

EXCERPTS* FROM
**SECURITIZATION IN THE POST-CRISIS ECONOMY:
AN ABA BUSINESS LAW SECTION WHITE PAPER**

November 20, 2009

The Committee on Securitization and Structured Finance and the Committee on Banking Law of the Section of Business Law of the American Bar Association have jointly prepared this paper¹ to help inform policymakers and their advisers about securitization, its role in the financial markets, and the potential effects of the legislation addressing securitization that has been proposed by the Obama Administration and various members of Congress as part of a package of financial system reform proposals. The views expressed in this paper are presented by the ABA Section of Business Law on behalf of the Committee on Securitization and Structured Finance and the Committee on Banking Law. They have not been approved by the House of Delegates or Board of Governors of the American Bar Association, and therefore should not be construed as representing the policy of the ABA.

Executive Summary

Securitization in its most common form is a technique that enables lenders to obtain funding by issuing securities that are supported by and paid out of cash receipts on their financial assets, such as residential mortgage loans, credit card loans, small business loans and auto loans or leases. Securitization is an important funding source for lenders providing consumer and corporate credit, and historically has provided important benefits to lenders, consumers and corporate borrowers alike. Key benefits that should be preserved include:

- Greater availability of mortgage loans, other consumer credit, and small business loans;
- Lower costs of borrowing for consumers and small businesses and for manufacturers of goods who use securitization to fund short-term customer invoices for their products;
- Lower costs of funding, enhanced liquidity, and diversified sources of funding for consumer and small business lenders;

For over thirty years, securitization investments were among the safest and most liquid securities that could be purchased, with elaborate structural and other safeguards that were carefully developed to support their high credit ratings. Legislative and regulatory reform should be targeted at addressing weaknesses revealed by recent performance issues, but there is no reason to believe that securitization or its structures are inherently flawed.

** For purposes of brevity and pertinence, these excerpts omit (or shorten if needed for context) portions of the White Paper that relate to types of credit other than residential home loans. Also, these excerpts omit sections that relate to the SEC's proposal to modify its Regulation AB. Deletions are marked with a bracketed row of asterisks: "[* * *]" The full White Paper is available upon request and on the Committee's web page at <http://apps.americanbar.org/dch/committee.cfm?com=CL112000>.*

¹ A list of drafting committee members who prepared this paper for the Committee on Securitization and Structured Finance and the Committee on Banking Law is provided at the end of this paper.

Legislative proposals have suggested mandating a 5% or 10% retention of risk by asset originators as part of the securitization process, based on the belief that this will align the interests of originators with the interests of investors and ensure less risky originations. Significant retention of risk and alignments of interest already exist in many transactions and asset classes, as we discuss in Appendix A. Moreover, although there are a handful of recent studies, discussed elsewhere in this paper, that attempt to determine whether likelihood of securitization affects loan quality, we do not believe there is currently meaningful empirical evidence that either supports the risk retention proposals or predicts whether those proposals will improve securitization or merely eliminate it as a funding source for many institutions.

The following are some of the key observations discussed in this paper regarding legislative or regulatory changes to the securitization markets:

- Securitization is critical to the availability of consumer credit and corporate liquidity, and any efforts to alter securitization practice need to be narrowly tailored so they do not make securitization so difficult or onerous that it is no longer able to continue its important role in the economy. To date, the effects of fewer private investors in the securitization markets have been partially offset through government programs that purchase or provide financing for the purchase of asset-backed securities, or ABS, thereby replacing the liquidity of the market. These government programs are not an effective or desired long-term solution. We do, however, believe the programs demonstrate the government's endorsement of securitization as an integral and necessary component of the modern financial market.
- Legislative mandates that, intentionally or unintentionally, change the economics of securitization, including those to require a 5% or 10% retained risk exposure to securitized assets, have the greatest risk of unintended consequences, including possible elimination of securitization as a funding source entirely. For instance, these requirement may make it difficult or impossible to conclude that the assets have been transferred in a "true sale," which is one of the core protections for investors in securitizations. To the extent that the credit crunch in the U.S. has been exacerbated by the loss of access to the securitization markets, the continued loss of access to those markets as funding sources likely will result in significant liquidity issues for financial institutions and borrowers alike.
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- More empirical studies, especially studies that compare losses within securitizations that had significant risk retention by originators to losses within securitizations that did not have meaningful retained interests, should be conducted before Congress mandates specified levels of risk retention.
- A "one size fits all" approach to risk retention and disclosures is unlikely to work for securitization, which is more varied in its structures, assets and economics than most observers realize. Most importantly, efforts to address issues relating to one asset class, such as mortgage-backed securities, may be inappropriate for other asset classes such as credit cards, auto loans, and other non-mortgage assets.

- Legislative and regulatory approaches that focus on closing gaps in disclosure that have been identified during the market upheavals may provide meaningful additional transparency and facilitate risk assessment. More disclosure is not always better disclosure, however, and any expansion of disclosure requirements needs to be evaluated in light of the reliability of the requested information, the costs of producing it, whether the information requested is so proprietary that the requirement will cause participants to exit the market rather than disclose such information, and the value to investors and others that it is expected to bring.
- The concept of an efficient market has been cast in serious doubt by events of the last two years. Altering securitization practices in an effort to improve origination practices for consumer loans is, at best, an indirect approach that may place the obligation of oversight on those who are too removed from the origination process to fulfill it effectively. A better approach, and one that is already part of some of the legislative proposals, may be to modernize regulatory oversight of the origination of consumer loans.
- Asset originators, and their regulators, should carefully assess the ways in which asset origination is rewarded within the organization; whether quantity is favored over quality; what cost and other constraints limit the loan diligence process and whether those have been shown to reflect an appropriate balance; and what systems, if any, are in place to evaluate and manage the risk of each individual asset origination in light of the risk profile of the organization as a whole.
- Investors in complex financial products, including securitizations and credit derivatives, should evaluate their aggregate counterparty credit risk, whether they can effectively unbundle such risk, and whether hedging strategies can effectively mitigate those risks.
- Industry efforts, such as Project RESTART from The American Securitization Forum (“ASF”), which bring together a wide range of participants in the market with deep knowledge of the related products, are more likely to provide effective and sustainable market solutions with respect to the fundamental economic terms of securitizations than broad-brush legislative efforts to regulate the substance of these transactions.

Introduction²

Much of the recent debate about the future of securitization has focused on the events of the last two years and the role securitization has played in those events. It is particularly easy to assign blame to securitization because so few people really understand what it is, how it works, and why it is so important to the economy as a whole. Securitization is not new. Securitization transactions, which were developed by certain government-sponsored entities, or GSEs, demonstrated safe, stable performance for more than 30 years.³ Only in the last 2 years have

² For purposes of this paper, we have focused only on proposals specifically addressed at securitization. We note, however, that a broad array of other proposals, including those relating to credit rating agencies, the banking system, and derivatives, potentially will also have a material effect on securitization, and consideration should be given to the aggregate effect of all such reforms.

³ For example, Fitch Ratings reports that for the period between 1991 and 2007, the average annual rate of default for all structured bonds rated investment grade (not merely AAA) by Fitch was 0.17%. Fitch Ratings 1991- 2007

broad volatility and investor losses arisen in this sector.⁴ Securitization provided crucial liquidity that first increased the availability of mortgage loans in this country, and later increased the availability of a broader array of consumer assets and corporate loans. It enabled lenders to diversify their sources of funding at a lower cost than had been previously available, and it led to lower borrowing costs for consumers.⁵ Securitization is a crucial driver of the US economy, and essential to the reestablishment of robust economic growth.

Securitization was initially developed for first-lien consumer mortgages loans, and indeed represents a government-sponsored effort to increase homeownership by increasing liquidity, and facilitating lending in the housing market. There was little secondary market in mortgage loans, which were not attractive to most investors.⁶ Savings and loan associations, or thrifts, depended on funds from their local branch deposits to finance local housing demand.⁷ The Great Depression highlighted some of the systemic vulnerabilities relating to mortgage loans,⁸ and in response, Congress enacted the National Housing Act of 1934, which was intended in part to create a secondary mortgage market.⁹ The National Housing Act created the Federal Housing Administration, or FHA, which in turn organized the Federal National Mortgage Association, or FNMA, in 1938, to provide liquidity to the primary mortgage market.¹⁰ FNMA, as a government-sponsored enterprise or GSE, purchased mortgage loans from some institutions and sold them to others.¹¹ By purchasing whole loans from mortgage lenders, FNMA provided a means for lenders to obtain more cash so that they could make more loans, thereby increasing

Global Structured Finance Transition and Default Study, March 18, 2008, available at http://www.fitchratings.com/creditriskreports/report_frame.cfm?rptid=383102 Similarly, according to Moody's research reports, between 1994 and 1997 no asset-backed securities, excluding mortgage-related losses, suffered any impairment. For all Aaa-rated securities, Moody's showed a lifetime impairment of 0.08% through 2006. Moody's Rating Service, Special Comment, Default and Loss Rates of Structured Finance Securities, 1993-2006.

⁴ See Moody's Rating Service, Special Comment, Default and Loss Rates of Structured Finance Securities, 1993-2008.

⁵ See, e.g., Faten Sabry & Chudozie Okongwu, Study of the Impact of Securitization on Consumers, Investors, Financial Institutions and the Capital Markets 119, NERA Economic Consulting, June 17, 2009, available at http://www.nera.com/publication.asp?p_ID=3859; Randall S. Kroszner, Governor, Improving the Infrastructure for Non-Agency Mortgage-Backed Securities, Address at the Federal Reserve System Conference on Housing and Mortgage Markets, Washington, D.C. (Dec. 4, 2008) (transcript available at <http://www.federalreserve.gov/newsevents/speech/kroszner20081204a.htm>) (regarding limits of model-based risk management practices and "knock on" effects).

⁶ Sabry, *supra* note 5, at 21.

⁷ Steven L. Schwarcz, Structured Finance: A Guide to the Principles of Asset Securitization 1:2 (Practising Law Institute, 3rd ed. 2008).

⁸ See, e.g., Peter M. Carrozzo, A New Deal for the American Mortgage: the Home Owners' Loan Corporation, the National Housing Act and the Birth of the National Mortgage Market, 17 U. MIAMI Bus. L. REV. 1, 7 (2008) (quoting National Housing Act: Hearing on S. 3603 Before the Senate Comm. on Banking and Currency, 73d Cong. 2, 50 (1934)); Richard E. Mendales, Collateralized Explosive Devices: Why Securities Regulations Failed to Prevent the CDO Meltdown, and How to Fix It, 2009 U. ILL. L. REV. 1359, 1365 (2009) (stating that the drafters of the National Housing Act were trying to create a secondary mortgage market, which had collapsed during the Great Depression); Silver Homes, Inc. v. Marx & Bendorf, Inc., 206 Tenn. 361, 365 (1960) (noting that congressional concern about the number of people who could not qualify for mortgage loans motivated passage of the National Housing Act).

⁹ National Housing Act of 1934, 12 U.S.C. § 1716 et seq. (2006).

¹⁰ Federal National Mortgage Association Charter Act, 12 U.S.C. § 1716 et seq. (2006).

¹¹ See Gary J. Silversmith, et al., Mortgage-Backed Securities: Developments and Trends in the Secondary Mortgage Market 21 (Thomson-West Editorial Staff, 2008-2009 ed.); Gary J. Silversmith, TAX Management Portfolios: REMICs, FASITs and Other Mortgage-Backed Securities A-1 (1999), (hereinafter referred to as "TMP").

liquidity in the mortgage market.¹² FNMA bought and sold mortgage loans nationwide. Therefore, thrifts were able to limit their reliance on local deposits and increase their access to funding.¹³

In 1968, Congress divided FNMA into two entities: FNMA (which later changed its name to Fannie Mae), a federally chartered but privately owned corporation which continued to serve its original role, and the Government National Mortgage Association, or Ginnie Mae,¹⁴ which is a wholly owned corporate instrumentality of the U.S. government within the U.S. Department of Housing and Urban Development. Ginnie Mae is authorized “to purchase, service, sell or otherwise deal in any mortgages” that are guaranteed by the FHA or the VA, the U.S. Department of Veteran Affairs.¹⁵ Ginnie Mae created the first mortgage pass-through security in 1970, pooling mortgage loans with similar quality, terms and interest rates in a trust and selling certificates of ownership to investors that represented fractional undivided interests in the pool of mortgage loans. Investors received a pro rata share of the interest income and principal payments generated by the mortgage loans in the pool, and likewise bore a proportionate share of the credit risk of the loans.¹⁶ The fundamental premise behind this type of structure was simple and powerful: rather than bear the risk of investing in individual loans, capital markets investors could invest in a diversified pool in which their exposure to any one loan was relatively small, and they could judge their overall risk by looking to the risk characteristics of the pool as a whole.

Congress also created, in 1968, the Federal Home Loan Mortgage Corporation, or Freddie Mac (also a GSE), to further expand mortgage liquidity. In 1983, Freddie Mac issued the first collateralized mortgage obligation, or CMO,¹⁷ a structure that directs payments to certain classes of debt securities in a specified order, allowing for different interest rates, payment schedules, and maturity dates.¹⁸ The Tax Reform Act of 1986 created the real estate mortgage investment conduit, or REMIC, as a new means of facilitating the issuance of multi-class mortgage-backed securities, also referred to as MBS, without adverse tax consequences.¹⁹ These new types of structures, which originally focused on mitigating, for some investors, the risk that a loan would prepay as a result of a sale or refinancing of the property, enabled “tranching” of risks (i.e., by dividing the securitization into different classes) and moved these transactions away from the more straightforward pass-through structures of the original deals. Investors could choose the level of risk they were willing to accept by trading off yield, so that a senior tranche would have a high rating but a low interest rate, and a subordinate tranche, bearing more of the credit risk of the pool, would have a lower rating or no rating but a significantly higher interest rate.

Since their inception, Fannie Mae, Freddie Mac and Ginnie Mae have focused on purchasing and securitizing loans that conform to certain standards of credit quality and loan

¹² Sabry, *supra* note 5, at 22.

¹³ The geographic benefits of this arrangement are discussed below.

¹⁴ 12 U.S.C. § 1717(a)(2)(A) (2006).

¹⁵ *See id.* at §1717(b)(1).

¹⁶ Schwarcz, *supra* note 7, at § 1:2.

¹⁷ Silversmith, *supra* note 11, at 85.

¹⁸ *See id.*

¹⁹ Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986); *see also* TMP, *supra* note 11, at A-36.

size.²⁰ In 1977, Bank of America issued the first rated, Securities and Exchange Commission (“SEC”)-registered secondary market private-label (*i.e.*, non-agency) MBS.²¹ Other private label issuances of residential mortgage-backed securities, also known as RMBS, soon followed. As the securitization market expanded and focused more and more on achieving high-level ratings for the senior-most tranches, including ratings significantly higher than those of the entity originating or transferring the assets, it became critical to ensure that the assets were held separate from the originator or transferor and would not be subject to the originator’s or transferor’s insolvency risk. This separation, referred to as “legal isolation,” became one of the core elements of securitizations. Over time, triple-A rated RMBS came to be perceived as among the safest and most liquid investments.

The real estate securitization sector expanded over time to include commercial mortgage-backed securities, or CMBS, and securitizations of home equity lines of credit, also known as HELOCs. The initial impetus for the growth of the commercial MBS market was the Resolution Trust Corporation (the “RTC”), which Congress created in 1989 in connection with the bailout of the savings and loan industry. The RTC was responsible for overseeing the disposal of the billions of dollars of assets acquired by the U.S. Government from failed savings and loan associations and thrifts. Much of these assets consisted of undesirable real estate and troubled commercial mortgage loans and ventures. The RTC developed a variety of strategies to dispose of these assets, including auctions of pools of the assets and securitization. By the time the RTC shut down at the end of 1995, it had accounted for nearly \$50 billion of single-family, multifamily and commercial mortgage-backed securities, and was the most active “private-label” MBS issuer in 1991 and the second most active in 1992.²²

Between 1990 and 2006, annual issuance of MBS increased from \$259 billion to \$2,018 billion.²³ What fueled this explosive growth? The early decades of growth of the MBS market were shaped by a number of factors, including the pressure of a consistent demand for housing credit; cash rich pension and mutual funds; the availability of foreign credit; the continuous need of investors to increase diversification and reduce risk; the improved federal climate in tax and securities regulation, including tax reform; the continuous need to increase the efficiency of pricing and trading real estate related securities; and the evolving capital requirements motivating insurance companies to invest in MBS and financial institutions to reduce balance sheet assets, thereby reducing capital levels.

[* * *]^{24 25 26 27} As the private secondary market ground to a halt in mid-2007, the U.S. government sought to support the housing industry by increasing the role of the three GSEs. As noted in footnote 20, in 2009 the three GSEs issued more than \$1 trillion in MB S.²⁸

²⁰ Sabry, *supra* note 5, at 24. In 1980, Fannie Mae and Freddie Mac securitized approximately \$78 billion of residential mortgage loans in the aggregate. In contrast, from January through July of 2009, the three GSEs (Fannie Mae, Freddie Mac, and Ginnie Mae) have issued \$1.197 trillion in mortgage-backed securities. *Id.*

²¹ *See id.* at 27.

²² Kenneth G. Lore, MORTGAGE-BACKED SECURITIES § 2:23 (2009).

²³ Sabry, *supra* note 5, at 16 (referencing data taken from The 2007 Mortgage Market Statistical Annual, Vol. II, pp. 3-7).

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Benefits of Securitization

Originators and sponsors of securitizations, and consumers and other borrowers each receive important benefits from securitization transactions.

Consumers. Although securitizations have been criticized over the last two years for failing to permit easy modification of mortgage loans, the resulting belief that securitizations do not benefit borrowers is incorrect. For instance, securitization is a key driver of liquidity in the mortgage market, making mortgages more widely available. Quite simply, lenders have more funds available to make new loans if such lenders can sell off their old loans rather than waiting for them to mature. In addition, data collected before the current financial crisis regarding ABS and MBS markets have shown that lower financing costs for issuers have flowed down to consumers, generally in the form of lower interest rates.²⁹ A report released in 2006 showed that Fannie Mae and Freddie Mac generated interest-cost savings for American home buyers ranging between \$18.8 billion and \$26.92 billion per year.³⁰ In addition, geographic disparities have declined as securitization has created a more cohesive national secondary mortgage market, in particular increasing the availability of mortgages in underserved areas.³¹

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Originators. Originators of financial assets are much better able to finance the origination of those assets—and thus to provide liquidity to the markets as a whole—when they have access to the securitization markets.

- *Lower cost funding.* As we discuss in more detail under “Securitization Basics,” below, the legal isolation of financial assets from a sponsor’s estate in a securitization transaction enables the ABS to receive a credit rating higher than the unsecured debt rating of the sponsor. Investors rely on the cash flow created by the assets and not on the payment promise of the company. The result is cheaper funding for the sponsor.
- *Diversified funding.* Securitization investors are generally different from corporate debt investors, and a securitization program therefore allows lenders to diversity their sources of funding.
- *Liquidity* – Securitization enables lending institutions to use the proceeds from the sale of securitized assets to make additional loans. In the absence of an established process for selling loans it is currently holding, an institution would be dependent on deposits and bank borrowings, and on the proceeds from repayments on existing loans, to make new loans.

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²⁸ Other types of transactions have developed that fall under the term “securitization,” which at its core involves transforming one or more financial assets into securities. [* * *]

²⁹ Sabry, *supra* note 5, at 119-120; see also Cowan, *supra* note 24, at 6-7.

³⁰ James Miller & James Pearce, *Revisiting the Net Benefits of Freddie Mac and Fannie Mae*, available at <http://www.freddiemac.com/corporate/reports/>.

³¹ Silversmith, *supra* note 11, at 2-3.

Historically, originators also have benefited from lower regulatory capital requirements by accounting for their transfers of securitized assets as sales. Although sale accounting treatment may no longer be achievable for many traditionally structured securitizations as a result of the recent adoption of Statements of Financial Accounting Standards Nos. 166 and 167,³² which take effect later this year, we believe the other benefits of securitization will continue to be substantial.

Securitization Basics

Securitization is primarily a financing technique in which companies raise money by transferring interests in their financial assets to capital market investors.³³ The following are some of the fundamental characteristics that cause a financing transaction to be described as a securitization rather than a secured financing:

1. *Investors invest only in assets, not in an operating company.* One of the primary goals of a securitization is to allow the investors to invest only in the assets of a company, and not in the enterprise as a whole. Securitization investors provide funding supported by a company's financial assets—trade, loan or lease receivables that obligate the company's customers to make cash payments to the company over time. Investors expect to be paid out of the cash flows on the assets, assume the credit risk of the obligors on the assets, and do not generally have the right to look to the seller of those assets if the cash flows are insufficient to repay the investors in full. Because the source of payment in a securitization is primarily the cash flow generated from the securitized assets, investors consider the nature and credit quality of the assets and not, in general, the sponsor's financial condition, rating or performance. Investors are generally protected against risks to the cash flows through various forms of credit enhancement³⁴ that are structured to absorb potential losses. Investors assume the risk that those assets will not pay out as they are supposed to because the obligors on the receivables default—but to the greatest extent possible they do not take on the risk that the company originating those receivables will itself encounter financial difficulty that will constrain its ability to repay its financing. It is not always possible to eliminate all enterprise risk in a securitization, but many of the structuring aspects of these transactions, as described below and in Appendix A, are designed to support that goal.

³² See Financial Accounting Series: Statement of Financial Accounting Standards No. 166, Financial Accounting Standard Board, June 2009; Financial Accounting Series: Statement of Financial Accounting Standards No. 167, Financial Accounting Standard Board, June 2009.

³³ See supra note 28.

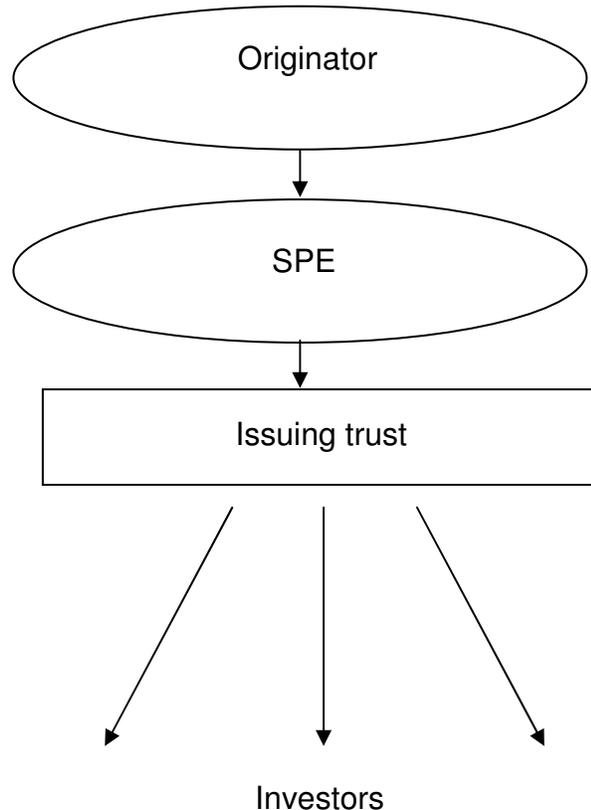
³⁴ "Credit enhancement" protects investors from the risk that assets will default and is generally included in the securitization transaction at the time it is established. Examples are cash accounts, a letter of credit or a financial guaranty. A senior class may also be "credit enhanced" by a subordinated class that bears loss on the assets before the senior class. We discuss credit enhancement in more detail in item 8 below.

In its simplest version, a securitization structure might look like the following diagram:

Originator transfers receivables to SPE for cash, debt and equity

SPE transfers receivables to issuing trust for cash

Issuing trust issues securities to investors for cash



However, a wide variety of possible structures and entities can be used in a securitization, and some structures may vary from this one quite substantially.

2. *The financial assets are separated, to the greatest degree possible, from the company that is securitizing them.* The first thing that typically happens in a securitization is the transfer of the financial assets to a legal entity, such as a limited liability company or a trust with an independent trustee, that is separate from the company sponsoring the securitization. As noted above, market participants often refer to this as the “legal isolation” of the assets. If the transferring company is subject to the U.S. Bankruptcy Code, this transfer will typically take the form of a true sale of the assets to the new entity, a true contribution of the assets to the new entity’s capital, or both. True sale and true contribution are concepts under both the Bankruptcy Code and state law, and are designed to ensure that the assets are transferred in such a way that they should no longer be considered property of the transferring company. Generally, this means that the assets have been sold for fair or reasonably equivalent value, there has been no attempt to defraud the creditors of the transferring company, the transferring company does not commit to cover losses on the transferred assets or retain the right to receive the income on those assets, and the parties agree that they intend the transaction to transfer all right, title and interest in the assets to the new entity. These transfers are usually coupled with a “backup security interest” to protect investors against the possibility that the transaction would be recharacterized as a secured financing or that the organizational separateness of the transferee would be breached.

Typically a true sale or true contribution is paired with a series of commitments by both the transferor and the transferee to keep the transferee separate from the transferor. While these are referred to as “separateness covenants” in securitizations, and securitization lawyers discuss being able to give an opinion that the assets of the transferee would not be substantively consolidated with the assets of the transferor in insolvency proceedings, many of the fundamentals of maintaining effective separation resemble those necessary to defeat efforts to pierce the corporate veil. Among other things, the new entity needs to maintain its corporate formalities, take actions in its own name, not hold itself out as liable for debts of the transferor, not commingle its assets with those of the transferor, and maintain separate books and records.

For entities that are not subject to the Bankruptcy Code, the form of transfer may be somewhat different. Insured depository institutions, such as banks, for instance, will typically be placed in receivership or conservatorship by the Federal Deposit Insurance Corporation, or FDIC, if they become insolvent, rather than commencing bankruptcy proceedings. Legal isolation for assets transferred by an insured depository institution therefore needs to consider how the FDIC would treat these assets, and does not depend on bankruptcy law. In 2000, the FDIC adopted a rule that provides that if the FDIC is acting as receiver or conservator for a failed insured depository institution, it will not seek to recover, reclaim or recharacterize as assets of the failed institution any assets that have been transferred in a securitization meeting certain criteria. That rule currently depends on the transfer being treated as a sale for financial accounting purposes. To achieve legal isolation, insured depository institutions will need to make sure their asset transfers comply with the FDIC rule but may not need to effect a true sale or true contribution of the assets under bankruptcy or state law standards.³⁵

3. *The new entity receiving ownership of the assets is a special or limited purpose entity.* Because one of the goals of a securitization is to allow investors to invest in assets rather than enterprises, securitization transactions are typically structured so that the entities to which the assets are transferred do not themselves present operating risk. The types of entities that are used are generally referred to as special purpose entities, or SPEs, but a more accurate name would be “limited purpose entities.” The distinguishing characteristic of these entities is that, by the terms of their organizational documents (e.g., their corporate charter, limited liability company agreement or trust agreement) they cannot engage in the full range of activities in which a corporation or other entity would normally be permitted legally to engage. An SPE used in a securitization would typically be limited to holding financial assets, investing proceeds of those assets, and either further transferring the assets or issuing equity interests in those assets or debt secured by them.³⁶ The SPE would be prohibited from incurring debt that was not part of or contemplated by the securitization transaction, and it would likely have either a trustee or one or more independent directors whose vote would be required to put the SPE into insolvency

³⁵ The FDIC is currently considering the effect of recent accounting changes on the rule and whether to promulgate a new standard to support legal isolation. In the meantime, the FDIC on November 12, 2009 adopted an interim final rule that clarifies that securitizations issued prior to the accounting change and in some circumstances until March 31, 2010, will continue to receive the benefits of the current legal isolation rule for the full term of the transaction. See Amendments to 12 C.F.R. § 360.6. Defining Safe Harbor Protection for Treatment by the Federal Deposit or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connections with a Securitization or Participation, 74 Fed. Reg. 59066 (Nov. 17, 2009) (interim rule amending 12 C.F.R. pt. 360), available at <http://www.fdic.gov/news/board/2009nov12no6.pdf> (“FDIC Interim Rule”).

³⁶ Some entities might issue both debt securities and equity securities.

proceedings or to change the entity's limited purposes. These characteristics are designed to keep the entity "clean"—in other words, to protect the investors from taking on the broader risk of an operating company—and to prevent other creditors³⁷ or shareholders from attempting to reach the assets supporting the securitization by forcing the SPE into bankruptcy. As a result, these entities are often described as "bankruptcy-remote SPEs."

Except for transfers by insured depository institutions that meet the conditions of the FDIC rule described above, most securitizations are structured as "two step" transfers, with the first transfer being the one that meets the requirements of a true sale or true contribution. The second transfer is to a trust or other entity that issues the securities, backed by the pool of financial assets, that are sold to capital markets investors. This second transfer often would not meet true sale or true contribution requirements, largely because the transferring SPE retains both a portion of the risk on the assets and a portion of the benefit of the upside potential. For one-step transfers under the FDIC rule, the insured depository institution itself may retain both risk and upside, with the legal isolation determined based on sale accounting treatment rather than bankruptcy concepts of true sale.³⁸

4. *SPEs generally are structured so that they do not incur entity-level taxation.* When sponsors structure securitizations, they are very careful to make sure that the structure does not cause the assets to incur a significantly greater degree of taxation than if they were retained by the sponsor. For mortgage loan securitizations, tax structuring was facilitated by the creation by Congress of the real estate mortgage investment conduit, or REMIC, a special tax structure created to support these transactions. Other securitizations may use LLC or partnership structures, grantor trusts, or other entities such that the entity issuing the securities would be disregarded for tax purposes.

5. *The representations and warranties made at transfer are intended to ensure that the transferred assets have the characteristics such assts are purported to have.* Because of the desire to achieve legal isolation, securitization structures generally have very limited or no credit recourse—if a borrower encounters financial trouble and cannot pay, that risk is borne by the investors, subject to any credit enhancement that protects them from those losses. On the other hand, originators generally do stand behind their representations as to the nature and credit characteristics of the assets and legal aspects of the transfer, such as first priority, perfected liens. Some of the representations and warranties are mandated by the credit rating agencies to support their ratings, and some are negotiated with the investors or with underwriters for the transaction to ensure that the representations and warranties are consistent with market standards and investor expectations and allocate risks appropriately. These representations and warranties historically have been an important but limited safeguard, intended to ensure that investors receive the legal interests they expected in the assets that were described to them. The representations and warranties generally have not been intended to guarantee the credit performance of the assets.

³⁷ The restrictions on incurring debt are intended to make sure that no other creditors exist. To the extent there are other creditors, they would be asked to agree that they would not attempt to put the SPE into bankruptcy until the securitization had paid in full and any applicable preference period had run.

³⁸ See FDIC Interim Rule, *supra* note 35.

6. *Servicing arrangements are designed to facilitate collections of the assets in accordance with their terms.* Financial assets generally consist primarily of obligations to make cash payments, which require attendant processes of billing the obligors, recording collections, addressing delinquencies, negotiating with obligors to mitigate losses, conducting foreclosures (if applicable) and otherwise managing the collection process that needs to be performed for every securitized pool.³⁹ This is referred to as servicing the assets. The servicer has contractual rights and obligations with respect to the assets, including rights to modify the assets under certain circumstances. Constraints on loan modifications are intended to limit the ability to make deals with obligors on the assets that would relieve the obligors from their obligations, especially where there is an ongoing business relationship between the servicer and the obligor, but servicers can generally modify loan terms where the loans are in default or default is likely and the servicers believe that modification will increase recoveries. The servicer generally can be replaced if it defaults in the performance of its servicing obligations. The servicer is paid a servicing fee from the cash flows on the securitized assets, and the fee is generally based on the aggregate principal balance of the assets being serviced. The servicer also may be entitled to the “float” (i.e., the investment income) on cash collections during the period before the collections have to be paid over to investors.

7. *Securitizations structure risk among different categories of investors by adjusting the priority of payments of cash collections, allowing securities to be tailored to the risk appetite of particular investors.* The simplest structure for an asset-backed security is a pass-through certificate in which each investor has an undivided beneficial ownership interest in each asset, and the investor’s right to collections from and risk exposure to the assets is pro rata based on the amount invested. For a diversified pool of assets that bear interest at rates that properly reflect the risk of loss, investors would expect to absorb some losses but to be compensated for those losses through a higher yield on the pool as a whole. If losses prove to be higher than anticipated, then investors may have losses that are not fully offset by interest payments. On the other hand, if losses are lower than expected, the investors will receive the benefit.

Some investors, though, would prefer to trade off some of their yield in order to be protected against losses, while other investors are willing to take more risk but demand a higher yield for doing so. This desire to meet the needs of particular investors by tranching risk, and in some cases other aspects of the cash flow allocations from the pool, has become an important part of the securitization markets. Asset-backed securities are frequently divided into two or more classes, or “tranches,” with different levels of seniority. As the issuer receives collections of the cash flows on the assets, it divides them among investors based on that seniority and any other contractual agreements about how funds will be allocated. Losses resulting from payment defaults on the assets also are typically borne by each class in reverse order of seniority. The set of cash-flow provisions that dictate the priority of payments to the various classes in a

³⁹ In some transactions, the servicer also agrees to make advances to the securitization in the amount of any delinquent payment obligations on the loans so that investors can receive a more predictable schedule of payments. These advances are repayable out of cash flows on a priority basis, and are made to address problems with the timing of payments rather than with the credit of the obligors.

securitization is sometimes referred to as the “waterfall” because the provisions are set forth in the relevant agreement as a series of cascading clauses.⁴⁰

8. *Credit ratings are based on legal and structural features, credit enhancement and an analysis of historical data involving the same or similar assets.* By legally isolating the assets in a securitization, companies using securitization to fund their receivables often are able to obtain credit ratings that are significantly higher than their corporate debt ratings and, therefore, to achieve a cost of funding that is significantly lower than they would otherwise have been able to obtain.⁴¹ Ratings models look at many aspects of the transaction, including the asset pool itself, the strength and experience of the servicer or servicers, the priority of payments under the documentation, and data about how assets in a particular asset class, with the same originator or servicer, historically have performed over time. Typically this involves stressing the historical data to create what is believed to be a worst-case scenario—for instance, defaults projected at a multiple of the historic maximum, and recoveries reduced by a significant percentage from historic lows. Securities in the most highly rated tranches are evaluated using the most severe stressors, while lower-rated tranches would reflect more moderate stress levels. On this basis, the amount of credit enhancement necessary to achieve the desired ratings would be determined. Credit enhancement typically would be provided in the form of insurance or guarantees, subordination of junior tranches, overcollateralization of the issuance vehicle, letters of credit, cash collateral accounts,⁴² or some combination of these. Credit enhancement levels vary from transaction to transaction, but, in general, a riskier asset pool would be expected to have more credit enhancement than a less risky pool. In our experience, prior to the events of the last two years, market participants generally trusted the rating agency models and believed that securitization transactions were as safe as their credit ratings indicated.

Causes of the Current Financial Crisis

The analysis of what triggered the economic crisis is still being conducted by economists, academics, government agencies and others, and it is premature to say at this point that the causes are fully understood. Securitization did play a role, but we do not believe it was a principal catalyst of the crisis. As we will discuss, by enhancing liquidity in the consumer lending markets, securitization indirectly allowed lenders to fund lower-quality loans, but there is

⁴⁰ One of the aspects of asset-backed securities that makes them so versatile is the ability to structure classes to meet the needs of a particular investor by creating very complicated waterfall provisions. Classes with the same rating might have different expected maturities, average lives, interest rates, liquidity support and credit enhancement. The trade-off for this flexibility is the related complexity, where investors in certain asset classes, such as mortgages, will have to decipher a different, nuanced waterfall for each issue of ABS. Other securitizations, such as credit card transactions using a master trust, may have a waterfall for the entire securitization structure that generally remains consistent across issuances for a particular sponsor. In these structures, the waterfall typically provides a framework that supports the ability to issue additional classes or tranches of securities backed by the same pool of assets, but with different interest rates, maturities and other economic terms.

⁴¹ The lower corporate ratings of the originators are, in fact, an additional reason that deal structures limit their reliance on originator representations and warranties—if a significant portion of the deal cash flows were expected to come from an originator with a corporate debt rating below that of the securities, that would put significant pressure on the ratings analysis.

⁴² Cash collateral accounts would also include “spread accounts” that are funded over time out of excess cash flows from the assets. These are discussed in more detail in Appendix A.

little evidence that securitization factored directly into lending standards or loan diligence, or that “skin in the game” for securitizations affected originators’ lending standards.

It is easier to describe what happened than why it happened. For purposes of this paper, we have described key aspects of the crisis⁴³ that we believe are relevant to a discussion of the role securitization may have played:

- Lending standards for mortgage loans, especially for mortgage loans considered to be “sub-prime,” declined dramatically, most likely beginning around 2005.
- U.S. housing values had become inflated over time, in part as a result of the easy availability of mortgage credit. The continual increase in home values skewed perceptions of borrowing capacity because borrowers and lenders both believed that the ability to refinance at lower rates or sell the home at a profit provided a safety net.
- Interest rate increases beginning in 2007 put pressure on both borrowers and home prices, which meant that at the same time borrowers began to have difficulty making mortgage loan payments, the safety net of rising housing values disappeared. As a result, mortgage loans defaults began to climb.
- The increase in mortgage loan defaults began to ripple through the capital markets, initially affecting RMBS and securities that were supported by RMBS, such as leveraged pools of RMBS known as collateralized debt obligations, or CDOs. Triple-A rated RMBS suffered ratings downgrades as the default assumptions on which their ratings were based came into question, and junior tranches began experiencing losses as well as downgrades. Leveraged vehicles that had invested heavily in junior tranches of RMBS transactions because of the higher yield began experiencing magnified losses. And monoline insurers, which had guaranteed payments of principal and interest on a large number of senior tranches of RMBS, were themselves downgraded as losses exceeded projections. These downgrades of the monoline insurers pulled down the ratings of vast amounts of RMBS and other securities that had depended on the monolines’ ratings.
- Lack of confidence in ratings, especially for structured products, significantly constrained the liquidity of a wide range of securities and the entities that depended on their ability to issue them. These issues further tightened the availability of credit and exacerbated problems in the housing market.
- Market values of securities declined, forcing entities that were required to mark their holdings to market to take significant writedowns. Commenters alternately decried fair value accounting for requiring institutions to take paper losses and criticized fair value accounting for failing to address all assets, such as loans held to maturity, that were likely impaired. Companies with no obvious connection to mortgage loans, such as pharmaceutical companies, took significant writedowns on holdings of MBS.

⁴³ We have not attempted to provide a comprehensive list of all the key events and circumstances that comprise the crisis, which is beyond the scope of this paper. For a very efficient timeline of events, see *Timeliness of Policy Responses to the Global Financial Crisis: Domestic Timeline*, Federal Reserve Bank of New York, available at http://www.newyorkfed.org/research/global_economy/Crisis_Timeline.pdf.

- Market participants began to appreciate the broad range of ways in which financial institutions and other companies were exposed to the housing sector, including through a variety of structured products, repurchase agreements, securities lending arrangements, credit default swaps and other over-the-counter derivatives. Market participants also began to appreciate the extent to which high degrees of leverage, in the products and the institutions, were magnifying those exposures. Concerned about hidden risks, financial institutions stopped lending to each other, leading to unprecedented levels of government intervention and support to stabilize the global financial system.

Decline in Lending Standards. A number of important questions have been asked in light of these events: Why did lending standards for mortgage loans decline so precipitously across the industry? Were there short-term incentives that encouraged lending without consideration of long-term risks? What were the flaws in securitization ratings and ratings models, such that loss levels on securitized pools exceeded estimates and led to massive ratings downgrades? Why were even the most sophisticated financial institutions, many of which had structured the products in which they were experiencing losses, apparently unaware of the degree of risk to which they were exposed?

Because market problems first manifested themselves at a large scale in securitizations of subprime mortgages, it is natural to consider whether and to what degree securitization played a role. To some extent, however, this is like blaming a seriously ill patient for causing the flu. That is not to say that there are not a number of things that could have been done differently in the securitization markets that would have minimized the spread of contagion. But we believe the fundamental premise on which legislative proposals for risk realignment are based—that securitization provided too liquid a market for mortgage loans and by doing so was a proximate cause of the decline in lending standards—is flawed.

The availability of easy credit was global and spanned many market sectors. In a speech in April 2008, Malcolm D. Knight, then the General Manager of the Bank for International Settlements, described “unusually accommodative global credit conditions” —including record low levels of risk spreads on emerging market sovereign debt, high yield corporate debt and other risky assets and a “spectacular” rise in equity values in many emerging markets—which he ascribed to “the interaction of monetary policy, the choice of exchange rate regime in a number of countries (particularly developing countries with a large labor surplus), and important changes within the global financial system itself.”⁴⁴ Securitization was absolutely part of this easy credit environment, but securitization transactions were being conducted in an environment in which diligence levels and risk premiums for all financial products had declined dramatically.

At the same time, significant changes were taking place in the financial sector that led to increased leverage and more exposure to mortgage loans. In the U.S., the barrier between traditional banks and investment banks was removed by the Gramm-Leach-Bliley Act of 1999, which repealed the Depression-era Glass-Steagall Act of 1933. As these institutions began to integrate, they also developed more complex risk structures that were regulated through

⁴⁴ Malcolm D. Knight, General Manager of the Bank for International Settlements, Some reflections on the future of the originate-to-distribute model in the context of the current financial turmoil, Speech at the Euro 50 Group Roundtable, London, England (Apr. 21, 2008) (transcript available at <http://www.bis.org/speeches/sp080423.htm>).

fragmented regulatory structures. Moreover, the removal of this barrier changed the competitive landscape and may have caused traditional banks to engage in more aggressive and riskier lending and trading practices in order to compete with investment banks.⁴⁵ Researchers from the Organisation for Economic Co-operation and Development suggest that other changes in the regulatory and political environment in the years before the crisis also may have caused banks to take on more risk in hopes of increasing revenues and share price. They point to four changes in particular: a government policy that encouraged low-income families to obtain zero equity mortgage loans; greater capital requirements and balance sheet controls imposed on Fannie Mae and Freddie Mac, which resulted in banks assuming more of the role historically played by the government-sponsored enterprises; the publication of the Basel II accord,⁴⁶ which informed banks that the new accord would reduce the amount of capital they would need to hold against mortgage loans and cause them to change their practices around mortgage loans in anticipation of the new standards; and the SEC's adoption of revised net capital rules that allowed investment banks to increase leverage ratios.⁴⁷

Those analyzing the crisis also have considered the role of misinformation, incorrect risk assumptions and a lack of incentives for market participants to act prudently. For instance, researchers at The Brookings Institution have cited the prevalent but mistaken belief that real estate prices would continue to rise, the exploitation of the financial system by financial institutions, and the failure of regulators and lawmakers to police that exploitation and adapt financial rules to prevent it.⁴⁸ Moreover, certain risks were not considered to be risks at all. One example of this was the requirement in many swap contracts that they be collateralized if the rating of the swap counterparty fell below a specified level, without the end users of these contracts realizing that the sudden obligation to collateralize an entire portfolio of swap contracts could itself cause the swap counterparty with which they had contracted to fail. A broad range of market participants, including sophisticated financial institutions and rating agencies, seems to have underestimated counterparty risk generally,⁴⁹ as well as risks related to the custody of assets, risks that transactions would not be fully or clearly documented, risks related to financial intermediaries, and risks that insurance or guarantees would turn into a source of weakness rather than strength when the ratings of the insurers fell.

⁴⁵ Matthew Benjamin & Christine Harper, *Glass-Steagall's Specter Returns To Haunt Wall Street*, BLOOMBERG.COM, Mar. 10, 2009, available at: http://www.bloomberg.com/apps/news?pid=20601208&sid=ad_KRWTbPsJw&refer=finance.

⁴⁶ Basel II is a recommendation of banking laws and regulations issued by an international banking committee, the Basel Committee on Banking Supervision of the Bank for International Settlements. The Basel Committee approved a package of enhancements to the Basel II capital requirements in July 2009, available at <http://www.bis.org/publ/bcbsca.htm>.

⁴⁷ Adrian Blundell-Wignall, Paul Atkinson & Se Hoon Le, *THE CURRENT FINANCIAL CRISIS: CAUSES AND POLICY ISSUES 3-4* (Organisation for Economic Co-operation and Development 2008).

⁴⁸ Robert E. Litan & Martin N. Baily, *FIXING FINANCE: A ROADMAP FOR REFORM 10*, 39 (Initiative on Business and Public Policy at Brookings 2009), available at http://www.brookings.edu/papers/2009/02175mance_baily_litan.aspx.

⁴⁹ Cf. Randall S. Kroszner, Governor, Address at the Risk Management Association Annual Risk Management Conference, Baltimore, Maryland (Oct. 20, 2008) (transcript available at <http://www.federalreserve.gov/newsevents/speech/kroszner20081020a.htm>) (regarding limits of model-based risk management practices and "knock on" effects).

Some commentators have pointed to the prevalence of nontraditional mortgage loan products and high-risk lending practices and have suggested that the misalignment of interests between originators and investors in asset-backed securities played a central role in encouraging such practices.⁵⁰ The basis for this suggestion is the “originate-to-distribute” model, which assumes that certain lenders make loans for the sole purpose of selling the loans to investors in the capital markets via securitization, rather than hold them to maturity.⁵¹ A recent study by the Federal Reserve Bank of Philadelphia, which has been cited as empirical evidence of this effect, shows that prime loans that were securitized had a higher likelihood of default than nonsecuritized loans, but found no correlation between securitization and default rate for subprime loans.⁵² The study does not, however, analyze whether the loan originators had significant retained interests in the securitization pool, whether the level of credit enhancement for the securitized loan pool appropriately reflected the risks of those loans, or whether the higher default rates for securitized versus nonsecuritized loans held true for particular originators. Indeed, the Philadelphia study references a study of 700,000 loans originated by a single originator showing that low-doc securitized loans were less likely to default, and explains this as relating to greater investor scrutiny. Securitization of residential mortgage loans, like other businesses, was a very diverse process with many different participants and a broad range of factors that determined what loans would be securitized, how they would be securitized, how they would be credit-enhanced, and whether the lender retained some or a significant portion of the loss risk and upside potential. In our view, the Philadelphia study, while interesting, does not control enough of the relevant variables to address the critical questions relating to retained risk and the “originate-to-distribute” model.

One economist who disagrees with the assumption that lenders make loans only to sell them has referred to it as the ‘hot potato’ hypothesis,” the idea being that lenders simply sell them down a chain until the last unlucky investor is left holding them.⁵³ In theory, this model would increase profitability for lenders by increasing fee generation, decrease the risk to which lenders are exposed because they can distribute risk throughout the market, and reduce the interest rate and fees charged to borrowers as a result of that risk distribution. Lenders would have significant incentives to generate a high volume of loans to increase origination and servicing fees, but few incentives to ensure loan quality or to discourage consumers from borrowing beyond their means.⁵⁴

The problem with the “hot potato” hypothesis, says Hyun Song Shin, is that it ignores the fact that credit supply is driven by factors within the financial system. In particular, leverage is a key element of return on equity for financial institutions, and they will seek to achieve the maximum leverage possible, generally by expanding their balance sheets. Shin goes on to note

⁵⁰ Committee on Capital Markets Regulation, *The Global Financial Crisis: A Plan for Regulatory Reform*, May 2009, at 129, available at [http://www.capmktreg.org/pdfs/TGFC-CCMR_Report_\(5-26-09\).pdf](http://www.capmktreg.org/pdfs/TGFC-CCMR_Report_(5-26-09).pdf).

⁵¹ *Id.*; see also Douglas W. Amer, *The Global Credit Crisis of 2008: Causes and Consequences*, 43 INT’L LAW. 91 (2009), at 11.

⁵² Ronel Elul, *Securitization and Mortgage Default: Reputation vs. Adverse Selection 3* (Federal Reserve Bank of Philadelphia, Working Paper No. 09-21, 2009).

⁵³ Hyun Song Shin, *Securitisation and Financial Stability*, THE ECONOMIC JOURNAL, March 2009, at 312, available at <http://www.res.org.uk/economic/freearticles/2009/March09.PDF> (last visited November 11, 2009).

⁵⁴ Eric Tymoigne, *Securitization, Deregulation, Economic Stability, and Financial Crisis, Part I: The Evolution of Securitization 22* (The Levy Economics Institute, Working Paper No. 573.1, 2009).

that “[a]s balance sheets expand, new borrowers must be found. When all prime borrowers have a mortgage but balance sheets still need to expand, then banks have to lower their lending standards in order to lend to subprime borrowers. The seeds of the subsequent downturn in the credit cycle are thus sown.”⁵⁵ In other words, lower quality loans aren’t being originated because they can be passed off like hot potatoes but because their origination is part of a large-scale expansion of leverage in the financial sector.

Moreover, the originate-to-distribute model does not explain why many originators, securitization structurers, and underwriters went bankrupt during the current financial crisis. Contrary to the belief that lenders passed all risk of nonperformance to unknowing investors, lenders typically did in fact retain risk. For instance, the Committee on Capital Markets Regulation points out that the failure of originators and other financial institutions was a result of their direct and indirect exposure to catastrophic levels of asset underperformance.⁵⁶ Other experts note that lenders faced a warehousing risk, whereby the lenders had to hold mortgage loans until they had accumulated a sufficient volume of loans to securitize.⁵⁷ If at any point the lenders could no longer securitize—a real risk if the assets they originated were perceived as being unusually risky—not only would they face the warehousing risk but their whole business model would be in jeopardy. In addition, mortgage lenders held residual risks in securitized loans through their interests in loan servicing fees and in junior tranches of the securitization, which were often the most difficult to sell, and the lenders were exposed to the risk of repurchase claims for any breaches of their representations and warranties.

Finally, the originate-to-distribute model does not explain why a sudden, system-wide shift in the quality of loan originations would have occurred. At the time of the crisis, securitization had been a significant and stable source of liquidity for mortgage loans for more than three decades.

Malcolm D. Knight has stated that he believes that when the originate-to-distribute model, when it functions correctly, it has the capacity to distribute risk and diversify revenue streams for banks.⁵⁸ He notes, nevertheless, that as the model became widely implemented, three key problems related to its implementation contributed to the current financial crisis. First, there was a decline in due diligence procedures, not only by those making the loans, but also, by the banks and other financial institutions at each stage of the securitization process, that placed too much trust in rating agencies and other institutions in the securitization process. Second, investors placed too much weight on credit ratings and were shocked by downgrades in the ratings of asset-backed securities, which meant that investors were exposed to losses much larger than they thought possible when they purchased the securities. Third, there was too much uncertainty associated with the originate-to-distribute model because investors did not understand where risks were concentrated; when the market declined, that uncertainty resulted in a lack of liquidity in the credit markets.

⁵⁵ Shin, *supra* note 53, at 310.

⁵⁶ Committee on Capital Markets Regulation, *supra* note 50, at 130.

⁵⁷ John D. Martin, A Primer on the Role of Securitization in the Credit Market Crisis of 2007 9 (2009), available at <http://ssrn.com/abstract=1324349>.

⁵⁸ Knight, *supra* note 44.

In our view, problems with the originate-to-distribute model do not sufficiently explain the deterioration in credit quality of securitized assets. For instance, large swaths of the asset origination sector—especially those originating revolving assets, such as credit cards, that involve continuing repayment and reborrowing—did not rely on an “originate to distribute” model, but instead used the more conventional approach, which we might refer to as a “distribute to originate” model, in which the distribution continued to be a critical funding source that allowed growth of managed pools of assets. It is possible that some originators may have incorrectly felt they did not have to worry about credit quality since they would be laying off all risks to the market, but our experience suggests that most originators were acutely aware of their ongoing exposure to their assets’ performance notwithstanding securitization. As Shin suggests, a more generous explanation for the deterioration in credit quality may have been what we would call the “originate to originate” model, under which lenders felt continuous pressure to grow their business, and performance and profits were measured by the scale of generation of new assets. At some point, when the pool of creditworthy borrowers had been fully tapped, growth began to be fueled through loans to less creditworthy borrowers, because the alternative—allowing the business to level off—was viewed as untenable.

Problems with the rating process. Numerous materials, including an important SEC study,⁵⁹ have suggested that conflicts of interest in rating agencies—where the sponsors of the rated deals were also the rating agencies’ largest customers and an important profit source for them—may have contributed to “grade inflation” for some securitized transactions. These materials also suggest that given the quantity of such deals and the speed with which they were being brought to market, ratings analysts simply did not have time to evaluate transactions fully—but rated them nonetheless.⁶⁰

While there have been numerous discussions of conflict problems at rating agencies, and several recent SEC actions to limit the effects of those conflicts,⁶¹ there also appear to have been problems with the rating models themselves. It is easy to assert, in retrospect, that a triple-A rating for ABS is very different from a triple-A rating for corporate or government debt and reflects broader systemic risk.⁶² Certainly the securities are very different, but historically there was a belief that a triple-A rating for a securitization would be less volatile and less subject to systemic risk than a similarly rated corporate bond. In the world of RMBS, not only was there a diverse pool of obligors on the loans, but the loans were secured by the borrowers’ most precious asset—their homes—and real estate seemed only to appreciate in value. Ratings models relied on historical data, and that data, generated during the housing bubble, suggested very little risk for mortgage loans. The many financial institutions, and others, holding highly rated RMBS in 2007 were understandably sanguine about their investments.

⁵⁹ Summary Report of Issues Identified in the Commission Staff’s Examinations of Select Credit Rating Agencies, Staff of the Office of Compliance Inspections and Examinations Division of Trading and Markets and Office of Economic Analysis (July 2008), available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>.

⁶⁰ *See id.* at 10-12.

⁶¹ *See, e.g.*, Credit Ratings Disclosure, Securities Act Release No. 33-9070A, Exchange Act Release No. 34-60797A, 74 Fed. Reg. 53086 (Oct. 15, 2009), *as amended by* Securities Act Release No. 33-9070A, Exchange Act Release No. 34-60797A, 74 Fed. Reg. 55162 (Oct. 27, 2009).

⁶² Ricardo J. Caballero & Pablo Kurlat, The “Surprising” Origin and Nature of Financial Crises: A Macroeconomic Policy Proposal 16 (2009).

One can point to the deterioration in lending standards and the failure of rating agencies and others to analyze the securities adequately and to conduct appropriate levels of due diligence with respect to the assets as proximate causes of the decline in value of highly rated RMBS, but the ratings models themselves—designed to provide an objective analysis of potential risk—may have had inherent flaws. Economists at The Levy Economics Institute, Bard College, found that rating agencies have been unable to foresee economic problems before they are clearly present and suggest that this hinders the rating agencies’ ability to provide a long-term view of credit risk.⁶³ A deeper problem may have been that the rating agencies were themselves economic actors that altered the environment they were trying to predict: for example, RMBS, and RMBS ratings, not only depended on loss projections for mortgage loans but also affected those projections.

When the ratings on subprime RMBS came under review, investors began to question whether triple-A ratings were flawed with respect to a broader range of securities, and investments in such securities accordingly tapered off. The ratings review based on asset quality in RMBS itself also placed concurrent pressure on the ratings of monoline insurers that had guaranteed RMBS payments and that were therefore unable to support new issuances. With less RMBS issuance providing a ready source of liquidity, mortgage loans became harder and more expensive to obtain even for prime borrowers; this in turn put downward pressure on housing prices. Falling home prices increased losses for defaulted loans and caused more mortgage loans to be “underwater,” meaning that the outstanding amount of the mortgage loans exceeded the value of the related properties. As a result, RMBS became even harder to issue, mortgage loans became even harder to get, and housing values continued to fall.⁶⁴ This feedback loop now seems entirely predictable, but there is little reason to believe that the role of RMBS was ever factored into the original ratings models.

Too many deals and too few skilled personnel. The growth of the securitization markets likely outpaced the development of the skills and knowledge of the markets’ participants and the availability of appropriately skilled personnel at all stages of the securitization process. Securitization transactions are complex and nuanced, and the number of deals grew exponentially in a relatively short period of time. This rapid growth meant that those experienced in structuring, rating and investing in securitizations had less time to devote to each transaction and had to rely increasingly on the assistance of those with less expertise. As noted above, rating agencies may have been swayed by conflicts of interest and may have had flawed ratings models, but they were also affected by substantial turnovers in personnel as top performers were lured away by investment banks. Some investors may have relied too much on ratings because they did not have time to perform independent detailed analyses of the structures or did not have enough experienced personnel to conduct those analyses for all products coming to market.

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⁶³ Tymoigne, *supra* note 54, at 22.

⁶⁴ Elizabeth A. Duke, Governor, Address at the Global Association of Risk Professionals’ Risk Management Convention, New York, New York (Feb. 11, 2009).

The complexity of securitization structures, derivative structures and other financial arrangements altered investors' risk exposures in ways that even the most sophisticated investors failed to appreciate. Asset-backed securities can be highly complex, sometimes involving many layers of subordination, obscure or convoluted cash flow waterfalls, high leverage, and embedded credit default obligations or other financial instruments. Even the most sophisticated investors, and the rating agencies themselves, had trouble fully appreciating the risks inherent in certain asset-backed securities,⁶⁵ the broader risks represented across their portfolios of these securities, or the ways in which the slicing and dicing of risk made it harder to hedge that risk effectively.

Risk Retention, Alignment of Interests and Securitization Economics

As we discussed above, there is a strong popular belief that the current economic crisis originated, at least in part, because loan originators did not have ongoing exposure to the performance of those loans as a result of securitization and therefore had no incentive to maintain robust lending standards. Legislative responses to the crisis have therefore looked to mandate risk retention by originators or sponsors as a key element of reforming securitization. The European Union has already adopted a directive that will require 5% risk retention in some circumstances,⁶⁶ and proposals from the Obama Administration and Congressional leaders have proposed mandated risk retention of 5% or 10% for all securitizations.* The idea that a misalignment of risk led to poor quality loan origination has been described as “common sense,”⁶⁷ but given the complexities of the financial industry we do not think it is that simple.

We understand that there may be rhetorical appeal and a degree of political momentum behind this approach, due in part to the popular belief that the “originate to distribute” model has played a major role in the economic crisis. In light of that, we began our review with a focus on the more technical details, such as how the 5% or 10% minimum would be defined, but ultimately we returned to the more fundamental questions we had not addressed: To what extent was the lack of “skin in the game” a factor in the crisis? What collateral effects might the proposed legislation have on our financial system? And the core question: is the assumption that there is no significant risk retention in securitization structures correct, not in isolated transactions (or types of transactions), but broadly across the industry?

In general, the world of asset securitization is broken into three main categories: static pool transactions (such as MBS and auto loan transactions), revolving transactions (such as credit card, trade receivables and home equity line securitizations) and managed transactions (such as CDOs). Many features of securitization structures reflect the characteristics of the underlying assets. In static pool deals, the loans generally consist of a fixed pool identified at the

⁶⁵ John B. Taylor, *How Government Created the Financial Crisis*, WALL ST. J., Feb. 9, 2009, at A19.

⁶⁶ The new directive amends the Capital Requirements Directive, in part to add article 122a, which contains the 5% minimum “skin in the game” requirement. Directive of the European Parliament and of the Council amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC, available at <http://register.consilium.europa.eu/pdf/en/09/st03/st03670.en09.pdf>.

* [The proposals that are referenced here essentially became the Dodd-Frank legislation that is now law.]

⁶⁷ See, e.g., Dr. William Irving, Portfolio Manager, Fidelity Investments, Testimony Concerning “Securitization of Assets: Problems and Solutions,” Testimony Before the Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Securities, Insurance and Investment, October 7, 2009, at 4.

beginning of the transaction, and the cash flows primarily reflect the self-liquidation of the pool over time. As money comes in, whether as interest or as principal, it is distributed to investors instead of being reinvested in new assets. This in turn can have significant effects on the value of the securities. For instance, one of the key issues for RMBS historically has been prepayment speed, which is the rate at which mortgage loan borrowers pay off their loans ahead of their scheduled amortization. Primary drivers of prepayment in a normal market are the rate of refinancing and the rate of sales of the property, both of which would normally increase in a low-interest-rate environment. Prepayment risk means that the investor does not know when it will receive its invested principal, and that in turn affects other characteristics of the investment, such as average life and estimated yield. It also means that there may be a risk that the higher yielding loans may pay down earlier than anticipated while the lower yielding loans remain in the pool. Many structural features in RMBS and other static pool deals relate to providing greater certainty around these issues.

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In Appendix A, we discuss some of the structural features, economics and risk retention aspects of “typical” structures within asset classes, though we note that there can be wide structural variation. As explained in Appendix A, we believe that securitizations of most asset classes using common structures already reflect significant risk retention by the originator or sponsor of the securitization and that the risk retention is already structured to create a strong alignment of interests between the originator and third-party investors. If any form of mandatory risk retention is adopted, legislators and regulators should closely examine the existing substantial risk retention in various securitization models and define mandatory retentions in a way that gives credit for those retentions. We are concerned that an effort to alter securitization economics for those asset classes that already have a strong alignment of interests will put undue pressure on financial institutions by increasing the costs of these transactions and limit the availability of securitization for consumer lending in areas where there is little reason to believe that such economics have created risk. In addition, legislators and regulators should consider whether existing models of risk retention from other asset classes, such as auto loans, may provide useful approaches for risk retention in mortgage loan securitizations that have already been proven to be a sustainable part of a securitization program.

We note, too, that risk retention may undercut the ability of legal practitioners to render the true sale opinions for securitizations that are essential to their ratings and market acceptance. Even in circumstances where risk retention is not likely to raise true sale issues, the size of losses expected on a pool of securitized loans will still figure in to an analysis of the size and form of interest to be retained by the sponsor. In this regard, a recent study highlights the difficulty in determining the appropriate type and level of risk retention. On the basis of modeling results, the study’s authors conclude that under unfavorable economic conditions, heavy loan losses are likely to render the most subordinate (or “equity”) class worthless. Consequently, its retention may not lead to better screening efforts. Increasing the size of the retained interest, on the other hand, may significantly raise the costs of securitization. Compelling sponsors to disclose

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information about the type and level of retained risk may be an alternative, the authors suggest, to a substantive risk retention requirement.⁷⁰

As with any type of surgical intervention, we believe securitization legislation should be approached with great care and not do more harm than good. Securitization is critical to the availability of consumer credit and corporate liquidity, and any efforts to alter securitization practice need to be narrowly tailored so they do not make securitization so difficult or onerous that it is no longer able to continue its important role in the economy. To date, the effects of the constriction in the securitization markets have been partially offset through government programs that are replacing that liquidity. We do not believe such programs are an effective or desired long-term solution. In addition, we make the following observations:

- Altering securitization practices in an effort to improve the quality of the underwriting standards and appropriateness of consumer loans is, at best, an indirect approach that may place the obligation of oversight on those who are too removed from the process to fulfill it effectively. A better approach, and one that is already part of legislative proposals, may be to modernize regulatory oversight of the origination of consumer loans.
- Legislative mandates that, intentionally or unintentionally, change the economics of securitization, including those to require a 5% or 10% retained risk exposure to securitized assets, have the greatest risk of unintended consequences, including possible elimination of securitization as a funding source entirely. For instance, these requirement may make it difficult or impossible to conclude that the assets have been transferred in a “true sale,” which is one of the core protections for investors in securitizations. To the extent that the credit crunch in the U.S. can has been exacerbated by the loss of access to the securitization markets, the continued loss of access to those markets as funding sources likely will result in significant liquidity issues for financial institutions and borrowers alike.
- More empirical studies, especially studies that compare losses within securitizations that had significant risk retention by originators to losses within securitizations that did not have meaningful retained interests, should be conducted before Congress mandates specified levels or forms of risk retention. Each of us has extensive anecdotal evidence of securitizations with significant risk retention that nonetheless have performed poorly in the economic downturn, especially as problems became pervasive across whole classes of assets. We believe it is important for lawmakers and regulators to understand how risk retention affected securitization performance, loan due diligence and loan origination standards before they impose new requirements that may have unintended consequences.
- As we indicate above and discuss in more detail in Appendix A, a “one size fits all” approach is unlikely to work for securitization, which is more varied in its structures, assets and economics than most observers realize.⁷¹ Most importantly, efforts to address

⁷⁰ Ingo Fender & Janet Mitchell, “The Future of Securitisation: How to Align Incentives?” BIS Quarterly Review (September 2009), 27, 42.

⁷¹ We note that the principal existing legislative proposals concerning improvements to securitization practices appear to rely on an analytical foundation focused on consumer mortgage securitization, and quite less so on other important asset types, such as consumer credit card and commercial mortgage securitization. We arrive at this belief

issues relating to mortgage-backed securities may be inappropriate for different asset classes such as credit cards, auto loans, and other non-mortgage loan assets.

- Under the proper circumstances, alignment of the interests of originators and sponsors with the interests of investors in a securitization can be accomplished without requiring the sponsors to retain an interest in the securitized loans. For certain asset classes (notably commercial mortgage loans) as to which sponsors retain no continuing interest in the related securitizations, the diligence function that risk retention is designed to promote is effectively performed by firms that specialize in investing in the junior (or “first loss”) classes. Because the most junior class in these securitizations is diminished in value, roughly dollar for dollar, for every loss in the loan portfolio, the purchasers of sufficiently large junior classes are motivated to acquire all relevant information about the underlying loans and, where feasible, to demand that sponsors remove unacceptable loans before they are securitized. The fact that the price of the junior classes is heavily negotiated by the investors serves as an inducement to the sponsor to conduct its own thorough assessment of the underlying loans’ value and to cooperate with the investors to meet their demands for information and input. Investors of all classes benefit from the loan review conducted by the junior class investors.

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Representations and Warranties

In a typical ABS transaction, the documentation under which the assets are transferred or debt backed by them is issued generally contains representations and warranties regarding the underlying loans or receivables, and specifies who is entitled to enforce those representations and warranties and under what circumstances. These representations and warranties address loan or lease documentation, the property underlying mortgages or leases, origination procedures, and various characteristics of the transferred assets. As we discuss above, the representations and warranties are meant to ensure that the transferred assets have the characteristics such assets were purported to have and that the risk of nonpayment is fairly allocated between the investors and other transaction parties who are in a better position to identify problems or discrepancies. As a general rule, the representations and warranties do not, and are not intended to, provide

due to, among other things, the proposals’ focus on broker and originator compensation, detailed loan-level disclosure, originator repurchase experience, and Securities Act Section 4(5)—all of which seem to derive from consumer mortgage loan securitizations.

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credit recourse—the transferor is assuming liability if the terms of the assets are not as presented, but not if the obligor fails to pay in accordance with accurately articulated terms. To a large extent this convention is driven by the legal structure of the transaction—credit recourse, beyond de minimis amounts, is inconsistent with a “true sale” of the assets, and thus would compromise the ability to achieve the legal isolation that is one of the defining aspects of a securitization.

Representations and warranties can be viewed either as a means of describing the asset pool with as much specificity as possible—in which case carve-outs for information that the seller cannot reasonably obtain or verify are appropriate and should be reflected in the price the buyer is willing to pay—or as a means of allocating risk, in which case buyers may ask for representations even as to matters such buyers know are not verifiable by the seller. But the latter type of representation is arguably inappropriate where the ultimate investor in the assets—who may not wish to assume any exposure to financial risk of the seller—does not have full information about whether the representations and warranties were believed to be accurate or whether they were instead structured to allocate risk. Entities, their officers and their legal counsel, may also be justifiably uncomfortable providing representations as to matters that they have not been able to verify. This may be particularly true for regulated entities such as banks, which may have difficulty concluding that making representations without reasonable support is consistent with prudent management.

The ASF, through Project RESTART, has issued for comment a set of model representations and warranties for residential MBS that reflects more than a year of discussion among issuers, investors, servicers, rating agencies and other transaction participants. These model representations and warranties are intended to establish industry standards, but are not intended to be binding upon industry participants. The commentary accompanying the request for comments addresses some of the tension described above. A useful example is fraud risk—originators, for instance, are willing to represent to the absence of fraud by them, and are willing to represent that they do not have knowledge of borrower fraud, but are understandably reluctant to represent that others, such as borrowers, have not *committed* fraud that the originators have not yet discovered. Investors, on the other hand, have indicated that they want originators to make an absence of fraud representation without knowledge qualifiers.

Although Regulation AB already requires disclosures of representations and warranties by issuers of a public transaction,⁸⁵ the draft securitization legislation proposed by the Obama Administration would require the credit rating agencies to describe the representations and warranties and related enforcement provisions for securitized transactions and to compare those terms in each of the agency’s ratings reports to other similar issuances. The legislation also proposes to require disclosure of fulfilled repurchase requests.

We think it is reasonable to require issuers of ABS to disclose clearly what representations and warranties have been provided, and what exceptions, including knowledge qualifiers, were taken with respect to those warranties. It is likely that MBS investors will require issuers to present that disclosure in such a way that the representations and warranties are

⁸⁵ Item 1111(e) of Regulation AB requires that issuers “Summarize any representations and warranties made concerning the pool assets by the sponsor, transferor, originator or other party to the transaction, and describe briefly the remedies available if those representations and warranties are breached, such as repurchase obligations.” 17 C.F.R. § 229.1111(e) (2009).

easily comparable to the final version of the ASF model provisions. We are concerned, however, that the proposed legislative approach may lead to mandatory requirements for representations and warranties that will force issuers to insure over problems rather than disclose them.

We also are not sure why the requirement to compare representations and warranties to industry standards would be placed with the credit rating agencies rather than with the issuers themselves. The parties involved in the transaction are in the best position to analyze the representations and warranties, repurchase obligations and other remedies for breach, and to explain any deviation from market standard. To the extent disclosure is intended to extend beyond that already required under Regulation AB—and it is not clear, for instance, whether these disclosure requirements would extend to offers and sales issued in transactions exempt from registration under the Securities Act of 1933—we believe that the burden of this disclosure is more fairly and effectively placed with the issuer.

The legislative proposal also requires disclosure “on fulfilled repurchase requests across all trusts aggregated by originator, so that investors may identify asset originators with clear underwriting deficiencies.” This proposal has a number of flaws that would make it unlikely to achieve the stated goals. First, the number of repurchase requests that have been fulfilled by an originator may not be as meaningful a disclosure as the number of repurchase requests that have been made by investors or the related trustees; however, even that number may not be meaningful as it may be skewed by how aggressively investors or trustees assert even tenuous repurchase claims. Second, the number of repurchase requests may not reflect the quality of the underwriting process but rather the quality of recordkeeping by the originator. Repurchase obligations do not reflect payment failures by the obligors, but failure of the securitized assets to have the characteristics they were represented to have. A simple example is a mortgage loan that is reflected in the loan file as having an outstanding balance of \$200,000 when in fact its outstanding balance is \$100,000. The loan may be of tremendously high quality, and may in fact be repaid in full shortly after transfer, but it would still be subject to a repurchase obligation because of the error in the stated amount. Third, a flat number of repurchase requests is not meaningful without knowing the principal balance of the assets transferred. Fourth, because repurchase obligations may vary from transaction to transaction, aggregate repurchase requests may not be comparable across transactions and would likely have to be analyzed as to underlying facts to be informative. Fifth, given the potentially large number of sponsors that may have been involved in securitizations of loans originated by a specific entity, it may be logistically impossible to obtain aggregate data for particular issuers. Sixth, the proposed legislation refers to requests “across trusts,” but there may be numerous transactions that involve comparable representations and warranties that do not involve trusts—including, for instance, sales to Fannie Mae, Freddie Mac and Ginnie Mae.

A more direct way to enable investors to identify originators with underwriting deficiencies would be to direct the SEC to evaluate whether any expansion of historical data regarding asset originators should be required under Regulation AB and whether there are logistical or cost challenges to that approach.

Conclusion

We wish there were an easy way to correct the problems that have beset the securitization market in recent years. We do not think there is. Nor do we believe that regulating the substance of securitization by legislating economic terms, representations and warranties, forms of documentation or simplicity of structures will have the desired effect. In fact, we fear unintended consequences for the financial sector and the economy as a whole. We can, however, make the following observations:

- The concept of an efficient market has been cast in serious doubt by events of the last two years. Altering securitization practices in an effort to ensure the quality and appropriateness of consumer loans that are originated is, at best, an indirect approach that may place the obligation of oversight on those who are too removed from the process to fulfill it effectively. A better approach, and one that is already part of legislative proposals, may be to modernize regulatory oversight of the origination of consumer loans.
- Asset originators, and their regulators, should be carefully assessing the ways in which asset origination is rewarded within the organization; whether quantity is favored over quality; what costs and other constraints limit the loan diligence process and whether such costs and constraints have been shown to reflect an appropriate balance; and what systems, if any, are in place to evaluate and manage the risk of each individual asset origination in light of the risk profile of the organization as a whole. The need to realign incentives in compensation to account for risk has already been recognized with proposals such as the Federal Reserve Board's recent guidance on incentive compensation.⁹² Although we are not here addressing the specific points enumerated in that guidance, we agree that ensuring that employees are not provided with incentives to take excessive risk is an appropriate place to start.
- Investors in complex financial products, including securitizations and credit derivatives, should evaluate whether they can effectively disaggregate the bundled risk represented by such products in order to assess their risk exposures more completely and whether hedging strategies can effectively mitigate those risks.
- Industry efforts, such as the ASF's Project RESTART, which bring together a wide range of participants in the market with extensive knowledge of the related products, are more likely to provide effective and sustainable market solutions with respect to fundamental

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⁹² Federal Reserve System Proposed Guidance on Sound Incentive Compensation Policies, 74 Fed. Reg. 55,227 (Oct. 27, 2009), available at <http://edocket.access.gpo.gov/2009/pdf/E9-25766.pdf>.

economic terms of securitizations than are broad-brushed legislative efforts to regulate the substance of these transactions.

- Legislative and regulatory approaches that focus on closing gaps in disclosure that have been identified during the market upheavals may provide meaningful additional transparency and facilitate risk assessment; however, more disclosure is not always better disclosure, and any expansion of disclosure requirements needs to be evaluated in light of the reliability of the requested information, the costs of producing it, whether the information requested is so proprietary that the requirement will cause participants to exit the market rather than disclose such information, and the value to investors and others that it is expected to bring.

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APPENDIX A

COMMON SECURITIZATION STRUCTURES⁹³

Asset-backed securities issued in conventional securitization transactions, which are sometimes referred to as “term securitizations,” are generally either undivided beneficial ownership interests in the underlying financial assets or debt obligations secured by the underlying assets. Securities of the first type, beneficial ownership interests in the assets, are generally referred to as “pass-through certificates” or “pass-through securities.” These are considered to be equity securities based on their legal form even though they are typically fixed-income securities and may be considered debt for tax purposes. The second type, which is issued in the form of debt, may also be referred to as “pay-through securities,” though that term is less common today.

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The assets underlying asset-backed securities are typically loans, receivables or leases, but the broadest sense of the term “asset-backed security” also encompasses interests in bonds, government securities or, in the case of some CDOs, other asset-backed securities. A list of all asset classes securitized to date would be quite lengthy. Common securitization asset classes include residential mortgage loans; commercial mortgage loans; credit card receivables; auto loans and leases; student loans; equipment loans and leases; trade receivables; home equity loans; small business loans; and retail installment contracts. Assets commonly financed through ABCP conduits include trade receivables, consumer debt receivables, auto and equipment loans and leases, and CDOs. Conduits may also invest in securities, including asset- and mortgaged-backed securities, corporate and government bonds, and commercial paper issued by other entities.⁹⁶

Securitized assets may carry fixed or floating interest rates (for example, mortgage loans) or no interest rates (for example, trade receivables). They may have long or short maturities, and they may or may not pay their principal over time in installments (also referred to as “amortizing” assets). Securitizations are almost always backed by multiple assets, but occasionally a securitization is backed by a single asset. For example, some commercial mortgage-backed securities transactions have been supported by a single, very large loan. Residual classes that represent the remaining value in a securitization after the payment in full of all other classes sometimes serve as single assets in what are known as re-securitizations (i.e., the securitization of an ABS). Typically, though not always, all the assets in the securitized pool are

⁹³ In this Appendix, we have not attempted to describe every type of structure or asset class that has been commonly used in securitization. Instead, we wanted to provide a sampling of the diversity of structures and varied economics that characterize the standard structures that fall under the rubric “securitization.”

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⁹⁶ In transactions known as synthetic securitizations (or synthetic CDOs), the investors do not have direct exposure to a portfolio of customary cash-producing financial assets, but rather to a credit default swap that references financial assets. Nevertheless, the term “asset-backed security” is also used to refer to the securities issued in such transactions.

of the same asset class -- e.g., they are all residential mortgage loans, or all student loans, or all credit card receivables.

The role and identity of the servicer of the assets tends to vary by asset class and by transaction. In trade receivables securitizations, the servicing is typically performed by the company originating those receivables, because that is the entity that has the customer relationship with the obligors. Similarly, in credit card securitizations, where there are continuing advances on the securitized accounts, servicing would typically be performed by the issuer of the cards or an affiliate of the issuer—i.e., by the originator of the assets.

In mortgage loan securitizations, however, there is less likely to be a relationship between the entity originating the loans and the entity servicing them. More than in any other class, individual components of the mortgage securitization process can be isolated. An originator might sell its loans to a third party “servicing released” (meaning that the purchaser acquires the servicing rights) and not know whether they were securitized or how they ultimately performed. A securitization sponsor might pool together loans from a number of different originators with literally dozens of servicers and a master servicer—charged with overseeing the servicers and handling performance reports—that was not involved either in originating the loans or in structuring the securitization. Moreover, servicing might change over the course of the transaction. In most asset classes, the question might be who has the servicing obligations; with respect to mortgage loans, it is more likely to be who has the servicing rights, which are bought and sold separately from the related mortgage loans.

RMBS structures have been criticized in the last two years for limiting the servicers’ ability to modify the securitized loans, but these structures were designed for a normal housing market in which mortgage borrowers could be expected to make payments on their mortgage loans in accordance with their contractual terms. In addition, REMIC rules themselves constrained the ability to modify pool assets. If people borrowed too much, or borrowed on too expensive terms, when they bought their homes, that used to be considered an error in their judgment which did not relieve them of their obligations. Only as the problem of inappropriate loans has become widespread has sympathy shifted to the borrowers, backed by a belief that the original lenders may also have been culpable in placing homeowners in unaffordable mortgages. However, RMBS investors believed they were investing in sound mortgages, and the servicing provisions of their deals continued to be designed around the expectation that loan modification would be a rare rather than commonplace remedy.

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Mortgage Loan Securitization

Mortgage loan securitizations have many structural features in common with auto loan securitizations, discussed above. Mortgage loans are securitized by a sponsor that is either the originator of the loans or a third party that purchases them from one or more originators. The sponsor typically transfers the loans to a trust via one or more transactions that are structured to constitute a “true sale” of the loans by the sponsor—*i.e.*, a sale that will not be characterized as a pledge of the loans by the sponsor should it enter bankruptcy or a similar insolvency regime. The trust usually issues multiple classes of securities. However, instead of notes (as in auto loan securitizations), the securities are in the form of certificates representing beneficial ownership interests in the underlying loans. Mortgage loan pools are “static”—*i.e.*, with certain exceptions, new loans are not added to the securitized pool after the date on which securities are issued—and payments of principal on the loans are applied on each monthly distribution date to reduce the principal balance of the securities issued in the securitization. The loan pools in residential mortgage loan securitizations tend to be fairly homogeneous in terms of size and loan characteristics. The loan pools in commercial mortgage loan securitizations typically exhibit significantly more variability.

When the sponsor sells mortgage loans into a securitization, it ultimately receives, as consideration for the transfer of the loans, either all cash (if all classes of the securities issued in the securitization are sold to third parties) or a combination of cash and one or more classes of the issued securities. Classes that represent a portion of the consideration for the transfer of the loans represent the sponsor’s retained interest in the securitization and tend either to be unrated or to have non-investment-grade ratings from the applicable credit rating agencies.

To the extent that the sponsor retains such an interest, as is often the case in residential mortgage loan securitizations, the sponsor generally has incentives as to the loan pool’s performance that are similar to, or the same as, those discussed above with respect to other asset classes. The type and size of the retained interest necessary to induce the sponsor to perform an appropriate level of due diligence with respect to the related loan originators and loan underwriting turn on a number of considerations, principally those that would tend to affect the expected risk of loss on the loan pool.¹⁰⁶ If the securitization is structured so that the sponsor’s retained interest is the most subordinate class of issued securities, and if losses on the loan pool are expected to exceed that class’s principal balance (or, for a class with no principal balance, if the expected loan losses would otherwise render the class worthless) irrespective of the sponsor’s screening efforts, retention of the class is unlikely to influence the sponsor’s diligence incentives. Increasing the size of the retained interest could theoretically increase the sponsor’s incentives; but, as with any other asset class, requiring retention of an interest whose risk of loss exceeds the loan pool’s expected losses could prevent the securitization from ever closing because it jeopardizes achievement of legal isolation (*i.e.*, a true sale) of the transferred loans. In short, whether retaining an interest in a residential mortgage loan securitization is likely to motivate a sponsor to better screen a securitization’s loans and loan originators requires a careful analysis of

¹⁰⁶ See, *e.g.*, International Monetary Fund, *Global Financial Stability Report: Navigating the Financial Challenges Ahead* 1, 101 (October 2009) (concluding, on the basis of recent studies, that the optimal size and seniority of the retained class or classes of issued securities depend critically on reasonable assumptions about the loan pool’s credit quality and the economic conditions (*i.e.*, high versus low probability of recession) expected during the life of the securitization).

factors that affect expected losses on the related loan pool. Relatively inflexible requirements as to the nature and size of retained interests may neither serve the intended purpose of increasing the sponsor's incentives nor promote the continuation of securitization as a financing tool.

In the case of all-cash mortgage loan securitizations, where sponsors retain no continuing interest in the securitized loans, the diligence function that risk retention is designed to promote may effectively be performed not only by the sponsor but also by investors in the classes the sponsor would otherwise have retained.¹⁰⁷ Firms that specialize in investing in the junior classes of residential and commercial mortgage loan securitizations are willing to purchase them only because they have developed the expertise to assess the value of these classes. A proper assessment may be made only if the investors have as much information as, or more information than, the sponsor has about the underlying loans. Junior class investors have every incentive to discover this information because, unlike the senior classes, the junior class (as the "first loss" class) is diminished in value, roughly dollar for dollar, for every loss in the loan portfolio. The fact that the purchase price of the junior classes will be heavily negotiated by the investors also serves as an inducement to the sponsor to conduct its own thorough assessment of the underlying loans' value.

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¹⁰⁷ See, e.g., Ronel Elul, *The Economics of Asset Securitization*, in BUSINESS REVIEW 16, 20 (Federal Reserve Bank of Philadelphia, third quarter 2005) (explaining how tranching a securitization into senior and junior classes encourages sophisticated investors to become as informed as the sponsor about the value of the assets underlying the securitization and how the sponsor need not retain any interest in the securitization when it has no informational advantage over the junior class investors).