MAYER • BROWN

What to Look for in Securitization Regulation in 2011

One result of the economic crisis has been a massive federal regulation of the US financial markets, particularly in the securitization market. But does this federal action appropriately address the dark side of securitization or does it paint with too wide a brush? We examine whether already adopted reforms are likely to accomplish their allotted tasks or instead deprive our economy of the values of securitization.

What to Look for in Securitization Regulation in 2011

By Jason Kravitt

Table of Contents

Introduction: Securitization, its Value and Risks 1
Accounting and Risk-Based Capital 2
The FDIC's Safe Harbor 3
Proposed Amendments to the SEC's Regulation AB 3
Dodd-Frank Act 4
Risk Retention 4
Orderly Liquidation Authority 5
Repurchases and Due Diligence Report Releases 5
Conflicts of Interest 6
The Volcker Rule 6
The Collins Amendment 6
Rating Agency Reform 7
The World of Mortgages 7
Conclusion 8

IRS CIRCULAR 230 NOTICE. Any advice expressed below as to tax matters was neither written nor intended by Mayer Brown LLP to be used and cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed under US tax law.

Introduction: Securitization, its Value and Risks

Niall Ferguson, in his latest book, *The Ascent of Money: A Financial History of the World*, wrote that the substantial increase in Western Civilization's standard of living since the Middle Ages has as much to do with the provision of credit within economies as with the constant improvement of scientific technology. That is, the technology of finance has been as important as the technology of science. If he is correct, then securitization is one of the financial technologies that has the most potential to improve the world's standard of living.

Securitization has five principal values. First, it is an efficient form of finance. One may sometimes use securitization to finance certain forms of activity—such as consumption or commerce—in a superior way to other forms. An obvious example of this would be a "B" rated auto manufacturer raising financing for its retail or wholesale receivables at "AAA" rates.

The second principal value is to increase liquidity. This is an important distinction from "merely" efficient finance. Sometimes, an issuer/borrower cannot raise any financing; it may find its access to the market limited or that a rating agency wishes it to demonstrate alternative sources of liquidity in case a time of financial stress ever arises. In such situations, the value of securitization is not necessarily its efficiency, but rather its availability.

The third value is balance sheet management. If an issuer can structure a securitization to be off-balance sheet (OBS), it can usually report superior financial ratios and perhaps even recycle some of its equity capital (which, of course, is its most expensive capital).

The fourth value is capital management. Often, an entity, especially a regulated financial institution, can reduce its required capital if it securitizes the assets financed, rather than borrowing money secured by such assets. Sometimes this is tied to whether a securitization is OBS, but often it is not.

Finally, the fifth value—incremental credit creation—is not merely limited to an issuer or an investor (or hanger-on, such as an underwriter, lawyer or accountant), but is society-wide. If an issuer can, by means of securitization, take the assets financed OBS, or perhaps just reduce its required capital—or both—it may likely create additional financial assets that it would not have been able to create if it were not able to have structured the financing in that fashion. That can be good for society, as using securitization to access the capital markets may allow the total amount of credit in an economy to be larger than it otherwise would have been (because of the finite amount of equity capital available to financial institutions).

But as we now know from sad experience, securitization also has a dark side. If the assets to be securitized have been poorly originated, one can use securitization to spread the risk inherent in such assets over an entire country, banking system or even the worldwide financial system. Excessive correlation and excessive leverage may particularly aid this process. Thus, reforms properly should focus on correcting this "dark side" of securitization. But have they? Will they? In this white paper, we look at the reforms that have been implemented or proposed since the beginning of the credit crisis and determine whether they are likely to accomplish their allotted

task or instead deprive our economy of one or more of the values of securitization. Since many reforms are merely in the proposal stage, we can focus on what will make sense in their ultimate form and substance based on the foregoing conceptual framework.

Accounting and Risk-Based Capital

FAS 140 and Fin 46R were rewritten in the form of FAS 166 and 167, respectively. The net effect of this reform was to make it easier to have a "sale" of financial assets, but extremely difficult to have a transfer to a special purpose entity (SPE) that would not be consolidated with the transferor's consolidated group (chiefly through eliminating the concept of a "Qualified Special Purpose Entity" and replacing the variability of loss or gain standard with a control standard).

The new Section 14 of FAS 167 essentially ensures that a transferor must surrender a meaningful amount of control over the assets transferred, as well as a meaningful amount of the profits, and that the new investor/owner of the SPE must put a meaningful amount of money at risk. While "underconsolidated" financials certainly can be misleading, so can "overconsolidated" financials. Consolidation is an unsatisfying accounting concept as it is a cliff—all or nothing. Neither consolidation nor nonconsolidation is nuanced properly. As the Financial Accounting Standards Board (FASB) seems reluctant to reform its new standard, the interesting issue in 2011 will be whether the market starts to produce practical structures that accommodate real transfers involving the sharing of control, economics and risk. If not, then the "good" of incremental credit creation will be severely reduced as, without OBS transfers, it is hard for a transferor to recycle its capital.

The difficulty of recycling capital has increased since the Federal Financial Institution Examination Council (FFIEC), in late 2009, tied risk-based capital (RBC) reduction for regulated banks to the accounting outcome of a transfer of financial assets. Notwithstanding the fact that RBC is supposed to be based on the amount of risk retained or transferred, the new rules permitted no capital reduction in a transfer that actually reduced risk unless the transaction were an accounting sale—although the accounting principles are now based on control, an entirely different concept. This is another development that will likely reduce incremental credit creation.

All, however, is not lost. Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act) essentially required federal bank regulators to rewrite their RBC regulations to forbid exclusive reliance on ratings in calculating such RBC. One of the most important items to look for in 2011 will be what new evaluation systems the federal bank regulators adopt to replace ratings. If they adopt practical and competitive systems based on market-available data and standards (that is, competitive with European and Asian standards that are based on *Basel II*), whether or not a transfer is to an OBS SPE, then the severe problems the regulators created for the industry, and especially bank sponsors of asset-backed commercial paper multi-seller conduits (ABCP Conduits), will be dramatically reduced and the effect of the roadblocks to incremental credit creation that FASB erected in FAS 167 may be materially moderated.

The FDIC's Safe Harbor

When FAS 140 was adopted, the FASB subsequently threatened to find that many transfers from banks to SPEs (such as master trusts) could not be accounting sales, as many of such transfers relied on policies of the Federal Deposit Insurance Corporation (FDIC) with regard to secured financings for bank transfers, and did not adequately isolate the investment in such trusts from the bankruptcy risks of the parent banks. In an enlightened response, in 2000, the FDIC created a safe harbor that essentially provided that so long as the transfer otherwise complied with FAS 140 (meaning it complied with terms other than bankruptcy remoteness), the transfer would be respected as bankruptcy remote. However, the amendment of FAS 167 destroyed this practical compromise, thus requiring an amendment to the safe harbor to maintain its usefulness.

Rather than a narrow, technical amendment to 12 C.F.R. 360.6 (the Safe Harbor), the FDIC made the policy judgment that it would use the Safe Harbor as a means of attempting to reform the securitization market *per se*. Accordingly, for a bank to comply, it must meet a large number of conditions that are tied to market reforms, including disclosure and risk retention. The FDIC, however, grandfathered a large class of existing transactions, including existing master trusts' future issuances (so long as the transaction continued to be off-balance sheet for FAS 140). The FDIC's reasoning was that, to avoid the bad aspects of securitization, there should be more robust disclosure, that originators or securitizers should retain part of the credit risk of the transaction in order to align their interests better with investors and that transactions in the MBS area should be simpler and more transparent.

In 2011, it will be important to see if banks find the extra burdens imposed on them workable, or if, instead, the FDIC's reforms render securitization too burdensome and expensive to be an effective form of finance. Also, a big question is what type of transaction does not need the protection of the Safe Harbor? What if the transfer is a traditional legal true sale? Most lawyers practicing in the area believe that such a structure (if constructed properly) does not need the protection of the Safe Harbor. It is unclear if ratings agencies will ultimately agree. A safer structure is to combine a legal true sale with an accounting true sale outside the bank's consolidated group (for example, in the first transfer to a parent or a sister affiliate). Will the ratings agencies accept such a structure without requiring compliance with the Safe Harbor?

Proposed Amendments to the SEC's Regulation AB

The Securities and Exchange Commission (SEC), similarly to the FDIC, seems to believe that dramatic reform is needed in order for securitization to cure its ills. Accordingly, the SEC has gone beyond proposing disclosure changes and has dipped its toe in the pond of substantive reform as well (e.g., retention). This article is not long enough to discuss all of the SEC's proposed reforms, but the most important issues will be as follows in 2011.

First, will the computer waterfall program that was proposed be adopted? This is an unpopular and potentially burdensome requirement from the issuer and underwriter point of view. Second, to what assets will loan-level data disclosure apply? The market applauds applying it to mortgages,

but certainly not to credit card receivables. How about something in between, like auto receivables? How this works out will be very important for the practicality of using securitization. For example, one would have to admit that the auto portion of the market is, and has been, its very best working part. Do we need to fix what is not broken?

Perhaps the most important unresolved issue is whether the SEC will, in fact, require public style disclosure for private offerings that rely on regulatory safe harbors (such as Rule 144A) for exemptions from the registration requirements of the Securities Act of 1933. There is perhaps no more fundamental principle in our capital markets than this distinction—that some investors are capable of looking after themselves and that very complicated and expensive disclosure rules do not need to be forced on capital offerings to such investors. If the SEC adopts a final Rule similar to what was proposed, there is no doubt that securitization as a form of finance will become considerably less attractive and practical. (A related question is what disclosure the SEC will require for ABCP Conduits, as analogous disclosure to single offerings of single pools of similar assets makes no sense for such Conduits.)

The last set of important issues will be conditions to shelf registration. The elimination of the investment grade requirement raises a difficult issue for the SEC. Retention (discussed below) will be required for all offerings, so certifications by CEOs and similar requirements are being discussed. The five-day waiting period prior to sale and pricing is also important and we need to find out if that time period will be reduced.

Dodd-Frank Act

In the case of the Dodd-Frank Act, there is a bewildering set of required rules and regulations for the industry and the regulators to sort through. The following are some of the more important rules.

RISK RETENTION

The philosophy behind risk retention is that an originator or securitizer will be less likely to originate defective financial assets if it must retain a meaningful part of the pool that it securitizes. There is little academic justification for such a proposal, but very large segments of the market believe that proposition to be true—particularly many investors. The form of retention outlined in Section 941 of the Dodd-Frank Act was generally less restrictive than that in the FDIC Safe Harbor, or as proposed by the SEC, but many questions remain. Apparently, as a result of the study released by the Board of Governors of the Federal Reserve System (FRB), there will be different percentages and forms of permitted retention for different kinds of asset classes and executions. That is a good thing, but the devil will be in the details and we need to see if what is actually proposed will be realistic.

The next important unresolved issue will be the definition of a qualified residential mortgage (QRM), as a pool of QRMs will be exempt from the retention requirement altogether. Mortgage originators will likely attempt to fit their originations within this definition when they can because

of the economic advantage pools of such mortgages will have over pools to which retention requirements apply. Accordingly, the definition will influence the type and amount of mortgage credit available in the entire United States. Similarly, the effect of retained interests on the accounting for mortgage or other kinds of transactions will materially affect the attractiveness of securitization for mortgage and other asset finance. However, the question remains whether the percentages and form of retention will allow such transactions to be structured to be OBS. This will be crucial, as we have seen, for the incremental credit creation value of securitization.

The fact that Congress was passing the Dodd-Frank Act while the new accounting rules punished a securitizer for retaining a part of the pool (and the accounting in turn determined the risk-based capital outcome) demonstrates the frustrations of our industry in a nutshell. To say that the proposed rules need coordination seems to be an understatement. There is no conceptual consistency to the proposed regulatory framework within the United States, let alone the world.

Another retention issue is whether holders of retained interests will be able to finance their interests. The FDIC Safe Harbor does not permit them to do so, but it is unclear why such financing should not be permitted so long as there is recourse to the holder of the retained interest. Finally, the conduit industry needs to find out how retention will be applied to their structures (e.g., does it apply to sponsors at all? If so, does liquidity or credit enhancement satisfy the test?), as it may either be a non-event or severely cripple their ability to structure their transactions. Finally, how will the US requirements relate to the European Union requirements under Article 122a of the Capital Requirements Directive, which are inconsistent with each other in some ways?

ORDERLY LIQUIDATION AUTHORITY

The FDIC, under the Dodd-Frank Act, also has the power to liquidate nonbank financial entities that pose systemic risk to the financial stability of the United States. The analysis of this authority is very complicated, and several troublesome issues have already arisen thereunder for securitization. The FDIC has been very constructive in attempting to resolve these issues quickly (though temporarily) and it is expected that this process will continue. However, the larger issues are yet to be worked out with finality. For example, will the FDIC respect the traditional true sale/nonsubstantive consolidation structures that have evolved under the regular bankruptcy code, and will it attempt to impose a safe harbor, similar to the one that it has adopted for banks for such systemically important companies, in order again to try to reform the entire securitization industry? The structure of the Safe Harbor, in essence, is that it treats nonaccounting sales as the equivalent of secured financings with special, streamlined remedies—not really as true sales.

REPURCHASES AND DUE DILIGENCE REPORT RELEASES

While the SEC's recently published rules offer nothing that puts securitization at risk, it is certainly possible that the "reasonable assurance" standard for required due diligence, which is a substantive one and not mere disclosure, will serve more to discourage issuance than improve transparency. Another interesting question here is the extent to which the repurchase warranty rules apply again to ABCP Conduits (though by far the better analysis is that they do not).

CONFLICTS OF INTEREST

Section 621 of the Dodd-Frank Act prohibits underwriters, placement agents, initial purchasers and sponsors from engaging in any transaction involving an asset-backed security (ABS) that would result in a "material conflict of interest" for that entity for one year after the initial closing. The legislative history of this provision makes clear that its sponsors were worried about transactions structured such that the above parties benefited from betting on their failure. Otherwise, for example, this could prohibit (i) being a warehouse lender and an underwriter, (ii) retaining a retained interest as an issuer and (iii) servicing and issuing. Therefore, if broadly interpreted, this could dramatically harm the ABS market. If the eventual rules are consistent with its intent, the provision should pose no risk of harm to the market.

THE VOLCKER RULE

This rule, Section 619 of the Dodd-Frank Act, was designed to prevent the combination of traditional commercial banking with proprietary trading. What has this to do with securitization? The problem, as so often is the case, is that the Congress, in its rush to legislate, used definitional short cuts that have unintended consequences. In this case, the shorthand definition of hedge or private equity fund was any entity that relies on either Section 3(c)(1) or (7) for an exemption from the definition of "investment company" under the Investment Company Act of 1940. The problem is that many securitization vehicles rely on such exceptions, and the Volcker Rule prohibits banks from sponsoring such vehicles. This is particularly an issue for banks that sponsor our now familiar ABCP Conduits. There is an exception for securitization of "loans"; we will have to see if the SEC chooses to broadly interpret the exception to apply to other financial assets or not.

THE COLLINS AMENDMENT

Few in the industry have yet focused on the potential implications of the so-called "Collins Amendment," Section 171 of the Dodd Frank Act. Basically, it provides that new risk-based capital requirements under Basel II (and presumably Basel III) cannot permit regulated banks to maintain less regulatory capital than would have been required under the RBC requirements in effect on July 21, 2010 (which July 21 requirements basically were Basel I rules). What does this mean? Does this render moot any Basel II rules or reforms? What is the effect of Basel III, which for "core banks" (the largest banks) raises RBC requirements far above those of (i) smaller banks and (ii) for the most part, the Basel I rules as well? How will the regulators interpret Section 939A of the Dodd-Frank Act (see "Accounting and Risk-Based Capital" earlier, which discusses the issues arising in connection with removing ratings from the RBC rules) in relation to maintaining minimum RBC tied to rules in effect on July 21, which in fact were tied to ratings? This is a bewildering set of questions without answers as of yet. What is clear is that the Collins Amendment requirements "layered" on top of Basel II and III have the potential to hurt the competitiveness of US banks materially.

RATING AGENCY REFORM

This is an extremely broad topic. While most regulators, Congress and the press know that the ratings agencies do not have a good record recently with regard to MBS, they mostly do not realize how well ratings for ABS held up during the recent credit crisis. Clearly, the agencies' methods of operation needs some reform; however, the question is whether they have been reformed to death. The myriad proposals and requirements (see Sections 932, 933, 939A, 939B, 939F, 939G and 943 of the Dodd-Frank Act, for example) are beyond the scope of this article, but there are two important questions to consider for the coming year.

First, in a related matter, as Section 17g-5 has thus far proved ineffective, will the SEC consider amending or doing away with it? Second, please recall that the so-called "Franken Amendment" was not rejected. Rather, it may come to life again if the study provided in the Dodd-Frank Act does not recommend another, superior alternative. Under the Franken Amendment, issuers would lose their ability to choose which ratings agency to use. A public utility-like Board would make the choice instead. So, will this truly unpleasant proposal be resurrected?

The World of Mortgages

Mortgages are the most "broken" part of securitization, with only one public or 144A securitization of private label mortgages taking place since the credit crisis began in earnest—and that offering was almost one year ago. What needs to be worked out is not only a new paradigm for disclosure (including loan-level disclosure), but a new, more practical set of mechanisms for enforcement and calculation of damages for breach of representations and warranties. In addition, we need to think about the role, compensation and qualifications for servicers and the role and compensation of trustees. All are profound questions with answers that are not obvious. The American Securitization Forum (ASF) has taken the lead in reforming disclosure and hopefully will also take the lead in crafting new industry mechanisms to meet the above challenges.

While recent problems arising with regard to foreclosures are not trivial, they are challenges of a traditional sort that the industry can overcome. Plain, old-fashioned skilled lawyering will solve those impediments. But creating a new capital markets model is a much more difficult task. As part of the dialogue through which the industry and its regulators must engage, particularly admirable is the attempt by Redwood Trust to get the discussion going on a constructive tack with the November 2010 publication of *Guide to Restoring Private-Sector Residential Mortgage Securitization*.

Finally, perhaps the most important set of issues facing the US securitization market is the fate of the government-sponsored entities (GSEs), Fannie Mae and Freddie Mac. Will they survive? Be broken up? Something else? Will government participation in the primary or secondary mortgage market disappear? Will, perhaps, the government's role be relegated to an insurer of catastrophic risk? It is unlikely that anyone can predict the outcome with assurance (though it seems likely that the GSEs will eventually be liquidated and the government's role reduced to providing some form of insurance after a very long transition period). It is also unlikely that either

Republicans or Democrats will compromise until they see whether the retrenchment that began with the 2010 elections will continue.

This, of course, raises the larger question of whether all or most of the regulators' proposed rules to be published over the next year will be influenced in tone and content by the recent mid-term election. An interesting bellwether might be the proposed SEC Rule to require private, "safe harbor" capital market offerings to have similar disclosure to public offerings.

Conclusion

While the accounting and RBC reforms of the past few years have been among the most important reforms adopted, there is little doubt that the ability of securitization to continue as a valuable and practical financing tool hangs in the balance. The above issues are among the most important that will determine the answer to the question of viability. Covered Bonds illustrate this concern.

Many in the industry find Covered Bonds to be a desirable alternative (or addition) to securitization. Without getting into the debate on whether they are good for the overall scheme of the economy or banks in general, it is important to note that, as there is full recourse to the credit of the sponsoring bank in the case of Covered Bonds, they are both on-balance sheet and save no RBC. In other words, they do not create any incremental credit; they are a form of secured financing. However, securitization can be a superior product as it does not involve recourse to the bank and is capable of being OBS and saving RBC, so that the securitizer can create incremental credit for the good of the economy as a whole.

There you have it. Will securitization continue in its potential role as a unique form of finance or will it end up in the United States being an expensive and burdensome form of secured finance? The decisions to be made this year will largely tell. ◆

About Mayer Brown

Mayer Brown is a leading global law firm with offices in major cities across the Americas, Asia and Europe. Our presence in the world's leading markets enables us to offer clients access to local market knowledge combined with global reach.

We are noted for our commitment to client service and our ability to assist clients with their most complex and demanding legal and business challenges worldwide. We serve many of the world's largest companies, including a significant portion of the Fortune 100, FTSE 100, DAX and Hang Seng Index companies and more than half of the world's largest investment banks. We provide legal services in areas such as Supreme Court and appellate; litigation; corporate and securities; finance; real estate; tax; intellectual property; government and global trade; restructuring, bankruptcy and insolvency; and environmental.

OFFICE LOCATIONS

AMERICAS
- Charlotte
- Chicago
- Houston
- Los Angeles
- New York
- Palo Alto
- São Paulo
- Washington DC

ASIA
- Bangkok
- Beijing
- Guangzhou
- Hanoi
- Ho Chi Minh City
- Hong Kong
- Shanghai

EUROPE
- Berlin
- Brussels
- Cologne
- Frankfurt
- London
- Paris

TAUIL & CHEQUER ADVOGADOS
in association with Mayer Brown LLP
- São Paulo
- Rio de Janeiro

ALLIANCE LAW FIRMS
- Spain, Ramón & Cajal
- Italy and Eastern Europe, Tonucci & Partners

Please visit www.mayerbrown.com for comprehensive contact information for all Mayer Brown offices.

Mayer Brown is a global legal services organization comprising legal practices that are separate entities (the Mayer Brown Practices). The Mayer Brown Practices are: Mayer Brown LLP, a limited liability partnership established in the United States; Mayer Brown International LLP, a limited liability partnership incorporated in England and Wales; Mayer Brown JSM, a Hong Kong partnership, and its associated entities in Asia; and Tauil & Chequer Advogados, a Brazilian law partnership with which Mayer Brown is associated. "Mayer Brown" and the Mayer Brown logo are the trademarks of the Mayer Brown Practices in their respective jurisdictions.

This publication provides information and comments on legal issues and developments of interest to our clients and friends. The foregoing is not a comprehensive treatment of the subject matter covered and is not intended to provide legal advice. Readers should seek legal advice before taking any action with respect to the matters discussed herein.

© 2011. The Mayer Brown Practices. All rights reserved.

Americas | Asia | Europe | www.mayerbrown.com

MAYER ♦ BROWN

700037225 0311