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Introduction

The securitization markets are very weak, as I'm sure the others testifying will report. This is unfortunate because securitization can be a major source of capital formation, yielding critical economic benefits.

For example, securitization can significantly decrease the cost of corporate credit. By raising funds without having to borrow from a bank or other financial intermediary, companies avoid the intermediary's profit mark-up. Furthermore, the interest rate paid by the company is ordinarily lower than the interest rate payable on corporate securities issued directly by the company. This interest-rate savings reflects that the mortgage loans and other "financial assets" being securitized are usually more creditworthy, and almost always easier to understand and value, than the company itself. For these reasons, securitization has become an important way for companies of all types to raise low-cost financing.

Securitization is also the principal means by which banks and other lenders turn their loans into cash, thereby enabling them to continue making new loans. Securitization of residential mortgage loans, for example, has facilitated the expansion of home ownership by enabling banks to continue to lend money to homeowners. Many other forms of consumer and business credit are also securitized, including automobile loans, student loans, credit card balances, and equipment loans.

Securitization can also reduce consumer costs. By expanding the "secondary" (*i.e.*, trading) market in consumer loans, securitization lowers the interest rate that lenders charge on those loans. [2]

By 1992, securitization had become so important to the American economy that the Securities and Exchange Commission observed that it was "becoming one of the dominant means of capital formation in the United States." [3] Securitization continued its strong growth until the recent financial crisis, rising from $2.9 trillion in 1996 to $11.8 trillion in 2008. [4] Even during the crisis, the Federal Reserve implemented a $200 billion Term Asset-Backed Securities Loan Facility (known as "TALF") in order to keep the securitization markets running. This helped to assure "the availability of credit to households and businesses of all sizes." [5]

Securitization's Role in the Recent Financial Crisis

The securitization of subprime mortgage loans—essentially mortgage loans made to risky borrowers—is widely viewed as a root cause of the financial crisis. The evil, however, was not securitization *per se* but a correlation of factors, some of which were not completely foreseeable.

Securitization transactions were sometimes backed, at least in part, by subprime loans. Because home prices had generally been increasing in the United States since the Great Depression, the expectation was that continuing home-price appreciation would enable even risky borrowers to repay their loans by refinancing their houses. At the worst, many thought, the steep rise in housing prices might level out for some period of time, although at least one rating agency's model assumed that prices could drop as much as 10 percent. Few predicted the complete collapse of housing prices.

Many argue that the "originate-to-distribute" model of securitization, enabling mortgage lenders to sell off loans as they're made, led to overreliance on the expectation of repayment through home-price appreciation. According to this argument, the originate-to-distribute model created moral hazard because lenders did not have

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[2] *Cf.* Patric H. Hendershott and James D. Shilling, "The Impact of the Agencies on Conventional Fixed-Rate Mortgage Yields", 2 *J. Real Estate Fin. & Econ.* 101 (1989) (finding that securitization of conforming fixed-rate mortgage loans significantly lowered interest rates on mortgage loans relative to what they would otherwise have been); C.F. Sirmans and John D. Benjamin, "Pricing Fixed Rate Mortgages: Some Empirical Evidence", 4 *J. Fin. Services Research* 191 (1990) (finding significantly lower interest rates on fixed rate mortgages that can be sold in the secondary market versus those that cannot).

[3] Investment Company Act, Release No. 19105, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 85,062, at 83,500 (Nov. 19, 1992) (provided in connection with the issuance of Rule 3a-7 under the Investment Company Act of 1940).

[4] These figures are drawn from *http://www.sifma.org/*.

[5] *See, e.g., http://www.ny.frb.org/markets/talf_faq.html; http://www.federalreserve.gov/newsevents/monetary20081125a1.pdf.*

to live with the credit consequences of their loans. Loan origination standards therefore fell.

There are other possible explanations of why subprime loans were made and securitized.[6] But whatever the explanation, the fall in home prices meant that subprime borrowers, who were relying on refinancing for loan repayment, could not refinance and began defaulting. The defaults had mostly localized consequences in traditional securitization transactions. But they had larger, systemic consequences in nontraditional transactions that involved complex and highly leveraged securitizations of asset-backed securities already issued in prior securitizations—effectively "securitizations of securitizations." The resulting leverage caused relatively small errors in cash flow projections—due to the unexpectedly high default rates on underlying subprime loans—to create defaults on substantial amounts of "investment grade" rated subordinated classes of these securities, and to cause even the most highly rated classes of these securities to be downgraded.

The important question is why those nontraditional securitization transactions were structured in a way that even relatively small errors in cash flow projections could cause defaults and downgradings. Although one answer is the widespread inconceivability of a housing-price collapse that could cause those errors, the full answer goes beyond that. Part of the answer may be that securitization's focus on mathematical modeling to statistically predict the payments on financial assets underlying these complex securities fostered an overreliance on modeling and an abandonment of common sense. Yet another part of the answer may be that investors, who seemed as anxious to buy these superficially attractive securities as underwriters were to sell them, were overly complacent and eager to follow the herd of other investors.

Whatever the reasons, these defaults and downgradings panicked investors, who believed that a "AAA" rating meant iron-clad safety and that an "investment grade" rating meant relative freedom from default. Investors started losing confidence in ratings and avoiding the debt markets. Fewer investors meant that the price of debt securities began falling. Falling prices meant that firms using debt securities as collateral had to mark them to market and put up cash, requiring the sale of more securities, which caused market prices to plummet further downward in a death spiral. With the failure of Lehman Brothers, investors lost all confidence in the debt markets. The lack of debt financing meant that companies could no longer grow and, in some cases, even survive. That affected the real economy and, at least in part, contributed to the financial crisis.

The crisis was also arguably exacerbated by the fact that securitization made it difficult to work out problems with securitized mortgage loans. The beneficial owners of the loans were no longer the mortgage lenders, but a broad universe of investors in securities backed by these loans. Although servicers were tasked with the responsibility to restructure the underlying loans "in the best interests" of those investors, they were often reluctant to engage in restructurings when there was uncertainty that their costs would be reimbursed. Foreclosure costs, in contrast, were relatively minimal. Servicers also preferred foreclosure over restructuring because foreclosure was more ministerial and thus had lower litigation risk. As a result, foreclosure was artificially favored, forcing many homeowners from their homes and further driving down property values.

Dodd-Frank's Response

The Dodd-Frank Act addresses securitization by focusing, essentially, on three issues: (i) adequacy of disclosure, (ii) conflicts between "securitizers"[7] and investors, and (iii) rating agency information.

(i) Adequacy of Disclosure: The Dodd-Frank Act directs the SEC to require more standardized disclosure of information regarding the underlying financial assets, including information on the assets underlying each class of asset-backed securities. This disclosure requirement is intended to facilitate an easier comparison of classes. The Act also directs the SEC to require securitizers to engage in a due-diligence review of the underlying financial assets and to disclose to investors the nature of the review.

(ii) Conflicts between Securitizers and Investors: The Act attempts to limit conflicts of interest between securitizers and investors by requiring securitizers, in trans-

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[6] These other explanations are bound up with the more important question, discussed in the next paragraph, of why nontraditional securitization transactions were structured in a way that even relatively small errors in cash flow projections could cause defaults and downgradings.

[7] In most cases, the "securitizer" is the company itself or a financial institution that pools financial assets for eventual issuance of asset-backed securities.

actions that are not backed entirely by "qualified residential mortgage" loans,[8] to retain an unhedged economic interest in the credit risk of each class of asset-backed securities.[9] This is colloquially known as keeping "skin in the game." The minimum retained interest is generally five percent, although it may be less if the financial assets meet quality standards to be announced by Government agencies.

(iii) Rating Agency Information: Dodd-Frank also mandates the SEC to adopt regulations requiring rating agencies to explain, in any report accompanying an asset-backed securities credit rating, the representations, warranties, and other enforcement rights available to investors, including a comparison of how these rights differ from rights in similar transactions.

Dodd-Frank Inadequately Addresses Securitization's Flaws

I believe that Dodd-Frank inadequately addresses securitization's flaws. Although it addresses one of the flaws (or, at least, alleged flaws), it underregulates or fails to regulate other flaws and it overregulates by addressing aspects of securitization that are not flawed.

A. Dodd-Frank Addresses One of Securitization's Flaws

Dodd-Frank addresses one of securitization's flaws—or at least one of its alleged flaws. I mentioned that the originate-to-distribute model of securitization is believed to have fostered an undisciplined mortgage lending industry, including the making of subprime loans. The Dodd-Frank Act, as discussed, addresses the originate-to-distribute model by requiring securitizers to retain skin in the game, *i.e.,* retaining a minimum risk of loss. The theory is that by aligning the incentives of securitizers and investors, the lending industry will become more disciplined.

There remains a question, though, of the extent to which the originate-to-distribute model actually caused mortgage underwriting standards to fall. Some argue that standards fell because of Federal governmental pressure on banks and other mortgage lenders to make and securitize subprime mortgage loans to expand home-ownership.[10] The fall in standards also may reflect distortions caused by the liquidity glut of that time, in which lenders competed aggressively for business; or it may also reflect conflicts of interest between lending firms and their employees in charge of setting lending standards, such as employees being paid for booking loans regardless of the loans' long-term performance. Blaming the originate-to-distribute model for lower mortgage underwriting standards also does not explain why standards were not similarly lowered for originating nonmortgage financial assets used in other types of securitization transactions. Nor does it explain why the ultimate beneficial owners of the mortgage loans—the investors in the asset-backed securities—did not govern their investments by the same strict credit standards that they would observe but for the separation of origination and ownership.[11]

The extent to which the originate-to-distribute model actually contributed to the financial crisis may never be known. If that model was not a significant causal factor, Dodd-Frank's skin-in-the-game requirement may well constitute overregulation. This requirement also might, ironically, lull some investors into a false sense of security. In the financial crisis, for example, there is some evidence that investors purchased senior classes of asset-backed securities because underwriters retained the most subordinated interests—effectively creating a "mutual misinformation" problem.[12]

B. Dodd-Frank Underregulates and Fails To Regulate Other Flaws

Dodd-Frank underregulates, and in some cases fails to regulate, other flaws of securitization. The Act does not, for example, directly address the problem of over-reliance on mathematical modeling. Mathematical models are not inherently problematic. If the model is realistic and the inputted data are reliable, models can yield accurate predictions of real events. But if the model is unrealistic or the inputted data are unreliable—as occurred when unexpectedly high default rates due to the

[8] The SEC and other governmental agencies are directed to collectively define what constitutes qualified residential mortgage loans, taking into account mortgage risk factors. Dodd-Frank Act §941(b).

[9] Dodd-Frank Act §941.

[10] *Cf.* Peter J. Wallison, "The Lost Cause: The Failure of the Financial Crisis Inquiry Commission" (2011) (making that argument), *http://www.aei.org/docLib/FSO-2011-02-g.pdf.*

[11] For one explanation of why the ultimate beneficial owners did not observe those standards, *see* Steven L. Schwarcz, "Marginalizing Risk", 89 *Washington University Law Review,* forthcoming issue no. 3 (2012), available at *http://ssrn.com/abstract=1721606.*

[12] Dodd-Frank does mandate the Financial Services Oversight Council, however, to study and submit a report to Congress on the macroeconomic effects of the skin-in-the-game requirements, including possibly proactively regulating mortgage origination as an alternative or supplement. Dodd-Frank Act §946.

housing collapse undermined the value of some asset-backed securities—models can be misleading.

To some extent this overreliance on mathematical models should be self-correcting because the financial crisis has shaken faith in the market's ability to analyze and measure risk through models. In the long term, however, I fear that—as market experience has often shown—investor memories will shorten.

Dodd-Frank also fails to address the complacency problem. I'm not sure, though, how effective regulation can be in changing human behavior. Market participants will probably always engage in herd behavior, for example, there being safety in numbers. And people will probably always invest in high-yielding securities they can't understand if others are doing it.

Dodd-Frank also does not address the servicing problem, but I find that less troublesome. Parties can—and in light of recent experience, should have incentives to—write underlying deal documentation that sets clearer and more flexible guidelines and more certain reimbursement procedures for loan restructuring, especially when restructuring appears to be superior to foreclosure. Parties can also minimize allocating cash flows to investors in ways that create conflicts. Furthermore, parties can agree, when appropriate, to subject servicers to—and regulation could also require—more realistic performance standards, perhaps akin to a business judgment rule that allows them to restructure loans in good faith without being exposed to liability. [13]

C. Dodd-Frank Overregulates by Addressing Aspects of Securitization That Are Not Flawed

Dodd-Frank overregulates by addressing some aspects of securitization that are not flawed. I have already indicated that the skin-in-the-game requirement might constitute overregulation. Dodd-Frank also requires securitizers to engage in a due-diligence review of the underlying financial assets; but in my experience, that is already routinely done.

Dodd-Frank also may overregulate in its requirements for more standardized disclosure of information. In principle it should be helpful for investors to get this information. My experience, however, is that prospectuses usually already provide much of this information, and that *the larger problem is not absence of disclosure but the fact that investors don't always read and understand the information already disclosed.*

There are at least two reasons for this failure. One reason is complacency, discussed above. The second reason is a conflict of interest within investing firms themselves. As investments become more complex, conflicts of interest are increasingly driven by short-term management compensation schemes, especially for technically sophisticated secondary managers. [14]

For example, as the VaR, or value-at-risk, model for measuring investment-portfolio risk became more accepted, financial firms began compensating secondary managers not only for generating profits but also for generating profits with low risks, as measured by VaR. Secondary managers therefore turned to investment products with low VaR risk profile, like credit-defaults swaps that generate small gains but only rarely have losses. The managers knew, but did not always explain to their seniors, that any losses that might eventually occur could be huge.

This is an *intra-firm conflict*, quite unlike the traditional focus of scholars and politicians on conflicts between managers and shareholders. Dodd-Frank attempts to fix the traditional type of conflict but completely ignores the problem of secondary-management conflicts. Regulation should also require that managers, *including secondary managers*, of financial institutions be compensated based more on long-term firm performance. [15]

Dodd-Frank's focus on disclosure may also be inherently insufficient. I have mentioned that investors don't always read and understand the disclosure. Financial products, including some securitization products, are becoming so complex, however,

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[13] *Cf.* Steven L. Schwarcz and Gregory M. Sergi, "Bond Defaults and the Dilemma of the Indenture Trustee", 59 *Alabama Law Review* 1037 (2008) (arguing that this standard should apply to indenture trustee duties after default).

[14] *See,* Steven L. Schwarcz, "Conflicts and Financial Collapse: The Problem of Secondary-Management Agency Costs", 26 *Yale Journal on Regulation* 457 (2009), available at *http://ssrn.com/abstract_id=1322536*; Steven L. Schwarcz, "Regulating Complexity in Financial Markets", 87 *Washington University Law Review* 211, 261–262 (2009/2010), available at *http://ssrn.com/abstract–id=1240863.*

[15] *See* "Conflicts and Financial Collapse", *supra* note 14, at 468–469 (observing that regulation is needed because there is a collective-action problem).

that disclosure can never lead to complete understanding.[16] On the other hand, it may well be counterproductive to try to limit complexity, such as requiring more standardization of financial products. Standardization can interfere with the ability of parties to achieve the efficiencies that arise when firms issue securities tailored to particular needs of investors.[17]

Conclusions

I have suggested certain regulatory responses to improve securitization, including the need to fix the intra-firm problem of secondary-management conflicts. Overall, however, there are no perfect regulatory solutions to the problems of securitization; and indeed those problems are not atypical of problems we will face in any innovative financial market—that increasing complexity coupled with human complacency, among other factors, will make failures virtually inevitable. Regulation must respond to this reality.

To that end, it is important to put into place, before these failures occur, regulatory *responses to failures* that supplement regulatory restrictions intended to prevent failures.[18] The financial crisis has shown the increasing importance, for example, of financial (*e.g.*, securities) markets and the need to protect them against the potential that investor panic artificially drives down market prices, becoming a self-fulfilling prophecy. A possible regulatory response would be to create financial market stabilizers, such as a market liquidity provider of last resort that could act at the outset of a panic, profitably investing in securities at a deep discount from the market price and still providing a "floor" to how low the market will drop.[19]

It also is important to provide incentives for financial institutions to try to minimize the impact of failures (externalities), and to absorb (*i.e.*, "internalize") the cost when failures occur. This could be done, for example, by regulation requiring at least systemically important market participants to contribute to a risk fund, which could be used as a source of stabilization (such as by funding the financial market stabilizers referenced above).[20] Fund contributors would then be motivated not only to better monitor their own behavior but also to monitor the behavior of other financial institutions whose failures could deplete the fund (requiring contributors to pay in more).[21]

The bill that would become the Dodd-Frank Act originally included the concept of a systemic risk resolution fund, to be sourced by large banks and other systemically important financial institutions and used as a possible bailout mechanism in lieu of taxpayer funds. The concept was dropped after some alleged it would increase moral hazard by institutionalizing bailouts.[22] Ironically, if structured properly, a systemic risk fund should actually have the opposite effect, minimizing moral hazard.

We also need to see the big picture. Securitization has existed for decades and has generally worked well. Even during the recent crisis, almost all traditional securitization structures protected investors from major losses. Additionally, we need to keep in mind what investor protection—one focus of this hearing—means in the securitization context. Investors in securitization transactions are generally large and sophisticated financial institutions. One might question whether regulation should have the goal of protecting these types of investors, except in cases when

[16] *See, e.g.,* Steven L. Schwarcz, "Disclosure's Failure in the Subprime Mortgage Crisis", 2008 *Utah Law Review* 1109 (arguing that disclosure is a necessary but insufficient response to complexity); Steven L. Schwarcz, "Rethinking the Disclosure Paradigm in a World of Complexity, 2004", *University of Illinois Law Review* 1 (2004) (same).

[17] *See* Iman Anabtawi and Steven L. Schwarcz, "Regulating Systemic Risk", 86, *Notre Dame Law Review,* forthcoming issue no. 4 (Spring 2011), available at *http://ssrn.com/abstract=1670017*. Dodd-Frank's focus on standardizing more derivatives transactions is a special case because the goal is less standardization *per se* (in order to minimize investor due diligence) than to enable more derivatives to be cleared through clearinghouses, which generally require a high degree of standardization in the derivatives they clear.

[18] *See generally* Steven L. Schwarcz, "Ex Ante Versus Ex Post Approaches to Financial Regulation: The Chapman Dialogue Series and The Chapman Law Review Symposium Keynote Address", forthcoming in *Chapman Law Review* 2011 symposium issue on "The Future of Financial Regulation", available at *http://ssrn.com/abstract=1748007.*

[19] *See* Anabtawi & Schwarcz, *supra* note 17 (showing how buying securities at a deep discount will mitigate moral hazard and also make it likely that the market liquidity provider will be repaid).

[20] *See id.; see also Marginalizing Risk, supra* note 11. Ideally, any such fund should be international to avoid anticompetitively "taxing" financial institutions in any given jurisdiction.

[21] *Id.*

[22] Dodd-Frank includes a provision for possible *ex post* funding of a systemic risk fund, but it is doubtful that any such fund could be created quickly enough to be effective. Financial institutions might even have difficulty providing such funding at the time of a systemic crisis.

their failures can harm others, such as by triggering systemic consequences,[23] or when market failures can discourage these types of investors from adequately protecting themselves.[24]

My comments focus primarily on creating an appropriate regulatory framework to help ensure long-term integrity of the securitization markets. I do not address how to quickly return depth and liquidity to securitization markets but trust that others testifying today, who are more intimately connected with the industry, will have proposals to that effect. Whatever the proposals, however, there may be relatively little need for securitization or other means of capital formation so long as lenders and companies sit on mounds of cash, reluctant to make loans and to invest in operations.

Thank you.

My testimony is based in part on the following sources, in addition to those already cited:

The 2011 Diane Sanger Memorial Lecture—Protecting Investors in Securitization Transactions: Does Dodd-Frank Help, or Hurt?, available at Securities and Exchange Commission Historical Society virtual museum and archive, *www.sechistorical.org*.

Identifying and Managing Systemic Risk: An Assessment of Our Progress, 1 *Harvard Business Law Review* Online (2011), forthcoming at *http://hblr.org*, also available at *http://ssrn.com/abstract=1788336* (in its original form as the Keynote Speech at the George Mason University 2011 AGEP Advanced Policy Institute on Financial Services Regulation).

The Conundrum of Covered Bonds, 66 *The Business Lawyer* (forthcoming issue no. 3, May 2011), available at *http://ssrn.com/abstract=1661018.*

The Future of Securitization, 41 *Connecticut Law Review* 1313 (2009) (symposium issue on the subprime crisis), available at *http://ssrn.com/abstract_id=1300928.*

[23] *See generally* Steven L. Schwarcz, "Systemic Risk", 97 *Georgetown Law Journal* 193 (2008).

[24] *See supra* note 15 and accompanying text (observing that in order to resolve the problem of secondary-management conflicts, regulation will be needed to fix a collective-action problem).