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It Is Statutorily Required that the Buck Stops Here: Risk Retention Requirements in the Dodd-Frank Wall Street Reform and Consumer Protection Act

Andrew Bradford*

I. Introduction

Congress signed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or the "Act") into law in July of 2010. The Dodd-Frank Act gives governmental regulators a significant increase in the power they can wield over financial services institutions and, at over 2300 pages long, covers a wide variety of previously unregulated practices. Title IX, Subtitle D, of the Dodd-Frank Act seeks to address problems with the asset-backed securitization process, most notably the creation and sale of a collateralized debt obligation (CDO). Incredibly complex by design and once seldom discussed outside the world of structured finance, these CDOs were thrust into the public consciousness as the "toxic assets" that began losing tremendous amounts of value in 2007 and precipitated the global financial crisis. This Comment describes the inherent problems in the creation and issuance of CDOs backed by subprime mortgages and examines the measures Congress has taken in an attempt to regulate CDO issuance. In addition, this Comment will analyze the Dodd-Frank Act's potential success or failure as well as the effects it will have on both governmental enforcement and private litigation against large financial institutions.

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2. Rivaled perhaps only by "shadow banking system" in terms of popular fear-inducing catchphrases.
3. It should be noted that, although the concept is inextricably intertwined with the ideas presented below, this Comment does not address the notion of "too big to fail." While one might argue that this is the underlying failure and banks simply monetized the problem, this Comment attempts to address only specific legislation. 

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II. BACKGROUND

A. Collateralized Debt Obligation Creation and Issuance

Residential Mortgage Backed Securities (RMBSs) represent one type of CDO that has gained considerable attention. RMBSs are bonds backed by a portfolio of residential mortgage loans that are tranched into various levels of credit risk. Banks were looking for ways to make profits in an area that became crowded with many other players that acted as lenders. Banks thought profit could be made beyond merely the interest on loans. Instead, banks thought they could divest themselves of the loans' risk, thereby freeing up capital to use for other ventures. This lucrative practice has an obvious advantage—the more capital available for loans, the greater the potential for profits. With a rapid rise in home ownership, however, many individuals received mortgages who might not have otherwise qualified for traditional mortgages; these individuals are known as subprime borrowers.

Generally, issuers of subprime mortgages are mortgage banks or brokers who sell their loans to investment banks, as opposed to commercial banks that deal with more traditional mortgages and guarantee their loans through government enterprises. The issuer of the mortgages aggregates many loans issued in a certain geographical area and subsequently sells these loans to a shell company called a special purpose entity (SPE) or special purpose vehicle (SPV). By using two tiers of SPEs, the assets move beyond the reach of the originator or its creditors and thus the structure is considered “bankruptcy remote,” meaning that if the originator goes bankrupt, the investor’s right to receive payments from the underlying assets will not be affected.

8. Id.
10. Tavakoli, supra note 4, at 8.
The first tier is an SPE that is a wholly owned subsidiary of the mortgage bank and the second is an independent entity.\footnote{Id.}

After bundling the mortgages into bonds, the SPE resells the product, now termed an “asset-backed security,” to an underwriting firm, which in many instances is an in-house operation of a large investment bank.\footnote{Id. at 16.} The sale of the securities allows the SPE to purchase additional loans, and through this arrangement, the process repeats itself. The investment bank’s function is to operate as the “securitizer.” It bundles the bonds once again into a CDO, a process that involves sorting the bonds into a series of tranches that combine to form the CDO as a whole.\footnote{Id. at 4.} A tranche is a slice of the CDO that represents varied levels of risk corresponding to the likelihood of default on the loans within that tranche. Tranching creates multiple classes of debt where banks pay investors in “junior” tranches a higher rate of return on their investment because they agree to take losses before the senior debt holders, who hold “safer” debt.\footnote{Id. at 120.} Additionally, the tranche system creates a “waterfall,” which means that banks pay investors in the order of the seniority of tranche the investors hold.\footnote{Kathleen C. Engel & Patricia A. McCoy, Turning a Blind Eye: Wall Street Finance of Predatory Lending, 75 Fordham L. Rev. 2039, 2047 (2007).} This means that when defaults occur in any underlying asset, the senior tranches are the first ones to receive payment, but each tranche’s payout is reduced by a fraction corresponding to an agreed upon definition in the security’s contractual materials.\footnote{Id.} As more and more mortgages default, the payout will approach zero.

Creating tranches is a way to price securities that may be difficult to price in their individual forms; it also opens up the loan market to investors who may not otherwise be able to engage in higher-risk investments.\footnote{Jones, supra note 5.} A single loan might have a very high risk of default (and so naturally, one would be wary of extending credit for this loan), but in a security composed of many loans, it should become increasingly unlikely that all will default. Therefore, investors will be willing to lend to a greater number of people who otherwise might not have been able to obtain a loan because the investors know that they have a greater chance of receiving a positive return on their investment. While the tranches must necessarily contain the underlying risk of the individual loans, prior to the 2008 crisis, the idea was that some level
of diversification was achieved. The belief was that mathematical models would allow investors to clearly recognize the risk in each tranche and invest according to their own needs or preferences. The models, however, failed to correctly analyze potential losses, a topic that will be addressed below.

Creating a tranche required the loans to receive a rating from one of several large credit ratings companies. Standard & Poor's ratings are as follows, in descending order from perceived lowest to highest risk: AAA, AA (senior investment grade), A, BBB, BB, B (investment grade or mezzanine/subprime mezzanine). The ratings scale continues below B grade, but these bonds are supposed to be located within an unrated "equity tranche." This bottom-rung tranche was meant to absorb the initial losses in the event of a default and would often receive only residual cash flow once the other banks had paid off the other classes. Tranche ratings reflected the quality of the underlying assets, as well as how much cash-flow protection a tranche is afforded by subordinate tranches. Ratings were achieved by analyzing variables such as the diversity of the loans within a tranche, but not necessarily the actual ability of the individual borrowers to repay these loans. Because no one was expected to buy asset-backed securities by looking at individual loans, CDO buyers ignored the possibility that banks could have issued many of these loans to borrowers who had no real possibility of repaying them.

Further complicating the process was the fact that ratings agencies often did not have their own models for how to properly determine credit risk in a CDO, all while attempting to rate an enormous amount of new offerings. Where models did exist, they were often an automated process with little oversight. Additionally, with the advent of "CDO squared," ratings agencies would then rely on their own, usually not fully accurate, ratings on the first level of assets to attempt to assign a rating for the end product. Next, when a bank asked an

18. Id.
19. Moody's and Standard & Poor's controlled the vast majority of the market.
20. Bethel et al., supra note 6, at 9.
21. TAVAKOLI, supra note 4, at 4.
22. Id. at 10.
23. Id. at 9.
25. See MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE 97 (W. W. Norton & Co., Inc. 2010) (providing an extreme example in which a bank lent to a migrant strawberry picker the full amount needed to purchase a $724,000 house, even though the picker had an annual income of less than $20,000).
27. Id. at 20.
agency to evaluate a product previously rated by a competitor, the agency would often simply take the rating and decrease it by one notch with the idea that this practice would safeguard against any potential errors in the first rating process. The process became so convoluted that banks often would provide their own rating models and the agency would rubber stamp the model.

In the final step, investment banks sold the completed CDOs, and the securitizer would potentially receive two forms of revenue: cash from the actual sale and the “excess spread,” which is any interest in excess of that owed to investors. The securitizer could capture these excess spreads by providing “credit enhancement” to the CDO; basically, through the structure of the CDO, the agencies could give the senior tranche a higher credit rating because the junior tranches would suffer the first losses. This excess spread was the source of the majority of profits for securitizers.

B. Later Developments in the Process

So popular were mortgage-backed CDOs that the demand for subprime bonds actually outpaced the supply. One way for banks to sidestep this problem was the creation of “CDO squared” and “CDO cubed,” which repackaged difficult-to-sell mezzanine tranches of already issued CDOs into completely new products. Through this process, the rating agencies often similarly rated the CDO squared across their tranches. The rating agencies, however, ignored the fact the banks composed the CDO squared of the lower rated tranches that the banks had difficulty selling in the first instance. An easy way to think of the situation is to answer this question: What will a securitizer be left with once a bank had issued a CDO? The answer is the rejected tranches that received the lowest ratings. These were the tranches that the banks repackaged into the CDO squared.

Additionally, products known as “synthetic CDOs” allowed investors to receive cash payments without the need for a physical borrower to buy a house by simply mimicking the performance of actual mortgaged-backed CDOs. This practice was achieved through the

28. Id.
29. Lewis, supra note 25, at 76.
33. Id. at 12.
34. Id. at 14.
35. Id. at 13.
use of contracts known as credit default swaps, which act like a form of insurance contract that protects against the default of an asset-backed security. A credit protection buyer pays a fee to a seller, called a credit protection provider, in exchange for a payment if a “credit event” occurs in the underlying assets. In a simplified form, the entity selling a credit default swap acts as the holder of a mortgage bond, receiving a certain premium per year for their insurance, while the investor would receive cash as the actual mortgage is paid off. Conversely, the investor or entity on the other side of the transaction gives up that premium in return for the promise that the banks will compensate the investor should the mortgage default. Credit default swaps serve as a protection against risk that the entity has already extended. But with the creation of the synthetic CDO, these swaps became a way to dramatically increase the market for mortgage-backed securities and, as a consequence, dramatically increase the risk posed by the securities by greatly expanding the market.

Synthetic CDOs also feature a top-level tranche dubbed “super senior,” which banks designed as a way to hedge against credit risk in their loan portfolios. Banks retained the super senior tranches on their balance sheets as a way to receive cash flow from what they considered impossible-to-default assets. This would offset any potential losses from the sale of lower rated tranches. While low-rated tranches might not default, they would decrease in value and could cause the bank to experience a loss in value without receiving any insurance payout for any credit default swap the bank purchased. Banks composed super senior tranches of assets similar to AAA tranches; however, two substantially similar CDOs might contain different sized super senior tranches without ratings agencies dubbing either an “incorrect” model. This means that one could line up two almost identical CDOs back-to-back and determine that one contained a greater percentage of “safe” assets than the other. Furthermore, credit rating agencies did not officially acknowledge the existence of super senior tranches and would again often simply rely on banks’ models for determining creditworthiness.

36. Id.
37. TAVAKOLI, supra note 4, at 47.
38. LEWIS, supra note 25, at 75.
39. Id.
40. TAVAKOLI, supra note 4, at 331.
42. TAVAKOLI, supra note 4, at 332.
43. Id. at 333.
traditional CDO allowed securitizers to introduce to the market and to their own balance sheets a tremendous amount of subprime risk that very few people thoroughly understood.44

Taken together, the creation of mortgage-backed CDOs in the years 1997 through 2006, when real housing prices in the United States rose about five percent per year, created substantial problems and risks.45 The underlying loans were often of poor quality and the structure of CDOs allowed risks to be hidden or glossed over. Also, CDO derivatives over-leveraged the amount of risk in the market, and institutions bought CDOs without understanding the risks they contained. Finally, ratings agencies approved classifications that had very little relation to the actual quality of the product. When this house of cards came crashing down, first silently in 2007, then with a bang in 2008, many began to attempt the difficult process of sifting through the murky world of CDOs and regulating the creation and issuing processes.

III. THE DODD-FRANK ACT

Introduced in late 2009 by Representative Barney Frank46 and Senator Christopher Dodd,47 the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law on July 21, 2010.48 Title IX, Subtitle D, of the Act is entitled “Improvements to the Asset-Backed Securitization Process.”49 Section 941 proposes that this Subtitle amend Section 3(a) of the Securities Exchange Act of 1934. The Act defines an originator as a person who “(A) through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security; and (B) sells an asset directly or indirectly to a securitizer.”50 The Act defines a securitizer as “an issuer of an asset-

44. Lewis, supra note 25, at 143 (indicating that the creation of the synthetic CDO was required by the simple fact that there were not enough Americans taking out loans to supply investors’ demand for actual mortgage-backed CDOs).
45. Bethel et al., supra note 6, at 17.
47. Mr. Dodd was a democratic Senator for Connecticut and was the Chairman of Senate Committee on Banking, Housing, and Urban Affairs from 2007 until 2011. History of Chairmen of the Senate Banking Committee, SENATE BANKING COMMITTEE, http://banking.senate.gov/public/_files/ChairmenoftheSenateBankingCommittee.pdf (last visited Nov. 15, 2011).
49. Id. sec. 941(a), § 3(a) (codified at 15 U.S.C. § 78c(a) (Supp. 2010)).
backed security” or “a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.”\(^5\)

The main focus of section 941 is the risk-retention requirement. The Act requires that any securitizer must retain an economic interest in “a portion of the credit risk for any residential mortgage asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party.”\(^5\) The amount of risk that banks must retain is at least five percent of the credit risk to any asset in an asset-backed security that is not a qualified residential mortgage.\(^5\) The same is true if the asset is securitized with assets that are not qualified residential mortgages.\(^5\) Additionally, the section prohibits the securitizer from hedging or transferring the required amount of retained credit risk.\(^5\)

The Act additionally recognizes that further rulemaking will be required to determine how to allocate risk retention requirements between securitizers and originators.\(^5\) The Act provides that federal banking agencies must

(1) reduce the percentage of risk retention obligations required of the securitizer by the percentage of risk retention obligations required of the originator; and

(2) consider—

(A) whether the assets sold to the securitizer have terms, conditions, and characteristics that reflect low credit risk;

(B) whether the form or volume of transactions in securitization markets creates incentives for imprudent origination of the type of loan or asset to be sold to the securitizer; and

(C) the potential impact of the risk retention obligations on the access of consumers and businesses to credit on reasonable terms, which may not include the transfer of credit risk to a third party.\(^\)\(^5\)

This provision suggests that a securitizer may be able to escape its duty to retain risk if the originator is already retaining risk itself. For reasons discussed later in this Comment, this reading of the statute may prove problematic. Additionally, the language in subsection (2)(B) may be especially important because a large force driving the


\(^5\) Id. sec. 941, § 15G(b)(2) (codified at 15 U.S.C. § 78o-11(b)(2) (Supp. 2010)).

\(^5\) This phrase is defined in the next paragraph.


\(^5\) Id. sec. 941(b), § 15G(c)(1)(A) (codified at 15 U.S.C. § 78o-11(c)(1)(A) (Supp. 2010)).

\(^5\) Id. sec. 941(b), § 15G(c)(1)(F) (codified at 15 U.S.C. § 78o-11(c)(1)(F) (Supp. 2010)).

\(^5\) Id. sec. 941(b), § 15G(d)(1)–(2) (codified at 15 U.S.C. § 78o-11(d)(1)–(2) (Supp. 2010)).
creation of subprime-backed CDOs was the appetite of investment banks for these types of instruments.

The Act modifies the risk retention requirement by allowing HUD and the FHA to define and exempt “qualified residential mortgages.” These mortgages are ones that historical loan performance data should indicate contain a lower risk of default. Lower risk will be determined by “documentation and verification of the financial resources relied upon to qualify the mortgagor” and standards such as:

(I) the residual income of the mortgagor after all monthly obligations;
(II) the ratio of the housing payments of the mortgagor to the monthly income of the mortgagor;
(III) the ratio of total monthly installment payments of the mortgagor to the income of the mortgagor . . . .

In essence, a borrower who receives a clean bill of health under these factors will be one who would have received a traditional, as opposed to subprime, loan in the past. As described previously, commercial banks generally provided these types of loans and the government insured the loans. While these loans were in the CDO pools as well, their credit-worthiness would potentially allow them to stand on their own without the need for securitization. Additionally, the Act looks beyond the individual borrower to aspects of the loan itself, such as:

(iii) mitigating the potential for payment shock on adjustable rate mortgages through product features and underwriting standards;
(iv) mortgage guarantee insurance or other types of insurance or credit enhancement obtained at the time of origination, to the extent such insurance or credit enhancement reduces the risk of default; and
(v) prohibiting or restricting the use of balloon payments, negative amortization, prepayment penalties, interest-only payments, and other features that have been demonstrated to exhibit a higher risk of borrower default.

Thus, like the provisions addressing the borrowers themselves, the Act attempts to restrict or prohibit particularly risky types of loans.

58. Id. sec. 941(b), § 15G(e)(4) (codified at 15 U.S.C. § 78o-11(e)(4) (Supp. 2010)).
Such loans feature balloon payments, negative amortization, or interest-only payments, which are often features of subprime mortgages, and almost always feature an adjustable rate.\textsuperscript{63} Many of these mortgages can contain considerable danger to a borrower, especially when the borrower may not realistically be able to make payments on such a loan. For example, a "hybrid adjustable rate mortgage" has a low fixed rate for an initial period (perhaps a year or two), then resets every six months beyond that based on a benchmark interest rate.\textsuperscript{64} These subsequent rates are often much higher than the ones during the initial period. A particularly hazardous mortgage called an "interest-only negative-amortizing adjustable-rate subprime mortgage"\textsuperscript{65} allows a borrower to roll over any interest payments owed into a higher principle balance.\textsuperscript{66} All of these are now under greater scrutiny.

Section 942 of the Act also requires that issuers of asset-backed securities disclose loan or asset-level data by stating that the Commission shall

(A) set standards for the format of the data provided by issuers of an asset-backed security, which shall, to the extent feasible, facilitate comparison of such data across securities in similar types of asset classes; and

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

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

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

(iii) the amount of risk retention by the originator and the securitizer of such assets.\textsuperscript{67}

These disclosure requirements are intended to assist investors' due diligence reviews, but the Act further requires that the SEC issue rules requiring issuers of asset-backed securities to conduct and disclose the results of their own review of the underlying assets in an asset-backed security.\textsuperscript{68}

\textsuperscript{63} Bethel et al., \textit{supra} note 6, at 8.

\textsuperscript{64} \textit{Id.}

\textsuperscript{65} If an acronym for this exists, it is seldom, if ever, seen.

\textsuperscript{66} \textit{Lewis}, \textit{supra} note 25, at 28 ("It wasn't hard to see what sort of person might like to have such a loan: one with no income.").

\textsuperscript{67} Dodd-Frank Act sec. 942(b), § (c)(2)(A)–(B) (codified at 15 U.S.C. § 77g(c)(2)(A)–(B) (Supp. 2010)).

Taken as a whole, the Act addresses many key problems, yet leaves others in a curious state of limbo. The next section will address some of these issues.

IV. DISCUSSION

A. Linguistic Contortions

In large part, beyond the failings of the instruments themselves, a lack of risk retention contributed to the severity of the mortgage crisis. Many authors have suggested that credit derivatives changed the traditional notion of how the banking system worked. While at one time banks would need to meet with and evaluate the party on the other side of the transaction to determine whether the investment was sound, derivatives squashed this antiquated notion. With derivatives, it did not matter if the loans were bad or not because the banks could trade the risk away. While increasing risk retention is at the heart of the Act, once one gets beyond the philosophical underpinnings of how the banking system should work, several problems arise in the Act's language.

Risk retention is important because it is tied to how much capital a bank must keep on its balance sheet. Risk retention reserves, in the end, determine what percentage of a bank's debts can be paid with short-term assets. The large banks all owe each other tremendous amounts of money and so on down the line until it becomes clear why "systemic risk" is such a concerning phrase. The impact of large institutions entering bankruptcy and the corresponding fears that the banks will not repay their debts are all too vividly etched into the minds of investors and the public at large after the events of 2008.

Requirements seeking to minimize the impact of risk have been around for some time. For example, the "G-10" nations, as well as Spain, signed the Basel I Accord in 1988. Basel I required banks to hold capital equal to eight percent of their risk-weighted assets. Banks did not like these rules because any capital that they needed to retain was capital that they could not use for additional, hopefully lu-

70. Id.
72. Id. at 3.
creative, investments and loans. The early forms of CDOs were explicit attempts by banks to circumnavigate the rules. With this as an overarching consideration, the language used in the Act must be analyzed for any loopholes, as banks will certainly be doing.

As mentioned above, one of the more critical provisions in the Act that requires clarification is that of a “securitizer.” The Act language uses “securitizer” in two different ways.

1. Securitizer as an Issuer of an Asset-backed Security

The first definition of securitizer, “an issuer of an asset-backed security,” would seem to logically suggest that this refers to SPVs or SPEs. A crucial step in the chain of CDO creation is the SPV. Originators construct SPVs primarily as shell companies that are supposed to protect investors by being bankruptcy-remote from the originators. By buying and selling the underlying assets, the SPVs are technically “off balance sheet” in that, legally, the assets are owned by the SPV, not the bank. This is, of course, one of the SPV’s many legal fictions. Even though the originator should not have access to the assets, the disposition of the assets is more often than not dictated by the entity that structured the SPV. Originators still oversee the assets, but in an ideal world, the originators have removed all the risk by selling off the assets through the SPVs. This is illustrated by the very first credit default swap, J.P. Morgan’s 1997 “Broad Indexed Secured Trust Offering” (BISTRO): the bank actually sliced up the SPV into tranches, against which it then sold insurance contracts. Thus, originators can claim to have divested themselves of the assets, and theoretically the risk as well, without this actually being the reality of the situation.

Another legal fiction of the SPVs is their very existence. The SPVs exist solely as a dumping ground for the underlying assets and in many cases, though technically independent entities, the parent company is

73. LANCHESTER, supra note 69, at 67.
74. Id. at 68.
76. See TAVAKOLI, supra note 4.
77. CASSIDY, supra note 69, at 272.
78. TAVAKOLI, supra note 4, at 10.
79. CASSIDY, supra note 69, at 272.
still attached to them economically.\textsuperscript{81} To assuage investors' concerns about buying assets from these unknown companies, banks gave the SPVs guaranteed credit lines: the ability to access the banks' capital at will.\textsuperscript{82} Lastly, an eccentricity of SPVs is that the "liquidity facilities"—basically the way the banks' credit lines reached the SPVs—were surprisingly ephemeral creatures. Because the timing of various cash flows was not perfectly in sync, banks used these liquidity facilities as a protection against the risk contained in the assets in the SPV.\textsuperscript{83} But the aforementioned Basel regulations on capital requirements applied to any credit line in existence for one year or more.\textsuperscript{84} However, banks circumvented this requirement by simply engineering the liquidity facilities to exist for 364 days, at which point the banks paid a fee to renew them.\textsuperscript{85}

Thus, the realities of SPVs mean that any risk retention rule applying solely to them would be meaningless. On one hand, by buying the underlying assets, the SPVs already technically contain all the risk. On the other hand, the risk retained by these vehicles did not remain in them. When a bank offers the SPVs temporary, yet unlimited credit lines, they are still responsible for any losses that may occur. For instance, losses might occur when one party is unable to pay due to defaulting mortgages and when another party is unwilling to pay due to its own liquidity concerns. Further, if banks can avoid existing capital requirements due to the short duration of the vehicles, requiring risk retention solves nothing. The risk already exists. Before the financial meltdown, banks simply were not forced to compensate for its presence. Now, any change in the use or control of SPVs would seem to come about by economic necessity, not regulatory intervention. When banks realized how unstable SPVs actually were, it was in their own best interest to cease or seriously reevaluate the practice. One final note on how a purely SPV-based risk retention requirement is meaningless: as of this writing, none currently exist. The final SPV to close, "Sigma Finance," was shut down in 2008 when J.P. Morgan

\begin{footnotesize}
\begin{itemize}
\item[81.] \textit{Id.}
\item[82.] \textit{Id.} As Cassidy remarks of the double standard, "[shell companies] were still attached to their parents, like well-to-do college students." \textit{Cassidy, supra} note 69, at 272.
\item[83.] \textit{Tavakoli, supra} note 4, at 38.
\item[84.] \textit{Lanchester, supra} note 69, at 120.
\item[85.] \textit{Tavakoli, supra} note 4, at 38.
\end{itemize}
\end{footnotesize}
cut off its credit line. The manager of that SPV was a group called Gordian Knot, a wonderfully appropriate name.

2. Securitizer as a Person Who Organizes Transactions

The second definition of "securitizer" in the Act is "a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer." This would seem to apply the definition to originators, a term commonly applied to the large investment banks that created the CDO process. At a base level, originators of asset-backed securities profit more from the quantity of the underlying loans than anything else, which provides an incentive to push through more loans. The sale of CDOs was not the main objective of originators; rather, the real money was in the fees they could charge customers by acting as the intermediary. Indeed, so many CDOs were sold that the returns offered to investors to accept the extra risk actually decreased. This was illustrated towards the end of the vast, failed experiment: "[in] 2003, the yield on subprime RMBSs was two to three percentage points higher than the rate on prime RMBSs: from 2004–2006, the gap fell to one to two percentage points."

Additionally, many originators purposely retained tranches of the CDOs they had created. Through its language, the Act prevents some of these actions, but is possibly inapplicable to others. An originator might have kept some of the super senior tranches on their books late in the game because there simply was not a market for them. When the yield on the subprime mortgages dropped between 2004 and 2006, the banks, instead of reducing the output of CDO sales, continued the steady supply and simply retained the super senior tranches because the yield, and therefore the investors' demand, was reduced. In some instances, individual banks ended up retaining more than fifty billion dollars worth of these tranches. Similarly, as noted above, banks retained the tranches willingly because they were considered a

87. Id.
89. LEWIS, supra note 25, at 215.
90. CASSIDY, supra note 69, at 273.
91. Id.
92. Id.
93. Id.
source of stable income. Once again, banks were already thinking about risk retention and capital requirements. Through credit default swaps, a bank could supposedly eliminate any risk present in the senior tranches and wind up, in effect, holding only the “safe” super senior tranches. The banks considered these tranches to be so safe that a bank could declare itself fully hedged even if it had sold off all the senior tranches and retained only the super seniors. After all, these were “risk-free” tranches. When a bank was fully hedged against any risk and yet still enjoying profits from the super senior tranches, this was indeed optimal because it could make an arbitrage profit.

A further practice of banks, often arising out of necessity, was to retain the equity tranches of a CDO. A common scenario, because a bank would in effect choose the assets that made up a CDO, would be to retain this tranche because it would suffer the first losses. Theoretically, if a bank had its own money and reputation at stake, it might be more careful selecting the underlying assets than it would otherwise.

As one commentator explains,

[T]he equity tranche bears a large share of the CDO’s risk but only a small share of the notional exposure amount. When a bank transfers credits from its balance sheet into a CDO but retains the equity tranche, it has transferred nearly all of the notional exposure but much less than all of the credit risk. Banks often did such balance sheet CDOs where equity tranche risk was retained, especially in the early days of the credit derivatives market (late 1990s), but some market participants may not have understood that the amount

94. Salmon, supra note 41.
95. Recall from above that credit default swaps act as a sort of insurance agreement, with periodic payments going to one party in exchange for a large, lump sum payment in the event of a default on the underlying assets. Of course the tranches were still on the books, but the thought was that the risk had been passed along to another party. See Tavakoli, supra note 4, at 47.
96. Salmon, supra note 41.
97. Id. (indicating that the banks were not, as it happened, fully hedged; however, the prevailing theory at the time was that the number of mortgages needed to default before the super senior tranches lost value could never happen).
98. Id. Arbitrage describes a transaction that produces theoretically risk-free profits by taking advantage of a mispricing in a market or between two markets. Chisholm, supra note 31, at 4.
99. Recall that the equity tranches receive the lowest payment priority and, even before the mortgage crisis, were not considered “investment grade” securities. See Bethel et al., supra note 6, at 10.
of risk transfer occurring in these transactions was smaller than the
notional amounts involved may have suggested.  

By the nature of its construction, a CDO cannot contain an equal
level of risk across its tranches; if it did, the “waterfall” payout model
would not work because the primary purpose of the model was to
allow the pricing of tranches based on preference for differing levels
of risk. Basically, the equity tranche must contain, at least in a perfect
world, a large amount of the total risk the CDO is carrying.

Another upside for banks was what could be accomplished with the
problematic assets of previously issued CDOs. Through a repack-
aging process, the banks could use tranches composed of what was
supposed to be triple-B rated assets and create a completely new
CDO. Despite the level of care that ratings agencies such as
Moody’s and Standard & Poor’s were supposed to exercise, banks dis-
covered that through reclassifying the loans, anytime a CDO was run
through a rating agency’s models, it would come out rated as if it were
composed of about eighty percent triple-A bonds. This meant that
the banks could simply repackage any assets that otherwise did not
appeal to investors into new CDOs, thus selling triple-B bonds for
triple-A prices, the above-described CDO squared.

B. Upsides and Downsides

In one area, the Act addresses very real concerns: it most notably
prohibits banks from hedging or transferring any of the five percent of
the risk that they are required to retain. This is a sensible, if unwel-
come, rule for two reasons. First, as demonstrated, the banks might
not be effectively hedging their risk, despite their best belief. This
ineffective hedging would become a moot point, since assumptions or
speculation about which assets carry risk would no longer be a factor.
When the financial instruments are so lacking in transparency, often
by design or deceit, it seems much safer to assume that the possibility
exists of any and all of the mortgages defaulting. Second, hedging risk
does not eliminate risk; rather, hedging merely reduces it, often
by transferring the risk to another party. Once again, without trans-
parency, there is a very real chance that such a party does not know
the nature or extent of the risk they are receiving. Thus, the five-

101. Id.
102. Lewis, supra note 25, at 129.
103. Id. at 140.
104. Id.
(Supp. 2010)).
percent-retention rule of the Act seeks to address such systemic risk concerns.

Common sense should dictate, however, that a solution of simply mandating the retention of five percent of the securitized risk is really no solution at all. A look at the common practice of retaining the equity tranches reveals this problem. As mentioned previously, a CDO attempts to structure the amount of risk in the tranches, with the intention that the equity tranches carry higher levels of that risk. When investor sentiment demands it, banks retain these tranches as a measure of goodwill. What this creates, however, is a situation in which the bank will already be holding the five percent, or possibly more. When this risk is on the balance sheets, credit problems like those experienced in 2007 and 2008 can arise.

The problem becomes even more complex when banks attempt to hedge their risk. What the Act leaves completely unclear is the use of the retained risk as collateral. This practice contributes substantial risk since a bank’s inability to repay its own loans on top of the loss of value in the underlying tranche used as collateral is doubly problematic. Before its demise, Bear Stearns had used an astonishingly simple method of obtaining capital: it had borrowed money by using the value of its retained super and super senior tranches as collateral.106 When the value of the underlying assets started to decline, Bear Stearns sold the assets at a loss to appease the creditors.107

Another form of effectively using risk as collateral is the “leveraged super senior trade.”108 In this case, investors (usually other banks) again performed a similar action: loaning money for very short periods (usually less than ninety days).109 When the borrower is unable to repay a short-term loan, it is not difficult to see how this type of trade contributes to systemic risk. The initial bank that provided the loan would also experience problems with the borrower’s lack of liquidity. These problems spread then to other banks that lent money to the initial bank, inevitably spreading to the entire banking industry. Taken together, these loans mean that a borrower already on the losing side of a CDO now has two losses to sustain: that of the actual CDO and the potential for any loans that they received. Taking into account the fact that the financial world runs on borrowed money, it is

107. Id. (indicating that when the value of the collateral drops below a certain agreed-upon minimum, the debtor must either increase that collateral somehow or dispose of their position).
108. Id.
109. Id.
almost inevitable that a bank will have taken out short-term loans. While these actions are extremely risky, they involve no hedging: the assets and the risk inherent in them stay squarely on the bank's balance sheets. The lack of clarity in the Act as to whether this practice will still be allowed needs to be addressed.

C. Old is New Again: The Return of Due Diligence?

A necessary question at this point is, with all that is now known about the risks of both the lowest and highest level tranches, what actual purpose will the risk retention portion of the Act serve? Before this question is answered, it is worth reviewing the language in section 942, the other relevant provision of the Act. Section 942 may contain the most profound, yet useless, requirement in the entire Act. As stated above, section 942 concerns due diligence, both among investors and the issuers of the CDOs. The pertinent language, included above, broadly requires disclosure of asset or loan-level information to allow for individual and comparative analysis of the underlying assets comprising the CDO.110 Additionally, the Act requires the banks to conduct their own reviews.111 Basically, the Act now requires both parties in a transaction to understand, or at least have an opportunity to understand, the risks that their transaction encompasses. This seems like such an intuitive concept that legislating its existence would seem unnecessary if it were not for the years leading up to the mortgage crisis: the lack of true understanding of the risk by either party is exactly what caused the crisis.

Without a lengthy tangent into the nature and philosophy of finance in the late 1990s and early 2000s, a brief summary of this period can be described as this: the cost of borrowing money was low due to low interest rates, and banks had every incentive to make loans to as many entities as possible. Following the dot-com bubble, many investors were shying away from the equity markets and looking for other opportunities, specifically, the housing market. Previously, banks simply made loans to those who seemed to have the ability to repay them. With the new spike in demand, however, banks began looking to borrowers they previously considered unsuitable for loans. The same forces that created the CDO generally enabled this trend: structured finance, or complex mathematical models that allow banks to value, package, and trade risk rather than retain it themselves.112

111. See Skadden Memorandum, supra note 68.
112. See generally Jones, supra note 5.
RMBSs differ from products composed of things such as corporate bonds; it is extremely difficult, however, to determine the correlation of the many loans that make up one of these securities and, therefore, difficult to predict the likelihood of default of the bonds. This creates a valuation issue: a buyer wants some idea of the probability of default. Until 2004, the large ratings agencies had used a “diversity score” when analyzing CDOs and so several different types of debt, including the sought-after subprime mortgages, needed to be included in order to receive a favorable rating. Even if not an optimal method, this at least had the benefit of an actual review of the underlying assets. The “diversity” method changed in August of 2004, however, being replaced with the use of “Gaussian copulas” by Moody’s and, later, Standard & Poor’s. Aside from the difficulty, whether statistics are involved or not, of determining correlation, the mathematical models suffered a serious flaw: the numbers that the rating agencies used in the models had very little to do with the realities of the housing market, often either using information better suited to traditional mortgage default rates or ignoring historical data altogether. While this is an extremely cursory explanation of what the process actually entailed, the end result requires no simplification: the formula created a situation where close to ninety percent of the CDO tranches rated received a AAA rating. In other words, relying on mathematical formulas, the majority of the financial industry convinced itself that the vast majority of subprime loans were debt as reliable as United States Treasury bills, supposedly the safest investment in the world.

This is why section 942 is important, yet superfluous all at once. Section 942, if followed, should assist investors when determining the suitability of the assets in a CDO. A simple reading of the statutory language gives the impression that the section requires banks to, at a minimum, compile and provide to investors details of the actual mortgages in the CDO. This will theoretically aid in the due diligence process, usually thought of as the steps taken to review financial records

113. Id.
114. Id.
116. Jones, supra note 5.
117. LANCHESTER, supra note 69, at 158–63.
118. Id. at 210.
119. Id. at 208.
or anything deemed material to a sale when purchasing an asset.\textsuperscript{120} A large part of the mortgage crisis was a failure of investors to perform any sort of due diligence, instead relying on the ratings agencies' flawed mathematical models as the final arbiter of reliability. This was, however, not because of any real lack of disclosure on the banks' part. Indeed, the astonishingly small number of investors who not just predicted, but profited from the collapse of the housing bubble, shared a common thread: they were some of the only investors to actually read the prospectus materials and do the credit analysis that investors should have performed in the first place.\textsuperscript{121}

The problem with the vast majority of investors is that non-performance of due diligence reviews shows a lack of concern for self-preservation, rather than mere negligence. This is a flaw that cannot be simply legislated away. The brief language of this section of the Act offers nothing to a truly rational actor who would and could have taken these steps without its assistance. As was seen, however, the investment community may not have been acting rationally, as often occurs during a bubble. On the other hand, perhaps following a herd mentality is a perfectly rational choice. Either way, grave consequences occurred. Now that the banks and investors have learned the hard lesson and, at least in the collateralized debt world, presumably taken it to heart, section 942 of the Act's only real purpose is to serve as a reminder that those who do not learn from history are doomed to repeat it. While banks and investors should heed this reminder, this section offers no additional protection. It is difficult to propose alternative legislation that would address a due diligence problem that creates any sort of governmental enforcement mechanism and, as stated above, it seems unnecessary. On the one hand, the investor may suffer the consequences of his or her actions, so legislating against poor choices would be an overly paternalistic act. On the other hand, if an investor were an institutional entity, responsible for the capital of others, preventing gross oversight would appear to be a simple matter of contract language between sophisticated parties.

Additionally, the Act states that potential exceptions to the risk retention requirements may be made, provided that they shall

\begin{enumerate}
\item[(A)] help ensure high quality underwriting standards for the securitizers and originators of assets that are securitized or available for securitization; and
\end{enumerate}

\begin{flushleft}
\textsuperscript{121} Lewis, supra note 25, at 50.
\end{flushleft}
(B) encourage appropriate risk management practices by the
securitizers and originators of assets, improve the access of consum-
ers and businesses to credit on reasonable terms, or otherwise be in
the public interest and for the protection of investors.\textsuperscript{122}

This language is troubling as well because although there were clearly
observable differences in the quality of the CDOs issued by the large
investment banks, the performance of these CDOs did not necessarily
reflect the quality of either the underlying assets or the due diligence
involved in their creation. Banks producing the greatest quantity of
CDOs also produced some of the worst performing ones, suggesting
that perhaps a lack of discrimination in selecting assets caused by a
desire to produce a large volume of products may have exacerbated
the problem.\textsuperscript{123} However, banks across the board, from the best to
worst performing ones, used the same RMBS suppliers to create their
CDOs.\textsuperscript{124} Finally, whether or not banks created their own in-house
mortgage originators, in which case one would assume that the addi-
tional knowledge of the loans available might create a more reliable
product, seemed to have no relation to the quality of the CDOs that
were being produced.\textsuperscript{125} Keeping these factors in mind, the question
becomes, what actions by a bank might receive protection under sec-
tion 941(e)(2) and how would this be measured? Recall that this lan-
guage in the Act does not necessarily refer to just the specific
exception for “qualified residential mortgages” under the same sub-
section, but rather proposes that Congress could grant additional ex-
ceptions. If proper due diligence were being performed, the risk
retention requirement should not require a waiver. In essence, had
the banks conducted the proper work from the beginning, the Act
would exempt the banks from the legislation, thus rewarding the
banks. Even if banks could engage in this practice, would they want
to? “Improving the access of consumers and businesses to credit on
reasonable terms” would imply, with a slightly cynical reading, that
these would refer to just the sort of subprime loans that precipitated
the risk retention requirements in the first place.\textsuperscript{126} If a bank does not
need to retain that risk, it would necessarily need to be transferred to

\textsuperscript{122} Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, sec.
11(e)(2)(A)–(B) (Supp. 2010)).

\textsuperscript{123} Barnett-Hart, supra note 9, at 92-93.

\textsuperscript{124} Id. at 93.

\textsuperscript{125} Id.

\textsuperscript{126} Dodd-Frank Act, sec. 941(b), § 15G(e)(2)(A)–(B) (codified at 15 U.S.C. § 78o-11(e)(2)
(A)–(B) (Supp. 2010)).
another party, and what party would now willingly receive that risk? This is, to say the least, a slightly peculiar provision of the Act.

Viewed in a universal, yet roundabout fashion, mandating risk retention addresses a problem that had been growing for some time. What remains to be seen is whether the Act will require banks to go above and beyond the measures they themselves would have taken in the fallout of the credit crisis. Further, it is not fully clear how future securitization processes will resemble past ones. The Act may be busy outlawing practices that will not be occurring in the future.

D. Miscellaneous Worries

One can only hypothesize as to what actual effects the Act will bring about. Federal agencies will soon put an end to the sort of linguistic speculation that this Comment puts forth. Apart from any sea change that the Act may, or may not, bring to the financial system, scholars often discussed two related issues. Though examined only in passing, these questions are what the practical effect of the Act will be on litigation and what might possible alternatives to regulatory legislation resemble.

The Act is too recent to have spawned any litigation, as federal agencies have not yet adopted its provisions. However, a quick examination of previous CDO litigation may be helpful in determining what changes the Act may accomplish. One recent, and notorious, example of a CDO-related lawsuit was the 2010 Securities and Exchange Commission case against Goldman Sachs. The SEC alleged that a Goldman Sachs personnel defrauded investors in a CDO ("ABACUS 2007-AC1") by representing that a management group selected the underlying RMBSs when, in reality, a hedge fund selected the RMBSs and intended to take a short position against the portfolio.127 Additionally, the SEC alleged that Goldman Sachs represented that the same hedge fund actually shorting128 the portfolio was taking a long position in the equity tranche.129 The SEC brought the action under Section 17(a) of the Securities Act, employing devices, schemes, or artifices to defraud,130 and Section 10(b) and Rule 10(b)-5 of the Securities Exchange Act, employing devices, schemes, or artifices to

128. A short position is the sale of a security with the belief that it will decrease in value while a long position corresponds to an expected increase in value. Short Selling, INVESTOPEDIA.COM, http://www.investopedia.com/terms/s/shortselling.asp#axzz1k34sOmJh (last visited Jan. 20, 2012).
defraud and making untrue statements or omissions of material facts.\textsuperscript{131} Goldman Sachs settled the suit three months after the SEC filed it and Goldman paid the SEC $550 million, the largest penalty ever levied against a bank.\textsuperscript{132} At the time of the settlement, Goldman Sachs stated that it had made a "mistake" and acknowledged the use of "incomplete information" while marketing the CDO.\textsuperscript{133}

Many previous CDO litigation actions have also alleged fraud in one way or another.\textsuperscript{134} Although the fraud claims were not always successful and, indeed, Goldman Sachs never explicitly admitted to fraud, the concept has been a popular one in previous cases. While it may be difficult to prove something like fraud, the Act could find a limited calling in providing an easier means of recovery against a bank. If fleshed out, the risk retention requirements, specifically if a determination of exactly what kind of risk that banks must retain, could provide a bright-line rule almost akin to strict liability that would greatly aid plaintiffs. Whether this consequence would be beneficial or desirable is a matter for debate. Additionally, questions arise as to who would be eligible to bring such an action and what would the plaintiffs be required to show. Further, would the CDO have to lose value, and to what extent? Would it matter if the bank could show that it otherwise attempted to comply with good practices in the construction and issuance of the CDO? At this stage, encouraging litigation based upon a risk-retention basis seems unwise.

Additional methods of preventing catastrophe besides the Act have also been suggested. Some of these include clearinghouses similar to those employed in commodities trading and industry-sponsored "bailout pools" that would at least attempt to internalize risk within the financial industry.\textsuperscript{135} Additionally, insurance programs beyond those already in place through the Federal Deposit Insurance Corporation have been suggested.\textsuperscript{136} One thought is that a program might function like something loosely analogous to the Attorney's Liability Assurance Society, of which many large U.S. law firms are mem-


\textsuperscript{133} Id.

\textsuperscript{134} Debussy LLC v. Deutsche Bank AG, 242 Fed. Appx. 735 (2d Cir. 2007); see, e.g., Daniel Boone Area Sch. Dist. v. Lehman Bros., 187 F. Supp. 2d 400, 403 (W.D. Pa. 2002).

\textsuperscript{135} Olufumilayo B. Arewa, Risky Business: The Credit Crisis and Failure (Part I), 104 Nw. U. L. REV. COLLOQUIY 398, 413 (2010).

\textsuperscript{136} Id. at 412.
Many of these novel ideas have a common theme: they would involve a certain degree of self-regulation. Indeed, at this time, many ideas like these seem to be attempting to strike a delicate balance with those contained in the Act. While many are loathe to permit the banks continue policing themselves, as the failure of self-regulation culminated in an abject catastrophe, there remains the sneaking suspicion that government regulations cannot, will not, or could not accomplish any meaningful changes to the system. The compromise that must be found between these positions will obviously involve a significant debate, one much beyond anything found in the Act.

V. Conclusion

Like many pieces of legislation, unfortunately, the Act is reactive, not proactive. Congress is playing catch-up to a system that was designed to operate in a fashion that, while not illegal or fraudulent, often takes a liberal reading of legislation that comes its way. If the risk-retention requirements of the Act are merely designed to prevent a future crisis of the nature that Wall Street recently experienced, they may achieve this narrow goal. If Congress truly aims to “reform” the financial industry, as the title suggests, this loftier goal will almost certainly fail if left to the rules in the Act. True reformation of an industry that is so vital and central to everyday life will not come from a piece of legislation such as this. The concerns it seeks to address have been learned the hard way and the system will adapt without the legislation, for better or worse. The role that CDOs will play in the future is unclear, but it is very unlikely that the banks will construct and issue the CDOs in the same manner that they constructed them during the past decade. If the old saying “change must come from within” was ever appropriate, now appears to be a time to apply it. The risk retention requirements of the Dodd-Frank Act are a good starting point for a serious discussion of what changes need to be made and in what fashion, but if it is a bill to actually “reform” the financial industry, it fails at this ambitious and lofty goal.

137. Id.