This paper analyzes changes in the regulatory landscape for securitizations and asset-backed securities following the Financial Crisis. It begins with an overview of the challenges asset-backed securities faced in the financial crisis of 2007–9. The perception that asset-backed securities performed particularly poorly led to calls for further regulation of asset-backed securities and the securitization process that creates asset-backed securities. The Dodd-Frank Act of 2010 included provisions authorizing new regulations of asset-backed securities and securitizations. Following the enactment of Dodd-Frank, the SEC promulgated Regulation AB-II, updating rules governing the offering process, disclosure, and reporting for asset-backed securities. Moreover, statutory and regulatory requirements shifted with the adoption of Credit Risk Retention (i.e., “skin in the game”) requirements for securitizations and Volcker Rule requirements limiting proprietary trading by banks but allowing some exemptions to preserve the securitization process. The regulatory landscape continues to evolve, as evidenced by emerging rules governing credit derivatives on mortgage-backed securities, collateralized debt obligations, and synthetic collateralized debt obligations.
New Regulations for Securitizations and Asset-Backed Securities

Sharon Brown-Hruska, Georgi Tsvetkov, and Trevor Wagener

After reading this chapter you will understand:

• The challenges asset-backed securities faced in the financial crisis of 2007–9;

• The Dodd-Frank Act’s provisions authorizing new regulations of asset-backed securities and securitizations;

• The changes that SEC’s Regulation AB-II made to rules governing the offering process, disclosure, and reporting for asset-backed securities;

• Credit Risk Retention Rule (i.e., “skin in the game”) requirements for securitizations;

• Volcker Rule requirements targeting proprietary trading and exemptions preserving the securitization process; and

• Emerging rules governing credit derivatives on mortgage-backed securities, collateralized debt obligations, and synthetic collateralized debt obligations.

The financial crisis of 2007–9 revealed problems with underwriting standards in mortgage markets that spread to the mortgage-backed securities (MBS) and asset-backed securities (ABS) markets more broadly. In 2010, the US Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which contained express provisions that sought to increase transparency in the market for securitized assets and to better align the incentives facing different classes of market participants. The resulting rulemaking extended beyond the
securitization and offering process for the issuance of ABS, creating requirements for ongoing disclosures, some applying to ABS issuers,¹ and others to the credit rating agencies that periodically assess the credit quality of ABS and other fixed income assets. Other structured products, including collateralized debt obligations (CDOs) on MBS and ABS indices whose performance was based on pools of mortgages or other assets, credit derivatives, and broader classes of securities-based swaps and financial assets, were subjected to new requirements for posting margin, collateral, and clearing aimed at reducing contagion and systemic risk that characterized the crisis.

Challenges in the Asset-Backed Securities Markets in the Financial Crisis

Asset-backed securities are financial products created by the process of securitization, which consists of bundling loans into asset pools and then issuing securities backed by the cash flows of the pools of underlying loans.² During the 2007–9 financial crisis, mortgage-backed securities, or more specifically, residential mortgage-backed securities (RMBS), the subset of ABS collateralized by residential mortgages, and in particular those based on loans made to subprime borrowers, performed poorly. This led policymakers and financial publications to attribute substantial blame for the financial crisis to ABS markets and more broadly to securitization

¹ Issuers are also called arrangers or sponsors in some contexts.

market participants. Post-crisis assessments by government entities such as the Financial Crisis Inquiry Commission (FCIC) and the Securities and Exchange Commission (SEC) identified four key factors requiring redress: opaqueness with respect to the securitization of pools of loans into ABS; the related reliance on credit ratings issued by a small number of credit rating agencies; misaligned incentives among different parties in the securitization process; and valuation and pricing challenges exacerbated by illiquidity and uncertainty characterizing the ABS markets during the crisis.

Throughout this chapter, examples may focus on MBS, but the processes, problems, and regulatory implications often also apply to the greater category of ABS.

**Market Opaqueness and Reliance on Credit Ratings**

The securitization process transforms individual loans into marketable securities in several distinct steps. For MBS, for example, banks, trusts, and other lenders act as originators and begin the process by underwriting, funding, and servicing a loan to a mortgagor. In the next step, many

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5 75 FR 23328 (May 3, 2010), pp. 23330–1.


such loans, often backed by similar underlying collateral types (e.g., residential mortgages), are purchased from originators by an arranger who bundles the underlying loans together into a pool. The arranger could be the Government National Mortgage Association (Ginnie Mae, a federal agency) or one of the government-sponsored enterprises (GSEs)—Freddie Mac and Fannie Mae—but could also be a private company. The arranger then sells the pool to a bankruptcy-remote special-purpose vehicle (SPV), which issues MBS backed by the SPV’s pool of loans and sells them to investors. Nationally recognized statistical rating organizations (credit rating agencies) are engaged to issue credit ratings for the MBS, which are used to market the securities for sale. The securities are then purchased by pension funds, insurance companies, asset managers, or other investors.\textsuperscript{9}

At each step of the securitization process, the potential for information asymmetry arises, since the purchaser may not have as much information regarding the assets in question as the seller. Moreover, the final investor is typically several degrees removed from origination of the underlying loans, adding to the potential difficulty in collecting all data relevant for performing due diligence.

One potential solution to the information asymmetry problem inherent to the securitization process could be for each purchaser in the chain to conduct independent due diligence on the underlying assets. Since building customized valuation models is time-consuming, costly, and requires investment in both data and labor,\textsuperscript{10} however, this solution could involve repeating

\textsuperscript{9} Adam B. Ashcraft and Til Schuermann, “Understanding the Securitization of Subprime Mortgage Credit,” Staff Report No. 318, Federal Reserve Bank of New York (March 2008), 5–10.

costly analysis several times. Compounding the information asymmetry, markets often move quickly, creating effective due diligence time constraints that require investors to collect and analyze relevant data in a short amount of time.

Brown-Hruska and Satwah opine that the high cost of independent due diligence on loan-level or asset-level information, market participants’ increasing dependence on third-party sources, and the assumption that ABS assets were efficiently priced combined to create a kind of “Grossman-Stiglitz Paradox.” A Grossman-Stiglitz Paradox occurs when incentives to invest in acquiring information about assets diminish as market prices are assumed to generally contain all relevant information. While the securitization process expanded the lending capacity of banks and issuers by passing credit risk to investors, the structural opacity and the cost of performing customized due diligence led some agents in the securitization process to rely upon the due diligence of third-party financial intermediaries and credit rating agencies better positioned to perform it.

Given the challenges in conducting due diligence on securities supported by the cash flows of a pool of loans with potentially varied risk characteristics such as borrower credit score, collateral geography, or loan-to-value ratio, the SEC created principles-based disclosure

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requirements for ABS by adopting Regulation AB and publishing the rule in the Federal Register in 2005.\textsuperscript{13} These disclosure requirements set minimum transparency and asset quality thresholds for so-called “shelf offerings” of ABS, which allow issuers to sell securities to the public without a separate prospectus for each offering in order to facilitate quicker access to capital markets.\textsuperscript{14} This effectively allowed “off-the-shelf” offerings, as long as credit rating agencies assigned an “investment grade”\textsuperscript{15} rating to the ABS and less than 20% of the underlying asset pool consisted of delinquent assets.\textsuperscript{16}

Regulation AB in some ways incentivized the reliance on the due diligence of third parties, namely the credit rating agencies, as credit ratings were written into the regulatory requirements. Moreover, the SEC in 2010 opined that the shelf registration offering process in Regulation AB\textsuperscript{17} did not require that issuers give prospective ABS investors sufficient time to conduct independent due diligence—\textsuperscript{18} an opinion shared by the CFA Institute Centre for Financial Market Integrity and the Council of Institutional Investors, which both argued that investors did not always receive comprehensive prospectuses or other sources of information regarding ABS

\begin{footnotesize}
\begin{itemize}
  \item\textsuperscript{13} 70 FR 1506 (January 7, 2005).
  
  \item\textsuperscript{14} 70 FR 1506 (January 7, 2005), pp. 1512–13.
  
  
  \item\textsuperscript{16} 75 FR 23328 (May 3, 2010), pp. 23331–3.
  
  \item\textsuperscript{17} 70 FR 44722 (August 3, 2005), p. 44766.
  
  \item\textsuperscript{18} 75 FR 23328 (May 3, 2010), p. 23330.
\end{itemize}
\end{footnotesize}
and their underlying collateral prior to making an investment decision. Such cases were presented as potential obstacles to performing proper due diligence, because each ABS offering involved a new and unique security backed by a new and unique pool of underlying assets. In the absence of a detailed prospectus, this meant that primary market purchases of ABS could be conducted with buyers relying substantially on the assessments of credit rating agencies, since no specific prospectus supplement was required to be made available until days after the offering.

Alignment of Incentives and Underwriting Standards

In the pre-crisis period, standard compensation practices at many financial institutions in the securitization process often incentivized volume over quality control. For example, originators and arrangers profited directly based upon volume, and faced market discipline if poor performance of underlying loans led to losses on their books. However, originators faced only the risk of delinquency or default before the loans could be sold to an arranger; arrangers faced only the risk of warehousing loans in their securitization pipelines before they put the loans into SPVs, issued ABS, and sold the ABS to investors. Some economists such as Markus

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Brunnermeier argued that, in essence, market discipline was transitory because a large portion of the credit risk was quickly transferred and ultimately borne by other parties.21

In an efficiently operating market, incentives are aligned via a combination of actual and predicted market signals such as price moves and reputational effects. In ABS markets, however, the limited nature of information available to final investors and the existence of multiple third parties throughout the securitization process meant that potential reputational damage was likely to be diffused, reducing the alignment of incentives among parties in the securitization process and final investors.

The FCIC concluded that the consequences of misaligned incentives were borne out by looser lending standards, a product of reduced due diligence by originators making the initial loans, arrangers who provided the immediate demand for purchasing most such loans, and ultimate investors who purchased ABS backed by the cash flows from such loans. The FCIC Report stated that in the lead up to the financial crisis:

Lending standards collapsed, and there was a significant failure of accountability and responsibility throughout each level of the lending system. This included borrowers, mortgage brokers, appraisers, originators, securitizers, credit rating agencies, and investors, and ranged from corporate boardrooms to individuals. Loans were often premised on ever-rising home prices and were made regardless of ability to pay.22

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Valuation Challenges and Contagion

Once doubts about the health of the housing market and the performance of the underlying assets surfaced, MBS valuation challenges became more pronounced. The declining performance of MBS heretofore considered “safe,” coupled with rating downgrades, created sudden and substantial uncertainty in markets. Some economists suggested that the lack of transparency in the primary ABS market, misaligned incentives among different parties in the securitization process, and the reliance on credit rating agencies contributed to uncertainty regarding the value of MBS securities, which led to a reduction in liquidity for a wide range of ABS and ABS-linked products, including CDOs collateralized by MBS and credit default swaps (CDS) written on MBS. This uncertainty-driven illiquidity in turn led to substantial declines in the prices for entire classes of products, including many well-performing MBS. As these assets formed a substantial portion of many financial firms’ balance sheets, the price declines in entire classes of assets threatened the survival of many major firms. As the FCIC described the consequences:

Through 2007 and into 2008, as the rating agencies downgraded mortgage-backed securities and CDOs, and investors began to panic, market prices for these securities plunged. Both the direct losses as well as the marketwide contagion and panic that ensued would lead to the failure or near failure of many large financial firms across the system.24

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The failures of funds affiliated with major banks and ultimately several of the major banks themselves during the financial crisis raised questions about banks’ proprietary trading activities in ABS, particularly MBS and structured products collateralized by MBS. The decline in confidence in MBS performance during the crisis also led to a substantial shift away from private-label mortgage securitizations by banks and toward agency issuances by GSEs. While agency MBS retain a government guarantee, investor credit risk is effectively restricted to the smaller nonagency category of MBS. As seen in Figure 4.1, the share of mortgage-related securities issued by nonagency sources fell from approximately half in 2006, just before the crisis, to a small fraction from 2008 through 2014.

<COMP: INSERT FIGURE 4.1 NEAR HERE>

The Dodd-Frank Act and Other New Regulations Following the Financial Crisis

The size and scope of investor losses on MBS and other ABS created political pressure for substantial financial reform, which ultimately resulted in the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in July 2010.25 This legislation

authorized a substantial body of rules and regulations relating to ABS securitization, issuance, disclosure, and markets, including:  

- **Disclosures and Reporting for ABS Transparency and Due Diligence:** Section 942 required the SEC to create rules setting standards for ABS data disclosures that would allow investors to independently perform due diligence, and to require ABS issuers to disclose asset-level or loan-level data, including compensation information for the broker or originator of underlying assets, the amount of risk retention by the originator and the securitizer of such assets, and unique identifiers relating to loan brokers and originators for each asset.  

- **Credit Risk Retention Rules:** Section 941 required regulatory agencies to create credit risk retention rules in order to ensure that securitizers retained an economic interest in a portion of the credit risk for any ABS issued and sold to a third party.  

- **Volcker Rule:** Section 619 required that federal financial regulatory agencies create rules prohibiting banking entities from engaging in proprietary trading or from acquiring or retaining an ownership interest in or sponsoring hedge funds or private equity funds, unless allowed by specific exceptions. As securitization activities can appear similar to  

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proprietary trading, banking entities require exemptions and exceptions to the Volcker Rule to continue issuing ABS. Regulators were left with substantial discretionary authority to interpret the statutory requirements when crafting the exemptions and exceptions in the implementing regulations.29

- *Due Diligence Analysis and Disclosure in ABS Issues*: Section 945 required that the SEC create rules that require ABS issuers to perform a review of the assets underlying the ABS and to disclose the nature of the review in the registration statement required to be filed pursuant to ABS issuance.30

- *Disclosures of Representations, Warranties, and Enforcement Mechanisms Available to Investors*: Section 943 required that the SEC create regulations mandating that credit rating agencies include in credit rating reports descriptions of representations, warranties, and enforcement mechanisms available to investors, including how they differ from the mechanisms in similar ABS; and mandating that securitizers disclose fulfilled and unfulfilled repurchase requests across all trusts aggregated by the securitizer, such that investors could identify asset originators with underwriting deficiencies.31

- *Conflict of Interest Restrictions*: Section 621 placed restrictions on ABS underwriters, placement agents, initial purchasers, sponsors, and affiliates and subsidiaries thereof


engaging in transactions that would result in a material conflict of interest with respect to any investor in a transaction relating to the ABS for a year after the initial sale of the ABS.\textsuperscript{32}

Financial regulators were authorized by these and other sections of the Dodd-Frank Act to issue rules and regulations substantially altering the typical ABS securitization process and related disclosures, generally with the aim of aligning the incentives of ABS issuers and investors and increasing market transparency in order to facilitate independent due diligence by investors.

Some of the most substantial regulatory changes following the financial crisis were the product of coordinated rulemaking by multiple regulatory bodies, including the SEC, the Office of the Comptroller of the Currency (OCC), the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), the Federal Housing Finance Agency (FHFA), and Department of Housing and Urban Development (HUD). Such coordinated rulemaking included the Credit Risk Retention Rule, which implemented Section 941 of the Dodd-Frank Act’s requirements that securitizers of ABS retain an economic interest in the credit risk of the assets collateralizing the ABS,\textsuperscript{33} and the so-called “Volcker Rule,” implementing Section 619 of the Dodd-Frank Act’s restrictions on proprietary trading by banking entities.\textsuperscript{34}


\textsuperscript{33} 79 FR 77602, “Credit Risk Retention” (December 24, 2014).

\textsuperscript{34} 79 FR 5536, “Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds” (January 31, 2014). See also 79 FR 5223,
In addition to such coordinated rulemaking, the SEC implemented ABS-specific disclosure and registration requirements via Regulation AB-II, which generally created underlying asset-level disclosure requirements for ABS offerings and reporting in order to increase ABS market transparency to investors. Several of these new rules are covered in the following sections.

Regulation AB-II

As briefly discussed above, in early 2005, the SEC published Regulation AB, which was intended to address the registration, disclosure, and reporting requirements for ABS. The principles-based set of disclosure items attempted to identify disclosure concepts and provide illustrative examples without creating detailed disclosure guides for each asset class.\(^{35}\) In practice, however, this created substantial ambiguity as to what disclosures were required.

In principle, Regulation AB required that issuers disclose information including:

- A transaction summary and risk factors;
- Static pool information on a sponsor’s prior securitized pools of the same asset type, including delinquencies, cumulative losses, and prepayments;
- Relevant details of the underlying asset pool;
- Significant obligors of pool assets;
- The structure of the ABS transaction;

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\(^{35}\) 70 FR 1506, “Asset-Backed Securities” (January 7, 2005).
• Derivatives instruments, such as swaps, altering the payment characteristics of the cash flows from the issuing entity; and

• Credit ratings.

In practice, however, the SEC eventually concluded that the latitude granted to issuers in determining the materiality of required disclosures, as well as the ability to delay providing required disclosures until two business days after the first sale of securities in an ABS offering, combined to create a situation in which prospective investors may not have had access to all desired information to conduct independent due diligence, and may have lacked time to adequately review the ABS transaction.36

Following the financial crisis, regulators began proposing changes to Regulation AB designed to address the perceived shortcomings in ABS offering disclosures and overall ABS transparency to investors. In September 2014, the SEC published a final rule adopting substantial revisions to Regulation AB. This rule became known as Regulation AB-II, and mandated substantial additional disclosure requirements for ABS. Notably, however, Regulation AB-II did not expand the scope of applicable securities covered by the regulation: only registered public offerings of ABS are covered by Regulation AB-II, and other ABS, such as private placements under the provisions of Rule 144A, are not covered.37 In addition, Regulation AB-II only applies to private-label securitizations, and does not apply to agency securitizations by the GSEs such as


37 79 FR 57184, “Asset-Backed Securities Disclosure and Registration” (September 24, 2014).
Fannie Mae and Freddie Mac, whose principal and interest are guaranteed while they remain under conservatorship.  

New Asset-Level Disclosure Requirements

Asset-level disclosure requirements were one of the more substantial changes to the ABS offering process and post-issuance market transparency. Regulation AB-II required that issuers provide asset-level data in a standardized format at the time of offering and on an ongoing basis. This asset-level data was required to include:

- Data regarding the payment streams related to particular assets underlying an ABS, such as contractual terms, scheduled payment amounts, basis for interest rate calculations, and how payment terms change over time, if applicable;
- Collateral-specific data, such as geographic location, property valuation data, and loan-to-value ratio;
- Performance data for each asset, such as information about obligor payment timeliness, delinquency, or default;
- Loss mitigation data on efforts by the servicer to collect amounts past due and losses that may pass on to investors;

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39 XML format in the rule, 79 FR 57184 at pp. 57187–8.

• Income and employment status verification for obligors;
• Mortgage insurance coverage, if relevant; and
• Lien position.

Such information was deemed important for facilitating independent investor due diligence, and consequently had to be included in the offering prospectus and in ongoing reports.

Asset-level data requirements apply to ABS collateralized by residential and commercial mortgages, auto loans and leases, debt securities, and resecuritizations of those asset classes; other classes of securitizations, such as those collateralized by consumer debts and student loans, were exempted from these requirements as regulators decided that the compliance costs to provide asset-level data would exceed benefits to investors.\footnote{79 FR 57184, “Asset-Backed Securities Disclosure and Registration” (September 24, 2014).}

New Shelf-Registration Eligibility Requirements


• Requiring that the issuer file a preliminary prospectus with transaction- and asset-level information at least three days prior to the first sale of ABS in the offering, and requiring
that any third-party due diligence reports, such as those of credit rating agencies, be filed at least five days prior to the first sale of ABS in the offering, in order to give investors more time to engage in their own due diligence;

- Removing the previous “investment grade” credit rating requirement;
- Requiring that the chief executive officer of the depositor certify the disclosure contained in the prospectus and the structure of the securitization at the time of each ABS offering;
- Requiring a provision in the ABS transaction agreement calling for the review of underlying assets for compliance with the representations and warranties upon the occurrence of specific trigger events;
- Requiring the inclusion of a dispute resolution provision in ABS transaction documents;
- Requiring disclosure of investor requests to communicate with other investors in the ABS; and
- Replacing the previous ABS shelf registration practice of filing a base prospectus and a later prospectus supplement for each takedown with the requirement that a single prospectus be filed for each takedown (though issuers have the option of instead filing a supplement to the preliminary prospectus highlighting material changes from the preliminary prospectus 48 hours prior to the first sale, subject to the Regulation AB-II asset-level disclosure requirements and timing requirements of both the initial prospectus and the supplements).

Notably, credit rating agency risk assessments are removed as a necessary criterion for shelf-offering eligibility. However, an SEC rule, published in the Federal Register in the same month as Regulation AB-II, recognized the common (and presumed continued) use of third-party due diligence services like credit rating agencies by ABS issuers. This rule, the Dodd-Frank
Nationally Recognized Statistical Rating Organizations implementing regulation (NRSRO regulation), required that credit rating agencies publicly disclose findings and conclusions in a due diligence report made available to potential investors and any users of credit ratings at least five days prior to the first sale in the ABS offering, if this credit rating agency report is used in place of Form ABS-15G. Form ABS-15G is generally required to be furnished by issuers at least two days prior to the first ABS sale, unless the issuer obtains a representation from a credit rating agency that it will publicly disclose its findings and conclusions; in this way the NRSRO regulation complements the Regulation AB-II disclosure requirements, which apply to issuers.

There were also numerous detailed reporting requirements for ABS added as part of Regulation AB-II intended to facilitate ongoing due diligence by investors, such as:

- Including all investor communications related to investor rights under the ABS in Form 10-D filings;
- Including descriptions of material changes in a sponsor’s retained interest in Form 10-D for that reporting period;

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46 79 FR 57184, “Asset-Backed Securities Disclosure and Registration” (September 24, 2014).

• Describing the role of each servicing party, as well as the 1122(d) servicing criteria applicable to each servicing party in Form 10-K;\textsuperscript{48} and

• Requiring servicers to disclose the occurrence of material instances of noncompliance (MINCs) with 1122(d) servicing criteria, any steps taken to remediate MINCs, and whether a MINC involved the assets of the specific securitization addressed in Form 10-K.

Draft Proposals Excluded from Final Regulation AB-II

Some proposals that appeared in earlier versions of the proposed Regulation AB-II were not included in the final rule after public comment on the associated compliance costs, including:\textsuperscript{49}

• Requiring ABS issuers to file a computer program modeling the flow of funds or “waterfall” provisions of the ABS to aid investors in monitoring ongoing performance;

and

• Expanding the scope of securities covered by the regulation to include Rule 144A, private securitizations, and other exempt ABS transactions, rather than just registered public offerings. As a result, generally only securities previously covered by Regulation AB are covered by Regulation AB-II.

\textsuperscript{48} Regulation AB required that firms filing Form 10-K annual reports with the SEC must include as exhibits reports from each party participating in the servicing function for ABS that assess compliance with a list of servicing criteria.

\textsuperscript{49} 79 FR 57184, “Asset-Backed Securities Disclosure and Registration” (September 24, 2014), pp. 57190–1.
Credit Risk Retention Rule

The enactment of the Dodd-Frank Act put a hold on the SEC’s independent efforts to create a shelf eligibility requirement for ABS issuers, mandating that they retain an economic interest (i.e., “skin in the game”) in each tranche of an ABS offering in order to better align the incentives of all participants in the securitization process with those of final investors in ABS. Instead, the SEC, OCC, Federal Reserve, FDIC, FHFA, and HUD coordinated rulemaking and jointly proposed a Credit Risk Retention Rule, which was published in the Federal Register in April 2011.\(^{50}\)

Following several comment periods, the regulators published the coordinated final rule in the Federal Register in December 2014.\(^{51}\) In terms of scope, the rule applied to all Exchange Act ABS,\(^{52}\) whether or not such securities are offered publicly. The rule clarified the options available to ABS issuers for retaining at least 5% of aggregate credit risk and exemptions to the requirements.\(^{53}\)

\(^{50}\) 76 FR 24090, “Credit Risk Retention” (April 29, 2011).

\(^{51}\) 79 FR 77602, “Credit Risk Retention” (December 24, 2014).

\(^{52}\) Section 941 of the Dodd-Frank Act adds section 3(a)(77) to the Securities Exchange Act of 1934, and defines the term “asset-backed security” as “a fixed-income or other security collateralized by any type of self-liquidating financial asset that allows the holder of the security to receive payments that depend primarily on cash flow from the asset.”

\(^{53}\) Some of these exemptions, for example, apply to government-sponsored enterprises, commercial mortgage-backed security issuers, and asset-backed commercial paper conduits.
Standard Risk Retention

The Credit Risk Retention Rule’s standard risk retention options—applicable to those offerings not eligible for exemptions or exceptions—were designed to be conceptually simple yet flexible. They allowed ABS sponsors to structure their minimum 5% credit risk retention “vertically” via equal shares of each tranche, “horizontally” via a first-loss piece equivalent to 5% of fair value of the underlying assets, or via an “L-shaped” customized combination of both vertical and horizontal retentions.

Eligible Vertical Retained Interest. The simplest compliance option consists of a vertical retained interest, in which a sponsor retains the same percentage of cumulative amount paid to all interests on each tranche of the ABS. Compliance can be achieved via either retention of the same percentage of each tranche of the ABS offered or a single vertical security with equivalent interest in amounts paid to each tranche, such that total of the par value of the retained interest results in an overall exposure of 5% to the underlying asset pool’s credit risk. Vertical retained interest is simple, transparent, aligns the interests of issuers with investors, and allows issuers to use the par value of their retained holdings to satisfy the requirement. As public comments submitted to regulators pointed out, however, by having issuers retain portions of typically lower-yielding senior tranches, it does prevent some of those safer and often more desirable ABS tranches from being sold to outside investors, and forces issuers to hold assets that may have a return below the issuer’s cost of capital.54

Eligible Horizontal Residual Interest. The major conceptual alternative to holding vertical retained interest is to create a residual first-loss holding, which would allow issuers to signal

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increased creditworthiness in the more senior tranches by absorbing the first 5% of losses. This might increase investor participation. However, pure horizontal residual interest retention does not necessarily align issuers’ incentives with all investors’ incentives, since substantial losses on the underlying asset pool could eliminate the issuers’ retained interest without impacting senior tranche investors. In this scenario, the issuer is left with fewer ongoing incentives to ensure effective future servicing of underperforming assets. As public comments noted, if the servicer is affiliated with the issuer, it could also lead to incentives to prefer loss mitigation approaches that favor junior tranches, such as loan modification, over approaches that favor senior tranches, such as liquidation of the securitized asset pursuant to uncertainty reduction. 55

In order to better align issuer incentives with investor incentives, the rule requires that horizontal residual interest be measured by fair value rather than par value. This should tie the issuer’s total economic exposure to the quality of the underlying pool of securitized assets. For low-quality asset pools, issuers would have to hold a larger residual tranche to meet the 5% fair value credit risk exposure requirement. For high-quality asset pools, the fair value of the residual tranche would be higher and issuers would be able to satisfy the requirement by holding a smaller residual interest. 56

The rule also provides sponsors with the option of establishing an eligible horizontal cash reserve account in an amount equal to the fair value of a horizontal residual interest, in place of actually retaining a first-loss tranche. This reserve account would be used to satisfy payments on


56 The regulators concluded that Generally Accepted Accounting Principles (GAAP) standards concerning fair value calculation methodologies were sufficient to prevent gaming of the requirement. 79 FR 77602, “Credit Risk Retention” (December 24, 2014), p. 77716.
ABS interests or relevant expenses, thus fulfilling the same first-loss role as retaining an actual first-loss tranche.\textsuperscript{57}

\textit{Eligible L-Shaped Interest.} The Credit Risk Retention Rule allows sponsors to combine horizontal and vertical interests in any combination adding up to 5\%, subject to the understanding that vertical interest is measured at par value and horizontal interest is measured at fair value. The regulators opined that such combinations can signal to investors that issuers’ incentives are generally aligned with investors’ across all tranches via the vertical interest component, while still allowing issuers to both signal confidence in the quality of the underlying asset pool and receive higher returns on capital on the first-loss horizontal interest component. Regulators allowed these L-shaped credit risk retentions in order to give issuers substantial flexibility in structuring their ABS offerings.\textsuperscript{58}

\section*{Special Risk Retention}

In addition to the standard risk retention options available to ABS sponsors, the rule included options for exempted asset classes and structures, recognizing that some specific ABS types may

\textsuperscript{57} “In lieu of retaining all or any part of an eligible horizontal residual interest under paragraph (a) of this section, the sponsor may, at closing of the securitization transaction, cause to be established and funded, in cash, an eligible horizontal cash reserve account in the amount equal to the fair value of such eligible horizontal residual interest or part thereof,” subject to conditions requiring treatment of the eligible horizontal cash reserve account on a first-loss basis. 79 FR 77602, “Credit Risk Retention” (December 24, 2014), p. 77742.

\textsuperscript{58} 79 FR 77602, “Credit Risk Retention” (December 24, 2014), pp. 77720–1.
already have effective credit risk retention requirements or otherwise align the incentives of ABS sponsors and investors.

**Government-Sponsored Enterprises.** ABS sponsored by Fannie Mae and Freddie Mac that receive a full guarantee while the firms remain under federal conservatorship are exempt from credit risk retention requirements. The investors in such securitizations are theoretically not exposed to credit losses, and the guarantee acts as an effective credit risk exposure for the government-sponsored issuers.\(^{59}\)

**Commercial Mortgage-Backed Securities.** Sponsors of ABS transactions collateralized solely by commercial real estate loans and servicing assets, commonly called commercial mortgage-backed securities (CMBS), have the option of satisfying the risk retention requirement by having one or two third-party purchasers of “B-piece” eligible horizontal residual interest in the issuing entity, meaning that these third-party purchasers must hold an eligible horizontal residual interest in the issuing entity in the same form, amount, and manner as would be held by the sponsor under the standard risk retention requirement. If multiple third-party purchasers are involved, then each party’s interest must be *pari passu* with the other parties’ interests. Several conditions must be met if CMBS sponsors utilize the CMBS option, including:\(^{60}\)

- Each third-party purchaser must conduct an independent review of each securitized asset’s credit risk, expected cash flows, collateral, and underwriting standards prior to the sale of the ABS;

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\(^{60}\) 79 FR 77602, “Credit Risk Retention” (December 24, 2014), pp. 77723–5.
• Each third-party purchaser must be unaffiliated with any party to the CMBS transaction, including other investors, the special servicer, or originators of less than 10% of the underlying assets;

• Each third-party purchaser must pay for their B-piece in cash, and may not finance the purchase from any other party to the CMBS transaction apart from other investors; and

• The purchase price paid by third-party purchasers for the B-pieces must be disclosed, so other investors can quantify the credit risk exposure of the B-piece buyers, and the resulting level of incentive alignment with other investors.

Asset-Backed Commercial Paper. Asset-backed commercial paper (ABCP) conduits are generally SPVs holding assets such as ABS, whose purchases thereof are financed by the issuance of commercial paper. Regulators recognized that if the ABS purchased by an ABCP conduit were issued with sponsors already retaining credit risk, then the Credit Risk Retention Rule might effectively “double tax” ABCP conduits. In order to prevent such doubling of credit risk retention requirements, the rule created an exemption for ABCP conduits with 100% liquidity support from a regulated institution whose ABS interests were all purchased in initial issuances from sponsors who already retained credit risk per the rule.61

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61 Regulators acknowledged that the exemption eligibility criterion requiring that all ABS interests be purchased in initial issuances might reduce liquidity in ABS secondary markets, but defended the requirement by noting that ABCP sponsors can only influence the terms of an ABS deal via initial issuance acquisitions, and also noted that ABCP conduit structures primarily relying on secondary ABS market purchases performed poorly during the financial crisis. 79 FR 77602, “Credit Risk Retention” (December 24, 2014), p. 77723.
**Open Market Collateralized Loan Obligations.** Collateralized loan obligations (CLOs) are ABS generally collateralized by tranches of senior secured commercial loans or similar obligations, often of borrowers with lower credit quality or lacking credit ratings. Two major types of CLOs exist: balance sheet CLOs securitizing loans already held by an institution and its affiliates, and open market CLOs sponsored by an investment adviser acting as an asset manager by purchasing the assets comprising the underlying collateral pool on the secondary market.

Despite industry comments contending that open market CLOs differ from other ABS because CLO sponsors are investment advisers and not necessarily in the chain of title on the securitized assets, the regulators rejected a blanket exemption for open market CLOs. However, CLO sponsors/asset managers can satisfy the risk retention requirement by holding only “CLO-eligible” tranches for which each syndicated loan’s 62 “lead arranger” retains at least 5% of the tranche’s value for the duration of the loan. A syndicated loan member qualifies as lead arranger if its initial allocation is at least 20% of the aggregate principal balance, and the largest allocation taken by any member. CLO-eligible tranches are subject to other restrictions, such as the requirement that they carry separate voting rights, which commenters suggested would be administratively difficult to implement. Moreover, if a syndicated loan has no lead arranger, CLO managers holding such assets must abide by the standard risk retention options. 63

**Other Special Risk Retention Options.** Sponsors of tender option bonds (TOBs) have two alternative options for risk retention, provided that sponsors ensure 100% liquidity protection

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62 A syndicated loan is a structured credit arrangement provided by a group of lenders, with one lender, the “lead arranger,” responsible for structuring, arranging, and administering the loan.

and provide for a mechanism aligning sponsors’ incentives with investors’; and sponsors of revolving pool securitizations collateralized by short-maturity assets such as credit card receivables or trade receivables typically retain a meaningful exposure to credit risk via what is known as the series subordinated seller’s interest, which can count towards credit risk retention in place of the standard retention methods.

Other Exemption and Exception Criteria

In addition to the exemptions for GSE-sponsored issuances and the special risk retention options for broad asset classes, the rule also included specific exemptions for defined “qualifying” assets.

Qualified Residential Mortgages. The rule exempts from risk retention requirements any securitization collateralized entirely by qualified residential mortgages (QRMs), and defines a QRM as a qualified mortgage (QM) under the Truth in Lending Act. By adopting the preexisting QM standard, regulators did not incorporate separate credit history standards or loan-to-value requirements as earlier versions of the rule had suggested they might.

Mortgage Loans Exempt from QM. The rule exempted securitizations collateralized by loans exempt from the QM “ability-to-repay” requirements, such as loans originating through community-focused lending programs. In addition, mortgage loans secured by three-to-four unit

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64 79 FR 77602, “Credit Risk Retention” (December 24, 2014), pp. 77730–77731.


residential properties that meet the criteria for QM apart from being consumer credit transactions
are also exempt from Credit Risk Retention Rule requirements.\textsuperscript{67}

\textit{Qualifying Commercial Real Estate Loans.} Securitizations collateralized entirely by
qualifying commercial real estate (CRE) loans are exempt from risk retention requirements. In
order to qualify for the exemption, a number of requirements must be met, including:\textsuperscript{68}

\begin{itemize}
  \item The underlying CRE assets must meet specific underwriting standards, such as
  amortization periods of 10–25 years for non-multifamily residential CRE loans or 10–30
  years for multifamily residential CRE loans, and loan-to-value caps of 70\% for first and
  junior loans and 65\% for first-lien loans, with exceptions;
  \item The securitization transaction must be collateralized solely by CRE loans and servicing
  assets; and
  \item The securitization transaction must not permit reinvestment periods.
\end{itemize}

\textit{Other Criteria.} Securitizations collateralized entirely by qualifying commercial loans are
exempt from risk retention requirements;\textsuperscript{69} likewise, auto loans meeting qualifying criteria are
individually exempt from risk retention requirements if securitized.\textsuperscript{70}

\textit{Blended Pools of Qualifying Assets.} Sponsors may blend pools of qualifying automobile
loans, qualifying commercial loans, or qualifying CRE loans with non-qualifying assets of the
same class in order to receive up to a 50\% reduction in the minimum required risk retention.\textsuperscript{71}

\textsuperscript{67} 79 FR 77602, “Credit Risk Retention” (December 24, 2014), pp. 77739–40.

\textsuperscript{68} 79 FR 77602, “Credit Risk Retention” (December 24, 2014), pp. 77679–83.

\textsuperscript{69} 79 FR 77602, “Credit Risk Retention” (December 24, 2014), pp. 77678–9.

\textsuperscript{70} 79 FR 77602, “Credit Risk Retention” (December 24, 2014), pp. 77683–5.
Volcker Rule

Section 619 of the Dodd-Frank Act, colloquially known as the Volcker Rule due to former Federal Reserve Chairman Paul Volcker’s personal appeals to lawmakers, generally prohibited any banking entity from engaging in proprietary trading or from acquiring or retaining an ownership interest in or otherwise sponsoring hedge funds or private equity funds (covered funds).

As industry commenters pointed out that issuing or making markets in ABS can be construed as proprietary trading, the Volcker Rule as implemented by the SEC, Federal Reserve, FDIC, and OCC has substantial implications for the ABS market. Of particular interest are the implications of restrictions on interests in covered funds and the applicability of exemptions to securitization structures and ABS-related special-purpose entities.

The SEC, Federal Reserve, FDIC, and OCC issued a joint final rule in January 2014. Due to the necessity of using detailed judgments relating to specific asset types or specific transaction types in determining when banking activities constitute, for instance, market making as opposed to proprietary trading, however, the most important aspects of the Volcker Rule from the perspective of the ABS market were the exemptions to the broad prohibitions on proprietary trading.

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Prohibitions on Covered Funds and Exemptions for Traditional Securitization Structures

The Volcker Rule prohibits banking entities from directly or indirectly acquiring or retaining an ownership interest in covered funds as principals; from sponsoring a covered fund, for instance by acting as a trustee, commodity pool operator (CPO), managing member, or general partner of a covered fund; or from being enabled to select the trustees, managers, or a majority of directors of a covered fund, subject to exemptions and exceptions.\textsuperscript{73}

\footnotesize\textsuperscript{73} 79 FR 5536, “Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds” (January 31, 2014), p. 5787.

The regulators’ determinations regarding the scope of applicability of the covered funds restriction, meaning which funds banking entities are unable to acquire or retain interests in, or to sponsor, dictate the scale of the prohibition’s implications.

The rule defines covered finds as:

- Issuers that would be considered investment companies under the Investment Company Act of 1940 but for section 3(c)1 or 3(c)7; or

- Commodity pools under section 1a(10) of the Commodity Exchange Act for which

  - The CPO claims an exemption under 16 CFR 4.7; or
  
  - The CPO is registered with the CFTC as a CPO, substantially all participation units of the pool are owned by qualified eligible persons under 17 CFR 4.7(a)(2) and 17 CFR 4.7(a)(3), and no public offering to persons ineligible under 17 CFR 4.7(a)(2) and 17 CFR 4.7(a)(3) has taken place; or
The implications of these definitions of prohibited covered funds on ABS are potentially substantial, as the regulators recognized that many securitization issuers would be considered investment companies under the Investment Company Act of 1940, and hence covered funds under the rule, but for the use of exemptions. Securitizations utilizing the exemptions under section 3(c)(5) of the Investment Company Act would not be affected by the restriction on covered funds, but those utilizing section 3(c)1 or 3(c)7 would be, unless another exemption can be utilized instead.

In addition, collateralized loan notes and some insurance securitizations may involve CPOs that must register with the Commodity Futures Trading Commission (CFTC), and as such would be considered covered funds under the rule. Industry comments suggest the broad wording of the covered commodity pool definition will likely require clarification from either the CFTC or judicial rulings in order to determine whether certain securitization structures would be considered covered funds.

The rule includes several specific exclusions from the covered fund definition, some of which may be utilized by some banking-entity-controlled issuers currently relying on section 3(c)1 or 3(c)7 exemptions under the Investment Company Act. The exceptions include: foreign public funds, wholly owned subsidiaries (which are still subject to restrictions on proprietary trading), joint ventures (which are still subject to restrictions on proprietary trading), acquisition

- Covered foreign funds, defined as entities organized outside of the United States, whose ownership interests are offered and sold solely outside of the United States, and which raises money from investors primarily for the purpose of trading or investing in securities, which is sponsored by or had ownership interests owned by a banking entity under the laws of the United States or of any State.
vehicles formed temporarily to effect a bona fide merger or acquisition, foreign pension or retirement funds, insurance company separate accounts, bank-owned life insurance, loan securitizations, qualifying ABCP conduits, qualifying covered bonds, Small Business Investment Company and public welfare investment funds, registered investment companies and excluded entities not relying on exclusions contained in section 3(c)1 or 3(c)7, and issuers in conjunction with FDIC receivership or conservatorship operations. 74

Several of these exemptions may apply to some ABS issuers.

Wholly Owned Subsidiaries. The rule includes an exemption for intermediate entities in the securitization process that are wholly owned by a banking entity or an affiliate thereof. 75

Loan Securitizations. Issuing entities for ABS are not considered covered funds, and thus are allowed under the Volcker Rule, if all of their assets or holdings are loans as defined in the rule, cash equivalent securities, securities received in lieu of debts from loans, interest rate or foreign exchange derivatives actively used to hedge loan risk, servicing rights, or special units of beneficial interest and collateral certificates issued by a qualifying loan securitization special-purpose entity to transfer to the issuing entity the economic risks and benefits of otherwise


75 “Wholly owned” means no more than 5% of the entity’s ownership interests may be held by employees or directors of the banking entity or its affiliate, and no more than 0.5% of the entity’s outstanding ownership may be held by a third party for the purpose of establishing corporate separateness or bankruptcy concerns, with the banking entity or its affiliate owning all other outstanding ownership interests (at least 94.5% of the wholly owned subsidiary). 79 FR 5536, “Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds” (January 31, 2014), p. 5788.
qualifying assets. Assets or holdings disqualifying an issuing entity from the loan securitization exception include securities (apart from cash equivalents or securities received in lieu of debts with respect to permitted loans) or derivatives (apart from interest rate or foreign exchange derivatives used to reduce loan risks). 76

A noteworthy loan securitization exception eligibility restriction for ABS issuers is the restriction on holding securities other than cash equivalents and securities received in lieu of debts, as some forms of securitized assets could plausibly be described as securities under some facts and circumstances, and described as a loan (or lease, or extension of credit, or receivable) under other facts and circumstances.

Qualifying ABCP Conduits. Issuing entities for ABCP are not considered covered funds, and thus are allowed under the Volcker Rule, if they exclusively hold loans and other assets permitted under the loan securitization exception, or ABS purchased during an initial issuance and supported solely by assets qualifying for the loan securitization exception; issue ABS comprised of residual interest and securities with a legal maturity of 367 days or less; and are backed by a regulated liquidity provider committed to provide unconditional coverage in the event that the issuing entity must use funds to redeem maturing ABS holdings. 77

Qualifying Covered Bonds. Entities owning or holding solely pools of loans or other assets that qualify for the loan securitization exception may issue debt obligations collateralized by that pool of assets provided that the payment obligations for those debt obligations are fully and


unconditionally guaranteed by an entity meeting the definition of a foreign banking organization, and such entities will not be considered covered funds provided they are wholly owned subsidiaries of a foreign banking organization.  

Remaining Areas of Concern

Industry comments noted that the exceptions included in the rule generally did not apply to ABS-issuing entities holding securities and derivatives, which appears to force banking entities to liquidate any holdings in such ABS issuers. This substantially limits the ability of banking entities to hold interests in or sponsor issuers of structured products, such as synthetic ABS, CDOs, and CLOs holding securities or derivatives, and collateralized mortgage obligations (CMOs) holding MBS.

*Synthetic ABS.* Synthetic ABS by definition employ derivatives to imitate the performance of a pool of reference assets. Using derivatives, it is possible to gain exposure to the economic risks and benefits of the pool of reference assets without actually holding them. Under the rule, such synthetic exposures to loans would not qualify for an exception to the covered funds restrictions.  

*CDOs and CLOs Collateralized by Securities or Derivatives.* CDOs often hold pools of securities, such as other ABS, and as such would be considered covered funds under the rule.

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The rule suggests regulators intend to disallow banking entities from engaging in some types of resecuritization, such as the creation of CDOs collateralized by structured products, noting that such transactions are complicated, difficult to value, lack long histories of performance data, and performed poorly in the financial crisis. Moreover, regulators expressed concern that allowing ABS issuers to hold securities such as other ABS or derivatives in the underlying pool of assets collateralizing a new ABS offering could allow banking entities to avoid the prohibition on ownership interest in covered funds.

Similar concerns applied to issuers of CLOs, which sometimes hold bonds or ABS in addition to loans. Whereas a CLO issuer holding only loans in its underlying asset pool would qualify for the loan securitization exception, a CLO issuer holding securities such as bonds or ABS would not, and thus would be considered a covered fund.80

*CMOs Backed by MBS.* Issuers of CMOs holding MBS rather than mortgage loans would not qualify for an exception to the covered fund definition unless they qualified for exemptions under section 3(c)(5) of the Investment Companies Act, which would depend on the characteristics of the MBS held. The same regulatory concerns regarding resecuritisations apply to CMOs as to CDOs and CLOs.81

The rule generally classifies ABS issuers engaging in resecuritization of an underlying pool of ABS or other securities or creating ABS with synthetic exposure to a pool of assets via derivatives as covered funds under the Volcker Rule. In the absence of a specific exception or

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exemption, banking entities and their affiliates will not be able to acquire, retain, or sponsor such ABS issuers. This applies to some issuers not always immediately associated with securitization or structured products, such as issuers of covered bonds, since the exception in the rule only applies to covered bonds backed by foreign banking organizations.  

Developments in the Regulation of Credit Derivatives

By 2006, dealer banks had created ABX indices, which are indices of credit default swap (CDS) contracts referencing multiple tranches of MBS. Perhaps the most famous of these was the ABX.HE index, a credit derivative that referenced a basket of 20 subprime RMBS tranches. The introduction of ABX indices created a reasonably liquid and observable market pricing of subprime mortgage risk. Economists such as Gary Gorton suggested the widely observed sudden and substantial deterioration of the ABX.HE index during the financial crisis may have helped add to perceptions of uncertainty regarding the actual value of entire classes of related securitized assets.  

As a result of the poor performance of ABX indices like the ABX.HE index during the crisis, the entire class of credit derivatives referencing securitized products came under regulatory scrutiny. The Dodd-Frank Act and related rules have targeted credit derivatives, with substantial new compliance requirements. Major regulatory changes affecting credit derivatives

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have included the swaps pushout requirement, new margin and collateral requirements, and new clearing and disclosure requirements.

Rules Related to Security-Based Swaps on ABS

Section 716 of the Dodd-Frank Act prohibited federal government assistance from being provided to any swaps entity with respect to any swap, security-based swap, or other activity of a swaps entity. 84 The Federal Reserve published an interim rule in June 2013 85 and a final rule in January 2014, entitled Regulation KK, 86 implementing Section 716’s restrictions with a clarification on the definition of an insured depository institution.

Industry comments suggested that Regulation KK effectively barred banking entities that were also swap dealers, security-based swap dealers, major swap participants, or major security-based swap participants from access to FDIC deposit insurance or Federal Reserve credit facilities or discount windows unless such swap activities were pushed into separate affiliates not eligible for such assistance. As a result, Section 716 and its implementing Regulation KK have become colloquially referred to as the “swaps pushout rule.”

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85 78 FR 34545, “Prohibition Against Federal Assistance to Swaps Entities (Regulation KK)” (June 10, 2013).

The statute and final rule had a number of exceptions, including allowing insured depository institutions to use swaps to directly hedge risks, and to act as swaps entities for swaps or security-based swaps involving rates or reference assets permissible for investment by a national bank, other than acting as a swaps entity for non-cleared CDS. The rule treats uninsured US branches or agencies of foreign banks as insured depository institutions for the purposes of Section 716, and establishes a process whereby state member banks and uninsured state branches or agencies of foreign banks may request a transition period to conform with the swaps pushout rule.

As a result of the exemptions, the swaps pushout rule primarily applied to CDS indices such as ABX, uncleared CDS, many physical commodity swaps, total return swaps, and equity swaps. It remained controversial due to concerns that pushing swaps into uninsured affiliates would create obstacles to the resolution of a bankruptcy or other wind-down of a complex financial company.

In December 2014, the swaps pushout rule was substantially weakened by the enactment of the 2015 Consolidated and Further Continuing Appropriations Act, which contained an amendment to Section 716. The so-called Lincoln Amendment limited the classes of swaps pushed out of insured depository institutions to structured finance swaps such as ABX and other CDS indices; in essence, swaps based on ABS or groups or indices of ABS like ABX.HE became the only swaps still covered by the updated swaps pushout rule. The amendment also

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tasked prudential regulators\textsuperscript{88} with creating regulations allowing insured depository institutions to engage in structured finance swap activities if such swaps meet credit quality thresholds set by the prudential regulators, or if structured finance swaps are used to mitigate risks, providing some expectation of relief to the targeted class of credit derivatives.

\section*{New Margin and Collateral Requirements}

Sections 731 and 764 of the Dodd-Frank Act require the CFTC and SEC to register swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants, and adopt rules jointly imposing both capital requirements and initial and variation margin requirements. Section 761 of the Dodd-Frank Act defines security-based swaps to include single-name and narrow-based credit swaps and equity-based swaps, while Section 721 defines swaps to include broad-based credit swaps. Comment letters indicate credit derivatives related to ABS, such as CDS indices, are directly affected by the ultimate rules adopted, as are synthetic ABS.\textsuperscript{89}

In September 2014, the CFTC and prudential regulators published proposed rules in the Federal Register that would require covered swap entities to post initial and variation margin for

\textsuperscript{88} Under the Dodd-Frank Act, prudential regulators include the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency. US Government Printing Office, \textit{“Dodd-Frank Wall Street Reform and Consumer Protection Act,”} Public Law 111-203, Section 721.

\textsuperscript{89} 79 FR 59898, \textit{“Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants,”} October 3, 2014; 79 FR 57348, \textit{“Margin and Capital Requirements for Covered Swap Entities”} (September 24, 2014).
uncleared swaps. The proposed rule granted preferential treatment to cleared swaps and futures over uncleared swaps in the calculation of initial margin requirements, requiring a ten-day closeout assumption for uncleared swaps, versus a five-day closeout assumption for cleared swaps and a one-day closeout assumption for futures.  

Public comments on the proposed rule noted that this longer closeout assumption will require counterparties for uncleared swaps to post additional initial margin, which usually must be held in assets with low expected returns likely below financial firms’ cost of capital, imposing both opportunity costs and direct costs of carry.

Many comments on the proposed rule, such as the cost-benefit analysis by Brown-Hruska and Wagener, were critical of its potentially high costs and substantially preferential treatment for cleared swaps and futures relative to uncleared swaps.  

As of May 2015, the regulators have yet to publish the final rules responding to public comments. If regulators adopt the proposed rule, the costs of some synthetic ABS and many common hedges for ABS may increase.

Rules Relating to Clearing and Disclosure

As the Dodd-Frank Act and related regulations pushed markets toward clearing swaps, regulations relating to clearing security-based swaps became increasingly important to the credit

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derivatives marketplace. In December 2012, the CFTC published a final rule requiring that North American and European untranchéd CDS indices be cleared pursuant to the rules of any eligible derivatives clearing organization.\(^{92}\)

Expected Consequences of New Regulations for ABS

Since the financial crisis, the regulatory landscape for ABS has shifted dramatically, with a particular emphasis on enabling greater and earlier ABS transparency down to the asset level, encouraging independent investor due diligence of ABS pool assets, and aligning the incentives of ABS issuers and investors. In addition, efforts to reduce proprietary trading by banks via the Volcker Rule are likely to have substantial impacts on the ability of banking entities to securitize certain assets, such as resecuritizations and synthetic securitizations. Finally, derivatives regulation following the financial crisis may force banks to push security-based ABS activities out into uninsured affiliates; new margin and collateral requirements may raise costs associated with security-based swaps and incentivize the use of futures and cleared swaps over uncleared swaps; and some classes of CDS, including those on ABS indices, are now required to be cleared.

As was previously mentioned, more than 90% of US MBS issuance since 2008 has been agency MBS, and hence guaranteed by the US government. These guarantees have resulted in exemptions for agency MBS from several major regulations, including Regulation AB-II and the Credit Risk Retention Rule. However, as the government guarantees of agency MBS are, as of

\(^{92}\) 77 FR 74284, “Clearing Requirement Determination under Section 2(h) of the CEA” (December 13, 2012).
May 2015, limited to the period of government conservatorship of the relevant GSEs, a change in the conservatorship status of the GSEs may make credit risk concerns relevant to future agency MBS issuances, and thus lead to the elimination of these exemptions or further changes to the regulations governing MBS and related products.93

Key Points

- Regulators and policymakers identified a lack of pre-trade transparency, flawed and outsourced due diligence, and a failure to align sponsor and issuer incentives with investor incentives as major drivers of poor ABS performance in the financial crisis.

- Following the crisis, the Dodd-Frank Act, implementing regulations, and coordinated rulemaking by financial regulators began to reshape the market for ABS and related derivatives.

- The SEC’s Regulation AB-II required asset-level disclosures by issuers, earlier disclosures in order to give investors more time to conduct independent due diligence, stricter criteria for shelf registration and offering eligibility, and a de-emphasis on the importance of credit ratings to discourage reliance on third-party valuations by ABS investors.

- The Credit Risk Retention Rule requires that most ABS issuers retain a 5% aggregate exposure to the credit risk of the assets collateralizing the ABS offering, via a vertical retention, horizontal residual retention, or a combination thereof.

- The Volcker Rule prohibited banking entities from engaging in proprietary trading or acquiring interests in, retaining interests in, or sponsoring covered funds such as hedge funds.

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funds or private equity funds, with exceptions and exemptions for some traditional securitization structures, but not for resecuritizations or securitizations of derivatives.

- Derivatives regulations following the financial crisis included an expansive swaps pushout rule later statutorily amended to only force banking entities to push out security-based swaps such as ABX, other CDS indices, and other structured finance credit derivatives into uninsured affiliated entities.

- New proposed margin and collateral requirements for uncleared swaps and a mandate to clear certain classes of CDS, such as untranchsed North American and European corporate CDS, may increase costs of some synthetic ABS and of common hedges for ABS.

- Regulators have yet to take final action on all rulemaking proposals, so the status of ABS and credit derivatives is still subject to change based on how regulators respond to public comments.

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Figure 4.1 US mortgage-related securities issuance, 1996–2014

Notes: Figures are annual. Agency securities include Fannie Mae, Freddie Mac, Ginnie Mae, and Federal Deposit Insurance Corporation/National Credit Union Administration issuances. Nonagency securities include MBS, home equity securities, and manufactured housing securities, as well as resecuritizations thereof.

Sources: Data from Securities Industry and Financial Markets Association