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United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
WASHINGTON, DC 20510-6250

November 15, 2010

VIA EMAIL (Rule-Comments@sec.gov)

Ms. Elizabeth M. Murphy
Secretary
Office of the Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

RE: Asset-Backed Security Reviews, File No. S7-26-10

Dear Ms. Murphy:

The purpose of this comment letter is to express support for, and offer recommendations to strengthen, the proposed rule to implement Sections 945 and 932 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) related to conducting reviews of asset-backed securities (ABS). To carry out Section 945, the proposed rule would require ABS issuers to perform a review of the assets underlying the security being issued and disclose to investors the findings and conclusions of that review in the security's registration statement. To carry out Section 932, the proposed rule would require ABS issuers and underwriters to disclose to investors the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter.

The goal of the relevant provisions in Sections 945 and 932 is to help restore investor confidence in the ABS market by ensuring investors gain access to material information about the assets underlying the ABS securities they are considering purchasing. If implemented well, these provisions could also provide important data to help analysts, regulators, and policymakers identify and understand ABS financial products, trends, and problem areas.

As currently drafted, the proposed rule contains only a general requirement for the issuer and third party due diligence reviews to be conducted and disclosed. This approach does not fully implement the statutory objectives of Sections 945 and 932, because it fails to mandate any minimum standards for such reviews. In the absence of minimum standards, issuer reviews may fail to provide key information about the ABS assets or may provide information about such a limited sample of assets that the results cannot be extrapolated to the rest of the ABS pool. The reviews may also contain such different types of asset analysis that they would hinder rather than aid comparisons of ABS asset quality. In addition, third party due diligence reviews commonly gauge whether a sample of loans meets specified requirements set by the asset seller and potential buyer. Without disclosing the seller and buyer requirements, the due diligence review's analysis and conclusions will be of little use to investors or analysts. To remedy these problems, the proposed rule would benefit from specifying minimum review standards requiring the use of statistically significant loan samples, data reflecting key indicators of asset quality, and disclosure of buyer and seller requirements established for third party due diligence reviews. The proposed rule would also be strengthened by specifying the types of minimum findings and conclusions that should be provided to investors.

In addition, the proposed rule should strengthen its coordination with Section 621 of the Dodd-Frank Act which bans securitizers from engaging in any transaction that would involve or result in a material conflict of interest with the investors in their securities. To ensure effective coordination, the proposed rule should require issuer reviews to include a discussion and assessment of any potential conflicts of interest that might relate to the quality of the assets.

Background. The recent financial crisis was fueled by toxic assets that were bundled and disseminated through ABS securities, in particular residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDOs) linked to residential mortgages. ABS securities are not confined to mortgage-related RMBS and CDOs, however, but also encompass securities backed by commercial mortgages, student loans, automobile loans, credit card receivables, and other revenue streams. Synthetic ABS securities typically rely on credit default swaps which allow one set of investors to bet that a referenced set of assets will increase in value, while a set of counterparties bets that the value will decrease. Because the performance of every ABS security depends upon the performance of its underlying assets, understanding the quality of those assets is key to informed investment decisions.

Poor quality assets led to the collapse of the RMBS and CDO markets, after credit rating agencies downgraded thousands of RMBS and CDO ratings from AAA to junk status. Banks, broker-dealers, pension funds, municipalities, and others were suddenly left with non-investment grade securities laced with poorly performing or defaulting mortgage loans. Two years later, the markets for these and other ABS securities remain weak, in large part due to a lack of investor confidence in ABS financial products. Sections 945 and 932 of the Dodd-Frank Act are designed to help restore investor confidence by mandating issuer reviews of each ABS security's underlying assets and requiring disclosure of any additional third party due diligence reviews of asset quality. Mandatory disclosure of these reviews to investors is intended to increase the quantity and quality of information available to investors, facilitate dialogue between investors and ABS issuers, and enable informed decision-making. Whether these reviews actually accomplish those goals will depend in large part upon how well the Commission carries out the statutory provisions.

Subcommittee Investigation. Over the past two years, the Permanent Subcommittee on Investigations, which I chair, has conducted an extensive investigation and held a series of hearings delving into key causes of the financial crisis. As a part of that investigation, the Subcommittee has analyzed more than 400 RMBS and CDO securities. We have examined millions of pages of documents in connection with those securities and interviewed dozens of industry, government, and academic experts, including loan originators, securitizers, and firms that conducted third party due diligence reviews of ABS assets. We also held four hearings and released thousands of hearing exhibits.

Our first hearing, which featured Washington Mutual Bank (WaMu) as a case study, focused on that bank's origination, acquisition, and securitization of high-risk mortgages due to their relatively higher profit margins. The hearing exposed multiple loan quality and disclosure problems. For example, internal bank reports showed that two high-volume WaMu loan offices had been issuing loans containing fraudulent borrower and appraisal information; that senior management had been informed that the two offices had loan fraud rates as high as 58% and 83%; that the fraudulent loans were being included in some securitized loan pools; and that investors had not been informed about the fraud problem affecting those loan pools. The hearing also showed that, in one instance, WaMu assembled a $2.3 billion RMBS called WMALT Series 2007-OA3, which included loans that had been selected on the basis of criteria designed to identify loans that were likely to become delinquent, without that selection process being disclosed to investors and despite a representation that no adverse selection process would be used to assemble the loan pool.

A later Subcommittee hearing, which featured Goldman Sachs as a case history, focused on a completely different set of asset quality and non-disclosure problems. In one ABS deal involving a $2 billion synthetic CDO called Abacus 2007-AC1, Goldman Sachs & Co. represented to investors that an independent collateral manager, ACA Management LLC, had selected the referenced assets, without disclosing that Paulson & Co., a hedge fund with economic interests directly adverse to investors, had significantly contributed to the asset selection. By six months after the Abacus securities were issued, the referenced assets lost over 90% of their value. The Commission subsequently charged Goldman Sachs with defrauding the Abacus investors. Goldman Sachs later settled those allegations by paying a civil fine of $550 million.

In another example, Goldman Sachs assembled a $2 billion synthetic CDO, Hudson Mezzanine Funding 2006-1, which referenced poorly performing assets from its inventory to reduce its own risk, taking the $2 billion short position in the transaction opposite investors. The Goldman Sachs sales force sold Hudson securities to dozens of investors while implying to investors the firm had no adverse interest in the transaction. Within months of the issuance of the Hudson securities, the referenced assets began losing value. Within a year after that, the Hudson investors had incurred substantial losses, while Goldman Sachs gained nearly $2 billion in profits from its short position.

As part of its investigative effort, the Subcommittee reviewed numerous documents showing how WaMu, Goldman Sachs, and others went about acquiring home loans, selecting loans for inclusion in securitization pools, and evaluating the quality and likelihood that those loans would perform. Among other documents, we reviewed internal reports, internal and external audits, third party due diligence reviews, repurchasing analyses and requests, sales pitches, prospectuses, and related memoranda, emails, and correspondence. The Subcommittee also interviewed one of the largest firms that conducted third party due diligence reviews of residential loans underlying RMBS and CDO securities, including more than 2 million home loans for securitizers like WaMu, Goldman Sachs, Bear Stearns, Citigroup, Deutsche Bank, JPMorgan Chase, Lehman Brothers, Merrill Lynch, and others.

Information provided by that due diligence firm provides important context for understanding the proposed rule. The firm told the Subcommittee that the vast majority of its due diligence reviews used loan samples that were devised by the potential loan buyer. It also said that the samples typically represented 10% or less of the loan pool, were not constructed to be statistically valid, and produced results that could not be extrapolated to an entire loan pool. The firm explained that its due diligence reviews consisted primarily of testing loan files against the loan tape to see if the information provided in the loan tape was accurate; evaluating the loans to determine whether they complied with state and federal lending laws; determining whether the loans met a set of underwriting guidelines provided by the loan seller; and flagging all loans that did not meet criteria specified by the potential loan buyer. The firm indicated that the underwriting guidelines provided by loan sellers varied from job to job, deteriorated from 2005 to 2007 to allow higher risk loans, and did not always provide information that would enable an investor to evaluate the loan quality. The firm indicated that the buyer criteria also varied dramatically, and often included elements that would be of little interest to investors. The firm explained that, after conducting its testing, it graded individual loans in the given sample with a "1" if the loan met the seller guidelines and buyer critieria; a "3" if the loan did not; or a "2" if a minor problem caused the loan to fail to meet the guidelines or criteria. The potential loan buyer could then choose to "waive" the problems affecting the loans carrying a "2" designation, or enter into an agreement with the loan seller to cure the identified problems. The firm often performed a similar grading exercise for loans tested for compliance with state and federal laws. The firm told the Subcommittee that its loan designations were meaningless without disclosure of the controlling guidelines and criteria, since weak guidelines and criteria could be used to produce "1" designations for poor quality loans.

The Subcommittee's investigation uncovered convincing evidence that, for many RMBS and CDO securities issued in 2006 or 2007, asset quality was poor, due diligence efforts were limited, and the disclosure provided to investors was wholly inadequate. One measure of the poor asset quality is evidence showing that over 90% of the AAA ratings given to nonprime RMBS securities during 2006 and 2007 have since been downgraded to junk status. Restoring investor confidence in these and other ABS securities will require a concentrated effort that must begin with meaningful asset quality reviews that are disclosed to investors. Past due diligence reviews as well as the case histories involving WMALT Series 2007-OA3, Abacus 2007-AC1, and Hudson Mezzanine Funding 2006-1 exemplify why the proposed rules need to mandate minimum review standards, disclosure of seller and buyer loan review criteria, and disclosure of potential conflict of interests.

Recommendations

Coordination with Section 942(b). Sections 945 and 932 do not stand alone; they are part of a larger set of statutory provisions intended to revitalize the ABS markets. Each needs to be interpreted in connection with other key ABS provisions in the Dodd-Frank Act. One such provision is Section 942(b) which directs ABS issuers to "disclose, for each tranche or class of security, information regarding the assets backing that security" including "asset-level or loan-level data, if such data are necessary for investors to independently perform due diligence." While Section 942(b) requires disclosure of data needed for investors to perform their own due diligence analysis, Section 945 requires the ABS issuer itself to review its assets and make its findings and conclusions available to investors in the security's registration statement. Both provisions focus on providing investors with the data needed to evaluate asset quality, and regulations relating to them ought to be designed in an integrated fashion with that objective in mind. Perhaps the best way to distinguish between the provisions is to view Section 942(b) as requiring issuers to provide investors with useful quantitative data on the assets in a pool, while Section 945 focuses on requiring issuers to conduct an intensive analysis of a sample of the assets and use that analysis to provide investors with conclusions about the pool as a whole.

Minimum Review Standards. The proposed rule currently requires issuers to conduct an asset review and disclose the findings and conclusions to investors, without providing any additional guidance on the nature of the review to be conducted or the findings and conclusions to be disclosed. Minimum review standards are essential, however, to ensure that the required review provides investors with meaningful information about asset quality.

For RMBS securities, for example, the minimum review standards should require disclosure of key indicators of loan quality, such as the loans' weighted average FICO scores, combined loan-to-value ratios, borrower debt-to-income ratios, and the absence of data suggesting loan fraud. Such indicators are already well developed in the mortgage industry, and could easily be identified. The proposed rule should specify key indicators for each asset class to ensure investors have the data needed to evaluate the quality of the pooled assets. Again, such indicators are already well developed in ABS markets. To display this information, the proposed rule could require use of a table in a specified format, in the same manner as the proposed rule requiring disclosure of repurchasing information, to ensure the information is presented in a clear, organized, and consistent manner.

In addition to mandating disclosure of information on key indicators, the minimum standards should require issuer reviews to use a statistically valid sample of assets whose analysis could be extrapolated to the entire asset pool. If the rule fails to include this requirement, findings and conclusions arising from analysis of the asset sample will be unable to be used by investors to evaluate the asset pool as a whole. A minimum sample size could also be specified to ensure a level playing field and that no issuer could gain a competitive cost advantage by using smaller sample sizes. The size of the sample and the selection parameters used in the issuer's review could also be disclosed to investors to assist in their understanding of the data.

Minimum review standards that mandate disclosure of key indicators and use of statistically valid asset samples would not only ensure that investors have meaningful data, but also allow investors to use consistent data elements to compare similar ABS securities. Displaying the data in a prescribed table would also make it easier for investors to comprehend and use the information. Consistent data across ABS securities would also enable analysts, regulators, and policymakers to deepen their understanding of ABS financial products, trends, and problem areas. In contrast, mandating issuer reviews without specifying minimum review standards would likely produce a bewildering variety of asset analyses that may not allow analysts to evaluate entire asset pools or compare ABS securities.

A related issue involves the proposed rule's current requirement that issuers provide their review's "findings and conclusions" to investors, without providing further guidance on what is meant by those terms. A better approach would be for the proposed rule to provide minimum findings and conclusions that should be included in each review. Those findings might include, for example, in a RMBS review, identifying what percentage of the reviewed loans in a sample: (1) confirmed the information in the loan tape; (2) contained adequate paperwork for the mortgage; (2) confirmed the mortgaged property's value; (3) complied with federal and state law; (4) contained no fraud indicators; and (5) met the seller's underwriting guidelines, supplemented with a description of those guidelines. These types of findings can be provided by due diligence firms today and would not require any change in industry practices.

The proposed rule could also identify minimum conclusions that must apply, not just to the asset sample, but to the asset pool as a whole. Those conclusions could include, for example in an RMBS review, that the review provides reasonable assurance that the loan tape is accurate for the entire loan pool, the pool's mortgage paperwork is adequate, the pool's property values are reasonably accurate, the loans comply with federal and state law, the loan pool is free of fraud, and the loans meet the specified underwriting guidelines. Those types of conclusions could help restore investor confidence in ABS asset quality. If the proposed rule were instead to continue its current course of providing no guidance on review findings and conclusions, the result will likely be a hodge podge of inconsistent findings and conclusions that investors will be unable to rely on or use to compare ABS securities. In addition, that approach would place securitizers who want to provide meaningful reviews at a competitive cost disadvantage compared to those providing limited information.

Issuer reviews would not, of course, be limited to presenting the data or conclusions prescribed in minimum review standards. Additional useful information could be encouraged, including data on the type of assets being offered, the historical performances of those or like assets, why certain assets were selected or excluded, the deal structure, the identity and performance of the asset originators, and other aspects of the securitization process. As set out in the proposed rule, the review could also explain how and why certain assets in the pool deviate from criteria expressed in the prospectus.

Third Party Due Diligence Reviews. Unlike issuer reviews, Section 932 does not mandate third party due diligence reviews of ABS assets, but instead provides that when an issuer or underwriter obtains such a third party review, it must disclose to investors the review's findings and conclusions. This statutory requirement arises from the common sense view that third party due diligence reviews produce material information that a reasonable investor would want to know.

One key issue here is that third party due diligence reviews typically evaluate a sample of assets according to underwriting guidelines provided by the asset seller and other criteria specified by the asset buyer. The underwriting guidelines and buyer criteria vary widely among due diligence reviews. The typical end product of due diligence reviews in the mortgage field is the grading of specific loans in a sample provided by the asset buyer, according to whether the loans meet the seller guidelines and buyer criteria or whether they comply with state or federal law. For investors to be able to understand the loan "grades" and evaluate the quality of the reviewed assets, however, investors will need to know what underwriting guidelines and criteria were used to produce the loan designations. Without disclosure of the controlling guidelines and criteria, the review itself – and the loans it deems as meeting or failing to meet the guidelines and criteria – will be of little use to investors.

The proposed rule should also require issuers to disclose third party assessments that were not solicited "for purposes of reviewing the pool of assets," but nevertheless produced asset quality data or information that a reasonable investor would want to know. In addition, the proposed rule should require third party reviews to include a discussion of the third party's overall relationship with the issuer, including whether it acts as a consultant or contractor or provides other services to the issuer beyond due diligence reviews, so that investors can evaluate the third party's level of independence from the issuer.

Unregistered Securities. The proposal requests comment on whether it should extend the issuer and third party review requirements to unregistered ABS securities by conditioning the registration exemption on conducting such reviews. Given the outsized role of unregistered CDOs in the recent financial crisis, the continued use of financial engineering to develop complex, unregistered ABS securities, and the ongoing need to strengthen investor confidence in ABS markets, it would make sense to include unregistered securities within the ambit of the issuer and third party due diligence review requirements. Exempting them from the review requirements would create instead an unwarranted incentive for issuers to favor unregistered securities. Extending the review requirement to unregistered securities would also help carry out the statutory objective of restoring investor confidence in the ABS markets by increasing investor access to asset quality information. Providing asset quality reviews to investors would also constitute a reasonable requirement for issuers seeking to sell unregistered ABS securities to U.S. investors.

Conflicts of Interest. Finally, the proposed rule should be strengthened by improving its coordination with Section 621's prohibition against conflicts of interest in asset-backed securitizations. The proposed rule could accomplish that objective by mandating that issuer reviews include a discussion and assessment of any potential conflicts of interest that could affect the quality of the assets in the security.

That discussion could provide, for example, a description of the asset selection process, including the roles played by different units within the issuer, any long or short investor, or any collateral manager or other third party. It should disclose any reason why a person involved in the selection process might favor assets expected to lose value. In addition, the discussion could indicate whether the issuer expects the assets to lose value, whether the assets were selected using criteria indicating that they were likely to lose value, whether the issuer or another person involved in the selection process has or intends to take or maintain any type of short position, and the size of that position, with respect to the ABS assets during the first year after the securities are issued, and any other reason that the issuer or another person involved in the selection process might favor the selection of assets expected to lose value.

The proposed rule should make it clear that information regarding any potential conflict of interest that might affect the selection or structuring of the assets in an ABS security is material information that a reasonable investor would want to know and, as such, must be disclosed in the issuer review appearing in the security's registration statement.

Thank you for the opportunity to comment on this proposed rule.

Sincerely,

Carl Levin

Carl Levin
Chairman
Permanent Subcommittee on Investigations