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Securitization Update
July 6, 2009

Financial Regulation Reform and Securitization

On June 17, 2009, the Obama administration released extensive proposals to change the financial services regulatory regime in the United States. The proposals, embodied in a report entitled "Financial Regulatory Reform: A New Foundation" (the "Report"), call for the most significant overhaul of the American financial regulatory landscape since the Great Depression and are intended to mitigate or forestall future financial crises.

This client update details the portions of the proposal relating to securitization. The Report can be found at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf; our summary of the overall Report can be found at http://mayerbrown.com/publications/article.asp?id=7026&nid=6; and our detailed look at the portions of the Report relating to regulation of OTC derivatives can be found at http://mayerbrown.com/publications/article.asp?id=7027&nid=6.

The securitization proposals are generally meant to change incentive structures for market participants, to increase transparency to facilitate investor due diligence, to strengthen the performance of credit rating agencies and to reduce reliance on credit ratings. Like the Report as a whole, the securitization proposals combine some legislative proposals and some proposals for new or changed regulations, many of which build on pre-existing projects. Some of the proposals are stated as high-level concepts, with details still to be worked out. We address each of the proposals in turn below.

Requiring Originators or Sponsors to Retain Credit Risk

This set of proposals addresses the perception that the originate-to-distribute model left originators and sponsors with insufficient incentives to worry about the performance of loans after they have been pooled and securitized. Similar to actions taken in Europe, the administration wants to better align the incentives of originators and sponsors with those of investors by requiring loan originators and sponsors to retain 5 percent of the credit risk of securitized exposures.

The administration seems to contemplate a mixture of regulatory and legislative actions on this issue. On the regulatory side, the Report calls for federal bank regulators to promulgate regulations that require the 5 percent retention, including a ban on hedging or otherwise transferring the minimum retention. On the legislative side, the Report states that the regulators "should have the authority"[1] to:

- Specify the permissible forms of risk retention (e.g., first loss position vs. a *pro rata* "vertical slice") and the minimum duration;
- Provide exceptions or adjustments for safety and soundness or as otherwise needed; and
- Properly align incentives by applying the requirements to securitization sponsors rather than loan originators when appropriate.

Though not explicit, the statement that regulators "should have" this authority suggests that the administration intends to support legislation that provides or confirms such authority.

Other Changes to Better Align Incentives of Other Market Participants

The Report also discusses several other measures that the administration believes would "provide appropriate incentives for participants to best serve the interests of their clients, the borrowers and investors."[2] In general, the Report calls for the compensation of brokers, originators, sponsors, underwriters and others involved in securitization to be linked to the longer-term performance of securitized assets.

In this connection, the Report cites with approval proposals, which have since been adopted by the Financial Accounting Standards Board (FASB), to eliminate gain on sale for many securitizations and to require consolidation of more securitized assets on the originator's balance sheet (our client update summarizing the accounting changes can be found at http://mayerbrown.com/publications/article.asp?id=7063&nid=6). Among other things, consolidation will cause the performance of the securitized assets to be reflected in the originator's consolidated financial statements going forward.

The Report calls for similar performance-based, medium- to long-term approaches to securitization fees in order to focus market participants on underwriting quality, such as:

- Requiring commissions received by loan brokers and loan officers to be disbursed over time and reduced if underwriting or asset quality problems emerge.
- Requiring sponsors to provide strong, standardized representations and warranties regarding the risk associated with the origination and underwriting practices.

Increasing Transparency and Standardization in the Asset-Backed Securities Markets

The Report notes ongoing efforts by the Securities and Exchange Commission (SEC) to improve and standardize disclosure practices by originators, underwriters and credit rating agencies involved in ABS and initiatives by market participants to standardize and increase transparency in the legal documents for ABS. The administration encouraged the SEC to continue its efforts and seemed to call for related legislative action to give the SEC "clear authority to require robust ongoing reporting by ABS issuers."[3]

Because the SEC already has authority to require reporting by ABS issuers (which it has exercised), the need for legislative action is not obvious, and the Report does not explain further. However, we believe that the administration wants to modify Section 15(d) of the Securities Exchange Act of 1934 to eliminate or change the provisions that currently permit ABS issuers (like traditional corporate securities issuers) to discontinue reporting if the related securities are held of record by fewer than 300 persons. The Report also specifically calls for regulations to require ABS issuers to disclose (i) loan-level data (broken down by loan broker or originator), apparently at inception and over the life of the transaction and (ii) the nature and extent of broker, originator and sponsor compensation and risk retention.

The Report also encourages market participants to complete their initiatives, stating in particular that the new standards should include clear and uniform rules relating to modification of securitized residential mortgage loans.

Finally, the Report comes out in favor of expanding the Trade Reporting and Compliance Engine (TRACE) to include ABS.

Strengthening the Regulation of Credit Rating Agencies

Just over a year ago, the SEC announced a series of rulemakings relating to credit rating agencies, in response to the market crisis. The SEC adopted several of the proposed new rules this February and proposed some others (our client alert on these actions can be found at http://mayerbrown.com/publications/article.asp?id=6121&nid=6). The Report encourages the SEC to continue these efforts, focusing on:

- Managing and disclosing conflicts of interest at the rating agencies (which has been a central part of the SEC's new rules and proposals to date);
- Differentiating ABS credit ratings from ratings of conventional unsecured debt (a pending SEC proposal that the Administration apparently supports); and
- Disclosure by the rating agencies of their rating methodologies and the meaning of their ratings, including what risks they do and do not address.

The Report does not take a position on the set of SEC proposals that are meant to facilitate unsolicited ratings and act as a counterbalance to the undue influence the SEC believes arrangers may exercise through their ability to select which agencies rate (and therefore are compensated for rating) particular securities.

Reducing Reliance on Credit Ratings in Regulations

Over the past year, the SEC has also been deliberating proposals to eliminate many of the existing references to credit ratings in its rules, on the theory that regulatory use of ratings may encourage undue reliance on the ratings by investors. The Report does not take a position on many of the details of those proposals, though it does state — in a heading — that "Regulators should reduce their use of credit ratings in regulations and supervisory practices, wherever possible."[4]

The Report seems to acknowledge that some continued use of ratings will be appropriate, as it addresses how regulators should act when making use of credit ratings: "they should recognize the potential differences in performance between structured and unstructured credit products with the same credit rating."[5]

The Report also takes some positions on the use of credit ratings in risk-based capital regulations, stating these regulations "should appropriately reflect the risk of structured credit products, including the concentrated systematic risk of senior tranches and re-securitizations and the risk of exposures held in highly leveraged off-balance sheet vehicles."[6]

The reference to systematic risk and re-securitizations seems likely to be meant as a reference to proposals that the Basel Committee on Banking Supervision made in January to revise the Basel II Capital Accord to reflect lessons learned in the credit and market crises (see our client update on Basel II at http://mayerbrown.com/publications/article.asp?id=6164&nid=6). The reference to the "risk of exposures held in highly leveraged off-balance sheet vehicles" seems to refer to implicit recourse issues (when banks and other regulated entities provide support to ABS beyond their contractual obligations), which are also addressed by the new Basel proposals.

Finally, the Report calls for regulations to minimize opportunities for regulatory arbitrage (where firms use securitization to reduce their regulatory capital requirements without a commensurate reduction in risk). The Basel proposals also address regulatory arbitrage (particularly in the context of the separate trading book capital rules), and the US bank regulators are likely to think further about the issue as they consider what, if any, adjustments to make to the regulatory capital rules in response to the recent accounting changes made by FASB, as discussed above under "Other Changes to Better Align Incentives of Other Market Participants."

Endnotes

1 Report, at p. 44.

2 *Ibid.*

3 Report, at p. 45.

4 Report, at p. 46.

5 *Ibid.*

6 *Ibid.*

If you have any questions with regard to the Report or any other matter raised in this Client Update, please contact any of the following lawyers.

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