United States Senate
WASHINGTON, DC 20510

July 28, 2014

Hon. Mary Jo White
Chair, Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Implementation of Dodd-Frank Act Securitization Reforms

Dear Chair White:

We write to express our concern about the slow pace of progress by the Securities and Exchange Commission (SEC) in putting into place critical investor and systemic risk protections related to securitization and structured finance markets as set out in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).

As you are well aware, poorly underwritten and weakly regulated asset-backed securities (ABS) were at the heart of the 2008 financial crisis and the recession that followed. The unregulated complex packages of loans that formed the securitization market "provided the kerosene that fueled the housing bubble,"[1] and played a direct role in the collapses of large Wall Street commercial and investment banks.[2] They also undermined the housing finance system and led to enormous losses by a wide range of investors.[3] Securitization also gave rise to some of the most egregious conflicts of interest when those underwriting and packaging the securities were, in fact, betting on them to fail and collecting billions of dollars from the clients they had convinced to buy the securities.[4] These conflicts were compounded by conflicts in the credit rating

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[1] "Starting in 2001, the share of subprime within the PLS [private-label mortgage backed securities] market began to grow, becoming majority of PLS by 2004, when the PLS market took off as it provided the kerosene the fueled the housing bubble … [A]t its peak in 2005-2006, the PLS market provided the financing for 38% of mortgage lending (by dollar amount). By 2008, however the PLS market had retreated to virtual non-existent." Testimony of Professor Adam Levitin, October 1, 2013 Senate Committee on Banking, Housing, and Urban Affairs' Hearing for "Housing Finance Reform: Fundamentals of a Functioning Private Label Mortgage Backed Securities Market" accessed via
http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=2a1bfc7b-52f6-423f-8dd6-193b55a4416a&Witness_ID=74b14ea1-b0e7-40f5-8d1c-5de7aea00e5a.

[2] Senate Subcommittee on Investigations, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse* (2010), available at http://www.hsgac.senate.gov/subcommittees/investigations/reports; Financial Crisis Inquiry Commission, Financial Crisis Inquiry Report (2011); Gary Gorton, Panic of 2007, NBER, September 2008, available at http://www.nber.org/papers/w14358.

[3] A Wall Street Journal study found that 61 percent of subprime borrowers in 2006 qualified for a safe and sound prime loan. Rick Brooks and Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy As Housing Boomed, Industry Pushed Loans To a Broader Market*, WALL STREET JOURNAL at A1 (Dec. 3, 2007). See also Financial Crisis Inquiry Commission, Financial Crisis Inquiry Report 122-25 (2011); Timothy Howard, MORTGAGE WARS 163-78 (2014).

[4] Senate Subcommittee on Investigations, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse* (2010), available at http://www.hsgac.senate.gov/subcommittees/investigations/reports; Jesse Eisinger and Jake

agencies' business model that encouraged inflated ABS ratings that were later downgraded to junk status. In sum, investors lost billions and the financial system was directly threatened because of the failed regulation of asset-backed securities.[5]

Unfortunately, six years after the financial crisis and four years after the Dodd-Frank Act directed the SEC to reform the securitization marketplace, far too little has been done. While we note reports of on-going work related to risk retention and appreciate recent statements regarding upcoming action,[6] there remain significant gaps in progress on the following matters, among others:

- **Credit rating agency reforms** mandated and authorized by Title IX of Dodd-Frank Act are incomplete and the proposals put forward so far fail to eliminate conflicts of interest, establish minimum internal controls, ensure risky financial products receive lower ratings, or strengthen ratings disclosure.[7] Credit rating agencies are critical to the process of securitization because investors purchase ABS precisely because they purport to turn packages of loans into AAA-rated bonds.[8] Investors in structured offerings continue to rely heavily on credit ratings, while investing with inadequate safeguards from inflated ratings. As such, the Commission's failure to date to complete mandated rulemakings and exercise its authority under the law exposes investors and the financial system to continued serious risks, since ratings inflated by a flawed business model that allows securities' issuers to pay for their ratings could produce the same types of consequences that, in part, ignited the 2008 financial crisis.[9]

Bernstein, "The Magnetar Trade: How One Hedge Fund Helped Keep the Bubble Going," *ProPublica*, April 9, 2010, available at http://www.propublica.org/article/the-magnetar-trade-how-one-hedge-fund-helped-keep-the-housing-bubble-going.

[5] The failure has led some to call these markets "shadow banking" and suggest that they are entirely lacking in regulation at all. For a contrary view, see Hon. Kara Stein, "Remarks to the Peterson Institute of International Economics," June 12, 2014, available at http://www.sec.gov/News/Speech/Detail/Speech/1370542076896#.U53iLBZVSlI.

[6] Alan Zibel and Andrew Ackerman, *Loosened Mortgage Rule Advances After SEC Drops Objection*, WALL STREET JOURNAL, June 10, 2014, available at http://online.wsj.com/articles/loosened-mortgage-rule-advances-after-sec-drops-objection-1402448800.

[7] In particular, the SEC's proposal fails to mandate standards governing internal controls, address the fundamental conflicts of interest present in rating structured products, or comply with the Dodd-Frank mandate to ensure ratings are meaningfully the same across asset classes. As the Consumer Federation of America highlighted in its 2014 letter, failure to implement these Dodd-Frank Act mandates leaves investors exposed to the same risks of abuse that permitted packages of toxic loans to obtain "AAA" ratings. See Letter to Elizabeth Murphy from Micah Hauptman, Barbara Roper, March 3, 2014, available at http://www.sec.gov/comments/s7-18-11/s71811-78.pdf. We also note that the SEC continues to provide an on-going exemption to section 939G, which mandated a higher level of accountability for rating statements, with no end in sight even for structured products.

[8] In contrast with a credit rating agency that is paid by the issuer, a bond guarantor or another entity with other forms of "skin in the game," like risk retention, has a stronger alignment of interest with the ultimate investor. See Timothy Howard, MORTGAGE WARS 167-68 (2014). At the same time, retention of risk, if ill-designed, can also be a problem. See Senate Subcommittee on Investigations, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse* (2010), available at http://www.hsgac.senate.gov/subcommittees/investigations/reports.

[9] See, generally, Financial Crisis Inquiry Commission, Financial Crisis Inquiry Report (2011).

- **Prohibitions on financial firms from betting against the securities they package,** as mandated in section 621 of the Dodd-Frank Act, have remained stuck for nearly four years now at the proposal stage. It is outrageous that this basic protection against abusive securitizations has yet to be finalized.

- **Improved ABS disclosures and SEC oversight of the ABS markets,** as mandated by sections 942 and other parts of Title IX of Dodd-Frank and embodied in proposed Regulation AB II, are also stalled, with public comment having been closed and opened again, now multiple times.[10] Especially concerning is the insufficiency of the SEC's oversight of ABS markets, especially those that are not registered with the Commission.[11] Structured finance products pose special investor protection and systemic risks that require greater attention by the SEC. Equally troubling are the provisions in proposed Regulation AB II that would eliminate loan-level disclosures for the most complex structures, including synthetic securities and "novel asset types or structures." Those were precisely the products most abused during the prelude to the financial crisis and most in need of transparency and oversight.[12]

- Section 956's mandated limits on **financial institution compensation structures that incentivize risk** also have an important role to play in preventing abuses in the ABS markets. They too appear to have stalled.[13] In the run up to 2008, employees that obtained bonuses based on selling (or retaining) securitized products without any care as to their quality brought the sponsors, investors and ultimately capital formation in the markets, to the brink of collapse.[14]

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[10] We certainly appreciate the SEC's willingness to address privacy concerns. For a discussion of these issues, see Letter to the SEC from Americans for Financial Reform, April 2014, available at http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2014/04/AFR-Response-To-SEC-ABS-Data-Request.pdf.

[11] Unfortunately, the financial crisis demonstrated that the SEC's classical approach to products sold to sophisticated investors does not work when it comes to structured finance. Many sophisticated investors, especially pension funds and others that invest the savings of working families, do not have the market power to force dealers to provide adequate loan-level disclosures or sufficient time to review those disclosures. Moreover, for the SEC to leave itself blind to important markets exposes all investors and the financial system to serious risks.

[12] As Americans for Financial Reform highlighted in its letter to the Commission, "innovation" has often been driven by "adding additional layers of complexity and opacity . . . mak[ing] clear understanding of the risk exposure by the investor much more difficult." From the experience of the 2008 financial crisis and the Dodd-Frank's new mandates on systemic risk, the SEC should take a more aggressive approach to preventing opacity and complexity, especially in structured finance. See Letter to the SEC from Americans for Financial Reform, April 2014, available at http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2014/04/AFR-Response-To-SEC-ABS-Data-Request.pdf.

[13] See Hon. Kara Stein, "Remarks to the Peterson Institute of International Economics," June 12, 2014, available at http://www.sec.gov/News/Speech/Detail/Speech/1370542076896#.U53iLBZVSlI (noting this is a joint rulemaking).

[14] See Arthur E. Wilmarth, Jr., "The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis," 41 CONN. L. REV. 963, 971 (2009); Senate Subcommittee on Investigations, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse* (2010), available at http://www.hsgac.senate.gov/subcommittees/investigations/reports.

Four years after the passage of the Dodd-Frank Act, it is long past time for these core reforms to be finished.

We recognize that the Commission has limited resources. But the Commission is required by law to complete the rules described above. Yet, in recent months, the Commission has taken a number of discretionary actions in the Corporation Finance Division, which also handles many securitization issues. We would, at a minimum, urge the Commission to prioritize its time and resources to addressing its mandatory obligations and key issues arising out of the financial crisis, and defer deploying resources on other less urgent – and in some cases controversial – matters.

As Secretary Lew recently highlighted, ABS markets are an important channel for attracting private capital to finance housing for the benefit of American families and the American economy.[15] For that channel to function effectively, investors must have confidence that the rules of the road are strong enough both to protect investors and address systemic risk. The losses that investors took during the Financial Crisis, especially pensions and other institutional investors that invest the savings of working families, and the systemic consequences of the crisis and Great Recession, have been a continuing drain on private and public employers, working families, and retirees across the country. We strongly urge you to move quickly to strengthen reforms and oversight of the ABS marketplace.

Sincerely,

Jeffrey A. Merkley

Al Franken

Carl Levin

Edward J. Markey

[15] See Remarks of Treasury Secretary Lew at the Making Home Affordable Five-Year Anniversary Summit, June 26, 2014, available at http://www.treasury.gov/press-center/press-releases/Pages/jl2445.aspx.

Bernard Sanders | Elizabeth Warren

[illegible] | Dianne Feinstein

Dick Durbin | Mazie K Hirono

Tammy Baldwin

cc: Hon. Jacob Lew, Secretary of the Treasury and Chair, Financial Stability Oversight Council
Hon. Janet Yellen, Chair, Federal Reserve Board and Vice Chair, Financial Stability Oversight Council