Commentary: SEC Aims to Clip Securitization's Wings

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Securitization and derivatives are the two pillars that supported the global financial system in the years prior to the Panic of 2008. Their collapse, more than anything else, is blamed for the ensuing financial turmoil and economic distress of the Great Recession that still haunts us in 2010.

Last week, the SEC produced a proposed rule change that would radically alter the disclosure for asset-backed securities, the financial product generated by securitization. The release describing the proposal has been described as "mammoth." It is 667 pages long. The most important attribute of the release is not its size, however, but the change in regulatory philosophy it represents.

Securitization was a financial innovation pioneered by Salomon Brothers in the early 1980s. In the late 1970s, Congress decided to deregulate the savings and loan industry. One of the unintended consequences of deregulation was that thrifts found they had to sell a lot of mortgages on their books to meet new capital requirements. There weren't a lot of buyers, so Salomon Brothers was able to scoop a lot of them up on the cheap. However, Salomon Brothers was in the trading business and had no interest in holding a lot of mortgages until maturity. So, it devised an ingenious way to sell them.

Salomon took a group of mortgages and dumped them into a company set up for the purpose, which we will call "Mortgage Pool." It then caused Mortgage Pool to sell IOUs, or more accurately, debt securities, to the public. The securities were secured by the mortgages, which served as collateral for the debt. For that reason, the debt securities were called "collateralized mortgage obligations" or "CMOs."

To make the debt issued by Mortgage Pool attractive, Salomon created several classes of debt with different priorities. So, for example, the A debt would be entitled to the first payments from the mortgages; B debt, the second payments; and so on until what was left was a residual, or equity, interest that got paid after every class of debt was paid in full. Mortgage Pool then took the proceeds of these sales of debt and paid Salomon for the mortgages.

As a result, Salomon made a tidy profit on the trade. Salomon no longer owned the mortgages because they were now owned by Mortgage Pool, which had purchased

them by selling its debt to the public. And because Salomon had purchased the mortgages on the cheap, it could "sell" them at a price that enabled Mortgage Pool to offer debt securities at very attractive rates.

Securitization turned out to be one of those really great ideas that kept thousands of high-priced bankers and lawyers employed for decades, primarily because it enabled banks to make a lot more money that they were ever able to make in the boring business of banking.

Before securitization, banks were limited in the loans they could make by capital requirements. Selling a loan frees up capital that can be used to make more loans. So, securitization enabled banks to make a lot more loans than they ever would have been able to carry on their books and earn tidy profits from what were essentially origination fees.

The investment bankers who sold CMOs and other asset-backed securities soon learned that institutional clients would pretty much buy anything that had a "Triple A" rating. Less good ratings were much more difficult to sell.

To boost the ratings, investment bankers employed two strategies. First, they obtained financial insurance from an insurance company. AIG, among others, wrote a lot of this type of policy. Second, they would combine less-highly rated debts from lots of Mortgage Pools into another company (let's call it Mortgage Pool 2) and sell its debt securities. It turns out that if the rating agencies were only willing to rate 20% of the debt securities issued by Mortgage Pool as "AAA," they were willing to rate 80% of the debt securities issued by Mortgage Pool 2 as AAA, even though the underlying securities were much less highly rated. This paradoxical result was based on the theory that diversifying Mortgage Pool 2 – by combining debt securities issued by many Mortgage Pools – would make the debt securities issued by Mortgage Pool 2 much less risky.

The disclosure documents used to sell asset-backed securities were extraordinarily complex. However, the disclosure tended to be very boiler-plate and not particularly helpful for anyone trying to find out more about the assets held as collateral by the Pool. The reason this was allowed to continue was that institutional investors didn't much care what was in the Pool, so long as the debt it issued had a Triple A rating.

The SEC, for its part, as well as most of us in the securities bar, adopted a theory of regulation that encouraged ever-weaker disclosure standards. The theory was that if an investor was rich enough, or big enough, it could protect itself and had no need for the expensive disclosure required under the federal securities laws. Purchasers of asset-backed securities were all institutional investors, with trivial exceptions. These purchasers were not clamoring for more disclosure, it was

expensive for issuers to provide, and the SEC, encouraged by the securities bar, took the course of least resistance. The most recent effort to make things easier for issuers of asset-backed securities occurred in a massive rewrite of disclosure requirements in 2004. The rest, to coin a phrase, is history.

A detailed description of the SEC's proposed disclosure requirements for asset-backed securities is well beyond the scope of this column. Suffice it to say that much more disclosure will be required than in the past. Nonetheless, two elements of the proposal are especially noteworthy.

The proposal would require issuers of asset-backed securities to provide investors with several days to review disclosure before they can be sold. In turn, the disclosure will now contain detailed, and computer readable, granular descriptions of the assets in the pool. This disclosure should enable investors to arrive at their own sophisticated views as to the risks in any particular pool. This will be backed up by periodic disclosures, which are intended to cause adjustments in positions well before the rating agencies get around to downgrading the instrument. All of this is intended to break the reliance of institutional investors on ratings. Triple A ratings, by the way, will no longer provide any relief from disclosure requirements, reducing one of the incentives for issuers to take extraordinary measures, such as obtaining insurance, to improve the ratings.

This will, of course, slow down the marketing of asset-backed securities. From time to time, markets will be missed, or potential investors will change their minds. When that happens, the expense preparing disclosure documents will be incurred in vain, to the great irritation of issuers and investment bankers. This part of the proposal resurrects the "stop, look and listen" theory of securities regulation that was prominent before we all became so enamored of market forces. Most important, this theory of disclosure regulation is being applied to investments purchased by institutions who, it had been argued, are competent to react more quickly than less sophisticated investors.

In addition, privately-placed asset-backed securities must provide disclosure to investors, no matter how "accredited" or "qualified" they are.

The idea that institutional investors need the protection of the federal securities laws, and particularly its disclosure requirements, represents a real sea change in the SEC's attitude. If this theory holds, there will be a real overhaul in securities regulations. Securities offerings will be a lot more expensive to do, and investment banking will be a lot less profitable.

Old habits die hard. We can expect to be sternly admonished by senior investment bankers and prominent members of the bar that these new rules are little more than

a power play by the SEC that will cast us back into the stone age of financial services.

I have been among those critical of the SEC for spending a lot of time fine tuning the equity markets, which actually performed rather well throughout the crisis, and closing the barn door after the cow is gone by resurrecting things like the old surprise audit rules for custody by investment advisers. But, I think the SEC has found its way on this one.

The SEC is putting its finger squarely on the problem that caused the crisis – asset-backed securities. Arguably more than disclosure will be required to fix this, but disclosure is the tool Congress gave the SEC to use. It is a bad workman that complains about his tools, and the SEC is in this case doing the best it can with what it has to work with.

If there's one thing we have learned from this mess, it is that the smartest guys in the room were full of hot air. In the last two weeks, we have witnessed the spectacle of financial wizards appearing before Congress loudly proclaiming to all and sundry that they had no idea what was going on and therefore should not be held accountable. I see no evidence that their testimony was untrue. The horrible, dawning reality is that they were all just as stupid as everyone else. Financial wizards need just as much regulatory protection as the most unsophisticated retail investor to keep from driving our nation's economy into the ditch.

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