

## Chapter 17\*

### Securitization Reforms

#### Overview

Securitization allows the transfer of risk from the originators of debt to capital market investors willing to hold the risk. This transfer allows originators, such as banks, to release capital for additional lending, and permits the market for credit to expand. In theory, the balance sheet of the lending bank is less constrained by the loan being made, while the risk is spread across a large number of investors. To ensure that incentive problems between originators, securitizers and investors are minimized, the optimal contract usually calls for some type of risk retention by the originators and securitizers.

#### The Crisis

Unfortunately, securitization created serious systemic problems and led to large losses in the value of securitized products during the financial crisis of 2007-09. The consensus view is that securitization as employed by financial institutions not only did not allow efficient risk transfer to occur but in fact caused them to concentrate risks on their balance-sheets. Furthermore, the general opacity of these products to investors and regulators alike also played a major role in the crisis.

Why did securitization fail us?

First, there is considerable empirical evidence that lending standards slipped considerably in the mortgage market in the five years leading up to the crisis. Several researchers have demonstrated that there is, indeed, a link between securitization and the reduction in loan quality. Unfortunately, given the large number of loans in these structures and the difficulty in monitoring them, private markets did not solve the incentive problem between the borrowers, originators and investors. With little or no originator “skin-in-the-game,” the incentive to screen and monitor the loans disappeared, leading to ever riskier securitized pools of loans over time. This was exacerbated by the rating agencies, whose optimistic credit assessment of these securitized pools and their tranches, encouraged investments from regulated entities restricted to investing in highly-rated securities, and an unfettered securitization market grew without much oversight or disclosure.

Second, although the “originate to distribute” model of securitization and the rating agencies were clearly important factors, the financial crisis occurred because financial institutions did not strictly follow the business model of securitization. Rather than acting as intermediaries by transferring the risk from mortgage lenders to capital market investors, these institutions themselves took on an investment role. They did this in three ways: the outright purchase of securitized products; off-balance sheet securitization (albeit with recourse back to the institution); and the purchase of “underpriced” protection for securitized products from monoline credit insurers and large insurance companies, principally AIG. In effect, securitization became a

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vehicle for financial institutions to retain credit risk in a manner that minimized the underlying capital requirements. In other words, credit risk transfer did not take place – financial institutions had, in effect, *too much* skin-in-the-game.

Third, the incentive to retain, rather than transfer, the risks was accentuated by the implicit guarantees offered to the Government-Sponsored Enterprises (GSEs), such as Fannie Mae and Freddie Mac, which accumulated large amounts of the credit risk, not just of prime-quality mortgage-backed securities which they guarantee, but also through financial investments of subprime-quality assets, through their securitized tranches.

## **Current Proposals**

The House and Senate proposals to address securitization are broadly similar. They focus on three areas: the skin-in-the-game issue; better disclosure rules to increase transparency of securitized products; and definition of accounting/regulatory standards for such disclosure.

For example, in the House bill, “the appropriate agencies shall prescribe regulations to require any securitizer of asset-backed securities that are backed by assets to retain an economic interest in a material portion of any such asset used to back an issuance of securities.”<sup>\*</sup> The bill then proposes regulations to “prohibit a creditor or securitizer from directly or indirectly hedging or otherwise transferring the credit risk such creditor or securitizer is required to retain under the regulation.” A major difference between the House and Senate versions of the bill is the proportion of credit risk that must be retained by the securitizer -- 5% versus 10%, respectively.

Moreover, in terms of disclosure requirements, the House bill requires “each issuer of an asset-backed security to disclose, for each tranche or class of security, information regarding the assets backing that security... the Commission shall set standards for the format of the data provided by issuers of an asset-backed security, which shall, to the extent feasible, facilitate comparison of such data across securities in similar types of asset classes. The Commission shall require issuers of asset-backed securities at a minimum to disclose asset-level or loan-level data necessary for investors to independently perform due diligence. Asset-level or loan-level data shall include data with unique identifiers relating to loan brokers or originators, the nature and extent of the compensation of the broker or originator of the assets backing the security, and the amount of risk retention of the originator or the securitizer of such assets.”<sup>†</sup>

To the extent that securitization has been addressed internationally as well, the focus has been on securitizers’ or originators’ retaining some portion of the risk of the underlying assets, e.g., the Group of Twenty and European Commission. Indeed, the Financial Stability Board’s

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<sup>\*</sup> HR. 4173, Sec. 1502. Credit risk retention. See similar language in the Senate bill, Sec. 941. Regulation of credit risk retention.

<sup>†</sup> HR. 4173. Sec. 1503. Periodic and other reporting under the Securities Exchange Act of 1934 for asset-backed securities. Almost identical language is provided in the Senate version, Sec. 942. Periodic and other reporting under the Securities Exchange Act of 1934 for asset-backed securities.

(FSB) proposals get to the root cause of the crisis by recognizing that financial institutions used securitization as a way to circumvent capital requirements via off-balance sheet financing. The FSB calls for the removal of the rules that allowed such activity to take place and the prescription of a clearer definition of capital adequacy to include such off-balance sheet vehicles.

## **Evaluation of Current Proposals**

### *“Skin-in-the-game”*

The guiding principle behind Congress’s major proposal for securitization -- namely that securitizers should have skin-in-the-game -- is reasonable and is a natural outcome of almost all models of securitization: to align incentives between investors and the securitizers. To the extent that this did not take place -- that is, the market failed -- there is a need for setting and enforcing standards.

Exploring why it failed is important in helping to frame the optimal regulation. While the evidence of a link between securitization and loan quality cannot be ignored, the case is not so straightforward. First, mortgage lenders do have skin-in-the-game to the extent that a considerable portion of their income derives from mortgage servicing fees. In addition, securitizers must house the loans during the securitization process. Second, the question arises as to why the private sector -- securitization firms and asset-backed security (ABS) investors -- could not enter into contracts with lenders to ensure they had right incentives to screen and monitor loans. Such failure might occur if the full costs of poor quality loans are not being borne totally by the holders of the ABS that these loans back, most likely because many of the parties in the marketplace for securitized products (at least for mortgage-related securities) have some type of implicit or explicit guarantee from the U.S. Government. \*. As long as one of these guaranteed entities is active in the securitization process -- as a lender, securitizer or investor -- incentives will be distorted somewhere, and potentially everywhere, down the chain. For example, the investor in prime MBSs that are guaranteed by a GSE does not necessarily care about the quality of the loan because she may be confident that the principal will be paid regardless. Similarly, if the investor is a depository institution with deposit guarantees from the Federal Deposit Insurance Corporation (FDIC), the external discipline to reject risky loans is diminished.

The presence of such government guarantees for parties involved in the securitization chain creates a potential rationale for government intervention in the securitization process. However, the main concern about Congress’s proposals is that, generally speaking, they are “one size fits all.” While there is room for exemptions, particularly in the House version, the problem is that, if the proposals are implemented, they will likely cause uncalled-for distortions in the securitization market:

- (1) The fixed levels (e.g., 5% or 10%) of economic interest retained do not vary with either the underlying risk or the opacity of the loans, or the specific nature of the tranches of the pool, and other risk characteristics of the structure. Clearly, the level of retention should

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\* Examples include the implicit guarantee on the GSEs, the explicit guarantee on deposits by the FDIC for deposit institutions, or the “very” implicit guarantee of too-big-to-fail of large complex financial institutions (LCFIs).

vary with these characteristics. There is no recognition that retention limits may place considerable costs on the institutions that originate or securitize loans with relatively safe assets, for which such fixed levels might end up being too high. As a more extreme case, for some securitized products, the underlying assets are bonds and leveraged loans which are traded securities. It is not clear why any credit risk retention is required in such cases, since these assets are monitored by the market.

- (2) Government guarantees play an important role in failing to align incentives in securitization. Therefore, one possibility is that financial firms with government guarantees should only securitize or purchase loans, such as mortgages, that have been originated by lenders with skin-in-the-game. The pricing of such guarantees should be determined by market conditions taking into account the risk of the structure.

### *Disclosure*

The other proposal by Congress with respect to securitization, namely better disclosure, is reasonable in principle, although the information to be disclosed should be defined more clearly. One of the major problems in the crisis was that, when some financial firms ran aground because of their holdings of securitized products, other firms, which did not have such holdings, were also affected by the contagion. There was general uncertainty about which firms were holding securitized products and what these securities were worth. This uncertainty was resolved, to a large extent, only after the government performed extensive stress tests on the large financial firms, on an equal basis, to separate them by asset quality.

With respect to the actual proposal, it is reasonable to force issuers of asset-backed securities to disclose asset-level or loan-level data, but it is not clear how investors or regulators can use this voluminous information. A more practical solution would be one that calls for a template to facilitate a comparison of risk metrics across securities of similar types of asset classes. Currently, the rating provided by the rating agencies is not sufficient. There should be a broader classification that takes into account the following factors: illiquidity (for example, Level 1, 2 or 3, as classified for financial reporting, and the likely status when the overall market does poorly); the concentration/diversification of the underlying loans; the credit risk of the security (related to the rating); the market risk of the security (performance when the overall market does poorly); and the degree of model error possible in these risk estimates. All these quantities are measurable and can be specified by the regulators, who should be charged with the responsibility for designing and implementing such a template.

### *Capital Adequacy and the Effect of Recent Accounting Changes*

Most importantly, the bills under consideration in Congress do not recognize the primary cause of failure of securitization in this crisis: financial institutions often use securitization to exploit loopholes in regulatory capital requirements in order to take large undercapitalized bets on credit risk, especially residential mortgage credit risk. The Financial Stability Board identified this as an international problem, with similar incentives for undercapitalized off-balance sheet securitization activities existing across countries. Erring in the opposite direction, the Department of the Treasury's recently enunciated "Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms" ([September 3, 2009](#)) propose that the required regulatory capital for securitizations be based (at a minimum) on the recently

issued Financial Accounting Standard Board Statements No. (FAS) 166 and 16. Getting capital requirements right – neither too high nor too low – is of paramount importance.

Specifically, FAS 167 (paragraph 14A) requires financial institutions to consolidate each securitization entity over which they have the power to direct the activities that “most significantly impact the entity’s economic performance” and for which they bear losses or benefits “that could potentially be significant.” While these conditions for consolidation are subject to some interpretation, they are far broader than the conditions for consolidation under prior GAAP, and under our interpretation their application appears to require financial institutions to consolidate most currently off-balance-sheet securitization entities. Such consolidation will bring all of the assets and liabilities of the securitization entities back on to the institutions’ balance sheets. However, recognizing that securitization sometimes transfers risk outside the institution (i.e., its intended purpose), FAS 167 (paragraph 22A) requires separate balance sheet presentation of assets dedicated to the settlement of the obligations of the securitization with no recourse (either explicit or implicit) to the financial institution.

The Treasury's proposal ignores this required separate presentation and instead stipulates that *all* of the assets and liabilities of securitization entities brought onto a financial institution's balance sheet be used in computing the institution’s required capital. The inclusion of the separately classified dedicated assets and non-recourse liabilities from this computation has particularly far-reaching and troubling implications, because it requires securitizing financial institutions to hold full regulatory capital even in for securitizations where they bear no or little risk of the securitized assets. This would impose significant costs on securitizers, leading to a smaller volume of securitizations and consequently lending, and possibly impeding economic recovery.

FAS 167’s requirements also directly interact with the skin-in-the-game requirements discussed above. By design, the latter would force financial institutions to bear losses or benefits “that could potentially be significant,” thereby causing financial institutions to consolidate their securitization entities under the former. This “Catch 22” type interaction prompted the Amendment to the bill requiring that a study be conducted to understand the joint impact of the credit risk retention requirements and FAS 166 and FAS 167.

We recommend that the proposals directly address the critical issue of getting capital requirements right. The proper approach is that every dollar of *economic* interest at risk in the securitization should face full regulatory capital requirements. But if and to the extent that financial institutions transfer credit and other risks to the securitization investors, then its capital requirements should be reduced accordingly.