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IN FOCUS

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Conflicts of Interest Rule for Asset-Backed Securities

The conflict of interest rule for asset-backed securities (ABS) refers to Section 621 of the Dodd-Frank Act (P.L. 111-203). The policy goal is to prevent people who help construct or underwrite ABS from having interests in opposition to the purchasers of the securities. Although the Securities and Exchange Commission (SEC) issued a proposed rule on September 9, 2011, a final rule has yet to be issued. Difficulties in defining statutorily required exemptions for hedges and traditional underwriting activities may be contributing to the delay. This *In Focus* describes incentive problems inherent in ABS, summarizes how Section 621 addresses incentives issues, and analyzes some of the policy trade-offs that must be decided in the final rule.

Background

ABS are financial instruments that represent a stream of revenues flowing from a pool of collateral, typically loans. For example, 1,000 auto loans can be pooled in a trust, with the revenues being distributed to 20 securities. This structure can be used to diversify investor portfolios equally; that is, each security buyer may face greater risk of a "bad bunch" of auto loans by individually buying 50 rather than buying 1/20th share of 1,000 loans. Or, this structure can be used to customize the risk/return profile in each category of security; that is, if some securities bear first loss and others last loss, then the first set will be higher risk and higher return, but the second set will be lower risk and lower return. Many other securities structures can be arranged.

Economists have analyzed several common information issues related to securities, including ABS. Underwriters and other financiers often get paid as a percentage of the deal, which, while maximizing the value of financial services, may also encourage investment bankers to exaggerate the quality of the securities. Anticipating these incentives to exaggerate (or hide defects), securities laws require an affirmative disclosure of material risks and market contracts include certain representations and warranties on the part of various participants.

Another potential information problem from an economics perspective is adverse selection. In markets in which prices must be based on pools or averages, adverse selection can occur when people know where their interests lie in relation to the average. For example, if an auto dealer self-finances some of its customers and sells some of its other auto loans, the auto dealer has an incentive to keep the loans that look like they are most likely to repay and sell the loans that look least likely to repay. But this strategy only works if the people buying the auto dealer's loans do not anticipate this behavior. Otherwise, prices adjust accordingly. Left unaddressed, economists generally believe that potential buyers will penalize such sellers by not be willing to pay the average price for the pool. Guarantees and other private contract provisions try to address these "lemons" problems.

Dodd-Frank Section 621 and SEC Proposed Rules

During 2007-2008, there were many complaints about potential conflicts of interest in the securitization chain for mortgages. Ratings agencies were accused of giving favorable ratings in return for repeat business. Thinly capitalized intermediaries were accused of "taking the money now" with a plan to declare bankruptcy "when the music stopped." These and other accusations were used to describe a purported "pass the trash" business model for ABS, including mortgages.

Although some of these accusations seem to ignore many of the longstanding contractual safeguards used among intermediaries (other assets have asymmetric information problems), several high profile failed transactions demonstrate that traditional safeguards did not always dissuade behavior that appears like conflicts of interest.

In April 2010, the SEC alleged that the investment bank, Goldman Sachs (Goldman), had been derelict in failing to provide investors vital information about the significant role that a hedge fund client had played in a synthetic collateralized debt obligation (CDO) composed of subprime residential mortgage-backed securities, ABACUS 2007-AC.1 (ABACUS), which Goldman structured and then marketed.

According to the SEC allegation against Goldman, in 2007, the hedge fund Paulson and Company (Paulson), a Goldman client, approached the bank, asking it to help buy protection against what it predicted would be a fall in the value of residential mortgage-backed securities. Later, Paulson and Goldman allegedly discussed potential transactions in which other investors would be the counterparties for the hedge fund's short trades. That Goldman vehicle CDO became ABACUS, which the SEC alleged Paulson shorted and played a "significant role" in the selection of its underlying securities, while failing to disclose those activities to investors.

In July 2010, before the enactment of the Dodd-Frank Act, a settlement was announced between Goldman and the SEC. Goldman did not admit wrongdoing, but agreed to pay the then record settlement amount of $550 million, and acknowledging that it should have disclosed Paulson's role in the selection of the ABACUS portfolio.

The Dodd-Frank Act included requirements for ABS sponsors to retain some of the risk (Section 941), and included provisions intended to minimize conflicts of interest (Section 621) among sponsors and other ABS participants even if not sponsors.

Section 621 prohibits ABS sponsors, underwriters, placement agents, initial purchasers, or any affiliates from engaging in a transaction that would involve a material conflict of interest with any investor in the ABS for one year. Establishing a conflict of interest requires both:

> (1) A securitization participant would benefit directly or indirectly from the actual, anticipated or potential adverse performance of the underlying pool of assets; or loss of principal, monetary default or early amortization event on the ABS; or decline in the market value of the relevant ABS; and
>
> (2) There is a substantial likelihood that a reasonable investor would consider the conflict important to his or her investment decision.

The statute exempts risk mitigating hedges arising out of underwriting, placement, initial purchase, and sponsorship of securitization. The statute directs the SEC to finalize the rule within 270 days of enactment (July, 21 2010), but the rule has still not been finalized.

Policy Trade-Offs in Constructing Exemptions

Section 621 requires that the SEC's final rule include exemptions for certain hedges that are part of the underwriting, placement, initial purchase, and sponsorship process of bringing ABS to market. To the extent that some of the traditional contract arrangements in securitization may look like bets against the interest of investors, but may instead be risk mitigating actions that facilitate the securities offering, the SEC faces a trade-off between attempting to reduce apparent conflicts of interest and unintentionally reducing the efficiency of capital markets.

Finding ways to provide the equivalent of insurance for the securities deal may appear like a conflict of interest. For example, a person who buys car insurance is betting against himself or herself in the sense that the insurance policy pays off when the person has an accident. Similarly, in some parts of the underwriting and placement process, investment bankers may provide the issuing firm certain guarantees. Traditionally, investment banks have not only been able to protect themselves in relation to such guarantees, but have been encouraged to do so. However, a risk mitigating hedge against the possibility of exercising the guarantee may be akin to a bet against the securities, basically similar to an insurance policy. Section 621 specifically exempts this type of risk mitigating activity.

Although insurance was merely an example to illustrate how a risk-mitigating hedge can appear like a conflict of interest, commenters on the proposed rule listed a number of other activities that they were concerned could be diminished or eliminated by a broad definition of conflict of interest. Some of the general activities that often support securitization include providing credit enhancement, liquidity facilities, warehouse lending, and the exercise of control rights.

The SEC proposed rule included an explanation that it believes that its exemptions can accommodate traditional activities. For example, in its view, there are permissible ways to finance another securitization participant, service and manage collateral assets, exercise remedies in the case of loan default, receive payments for additional securitization services, and retain rights in specific tranches of securities (credit enhancement).

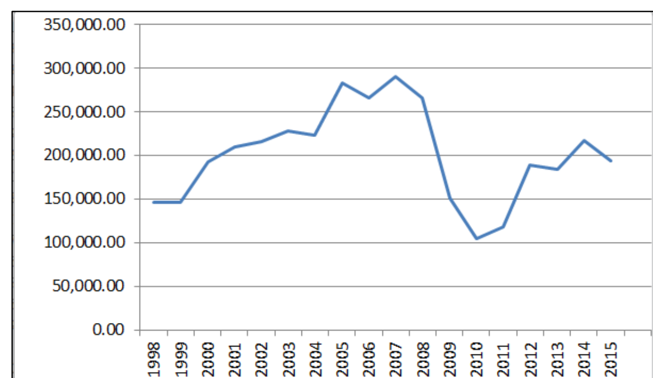
Other Issues and Trends

Some legal issues are beyond the scope of this *In Focus*. The term *ABS* is defined slightly differently in different places in the law. Of the covered entities (underwriters, placement agents, initial purchasers, and sponsors), only *underwriter* had a definition in the securities act prior to Dodd-Frank. The SEC would also like to include collateral managers among the covered participants.

Although Section 621 applies to residential mortgages as well, **Figure 1** shows the trend in ABS issuance during 1998-2015. Unsurprisingly, annual ABS issuance grew during the securitization boom of the early 2000s, fell steeply during the priod of financial crisis and recession of 2008-2009, and has since generally recovered. However, the 2015 annual issuance was still close to 30%t below peak ABS issuance in 2007.

Figure 1. U.S. ABS Issuance, 1998-2015

Millions of U.S. Dollars



Source: SIFMA

Note: Some of the largest asset classes include autos, credit cards, equipment, and student loans.

Further Readings

CRS Report R41381, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Standards of Conduct of Brokers, Dealers, and Investment Advisers*, by Michael V. Seitzinger

CRS Report R43345, *Shadow Banking: Background and Policy Issues*, by Edward V. Murphy

CRS In Focus IF10032, *Introduction to Financial Services: The Securities and Exchange Commission (SEC)*, by Gary Shorter

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