course, a narrow QRM (and new regulations thereunder) will inevitably reign in the free flow of capital seen during the pre-crisis days—this seems right given that the pre-Financial Crisis market was artificially created.<sup>214</sup> This token critique of the risk retention rules, that it scalps capital market liquidity, may prove beneficial if it prevents excess leveraging on a consumer and corporate level. Left unregulated, securitization encouraged over-borrowing, both from consumers who sought home loans and financial institutions that borrowed against mortgage securities products.<sup>215</sup> Before pointing out that skin-in-the-game will decrease liquidity, it is helpful to be mindful that the inflated rate of household borrowing seen prior to the Financial Crisis in the United States was unsustainable.<sup>216</sup> Further, at some point, the federal funds rate will have to increase, and worse still, the eagerness of net lenders to finance American borrowing will cool.<sup>217</sup> Some economists have forecasted the shift from net-debtor country to net-creditor country as potentially catastrophic given our current household borrowing level.<sup>218</sup> I am not suggesting that skin-in-the-game is a potential solution to the balance of payments problems, but a cursory mention of these issues highlights that excessive liquidity and leveraging are unsustainable in the long run. Addressing over-borrowing is a concern that should be at least *pari-passu* with the expansion of homeownership. If a narrow QRM that includes a down payment requirement means that

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213. See Press Release, FDIC, *supra* note 26.

214. See *e.g.*, Oesterle, *supra* note 76, at 759–60.

215. See *supra* Part I.B.

216. See, *e.g.*, CHARLES ROXBURGH ET AL., MCKINSEY GLOBAL INSTITUTE, DEBT AND DELEVERAGING: UNEVEN PROGRESS ON THE PATH TO GROWTH 2–4 (Jan. 2012), available at [http://www.mckinsey.com/insights/mgi/research/financial\\_markets/uneven\\_progress\\_on\\_the\\_path\\_to\\_growth](http://www.mckinsey.com/insights/mgi/research/financial_markets/uneven_progress_on_the_path_to_growth) (arguing that sustainable household borrowing must be measured at rates observed prior to the housing bubble and that the U.S. economy is only half-way towards deleveraging to a natural rate); accord Stijn Claessens, *Shedding Debt*, FIN. & DEV., June 2012, at 23, available at <http://www.imf.org/external/pubs/ft/fandd/2012/06/pdf/claessens.pdf>.

217. See, *e.g.*, Nouriel Roubini & Brad Setser, The US as a Net Debtor: The Sustainability of the US External Imbalances 6–7 (Nov. 2004), available at <http://people.stern.nyu.edu/nroubini/papers/Roubini-Setser-US-External-Imbalances.pdf>.

218. See *id* at 6–7.

individuals have to save more to attain homeownership, this result may prove more socially desirable than recklessly expanding homeownership by having individuals borrow at unsustainable rates.<sup>219</sup> In contrast, omission of the down payment restriction would result in a truly absurd result: Dodd-Frank regulations would not impose on lenders an obligation to require consumers to retain any equity in their homes to avail themselves of safe-harbor provisions under Title 14 and Section 941 of the Act.<sup>220</sup>

Should it become apparent that homeownership has become a significant impediment to disadvantaged groups due to the QRM, then regulators should craft specific rules to target such distressed neighborhoods<sup>221</sup> under their authority to establish exemptions in the public interest *ex post*.<sup>222</sup> Moreover, these exemptions should be crafted narrowly. As we saw in the 1990s, government housing initiatives that were targeted at underprivileged communities led to lax lending standards that were effectively given to everyone, including real estate speculators, second home buyers, and wealthy homeowners.<sup>223</sup> It would not be desirable policy to subsidize those markets in the name of ameliorating the disparate effects of income inequality.<sup>224</sup> In addition to making the market for non-QRM loans less liquid, expanding the QRM exemption may re-open the door to shady lending practices seen in the pre-Financial Crisis securitization market, as more loans would then be structured in a market where risk retention is not required.<sup>225</sup>

#### B. MODIFYING THE PREMIUM CAPTURE ACCOUNT; MAINTAINING DURATION OF RISK RETENTION AND RESTRICTIONS ON HEDGING

It is important to keep the interests of securitizers and those of investors closely aligned to deter the creation of products that profit

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219. See *supra* notes 78–87 and accompanying text.

220. See *supra* note 108 and accompanying text.

221. See Oesterle, *supra* note 76, at 759–60.

222. See 15 U.S.C.A. § 78o-11(c)(1)(G)(i), (iii) (West 2012) (giving rule makers the authority to exempt securities from risk retention, particularly those backed by state governments, if in the public interest and for the protection of investors). Or perhaps state governments could remediate disparate effects of income inequality themselves by guaranteeing a subset of home loans to targeted communities. See *id.* (exempting ABS backed by any state of the United States or by the United States from risk retention).

223. See *supra* Part I.C.

224. See Oesterle, *supra* note 76, at 760.

225. See *supra* notes 172–76 and accompanying text; *accord* Press Release, FDIC, *supra* note 26.

securitizers but harm investors, borrowers and the economy at large.<sup>226</sup> At the same time, a balance must be struck between this interest and the interest of preserving a financial incentive for financial institutions to participate in structured finance altogether so that credit may flow to worthy borrowers.<sup>227</sup> The Premium Capture Account established by the Proposed Rules is thus needed but requires modification.

The reserve account is needed so that profits collected from arranging a securitization transaction do not offset the required risk retention that a securitizer retains.<sup>228</sup> For instance, in a \$1 billion transaction, if a securitizer collects \$75 million in fees and retains 5% or \$50 million of the ABS, regardless of what ultimately becomes of the ABS, the securitizer will receive a net profit of at least \$25 million. The Premium Capture Account in the Proposed Rules would require such amount to be held in trust to serve as a first loss position for the benefit of investors until the ABS pays investors off in full.<sup>229</sup>

This proposal, however, is too onerous in that amounts from the Premium Capture Account cannot be realized by a securitizer for many years (potentially ten to thirty years depending on the duration of the underlying mortgage loans), which, practically speaking, would eliminate the incentive to arrange a securitization except for financing purposes.<sup>230</sup> Financiers are driven by realizing short-term profits and such a rule does not put the private sector on fair footing to compete with Fannie and Freddie securitizations while under the FHFA.<sup>231</sup>

As a result, the final risk retention rules should modify the Premium Capture Account such that it holds a securitizer's profits in trust to serve as a first loss position in an ABS for the first three to five years after the RMBS transaction closes.<sup>232</sup> After this point, the trustee

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226. See, e.g., *supra* notes 1–9 and accompanying text.

227. See *supra* notes 187–94 and accompanying text.

228. See Credit Risk Retention, 76 Fed. Reg. 24,090, 24,096, 24,113–14 (proposed Apr. 29, 2011).

229. See *supra* notes 114–17 and accompanying text.

230. See *supra* notes 190–94 and accompanying text.

231. See *supra* notes 190–94 and accompanying text.

232. Empirical research suggests that default rates decline substantially once a mortgage performs for three years. See, e.g., SHANE M. SHERLUND, BD. OF GOVERNORS OF THE FED. RESERVE SYS., MORTGAGE DEFAULTS 5–6 (2010), available at [http://www.chicagofed.org/digital\\_assets/others/region/foreclosure\\_resource\\_center/more\\_mortgage\\_defaults.pdf](http://www.chicagofed.org/digital_assets/others/region/foreclosure_resource_center/more_mortgage_defaults.pdf). Default rates flatten further after three years from origination. *Id.*

of the account should be allowed to release all or a portion of the funds back to a securitizer at her discretion if the ABS has generally made timely payments to investors. For fairness, the trustee could have fiduciary obligations to both investors in the ABS and the securitizer, and would only inhibit profit collection for a securitizer if there is a substantial risk that the ABS is not as valuable as marketed to investors at closing. This rule would deter a securitizer from arranging a transaction that is destined for failure while at the same time allow a securitizer to realize a profit from arranging a healthy ABS within a reasonable time-frame, thereby preserving a realistic financial incentive for private entities to participate in structured finance.<sup>233</sup>

The duration of a securitizer's required 5% risk retention, however, should continue until the ABS reaches maturity and should take the form of horizontal retention of the most subordinated tranche in an ABS. This way, a securitizer has an economic interest that is aligned with that of investors over the duration of the ABS and absorbs the riskiest position in an ABS, thereby maintaining a securitizer's incentive to scrutinize loan-underwriting standards closely.<sup>234</sup> In turn, this retention should give investors confidence that they are not being duped into purchasing RMBS products that fail in later years and should hopefully generate enough investor demand in RMBS products to keep mortgage rates from becoming prohibitively costly.<sup>235</sup> The prohibitions on hedging (except for the limited purpose for hedging against interest rate and foreign exchange risk) in the Proposed Rules<sup>236</sup> should remain intact in the final rulemaking to ensure that the interests of securitizers are never adverse to those of investors and that the incentive to monitor loan quality is not offset, as seen in the years leading up to the Financial Crisis.<sup>237</sup>

## CONCLUSION

The failures of the originate-to-distribute model of securitization demonstrated how powerful financial incentives can be in influencing

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233. Cf. *supra* notes 190–94 and accompanying text.

234. See Press Release, FDIC, *supra* note 26; see also *supra* notes 110–11 and accompanying text; Credit Risk Retention, 76 Fed. Reg. 24,090, 24,102 (proposed Apr. 29, 2011).

235. Mortgage credit is supply driven as seen in the years leading up to the financial crisis. See *supra* note 36 and accompanying text.

236. See *supra* notes 119–121 and accompanying text.

237. See *supra* notes 1–9 and accompanying text.

the activities of intermediaries in the mortgage securitization process.<sup>238</sup> Financial incentives led to knowingly shady activity on the part of originators, securitizers and credit ratings agencies all for the purpose of generating profits.<sup>239</sup> Thus, forcing securitizers to maintain a financial interest in the products they distribute is likely crucial to correcting the flaws in private label mortgage lending that caused the Financial Crisis.<sup>240</sup>

The Agencies undertook a daunting task in proposing risk retention rules in a previously unregulated area of structured finance.<sup>241</sup> Commentators are right to point out that homeownership will be more difficult to attain as a result of the Proposed Rules, but they fail to explain why increasing homeownership is a national goal that takes precedence over all others, including curtailing the excessive leveraging and unsustainable borrowing that led to the Financial Crisis.<sup>242</sup> The Proposed Risk Retention Rules deserve praise for crafting a narrow safe harbor and prohibiting a securitizer from profiting off of arranging a securitization pool if it ultimately fails.<sup>243</sup> These proposals ensure that most RMBS products would be arranged in a system where risk retention is required, thereby giving securitizers a financial incentive to monitor underwriting quality. This is crucial to making mortgage securitization safe in a world filled with investors with a penchant for irrational exuberance; where localized booms and busts have broad macroeconomic consequences.<sup>244</sup> These accomplishments should not be

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238. See *supra* notes 1–9 and accompanying text; see also *supra* Part I.

239. See *supra* notes 1–9 and accompanying text.

240. See *supra* notes 91–92 and accompanying text.

241. See Press Release, FDIC, *supra* note 26.

242. See *supra* Parts I.A.–I.C.

243. This is not to say that the risk retention rules are the panacea for fixing the causes of the financial crisis. The risk retention provisions compliment other parts of the Dodd-Frank Act, which are intended to make securitization and mortgage lending safer and more transparent. This includes restricting mortgage loan origination unless a lender has verified a borrower's ability to repay, regulating credit ratings agencies, requiring more review and disclosures with respect to the assets underlying ABS pools; vesting the Consumer Financial Protection Bureau with the power to regulate mortgage lending; regulation of dangerous financial interconnectedness and the creation of the Financial Stability Oversight Council—the ultimate stopper in the regulatory overhaul. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 163, 610, 932, 935, 936, 943, 945, 124 Stat. 1376, 1422, 1611, 1872, 1884–85, 1897, 1898 (2010).

244. See *supra* note 75 and accompanying text.

lost when regulators sit down and craft the final rules. At the same time, it is paramount that regulators ease the consequences of the Premium Capture Account such that a securitizer may realize some profit off of arranging a healthy ABS transaction a few years after a transaction closes, thereby keeping private label interest in arranging ABS transactions alive.<sup>245</sup> Regulators should proceed with caution in easing other requirements in the Proposed Rules, however, as their primary goals should be to make securitization safe by deterring excessive leveraging and liquidity creation that could cause widespread economic harm. This in turn should hopefully create a healthy private label mortgage securitization market that generates enough investment demand for RMBS products and equity stakes in the entities that issue them to allow for the flow of sustainable credit to the housing market.

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245. See *supra* notes 232–33 and accompanying text.