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Loan-Level Disclosure in Securitization Transactions: A Problem with Three Dimensions

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Abstract

The collapse of the credit markets revealed that information critical to assessing the quality of many mortgage backed securities was unavailable. When subprime losses began to mount in 2007 and 2008, analysts were unable to obtain information necessary to assess the performance characteristics of loans that had first been securitized into mortgage backed securities and then often re-securitized – with tranches of initial securities being merged with tranches from other offerings into collateralized debt obligations (CDOs) and other complex capital market instruments. Critical information was unavailable because there were no common requirements or formats for reporting such information. In the absence of loan level information, it was impossible to distinguish good loans from bad one or to value CDO and associated derivatives whose performance depended upon underlying loan pools. With analysts unable to value securities appropriately, demand dried up and securities were marked to an illiquid market. As a result of these problems, many are now arguing for new reporting requirements for securitized loans, and the recently adopted Dodd-Frank Wall Street Reform and Consumer Protection Act mandates the promulgation of new disclosure requirements for securitization transactions. This chapter examines the degree of loan-level transparency (or lack thereof) in securitization transactions, spells out the implications of the current lack of transparency for public policy, and makes the case for new regulations that mandate public disclosure. Not only would such requirements improve the pricing of investments in securitization transactions, these requirements might also improve the rate of mortgage renegotiations and enhance the capacity of public authorities to identify unfairly priced mortgage originations and discriminatory lending practices in violation of the Equal Credit Opportunity Act. The paper concludes with a discussion of the pros and cons of releasing information on loan-level data publicly as opposed to limiting release to government authorities. Finally, the chapter explores possible interactions between other proposals to reform assets securitization and requirements focused on loan-level disclosures.

Loan-Level Disclosure in Securitization Transactions: A Problem with Three Dimensions

The securitization of residential mortgage and other forms of consumer credit has become a subject of intense national interest and debate. Many have questioned the wisdom of the originate-to-distribute model of loan underwriting and others have focused on the conflicts inherent in the role of investment banks assembling securitization pools and then marketing them to their institutional clients. The capacity of credit rating firms to rate accurately the securities backed by securitization pools has been roundly criticized in many quarters. Still others have identified as problematic the manner in which borrowers were encouraged to obtain mortgages that they were unlikely to be able to repay without refinancing or resale of the underlying property at an inflated price. These concerns and other have led to a series of regulatory proposals as well as a number of provisions in the recently adopted Dodd-Frank Wall Street Reform and Consumer Protection Act.

In this essay, I focus on a different aspect of the securitizations: loan-level information on assets assigned to securitization pools. Limitations on this information came to the fore when the financial crisis unfolded in 2007 and 2008 as investors began to question the value of interests in securitization pools and found themselves unable to obtain sufficient information about underlying mortgages to ascertain the current values of their investments. While the relationship between inadequate loan level disclosures and the valuation of toxic assets has received the most attention in the academic literature, there are at least two other dimensions of public policy on which loan-level information has been found wanting. One is in the area of mortgage renegotiations. While an array of institutional barriers inhibit the renegotiation of under-water mortgages, one aspect of the problem is uncertainty as to the fair market value of loans held in securitized pools and the terms on which comparable loans have been renegotiated or sold in other market transactions. Another dimension on which the value of securitized loans comes into play is in disputes over the fairness of the origination of loans that were transferred into securitization pools. The amount by which originators “marked up” mortgages above the price at which those mortgages were sold into securitization pools offers critical evidence as to the presence of unfair origination practices as well as violations of the Equal Credit Opportunity Act and other consumer protection statutes. While economists have developed techniques to estimate excessive markups and discriminatory impacts from other sources of data, the preservation of data regarding prices at which individual mortgages were purchased by securitization pools as well as contemporaneous data on loan and borrower

characteristics would offer more accurate source of information with which public officials could police the fairness of the origination process.

This chapter proceeds in three sections. First, I review the debate over loan level information for the purpose of improving the pricing of interests in securitization pools, discussing both problems that emerged in the recent financial crisis and steps that are being taken to address those concerns, as reflected in federal financial reform legislation and best practice standards being developed under the American Securitization Forum's Project RESTART. The principal elements of these reforms include

- The development of consistent disclosure requirements for loans assigned to securitization pools;
- Imposition of periodic updating requirements for loan level disclosures for outstanding securitization transactions;
- Development of model representations and warranties for loan sales into securitization pools; and
- Various efforts to improve the transparency and efficiency of loan modifications

I then review the emerging literature on barriers to the renegotiation of underwater mortgages and explain how the availability of better loan-level data on securitization pools, if supplemented with additional inform on loan sales and renegotiations, may help facilitate both private renegotiations and also possibly government purchase programs. Among other things, this analysis emphasizes:

- Loan level information useful for investors in securitization pools is also useful for parties seeking to value individual loans in negotiations over loan modifications;
- The supply of updated loan level information contemplated under current reform proposals to assist investors in securitization pools could also assist in loan renegotiations; and
- More aggressive forms of government intervention – including loan purchases or write-downs of loans in bank examinations – could also make use of such loan level data from securitization pools.
- Finally, I discuss the role the loan-level data from securitization pools might play in

policing the fairness of loan originations, both as offering a metric against which to measure loan markups and also as providing a more precise instrument for detecting discriminatory lending practices. Here the key points are

- Whereas securitization pool investors and loan renegotiators are critically concerned with the value of loans over the life of the pool, borrowers are interested in the value of the loan at the time it is transferred to the pool, that is, the price the pool paid to purchase the loan
- Borrowers (or regulators acting on behalf of borrowers) can use the origination purchase price information to ascertain the mark-up the originator earned on the pool as well as any potentially problematic variations in pricing based on impermissible categories.
- The chapter concludes with a short review of other proposals to reform the securitization of financial assets – particularly those designed to require loan originators to retain additional “skin in the game” – and considers how these reform might interact with efforts to improve the transparency of loan-level disclosure. Interestingly, the form of “skin in the game” can affect the usefulness of loan-level pricing information on all three dimensions discussed above. In particular, the retention of originator risk in individual loans reduces loan level transparency; where the allocation of securitization pool interests to the originating firm does not. I also raise the question of whether loan-level disclosure requirements should be extended to portfolio lenders and government sponsored entities (GSEs) as well as securitization polls. Finally, the conclusion touches upon privacy concerns raised by loan-level disclosure requirements and consider briefly the options for limiting disclosure of loan-level information to regulatory authorities and rating agencies but not the public markets.

Part I – Loan Level Information and the Pricing of Mortgage Backed Securities

Throughout the past few decades, an increasing share of US residential mortgages were financed through securitization transactions. By year-end 2004, roughly 45 percent (or \$4.8 trillion) of the \$10.7 trillion in outstanding mortgages were held in mortgage pools or trusts.¹ Just three years later at year-end 2007, the share of securitized mortgages approached 51 percent

¹ <http://www.federalreserve.gov/econresdata/releases/mortoutstand/mortoutstand20090331.htm>.

(or \$7.4 trillion) on \$14.6 trillion of outstanding mortgages.² While government backed pools remained the dominant share of securitized mortgages, growth in private securitizations in the mid-2000s (some 102 percent between year end 2004 and year end 2007) greatly outpaced overall growth in mortgages outstanding during the same period (36 percent) and contemporaneous growth in government backed securitization pools (32 percent). As a result, private mortgage securitizations accounted for nearly forty percent of total mortgage securitizations by year-end 2007 and over twenty percent of all mortgages outstanding.³ As the vast majority of the loans placed into private securitization pools constituted subprime or Alt-A originations,⁴ these investment vehicles were peculiarly vulnerable to the bursting of the U.S. housing bubble and the ensuing economic downturn that engulfed the global economy in 2008.

By 2009, government officials, policy analysts, and industry representatives were converging on a package of reform proposals designed to address the problems of mortgage securitization and structured financing more generally. The Obama Administration's proposal for financial regulatory reform, unveiled in June 2009, identified strengthening the supervision and regulation of securitization markets as a key plank of regulatory reform, and included five basic components in its reform package:

1. Federal banking agencies should promulgate regulations that require originators or sponsors to retain an economic interest in a material portion of the credit risk of securitized credit exposures.
2. Regulators should promulgate additional regulations to align compensation of market participants with longer term performance of the underlying loans.
3. The SEC should continue its efforts to increase the transparency and standardization of securitization markets and be given clear authority to require robust reporting by issuers of asset backed securities.
4. The SEC should continue its efforts to strengthen the regulation of credit rating agencies, including measures to require that firms have robust policies and procedures that manage and disclose conflicts of interest, differentiate between structured and other products,

² *Id.*

³ *Id.*

⁴ See Adam B. Ashcraft and Til Schuermann, Understanding the Securitization of Subprime Credit 2 (March 2008) (Federal Reserve Bank of New York Staff Report No. 318).

and otherwise promote the integrity of the ratings process.

5. Regulators should reduce their use of credit ratings in regulations and supervisory practices, wherever possible.⁵

For purposes of this chapter, the third of the Administration's priorities – increased transparency and standardization in securitization markets - is of most relevance, and I will return to that aspect of the Treasury Department's recommendations in a moment. But it bears noting that the Obama Administration reforms also include two other important components. The first, reflected in the first two points listed above, is that the Administration contemplated mandatory requirements that originators and sponsors retain "skin in the game" and accept compensation packages that align their incentives with the interests of both borrowers and investors in securitization pools. Reforms of this sort respond to wide-spread criticisms of existing originate-to-distribute business models and the associated agency problems that these arrangements have generated in terms of generating high risk loans, which have proved detrimental to both borrowers and investors, as well as burdensome on the broader economy as a result of what have proved to be substantial negative externalities. The second component of the Administration's securitization reform proposals address credit rating agencies and contemplate (a) increased regulation of these agencies to improve the usefulness of ratings for investors in structured products and (b) reduced reliance on ratings for supervisory purposes, thereby encouraging more direct market discipline (and fewer regulatory safeharbors and incentives) for rated securities. Implicit in these proposed reforms of credit rating agencies is a greater reliance on investors to police securitization transactions, thus indirectly linking credit rating reforms with the increased transparency of securitization pools.

5 U.S. Department of Treasury, A New Foundation: Rebuilding Financial Supervision and Regulation 43-46 (June 2009) (http://www.financialstability.gov/docs/regs/FinalReport_web.pdf).

Returning now to the central component of the Administration's reform proposal – transparency and standardization in securitization transactions – a number of points bear emphasis. First is the regulatory body to which the proposal is addressed: the Securities and Exchange Commission (SEC). What the Obama Administration contemplated in these recommendations is the improvement of SEC disclosure requirements for securitization transactions, building off of specialized rules that the Commission adopted in the 1990's.⁶ In a brief textual summary, the Administration's proposal noted four distinct areas for improvement. First was the need for loan level information in SEC filings, including information about the identity of the broker or originator associated with each loan and information regarding the compensation structures and risk exposures of the sponsor and other key parties to the securitization. The second area of reform addressed the updating of information over the life of the securitization; under current SEC requirements, while extensive disclosures were mandated at the time of initial offering of interests in securitization pools, the interests were typically exempt from periodic reporting requirements under the Securities Exchange Act of 1934 as the number of holders typically fell beneath thresholds established under section 15(d) of the Act.⁷ Third, the Administration called for standardization of legal documentation for securitization transactions both to make it easier for investors to value interests in securitization pools and also to facilitate loan modifications. This last aspiration moves a bit beyond disclosure and standardization into the imposition of mandatory terms that would increase the discretion of loan servicers to modify mortgages if the modification would benefit the trust as a whole. Finally, the Obama blueprint addressed the need to improve electronic trade reporting databases for asset-backed securities.

6 A number of SEC requirements touch upon securitization transactions. In terms of disclosure requirements, the provisions of the Securities Act of 1933 apply to public offers of securities. In Regulation AB, the SEC has codified its registration and disclosure requirements for asset backed securities. See SEC Final Rule on Asset-backed Securities, 70 Fed. Reg. 1506 (Jan. 7, 2005). These requirements do not apply to securitization transactions that are privately placed (as opposed to publically offered) or otherwise exempt from the SEC reporting requirements, including most importantly mortgage backed securities underwritten or guarantees by government sponsored agencies like Fannie Mae and Freddie Mac. In general, when a corporation issues securities to the general public, the issuer will have on-going periodic reporting obligations under the Securities Exchange Act of 1934. These obligations, however, expire if a sufficient number of investors do not hold the issuer's securities. Under Section 15(d) of the 1934 Act, deregistration from the 1934 Act's periodic reporting requirements is available when an issuer has fewer than 300 holders of securities, and most private securitization transactions currently qualify under this standard. Accordingly their continuous reporting obligations typically expire within two years of their initial offering. A final set of SEC exemptions for securitization transactions concern the Investment Company Act of 1940. As pools of financial assets, securitization transactions are presumptively subject to regulation under the 1940 Act. As the requirements of the 1940 Act are strict and inconsistent with the structure of most securitization pools, transactions are invariably designed to conform with 1940 Act exemptions, such as 3(c) (1) and 3(c) (7) of the 1940 Act, which are available to privately placed securitization, or another exemption promulgated under SEC rulemaking authority and available to publicly sold securitizations that receive sufficient credit ratings and meet other standards. See Rule 3a-7 under the 1940 Act. See John C. Coates, Reforming the Taxation and Regulation of Mutual Funds, 1 Journal of Legal Analysis 591. 663 (2009). For certain securitization transactions, the Trust Indenture Act of 1939 also applies.

While the Obama Administration’s proposals for securitization reform were sketchy and conceptual, the Administration drew up its recommendation in response to several more detailed studies of the problems facing investors in securitization transactions during the market disruptions of 2008 and 2009. The most comprehensive of these studies can be found in the Committee on Capital Markets Regulation (CCMR) May 2009 report titled *The Global Financial Crisis: A Plan for Regulatory Reform*.⁸ The CCMR study is instructive because it presents an empirical study of the actual loan level data available for a sample of major private mortgage securitizations in 2006, the height of the housing boom. Measured against the 165 fields of data that the rating agencies had identified as required or recommended to assess the credit-worthiness of loan pools, the CCMR research found that many of the fields were unavailable in the majority of transactions, often including fields that investors deemed of critical importance. The study also documented systemic failures on the part of securitization sponsors to update loan-level data on a monthly basis or to present the loan-level data in a form that permitted effective evaluation of downstream products, like collateralized debt obligations. Criticizing the laxness of SEC Regulation AB, which defines the disclosure requirements for asset-backed securities distributed in public offerings, the CCMR report paints a disconcerting picture of loan-level disclosure practices in the mid 2000s, but one that is fully consistent with the difficulties that investors and government officials encountered in their efforts to value “toxic assets” in the fall of 2008, as the widespread deterioration of housing markets became apparent and the level of mortgage defaults skyrocketed above historical averages and model assumptions.

Reform of loan-level disclosure requirements has now proceeded on four distinct, but related tracks. On the congressional front, legislative proposals in both the House and Senate included securitization reform provisions and these proposals were melded into Subtitle D – Improvements to the Asset-Backed Securitization Process of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act.⁹ Section 942 of the Dodd-Frank Act addresses the issue of loan-level losses in two ways. First, the subsection 942(a) amends section 15(d) of the Securities Exchange Act of 1934 to prevent issuers of asset backed securities from discontinuing periodic disclosures relatively soon after a public offering is complete (which is generally

7 See supra note 6.

8 http://www.capmksreg.org/pdfs/TGFC-CCMR_Report_%285-26-09%29.pdf.

9 Conference Report 111-517 to Accompany H.R. 4173, 111th Cong. 2d Sess. §§ 941-957 (June 29, 2010). These legislative reforms deal with the full gamut of asset backed securities and in certain respects establish different rules for different asset classes. In this chapter, I focus primarily on asset backed securities based on residential mortgages.

permitted for classes of securities with fewer than 300 holders, as is typically the case with securitization offerings) and grants the SEC authority to adopt specific rules for allowing the discontinuation of periodic reporting requirements for asset backed securities.¹⁰ Second, subsection 942(b) instructs the SEC to amend its disclosure requirements for asset-backed securities to mandate additional loan-level data, which would facilitate investor comparisons across different securities and permit investors to perform their own due diligence regarding both the underlying loans and their origination process, including compensation arrangements for originators and risk retention provisions.¹¹

The legislation also includes fairly extensive provisions establishing risk retention requirements for assets financed through asset backed securities, contemplating a presumptive risk retention requirement of five percent but allowing lower amounts of retention for qualified mortgages and full or partial exemptions for certain asset classes.¹² Unlike the Dodd-Frank Act's ABS disclosure requirements, which fall within the exclusive jurisdictions of the SEC, the Act's risk retention provisions are to be implemented through joint rulemaking among the Commission, the federal banking agencies, and in some instances also the Department of Housing and Urban Development and the Federal Housing Finance Agency. The responsibility for coordinating joint rulemaking under the risk-retention provisions is assigned to the Chairperson of the Financial Stability Oversight Council, who is the Secretary of the Treasury.¹³

The Act also directs the SEC to improve disclosures regarding the terms of representations and warranties governing the contracts under which loans are transferred to securitization pools. Most notably, with respect to ABS transactions, credit rating agencies will be required to report on the quality of representations and warranties as compared with industry

¹⁰ Id. §942(a). The bill would also eliminate an exemption from the Securities Act of 1933 for certain notes secured by real estate. Id. § 944. While presumably designed to increase the application of the SEC public offering rules, it is not clear how significant this reform would be in practice as the remaining exemption for private placements remains available and typically exempts offerings of securities sold exclusively to institutional investors.

¹¹ The exact language reads as follows:

"(c) DISCLOSURE REQUIREMENTS. –

(1) IN GENERAL. – The Commission shall adopt regulations under this subsection requiring each issuer of an asset-backed security to disclose, for each tranche or class of security, information regarding the assets backing that security.

(2) CONTENT OF REGULATIONS. – In adopting regulations under this subsection, the Commission shall —

(A) 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; and

(B) require issuers of asset-backed securities, at a minimum, to disclose asset-level or loan-level data, if such data are necessary for investors to independently perform due diligence, including-

(i) data having unique identifiers relating to loan brokers or originators;

(ii) the nature and extent of the compensation of the broker or originator of the assets backing the security; and

(iii) the amount of risk retention by the originator and the securitizer of such assets."

§ 942(b) (to be codified at 15 U.S.C. § 77g).

¹² See id. § 941.

standards.¹⁴ In addition, the Commission will have to establish aggregate disclosure requirements with respect to “fulfilled and unfulfilled repurchase requests across all trusts aggregated by the securitizers, so that investors may identify asset originators with clear underwriting deficiencies.”¹⁵ The Act also mandates two separate studies on risk retention; one focusing on potentially negative effects of risk retention requirements on the availability of credit to be conducted by the Federal Reserve Board (working in conjunction with federal banking agencies and the SEC)¹⁶ and another on positive macroeconomic effects of risk retention requirements in reducing asset bubbles to be conducted by the Chairman of the Financial Services Oversight Council.¹⁷ A separate title, addressing the reform of credit rating agencies, includes another provision specifically targeted at securitization transactions: one mandating first an SEC study of the feasibility of establishing a system for assigning credit rating agencies to securitization transactions to be followed, if appropriate, by SEC rulemaking to implement such a system.¹⁸

While the final legislation is generally consistent with the Obama Administration’s June 2009 proposals and responsive to the defects revealed in the CCMR study, the statutory language is still vague, especially with respect to precise loan level disclosure requirements and much is left to the SEC for implementation. Where details are being worked out is the industry level. The American Securitization Forum, an industry group, launched in July of 2008 Project RESTART, which has evolved into a multi-faceted effort to address weaknesses in securitization practices.¹⁹ Among other things, the ASF project includes a model disclosure package for residential mortgage backed securities including 135 data fields for pool and loan level information, an associated periodic reporting template that would specify fields of loan data for monthly updating, and coding protocols to establish unique numbers for individual loans, which would permit investors to track individual loans notwithstanding changes in ownership or servicing.²⁰ The ASF work also entails the development of standards representations and

13 Id. § 941(h).

14 Id. § 943(1).

15 Id. § 943(2).

16 Id. § 941(c).

17 Id. §946

18 Id. § 939F. Elsewhere in the Dodd-Frank Act is a provision adding new section 27B to the Securities Act of 1933 and establishing special conflict of interest rules for the sales of asset-backed securities. See Section 621 of the Dodd-Frank Act.

19 For an overview of the project, see <http://www.americansecuritization.com/restart>.

20 For a good analysis of both existing loan level disclosure practices and ASF reform proposals, see Scott Peppet, Smart Mortgages, Privacy and the Regulatory Possibility of Infomediation (Aug. 19, 2009) (avail. at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1458064).

warranties for securitization transactions, and purports to include various information that would be helpful in facilitating and tracking loan modifications.²¹

Another somewhat surprising and parallel line of securitization reform is taking place at the Federal Deposit Insurance Corporation. The FDIC has long has an indirect role in the regulation of securitization transactions in that the Corporation back in 2000 issued a regulation clarifying that the FDIC, as receiver, would not seek to recover assets from a securitization transaction undertaken by an insured bank that later become insolvent provided the transaction was structured in compliance with the sale accounting treatment under generally accepted accounting principles.²² This ruling was of critical importance to the development of securitization markets because investors and rating agencies needed assurance that securitization vehicles would be “bankruptcy remote” from sponsoring banks. Without the FDIC regulations, the capacity of insured depository institution to transfer loans into securitization pools could be called into question. In the summer of 2009, however, the continued viability of the FDIC regulation was called into question when the Financial Accounting Standards Board revised its rules on loan transfers for reporting periods beginning after November 15, 2009. The New FASB rule would likely require consolidation for accounting purposes of securitization vehicles that were previously considered off balance sheet.²³

To resolve uncertainty raised by changes in generally accepted accounting standards, the FDIC issued an interim rule in November of 2009, grandfathering its current regulatory safe harbor for securitization pools assembled and financed before March 31, 2010. Shortly thereafter the FDIC released an advanced notice of proposed rulemaking dealing with the structure of a proposed new safe harbor for future securitizations.²⁴ Unlike the 2000 safe harbor, the FDIC’s advance notice contemplated a highly prescriptive set of rules governing many aspects of the structure of securitization transactions. including disclosure requirements. So,

21 For example, AFS literature notes that its model disclosure packages address:

- “* Significant expansion of public and investor reporting of loan modification activity by mortgage servicers nationwide;
- “* Disclosure standards for securitization or resecuritization of mortgage loans that have previously been modified in the loss mitigation process;
- “* Uniform national standards for the secondary market definition of a full documentation loan;
- “* Proposed mechanism for owners of 1st lien mortgages to immediately know a 2nd lien mortgage has been originated on the subject property;
- “* Methods to address higher rates of fraud in new originations and in modifying loans; and
- “* Recommendations for universal loan identification system for mortgage and consumer loans.”

Id.

22 See. 12 C.F.R. § 360.6 (2009).

23 See 74 Fed. Reg. 59,066 (Nov. 17, 2009).

24 75 Fed. Reg. 934 (Jan. 7, 2010).

under the draft regulatory provision, the FDIC would mandate an extensive list of loan-level information, including all of the information that the SEC Regulation AB requires for public asset backed securities offerings even if the transactions were structured as private placements and thus formally exempt from Regulation AB.²⁵ Perhaps not surprisingly, the FDIC's initiative prompted swift and vehement objections from industry representatives, including the ASF,²⁶ although others have endorsed the FDIC's efforts and even advocated more stringent daily updating of loan-level data.²⁷ Notwithstanding initial criticisms, the FDIC moved forward to the next stage of the rulemaking process with a notice of proposed rulemaking released on May 17, 2010, largely tracking the Corporation's previous announcement with respect to disclosure requirements and also including extensive provisions regard compensation, capital structure and risk retention for securitization transactions.²⁸

The final participant in the reform of securitization disclosure requirements is the SEC itself, which released on May 3, 2010, its own notice of proposed rulemaking involving extensive revisions of Regulation AB, which governs disclosure requirements for asset-backed securities.²⁹ The SEC proposal includes elaborate, new requirements for loan-level disclosures both at time of offering and on an on-going basis, and includes a host of ancillary reforms designed to ensure that information is available in machine-readable formats and to slow down shelf offerings so that investors can review disclosures before making investment decisions.³⁰ The SEC proposal draws quite explicitly on the work of the ASF in its Project RESTART as well as several other sources of standardized terms for loan-level disclosures.³¹ In addition, the SEC's proposal includes periodic reporting requirements focused on loan modifications and renegotiations.³² Finally, like the FDIC proposal, the SEC's new rules would extend to privately placed asset backed securities offerings, imposing for the first time extensive mandatory

25 *Id.* at 940.

26 See <http://www.americansecuritization.com/uploadedFiles/ASFFDICCommentLetterSafeHarbor010409.pdf>

27 <http://www.fdic.gov/regulations/laws/federal/2010/10c02AD55.PDF>

28 75 Fed. Reg. 27,471 (May 17, 2010).

29 75 Fed. Reg. 23,328 (May 3, 2010). In a speech in the fall of 2009, SEC Chair Mary Shapiro announced that the Commission might seek additional statutory authority to provide more comprehensive and substantive oversight of asset backed securities, perhaps modeled on the Investment Company Act of 1940, from which the securitization transactions are currently exempt under safe harbor rules that the SEC adopted many years ago. See Speech of SEC Chair Mary Schapiro Before the SIFMA Annual Conference (Oct. 27, 2009) (avail. at <http://www.fdic.gov/regulations/laws/federal/2010/10c02AD55.PDF>). Such a reform would constitute a reversal of the SEC's current practice of providing fairly generous 1940 Act exemptive relief to securitization transactions. These proposed reforms were not incorporated into the Dodd-Frank Act and are not reflected in the SEC's proposed amendments to Regulation AB.

30 The SEC proposal includes two new schedules: Schedule L (Asset-level information) (to be codified at 17 C.F.R. § 229.1111A) and Schedule L-D (Asset-level performance information) (to be codified at 17 C.F.R. § 229.1121A).

31 75 Fed. Reg. at 23,356, 23,360.

32 *Id.* At 23,368-70.

disclosure obligations to an important class of privately placed securities.³³

In sum, the debate over loan-level disclosures in securitization transactions is a quadrille with many partners, not all of whom are dancing to the same music. Building on the Obama Administration's June 2009 proposal, the Dodd-Frank Act contemplates SEC implementation of expanded loan level disclosure standards to be imposed on a periodic reporting basis to at least securitization financings sold to the general public, complemented with risk retention rules to be implemented by the SEC working in conjunction with a number of other agencies. The SEC's May 2010 proposal – while antedating the passage of the Dodd-Frank Act – offers an extensive system of loan level disclosure, building upon the Obama Administration's framework and incorporating the prior work of the ASF and its working groups. The FDIC initiative covers similar ground, but at this stage seems somewhat out of step with intervening developments. In terms of loan level disclosures, the most striking feature of the FDIC's proposal was the extension of SEC disclosure obligations for public securitization transactions to privately placed offerings sponsored by insured depository institutions. With its May 2010 proposal, the SEC would impose a similar requirement on all privately placed securitization transactions, effectively superseding this aspect of the FDIC's proposal and arguably also going beyond the contours of the relevant provisions of the Dodd-Frank Act, which seem limited to public offerings of ABS.³⁴ The other significant aspect of the FDIC initiative – its proposals on risk retention – do not track the legislative compromises incorporated into the Dodd-Frank Act, which include a number of exemptions for certain asset classes, and it remains an open question whether the FDIC will choose to proceed with a distinctive set of risk retention rules for insured depository institutions when Congress has mandated another set of risk retention rules for general application.

While the focus of this essay is on the evolution of the loan-level disclosures requirements for securitization transactions, one cannot help be struck by the tension evident in the range of reform initiatives to move beyond mere disclosure into more intrusive mandatory requirements. Even in the Obama Administration's initial proposals, this tension was apparent

³³ *Id.* at 23,393-99.

³⁴ While it is beyond the scope of this chapter, the SEC's proposal to impose substantial disclosure obligations on privately-placed securities offerings raises some interesting questions of agency authority. Traditionally, the section 4(2) Securities Act exemption for private placements has been understood to be self-executing, that is operating without any need of SEC implementing regulations. While the SEC has broad statutory latitude to add additional exemptions, the authority of the agency to limit the private placement exemption for offerings to institutional investors – the primary purchasers of asset backed securities – may be susceptible to legal challenge, notwithstanding the strong public policy arguments in favor of the SEC's proposal.

with the inclusion of “skin in the game” requirements that have evolved into legislative provisions setting 5 percent credit retention as a presumptive standard. The FDIC proposed rulemaking pushed even further into mandatory terms, dictating not just credit retention but dealing with permissible capital structures and potentially even loan terms. And the Dodd-Frank Act itself mandates both enhanced disclosure and extensive provisions regarding risk retention. While understandable, this turn of events is modestly ironic, as the securitization of financial assets initially emerged as a way of escaping the mandatory requirements imposed on banks and other highly regulated financial intermediaries.³⁵ These more intrusive reform initiatives attempt to replicate those regulatory requirements in a new and specialized form applied directly to the securitization vehicles themselves. The logic of enhancing the substantive content of securitization oversight as well as the disclosure obligations is understandable in light of the profound problems that securitization transactions have imposed on the rest of the economy in the recent financial crisis. As the next part of my analysis explores, however, one complexity of implementing this expanded regulation of securitization transactions is that the agency primarily responsible for the oversight of securitization transactions is the Securities and Exchange Commission, and it is not at all clear that the Commission’s expertise is well suited to the task of taking into account all of the collateral ramifications of large scale asset securitizations.

Part II – Other Potential Public Uses of Loan Level Disclosures

At root, the debate over loan-level disclosure in securitization transactions recounted above centers on two different points of disclosure: the initial disclosure of information at the launching of the securitization vehicle, when funds are raised in the capital markets, and then continuous updating of information while the securitization is outstanding. The debate touches upon many issues of implementation – which kinds of offering are covered, only public offerings or also private placements?; how long should the continuous reporting obligations continue?; what is the appropriate content of the disclosure requirements – but the essence of the matter consists of offering disclosure under the 1933 Act and continuous disclosures under the 1934 Act. Because the debate is largely framed as a matter of securities regulation and thus within the regulatory bailiwick of the SEC, the issue is generally evaluated in terms of investor

³⁵ See Lowell L. Bryan, *Breaking Up the Bank: Rethinking an Industry Under Siege* (1988) (early work propounding securitization as a more efficient form of financing credit).

protection. What information do investors need to properly value interests in securitization pools and derivative products? Certainly investor protection is the bread and butter of SEC oversight, and groups such as the ASF are also primarily concerned with the interests of investors, if not for the purposes of protecting investors themselves then at least for the purposes of restoring sufficient confidence in the securitization process to allow the market to begin operations again. Even when the reform proposals extend to the standardization of representations and warranties or disclosures regarding compensation arrangements and loan modification terms, issues of transparency and investor confidence remain the primary focus.

There are, however, a number of other public uses of loan-level disclosure information that should be factored into any mandatory rules for securitization transactions. In terms of facilitating loan modifications and reducing foreclosures and resultant economic and personal dislocations, loan level disclosures broadly construed could play a helpful role. Loan-level disclosures, particularly at the offering stage, could also prove useful in policing loan abuses and discriminatory practices in loan origination. Consideration of these uses might well factor into a fully informed public debate over mandatory loan-level disclosure requirements.

A. Loan Modifications and Disclosures

As is well documented elsewhere in this volume,³⁶ one of the great public policy challenges of the subprime crisis and subsequent bursting of the housing bubble has come from the difficulty borrowers have encountered in their efforts to renegotiate lending transactions and seek meaningful modifications of principal balances. As with any negotiation, one of the chief barriers to settlements is disagreement over the value of contractual commitments and fair terms for renegotiation. While the SEC proposal does specifically address the issue of loan modifications, the focus of the SEC's disclosure requirements is on providing useful information to investors seeking to value interests in securitization pools. The Commission's proposals are not principally concerned with potential value of loan modification for borrowers and lenders with mortgages held in other forms, such as portfolio holdings or government sponsored securitization pools.

With relatively modest adjustments in structure and content, however, one could imagine loan-level disclosure requirements in securitization transactions playing an important role in

facilitating private renegotiations of other loans. Particularly important would be information on settlement terms accepted by securitization services for loans in specific markets with specific underwriting characteristics. The beauty of mandatory continuous disclosure obligations terms for securitization transactions is that it would produce current data about loan characteristics. Such current data could be extraordinarily useful for others seeking to renegotiate loan terms or to the government if it were to initiate a program of loan purchases as I and others have advocated.³⁷

While the technical task of broadening the scope of loan level disclosures to facilitate loan renegotiations is not particularly challenging, the institutional barriers may be more severe. As enacted, the Dodd-Frank Bill vests the SEC with the power to develop loan level disclosure requirements. And, in practice, it seems likely that the ASF and other industry groups would likely play a valuable (indeed indispensable) role in formulating the final rules. The expertise of these organizations does not, however, extend to loan renegotiations. Indeed, to the extent that enhanced bargaining power for borrowers and their representatives might impose costs on investors and the securitization industry, one might imagine that these groups would have some resistance to broadening access to loan-level disclosures. Accordingly, public policy concerns may well justify broader access and slightly more transparent and extensive loan level disclosure obligations than investors would themselves demand. Accordingly, in finalizing its reforms of Regulation AB, the Commission should consider whether its disclosure requirements provide sufficient access to borrowers and their representatives seeking to gain a better understanding of the terms on which individual loans in particular markets are being modified.³⁸

B. Abusive and Discriminatory Origination Practices

Again other chapters in this volume address in considerable detail the problems of policing abusive and discriminatory origination practices in residential mortgage originations.³⁹ As is explained in those chapters, one of the complexities of effectively policing these practices

³⁶ See Pat McCoy, *Of Loan Modifications and Write-Downs* (2010).

³⁷ See, e.g., Howell E. Jackson, *Building a Better Bailout*, CHRISTIAN SCIENCE MONITOR, Sept. 25, 2008.

³⁸ The disclosure provisions of the Dodd-Frank Act – section 942(b) – amend section 7 of the Securities Act of 1933, which allows the SEC in establishing disclosure obligations for registration statements to require such information “as the Commission determines necessary or appropriate in the public interest or for the protection of investors.” This grant of authority allows the Commission to look beyond investors interests in appropriate cases.

³⁹ See Allen Fishbein and Ren Essene, *The Home Mortgage Disclosure Act at Thirty-Five*:

Past History, Current Issues (2010). The kinds of models discussed in Peter Zorn and Marsha Courchane, *Risk-Based Pricing: Problems, Possibilities, and Prospects* (2010) have also played an important role in detecting abusive and discriminatory practices.

has been an inability on the part of regulators and aggrieved parties to control for risk characteristics of mortgages at the time of origination. One could imagine expanding upon the HMDA disclosure requirements (as Allen Fishbein and Ren Essene discuss in their chapter). Or one could leave it to private litigants and government enforcement officials to collect and reconstitute relevant risk factors through discovery and other litigation techniques. But here again loan level disclosures in securitization transactions offer a potentially efficient and highly accurate source of supporting data.

For these purposes, the relevant source of information is at the offering stage of the securitization transactions. As contemplated in the Dodd-Frank Act and the SEC proposal, sponsors of securitization transactions would be required to assemble all materially important information on loan and borrower characteristics with a unique loan identification code. As long as these codes were linked up to associated HMDA disclosure dataset, regulatory authorities (and potentially litigants) would have a ready made resources for all relevant risk controls.⁴⁰ With a few modest refinements – adding in links to RESPA HUD 1 forms and providing an allocated price for each loan transferred to the securitization pool – and loan level disclosures could revolutionize the manner in which we police mortgage originations in the United States.

Again, expansion of disclosure obligations along these lines are unlikely to be the kind of amendments that the SEC or investor groups would propose on their own initiative. The agencies charged with policing abusive lending practices – currently the Federal Reserve Board and, in the future, presumably the new Bureau of Consumer Financial Protection – would be more plausible proponents, and perhaps their views can be factored into SEC deliberations as it revises its May 2010 proposals. But clearly the possible benefits of loan level disclosures for policing loan originations should be part of the debate.

Part III – Further Thoughts and Extensions

In this final section, I offer a few thoughts and possible extensions of the foregoing analysis. One concerns the relationship between proposals for mandatory credit retention and loan-level disclosures. A second touches upon the appropriate scope of loan-level disclosure proposals beyond securitization transactions. And finally I flag very important issues of

⁴⁰ In an earlier paper, I explored the usefulness of individual loan transfer prices for policing origination abuses. See Howell E. Jackson, *Enlisting Market Mechanisms To Police the Origination of Home Mortgages* (draft of Nov. 2007).

individual privacy and possible limitations on the scope of loan-level disclosure.

Credit Retention and Loan Level Disclosures.

As explained earlier, both the Obama Administration's initial recommendations and the Dodd-Frank Act include requirements that loan originators and securitization sponsors retain credit risk on loans transferred to securitization pools, presumptive 5 percent of total credit retention, subject to various statutory exemptions. While there are various ways in which this retention could be structured, much of the statutory languages points towards either an actual retention of interests in the loan or some sort of loss coverage for loans assigned to a securitization pool.⁴¹ While an understandable response to concerns that the originate to distribute model fueled the subprime crisis, this approach to credit risk retention has several drawbacks. To begin with, leaving the securitization pool with fractional interests in loans complicates the valuation exercise for investors in loan pools, thereby reducing pool transparency and also complicating interpretation of loan modification terms or the value of loan originations. In addition, requiring at least two parties to have an interest in each loan assigned to a loan pool could also complicate loan renegotiations themselves. An alternative approach would be to force originators and sponsors to retain interests in the securitization pool itself (either in the most junior tranche or perhaps a pro rata share in all tranches.) This approach, which is similar to the direction that European reforms are taking,⁴² allows for greater transparency as to loan values and also more directly aligns the interests of originators and sponsors to pool investors. To be sure, in cases where securitization pools contain loans originated by multiple parties, agency problems may emerge. But at least for the immediate future, securitization sponsors will be keenly attuned to such matters and can use other mechanisms, such as deferred compensation arrangements, to safeguard against opportunistic behavior.

41 As a technical matter, the SEC and other agencies responsible for implementing the Dodd-Frank Act risk retention rules do appear to have some latitude in how the requirements are satisfied, and certain classes of assets – most notably qualified mortgages – will be exempt from these requirements. See Section 941 of the Dodd-Frank Act.

42 See Allen & Overy, ECB Eligible Collateral Framework (Jan. 15, 2010) (avail. at <http://www.allenoverly.com/AOWEB/AreasOfExpertise/Editorial.aspx?contentTypeID=1&itemID=54420&prefLangID=410>).

Appropriate Scope of Loan Level Disclosure Requirement.

The remit of this chapter was loan level disclosures in securitization transactions, and so far I have been reasonably faithful to that assignment. But if one considers the primary goal of imposing mandatory rules in this area – to improve transparency of loan values so as to improve the pricing of interests in securitization pools – one may quite reasonably ask whether similar information should not be retained and updated for loans held in institutional portfolios or on the books of government sponsored entities and the securitization pools those GSEs guarantee, where the vast majority of residential mortgages were still financed even at the height of the subprime boom. After all, the loan-level disclosure movement is premised on the assumption that this information is essential for valuing pools of mortgages. Regulatory officials charged with policing the solvency of financial institutions and also GSEs should be keenly interested in precisely the same information. Indeed, one wonders what the argument would be for such regulators not to demand the retention and updating of this information once the SEC and market participants conclude that it is essential for securitization pools. After all, if investors need this information to evaluate securitization pools, regulators must also need it to oversee institutional balance sheets.⁴³ And, of course, the public benefits of retaining this information to facilitate loan modifications and policing of origination abuses and discrimination are equally applicable to loans held on institutional portfolios and on GSE balance sheets. Finally, a broader application of loan level disclosure requirements would prevent the promulgation of these rules from favoring some forms of loan financing over others.

Loan Level Disclosures and Privacy Concerns.

Finally, a word on loan level disclosures and privacy concerns. As Allen Fishbein and Ren Essene have already recounted, privacy concerns have already been identified as a problem in the area of HMDA disclosures, and Scott Peppet has recently written a quite helpful paper discussing the not-inconsiderable privacy issues presented by the ASF's preliminary proposals on loan level disclosure.⁴⁴ Clearly, these are serious issues. However, the logic of loan level disclosure is that this information needs to be provided to the broader market in order to obtain

43 To be sure, the costs of collecting loan level data may be unduly burdensome for smaller institutions with relatively limited exposures and so mandatory collection rules would likely be appropriate only above some asset threshold.

44 See Scott Peppet, Smart Mortgages, Privacy and the Regulatory Possibility of Infomediation (Aug. 19, 2009) (avail. at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1458064).

accurate pricing. Limiting disclosures to a narrow group of parties – like credit rating agencies – defeats the purposes of the proposals and was itself thought to be one of the sources of the subprime crisis. Similarly, to the extent that loan level disclosure were being used to facilitate third party loan renegotiations, public access would be essential. To be sure, some information might be kept out of public hands. For example, the key connecting unique loan codes to HMDA data need not be disclosed to the general public. Rather, access to this information could be limited to regulatory officials conducting fair lending reviews and private litigants conducting discovery under court-supervised conditions. But, in large part, loan level disclosure should be public disclosure, and the complexities of privacy protections are simply one more issue that public officials will need to address.

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