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Written Testimony of

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Committee on Financial Services
Subcommittee on Capital Markets and Government-Sponsored Enterprises

"The Dodd-Frank Act's Impact on Asset-Backed Securities"

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Witness Background Statement

Adam J. Levitin is a Professor of Law at the Georgetown University Law Center, in Washington, D.C., where he teaches courses in financial regulation, structured finance, contracts, bankruptcy, and commercial law.

Professor Levitin has previously served as the Bruce W. Nichols Visiting Professor of Law at Harvard Law School, as the Robert Zinman Scholar in Residence at the American Bankruptcy Institute, and as Special Counsel to the Congressional Oversight Panel supervising the Troubled Asset Relief Program (TARP). Professor Levitin currently serves on Consumer Financial Protection Bureau's Consumer Advisory Board.

Before joining the Georgetown faculty, Professor Levitin practiced in the Business Finance & Restructuring Department of Weil, Gotshal & Manges, LLP in New York, and served as law clerk to the Honorable Jane R. Roth on the United States Court of Appeals for the Third Circuit.

Professor Levitin holds a J.D. from Harvard Law School, an M.Phil and an A.M. from Columbia University, and an A.B. from Harvard College. In 2013 he was awarded the American Law Institute's Young Scholar's Medal.

Professor Levitin has not received any Federal grants or any compensation in connection with his testimony, and he is not testifying on behalf of any organization. The views expressed in his testimony are solely his own.

Mr. Chairman Garrett, Ranking Member Maloney, Members of the Committee:

Good afternoon. Thank you for inviting me to testify at this hearing. My name is Adam Levitin. I am a Professor of Law at the Georgetown University, where I teach courses in financial regulation and structured finance, among other topics. I also serve on the Consumer Financial Protection Bureau's statutory Consumer Advisory Board. I am here today solely as an academic who has written extensively on structured finance and financial regulation and am not testifying on behalf of the CFPB or its Consumer Advisory Board.

Today's hearing is on the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act on the ABS and CLO markets. My written testimony is confined to ABS excluding mortgage-backed securities (MBS), both because MBS are traditionally categorized as distinct from ABS, and because this Committee has previously heard testimony from me regarding reform of the mortgage securitization market.[1]

The Dodd-Frank Act set forth three major regulatory provisions affecting ABS and CLOs: the Volcker Rule restrictions on bank investments and transactions,[2] the additional disclosure requirements for credit rating agencies,[3] and the "skin-in-the-game" credit risk retention requirement.[4] I address each in turn below. I leave unaddressed some more minor provisions in the Dodd-Frank Act that related to ABS.[5] I am troubled that the SEC, in particular, has failed to act on some of the most important rulemakings related to ensuring systemic stability. I also believe that some of the proposed regulatory implementations, particularly the Qualified Residential Mortgage (QRM) rulemaking, leave something to be desired. Nonetheless, I would urge this Committee not to move precipitously and to give the Dodd-Frank reforms a chance to take effect so that they can be properly evaluated.

I. THE FINANCIAL CRISIS AND REFORM OF THE ABS MARKET

As an initial matter, three general observations about the ABS market are in order.

A. Structured Finance Caused the Financial Crisis

First, we are now five years past a financial crisis caused by structured financial products. Structured financial products fueled the housing bubble, and structured financial products ensured that the collapse was more painful and messier. Bank

[1] *A Legislative Proposal to Protect American Taxpayers and Homeowners by Creating a Sustainable Housing Finance System: Hearing Before the H. Fin. Serv. Comm.*, 113th Cong., (2013) (statement of Professor Adam J. Levitin, Geo. U. L. Center).

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619 (codified at 12 U.S.C. § 1851).

[3] *Id.* § 943 (2010) (codified at 15 U.S.C. § 78o-7 note).

[4] *Id.* § 941 (codified at 15 U.S.C. § 78o-11).

[5] *E.g., id.*, §§ 942 (amending 15 U.S.C. §§ 78o-d and 77g to provide that the SEC undertake a rulemaking requiring that ABS issuer disclose information on the securitized assets), 945 (amending 15 U.S.C. § 77g to require a SEC rulemaking providing that ABS issuers undertake and disclose a review of the securitized assets).

investment in structured financial products meant that an outsized proportion of the risk on the assets underlying the structured products was concentrated on critical financial intermediaries, thereby necessitating a federal bailout. And because of the contractual complexities of structured financial products, both understanding where losses lay and attempting to restructure troubled debts was more complicated. Not surprisingly, then the crisis resulted in the collapse of the ABS market, as investor confidence in structured products was greatly shaken.

Regulation of the structured financial products market is essential for the on-going stability of the United States economy. The Dodd-Frank Act's reforms of the ABS market and the Volcker Rules attempt to undo some of the linkages between too-big-to-fail depositories and speculative investments are an attempt to deal with the systemic stability problems in the structured finance market. Arguably, the Dodd-Frank reforms and their regulatory implementations could have gone further. In particular, the Securities and Exchange Commission needs to issue a revised Regulation AB and to take action under section 939F of the Dodd-Frank Act (the Franken-Sherman amendment) to address conflicts of interest in credit ratings.[6]

The SEC also needs to finalize a rulemaking under Dodd-Frank Act section 621 (the Merkley-Levin amendment). Section 621 was written in response to the Senate Permanent Subcommittee on Investigation's examination of the Goldman Sachs ABACUS CDO scandal, involving an underwriting making proprietary bets against its own synthetic securitization. Section 621 prohibits ABS underwriters and sponsors from engaging in any transaction that would produce a conflict of interest with an investor in an ABS transaction for the first year after the ABS are issued.[7] The SEC has still not even proposed rules under section 621, despite being statutorily required to do so by April 2012.[8] Until the SEC finalizes rules under section 621, the statutory conflict of interest prohibition does not take effect.[9]

The SEC needs to take its systemic stability mandate just as seriously as it does its investor protection mandate (and to recognize that even apparently sophisticated institutional investors often need regulatory protections, as the investment failures of 2008 should have made clear). Reform of the structured finance markets is one of the three pillars of the Dodd-Frank Act, along with an attempt to address too-big-to-fail, and improved consumer financial protection. Leaving structured finance reform unfinished, much less rolling back the progress that has been made, invites future crises.

B. There Have Been Major Changes Affecting the Structured Finance Market Besides the Dodd-Frank Act

Second, the Dodd-Frank Act reforms have not been the only or even the most important changes affecting the ABS market in the past few years. By far the most important change was the Financial Standards Accounting Board's adoption of Statement of Financial Accounting Standards 166 and 167, which resulted in many securitizations being brought back onto the balance sheets of their sponsors and decreased the incentive

[6] *Id.* § 939F (codified at 15 U.S.C. § 78o-9).
[7] *Id.* § 621 (codified at 15 U.S.C. § 77z-2a).
[8] *Id.* § 621(a) (codified at 15 U.S.C. § 77z-2a(b)).
[9] *Id.* § 621(b) (codified at 15 U.S.C. § 77z-2a note).

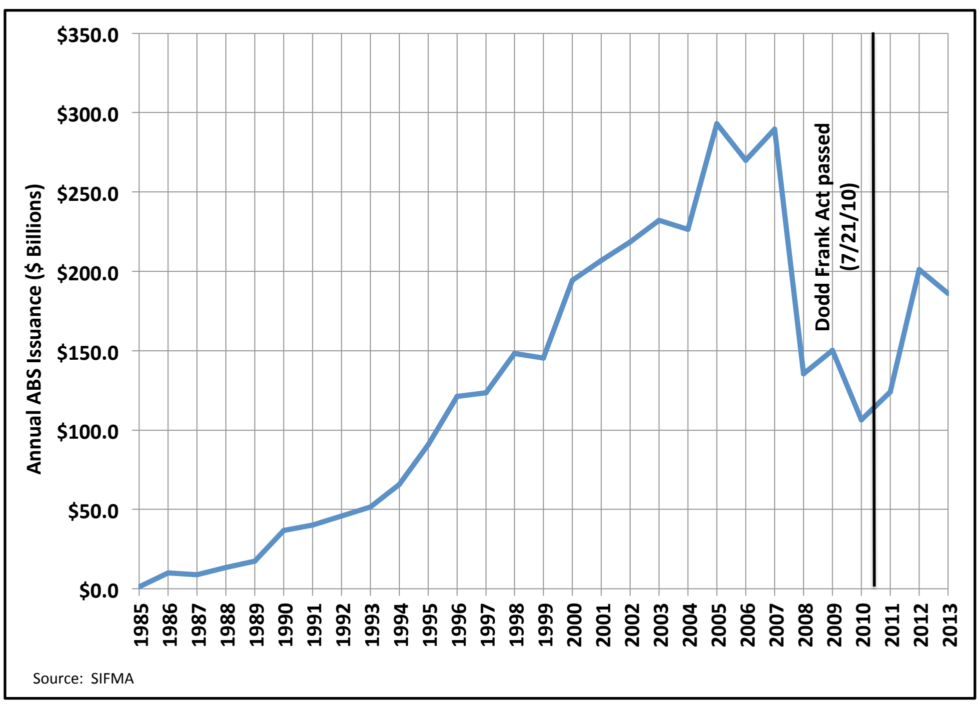
for banks to engage in securitization in order to obtain regulatory capital relief. Securitized assets also became relatively less attractive investments for banks and insurance companies because the Basel III capital standards made certain securitization assets more costly in terms of regulatory capital requirements for banks, just as changes in the National Association of Insurance Commissioners risk-based capital breakpoints increased the amount of capital that insurance companies have to hold against securitized assets.

Market changes unrelated to the Dodd-Frank Act also affected three particular ABS markets—commercial mortgage securitization (CMBS), auto loan securitizations and student loan securitizations. The CMBS market collapsed when the commercial real estate bubble imploded in 2008. The travails of the US auto industry and the general economic downturn in 2008 resulted in a notable decline in auto loan ABS. And the shift from government guaranteed to direct government lending in the student loan market in 2010 reduced the issuance of student loan backed ABS.

C. The ABS Market Is Rebounding Without Congressional Action

Third, the ABS market is rebounding, as Figure 1, below, shows. While I would hesitate to attribute this rebound to the Dodd-Frank Act reforms, the reforms do not appear to have impeded the market. Thus, while there are particular details of the Dodd-Frank reforms or their regulatory implementation that leave something to be desired, when one steps back and looks at the big picture of the ABS market, there are grounds for optimism. The prudent course of action is to give the Dodd-Frank reforms a chance to take effect before evaluating them.

Figure 1. Annual ABS Issuance, 1985-2013



II. VOLCKER RULE

Section 619 of the Dodd-Frank Act, known as the "Volcker Rule," prohibits banks from engaging in proprietary trading and from ownership interests in certain investment funds. To understand what the Volcker Rule aims to do vis-à-vis ownership interests in structured products it is necessary to understand the connection between proprietary trading and the financial crisis. Underlying the financial crisis was a giant proprietary "carry trade" by financial institutions. A carry trade is simply a funding arbitrage, whereby low cost funding is used to invest in higher yielding assets. When a carry trade works, it is inherently profitably. But if the cost of the funding is fixed and the assets underperform, a carry trade can be disastrous.

Regulatory capital rules permitted banks to hold minimal capital against highly rated positions on their trading books. Accordingly, these highly rated positions were cheaper to fund relative to investments. Therefore, banks loaded up their trading books with senior tranches of structured financial products, which they used to earn a levered carry on the spread between returns on the structured financial products and funding costs.[10] This carry trade, enabled by the Basel capital requirements, significantly increased demand for structured financial products, as structured finance is the only way to generate large amounts of AAA-rated securities. The structured products carry trade thus provided much of the financing for the housing bubble, but also leaving banks extremely exposed when the bubble burst.

Although structured products were held on banks' trading books, they were rarely in fact traded. The problem with bank investment in structured products was less one of "proprietary trading," than one of "proprietary holding." Many of these structured products that were held on bank balance sheets were collateralized debt obligations (CDOs), which are close-end investment funds that are usually actively managed. A CDO is functionally indistinguishable from a hedge fund. Thus, the Volcker Rule is in part a response to the financial crisis created by bank holdings of actively managed, close-end investment funds. Collateralized loan obligations (CLOs) are simply another flavor of actively managed close-end investment fund. ***For all intents and purposes, CLOs are indistinguishable from CDOs.*** Thus, the concerns animating the Volcker Rule apply to CLOs every bit as strongly as they do to CDOs and hedge funds.

A. Regulation VV Under the Volcker Rule Prohibits "Ownership Interests" in "Covered Funds"

Federal financial regulators recently finalized the joint regulations implementing the Volcker Rule. The joint rulemaking is codified separately for the OCC, FDIC, SEC, and Federal Reserve Board. However, I will refer to the rulemaking under its Federal Reserve Board moniker, Regulation VV.[11]

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[10] *See* Gillian Tett, *Super-senior losses just a misplaced bet on carry trade*, FIN. TIMES, Apr. 18, 2008.

[11] The different agencies' regulations are to be codified at 12 C.F.R. pt. 44, 12 C.F.R. pt. 351, 17 C.F.R. pt. 253 and 12 C.F.R. pt. 248 respectively.

As Reg VV relates to the ABS and CLO market, it provides that after July 21, 2015, a bank may not have an "ownership interest" in a "covered fund."[12] Furthermore, banks are subject to limitations on their other relationships with covered funds.[13]

Certain ABS and CLO investments qualify as "ownership interests" in "covered funds". A quick tour into the regulatory definitions is necessary to understand why. As a starting point, however, keep in mind that the Volcker Rule prohibition applies only if there is both (1) an ownership interest and (2) it is in a covered fund. Either condition by itself is insufficient to trigger the Volcker Rule prohibition.

A "covered fund" is any entity that would be an investment company, as defined in the Investment Company Act of 1940, without regard to the exemptions under section 3(c)(1) or 3(c)(7) of that Act that usually exempt structured financial products from investment company regulation.[14]

The Volcker Rule's coverage of "funds" is important because securitization always involves an investment in a fund. The fund might be in the form of a trust or corporation or LLC that are at least nominally separate from the financial institution that sponsors the securitization. The fund might be actively managed or it might be passively managed according to a fixed set of detailed investment instructions. Irrespective of its form, the fund is the entity that holds the securitized assets—loans, securities, derivatives, or other rights to a cash flow—and the fund is also the entity that issues various securities (debt and equity).[15] Thus, the Volcker Rule's initial coverage trigger is just that there is a fund (meaning investment company), which covers all sorts of funds.

Reg VV exempts from the definition of "covered fund" any ABS issuer that meets certain requirements. The most critical of these requirements for exemption from "covered fund" status is that the ABS issuer's assets are comprised solely of "loans," cash equivalents, certain interest rate and foreign exchange derivatives related to the hedging the risks on the loans, and "special units of beneficial interest and collateral certificates."[16] "Loans" are defined as excluding securities and derivatives.[17] Thus, any ABS issuer that has securities (such as bonds) or prohibited derivatives (such as credit default swaps) among its assets will not qualify for exemption from the definition of "covered fund."

B. Volcker Rule and ABS

The Volcker Rule investment prohibition does not apply to most ABS (other than CLOs, addressed below) because most ABS issuers do not have any securities or

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[12] 12 C.F.R. § 248.10(a)(1). The regulations' effective date in April 1, 2014, but the divestment requirement does not go into effect until July 21, 2015. *See* Board Order Approving Extension of Conformance Period, *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf.

[13] 12 C.F.R. § 248.14.

[14] 12 C.F.R. § 248.10(b).

[15] Some securitizations involve two funds, one of which holds the assets and issues obligations to a second fund, which in turn issues different securities. This two-fund structure involving an intermediate securitization is common for securitizations of credit card receivables, equipment leases, and floor plan loans, as well as some foreign mortgage securitizations.

[16] 12 C.F.R. § 248.10(c)(8).

[17] 12 C.F.R. § 248.2(s).

prohibited derivatives among their assets. The assets of most ABS issuers (the fund) are either loans or special units of beneficial interest or collateral certificates as well as certain permitted ancillary assets such as interest rate and currency derivatives.[18] Accordingly, banks are free to invest in most forms of ABS under the Volcker Rule.

If, however, an ABS issuer invests in any securities (including in ABS other than collateral certificates and special units of beneficial interest) or prohibited derivatives, such as credit default swaps, then the ABS issuer does not qualify for the exemption from being a "covered fund".[19] Accordingly, the Volcker Rule prohibition *might* apply, based on (1) whether the bank's investment would be an "ownership interest" and (2) whether the fund meet the definition of an investment company (without regard to certain exempts). Thus, resecuritizations of ABS (collateralized debt obligations or CDOs) might be "covered funds" because their assets include securities (the ABS). Even so, an analysis of a bank's particular holdings in such resecuritization would be necessary to determine if they constituted an "ownership interest," which is unlikely to be the case for most ABS other than some CDOs. The Volcker Rule thus does not affect most ABS.

C. Volcker Rule and CLOs

The Volcker Rule's regulatory implementation will potentially require banks to divest from some collateralized loan obligations or CLOs, a particular species of ABS. I do not find this of particular concern. If divestment is required for CLOs, it is no different than the divestment from any other type of fund mandated by the Volcker Rule. Moreover, the application of the Volcker Rule to CLOs will not chill the CLO issuance market.

1. What Is a CLO?

A CLO is a securitization of corporate loans, or more precisely a securitization of a "leveraged loans", a particular type of corporate loan. CLOs are generally actively managed, rated, closed-end, structured investment funds. The term "CLO" refers to both the fund and to the securities it issues. CLOs tend to be actively managed, meaning that the CLO manager may buy and sell assets within preset investment parameters and guidelines.[20] CLO's securities are generally rated by credit rating agencies. CLOs have limited lifetimes (usually less than 10 years, more typically 7-9 years) and a single funding period, so they are closed-end funds. What distinguishes CLOs from other types of investment funds is a CLO invests primarily or exclusively in corporate loans and that

[18] For direct securitizations, such as of most US mortgages, car loans, and student loans, the issuing entity holds the loans directly. For other asset classes, such as equipment lease securitizations, floor plan loan securitizations, and credit card receivable securitizations and some UK RMBS, there is an intermediate securitization, and the ultimate issuer holds the collateral certificates or special units of beneficial interest issued by the intermediate securitization entity, such as a master trust, issuance trust, or collateral trust.

[19] 12 C.F.R. § 248.10(c)(8)(iii).

[20] Loan Syndications and Trading Association, Comment Letter on Credit Risk Retention, Oct. 30, 2013, *at* http://www.lsta.org/WorkArea/showcontent.aspx?id=17146 at 27 ("CLOs are actively managed, and CLO managers can continue to monitor asset quality, and respond appropriately through asset dispositions, through much of the life of the CLO.").

the interests in the CLO are structured (meaning tranched) so that credit and interest rate risks are not allocated pro rata among investors.[21]

The key point to see here is that ***<u>there is no clear difference between a CLO and either a CDO or a hedge fund</u>*.** A CLO is indistinguishable from a rated, structured hedge fund that invests primarily in corporate loans.[22] Not surprisingly, none of the major credit rating agencies have separate ratings criteria for CLOs. Instead, CLOs and collateralized bond obligation are both treated as flavors of collateralized debt obligations (CDOs) by the rating agencies. Likewise, in the UK, CLO is used as the generic term to refer to all CDOs.

Given that there is no substantial difference between CLOs and CDOs, one would expect CLOs to be treated the same as CDOs and hedge funds by Reg VV. In fact, they are not, to the extent that a CLO holds only loans as assets, Reg VV treats it as akin to a passively managed securitization, like those that exist for residential mortgages. This disparate treatment of similar funds is apparently necessitated by a provision in the Volcker Rule that provides that, "Nothing in this section shall be construed to limit or restrict the ability of a banking entity or nonbank financial company supervised by the Board to sell or securitize loans in a manner otherwise permitted by law."[23] Thus, Reg VV distinguishes between CLOs with loan-only assets, and all other CLOs, which might also have securities or prohibited derivatives as assets. This provision is a comfort provision for community banks that regulators have incorrectly interpreted as a super-exemption to benefit the too-big-to-fail banks' CLO business.

It also bears emphasis that CLOs are *not* financing small businesses. CLOs invest primarily in the "leveraged loan" market—the highly liquid market in large, syndicated, high-yield corporate loans. The leveraged loan market is the loan equivalent of the high-yield or "junk" bond market. Leveraged loans are heavily traded, tracked on indices, and even receive credit ratings, just like bonds. Leveraged loans are used extensively as financing for takeovers and leveraged buyouts (LBOs), rather than for providing operating capital to Main Street businesses. CLOs provide only part of the market for leveraged loans.

2. CLO Assets: Syndicated Leveraged Loans, but Sometimes More

While CLOs invest primarily in syndicated leveraged loans, some CLOs hold some corporate bonds as well, and more CLOs are at least authorized to purchase corporate bonds. We do not know this because CLO deal documents are not publicly available. Because CLOs are actively managed, those CLOs that are authorized to purchase corporate bonds may do so in the future; the CLO manager is not required to take into account the Volcker Rule effect on CLO investors in its investment decisions. Thus, any CLOs that either hold or are authorized to purchase corporate bonds or derivatives would potentially be "covered funds."

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[21] Indeed, UK terminology uses CLO to refer to genus of structure financial products known in the US as a CDO.

[22] Cf. Davis Polk, Client NewsFlash, *Who Knew CLOs Were Hedge Funds?* Feb. 10, 2014 (assuming that CLOs are obviously different from hedge funds—themselves a poorly defined category of investment fund—but never explaining why).

[23] 12 U.S.C. § 1851(g)(2).

Significantly, we do not know how many CLOs in fact have authority to purchase corporate bonds, much less hold them. There has been some speculation in news media,[24] but there is no data available on this because CLO deal documents are not publicly available. Likely the CLO world separates into three "buckets": a group of CLOs that have no bond or prohibited derivate holdings; a group of CLOs that have a single high-quality bond that can easily be swapped out; and a group of CLOs that have more extensive non-loan holdings. Without knowing the relative sizes of these buckets, it is very difficult to say anything about the effect of the Volcker Rule on existing CLOs. As discussed below, this lack of data point underscores the problems that exist in regulating the CLO market and structured financial products in general given the extensive use of private placements of structured products.

3. CLO Ownership Interests: "For Cause" Removal, Evasion, and Implicit Guarantees

As Reg VV currently stands, banks will be prohibited from holding "ownership interests" in CLOs that are "covered funds." Not all bank investments in CLOs are "ownership interests," however. Reg VV defines "Ownership interest" as "any equity, partnership, or other similar interest,"[25] as well as includes an interest that:

> [h]as the right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading advisor of the covered fund (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event).[26]

CLOs typically permit investors to remove the CLO manager upon an event of default (as defined in the CLO agreement). Some CLOs also give investors the right to replace the CLO manager "for cause," such as fraud, criminal activity, or material breach of the CLO manager's contract, which might not constitute an "event of default" under the CLO agreement.

Such "for cause" removal rights raise potentially thorny Volcker Rule evasion issues. On their face, "for cause" removal rights are creditor protections, but they can also be used as leverage to exert control over the CLO manager by threatening removal unless the manager accedes to the demands of the investor. Moreover, "for cause" can be defined in ways that link removal rights to fund performance. For example, a failure to hit particular return hurdles could be defined as a material breach of the CLO manager's contract. As with CLO investment authority and actual investment patterns, we do not know how widespread such "for cause" removal provisions are among CLO contracts, much less exactly what they cover. Accordingly, legislating to protect "for cause" removal potentially opens the door to a serious Volcker Rule evasion problem.

The ultimate concern regarding "for cause" removal is not Volcker Rule evasion per se, but that exercise of "ownership rights" will result an implicit guarantee of uninsured investment funds by insured depositories. If bank investments in CLOs have the indicia of ownership of the CLOs, banks might feel under pressure for reputational

[24] Davis Pollk, *supra* note 22.
[25] 12 C.F.R. § 248.10(d)(6)(A).
[26] 12 C.F.R. § 248.10(d)(6)(B).

reasons to bail out their affiliated CLOs should the CLOs get in trouble, even though there is no legal obligation to do so. This type of implicit guarantee can result in the deposit insurance safety net leaking out beyond depositories and effectively insuring speculative investments—without payment of any insurance premia for the risk.

This leakage of deposit insurance beyond insured depositories to speculative investment funds is exactly what the Volcker Rule is designed to prevent. Allowing "for cause" removal rights or any other indicia of fund ownership raises the specter of banks bailing out legally separate funds. This is not a speculative concern. We have seen it happen repeatedly with credit card securitizations, as banks routinely rescue their credit card securitization vehicles from impending "defaults".[27] We also saw this occur in 2007, when many banks took their sponsored Structured Investment Vehicles (SIVs) back on balance sheet[28] and when Bear Stearns bailed out two nominally independent, external hedge funds.[29] In the case of SIVs and the Bear Stearns funds, the implicit guarantee was based around sponsorship and provision of liquidity puts, rather than control in the form of removal rights. All the more so would sponsorship and removal rights be likely to create an implicit guarantee. Accordingly, any sort of ownership indicia, including "for cause" removal rights, might engender the type of implicit guarantee the Volcker Rule is meant to prevent.

4. CLO Ownership Interests: More Than Just "For Cause" Removal

Reg VV's definition of "ownership interest" extends beyond equity interests and "for cause" removal rights. It also includes a set of provisions that effectively make a CLO interest an "ownership interest" if the investor's returns depend on the CLO's performance—indicia that the interest is more like equity than debt. Thus, Reg VV defines "ownership interest to include an interest that:

> (D) Has the right to receive all or a portion of excess spread (the positive difference, if any, between the aggregate interest payments received from the underlying assets of the covered fund and the aggregate interest paid to the holders of other outstanding interests);
>
> (E) Provides under the terms of the interest that the amounts payable by the covered fund with respect to the interest could be reduced based on losses arising from the underlying assets of the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest;

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[27] *See* Adam J. Levitin, *Skin-in-the-Game: Risk Retention Lessons from Credit Card Securitization*, 81 GEO. WASH. L. REV. 813, 840-41, 847-48 (2013); Joseph R. Mason et al., *Asset Sales, Recourse, and Investor Reactions to Initial Securitizations: Evidence Why Off-Balance Sheet Accounting Treatment Does Not Remove On-Balance Sheet Financial Risk*, May 22, 2009, *available at* http://ssrn.com/abstract=1107074 (sponsors intervened for credit card securitization trusts 17 times between 1991 and 2001). Technically, the issue for credit card securitizations is not a "default," but an early amortization event that will result in the termination of the securitization vehicle as a funding mechanism for future credit card lending.

[28] William W. Bratton & Adam J. Levitin, *A Transactional Genealogy of Scandal: From Michael Milken to Enron to Goldman Sachs*, 86 S. Cal. L. Rev. 783, 842 (2013)

[29] *Id.* at 841-42.

> (F) Receives income on a pass-through basis from the covered fund, or has a rate of return that is determined by reference to the performance of the underlying assets of the covered fund;[30]

Many CLO interests will qualify as an "ownership interest" on the basis of these tests, irrespective of "for cause" removal rights. In particular, nearly all CLOs have overcollateralization (O/C) and interest coverage (I/C) tests as standard creditor protections.[31] If these tests are not met, then cashflows are diverted from junior tranches to pay down senior tranches and deleverage the CLO. The effect of O/C and I/C tests is to ensure that "the amounts payable by the covered fund with respect to the interest could be reduced on based on losses arising from the underlying assets of the covered fund". Accordingly, legislating changes to protect "for cause" removal rights may not have much effect on the application of the Volcker Rule to CLOs. Bank investments in CLOs may still be "ownership interests" on separate, independent bases than "for cause" removal rights.

5. Legacy CLO Issues: Uncertain Scope, Limited Concern, and Surgical Fixes Possible

Recall that Reg VV would require a bank to divest from a CLO only if both (1) the CLO has an investment in corporate bonds or prohibited derivatives and (2) the bank's interest in the CLO would give it the right to remove management absent an event of default (or an equity interest). No one knows the universe of CLOs for which these two conditions both apply, and it is specious to suggest that concern over this issue is somehow chilling the CLO issuance market. At most, the Volcker Rule is a problem for some bank investments in legacy CLOs. The Volcker Rule is *not* a problem for the CLO market going forward.

For some unknown number of legacy CLOs, banks will potentially have to divest if the CLOs hold bonds and if the bank's investment qualifies as ownership interest for any reason, not just "for cause" removal, but also sharing in upside benefits or downside risk. We should not assume, however, that banks are helpless in regard to the investments of CLOs.

Because too-big-to-fail banks are major sponsors and buyers of CLOs, too-big-to-fail banks have a great deal of market power that they can exert on CLO managers. (Community banks are unlikely to have significant holdings of CLOs.) A CLO manager that wants to get future business from too-big-to-fail banks is likely to agree to remove isolated bond holdings from a CLO's portfolio. Banks' market power alone is likely to result in many of the CLOs that currently qualify as "covered funds" to cease to meet that definition by the divestment date in Reg VV.

To the extent that divestment is required, it is not particularly problematic. Banks have until July 21, 2015 to divest from ownership interests in covered funds,[32] and

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[30] 12 C.F.R. § 248.10(d)(6)(D)-(F).

[31] *See, e.g.,* Babson Capital White Paper, *What are CLOs and how do they work?* July 2009, at http://www.babsoncapital.com/BabsonCapital/http/bcstaticfiles/Research/file/CLO%20White%20Paper_CLOWP4309_Jun09.pdf.

[32] *See* Board Order Approving Extension of Conformance Period, *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf.

individual banks may receive a two-year extension for the divestment period.[33] Additionally, the Federal Reserve Board has authority to extend the conformance period for all banks for up to two additional years.[34] The CLO market is reasonably liquid,[35] so there is little reason to think that such divestments with a period of up to three years would result in fire sale prices and losses for too-big-to-fail banks (provided that banks have been keeping their CLO interests on their trading books and marking them to market, rather than keeping them at book value as hold-to-maturity assets). Indeed, banks will not need to divest at all from many ownership interests in covered funds because the funds will have paid off before the end of the divestment period.

Concerns about divestment prices are not unique to CLOs. This is an issue that applies to all other sorts of proprietary investments of banks that are prohibited under the Volcker Rule. There is nothing special about CLOs in regard to the Volcker Rule. While one might reasonably criticize Reg VV for imposing an artificial distinction between bonds and loans (particularly between bonds and syndicated loans), this is a distinction that has long existed in securities regulation, and there are still important differences between bonds and loans (as a general matter): bonds tend to have fewer and weaker covenants and tend to be unsecured, whereas loans tend to have more covenants and are secured. Accordingly, it might make sense to treat an investment in a fund containing solely loans as less speculative than an investment in a fund containing both loans and bonds.

If Congress thinks it is appropriate to reopen the legal distinction between loans and bonds, it is important to recognize the implications. If we were to treat bonds and loans identically for regulatory purposes, we could either ratchet down and deregulate the bond market…or we could ratchet up and subject the syndicated loan market to securities regulation, which is the last thing that market wants. I express no position here as to which would be the proper course. Instead, I only make this observation to underscore that disregarding the loan-bond distinction has implications that reach beyond the CLO market.

To the extent that Congress is worried about banks having to divest from legacy CLOs, there are a number of discrete, surgical fixes possible, and most do not require legislation. First, regulators could be persuaded to clarify Reg VV to create a *de minimis* bond holding exception for existing CLOs or to create an exception for "for cause" removal rights in CLOs. Another solution would be for regulators to announce a policy of forbearance for banks that waive their "for cause" removal rights. Yet another would be a longer divestment period. Most CLOs have a life of 10 years or less, so the longer the divestment period, the greater the run-off of existing CLOs and the less divestment necessary. Moreover, banks often hold the senior tranches of CLOs, which might have faster paydowns than the junior tranches, so the maturity of bank investments in CLOs might be less than CLO lifespans.

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[33] 12 C.F.R. § 248.12(e).

[34] See 12 U.S.C. 1851(c)(2) (the Board has already granted one additional year of conformance time, so only two additional years can be granted now).

[35] *See* Andreas A. Jobst, *Collateralised Loan Obligations (CLOs); A Primer*, http://www.securitization.net/pdf/fmg_clo_100102.pdf.

6. The CLO Market Going Forward: Market Solutions

What is clear is that the Volcker Rule's application to CLOs should not affect the availability of capital to business borrowers. Divestment from existing CLOs does not affect capital availability, as these CLOs, and the loan they have invested in, are already funded. Although some critics of the Volcker Rule have attributed a recent drop in CLO issuance to the Volcker Rule, they have neither identified why the Volcker Rule would cause such a drop in issuance, nor have they explained why CLO issuance is now up for the first three weeks of February 2014 to $4.4 billion over its 17-month low of $2.55 billion in January 2014.[36]

Going forward, the Volcker Rule should not be a problem for the CLO market. If CLO sponsors want to attract banks to the investment class—which they surely will—they will structure CLOs to either (1) restrict investments solely to loans, (2) remain outside of the definition of covered fund by using the Rule 3-a7 exemption from the definition of "investment company," or (3) provide for CLO interests without removal rights, potentially as a separate class of CLO interests.

Already, some new CLOs have loan-only investment restrictions.[37] Similarly, some new CLOs are being structured to qualify for the Rule 3-a7 exemption from the definition of "investment company," which is the starting point for the definition of a "covered fund."[38] Finally, the issuance of separate classes of securities to satisfy regulatory requirements is already widely done to ensure that securities are available for purchase by insurance companies or pension plans. NAIC rules require that insurers invest in securities from domestic issuers. Thus, CLOs and CDOs, which use Cayman Islands entities as their primary issuers, will also have a Delaware entity co-issuer for a class of securities for sale to insurance companies. Similarly, pension plans are required to purchase only ERISA-qualified securities, and many ABS deals will have a special ERISA-qualified class or classes to satisfy this market. In short, I do not see the Reg VV treatment of CLOs as a particular concern, and I do not it as a basis for a broader reconsideration of the Volcker Rule.

III. Representations and Warranties

One of the biggest lessons for ABS markets from the financial crisis was the importance of representations and warranties and their enforcement mechanisms. ABS investors are investing in a discrete pool of assets, and their investment pricing is based on the quality of those securitized assets. If the assets are not of the quality promised, then the entire basis for the investment decision is undermined. This was particularly a problem for private-label mortgage securitizations, but the issue is of concern to ABS

[36] *The Impact of the Volcker Rule on Job Creators: Hearing Before the H. Fin. Serv. Comm.*, 113th Cong., (2014) (statement of Elliot Ganz, Executive Vice President and General Counsel of the Loans Syndications and Trading Association); *See also* Kristen Haunss, *CLO Issuance Jumps as U.S. Managers Bet on Volcker Rule Verdict*, BLOOMBERG (Feb. 19, 2014), http://www.bloomberg.com/news/2014-02-19/clo-issuance-jumps-as-u-s-managers-bet-on-volcker-rule-verdict.html.

[37] Carol J. Clouse, *Another Volcker Workaround for CLOs*, ASSET SECURITIZATION REPORT, Feb. 18, 2014.

[38] *Id.*

investors generally. ABS investors need to have confidence that the representations and warranties that accompany their investments will be correct and, to the extent they are breached, that they will be enforced. To the extent that ABS investors do not think that the representations and warranties on their investments will be honored, they will be reluctant to invest, particularly in the more junior tranches that bear the majority of the credit risk.

Section 943 of the Dodd-Frank Act is an attempt to help create better market discipline for ABS by forcing disclosure of information about representations and warranties and loan repurchase requests. Section 943 requires the SEC to promulgate regulations requiring credit rating agencies to include in their ABS ratings reports a description of the deal's representations and warranties and enforcement mechanisms and their difference from similar deals.[39] Section 943 also requires the regulations to require securitizers to disclose the fulfilled and unfulfilled repurchase requests for all of its trusts "so that investors may identify asset originators with clear underwriting deficiencies." The SEC fulfilled its rulemaking requirement in early 2011.[40]

The information required by section 943 is not particularly burdensome to compile, and it is potentially very valuable for improving the efficiency of ABS markets, as the data allows ABS investors to identify problematic originators (and sponsors) and thus avoid their future deals. In theory, this should enable better market discipline. Originators and sponsors should be incentivized to securitize loans that conform to the representations and warranties made on them, so that they will be able to sell future deals.

I have doubts about whether such disclosures are likely to be effective. First, originators can easily avoid reputational sanctions by operating under multiple (and changing) names. And second, the information produced may not be timely. Putting aside early payment defaults, the indications of high repurchase requests are unlikely to occur for a few years, by which point it may be too late; it only takes a few years for an asset bubble to form. To wit, the housing bubble was only from 2003-2006. Nonetheless, section 943 is a step forward toward a more transparent ABS market.

It is worthwhile noting that section 943 and the rules thereunder require only disclosure. They do not mandate the use of any particular representations and warranties. While there is some purchase to the idea of a mandatory or at least a default set of representations and warranties for different ABS classes—something that Chairman Garrett has proposed in both PATH Act[41] and the Private Mortgage Market Investment Act[42]—section 943 does not go so far as mandating contract terms for sophisticated private parties.

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[39] *Id.* § 943 (codified at 15 U.S.C. § 78o-7 note).

[40] 76 Fed. Reg. 4511, Jan. 26, 2011, *codified at* 17 C.F.R. §§ 229.1104, 229.1121, 240.15Ga-1(a), 240.17g-7.

[41] Protecting American Taxpayers and Homeowners Act, Title III, *available at* http://financialservices.house.gov/uploadedfiles/bills-113hr-pih-pathdd-ss.pdf (directing a privately owned mortgage securitization utility to develop "best practices" for representations and warranties and remedies).

[42] Private Mortgage Market Investment Act, Title II, *available at* http://financialservices.house.gov/uploadedfiles/pmmia_bill.pdf.

IV. Credit Risk Retention

Section 941 of the Dodd-Frank Act requires securitization sponsors and issuers to retain at least 5% of the credit risk in any non-exempted securitization. Statutory exemptions exist for securitizations backed by "qualified residential mortgages" (QRM) and for securitizations meeting certain underwriting standards, which are to be defined in a joint rulemaking by the SEC, Federal Reserve Board, FDIC, OCC, FHFA, and HUD.[43] These agencies issued an initial notice of proposed rulemaking under section 941 on March 28, 2011.[44] The agencies have subsequently re-proposed a revised rule on August 26, 2013.[45]

A. Qualified Residential Mortgage Definition

There are serious deficiencies with the re-proposed rule, particularly related to the treatment of residential mortgage securitizations. Most significantly, in the re-proposed rule, QRM is defined in the broadest possible way permitted by statute,[46] namely as any mortgage that meets the regulatory definition of a Qualified Mortgage (QM), which is used to provide a safe harbor for the Dodd-Frank Act's ability-to-repay requirement.[47] QM is variously defined for different types of mortgages by the CFPB,[48] HUD,[49] the VA, the Department of Agriculture, and the Rural Housing service.[50]

The breadth of this definition is surprising because the CFPB's QM rulemaking was a consumer protection rulemaking, rather than a systemic stability rulemaking. Thus, some commentators have (wrongly) criticized the QM rulemaking for not accounting for loan-to-value ratios,[51] but loan-to-value ratios do not affect *ability* to repay a mortgage, and the CFPB correctly adhered to its statutory mandate. Loan-to-value ratios do, however, affect the probability of default and loss-given-default, both of which matter from a systemic stability standpoint.

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[43] 12 U.S.C. § 78o-11(c)(1)(B).

[44] Credit Risk Retention, 76 Fed. Reg. 24090, 24167 (Apr. 29, 2011) (original proposed QRM rule). Federal Register publication lags behind agency approval of proposals.

[45] Credit Risk Retention, 78 Fed. Reg. 57928-01 (Sept. 20, 2013) (reproposed QRM rule). Federal Register publication lags behind agency approval of proposals.

[46] Credit Risk Retention, 78 Fed. Reg. 57928-01 (Sept. 20, 2013) (the reproposed rule making has some other minor requirements, such as the loans be performing loans, that they not include any resecuritizations, and that the securitizer certify certain internal controls).

[47] 15 U.S.C. § 1639C.

[48] 12 C.F.R. §1026.43.

[49] Qualified Mortgage Definition for HUD Insured and Guaranteed Single Family Mortgages, 78 Fed. Reg. 75215-38, (Dec. 11, 2013), *codified at* 24 C.F.R. §§ 201.7 (property improvement and manufactured housing loans), 203.19 (single family), 1005.120 (Indian housing), 1007.80 (Native Hawaiian housing).

[50] 15 U.S.C. § 1639C(b)(3)(B)(ii).

[51] *See, e.g.,* Edward J. Pinto, Peter J. Wallison, *New Qualified Mortgage Rule Setting us up for Another Meltdown*, WASHINGTON TIMES (Mar. 3, 2013), http://www.washingtontimes.com/news/2013/mar/3/wallison-and-pinto-new-qualified-mortgage-rule-set/?page=all.

The original credit risk retention proposal defined QRM to include reference to loan-to-value ratios,[52] as well as downpayment and appraisal requirements,[53] and more restrictive debt-to-income ratios than permitted under the CFPB's and HUD's QM rulemakings.[54] The absence of loan-to-value ratios or of other features designed to discourage pro-cyclical lending means that QRM is not doing any work that is not already done by QM. The absence of loan-to-value requirements for residential mortgages in the section 941 rulemaking is particularly striking because there is a loan-to-value requirement for commercial mortgage securitizations to be excused from credit risk retention.[55] Skin-in-the-game is meant to be a systemic stability regulation, but it has instead been pegged to a consumer protection regulation.

The section 941 credit risk retention reproposal also provides that for *commercial* mortgage securitizations to be exempted from credit risk retention the securitizations had to employ independent, unconflicted operating advisors.[56] An independent operating advisor will help reduce some of the conflicts of interest in commercial mortgage securitizations. It is puzzling why a similar intervention was not required for the QRM exemption for *residential* mortgages given the serious conflicts of interest that have plagued residential mortgage securitizations due to the affiliations between servicers, sponsors, and depositors, and the lack of incentives for trustees to monitor performance of the loans or representations and warranty compliance.

Indeed, the operating advisor requirement for CMBS underscores a significant change in the QRM reproposal from the original proposal. The original credit risk retention proposal also included a requirement as part of the QRM definition that a securitization's deal documents must require loss mitigation with a goal of maximizing net present value of the loan, without reference to the interests of any individual tranche of MBS investors.[57] This requirement was eliminated—without any comment by the agencies—from the reproposed rulemaking. The elimination of loss mitigation is not in reaction to CFPB regulations, as the CFPB's Reg X servicing rules do not require such loss mitigation; instead Reg X requires that if loss mitigation is offered, it must comply with certain regulatory features.[58] The QRM reproposal should include a net present value positive loss mitigation requirement and provisions mandating an equivalent of an independent operating advisor to ensure representation and warranty compliance in MBS, which is an important step toward creating a stable and sustainable private-label MBS market.

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[52] Credit Risk Retention, 76 Fed. Reg. 24090, 24167 (Apr. 29, 2011) (proposed QRM rule).

[53] *Id.*

[54] *Id.* at 24166.

[55] Credit Risk Retention, 78 Fed. Reg. 57928-01 (Sept. 20, 2013), proposed rule §§ _.17(5) (LTV and CLTV requirements for commercial mortgages), _.15 (no credit risk retention required if underwriting standards are met); _.14 (definitions of LTV and CLTV.

[56] Credit Risk Retention, 78 Fed. Reg. 57928-01 (Sept. 20, 2013), proposed rule § _.7(b)(6) (requirements for CMBS exemptions from credit risk retention).

[57] Credit Risk Retention, 76 Fed. Reg. 24090, 24167 (Apr. 29, 2011) (proposed QRM rule).

[58] Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act (Regulation X), 78 Fed. Reg. 10696, 10823 (Feb. 14, 2013), *codified at* 12 C.F.R. Pt. 1024 ("the Bureau has clarified in response to inquiries raised by commenters that servicers are not required by the Bureau's rules to offer any particular loss mitigation option to any particular borrower.").

B. Impact of Credit Risk Retention on ABS Markets

It is hard to say what the ultimate impact of the credit risk retention rules, if adopted, will be on ABS markets. The rulemaking estimates an impact of between zero and 30 basis points for the cost of credit, depending on whether the retained credit risk is funded through equity issuance, term debt, or bi-lateral repo.[59] I have no reason to gainsay this estimate.

The impact of credit risk retention is likely to vary by market. For some markets, like credit card ABS, it should not matter, as there is already credit risk retention mandated by deals, namely that the seller keep an untranched "vertical" seller's interest of a specified percentage (often at least 4%, if not 7%).[60] Moreover, many ABS markets are really funding markets, rather than risk transfer markets. For operating companies that rely on securitization as a steady funding source—credit card issuers, auto finance companies—credit risk retention should not particularly matter because these issuers are already strongly incentivized to engage in good underwriting in order to retain future access to capital markets. For these companies, credit risk retention might result in a small increase in the cost of funding, which would have to be done through other means—deposits and general corporate debt. Credit risk retention only really matters for mortgage securitization markets where the securitizers are not the operating companies and securitization is about credit risk transfer as well as funding.

C. Credit Risk Retention Will Not Work Unless Too-Big-to-Fail Is Addressed

Irrespective of the details of the section 941 rulemaking, I am skeptical whether credit risk retention can be effective so long as the too-big-to-fail (TBTF) problem remains unaddressed. The conceit behind credit risk retention is that if securitizers have to "eat their own cooking," they will take care that it is not toxic—credit risk retention should ensure better underwriting of securitizations. Credit risk retention may not work, however, when dealing with TBTF financial institutions. If a TBTF bank believes that it will be bailed out at taxpayer expense, credit risk retention will not incentivize it to ensure better underwriting of securitizations. In a TBTF world, securitizers gain all of the upside of undertaking more securitizations, while the downside risk from the credit risk retention is borne by the taxpayers. We saw a version of this in the 2008 financial crisis. Some of the firms that blew up were the ones that retained the most risk, such as Citibank (retained tranches of CDOs), Countrywide (payment option ARMs kept on balance sheet), and Washington Mutual (various non-prime mortgages kept on balance sheet). Even worse, the section 941 credit risk retention requirement could have a lulling effect on other investors, who wrongly assume that the structured financial products are safe for investment because the securitizers are also investing in them. As long as we are living with TBTF, we should be encouraging credit risk retention only for financial institutions that can actually fail. TBTF needs to be addressed for structured finance reforms to be effective.

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[59] Credit Risk Retention, 78 Fed. Reg. 57928-01, 58020 ("Our range of reasonable estimates of the cost of risk retention is between zero and 30 basis points.").

[60] Levitin, *supra* note 27, at 816, 831.

CONCLUSION

A great deal of uncertainty still hangs over the ABS and CLO markets as the shape of both regulatory reform and market reform are not yet complete. The largest ABS markets are based around the financing of mortgage loans, and as long as the GSE question remains unresolved, it seems unlikely that we will see a major rebirth of private-label mortgage securitization. Yet other ABS markets have been rebounding and hopefully will continue to do so. The best regulatory approach at present is to allow Dodd-Frank Act rulemakings to go into effect and continue to monitor the market's recovery rather than to try and correct course prematurely.