The Experts Forum: FTI Consulting | Compass Lexecon

Dodd-Frank, Derivatives and Structured Finance

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Dr. Craig Lewis: Good afternoon and welcome to the inaugural program of The Experts Forum: FTI Consulting | Compass Lexecon, broadcast live on www.sechistorical.org. I am Dr. Craig Lewis, Madison S. Wigginton Professor of Finance at Vanderbilt University's Owen Graduate School of Management, and moderator for today's program.

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This afternoon's program will be the first in a series discussing cutting edge issues at the intersection of finance, economics, and regulation.

Our topic today is Dodd-Frank, derivatives, and structured finance. Joining with me are Dr. Christopher Culp, Senior Advisor at Compass Lexecon. Chris is an expert on structured finance, derivatives, structured insurance, credit risk and credit markets, and risk management. Jason Kravitt is a partner with Mayer Brown, LLP. Jason was the founder of his firm's securitization practice, and serves as the practice's senior partner. Dr. James Overdahl is a partner with Delta Strategy Group. Prior to joining Delta Strategy Group last year, Jim was a

Vice-President with NERA Economic Consulting. He has previously served as Chief Economist for both the SEC and the Commodity Futures Trading Commission. Welcome.

Let us begin with a brief stage setting discussion. Jim, as a former Chief Economist at both the SEC and the CFTC you have a unique perspective on the events that precipitated the financial crisis of 2007 and 2008 that led to the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Could you describe the key market failures that Dodd-Frank addresses?

Dr. James Overdahl: Sure Craig. The Dodd-Frank Act was the response of the U.S. Congress to the financial crisis of 2008, a crisis that included the collapse of Lehman Brothers, AIG, and the near collapse of several other systemically important financial institutions. Congress was acting to address what they felt were the key causes of the financial crisis. First they sought greater transparency across financial markets, transparency to both regulators and to end users of the market. Many of these transparency reforms were aimed at the market for over-the-counter derivatives. For example, Congress required regulators to implement real-time reporting of over-the-counter derivatives transactions to swaps data repositories. In addition to this transparency objective, Congress directed that central counter-party clearing be required for most over-the-counter derivative transactions. Congress felt its central counter-party clearing would address counter-party credit risks that were a feature of the financial crisis, particularly with AIG when it was unable to perform on certain credit default swap contracts, and there were of course concerns about the spillover effects to other systemically important firms that had related exposures.

Congress also was addressing issues related to structured finance, in the so-called “originate to distribute” model of banking, particularly as it was applied to sub-prime home loans where the cash flows of home loans were packaged into marketable securities with different risk-return characteristics.

Congress directed regulators to require that banks retain some risk in the process, sometimes called the “skin in the game” requirement with respect to securitizations, and also attempted to make credit rating agencies more accountable for the ratings that they gave to various tranches associated with these securitizations.

In addition to addressing market transparency, clearing, and sub-prime mortgage securitizations, the legislative process that created Dodd-Frank has been likened to a barroom brawl, where the participants refrained from hitting the guy who started the fight in favor of hitting the guy they’ve been looking for an opportunity to hit. With Dodd-Frank, the legislation failed to address many key issues that were widely viewed as central causes to the financial crisis, such as the unraveling of systemically-important government sponsored enterprises, such as Freddie Mac and Fannie Mae. However, like the aforementioned brawl, Dodd-Frank addressed many issues that were not central or even remotely related to the crisis, but had more to do with settling longstanding grievances.

The legislative response to the financial crisis has produced financial markets reforms that have not been seen since the Great Depression. However, unlike the New Deal reforms that were aimed primarily at bank runs on retail deposits, the financial crisis of 2008 has produced reforms aimed at institutional bank runs on repurchase agreements, that is, the repo market, prime brokerage, collateral, and prime money market mutual funds. Current reforms are also aimed at bolstering the resiliency of banks and other systemically important financial institutions through regulation of bank capital, bank risk profiles, and the scope of bank activities. Current reforms also addressed the issue of financial institutions that are judged too big to fail or too interconnected to fail.

Additional reforms sought to reduce effects of failed systemically-important institutions by authorizing greater resolution powers to government authorities, and considerable controversy exists over whether these reforms will be effective in preventing another financial crisis or whether they will have the undesirable consequence of planting the seeds for the next financial crisis by merely shifting risk from one set of systemically important financial institutions to other vulnerable parts of the economy.

Those are the main features on the main parts of the response of Congress. Of course that was the enactment of the law and now what we're seeing is this law being implemented. We have gone past the four year anniversary since the law's passage and implementation through regulatory agencies across the federal government continues.

Dr. Craig Lewis: Thank you Jim for those insightful comments. I'd like to distill the central themes that emerge from your remarks because they are going to be what we focus on next. As we just heard, innovations in the market for over-the-counter derivatives securities resulted in two key market failures.

The first was the facilitation of the originate to distribute banking model that allowed too big to fail banks to create asset-backed securitizations that were sold to investors that ultimately relied on credit rating agency assessment of risk rather than performing their own due diligence.

The second market failure we will address this afternoon stems from the interconnected nature of the market for credit default swaps and the systemically important exposures financial institutions had to one another. The bankruptcy of Lehman Brothers made it clear that the inherent opacity of the pre-crisis OTC derivatives market prevented financial institutions from fully understanding the systemic nature of their exposures to other financial institutions, which ultimately led to the failure and subsequent government bailout of AIG.

Jason, could you discuss the regulatory responses to the market failure surrounding the asset-backed securitization market?

Jason Kravitt: Okay, I'd be happy to. First of all we have been putting emphasis on the originate to distribute model, but I'd like to take a step back from that. The problem that we're trying to solve was the creation of poor quality asset-backed securities. And very quickly the regulators, legislature, and a big part of the market assumed that the predominant cause for that was the originate to distribute model, meaning that originators originated assets to distribute them through securitization. Originators didn't keep a piece of them and therefore didn't bother to vet their credit quality in a way that they would have had they had the so-called “skin in the game” that’s been mentioned.

To my knowledge there is no definitive academic proof that the originate to distribute model was the cause of the poor underwriting, but Congress quickly came up in Dodd-Frank with a requirement that six different agencies together adopt a risk retention model. And by the way, when the agencies originally proposed the rule they got over 10,000 comments. I don’t think that, if we proposed an amendment to the United States Constitution, we’d get more comments than that.

The interesting thing is, in the model they came up with, the very asset class that people feel started the problems, sub-prime mortgage-backed securities, ended up in large part not having to have any required risk retention. What the regulators decided was that if the underlying mortgages were written in accordance with what the CFPB calls “qualifying mortgage” rules and what in retention is called “qualifying residential mortgage,” or “QRM” rules, securitizers don’t need to have any retention. QRM mortgages expected to be the majority of the market.

Similarly, if it’s a GSE-guaranteed RMBS, so long as the GSE is in receivership, which appears to be eternal at the moment, they also don’t have to have risk retention. So going back to the barroom brawl analogy, in that barroom brawl the people who threw the original punches received no punches in return and are not required to have risk retention. On the other hand, in asset-backed commercial paper, seller vehicles in which no investor in ABCP has lost a penny in the history of that type of vehicle, depending on how you look at it, the sponsor could be required to have a 100% risk retention position instead of the normal 5% risk retention.

The next regulatory matter that I’d like to focus on is the amendment of the disclosure requirements for securitizations that the SEC adopted. I think that the SEC did a good job on this; it’s a very difficult task and the compromises they came up with I think were well thought out, if not universally loved or always practical.

First, because of Dodd-Frank, they had to get rid of ratings as a requirement. So they tried to focus on quality in other ways, such as a CEO certification that we can talk about in more detail later. They also tried to solve the problem of very poor enforcement mechanisms for breach of warranty or servicing, and they have a new enforcement mechanism for shelfs. They try to improve bond holder communication with new bond holder communication provisions, and finally with regard to the disclosure that everybody complained about, they have tried to correct its perceived gaps by requiring asset specific disclosure, in certain asset classes, and they will probably expand those classes to others in the future.

The FDIC came out with its own risk retention rule years ahead of the market because they wanted to prove that they were the vanguard of regulatory reform. Finally, Congress and the regulators also came out with the Volcker Rule. Now, we are really going back to the barroom where an innocent bystander in the entrance hall who did nothing to start the fight not only got punched, but was knocked unconscious. To my knowledge nobody alleges that proprietary trading in the type of securities that Volcker deals with was a cause of the “Great Recession,” as it would eventually be called. But I was at the NYC Economics Club luncheon where Paul

Volcker announced that he thought that restriction should return, which in my opinion is also close to reinstatement of portions of the Glass-Steagall Act.

Securitizations had to deal with Volckr because the definition of hedge fund and private equity fund, which is what the rule purports to deal with, use exemptions from registration under the 1940 Act which overlap with those used by many securitization structures. We can talk about that later if we have time.

Finally, the regulators also required restructuring of risk based capital and the creation of two liquidity ratios for banks. You can easily see that banks didn't have enough capital and that securitizations probably should have required more capital, but the problem that no one has been able to solve so far is how to figure out how to rationally increase their capital without killing the goose that laid the golden egg. Securitization now, instead of being a capital arbitrage, actually has a cost of capital disadvantage to more traditional types of financing like lending. I think I'll stop there.

Dr. Craig Lewis: Thank you Jason. And now I'd like to turn out attention to the OTC market for credit derivatives and the regulation contained in Title VII of Dodd-Frank. Chris could you explain what is happening in this area?

Dr. Christopher Culp: Sure, and I appreciate Jim's original barroom brawl analogy, because Title VII of Dodd-Frank which deals with over-the-counter derivatives contains a very large amount of punches being thrown that have been based on in some cases several decades of jurisdictional regulatory question marks that aren't quite as related to the causes of the financial crisis as it first might seem.

The underlying logic of Title VII is that exchange-traded derivatives markets, namely futures markets, have a history of having worked very well when it comes to containing the implications of failures, and to preventing the systemic spread of companies that experience financial problems and/or default. The so-called futures model which involves calculation of initial margin requirements, money that has to be posted before a trade is made, variation margin, marking to market, central counter parties that oversee their clearing members and that have capital requirements, and a variety of other requirements. This whole model has worked quite well for a long time. It was developed in the late 1800s in the United States and has withstood a test of time and a lot of major financial disruptions.

Part of Dodd-Frank, the logic seems to have been that if we can simply push as much as possible, that's my interpretation if you will of what happened. If we can simply push as much as possible into the world that we know and trust of exchange-traded derivatives, then we'll solve and address these problems that we saw during the crisis associated with lack of transparency and excessive opacity, and potential concerns about systemic risk.

We can discuss later whether or not that is actually true, but the result in Title VII just to summarize is actually an effort in the United States that's going on in most of the Big 20 industrialized countries around the world. In September 2009 the heads of state of the G-20 nations got together and basically said we want three things to happen. We want to establish central counter party clearing for previously non-cleared over-the-counter derivatives, we want to establish mandated execution venue format requirements, i.e., transactions that are subject to mandatory clearing should be executed on a transparent trading facility, and we want to establish mandated reporting requirements.

Not very long thereafter the BIS and IOSCO got together and said let's add to that non-cleared over-the-counter derivatives that remain outside of these things should be subject to higher margin requirements, and that capital required to support non-cleared swap transactions also needs to be greater than it was before. So you have those sort of five basic principles, and each country is implementing them in a different way. The United States was essentially the first mover through Dodd-Frank. We can come back and talk about the problems this has created later, but Europe in particular is rather far behind. And although some of the principles underlying the various regulations for swaps and non-cleared swaps and cleared swaps are similar in spirit, the devil is in the details and there are a lot of cross-border issues that continue to plague the implementation of this area.

But just for a moment, in the United States one thing we have is we have new registration requirements that classify derivative participants. In this case I say derivatives meaning over-the-counter derivatives in essentially three categories. The official two categories are swap dealer and major swap participant. Swap dealers and end users are historical terms of art that have previously been kind of like an "I'll know it when I see it" without a precise definition. The OCC examination guidance had kind of a definition for a while, but an official bright line distinction was never there. Under the implementing regulations pursuant to Dodd-Frank, we now have size based definitions of swap dealers which are essentially on both sides of the market acting as market makers or classic intermediaries. The second category of major swap participant is essentially an institution whose activities are big and diverse but isn't necessarily on both sides of the market on a regular basis, and then there's the unofficial third category of an end user, which we kind of think of as a customer using futures market terminology. That would be the airline that uses jet fuel derivatives to manage its price risk, the agricultural cooperative that uses wheat and corn derivatives to manage its price and quantity risk, and so forth.

These requirements that are aimed at non-cleared swaps and cleared swaps, as I said fall into areas that Jim also mentioned. The first one is the mandated clearing requirement, and that essentially requires that most standardized OTC derivatives be cleared by a central counter party now. I have to sort of pause to comment again on the barroom analogy. The practical implementation of that thus far has had the impact of moving plain vanilla interest rate derivatives like interest rate swaps, basis swap, overnight index swaps, and forward rate agreements, as well as certain credit default swaps on single-name entities and certain corporate index products into central counter parties.

That's not new. What we call OTC-cleared derivatives were going on since the late 90s, and so market participants were already moving toward the model which is somewhere between bilateral derivatives and exchange-traded derivatives of negotiating them bilaterally and then booking them into a CCP. What this rule does is it essentially mandates it rather than letting the market decide which products want to move in that direction. This sort of does it for everyone.

The products that are involved, especially the interest rate derivatives are not the products that caused the crisis.

To use the language Jason used, I'm aware of essentially no credible study that blames plain vanilla fixed-for-floating interest rate swaps for the global financial meltdown. Yet, a lot of those products are exactly the ones that have been implicated by the mandatory clearing rule. Related to that is a mandatory venue execution rule, for products that are subject to the clearing mandate or for other products that are specifically identified by the CFTC or SEC, they now can't be traded bilaterally they have to be traded on what's called a swap execution facility. Without doing inadequate justice to a complicated term in a complicated debate, you can view a SEF as essentially an exchange light. It's a trading forum that isn't a full exchange. It doesn't pretend to be a full exchange, but it offers an organized forum for the electronic execution of transactions that are then booked into a central counter party.

Also that applies to these standardized products, the highly liquid products. Thus far it's focused on credit defaults swaps of a single-name, nature, and the interest rate product group. To underscore, the problems that AIG had with credit default swaps for example were not in single name CDS's. They were in credit default swaps based on asset-backed securities such as collateralized debt obligations. And so under the rules as they have been articulated, ABS CDOs would not actually be subject to the mandatory clearing requirement because they are too complicated and are essentially un-clearable. These new rules would actually not have covered some of the transactions that people pointed at to rationalize the rules.

A third category, quickly moving along, is the reporting requirement. This is comprehensive, and although there is some disparity across countries in how they're implementing clearing and mandated execution, most countries have just gone all-out on reporting and said you need to have at least some kind of organized reporting to a swap data repository or a trade repository as it's called in Europe for pretty much all OTC derivatives. Most of those rules are in effect and they range from, as Jim mentioned, real-time reporting requirements to in some cases back-dated loading of transactions that date to the adoption of Dodd-Frank, and then in the European Union you have to backload transactions that date back to the European Market Infrastructure Regulation implementation date.

Margin and capital are also out there, but I'm going to say that they're out there and stop there because they are still in the pipeline, and although not everything is done in the clearing, execution, and reporting areas, I think we've got at least enough under our belts to get the discussion rolling forward, so I'll stop there.

Dr. Craig Lewis: Thank you Chris. It's clear that there's been a lot accomplished but there is a significant amount of unfinished business. At this point in the program I think the panel would like to change gears and move to a more open-ended discussion. I have a number of questions that I think will shed additional light on some of the topics we've already discussed. Jim, since you kicked things off, let me return to you. What have been some of the unintended consequences of the Dodd-Frank Act and subsequent Rule makings?

Dr. James Overdahl: Well I think you could point to several, one that stands out is with respect to swap data repositories. Part of the Dodd-Frank Act required that regulators, in this case the CFTC, implement a swap data repository rule that is called the real time reporting requirement. What we found is that for some end users they have had their information put into the public domain and maybe not directly by them as the end user, but by the counter party to their swap where it can be understood by the market of who's playing, particularly in some illiquid markets. What this means is for the end user is that they face higher costs to get their swaps done. The counter party is going to require a higher spread because it's going to be more costly for them to hedge in a market where people know that they're coming to the market with size, particularly an illiquid market.

Actually today is a good day to be discussing this because the CFTC granted regulatory relief just this morning to Southwest Airlines which was one commercial hedger who had a jet fuel hedging program where their swap transactions, they felt, was costing them, I think in their Congressional testimony they said up to $60 million a year in extra hedging costs just because of the reporting requirement. Clearly the law was not aimed at commercial users of futures products or derivatives, they're the people who are using these markets to prudently manage their risk. And so that would be one example I can point to where a law that was designed to help protect users may have actually caused them harm.

Dr. Craig Lewis: One of the things I thought was interesting in Chris' remarks was something I fundamentally agree with and that is Title VII is essentially creating an "exchange light" environment for clearing and transacting in the over the counter derivatives market. One of the things that I struggled with when I was Chief Economist in putting the economic analysis together on some of these rules was some of the different requirements that exist in Title VII and most notably the transparency requirement in the real time reporting obligation that exists for U.S. entities vis-à-vis their foreign counterpart, say in the U.K.

One of the issues I felt that was salient was asking the question if there are differential transparency regimes what will happen to transaction activity and what's the likely consequence of that? It seems that an unintended consequence of Dodd-Frank would be to have significant transaction volume migrated from the U.S. to Europe.

Dr. Christopher Culp: I agree with you and Jim on a lot of different levels. One of the broad areas of unintended consequences that we're just starting to see emerge is in the area of liquidity. There are multiple uses of that term that Dodd-Frank can affect. I am not talking about collateral and margin; I'm talking about market liquidity because the belief was if we do it like exchanges, which have been natural arenas for price discovery from time memoriam, and we push everything into a transparent world. If we build it they will come; in this case, it's as if we put it there, liquidity will come. Well that's only true if liquidity doesn't get fragmented in the process, and also it's important to keep in mind that especially in the interest rate derivatives area the interdealer broker market was highly transparent and highly liquid before the Dodd-Frank rules went into place. If you look at some of the studies that ISDA did on transparency in the interest rate derivatives area, not as much as in some of the other products, but there weren't really a lot of complaints from end users or other categories about a lack of transparency.

However, as you say by pushing stuff into these regulatory defined structures you're redefining the liquidity pool based on differing institutional and regulatory definitions. One of the problems is that a U.S. SEF is not the same thing as an MTF or multilateral transaction facility under MiFID-2 in Europe. Europe is also behind us and so there have been a ton of cross-border issues associated with that. If you have a transaction that involves one, what we call "U.S. person," essentially a U.S. market participant but with one non-U.S. person, then to date you've essentially been subject to the U.S. rules which means that we've seen a pattern where activity in U.S. dollar denominated derivatives is tended to concentrate in SEF exchanges by U.S. entities. This is sort of working itself out, and as Europe implements some of these rules it could either become better or worse because Europe is sufficiently not far along that we have this concept of substituted compliance which is that in principle, in Europe, they should say and the other European regulators should say as long as you're compliant with the equivalent of what our regulations are in the U.S. then you can play here.

But that hasn't been the attitude that everybody has adopted at the different agencies and so, Craig, you're right, we are seeing this sort of fragmentation occurring along certain institutional dimensions. It was clearly not intended. Nobody sat down and said, "I'm going to increase my size of the pie by designing this particular part of the rule." I'm from the University of Chicago, and we think that does occasionally happen with regulations, but this does appear to have been something that people didn't expect when this was adopted.

Dr. Craig Lewis: I agree. Jason I have a question for you about risk retention. While it's understandable that purely on credit protection for investor grounds, GSE-guaranteed mortgage loans will require no retention. What about stepping back and looking at the idea behind risk retention as a whole? Does the architecture of the rule fit its purpose? And then could you discuss the lack of an investor down payment requirement?

Jason Kravitt: Sure, thanks very much. Again remember that the purpose of the risk retention rule was essentially to bring back quality into the securitization market. The question is does it do that where it's necessary and does it not do it where it's not necessary? Clearly it does it where it's not necessary – take autos, I jokingly refer to autos as the "cockroaches" of securitization as they continued to function perfectly during the meltdown and appear to be indestructible. Their volumes held up, and they are fabulous investment from a credit risk point of view. There is no need to require risk retention on autos, and the standard structure for autos is for the seller to keep a retained subordinated interest.

On the other hand, it looks like we're going to have 100% retention in the ABCP market because the safe harbor that they came up with is not practical. Fortunately there's probably a way around that if a bank buys a vertical interest in all the ABCP that the conduit issues, but why do we need to have a bank finance 5% of the ABCP that a conduit issues when no one has ever lost a penny? I mean literally a penny in that market.

On the other hand we have the QRM exemption which will be the lion's share of the market whether it's a GSE market or the non- GSE market where there is no risk retention and where we had all the problems before.

I’d like to discuss the down payment because that I find that fascinating. First of all, everybody treats the 30-year fixed rate mortgage as really God’s gift to humanity and American civilization in particular. But you have to realize, first of all, that there was no 30-year fixed rate mortgage until the 1950s. It also has turned out to be a simply horrendous way for households to build wealth. The 30-year mortgage takes an extremely long time for somebody to develop equity in their house and it leverages you to the hilt. At more common rates than today’s unusually low rates, you end up paying three times the amount that the house cost, and you only build up equity after many years have passed. I don’t think it’s a product that it’s worth distorting the system to preserve. I think either a 15-year mortgage which is designed for the consumer to build up equity very quickly, or a mortgage that has a higher down payment and therefore gives you equity that you’ll have to defend and therefore makes you a much better credit risk, is really the answer.

Let’s take the GSEs. The investor doesn’t need retention there, because they’ve got the federal government standing behind it, but the GSEs themselves need protection. Just recently Director Watt said he was intending to loosen guidelines on down payments for GSE mortgages. A lot of people think we’re sliding down the slippery slope again of poor underwriting, so I think there’s a lot of irony, if we want to be generous in the way we described it, in the rule.

Let me say I’m not intending to criticize any particular regulator. I think it’s a very, very hard mandate to meet but from my point of view, from being a market participant that’s the way I look at it. I will also say one other thing, I think the United States is still too arrogant a regulator with regards to the rest of the world. There is no way under the risk retention rule for a foreign issuer to comply with the rule by arguing that its country’s own risk retention rule is a substantial equivalent to the U.S. rule so that they can just comply with their own risk retention rule. Now maybe they can go the no-action route to do that, but I do think that if the United States wishes to continue to have the best and most attractive, deepest and most liquid capital markets in the world we ought to start recognizing that some other very sophisticated markets do things differently, and just acknowledge that that’s the case. Then the investor can decide whether it’s adequate for itself or not.

Dr. Craig Lewis: I’m going to follow up if I could on some of those remarks, because during your earlier remarks you had indicated that you thought that Reg AB2 came out as a pretty decent rule for the SEC and the basic idea underlying Reg AB2 was to effectively solve, to use an economic term, an adverse selection problem where investors were being asked to value a security, in this case a securitization, but they didn’t actually understand the assets that comprised the loan pool that they were trying to value. So Reg AB2 is a rule that intends to create transparency so investors could do a better job of pricing these securities in the first place. The SEC felt that this was an important consideration. To give you an idea of some of the issues around this, when the SEC was developing the risk retention and Reg AB2 rules, the economists at the SEC did a study where they actually tried to evaluate the rates of serious delinquency in private-label securitizations as a way of considering whether the qualified mortgage standard was appropriate or whether QRM should be set equal to QM which is where the rule came out.

The study found was that the private label markets experienced default rates of about 34%. By contrast, the GSE loans defaulted about 10% of the time. It was our thinking that, if the loan standards were that lax, you could end up with failure rates on the order of about one out of every three loans in a pool. Given this experience, investors should be allowed to look at the actual data or have the opportunity to look at the actual data before investing.

Let me actually end that discussion with a question – what do you expect to be the combined effect of requiring some assets to have asset level disclosure and not others? What do you think about the CFPB's opinion on privacy and how does that extend to public markets but not private deals?

Jason Kravitt: I think that's a very interesting question. Where is the dynamics of Reg AB2 going to drive offerings? How is it going to change the marketplace? First of all the big fear that what used to be the public market is being driven into 144A will not occur in my opinion. If for no other reason than a huge part of the public market consists of frequent large issuers. There is no way that the 144A market could absorb that sort of volume; securitization is too important to large frequent issuers. One thing that the SEC is afraid of was that the new rules would drive everything into 144A market and therefore the SEC was going to have to regulate 144A offerings down the road, just as they do public offerings now. It's not going to come to pass, at least for the most part.

Now the privacy issue is a very serious one, because what the CFPB did was write an opinion that applied only to disclosure under the '33 Act on EDGAR. If as we expect to be the case that the public disclosure requirements will bleed into the 144A market, the asset specific disclosures which you think so highly of, and I understand why, can't bleed into the private market until the privacy issue is resolved because the CFPB opinion is useless, literally, with regard to the private market. But by the way, the CFPPB opinion also doesn't cover Gramm-Leach-Bliley for the public market, and so there's still a lot of work to do on how we're going to solve our privacy issues and maybe it's going to take Congress as a matter of fact to do that.

I'd like to point out that with the change in political parties controlling Congress the opportunity for that might be a little better than if that hadn't happened. Now with regard to asset level disclosure, I don't even think we're done. We cover certain assets now like autos, auto leases, CMBS, RMBS and loans, but we don't cover other important asset classes. Dodd-Frank literally requires it for asset specific disclosure for other assets where appropriate, so I expect the SEC to add asset classes as we go along.

I think the issuers that will go into the 144A market are as follows – I think foreign issuers are going to be frightened of the CEO certification. The reputation Americans have for putting you in jail for capital markets crime is really quite outsized throughout the world, so I think this Sarbanes-Oxley analogue in the CEO certification is going to scare some foreign issuers into the 144A market. And by the way it doesn't have to be the CEO of your company, it's the CEO of the depositor, so it will be the guys that are in charge of securitization, not the CEOs of the big issuers themselves.

Also many issuers are worried about the certification requirement, that there's a reasonable basis to believe that the cash flows will match required payments in the contract. So you may see a bifurcation where your senior tranches are publically registered and your subordinated tranches go into the 144A market.

Until you get the privacy issue solved I don't think you'll get asset level disclosure to go into the private market and I think that maybe is the biggest issue to come out of the new Reg AB2, with the possible exception of whether there is enough asset level disclosure to bring back private label RMBS.

Dr. Christopher Culp: Jason, you may have more informed thoughts than I do but I was giving a talk on this subject in Zurich a couple of months ago and one of the issues in Europe has been a question mark over why the once-vibrant, frankly the staggeringly rapidly growing market for securitization based on loans to small and medium business enterprises has experienced such significant contraction recently. The European Central Bank has tried to advance some sort of specific rules in this area that are designed to get AB2-like disclosures in transparency for some of the underlying European ABS, but the questions that I heard in that forum and from what I've been hearing elsewhere is the operational problems are just huge. Actually getting compliance, and this may be more of a unique problem in Europe than it is here because you have like 70 different underlying jurisdictions. But it seems like very little use is being made of what information is being reported on the underlying asset classes, and that the information itself is pretty bad from what I've heard – right?

Jason Kravitt: Let me say this about that, to quote President Kennedy. He always used to start off that way. The Europeans have had what I call an Alec Guinness moment. If you remember the Bridge Over the River Kwai, after the British prisoners of war took over building the railroad from the Japanese army, the British sent a commando unit led by Jack Hawkins and William Holden into the Burmese jungle to blow up the bridge. Alec Guinness, the British commander, was so proud of the job his troops had done that he tried to stop the sabotage from occurring. Then, all of a sudden, he comes to his senses and say, "My God, what have I done," and he falls on the lever and blows up the bridge. Okay, that's what I call an Alec Guinness moment, when you realize to your own horror that you've been utterly blind and you've caused the problems that you were supposed to be fixing.

The Europeans have really screwed up securitization through over-regulation, among other things. Their economic growth looks anemic even compared to the United States economic growth, and so they're trying to figure out how to bring securitization back now. One of the things they're doing is to try to fix all the excessive regulations that they've imposed on securitization in Europe, which is doubly ironic because they didn't create the bad assets in the Great Recession, the Americans did, and all of our markets have come back except for sub-prime private label RMBS.

I think Europeans have generally been behind Americans, and again I'm not indicating that they are backwards or we're always going to be better or we know more about technology than they do, but their businesses have always been behind on the technology of receivables financing, and that's one reason I think that securitization took longer to develop in Europe. And then you have, you’re absolutely right, I couldn’t agree with you more, you atomize the market there with over 20 members of the Common Market, every country having different laws and rules in having receivables as collateral. You perfect in different ways, you’ve acquired businesses in different countries so your computers don’t necessarily sync with each other. Just a much more difficult job to do.

Dr. Craig Lewis: Chris, maybe I could direct the next question to you. How is the implementation of mandated clearing and execution regulations in the U.S. and Europe impacted liquidity in dollar versus non-dollar swaps?

Dr. Christopher Culp: That’s a good question and the empirical evidence continues to be evolving because a lot of these mandated clearing and mandated venue execution rules got phased in in 2013 and some of them have carried into 2014, so we have good data that are coming out of the swap data repositories. It’s interesting because you ask an academic economist do you want more data, usually the answer is yes without having to stop and think too hard about it. It’s worth going back to Jim’s comment. It imposes tremendous costs to get all this reporting going on, but from an academic perspective, oh gee, we’ve now got great data coming out of swap data repositories that we can start to study.

What we’re seeing both from anecdotal evidence as well as some of the data that you look at ...by the way, the format of this data isn’t easy to analyze in this particular context, because what you get is stuff that is reported and stuff that is traded on SEFs, it doesn’t necessarily mean it had to be. Without getting too nuanced, made-available-to-trade transactions that are required to be traded on SEFs do not represent all of SEF volume. There is still about 10% on any given month of the activity that is actual optional. It’s the market deciding, “I’d like to trade here.”

Then you also have impediments to that through things like the fact that CFTC continues to push off at least as recently as today, there was another deferral, maybe yesterday, another deferral of the package trade rule.

Basically if you have a transaction that’s subject to the clearing and execution requirements bundled together with one that isn’t, which is very common with interest rate derivatives that have embedded optionality and other products, or swaps that isn’t subject to these rules combined with an interest rate swap or something like that. We still have no idea how those are going to be handled from a regulatory standpoint, and all of this is resulting in, the same as Jason said, but the Europeans have realized they followed a lot of our lead. They haven’t implemented the regulations yet but they are also noticing some of the problems, and European institutions not regulators are concerned about getting subject to one of these requirements. If you do something that’s got a question mark over it, do you have to be registered as a SEF? One of the big market participants in this area, I won’t name them – I guess it’s public information, but they have both a SEF and the European equivalent of a SEF just to be sure so that if a non-U.S. person decides they want to do a transaction then they’d end up taking the regulatory risk. If you want to play it safe you do it with a SEF because you might get classified as subject to CFTC regulations even though you’re not a U.S. entity you might be considered a

U.S. person under current rules. All of this is very arcane in some ways but it's evolving, which is why it's a good question but a hard question.

The anecdotal evidence, at least for a while, indicated that there was a big shift toward U.S. dollar denominated transactions occurring in SEF's, simply because non-U.S. institutions were afraid of transacting with U.S. institutions in a U.S. currency without being classified or registered as a SEF. The CFTC at one point was making it pretty clear that it was going to go after people abroad, and I think that one is a big stay-tuned. Honestly it could go either way. The liquidity could end up more fragmented or some of this could equalize. I am not sure, maybe you have an opinion – Jim, do you?

Dr. James Overdahl: No.

Dr. Christopher Culp: I think it's a stay-tuned.

Dr. Craig Lewis: Jim, let me throw one your way. Since we're talking about the CFTC a little bit, how will it use its anti-disruptive trading authority and how will the CFTC determine what disruptive trading actually is?

Dr. James Overdahl: The anti-disruptive trading section was part of the Dodd-Frank that amended the Commodity Exchange Act; however, the term was not defined. There were some examples given in the statute of what they wanted the CFTC to do, but I think part of the problem is that the CFTC has been considering this for up to four years now and has been unable to come up with a bright line of what constitutes disruptive trading. I think what this means is it's going to be determined by enforcement actions and you're going to see cases brought and we'll decide whether they are part of that or not. I think the difficulty for the CFTC is to distinguish between trading behavior that is maybe in line with what Congress was intending that would prohibited, such as somebody intentionally cancelling orders after they place them in order to try to influence the price versus legitimate market making where market maker is cancelling orders in order to update to new information in the order flow coming in. It's going to be a difficult task for a regulator to discern just based on the data without knowing what this activity is. But I think because it's so hard to define a bright line, you're going to see this resolved through enforcement actions and unfortunately that's not very good news for compliance departments who have to figure this out, but I think that's the state of the world.

Dr. Craig Lewis: So this is just another example of how difficult it is to draw bright lines. There is a direct analogy in my mind to the Volcker Rule and the implementation of the Volcker Rule. Howare you going to distinguish between proprietary trading activity and simple market making?

Dr. James Overdahl: I think part of the anti-disruptive trading was to try to come up with a manipulation light, something where you didn't need to go through the entire process of working up a manipulation case to deal with data that Congress felt should not be in the market. But yes, you're going to have this issue of how do you separate out nefarious activity just based on the data versus legitimate behavior, not only legitimate behavior but behavior you would want to encourage in the market because it helps make the markets work better for all end users.

Jason Kravitt: Could I make a comment on that, please? This is a comment on every question you've asked. I would distill it down to one question: are we doing things the right way? Is the type of rules that we're adopting correct? Is the process we're using correct? Is the outcome correct? Are the new rules good for the market, because certainly the intentions have all been good. I have no doubt about that. I just want to give you some statistics to make everybody think about this.

The Ten Commandments, which is the moral foundation of western society, is about 200 words. The United States Constitution, which I consider to be the greatest constitution in the history of the world and has really functioned pretty well for over 225 years, is a little over 7,000 words. The proposing release for the CFPB rule on QM, which by the way is whether a customer can afford to repay a mortgage, which I think should be a bank/core competency, is more than a quarter of a million words. There is no rule that's been proposed recently where the proposing release is under 500 pages. I just think we've gone astray in the way that we propose, adopt, and apply rules because the more complicated they become, instead of becoming more precise and therefore a way for you to conduct your activity, they just create more and more questions and nobody develops a moral sense of what they're supposed to be doing. Bankers just play to the extremely complicated rules. I literally think that we've gone astray in the way we're trying to regulate ourselves now, and it's not an excuse that the economy itself is so complicated.

Dr. Craig Lewis: I have a tendency to agree with that perspective and the way I think about it is that – so I'm new to regulation or I was new to regulation when I came to the SEC three years ago. As an economist I try to think of first order effects. What are the principal ideas you're trying to communicate, and it seems to me that if you were to regulate around first order implications, you could capture 99% of whatever market failure you're trying to correct. One of the reasons why these rules become so long and complicated is that I believe that most regulators think they only have one bite at the apple so they try to anticipate every possible contingency and bake that into the rule ahead of time. Whereas from my perspective, I think we would be much better off if we had simple rules where it was easy to then subsequently see where the market failures actually occurred in response to arbitraging a particular regulation.

Jason Kravitt: I agree with you, and I think the pernicious part of it is it gives regulators an excuse not to regulate; all they have to do is go look at the rule. But it gives the people they regulate no training as to what's good and what's bad. It's just a set of rules that they have to comply with. You are not developing bankers who develop a sense of right and wrong, which you would have with a rule of principles as opposed to 2,000 page rules.

Dr. Christopher Culp: Interestingly though, the idea of principles-based regulation can still lead you in one of two different directions. We have had a problem in derivatives regulation, as everybody here knows, since the Shad-Johnson Accord in 1986 all the way up to the Commodity Futures Modernization Act of 2000, which ironically was blamed by some as being a part of a cause of the crisis. What the CFMA of 2000 did is it moved us away from a product-based toward an institutional-based regulatory structure.

Dodd-Frank brought back product regulation in force, because all of these hundreds of pages are about what is a CDO, what is an ABS, what is a non-cleared swap, what is a swap. These are not institutionally founded, and the problem is if you're an individual or a company and you're actually a market participant, you're doing what you're doing but you're doing it in a framework of regulations that are aimed at products which are constantly changing. No matter how many pages, there is no way that you can adopt a sort of ethics and principles based approach to a product. A product is a product. It's a piece of paper with a staple in it, it's not a thing. In any case, this poses too philosophical to get into this late in the discussion. But I'm not actually arguing against product-based regulation, although I have in some of my writings. I am just saying that it is certainly one of the reasons for this. When you're going to establish a regulatory framework based on what an ABS is, you got to spend a lot of time defining an ABS, as a regulatory and legal matter.

Dr. Craig Lewis: Gentlemen, I think we are actually approaching the end of our broadcast. So Chris, Jason, and Jim, thank you for the excellent discussion today. It's been a pleasure being with all of you.

Today's broadcast will soon be available in audio/mp3 format in the virtual museum and archive at www.sechistorical.org. An edited transcript will be added later. Both the audio and transcript will be accessible under Programs, and under the dedicated The Experts Forum site under Programs in the virtual museum and archive.

On behalf of the SEC Historical Society I'd like to thank again FTI Consulting and Compass Lexecon for their generous commitment and assistance in making today's program possible.

Thank you for joining with us today, and good afternoon.